Managing fraud risks in Private Equity

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Much has already been written about the rising incidence of fraud during the COVID-19 pandemic (warning about the risk in early 2020, reporting on the occurrences since, etc.). It's an all-too-familiar phenomenon in any time of crisis. Fraud has impacted every sector: banking, insurance, industry and private equity. (By "fraud" we mean any form of misappropriation – embezzlement, misuse of corporate assets, corruption, money laundering, etc.)

For private equity funds, misappropriation has occurred in portfolio companies irrespective of financial health, during the acquisition or exit phase, or simply in company life. Unable to explain worsening performance, some shareholder funds have grown suspicious, opting for forensic investigations. Analysis of financial information and electronic data (emails, chats and attachments) together with external research on conflicts of interest and reputation have revealed practices that have sometimes gone on for years, or begun even before investment. In some cases, court-appointed administrators, liquidators and judges have ultimately been willing to commission meticulous forensic investigations in order to establish liability – including of shareholder funds – and to launch asset searches in order to reimburse creditors. **These situations significantly reduce return on investment, and can even wipe it out.**

At the same time, **pressure by the authorities** on the private equity sector is increasing. The US Department of Justice announced in late 2021 that it would not hesitate to prosecute investment funds under the FCA (False Claim Act), once again highlighting the importance of robust, well documented pre-acquisition due diligence and, if necessary, post-closing investigations, especially on fraud and corruption. The regulator and the judiciary also evaluate remediation efforts when material weaknesses are identified in risk management and overall compliance. In France, the UK and the US, funds can now be held criminally liable for bribery if they have neglected their pre-acquisition and post-closing due diligence on target companies. Here, "due diligence" means detailed, comprehensive research using different sources, both public and non-public – well beyond mere "checks".

Risks increase as investors in search of return target new sectors (startups) with different risks, or jurisdictions requiring many interactions with public officials. Commercial pressure to rapidly build profits often leads to botched compliance controls or due diligence on partners (suppliers, agents and customers). The authorities in several countries (US, UK, France, etc.) are currently actively investigating and prosecuting corruption, and are not particularly accommodating when "red flags" and compliance rules have been wilfully ignored.

Private equity is more vulnerable to fraud risk because **the sector interacts with so many stakeholders** – GPs, LPs, portfolio companies and their managers, employees and other partners (suppliers, customers, etc.) – and all stakeholders can be understood to pose some risk of fraud. A 2020 arbitration ruling was won in Europe by a private equity fund (buyer) against another private equity fund (seller) illustrates this vulnerability. The seller had deliberately manipulated the target company's financial statements to increase the sale price, and auditors discovered accounting irregularities shortly after the sale in 2018. The buyer then commissioned a forensic investigation to determine the origin and extent of the wrongdoing, and to prepare the arbitration procedure. The award in favour of the buyer totalled €87 million.

At present, fraud risks can flourish in areas where ready cash and investment opportunities abound, as with companies in buoyant sectors (medical, pharmaceutical, e-commerce, tech, etc.) or those in economic distress. While the risk is never zero, certain factors require **enhanced due diligence** and, above all, **strict refusal to ignore red flags**. This applies beyond private equity: the case of Theranos illustrates the fatal errors that can ensue from "FOMO" (**fear of missing out**).

Risks evolve rapidly (through technological breakthroughs; new work methods, sectors and professions; etc.) and must therefore be assessed continuously. But we do know what the **key areas for vigilance** are:

Window dressing and manipulation of financial information. In times of crisis, it is all the more important to distinguish the cyclical (impact of the pandemic) from the structural (sector, management, competition, operations, etc.) and turn to forensic experts, in addition to auditors.

Cyber attacks and intrusions – simple or sophisticated – can lead to large and rapid transfers of funds, often to ephemeral accounts in uncooperative jurisdictions. A resurgence of social engineering tactics has been observed in all sectors, and private equity is no exception (e.g. fraudulent international wire transfers by identity theft and intrusion into IT systems). Funds aren't the only thing stolen in these schemes: the phenomenon is also on the rise for data theft (IP, medical data, etc.) with the spread of remote work and the digitalisation of the global economy.

One of the most common types of fraud in recent years has been to *cover up operational or management deficiencies* by blaming the pandemic. Often, perpetrators will assert that physical inventories of stocks could not be performed due to widespread working from home or successive lockdowns. Supply chain fraud has increased significantly.

The fraud triangle is more relevant than ever at a time when short-time work, layoffs and salary cuts have affected many employees. Its three sides (**pressure**, **opportunity** and **rationalisation**) combine to create a breeding ground for internal fraud, including at managerial level. Fund portfolio companies have not been spared either. This risk is all the greater in relations with third parties, through whom funds are often diverted (with or without their complicity). Strengthening internal controls and due diligence is not incompatible with business survival and resilience; on the contrary. A fraud scandal won't help anyone emerge unscathed from the current economic crisis.

The discovery of wrongdoing often means **litigation, with the financial, operational and reputational cost** this brings with it. And it's worse when investigations were performed late or without the help of experts. **The stakes are high**.

Fraud and corruption risk detection and prevention are differentiating competitive factors for private equity funds. Many investors (LPs) are now more demanding on these issues, and regulations are tougher (and strictly enforced). Cavalier complacency in this area is incompatible with fund raising and return on investment.

Pre-acquisition **due diligence** is meant to cross-check information that is public or provided by the target or seller. Sources must therefore be varied and complementary, beyond databases and the internet. Targeted field interviews (which can be discreet and non-intrusive) with business partners, former employees and others are an effective and underestimated method. And if grey or red areas come to light, a well-documented investigation is critical. Risks cannot be mitigated if they aren't clearly identified.

The race to the deal has led too many to deliberately ignore warning signs, resulting in millions or billions in losses. And due diligence must continue during the closing and post-acquisition periods – access to information and internal personnel is better at this stage, and risk areas identified ahead of time can be analysed more closely. It is perfectly legitimate for a buyer to perform an investigation when there is cause for doubt; this will only enhance the fund's reputation in the marketplace. Finally, if an investigation should reveal facts leading to litigation, its documentary records and thoroughness will be key to asserting one's rights (versus a third party) or one's good faith (to the regulator).

Vigilance must then be maintained throughout the term of the investment. The landscape is constantly changing (new markets, partners, technologies, contracts, legislation, etc.) and risk mapping cannot be static. We rely on it to evaluate and adapt controls, and to deploy corrective actions. It is no longer rare for funds to ask experts to conduct fraud and corruption "health checks" to detect new risk areas and deviations from compliance standards, and to recommend procedures for improving safeguards.

Remediation. The added value of due diligence is that – with the help of external experts – it accelerates post-acquisition remediation solutions (and enables a cost assessment that should be taken into account in negotiations).

Diligence, vigilance and remediation must **accompany portfolio companies' business development and growth**. As companies deploy new strategies and enter new markets, they must also invest in suitable compliance. Excessive pressure to improve performance and poor communication of objectives can prompt illegal behaviour (bribery to win contracts). Compliance and growth are by no means mutually exclusive.

Intent. Private equity funds can, and should, intend to become involved with portfolio companies on these issues. This is justified because they stand to inherit liability – including criminal liability. Obviously, a balance must be struck to ensure that the risks associated with fraud and corruption (financial losses, regulatory shaming, etc.) are managed without the fund becoming too involved in operations. Here again, the advice of lawyers and experts is essential.

It is complex and difficult enough to manage risks and conduct investigations as a majority shareholder or manager; the challenge is even greater for GPs and LPs. These investors have no involvement in the day-to-day management of funds or portfolio companies, and their boards rarely review the management decisions. The responsibility of boards of directors (of private equity funds or any other organisation) in fraud and corruption risk management and investigation is another fertile topic for future discussion.

ESG Outlook 2022:

Three key priorities in sustainable investing

An investor's guide to the year ahead across environmental, social and governance (ESG) factors - including the key themes of deforestation, the just transition and double materiality.

By Jenn-Hui TAN, Global Head of Stewardship and Sustainable Investing for Fidelity International

For investors focused on sustainability, 2021 was a year dominated by the runup to and takeaways from November's COP26 climate change negotiations in Glasgow, Scotland. But the true test is just beginning now: What actions will countries take to deliver on their pledges, not only in terms of emission cuts but in preserving our biological diversity and ensuring a fair and equitable transition to a low carbon world? As we head into 2022, we see three big themes coming into greater focus: deforestation, the just transition and double materiality.

No. 1: Deforestation

Ending deforestation is critical to curbing climate change and protecting the world's biodiversity. Reducing greenhouse gas emissions is only part of the battle; we also need to actively remove carbon from the atmosphere if we're to stand a chance of meeting mid-century global targets for curtailing global warming and achieving net zero. One of the simplest and most effective ways of removing carbon from the atmosphere is a natural one: ending deforestation. Globally, natural capital has been undervalued for decades. And it's not only the emission cuts that forests bring - they are also home to most of the world's terrestrial biodiversity and support the food security, jobs and livelihoods of many millions of people across the world. One encouraging highlight from COP26 was a commitment from more than 100 world leaders to end deforestation by 2030.

But as investors we think we can be more proactive in this regard. Specifically:
- At COP26 in Glasgow, Fidelity joined over 30 financial institutions representing more than US$8.7 trillion in assets under management in signing a pledge to eliminate agricultural commodity-driven deforestation risks across our investment portfolios by 2025. This pledge puts a focus on key 'forest-risk' agricultural commodities like palm oil, soy, beef and leather, pulp and paper, and starts with an exposure assessment to be completed by the end of 2022.
- We also joined the Natural Capital Investment Alliance, a group of 15 asset managers who have collectively pledged to mobilise more than US$10 billion by the end of 2022 into investment products aligned with protecting natural capital. This ranges from direct investments in sustainable forestry to investments in businesses that act to relieve pressure on forestry, biodiversity, and ecosystems.

No. 2: The just transition

Rich countries grew rich on the back of the carbon emissions created through industrialisation. It is right that they are now leading the decarbonisation charge. But the drive to net zero shouldn't prevent developing economies from developing or employees who are displaced by greener technologies from finding meaningful work.

This is what we mean by a just transition. Fidelity's new climate investing policy supports this and prioritises active engagement over passive exclusion across our investment portfolios. Throughout 2022, we will be targeting the biggest emitters through transition engagement, starting with thermal coal producers. We will expand this engagement to utilities and power generators, leading to a phase-out of thermal coal exposure across our portfolios by 2030 for OECD markets and by 2040 globally. The private sector has a key role to play in facilitating the shift to clean energy, but in a way that scales genuine alternatives for baseload power generation in the many countries that remain dependent on fossil fuels while also addressing the social challenges for workers and communities impacted by the transition. The race to net zero can't afford to leave anyone behind.

No. 3: Double materiality

Double materiality recognises that companies are not only responsible for managing the financial risk of the social and environmental factors upon which they depend - it also means that companies are responsible for the actual impact that their business has on people and the planet. As investors driven by fundamental research, we are seeking to embed this principle of double materiality in the next iteration of our proprietary forward-looking sustainability ratings, and to integrate the non-financial impact of our decisions as investors.

Fidelity's ESG ratings span our equity and fixed income coverage universe and now include around 5,000 companies. We are constantly adding more. In addition, we are introducing a specific and proprietary climate rating to assess the genuine ambition and alignment of our investees to a net zero future. This is just one way we are putting our beliefs into action, because in the long run, profitability can't exist without sustainability.