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PRIVATE EQUITY INTERNATIONAL

# THE US PRIVATE EQUITY FUND COMPLIANCE COMPANION

Operational guidance and regulatory advice for chief compliance officers

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

Charles was lead editor for *The US Private Equity Fund Compliance Guide*, which was published by PEI in 2010. □

# Introduction

Since the publication of *The US Private Equity Fund Compliance Guide* in 2010, the Securities and Exchange Commission (SEC), as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and on its own initiative, has instituted a number of reporting changes for registered investment advisers. Dodd-Frank removed the available exemption relied on by many advisers to private funds that did not have to be registered with the SEC if they had fewer than 15 clients (funds). In addition, the SEC has revised its Form ADV Parts 1 and 2, introduced a new reporting requirement (Form PF) for advisers with over $1 billion in assets under management and adopted new whistleblower regulations. The SEC also adopted limitations on political contributions (pay-to-play regulations) and a number of states, perhaps most importantly New York and California, have adopted state lobbying regulations after corruption scandals involving placement agents came to light. In Europe, regulators are proposing enhanced regulatory and disclosure requirements for private fund advisers with the Directive on Alternative Investment Fund Managers (AIFM), and are introducing legislation from a new financial regulator, the European Securities and Market Authority. Both US and non-US regulators are being more attentive to potential improper payments to government officials.

These new regulations will apply to most US private equity fund advisers. Even advisers to private funds that do not meet the $150 million requirement for SEC registration under the Investment Advisers Act of 1940, or those who claim exemptions under the venture capital exemption rule, will have to comply with certain requirements (exempt reporting advisers). These new regulatory requirements will present a landscape which at first may seem complex and burdensome, but will become routine as advisers establish their compliance programs and become familiar with SEC requirements.

To this end, this guide, *The US Private Equity Fund Compliance Companion*, is designed to complement *The US Private Equity Fund Compliance Guide*, the first-of-its-kind guide to assist private equity fund managers in registering with the SEC and establishing a compliance program to meet SEC requirements. The *Compliance Companion* addresses all of the above new regulations, parsing the laws and offering practical legal and operational advice for private equity compliance professionals. In both guides, we have sought to provide assistance to the business leader who finds him or herself in the role as chief compliance officer or has oversight responsibility for the compliance function at an adviser to a private equity fund. Once registered, the adviser needs to prepare for the next steps after registration, such as conducting the required annual review of its compliance program and preparing for an examination by the SEC.

The *Compliance Companion* presents chapters on the annual review and SEC examinations, as well as addresses risk management, auditing, compliance for multi-strategy

firms, and for the first time ever, a dynamic roundtable discussion among a private equity head of investor relations, a private equity chief compliance officer and three legal experts on what being registered really means for a private equity firm. Among the topics discussed are reporting net as well as gross performance results, limitation on general or public solicitations of investors, fundraising in new markets, limited partner due diligence and social media policy – it's a discussion you will find candid and informative.

The SEC postponed the required registration date for new advisers to be declared effective from July 20, 2011 to March 30, 2012. Given that the SEC has a 45-day time period for review and approval, the Form ADV Part 1 must be filed by February 14, 2012. Although the SEC's review is not a substantive review for the Form ADV 1, advisers should allow enough time to make the changes and corrections that might be presented by the SEC reviewer, which may be minor. Therefore, advisers should consider filing prior to February 14 to allow some days to gather the information, effect the changes and reactivate the filing.

Once the adviser is registered, it is expected to be fully compliant with regulatory requirements, including appointing a chief compliance officer and having appropriate written policies and procedures in place that addresses regulatory concerns and establishes policies and controls for its business. The evaluation and subsequent adoption of policies and procedures should be developed with the involvement of all levels at the firm, particularly management, and be tailored to the firm's particular operations and risks.

I want to express my appreciation to Wanching Leong, the PEI editor, who ensured that we remembered our audience so that the material is both informative and readable, and to the authors who have written their chapters during a busy time of preparing their clients for registration with the SEC. The authors, all experts in their respective subject matters, have provided what I believe are useful and practical insights on the regulatory requirements for private equity advisers who are registering for the first time or already are registered with the SEC and need to maintain an effective compliance program.

**Charles Lerner**
**Fiduciary Compliance Associates**

# 1 Part 1A of Form ADV

*By Erik A. Bergman and Justin J. Shigemi, Finn Dixon & Herling LLP*

## Introduction

Form ADV is a two-part form used by investment advisers that register with either the Securities and Exchange Commission (SEC) or state securities authorities and, effective January 1, 2012, investment advisers that qualify for registration exemptions under Sections 203(l) and 203(m) of the Investment Advisers Act of 1940, as amended (Advisers Act) and Rules 203(l)-1 and 203(m)-1 promulgated thereunder (exempt reporting advisers).

Part 1 of Form ADV requires information about the investment adviser's business, ownership, clients, employees, business practices, affiliations and any disciplinary events of the adviser or its employees. It is organized in a check-the-box, fill-in-the-blank format, and is divided into two subparts. Part 1A of Form ADV must be completed by SEC-registered and state-registered investment advisers and exempt reporting advisers. The SEC reviews the information in Part 1A to process registrations, manage its regulatory and examination programs, and identify the owners and business models of, and potential risks to investors associated with, exempt reporting advisers. Part 1B of Form ADV is only completed by state-registered investment advisers and is not addressed in this chapter.[1] Part 1 is available to the public on the SEC's Investment Adviser Public Disclosure (IAPD) website at www.adviserinfo.sec.gov.

In June 2011, the SEC extensively revised Part 1A to conform its format and disclosure requirements to rules promulgated by the SEC under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Certain changes to the form were required to elicit information regarding an investment adviser's eligibility to register with the SEC and the information required to be provided by each category of investment adviser, while other changes reflect the SEC's decision to broaden the scope of information required to be disclosed, both as a general matter and with respect to private funds in particular.[2]

This chapter will provide an overview of the revisions to Part 1A and address certain issues, such as calculating assets under management, that are of particular concern to private equity fund advisers. For a discussion about how to file Form ADV electronically through the IAPD and a general overview of Form ADV (pre-amendment) and its delivery and amendment requirements, please refer to Chapter 2 (Preparing to file Form ADV) of *The US Private Equity Fund Compliance Guide* (PEI, 2010).

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[1] For Part 2 of Form ADV, please see Chapter 2, Form ADV Part 2 update, in this guide.

[2] Part 1A, as amended, is available at http://www.sec.gov/about/forms/formadv-part1a.pdf. A copy of the instructions to Part 1A and the glossary of terms is available at http://www.sec.gov/about/forms/formadv-instructions.pdf.

## New registration thresholds

As a general matter, and for purposes of completing Part 1A, Section 203A of the Advisers Act, as amended pursuant to the Dodd-Frank Act, prohibits an investment adviser that is regulated by the state securities authority in which it maintains its principal office and place of business from registering with the SEC unless the adviser has at least $100 million in assets under management. Advisers with $25 million to $100 million in assets under management (mid-sized advisers) are (generally) required to register with the relevant state securities authorities, although the SEC has adopted a registration buffer that allows certain advisers with more than $100 million, but less than $110 million in assets under management to maintain their registration with a state and permits advisers with at least $90 million in assets under management to maintain their registration with the SEC. A foreign adviser that has a place of business[3] in the US will generally be required to register with the SEC if it has $25 million or more in assets under management unless an exemption is available.

As part of the transition rules associated with the Dodd-Frank Act, a mid-sized adviser registered with the SEC as of July 21, 2011 must maintain its SEC registration until January 1, 2012 unless it qualifies and files for a 'full withdrawal' on Form ADV-W and withdraws from registration in all of the jurisdictions with which it is registered prior to such time. Between January 1, 2012 and March 30, 2012, a mid-sized adviser previously registered with the SEC or that has an application for registration pending with the SEC must file an amendment to Form ADV indicating, among other things, the amount of its regulatory assets under management. A mid-sized adviser that is no longer eligible for SEC registration must mark Item 2.A.(13) of Part 1A, withdraw from registration by filing Form ADV-W by June 28, 2012 and determine its registration status and requirements in its home state.

## Exempt reporting advisers

Effective January 1, 2012, Part 1A will be entitled the 'Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers' to reflect the requirement for exempt reporting advisers to complete and file certain items in Part 1A with the SEC. An exempt reporting adviser that is not registering with any state securities authority must only complete the following items in Part 1A: 1 (Identifying Information), 2 (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliates and Private Fund Reporting), 10 (Control Persons) and 11 (Disclosure Information), and any corresponding schedules. An exempt reporting adviser that is registering with any state securities authority must complete all of Form ADV.[4]

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[3] 'Place of business' is defined in Rule 202(a)(30)-1 by reference to Rule 222-1, which in turn defines place of business as any office where an investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities. The definition of place of business is discussed at length in the SEC's adopting rule release implementing new exemptions from the registration requirements of the Advisers Act for advisers to certain privately offered investment funds, Rel. No. IA-3222, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 million in Assets Under Management, and Foreign Private Advisers, (June 22, 2011).

[4] For more on exempt reporting advisers, please see Chapter 4, Investment adviser registration exemptions, in this guide.

# 13 Annual review

*By Scott Pomfret, Highfields Capital Management*

## Introduction

Rule 206(4)-7 under the Investment Advisers Act of 1940 (the Advisers Act) requires advisers registered or required to be registered with the Securities and Exchange Commission (SEC) to 'review, no less frequently than annually, the adequacy of policies and procedures… and the effectiveness of their implementation.' The purpose of the review is to ensure that the policies and procedures that have been adopted are 'evergreen' (that is, they keep up with the changing regulatory and business environment and changes to the adviser's business). In the words of Gene Gohlke, former associate director of examinations at the SEC's Office of Compliance Inspections and Examinations (OCIE), the goal of an annual review is 'to determine if the firm's compliance program continues to reasonably and effectively prevent compliance issues from happening, detect those compliance issues that do happen, and prompt correction of the issues that do occur.'[1] Although the SEC has not prescribed a specific timeline for newly registered advisers, advisers should generally conduct their first annual review within a year of becoming registered with the SEC.

## What form should the annual review take?

The SEC has not prescribed any particular form for the annual review. Instead, the SEC and its staff have repeatedly stated that the investment adviser should tailor its review to its particular business risks. The annual review appropriate to a hedge fund adviser is therefore likely to be different in many respects from that of a private equity adviser. To account for such differences and to ensure that resources of the persons conducting the annual review are appropriately deployed, every annual review should be preceded and governed by an inventory (a risk inventory) of the firm's particular compliance risks, as described more fully below.

Despite the need for tailoring the approach to particular risks of the adviser's business, there are some issues that the SEC will expect every annual review to consider. For example:

- What was the nature and frequency of any of the compliance matters that arose during the period covered by the review? Does this data suggest that a change in either is warranted? Examples of 'compliance matters' include violations of the code of ethics or compliance manual, sanctions applied, complaints received, and litigation, regulatory action or investigation commenced.
- How has the adviser's business changed over the year since the last annual review was conducted? Are there new business personnel, risks, products, issues, units or affiliates that require a change to its policies and procedures?

[1] Speech by Gene Gohlke, 'Examiner oversight of 'annual' reviews conducted by advisers and funds' on April 7, 2006, available at http://www.sec.gov/info/cco/ann_review_oversight.htm.

- How does the adviser go about identifying conflicts? What new conflicts has the adviser identified during the period under review? What new measures, if any, are needed to address the conflicts identified?
- What changes in the laws and regulations applicable to advisers have occurred during the period under review, or are expected to come into effect in the near future?

## Who should conduct the annual review?

Most private fund advisers carry out the required annual review under the direction of the firm's chief compliance officer. Based on a risk inventory, the chief compliance officer creates the game plan for the review and oversees the performance of particular tests, reviews, inquiries, interviews and other tools necessary to carry out the review. In a larger firm, the chief compliance officer and his or her staff may have sufficient resources to carry out the annual review without assistance from employees in the business units. However, in a firm of any size, the better practice is for the chief compliance officer to set a plan and tone with the business unit employees carrying out much of the testing under the direction of compliance staff who then review the results. This approach leverages compliance resources to allow a more comprehensive review and emphasizes that compliance is the responsibility of everyone, not just designated compliance professionals. However, compliance must always ensure that the business unit employee carrying out the review is independent (that is, business unit employees should not review their own work).

Some investment advisers hire third parties (primarily compliance consultants and law firms) to conduct annual reviews on their behalf. The third-party reviewer may not only have the advantage of experience with a wide variety of advisers and approaches, but also are often former SEC examiners. For an adviser with no or a small staff, an outside review provides a fresh look at the compliance program. Typically, based on a risk inventory, the third-party reviewer works with the chief compliance officer to establish an agreed-on scope for the annual review. The reviewer's findings are incorporated into a report to management.

From time to time, such reviews may consist of a full 'mock SEC examination,' in which the third party provides a document request and simulates the experience of a visit by SEC examiners. While this approach may be very comprehensive, it is also expensive. Therefore, other more limited or targeted reviews may be appropriate. For example, an adviser may conduct a mock review every four to five years, but have a more targeted review in each of the other years.

## When does the annual review take place?

The SEC has not prescribed any particular time for the annual review. Gohlke's speech on the goal of an annual review describes a range of timing from 'as compliance issues arose' to 'rolling routine review by functional area' to 'work concentrated toward end of annual period.'

Notwithstanding its name, the annual review can be a culmination of ongoing compliance activity throughout the year, perhaps supplemented by additional year-end

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# Compliance roundtable

In this exclusive roundtable discussion for *The US Private Equity Fund Compliance Companion*, five private equity professionals gathered at the New York office of Proskauer Rose LLP in November 2011 to discuss Securities and Exchange Commission (SEC) registration for private equity advisers and what it means for fundraising and investor relations. The participants were:

**Moderator: Charles Lerner,** principal, Fiduciary Compliance Associates LLC

**Ralph P. Money,** managing director and head of investor relations, Commonfund Capital

**Robert E. Phay, Jr.,** associate general counsel and chief compliance officer, Commonfund

**Howard J. Beber,** partner, co-head of the private investment funds group and head of the RIA Task Force, Proskauer Rose LLP

**Michael R. Suppappola,** senior associate and member of the RIA Task Force team, Proskauer Rose LLP

## Introduction

**CL:** We're doing this dialogue to be part of PEI's *Compliance Companion* to assist private equity advisers who will be registering with the SEC for the first time by March 30, 2012. The marketing and investor relations world for a registered adviser is very different than it is for an adviser that has not been registered. Newly registered advisers will now be subject to more scrutiny because information will be filed with the SEC and the firm will be subject to examinations by the SEC. I think they need a background and an understanding for what the world will be like once they're registered. So to kick it off, Ralph, can you give us some background about Commonfund?

**RM:** Commonfund is a 40-year-old global investment management organization with core strengths in the areas of private capital investing, hedge fund investing and outsourced CIO solutions for sophisticated investors. Commonfund Capital, where I spend my time, is the private capital subsidiary focused exclusively on private equity, venture capital and private natural resources investing, and we've been doing that since 1988. Most of our clients would find themselves in one of our fund of funds, and within each fund of funds there could be a pre-mix of primary fund investments in which we would work with a number of underlying managers either based here in the US or in other countries. Opportunistically, we will make secondary investments in funds that we have a high interest in and from time to time we might also complement our programs with direct or co-investments. Most of those co-investments would be alongside one of the managers we're very close with today.

## Hand-in-hand: investor relations and compliance

**CL:** Rob, can you describe your role and the involvement of compliance in marketing?

**RP:** Commonfund has a number of different subsidiaries. Ralph represents Commonfund Capital and its private equity business. The role of the compliance

department and the role of the chief compliance officer at Commonfund is to manage and supervise the compliance programs for all of those entities at Commonfund. As it applies to Commonfund Capital, that compliance function makes sure that we are living up to our obligations under the rules and statutes and that as a registered investment adviser, Commonfund Capital is doing what it's supposed to do with its business in terms of working with its managers, and also with its clients.

**CL:** Ralph, can you describe what types of marketing material you use for your investors and what's the process for preparing and reviewing those materials?

**RM:** At the heart of any offering would be a private placement memorandum. Secondarily, we would develop a set of slides that serve as a sharp executive summary of what's in the offering memorandum. A third set of marketing materials might include not just printed materials, but from time to time we'll have conference calls with groups of qualified investors where we might include one of our underlying managers to add color as to how we're executing a certain private market strategy. Each of those pieces would be reviewed in advance by members of our compliance team. From a marketing and investor relations perspective, we'll have some ideas of what clients might appreciate learning about. We have the investment side and the compliance side – we'll review and bounce ideas off of the compliance team in advance of preparing a pitchbook. So in a collaborative way we want to get our points across and we want to do it in a way that is consistent with our registration and in such a way where our compliance team is very comfortable with how we do it.

**RP:** Our view at Commonfund is that all of those marketing materials are sales literature and we review all of them before they are used to make sure they pass muster. If that slide or material is used a second time we don't need to review it again, but the first time we always do.

**CL:** Rob, what does compliance do and what do you look for when you're looking at the various documents?

**RP:** One thing that makes Commonfund a little different is we have a registered broker-dealer affiliate and so when we're looking at marketing materials we're actually looking at it through a FINRA lens of regulation. As a result when I'm looking at marketing material I tend to focus on performance reporting. That's the issue that I'm mostly concerned about – are we presenting it fairly and comprehensively, so that it answers the questions that investors may wonder about? One of the challenges at Commonfund is applying rules from FINRA and from the SEC that are focused on a retail audience, but applying it to an institutional investor marketplace and in particular fund of funds and talking to clients who are looking for a fund of funds. It's not easy sometimes for us to compare ourselves to the rest of the private equity world. Most of the private equity managers are direct managers.

**CL:** What do you see are the differences in the issues between a retail focus and a more institutional focus for investors?