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How the SCOTUS Sales Tax Decision May Impact the Financial Services Industry

By Robert Zonenshein

The Supreme Court of the United States ("SCOTUS") has issued a landmark ruling, *South Dakota v. Wayfair, Inc.*, Dkt. No. 17-494 (U.S. S. Ct. June 21, 2018), that paves the way for states to require out-of-state businesses to collect and remit sales/use tax, regardless of whether the business has a physical presence in the State. In two prior decisions, once in 1967 and again in 1992, SCOTUS ruled there must be some bright-line physical presence in the state in order for the state to impose sales/use tax collection requirements (see ***National Bellas Hess, Inc. v. Illinois Dept. of Rev.***, 386 U.S. 753 (1967); ***Quill Corp. v. North Dakota***, 504 U.S. 298 (1992)). In ***Wayfair***, SCOTUS ruled that the physical presence test was an unsound and incorrect interpretation of the Commerce Clause and that physical presence is not perquisite for states' ability to impose sales/use tax collection obligations.

At a basic level, individuals and businesses should expect to see an increase in sales/use tax paid on purchases, as well as their obligation to collect and remit sales tax as a retailer -- regardless of where the retailer is physically (or digitally) located. For more on the sales tax implications, see EisnerAmper's *SCOTUS Rules on Landmark Wayfair E-Commerce Taxation Case*. However, the decision has the potential to have far-reaching implications beyond sales tax responsibilities.

THE DECISION

The decision involved a South Dakota statute enacted specifically to test the physical presence requirement. South Dakota was encouraged by a prior comment from Justice Kennedy (who authored the majority opinion in ***Wayfair***) inviting such a challenge (see ***Direct Marketing Assn. v. Brohl***, 135 S.Ct. 1124 (2015)). The law enacted an "economic nexus" threshold for sales tax collection purposes for entities with annual sales of $100,000 or more or engaging in 200 or more separate transactions in South Dakota (regardless of the dollar amount of each transaction) (note that South Dakota's sales tax applies to most services).

POTENTIAL INCOME TAX IMPLICATIONS

Over the years, there has significant debate regarding whether the physical presence standard extended beyond sales/use tax collection responsibilities, which was the issue presented in the former Supreme Court decisions (*National Bellas Hess, supra; Quill, supra*).

States have become increasingly aggressive in asserting that out-of-state companies have income or other tax obligations based solely on economic or financial connections with a state. Several states have enacted so called "factor-presence" nexus standards, where the mere receipt of income from state sources is sufficient to trigger an income tax liability (e.g., $500,000 sales in California indexed for inflation, $500,000 sales in Connecticut, $1 million receipts in New York State for corporations only). In addition, several states have imposed gross-receipts-type taxes based on sales thresholds (e.g., the Washington Business & Occupations tax threshold of $250,000 or the Ohio Commercial Activity Tax minimum of $150,000). Other states have adopted "economic nexus" standards that impose income tax based solely on economic activities in the state (e.g., New Jersey for corporate entities). Further, several states have bright-line rules for financial organizations, such as West Virginia's rule that soliciting business with 20 or more persons in the state or having $100,000 of West Virginia gross receipts triggered income tax nexus. SCOTUS has previously denied certiorari in cases involving the New Jersey and West Virginia provisions (see ***Lanco, Inc. v. Director, Division of Taxation***, Dkt. # 06-1236; ***FIA Card Services, f/k/a MBNA America Bank v. Tax Commissioner of the State of West Virginia***, Dkt. No. 06-1228). According to a recent survey by the Bureau of National Affairs, Inc. at least 15 states definitively stated that making "personal loans to 20 or more residents" in the state created nexus for income tax purposes.

CONSIDERATIONS FOR THE FINANCIAL SERVICE INDUSTRY

For retailers, the ultimate cost of the ***Wayfair*** decision is likely to be the increased costs of complying with sales/use tax laws in all of the relevant jurisdictions. The additional taxes paid in to the states is ultimately borne by the customer. However, if states are encouraged to enact nexus standards based solely on economic activities in the state, any additional tax and compliance costs would be a direct additional cost to the business (or to the owners of the business). Consider a financial service partnership based in New York City, with all of its physical activities (offices, employees, etc.) in New York City. Under New York's apportionment rules for partnerships, 100% of the entity's income is likely to be sourced and taxed by New York (unless an exemption is applicable). If the entity meets the factor-presence nexus standard (e.g., more than $500,000 in receipts from customers in another state), the entity would also have to file returns and pay tax to the other state.

In addition, states that apply economic nexus concepts (without a fixed dollar threshold) may also require returns to filed and tax to be paid in that state based on some economic activity in the state. The result for financial service businesses could be multiple taxation on the same streams of revenue in multiple states.

Although the immediate impact of the ***Wayfair*** decision will be focused on sales/use tax compliance and related obligations, financial service companies should be aware of the real possibility that states will be encouraged to enact or enforce economic nexus concepts for income tax purposes.

Robert Zonenshein is a senior tax manager in the State and Local Tax Group at EisnerAmper. Questions? He can be reached at 212.891.6950 or robert.zonenshein@eisneramper.com.

Current Fund Terms for Small/Emerging Managers

By Christopher Riccardi, Partner, Seward & Kissel

The capital raising environment for small and emerging managers remains challenging. In order to compete with well-established managers with successful track records, small and emerging managers continue to offer special terms to incentivize investors to invest with them. Some of the more popular terms are:

- *Co-Investment Rights:* Investors are typically given a special right to invest in potential investment opportunities that can't be made within a manager's commingled fund, in situations where it is impractical to offer the opportunity to all investors.
- *Capacity Rights:* Investors are given the right to make additional investments in a manager's co-mingled fund (or in new products the manager may offer in the future), typically for a limited period of time.
- *Bespoke Separately Managed Accounts (SMAs):* Many institutional investors prefer investing in so-called "funds-of-one" or on a separately managed account basis vs. investing in a manager's commingled fund. Typically the separately managed account will trade side-by-side with a manager's commingled fund, although the investor may also impose its own portfolio parameters or risk guidelines based on its internal policies.
- *Aggregate Performance Compensation Across Products:* Managers are agreeing to aggregate the profits and losses of each fund and/or special purpose vehicle in which a particular investor is invested when calculating their performance compensation.
- *Tiered-Management Fees:* Managers may charge a management fee at different rates based on the assets under management (AUM) of a particular fund (e.g., a lower rate based on different levels of AUM), the AUM of the manager as a whole, and, for particular investors, based on the investors' AUM across all of the manager's products, which are then also tiered.
- *Founders Fees:* Investors are typically paying management fees and performance compensation at rates that are discounted 25% - 50% from the manager's standard fee schedule.
- *Hurdles and Multi-Year Performance Compensation:* Managers are more frequently agreeing to take their performance compensation on profits in excess of a hurdle return, and devising structures whereby the performance compensation is allocated over several years and not all paid in a single year.
- *Most Favored Nation Clauses:* It has become fairly standard for emerging managers to grant so-called most-favored nation rights to investors that would ensure the investors are always getting the "best deal" offered by the manager.
- *Gates:* While limitations on the right to make withdrawals from a hedge fund (sometimes referred to

as a "gate") are typically viewed as an impediment to raising capital, in certain strategies investors generally recognize the value of a fund having a gate. However, today those gates are overwhelmingly structured as investor-level gates vs. fund-level gates (this is generally preferred by sophisticated investors so that one panicky investor cannot cause a liquidity crisis for the fund and the remaining investors).

- *Carryover of High-Water Marks:* Managers who launch a new fund are typically incentivizing their existing investors to make an investment in the new fund, and if the investor is in a high-water mark situation (i.e., the investor has been allocated losses that have yet to be offset by subsequent profits), the manager typically will carryover the high-water mark to the new fund (which effectively serves as a "hurdle" in the new fund before the manager can earn its performance compensation).
- *Customer Loyalty Programs:* To incentivize investors to keep their investment with a manager, or to increase the size of their investment with a manager, many managers have been devising policies whereby certain long-time investors are granted various types of special rights if they remain invested with the manager (typically some combination of the terms described in this article).

These are just some of the terms that smaller or emerging managers are offering in order to raise capital. These terms (or some combination thereof) are frequently offered to most if not all investors, but it's also important to note that the vast majority of emerging managers that launch new funds with significant capital (e.g., in excess of $50M) typically have an "anchor" or "seed" investor who, in addition to most of these terms, is given an economic-sharing arrangement whereby the investor participates in the profits or gross revenues of the manager.

Christopher Riccardi is a partner at Seward & Kissel. Questions? He can be reached at 212.574.1535 or riccardi@sewkis.com.

AICPA Issues Draft Accounting and Valuation Guide to Provide Best Practices for Portfolio Company Valuations for Private Equity and Venture Capital Firms

By Michael Aronow and Craig TerBoss

The AICPA's Private Equity and Venture Capital Task Force (the "Task Force") recently released for public comment a working draft of its Accounting and Valuation Guide: Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies (the "Guide"). The Task Force was formed in early 2013 to address concerns of numerous parties (participants and industry groups, accountants, valuation specialists) regarding valuation processes and to reduce diversity in practice for fair value measurements.

The Guide, which is not authoritative, is not meant to change any existing guidance; rather it is designed to help interpret and apply existing fair value concepts consistent with FASB Accounting Standards Codification ("ASC") 820, Fair Value Measurements, which emphasizes that fair value is a market-based measurement, not an entity-specific measurement; and provides investment companies with an overview of the valuation process, concepts and roles and responsibilities of the various parties involved in the process. The Guide includes chapters addressing fair value related concepts, including:

- Market participant assumptions,
- Overview of valuation approaches,
- Control and marketability factors, and
- Valuation of debt and equity securities.

Since the introduction of ASC 820, several accounting and related valuation issues have evolved and the Guide addresses and helps clarify these issues, including those related to:

- Complex capital structures,
- The unit of account and assumed transaction, and
- Calibration.

UNIT OF ACCOUNT AND ASSUMED TRANSACTION

Defining the unit of account for investment companies is challenging. FASB ASC 946, Financial Services - Investment Companies, does not provide explicit unit of account guidance. The topic contains specialized accounting and reporting requirements for investment companies. Under U.S. GAAP, investment companies generally measure their investments at fair value, including controlling financial interests in investees that are not investment companies.

Further complicating this issue is that many investment companies hold significant positions in their portfolio companies, giving them the ability to influence the direction of these companies, or may hold multiple types of investments within a portfolio company. The Guide provides considerations and assumptions that market participants might utilize to estimate the value expected to be realized from an investment, which helps define the unit of account.

The Guide addresses how to assess the unit of account and an assumed transaction for purposes of estimating fair value under ASC 820. This assessment focuses on three questions:

- Does the assumed transaction appropriately consider market participant perspectives on the sale of the specific investment held by the fund or the sale or transfer of a larger group of assets?
- If the funds hold equity and debt investments, how should they be grouped together considering their best economic interest?
- How does the estimate of fair value consider market participant assumptions relating to the fund's investment strategy and how, and when, will that value be realized from the investment?

When estimating the fair value of a fund's holdings in a portfolio company, the concept of "economic best interest" is important to consider when determining how debt and equity investments are grouped together. In situations in which the investors hold the investments and the investors' interests aligned, it may be appropriate to value an equity investment based on its pro-rata interest in the company, and allocate the value to be received from the sale of the portfolio company and allocate to the various interests.

When a fund makes an investment into debt and/or equity, it considers the expected cash flows over an estimated time horizon and the risks associated with those cash flows. This is an important reason why calibration is so important to the process of evaluating and estimating fair value at the initial investment date. This calibration should consider the attributes, risks, and anticipated strategies to maximize value associated with these investments, as well as the inherent level of control and marketability of the investment. These factors should all be assessed based on market participant perspectives acting in their economic best interest as of the initial investment date and subsequent valuation dates.

CALIBRATION

When using a valuation technique that requires unobservable inputs, the Guide discusses the importance to calibrate these inputs to observed transactions in the investment itself, providing an initial set of assumptions that are consistent with the transaction price when the transaction price represents fair value. One of the key aspects of calibration involves monitoring the difference between the multiples and rates used in valuing the company in the initial transaction and the changing market multiples and rates for the comparable universe against which the initial transaction was benchmarked. For example, at subsequent measurement dates, these input assumptions such as financial metrics for the company (revenues and EBITDA or projected cash flows), specific operating key performance indicators (number of customers or volume) and market-related inputs (valuation multiples, cost of capital, or other factors) should then be updated to reflect changes in both the investment and changes in market conditions, maximizing the use of observable inputs.

MARKET APPROACH UNDER CALIBRATION

In selecting a multiple in the market approach, it is important to consider not only the range of observable multiples, but also the differences between the portfolio company and the selected guideline companies or transactions, which might indicate that a higher or lower multiple is appropriate. Calibration provides an indication of the way that market participants would value the investment as of the transaction date given the differences between the portfolio company and the selected guideline public companies or transactions. These initial assumptions can then be adjusted to take into account changes in the portfolio company and the market between the transaction date and each subsequent measurement date.

It is important to distinguish if the differences between the portfolio company and the selected guideline companies or transactions relate to operational differences or issues with control and marketability. For example, consider a transaction where a portfolio company investment is acquired with a transaction price that would equate to a multiple of 7.0x last twelve months ("LTM") EBITDA when the guideline public companies are trading at multiples of 10.0x LTM EBITDA. In this example, the transaction price reflects a 30% discount to the guideline public companies. One explanation might be to call this discount a "marketability discount" or "illiquidity discount" without further analysis. These terms may imply that the discount results solely from the illiquidity of the position, rather than focusing on the reasons that market participants would demand a higher rate of return than the valuation model might otherwise indicate. In updating the valuation inputs for subsequent measurement dates, it is necessary to understand the underlying rationale for the low price paid – that is, to describe the differences between the portfolio company and the guideline public companies that led to this lower valuation as of the transaction date, so that it is possible to assess to what extent these differences still apply as of subsequent measurement dates. It may be that a transaction price that reflects a discount to the guideline public companies when measured relative to LTM EBITDA might reflect a need to invest more capital in the business or to strengthen the management team in order to reach a normalized level of performance. In this example, after these improvements are made and reflected in the portfolio company's expected performance, such a discount may be significantly reduced or no longer apply.

VALUATION OF EQUITY INTERESTS IN COMPLEX CAPITAL STRUCTURES

Estimating the value of the different classes of equity in a portfolio company requires an understanding of the rights, both economic and non-economic, associated with each class. The Guide describes possible methods for valuing equity interests within complex capital structures. A more comprehensive examination regarding complex capital structures will be addressed in the fourth quarter edition of EisnerAmper's Asset Management Intelligence.

CONCLUSION

In addition to the concepts discussed above, the Guide also describes leading practices compiled by the Task Force in the following areas:

- Using backtesting to improve a fund's valuation processes, and
- Evaluating the impact of events at or near a transaction date.

The proposed Guide also addresses frequently asked questions and includes appendices on best practices pertaining to the valuation process and case studies illustrating different investment scenarios and factors to consider in arriving at fair value.

When finalized, the Guide will be the first guidance on how to apply ASC 820 specifically targeted to the complexities experienced by investment companies in valuing portfolio investments in accordance with ASC 820. Comments on the working draft are due to the AICPA on August 15, 2018. A final version of the Guide is expected to be released in May 2019.

Michael Aronow is a partner in the Corporate Finance Group at EisnerAmper and Craig TerBoss is a principal in the Corporate Finance Group at EisnerAmper. Questions? Michael can be reached at 212.891.4170 or michael.aronow@eisneramper.com and Craig can be reached at 212.891.6029 or craig.terboss@eisneramper.com.

Subscription-Secured Credit Facilities

By Bonnie Sussman

We have seen an increasing number of managers utilizing subscription-secured credit facilities over the last few years. As reported by eVestment, two-thirds of managers now use credit facilities and, as reported by Reuters, "Fund financing is one of the fastest growing areas of the syndicated loan market…"

So, what are subscription-secured credit facilities? They are loan facilities from banks to close-ended funds, backed by the commitments of the funds' investors. Investors are legally committed to the funds in the amount of their unfunded commitments. Historically, such credit facilities were mainly used to bridge the time between a capital call, which can take multiple weeks, and funding an investment. These loans were typically repaid back within 90 days from the drawdown date. More recently, however, due to relatively low interest rates, these credit lines have developed beyond a bridging function.

Subscription-secured credit facilities are beneficial to both fund managers and investors.

Benefits to fund managers:

- Managers can bridge the time between a capital call and making an investment.
- Managers have more flexibility to execute deals and pay fund expenses without making frequent capital calls.
- The fund's Internal Rate of Return ("IRR") is enhanced by delaying capital calls. Capital calls can drag the IRR by holding onto cash (I will go into more details later).
- Timing and amounts of capital calls are more predictable and exact. This allows funds to not carry excess cash (and drag IRR).
- For general partners, the preferred return calculation (similar to the IRR calculation, see illustration below) is accelerated causing an earlier payout of carried interest.

Benefits to investors:

- Many institutional investors can have numerous capital calls across their private equity investments. The use of credit facilities reduces administrative headaches of funding multiple and frequent capital calls.
- Investors have the opportunity to make short-term investments with their uncalled capital.

However, despite the benefits, it is important to note some of the downsides to credit facilities:

- Additional expenses are incurred, such as interest and borrowing costs.
- The final benefit mentioned for managers could be a downside for investors. The investors may pay carried interest earlier due to the preferred return calculation being accelerated.

- The first benefit mentioned for investors could also be a downside. Investors may take on more investment and liquidity risk by mismanaging and over-utilizing their uncalled capital.

INTERNAL RATE OF RETURN

IRR is an important performance metric in the private equity space. As noted above, funds using credit facilities tend to report higher IRRs relative to similar funds not utilizing such lines. See below for a simplified illustration:

Date	Description	Fund A*	Fund B**
01/01/18	Capital call for investment	$ (1,000)	*Drawdown*
01/01/18	Capital call for management fees	(20)	*Drawdown*
01/01/19	Capital call for investment		$ (1,000)
01/01/19	Capital call for management fees	(20)	(40)
01/01/19	Capital call interest		(55)
01/01/20	Capital call for management fees	(20)	(20)
01/01/21	Capital call for management fees	(20)	(20)
01/01/22	Capital call for management fees	(20)	(20)
12/31/22	Distribution from sale of investment	1,800	1,800
	IRR	**10.71%**	**12.02%**
*Fund A does not utilize a subscription-secured credit facility			
**Fund B utilizes a subscription-secured credit facility			

U.S. GAAP requires disclosure of the inception-to-date IRR. It is calculated based on the cash inflows and outflows and the ending net assets at the end of the period.

As shown in the above illustration, the investment, management fees and distribution amounts are the same for both funds. Fund B, with a credit facility, pays interest, which is an additional expense. Even though it incurs $55 of additional expense, the IRR is still higher when compared to Fund A. This is driven by the deferral of capital contributions in the early years where the dollar is more heavily weighted.

Since not all managers utilize subscription-secured credit facilities, IRRs have been difficult to evaluate as U.S. GAAP does not require disclosure of unlevered IRR. However, we have seen many managers disclose both levered and unlevered IRRs on their financial statements. This is an additional disclosure by the fund to be more transparent to the investors. Investors should look beyond traditional IRR calculations to measure a fund's performance.

BEST PRACTICES

In June 2017, the Institutional Limited Partners Association ("ILPA"), a trade association for institutional limited partners in the private equity asset class, issued a white paper called "Subscription Lines of Credit and Alignment of Interests, Considerations and Best Practices for Limited and General Partners." They provided recommendations on the use of subscription lines, which include the following:

1. Within partnership agreements, waterfall provisions should specify that the date used to calculate the GP's preferred return hurdle aligns to when the credit facility is drawn, rather than when capital is ultimately called from the LPs.
2. Managers using credit lines should disclose to their LPs the following as part of quarterly reports:
   - The balance and percent of total outstanding uncalled capital. Such disclosures should be provided as part of a holistic reporting of the total debt/credit in use by the fund.
   - The number of days outstanding of each draw down.
   - The current use of the proceeds from such lines, i.e., solely to bridge capital calls (and the nature of those capital calls), or for other purposes (such as accelerated distributions).
   - Net IRR with and without the use of the credit facility.

- Terms of the line (upfront fee, drawn and undrawn fees, etc.).
- Costs to the fund (interest and fees).

3. Managers are advised against using these facilities to cover fund distributions in anticipation of, but prior to, a portfolio company exit.
4. Disclosure of investment details in the underlying portfolio should not lag the execution of a deal due to capital calls delayed by use of these facilities. Reporting should be on a mutually agreed and reasonable basis, regardless of the timing of the capital call.
5. Provisions addressing use of subscription facilities within partnership agreements should delineate reasonable thresholds for their use, such as:
   - A maximum percentage of all uncalled capital, e.g., 15-25%. Subscription facility exposure should be considered and reported holistically, taking into account the more traditional limitations on fund borrowings for any other purpose.
   - A maximum of 180 days outstanding.
   - Maximum period of time for which such lines can be utilized, aside from agreed upon parameters related to the maturity of such facilities.

It seems that subscription-secured credit facilities are here to stay and their use will continue to grow. As noted above, these credit facilities offer flexibility to both fund managers and investors by better aligning capital calls with a fund's actual need for cash and allowing investors to minimize administrative work, while maximizing potential return. As the use of these facilities grow, fund managers and investors will need to collaborate to ensure transparency and comparability between funds

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Bonnie Sussman is a senior audit manager at EisnerAmper. Questions? She can be reached at 212.891.8665 or bonnie.sussman@eisneramper.com

**Last year EisnerAmper's Asset Management Intelligence published an article on the topic: eisneramper.com/subscription-secured-credit-facilities-ami-0517*

Alternative Investment Industry Outlook for Q3 and Beyond

By Elana Margulies-Snyderman

Despite mixed performance in the first half of 2018 amongst the various hedge fund strategies and CTAs, institutional investors across the globe including pensions, endowments and foundations, funds of hedge funds, and insurance companies along with family offices and high-net-worth individuals are still interested in allocating to them given they have been more satisfied with their performance lately. In addition, LPs are also eyeing more illiquid investments such as private equity along with private debt.

When it comes to fees of their underlying managers, institutional investors still prefer lower hedge fund fees than the long-gone 2/20 industry standard. They also continue to integrate alternative risk premia ("ARP") into their portfolios, which offer reduced fees.

On the new hedge fund launch side over the last quarter or so, the industry has seen a handful of billion dollar plus debuts with backing from their former employers. Meanwhile, with respect to strategy, one of the most notable trends was a slowdown in the number of new cryptocurrency fund launches.

INVESTOR OUTLOOK

At EisnerAmper's recent Alternative Investment Summit, a trio of institutional investors concurred they are interested in allocating to hedge funds. There was a particular preference to deploy assets to Women and Minority Business Enterprise ("WMBE") funds.

Additionally, EisnerAmper has heard that environmental, social and governance ("ESG") investing and co-investments continue to be popular.

Sean Holland, Principal, Comave Advisors, told Asset Management Intelligence that ESG investing is gaining greater momentum amongst larger, U.S. institutional investors while the demand for co-investments continues to increase.

"The U.S. traditionally lagged behind the U.K. and Europe with ESG given an American perception that ESG is corporate philanthropy, but it is changing," he said. "ESG drivers include Millennials and Generation Z wanting to save the planet, but ESG is increasingly more systemic as CIOs and investment committees consider ESG more with their asset allocation.   Institutional investors also view ESG as enhancing their reputations while reducing portfolio risk by providing insurance to misactions – accidental or intentional."

He added: "Demand for co-investments continues to climb as American public pensions strive to re-create the direct investing ethos championed by sophisticated Canadian public pensions and Asian Sovereign Wealth Funds," he said. "Savvy GPs see co-investments as a tool to both extend their own investing dry powder while solidifying strategic relationships with LPs anxious for more co-investments. LPs in turn hope to reduce fees."

Meanwhile, in Europe, capital introductions professionals told EisnerAmper that institutional investors are seeking to invest across globally diversified sets of strategies, in both new and existing managers. Some of the most favored strategies include special situations, global macro and managed futures.

FEES

Investors still demand that managers be more flexible with their fees, hence continue to offer allocators a founders' class with 1/10 fees and if their assets under management increase, then they will offer 1/15 fees.

Jeff Parker, a partner in the Financial Services Group at EisnerAmper based in New York, confirmed the industry trend he has seen amongst the firm's hedge fund clients and prospects.

"We are seeing lower fees, as well as founders' classes," he said. "We are also seeing variations on the traditional management fee/incentive allocation structure."

Additionally, at a recent industry conference, a handful of institutional allocators said they have integrated ARP into their portfolios to reduce fees.

LAUNCH TRENDS

The industry this year has seen a handful of several billion dollar launches, most notably multi-strategy ExodusPoint Capital Management, which launched with $8 billion, reportedly the biggest launch of all time; along with long/short equity manager D1 Capital, which debuted with $4 billion and macro fund Kirkoswald Capital Partners, which rolled out with $2 billion.

Eugene Tetlow, business development manager in EisnerAmper's Financial Services Group based in San Francisco, confirmed the above mentioned trend that there has been a pick-up in managers successfully raising assets, either from their old firms or other traditional avenues.

"On the hedge fund side, new managers are spending more time ensuring that their fund is institutional ready before going to market," he said.

Tetlow also said this past quarter experienced a decline in the number of cryptocurrency hedge fund launches, reversing course from the last year or so which saw a number of them come to market.

CONCLUSION

With nearly three-quarters of 2018 behind us and investors more satisfied overall with hedge fund performance, coupled with a few billion-dollar-plus launches, the industry is anticipated to receive substantial inflows in the last few months of 2018. And managers will definitely make it easier for investors to allocate by offering them more attractive fees and/or reduced fee products.

Elana Margulies-Snyderman is a senior manager in EisnerAmper's Financial Services Group. Questions? She can be reached at 212.891.6977 or elana.margulies-snyderman@eisneramper.com.

How Has MiFID II Affected U.S. Managers?

By Robert Mirsky and Natalie Willans

The start of 2018 marked the arrival of one of the most significant financial regulatory changes the European Union has seen in recent years. The original Markets in Financial Instruments Directive ("MiFID"), which came out in 2007 just prior to the financial crisis in 2008, was then reviewed in 2012 following criticism regarding transparency within the industry and the changes were finally put into action in the form of MiFID II on January 3, 2018.

The revised Directive looks to tighten regulation and provide greater transparency across the E.U. by:

- Harmonizing the operating requirements among investment firms;
- Fostering more effective investor activity across a broad and complex set of financial instruments and services; and
- Addressing weaknesses in the functioning and transparency of financial markets.

Whilst there are several important changes that asset managers have had to make, one area that will have a significant impact on U.S. managers is the 'unbundling rules,' which prohibit the payment of research from being tied to the payment of execution fees, thereby giving investors greater clarity as to what they are being charged by brokers. Managers must now either pay for their research directly from their fund's P&L, or, if they choose to use their clients' funds, they must use a segregated research payment account ("RPA").

As with most non-U.S. regulations, the impact of MiFID II largely depends on the level of contact or interaction the U.S. manager has with the E.U. Many U.S. asset managers are already subject to requirements in various E.U. jurisdictions under the E.U.'s Alternative Investment Fund Managers Directive ("AIFMD") and therefore have a basic understanding of how these regulatory changes can impact their investment processes, but most are only just coming to terms with the full scale global effect. Where the original MiFID legislation affected only U.K. and E.U. firms, primarily on the sell side, the new rules will mean that anyone who has relationships with the E.U. as an investor, customer or counterparty, will now be affected.

Behind closed doors, Wall Street brokers have been lobbying to steer legislation away from conforming to the E.U.'s new rules. However, huge state pension funds have been putting up strong resistance, saying that the new rules will reduce costs and allow greater clarity across the market. As a result, the SEC has had to bring this debate out into the open. Having consulted with the European Commission and to allay the growing fears and confusion, the SEC eventually sided with the brokers on a temporary basis by introducing short-term, no-action relief towards the end of 2017. This relief came in the form of three no-action letters, confirming that the SEC would not prosecute any of the following situations:

- A broker-dealer that sells research to an investment manager subject to MiFID II without complying with the Investment Advisers Act of 1940;
- A money manager that relies on Section 28(e) of the Securities Exchange Act of 1934 to pay for brokerage and research services while complying with the side-by-side payment mechanism under the Directive;
- An adviser complying with MiFID II that relies on previous no-action relief from Section 17 and Rule 17d-1 of the Investment Company Act of 1940 and Section 206 of the Advisers Act to aggregate orders for client accounts.

These no-action letters allow U.S. asset managers to make payments for research separately from trades, ensuring that U.S. managers can still receive access to valuable research from the E.U. However, this step towards a dual regulatory system will only be available until July 2020, when the no-action relief will cease and presumably the U.S. will adopt a similar framework to comply with the E.U. rules.

For those that are subject to the full MiFID II obligations, the cost of these changes is only just coming to light, with some consulting firms initially estimating a global spend of approximately $2 billion to incorporate the changes. However, at the close of Q1 2018, several managers reported lower relative costs than this. Moody's reported that funds are looking between a 0.5-5% increase in costs, to cover all changes related to the legislation, with the smaller managers being the hardest hit. As time passes and more evidence is collected measuring the effects the new legislation has had and the quality of the research being provided, there will be an opportunity for the U.S. to determine how it will adhere to these rules in the future.

U.S. asset managers hope the SEC can use the E.U. as an example and establish a fully robust yet practical approach to the demand for greater transparency. A recent survey conducted by RSRCHXchange looking at the global effect of MiFID II has seen a large number of U.S. asset managers agreeing that the U.S. could be only four years behind the E.U. in establishing the requirements for stricter regulation.

Overall, the U.S. has taken the flexible approach for the time being, allowing individual firms to take the decision whether they wish to continue their relationships with the E.U. However, there is no doubt that once the no-action relief expires, there will be a shift in the industry's attitude toward research. It is likely the new rules will require a degree of transparency in costs that heretofore weren't seen within the industry.

Robert Mirsky is the head of the London Office and of EisnerAmper's Asset Management Group and Natalie Willans is Director – Operational Consulting. Questions? Robert can be reached at +44 (0) 7825 043 031 or robert.mirsky@eisneramper.com and Natalie can be reached at +44 207 409 5082 or natalie.willans@eisneramper.com.