

## SEC Issues Risk Alert on Investment Advisers' Due Diligence Processes for Selecting Alternative Investments

Written by Tiffany Ann Ford, Jennifer M. Macarchuk

February 11, 2014

On January 28, 2014, the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission (the "SEC") issued a National Exam Program Risk Alert (the "Risk Alert") resulting from its review of advisers' due diligence processes for selecting alternative investments. The Risk Alert summarizes current industry practices and highlights deficiencies in advisers' due diligence methods.

The SEC noted several trends regarding advisers' due diligence processes in the Risk Alert, including:

- **Requesting Increased Information from Managers.** Advisers are requesting increased and broader information and data directly from alternative investment managers.
- **Using Third-Party Service Providers.** Advisers are using third-party service providers, such as administrators, custodians, and auditors to supplement analysis and validate information regarding alternative investments.
- **Increasing Due Diligence Processes.** Advisers are enhancing and expanding their due diligence processes by establishing operational due diligence groups, reviewing legal documents, focusing on liquidity issues, expanding their review of audited financial statements, and conducting onsite visits to managers.
- **Adopting Detailed Written Policies.** Advisers are more likely to have consistently applied due diligence processes if they adopted detailed written policies and procedures that required adequate documentation.

Rule 206(4)-7 under the Advisers Act of 1940 (the "Advisers Act") requires advisers to adopt, implement, and annually review written policies and procedures reasonably designed to prevent violations of the Advisers Act. The Risk Alert highlighted several areas of deficiencies or control weaknesses in advisers' due diligence practices as required by the Advisers Act, including:

- **Inadequate Annual Reviews.** Some advisers are failing to review their due diligence policies and procedures for alternative investments in their annual reviews.
- **Providing Materially Different Disclosure to Clients.** Some advisers are providing due diligence practice disclosures to clients that are materially different from their actual due diligence practices.
- **Providing Misleading Marketing Materials.** Some advisers are providing marketing materials with possibly misleading or unsubstantiated information regarding the scope and depth of their due diligence processes.
- **Conflicts of Interest and Inadequate Recordkeeping Regarding Access Person Participation in Alternative Investments.** Some advisers are recommending an alternative investment to their clients while also permitting access persons to acquire an interest in the same alternative investment, but with preferential investment terms. Such arrangements create a conflict of interest that may influence an adviser's due diligence process to the detriment of clients. In addition, some advisers are not maintaining adequate records of any decision, and the reason supporting the decision, to approve the acquisition of such investments by access persons.

Advisers to funds of funds and separate accounts that invest in alternative investments should read the entire Risk Alert and consider whether any changes need to be made to their current due diligence processes (and related compliance policies and procedures) to conform such processes to industry standards and/or address any noted compliance deficiencies.

The full text of the Risk Alert is available [here](#).

#### RELATED INDUSTRIES

- [Investment Advisers & Private Funds](#)
- [Professional Services](#)

#### RELATED PRACTICES

- [Business Counseling](#)
- 

This communication is intended for general information purposes and as a service to clients and friends of Foley Hoag LLP. This communication should not be construed as legal advice or a legal opinion on any specific facts or circumstances, and does not create an attorney-client relationship.

United States Treasury Regulations require us to disclose the following: Any tax advice included in this document was not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.

Attorney advertising. Prior results do not guarantee a similar outcome. © 2017 Foley Hoag LLP. All rights reserved.