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Q4 2016

Asset Management Intelligence

A publication from The Financial Services Group

Doing Business in Europe Post-Brexit – Considerations for U.S. Investment Managers

By Ray Kelly and Brian Hillery

INTRODUCTION

On October 5, 2016, the UK Prime Minister, Theresa May, announced the UK's intention to trigger the withdrawal mechanism of Article 50 of the Lisbon Treaty ("Treaty on European Union") by the end of March 2017. The Prime Minister raised the prospect of the UK leaving the EU by Spring 2019 in what is being termed a 'hard' Brexit. Pre-negotiations between the EU and the UK to agree the terms of Brexit will now begin in earnest although no official negotiation will take place until after Article 50 has been triggered.

The Prime Minister also intends to expedite the process of leaving the EU by passing a piece of legislation called the Great Repeal Bill. This historic proposal aims to end the EU's legal supremacy in the UK by converting all EU requirements into British law as soon as Britain exits the EU.

The purpose of this article is to provide an overview of some key considerations relating to Brexit for U.S. investment managers, both in the short-term and long-term.

BREXIT CONSIDERATIONS FOR U.S. INVESTMENT MANAGERS

I. EU Investment Opportunities and Challenges

Brexit will impact the position of UK and European investors, as well as the investment environment within the EU, leading to both investment opportunities and challenges. Hedge fund managers are already preparing for investment opportunities created by the UK's decision to leave the EU. Since the UK's vote to leave, the British pound has fallen to a 31-year low against the U.S. dollar, thus creating significant market volatility. Press reports also indicate that Marathon, a $13 billion U.S. hedge fund, is building a big Brexit trade, increasing its investments in property across Ireland, France, Germany and the Netherlands, in a bet to be among the big beneficiaries from companies departing London over the coming years.

II. U.S. Investment Managers with UK Operations

The impact of Brexit for U.S. investment managers with UK operations will depend on the UK entity's tax status and regulatory position. Particular points for consideration include:

- *Tax structuring*
  Post-Brexit, access to benefits available under tax treaties and EU based exemptions such as the Parent – Subsidiary Directive available to EU-based portfolio companies owned by UK entities may be lost. Identifying, over the coming months, which fund investments may suffer tax leakage as a result of these changes and developing appropriate contingency plans will be crucial.

- *EU passporting rights*
  Passporting rights currently allow UK financial services entities to operate across Europe. A key consideration for U.S. investment managers with UK operations is whether its UK entity makes use of, and will continue to require, EU passporting rights. In this regard, the head of Prudential Insurance's M&G fund management arm, Anne Richards, said they are considering shifting more funds to Dublin and Luxembourg as a result of the Brexit vote to maintain access to the EU's single market.

III. U.S. Investment Managers Marketing Cayman-Domiciled Funds in the EU

For U.S. investment managers marketing Cayman-domiciled funds in the EU, it is unlikely that the Brexit decision will require fundamental changes to the way in which funds are marketed in Europe (given the managers' existing status as non-European managers of non-European funds). For the time being, U.S. fund managers will continue to market in Europe and the UK using the National Private Placement Regimes. However, going forward, marketing in the UK may be regulated differently, as it may no longer be subject to the Alternative Investment Fund Managers Directive.

IRELAND & BREXIT

It is important to note that Ireland remains a full member of the European Union and the only English-speaking member with the euro as its currency. While there will be uncertainty and volatility, we expect there to be opportunities for jurisdictions like Ireland to provide market routes for global firms into Europe that have traditionally gone through the UK. Ireland is well placed to support the UK by providing and maintaining a route for UK firms to the EU marketplace with minimal interruption and low frictional cost.

The fact that the European Central Bank licenced the Irish supervisory framework for use in their Single Supervisory Mechanism is a strong selling point for the high regard in which the Irish regulatory system is held internationally. It has been reported that the Central Bank of Ireland is to split the organisation's key markets supervision division into two units as it deals with a surge of enquiries from investment funds and firms following the Brexit referendum.

Additionally, fears of a "hard" Brexit have led to a spike in the number of UK-based people seeking jobs in Ireland. In the 100 days since the June referendum, UK searches for jobs in Ireland on Indeed.com, the world's largest recruitment site, have risen by 20%. "We now see that the increase in people looking at jobs outside the UK post-Brexit is both sustained and increasing," said Mariano Mamertino, economist with Indeed. "As the only English-speaking EU member, with the fastest growth rate and flexible labour markets, Ireland is well placed to attract these labour flows and potentially additional foreign direct investment."

BENEFITS OF DOING BUSINESS IN IRELAND

Ireland is an open and agile economy that has been responsive to the needs of international players for more than half a century. Companies establish operations in Ireland to serve local, European, and international markets, and in doing so leverage Ireland's advantages as a gateway to these markets. These advantages include:

- A stable political environment and respected regulatory regime;
- Membership of the European Union;
- The only English-speaking jurisdiction in the Eurozone;
- A low corporate tax rate – corporation tax on trading profits is 12.5%;
- An extensive double tax treaty network;
- A common law jurisdiction, similar in nature to that of the U.S. and the UK;
- Availability of fiscal incentives for R&D activity;
- Strong international broadband and transport connectivity; and
- Supportive legal and economic environment for internationally trading businesses.

CONCLUSION

Businesses impacted by Brexit are beginning to develop their plans for the new reality of a European Union without the UK. For U.S. investment managers, it is timely to consider potential threats to their European business models and also emerging investment opportunities and to develop appropriate strategies to mitigate these threats and capitalise on the opportunities.

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Budgeting for Launch

By Ken Poudrier, Founder, Pillar Fund Services

"When I arrived down at the marina the other day, there was a new boater on my dock. He had the latest model tournament boat, top fishing gear and the best available private captain and crew. As I stopped to greet my new neighbor, he told me that he decided to become a professional tournament fisherman. I wished him luck. For sure, he was the best outfitted boat at the marina and certainly appeared ready to take on the challenge.

A month later, I saw that same neighbor down at the dock and asked him how he was doing in the fishing tournaments. He told me that he had to sell the boat and fishing gear and let the crew go. He had to WIN a tournament in the first month to afford continuing with his fishing operation. He left the marina that day still shaking his head and wondering what went wrong."

If you have considered, or are considering, launching a fund, then the fictional anecdote you have just read can provide insight into some valuable considerations that can increase the likelihood of your success.

First, remember that when you launch a hedge, private equity, or venture capital fund, you are also starting a small business. Unlike the boater in our story, start with a realistic budget that provides a long enough runway to allow the operations to become self-sustaining. Individual circumstances and capital outlay required to cover the early years of operation may differ dramatically between launches, but expenses such as legal, filing fees, IT infrastructure, IT support, research, travel, rent, utilities, marketing, printing, accounting, tax preparation and potentially salaries/benefits for employees should be considered. Additionally, an investment manager will need to consider whether they will reimburse some or all of the fund level operating expenses during the formative year(s) of the launch. While this has great appeal to your potential investors and helps your overall performance, as an investment manager, these items represent a further drain on the operating budget.

To make an operating budget go further, managers can either increase revenue or reduce expenses. Let's start with increasing revenue, since this is always a positive. To an investment manager, this means raising capital. Given we are concentrating on new launches, there is an inherent optimism in the prospects of raising capital and successfully launching a fund. My advice for investment managers, which would have served our friendly fisherman well, would be to temper the expectations of the launch. If after talking to prospects a manager expects $40 million at launch based on those conversations, then I propose the manager budgets for half that amount. Raising capital is a challenging prospect in today's environment. Inevitably, some prospects will not invest when the time comes and others may be significantly delayed in funding their verbal commitment. Obviously, these events reduce the revenue earned and may adversely impact how long a venture can be sustained.

Fortunately, there is another side of the equation available to managers looking to extend the budget and create a longer window of opportunity. Very simply put, reduce expenses. Just as our boater would have doubled his time to succeed by purchasing a used boat that cost half as much, investment managers can make similar choices.

One of the major decisions facing an investment manager during launch is determining what functions to perform internally and those that should be outsourced. Performing functions in-house for the fund (such as fund administration, tax preparation, etc.) tend to require additional IT infrastructure and support costs as well as potential increased staffing and related expenses. Keeping these functions in house is more prevalent in the private equity and venture capital markets than the hedge fund markets. On the investment manager side, hiring a CFO, trader, administrator, etc. to support the operations can significantly increase the internal budget in the early years. While hiring a full complement of staff at all levels may make sense for the $200 million dollar launch, the $20 million dollar launch with friends and family money may find an outsourced model preferable. When evaluating staffing decisions, a manager must determine if there is sufficient work to support the hire and if there are outside influences that would prevail in requiring the internal hire. Depending on the circumstances, by outsourcing the traditional internal functions (trader, CFO, compliance, IT support, accounts receivable/payable, etc.), the manager may be able to "staff" their company with experts across many fields for the same cost as a single senior level hire.

One should not lose sight of the fact that while we have been discussing the budgets of the investment manager, the expense budget of the fund is important as well. Every vendor decision that is made at the fund level will directly impact performance and expense ratios. In turn, this could negatively influence capital raising if the effect is significant enough. Investment managers need to impartially and critically review themselves to identify the best vendor solutions for their individual needs.

The good news for managers is that in any given area of service, vendor choices range from the big guns to the boutique shops and cover every tier, sector and specialty in between. With so many choices available, the challenge of each manager is to identify the vendor that best compliments the fund's complexity, strategy, investor base and management team as well as the budget. In today's landscape, there is most certainly a service provider that is the right fit, with the right personality and right cost for virtually every manager in the industry.

Launching a fund should be exciting and requires founders to take a leap of faith, expend a whole lot of effort and be blessed with a little bit of fortune to succeed. Remembering that you are also launching a small business; establishing a realistic budget will maximize the opportunity you have for success.

Ken Poudrier is founder of Pillar Fund Services, which provides outsourced CFO/COO, fund administration and consulting services for the alternative investment community. Questions? You can contact Ken at (617) 312-1988 or krp@pillarfs.com.

Are you Ready for Your Annual Audit?

By Vikram Deshpande

It's that time of the year! As we are in the fourth quarter and move closer to year-end, 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 to 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

With nine months of the fiscal year behind us, the fourth quarter is the ideal time to set up a planning meeting to discuss and provide an update to your auditor about what has occurred so far 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 interim and final 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 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 for 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.

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 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 to provide timely responses to all their questions will ensure an efficient audit.

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 work. 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 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.

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Alternative Investment Industry Outlook for Remainder of Q4 and Early 2017

By Elana Margulies Snyderman

INTRODUCTION

The conclusion of 2016 is nearly upon us, highlighted by large institutions redeeming from equity-focused hedge funds and funds of hedge funds in favor of private equity while family offices have been more amenable to them. The industry has also seen more launches in the credit/debt, private equity and real estate space and a slowdown in new long/short equity debuts. Further, hedge fund managers have been instating more creative fee terms to accommodate allocators. With respect to these abovementioned topics, EisnerAmper anticipates what's in store for the remainder of this year and early next year for the alternative investment industry.

INVESTOR OUTLOOK

We're seeing that a number of institutional investors including insurance companies, pensions, endowments and foundations are continuing to pare down their hedge fund portfolios in favor of private equity. At EisnerAmper's September Breakfast Series event, investment representatives from large institutions, including MetLife Investments and Morgan State University Endowment in Baltimore, said they have reduced their hedge fund portfolios in favor of private equity and other less liquid investment opportunities.

Maria Tarhanidis, Managing Director, Alternative Investments-Hedge Funds at MetLife Investments, said the pension will continue to favor both mezzanine debt and private equity because they have performed better than hedge funds, which they have eliminated.

"While we think the returns going forward will be lower than they have been for mezzanine debt and private equity, since they have been great for many years, we think they can still be attractive and more so than hedge funds," she said.

Additionally, EisnerAmper has heard that family offices continue to be more open to hedge funds. Engineers Gate Investments in Connecticut continues to favor both emerging managers and credit offerings.

"We are thinking of increasing our credit exposure due to the interest rate environment," said Robert Maroney, Founder of Engineers Gate. "Some of the niche credit funds we have invested in have done well, especially those focused on secured loans."

Additionally, capital introductions personnel from organizations ranging from the biggest prime brokerage firms to second tier ones and boutique firms told EisnerAmper that family offices continue to favor low-net long/short equity managers, both generalist and sector focused, especially in health care, TMT, consumer and energy, along with market-neutral, quant and systematic hedge fund strategies. And on the less liquid side, they are looking at direct lending and private equity opportunities.

LAUNCH ACTIVITY

With respect to launch activity, EisnerAmper has witnessed a significant uptick in credit/debt, private equity and real estate while there has been a slowdown in long/short equity debuts, along with new venture capital offerings.

"The current interest rate trends and fixed-income yields are perceived as offering an opportunity to managers in credit strategies that has generated a lot of interest among managers investing in fixed-income instruments of all types," said Keith Miller, Partner in the Financial Services Group in EisnerAmper's San Francisco office.

He added that real estate continues to be attractive on the West Coast and fund strategies holding or connected to real estate continue to launch as a result.

FEES

Investors, especially seed investors, continue to have the upper hand when it comes to fee negotiation with managers, and managers will continue to find ways to accommodate them.

"Fund managers have continued to get more creative with their terms and fee structures," said Jaclyn Greco, Manager in the Financial Services Group in EisnerAmper's New York office. "We've seen new managers incorporate longer lock-up periods as well as preferred returns or 'hurdles' before the incentive fee is earned, to further align their interests with investors. Some managers are even using tiered fee structures, where in Year 1 they are charging X management and incentive fees, Year 2 they are charging Y and Year 3 they are charging Z. This is a further enticement for an investor to keep their capital in the fund for longer periods."

Miller added, "What I am seeing is far more managers looking at reducing their carry from 20% to 15%. Some founders' classes are offering a 10% carry in return for a lock-up. I feel like I'm seeing real fee pressure there. Founders' classes aren't particularly new. They've been around for a few years but they do seem to be a fairly standard feature of most new launches now."

CONCLUSION

For the remainder of 2016 and early 2017, it is evident that the majority of hedge funds will continue to face challenges raising capital from the biggest institutional investors as they are paring back their hedge fund allocations in favor of private equity and less liquid alternative investment opportunities. Further, the interest rate environment is expected to be promising for new credit fund launches at least in the near term. Finally, managers are expected to be more flexible with regards to their fee structure to entice investors.

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Private Fund Managers: A Practical Approach to Anti-Money Laundering Policy

By Louis Bruno, Barry Eisenberg and Venkat Rao

The compliance burden is increasing again for many private fund managers. The Financial Crimes Enforcement Network ("FinCEN") has proposed a rule requiring registered investment advisers to implement anti-money laundering ("AML") programs, and detect and report suspicious activity. Additionally, the rule would expand the definition of "financial institution" under the Bank Secrecy Act ("BSA") to include investment advisers, subjecting them to additional regulations, such as recordkeeping and filing currency transaction reports ("CTRs"). Lastly, the proposed rule would provide the SEC with examination authority over private fund managers in AML matters.

The challenge for private fund managers is that their AML risk profile differs from larger institutions, such as banks managing hundreds of daily transactions. To meet this challenge, practical risk-based considerations would serve private fund managers well in effectively and efficiently fulfilling their AML obligations.

A practical approach means AML programs will vary; a large hedge fund's program will likely differ from that of a smaller private equity fund. Smaller funds have fewer compliance resources, are less likely to employ a full-time Chief Compliance Officer and may outsource the function entirely. Moreover, these organizations may lack the expertise to identify AML issues, particularly when onboarding new investors.

KEY ELEMENTS OF AN AML PROGRAM

Regardless of the FinCEN proposed rule, a private fund manager should implement a risk-based AML program meeting industry best practices with the following elements:

1. **Management oversight –** Management is responsible for the AML compliance program and should clearly define and document the investor review and approval process.
2. **Written policies –** AML policies should be reasonably designed to achieve compliance with the proposed rules;, delineate responsibilities for identifying and reporting suspicious activities and conducting investor due diligence requirements; address management approval and define risk appetite for onboarding new investors.
3. **Written procedures –** Separate from the policy, an AML program requires written procedures reasonably designed to prevent the firm from being used for money laundering or terrorist financing activities. These controls must be designed to address applicable AML risks to the adviser.
4. **Periodic independent testing of the AML program –** Such periodic testing (i.e., annually) must be conducted by an entity independent of the investment adviser.
5. **Designation of an AML Compliance Officer –** AML Compliance Officers must be "knowledgeable and competent" on applicable regulatory requirements to effectively fulfill the responsibilities attached to the role.
6. **Training –** Employees of the adviser, depending on their roles, would require periodic training on the requirements of the BSA and related AML regulations.

To properly implement key AML components, fund managers should address the following questions:

- Is there established governance allowing management to review and approve new investors?
- Has a risk assessment outlining the adviser's AML risks and corresponding controls been implemented?
- Has management defined the firm's risk appetite for onboarding potentially high-risk investors?
- Is the firm staffed to support investor due diligence, monitoring and reporting or is outsourcing necessary?

KNOWING YOUR INVESTOR

Unlike other financial institutions, investment advisers are not required to enact a Customer Identification Program ("CIP") under the proposed rule. Nevertheless, an effective AML program requires monitoring and detecting suspicious activity, and possibly filing suspicious activity reports ("SARs"). In addition, FinCEN anticipates addressing a CIP requirement in future joint rulemaking with the SEC. Therefore, a fund manager's AML program requires adequate due diligence before accepting investor money to meet SARs and CTR responsibilities.

DEVELOPING AML POLICY

Compliance policies can vary across organizations. However, in the simplest form, a policy should describe the business activities, along with the associated risks and controls to mitigate the risks. AML risk assessments can be incorporated into an investment adviser's annual review under Rule 206(4)-7 of the Investment Advisers Act of 1940, but higher risks may need more frequent review.

Elements of a risk-based AML policy should include:

- clear "money laundering" definition;
- examples of "red flags" indicating suspicious activities;
- identifying the person(s) responsible for administering and enforcing the AML program;
- criteria and tolerance for onboarding high risk investors (e.g., politically exposed persons ("PEPs"), particularly where sources of funds are unclear; and
- consequences for policy violations.

Importantly, AML policies are frequently distinct documents from an investment adviser's compliance manual. To promote a consistent compliance program, fund managers should align the AML policy to the compliance manual.

OUTSOURCING AML PROCEDURES

Many fund managers outsource some or all of their AML procedures to third parties, such as fund administrators. Regardless of any outsourcing, FinCEN emphasizes that fund managers remain fully responsible for the adequacy and effectiveness of their AML program, including elements performed by third-party service providers. Regulators will not accept blame by advisers for a third-party's investor due diligence failure.

If fund managers elect to outsource, several best practices apply for fulfilling AML responsibilities. A fund manager's AML policy should specify the level of investor due diligence performed by a third party, and the amount of oversight by the manager. Examples may include periodic onsite visits to the third party, testing of processes and meeting with key personnel to gain comfort with procedures.

Additionally, when completing service level agreements ("SLAs"), fund managers should consider the following:

- **Level of due diligence:** SLAs must address the level and scope of fund manager due diligence on the outsourced third party. SLAs should provide a fund manager the right to inspect an administrator's due diligence reviews on new investors. For high-risk investors, such as PEPs, SLAs should articulate any enhanced due diligence procedures performed by the third party that would allow the fund manager to gain comfort with the investors' source of funds. Enhanced due diligence procedures may require additional documents or information from the investor. These concerns are illustrated by the recent publication of the Panama Papers.
- **Record retention:** If the fund administrator holds AML records on behalf of the fund manager, SLAs should clearly define regulatory expectations on document production. Typically, regulators require document production within 24-48 hours for an examination request, and SLAs should contain appropriate language to protect fund managers.
- **On-site inspections:** An adviser's periodic on-site due diligence of third parties should include reviews of AML files the third party maintains for the fund manager and testing of AML activities. SLAs should allow advisers the right to review such files and conduct testing of the third party's procedures.
- **Escalation procedures:** If a fund administrator identifies any red flags during AML reviews, SLAs should contain escalation procedures to immediately notify the AML compliance officer. Red flags may include the presence of PEPs or negative investor information, but fund managers must be prepared to take prompt and appropriate action in such circumstances.

CONCLUSION

Private fund managers can ease their anxiety concerning the new FinCEN rule by following AML fundamentals. Risk-based AML policies start with knowing your investors and their source of funds through proper diligence. A practical approach may include outsourcing AML tasks to third parties, but fund managers must provide proper oversight and draft agreements taking AML responsibilities into consideration to reduce their compliance risk.

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