

DUE DILIGENCE MATTERS - FEBRUARY 2022

Our flexible **Allocator On-Demand ODD**, **Investment Manager ODD Therapy**, and **Service Provider ODD** work continues, with an ongoing bias towards private equity, credit and crypto operational due diligence.

As our client base expands, we were pleased to be commissioned by a leading sports racing team to perform ODD on a sponsor.

Please click [here](#) to access a recent private equity fund governance podcast featuring James Newman.

We are delighted to be sponsoring the March 30, 2022 **CryptoCompare Digital Asset Summit** helping to bridge the gap between the digital asset and traditional finance markets.

INSIGHTS, THOUGHTS AND OBSERVATIONS

What Firms Should Know About the Deficiencies Uncovered in Private Fund Manager Examinations (notes from an ACA Global webcast February 15, 2022)

On January 27, 2022, the SEC's Division of Examinations (EXAMS) shared observations relating to common deficiencies uncovered in the examination of private fund advisers over a five year period.

The EXAMS staff observed the following failures to act consistently with material disclosures to clients or investors:

- Failure to obtain LPAC consent where explicitly required under fund governing documents
- Failure to follow practices described in fund disclosures regarding the calculation of Post-Commitment Period fund level management fees
- Failure to comply with LPA liquidation and fund extension terms
- Failure to invest in accordance with fund disclosures regarding investment strategy

- Failures relating to recycling practices
- Failure to follow fund disclosures regarding adviser personnel

Disclosures regarding performance and marketing

- EXAMS staff observed private fund advisers providing to investors or prospective investors misleading track records or other marketing statements

Inadequate Investment, Operational, and Vendor Due Diligence

- EXAMS staff observed potential failures to conduct a reasonable investigation into an investment, to follow the due diligence process described to clients or investors, and to adopt and implement reasonably designed due diligence policies and procedures pursuant to the Compliance Rule.

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Inappropriate Hedge Clause in Fund Governing Documents

- Whether a clause in an agreement, or a statement in disclosure documents provided to clients and investors, that purports to limit an adviser’s liability (a “hedge clause”) is misleading and would violate Sections 206(1) and 206(2) of the Advisers Act depends on all of the surrounding facts and circumstances.

- EXAMS staff observed private fund advisers that included potentially misleading hedge clauses in documents that purported to waive or limit the Advisers Act fiduciary duty except for certain exceptions, such as a non-appealable judicial finding of gross negligence, willful misconduct, or fraud. Such clauses could be inconsistent with Sections 206 and 215(a) of the Advisers Act.

Digital Asset Custody Risk

- We have considered the risk of self-custody of digital assets by Investment Managers (IM), i.e. where the IM custodies their own keys in a wallet, and the risk of custody by a qualified custodian, or a custody IT solution. The use of the latter two reduces the IT security risk faced by investors; the cost of such solutions incorporates enhanced and tested IT security. The IM is effectively relocating this risk to a third party, which we would expect to have a controls report, such as a SOC report or ISO certification, which the IM is unlikely to have. The risk of loss due to error or hacking is somewhat reduced.
- The use of a qualified custodian or custody IT solution does not, however, mitigate the risk of fraud by authorised

keyholders, any more than a self-custody solution. Regardless of how strong the controls in place are, the IM is responsible for setting up the protocols which allow assets to be withdrawn, such as the number and nature of the authorisers, and the whitelisted IP addresses or wallets to which assets can be transferred. Often the IMs are small and have few employees, meaning that the number of signatories is also small and the risk of collusion heightened. In our experience, this is a scenario unique to digital asset funds and is due to the nascent nature of the asset class. In a traditional hedge fund set-up, trades take place in the Fund’s name between registered executing brokers and are given up to regulated prime brokers or custodians; there is limited scope for assets to move outside the regulated environment.

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DUE DILIGENCE SERVICES

perform Due Diligence Services Limited is an award-winning provider of operational due diligence services for a diverse base of UK and international Allocators and Investment Managers.

Launched in 2019 as the only London-based and technology-led ODD service of its kind, perform is a growing team of highly experienced ODD practitioners

with a laser-like focus on client service which ensures high levels of client satisfaction, trust and partnership. In October 2021, perform announced it had been formed as a subsidiary company of JTC Group PLC, an award-winning provider of fund, corporate and private client services.