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# PRIVATE EQUITY FIRMS: BEYOND SEC REGISTRATION AS AN INVESTMENT ADVISER

# HOW TO BUILD AND ADMINISTER AN EFFECTIVE COMPLIANCE PROGRAM

*Susan Mosher**



The Securities and Exchange Commission (the "SEC" or the "Commission") recently adopted new rules and rule amendments under the Investment Advisers Act of 1940 (the "Advisers Act") that serve to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

The new rules and rule amendments under the Advisers Act relate to provisions of Title IV of the Dodd-Frank Act (the Private Fund Investment Advisers Registration Act of 2010) that, among other things, require certain private fund advisers and private equity firms to register with the Commission.[2]

This article is intended to assist firms that are newly subject to federal registration requirements with information and practical advice regarding the development of a robust compliance regime tailored to firms' business operations.

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1. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-21 (2011); Rules and Regulations of the Investment Advisers Act, 17 C.F.R. § 275 (2012); Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2. Private Fund Investment Advisers Registration Act of 2010, Pub. L. No. 111-203, §§ 401-416, 124 Stat. 1376.

## I. Provisions of Importance to Registered Investment Advisers

To put federal registration in context, it is important to review the provisions that govern an investment adviser's relationship with its clients, and the regulatory implications of that relationship.

### a. *Fiduciary Duties*

The term "investment adviser" is defined under the Advisers Act as follows:

> "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[3]

The foundational principle of the Advisers Act is that investment advisers owe fiduciary duties to their clients.[4] In outlining the nature of fiduciary responsibilities, Section 206 of the Advisers Act states, in pertinent part, that it is unlawful for investment advisers to perform any of the following:

- Employ any device, scheme, or artifice to defraud a client or prospective client;
- Engage in any transaction, practice, or course of business which defrauds or deceives a client or prospective client;
- Knowingly sell any security to, or purchase any security from, a client when acting as principal for his or her own account, or knowingly effect a purchase or sale of a security for a client's account when also acting as broker for the person on the other side of the transaction, without disclosing to the client in writing before the completion of the transaction the capacity in which the Adviser is acting and obtaining the client's consent to the transaction; or
- Engage in fraudulent, deceptive or manipulative practices.[5]

Understanding and embracing the concept of fiduciary duties is the foundation of being an effective investment adviser. In 1963, the United States Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* deliberated on the scope of the fiduciary duties imposed by Section 206 of the Advisers Act.[6] Ultimately, the Court held that the Advisers Act clearly highlights an adviser's fiduciary relationship to its clients. The Court stated that the fiduciary has "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirm-

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3. 15 U.S.C. § 80b-2(a)(11).

4. *See id.* § 80b-6.

5. *Id. See also* Sec. & Exch. Comm'n, Div. of Inv. Mgmt., General Information on the Regulation of Investment Advisers (May 10, 2005), http://www.sec.gov/divisions/investment/iaregulation/memoia.htm.

6. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); 15 U.S.C. § 80b-6.

ative obligation 'to employ reasonable care to avoid misleading his clients.'"[7]

b. *Anti-Fraud Provisions*

Fiduciary duties include anti-fraud provisions, restrictions on principal trading by an investment adviser, and other fundamental provisions of significance noted below. Section 206 of the Advisers Act also prohibits misstatements or misleading omissions of material facts and other fraudulent acts and practices in connection with the conduct of an investment advisory business.[8]

As a fiduciary, an investment adviser owes its clients undivided loyalty, and may not engage in activities that conflict with a client's interest without the client's prior consent. In *S.E.C. v. Capital Gains Research Bureau, Inc.,* the United States Supreme Court held that under Section 206, advisers have an affirmative obligation of utmost good faith and full and fair disclosure of all material facts to their clients as well as a duty to avoid misleading them.[9]

Section 206 applies to all investment advisers who meet the definition of "investment adviser" under the Advisers Act (as set forth above), whether they are registered with the Commission, a state securities authority, or not registered at all. This anti-fraud provision is often the method by which the SEC brings enforcement actions against investment advisers when such conduct comes to light.

c. *Restrictions on Principal Transactions*

Section 206(3) of the Advisers Act contains another important regulatory provision, which prohibits an investment adviser, whether federally registered or not, from acting as a principal for its own account, from knowingly selling any security to a client, or from purchasing any security from a client (referred to as a "principal transaction"), without first notifying the client in writing and obtaining the client's consent before the completion of the transaction. Client notification and consent for principal transactions must be obtained separately for each transaction.[10]

Notwithstanding the above-noted restrictions on principal transactions, Rule 206(3)-2 under the Advisers Act permits an investment adviser to act as broker for both its advisory client and the party on the other side of the brokerage transaction (known as an "agency cross transaction") without

7. Capital Gains Research Bureau, Inc., 375 U.S. at 194.

8. 15 U.S.C § 80b-6.

9. Capital Gains Research Bureau, Inc., 375 U.S. at 194.

10. 15 U.S.C § 80b-6(3). *See generally* Gardner Russo & Gardner, SEC No-Action Letter, [2006 SEC File No. 801-41357] (June 7, 2006) (The Commission has indicated in a no-action letter that, absent unusual circumstances, the Commission staff will generally not view cross trades between funds advised by an investment adviser to be a principal transaction where the investment adviser and/or its controlling persons own, in the aggregate, 25% or less of the fund.)

obtaining the client's consent prior to each transaction, provided that the adviser obtains prior consent for agency cross transactions from the client, and also complies with other specified conditions set forth in Rule 206(3)-2.[11] The rule does not, however, relieve advisers of their fiduciary duties to obtain best execution and best price when executing these types of transactions.

The above-referenced provisions should figure prominently when creating and implementing an investment adviser's compliance policies and procedures, as noted below.

## II. Overview of the Compliance Rule and the Chief Compliance Officer's Role

On December 17, 2003, the Commission adopted final rules requiring each investment adviser registered with the Commission to adopt and implement written policies and procedures reasonably designed to prevent violation of federal securities laws[12] by the investment adviser or any of its supervised persons[13] (the "Compliance Rule").[14] Further, the Compliance Rule requires each such investment adviser to designate a Chief Compliance Officer ("CCO") to be responsible for administering the adviser's policies and procedures, and to review these written policies and procedures annually to determine their adequacy and the effectiveness of their implementation. In the Adopting Release, the Commission indicates that the Compliance Rule is necessary because it is important for investment advisers to have strong systems of controls in place to prevent violations of law and to protect the interests of advisory clients.[15]

### a. *Creation of Compliance Procedures*

While the Compliance Rule does not require that written policies and procedures be consolidated into a single document, creating a single "com-

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11. 17 C.F.R. § 275.206(3)-2 (2012). *See also* Lori A. Richard, Director, Office of Compliance Inspections and Examinations, Sec. and Exch. Comm'n, Fiduciary Duty: Return to First Principles, Speech by SEC Staff at the 8th Annual Investment Adviser Summit (Feb. 27. 2006), http://www.sec.gov/news/speech/spch022706lar.htm.

12. "Federal securities laws" refers to the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Investment Company Act of 1940, the Investment Advisers Act of 1940, Title V of the Gramm-Leach-Bliley Act, any rules adopted by the Commission under these statutes, the Bank Secrecy Act as it applies to funds and any rules adopted thereunder by the Commission or the Department of the Treasury.

13. 15 U.S.C. § 80b-2(a)(25). The term "supervised person" is defined as "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser." § 202(a)(25) of the Investment Advisers Act.

14. 17 C.F.R. § 275.206(4)–7) (2012).

15. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26299, 67 Fed. Reg. 74714, at 74714 (Dec. 24, 2003).

pliance manual" provides a convenient method for distributing and maintaining all relevant policies and procedures, and for facilitating compliance training for adviser personnel. As a result, it has become common practice among investment advisers to take this approach. However, if an investment adviser attempts to address each and every potentially relevant risk or regulation when drafting a compliance manual, the document will be difficult to manage and not necessarily helpful in educating investment advisory personnel about compliance matters.

A better approach is for investment advisers to create a compliance manual that is tailored to the adviser's business operations and risk profile, and understandable for employees who are not well versed in compliance. In this article, we refer to the compliance manual, including all policies and procedures that become exhibits, as the firm's "Compliance Program." While the content of each adviser's Compliance Program may vary based on the particulars of their business, all Compliance Programs should address certain specific subjects, such as: (i) standards of conduct, (ii) portfolio management, (iii) advertising and marketing, (iv) valuation, (v) books and records (including electronic communications); and (vi) business continuity. More information regarding the selection of specific content for a Compliance Program will be discussed below in this article.

A good approach for investment advisers in creating a tailored Compliance Program is to involve members of various business units within the firm in a collaborative process. Seeking input from the investment, financial, and marketing teams is recommended so that the compliance policies and procedures created within the Compliance Program accurately reflect a firm's actual business practices. This collaborative approach to developing a Compliance Program helps ensure acceptance and understanding of the final product by all advisory personnel.

#### b. *The Role of the Chief Compliance Officer*

The Compliance Rule requires that registered investment advisers designate a competent and knowledgeable CCO, and charge he/she with the responsibility of developing and administering the firm's compliance policies and procedures.[16] It is important that the CCO be knowledgeable regarding the investment adviser's business operations, so that he/she can appropriately identify and manage risks through the development of policies and procedures aimed at mitigating such risks. Furthermore, as the Commission indicates in the Adopting Release, the CCO should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures on behalf of the firm, and should have a degree of seniority and authority so that he/she can compel others to follow the firm's compliance policies and procedures.[17]

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16. 17 C.F.R. § 275.206(4)–7(c) (2012).

17. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26299, 67 Fed. Reg. 74714, at 74720 (Dec. 24, 2003).

#### c. *Annual Review Requirement*

Once the Compliance Program has been created and its policies and procedures implemented, the CCO must conduct an annual review to determine the adequacy of the compliance policies and procedures and the effectiveness of their implementation.[18] The first annual review should be completed within the first eighteen months after the compliance policies and procedures were created and approved by the management of the investment adviser.[19] When conducting the annual review, the CCO should address any compliance exceptions that arose during the previous year and document whether additional policies and procedures have been enacted to help prevent recurrence. Additionally, the CCO should focus on any changes in the firm's business operations and any new Commission initiatives that might require changes to the firm's compliance policies and procedures.

## III. What Should Be Addressed in an Adviser's Compliance Program?

The Adopting Release does not specify what elements must be included in an adviser's Compliance Program. Accordingly, all investment advisers are free to select and draft only those policies and procedures that are relevant to their business operations. One important concept to remember when investment advisers create policies and procedures is that the procedures must accurately reflect the processes investment advisers intend to follow. Avoid the tendency to craft procedures that look official and contain many recitations of the regulatory requirements related to the topic but lack enough practical substance to address how the investment adviser is to act. The procedures must allow for the investment adviser to ensure that regulatory requirements will be followed, and set out whose responsibility it is to take actions necessary for compliance. Furthermore, the danger in drafting procedures that are not tailored to one's business is that it could lead to citations for failure to follow procedures when the adviser comes under a routine regulatory examination, as discussed later in this article. All newly-registered investment advisers are recommended to seek guidance from outside experts when undertaking the initial drafting of their Compliance Program.

In creating a Compliance Program, investment advisers are urged to first identify all potential conflicts with clients and other factors that could create operational, regulatory, and reputational risks for the firm and ultimately for the firm's clients. This identification exercise is known as con-

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18. 17 C.F.R. § 275.206(4)–7(b) (2012).

19. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26299, 67 Fed. Reg. 74714, at 74723 (Dec. 24, 2003).

ducting and documenting a risk assessment.[20] Once this exercise is complete, the investment adviser can then develop procedures that address and mitigate the identified conflicts and risks. On the whole, compliance policies and procedures should be designed to assist the investment adviser in preventing federal securities law violations from occurring, detecting violations that may occur, and promptly correcting violations that have occurred. A robust Compliance Program is one where the theme of "prevent, detect and correct" is at the forefront of its process of creation.

While the Adopting Release is not specific in all respects, the Commission has stated that, *at a minimum*, an investment adviser's compliance policies and procedures should address the following topics (where relevant):

- Portfolio management processes (including allocation of investment opportunities among clients);[21]
- Trading practices, including best execution, soft dollar arrangements and trade aggregation;
- Proprietary trading of the investment adviser and personal trading activities of supervised persons;[22]
- Accuracy of disclosures made to investors, clients, and regulators, including advertisements;
- Safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- Creation of required records and their proper maintenance;[23]
- Marketing advisory services, including the use of solicitors;[24]
- Processes to value client holdings and assess fees bases on such valuations;
- Safeguards for privacy protection of client records and information;[25] and
- Business continuity plans.[26]

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20. *Id.* at 74716 (The Commission recommends that each investment adviser "should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations.").

21. *Id. See also* 17 C.F.R. § 275.206(4)–6 (2012) (relating to the requirement that investment advisers adopt and implement written policies and procedures to ensure that the adviser votes proxies in the best interest of clients).

22. *Id. See also* 15 U.S.C § 80b-4a (2011) (requiring investment advisers to have written policies and procedures to prevent the misuse of material nonpublic information by advisers or persons associated with advisers); 17 C.F.R. § 275.204A-1 (2012) (requiring investment advisers to establish, maintain and enforce a written code of ethics).

23. *Id. See also* 17 C.F.R. § 275.204-2 (2012) (requiring investment advisers that maintain records in electronic formats to establish and maintain procedures to safeguard the records).

24. *Id. See also* 17 C.F.R. § 275.206-4-3 (2012) (requiring that written procedures set forth procedures to govern solicitation activities conducted by certain third parties on behalf of an investment adviser).

25. *Id. See also* 17 C.F.R. § 248.30 (2012) (requiring investment advisers to "adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information").

26. *Id.* In FN 22, the Commission stated the following: "[w]e believe that an adviser's fiduciary obligation to its clients includes the obligation to take steps to protect the clients' interest from being placed at risk as a result of the adviser's inability to provide advisory

These topics are discussed in further detail below.

a. *Portfolio Management Processes*

These are policies and procedures designed to ensure the suitability of all client investments (*e.g.* ensuring that all client guidelines and restrictions are being followed), allocation of investment opportunities among clients in a manner that does not favor one client over another, voting of securities in the best interest of one's client, and participation in class actions to secure benefits that are owed to the adviser's clients. When drafting proxy voting policies, it is important to address how the investment adviser intends to manage any actual or apparent conflicts when voting proxies on behalf of clients. With the exception of investment allocations, many of these topics may not be particularly relevant to the business operations of a private equity firm and accordingly may not necessarily require significant focus in a firm's Compliance Program.

b. *Trading Practices*

This category includes the proper documentation of all trading activity (usually via an electronic system) that at a minimum meets regulatory requirements and is maintained in accordance with the recordkeeping requirements of the Advisers Act.[27] Additionally, investment advisers should ensure that the allocation of investment opportunities among clients is undertaken in a fair and equitable manner in keeping with the adviser's fiduciary duties. Other trading practices include policies and procedures to address cross trades among client accounts, transactions undertaken with affiliated parties, and best execution.

As a fiduciary, investment advisers have the duty to seek "best execution" of all client transactions under the circumstances of each transaction. This means that an investment adviser should execute security transactions for clients in a manner that ensures that the clients' total cost or proceeds in each transaction is most favorable under the circumstances.[28] While trading practices may not be particularly pertinent to private equity firms, they should nonetheless be addressed in at least a summary fashion in a firm's Compliance Program.

c. *Proprietary Trading and Personal Trading Activities*

Issues concerning proprietary trading and personal trading activities are relevant to all investment advisers, including private equity firms that will be federally registered.

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services after, for example, a natural disaster or, in the case of smaller firms, the death of the owner or key personnel.".

27. 17 C.F.R. § 275.204-2 (2012).

28. Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Securities Act Release No. 23170 (April 28, 1986).

### i. Code of Ethics

Investment advisers must adopt and enforce a Code of Ethics ("Code") that operates pursuant to Rule 204A-1. At a minimum, the Code must include a firm-wide standard of conduct and personal trading procedures that require periodic reporting of personal holdings and transactions by employees.[29] A firm's standard of conduct stems from its fiduciary relationship to its clients. As a result, the Code should promote and enforce the highest levels of ethical conduct, with a strong emphasis on honesty, integrity and professionalism.

The Code's standard of conduct should apply to all firm employees. The Code's personal trading procedures should apply to all "Access Persons," which include any employee who has access to nonpublic information regarding clients' purchase or sale of securities, who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic.[30] Many smaller investment firms, including private equity firms, will typically designate all firm employees as "Access Persons" because most employees will have some level of exposure to client information.

An investment adviser's Code should memorialize the firm's ethical expectations of its employees and educate them on general principles that govern all conduct. It is crucial that the Code place a strong emphasis on each employee's responsibility to adhere to the standards of conduct set forth. Employees should be encouraged to raise questions to the CCO, especially if there is any concern that the standards are not being met. Violations of the Code can be cause for corrective action, and can result in disciplinary action up to and including termination.

### ii. Conflicts of Interest

Establishing a firm's standards of business conduct involves identifying potential conflicts of interest. As a result, many firms will typically address conflicts of interest in their Code. Potential conflicts of interest can arise in the context of an investment adviser's fiduciary relationships. In the case of private equity firms, conflicts of interest can arise with respect to advising a diverse range of investors with different investment strategies, tax status, and regulatory status. Firms should always consider the objectives of their funds when making investment decisions with respect to the selection, structuring, and sale of portfolio investments. Firms should also look at whether the interests of existing funds may conflict with subsequent funds managed by the firm.

The following specific conflicts of interest may be present for private equity firms:

- To the extent that the firm or its affiliates co-invest in the investments of its funds, this may give rise to potential conflicts. In order to mitigate this con-

29. 17 C.F.R. § 275.204A-1 (2012).

30. *Id.*

flict, the firm, or a delegated committee, should approve each co-investment opportunity.

- Some firm employees may have other professional obligations in addition to serving the funds. The firm should delegate to certain "principal" firm employees the primary attention of day-to-day operational responsibility for a specific fund.
- To the extent that a firm participates in recapitalization transactions involving portfolio companies, existing investors may be treated differently than new investors. Firms are encouraged to disclose this type of conflict in their offering documents and within their firm brochure.

Although not explicitly required under the Advisers Act, it is considered industry best practice to impose restrictions on gifts and entertainment in an effort to avoid actual or potential conflicts of interest. Such restrictions may require setting a *de minimis* standard for gifts and entertainment (e.g., $250 to $500 per gift or event) to or from existing clients, prospective clients, or any entity that does or seeks to do business with the firm. Anything in excess of the *de minimis* standard would normally require pre-approval from the firm's CCO. In addition, it is also industry best practice to maintain a gifts and entertainment log which documents all gifts given or received by firm employees.

All investment adviser CCOs should be alert to their firm's potential conflicts of interest and, as noted earlier, consider conducting a risk and conflicts assessment of their firm. A sound risk assessment will map the firm's existing policies and procedures to each identified risk or conflict, and will set forth how the particular policy and procedure works to mitigate the risk or conflict in question.

### iii. Personal Trading

Personal trading procedures are designed to prevent investment adviser personnel from capitalizing on their access to information about their firm's securities trading in a manner that violates their fiduciary duties to the firm's clients. Access Persons must periodically report their personal securities transactions and holdings to the CCO or other designated persons.

Transactions with respect to securities in accounts over which an Access Person has no direct or indirect influence or control (discretionary accounts) are, however, exempt from reporting requirements. In addition to reporting, Rule 204A-1 requires pre-clearance of any investments in initial public offerings and private placements.[31] Rule 204A-1 does not include any additional specific provisions regarding the manner in which personal trading of Access Persons should be regulated. However, the Commission has provided guidance on best practices for personal trading procedures. Depending on the nature of a firm's culture (*e.g.* types of investments held in client accounts), an investment adviser may choose to adopt all, some, or none of the following as part of the firm's Code:

31. *Id.*

- Receive written pre-clearance before Access Persons can place a personal securities transaction (*e.g.* a written pre-approval procedure for purchases of equity or fixed income securities in which the CCO or other designated person will run the particular security against positions in the firm's portfolio for any discrepancies; since private equity firms do not often hold public securities, pre-clearance may not be necessary);
- Maintain a list of issuers or securities that the firm is analyzing with the potential to recommend for client transactions, and develop prohibitions or pre-clearance requirements related to personal trading in securities of those issuers;
- Maintain "restricted lists" of issuers about which the firm has inside information, and develop prohibitions on any trading in these securities (see *infra Section III.c.iv.* for discussion on Insider Trading);
- Create blackout periods, when client securities trades are being placed or recommendations are being made, including prohibiting the placement of personal securities transactions by Access Persons during the blackout period;
- Develop prohibitions or restrictions on "short-swing" trading and market timing;
- Require trading only through certain brokers, or limit the number of brokerage accounts permitted;
- Provide the firm with duplicate trade confirmations and account statements; and
- Develop procedures for assigning new securities analyses to employees whose personal holdings do not present apparent conflicts of interest.[32]

Monitoring compliance with a firm's Code can be time-consuming. To assist with this process, the automation of personal securities reporting through compliance software has become quite popular. Although not required, during regulatory examinations the Commission staff has anecdotally expressed their preference for electronic reporting, as the software has the ability to compare the holdings of an Access Person against client accounts. In addition, some software can run reports that tie personal trading to relevant market activity in the same security, a process known as "forensic testing."

### iv. Insider Trading

Insider trading refers to the buying or selling of a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Trading by "insiders" generally means trading that is effected by the officers, directors or employees of a particular issuer and involves trading in the issuer's public stock.[33] Material nonpublic information is generally regarded as information which is undisclosed to the public and would be considered relevant to an investor who is considering buying or selling that particular security.

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32. Investment Adviser Code of Ethics, Investment Advisers Act Release No. 2256, Investment Company Act Release No. 29492, 69 Fed. Reg. 41696, at 41697 (July 9, 2004).

33. U.S. SEC. & EXCH. COMM'N, http://www/sec.gov/answers/insider.htm.

Common examples of material nonpublic information in the context of a private equity firm's operations include information received in reliance upon a non-disclosure agreement, or information received regarding publicly offered securities when firm personnel serve in the capacity of officers or directors or as members of an advisory board, creditor committee, or steering committee of the public company.

Insider trading can occur in each of the following scenarios: (i) trading by an insider while in possession of material nonpublic information, (ii) trading by a non-insider while in possession of material nonpublic information, where the information was disclosed to the non-insider in violation of an insider's duty to keep it confidential, or (iii) communicating material nonpublic information to others in breach of a fiduciary duty, which is referred to as "tipping."[34] As noted earlier, Section 204A-1 of the Advisers Act requires registered investment advisers to establish, maintain, and enforce reasonably designed written policies and procedures which takes into consideration the nature of the adviser's business to prevent the misuse of material non-public information by the adviser and any of its advisory personnel.[35]

Insider trading is an important issue for the Commission as evidenced by the criminal conviction and lengthy sentence recently received by Galleon Group founder Raj Rajaratnam, a case which involved his trading in Goldman Sachs and Procter & Gamble securities while in possession of material nonpublic information.[36]

Accordingly, private equity firms should develop compliance procedures that address potential insider trading and that take into account the potential sources of investment information within the firm. The CCO should fully understand the sources of all information used to make investment decisions on the behalf of the firm's clients. Annual disclosure of all pertinent business relationships by firm personnel, including those relationships held by family members, is an effective way to monitor the potential sources of such information. Insider trading prevention procedures should provide for a mechanism that permits the CCO to pay close attention to these relationships.

A good practice that is common in the investment adviser community is to disseminate a questionnaire to all firm personnel. This questionnaire should inquire into personal and family business relationships that have the potential to put that person in contact with material nonpublic information. This topic should also be covered during the CCO's risk and conflicts assessment. A firm's insider trading prevention procedures should provide for the creation of a "restricted list" for issuers about whom the firm has, or may be deemed to have, material nonpublic information. Both the firm and its personnel should be prohibited from trading in securities

34. *Id.*

35. 17 C.F.R. § 275.204A-1 (2012).

36. U.S. v. Rajaratnam, 802 F.Supp.2d 491, 495 (S.D.N.Y. 2011).

that are placed on the restricted list until the restricted security is removed from such list.

Special insider trading-related issues for private equity firms include the use of "big boy letters," or the firm's dealings with the expert network industry. Big boy letters typically occur between sophisticated investors and acknowledge that one party to a transaction (typically the seller) has access to nonpublic information while the other does not, and yet both parties want to proceed with the sale. Additional procedures may need to be implemented in this situation, for example, requiring the CCO to review all proposed terms and conditions prior to the execution of a big boy letter. It should be noted, however, that Commission staff have indicated their personal view through presentations at industry conferences that big boy letters may not by themselves be sufficient to insulate parties from enforcement actions brought by the Commission for insider trading.

If a firm's business operations include relationships with industry expert networks, it should also consider implementing procedures regarding the interaction of advisory personnel with such networks. Industry experts or similar consultants may have access to and could inadvertently or otherwise communicate material non-public information to the firm. Additional procedures may contemplate requiring investment personnel to obtain approval from the CCO or other designated personnel prior to communicating with the industry expert or consultant along with conducting due diligence on these businesses and their personnel prior to engagement. It is of paramount importance that the CCO keep abreast of all matters relating to this area of the firm's operations.

#### d. *Accuracy of Disclosures, Marketing and the Use of Solicitors*

Care should be taken to ensure that all disclosures that are made in the firm's Form ADV Parts 1 and 2 are accurate and not misleading. The rules governing advertising by registered investment advisers are complex. Therefore, all such advisers should adopt compliance policies and procedures to ensure that the CCO is involved in the review of all firm disclosures, including any marketing materials, fund fact sheets, and any documents that contain performance information. Further, as noted above, Rule 206(4)-3 requires an adviser to create written procedures that govern the solicitation activities conducted by third-party solicitors. If a firm is contemplating using third-party solicitors, compliance or legal counsel should be consulted to ensure that the procedures put in place will be adequate.[37]

#### e. *Privacy Safeguards*

As noted earlier, Regulation S-P requires that all investment advisers, regardless of whether they are registered with the Commission, adopt policies and procedures designed to safeguard personal information that they

37. 17 C.F.R. § 275.206-4-3 (2012).

possess regarding their investors. Among the requirements is that all investors who meet the definition of a "customer" under the regulation must be provided with a "Privacy Notice" at the commencement of the relationship and annually thereafter. There are also specific requirements that pertain to the content of the Privacy Notice and the method of delivery.[38]

With regard to safeguarding client assets from unlawful conversion or inappropriate use, the custody rule sets forth significant reporting and regulatory requirements that are applicable to investment advisers who have (or are deemed to have) custody of client funds or securities. Under the custody rule, an investment adviser has custody of client funds or securities when it holds "directly or indirectly, client funds or securities or any authority to obtain possession of them." The custody rule also sets forth guidance in the form of examples where investment advisers would be deemed to have custody of client assets, such as if arrangements exist whereby the adviser is authorized or permitted to pay advisory fees or expenses directly from a client's account, or any capacity that gives the adviser or one of its personnel legal ownership or access to client funds or securities, such as when the adviser is the general partner of a limited partnership, trustee of a trust, or the managing member of a limited liability company.[39] Given the complexity of the determination of whether an investment adviser has custody of client funds or securities (or whether the adviser can avail itself of certain exemptions afforded by the custody rule), legal counsel or compliance assistance should be sought prior to adopting policies and procedures relating to the custody rule.

#### f. *Valuation of Client Holdings*

As a fiduciary, an investment adviser has an obligation to accurately value all securities held in client accounts. This process is critical for determining the net asset value of each account or fund managed by the adviser when calculating advisory fees, and when new investors are admitted or existing investors make withdrawals from their accounts, as the case may be.[40] In determining the value of such securities, investment advisers generally use market quotations when they are available.

However, for assets for which a market quotation is not available, the adviser must determine a security's "fair value." In most cases, an adviser's private fund offering documents specify methods or guidelines for valuing investments. It is very important that the disclosures found in these documents be consistent with the valuation policies and procedures that are adopted as part of the adviser's compliance manual. This is an area of particular concern to the Commission and should receive an appropriate amount of attention when compliance policies and procedures are developed.

38. 17 C.F.R. § 248.30 (2012).

39. 17 C.F.R. § 275.206(4)-2 (2012).

40. 15 U.S.C. § 80b-5 (2011); *See also* 17 C.F.R. § 275.205-1 (2012).

#### g. *Books and Records*

Rule 204-2 under the Advisers Act (the "*Recordkeeping Rule*") requires firms to create and maintain certain books and records for specified periods of time.[41] It is good practice to develop policies and procedures that encompass the following: (i) identify all required books and records by reviewing the examples set forth in the Recordkeeping Rule, and (ii) provide for the location of the record. Additionally, the CCO should be given responsibility for ensuring that the firm complies with all applicable provisions of the Recordkeeping Rule. Records are permitted to be maintained in electronic format.[42] Further, all personnel should be trained and instructed that they must always consult the CCO before destroying any of the firm's records.

#### h. *Business Continuity and Disaster Recovery*

In footnote 22 of the Adopting Release, the Commission noted that a registered investment adviser has a fiduciary duty to take steps to protect its clients' interests in the event of a natural disaster or, for a smaller firm, the death or departure of the owner or other key personnel.[43] Moreover, it is prudent business practice for an investment adviser to adopt and implement a Business Continuity and Disaster Recovery Plan (the "*BC/DR Plan*") that provides for specific guidelines in the event of a business disruption.

A BC/DR Plan should provide for a process where employees will be notified, either by their supervisor or through a call tree mechanism in the event of an emergency, and given instructions that ensure business will resume and continue as quickly and efficiently as possible. It is common practice that most advisory personnel are provided with the functionality to work from their homes while utilizing remote access to all critical files and functionality. All personnel with investment responsibilities should have access to pertinent portfolio information and trading capabilities from anywhere they can access the Internet or a telephone. It is also good industry practice to periodically (at least annually) test and evaluate a BC/DR Plan to assess whether the firm's operations can continue without significant disruption during and after an emergency.

## IV. You Have Produced a Compliance Program—Now What? Practical Tips on Effective Administration of a Compliance Program

Administering a Compliance Program effectively depends to a large extent on the firm's "culture of compliance," an atmosphere within the

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41. 17 C.F.R. § 275.204-2 (2012).

42. 17 C.F.R. § 275.204-2(g) (2012).

43. Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26299, 67 Fed. Reg. 74714, at 74716.

firm of ethical behavior and decision-making.[44] Senior management and other key executives must set a tone at the top of the organization that fiduciary and regulatory obligations are to be taken very seriously and must make it clear that they expect the firm and all of its employees to operate ethically and consistent with fiduciary and legal obligations.

As noted earlier, the Compliance Rule mandates that each registered investment adviser has a Compliance Program and designates a CCO. The designated CCO in smaller private equity firms is often also the firm's Chief Financial Officer. Wearing multiple hats should not constrain the CCO from administering the Compliance Program and continuously educating employees regarding their responsibilities under the policies and procedures that federal registration imposes. If the CCO does not have any compliance staff (as is often the case), there are a number of tools that can help. For example, automated compliance software can facilitate disclosures and reporting, and can also incorporate a calendar/reminder function. In addition, an independent compliance consultant can provide support and advice.

Joining a trade association such as the Investment Adviser Association (www.investmentadviser.org) or the National Society of Compliance Professionals (www.nscp.org) is a good way for the CCO to keep abreast of regulatory news and "best practices" in the industry. These two organizations also sponsor national and regional conferences that have informative programs. If the CCO finds it difficult to get away from the office to attend conferences, there are many educational webinars. The Commission also sends out regular email updates (http://sec.gov/news/press/subscribe_updates.htm). Finally, many larger cities have groups of CCOs that meet regularly to discuss the compliance issues they are facing at their firms. These can usually be found by contacting either the Investment Adviser Association or the National Society of Compliance Professionals.

It is easier to administer a Compliance Program when it is in line with the firm's business operations and culture. Private equity firms may not need to impose pre-clearance restrictions on personal trading, since their client accounts rarely hold public securities. Nonetheless, a restricted list would be extremely helpful for enforcing the prohibition against disclosure of material non-public information. To limit gifts and business entertainment reporting, a *de minimis* amount of $250-$500 threshold should be set, as noted earlier. Pre-clearance of gifts and business entertainment may or may not be practical for the firm depending on whether there are concerns regarding the appearance of impropriety.

Following the firm's registration approval by the Commission, the CCO should hold a training session with all employees to educate them in their duties as employees of a registered investment adviser and to help

44. Lori A. Richard, Director, Office of Compliance Inspections and Examinations, Sec. & Exch. Comm'n, Fiduciary Duty: Return to First Principles, Speech by SEC Staff at the 8th Annual Investment Adviser Summit (Feb. 27. 2006), http://www.sec.gov/news/speech/spch022706lar.htm.

them become familiar with the Compliance Program's policies and procedures. Following the initial training, the CCO should schedule annual trainings as well as trainings for new employees. Training should highlight both the policy on insider trading (including use of a restricted list, if applicable) and the Code of Ethics (emphasizing pre- clearance, reporting and affirmations of acknowledgement and compliance). Making the compliance manual available electronically as well as in hard copy makes it easy for every employee to access it at all times. When policies and procedures are amended, the compliance manual should be updated and employees notified of the changes. It is a good idea for the CCO to discuss any new regulations or enforcement cases that are relevant to the firm's operations at staff meetings. This information can also be sent out via email while reminding employees of the importance of following the firm's Compliance Program.

Being a registered investment adviser requires the firm to make disclosures regarding various aspects of its activities, performance, and ownership. Compliance touches upon all functional areas of the firm. The CCO should ensure that he or she is included in meetings where the discussions focus on changes in existing products or new product initiatives, the departure of key personnel, or changes to marketing strategies. These topics may have an impact on the firm's disclosure brochure and supplement, known as Form ADV 2, as well as its responses given within due diligence questionnaires provided to the firm by current and potential investors.

Changes regarding human resources also matter. For example, if a firm has adopted the provisions of a political contributions policy because it is relevant given the firm's investor base, the CCO should work with human resources to vet serious employment candidates regarding any political contributions they have made that may constitute a violation of that policy.

Support of senior management for the CCO and the new Compliance Program is particularly important in the area of employee disclosures. Employees will be required to make personal disclosures that they have not previously been required to make concerning their personal securities accounts and those of the members of their household, outside business activities, civil and criminal offenses, and private investments. They may face restrictions in their personal trading, although in private equity firms these tend to be minimal since there are few trades in the public equity markets. Some employees may resist providing disclosures and may object to restrictions. This may result in a violation of the firm's Code. Violations must be reported to the Commission during an examination and may have to be reported to current and potential investors.

The policies and procedures in the Compliance Program require frequent review and testing; compliance policies are not written in stone. If testing reveals that a policy is not being followed or has not been designed properly, the CCO should closely examine the procedures to determine what needs to change—the behavior or the policy. New Compliance Programs, although customized to the firm and its culture, often need to be modified, but the necessary modifications cannot be determined until the Compliance Program has been implemented for six months to a year. It cannot be stressed enough, from both a regulatory and management perspective, how important it is for policies and procedures to reflect the reality of what is actually being done at the firm. Testing may require the CCO to gather information from other business units such as accounting and marketing. CCOs should therefore have access to any information they need for testing purposes. For example, if the firm's Code requires reporting of business entertainment over a certain monetary amount, the reporting for compliance may be compared to the reporting on expense reports.

One of the keys to administering a strong, effective Compliance Program is ensuring appropriate documentation. Any compliance violations should be documented as to the nature of the violation, the response, the resolution, and steps taken towards future prevention. If the firm has committees that meet on a regular basis, such as a Valuation Committee or an Investment Committee, there should be documentation of each meeting to report on any decisions or actions that may result. Documentation regarding performance calculations and investment decisions is particularly important from both a regulatory and legal perspective.

Registered investment advisers have specific requirements regarding retention of books and records. Email is considered a communication that must be retained: an email archiving firm should be engaged prior to the registration approval to ensure that all emails are archived and can be retrieved. If the firm has an electronic communications and social media policy in its employee handbook, the Compliance Program can use or refer to that. If such a policy does not exist, it should be created in the Compliance Program. Books and records may be maintained in electronic format; however, complete records must be retrievable in a timely manner.

As discussed earlier, the CCO should spearhead the development of a risk assessment to identify conflicts and other compliance factors creating risk exposure for the firm and its clients resulting from their operations. Furthermore, the Compliance Program should address all conflicts of interest and other risks the firm may be exposed to. There are templates available to aid the CCO in creating a risk assessment matrix. The private offering memoranda for the fund(s) that are managed by the firm are also good sources of information on risks and conflicts of interest.

It is difficult to predict when a newly-registered investment adviser will have to undergo a regulatory examination by Commission staff. The Commission has said in numerous industry conferences that its examination program is based on a firm's risk profile. An examiner from the Commission's regional office will notify a CCO that an exam will commence on a specified date. Contemporaneously, an information request list will be sent to the CCO. The request list is typically divided into information that must be gathered prior to the staff's arrival at the firm's offices and information that may be requested as the exam progresses. It is important for the CCO to manage the exam process by serving as the liaison between the examiners and the firm. The staff examiners will want to meet with senior management and various other advisory personnel such as the firm's director of marketing, chief financial officer, and portfolio managers. The CCO should sit in on each interview to record an accurate account of what was discussed during the meeting. It is important to keep in mind that the examination staff will likely have limited experience examining private equity firms and thus certain facets of the firm's operations may be new to the Commission staff. The CCO should be prepared to play a role in educating the examiners with regard to the distinctions between the firm's operations and those of a more traditional investment adviser.

When the examiners have finished, they will grant the CCO an "exit interview," during which they will briefly summarize their findings and point out problem areas where they will be focusing attention as they finish the exam in their offices. The CCO should request an exit interview if the examiners do not offer one and should be prepared for additional information requests as the examiners work to conclude the exam off-site. A "deficiency letter" summarizing problems that need to be remedied and areas of concern that need to be addressed should likely arrive within three months of the conclusion of the off-site portion of the exam. The CCO must generally prepare a response to the Commission within the specified time period noted in the deficiency letter, a period which is typically 30 days. It is recommended that legal counsel be consulted as necessary during the exam and when preparing the response to a deficiency letter.

Once a private equity firm becomes a federally registered investment adviser, the firm becomes subject to a myriad of federal securities regulation whose concepts often seem foreign or potentially in contradiction with the typical manner in which a private equity firm runs its operations. Accordingly, it is important that the private equity firm give sufficient focus to this transition time, in order to create and adopt a sound Compliance Program, provide education to its personnel, and designate the right individual to serve as the firm's CCO. Seeking help from third-party experts and discussing compliance with industry peers who are similarly situated will also help make for a smoother transition to the firm's new regulatory status.