Managing Potential Pitfalls of Operational Diligence

- Tiffany Lauterbach, Chief Compliance Officer, Capstone Partners

Over the last couple of years we have seen an increased level of regulatory scrutiny on private equity managers. Given this, are you doing anything differently with your clients during or after a capital raise?

We are definitely spending more time talking to our clients about regulatory matters, but let me qualify all of my comments by saying that our number one piece of advice is to consult with Counsel as they are equipped with regulatory experts. We do not provide legal, accounting or regulatory advice; however, as Chief Compliance Officer at Capstone, an important part of my role is to stay current on the evolving private equity regulatory environment and to make sure that our clients are aware of regulatory hot topics and actively coordinating with the appropriate experts to ensure firm and fund compliance.

What specific suggestions are you making to your clients?

With headlines over the last year surrounding SEC settlement cases, we believe that now, more than ever, private equity firms must be diligent in ensuring a robust compliance and operational platform. This is critical not only to avoid potentially costly sanctions and fines from regulators, but also to avoid negative press and potential diligence issues during a capital raise. We also make sure they are aware that although the registration deadline resulting from the Dodd Frank Act was not effective until May 2012, the regulatory framework under which firms must operate will apply to all funds actively managed by the registered advisor. That means that regulators can and have evaluated all active vehicles managed by advisors during recent presence exams and will continue to do so as part of its risk-based examination program. For this reason, we are encouraging firms to execute a comprehensive evaluation of their policies and procedures to ensure they are: a) being executed as defined in the relevant fund documents (LPA, Management Agreement etc.) and b) acceptable based upon the SEC's recommendations and assumptions resulting from recent exam findings.

Are there any specific areas that you see receiving heightened scrutiny by prospective investors and likely SEC examiners?

Yes, there are a number of areas that have increasingly become a focal point during operational due diligence, including:

Third-Party Compliance Consultants: The SEC appears to be comfortable with the use of third-party compliance providers to ensure proper policies and procedures are in place; however, if utilized, it is important that a firm's policies and procedures are sufficiently specific to the firm's business and not generic templates. Regardless of whether a firm engages a third-party compliance consultant, it is critical that a professional within the firm be designated to take responsibility for the review, approval and implementation of all compliance policies and procedures.

Valuation Methodology/Track Record Disclosure: Fund managers should ensure that the valuation methodology utilized in practice is consistent with the valuation methodology promised to investors. Some of the most common valuation issues cited include cherry picking of comparable companies and inconsistent application of the methodology. It is also important that track record reporting in marketing presentations be consistent with SEC guidelines and include applicable footnotes.

Co-Investment Allocation: Increasingly, examiners are focusing on the methodology utilized when allocating co-investment opportunities, including scrutiny of side letter agreements that provide priority to select investors and evaluation of the fund's allocation vs. allocation offered to co-investors. Fund managers that generate co-investment opportunities should consult with Counsel to ensure that their allocation methodology and related communication to investors is compliant.

Allocation of Fees and Expenses: This is a real hot button and the SEC has noted that it is by far the most noted deficiency in exams. There has also been a great deal of pressure from LPs to be more transparent in the disclosure of fees and expenses. It is imperative that fund managers have sufficiently detailed policies relative to the allocation of fees and expenses.

AML Programs: Under a proposed rule, likely to be instituted sometime during the first half of 2016, all Registered Investment Advisors will be required to establish Anti-Money Laundering (AML) programs. Fund managers that already have an AML program in place should review the provisions of the proposed rule to ensure its program meets the minimum requirements; those without an AML program should begin planning to develop and implement one.

FATCA and CRS Tax Compliance: For foreign fund structures, recent US tax regulations (FATCA) and international tax regulations (CRS) have added significant complexity and risk. It is imperative that fund managers have comprehensive policies and effective procedures that are well documented and implemented to address these tax regulations.

Demonstration of a culture of compliance, along with active self-monitoring and corrective action, can help firms mitigate any issues that may arise during a diligence exercise.

Capstone Partners

Founded in 2001, **Capstone Partners** is a leading independent placement agent focused on raising capital for private equity, credit, real assets and infrastructure firms from around the world.

Tiffany Lauterbach is responsible for regulatory compliance of Capstone Partners' global platform and provides regulatory and operational guidance to Capstone's clients worldwide.

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