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The Evolving Regulatory Framework: Are Virtual Currencies Securities or Commodities?

By Venkat Rao

Regulators continue to grapple with how to oversee high-profile products using blockchain technology, particularly cryptocurrencies and initial coin offerings ("ICOs"). The marketplace for these products has grown significantly over the past few years through rapid technological change, and cryptocurrencies have increased as a source of capital raising. Such growth carries significant risks, such as fraudulent actors and failure to comply with established financial services regulations. The SEC and the Commodity Futures Trading Commission ("CFTC") have been at the forefront of this scrutiny with several statements and enforcement cases over the past year.

Regarding securities law, the SEC has naturally raised the question as to whether virtual currency products and services are subject to those laws. The Commission has reviewed the use of virtual currencies on a case-by-case basis through established and traditional approaches to securities regulation. In a recent investigative report, the SEC stated unequivocally that "foundational principles of the securities laws" apply to virtual currency firms and those making use of distributed ledger technologies, such as blockchain.[1] Under a four-part test (known as the "Howey test"),[2] ICOs will be deemed securities by the Commission if the transactions are:

1. An investment of money;
2. In a common enterprise;
3. With a reasonable expectation of profits; and
4. Profits are derived from the entrepreneurial or managerial efforts of others.

As noted, the SEC has found ICOs or token sales to meet each element of the Howey test through some key factual findings. First, an "investment of money" is not limited to cash, therefore digital currencies, such as Etherium or Bitcoin, meet the first element. Second, the content of promotional materials will be decisive in determining whether the investment occurs in a "common enterprise with a reasonable expectation of profits." Key factors to consider include whether the investment included funding of projects in exchange for a return on investment. Finally, when determining if profits are derived from managerial efforts of third parties other than the investors, the Investigative Report cites the central issue is whether these efforts "are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[3]

The SEC is also concerned that investors, especially in retail, have a limited understanding of the risks involved in cryptocurrency products. The Commission has noted that cryptocurrency products are promoted in a similar manner as traditional financial services products, but contain unique risks such as:[4]

- Lack of government backing and support, unlike fiat currencies;
- No federal deposit insurance for cryptocurrency accounts (or wallets);
- Higher than usual volatility;
- Reliance on cryptocurrency companies that lack adequate internal controls; and
- Heightened cybersecurity or money laundering risk.

As for commodities regulations, the CFTC has taken a more direct approach by declaring virtual currencies, such as Bitcoin, commodities under the Commodity Exchange Act.[5] The use of virtual currencies in derivative contracts invokes the CFTC's jurisdiction, where firms may be required to register as swap execution facilities ("SEFs"), designated contracts markets ("DCMs") or derivative clearing organizations ("DCOs").[6] Very recently, the CFTC also announced it will be mandating notification of transactions in virtual currencies or virtual currency derivatives.[7]

New and existing market participants in virtual currencies are urged to be diligent in exploring these regulatory issues. New sell-side market participants may be required to register as broker-dealers with the SEC and become members of the Financial Industry Regulatory Authority ("FINRA"). Buy-side firms managing cryptocurrency assets may be required to register with the CFTC as CPOs (fund managers of pools executing cryptocurrency transactions) and/or CTAs (trading programs including cryptocurrencies for managed accounts). Existing market participants will need to observe regulatory guidance and watch for additional registration and reporting requirements.

What's the upshot of these pronouncements? Simply put, if you are a financial firm subject to these laws and regulations, you must properly register your firms with the SEC and/or CFTC and become members of FINRA and/or the NFA. Registration processes can take several months, and firms must have detailed business plans explaining the use of cryptocurrency products. The business plan is particularly important to fit virtual currency products within regulatory constructs dating back decades when technology was far less advanced. Policies and procedures must be created and implemented to cover various topics, including but not limited to codes of ethics, marketing and advertising, anti-money laundering, cybersecurity, business continuity planning and operations/trading requirements. As regulators increase scrutiny, existing and new market participants can expect greater reporting requirements.

No doubt, financial services firms will need to consult legal counsel to determine whether their cryptocurrency activities implicate securities laws. More importantly, firms must consider the scope of their business activities and plan for potential regulatory scrutiny.

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[1] https://www.sec.gov/litigation/investreport/34-81207.pdf, Securities and Exchange Commission, Securities Exchange Act of 1934, Release No. 81207/July 25, 2017. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO ("Investigative Report").

[2] See SEC v. Howey Co., 328 U.S. 293 (1946). The Supreme Court interpreted the meaning of an "investment contract" under the Securities Act of 1933.

[3] See Investigative Report, citing SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973). The SEC cites limitations on voting rights as indicative of relying on management by third parties.

[4] See http://www.nasaa.org/44073/nasaa-reminds-investors-approach-cryptocurrencies-initial-coin-offerings-cryptocurrency-related-investment-products-caution, North American Securities Administrators Association ("NASAA"), January 4, 2018, NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution.

[5] In the Matter of Coinflip, Inc. d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29, September 17, 2015.

[6] See http://www.cftc.gov/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf, A CFTC Primer on Virtual Currencies, October 17, 2017, where permitted activities under commodities law may require firms to register with the CFTC as SEFs, DCMs or DCOs.

[7] https://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4974, See National Futures Association ("NFA") Notice to Member I-17-28, December 14, 2017. Additional reporting requirements for Commodity Pool Operators ("CPOs") and Commodity Trading Advisers ("CTAs") that trade virtual currency products.

Private Equity Expense Allocations

By Stephen Mazzotti, EisnerAmper and Peter Tsirigotis, Stradley Ronon Stevens & Young, LLP

INTRODUCTION

Since their "Spreading Sunshine in Private Equity Speech" delivered on May 6, 2014 by Andrew Bowden, Director, Office of Compliance Inspections and Examinations, the SEC has shined a bright spotlight on how private equity fund managers are treating direct and allocated expenses to the funds they manage. It's no longer a matter of ensuring the appropriate language is included in the governing documents allowing the general partner to charge its respective fund expenses either directly or indirectly related to the investment activity. Financial statement disclosures of how and which expenses were charged and allocated to the fund and the internal documentation of the thought process as a fiduciary to the fund are also expected.

OVERVIEW: HOW PRIVATE EQUITY FIRMS ALLOCATE EXPENSES TO FUNDS THEY MANAGE

Private equity funds invest directly or via another entity (e.g., blocker corporation) in a portfolio company. As is typical with such investments, private equity firms will secure board seats to help guide the portfolio company to unlock value and hopefully sell at a later date for a profit to a strategic investor via an initial public offering. The appointed board directors may receive director fees for their service and may appoint affiliated consultants to help unleash the portfolio company's untapped value and receive consulting fees. In addition, it is customary to receive transaction fees and ongoing monitoring fees from the portfolio company.

More recent fund vintages have management fee offset provisions within the governing documents that would essentially reduce the management fees charged at the fund level. The fees that the portfolio companies pay bypass the fund and go directly to the investment adviser or its personnel. For example, if the management fee offset provision stipulates that any fees received from a portfolio company are a 100% offset to management fees charged at the fund level, the management fees would then be reduced by those received fees. If the LPs owe the investment manager $2,000,000 in management fees and transaction fees received by the investment manager amounted to $1,000,000, the LPs of the fund will only be charged a management fee of $1,000,000 at the fund level.

In addition, certain fees that the management companies incur related to running the business are often allocated to the funds the investment adviser manages. As such, the investment adviser will allocate these expenses to the respective funds. The SEC has focused on how these expenses are allocated and will review the allocation methodology and determine if this is in accordance with the LP agreement and other offering documents. In addition, the SEC will focus on the nature of the expenditure. For example, if legal fees are incurred for services rendered to a specific fund, that specific fund should be charged the legal expense and not allocated to the fund group or multiple funds.

SEC FINES INVESTMENT ADVISER POTOMAC ASSET MANAGEMENT FOR ALLEGEDLY IMPROPERLY ALLOCATING EXPENSES

On September 11, 2017, the SEC issued an order instituting administrative cease-and-desist proceedings (the "Order") against Potomac Asset Management Company, Inc. (the "Adviser") and Goodloe E. Byron, Jr., the Adviser's principal.[1]

The Adviser served as an investment adviser to two private equity funds, hereby designated as "Fund I," "Fund II," and, collectively, the "Funds." As set out in the Order, the SEC found that the Adviser violated the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The violations included improperly charging $2.2 million of expenses of a portfolio company to Fund I; failing to offset fees received from a portfolio company against management fees, as required by the limited partnership agreement; and improperly using the Funds' assets to pay the Adviser's expenses, including compensating a member of the investment team, and paying rent and other expenses.

The Order generally follows a string of similar orders issued by the SEC against private equity fund managers.[2] In one case, an adviser was improperly allocating costs, either by charging costs that it did not disclose or charging expenses in a manner that was inconsistent with its disclosure that should have been borne by the adviser instead of the fund. However, this Order presents somewhat of a unique twist, in that the SEC also stated that since the Funds' audited financials did not adequately disclose the Funds' fees, the Funds' financials were not prepared in accordance with U.S. Generally Accepted Accounting Principles ("GAAP").[3] The SEC also found that since the Funds' audited financials were not prepared in accordance with GAAP, the Adviser violated Rule 206(4)-2 under the Advisers Act (the "Custody Rule").

The Custody Rule regulates the custody practices of advisers registered under the Advisers Act. Generally, general partners of limited partnerships (or managing members of a limited liability companies) are deemed to have custody of client assets. The rule requires advisers that have custody of client securities or funds to implement a set of controls designed to protect those client assets from being lost, misused, misappropriated, or subject to the advisers' financial reverses. The Custody Rule provides that a private fund manager can demonstrate compliance if it distributes, at least annually, the fund's "audited financial statements **prepared in accordance with [GAAP]** to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year" [emphasis added].

HOW PRIVATE EQUITY MANAGERS CAN IMPLEMENT BEST PRACTICES

Due to the recent press and SEC orders, private equity managers should revisit their existing best practices methodologies and compliance manuals. Here are some suggestions that private equity firms should consider when revisiting or enhancing their best practices methodologies and compliance manuals.

Suggested action items for an investment manager:

1. Conduct a Mock Audit - Outsourced compliance service providers and consultants can emulate an SEC mock audit and provide suggested areas of improvement. A mock audit will aid in the shift of the compliance mind set of an investment advisory firm and view compliance as a value add and incorporate it into the firm's culture.
2. Pursuant to an adviser's fiduciary duty, document the allocation methodology to provide a defensible rationale for the allocation process.
3. Ensure its compliance program is consistent with and tailored to the adviser's business–avoid boilerplate compliance manuals.
4. Ensure that expense allocation methodologies are in accordance with governance documents.
5. Ensure financial statement disclosures, communications with limited partners, and required regulatory disclosures are consistent with business practice and governing documents.
6. For earlier vintage funds that do not specifically address management fee offsets, consider following a methodology that is expected from a fiduciary.

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[1] See In the Matter of Potomac Asset Management Company, Inc. and Goodloe E. Byron, Jr. (IA Release No. 4766/September 11, 2017)
[2] See In the Matter of Kohlberg Kravis Roberts & Co. L.P., (IA Release No. 4131/June 29, 2015)(broken deal expenses); In the Matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C., (IA Release No. 4219/October 7, 2015) (accelerated monitoring fees and discounts on legal fees); In the Matter of Fenway Partners, LLC, Peter Lamm, William Gregory Smart, Timothy Mayhew, Jr., and Walter Wiacek, CPA (Release No. 4253/ November 2015)(undisclosed payment by portfolio companies of consulting fees to an affiliate of the adviser).
[3] In the Matter of Alpha Titans, LLC, Timothy P. McCormack, and Kelly D Kaeser, Esq. (IA Release 4073/April 29, 2015) the SEC also found that the fund's audited financials were not in accordance with GAAP.

Limitation on the Deductibility of Net Interest Expense

By Simcha David

The Tax Cuts and Jobs Act is the most sweeping tax legislation since the Internal Revenue Code was completely overhauled by then President Ronald Reagan in 1986. The Act has provisions that affect individuals, corporations, flow-through entities, multinational corporations and tax-exempt organizations. One of the provisions of the Act that may have a profound impact on the world of finance is the far reaching limitation on the deductibility of net interest expense (the new IRC Section 163(j)). In the past, Congress, being wary of the possibility of abusing the benefit of the interest expense deduction, had limited the use of the interest expense deduction in only certain very specific situations. The new limitation, however, applies much more broadly.

To illustrate the difference between the old 163(j) and the new 163(j), the old rule applied only to corporations that had related-party debt and had a debt-to-equity ratio that was greater than 1.5:1. By contrast, the new rules apply to all "business interest." The rules apply to related and non-related party interest; they apply to sole proprietorships, partnerships and corporations; and they apply regardless of the debt-to-equity ratio of the entity.

As with every good piece of legislation, this new rule has a number of exceptions. The new limitation does not apply to any business with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $25 million (aggregation rules apply as they do in IRC Sec. 448(c)). This exception stems from recognition of the difficulty a growing small business might have if it was paying interest expense and not getting the benefit of a deduction for that interest expense. If such interest expense was limited, the business may find itself paying federal income tax on higher net income, even though it did actually pay out a now otherwise non-deductible expense. Since most state and local jurisdictions use federal taxable income as the starting point to determine state and local income taxes, the small business may find itself paying state and local income taxes on that amount as well.

Another important exception to the new rule is that a partnership invested in real estate can elect to be treated as an electing real property trade or business and remove itself from this new limitation. In exchange, the electing real property trade or business must use the ADS methodology of depreciation as opposed to the MACRS methodology for certain assets. In practical terms under the new depreciation rules, also enacted as part of the Act, this extends the depreciable life of the residential real property from 27.5 to 30 years and qualified leasehold improvement property from 15 to 20 years. With certain other tangible property that the electing real property trade or business is not required to use ADS for, such as furniture and fixtures, the new bonus 100% expense deduction would likely apply. The change in depreciable life is a small price to pay for the ability to deduct all of the interest expense generated. The real estate exception does make sense on some level as the industry runs on the use of debt to finance the purchase of real property.

To give a brief overview of the provision, we will start with the definition of business interest. Business interest income is defined as the amount of interest includible in the gross income of the taxpayer for the taxable year, which is properly allocable to a trade or business. Such term does not include investment interest as defined by reference to subsection (d) of IRC Section 163. IRC Section 163(d) limits the deduction of investment interest expense to the amount of net investment income a taxpayer includes in his income in a particular tax year. Otherwise, such interest is non-deductible and is carried forward to future years. In the asset management industry, this limitation is commonly referred to as the net investment interest expense limitation. The interest expense generated by the use of leverage in both trader funds and investor funds should be included in the 163(d) limitation (except perhaps the GP's portion of the interest expense of a trader fund to which 163(d) does not apply) and as such it would seem that the limited partners share of such interest expense would not be further limited by the new section 163(j) limitation.

Limitation:

In general, the amount allowed as a deduction for business interest expense shall not exceed the sum of:

1. The business interest income of such taxpayer for such taxable year;
2. 30% of the adjusted taxable income ("ATI") of such taxpayer for such taxable year; PLUS
3. The floor plan financing interest of such taxpayer.

Generally, in the financial services area, it is points (1) and (2) that will have the greatest impact unless your underlying portfolio company is an auto dealership. What is still unclear is whether payment of interest on shareholder loans to a blocker corporation whose proceeds are used to invest in an underlying operating partnership is really considered business interest expense.

ATI is defined as the taxable income of the taxpayer computed without regard to: (i) any item of income, gain, deduction or loss which is not properly allocated to a trade or business; (ii) any business interest or business interest income; (iii) the amount of any net operating loss deduction; (iv) the amount of any deduction allowed under IRC Sec. 199A (which is the new 20% deduction for pass-through entities) and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion. ATI for tax years beginning before January 1, 2022 for the most part would reflect the EBITDA of an entity. ATI for tax years beginning after January 1, 2022, would reflect EBIT.

The Act also allows for any disallowed business interest expense to be carried forward indefinitely. While the limitation and carryforward are straightforward when it comes to corporations, the rules are bit more nuanced when it comes to partnerships.

APPLICATION TO PARTNERSHIPS:

The application to partnerships is new. The same limitation applies to partnerships and seems to apply at the partnership level. The business interest deduction will be taken into account in determining the non-separately stated taxable income or loss of the partnership (essentially the net business income of the partnership). The Act puts into place rules to ensure that a partner in a partnership does not include the flow-through income of the partnership in order to be able to take additional interest expense at the partner level using the same income initially utilized at the partnership level. Without this provision, the partnership would deduct interest and the partner would be able to deduct even more interest expense if the partner had the ability to increase his adjusted taxable income with the already fully utilized flow-through income from the partnership. The Act does allow for a partner to increase his ATI from the underlying partnership by including the partnership's "excess taxable income." This provision allows a partner to take advantage of the partner's allocable share of the excess limitation that the partnership was not able to utilize because of the lack of additional interest expense at the partnership level.

For example, if a partnership has $200 of ATI, this would allow the partnership a $60 deduction for interest expense ($200*.30=$60). If the partnership has only $40 of interest expense to deduct, the extra $20 will be allowed at the partner level (assuming the partners have additional partner level (non flow-through) interest expense) by increasing the partners' own ATI by the partnership excess taxable income.

If the partnership has interest expense that is not deductible in the current year, it allocates that non-deductible interest expense to its partners and the partners will immediately decrease their outside basis in the partnership accordingly. In future years, if the partnership that generated the non-deductible interest expense flows-through to its partners any excess taxable income, the partners may utilize such income and deduct the non-deductible interest in that future year. In such future years, the partner must first utilize excess taxable income that flows from a particular partnership to offset any non-deductible interest expense carry overs from prior years from the same partnership before including the excess taxable income in its own ATI to allow for a deduction of any partner level interest expense.

For example, assume the same facts as above, except that Partnership A has $80 worth of interest expense in year one. Only $60 is deductible and so Partnership A will pass $20 of non-deductible interest expense to its partners in year one. In year two, if the ATI of Partnership A is again $200 but Partnership A has only $40 of interest expense to deduct, there will be a component of excess taxable income (enough to allow for an additional $20 of interest expense) flowing up from Partnership A to its partners in year two. Even if the partners have partner level (non flow-through) interest expense of their own to deduct, they must first deduct the prior year non-deductible interest expense of $20 in year two because there is sufficient excess taxable income flowing to them from Partnership A in year two to allow for the deduction. If, on the other hand, the partners receive excess taxable income in year two from Partnership B and not Partnership A, they would not be able to deduct the $20 of prior year non-deductible interest expense allocated to them from Partnership A, although the partners may include the Partnership B excess taxable income in their own ATI to take their own partner-level interest expense.

If on the sale of the partnership interest the partner still has a balance of non-deductible interest expense from that partnership, the partner may increase the basis of his partnership interest by the amount of the non-deductible interest expense, thereby lowering the capital gain on the sale of the partnership interest. It is unclear how this basis add-back would apply, if at all, to a partnership distribution in excess of basis that gives rise to capital gains.

While the new limitation will affect the portfolio companies of PE funds, it will also have an effect on certain fund level structures, such as the use of levered blockers. As mentioned above, it may put a limitation on the ability of the GP of a trader fund to deduct interest expense allocated to it from the fund. This rule could also significantly increase the after-tax cost of LBO financing and may make preferred equity financing or other interest equivalents more attractive than debt financing.

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Are You Ready for Your Annual Audit?

By Vikram Deshpande

It's that time of the year again! There are some best practices to follow to avoid pitfalls and issues while undergoing your year-end audit. Implementing these best practices will enhance the value your organization receives from the audit process and will help you comfortably meet your deadline for distributing audited financial statements to your investors.

MANAGEMENT'S RESPONSIBILITY

It is management's responsibility to prepare financial statements and to design, implement and maintain internal controls relevant to the preparation and fair presentation of financial statements. Management's first step is to have an in-house accounting team who are capable of achieving effective financial reporting which enables management to prepare financial statements that are fairly presented. While management can alternatively outsource the accounting function to a third-party service provider (for example, an external fund administrator) who can assist with preparation of the financial statements, it is important to keep in mind that management retains responsibility for the financial statements.

SCHEDULING A PLANNING MEETING WITH YOUR AUDITOR

If you haven't already set up a planning meeting with your auditor, set it up now to discuss and provide an update to your auditor about what has occurred during the year. Matters of interest to your auditor will include amendments to the partnership agreement and other fund documents, capital activity, fund performance, any new or difficult-to-value investments, and any other notable changes that occurred during the year. Expected timing of audit fieldwork and audit completion should also be discussed at the audit planning meeting. If you have outsourced your accounting function to an external fund administrator, ensure that the expected timing fits into their schedule. Ask your auditors if they are aware of any new accounting pronouncements that are applicable to you that you should be considering while preparing your annual financial statements. Address any concerns with auditors now!

ASK FOR THE AUDITOR'S YEAR-END REQUEST LIST (also known as the PBC or "Prepared by Client" list)

It is a standard practice for auditors to provide their clients with a list of items they will need to get the audit rolling. Ask your auditor to provide this list well in advance of your fiscal year-end. Knowing ahead of time about some of the schedules and documents your auditors are going to need will help you keep these items in mind when you are going through the process of your year-end close. Share the list with your external fund administrator and agree on the expected timing of any audit schedules they can help prepare. Carefully consider each of the schedules you may be preparing for the auditors. If any of them are considerably time consuming for you or your external fund administrator to prepare, ask the auditors to explain why they need them. It is possible they could get the same information from another resource.

REVIEW THE SCHEDULES YOU SUBMIT TO YOUR AUDITORS

Before providing any of the requested schedules, documents, or back up to your auditor, check to make sure the information agrees with your trial balance and/or internally prepared financial statements. As an example, if you provide a schedule of partner contributions and withdrawals that does not reconcile to the corresponding amounts recorded in your trial balance, you will have opened up a whole can of worms. Even if you ultimately end up providing a corrected schedule that agrees to the trial balance, your auditors would want to know what changed and the reasons for the mismatch. Any errors and/or reconciliations during the audit process add to the cost of the audit. Reviewing the audit schedules in advance can save you time during the audit and helps everyone focus on more important issues.

DESIGNATE AN AUDIT POINT-OF-CONTACT

The audit schedules that you submit to your auditors provide a good data point for them to begin their audit. The auditors will have additional questions and most likely need to talk to you and/or your external fund administrator throughout the audit process. Designating an individual to handle all audit-related requests and to provide timely responses to all their questions will ensure an efficient audit. Ensure that someone from the senior management is available to periodically resolve any issues to keep the audit moving.

DO NOT WAIT TO SEND BANK, CUSTODY AND OTHER AUDIT CONFIRMATIONS

It is standard procedure for auditors to request confirmations from banks on account balances on all significant cash accounts. Other areas auditors may want to seek confirmations on include investments and cash held at a qualified custodian, private investments (whether or not held at a qualified custodian), and capital activity including contributions, withdrawals and transfers of interests. Auditors are required to transmit the confirmation requests themselves directly to the bank, custodian or investor and in turn, the auditors must receive the confirmation reply directly from those parties in order for it to be valid. When inaccurate balances or incorrect information is provided on the audit confirmation, someone has to spend the time following up to get corrected information. The best chance at improving the accuracy of your confirmations is to prepare them as close to the confirmation date as possible. So if your auditor needs a confirmation as of December 31, make sure that you have either signed any paper confirmations, or given electronic approval before this date. The approved confirmation requests need to go out in the first week of January or as close to the year-end as possible.

ASK IF YOU CAN HAVE TESTING SELECTIONS IN ADVANCE OR IF THE AUDITOR CAN PERFORM INTERIM TESTING

Auditors are required to include some element of "surprise" in their audit, so they are unable to tell you in advance absolutely everything that they plan to test. However, you can ask if there are any tests or testing selections that can be done ahead of time. Most accounting firms perform interim work covering transactions occurring in the first three quarters of the year. Purchase and sale of investments, realized gains and losses on sale of investments and capital activity are the most common audit areas that get covered during interim. Interim procedures are the best way to avoid surprises at year-end as they provide your independent auditor an opportunity to look at your accounting records and provide recommendations way before the chaos of year-end hits you.

HARD-TO-VALUE INVESTMENTS

Valuation of hard-to-value investments is of critical importance to investors and is often an area that is closely looked at by auditors and their valuation specialists. Your valuation policies and procedures should establish methodologies for various classes of investments, address effective alleviation of potential conflicts of interests, and provide for appropriate disclosures. You should also consider including qualified valuation professionals in your team who can contribute to implementation of your valuation policies and procedures. Most auditors will expect management to prepare a comprehensive year-end valuation package for all hard to value assets they hold. The valuation package should provide a comprehensive write-up for each private investment being valued, including references to applicable support and documentation included within the valuation package. Clearly explain within the valuation package your rationale for any specific factors such as discounts due to lack of marketability or lack of control inputs. Providing substantial rationale for any changes in valuation methodology or inputs that have changed from prior valuation periods helps avoid follow-up questions from your auditors.

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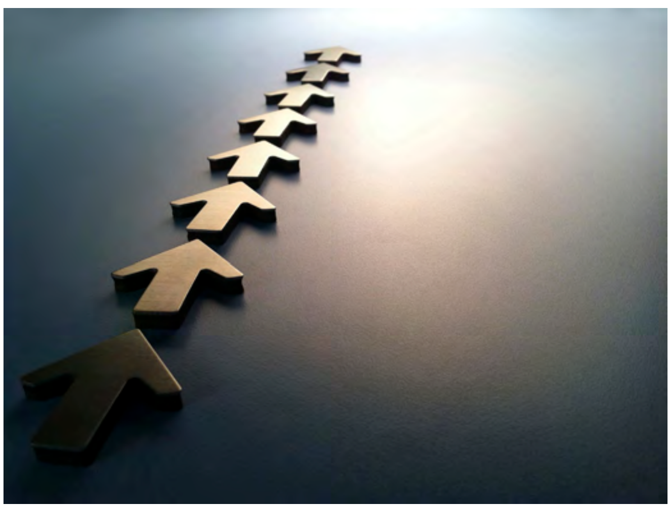
Alternative Investment Industry Outlook for Q1 and Beyond in 2018

By Elana Margulies-Snyderman

INTRODUCTION

Following a positive 2017 for both hedge funds and private equity including 12 months of outperformance for hedge funds and the best year for private equity investments and exits, investors globally, including various institutions, family offices and high-net-worth individuals, are on track to continue allocating to alternative investments this year. Yet the positive momentum doesn't go without continued investor concerns -- more specifically for hedge funds, both their fees and performance. Additionally, with respect to hedge fund launches, long/short equity strategies still continue to dominate. However, continuing on from 2017, the industry now has new dedicated strategy categories due to the plethora of new launches focused on cryptocurrency, artificial intelligence and alternative risk premia.



INVESTOR OUTLOOK

ALTERNATIVE ASSET PREFERENCE

Institutional investors globally continue to express interest in alternatives. According to a ***Preqin*** report from the end of last year titled "Hedge Fund Spotlight," private equity and real estate had the most assets, where 56% of investors had exposure to both these asset classes, followed by hedge funds (46%), and then natural resources (38%), private debt (34%) and infrastructure (33%).

HEDGE FUND SPOTLIGHT

Capital introductions professionals from both boutique and top-tier prime brokerage firms told EisnerAmper that investors across the globe look to maintain hedge funds in their portfolios. They said that one common theme amongst allocators in the U.S., Europe and Asia was a preference toward non-U.S. strategies, given they feel those regions, including Europe, Asia and emerging markets, present more attractive investment opportunities in the current market environment. More specifically, they noted that family offices globally favor non-U.S. managers focused on long/short equity or activist investing.

Additionally, EisnerAmper learned of the following allocator preferences specific to the below mentioned continents:

- In the U.S., various investor groups are seeking multi-strategy managers and niche/ differentiated strategies. In addition, there continues to be a strong favoritism to sector-focused managers in health care and technology, media and telecommunications ("TMT").
- In Europe, there is a strong demand for liquid alternatives.
- In Asia, just like the U.S, there is a consensus toward favoring differentiated strategies. In addition, investors there are interested in deploying capital to those who have the ability to add short-side alpha instead of just using shorts for hedging.

PRIVATE EQUITY PERSPECTIVE

Investors will continue to allocate capital to private equity funds, with the majority of it going to fewer yet larger funds, according to ***Pitchbook***. Further, managers continue to take advantage of the positive fundraising environment and launch follow-on funds to their predecessors, which are expected to have even more assets.

"Private equity continues to ride the wave after setting fundraising records in 2017, and market conditions suggest that this trend is likely to continue throughout 2018 despite certain large institutional investors beginning to proceed with caution," said Elena Newman, partner in EisnerAmper's Financial Services Group. "Also, the pro-business elements of tax reform should help maintain the buoyancy of an active, though high-priced, deal-making environment. In this environment, a manager's operations and ability to leverage rapidly-advancing technology to meet investor demands will be a competitive advantage."

INVESTOR CONCERNS

Investors concur that looking ahead this year, their biggest concerns include performance and fees for hedge funds.

The *Preqin* report revealed that investors were concerned about hedge funds' three-year performance and, in addition, had a negative outlook on managers' performance in general. Over the past three years, the majority of investors surveyed (70%) said portfolios' performance fell short of expectations. Only 20% said they met expectations.

Regarding fees, the report stated that 50% of investors are looking to change hedge funds' fees, driven by returns relative to cost.

Philip DeRosa, managing director in EisnerAmper's Connecticut office, said he continues to see clients' and prospects' fee structures, in an effort to accommodate allocators, move from the traditional '2/20' to a typical management fee (1.25-1.50%), incentive fee (still about 20%), and – because of the underperformance in the hedge fund industry – to a hurdle rate.

"Since at least the last quarter of 2017, we continue to see managers' fees move in this direction to meet investor demands who can determine whether or not they can outperform either a risk-free rate or a benchmark rate."

LAUNCHES

In the first quarter of 2018, EisnerAmper has seen a continuation of new launches focused on long/short equity strategies. They are a combination of generalist and sector focused strategies including TMT and financial services.

"Long/short equity managers still dominate the landscape of launches that I see," said Jaclyn Greco, manager in the firm's Financial Services group. "In addition to some very large launches with $1bln+ planned for Q2 and Q3 this year, we're seeing more and more fund managers launching with the use of separately managed accounts ("SMA") allowing investors greater transparency and control. The size of these SMAs has been as low as $10mm and as high as $400mm with some of the larger SMA allocators"

Additionally, the industry has defined new categories of hedge fund strategies due to the abundance of launches focused on alternative risk premia, cryptocurrency/ blockchain and artificial intelligence, which began in 2017. These strategies have also garnered lots of investor interest.

"2017 saw the rise of cryptocurrency funds with the West Coast dominating this trend," said Eugene Tetlow, manager in the firm's Financial Services Group based in San Francisco. "So far in 2018, cryptocurrencies and Bitcoin in particular have been off to a slow start. It will be interesting to see how this emerging asset class fares and whether we see a continuation in the growth of crypto funds or a correction in the market.

CONCLUSION

If the first quarter is any indication of how 2018 should play out, then hedge funds and private equity firms should both fare well this year on the heels of increased investor inflows, especially dedicated to the newest strategies in bitcoin and AI. However, concerns will continue to persevere with respect to hedge funds justifying their fees, especially in terms of their performance.

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The Benefits of Establishing Fund Management Companies in Singapore

By Grady Poon, Head of Financial Services, EisnerAmper Singapore

WHY ESTABLISH A FUND MANAGEMENT COMPANY IN SINGAPORE?

Singapore is a global innovation hub and ranked as the most innovative economy in Asia, and seventh in the world. According to the International Monetary Fund ("IMF") statistics issued in October 2017, Singapore, a city-state with an estimated population of 6 million, has a gross domestic product (GDP) of US$316.87 billion, and the adjusted for purchase power (PPP) per capita is nearly US$55,230. Assets under management ("AUM") in 2017 grew by 7% to $1.9 trillion. Globally, Singapore is also ranked fourth by the Global Financial Centres Index 22, which evaluates and ranks the competitiveness of financial centers based on 102 instrumental factors and supplemented by a survey.

Key Benefits of a Singapore Fund Management Company

- Positive growth outlook
- Sound regulatory and business environment
- Wide distribution channels
- Resources and government support
- Financial incentives and international cooperation
- Robust infrastructure and connectivity

POSITIVE GROWTH OUTLOOK

According to the IMF, Asia's dynamic economies continue to lead global growth. In China, the world's 2nd largest economy and Asia's largest economy, growth is still expected to be strong. The report also cites the more favorable global environment with growth accelerating in many major advanced and emerging market economies—notably the United States and commodity exporters, as supporting Asia's positive outlook.

In South East Asia, between 2002 and 2016, the Association of Southeast Nations ("ASEAN") grew approximately at an average of 6% annually, compared with the global average of 4%. In 2015, the ASEAN Economic Community plan was implemented to enhance regional growth and development by integrating the region's collective strength to create an impact in the global market.

Additionally, with a combined population in Asia of more than 4.4 billion (of which circa. 600 million are from ASEAN), there is potential to ride on the back of continued consumerism to drive growth.

As a global financial hub located in Asia, Singapore's financial sector is well-positioned to take advantage of this economic expansion. Sensing such opportunities in the region, many global fund management companies have chosen Singapore to expand into Asia and many corporations in Asia have chosen Singapore as a base to better access global financial markets.

SOUND REGULATORY AND BUSINESS ENVIRONMENT

As Singapore's fund management industry evolves and grows in terms of complexity and size, its underlying system is required to respond by enhancing the sophistication of its regulatory framework. The need for heightened supervision and enhancement of standards are considered vital for the industry ecosystem. Singapore's industry regulator, the Monetary Authority of Singapore ("MAS"), has responded to growing concerns of investors by its recent enhancement to the regulatory framework for the Fund Management Companies ("FMC") after elaborate public consultations. Industry players have welcomed the move as Singapore's role in the regional fund management industry is developing and expanding quickly.

To enhance Fintech innovations so that promising innovations can be adopted in Singapore and globally, the MAS has recently launched a "regulatory sandbox," so that Fintech firms can test their new products, technology, and business models in a controlled environment where some legal and regulatory requirements are suspended.

To further strengthen Singapore's position as a compelling hub, the MAS has also proposed a corporate and regulatory framework to facilitate the incorporation and domiciliation of investment funds across traditional and alternative fund vehicles.

MAS has also responded to the business environment and put in place different types of licensing requirements for the different needs in the asset management industries. They are namely, Licensed FMC - Retail, Licensed FMC - Accredited Investors (A/I), Registered FMC and Venture Capital FMC ("VCFM"). The below table summarizes the respective regulatory requirements.

Compliance Arrangement - All FMCs should ensure they have adequate compliance arrangements that are commensurate with the scale, nature and complexity of their operations.

Risk Management Framework - FMCs must ensure adequate risk management framework to identify, address and monitor risks associated with the customer assets that the FMC manages. The risk management function should be subject to adequate oversight by the board and senior management of the FMC and must be entrusted to competent staff and separated from portfolio management.

Auditing requirements - FMCs must be subjected to adequate internal audit. The internal audit may be conducted by an internal audit function within the FMC,

Table: Summary of the Regulatory Requirements of FMCs.

	LFMC - Retail	LFMC - A/I	RFMC	VCFM
Type of investors	No Restrictions	Qualified investors	Not more than 30 qualified investors and AUM not more than S$250M	Qualified investors
Base capital	S$500K to S$1M	At least S$250	At least S$250K	No minimum capital requirements
Risk-based capital	Financial resources at least 120% of operational risk requirements	Financial resources at least 120% of operational risk requirements	No requirements	No minimum capital requirements
Investment restrictions	Not Specific	Not Specific	Not Specific	Unlisted securities
Risk management framework	Yes	Yes	Yes	Subjected to licensing conditions
Internal audit	Yes	Yes	Yes	Subjected to licensing conditions
Annual audit	Yes	Yes	Yes	Subjected to licensing conditions
Professional indemnity insurance	Yes	Encouraged	Encouraged	Subjected to licensing conditions
Frequency of periodic returns	Quarterly and Annually	Quarterly and Annually	Annually	Annually
Directors' years of experience	10	5	5	Subjected to licensing conditions
Number of directors	At least 2	At least 2	At least 2	At least 2
Number of local representatives	At least 3	At least 2	At least 2	At least 2
Representatives' years of experience	At least 5	At least 5	At least 5	Subjected to licensing conditions

General requirements - FMCs should be Singapore-incorporated companies and have a permanent physical office in Singapore.

Competency Requirement - An FMC should ensure that the minimum competency requirements for its key personnel satisfy MAS that its shareholders, directors, representatives and employees, as well as the FMC itself, are fit and proper, and to ensure that the relevant individuals perform the regulated activities fairly and efficiently in the best interest of their shareholders.

Capital Requirement - An FMC shall at all times meet the base capital thresholds. The MAS further request all the LFMCs to comply with the risk-based capital requirement.

an internal audit team from the head office of the FMC, or outsourced to a third-party service provider.

An FMC shall meet the annual audit requirements and the MAS may direct the FMC to appoint another auditor if the appointed auditor is deemed to be unsuitable for the scale, nature and complexity of the FMC's business.

Professional indemnity insurance - FMCs are strongly encouraged to maintain adequate Professional Indemnity Insurance ("PII") coverage. PII may also be imposed as a requisite condition for licensing where the MAS deems it fit.

Independent Custodian - FMCs are required to entrust the AUM to independent custodians such as prime brokers, depositories and banks that are suitably licensed, registered or authorized in their respective jurisdictions.

Independent Valuations - AUM shall be subjected to independent valuation and reporting.

Conflicts of interest - FMCs shall minimize conflicts of interest and where one arises, it should be properly disclosed. Adequate disclosures should be provided at the inception of the fund, or at the point that the customer's account is set up, along with proper disclosures involving changes that arise.

Disclosures - Relevant disclosures include investment and valuation policy; strategy and the associated risks; terms covering fees; terminations; payments and exits; aspects relating to leverage and information regarding third parties engaged and involved.

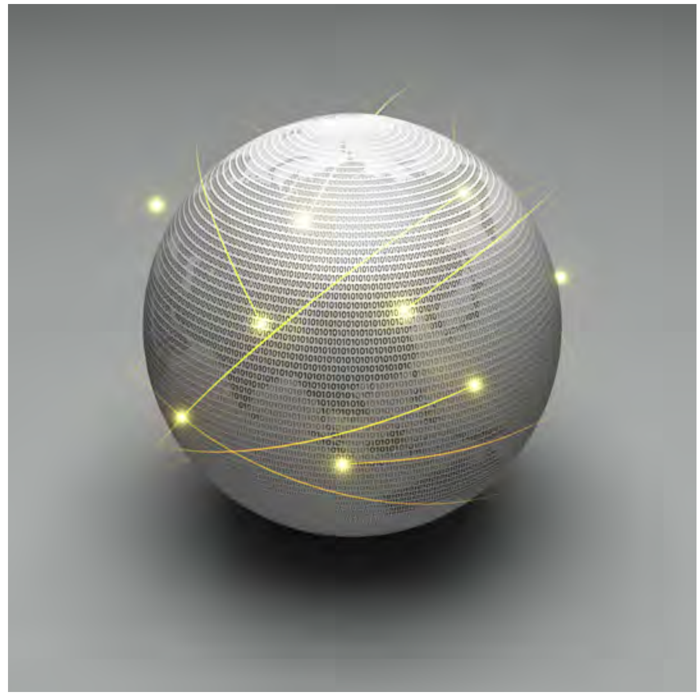
AML/CFT - All FMCs shall comply with Anti Money Laundering/Combating the Financing of Terrorism ("AML/CFT") requirements and promptly report any misconduct and further, ensure that competent service providers are engaged.

WIDE DISTRIBUTION CHANNEL

Singapore is located within a six-hour flight to most cities in Asia, including Beijing, Shanghai, Tokyo, Seoul, Mumbai, Hong Kong, Taipei, Jakarta, Kuala Lumpur, Bangkok and Perth, among others. Strategically located in the heart of Asia, Singapore is a vibrant global financial hub.

The wealth management industry in Singapore has developed very quickly with increasing wealth generation capabilities in Asia. Some reports have even anticipated that Singapore could overtake Switzerland by 2020 to become the largest global offshore wealth centre.

In 2014, Singapore, Malaysia and Thailand launched the ASEAN Collective Investment Scheme ("CIS") framework which allowed participating countries to distribute their fund products across the border without significant cost on regulatory requirements. Continuing the framework, Singapore, Australia, South Korea, Malaysia, Indonesia and Thailand then launched the Asia Fund Passport in 2014 which allows the participating country to distribute their products across different jurisdictions. Under the auspices of Asia-Pacific Economic Cooperation (APEC), these initiatives will widen the opportunities for investors and fund managers locally within Singapore and globally.



RESOURCES AND GOVERNMENT SUPPORT

The Singapore Ministry of Manpower's statistics show that the workforce in financial services represent 5.7% of the Singapore total workforce, excluding the foreign workforce of approximately 2.5%.

Improving the talent pool in the financial services sector across different classes is essential to ensure there is sufficient manpower supporting the industry. The SkillsFuture programme, launched by the Singapore government in Oct 2016, aims to help the financial sector workforce build world-class skills and maintain a strong Singapore Core that will complement the business strategies and innovation agenda.

The Future Economy Council ("FEC") in Singapore has also launched the financial sector SkillsFuture Study Award that provides financial support to individuals seeking to upgrade their knowledge in compliance, data analytics, cybersecurity and investment management. The Award encourages individuals to develop and deepen specialist skills needed by future economic growth sectors or in areas of demand, including those who already have deep specialist skills to develop other competencies. The Institute of Banking and Finance ("IBF") has also developed future-oriented, skills-based competency standards to keep pace with financial sector transformations.

FINANCIAL INCENTIVES AND INTERNATIONAL COOPERATION

In order to continually grow Singapore's asset management industry, the government has extended and refined tax incentive schemes for qualifying funds. Additionally, Singapore has economic and tax treaties with over 70 countries, giving it a substantial advantage over other traditional choices.

This, coupled with a low income tax and zero capital gain tax regime, has made the country attractive to fund managers by design.

Singapore is also committed to international tax and regulatory cooperation. Singapore's financial institutions are required to comply with requirements in the Foreign Account Tax Compliance Act ("FATCA"), the Common Reporting Standards ("CRS") developed by the Organisation for Economic Co-operation and Development ("OECD") and the Alternative Investment Fund Management Directive (AIFMD) requirements.

Fund managers can sleep soundly knowing that they are operating in an attractive and supportive and well-regulated jurisdiction.

ROBUST INFRASTRUCTURE AND CONNECTIVITY

Singapore boasts world-class infrastructure with top-notch transportation facilities. The country has also benefited from its strong infrastructure network with close proximity to China and Australia.

Singapore has built up and maintained its strong links with its immediate ASEAN members while developing and building up stronger links with countries in Asia such as China, Australia, India, Japan and Korea.

The Singapore government has always been encouraging global companies to establish their Asia headquarters in the city-state. Many multinational corporations have set up their regional or global headquarters here to build their Asian markets, conduct R&D, and deploy regional strategies. In fact, in 2015, global bank HSBC was considering relocating its global headquarters to Asia, and Singapore was one of the places under consideration.

In Singapore, there are 40 international fund administrators, 80 brokers, 150 banks, 60 licensed trust companies, and more than 15 audit firms to support the financial services industry. Industry associations for financial services such as Investment Management Association of Singapore ("IMAS"), constantly engage their members to provide feedback to the MAS to discuss regulatory and industry issues. The MAS utilizes industry feedback to develop the financial services industry in Singapore.

CONCLUSION

The Singapore government understands that an innovative regulatory framework is needed to address the sophisticated fast changing business environment. The government has also been looking at the regulatory and business environment to make it more conducive to innovation, without compromising safety and stability.

The MAS intends for Singapore to continue to deepen its venture capital and private equity capabilities and establish itself as a vibrant enterprise financing hub to support the next generation of Asian growth companies.

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