Private Equity Groups: Don’t Get Caught in a Tangled Web of Regulations

Background
The complexity and rate of change for compliance requirements for financial service entities have increased dramatically since the financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has greatly expanded regulatory scope to include many private equity (PE) groups and added new reporting, record-keeping and inspection requirements. These changes also have greatly increased the complexity of the regulatory framework for PE funds, which previously enjoyed many exemptions from oversight.

How funds are structured and how management uses and distributes audited financial statements may affect regulatory compliance. While using various holding companies for acquisitions may be beneficial for tax or legal purposes, the presence of minority interests in these structures may impose regulatory requirements that did not previously exist.

Regulatory Framework

Investment Company Act
In general, any entity that invests, reinvests or trades securities is an investment company under the Investment Company Act (ICA). PE funds would fall into this category; however, there are a number of exclusions available. The two exclusions PE funds most often rely upon are Section 3(c)(1), which limits the number of investors, and Section 3(c)(7), which permits only “qualified” investors.

Investment Advisers Act
Unlike the ICA, which regulates the fund itself, the Investment Advisers Act of 1940 regulates the sponsors and advisers to a fund. The act regulates investment advisers by requiring them to register as an investment adviser (RIA) with the SEC unless an exemption is available. Historically, many PE fund sponsors avoided registration with the SEC by relying on an exemption for investment advisers with fewer than 15 clients (with each fund advised counting as only one client) and that do not hold themselves out to the public as investment advisers (often referred to as the private investment adviser exemption).

Dodd-Frank Act
Dodd-Frank amended the Advisers Act to eliminate the private investment adviser exemption, greatly expanding the population of advisers required to register with the SEC. Dodd-Frank also changed the “fewer than 15 clients” exemption and increased the dollar threshold for advisers that are required to register with the SEC. In general, most U.S. fund managers with assets under management of $150 million or more must register with the SEC as investment advisers. Advisers registering under Dodd-Frank are subject to the Custody Rule imposing additional recordkeeping, reporting, examination and audit obligations. Many PE group RIAs engage a bank or prime broker to custody client assets and therefore do not have physical possession; however, the RIA is deemed to have indirect custody because they or their affiliates frequently will serve as the general partner of a limited partnership or manager of a limited liability company, which gives them the authority and the ability to transfer the fund assets without the consent of the limited partners or members.
Custody Rule

In December 2009, the SEC approved modifications to the Custody Rule of the Advisers Act, adding additional protections for advisory clients to prevent theft or misuse of funds and securities. Requirements include:

- Annual surprise examination to verify client assets in custody
- Timely delivery of account statements to investors
- Additional disclosures
- Annual preparation of an Internal Control Report (ICR) on controls over custodied client assets or retaining a “qualified” custodian

Many RIAs elect to have an annual audit in lieu of undergoing the surprise exam, since many of their fund’s partnership agreements already require an annual audit. This would be the practical approach, along with having a qualified custodian send quarterly account statement to fund investors. The following requirements must be met to qualify for this “audit exception”:

- The fund managed is subject to an annual audit by an independent public accountant registered with and subject to inspection by the PCAOB
- Audited financial statements must have an unqualified opinion and be prepared in accordance with U.S. GAAP and delivered to investors within 120 days of its fiscal year-end
- A final liquidation audit must be performed and audited financials be distributed to investors promptly after completion

Common Issues with Custody Rule

The SEC has issued two guidance updates to address issues identified in examinations and inquiries from registrants related to the Custody Rule. The SEC has made compliance with the Custody Rule one of its 2014 examination priorities. Below are some common “foot faults” you should be aware of to ensure continuous compliance.

Auditor Independence

Auditor’s independence rules are different for nonpublic companies and companies required to register with the SEC—such as investment funds. Custody rule compliance requires auditors to apply the more restrictive SEC independence rules. In addition, the SEC’s independence rules apply not only to the audited entity complying with the custody rule but also to each of the entity’s affiliates. Since PE groups also frequently engage multiple public accounting firms to provide nonaudit services, careful review is required to avoid an unintentional taint of an auditor’s independence.

Nonaudit Services

The SEC’s principles of independence for auditor’s services are based on the following basic principles, violations of which would impair the auditor’s independence:

- An auditor cannot function in the role of management
- An auditor cannot audit his or her own work
- An auditor cannot serve in an advocacy role for his or her client
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Entities Requiring SEC Independence

If the SEC independence rules apply to an audited company, they also apply to the entity’s affiliates, as defined by the SEC, including the following:

- An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client—including the audit client’s parents and subsidiaries—control is presumed if there is more than 50 percent ownership interest
- An entity over which the audit client has significant influence, unless the entity is not material to the audit client (ownership interest or board rights are more than 20 percent but less than 50 percent)
- An entity that has significant influence over the audit client, unless the audit client is not material to the entity
- Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex

The below diagram illustrates the concept of common control and significant influence for a PE group and the ownership interests in each of its funds.

The auditor for an investment adviser relying on the audit exception to comply with the Custody Rule must maintain SEC independence for the following entities:

- The audited fund
- GP or sponsor of the fund
- RIA of the fund
- All entities controlling the RIA of the fund
- All entities controlling the GP of the fund
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- All other pooled investment vehicles advised by the RIA
- All other pooled investment vehicles in which the GP holds the GP interest
- All portfolio investee companies controlled by the fund
- All portfolio companies over which the fund has significant influence, unless the portfolio company is immaterial to the fund
- All entities under common control with the fund including, but not limited to, other funds and their controlled portfolio investee companies in the complex
- Significant influence investors in the fund, if the investment is material to the investor

Entities shaded in green in the illustration above are presumed to require SEC independence by the auditor of Fund A.

Fund Structure – Holding Companies

While most RIAs understand how the Custody Rule is applied at the fund level, many still grapple with the understanding of its application to other entities within the fund complex. PE funds often use holding companies to facilitate acquisition of investments. In certain situations, when there is an intermediate holding company between a fund and the portfolio company, the custody rule could apply, which would require auditor compliance with the SEC’s independence rules for the audit of the portfolio company and its affiliates.

A holding company can be wholly owned by one or more funds and investors considered under common control of the fund manager. For example, in some cases there may be investors outside the common control group, e.g., minority shareholders in the acquired portfolio company. The presence of external, third-party investors may have a significant impact on the application of the custody rule.

When a holding company is included anywhere in a private equity structure, the PE group should discuss internally and with their SEC counsel to determine if an entity must comply with the custody rule requirements. The PEG should also include the entity’s auditor in the discussions, as compliance with the custody rule also means compliance with SEC independence rules.

Auditors for investment advisers not registered with the SEC, and other nonpublic entities, can follow the independence rules of the American Institute of CPAs (AICPA). SEC independence requirements would govern the financial statement audit of an entity having to comply with the Custody Rule. The following table highlights key differences between the independence standards of the AICPA and the SEC:
## Comparison of Audit Independence Rules for Nonaudit Services

<table>
<thead>
<tr>
<th>Service Type</th>
<th>SEC Independence Rules</th>
<th>AICPA Independence Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forensic Accounting</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax Services</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax services for officer or director who acts in an Financial Reporting Oversight Role (FROR)</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax services for refunds of amended returns for a contingent fee</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>M&amp;A or Transaction Support (2)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Due diligence</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Bookkeeping, preparation of tax provision, or drafting financial statements</td>
<td>No</td>
<td>Yes (4)</td>
</tr>
<tr>
<td>Valuations, Appraisals or Fairness</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Financial reporting – purchase price allocations, goodwill or intangible impairment</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Internal Audit Services</td>
<td>No</td>
<td>Yes (4)</td>
</tr>
<tr>
<td>Install information system with access to source code</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Install off-the-shelf system</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Project management services</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

(1) Permitted only for fees fixed by a court or other public authority or fees based on the results of judicial proceedings or the findings of governmental agencies

(2) Beyond due diligence services, there are many additional potential M&A services for which the independence considerations relevant to M&A services that are complex and beyond the scope of this analysis

(3) If the bookkeeping services will result in a set of financial statements, the client must:
- Approve all account classifications
- Provide source documents to the member so that the member can prepare journal entries
- Take responsibility for the results of the member’s services, e.g., financial statements
- Establish and maintain internal controls over the member’s bookkeeping activities

(4) SEC rules prohibit the performance of these services to an audit client whenever the auditor expects that the results of those services will later be subject to the firm’s audit procedures

(5) To maintain independence, the client must:
- Designate competent management to oversee the internal audit function
- Determine the scope, risk, and frequency of internal audit activities
- Evaluate the findings and results of internal audit activities
- Evaluate the adequacy of the audit procedures performed and related findings
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U.S. GAAP Financial Statements

The audit exception may not be available if there are exceptions to U.S. GAAP or if a qualified audit opinion is issued. Funds organized outside the U.S. may use accounting standards other than U.S. GAAP, e.g., International Financial Reporting Standards, as long as both of the following are true:

- The financial statements contain information substantially similar to statements prepared in accordance with U.S. GAAP and the footnotes reconcile any material variations with U.S. GAAP
- The financial statements are otherwise audited in accordance with U.S. generally accepted auditing standards

Common errors that could lead to a qualified opinion and preclude reliance on the audit exception include the following:

- Improper capitalization of organizational expenses (rather than expensed as incurred)
- Federal income tax basis used for financial statements
- Failure to substantiate fair valuations

Summary

At the end of the day, application of the custody rules is a complex question. Compliance with the custody rule requirements is a legal question that should be discussed and determined for each entity with help from legal counsel. Compliance with the custody rules also means compliance with the SEC independence rules for the entity’s auditor, which could have consequences for affiliates of the entity within the fund complex and on nonaudit services provided by the auditor. Contact your BKD adviser for further information or to discuss implications of these issues on your organization.

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