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The Risk of Hedge Fund Herding and its Role in Today's Financial Markets

By Garth Puchert, Venkat Rao, and Sabrina Tran

Over the past several decades, hedge funds have grown from a niche investment to a key asset management tool for institutional investors around the world. Since 1997, hedge assets under management have skyrocketed from $118 billion to nearly $3 trillion. In recent years however, "herding" has become more common in the industry, posing increasing risks for investors. Specifically, hedge fund "groupthink" reflects managers chasing too few ideas and finding little to no success when an investment fails for multiple funds. While hedge fund managers research possible investments, outside information can be just as influential. Fund managers find themselves receiving information among their peers at various networking events, and may use certain ideas to make certain investment choices. This type of information influence can be referred to as informational cascade. As hedge fund herding remains a reoccurring issue, it will continue to adversely affect the financial industry.

Herding became a term linked to market downturns such as the bursting of the dotcom bubble of the late 1990s and the financial crisis of 2008. Essentially, herding is a mentality characterized by minimal individual decision-making, resulting in fund managers thinking and acting as their peers. From a psychological standpoint, the study of observable human behavior, also referred to as behavioral theory, supplements why herding may occur. People learn to respond to particular situations through observing others and viewing those people as models for imitation and guidance. Common models are those who are seen as successful and are rewarded individuals. These models can be used for two types of herding: intentional and unintentional herding. Intentional herding refers to the common situation where managers are aware of the popularity of his or her stock pick. Essentially, those who intentionally herd consciously follow the crowd. In contrast, many fund managers also find themselves unintentionally herding, or investing in the same stocks as others with no prior agenda. Though there are distinct definitions between intentional and unintentional herding, there is no definitive way to differentiate between the two forms of herding. It is easy to merely accept intentional herding as the reason for fund managers investing in similar stocks, but there are situations where the herding is purely unintentional.

All hedge fund managers have access to publicly available information, but research and analysis internal to a firm also influences decision making. When a fund manager makes a decision, it often starts a ripple effect of knowledge that travels from person to person. Their choices, in addition to their own personal knowledge and inferences, inevitably and unintentionally influence the decision making of fund managers to come. The name for this trickling information signal is called informational cascade. An informational cascade can be illustrated by a simple example: An average individual assumes, unlike himself, a financial specialist has a calculated understanding of stocks. As a result, the individual imitates the specialist's investment decisions. A friend of the average individual observes him boasting about his successful stock picks and by making the same initial assumption as the average individual, the friend ultimately decides to invest in the same stocks. The pattern will continue to spread from person to person. This cause and effect is a blind trust of information and essentially starts the informational cascade. Overall, the flow of private knowledge from person to person, whether the recipient knows it or not, influences that individual's decision making. When fund managers are unaware of their participation in the cascade their actions can resemble intentional herding. In truth managers are unintentionally herding as a result of their decisions trickling down from someone else's previous investment decisions.

As the competition to meet client demands has become fierce, the industry has developed to the point where fund managers have immense pressure to retain clientele and to deliver on clients' return expectations. The competition throughout the industry has also sparked competition amongst fund managers within their own firms, driving managers to work towards minimizing their blame for company return on investment. This results in a great deal of fund managers finding themselves uncertain in their skills and fearful of tarnishing their reputations. This risk-averse mentality, which many managers are similarly victims of, is an outgrowth of the fear of reputation risk. They become more reliant on what they are accustomed to investing in and look for investments that offer certainty. Many fund managers invest in specific stocks and securities that fill the previously stated requirements only to find many other managers using the same strategy. While this may seem like herding, their unintentional mentality and similar situations ultimately force managers to invest in the same types of available stocks and securities.

Fund managers should consider the long-term risks and consequences of herding. A few of the risks can be observed during the burst of the dotcom bubble in the 1990s, as it was the result of excessive investment in online retailing and tech stocks. NASDAQ tech stocks grew from around 1,000 points in 1995 to more than 5,000 in 2000, but by April of 2000 nearly a trillion dollars' worth of stock value was gone. The rush of investments in the same stocks resembles the theory of informational cascade. In the event a fund manager in an informational cascade loses money, everyone in that herd follows with the same losses. When herding occurs, the majority has taken the same position and direction in the market, resulting in there being no one left to push trends any further. Therefore, as the herd grows, the risk for a financial crisis increases exponentially.

Transitioning into a great digital age in today's markets, another risk has also emerged. Artificial intelligence poses a risk to fund managers, as a result of robots being able to complete the same tasks humans are currently completing, but without human biases and sensitivities. If herding continues, it might put fund managers at an even greater risk of replacement. Therefore, intentional or not, herding remains a hurdle in the financial industry, and finding possible solutions for the problem is an integral part of preventing future investment risks and catastrophes from arising.

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Trends in Fund Administration:
Consolidation, Fee Alignment and Market Transformation

By Eamonn Greaves, Managing Director, Head of Business Development at SS&C GlobeOp

The fund administration business is undergoing a significant transformation. Merger and acquisition activity among fund administrators is expected to continue, as is the shift away from bank-owned administration businesses. Increased focus on fee alignment, a volatile regulatory landscape and the overall digital evolution of the financial services market are signifiers that fund administrators must adapt to meet rising expectations in order to succeed.

CONSOLIDATION

The fund administration business has witnessed quite a bit of consolidation over the past few years, especially due to the decision of many large banks to exit the space, including Citi Bank, Wells Fargo and Credit Suisse, just to name a few. Banks have understandably been reluctant to keep investing in an activity that is on the fringe of their core business, so it is likely that the industry will continue to undergo even more consolidation as banks realign priorities. As the fund administration business continues to experience a digital transformation, banks have also realized that they don't want to sink resources into software development for their fund administration businesses. The transition from banks to independent fund administrators is a logical one, as it allows banks to re-focus on the more profitable parts of their business and provides a higher level of service for funds that only an independent administrator can deliver.

Investing in new technologies and staying abreast of market trends, investor needs for transparency and the regulatory environment is essential to running a successful administration business. Free from the red tape that's often tied to banking, independent fund administrators can be more agile and scalable, and place a larger emphasis on technology development. The benefits of using a truly independent fund administrator are plenty, but most importantly, an independent provider is focused on providing the highest quality of service. Many funds have either moved away or are currently exploring moving from bank-owned administrators to seek better service provided by specialist fund administration companies.

FUNDS SEEK GREATER VALUE

Another emerging trend is the pressure brought on by general underperformance of hedge funds over the past couple of years. There's little question that fund managers expect more from their fund administrators than they did in the past. Managers that still perform their fund administration in-house may likely explore third-party enterprise solutions for the first time, but they will be very conscious of cost. As funds are feeling a squeeze on profitability, administrators are feeling some pressure to make sure their fees are in alignment with their clients' needs and expectations. This may mean taking a variable fee approach, while simultaneously ensuring that managers are delivering services as efficiently and cost-effectively as possible.

In addition to greater cost value, investors expect more value from their reporting. Asset managers are calling for increased transparency and are holding administrators to the highest standard of regulatory reporting. The complexity of evolving regulatory standards, such as FATCA, means that the operational burden facing managers is substantial. While larger managers might be better equipped operationally, meeting compliance standards such as FATCA present a massive operational challenge for most firms. To ensure efficient regulatory reporting and continued client success, fund administrators need to take a centralized approach to data management. By finding ways to create measurable efficiencies, administrators will be able to produce greater value for their clients.

A TRANSFORMING MARKET

Much has been written lately about the trend toward quantitative strategies, especially on the part of larger funds. While the expectation might be that this would drive higher trading volume, administrators won't feel a large impact from an operations or technology point of view. Instead, the more disruptive trend is demand from traditional asset managers as they seek to pursue alternative strategies. As the lines between these businesses become more and more blurred and asset classes continue to expand, asset managers are looking at how to improve their middle office processing capabilities to handle the volume and level of complexity they have not been accustomed to. For administrators that can deliver middle office expertise underpinned by a solid technology backbone, this segment of the market is likely to be a strong growth area in the near term.

As client needs evolve, so too do the services and capabilities fund administrators must deliver. Flexibility and an adaptable technology infrastructure are critical to success. The primary goal of any fund administrator is to retain clients and ensure they're receiving what they need, including timely and accurate regulatory filings. It's vital to invest in technology to accommodate the changing demands of fund managers. Administrators that are diversifying their offerings and implementing new technologies while maintaining a consistent level of quality service stand to succeed in this environment.

Eamonn Greaves is managing director, head of business development at SS&C GlobeOp.

Loan Origination as an Asset Class — What Tax Issues Do I Need To Be Aware of?

By Simcha David, CPA, JD

In Hollywood, everyone you meet in a café is a director or producer in the film industry. Today in the asset management industry, everyone you meet is interested in direct lending. Many times the origination fees associated with a direct lending opportunity make for stellar returns on these investments. Direct lending, however, can lead to unanticipated tax consequences for certain limited partners. There are ways for both hedge funds and private equity funds to engage in such loan origination activity and to minimize the impact that this asset class may have on their non-U.S. and tax- exempt limited partners. The purpose of this article is to give a brief overview of the issues and possible consequences of engaging in loan origination.

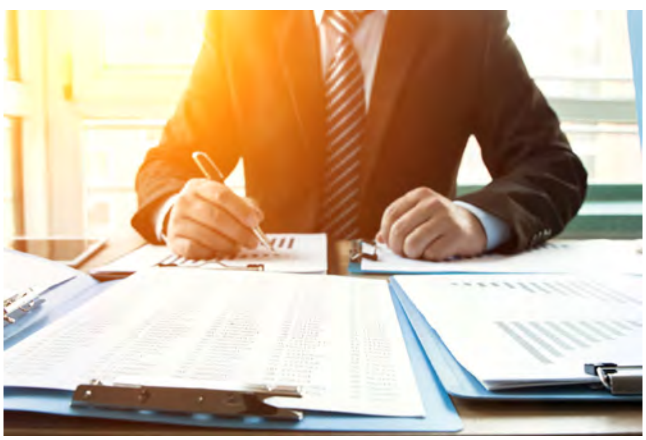
There have long been debt funds that have relied on purchasing debt on the secondary market. After the collapse of the debt markets in 2008, distressed debt assets were a very common asset class in hedge and private equity funds. As the availability of these assets began to become scarcer, some of the larger funds started to purchase distressed assets in Europe and Asia. Others began to focus on the U.S. lending markets to help fill a void that large banks had left in the loan origination space post the 2008 financial crisis.

Purchasing debt on the secondary market from a tax perspective is like purchasing any other security. For a non-U.S. limited partner in a fund, the interest income would most likely not be subject to withholding under the portfolio interest exception and the ultimate sale of the debt instrument would be a capital gain sourced to the domicile of the non-U.S. investor. Technically, one could buy and sell debt on the secondary market on a regular and continuous basis and not generate income effectively connected with a U.S. trade or business. This is due to the Internal Revenue Code Section ("IRC") 864(b)(2) safe harbor provision that excludes from the definition of the term "trade or business within the United States" trading for one's own account through a U.S. broker or manager so long as the activity does not rise to that of a dealer in stocks and securities.

Loan origination on the other hand is not protected under the Section 864(b)(2) safe harbor. Over the years, courts have focused on certain attributes to distinguish between origination activities that rise to the level of a lending or financial trade or business and the act of simply purchasing debt securities on the secondary market. Some of the common attributes of a lending trade or business include: Interaction and or negotiation with borrowers or issuers; solicitation of customers; receipt of fees for lending (i.e., "origination" or similar fees); performance of ancillary services; and the activity being considerable, continuous and on a regular basis.

What is interesting about the court cases on loan origination is that at times it is more advantageous for the government to argue that a taxpayer is not in a trade or business and other times it is more advantageous for the government to conclude that it is in a trade or business. With regard to U.S. taxpayers, if a debt investment goes bad, the bad debt expense will be an ordinary loss rather than a capital loss if the taxpayer was engaged in a trade or business. The government would rather not give a taxpayer an ordinary loss which would offset ordinary income as opposed to a capital loss which can only offset a minimal amount of ordinary income. On the other hand, where a non-U.S. taxpayer is involved, the government would rather conclude that the taxpayer is in a trade or business and is in receipt of effectively connected income ("ECI") to a U.S. trade or business subject to withholding, and, if not structured properly, may also be subject to an additional branch profits tax bringing the effective tax rate to over 50%.

How many loans need to be originated to be considered engaged in a U.S. trade or business? In Pasquel vs. Commissioner, the Tax Court concluded that one loan from a foreign individual to a U.S. taxpayer did not rise to the level of a trade or business. Many service providers tell their clients that a fund can safely originate up to five loans before having to be concerned that it is going to be treated as engaged in a lending trade or business. The magic number "five" comes from a private letter ruling issued by the IRS in the context of whether income from the loan origination activities of a particular fund could qualify for the "qualifying income" exception that hedge funds utilize to keep from being treated as a publicly traded partnership ("PTP") that would be treated as a corporation. In that letter ruling, the taxpayer represented that it would not originate on average more than five new mortgages per year over any five-year period. The ruling concludes that this activity did not rise to the level of a financial business and as such the interest income generated would be "qualifying income" which includes simple interest income but does not include interest income from a financial or insurance business. In the private equity fund context where a fund lends money to an investment in which they also own equity, the U.S. Supreme Court concluded in Whipple vs Commissioner that such lending activity is not considered the activity of a lending trade or business as there is already a pre-existing relationship with the "customer" and the loan is made to enhance the equity investment.



Direct lending takes on many forms. There is traditional lending, there is loan syndication, there is buying borrower dependent notes or trust certificates from a lending platform, there is buying loans from a third-party originator with or without a prior commitment to the originator and many other variations on the above. In addition, even when purchasing a loan from a non-related third-party originator, the originator may be deemed the agent of the fund if the relationship is not properly structured. Also, in the distressed debt area, caution is prudent where the terms of a loan may be renegotiated with the borrower and be considered a significant modification resulting in a new loan for tax purposes. While not all of these scenarios will result in a fund being considered in a U.S. trade or business, prudence requires that a conversation be had with one's accountant and attorney.

If a hedge fund is found to be engaged in a lending trade or business, it will result in ECI withholding on income attributed to the offshore feeder (which is generally set up as a Cayman corporation) and a branch profits tax at the offshore feeder. In the private equity context, where the offshore feeder is generally a pass-through entity for U.S. tax purposes, not only will there be withholding but the offshore investors will now have a U.S. filing requirement.

There are ways to structure the loan origination activity so that some of the adverse tax consequences are mitigated. It is important to be aware of the tax consequences of being in a lending trade or business so that proper steps can be taken, depending on each fund's particular circumstances.

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The Operational and Compliance Benefits that Establishing an Irish Fund May Have for U.S. Managers

By Tom Brennan, Partner, EisnerAmper Dublin, and Carol O'Sullivan and Graham Roche, Davy Investment Fund Services, Dublin

WHY ESTABLISH YOUR FUND IN IRELAND?

Ireland has become a key strategic location for investment funds employing over 13,000 people directly in investment fund related activities. Irish domiciled funds had aggregate NAV of $2.6 trillion at Q1 2017, with growth ranging on average of 16% per annum since 2010, and Brexit has resulted in a further increase in activity.

Key benefits for a U.S. fund manager establishing in Ireland are:

- Ireland is a centre of excellence for funds with a strong infrastructure to provide access to the EU market of 500 million people.
- AIFs authorised in Ireland can be sold across the EU under a marketing passport.
- Ireland has a strong open Euro Zone economy with a politically stable government and a legal system based on common law, an independent judiciary and strong property rights.
- Irish funds are not subject to any fund tax, and non-Irish tax resident investors are not subject to Irish tax. The corporation tax rate is 12.5% with double tax agreements with 70 countries.
- Ireland has been particularly innovative in the funds industry becoming the first EU member states to introduce a specific regulatory framework for loan originating investment funds. Recent enhancements to this regime make loan origination funds even more attractive for promoters, managers and, most importantly, investors.
- The introduction of a new investment vehicle called an Irish Collective Asset-Management Vehicle ("ICAV") in 2015, a corporate vehicle designed for Irish Investment Funds. It may be established as an umbrella structure with a number of sub-funds and share classes, and has "check-the-box" functionality for U.S. investors.
- Ireland has a clear and practical regulatory framework.

THE AIFMD COMPLIANCE FRAMEWORK

The Alternative Investment Fund Managers Directive ("AIFMD") refers to the EU law implemented in 2013 following the global financial crisis. AIFMD introduced regulation that impacts the management of hedge funds, private equity, real estate funds and other alternative investment funds in the European Union. The big benefit associated with AIFMD is that it can facilitate the marketing of funds managed by an EEA[1] AIFM to professional investor's based in the EEA — a market with some 500 million+ inhabitants.

The Central Bank of Ireland ("CBI") has configured the AIFMD management functions into six headings.

1. Regulatory Compliance
2. Fund Risk Management
3. Operational Risk
4. Investment Management
5. Capital & Financial Management
6. Distribution

*As outlined in CBI Guidance of 19 December 2016. The CBI also requires that the chair of the board of the AIFM assume responsibility for the organisational effectiveness of the AIFM to ensure that it is and remains fit for purpose, with due consideration for conflicts of interest and supervision of its delegates.

[1] *The European Economic Area ("EEA") includes EU, Iceland, Liechtenstein and Norway.*

OUTSOURCING OF AIFMD COMPLIANCE FUNCTIONS

Whilst the cost and resource involved in establishing and operating its own EU AIFM are likely to suit only a larger scale investment manager, there are various compliance outsourcing solutions available through third-party service providers. Although AIFMD envisages delegation of certain management functions, it is clear that substance in the EU is expected and that delegation of management functions to the point of the AIFM becoming a letter box entity is not permitted. However, management functions may be delegated provided that certain conditions are met. This can be an attractive option for U.S. investment managers. Each model described below allows for the delegation of the portfolio management function to a U.S. investment manager.

OUTSOURCING MODELS AND BENEFITS

1. Self-Managed AIF

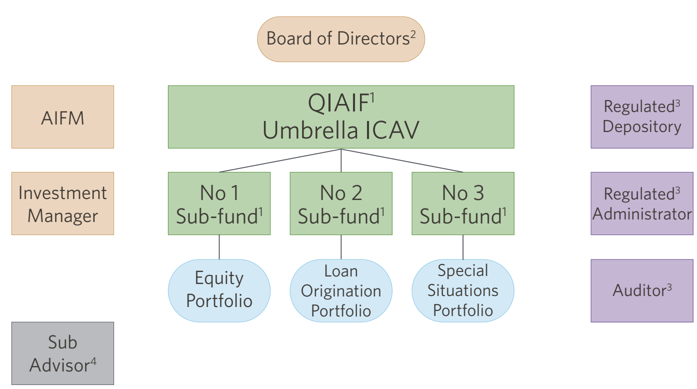
A U.S. investment manager could choose to establish a self-managed AIF, and this would typically be structured as a sub-fund of a dedicated ICAV platform established by the manager. The AIF may apply itself to the CBI for authorisation as an AIFM; however this is quite a time consuming process, and typically takes eight or nine months from a standing start. In this case, the board of the AIF assumes responsibility for compliance with the requirements of AIFMD. In its execution, the AIF must of course be capable of evidencing to the regulator its thorough compliance with the requirements of AIFMD resulting in additional costs, as it will need the requisite level of local compliance expertise. From an outsourcing perspective, the AIF's board could seek the support of "designated persons,"

whereby suitably experienced individuals, pre-approved by the CBI, are appointed to support the board in respect of certain of the AIFMD management functions. The liability for non-compliance, however, remains with the board. A fund manager may also weigh up the monetary cost to investors of the self-managed model as against opting for an outsourcing model. The size of the AIF should warrant the resources expended to achieve AIFMD compliance. The self-managed model does not offer the benefits of an arm's length oversight of the AIF. Investment managers, who are at a physical remove from the location of their fund, may consider the benefit of an external AIFM which can offer a local, independent oversight of the fund and its appointed service providers.

2. External AIFM

An increasingly common alternative is for the AIF to appoint an external AIFM, a fund management company that is independently authorised by the CBI to fulfil the role of AIFM. It is a separate legal entity, appropriately capitalised and staffed, with a suitably experienced board of directors. In appointing an external AIFM, the AIF delegates compliance with AIFMD in respect of the AIF to the AIFM. The responsibility for AIFMD compliance then sits with the board of the AIFM and not with that of the AIF. The AIFM then typically delegates the portfolio management back to the U.S. investment manager (subject to authorisation by the CBI). A major advantage to this option is that it significantly reduces the critical path to launching the fund as a local AIFM will already have the requisite regulatory approval. It is possible to launch an AIF within three months under this model. Economies of scale can also be expected and this may suit an AIF with a lower assets under management figure. A reduced regulatory cost could free up resources to be directed at core activities, including fundraising and marketing. The appointment of an external AIFM should ideally leave an AIF with the financial and regulatory relief of delegating to an external party on appropriate commercial terms, with the flexibility that a third-party appointment offers for future change. An AIFM may also seek authorisation from the CBI to act as a UCITS ManCo, giving it "Super ManCo" status and offering additional flexibility to investment managers who may wish to market different products under both headings but outsource the associated compliance function.

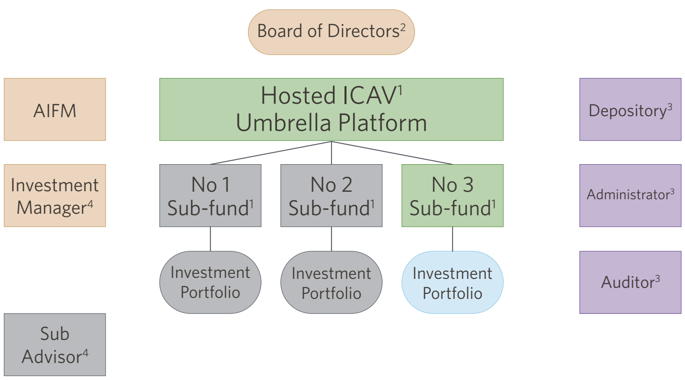
An alternative option is to have the local AIFM take the discretionary investment decisions for the fund, where the AIFM acts under the advisement of the U.S. sub-advisor. In this instance, there is no requirement for the sub-advisor to seek authorization from the CBI.



1. Dedicated ICAV platform - the umbrella structure lends itself to the creation of individual self-contained sub-funds, each with its own investment strategy.
2. The U.S. manager selects the board of directors (must include a minimum of 2 Irish resident directors).
3. The U.S. manager selects all service providers.
4 The AIFM could appoint a third party investment manager, with the U.S. manager acting as sub-advisor.

3. Hosted Platform

A more cost effective and expedient variation of option 2 above is where the AIF is structured as a sub-fund of the AIFM's hosted umbrella ICAV platform. Here, the U.S. investment manager can avail of economies of scale by leveraging the AIFM's pre-established infrastructure, including board of directors, AIFM, administrator, depositary and auditor. As the directors and company secretary are common to the platform, their costs are allocated across each of the hosted sub-funds. It is possible to launch an AIF within two months under this model. A hosted platform solution is akin to "plug and play," and may be suitable for AIFs where there is uncertainty on the ultimate fund size. This option is facilitated by the flexibility of the ICAV investment fund vehicle, and in particular the segregation of assets and liabilities between sub-funds. The benefits associated with this option are the speed-to-market and the lower operating and establishment costs; however this should be weighed up against the inability to appoint directors or choose the service providers.



1. The ICAV is an umbrella fund with segregated liability between all sub-funds.
2. The board of directors is appointed at ICAV level and must comprise a minimum of 2 Irish resident directors. An established hosted platform will already have the board of directors in place.
3. Service providers are appointed at platform level; therefore common to all sub-funds thus providing economies of scale.
4. The investment manager (and sub-advisor – if any) are appointed at sub-fund level.

CONCLUSION

The outsourcing of AIFMD compliance functions can take different forms to suit U.S. managers of varying size and needs. In each form, the benefits include a local knowledge of the requirements and a freeing up of the U.S. investment manager's time and resource to focus on its core expertise, in a cost efficient manner.

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DIFS is part of the Davy Group which was established in 1926, and has "Super ManCo" status. In 2014 it was authorised by the Central Bank of Ireland as an Alternative Investment Fund Manager ('AIFM'), and in 2017 it was authorised to act as a UCITS ManCo.

Alternative Investment Industry Outlook for Q3 and Beyond in 2017

By Elana Margulies-Snyderman

INTRODUCTION

With continued outperformance for hedge funds in the first half of 2017, investors across the globe looking ahead are still bullish on them, unsurprisingly a consensus toward favoring quantitative managers. Yet, beyond quants, strategy preference tremendously varied throughout the geographic regions. On the heels of enhanced allocator interest, despite the number of launches this quarter being lower than in prior quarters, the launch sizes comparatively speaking are larger. And as expected, investors still continue to exert fee pressure on managers and lower fees are becoming the new industry standard.

INVESTOR OUTLOOK

EisnerAmper has heard from capital introductions professionals from boutique through top-tier prime brokerage groups that all types of investors worldwide were looking at quantitative managers, with most popular managers in this space receiving the most inflows. However, besides quant, there appears to be a dispersion amongst investors when it comes to other strategies of choice.

Here are some brief takeaways from across the globe:

- U.S. investors are comfortable with the number of hedge funds in their overall portfolio and are looking to replace managers who aren't performing. Strategies of appetite included fundamental, systematic and emerging markets, due to the inefficiencies that exist.
- For Europeans, funds that employ environmental, social and governance ("ESG") investing appear to be a big theme due to concerns about environmental sustainability.
- In the Middle East, dominated by Sovereign Wealth Funds, there is favoritism to the large blue chip managers although some have invested in some high-profile $1 billion plus spinouts. Regarding strategy, they are looking at Europe and Asia-based managers to diversify their heavily-focused U.S. portfolios. Some attractive new investment themes in Asia investors are looking to capitalize on include Japan's shareholder-friendly corporate governance reform and the China domestic consumer play.
- In Asia, long/short managers appeared to be the most popular, followed by macro.

HEDGE FUND LAUNCHES

The launch pace of hedge funds has subsided this quarter comparatively speaking to other quarters. However, the launches the industry is seeing appear to be bigger this quarter.

"Although a slower than normal quarter in terms of volume of launches, the launch sizes appear to be larger than normal with three new funds, that we are aware of, that have raised/are raising over $1 billion in startup capital," said Frank Napolitani, director in EisnerAmper's Financial Services Group based in New York."The strategies are still heavily favored towards equity strategies and we believe this is a continuation of the post-Election market rally."

FEES

Investors continue to exhibit the upper-hand with fees they are paying for their underlying managers. At an EisnerAmper-co-hosted event on the West Coast this Summer, investors, including a fund of fund (FoF)/institutional advisor, single family office and bank alternatives platform, showcased their outlook on alternatives. Unsurprisingly, the topic of fees was a big part of the discussion.

"Fees continue to see downward pressure," said Eugene Tetlow, business development manager in EisnerAmper's Financial Services Group based in San Francisco. "Investors understand that a fund manager needs to keep the lights on but as the fund grows, early stage investors like to feel that they are being rewarded for getting into the fund early and expect a further break. There is no indication that we will ever return to the told 2/20 model and with increased competition from new fund strategies, 1.5/15 seems to be the new normal."

The three investors present had different views on how they address fees. Since the FoF runs large long-only multi-manager vehicles in addition to hedge funds, it is used to hurdle rates that the hedge fund industry is adopting. The single family office, who views everything on an after-fee basis, for the right strategy, is willing to pay higher fees. Finally, the bank platform, who thought the discount on fees, especially the carry, makes a lot of sense, is willing to pay the first 2%/15% for the founder's class shares but as AUM milestones are reached, they would hope that managers would lower their fees for these early investors.

CONCLUSION

If predictions hold true for the remainder of 2017, based on enhanced global investor interest in hedge funds, managers should reap the benefits, especially the new launches who are poised to debut with greater AUM compared to prior quarters. Finally, managers should still be prepared to exert flexibility when it comes to fee requirements from investors who continue to demand lower fees or special arrangements for the earliest partners.

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Focus on Private Funds: SEC Enforcement Priorities

By Todd Hankin and Gautham Deshpande

When it comes to portfolio valuation, independent auditors frequently consider whether valuation policies and procedures are properly designed and implemented and are being monitored for ongoing operating effectiveness. Consequently, private fund advisors devote resources to ensure that their valuation policies and procedures are "audit-ready."

But did you know that having properly designed valuation controls in place and operating effectively can also pay big dividends when it comes to SEC examinations?

Speaking at the recent Securities Enforcement Forum West 2017, Jina L. Choi and Michele Wein Layne, directors of the SEC's San Francisco and Los Angeles Regional Offices, respectively, noted that private fund advisors can expect that valuation practices will continue to be an exam and enforcement priority. In particular, the SEC is focusing on structural issues around valuation, such as failure to follow firm policies and procedures or breakdowns in controls. For example, Directors Choi and Layne noted recent enforcement cases where advisors failed to follow appropriate procedures in valuing illiquid securities and those individuals responsible for governance oversight, such as directors, were charged with failure to fulfill their fair value-related obligations. The directors emphasized that both advisors and those responsible for governance can expect to face continued scrutiny of their valuation policies and procedures, including the oversight of those processes.

STRUCTURAL ISSUES AROUND VALUATION

As the SEC makes clear, the process by which a private fund advisor determines a fair value measurement can be just as important as the amount ultimately recorded in the portfolio. Advisors can expect that their chosen valuation approaches (for example, market or income), the techniques selected under each approach (for example, guideline public company or discounted cash flow), and the inputs used will be scrutinized and challenged. Being ready for this challenge requires policies and procedures that are robust and at the same time realistic. In other words, it does no good to have a beautifully crafted set of valuation policies and procedures if the investment advisor is unable to implement and adhere to those policies and procedures.

ARE YOUR VALUATION POLICIES AND PROCEDURES AUDIT- AND SEC-READY?

A well designed valuation policy includes:

1. A control environment in which those individuals responsible for governance provide active oversight of management's valuation process.
2. An assignment of authority and responsibility that ideally segregates the duties of those responsible for selecting investments, those valuing investments, those settling investments, and those accounting for the investments. When an entity is too small to achieve ideal segregation of duties, the role of management and those charged with governance is of even greater importance.
3. Ongoing monitoring of activities designed to detect and correct any deficiencies in the effectiveness of controls over investment transactions and their valuation.
4. A valuation methodology that begins with a thorough understanding of the investment being valued in order to identify and evaluate all relevant market information that is available.
5. A defined process for handling deviations from valuation guidelines.

When developing specific valuation techniques, factors considered by management and those charged with governance may include:

- Whether the valuation techniques are commonly used by other market participants and have been previously demonstrated to provide a reliable estimate of prices obtained from market transactions.
- Whether the valuation techniques operate as intended, and there are no flaws in their design, particularly under extreme conditions, and whether they have

been objectively validated. Indicators of flaws include inconsistent movements relative to benchmarks.

- Whether the valuation techniques take into account the risks inherent in the investment being valued, including counterparty creditworthiness, and own credit risk in the case of valuation techniques used to measure financial liabilities.
- How the valuation techniques are calibrated to the market, including the sensitivity of the valuation techniques to changes in variables.
- Whether market variables and assumptions are used consistently and whether new conditions justify a change in the valuation techniques, market variables, or assumptions used.

SPECIAL CONSIDERATIONS WHEN USING A THIRD-PARTY PRICING SOURCE

Investment advisors may make use of a third-party pricing source, such as a pricing service or broker, in valuing investments. Understanding how the pricing service operates assists management and those charged with governance in determining the relevance and reliability of information provided by third-party pricing sources. The degree to which an investment advisor has controls in place to review and approve the use of the third-party pricing source, including consideration of the reputation, experience, and objectivity of the third-party pricing source and to determine the completeness, relevance, and accuracy of the prices and pricing-related data, affects the reliability of the fair value measurement.

The following matters may be relevant when an investment advisor uses a third-party pricing source:

- *The type of third-party pricing source.* Some third-party pricing sources make more information available about their process. For example, a pricing service often provides information about its methodology, assumptions, and data in valuing financial instruments at the asset-class level. By contrast, brokers often provide no, or only limited, information about the inputs and assumptions used in developing the quote.
- *The nature of inputs used and the complexity of the valuation technique.* The reliability of prices from third-party pricing sources varies depending on the observability of inputs (and, accordingly, the level of inputs in the fair value hierarchy) and the complexity of the methodology for valuing a specific security or asset class.
- *The reputation and experience of the third-party pricing source.* For example, a third-party pricing source may be experienced in a certain type of financial instrument and be recognized as such but may not be similarly experienced in other types of financial instruments.
- *The objectivity of the third-party pricing source.* For example, if a price comes from a counterparty, such as the broker who sold the financial instrument to the entity, the price may be less reliable than a price from an objective third party.
- *The third-party pricing source's controls.* A third-party pricing source may have strong controls around how prices are developed. In addition, the third-party pricing source may include the use of a formalized process for customers, both buy and sell side, to challenge the prices received from the pricing service when supported by appropriate evidence. This enables the third-party pricing source to constantly correct prices to more fully reflect the information available to market participants.

An important element to emphasize is that, while an advisor may engage others to assist with fair value measurements, the advisor remains ultimately responsible for the determination of fair value.

OTHER ENFORCEMENT PRIORITIES

In addition to its focus on valuation of investments, the SEC earlier this year announced several other examination priorities including a focus on protecting retail investors, senior investors and retirement investments, addressing market-wide risks and cybersecurity. Further, SEC enforcement activity continues to be strong, with 868 enforcement actions during 2016 compared to 807 enforcement actions in 2015 and 755 during 2014. 2016 also saw a record-breaking 160 enforcement cases involving investment advisors and investment companies. The SEC also brought 8 enforcement actions related to private equity advisers, bringing the total number of actions relating to private equity to 11 in the last two years.

The SEC's examination of private funds has focused on:

- **Insider trading –** cases involving complex insider trading rings cracked using innovative data and analytics to spot suspicious trading;
- **Valuation of illiquid securities –** failure to follow written policies and procedures disclosed to investors;
- **Undisclosed fees –** failure to adequately disclose fees or compensation that directly and indirectly benefit the adviser; and
- **Trade allocation –** focus on 'cherry picking' allocation to benefit the advisor by allocating favorable trades to high

fee accounts or not allocating in a manner consistent with disclosure made to investors.

The SEC has also brought action against 'gatekeepers' such as attorneys, independent accountants, fund administrators and consultants for failure to comply with professional standards.

CONFLICTS OF INTEREST

The SEC in the recent past has also focused on adequate disclosure of potential or perceived conflict of interest to investors. It recently brought an enforcement action against the subsidiaries of a large investment manager for failing to disclose conflicts of interest to clients. The firms charged admitted to wrongdoing in their settlements with the SEC.

CYBERSECURITY

The SEC generally views hacked entities as victims. However, based on recent statements made by the SEC staff, one cannot rule out the possibility that the SEC would hold a hacked entity liable, particularly if it failed to implement robust cybersecurity policies or procedures to mitigate risks, or knew it had vulnerabilities and failed to address them.

DO YOU DO WHAT YOU TOLD YOUR INVESTORS?

In conclusion, the SEC seems to be focusing on whether the private fund advisers are following through on the commitments/promises made to investors through their offering documents and financial statements. Be it controls around valuation, cybersecurity, trade allocation or conflict of interest, the focus is on implementing in proper spirit the policies, procedures and safeguards communicated to the investors that create a reasonable belief or expectation that such policies will be followed.

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