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The scale and impact of operational compliance requirements on private equity firms

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This chapter:

- Looks at the evolution of regulation imposed on the private equity industry since the 2007-08 financial crisis and the current scale of operational compliance requirements.
- Considers how operational complexity is affecting the infrastructure of private equity firms.
- Explains how investors are measuring operational excellence.
- Discusses how the approach to achieving operational excellence varies depending on the size and type of a private equity firm.

In the late 1990s, when I started advising on structuring private equity funds, the internal functions of management companies seemed more straightforward than they are today. Perhaps this was because I was still a novice and blissfully unaware of how little I knew. Looking back at that time, however, it is clear that while certain tax fiduciary and other legal requirements (including laws like ERISA in the United States) had an impact on the operations of private equity firms, politicians and regulators generally did not trouble themselves too much with the internal running of such businesses. True, the UK did require private equity firms to be regulated (since 1988, the Investment Management Regulatory Organisation (IMRO), one of the organisations that was a pre-cursor to the Financial Conduct Authority (FCA), has required the regulation of businesses engaged in discretionary investment management), but it was a relatively light-touch self-regulatory approach. The UK was also a bit of an anomaly at this time because in other jurisdictions the need to become regulated and authorised to run a private equity firm was still a long way off.

Over the last 25 years, the private equity industry has evolved and matured in the face of changing circumstances. There have been significant increases in the regulatory, tax and legal requirements, and obligations imposed on private equity firms. This has in turn affected how these businesses operate. Further, private equity does not function in a vacuum: as well as the laws politicians impose to deal with the (real or imagined) systemic risks the industry might create, external investors, from whom capital is raised, themselves have requirements and concerns that need to be addressed. Increasingly, as part of the GP-LP relationship, investors are seeking to assess and measure the adequacy of private equity firms' operations during a fundraising process and on an ongoing basis.

Scale of operational compliance requirements

In response to the global financial crisis of 2007-08, regulators around the world looked afresh at the systems in place to govern and monitor the financial markets. Much of the regulation now impacting private equity (see Figure 1.1) is directly attributable to this response. Here are two examples:

1. ***Dodd-Frank Act, United States.*** This legislation included the Private Fund Investment Advisers Registration Act 2010, which imposed a federal registration system on US-based private equity firms (in most cases, for the first time). As SEC- registered investment advisers, private equity firms are required to make filings with the SEC, are subject to examination by the SEC, must disclose specific information to clients and investors, and are required to have a compliance programme in place. If a non-US private equity firm has operations in the US, or raises sufficient capital from US investors, the regime also requires that foreign firm to register for an exemption. These requirements have operational implications such as having systems in place for effective record-keeping and reporting, appointing a chief compliance officer, regular monitoring and reviewing of the compliance policies and possibly upgrading technology to assist with these requirements.

2. ***Alternative Investment Fund Managers Directive (AIFMD).*** This EU directive came fully into force in 2013 and imposes additional regulation on alternative investment fund managers (AlFMs), including private equity firms, across the member states of the European Economic Area (EEA). The AIFMD includes detailed rules on:

- operational matters (in respect of, for example, conduct of business, managing conflicts of interest, risk management and liquidity management),
- the internal organisation of the firm,
- the marketing of new funds, and
- reporting to the regulator (referred to as Annex 4 Reporting) and to investors. Non-EU fund managers that wish to market their funds into the EEA must also comply with a set of 'third country' provisions, which require notification to individual regulators in the EEA member states where marketing is carried out and ongoing reporting and disclosure obligations. Further, some private equity firms are required to comply with the Markets in Financial Instruments Directive (MiFID). This EU directive regulates firms that provide services to clients linked to financial instruments (including shares, interests in collective investment schemes and derivatives). From 3 January 2018, new legislation known as MiFID II will take effect to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection.

Dodd-Frank and the AIFMD are the most notable for imposing regulation on private equity firms that impact operational matters, but they are by no means unique. Most jurisdictions have tightened their rules on how private equity firms are required to function. Offshore jurisdictions are also not immune from this trend. In order to demonstrate equivalency with onshore jurisdictions, and to ensure they remain on the various white lists for transparency and tax exchange information, major offshore centres have worked hard to improve regulatory supervision and to strengthen ant: money laundering and 'know-your-client' (KYC) requirements.

The other legislative factor that has increased operational compliance requirements on private equity firms is related to taxation. In 2010, the United States introduced the Foreign Account Tax Compliance Act (FATCA), which aimed to reduce tax evasion by US taxpayers holding funds in foreign accounts. The consequence is that private equity firms must:

- obtain information on the identity of US taxpayers to whom payments are made, or
- withhold a tax of 30 percent on every payment made to a non-compliant account holder.

The US has entered into several intergovernmental agreements to implement FATCA worldwide, but a more global response to the crackdown on lax evasion is the Common Reporting Standard (CRS). Introduced in 2014 by the OECD, CRS requires jurisdictions to obtain information from financial institutions and automatically exchange that information on an annual basis. Roth FATCA and CRS impose compliance and reporting obligations on private equity firms on an ongoing basis.

The OECD is also increasingly troubled by the strategies employed by multinational companies to exploit gaps and mismatches in tax rules to artificially shift profits to low or non-tax jurisdictions. This type of sophisticated corporate tax planning is often referred to as base erosion profit shifting (BEPS) and OECD countries have been collaborating and implementing a number of 'BEPS Actions' to combat the practice. Although the BEPS initiative appears to be mainly targeting companies that have benefited from globalisation, a number of the BEPS Actions have an impact on private equity. For example, tax authorities are now scrutinising the amount of organisational and economic activity (or 'substance', to use the current buzzword) in different jurisdictions and are requiring the level of taxable profits to be in line with the amount of substance in a particular jurisdiction. To the extent a private equity fund is operating in a number of different jurisdictions (or using investment structures in different jurisdictions to make use of double tax treaties), it is now important for that private equity firm to consider substance requirements in those jurisdictions to ensure tax planning and structuring is robust for itself and for investors in the relevant fund.

In addition to legislative and regulatory changes, some of the increases in operational complexity are in response to internal drivers. The private equity industry has matured, and some firms have grown and become more global in outlook As firms develop a presence in different locations, it introduces another layer of operational complexity. Further, as investors have looked to concentrate on fewer relationships, private equity firms have responded by diversifying their platforms with different teams focusing on different strategies (for example buyouts, growth and private debt) and by accommodating segregated accounts for individual investors.

How operational complexity is affecting the GP infrastructure

A private equity business traditionally operates through a fund vehicle into which third-party investors contribute capital. The limited partnership (or equivalent in civil law jurisdictions) is by far the most common fund vehicle used and allows a distinction to be drawn between the limited partners (the passive third-party investors) and the general partner (GP).

A GP is responsible for the management and operation of the limited partnership, but typically also has unlimited liability for the liabilities of the fund over and above the partnership assets. This potential unlimited liability is the reason that many private equity funds are structured so that the GP can either delegate all management activity to a separate investment manager or appoint an investment adviser. The substantive business of the private equity firm is contained within this investment manager/adviser, with an executive board to run the business and an investment committee to make decisions or recommendations on investment activity. A further option, which may be relevant, is to domicile the fund, the GP and (potentially) the entity acting as investment manager/adviser offshore to make use of attractive structuring options that may be available in such jurisdictions.

Clearly, this is an overly simplistic description of the vast majority of private equity businesses, but it is a useful base-case for demonstrating how the organisation of a private equity firm is being affected by the increasing scale and complexity of operational compliance requirements.

Discussed below are six illustrations of this trend:

1. ***Control of risk.*** This is a key theme arising from the global financial crisis. Driven by compliance policies and procedures imposed by global regulators, there is now more focus on this topic. In some cases,

regulators require additional disclosure to investors of potential risks, but a more overt impact on the operations of a private equity firm flows from the AIFMD. As a direct consequence of the AIFMD, fully authorised AlFMs in the EU must now have a permanent risk management function that is functionally and hierarchically separate from the portfolio management function, and an adequate risk management system that is reviewed at least annually.

2. ***Management and resolution of conflicts of interest.*** Although not a new issue, it is increasingly important. As private equity firms have diversified, investors want more robust arrangements in place for dealing with conflicts of interest between different strategies, and regulators want clearly defined policies to be put in place and followed. Consequently, a private equity firm is likely to have different personnel or committees to monitor conflicts. It is also common for greater powers to be given to the limited partner advisory committee (LPAC) to review and approve potential and actual conflicts of interest.

3. ***Substance.*** It is more challenging for a fund to benefit from a tax or regulatory advantage by establishing itself in a different jurisdiction from where the key private equity executives are based. For any new fund or product line, private equity firms must consider substance requirements, tax compliance and investor sentiment of being required to participate through a particular jurisdiction. Increasing the 'boots on the ground' and ensuring those people can demonstrate significant influence over decision-making are important factors. Clearly, this affects offshore jurisdictions, but it will also influence a decision to establish a fund in, for example, places like Luxembourg or Ireland when the private equity firm itself is predominantly based elsewhere.

4. ***Multiple regulated entities.*** When operating in different regions, or running an alternative strategy or accessing a different group of investors, it is likely that a private equity firm will need to contend with multiple regulated entities, potentially in different jurisdictions. This may help with some of the issues referred to above (managing risks and conflicts, and substance issues) but it places significant burdens and costs on the business, and can result in barriers to entry for new firms.

5. ***Establishing different vehicles or setting up particular structures to accommodate specific strategies or investor requirements.*** As private equity firms have diversified and investors have become more sophisticated, funds are being established with dedicated sleeves' for particular strategies. For example, segregated accounts/funds-of-one are being used for individual investors and dedicated vehicles are being set up for investor co-investment requirements. With more vehicles to operate, there is a greater need for operational controls and back office staff to deal with the different reporting and monitoring obligations.

6. ***Outsourcing.*** Additional complexity tor some provides opportunities for others. To deal with the scale of operational compliance, it is increasingly common for private equity firms to utilise outsourcing solutions [(see chapter 9)] and a range of different service providers are now available. For example: fund administrators may be responsible for cash movements, investor reporting and FATCA compliance; compliance consultants can check that all regulatory obligations are dealt with- the AIFMD obliges funds to appoint a depositary to safeguard the assets of a fund; some private equity firms may make use of a regulatory hosting platform; and firms can obtain advice from accounting, tax and legal specialists to guide them through the complexities of running both their business and the fund. While these providers alleviate some of the burden, a private equity firm still needs operational sophistication to monitor and supervise the services being provided.

How investors measure operational excellence

With the increasing scale of the legal, tax and regulatory issues affecting how a private measure equity firm functions, it is no surprise that investors want to assess how effective the operational firm is at complying with these requirements.

Some investors see a strong positive correlation between a private equity firm's ability to excel in operational compliance and its investment performance. Checking how a fund is operated can also protect downside risks:

it is an extreme example, but how many investors would have committed to Bernie Madoff's funds if they had paid more attention to the fact that the auditors were a firm with only one active accountant based in a small hamlet in the Rockland County suburbs north of New York?

Connected to this, many institutional investors are themselves fiduciaries responsible for the money of others (whether it be pension fund trustees, fund of funds managers or family offices), so there is potentially professional and reputational damage if they fail to carry out sufficient checks on a private equity firm. Using background checks to reinforce initial impressions is a tried and tested way of completing due diligence. An investor client recently described an occasion when, before committing to a private equity fund, they carried out a range of background checks and uncovered multiple tickets over a long period of time for minor traffic violations by one or the principals. This chimed with the front office view of a possible disregard for due process. As a result, the investment did not go ahead. This proved to be a good call when a couple of years later the performance of the private equity firm was impaired by more serious misdemeanours by that principal.

The methods used by investors to measure operational excellence vary depending on the statutory and contractual obligations imposed on the investor as well as its experience sophistication and level of resource. Below is a discussion of four common approaches:

1. At a basic level, there is the *relationship between GPs and LPs*. This relationship permits investors to meet with, talk to and form opinions on the private equity firm. This process starts when the investor is first considering making a commitment to a particular fund and continues through ongoing monitoring of an investment and, potentially, into making a new commitment to a new fund being raised by that firm. Part of this relationship involves the investor making assessments on the attitude and aptitude of the GP for regulatory and governance matters. Through the lifecycle of a fund the investor will see the quality and accuracy of the reporting, will make site visits to see the GP and will have evidence of how the GP adjusts to changing circumstances. This process allows the LP to form a subjective view on the operational excellence of the firm.

2. Talk to any GP about the fundraising process and they will remark on the amount of time it now takes to respond to *investor due diligence questionnaires* and the increasing number of *side letter requests* that all LPs now seem to make. Both trends are evidence of investors' use of objective criteria to assess private equity firms. With standard questions it is easier to compare and contrast different firms. Requesting and reviewing policies on matters like valuation, ESG, conflicts of interest, remuneration, anti-corruption compliance and succession planning allows the investor to benchmark against best practice. Imposing ongoing obligations through side letters for standardised reporting or disclosure of information also allows comparative analysis and monitoring throughout the life of the fund. Further, the ability to persuade a private equity firm to change its approach is easier at the time of fundraising than during the investment period.

3. There is always a danger that an assessment becomes a tick-box exercise. To counter this, a number of sophisticated investors use *specialist operational due diligence teams* (either internal or external consultants) to improve their understanding of a private equity firm. Inevitably, this team works to a bespoke checklist, but the extra resource and experience gives investors the ability to go into a lot of detail and discuss findings at length with a private equity firm. When this is coordinated with the view on investment performance, it results in a more holistic approach to assessing a private equity business.

4. Some investors use *co-investment rights* to understand how a private equity firm operates in practice and executes transactions. While it may be a little easier for GPs to keep investors at arm's length during a fundraising process, when an investor co-invests alongside the fund, it is possible to see first-hand how a firm assesses underlying businesses, and negotiates and operates under the stress of completing a deal.

A one-size-fits-all approach to operational excellence?

Is there a clearly defined gold standard of operational excellence that all firms can work towards? Arguably, this has been a target for legislators/regulators around the world and for investors. Globalisation has facilitated co-ordinated approaches by tax authorities on tax avoidance (for example, FATCA, CRS and BEPS). Regional regulation, such as the AIFMD, has created the harmonisation of compliance requirements for private equity firms operating in the EU. Further since 2009 the Institutional Limited Partners Association (ILPA) has developed both standard principles for private equity investing and common templates for operational matters such as capital calls, distribution notices, periodic reporting and disclosure of fees charged to underlying portfolio companies.

Yet, because the size and scale of private equity firms varies significantly across the industry, it is difficult to take a one-size-fits-all approach to operational excellence. A first-time fund manager raising a UK lower mid-market private equity fund clearly has different operational requirements to a global business such as Carlyle KKR or CVC. Compliance requirements in one country (or region) have different outcomes to what is needed for a private equity firm in another country. A fund focused on businesses that have supply chains in developing countries clearly requires a better understanding of certain E5G policies than a Silicon Valley-based technology fund.

The need for a varied approach is acknowledged in industry guidelines. For example, the introduction to the ILPA Private Equity Principles states: "Each partnership should be considered separately and holistically. We recognise that a single set of terms cannot provide for the broad flexibility of market circumstance".

When investors assess the operational performance of a private equity firm, there must be an appreciation of what is relevant and appropriate for a firm of that size. An assessment cannot pass/fail based on a pre-ordained and fixed set of criteria. Nevertheless, the increased complexities involved in running a private equity firm mean it is a challenge for smaller firms and./or new businesses to demonstrate operational excellence. The box on page 8 recommends four ways that smaller firms can address this.

How to minimise operational complexity and demonstrate excellence: guidance for small GPs

- Keep the structure of your fund simple by avoiding multiple vehicles and jurisdictions, so the focus is on investment performance rather than operational complexity.
- Avoid diversifying into different strategies and asset classes until your firm has the scale to run each of the businesses without diluting operational performance.
- Appoint trusted advisers with sufficient expertise in this area to guide your firm through the legal and regulatory requirements.
- Outsource to quality service providers.

Key takeaway

Every GP can show its operational functions are performing to a high level if it can grasp the complexities now inherent with running a private equity business and understand that a private equity firm is a fiduciary that owes duties to its investors.

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Figure 1.1: Evolution of compliance obligations on private funds, 2000 to 2018