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HOW TO CREATE A COMPLIANCE FRAMEWORK USING THE PRIVATE EQUITY OFFICE (PEO)

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Background

For the private equity or venture capital firm, compliance is an area that may not assert itself as a critical topic on a day-to-day basis. Compliance, when disregarded or ignored, tends to assert itself to a level of definitive urgency. It is a bit like a Dragon (not the benign Eastern incarnation), drifting in and out of slumber. It might remain silent on a day-to-day basis, but it will assert itself eventually – sometimes with ferocious force.

Within the subliminal of Managing Directors, GPs or CFOs, Jung's collective unconscious resonates with full tonality that the sleeping dragon of compliance must be managed - lest disaster occur. There is very good reason for this. Principals in the firm now carry personal responsibility for compliance areas. Large sums are spent to obtain appropriate compliance, and they recognize that despite their best efforts to run the business efficiently, ethically, and legally, the dragon may awaken, from simple mistakes to gross malfeasance.

Increased Complexity

Due to the requirements of the Sarbanes-Oxley Act and other regulatory requirements, a robust, integrated automated framework combined with disciplined manual procedures, are essential for the private equity fund manager. The objective is to be pro-active with practices and automation to substantially and uniformly limit compliance exposure. Based upon this established terrain, this whitepaper will focus on the automation elements that can serve a holistic compliance framework for the private equity fund manager.

Virtual legions of resources exist to help with the manual process elements of compliance. The Big 4 and numerous other professional services firms offer robust process frameworks for compliance. This whitepaper will therefore focus on the automation elements of compliance as they relate to automated solutions, and specifically the Private Equity Office (PEO) software package. We will make the case that PEO mitigates compliance exposure in a profoundly superior way to any other framework available for the global private equity community.

An Integrated Automated Framework Is Required

Private equity firms have long relied on regularly scheduled audits based on standard rules to unveil irregularities and financial control issues. Increased complexity and requirements for operational risk reporting are proving beyond the capability of the cycle audit to effectively protect fund managers. Even with numerous controls in place, the cycle audit does not reveal what occurs in between audit cycles. Further – it is in the space of isolated sub-systems – pockets of personalized information, where much of the enterprise risk occurs. For a private equity firm, - the most classic, and prevalent pockets of personalized information are represented by numerous Excel spreadsheets, that exist throughout the organization.

Private equity firms must to move from annual audits to day-to-day risk management based upon the following paradigms:

- A holistic data approach focusing on the key operative paradigms of Granularity and Transparency. Transparency is the door – Granularity is the key.
- Internal operations management transparency achieved through standardized approaches, alerts and data mining.
- Investor reporting *managed transparency*, for data published to limited partners over the Internet.
- Dimensional data warehouse reporting that focuses on interconnected processes including the connection between the deal pipeline, asset management, fund administration, and investor relations.

Granularity

Granularity as it relates to private equity transactions in a financial system refers to componentized transactions that layer perfectly throughout a financial hierarchy. In other words, the ability to structure asset transactions with the appropriate amount of calculation detail, and to layer these through various layers of abstraction such as holding companies, or first tier, 2nd tier, or n tier funds. We refer to this as asset and fund transaction layering and it is a trademark of the PEO's financial model.

Granularity means that, although a particular investor exists at the 5th level down in a fund hierarchy, reports can precisely describe the related componentized transactions and the hypothetical asset ownership at any level in the financial hierarchy. This level of granularity is essential and critical for most private equity firms, but is seemingly optional for many venture capitalists firms. However, it really is not optional in terms of compliance. This level of granularity meets the critical financial cycle control audit theory demand for the ability to traverse and explode granularity from a balance sheet and income statement to the financial statements primordial transaction based origins.

Taking it one step further, granularity from the accounting perspective means that asset management and fund administration are directly linked with the general ledger. This is a critical connection, as it makes it possible to take a fund's set of financial statements, balance sheet, income statement, and drill down to the asset management or fund administration transactions that created the debits and credits against the PE firm's hierarchical accounting codes. For instance, when IRRs are generated, the performance metrics are linked to cash flows, which are linked to transaction components, which are linked to general ledger entries. In effect, PEO bridges the gap between management reporting and analysis for the GP, investor relations, and the actual generation of accounting ledger entries – the world of debits and credits.

Documents can be captured, and related, not only to legal entities, but also to any object in a private equity firms' universe. By object – this means anything – from disposal to capital call – to investor interaction. However, what is the use of capturing documents if they are not classified in a persuasive fashion that maximizes the array of compliance applications? Much like a GL hierarchical structure, documents must be able to be tagged and organized into hierarchical classification schemes. Consistent hierarchical classification is the key link that makes the documents instantly assessable for compliance purposes.

Granularity also refers to the ability to model a financial scenario cleanly without having to resort to sub-optimal financial structures - and to have this data available for data mining purposes. For instance, it is possible to manage opt-outs in a way that cleanly demonstrates the way that an investor can make an individual investment within a fund with a mini capital reconciliation, whilst staying under the fund umbrella. It is also possible to manage a financing vehicle that spans specific fund legal entities, or holding companies that operate as a virtual asset intermediary before allocating to a fund legal entity.

Transparency

There are two types of transparency in PEO: (1) Management transparency, where operational and financial data is readily available to management personnel in the organization; and (2) Investor transparency, where information is published to investors with full ability to back it up in a granular fashion. From the perspective of the financial professional, (indeed in order to protect his or her dignity as a human being) transparency must be managed. That is to say - in-transition financial data must not be transparent. Rather, the financial professional publishes the data using an automated system to provide this transparency, typically on a quarterly basis.

Transparency, through the use of a data-warehousing scheme, substantially reduces the risk of compliance errors. Management reviews of data from a published represents a vastly superior paradigm to reliance on the island pockets of information that tend to proliferate with excel spreadsheets and boutique database solutions. Further, reports are available online (Intranet) though a web browser – facilitating surveillance and thus helping to insure that compliance standards are met.

Transparency exploits the available granularity for legal entities, transactions, documents, and other objects by taking advantage of OLAP cube, snowflake schemas to surf dimensions in a data warehouse. All of the rich granularity of asset level components flowing through fund legal entities, holding companies, or financing vehicles is instantly available, sliced by vanilla categorization schemes such as industry, geography, and also by any category dimension created by the user. Such dimensions, including the dimension of time, empower and liberate the transparency paradigm with unprecedented dimensional analysis.

Investor Transparency

Traditionally, investor transparency has not been a particular area of focus for venture capital firms. When an investor inquires what they own of say “ABC Portfolio Company”, they receive an answer about their ending capital balance in the fund. Private equity firms on the other hand, have had to deal with their investors demanding granularity for years, and so they generally require more robust automated solutions. However, the level of asset transparency from the fund equity side, even though the ownership of the underlying asset pool may be hypothetical – is absolutely essential for compliance purposes.

The physical incarnation of the investor managed transparency paradigm, from the investor’s perspective, is the ability to publish critical information, via the World Wide Web, and easily export out to formats such as XML or Excel. However - it is not essential that investors have access to the full compliance framework of PEO. Rather – it is essential that PEO repository can backup, with full granularity, any information published to limited partners. Investor transparency, from the perspective of the fund manager then, is the ability to traverse for-

wards or backwards from a published investor capital account through all the nodes in a compliance framework. This illuminates the inherent links that exist in asset opportunities, fundraising, asset management and fund administration with lucid granularity on demand.

Investor transparency becomes particularly intricate when the elements of a tiered allocation waterfall are introduced. Attorneys spend a great deal of time creating “compelling” structures for the allocation of distributions to GPs and LPs. Most rules use various evaluation criteria (from preferred return to net gain), which must be evaluated “in-state”. The rule stack can also include dynamic calculations of tiered allocation ratios based upon the in-state economics of an investor or investor pool. Exploiting the level of granularity captured and calculated for an investor can answer those questions of “why?” and “how?” when compliance questions arise. Further, answers are immediately assessable from the published warehouse, without research, and therefore constitute proactive compliance.

Peo Is A Holistic Compliance Framework For Private Equity

PEO comprises a holistic compliance framework that connects private equity business object layers through entity management, transaction granularity, transparency, automated alerts, document management, and full integration of front, middle, and back-office. PEO allows full visualization of these business object layers and provides a rich alert system that can mitigate compliance risk. The sheer operational power of the platform including opportunity dashboards, CRM, powerful surveillance capability in the middle office, extraordinary granularity, and peerless robustness of the underlying financial model, comes together in an enabling fashion as the ultimate private equity compliance platform.

Imagine for a moment, an asset opportunity flowing into the actual purchase of the asset. The purchase of the asset is then allocated down through a financial hierarchy out to the investors. Related documents are captured and classified each step along the way. Essentially, deal sourcing, fundraising, asset administration, fund administration, and investor relations are all inexorably linked together. Those links are captured with full granularity, and exploited using transparency paradigms. This type of holistic capability, using PEO, can result in better use of a thinly spread workforce, increasing the fund manager’s ability to proactively deal with compliance risk items. In addition, such an approach can help create dimensioned, transparent management reporting that spans across data encapsulated silos, where compliance problems are often obscured.

About the Author

Donald Lee Winger is the President and CEO of AnalytX Inc. Prior to founding AnalytX, Mr. Winger founded ABS Consulting where he was one of the key architects of the KPMG fixed asset securitization system that modeled over \$1.8 trillion in collateral backed securities. Prior to founding ABS, Mr. Winger was a Senior Manager in Coopers and Lybrand's (PWC) consulting and National Tax divisions. While tenured at PWC Mr. Winger performed as a financial analyst, systems analyst and software engineer architecting various tax systems including the K-1 plus system, utilized to produce hundreds of thousands of tax returns for all financial sectors. Mr. Winger holds a BA in Philosophy and Economics from Randolph Macon College and an MBA/Finance from George Mason University.

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