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PRIVATE EQUITY
INTERNATIONAL

THE US PRIVATE EQUITY FUND COMPLIANCE GUIDE

VOLUME III

Essential guidance on SEC compliance priorities

Edited by
Charles Lerner, Fiduciary Compliance Associates

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About the editor

Charles Lerner is a principal of Fiduciary Compliance Associates LLC, which provides full-service compliance support to investment advisers and private investment funds. During the first part of his career, Charles was an attorney and special counsel in the Division of Enforcement at the US Securities and Exchange Commission in Washington, DC, where he investigated and litigated complex and precedent setting cases for violations of the federal securities laws. He then became the director of enforcement at the Pension and Welfare Benefits Administration at the US Department of Labor (the predecessor agency to the Employee Benefits Security Administration), which has regulatory and enforcement responsibilities for the fiduciary responsibility, reporting and prohibited transactions provisions of the Employee Retirement Income Security Act of 1974. ERISA is the federal law that regulates private sector pension, health and welfare plans. He directed a nationwide enforcement program that conducted civil and criminal investigations for violations by fiduciaries (including investment advisers) and service providers to employee benefit plans. In recent years Charles has been a managing director at major banking and investment advisory institutions (Bankers Trust Company, Deutsche Bank and BlackRock Financial Management) and chief compliance officer of the advisers to private investment funds at UBS AG and Duff Capital Advisors. Charles is also a senior adviser and regulatory consultant to Milne Legal, a law firm located in Zurich and Paris, which assists non-US entities, such as investment advisers registered with the SEC or serving as custodians to any US person to comply with US laws and regulations. Charles is an attorney and graduated from Cornell University and Brooklyn Law School.

Charles was lead editor for PEI publications *The US Private Equity Fund Compliance Guide* (2010), *The US Private Equity Fund Compliance Companion* (2012) and *The US Private Real Estate Compliance Guide* (2012).

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Introduction

Sunlight is said to be the best of disinfectants.
– Justice Louis D. Brandeis

The SEC's increased focus on private equity

The world for private equity advisers in the US changed on March 20, 2012. That is the date the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) required advisers to private funds, including private equity firms, to register with the Securities and Exchange Commission (SEC). Before that date, many advisers to private funds were exempted from registration if they had fewer than 15 clients or funds. Thereafter, investment advisers with at least $150 million in assets under management had to register with the SEC and, with registration, be subject to SEC oversight.

The SEC has increased its attention to private equity firms with examinations by the Office of Compliance Inspections and Examinations (OCIE) and with some enforcement actions. But it has more directly delivered its concerns to the private equity community in speeches by senior staff officials. While criticizing private equity firms for inadequate disclosure to limited partners, the SEC has questioned the practice of accepting transaction fees from portfolio companies and the allocation of expenses between the adviser and the funds. The general partner (GP)–limited partner (LP) relationship is governed by the terms established in the limited partnership agreement; GPs view LPs as sophisticated investors who knowingly enter into arrangements providing fees to the private equity adviser.

While the Investment Advisers Act of 1940 (Advisers Act) establishes the legal and regulatory requirements for investment advisers, it generally makes no distinction of the nature of the adviser's business. The same set of regulations apply to firms that manage millions of dollars or billions of dollars; that have one or two clients (private funds) to thousands of individual clients (retail funds); that market to less sophisticated investors or very sophisticated investors; that act as advisers to separately managed individual accounts, mutual funds or private investment funds; that have five or 1,000 employees. Under the Advisers Act, the challenge for private equity advisers is then to establish a compliance program suited to its size and business. The SEC has consistently reiterated that a compliance program should be developed with the specific business of the adviser in mind and risks involved.

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The most prominent speech regarding private equity firms has been the May 2014 speech by the then head of the OCIE, Andrew J. Bowden, who reported on the results of the SEC's examinations of private equity funds.[1]

Mr. Bowden reported on the results of the SEC's presence exam program that began in October 2012 where OCIE examiners conducted short and focused examinations of the newly registered advisers. While recognizing that "the private equity model is very different," he called into question certain of the industry's ongoing practices. Analysis of his speech and subsequent SEC enforcement actions finds that the practices themselves are not necessarily the issue, but rather whether LPs were fully informed and accepted them in the limited partnership agreements and operating documents. For example, Mr. Bowden cited that limited partnership agreements may describe too generally (i) the fees and expenses that can be charged to portfolio companies; (ii) the valuation process; and (iii) the method for mitigating conflicts of interest. This lack of transparency has been the norm for private equity advisers, he said. Mr. Bowden also stated that the SEC sees that most limited partnership agreements do not provide LPs with sufficient rights to be able to adequately monitor not only their investments, but also the operations of their manager, even though many managers voluntarily provide their investors with important information and disclosures.

Mr. Bowden cited that "the deficiency rate for the two most commonly cited deficiencies [inadequate policies and procedures and inadequate disclosure] from the OCIE examinations usually run between 40 percent and 60 percent of all adviser examinations conducted, depending on the year. So for private equity firms to be cited for deficiencies involving their treatment of fees and expenses more than half the time we look at the area is significant."

Some of the common deficiencies also relate to so-called 'operating partners' who are promoted on the firm's website and otherwise, with the appearance that they are employees of and paid for by the manager, but in fact operate at the portfolio company and are paid by the portfolio company. The SEC views this as enhancing income to the manager as it reduces its costs.

Other fees which Mr. Bowden described as hidden fees are "accelerated monitoring fees where the manager has contracted to receive from a portfolio company an annual fee but as part of the agreement if the portfolio company is sold then it will pay the manager fees at closing that would have been paid for as much as ten years."

With valuation, the issue is not so much the valuation itself, but whether the manager has followed a consistent and well-described valuation process, and whether changes were made in the process such as changing the valuation methodology without adequately explaining the reason for the change.

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[1] Andrew J. Bowden, director, OCIE, *Spreading Sunshine in Private Equity*, speech given at Private Equity International's Private Fund Compliance Forum on May 6, 2014, *available at:* http://www.sec.gov/news/speech/2014--spch05062014ab.html.

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The importance of disclosure

Justice Louis D. Brandeis wrote in 1914 (*Other People's Money—and How Bankers Use It*) before he became a Supreme Court Justice in 1916: *'Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.'* The seminal message from the SEC actions in the private equity arena and, in fact, a basic premise of the federal securities laws is, full and fair disclosure. While criticizing a number of the private equity firm practices, the SEC finds fault with the practices, such as expense allocation and use of operating partners, but in the end concludes that investors were not informed of, and did not agree to, these practices.

As a result of the SEC's focus and publicity on the additional fees received by GPs, private equity advisers have greatly increased the disclosure in offering documents and operating agreements in more recent funds being raised and, where it is difficult to amend documents for existing funds, firms have taken to providing more information in the Form ADV 2 disclosure brochure and making expanded disclosure in investor communications. Full, fair and complete disclosure of many of the issues discussed in this compliance guide will go a long way to alleviate regulatory concerns. In addition, private equity firms have adjusted their methods of receiving income such as, in many instances, changing management fee offsets to 100 percent where in the past there has been no offset or only a partial offset.

Our goal for the compliance guides

This publication is the third volume in a series of compliance guides written for private equity compliance officers on how to register and maintain an effective compliance program under the Advisers Act. The first volume, *The US Private Equity Fund Compliance Guide*, published in 2010, sought to provide guidance to advisers that for the first time would be registering with the SEC as an investment adviser. The second volume, *The US Private Equity Fund Compliance Companion,* published in 2012, provided operational and regulatory guidance to advisers who had just registered.

The contents of this guide cover how regulatory and compliance requirements have changed, as well as policies that should be considered for a compliance manual. There are chapters on valuation, allocation of expenses and transaction fees (areas of highlighted concern by the SEC); enhanced due diligence by potential and current investors in the current climate; cybersecurity; SEC enforcement investigations and actions; handling an SEC examination; and the marketing in the US and the European Union with changes brought under the Alternative Investment Fund Managers Directive (AIFMD). A timely issue is the potential liability of chief compliance officers (CCOs) who have recently been under SEC scrutiny and subject of enforcement actions. We also held a roundtable discussion, where two CCOs and a partner in a national law firm came together to talk about how they have handled these issues and to provide practical solutions.

The three compliance guides primarily are directed at the CCO without a professional background or experience in adviser compliance, and who in many instances may have other responsibilities, such as chief financial officer or chief operating officer. However, the guides offer enough specificity for the experienced compliance professional. In this volume, we have again assembled a group of experts from well-recognized law firms and

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chief compliance officers who work daily and directly with the regulatory issues confronting private equity firms. These lawyers and CCOs have graciously and generously shared their experiences and strategies on how to best tackle these issues. We greatly appreciate the authors for taking the time to share their expertise with you and hope you find this enlightening and informative reading.

Charles Lerner
Fiduciary Compliance Associates

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