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Asset Management Intelligence

- A publication from the Financial Services Group -

What Are the Top Three Things U.S. Asset Managers Should Be Doing to Prepare for Brexit?

By Rob Mirsky & Natalie Willans

With Brexit looming, U.S. asset managers should be preparing themselves for an overhaul in the way U.K. and E.U. regulation and legislation affects their future. Brexit may change the course for all funds and managers looking to do business in the U.K. and E.U. Managers should ensure they are considering steps to mitigate the uncertainties surrounding the U.K.'s departure from the E.U. in March 2019. Below are some key areas to consider:

1. Distribution Strategy
   A key focus for U.S. asset managers in the run up to Brexit is to put in place a clear distribution strategy focusing on the investors they are targeting. By getting a clearer understanding of the overall distribution strategy (by both product and investor type and location), managers can focus on jurisdictions and regimes under which they might fall. For example, a distribution strategy targeting the U.K. should be focused on the appropriateness of product for that market. While it is likely a given that an E.U. 27 product will still be saleable in the U.K., the question is for how long? Also, is a U.K. product now more viable? The converse will also be true for a U.K. product sold to E.U. 27.

   Currently, U.S. asset managers with no operations in the U.K. who classify themselves as Non-European Economic Area (EEA) Alternative Investment Fund Managers (AIFMs) will continue to function with little or no change going forward, as they have never had access to the passporting rights that are afforded to EEA AIFMs. They will, however, continue to be able to use NPPRs (National Private Placement Regimes) and reverse solicitation to do business with the E.U. 27 to the extent national regulators continue to allow them. Reverse solicitation, while not a strategy, may also continue to be used. However, the European Securities Marketing Authority (ESMA) has requested changes to the Markets in Financial Directive (MiFID) II regulations to increase restrictions on the use of reverse solicitation.

   Additionally, from March 29, any U.S. asset manager who uses a U.K. Undertakings for Collective Investment of Transferable Securities (UCITS) to sell within the E.U. 27 will have to rethink their European product set. Establishing an E.U.-based UCITS, whilst seeming like the most straightforward option to bypass this issue, is potentially costly.

2. Processes
   Despite the increased costs, managers are in the active phases of contingency planning for a U.K. exit from the E.U., including additional compliance measures that will need to be considered. In particular, large banks and asset managers have grown weary of waiting to see how

Brexit will impact them and several firms have already made significant changes to processes.

As the U.K. could soon be classified as a 'third country' under MiFID, any U.S. asset managers who use U.K. operations to do business within the E.U. should consider applying for passport licences within E.U. jurisdictions. By establishing subsidiaries with substance within the E.U., they should effectively be able to access similar passporting rights as they have currently from the U.K.

Luxembourg and Ireland have become the frontrunners for managers looking to ensure their continued ability to do business in the E.U. Both jurisdictions have seen a huge increase in the number of license applications over the last few months.

The E.U. could also grant the U.K. 'equivalence,' which would be in line with the current arrangement between the U.K. and the U.S. Equivalence is based on the notion that a third country has similar regulatory and compliance structures to the E.U. and can continue to trade and distribute without having to directly adopt the E.U.'s regulations.

3. Personnel
Another significant change that U.S. asset managers should consider is the location of their U.K. and European based personnel. Some of the U.K.'s largest financial institutions such as UBS and Goldman Sachs have already taken the costly decision to move some operations and personnel to cities like Frankfurt or Paris. While this move hasn't been seen to the same extent in the asset management space, managers should be considering where they need to base personnel. This is as a result of the new paradigm of a U.K. outside the E.U. and the visa requirements that might follow, or because of the need for additional substance to maintain effective connectivity with the U.K. and E.U. 27 post-Brexit.

Predicting and understanding what changes will come into play post March 29 is something that our clients are considering carefully in the run up to the U.K. leaving the European Union. Fundamentally, the continued uncertainty surrounding whether there will be a hard Brexit, soft Brexit, no-deal or a delay in the entire withdrawal agreement means that most fund managers are adopting a process which minimises risks no matter how the U.K. leaves. The U.K. government's deliberations are mired in political infighting and complexity with only a handful of weeks remaining. While the E.U. is stating that the chance of no-deal is becoming much more likely with every passing day. As with U.K.-based fund managers, U.S. fund managers are left second guessing which way events may unfold, but immediate contingency planning should help weather the Brexit storm....

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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 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. For example, In August 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement. ASU 2018-13 significantly reduces disclosure requirements related to Level 3 investments held by private investment companies. While ASU 2018-13 is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2019, early adoption is permitted.

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. Ensure that you share the list with your external fund administrator and agree on the expected timing of any audit schedules that 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 that they could get the same information from another resource.

For continuing or repeat audits, it is worth saving copies of the current-year schedules and documents you've submitted to your auditor for future reference. Make a note of the source within your accounting system, and the methods you have used, to extract specific customized reports that were part of the auditor's current-year request list. In absence of significant changes in your business or operations, your auditor will most likely request those specific customized reports on an annual basis. Revisiting your notes from the prior year audit will reduce your efforts in extracting those reports in the current year. This step is particularly helpful if you have had turnover in your accounting department and a new employee has taken over the responsibility of preparing and submitting information to your auditors.

REVIEW THE SCHEDULES YOU SUBMIT TO YOUR AUDITORS

Before providing any of the requested schedules, documents or backup to your auditor, check to make sure that 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 provide timely responses to all 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 audit areas involving the confirmation process 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 on your team who can contribute to implementation of your valuation policies and procedures. Most auditors will expect that the management will 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.

USE OF TECHNOLOGY

Encourage use of technology and request access to all the available tools/solutions that your auditor's firm offers. Audit firms across the globe invest significantly in technology and solutions that make life easier and work more productive. Some of the common technology solutions offered by audit firms to their clients include use of secure file sharing portals/erooms and use of electronic signature technology services such as DocuSign. Utilizing all the available technology solutions can significantly enhance efficiency and add value to the audit process.

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Should I Market My Fund in Europe? Considerations for Non-E.U. Managers Marketing to E.U.-Based Institutional Investors

By Howard Eisen, Leader, Americas Distribution, DMS Governance

On July 22, 2013 the rules for marketing private funds within the European Union (EU) changed dramatically. On that date the Alternative Investment Fund Managers Directive, or AIFMD, came into full effect, creating a range of regulatory requirements for managers of Alternative Investment Funds (AIFs) – principally hedge funds, private equity funds and real estate funds – to market within the borders of the E.U. The objective of the Directive is to enhance transparency in order that, in the wake of the Global Financial Crisis, the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) will have the information they need to monitor E.U. markets holistically. AIFMD applies to the following Alternative Investment Fund Managers (AIFMs):

i. E.U. AIFMs managing one or more AIF (regardless of whether that AIF is in the E.U.),

ii. Non-E.U. AIFMs managing E.U. AIFs, AND

iii. Non-E.U. AIFMs who market their AIFs in the E.U.

It is the third category above with which this piece is concerned – managers based outside of the E.U. who are considering marketing their funds/strategies to investors within the borders of the E.U.

MAIN REQUIREMENTS & THEIR IMPLICATIONS

AIFMD, as with all regulations, carries with it a wide range of requirements, including registration, disclosure/reporting and maintenance of compliance requirements. The list of requirements is extensive and complex, and managers should always consult legal counsel for comprehensive advice of what is required under the Directive. For the purposes of this discussion, we focus on the business considerations of what is perhaps the most burdensome of the requirements, the establishment of portfolio management and/or risk management functions within the E.U. For the purposes of AIFMD, either or both of these functions must take place physically within the E.U.

From a practical perspective this means that, to be compliant with AIFMD's rules for marketing an AIF in the E.U., a manager must create an E.U. office, and base a meaningful amount of either portfolio management or risk management activities in that office, regardless of whether it is additive or dilutive to either function. Consider some of the costs associated with this:

- Salaries
- Benefits

- Office Rent
- Insurance
- Legal
- IT Set-Up/Maintenance
- Compliance
- Local Taxes
- Travel and Expenses

DMS estimates the cost of creating and maintaining one's own E.U. AIFM as being in the $1-2 million range annually.

That cost burden is small, however, when compared to managing the effects of spreading the investment and/or risk management teams from their home base to another region. For the largest funds in the world, this is less of a concern – their investment, operations, risk, and compliance teams are typically already distributed across multiple global offices. Similarly, for the smallest emerging managers, this is a non-issue as they do not have the resources to open a location away from their home base, let alone in the E.U. But what about the mid-sized manager? Should they go through the cost, restructuring and distraction of making themselves AIFMD-compliant so they can market their strategies in the E.U.? The answer is not clear-cut and each manager's circumstances are different.

Pre-crisis, the old adage "If you build it, they will come" had some merit. Flows into alternatives were plentiful and both intermediaries and asset owners were consistently looking for managers to manage their increasing AUM. Since the crisis, however, managers cannot rely on that adage to justify making upfront investments of money, time and other resources. A long-running bull market (4Q18 notwithstanding) has reduced the flow of capital into alternatives, as investors have preferred exposure to lower cost beta. Raising capital for alternatives has become a much more difficult endeavor, and the investment process of most allocators has become massively elongated.

THE BIG QUESTION: TO MARKET OR NOT TO MARKET

So how does a manager of an alternative investment strategy decide whether it makes sense for them to become AIFMD-compliant and go through the other requirements to become eligible to market in the E.U.? There are a few key questions to be considered, which we pose to managers considering fund raising in the E.U.:

Is My Strategy "In Demand"?

Where we sit on the demand curve for your particular strategy is a critical question. Demand for different products ebbs and flows, and where we are on the curve of that cycle informs the question of how salable your strategy is, and over what time frame. For example, if we are at the nadir of the demand cycle, perhaps it is the right moment to begin preparing for recovery by establishing an AIFM in the E.U. Completion of that process could coincide nicely with the return of interest in the strategy. Conversely, if we are late in the demand cycle and/or contraction has begun, one may take the decision to wait.

How Does My Performance Compare to My Peers?

Regardless of whether demand is tepid or hot, marketing a strategy with returns that are mediocre (or worse) when compared to peers must be considered when weighing the decision to form an AIFM and market in the EU. The commitment of time, money and management attention is far too high if investors have more attractive options for exposure to your strategy or asset class. We would recommend that a manager be consistently in the top quartile of performers before embarking down the AIFM path.

Is My Firm "Institutionally Marketable?"

By definition, an AIF is marketed to institutional investors (versus UCITS products which are geared more for individual investors). As a result, the expectations of your investors will be quite high when it comes to operational infrastructure, best practices, service providers and other elements commonly associated with an institutional-quality fund manager. If your firm has somehow achieved success without, for example, having an independent administrator or without maintaining shadow books and records to check that administrator, it is unlikely you will be successful in marketing your strategy to European institutions. Your enterprise and your strategy must be able to stand up favorably to the most rigorous investment and operational due diligence.

What Is My Timeline for Success?

As stated above, the process for institutional investors has become greatly elongated. What was previously a three-six month investment process is now routinely one-two years from first contact. Are you prepared to weather a period of that length with lower asset levels in your E.U.-domiciled AIF?

Have I Demonstrated a Commitment to the Region?

Simply creating a structure that is AIFMD-compliant does not necessarily represent a "commitment" to the region. European allocators will expect to see members of the investment team with some degree of regularity and expect access to investor relations staff as needed, regardless of time zone considerations. Just setting up a small satellite office, or delegating to a third party (discussed below), is not sufficient. A manager must establish and be able to articulate their plan for servicing the needs of E.U.-based clients.

DELEGATION

An intermediate method for achieving AIFMD compliance is to delegate either the portfolio or the risk management functions to a third party which is properly registered with the E.U. as an AIFM. Most of a fund manager's value-proposition resides in their portfolio management function, so most managers choosing delegation select the risk management function to be delegated. This can be an efficient way for a manager to tackle some of the most burdensome elements of becoming eligible to market under AIFMD, as the cost is much lower and the set-up is managed by the delegated firm. It is not, however, without its own important considerations.

CONCLUSION

In any industry, entering new markets is always marked with additional costs, rules, regulations and mistakes. Asset management is no different. What is different, however, is that many non-E.U. industry practitioners had previously been able to address the E.U. market like any other offshore market. That has all changed and even today, several years after AIFMD went into effect, managers are still unsure of what they can or cannot do, or how to remedy "holes" in their E.U. marketing practices.

Ultimately, those most harmed by this uncertainty are the European pensions, insurers, private banks and their clients who do not get access to the fullest possible range of fund products globally. It is our hope that, by consulting trusted advisors, as many non-E.U. managers as possible will become compliant and take advantage of the opportunities available in the EU markets.

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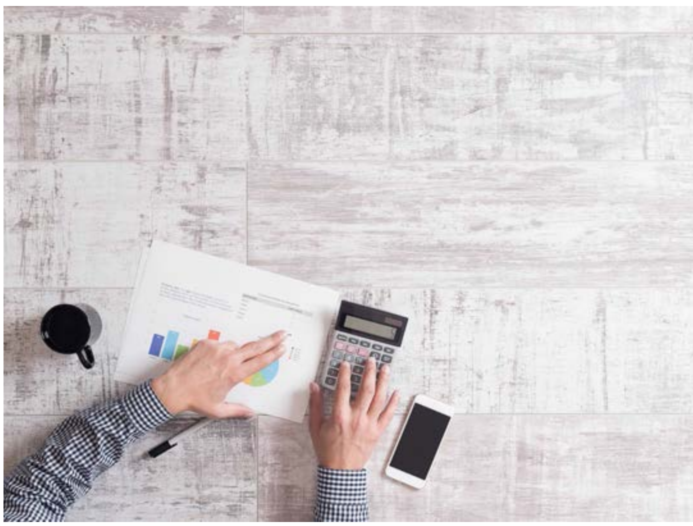
The Impact of the New Interest Expense Limitation Rules on Trader Funds

By Simcha David

The business interest expense limitation, new Internal Revenue Code (IRC) Sec. 163(j), is among the many new provisions of the IRC that was added by the Tax Cuts and Jobs Act of 2017 (TCJA). The limitation on its face seems to be rather simple. Interest expense is limited to 30% of the adjusted taxable income (ATI) of a trade or business. However, the practical application of this provision is anything but simple. Part of the reason is because the limitation applies to partnerships, corporations and individuals that are in a trade or business. Treasury recently issued proposed regulations to explain the nuances. Buried in the preamble is a troubling application of the new rules as it applies to trader hedge funds. In general, treasury regulations cannot be used to promulgate new laws. That is for Congress to do. However, the practical application and interpretation of the law and intent of Congress is very much in the purview of the authors of the treasury regulations.

Hedge funds fall into two categories, investor funds and trader funds. In the simplest form, investor funds invest in the markets for longer-term appreciation while trader funds invest for short-term gains or swings in the market. In general, trader funds will have a much higher trading volume than investor funds. Trader funds may still have some long-term capital gains, but those are the exception rather than the norm. Because of this, many trader funds make an IRC Sec. 475(f) mark-to-market election which removes the necessity to perform securities analysis on the portfolio as it is marked to market on an annual basis and all gains and losses are ordinary rather than capital in character. In addition, the expenses related to a trader fund are considered to be trade or business expenses, deductible against the income generated by the trader funds, while most expenses relating to investor funds are investment expenses that are no longer deductible.

Under pre-TCJA law and still under current law, interest expense that is utilized to create investment (non-trade or business) income is subject to the investment interest expense limitation of IRC Sec. 163(d). This limits the amount of interest expense that a partner in an investment partnership can deduct on his personal income tax return to the amount of investment income earned. For example, if an investor fund utilizes a margin account and pays interest on it, the fund will separately report this interest expense to its investors on the schedule K-1. The partners are then required to calculate how much investment income they have earned that year to determine if they can deduct the interest expense allocated to them. If a taxpayer is invested in multiple funds, they aggregate all of the investment income to determine if they can utilize the interest expense to offset their income. Although trader funds are considered to be in a trade or business, the income they generate is primarily investment type income. However, if the law did not specifically include the trader income in the definition of investment income, the interest expense utilized to generate trader fund income would be deductible without limitation. In order to bring parity in the investment world, Congress included in the definition of investment income, a limited partner's share of a trader fund's income, which then makes the interest expense allocated to a limited partner in a trader fund subject to the investment interest expense limitation. The interest expense allocated to the general partner of a trader fund is generally not subject to the investment interest expense limitation. This is because of the language in IRC Sec. 163(d).



Under the TCJA, which added new IRC Sec. 163(j), we now have an interest expense limitation that applies to trade or business interest. A trader fund is a trade or business. As noted above, the expenses of a trader fund, other than interest expense, which may be limited under the investment interest expense limitation of IRC Sec. 163(d), are fully deductible. So, one could conclude that the interest expense of a trader fund is now subject to the Sec. 163(j) trade or business limitation. However, under IRC Sec. 163(d), the interest expense of a trader fund is investment interest subject to the investment interest expense limitation. The business interest expense limitation is an entity level limitation (fund level) while, as explained above, the investment interest expense limitation is a partner level limitation (individual return). So which provision should apply?

IRC Sec. 163(j)(5) defines "business interest" for purposes of the new trade or business limitation as follows: "For purposes of this subsection, the term 'business interest' means any interest paid or accrued on indebtedness properly allocable to a trade or business. **Such term shall not include investment interest (within the meaning of subsection (d)).**" Based on this definition it would seem clear that, in a trader fund scenario where IRC Sec. 163(d) (investment interest expense limitation) applies, neither the interest income generated nor the interest expense generated should be deemed to be business interest. While this may seem clear to us, the opposite was clear to Treasury in the preamble to the new proposed regulations. Treasury specifically applied the new rules under IRC Sec. 163(j) to trader partnerships. As mentioned above, in the trader fund context, the business interest expense limitation will first be applied at the partnership level. They further concluded that once the interest is an allowable expense at the partnership level, the partner would still have to have enough investment income in order to actually deduct the interest (the investment interest expense limitation of IRC Sec. 163(d)). In addition, if interest expense is limited in the current year at the partnership level (excess business interest expense) once the excess business interest expense is allowed in a future year at the partner level , the partner would still have to have enough investment income in that year in order to actually deduct the interest (the investment interest expense limitation of IRC Sec. 163(d)).

Clearly, Treasury seems to be ok with the notion of applying both IRC Sec. 163(j) at the partnership level and IRC Sec. 163(d) at the partner level, even though it is clear from the statute that the intent of Congress was that IRC Sec. 163(j) should not apply if IRC Sec. 163(d) is applicable. To add insult to injury, Treasury is not even asking for comments on this. Instead this paragraph concludes that:

> "The Treasury Department and the IRS have concluded that this is the result of the statutory rules contained in section 163(d)(4)(B) and (d)(5)(A)(ii) and, therefore, no additional rules are needed in regulations to reach this result."

To further illustrate how these new rules burden a limited partner in a trader fund, consider this scenario: An investor owns an interest in two different trader funds. Fund 1 utilizes margin but has losses for the year and Fund 2 does not utilize margin and has income for the year. In the past, as long as Fund 2 generated enough investment income to shelter the interest expense generated by Fund 1, the interest expense of Fund 1 could offset as a deduction the investment income generated by Fund 2. If we followed the above preamble, in this scenario, the interest expense generated by Fund 1 would not be deductible in the current year regardless of the amount of investment income at the partner level because it is limited under IRC Sec. 163(j) to 30% of ATI. Fund 1 has zero ATI in the current year and so the interest expense is no longer deductible. In order for the interest expense of Fund 1 to be deductible in a future year, Fund 1 will have to generate "excess taxable income" and allocate such income to the limited partner. If in that future year the "interest expense" becomes allowable, the limited partner must then determine if it has earned enough investment income to deduct that interest expense under the IRC Sec. 163(d) limitation.

Thankfully, there is a separate exception under Section 163(j) called the "small business exception."[3] Congress did not want to burden a growing business with a limitation on the deductibility of its interest expense. The small business exception states that if an entity passes the "gross receipts" test of IRC Sec. 448(c), such business will be considered a small business and will not be subject to the business interest expense limitation. IRC Sec. 448(c) states that an entity that does not have aggregate gross receipts for the prior three years in excess of $25 million passes the gross receipts test. How a fund calculates gross receipts for this test is itself unclear, and one should contact his/her tax advisor to help with that determination.

As can be imagined, this seemingly innocuous piece of the preamble has caused an outcry in the financial services community, as it seems to be contrary to Congressional intent and to the four corners of the statute itself. Many letters have been and are being written to Treasury asking that the position be reconsidered. If that effort is successful, it will hopefully be "status quo" when it comes to the limited partners' share of trader fund interest expense, such that the investment interest expense limitation will apply at the partner level and no business interest expense limitation will apply.

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[1] For federal tax purposes, a partnership does not pay tax. Instead, the income earned and expenses allowed at the partnership level flow up to the partner in a K-1 (partner level). Although a partnership seems to be the aggregate of its partners, there are some limitations that apply at the partnership level that treat the partnership as an entity on its own.

[2] Section 163(j) has a mechanism in place that requires the partners in a partnership to track the excess business interest expense and to determine when that interest expense may be deductible for Sec. 163(j) purposes in a future year.

[3] IRC Section 163(j)(3)

Alternative Investment Outlook for Q1 and Beyond

By Elana Margulies-Snyderman

INTRODUCTION

Following a challenging Q4 for the hedge fund industry as a whole, many prominent managers have shut down or converted to family offices, especially those in the equity space due to poor performance that lagged the S&P 500. As a result, the space is anticipated to see new launches from employees of these shuttered funds, while those still investing in equities could face outflows from institutional investors and family offices. On the other hand, the areas that appear to be poised for inflows from allocators include global macro, Asia-focused offerings and, on the less liquid side, qualified opportunity funds.

STRATEGY OUTLOOK

GLOBAL MACRO

Global macro appears to be one of the most promising strategies on the premise that investor diversification into discretional macro strategies could mitigate market volatility risk to overall portfolios.

"Although performance in these strategies has not met investors' expectations, the current backdrop for discretionary global macro investing has been improving," said Phil DeRosa, managing director of EisnerAmper's Connecticut office. "Monetary policy normalization is a key factor in the improving backdrop for the strategy, but high asset valuations also play into the strategies' important role within a portfolio."

He added: "While it can be debated if equity-market valuations have reached so-called levels of 'irrational exuberance,' most investors would agree that the future path of equities is less certain. This is good news for discretionary global macro investment managers, as any adverse moves, particularly in equities, would generally be accompanied by an increase in realized volatility. Historically speaking, discretionary global macro strategies have an inherent long volatility bias, and therefore can act as risk diversifiers in times of equity market stress."

ASIA

Despite 2018's decline in the Asian markets and reduction in demand for Asian managers, at the start of this year, Asia appears to be the main focus for investors to deploy capital, putting aside the pending impact of U.S. and China trade policies.

"Across the hedge fund investor landscape, opportunities may exist as the International Monetary Fund reported that two thirds of world economic growth will come from Asia in the next five years," said Grady Poon, head of financial services, EisnerAmper Singapore. "The Global Capital

Markets Growth Index also indicates that the Asian markets could have the significant boom in the shares of global capital markets over the next few decades."

QUALIFIED OPPORTUNITY FUNDS

Institutional investors and family offices have also been heavily eyeing opportunity funds since investing through these vehicles provides developers and investors with tax-advantaged investment opportunities designed to spur local economic development.

"Since enactment, qualified opportunity funds (QOFs), the instrument to invest in qualified opportunity zones, have become a very hot topic," said Lisa Knee, national leader of EisnerAmper's Real Estate Private Equity Group. "Tax benefits include a temporary deferral of tax on gains, the elimination of up to 15% of the tax on the deferred gain and potential exclusion from tax on gain generated from the appreciation of investments within the QOF."

EisnerAmper has created a guide called *Qualified Opportunity Funds: A Guide for Real Estate Investors* to help real estate investors navigate this tricky terrain. To learn more about QOFs and receive a complimentary copy of this comprehensive how-to guide, visit *eisneramper.com/REPE*.

CONCLUSION

With 2019 just beginning and many big name hedge funds finishing their wind-downs, over the next few quarters the industry is expected to see a series of new launches from these employees who fell victim to the closures. Yet, capital raising for them will continue to be a challenge as allocators overwhelmingly have their eyes set on non-equity strategies.

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Secondary Private Equity Market: Offering Flexibility amid Brexit

By Robert Mirsky

Amid the uncertainty over Brexit's outcomes and challenges in the British economy, the U.K. private equity (PE) market remains strong. PE returns have been steadily increasing and have demonstrated "significant levels of stability," the last data from the British Private Equity and Venture Capital Association (BVCA) show.

But for investors wary of Brexit's looming uncertainties, a more adaptable alternative exists: the secondary PE market.

PE investors have been careening toward the secondary market, where they can buy and sell assets before the end of a PE fund's traditional ten-year term. Investors traded $36.7 billion in the more liquid secondary PE transactions in the first half of 2018, up by 26.2% from the same time last year, according to secondary market brokerage firm Setter Capital.

As investments in secondary markets tend to be more liquid, the market for secondary PE investment in the U.K. is set to expand, especially for investors who have been timid in allocating more investment in U.K. funds over fears around Brexit.

The secondary PE market provides a quick escape during ominous foreign exchange swings, which have been a staple for the sterling since the Brexit referendum in June 2016. The pound plunged to $1.2659 — the weakest it's been since June 2017 — on December 4 as the House of Commons debated on Brexit. But on December 5, it rebounded to $1.2777 as Parliament signaled the impossibility of a no-deal Brexit.

Whichever direction the pound ticks, investors in the sterling-denominated secondary private equity have the leverage to deploy — or relinquish — their shares at the right moment. A weaker sterling, for instance, would attract overseas investments in U.K. funds.

There are two ways investors can engage in the secondary PE market. First, one can invest directly in an operating company or portfolio of companies from another investor who seeks liquidity — also known as a direct interest purchase. Second, a pre-existing investor in a limited partnership can sell their shares to another investor — also known as fund interest purchase.

Secondaries, traditionally the preferred investment among limited partners who seek liquidity, have also gained traction among general partners, according to a Blackstone Group report. The secondary market not only allows general partners to scout for buyers' interest in primary investment, but also serves an opportunity to enhance their limited partner base, the report said.

MORE FLEXIBILITY, RISK-WEIGHTED RETURNS

Two decades ago, secondary PE's reputation was marred by sellers on the rush to dispose of their assets and significant discounts. Today, secondary PE investments are well-received among asset managers, as they provide more fluid cash flows, a more diverse portfolio and easier portfolio monitoring.

Secondary PE investments also tend to have lower risk — with potentially more attractive returns, according to a report by PE firm Coller Capital. By tapping into more mature funds, investors have the ability to mitigate the likely period of negative returns during the investment's early stages, the report said.

With PE firms establishing new offices and relocating people as Brexit looms, investing in U.K. secondary PE investments would help mitigate foreseeable negative exposures. Among the industries entangled in the quagmire are highly regulated sectors such as pharmaceuticals, aerospace and industries reliant on shipping. But a secondary investment into those industries' funds, having matured past their early stages, could potentially still bring risk-adjusted returns.

In the U.K., medium-term PE investments have performed better than their long-term counterparts, BVCA said in a report. Five-year investments in the 310 firms surveyed by BVCA resulted in a 327.8% per annum internal rate of return (IRR), which is an annualized rate of earnings in an investment. Meanwhile, the traditional ten-year investments in those same firms yielded a 290.8% IRR.

U.K. private-equity investors also seemed to have shrugged off their concerns surrounding Brexit. Foreign investors have been keener to strike deals as the pound dips, the Financial News reported October 12. From July 1 through September 30, buyout and growth firms invested in 65 U.K. companies, the report said, citing analytics company Dealogic. The number rose by about 14% from the same time last year.

In contrast, other parts of Europe saw a decline in the number and total value of deals. Investors struck 176 deals worth $37.57 billion across Europe from July to September—down from 189 deals worth $44.17 billion the same time last year, Dealogic data show. With U.K. investments over-performing those of the continent, the U.K. secondary PE market is set to grow — and be more competitive.

REGULATORY REFORMS

But even without Brexit, secondary investments in PE are robust thanks to post-crisis banking regulations.

During the global financial crisis of 2008, investors treated private equity secondaries with caution, as their bid-offer spread widened. But as the spread narrowed afterwards, the secondaries' transaction volume surged. Financial institutions partly drove the rally in investment as post-crisis regulations limit banks' ability to invest in funds.

Under the Bank of International Settlements' Basel III, for instance, banks must meet minimum capital requirements and proper leverage ratios. And under the United States' Dodd-Frank Wall Street Reform and Consumer Protection Act's Volcker Rule, banks are prohibited from investing in private-equity funds in most circumstances.

Thus, secondary private-equity investment will still warrant its own robust market, especially in the U.K. — even through the tides of Brexit.

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