

More Due Diligence for Investments in Private Funds

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The SEC's Office of Compliance Inspections and Examinations (OCIE) issued a January 28, 2014 Risk Alert summarizing current practices and trends in how investment advisers conduct due diligence on private funds they recommend or cause their clients to invest in. Such funds include hedge funds, private equity, venture capital, and real estate funds, as well as "funds of" such funds. Based on OCIE's own observations and outside studies, the nine-page Risk Alert contains a wealth of information about due diligence practices and trends. Although OCIE generally does not specifically recommend procedures for advisers to follow, given their particular circumstances, many advisers will doubtless compare (and in some respects conform) their procedures to those in the Risk Alert. OCIE does, however, specifically identify the following as deficiencies:

- An adviser's failure to annually evaluate the adequacy and effectiveness of its due diligence policies and procedures for private funds, notwithstanding that investing in or recommending such investments was a key part of the adviser's business;
- Failure to assure that the adviser does not make disclosures about its due diligence practices and capabilities that are inconsistent with the facts or "with fiduciary principles," or that are materially incomplete; and
- Investment in private funds by an adviser's related persons on more favorable terms than are available to the adviser's clients, without maintaining required records about why each such investment by a related person was permitted.

Broker-dealers, too, have extensive due diligence responsibilities when they are involved with private offerings. In 2010, FINRA articulated many of those responsibilities—which are often similar to those described in OCIE's Risk Alert—in Regulatory Notice 10-22. Moreover, FINRA's published regulatory and examination priorities for 2014 single out broker-dealers' possible failures to perform these responsibilities as a prominent area of concern.

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