The US Private Equity Fund Compliance Guide

How to register and maintain an active and effective compliance program under the Investment Advisers Act of 1940

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Contents

About the editor xi

Foreword and appreciation xiii

An overview of the private equity compliance landscape xv
By Charles Lerner, Fiduciary Compliance Associates LLC

- Introduction xv
- Recent financial reform legislation xv
- A short regulatory history xvii
- Building a compliance program xviii
- The US Private Equity Fund Compliance Guide xix

SECTION I BEFORE REGISTERING 1

1 The human capital factor and cost considerations 3
By John J. Schneider, KPMG LLC and Daniel S. Bender, Navigant Consulting, Inc.

- Introduction 3
- Compliance program development 4
- Compliance roles and responsibilities 4
- Maximizing spending efficiency 6
- Compliance program benchmarking 10
- No one-size-fits-all 11
- Conclusion 11

2 Preparing to file Form ADV 13
By Joel A. Wattenbarger and Brianna J. Cox, Ropes & Gray LLP

- Introduction 13
- Creating an IARD account 13
- General overview of Form ADV 14
- Review of Form ADV and effectiveness of registration 22

3 How to write a compliance manual 25
By Joel A. Wattenbarger and Brianna J. Cox, Ropes & Gray LLP

- Introduction 25
- Developing compliance policies and procedures 25
- Review of compliance policies and procedures 27

SECTION II POLICIES 29

4 **Code of ethics** 31
By Richard D. Marshall, Ropes & Gray LLP
Introduction 31
Why a code of ethics is required 31
Origins of the code of ethics rule 32
Current codes of ethics requirements 34
Personal trading 35
Conclusion 37

5 **Insider trading** 39
By Richard D. Marshall, Ropes & Gray LLP
Introduction 39
Material nonpublic information 39
Applicability of insider trading: a breach of duty at the source 40
Possession v. use 45
The insider trading prohibition does not apply to legitimate market analysis 46
Regulation FD 47
Scienter 48
Institutional liability 48
Relevant policies and procedures 50

6 **Creating and maintaining books and records** 53
By Scott D. Pomfret, PricewaterhouseCoopers LLP
Introduction 53
Required books and records 53
Books and records that are not required 57
Form, storage and duration requirements 58
Best practices for a compliant regime 58
Electronic books and records 59
Emerging books and records issues 60
Appendix: Books-and-records matrix 62

7 **Setting up and managing a data retention policy and business continuity plan** 77
By Damian N. Walch, Deloitte & Touche LLP
Introduction 77
Definition of a business continuity plan 77
Relationship between data retention and business continuity 78
Regulations, standards and guidelines 78
Risks and threats that impact business continuity and data retention 79
The recovery and restoration process 80
Business continuity methodology 81
Conclusion 85

8 **Identifying potential conflicts of interest** 87
By Laura S. Friedrich and Steven A. Homan, Shearman & Sterling LLP
Introduction 87
Legal and regulatory requirements 87
Discussion of certain potential conflicts of interest 89
Conclusion 94
Appendix: Questionnaire for private equity fund managers and sponsors to assist with identifying conflicts of interest 95

9 **Marketing, advertising and fund solicitations** 99
By Julia D. Corelli, Pepper Hamilton LLP
Introduction 99
Private placement memoranda and Regulation D 100
Websites and electronic distribution of offering materials 103
The Advisers Act's limitations on advertising and other communications 104
Press releases and other communications 107
Chief compliance officer's role 108
Conclusion 109

10 **Political contributions** 111
By Raj Marphatia and Nicole L. Cross, Ropes & Gray LLP
Introduction 111
To whom does the rule apply? 112
What does the rule require? 113
Recordkeeping requirements 118
Effective date 118
Practical tips and traps to avoid 119

11 **Side letters** 123
By Erik A. Bergman and Justin J. Shigemi, Finn Dixon & Herling LLP
Introduction 123
Common side letter terms 123
Administrative considerations 124
Regulatory considerations and concerns 125
Practice tips in connection with the use of side letters 128
Conclusion 129

12 **Anti-money laundering** 131
By Eugene I. Goldman and Rahul Rao, McDermott Will & Emery LLP
Introduction 131
What is money laundering? 131
Laws that regulate and/or prevent money laundering 132

The Office of Foreign Asset Control 134
Guidance for private equity funds regarding AML policies and procedures 135

13 **Custody** 143
By Edwin C. Laurenson, McDermott Will & Emery LLP
Introduction 143
Definition of 'custody' 143
The audited fund exception 145
Requirements when custody is present 146
Additional compliance considerations 149

14 **ERISA** 151
By S. John Ryan, Seward & Kissel LLP
Background 151
The VCOC exception 152
Significant participation or the 25 percent test 153
Implementation 154
Pros and cons of each exception 155
Avoiding PBGC liability 157

15 **Foreign investments and the FCPA** 159
By Paul J. McNulty and Jerome Tomas, Baker & McKenzie LLP
Introduction 159
Anti-bribery provisions 159
Majority v. minority ownership – is there a difference? 160
Compliance lessons from private equity-related cases 161
Accounting provisions 162
Conclusion 163

16 **Privacy and information safeguarding** 165
By Nathan J. Greene and Jesse P. Kanach, Shearman & Sterling LLP
Introduction 165
What is information security? 165
Business considerations 165
Existing legal and regulatory framework 166
Consumer privacy legal and regulatory developments – federal level 168
Consumer privacy legal and regulatory developments – state level 171
Conclusion 172

17 **Proxy voting** 175
By Erik A. Bergman and Justin J. Shigemi, Finn Dixon & Herling LLP
Introduction 175
Fiduciary duty 175

	Conflicts of interest	177
	Disclosure	178
	Recordkeeping	179
	Proxy voting policies and procedures	180
	Third-party services	181
	Conclusion	183
18	**Selection and oversight of service providers**	185
	By Karl J. Ehrsam, Alexa V. DiGiorgio and Joseph Dietzer, Deloitte & Touche LLP	
	Introduction	185
	Selecting service providers	185
	Evaluating potential service providers	186
	Monitoring service providers	188
	Conclusion	189
	Appendix: Questions to consider when selecting service providers	191
19	**Valuation and pricing**	193
	By John N. Marshall and Thomas C. Kaylor, Deloitte Financial Advisory Services LLP	
	Introduction	193
	Regulatory requirements and accounting standards	193
	Fair valuation	195
	Conclusion	199
	Appendix: Valuation checklist	201
SECTION III	**AFTER REGISTERING AND BEYOND**	203
20	**The first year after registration**	205
	By John M. Ford and Lisa D. Zeises, Pepper Hamilton LLP	
	Introduction	205
	Establishing a culture of compliance and the right tone at the top	205
	Designating the chief compliance officer	206
	Developing an effective compliance manual	206
	Implementing a compliance program	207
	Establishing effective oversight	208
	Developing a mechanism for making required disclosures	209
	Establishing the appropriate investment advisory contract	210
	Completing the first annual review	211
	Conclusion	212
21	**Ensuring compliance within the firm**	213
	By K. Susan Grafton and Andreas J. Meyer, Gibson, Dunn & Crutcher LLP	
	Introduction	213
	Establishing a culture of compliance	213

	The annual review requirement	213
	Post-review documentation and remediation	217
	Ongoing compliance tools	217
	Conclusion	219
22	**Managing SEC inspections**	221
	By Alex Koplin and Scott D. Pomfret, PricewaterhouseCoopers LLP	
	Introduction	221
	Examination background and types	221
	Preparation for the SEC exam	222
	Selection for examination	224
	SEC on-site	225
	Meeting the SEC's expectations in likely SEC focus areas	228
	Other resources	230
23	**Managing litigation risks**	233
	By Hal S. Shaftel and Reginald D. Lucas of Cadwalader Wickersham & Taft LLP	
	Introduction	233
	Handling and preserving important information	233
	Structuring relationships with portfolio companies	236
	Defining rights and remedies governing internal fund disputes	239
	Conclusion	240
24	**European Union Directive on Alternative Investment Fund Managers: Impact on US fund managers**	243
	By Raj Marphatia and Rachel A. Evans, Ropes & Gray LLP	
	Introduction	243
	Legal and regulatory requirements	244
	Operational changes	245
	Substantive regulation	249
	AIFM domiciled in third countries	251
	AIF domiciled in third countries	253
	Effective date	253
	Next steps in the regulatory process	253
	Chapter update	254
SECTION IV	**APPENDICES**	259
Appendix 1	**Information for Newly Registered Investment Advisers**	261
	Prepared by the Staff of the Securities and Exchange Commission's Division of Investment Management and Office of Compliance Inspections and Examinations	
	Investment advisers are fiduciaries	261
	Investment advisers must have compliance programs	262

	Investment advisers are required to prepare certain reports and to file certain reports with the SEC	262
	Investment advisers must provide clients and prospective clients with a written disclosure statement	263
	Investment advisers must have a code of ethics governing their employees and enforce certain insider trading procedures	264
	Investment advisers are required to maintain certain books and records	265
	Investment advisers must seek to obtain the best price and execution for their clients' securities transactions	266
	Requirements for investment advisers' contracts with clients	267
	Investment advisers may be examined by the SEC staff	268
	Requirements for investment advisers that vote proxies of clients' securities	268
	Requirements for investment advisers that advertise their services	268
	Requirements for investment advisers that pay others to solicit new clients	270
	Requirements for investment advisers that have custody or possession of clients' funds or securities	270
	Requirements for investment advisers to disclose certain financial and disciplinary information	271
	Informational resources available from the SEC	272
	Additional information: reference materials	272
Appendix 2	'A Job Description for CCOs of Advisers to Private Investment Funds'	277
	Speech by Gene Gohlke, Associate Director Office of Compliance Inspection and Examinations, SEC	
	Introduction	277
	Background – Status as fiduciaries	278
	Compliance Rule	279
	Adviser CCO qualities and duties	279
	Summary	283
Appendix 3	Notes from the PEI Fund Compliance Forum	285
	This section provides a selection of quotes from speakers at the PEI Private Fund Compliance Forum held in New York on June 22 and 23, 2010	
	Culture of compliance and choosing a CCO	285
	Firm operations	286
	Fundraising and marketing	287
	Compliance manual and code of ethics	288
	Conflicts of interest	289
	SEC examinations and mock audits	290

SECTION V FROM THE PEI ARCHIVES 293

Regulatory reality 295
By Jenna Gottlieb

Compliance comes to town 301
By Jenna Gottlieb

Dodd-Frank to reduce pool of 'accredited investors' 303
By Nicholas Donato

Q&A: Custody rules 305
By Nicholas Donato

About PEI Media 308

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 an attorney and graduated from Cornell University and Brooklyn Law School.

An overview of the private equity compliance landscape

By Charles Lerner, Fiduciary Compliance Associates LLC

'It is easier to stay out of trouble than get out of trouble.'

'It takes twenty years to build a reputation and five minutes to lose it. If you think about that you will do things differently.'

Warren Buffett

Introduction

A private equity fund investment adviser's reputation takes years of strong fund performance to build, but even a stellar reputation – along with scores of clients – can be lost quickly when compliance breaches are brought to light by regulators. It is not enough to say, 'we hire honest people.' It is not enough to actually hire honest people. Establishing a compliance program that meets regulatory standards can enhance a firm's ability to detect and prevent violations of federal and state securities laws. Advisers have fiduciary duties to their clients and so do their investors or limited partners, including the responsibility to select manager who conduct their business in compliance with regulatory requirements. So, not only is a compliance program required; it is good business and good for business.

A well-designed compliance program demonstrates to investors that an adviser values protecting its reputation and safeguarding its clients' investments. It also sends a message to its employees that the adviser takes its regulatory compliance and fiduciary obligations seriously and that it expects its employees to act responsibly.

While this guide focuses in particular on private equity funds, the Securities Exchange Commission (SEC or the 'Commission')'s requirements for advisers are the same for managing separate accounts or hedge funds. Therefore, the basic requirements for the development of a compliance program presented in this guide are applicable to any registered investment adviser. *The US Private Equity Fund Compliance Guide* is written for the private equity business leader, who must decide how to register with the SEC and who will be called upon to answer tough questions, including: 'what do we have to do?' 'what will we have to change?' and 'how will we do it?'

Recent financial reform legislation

The enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (the 'Dodd-Frank Act') on July 21, 2010 heralds a new dawn for private equity

managers. The Act requires advisers of private funds, including private equity and hedge funds, with more than $150 million in assets under management to register with the SEC under the Investment Advisers Act of 1940 (the 'Advisers Act'), within one year after the enactment. Prior to the enactment of the Dodd-Frank Act, advisers with fewer than 15 clients (with each fund considered a client) were not required to register with the SEC. The Dodd-Frank Act removes the 15-client exemption so that advisers with one client and the minimum stated assets under management must register and fulfill the obligations of a registered investment adviser. Venture capital managers escaped this registration requirement, but the SEC is required to formulate a definition of the term 'venture capital fund adviser,' as well as the term 'family office,' another category of advisers also currently exempt from registration. The Commission will be busy in the coming years as it is required to write more rules and conduct more studies than any other agency under the Dodd-Frank Act.

Other parts of the Dodd-Frank Act that will significantly impact investment advisers are the new reporting requirements designed to gather information regarding 'systemic risk.' The Dodd-Frank Act requires the SEC to promulgate regulations requiring advisers to private funds to maintain records and provide reports to the SEC that may include:

(i) records and reports regarding private funds advised as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk;
(ii) a description of the amount of assets under management for each private fund advised and the use of leverage, including off-balance sheet leverage and counterparty credit risk exposure;
(iii) trading and investment positions;
(iv) valuation policies and practices of the fund;
(v) type of assets held;
(vi) side arrangements or side letters providing certain investors more favorable rights or entitlements;
(vii) trading practices; and
(viii) such other information as the SEC determines which may include the establishment of different reporting requirements for different classes of fund advisers, based on type or size of private fund being advised.

The SEC will share this information with other financial regulators, enabling the regulators to have current information regarding systemic risk within the nation's financial institutions.

Non-US advisers will also be required to register with the SEC. A foreign adviser will be exempted, and not required to register with the SEC, if all of the following are applicable: it (i) has no place of business in the US; (ii) has fewer than 15 clients and investors in the US in private funds it advises; (iii) has less than $25 million (or such higher amount as the SEC may deem appropriate) in assets under management attributable to US clients and investors in the US private funds it advises; and (iv) neither holds itself out to US investors as an investment adviser nor is it as an investment adviser to an investment

company registered under the Investment Company Act of 1940. Foreign advisers will find many of the US requirements different than those required in their home jurisdictions. Examples of these US requirements include reporting and review by the adviser of employees' personal securities trading, the five-year period for retention of books and records (particularly having to retain as books and records e-mails and other electronic communications), the need for a business continuity and disaster recovery plan, and the disclosure requirements to the SEC and investors.

A short regulatory history

The Advisers Act was enacted in response to and to avoid financial markets issues that arose during the Great Depression regarding the pooling of investment assets. Initially, the regulatory scheme that developed under the Advisers Act did not operate so much to regulate investment advisers, but to keep a record of who was operating as an adviser of other peoples' money and what methods advisers used. There were not then and there still are no federal qualifications, licenses or minimum amount of capital required to become an investment adviser.

In 1984, the Commission attempted to enhance its regulatory reach over private fund advisers by changing the definition of a 'client,' piercing through long-standing precedent that viewed the fund itself as the adviser's client, to instead count the 'investors' in private funds as clients of the adviser. While this change was in effect, the benefits of the 15-client exemption were lost and more advisers were required to register with the Commission, and, so, a number of them did. However, one adviser, Phillip Goldstein, sued the Commission and a federal court of appeals found in his favor, ruling that the SEC could not revise its definition of 'client' (*Goldstein v. SEC*). Once again, advisers with fewer than 15 fund clients did not have to register with the SEC.

The SEC has traditionally regulated and examined and as a result is most familiar with advisers of separately managed accounts and investment companies that actively trade securities. In recent years, as private funds have increased their impact on the financial markets, the SEC, seeking to become more knowledgeable about hedge funds, formed a special team to conduct 'sweep' inquiries to examine hedge funds' compliance, operations and trading activities. However, as we already know, there are many differences between a hedge fund and a private equity fund, the most important being typically private fund managers neither purchase nor actively trade public securities.

To further enhance the SEC's focus and expertise, in August 2009, the SEC's Director of Enforcement, Robert Khuzami, created five special enforcement teams, each to focus on different areas of enforcement interest. The Asset Management Unit will focus on investment advisers, investment companies, hedge funds and private equity funds. Specifically, this team will target disclosure, valuation, portfolio performance, due diligence and diversification, affiliate transactions, and conflicts of interest. They will also continue to work with the SEC's Office of Inspections, Compliance and Examinations (OCIE), the unit principally charged with conducting inspections of advisers.