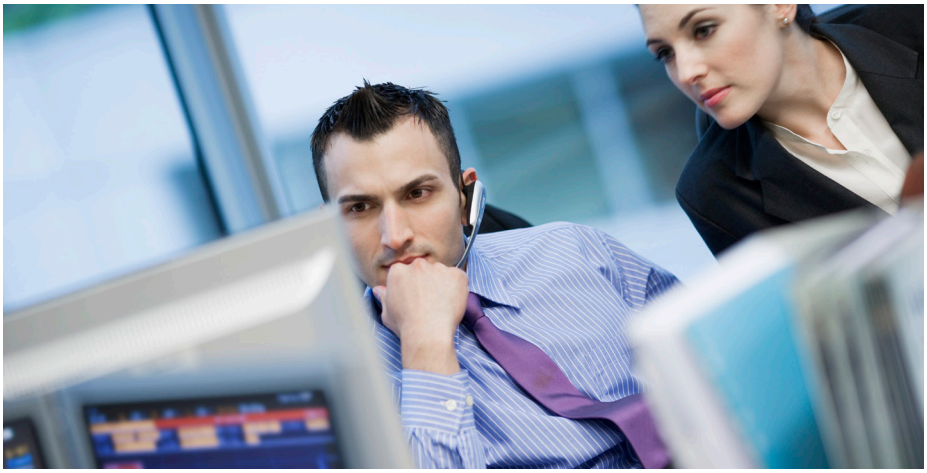
August 2011

Considerations for auditor independence before SEC registration of private fund advisers

by Doreen M. Michelotti

As history continues to repeat itself, the financial markets are still being faced with increased government regulation in response to the global financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) continues to have an impact on virtually every financial institution and commercial company that operates in the US, and many that operate beyond US borders. Many more private entities are now subject to regulation, as a portion of the Act eliminates the private adviser exemption previously allowed under the Investment Advisers Act. Thus, a significant number of previously non-regulated investment advisers are required to register with the US Securities and Exchange Commission (SEC) or the states in which they do business. Originally, the SEC's registration deadline for private fund advisers was to coincide with the effective date of the investment adviser provisions of the Act, which was 21 July 2011 — the one-year anniversary of the enactment of the Act. However, during its recent 22 June 2011 open meeting, the SEC extended the registration deadline for private fund advisers to 30 March 2012, in an effort to provide more time for applicants to develop appropriate compliance systems and ensure compliance with the appropriate SEC requirements. Thus, many previously non-registered private investment firms have registered with the SEC or are now in the midst of preparing for registration.



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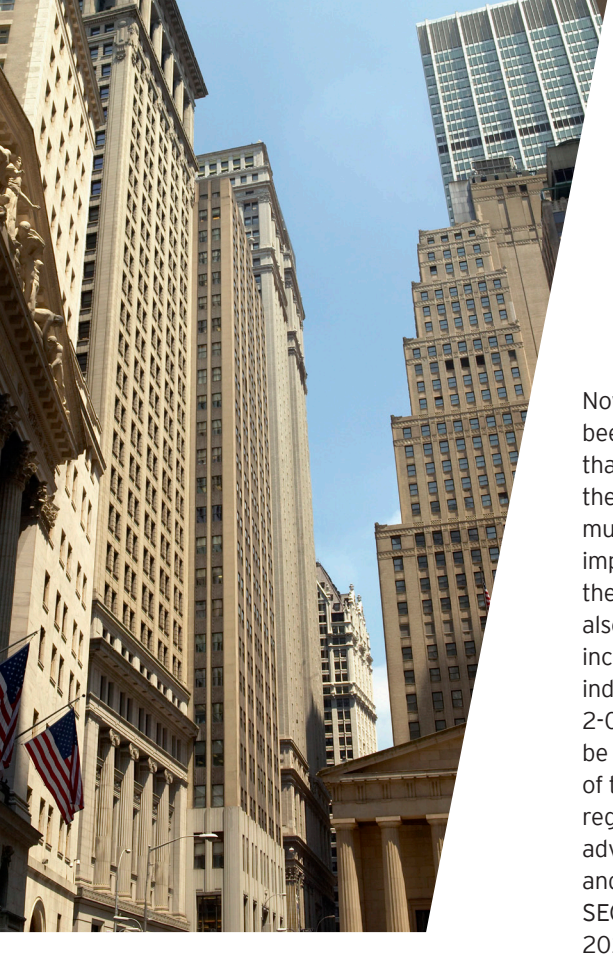

Any audit or examination report that is used to satisfy an SEC requirement will oblige the auditor to be independent under the SEC independence rules.

Now that the registration deadline has been extended until 30 March 2012, firms that have not yet fully considered all of the ramifications of their registration must focus not only on the operational implications, such as the development of the required compliance programs, but also on certain regulatory implications, including the fact that the SEC's auditor independence rules (Regulation S-X, Rule 2-01, SEC Independence Rules) will have to be retroactively applied to the beginning of the audit client's fiscal year in which the registration takes place. This means that an adviser with a 31 December fiscal year-end and its auditors must be in compliance with SEC independence rules as of 1 January 2012 — even if the adviser does not register with the SEC until the end of Q1 of 2012.

In addition, the auditors of funds advised by a newly registered investment adviser (RIA) are also required to comply with the SEC independence rules if that adviser uses the audit provision as a means of satisfying Rule 206(4)-2 of the Investment Adviser's Act of 1940 (the custody rule).

How the SEC auditor independence rules are triggered

In accordance with the Act, advisers to private funds with more than US$150 million in assets under management (AUM) are required to register with the SEC by 30 March 2012, unless they qualify for one or more of the limited specific exemptions. As new RIAs, many of these private fund advisers will have to comply with the custody rule. Effective 12 March 2010, the custody rule requires RIAs having custody of client funds or securities to:

- Maintain client assets with a qualified custodian and undergo an annual surprise examination to verify client assets in custody
- Have the qualified custodian send account statements directly to the advisory clients (i.e., investors in the funds)
- Obtain a report on internal controls relating to the custody of those assets unless client assets are maintained by an independent custodian

The custody rule also indicates that an RIA that advises a fund may elect to engage an independent public accountant to perform an annual audit of the financial statements of the fund in lieu of undergoing an annual surprise examination and having a qualified custodian send quarterly account statements to fund investors. This is referred to as the "audit provision." Many RIAs utilize the audit provision since the funds' partnership agreements often already require an annual audit of the fund.

When an independent public accountant is engaged to render a financial statement audit report, an annual surprise examination report or an internal control report to comply with the custody rule, SEC independence is required. In addition, the accountant issuing these reports must be registered with the Public Company Accounting Oversight Board (PCAOB) and be subject to regular inspection by that board.

Why the need for compliance before registration

Any audit or examination report that is used to satisfy the custody rule will oblige the auditor to be independent under the SEC independence rules, as provided within Rule 2-01 of Regulation S-X. These rules indicate that an auditor must be independent during the "audit and professional engagement periods." Thus, even if an adviser were to register on 30 March 2012, the audit period will commence on 1 January 2012, assuming a 31 December fiscal year-end. This is an important aspect of the SEC independence rules for advisers. Many advisers may not know that certain SEC rules require compliance prior to their actual SEC registration date. Both the accountant

and the RIA are mutually responsible for ensuring that SEC independence is maintained.

Entities requiring SEC independence

It is imperative to understand that SEC independence rules apply not only to the entity for which the accountant is auditing or performing an examination, but also to each of the audit client's affiliates, as defined by the SEC. In general, SEC independence must be maintained for the following entities if the RIA is using the audit provision to comply with the custody rule:

- The audited fund (the fund)
- The general partner (GP) or sponsor of the fund
- The RIA of the fund
- All entities that control the RIA of the fund
- All entities that control the GP of the fund
- 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

Clearly, there is a wide spectrum of entities that may require compliance with the SEC independence rules.

Specific rules requiring compliance prior to registration

Several sections of the SEC independence rule require compliance throughout the entire audit and professional engagement periods, which may commence before the actual date of the adviser's SEC registration.

Employment relationships

Among the SEC prohibitions on employment relationships, a former partner or professional employee of the accounting firm may not serve in an accounting role or financial reporting oversight role for the audit client. If he or she serves in such a capacity, the accounting firm may not be able to continue serving as the independent public accountant under the SEC independence rules unless the individual meets the following criteria:

- Does not influence the accounting firm's operations or financial policies
- Has no capital balances in the accounting firm
- Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits or earnings of the accounting firm)[1]

Business relationships

The accounting firm and certain partners and professional employees are prohibited from having certain direct or material indirect business relationships with the audit client, its officers, directors or substantial stockholders. The accountant will not be independent under the SEC rules if prohibited business relationships exist at any point during the audit or professional engagement periods. It is important for the management of the RIA to inventory and evaluate the nature of any relationship between such parties in advance of the audit and professional engagement periods or the date on which the auditor is engaged to perform an audit or attest services requiring SEC independence, whichever is earlier, so that prohibited relationships can be disbanded appropriately.

Non-audit services

There are certain services that an accounting firm may have been able to provide to a non-RIA under the independence standards of the American Institute of Certified Public Accountants (AICPA) that would be prohibited under the SEC independence rules. The management of an investment adviser that is now required to register with the SEC must be sure it fully understands the nature of any non-audit service the accounting firm may be providing to the audited entity or its affiliates. Prohibited services have to cease before the beginning of the audit and professional engagement periods, which may begin before the date that SEC registration occurs. While all of the services listed below are prohibited from being performed for the audit client, certain services may be allowable at certain affiliates when the results of those services will not be subject to audit.

- Bookkeeping (including financial statement preparation services)
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions and contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions, including acting in the capacity of an employee (including "loaned staffing" arrangements)
- Human resource functions (such as negotiating employment contracts or recommending a specific candidate for a specific job)
- Broker-dealer, investment banking and investment advisory services
- Legal services

1 Regulation S-X 210.2-01(c)(2)(iii)(A)

Expert services unrelated to the audit

Management should take an inventory of all non-audit services provided to the audit client, including each affiliate of the audited entity, by its accounting firm and evaluate these services for compliance with SEC rules.

Prohibited fee arrangements

Providing any service to the audit client or its affiliates on a contingent fee basis is strictly prohibited under the SEC independence rules. The accountant may be able to continue the service without impairing its independence if the fee arrangement is renegotiated before the audit and professional engagement periods commence.

What should an investment adviser do?

If you are an investment adviser that has registered or will soon be registering as an RIA, we suggest that you complete the following steps as soon as possible in order to avoid any surprises when you are planning to issue your audited financial statements to your limited partners:

- Confirm your auditor is registered with the PCAOB and is subject to its regular inspection.
- Determine the entities deemed to be affiliates of each audited entity in accordance with the SEC's definition of audit client and affiliate found in Regulation S-X, Rule 2-01(f).
- Determine if any current employee of the audited entity or its affiliates was previously a partner or a professional employee of your audit firm. If such individuals are identified, you should confirm their current relationship with the accounting firm.
- Inventory all business relationships the audited entity or its affiliates have with your audit firm and its affiliates. Determine whether the relationships qualify as "consumer in the ordinary course" relationships.
- Survey all officers, directors and substantial shareholders that have decision-making ability as to the nature of any business relationship they may personally have with your auditor. Determine whether the relationships qualify as "consumer in the ordinary course" relationships.
- Inventory all non-audit services that your auditor may currently be providing or has been engaged to provide for the audited entity or its affiliates. Determine whether any contingent fee arrangements exist. Also determine whether any prohibited non-audit services have been provided during the audit and professional engagement period.

As you evaluate matters that may be identified as a result of performing the procedures above, your evaluations should be shared with your auditing firm. Since the SEC independence rules are often subject to interpretation, you may need to consult with your legal counsel. Your accounting firm and legal counsel may recommend that matters be brought to the SEC staff in certain situations, to reach a proper conclusion on the appropriateness of a service or relationship. Effective communication between management and the accounting firm is important in concluding these evaluations.

There will likely be many operational, reporting and record-keeping enhancements that will have to be made in anticipation of your pending SEC registration. You can prevent the potential need to engage a new accounting firm to be the auditor of your private fund if you take the time now to assess the implications of the SEC auditor independence rules, take any necessary action and rectify any potential violations before the commencement of the audit period.

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EYG No. CK0457
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