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Institutions Push Private Equity Managers to Outsource Ops

By Tom Stabile

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Private fund managers face growing pressure from institutional investors to show they have strong compliance and operational systems in place, with many of them being nudged to hire outsourcers and establish independent controls as routine practice.

The due diligence push of recent years that largely aimed to help investors avoid Bernard Madoff-style frauds is giving way to more rigorous ongoing operational reviews. That is pushing the emphasis beyond an initial investigation to a new level of expectations where managers must prove they can conduct constant vetting for regulatory compliance and ensure the integrity of fund accounting.

“I think the operating model is going to change dramatically in the industry,” says Jason Garelli, director for operational due diligence at Strategic Investment Group, an institutional investment consulting firm. “It’s no more just taking their word for it.”

Even after the Madoff scandal in 2008, institutions mostly homed in on investment and custody matters, largely giving private equity funds a pass on most of their operational systems, Garelli says. Today, the consultant is asking managers to show they are monitoring for compliance with the Securities and Exchange Commission’s “bad actor” rule, conducting sound cash management, establishing corporate governance policies, and using fund administration experts to manage expense, capital call, and investment processes.

“You don’t want to still see the general partner running all the processes itself – determining what the valuations are, deciding what to tell the [limited partners] about conflicts of interest,” he says.

The worries are less about getting a good night’s sleep, and more to make sure managers are keeping investors up to speed about the potential dangers from regulatory sanctions, lawsuits, internal operational hiccups, personnel problems, and reputational damage, Garelli says.

“It’s been building up to the point where if LPs don’t get the answers they want, they make the managers change procedures,” says Joseph Holman, CEO of Orangefield Columbus, a fund administrator.

The changes reflect the natural evolution of private equity into a more professional branch of asset management, says Paul Harris, director of business development and client service at Strategic Investment Group. “It used to be more immature, but both regulators and more sophisticated LPs, and now firms like us, are increasing pressure,” he says.

That doesn’t mean the change is coming rapidly, with many private equity shops still conducting most of their business on spreadsheets rather than more advanced systems, Garelli says.

The heightened interest in better controls is more a concern for smaller and mid-sized fund managers serving larger institutions for now, instead of firms with smaller investors and high-net-worth clients, Garelli says. But even for large institutional clients and consultants, the shift has been recent, with Strategic Investment Group only stepping up its operational due diligence of private funds in the past 18 months.

Even some smaller institutions are beefing up their operational due diligence efforts. For instance, the Carnegie Corporation has begun a new process to review all of its existing private fund managers that it plans to keep or with which it has a significant level of assets, says Alisa Mall, director of investments for real assets at the $3.2 billion institution.

The foundation had for years conducted operational due diligence of managers in liquid markets, but not of private funds, where it had looked more closely at investment strategies and the underwriting process. “The expectations had been different in these longer partnerships, and institutions had been slower to expect this level of review [of managers],” she says.

For real estate managers, the review will look at documents and contracts, cash management systems, revenue collection policies, lockbox procedures, and other recordkeeping items, Mall says.

Even now, it’s too aggressive to expect all private fund managers to have their systems in top shape, Garelli says. The consultant often points out deficiencies and then helps the manager plan to address them over six months by hiring outsourcers or staff, or making policy or systems changes, he says.

Fund accounting is one of the biggest stumbling blocks, with managers often not able to prove the integrity of their numbers. Garelli says his team has found many instances of sloppy procedures, where a fund manager will carelessly dip into the wrong accounts to pay off expenses or generate incorrect fee calculations. It is leading to a consensus that private equity funds need to hire external fund administrators, he adds.

“I wouldn’t be surprised if within two years, we’ll require that [private equity] general partners have separate fund administrators like hedge funds have.”

A big reason for that movement is that many institutions and consultants are asking the operational due diligence teams that vet hedge funds to now oversee private equity – and they are asking many of the same questions of both groups, Holman says. They are looking at functions for capital calls, distributions, and cash controls, and finding private equity to be delinquent compared to hedge funds.

Ongoing compliance monitoring for regulatory and legal troubles that may trip the bad actor rule is also rising as a concern, says **Tim Mohr**, principal and national practice leader for financial services advisory at **BDO Consulting**. Managers are no longer safe with just a “one-time look” for compliance of their staff and marketing agents during the initial round of fundraising.

“It’s moved to the point of continuous monitoring of that fund manager and all of its partners,” he says. “You don’t want a case where it’s the regulator or one of your investors that finds [a problem].”

Managers are only now starting to implement systems to monitor such compliance needs constantly, more in response to concerns from their LPs than from regulators, says **Scott Augustus**, senior manager at **BDO**. “GPs are concerned that if something goes sideways, they would be unable to raise capital from their investors,” he says.

Managers are also getting pressure to better account for their investments, with more of them hiring independent custodians to confirm deals and prove ownership of assets, says Scott McCartan, CEO of Millennium Trust Company. The Dodd-Frank financial reform law makes it harder for fund managers to act as their own custodians, and some enforcement cases have hinged on violations of the new custody rule, he says.

“You have to watch that trap of not having an independent custodian,” he says.

The upshot for fund managers is that expectations for strong operations won’t be shrinking, Garelli says. “It’s a consultative process,” he says. “I tell GPs, ‘You either can listen to us now or you’re going to hear this from your regulator.’”