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SEC Exams Cut Deeper into Private Equity Firms

By Tom Stabile November 19, 2014

Securities and Exchange Commission (SEC) examinations of private equity firms have gotten noticeably longer and more complex this year, said panelists at a conference in New York, and the turning point may have been a major speech by one of the agency's top officials.

The May speech by **Andrew Bowden**, director of the SEC's Office of Compliance Inspections and Examinations, outlined regulatory findings and priorities for private equity firms, and appeared to mark a new chapter in the agency's approach to the industry, said panelists at the **Financial Research Associates** conference last week.

"[W]hat I'll call the post-Bowden speech exams [are] very distinguishable from the 'presence exams' of the past couple of years," said panelist **Jason Brown**, partner at Ropes & Gray, a Boston-based law firm.

The newer process departs from the quicker presence exam format the SEC has used in recent years to review private equity shops, Brown said. The exam pace has slowed, and the site visits seem to follow a great amount of preparation.

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Jason Brown
Ropes & Gray

"By the time [SEC examiners] get on site, they have a very good sense of what your issues are and what they're going to be looking into," Brown said. "They've also been lasting much longer. Some exams have been going on for four or five months."

The lengthier nature of "post-Bowden speech" visits is clearly an evolution, said **Ted Eichenlaub**, partner at ACA Compliance Group, who also spoke on the panel. "I would view this as a hybrid of the old approach and the presence exam approach," he said.

Bowden's "[Spreading Sunshine in Private Equity](#)" address has become a watershed moment for the industry this year. In it, he described many findings from the more than 150 presence exams the SEC had conducted since October 2012, after the federal Dodd-Frank Act required private equity firms managing more than \$150 million to register as investment advisors. But what was partly billed as effort to conduct a shorter introductory visit and quickly "engage" with these newly registered firms was also turning up examples of bad behavior, he said.

Among the most striking findings, Bowden said, was evidence of "violations of law or material weaknesses in controls over 50% of the time" in the handling of fees and expenses by private equity fund managers. Among the common faults were firms mishandling how they allocated expenses between funds and the manager, particularly when it involved salaries of professionals dispatched to work at companies owned in a portfolio. Bowden also detailed concerns around how managers collect fees, draft limited partnership agreements, and share relevant data with investors.

Some of those topics are coming up in the new, longer visits since the speech. That contrasts with earlier presence exams, which typically covered less material, Brown said.

"In a presence exam, the goal was to touch maybe one topic, maybe two topics," he said. "The SEC would be onsite for a couple of days, maybe up to a week. The whole exam would last a couple of weeks, maybe ... a month and a half."

The shorter presence exams were such a departure from the SEC's standard exams of investment managers that some fund shops were lulled, said another private equity firm panelist at the event, who asked not to be named.

"[T]hey're great from an SEC standpoint, but I think there's a false sense of security," the source said. "There's not a lot of findings in some of these [presence] exams. [One] CFO at a mid-sized firm [told me] 'Hey, this is easy,' ... and I [said], 'Wait until the first real exam, and they're in there clobbering you.'"

The post-Bowden speech visits – still called "presence exams" by the agency – more closely resembles a full-fledged SEC review. The new process entails several levels of research, starting with initial document requests and "substantive" phone interviews, followed by more written inquiries over a series of weeks, all before the first site visit occurs, Brown said. The examiners have their agenda set upon arrival. "The SEC knows what they're looking for," he said.

The initial document list the SEC team calls for can be up to 50 items long, and that might not dampen the significant number of requests that can come during the onsite visit, Eichenlaub said.

Another way the SEC appears to have kicked up its intensity is through the makeup of the site visit teams, which on numerous occasions recently has included **Igor Rozenblit**, co-head of the private funds exam unit, during the initial interviews, or has had members of the agency's enforcement division along for the ride.

Such activity is a sign the SEC is beefing up inter-division cooperation and coordination within the exam unit itself, Eichenlaub said. "It doesn't mean that your firm is in deep trouble," he added. "It's just a matter of the SEC again getting better at sharing information."

In addition, request and exam letters have become more uniform, post-Bowden, Brown said. And the SEC has been adding more subject matter specialists to exam teams, including valuation experts who will question fund managers on their inputs into pricing decisions, he said.

That greater level of expertise on the exam teams is evident across the board, Eichenlaub said. "They're better at filtering data these days," he said. "They're better at collecting data... They're going to know a lot about your firm – even if they [have] never examined you before – before they walk in the door, and before they talk to you on the phone even in your initial interview."

Private equity firms that have more assets under management or more layers of complexity in their businesses are likely to get greater scrutiny from exam teams, said **Paula Bosco**, chief regulatory counsel and chief compliance officer at **New Mountain Capital**, who also spoke on the panel. Her firm manages hedge fund,

private equity, and business development company units, which is likely why New Mountain's first SEC exam last year took six months, she said.

The examiners spoke to a range of top officers at the firm, including the CEO, COO, CFO, and various operations and finance department managers, particularly exploring how well they understood the 1940 Adviser's Act, the firm's code of ethics, and its policies on conflicts of interest, she said. The examiners also carefully reviewed the firm's fee and expense policies.

The exam staff was onsite for entire days during its four-month stay, requiring compliance staff to work after hours on their regular duties, Bosco said. "Be prepared," she added, "in terms of resources and time."

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