

Hidden between the cracks

Even private fund managers with the most robust compliance programs in place are trying to detect areas of weakness

by NICHOLAS DONATO

A dedicated chief compliance officer appointed? Check. Adequate firm-wide compliance training? Check. All the required records up to date and filed? Yep, got that covered too.

It can be reassuring for the firm's compliance team to run down a checklist of requirements and see each box ticked. News that a fund manager was able to siphon millions in fund fees straight into their own pocket must mean a major compliance failure. Someone in compliance didn't just drop the ball; they never picked it up in the first place.

But compliance officers speaking to *PFM* say the real dangers are buried deep in the detail. And if compliance gaps remain hidden, the firm opens itself up to reputational risk and possibly even enforcement action depending on the severity of an infraction.

"You hear it said that a Bernie Madoff-type fraud could never happen

“You’ll hear it said that a Bernie Madoff type fraud could never happen at this firm, and that may be true. But don’t fall into the trap of assuming that means your compliance program is airtight”

at this firm, and that may be true. But don't fall into the trap of assuming that means your compliance program is airtight," says one CCO of a US private equity firm.

A recent Securities and Exchange Commission (SEC) enforcement case illustrates the point well. In February, the US securities regulator charged Arizona private equity firm Clean Energy Capital with using fund capital to pay off expenses that should have been borne by the management firm or individual partners. The case grabbed the media's attention because one of the firm's founders, Scott Brittenham, allegedly used investors' money to pay for things like employees' tuition costs, car washes and holiday cards. But go beyond the headlines and the real news here for CCOs, sources stress, is that inspectors want to see fund expenses properly disclosed and allocated between investors and GP.

Indeed, virtually all CCOs have controls in place that would catch egregious things like education costs being passed to investors. But what about more innocuous items like dead deal costs?

"Most GPs have detailed policies about how investments will be split across funds, but often have significantly less detailed procedures on expense allocations," says private funds attorney Joseph Morrissey of law firm Seward & Kissel.

"Accordingly, before due diligence on a target even begins, the compliance and deal team would ideally determine – and more importantly document – how broken deal expenses will be split."

Unfortunately that's a level of detail that isn't included in most GPs' marketing documents or partnership agreements, according to legal sources reviewing the Clean Energy case.

What's more is that the SEC has reportedly created an inspections unit dedicated to private equity and hedge funds. The unit may be a result of the SEC's belief that about half of GPs charge "unjustified fees and expenses without notifying investors," according to a recent *Bloomberg* report, citing an anonymous person with knowledge of the findings. See p.8 for details.

Meanwhile in Europe, the lesson that details are paramount when it comes to compliance can be seen in the Alternative Investment Fund Managers Directive (AIFMD). Similar to the situation with the SEC in the US, regulators across the EU are undergoing a crash course in the internal mechanics of real estate, private equity, infrastructure and private debt firms, as they review hundreds of applications from GPs seeking authorization under the directive.

It's safe to assume that regulators in Asia and Latin America, who are reviewing their own private funds frameworks, are taking note of Western practices too.

It's arguably impossible to build a compliance program that has a 100 percent success rate in preventing acts of fraud or abuse, or that meets all of investors and regulators' heightened expectations. But compliance officers say that in order to come close to doing so, they need to dig deep into their firms' procedures and policies for signs of weakness. ■