PRIVATE EQUITY INTERNATIONAL

PEI Alternative Insight


# Spotlight: Coping with Compliance in 2019

Compiled by the PEI Private Fund Compliance Forum

Defining the evolution of the private equity CCO

**CVC COMPLIANCE SUCCESSES**
Keeping a $70bn company in check

**COMPLIANCE GRAY AREAS**
Limitations on compliance chiefs' liability

**SEC DECLARES 2019 EXAM PRIORITIES**
An emphasis on cyber-risk management and anti-money laundering

# SEC declares 2019 exam priorities

## The regulator will focus on cyber-risk management and anti-money laundering as it checks up on firms. By Brian Bonilla

Private equity firms should pay attention to their protocols on cyber-risk management and anti-money laundering programs, which have become part of the Securities and Exchange Commission's examination priorities for this year.

The agency's Office of Compliance Inspections and Examinations said in its 2019 Examinations Priorities report that it will be looking into what policies and procedures firms have in place when it comes to cyber-risk management and incident response. It will specifically look into how staff are trained related to cyber-risk management and establish whether firms are taking the proper steps to prevent the loss of data from cyber-attacks.

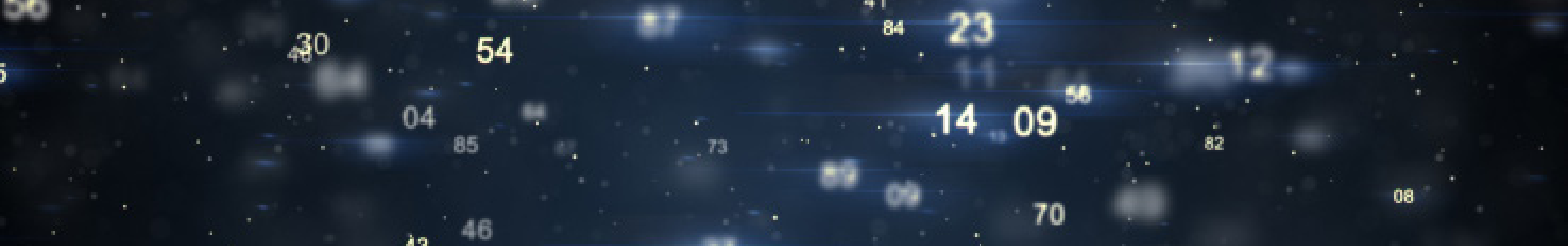
Cybersecurity was first listed as a major examination category for OCIE in 2015, and focus on the issue has recently started to increase. In 2017 OCIE sent out a risk alert highlighting its findings from examinations relating to cybersecurity. In October last year cybersecurity was a major topic at Private Equity International's Private Fund Finance & Compliance Forum 2018 in San Francisco.

"The minute you have a breach, then [the SEC] will come down on you. That's why it's so critical to be prepared on the cyber side," an advisor said at the conference.

OCIE will also be making sure companies have the right policies in place to monitor suspicious activity and prevent money laundering activities. OCIE encourages filing suspicious activity reports with the Financial Crimes Enforcement Network when necessary. The report only mentions broker-dealers, but private equity firms can also be affected by money laundering and therefore should prepare for OCIE to test them on this matter as well.

"Although OCIE emphasized compliance with anti-money laundering requirements applicable to broker-dealers, private fund managers should ensure that all elements of their AML policies and procedures have been implemented and that compliance with those procedures is tested as part of the manager's annual compliance review," law firm Kleinberg Kaplan said in a note.

OCIE said it completed more than 3,150 examinations in fiscal 2018, which was up 10 percent from the year earlier. It did not break down how many of those involved private funds, but it did disclose that examinations of investment companies rose by about 45 percent last year.



# CCOs need to fill in compliance gray areas with paperwork

## An SEC ruling on email monitoring has done little to clarify the limits of compliance chiefs' liability. By Dominic Diongson

OK, so you manage your own inbox. But are you monitoring everyone else's?

In late October, the Securities and Exchange Commission upheld a Financial Industry Regulation Authority ruling against Thaddeus North – who was chief compliance officer of Southridge Investment Group, a Connecticut-based hedge fund, in 2010 – for failure to "reasonably review" e-mail correspondence, and for failure to report an employee's relationship with a disqualified FINRA member.

While most of the memo dealt with broker-dealers (subject to different regulatory requirements and FINRA disciplinary action), it is applicable to all CCOs of private funds.

At the heart of the ruling is the fundamental question of when CCOs are liable for compliance failings of their colleagues. It leaves plenty of grey area.

In one specific passage the SEC lays out situations where it is likely to charge a CCO, such as with improper conduct or engaging in a cover-up, and where it isn't, such as when CCOs act in good faith or engage in reasonable inquiry and analysis.

Still, "that's not really where the struggle is. It's in the gray area, in between," says Sam Waldon, a partner in the litigation department at law firm Proskauer. Waldon served for eight years as assistant chief counsel in the SEC's Division of Enforcement, where he helped develop and implement many of the unit's policies and procedures.

"And the way I read this opinion in the gray area, they pretty much punt; and what they say is, 'When the facts and circumstances of matters fall outside these relatively clear examples of where liability should or should not attach, liability determinations will require matter-specific analysis and informed judgment.'"

He offered an example of an investment advisor to the fund having been found to engage in an undisclosed conflict of interest. That could result in a compliance rule violation by the advisor, and the SEC would then be able to charge the CCO for causing that violation based on negligent conduct.

"Is it right to do it purely based on negligence, or should it be some higher standard?" Waldon asks. "What we've gotten from the North opinion is 'maybe.' They really haven't answered it. The SEC leaves open the possibility that they could bring a case based on purely negligent conduct. But they also don't say that that is necessarily the standard. Basically, what they're saying is they're going to look at the facts and use their judgment and decide whether or not it's appropriate to bring an action."

In other words, the SEC is basically saying, "we'll know it when we see it," which may not be hugely comforting to CCOs.

The answer, as often, is documentation. Says Waldon: "If I am a CCO, and I'm confronting a problem, I'm going to clearly document everything I do: and not just what I do but why I do it. Because at the end of the day, you could have someone come in and essentially second-guess what you've done and why you've done it."

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# 9 things we learned at the CFOs & COOs Forum

**From cybersecurity woes to valuation challenges to benchmark selection, the team rounds up the top talking points from our 16th annual forum.**

By Isobel Markham

It was a whirlwind two days at *Private Equity International's* CFOs & COOs Forum 2019 in New York, where more than 600 delegates gathered to hash out the topics that matter most to the private equity back office. Here are some of the major themes.

## 1. CFOs are on the front line of the war for talent

Private equity is a people business, as the adage goes. No one seems more acutely aware of this than the CFO or COO. Sixty percent of CFOs surveyed by EY considered talent management to be a top strategic priority. What seems on the surface like a "softer" element of running an investment manager ("we had a ping-pong table for a couple of months", said one exasperated CFO) is anything but. More than three-quarters (78 percent) of the CFOs said investors are requesting information about their firm's talent management programme.

Some of the Forum's top talking points fell under this umbrella; how do I create a culture that allows me to compete for talent with tech firms? And how do we foster more gender and cultural diversity?

## 2. Tech is both an opportunity and a cost

Technology in all its forms was a major area of discussion throughout the Forum. We overheard CFOs swapping notes on the best software programmes and data tools, and asking questions about the best ways to harness their own data to grow and improve their firms.

For many CFOs at smaller firms, technology is presenting a cost, with potential savings proving thus far elusive: "It is not just the upfront cost – both of money and time, because you have to run the new and old systems in parallel for a while – people are mostly seeing [an] increase in technology costs and we are not yet seeing the benefit," said one CFO.

There are technology challenges on the regulatory front too. We spoke to a couple of CFOs about the tricky area of instant messaging. One spoke of the need to make employees aware that text messages could be subject to review in the same way as emails, and has asked their staff not to send any business-related information in instant messages.

## 3. Relationships with third-parties are more important than ever

Outsourcing was naturally a major topic of discussion throughout the Forum. According to EY's survey of 103 CFOs, tax is the area most consistently outsourced, with 94 percent outsourcing at least some of this task, and 46 percent choosing to primarily outsource it. The least popular area to outsource is portfolio analysis; just 18 percent of respondents outsource any part of this task.

It should perhaps go without saying, but CFOs are looking for third-party partners who will take ownership of the tasks given even though they are not themselves part of the firm. One CFO also mentioned a need to feel comfortable putting their chosen provider in front of LPs. A word of caution from another CFO: you can outsource the function, but you can't outsource risk. At the end of the day, the responsibility still falls on you.

## 4. The secondaries market is making valuations matter more

Get 600 private equity CFOs together and the conversation will at some point turn to valuations. There is no standard way of doing it – firms still blend a number of different methodologies to get to what they think is a sensible mark, sometimes using different methods from one company to another in the same portfolio (if the different nature of the businesses demands it).

One of the key learnings from this year's forum is that third-party advisors are infrequently used to do the "heavy lifting". An audience poll in a break-out session on this topic showed that 82 percent of the CFOs in the room do not ask independent specialists to carry out the valuations. As one CFO put it, no one knows their portfolio better than them. Another learning is that the rise of the secondaries market and the improved liquidity it brings has made interim valuations much more important; LPs want to know what they could potentially get for their fund stakes.

## 5. Cybersecurity is a major headache

Cybersecurity is coming through as one of the biggest headaches for a CFO; one estimated this area to be the third biggest cost their firm faces after rent and salaries.

Cybersecurity is a top area of concern for the Securities and Exchange Commission; it's on the list of 2019 priorities for the agency for the third year in a row. CFOs are in a unique position to weed out cybersecurity issues within a firm, one CFO panelist said, as they can "see how sensitive data moves between the firm internally, limited partner investors, external regulatory bodies and third-party investors".

"[CFOs] have a unique view to find out where the chinks in the armour could be."

## 6. Some firms are pumping up their TVPI

One LP delegate shared that a few firms are starting to boost their total-value-to-paid-in on deals by offsetting early realizations against the original contributed capital, rather than treating them as distributions. In other words: a GP makes a $100 million investment in a company and an early recap returns $25 million. Instead of the $25 million counting as a distribution, it is offset against the original investment, meaning the original contributed capital is marked as $75 million. "We've seen a 2x deal become a 10x deal," said the same LP, who was not impressed.

## 7. PME is becoming a more popular benchmark

Investors are increasingly relying on public market equivalents – rather than comparison of vintage year IRRs – to assess fund manager performance. Around 25 percent of investors are now using a public market equivalent as their policy private equity benchmark, said one executive with a view over a broad universe of LP private equity programs.

Significant variations in the way performance is calculated means that comparing one fund's IRR with its vintage year peer group becomes problematic. Even if an LP is comfortable with the methodology behind the performance data for one fund, they may not be able to get comfortable that this is the same for the universe they are benchmarking against. They may even be using different definitions of vintage years.

LPs are increasingly asking for underlying granular cashflow data in order to calculate their own performance numbers, the executive noted.

## 8. Diversity is moving up the agenda

Private equity firms are starting to take action in response to a long-term problem: a lack of women in senior positions. According to a poll of about 60 CFOs and other members of the PE industry at the Forum, 52 percent are taking steps to increase diversity and a further 34 percent are thinking about it. One CFO panelist hired a consultant to "help disrupt unconscious bias around searches, compensation, performance reviews and other areas", while another's firm has set up a mentoring programme.

## 9. Launching a new strategy can be a back-office headache

It may seem a natural step for a private equity firm looking to grow its assets under management to branch out into private credit, but the back-office requirements of making such a move shouldn't be underestimated, delegates heard. Tracking private equity strategies is much more routine than doing so for credit strategies, one CFO noted.

Following debt investments can be more unpredictable, too. Several responsibilities not necessarily associated with private equity, such as tracking loan drawdowns, interest payments and monitoring loan balances, are all labor-intensive and require a larger staff.

In fact, one attendee that works at a firm with both credit and equity platforms noted it would be an easier task to add a buyout strategy than a credit strategy.

# For the record: How CVC does compliance

**Raju Hussain, CVC's compliance chief, explains how he keeps the $70bn firm on the right side of its many regulators and how he guided it through three exams.**

By Toby Mitchenall

Raju Hussain is well placed to give advice on how to deal with financial authorities. A former regulator himself – he cut his teeth at what is now Financial Conduct Authority in the UK – he has in the last two years guided Europe's largest private equity firm, CVC Capital Partners, through three regulatory exam processes as the firm's global head of compliance. Two of these were with the US Securities and Exchange Commission.

CVC operates from 24 offices and is regulated in the US, Jersey, the UK, Hong Kong, Singapore and Luxembourg. Despite being a Europe-headquartered firm, Hussain considers the SEC to be CVC's "lead regulator." This is because the firm has numerous US investors – think of any US public pension plan with an appetite for private equity and they are likely to be in the firm's latest €16 billion flagship fund – and there is cross-border application of the SEC rules. Over the past five years – in particular, since the tenure of previous SEC chairwoman Mary Jo White – the commission has worked closely with PE firms and got to know the asset class well.

The examination processes Hussain has led the firm through – lasting on average for eight or nine months, he says – are "intense," but they have not tarnished his view of the SEC. On the contrary, "I think our regulators are fantastic," he told pfm, when they met in early November 2018 at the firm's London headquarters overlooking the Thames. "The SEC is not looking to catch you out, although a lot of firms look at it like that. It's a partnership."

Hussain's view is no doubt influenced by the outcome of the examinations, the most recent of which was part of a thematic industry-wide "sweep" in which the commission was looking at compliance with rules around political campaign contributions – topical as the meeting took place in the run up to US mid-terms. Under the Investment Advisers Act Rule 206(4)-5, employees of investment firms who make donations to political campaigns are then barred from providing advisory services to any government entity for two years. For private equity firms who manage public pension money (which is most of them) this is a very real issue. CVC was not among a handful of firms that settled with the SEC over campaign donations this summer.

Much of Hussain's day job will look familiar to many who wear the compliance hat. He is involved in (but careful to stress not solely responsible for) everything from GDPR compliance to personal trading, know your customer to pay-to-play.

One of the challenges Hussain's team faces is implementing policies across a diverse group of countries. "Since I first joined, our network has grown, the complexity within our business has multiplied and legislation has changed," he says. "When we look at regulation today, when we adopt policies, we try to do it on a global level, supported by local policies, but it is pretty difficult. For example, data privacy rights in the 24 jurisdictions in which we operate today are very different. How do we implement email surveillance adequately without impacting people's privacy?"

The approach, Hussain continues, is to: "take the highest common denominator and apply it on a commercial basis, trying to be pragmatic, commercial and risk-based."

Hussain reports to the chief operating officer and managing partner Fred Watt as well as to the firm's local and global boards. The compliance team numbers five plus him: three in London, one in Singapore and one in New York. He is looking to add another to his staff in New York before the year is out.

Where Hussain believes CVC's compliance team "is different compared to most firms" is the collaboration with the deal team. "We work in partnership with our deal teams, so that with the investments we are making, we are covering general regulatory risk, the risk of bribery and corruption, money laundering risk, sanction risk, audit and independence issues," he says.

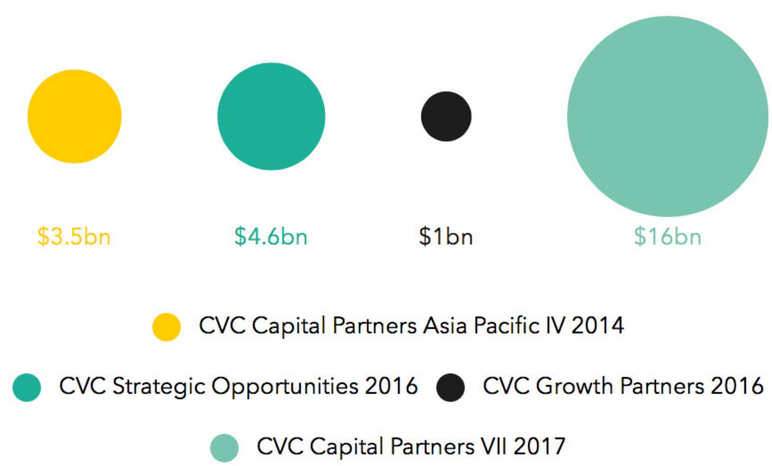
"For example, if we are doing a FIG [financial institutions group] deal today, what are areas that we want the deal team and external counsel to focus on as part of the due diligence?"

Compliance deficiencies in a target company do not necessarily break a deal.

"There could be areas we want to remediate immediately on closing or within six months of closing. It is quite a fluid process of looking at and mapping risk, and then addressing those risks that have a potential impact on our business or funds."

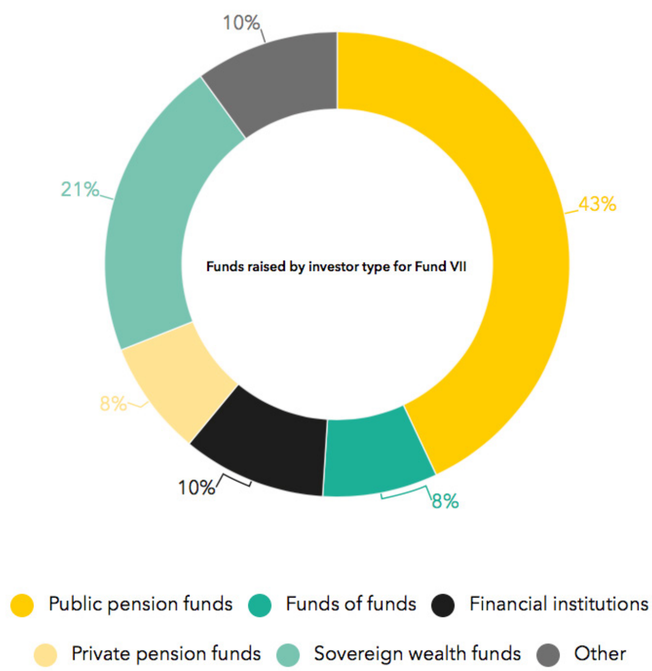
## CVC IN BRIEF

**The most recent vintages of the four distinct strategies in CVC's PE business**




Source: PEI

**Public pension funds accounted for the largest slice of CVC's most recent flagship private equity fundraise**




Source: CVC Capital Partners

## High flyer

Hussain comes across as a serious individual. But he cracks up when asked how he would explain his job to a small child. "My [five-year-old] son thinks my job is to fly around the world," he says, referencing that fact that the week after we meet he is due in Singapore to deliver training to the deal team alongside various outside advisors, as well as meet the internal auditors, the firm's regulator, and spend a day onsite with a portfolio company.

A large part of the compliance chief's job involves telling people what they can no longer do: rarely a popular exercise. Is Hussain left sitting by himself in the CVC canteen?

"It was historically the role of compliance to be unpopular," he says. "It is a control function and it is there to say fundamentally 'no' – you are not going to make people happy. It is important to have integrity and to ensure you treat everyone the same. That is super-important."

Importantly, Hussain continues, the "tone for compliance is set right from the top. Our role is to advise, to challenge. Our senior management team have really empowered us to do the right things." What is front of mind for Hussain's team now? Brexit: specifically, what it means to CVC and its portfolio companies. CVC's initial reaction to the UK vote to leave the EU in June 2016 was work through the portfolio to "understand the risks from a currency, financing and EBITDA perspective."

"From this summer we have been looking more in-depth at Brexit because of the growing likeliness of a no-deal scenario," he says. "We have had legal and compliance working closely and leading our deal and business support teams in the UK and Europe. We employ a number of EU nationals in our London office, what does it mean for them? What will the impact on equity and debt capital markets be?"

As compliance chief for one of the world's largest private equity firms, does Hussain see any dark corners of private markets that regulators will shine their light onto next? If he does, then he is perhaps understandably not saying so. "Private equity is now in a pretty good place in terms of transparency," he says. "The area of capital call facilities, for example, is now highly disclosed to investors."

He notes the sophistication of investors and their representative body, the Institutional Limited Partners Association, as playing a part in this. He adds, however, that with funds that are a minimum of 10 years, but almost always longer, one cannot tell what regulatory changes will happen or what terms will change.

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