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How to create a compliance manual

Registering as an investment advisor? Here's what you have to know before drafting a compliance manual.

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One of the first steps to becoming a registered investment advisor – a process that US private equity firms may soon be required to complete – is putting together a compliance manual. Though this might seem like a mere formality for firms that already have strong internal controls in place, it's actually quite complex, and should be undertaken with care, according to Howard Beber and Michael Suppappola of Proskauer Rose.

The manual should include a standard of business conduct, as well as policies regarding portfolio management relative to investment allocations, marketing, safeguarding client assets and disclosures to investors. While such manuals can vary, it is important that they are customized to fit a particular firm.

"You don't want to just take something off the shelf for a private equity firm that may have originally been drafted for a hedge fund or some other kind of investment manager," Beber said. "That's the sort of mistake that we do see managers make, because a lot of folks out there in the industry will sell 'shrink-wrapped-one size fits all' compliance manuals. It can certainly lead to trouble when you are examined and the SEC sees that you have a compliance manual that does not fit the operations or address the particular risk areas of your firm."

The firm also needs to put together a code of ethics that requires a chief compliance officer (whom the firm must hire or designate) to review on an ongoing basis the personal trading activity of certain members of the firm as well as family members living with them. The code should also require CCOs to pre-clear certain types of personal trading activity like investments in private placements or initial public offerings.

"Now more than ever it's also very important that the code of ethics include policies and procedures regarding gift giving, political campaign contributions and insider trading," Beber said. "These are all very hot areas for the SEC that need to be addressed so the firm can eliminate or at least mitigate any potential conflicts of interest. Given the recent high profile pay-to-play events, political campaign contributions by investment advisers and their employees is an issue receiving increased scrutiny from the SEC and state regulators."

While putting together such a manual can be time-consuming, especially for larger firms, there also needs to be coordination between various aspects of the firm. "Drafting a compliance manual really should be a collective effort by the chief compliance officer, legal counsel and the business team," Suppappola said. "If the business team isn't familiar with the firm's policies and procedures, then the policies will be less effective - the business team may have knowledge of certain risk areas and potential conflicts that compliance may not be aware of. You really need input from all sides to have an effective compliance programme."

Before doing any of this though the firm must determine who will head up its compliance programme. "They'll usually be the first person the SEC meets with and has their morning cup of coffee with during an examination, and having a very effective and empowered CCO that the SEC is comfortable with can make a big difference during the examination process," Beber said. "Appointing a CCO is a crucial point. You have to decide whether you will appoint someone from within the firm or – if you don't have someone with that level of experience or time to devote to the position – you start looking outside the firm."

Once a decision is made on that, a firm should then do an analysis from the ground up of where are the areas in a firm where the particular risks lie, such as conflict of interest. "Once you've identified as many risk areas as you can that are specific to the firm's business operations and infrastructure, you can use that as an outline with which to create your compliance policies and procedures," Suppappola said. "Your procedures really need to address your firm's specific risks, as there is no one-size-fits all approach. Start with your specific risk areas and the manual will flow from there."