PRIVCAP REPORT/

PLUS:
- Seeking Clarity Around SEC Rules
- Compliance Challenges CFOs Face

CFO Roundtable: **Five Compliance Gray Areas in Need of Clarity**

Three mid-market CFOs discuss partnering with the ACG to compile best practices in order to stay in step with SEC regulations.

With Expert Insights from:

The Riverside Company
Blue Wolf Capital Partners
Saw Mill Capital

Some Assembly Required

The good news is that private equity is a corner of Wall Street that is among the least culpable for the blowup that led to the Great Recession. No "liar loans" or Ponzi schemes here—just a bunch of investors seeking to build the value of mostly middle-market private companies.

The bad news is that private equity now finds itself slapped with a set of regulations designed to curtail potential abuses in a very different type of investment management market. The SEC is clear about the principles set forth in rules governing registered investment advisers, but not overly helpful in providing explicit details about how those principles should be achieved.

This lack of clear guidance puts all private equity firms, but especially those in the middle market, in an uncomfortable position: How do you comply with rules just enough that the firm will not be found lacking when vthe SEC comes by for an examination, but not so much that its finite resources and infrastructure are unnecessarily taxed?

This special report presents the observations of three influential private equity CFOs who are leading an effort to arrive at PE-specific guidelines for compliance. The hope is that this effort will curb overconservative practices and take much of the guesswork out of running a compliant firm.

We trust that anyone charged with keeping a private equity firm out of trouble will find the intelligence shared here to be valuable. These featured CFOs, as well as their partner, the Association for Corporate Growth, hope that some readers may even be inspired to join the cause for greater clarity.

Best,

David Snow
CEO & Co-founder
Privcap
@SnowsNotes

In This Report

Seeking Greater Clarity **Around SEC Rules**

A group of mid-market CFOs are partnering with the Association for Corporate Growth to create a set of best practices in order to stay in step with SEC regulations

In the following pages of this CFO Special Report, we will drill down into some of the challenges that middle-market private equity firm managers are facing in the compliance function. Progress will bring clearer guidelines.

While big private equity firms like KKR and Blackstone have divisions that deal exclusively with regulatory issues, many middle-market firms with smaller staffs are struggling to understand how to comply with new PE regulations put forth by the Securities and Exchange Commission.

Enter PERT—the Private Equity Regulatory Task Force—an Association for Corporate Growth-affiliated consortium of chief financial officers who are helping the entire PE middle market by proactively attempting to define regulatory dos and don'ts.

"The idea is to try to develop what we believe are best practices among ourselves to meet the guidelines that the SEC has put forth," says Bela Schwartz of The Riverside Company. "And, where appropriate, approach the SEC for some no-action letters so that there's comfort that if you follow a series of processes or procedures, the SEC will have deemed that adequate to meet their requirements."

"It really started with the private equity firms getting scoped into the SEC's regulatory framework, where we now need to register with the SEC," says Joshua Cherry-Seto of Blue Wolf Capital Partners.

"In that framework, the SEC was really organized around the public markets and businesses that are much more 'trading businesses,' so a lot of the rules are different when we look at how we're applying them," Cherry-Seto says. "And so there isn't a lot of clarity on how we should react to some of those trading-based, public-market-based rules."

PERT's approach is to seek a seat at the SEC's table and advocate best practices for an entire industry. The group has identified six areas of concern that need greater regulatory clarity: co-investment, valuation policy, fee and expense disclosure, broker-dealer issues, advertising and marketing rules, and ethics.

While the SEC expects all compliant GPs to exhibit excellence in these six areas, the commission isn't going to be crafting a guidebook detailing exactly how to comply. This presents a challenge to most middle-market GPs struggling to define compliance policies.

"The SEC has set out a broad base of issues that you need to address, but they're not telling you how to address it," says Brinn Cirella of Saw Mill Partners. "You need to have a insider trading policy, and that one's maybe a little easier to understand and follow. But you need to have a co-investment policy. Okay, well what's that supposed to look like? I've got a co-investment policy but is it adequate and is it going to keep me out of trouble when the SEC shows up?" ■

Click to watch videos
➜A CFO Task Force Seeks Guidelines
➜Fees, Expenses, and Broker-Dealer Dangers
➜Seeking Clear Website Content Rules

Five Compliance Challenges Facing PE

Three private equity CFOs explain why middle-market firms should band together to seek greater clarity and best practices around five ill-defined areas of compliance

THE CFOs

Bela Schwartz
CFO
The Riverside Company

➜BIO

Before joining Riverside, Schwartz was the vice president at Bassini, Playfair & Associates LLC, CFO and treasurer of The Clipper Group LP, Windward Capital Partners LP, and Securitas Capital LLC. He received an M.B.A. from the University of Michigan and degrees from Northwestern University and Oberlin College.

Joshua Cherry-Seto
CFO
Blue Wolf Capital Partners

➜BIO

Cherry-Seto was previously a portfolio and finance manager at Grove International Partners and had a variety of positions within Citigroup. He received degrees from the Cornell University School of Industrial and Labor Relations and from Columbia University, and an MBA from New York University.

Blinn Cirella
CFO
Saw Mill Capital

➜BIO

Cirella was previously a director at BISYS Private Equity Services, the controller at CommonFund Capital Inc., and the treasurer and director of finance and administration for Orien Ventures, Inc. She received a degree from Sacred Heart University.

➜CONTINUES ON NEXT PAGE

Anyone tasked with managing a private equity firm, especially a midsized firm without ample compliance resources, will agree that there are too many compliance gray areas. In part to help its members gain greater clarity in the compliance function, the Association for Corporate Growth has formed the Private Equity Regulatory Task Force—or PERT—to be a voice for the middle-market firms in Washington, D.C., and with the SEC.

Within PERT is a group of CFOs driving an effort to create guidelines around key regulatory requirements affecting PE firms. Privcap gathered three such leading CFOs for a conversation about the five key areas they are targeting for greater clarity. What follows is a condensed version of their conversation.

Compliance Clarity Needed in… **LP Co-investment**

While LP co-investment has been a feature of the private equity landscape for a long time, its popularity among investors and volume has been steadily increasing, leading to some regulatory concerns that not enough about how these deals are sourced, allocated, and structured is being disclosed by GPs.

Our CFO experts exchanged comments on why this area of compliance is badly in need of more standardized best practices.

Notes Bela Schwartz of The Riverside Company, "Some partnerships will define your obligation to share co-investment with limited partners who have invested over a certain amount [of capital]. But in many other partnership agreements, there absolutely are no guidelines. Co-invest is totally at the discretion of the general partner. So how does the general partner meet its fiduciary obligation to the investors of one fund or another fund when an opportunity is available to co-invest?"

"There are also some issues around giving LPs adequate time to make the decision," says Blinn Cirella of Saw Mill Capital. "And everybody knows this stuff happens pretty quickly. So what's the appropriate amount of time? Is it four days? Is it four weeks? What can you tolerate as a firm? And so trying to put parameters around those things is important for us."

Schwartz adds: "What we really want to try to do is try to develop a series of guidelines. The sense that I get from hearing what the SEC says is it's all about disclosure. As long as you disclose what you're doing to your limited partners, even if there's no policy, you're probably going to be viewed as doing the right thing by the SEC."

Compliance Clarity Needed in… **Fee and Expense Disclosure**

Fees and expenses have always been hot-button issues with limited partners. But recently the SEC has highlighted what its commissioners feel

➜ CONTINUES ON NEXT PAGE

is poor disclosure around how private equity firms are paying for the services, such as operating partners, that they use in the investment function.

These SEC comments have put an exclamation point next to the need for GPs to be more meticulous in documenting their budgets and disclosing fees and expenses to investors. But how much disclosure is too much?

"The issue on fees and expenses is that the SEC has really said that it's a disclosure issue," says Joshua Cherry-Seto of Blue Wolf Capital Partners. "They're not necessarily questioning what we do, but we do have that challenge with our old funds—what we said in our PPMs and our [limited partnership agreements] were a little light. So conceptually, we're going to be charging our portfolio companies reasonable fees and expenses. But that hasn't been traditionally disclosed, and so a lot of us are sort of struggling with how do we bridge that gap. Nobody wants to blaze a new trail and be the one that's disclosing everything."

Cirella gives an example of a firm (not her own) that, five years into the life of its fund, decided to outsource to a fund administrator. "So now that expense, which can be substantial, was being passed through to the fund," she says, as opposed to being paid for by the management fee, which would come out of the pockets of the GPs. "There was concern that that wasn't appropriately communicated to the LPs of that fund, although it is on the income statement when you see more expenses."

"A lot of it is tightening up the language in future limited partnership agreements so that your expenses are more clearly defined," says Schwartz. "What we've not been asked to do is say how much third-party costs we incur as a general partner that we bill to the fund or to the portfolio company and got reimbursed. We're not saying how much money we received as a management company from a portfolio company. That has never, to my knowledge, generally been disclosed by GPs."

"The other issue is that we have to live with our LPAs for 10, 12, 15 years," adds Cirella. "So crafting language today that's going to take us through the next 12 years is difficult."

Compliance Clarity Needed in… **Valuation Policy**

The subject of valuation in the private capital investment business was already fraught before Registered Investment Advisor (RIA) regulations came into force. Arriving at fair value for a private investment is a difficult but necessary requirement for GPs, and there are as many valuation best practices as there are private equity firms, leading to the need for greater sharing of practices and standardization.

Cirella says PERT has been reaching out to many middle-market private equity CFOs to survey the range of valuation practices used: "Some of the stuff that we're trying to gather is informational. Others are best practices. But some of the [possible areas of concern] we're looking at are cherry-picking your comps, asking what multiple you're using and trying to put parameters around that."

Cirella, on PERT's valuation committee, described an initial conference call to assess progress made to date: "It was interesting that if we put all the policies together, we really had a set of what

➜ CONTINUES ON NEXT PAGE

Bela Schwartz, Riverside; Joshua Cherry-Seto, Blue Wolf Capital; Blinn Cirella, Saw Mill Capital; David Snow, Privcap

would make best practices. It was clear that everybody was putting together different options that worked for them, but no one person had all of it together."

One thing that Schwartz notes is clear about the best way to arrive at valuations: The LPs do not want to be part of the process. "There's been a move among a number of LPs to forcefully state that they do not want to approve valuations," she says. "They feel they're not in the business of doing that, and that's what they've hired us to do."

There has been a migration of valuation policies in PE from conservative hold-at-cost practices to fair-value methodologies, which require investors to estimate what their portfolio positions would sell for if sold today, Cirella notes. The fair-value requirement has actually brought greater complexity to the valuation process, as well as greater risk that GPs will be accused of monkeying with the numbers for their own benefit.

"As I was thinking about this whole conversation, it occurred to me that the new [fair-value] rule that was passed in 2007 is actually causing this issue with the SEC because before this we held at-cost," says Cirella. "So now the SEC is on us about valuations that were put on us by another regulatory body. There's a perfect example of where two regulatory bodies are colliding and we're sort of caught in the middle of it."

Compliance Clarity Needed in… **Broker-Dealer Issues**

Private equity firms over a certain size threshold must become SEC-regulated RIAs. But few private equity firms would think of themselves as broker-dealers—sellers of securities, as opposed to managers of securities. And yet there is concern among many middle-market private equity firms that certain structures and practices may, in the view of the SEC, trigger a need for the firm to register as a broker-dealer and thus comply with an entirely different set of regulations.

"If you don't have 100 percent offset on your management fee, [the SEC is] wondering if you look like an investment banker because you charge these fees," says Cherry-Seto. "That's a big issue for [private equity]. It's part of the mechanism of how we operate, and we're not investment banks. So it's a very remedial conversation just to make sure we're talking about the same issues. It's very important, particularly for smaller firms, startup firms, [where it is] rare that there'll be 100 percent offset."

Cherry-Seto adds that many firms have in-house professionals to help maintain investor relations and raise funds, but he stresses, "We're not placement agents, and so there's a lot of work and education to describe what our teams do. [In-house IR teams are] for execution. We hire placement agents to do placement agent work. But there hasn't been enough of a conversation about that."

"You really have to take a step back and say, 'What's the spirit of a broker-dealer, and what's the spirit of a private equity firm?'" says Cirella. "And let's not just get very literal in a strict reading of the regulations. We need to take a step back and be practical and say, 'Private equity firms are not broker-dealers.' If you have somebody in-house that does happen to help you with fundraising, it's important that they are not compensated based on fundraising targets or dollars brought in-house. They have to be an employee."

Schwartz adds, "On the other side of our business related to portfolio companies, if you give your CEOs a mandate and say, 'If you see a company or you have a friend who's a CEO who might be interested in selling his company, bring it to us. If we buy it, we'll pay you a success fee.' If you make that success fee tied to the value of the company, you may run into this broker-dealer question."

Compliance Clarity Needed in… **Ethics**

Ethics is a big topic. So big, in fact, that few firms have been able to codify where ethics apply in every conceivable private equity situation. Ethics and its related policies are additional areas where private equity firms are in need of better standardized compliance practices.

Cherry-Seto notes that in the private equity context, much of the work in defining ethics has to do with areas of potential conflicts of interest.

"We all have policies around a lot of these issues, but a large area of it is conflicts of interest," he says. "For a lot of us, especially the really small firms that just registered [with the SEC] in 2012, the code of ethics came with our compliance manual, and it was somewhat boilerplate. And so the time has come for us to really sit down and craft that in a way that's more meaningful."

As an example of a somewhat obscure area in private equity that doesn't have well- defined guidelines, Schwartz brought up the issue of gifts—a big topic where managers of public funds and private asset managers overlap. But there's less of a clear conflict of interest where private equity firms and the intermediaries who bring them potential deals do business.

"What about vendors that provide tickets to sporting events or concerts or other things?" asks Schwartz. "What type of disclosure should there be? What type of approval should there be, and what's the dollar amount?" ■

From the Archives

Dealmaking

Fees Outside the 'Offset Paradigm'
Experts from Gen II Fund Services, Credit Suisse, and Kirkland & Ellis LLP dive into fees charged to porfolios that fall outside of the traditional fees normally shared with LPs.

Standing Out in a Competitive Market
Heads of business development for three PE firms talk about how they set themselves apart in their approach to sourcing opportunities.

Fundraising & IR

The BlackRock Outlook
Arslan Mian of BlackRock Private Equity Partners talks about topics including why energy and healthcare are the next big investment opportunities.

How Much Does a Fundraising Cost?
Three PE leaders discuss how much a GP should expect to spend raising a fund.

Middle Market

How Corinthian Does Business
Corinthian Capital Group's Kenneth Clay discusses its middle-market expertise, sourcing entrepreneurial companies, and a recent exit.

Ascension's Long-term Approach to PE
The firm's Dale Hunt discusses its strategy, deal sourcing, due diligence and risk mitigation.