

A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act



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Part of an ongoing series

Impact On

Advisers to Private Equity Funds

May 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or “the Act”) will for the first time bring private equity fund advisers under the oversight of the Securities & Exchange Commission (SEC). For private equity firms, the impact of new regulation and oversight will be significant and will require changes to controls, staffing, record-keeping, and disclosures to fund investors, as well as establishing new compliance programs under the Investment Advisers Act of 1940 (Advisers Act).

The SEC recently indicated that private fund advisers—including advisers to private equity funds—will have until the first quarter of 2012 to register as advisers with the SEC and come into compliance with their new obligations under the Advisers Act. Advisers should use this brief additional time to ensure that they have implemented effective controls and compliance programs and are fully ready for registration. This *A Closer Look* describes the impact of Dodd-Frank on private equity advisers and looks into some of the particular issues they’ll face. It complements earlier *A Closer Look* pieces such as *Impact on Alternative Asset Managers* (August 2010) and *Reporting by Private Fund Advisers on Form PF* (March 2011).

What's changed? Registration requirements for advisers to private equity funds

Advisers to private equity funds have historically been exempt from SEC registration due to the “private adviser” exemption (Section 203(b)(3)) of the Advisers Act, which extended to advisers that (1) had 15 or fewer clients, (2) did not advise registered investment companies or business development companies, and (3) did not hold themselves out to the general public as an investment adviser. Dodd-Frank removed this exemption. As a result, many advisers to “private funds” will need to register as advisers with the SEC.

The number of clients—a particularly important consideration for alternative investment advisers—had previously been calculated by counting any advised private funds as a single client. Dodd-Frank does away with this macro-accounting to “look through” the fund, and instead counts the number of investors in the fund.

Private funds include so called “3(c)(1)” and “3(c)(7)” funds: private equity funds and other types of pooled investment vehicles that are excluded from the definition of “investment company” under the Investment Company Act of 1940 (Investment Company Act) by reason of sections 3(c)(1) or 3(c)(7) of that law. Section 3(c)(1) is available to a fund that does not publicly offer the securities it issues and has 100 or fewer beneficial owners of its outstanding securities. A fund relying on Section 3(c)(7) cannot publicly offer the securities it issues and generally must limit the owners of its outstanding securities to “qualified purchasers.” While the funds themselves do not need to register as investment companies, their advisers will need to register as investment advisers.

New exemptions

Dodd-Frank also created new exemptions, and the SEC has proposed rules outlining these exemptions. Exemptions for which some advisers to private equity funds may be eligible include the following:

Proposed venture capital funds exemption. Under the proposed rules, an adviser will qualify for this exemption if the adviser manages solely (1) venture capital funds and/or (2) funds that are grandfathered. Advisers to other types of clients would not be eligible for this exemption. The SEC’s proposal defines a “venture capital fund” as a fund that (1) invests in equity securities of private companies (at least 80 percent of which are acquired directly from the companies) for the purpose of providing operating and business expansion capital; (2) provides or offers to provide significant managerial advice to the company; (3) does not borrow or incur leverage, other than nonrenewable borrowing with a term no longer than 120 days and of no more than 15 percent of a venture capital funds’ total committed capital; (4) does not offer redemption or liquidity rights outside of extraordinary experiences; and (5) is not registered under the Investment Company Act and has not elected to be treated as a business development company. In order to maintain their exemption, venture capital funds must invest in companies that are not publicly traded, do not incur leverage relating to the private fund investment, use the new capital for operating or business expansion purposes, and are not themselves funds.

Advisers to private funds that do not meet all the conditions to qualify as “venture capital funds” may nevertheless be eligible for the exemption through the proposed rule’s “grandfathering” provision. Under the grandfathering provision, an adviser will be deemed to qualify for the venture capital fund exemption, provided that (1) the private funds it advises were marketed as venture capital funds at the time the securities were offered; (2) it has sold securities in the private funds it advises to investors prior to December 31, 2010; and (3) it does not sell further securities in the private funds it advises after July 21, 2011, (unless the private fund meets all the conditions outlined above to qualify as a venture capital fund). The SEC notes that committed capital need not have been called to qualify for grandfathering.

Proposed smaller advisers exemption. Advisers that solely advise private funds with assets under management of less than \$150 million, and other advisers with less than \$100 million in assets under management, are not (with certain exceptions) subject to registration with the SEC. For advisers in states that do not require the adviser to register and be subject to examination by the state’s securities agency, and advisers that would have to register with 15 or more states, the minimum assets under management for SEC registration will be \$25 million. While exempt from registration, these advisers may be subject to record-keeping and reporting requirements.

Proposed foreign private fund advisers exemption. Foreign private fund advisers are exempt if they do not have a place of business in the United States, have fewer than 15 clients in the United States, and have less than \$25 million in assets under management in private funds for US clients and investors.

Proposed family offices exemption. Family offices are exempt from registration consistent with the SEC’s current exemptions. The SEC will define the term in a manner consistent with existing exemptive orders.

For more information on the proposed exemptions, please see our earlier *A Closer Look: Impact on Asset Managers* (December 2010).

It will be critical for advisers to private equity funds to assess accurately whether they will be required to register with the SEC or will be eligible for an exemption from registration. Even if exempt, advisers will need to accurately assess whether they will be subject to new record-keeping and reporting obligations (described below), and they remain subject to the anti-fraud rules, and thus to the SEC’s enforcement authority. In addition, state-regulated advisers will need to be alert to state regulatory requirements, including possible new examination strategies.

New reporting obligations

In addition to registering as an adviser, advisers to private equity funds should be prepared to submit information and data regularly to the SEC. This includes information on Form ADV and on the proposed new Form PF (“private fund”), described below.

Form ADV. The SEC is proposing to use Form ADV Part 1 to collect additional information from investment advisers in order to better assess risks and discern common business activities, and thus enhance its oversight. All information on Form ADV will be public. This new information falls into three general areas:

- Information regarding each private fund that the adviser advises.
- Data relating to an adviser's business operations, types of clients, employees, and advisory activities, and any conflicts of interest posed by the adviser's business practices (i.e., use of affiliated brokers, soft dollar arrangements, and compensation for client referrals).
- Additional information about advisers' non-advisory activities, including their financial industry affiliations.

Among the new information required in the proposed Form ADV Part 1 is:

- **Item 1.** Requires additional reporting for advisers with more than \$1 billion in assets under management, to enable the SEC to address compensation arrangements for such advisers as required by Dodd-Frank Section 913(l). For more information about new incentive-based compensation requirements, see our *A Closer Look: Incentive-Based Compensation Requirements for Certain Firms* (April 2011).
- **Item 5.** Requires additional information concerning, among other things, the number of employees registered as investment advisers and insurance agents, the number and type of clients, and the number of clients that are US persons.
- **Items 6 and 7.** Requires additional reporting of related persons, including, among other things, reporting of related persons that are major swaps participants or swaps dealers under Dodd-Frank.
- **Item 7.B. and Schedule D.** Requires reporting on private funds advised by the adviser, including basic organizational and operational information, size of the fund (including gross and net assets), type of investment strategy, number and types of investors in the fund, a breakdown of assets and liabilities held by the fund (by GAAP fair value category), and the identities of the fund's "gatekeepers" (such as auditors, prime brokers, custodians, administrators, and marketers).
- **Item 8.** Requires additional reporting of, among other things, compensation received for referrals and additional reporting concerning soft dollar benefits and whether they qualify for the safe harbor under Section 28(e) of the Securities Exchange Act of 1934.

New Form PF. In January 2011, the SEC and the Commodity Futures Trading Commission proposed a new rule that would require registered investment advisers to private funds to file new reports that would help the agencies assess those advisers' systemic risk. The proposal is intended to implement Dodd-Frank Section 404. If this proposal is adopted, advisers to private funds would be required to submit detailed information on a new "Form PF," including the adviser's assets under management, the investment strategies of the private funds it advises, the funds' use of leverage, the funds' counterparty exposure, and many other matters. Large private fund advisers would file quarterly, and other advisers would file annually. Unlike Form ADV, the information would not be made public. If adopted, the rule would impose substantial reporting burdens on affected advisers, particularly those with over \$1 billion in assets under management.

For advisers to private equity funds, the information required by Form PF would include the following:

- **Information about the adviser, including:**
 - Name of adviser and all related persons whose data is included
 - Total and net assets under management
 - Assets under management broken out by types of funds advised
- **Information about each fund, including:**
 - Fund's gross and net assets
 - Aggregate notional value of derivative positions
 - Location of all creditors
 - Identification of and amount owed to creditors that is in excess of 5 percent of the fund's net asset value
 - Number of fund's beneficial owners and percentage of fund owned by the five largest owners
 - Monthly and quarterly performance information
- **For each private equity fund managed:**
 - Outstanding balance of fund's borrowings and guarantees
 - Weighted average debt-to-equity ratio of controlled portfolio companies
 - Information about portfolio company debt and any defaults
 - Identity of institutions providing bridge financing, and amount thereof
 - Identification of and more detailed information concerning financial industry portfolio companies¹
 - Whether related persons co-invest in portfolio companies
 - Breakdown of portfolio companies by industry and geography

These new filing obligations are significant, particularly for advisers to private funds (including advisers to private equity funds), who would file information that would be publicly accessible on Form ADV, plus a raft of non-public information on the new Form PF. Compiling the required information for Form PF, especially for funds that have over \$1 billion in assets under management and must file quarterly, will provide significant logistical challenges. New processes must be developed to track Form PF metrics and to collect the information to the extent it is not currently collected. Compounding the challenge will be the proposed 15-day filing window provided for those funds filing quarterly. The 60-day annual filing window may also pose potential resource issues for smaller funds. A definitive process for identifying, aggregating, and accurately reporting Form PF data will be instrumental in maintaining compliance with this new proposed rule.

¹ The proposed rule defines a “financial industry portfolio company” as a non-bank financial company (as defined by Section 102(a)(4) of Dodd-Frank), a bank holding company or financial holding company, a savings and loan holding company, a credit union, or a Farm Credit System institution.

What does SEC registration mean for private equity advisers?

Transitioning from operating as an unregistered adviser to an SEC-registered adviser will require compliance with numerous requirements of the Advisers Act. The key new compliance obligations include:

206(4)-7 “Compliance Rule.” The Compliance Rule requires registered advisers, including advisers to private equity funds, to: (1) designate a chief compliance officer who is responsible for administering the policies and procedures of the adviser; (2) adopt and implement written policies and procedures; and (3) no less than annually, conduct a review of the adequacy of those policies and procedures. The compliance program should seek to assure that the adviser and its employees are meeting its fiduciary duties to clients and are providing compliance oversight of the firm.

Code of ethics. Registered advisers are required to adopt a written code of ethics setting forth a standard for employee conduct.

Monitoring and surveillance procedures. Registered advisers should develop surveillance procedures to monitor compliance with policies, procedures, and the code of ethics, to ensure that the firm operates within the scope of applicable law and its own policies.

Books and records. Registered advisers, including private equity advisers, are required to maintain and preserve the appropriate books and records of the firm, per Rule 204-2 of the Advisers Act.

Form ADV. As part of their SEC registration, private equity advisers (like other advisers) must complete and file a Form ADV, which identifies certain aspects of the adviser’s business, including a statement of the adviser’s policies and procedures, any noted conflicts of interest, and biographies of key employees. Proposed new changes to Form ADV are described above. The Form ADV must be kept current, either annually or upon any material changes. The disclosures must also be written in plain English. Exempt reporting advisers to private equity firms that are not required to register must still file a limited Form ADV providing basic identifying information for the adviser and the identity of its owners and affiliates, information about the adviser’s private funds and other business activities that present conflicts of interest, and any disciplinary history of the adviser and employees that reflects on their integrity.

Valuation. Registered advisers are expected to have a written valuation policy incorporating ASC 820 guidelines. The policy should outline valuation methodologies, detail the processes used to perform valuation, and be tailored to a firm’s business needs and operations.

SEC registration entails significant obligations. Upon registration, advisers must comply with the Advisers Act. This includes providing disclosure to advisory clients of all material conflicts of interest and other information, complying with rules governing trading, ensuring that advertising and performance reporting complies with regulatory rules, implementing codes of ethics governing various issues including trading by firm principals, naming a chief compliance officer, and implementing an effective compliance program. In addition, once registered, advisers become subject to examination oversight by the SEC.

Prior to registration, advisers should undertake a comprehensive review of their operations to identify needed enhancements to controls and disclosures. Important steps include:

- *Identifying conflicts of interest associated with the adviser and its employees*
- *Implementing a tailored compliance program with written policies and procedures and an effective surveillance and testing program*
- *Designating a competent chief compliance officer and ensuring adequate compliance resources*
- *Reviewing existing disclosure documents and identifying needed improvements*
- *Drafting clear and accurate registration documents (Form ADV Parts 1 and 2)*
- *Ensuring that newly required records will be created and maintained consistent with books and records requirements*

Special considerations for advisers to private equity funds

While all advisers must comply with the Adviser's Act, there are unique issues that advisers to private equity funds should be aware of when implementing compliance and other controls in preparation for registration and while conducting business as a registered adviser. Some of these are outlined below.

Institutional conflicts

Private equity fund advisers that register with the SEC need to pay careful attention to the conflicts presented by the type and structure of investments those funds typically make, and ensure that conflicts are identified, mitigated, and disclosed.

Successive funds. One area of which private equity advisers should be cognizant is the use of successive funds to support older investments. Using newer funds to maintain operations of an older fund's investment until an appropriate exit opportunity arises carries the potential for conflicts of interest between the funds. Policies and procedures must be developed to provide a guide to think through, document, approve, and, importantly, disclose such conflicts.

Allocation of investments. When a private equity firm has several funds operating in a similar space, disclosure should also be made to investors as to how allocation decisions are determined. Similarly, when an adviser has two funds that both own a piece of a portfolio company, there should be adequate disclosures around the method of valuation of that portfolio company by both funds. A policy for valuation in such an instance would also be helpful. Cross-trades between two funds must also be executed according to established policies and procedures that have been disclosed previously to investors.

Expenses. Disclosures, policies, and procedures should also address the allocations of expenses between the adviser and the funds. Expenses borne by the funds should be plainly disclosed, and the adviser should ensure that no additional expenses are charged to the funds. Allocation of expenses in cases where there are co-investors with the fund, especially in the case of broken deals, should also be allocated fairly across all funds, including the co-investment vehicles. The adviser and co-investors should have a policy about how such expenses are paid by the various investors and how those expenses will be allocated amongst the co-investors.

Regardless of whether a private equity adviser must register, advisers are held to a fiduciary standard of honesty and transparency with investors. All advisers are subject to the antifraud provisions of the Advisers Act, which make it unlawful to “engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.” Advisers have a duty to disclose material facts to clients where the failure to disclose would defraud or operate as a fraud or deceit. The best rule of thumb with conflicts is to always fully and fairly disclose them to investors.

Identifying and monitoring potential sources for material nonpublic information

Insider trading. All advisers are required to have policies and procedures to prevent insider trading. A private equity adviser should work to identify all possible sources of material non-public information (MNPI) flowing into or out of the firm and then establish policies to help mitigate any related risk. Due to the complexity of the private equity business, there may be a large number of possible MNPI sources. These sources could include discussions in one or more portfolio companies regarding a major supplier, vendor, or customer; employees who sit on outside boards; senior advisors; strategic investors who, in addition to being investors in the fund, are also officers or directors of outside companies or are invested in other funds; and outside consulting/research firms. A compliance program should include regular training on identification and mitigation of risk surrounding MNPI and a legal or compliance-based resource that is available to consult on these issues.

Public and private sides. Many private equity funds have a public and private side (whether the public side is an equity fund or, more often, a debt fund). A challenge for private equity advisers in particular is the need to carefully enforce and monitor the policies and procedures used to mitigate risk of MNPI distribution within the investment adviser, such as information walls and restricted and watch lists. It is incumbent upon private equity personnel to be able to identify instances carrying a higher risk of MNPI transmission and either avoid them or obtain a reasonable level of comfort that both parties do not intend to share any MNPI. Advisers should create detailed written policies and procedures surrounding the public and private businesses, including information barriers between the two sides, identifying who sits on top of the wall, and what the wall-crossing procedures will be. In addition, compliance might want to chaperone such wall-crossing meetings, or at least maintain a record of such meetings and receive notes as to what was discussed between the public and private sides.

One successful process that firms have used to identify risky relationships and bring them to light, both for employees and compliance personnel, is the creation of a matrix of all contacts between employees of the firm and outside potential sources of MNPI. Knowledge of these connections will help the firm develop an effective monitoring program and create awareness across the firm of relationships that carry a higher risk of MNPI exposure.

Safeguarding investor assets

206(4)-2 “Custody Rule.” Registered advisers, including private equity advisers, must comply with the Custody Rule, which applies to client assets under management over which the investment adviser has custody. “Custody” is a very broad term that includes physically holding cash or securities and the ability to control assets through a related party such as a general partner of a fund. The Custody Rule creates many requirements, including having qualified custodians sending statements, annual examinations performed by an independent auditor, and internal controls reports over qualified custodians. Advisers may be exempt from some of these requirements if the client assets are in a pooled investment vehicle meeting an audit exemption.

Fees and expenses. For private equity advisers, special care should also be paid to waterfall calculations and other fee provisions that impact client assets. After the legal offering documents establish the fee methodology, a policy should be implemented to monitor the related calculations and provide notice to investors if any changes occur. As discussed above, expense allocations should be disclosed, but expenses, both routine and those incurred during investment due diligence, should also be monitored. Monitoring provides a record of compliance with state policies and legal documents, and helps ensure that investor assets are not used for expenses that are the responsibility of the adviser, co-investors, or other client accounts.

Marketing

Performance claims. Registering as an investment adviser also results in documentation and retention of records requirements related to marketing. Advisers must maintain documentation to confirm the accuracy of any past performance information given to current and prospective investors. Such documentation to support performance data must be maintained for five years after its last use. Private equity fund advisers typically use an internal rate of return (IRR) for stating fund performance results. Different than a yearly total return metric, IRR is a metric that goes back to the initial close date of the fund. Because an IRR from a previous fund is often used to market a newer fund, private equity advisers will need to ensure they have the appropriate performance backup for a longer period than is traditional with hedge funds (e.g., investment records for performance in 1990 that were used in 2011 must be kept until 2016).

FCPA. When an adviser is meeting with clients or potential clients, it is important to also be aware of the Foreign Corrupt Practices Act (FCPA). Private equity firms have likely focused on FCPA issues related to target acquisition due diligence, but they should also actively keep the FCPA in mind after acquisitions and during their own marketing activities. The FCPA prohibits improper payments and other practices (such as bribery) as well as the offer to make payments to a foreign official in order to secure any improper advantage in obtaining or retaining business for or with, or directing business to, any person. The adviser should have policies and procedures for monitoring and reviewing activities at its portfolio companies that could create FCPA risk. The Department of Justice has recently focused on alternative asset managers as it continues to broaden the number of industries that are investigated under the scope of the FCPA.

In early 2011, the SEC sent letters of inquiry to multiple banks and private equity firms requesting that they retain documents relating to financial relationships with sovereign wealth funds. Sovereign wealth funds are foreign government-owned investment funds. These formal inquiries by the SEC have put the banking and investment industry on notice that regulators are interested in the relationship between banks, investment funds, and sovereign wealth funds. Private equity advisers should ensure that they have policies and controls in place to address FCPA issues and risks.

More to come: Upcoming PwC thought leadership for advisers to private equity funds

This *A Closer Look* is the first in a series of thought leadership pieces specific to private equity advisers. Our FS Regulatory team will provide Financial Services Regulatory Briefs tailored to private equity advisers and the compliance challenges they face, including:

- Implementing a formal compliance program
- Custody Rule considerations
- Material non-public information
- FCPA
- Marketing/advertising rules
- Allocation of expenses

While Dodd-Frank will have an impact on private equity fund advisers, many implementation issues are currently unclear and the SEC will need to fully digest comments received from constituents before promulgating final rules. PwC will continue to monitor developments and provide you with updates, which will be available at www.pwc regulatory.com.

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