

FS Regulatory Brief

Compliance Program Requirements for Private Equity Fund Advisers

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or “the Act”) requires many private fund advisers, including those to private equity limited partnerships, to register as investment advisers with the Securities and Exchange Commission (“SEC”) and be subject to its oversight.

Private equity firms with more than \$150 million assets under management will be required to register with the SEC as investment advisers and be fully compliant with the Investment Advisers Act of 1940 (the “Advisers Act”) by March 30, 2012.

For private equity firms, the impact of the new regulation and oversight will be significant – becoming a regulated entity represents a significant transition, requiring changes in the design and implementation of controls, the development and implementation of a compliance program, as well as in staffing and record-keeping.

One of the more important rules under the regulatory framework for investment advisers is the “Compliance Program Rule” (Advisers Act Rule 206(4)-7), which among other things, requires an investment adviser to adopt and implement formal written compliance and supervisory policies and procedures.

This FS Regulatory Brief describes considerations for private equity firms in creating and implementing a compliance program, and some action items that private equity firms can consider to help them in adopting a compliance program tailored to the particular compliance risks they face.

It complements our earlier *Closer Look* pieces on Dodd-Frank: *Impact on Alternative Asset Managers* (August 2010) and *Advisers to Private Equity Funds* (May 2011).

Key impacts to private equity advisers

Private equity firms have historically operated in an environment largely free of regulatory oversight. Registration with the SEC and the compliance obligations under the Advisers Act may require a significant effort in terms of time and resources for many firms and in some cases may require a change in the business practices and culture of the firm.

The SEC has been working to develop an in-depth knowledge of the private equity industry. Moreover, the SEC has publicly stated that it believes there are various conflicts of interest specific to the private equity arena.¹ As such, it is not unreasonable to expect that the SEC will make private equity advisers a focus of its examination program.

¹ Speech by SEC Staff: Private Equity International’s Private Fund Compliance (May 3, 2011), available at www.sec.gov/news/speech/2011/spch050311cvd.htm. Officials at the SEC have stated that they believe the private equity arena presents unique conflicts of interest, and have often referenced the International Organization of Securities Commissions’ Final Report on Private Equity Conflicts of Interest, (November 10, 2010), available at www.iosco.org/library/pubdocs/pdf/IOSCPD341.pdf.

Accordingly, private equity advisers may need to develop, implement and fine-tune their compliance programs.

In designing an effective compliance program, private equity advisers should be aware of the risks and conflicts of interest unique to their business models and develop appropriate policies and procedures specifically designed to address such risks and conflicts. In addition, they should make new disclosures of their conflicts of interest.

The Compliance Program Rule and SEC expectations of an adviser's compliance program are outlined below. In addition, we describe some common conflicts of interest that private equity firms face, and some leading practice controls that private equity advisers can implement to mitigate their risks.

Overview of the Compliance Program Rule

All investment advisers that are registered with the SEC must comply with the Compliance Program Rule (Rule 206(4)-7 of the Advisers Act), which requires advisers to have and maintain an effective compliance program to prevent violations of the Advisers Act. Specifically, under the Rule, an investment adviser must:

- Adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act;
- Appoint a chief compliance officer; and
- Conduct a review of the compliance program, at least annually, to test the efficacy of the compliance program's procedures and controls, identify weaknesses and take corrective action if necessary.

SEC expectations of advisers' compliance programs have increased significantly in recent years. In developing, implementing and monitoring a compliance program, private equity firms are strongly encouraged to broadly consider the following:

- **Senior management involvement and oversight.** The SEC has indicated the need for senior management to be more involved in the oversight of risk management, including compliance risk.

Senior management should thoroughly understand the risks and conflicts of interest inherent in the business model so as to make proactive and informed decisions.

- **Principles-based approach.** Compliance with the Advisers Act may require a cultural change for many newly-registered private equity fund advisers. The Advisers Act is principals-based. Investment advisers have a fiduciary duty, which requires an investment adviser to place the interests of each of its clients above its own, as well as an obligation to disclose its various conflicts of interest. To that end, compliance programs should be developed to comply not only with the requirements of the rules, but also to help the adviser fulfil its fiduciary duty.
- **Tailored policies and procedures.** Formal, documented policies and procedures should be tailored to each investment adviser's unique risks and business model. There is no "one size fits all" approach. An effective compliance program is "evergreen" - continually evolving and reflective of changes in the firm's operations and regulatory expectations. Moreover, ongoing risk assessments should be conducted to identify high-risk issues, potential conflicts of interest and areas for improvement.
- **Capable chief compliance officer ("CCO").** The CCO should possess the necessary knowledge, experience, independence and authority to carry out his/her responsibilities. The CCO is expected to be a senior person within the firm with full access to and support from senior management. In addition, the compliance function should have adequate resources to address the size, complexity and scope of the organization.
- **Technology assisted surveillance.** Regulatory expectations concerning compliance oversight have increased significantly in recent years. Monitoring and exception-reporting tools to identify potential compliance violations should be implemented to provide sufficient oversight. Technology is fast becoming an integral and necessary part of a robust

compliance program. See our recent piece on *Integrating Technology into Your Compliance Program to Improve Effectiveness and Efficiency*.

- **Regular reviews.** Periodic and at least annual compliance reviews should be performed, including forensic testing to evaluate the effectiveness of the compliance policies and procedures, and to identify areas for improvement. Compliance reviews should be documented and the results communicated to senior management.
- **Implement surveillance and review.** Develop surveillance and review procedures and reports to support a strong internal control environment. Surveillance and review should cover all high-risk areas. In addition, firms should review all exceptions noted and maintain sufficient documentation relating to the steps undertaken to address the exception.

Some common conflicts of interest and leading practice controls

Common conflicts of interest faced by private equity fund advisers are described below (though this is not an all-encompassing list), along with some suggested practices to address each conflict. Each adviser should design their compliance program to address the unique risks specific to their firm's operations.

1. **Allocations of expenses and fees.** The charging and allocation of fees and expenses are areas rife with potential conflicts of interest. Any situation in which a fee or expense is allocated or charged, and the fee or expense could be charged to the adviser and/or one or more funds or clients presents a conflict. For example, there is the potential for expenses that should be borne by the adviser to be improperly allocated and paid by the fund. Similarly, there is the potential for due diligence or dead deal expenses related to an acquisition to be improperly allocated between funds, limited partners or co-investment vehicles. Finally, fee waivers and favorable treatment with regard to

expenses for co-investment vehicles create similar potential conflicts of interest that should be addressed.

Action item

Review all fund expenses to determine whether such expenses are permitted by fund agreements to be charged to the fund. Expenses involving an investment between two funds should be allocated according to a formal policy, which is consistently applied and appropriately documented. Disclosure of policies concerning the receipt of fees for dead deals and/or board service, including any credits back to the fund as well as policies concerning fees and expenses related to co-investment vehicles should be prominently disclosed in the governing documents of the fund(s) and the adviser's Form ADV.

2. **Co-investments.** The allocation of co-investment opportunities presents significant conflicts of interest, including for the adviser to favor certain investors by allocating investment opportunities to a co-investment vehicle on a deal by deal basis, in effect *cherry picking* investments, or providing certain investors with priority or preferential treatment in participating in co-investment opportunities.

Action item

The process by which investors can participate in co-investment opportunities should be disclosed in the governing documents of the fund(s) and consistently applied. Policies and procedures surrounding co-investment opportunities should be developed, and disclosure of such practices should be included in the fund(s) governing documents and the investment adviser's Form ADV.

3. **Consultants.** The use of consultants acting as placement agents during the fund-raising stage, or during the investment stage to assist in due diligence reviews of prospective portfolio companies creates a number of risks. For example, in the case of a consultant acting as placement agent, the question is how the consultant's relationship to the adviser and compensation arrangement is

disclosed to prospective investors. In the case of consultants participating in due diligence reviews of prospective portfolio companies or providing ongoing assistance to existing portfolio companies, an issue may be access to potential material non-public information.

Action item

An adviser should fully disclose compensation arrangements and any affiliations with placement agents up-front to potential investors and in the governing documents of the fund(s). In addition, as material non-public information concerning the publicly-traded suppliers and customers of prospective portfolio companies is often available during due diligence reviews, advisers are strongly encouraged to review the access to information that they provide to external consultants, and consider whether such consultants should be treated as access persons, subject to the adviser's oversight and code of ethics.

4. Access to non-public information.

As noted above with respect to consultants, private equity firms may often be privy to material non-public information concerning public companies. Such information could be obtained, for example, as a result of due diligence conducted on prospective acquisition candidates or gleaned during portfolio company board meetings.

Action item

Private equity firms should conduct an inventory to identify all situations where their employees could gain access to potential material non-public information. Firms should consider restricting employee or firm trading in publicly traded securities of companies in which the underlying portfolio companies or acquisition candidates have business relationships; as such relationships are often a source of material non-public information. In addition, be mindful of the outside board and business relationships of non-employee portfolio company board members as such relationships present certain risks.

- 5. Business relationships.** Private equity firms often have relationships with investment bankers and other unaffiliated parties that, due to their economic incentives, can give rise to various conflicts of interest.

Action item

Conduct a review and inventory of every significant business relationship to identify any potential conflicts of interest, including any *quid pro quo* arrangements. Appropriate risk mitigation procedures should be developed and implemented into the compliance program. In addition, disclosure of such practices should be provided to limited partners in the governing documents of the fund(s).

- 6. Performance advertising.** The SEC takes a strict view and requires that advisers maintain documentation to support any performance claims made. Private equity fund advisers may not maintain the requisite documentation necessary to substantiate performance advertising.

Action item

Conduct an inventory to gather the required records necessary to support performance claims, and develop procedures to maintain the required records on an ongoing basis.

- 7. Valuation methodology.** An area of focus for the SEC is disclosure and consistency of valuation methods and the use of unrealized performance. Performance from prior funds that includes unrealized positions is often used to market new funds. Inadequate controls and inconsistency around the performance measurement and valuation function is an area of possible concern for private equity advisers.

Action item

Closely review the valuation methodology of unrealized positions – especially when such positions are used in marketing materials for subsequent fund launches. Ensure that valuation methodologies are consistently applied and appropriate documentation is maintained.

8. Allocation of investment opportunities between funds.

Private equity fund advisers can find themselves in a situation in which two funds with similar strategies have available capital. This often occurs when an older fund is winding down while a newer fund is being launched. This situation can present the fund adviser with a conflict of interest when attempting to allocate an attractive investment opportunity.

Action item

Develop well-defined policies and procedures in advance for allocating investment opportunities between funds. Such policies should be disclosed in the governing documents of the fund(s) and the adviser's Form ADV.

Conclusion: Action points for private equity firms

Advisers to private equity firms should be prepared for SEC scrutiny of their compliance programs – which should be designed and implemented to meet regulatory expectations, tailored to the firm's business model and address the specific conflicts of interest inherent in the private equity industry. Operating as a registered entity will be new for many private equity firms, however, registration offers no grace period. The SEC fully expects new registrants to have well-thought out and effectively-operating compliance programs on day one of registration. Private equity firms should carefully consider the points outlined above in designing and implementing an effective compliance program.

Additional information

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