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Monitoring Compliance at Private Equity Firms
– Issues for CCO's

July 2010

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Certain provisions of the Advisers Act apply to all investment advisers – registered or unregistered

Advisers Act Compliance – All Investment Advisers (Section 206)

Fiduciary Duties
Investment Adviser owes its clients a “duty of undivided loyalty” and “should not engage in any activity in conflict with the interest of any client”

Investment Opportunity Allocation
Must allocate securities and advisory recommendations fairly and equitably

Best Execution, Soft Dollars & Trade Errors

- Must seek best execution of client trades
- Exchange Act Section 28(e) safe harbor for soft dollars
- Must correct trade errors consistent with fiduciary duties

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Advisers Act Compliance – All Investment Advisers (Section 206)

Anti-Fraud Provisions

- Prohibit fraud against clients (including investors in pooled investment vehicles)
- Subject to Exchange Act Section 10(b) and Rule 10b-5, which prohibit insider trading and fraud in connection with purchase and sale of security

Principal Transactions
Section 206(3) prohibits principal or agency cross transactions in securities b/t adviser and its client, unless:

- Prior disclosure in writing
- Prior client consent

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Rule 206(4)-7 – “The Compliance Rule”

Registered Investment Advisers must establish an internal compliance program that addresses the advisers performance of its substantive and fiduciary obligations under the Advisers Act

Advisers Act Compliance - Registered Investment Advisers

Registered Investment Advisers must:

- Adopt and implement written policies and procedures “reasonably designed to prevent violations of the Advisers Act”
- Must review policies and procedures at least annually for their adequacy and the effectiveness of their implementation
- Must designate a chief compliance officer (“CCO”) to be responsible for administering policies and procedures

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Implement a compliance program reasonably designed to prevent violations of the Advisers Act and identify risks and conflicts that are relevant to the Adviser’s business

Key Compliance Program Elements

- Risk Assessment
- Policies & Procedures
- Training
- Monitoring & Testing
- Annual Review
- Management Reporting

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Advisers must analyze individual operations and identify conflicts and other compliance factors that create risks for the firm and then design policies and procedures that address those risks.

Key Policies & Procedures

SEC expects policies and procedures, at a minimum, to address the following issues to the extent that they are relevant to the business*:

Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients’ investment objectives, disclosures to clients, and applicable regulatory restrictions;

The *accuracy of disclosures* made to investors, clients, and regulators, including account statements and advertisements;

Proprietary trading and the personal trading activities of supervised persons;

Safeguarding of client assets from conversion or inappropriate use by personnel

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* Advisers Act Release No.2204 (Dec. 17, 2003)

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Policies & Procedures (con't)

The accurate creation of *required records* and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;

Safeguards for the *privacy protection* of client records and information;

Trading practices, including procedures to satisfy best execution obligation, use client brokerage to obtain research and other services (referred to as "soft dollar arrangements"), and allocate aggregated trades among clients;

Marketing advisory services, including the use of solicitors;

Processes to *value client holdings* and *assess fees* based on those valuations;

Business continuity plans;

Code of Ethics

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Annual Review (206(4)-7)

Compliance rule requires annual review of policies and procedures to determine adequacy and effectiveness of their implementation

Review should consider:

- Any compliance matters that arose during the previous year
- Any changes in business activities of the adviser or its affiliates
- Any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures

Although Rule requires annual review, consider interim reviews in response to:

- Significant compliance events
- Changes in business
- Regulatory developments

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Monitoring & Testing

Risk-based testing of compliance with policies and procedures to identify exceptions that need to be followed-up. Consider:

- Routine testing
- Forensic testing
- Monitoring
- Checklists

Investigate exceptions and outlier results

Report results to management

Take remedial actions to correct non-compliant practices

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SEC unanimously approved Pay To Play Rule 206(4)-5 for investment advisers prohibiting certain political contributions and banning third party placement agents.

Pay to Play

- Modeled after MSRB G37 and G38
- Covers investment advisers (unless exempt per 203(b))
- Covers investment advisory services provided:
 - directly to state or local govt entity (such as separate accounts, cash management accounts and certain discretionary brokerage accounts), or
 - to an investment pool in which such govt entity invests (including PE funds)

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Pay to Play – Highlights of New Rule

Special Transition
 Effective Date for advisers to covered investment pools is July 1, 2011

Ban on Making Political Contributions
 Prohibits advising or managing a state local govt entity's funds (or a covered investment pool) for compensation for 2-years if the investment adviser, its covered associate, or any PAC they control contributes to an official of that governmental entity. (Effective March 1, 2011)

Placement Agent Ban
 Prohibits investment adviser or covered associate from paying any person other than:

- Exec officer, gp, managing member (or similar function) or employee;
- Registered adviser that has not made a banned contribution
- Registered broker-dealers subject to FINRA's pay-to-play rule. (FINRA drafting)

(Effective September 1, 2011)

Record-Keeping

- Info about covered associates
- Govt entities clients/investors
- Info regarding contributions by investment adviser, covered associate or PAC
- Name and business of permissible third party payees

(Effective March 1, 2011)

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Anti-Money Laundering

Key Elements of AML Program

- Policies, procedures and internal controls
- Designation of an AML compliance officer
- Training
- Investor identification
- Recordkeeping

AML Risk for PE Funds

- Investor take on process
- Investor relations (e.g., transfers)
- Co-investor relationships
- Portfolio investments

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Rule 206(4)
 Unlawful for adviser to engage in any "act, practice, or course of business which is fraudulent, deceptive, or manipulative"

Marketing Materials and Publicity

Definition of "Advertisement" (Rule 206(4)-1(b))
"any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

Restrictions on Advertisements:

- Use of testimonials (Rule 206(4)-1(a)(1))
- Past specific recommendations (Rule 206(4)-1(a)(2))
- Use of graphs, charts, formulas (Rule 206(4)-1(a)(3))
- Reference to "Free service" (Rule 206(4)-1(a)(4))
- General prohibition on misleading ads (Rule 206(4)-1(a)(5))

Recordkeeping

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The Anti-Bribery provisions of the FCPA apply to:

- Any entity organized under United States law
- Any United States citizen
- Any person, including non-United States citizens, who acts for or on behalf of any of the above in many circumstances
- Any person "while in the United States" (broadly defined)

FCPA and Anti-Corruption

The Anti-Bribery Provisions (15 U.S.C. § 78dd-1 et seq.)

- Prohibit offering anything of value to a non-U.S. "government official" (including an employee of an SOE) in order to influence official action or obtain an improper advantage
- Prohibit offering anything of value to any person in circumstances where it is probable that some or all of the thing of value will be given to a government official

The Books and Records Provisions (15 U.S.C. § 78m(b)(2)(A))

- Require firm, including its consolidated subsidiaries, to maintain accurate books and records that describe transactions in reasonable detail

The Internal Controls Provisions (15 U.S.C. § 78m(b)(2)(B))

- Require firm, including entities it controls (whether or not consolidated), to create and maintain a system of internal controls sufficient to ensure that transactions are appropriately executed and recorded and that assets are appropriately accounted for
- With regard to entities that are not majority controlled, require firm to use its influence in good faith to adopt a system of internal controls for compliance with the FCPA

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What Are Satisfactory Anti-Bribery Controls?

Controls at:

- Investment Adviser
- Subsidiaries and Affiliates
- Portfolio Companies

- Written policies, and related procedures, against violations of the anti-corruption laws
- Anti-corruption training for directors and officers, and for employees (and business partners, as appropriate) who are likely to interact with government officials or SOEs
- A system of internal controls, sufficient to provide reasonable assurance that transactions are executed, and assets are disposed of, only in accordance with management's general or specific authorization
- A requirement that books and records, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the entity's assets
- Periodic audits to test the effective implementation of the entity's internal controls and anti-corruption policies
- As appropriate, annual certifications that the entity has complied with any anti-corruption representations and warranties or covenants in the transaction agreement

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Office of Compliance Inspections and Examinations (OCIE) conducts SEC's exam program for Registered Investment Advisers.

Identify emerging areas of compliance risk, detect fraud, conduct examinations and take steps to remedy identified problems.

SEC Compliance Examinations*

The Examination Process

- Review of Books & Records
- Interview management and employees
- Analyze entity's operations
- On-site visit

What to Expect

- Entrance Interviews
- Document Requests
- Questions
- Exit Interviews/Conference Calls
- Written result of Findings (From deficiency letters to referral to Enforcement)

*SEC speaks in 2010 conference materials – Examinations by the Securities and Exchange Commission Office of Compliance Inspections and Examinations – February 2010

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Staff determines scope of the examination based on risk

SEC Compliance Examinations

Select Areas of Focus for Investment Advisers

- Portfolio Management
- Brokerage Arrangement/Best Ex*
- Allocations
- Conflicts of Interest*
- Personal trading*
- Valuation
- Books & Records/Disclosures/Filings*
- Marketing*
- Custody/Safeguarding client assets*
- AML
- Compliance Program Deficiencies*

*Common matters referred to DOE in 2009

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