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REGULATORY COMPLIANCE

Facing up to stricter standards and round-the-clock reporting

The private equity industry is not immune from public scrutiny, as well as demanding investors. Aidan Connolly, CEO of Luxembourg-based fund services provider Alter Domus – and previously CFO at UK retailer Wilko and payment services provider Worldpay – considers what buyout firms need to learn from other industries

***Connolly**: firms are getting the message*

Q As an experienced CFO new to the private equity industry, what do you think PE funds can learn from other industries as they continue to grow and develop their businesses?

There is a contextual issue for private equity houses at the moment. We are in a time where relative inequality is highlighting some of the more egregious aspects of the 'haves' business model, and private equity stands full-square in the middle of that. That is going to impact private equity, and there are lessons to be learned from other industries that have been through the mill.

The more enlightened private equity houses are having a dialogue and understand that changes need to be made. This perception of inequality is not going to go away, and firms are going to have to become much more transparent about the way they do things. Corporates have been forced into disclosure regimes that could be easily adapted for large-scale private funds, many of which are of a similar size to FTSE 100 and S&P 500 businesses. There is no reason why they should not be subject to the same disclosure regimes.

It is only relatively recently that private equity firms have started to get to grips with the concept of diversity and started to address those issues, where even unregulated industries have been quicker to take more radical approaches.

The US has become very active against businesses that discriminate and has started to take that across all sorts of discrimination, beyond much more than gender. But it is still difficult to imagine a picture of the leaders of the top 20 private equity firms containing any more than one or two women, so the industry needs to up its game.

Then, in ESG, it is fair to say that private equity has recently started thinking about its portfolio impact and taking responsibility for that, but that has been a long time coming and it will probably be forced to go further.

It is a challenging landscape, but if firms can address these issues, the alternative funds industry can be seen to be socially additive rather than negative. They do not really have a choice, as regulators become more ambitious in their scope and are pushed to represent the masses. I already see private equity firms getting the message – we are seeing ESG policies coming out that even a decade ago would have been unimaginable. So, things are certainly changing.

Q As reporting and compliance standards for the private equity industry continue to increase, how do you envisage the role of the CFO changing in response to investor demands?

As the industry opens up to greater scrutiny, standards will have to be higher and the CFO is going to be held to a different level of account than he or she has previously been used to.

There is going to be a much more strategic balance sheet issue to address, because increasingly compliance requires capital behind it as a safeguard. Finding the right way to report that is a challenge that banks have grappled with, and by and large the European banks have not been

***Ready for change**: private equity can learn from other industries*

very convincing in their approach to the new scrutiny of regulators.

A lot of parallels can be drawn with the fund industry, where there is increasing pressure to communicate a capital management strategy and the way in which the business model mitigates risk for investors. That creates opportunities for outsourcers to step into that space as a strategic partner to the fund, and through the fund to the investor base.

24/7 reporting will become almost the norm, with funds required to demonstrate compliance at any time, rather than simply at certain key dates, like year-end. That changes the boardroom debate, with different voices becoming required listening. The role of the chief risk officer, the chief compliance officer and the CFO will all become a much more important part of the investor message than they have been in the past, and more of an arbiter of value.

Q Luxembourg has seen a significant influx in private equity funds in recent years and continues to expand as a funds hub. Where do you expect new business to come from over the next decade, and how do you see the industry developing geographically?

Luxembourg now faces the classic dilemma of somewhere that has been very successful. If you go back to Luxembourg in the 1970s and 1980s, it was pricing itself out of the market and other people took that space. Now, with the difficulty in recruiting great talent and the costs of operating, there is a risk of that happening again, and that success starts faltering because of the sheer cost of supporting fund structures »

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» – a business which is supposed to be a low-cost activity.

This goes back to how you set yourself up to deal with geography, compliance, risk and risk mitigation. For outsourcers based in Luxembourg, we have to look at more global solutions and press regulators to come with us on that. Ever-rising costs simply will not work as a way forward.

For us, clearly Europe is still an important centre for growth with lots of opportunities and lots of wealth being funnelled into investment vehicles that need servicing. Europe is now a pretty sophisticated market for outsourcing, whereas the US is relatively less sophisticated because it has not needed to be. Nevertheless, regulatory pressure will create more need for outsourcing and so we will see growth there.

Then you have to look East, and particularly to the Chinese and Indian economies where there are such emerging depths of population calling out for solutions to help them manage their savings. Businesses will see opportunities in Asia-Pacific and work will flow to those territories seen as the most accessible and safe hubs, such as Singapore and Hong Kong.

Q How do you expect the role of the PE fund administrator to change over the next 10-20 years?

The reliance on technology to do the donkey work will become more and more prevalent. Talent will be attracted into the industry if the drudgery can be taken out of it, so technological development is vital. Whilst there is technology in our industry, the disruptive impact we have witnessed in other areas has not yet reached our shores, but I think it will come.

Because of regulation, the necessity to demonstrate compliance will mean much closer integration with our clients as far more will have to be demonstrated in real time and our role will become continual rather than periodic. One can already see the audit industry starting to think along these lines, and we will have to respond to match that demand. We are going to have to demonstrate that we are on the ball all the time, and people can invest safely into fund structures without risk of malfeasance.

> **Europe is now a pretty sophisticated market for outsourcing, whereas the US is relatively less sophisticated**

That, in turn, demands more from everybody and requires thinking in wholly different terms – it is like transferring from a horse-and-cart economy to a car economy. Scale will also come into it, because the level of investment in systems and maintenance required will be much greater, driving our industry to consolidate around fewer and fewer players. We can already see that activity starting to occur and I expect we will see more of it. ■

Q A greater role for outsourcing?

There is a real tension between growth, the back-office and regulation. Private equity has been facing a challenge that perhaps other industries have already faced, which is the constraints of the impact of geography and technology as against the regulatory impact of control and supervision.

For example, the natural reflex of any industry where it has an opportunity to reduce productivity costs for the back office is to look to lower-cost environments in which to house those services. We have seen business process outsourcing grow over the years and then decline, as other industries have moved into that space. The issue that private equity firms face is that regulators want funds, and particularly those that have retail money in them, to become much more constrained in the extent to which they can use geography to lower costs. Technology has no geographic boundaries, so there is a tension for the back office.

Similarly, there are increased regulatory requirements around managing risk which constrain the ability of funds to distribute their businesses in the way they would like to. The issue of data control and stewardship, for instance, can be addressed in a variety of ways, very few of which would find favour with regulators. If you are looking to prevent a data disaster, one way would be to replicate data in a number of places, but you are almost immediately at loggerheads with regulators if you start viewing your data as global.

Those are the kinds of places where we are going to see a battle over the next decade. That will lead to a different approach to outsourcing, pushing us to come up with 21st-century solutions to these problems. Outsourcers, because of their scale, are probably better placed to make the investments necessary to provide those solutions, so they will increasingly be seen as strategic partners to funds, rather than a necessary evil.