

PE Regulatory Compliance in a Trump Administration: What You Need to Know



February 21, 2017

Agenda

- Introduction (Scott Gluck)
- Cybersecurity Best Practices (Mike Pappacena)
- Pay-to-Play Best Practices (Ron Jacobs)
- The Trump Administration (Basil Godellas)
 - Executive orders
 - SEC
- The 115th Congress (Langston Emerson)
 - Dodd-Frank Reform/Investment Adviser Relief Legislation
 - Tax Reform
- Current Hot Button Regulatory Issues (Scott Gluck)
 - Recent SEC Enforcement Actions
 - Things on the Horizon

Hot Topic - Cybersecurity (Mike Pappacena)



ACA Aponix
Cybersecurity and Risk

Cybersecurity: SEC Priority in 2017

- OCIE to continue exams on procedures and controls
- Examiners are more experienced cyber professionals
- Focus across key areas:
 - Governance and Policy
 - Access Control
 - Risk Assessment
 - Data Loss Prevention
 - Training
 - Vendor/Third Party Risk
 - Incident Response
 - Network Protection
- Ensuring firms and third-parties protect investor data and investments at portfolio companies
- Firms need an ongoing program to demonstrate policies and controls are enforced
- Evidence effectiveness of program

Trends: Ransomware, Cap Calls, and “BEC”

- Uptick in both general and targeted phishing attacks
 - Ransomware, Capital Calls/Redemptions, “BEC” scams
- Ransomware: Files held hostage, without ability to respond and restore backups, critical data lost
- Capital Calls: Requests from firms to clients to call capital with fake instructions
 - Ensure investors are aware of best practice to validate requests
- Redemptions: Attempts to change investor contact and wire / account instructions
- Business Email Compromise (BEC)
 - Request from an executive to pay a third-party : \$50K
- Portfolio Company BEC
 - Elaborate email threads from compromised account and similar, fake domain to PE firm
 - Substantial wires sent by PE firm to fraudulent accounts: \$725K+

Portfolio Company Cyber Due Diligence

- Attacks and data breaches are industry agnostic, and affect businesses both publicly and privately held
- The cost of a breach in terms the diversion of resource allocation and brand damage can impact the value of the company and its business strategy
 - 2016 average cost of Cybersecurity Incidents/Breaches was over \$2.5M
- PE firms should consider a more hands-on approach with Portcos to effectively influence the adoption of more sweeping cybersecurity enhancements
- Many of the most overwhelming breaches continue to leverage “relatively unsophisticated” attacks which could have been avoided or minimized with modest, proactive security investments and program design

Cybersecurity Due Diligence Lifecycle

- Pre-Deal IT/Cyber Evaluation (Remote)
 - Due diligence evaluation prior to issuing Letter of Intent to acquisition target, covering key technology and security domains, processes, and compliance management
- Pre-Deal IT/Cyber Risk Profiling (Onsite)
 - Cybersecurity risk profiling of business strategy and technology
 - In-depth review of on key cybersecurity risk domains
 - Direct inspection and control operation validation
- Post-Deal IT/Cyber Compliance Assessment (Onsite)
 - Industry, regulatory and legal technology and cybersecurity compliance review
 - Can include reviews related to HIPAA, PCI, ISO, Nerc/CIP, OCIE or FFEIC cybersecurity to identify the operational state of the acquisition and create gap roadmap
- Post-Deal Ongoing Cybersecurity Monitoring (Remote/Onsite)
 - Revisit of risk profiling and key cybersecurity risk domains

Hot Topic – Pay-to-Play (Ron Jacobs)

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Pay-to-Play Rules

- Apply when state and local government entities are investors in a fund.
- SEC rule applies to “Investment Advisors”
 - Advisor provides services to fund in which state is invested
 - Includes covered investment pools
- SEC rule prohibits contributions by “covered associates”
 - General partner, managing member or executive officer, or other individual with a similar status or function;
 - Any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee.

“Time Out” on Compensation

- Rule prohibits compensation for two years from date of contribution
- SEC says this is not a prohibition, just a restriction on compensation
- Recent enforcement cases demonstrate this is not the case:
 - Impose a variety of fines on investment advisors

SEC Enforcement Actions

- Contributions to state officials who are candidates for federal office
- Contributions made by those who may not be covered associates
- Contributions to failed candidates when ongoing relationship with the pension fund
- Contributions in relatively small amounts (\$500)
 - De minimus threshold of \$350/\$150 if not entitled to vote for candidate
- Contributions that have been refunded

State Laws

- State pay-to-play laws
 - Differ in scope from SEC rule
- State lobbying disclosure laws
 - Apply to efforts to “sell” to the state
 - Apply to investment pitches
- Chicago fined lobbyist \$90,000 for one contact
 - Contact discovered in email released in public records request from mayor
 - Board said violation was ongoing until registration occurred

Best Practices: Pay-to-Play

- Frequent reminders of pay-to-play rule and preclearing policy for contributions disseminated to staff
- Check campaign finance databases and other public sources to track employee giving
 - www.followthemoney.org
- Consider prohibition on giving by most or all employees
 - Beware that state employment law puts you in catch
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Best Practices: Pay-to-Play

- Restrict contributions to small dollar donations
- Easier to get refunds
- Understand who your government customers are
- Lots of training
- Clearly identify covered associates

Best Practices: Procurement Lobbying

- Understand state and local rules
- Require sales teams to report pitch plans
- Keep activities below thresholds if necessary
- Register and report otherwise
 - Develop compliance calendar

The Trump Administration (Basil Godellas)

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THE TRUMP ADMINISTRATION

- Trump Administration = Growth through less regulation
 - What has happened to date?
 - President Trump has signed 12 Executive Orders and 12 Presidential Memoranda
 - Executive Orders vs. Executive Memoranda:
 - » Executive Orders may have more authority, but for all practical purposes Executive Orders and Executive Memoranda carry the same weight

The Trump Administration (cont'd)

- Executive Orders and Executive Memoranda are legally binding on executive departments and agencies not independent agencies
 - » Securities Exchange Commission = independent agency
 - » Commodity Futures Trading Commission = independent agency
 - » Federal Reserve Board = independent agency
 - » Consumer Financial Protection Bureau = independent agency
 - » Treasury Department = Executive Department
 - » Department of Labor = Executive Department
- Historically, the SEC has generally complied on a voluntary basis with Executive Orders and Memoranda

The Trump Administration (cont'd)

- January 20, 2017 - Presidential Memorandum for the Heads of Executive Departments and Agencies
 - » President ordered an additional layer of review before regulations that have not gone effective can go effective
 - » Includes Treasury Department (FinCen)
 - Impacts proposed AML Rule (2015)
 - But SEC examiners have expected AML policies for years
 - » Does not include the SEC (but historical compliance)
 - Impacts the Business Continuity Rule
 - But SEC examiners may (and institutional investors will) expect some level of compliance

The Trump Administration (cont'd)

- January 23, 2017 - Presidential Memorandum Regarding the Hiring Freeze
 - » President has ordered a freeze on hiring of (virtually) all federal, non-defense related, employees across the executive branch.
 - Assuming compliance, this will slow down the SEC – especially in adopting new programs and/or initiatives
 - Less flexibility and less staffing even for existing programs

The Trump Administration (cont'd)

- January 30, 2017 - Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs
 - » President has ordered that for every regulation proposed, 2 regulations must be identified for repeal
 - SEC may follow this order
 - Although unclear how this order will be translated; overall impact will be less regulation.

The Trump Administration (cont'd)

- February 03, 2017 - Presidential Memorandum on Fiduciary Duty Rule
 - » President has ordered the DOL to re-examine the Fiduciary Duty Rule to determine if it adversely affects the ability of Americans to gain access to retirement information and financial advice and to prepare and updated economic analysis.
 - Why necessary “regulatory freeze” order – Rule was “effective” April 2016 but compliance is April 2017
 - DOL is an executive department and must follow the memorandum

The Trump Administration (cont'd)

- DOL has submitted to the OMB a proposed rule to delay the compliance date reportedly by 180 days with an abbreviated comment period.
 - Rule is expected to be delayed – BUT
 - Bureaucratic process could result in missing April 10 compliance date
 - Someone could fight the DOL in court seeking injunctive relief – although burden would be high
- Long term view (at this point)
 - Administration has stated it wants a full repeal, but the press is reporting that the public seems to be in favor of some type of fiduciary standard
 - modified fiduciary rule
 - joint rule with the SEC as originally planned – Choice Act 2.0 – longer delay

The Trump Administration (cont'd)

- February 03, 2017 - Presidential Executive Order on Core Principles for Regulating the United States Financial System
 - » President has ordered the Secretary of the Treasury to consult with the members of FSOC and report within 120 days if there are any laws, regulations, treaties or other policies that conflict with 6 “core principles” listed in the Order
- Core principles are generally concerned with a pro-growth agenda, with some tax payer specific protections
 - » Treasury Department must comply
 - » This order is the President’s first shot at his stated goal of repealing all or part of Dodd Frank and similar laws and regulations that were enacted as a result of the financial crisis

The Trump Administration (cont'd)

- Status of the SEC
 - Jay Clayton Nominated as Chair
 - Background is law and capital markets
 - Confirmation hearings have not begun, but he is expected to fall in line with the Trump Administration's policy of encouraging economic growth through less regulation
 - But, likely to focus more on capital market formation rather than regulations affecting advisers
 - expect the status quo for now as to existing regulatory scheme applicable to advisers
 - 2 more vacancies must be filled by the President
 - With the President appointing 3 of 5 Commissioners to the SEC, most expect a more capital market friendly commission with less focus on regulation and more focus on efficiency

The Trump Administration (cont'd)

- Michael Piowar currently is the acting Chair
 - Moving forward with Administration's/business agenda
 - Publicly stated that a number of Dodd Frank rules are under review
 - January 31 – Announced reconsideration of Conflicts Minerals rule
 - February 6 – Announced reconsideration of Pay Ratio rule
 - February 15 – Press reported that Acting Chairman Piowar revoked subpoena authority from about 20 senior enforcement officials – authority rests only with the director of the SEC's enforcement division
 - » Impact – may further slow the enforcement process

The Trump Administration (cont'd)

- Now what?
 - Stay the course – so far there has been a lot of talk, but nothing has changed yet
 - Do not reduce or diminish any of your current policies and procedures
 - Continue to enhance policies and procedures where necessary
 - Until we know otherwise, SEC examiners will expect to see business as usual
 - Enforcement is not going away, SEC action over conflicts and other traditional enforcement issues relating to investor protections are still going to happen
 - Institutional investors will continue to demand what they have come to expect
 - Diligence includes a regulatory compliance component (including conflicts, disclosure, transparency and fees)
 - Lax compliance/policies and procedures can put a fund manager at a competitive disadvantage

The 115th Congress (Langston Emerson)



The Cypress Group

115th Congress - Dodd-Frank Changes

Changes to the Dodd-Frank Act are a priority for the Trump Administration and Republicans in Congress but will likely not occur in the first 100 days, or even in 2017. We expect key personnel changes at the financial regulators, resulting in an easing of regulations, and legislative changes to Dodd-Frank to be enacted in 2018 or later.

Regular Order

- Rather than relying on attaching policy riders to appropriations bills, Republican authorizing committee chairs and Republican leadership will likely seek to move Dodd-Frank changes through regular order.
- We expect Financial Services Chair Hensarling (R-TX) to release a Financial CHOICE Act “2.0” early this year, perhaps as soon as this month. Some version of this legislation is likely to pass the House this year.

Congressional Review Act (CRA)

- House and Senate leaders plan to move early this year on disapproval resolutions under the Congressional Review Act (CRA) to repeal Obama Administration regulations that have been finalized in the last 60 legislative days.

Budget Reconciliation

- Congress also could target some specific Dodd-Frank provisions for repeal/reform through the budget reconciliation process, which provides for expedited consideration in both chambers and approval by simple majority in the Senate (no filibuster).

FY17 Spending Package

- As an alternative to regular order, Congress also could seek to include various policy “riders” in a FY17 spending package before the current April 28, 2017 funding deadline.

Investment Advisers Modernization Act

Summary

- The bill would modernize requirements relating to investment advisers and tailor regulation for private equity firms that the Dodd-Frank Act required to be registered with the SEC.

114th Congress (2016)

- The House Financial Services Committee approved the legislation 47-12.
- The full House of Representatives approved the legislation 261-145.
- The legislation was not considered by the Senate.

115th Congress (2017)

- Similar legislation is expected to be reintroduced this Congress.

115th Congress - Tax Reform Prospects

A Trump Administration and Republican Congress will generate significant momentum for comprehensive tax reform in 2017, and we would expect early iterations of a tax reform proposal to reflect the House tax-writer efforts. If Congress is unable to move comprehensive reform, it could still pursue efforts on corporate/international tax reform – potentially linking highway infrastructure funding paid with revenue through deemed repatriation.

Trump White House

- Similar to the House blueprint, the Trump tax proposal consolidates the current seven tax brackets into three, with rates of 12%, 25%, and 33%.
- Taxes carried interest as ordinary income, which could generate a fight on this provision in Congress.
- Reduces the corporate tax rate from 35% to 15% (House blueprint corporate rate is 20%)

Republican House “Blueprint”

House GOP tax “blueprint” will help shape tax policy agenda in the House in 2017
Chair Brady stated that he has discussed with Speaker Ryan and they will have a legislative proposal released early this year and there will be a vote in 2017 (“can’t say it will be Q1”).

Republican Senate

- Majority Leader McConnell (R-KY) and Senate Finance Chair Hatch (R-UT) will take prominent roles in negotiating tax reform in the Senate. Sen. Portman (R-OH) also could take a leadership role on corporate/international reform efforts given his work with Sen. Schumer (D-NY) on the issue in the Senate Finance Committee.
- A bipartisan, stand-alone tax reform bill is the preferred route of Congressional tax-writers but a budget reconciliation bill will be pursued if needed as a backstop if the White House and Senate Republican leaders determine that they are unable to garner 60 votes to clear a filibuster.

Hot Button Compliance Issues (Scott Gluck)

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INNOVATIONS IN
PRIVATE EQUITY LAW

Private Equity Regulatory Task Force (PERT)

- 50+ Middle-Market Private Equity Firm Members
- Interacts with SEC on relevant issues
- Released industry best practices
 - Co-Investments
 - Cybersecurity
 - Fees and Expenses
 - Valuations
- Push legislation to modernize the Investment Advisers Act
- For more information contact Scott Gluck
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Recent SEC Actions

- Perceived conflicts of interest – [Centre Partners](#)
- Insurance premium allocation – [First Reserve](#)
- Vendor discount – [First Reserve/Blackstone](#)
- Affiliated entities – [First Reserve/Fenway Partners](#)
- Accelerated monitoring fees – [Blackstone/Apollo](#)
- Loans between funds and manager affiliates – [Apollo](#)
- Broken deal expenses/co-investments – [KKR](#)
- Expense allocation between funds – [Lincolnshire](#)
- Personal expenses borne by funds – [Apollo](#)
- FCPA – [Och-Ziff](#)

Issues On The Horizon

- [Changes to Form ADV](#)
 - Not effective until October 2017
 - SMAs
- [Proposed Rule](#) on Business Continuity and Transition Plans
- [Proposed FinCEN Rule](#) on AML/KYC
- Potential Broker-Dealer Registration
- Potential Proposed Rule on Third-Party Compliance Audits
- [ILPA Template](#)
- Changing State Regulations
 - [NYS Cybersecurity](#)
 - [California Fee Disclosure](#)
- Tax Reform

SEC 2017 Exam Priorities

OCIE Examination Priorities for 2017

- Private Fund Advisers – “We will continue to examine private fund advisers, focusing on conflicts of interest and disclosure of conflicts as well as actions that appear to benefit the adviser at the expense of investors.”
- Expanding Never-Before Examined Adviser Initiative
- Cybersecurity
- FINRA
- Retirement Investments
- Market-Wide Risks

What Should You Be Doing?

- Document Ongoing Compliance Efforts
 - Testing
 - Compliance Matters and Corrective Actions
 - Determinations That Are Made
- Take Credit for the Positive Things You Do
- Robust Annual Review
- Training
- Start Preparing for an SEC Examination Now
- Stay Current on Regulatory Changes
 - PERT
- “If it isn’t documented, it didn’t happen”

PERT Principles – Key Themes

- Adviser is a fiduciary
 - Duty of transparency
 - Duty of good faith
 - Duty to put clients' interest above their own
- Ambiguities interpreted against advisor
- Disclosure, consistent with fund offering documents, marketing materials, website, regulatory filings, etc.
- Document, document, document
- “If it isn't documented, it didn't happen”
- LPAs are highly negotiated and private equity LPs are sophisticated investors

PERT Principles – Co-Investments

- Keep in mind adviser is a fiduciary
- Know obligation to each investor – i.e. side letters
- Have a written policy re: allocation
- Make investors aware of the co-investment policy
- Follow written procedures throughout the co-investment process
- Ensure investors have sufficient time to respond
- Unless offering documents expressly states otherwise, consider allocating broken deal expenses pro rata
- Document, document, document

PERT Principles – Valuations

- Importance of consistency with:
 - LPA
 - Marketing materials
 - Regulatory filings
- Performed on quarterly basis
- Changes in valuation methodology should be disclosed
- Adbacks should be consistent period to period
- Periodically re-evaluate the comp set
- Exercise caution during fundraising periods
 - Note 2013 [Oppenheimer](#) matter
- Takes no position on
 - Use of valuation software, tools, outside service providers
 - Source of precedent comps

PERT Principles – Cybersecurity

- Modeled after the [9/15 SEC Guidance](#)
 - Governance and risk assessment
 - Access rights and controls
 - Data loss prevention
 - Vendor management
 - Training
 - Incident response
- Consider state laws
 - [Massachusetts](#) and [New York](#)
 - Transmission of PII/Breach notification requirements
- Extra protections for “PII” and “Confidential Information”
- Focus on Firm-Specific Risk Profile
- Effective Program ≠ High Cost

Guide To PE Regulatory Compliance

- Online and Print Versions Available
 - Appendix (online)
 - Key SEC speeches, FAQs and SEC Guidance
- User-Friendly Format
 - Text boxes and key points
 - Broad range of topics (statutory and non-statutory)
- Quarterly Supplements
 - Updated information
 - New topics being added (AIFMD, ESG, ILPA Template)
- 24-hour technical support
- <http://www.thompson.com/public/offerpage.jsp?prod=XFUND>

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