July 2017

Wells Fargo Prime Services

Industry and Regulatory Updates

Highlights

Industry Trends

Updates in Cash Management

***Wendy Beer** interviews: **April Frazer**, Managing Director and Global Head of Regulatory Advisory and Capital Structuring, Wells Fargo Securities; **Geneviève Piché**, Managing Director and Relationship Manager, Financial Institutions Group, Wells Fargo Securities; **Katie McGuire**, Director and Relationship Manager, Financial Institutions Group, Wells Fargo Securities*

Can you please set the table for us on U.S. banks and their appetite for deposit exposures post Basel III?

With the implementation of U.S. versions of the Basel III liquidity coverage ratio, U.S. banks began paring back their appetite for deposit exposure to certain counterparties. As the estimated cost of providing deposits to these counterparties rose in 2015, activity in deposit substitutes climbed, and plans for alternative approaches to short-term investing accelerated. The shift in bank deposit behavior is exhibiting itself in 3 ways:

1. The term structure of short-term CD offerings has been truncated and switched into floating-rate product.
2. The availability of favorably priced deposit products for financial companies has diminished
3. Investment approaches of financial companies have changed

Around the time of implementation for the Liquidity Coverage Ratio ("LCR") in the U.S., issuance in the bank CD market began to shift from short-dated fixed-rate to longer-dated floating-rate products. This has allowed banks to access the same large money market fund buyer base without tripping the 30-day LCR threshold. The move to more floating-rate structures allowed money market funds to buy longer-dated CDs without extending their weighted-average maturity profiles. The percentage of floating-rate vs. fixed-rate CDs in money market funds has changed significantly over the past two years.

Percentage of Floating-Rate CDs in Prime Portfolios		
	January 2015	May 2017
Fixed	69.3%	42.6%
Floating	30.7%	57.4%

Do CDs pose an alternative investment option for short- term cash management?

CDs represent the same counterparty credit risk as other deposit products, but in negotiable form. Nevertheless, while CDs are considered to be "negotiable" instruments, meaning they have a CUSIP and can be bought and sold in the secondary market, they are not typically traded with the frequency of corporate bonds.

How has Money Market reform affected the CD market?

The market for CDs has grown exponentially in the past 25 years in the U.S. as foreign institutions have gained access to the U.S. market and grown their desire for dollar funding. Money market funds still represent the major buyer base for large CDs, but with the advent of money market fund reform, banks have lost a significant amount of direct short-term wholesale funding. Prime money market funds have lost over $1 trillion in assets, and bank CDs have been affected more than any other investment class. A decrease in short-term funding availability has forced banks to reprice their money market offerings and steepen the LIBOR curve.

Basel III is ultimately the regulatory standard for bank capital adequacy, stress testing and LCR. What do we need to understand about LCR and its impact on how banks are managing cash holdings (i.e., how they are classified toward the bank's capital reserves)?

AF: *A brief review of LCR is a good place to start:* The Federal Reserve adopted the LCR in 2014. The LCR standard applies in full to U.S. depository institutions and U.S. depository institution holding companies with greater than $250bn in assets or $10bn in international exposure. A modified LCR applies to bank holding companies and savings and loan holding companies that maintain between $50 billion and $250 billion in assets and are not significantly engaged in insurance or commercial activities.

The LCR requires that these institutions hold enough High Quality Liquid Assets ("HQLA") to withstand severe deposit outflows over a 30-day period. LCR, which focuses on the short end of a bank's funding liability side (less than 30 days), aims to improve the banking sector's ability to absorb shocks arising from financial and economic stress.

Net outflow assumptions take into account the deposit's purpose and depositor type (wholesale or retail). Wholesale deposits are divided into operational and non-operational sub-categories. Regulators now require that all deposits from non-regulated institutions including investment advisors, investment companies and non-regulated funds are considered non-operational in nature. Operational deposits are subject to a 25% runoff factor (or 5% if entirely covered by deposit insurance). Non-operational deposits placed by financial entities or affiliated entities are subject to a 100% runoff factor, ***therefore U.S. LCR rules assume a 100% run off for all AAM and PE deposits.***

Liquidity Coverage Ratio 100% < Total HQLA Net Cash Outflows over Stress Horizon

What has changed in the Landscape from 2015 when LCR was first implemented to now?

AF: A number of post-crisis regulations have been proposed or finalized since the LCR was first implemented, including Total Loss Absorbing Capacity ("TLAC") requirements, Net Stable Funding Ratio ("NSFR;" note: NSFR requirements have not been finalized in the U.S.) requirements, and the Method 2 G-SIB surcharge. These regulatory requirements, among others, discourage reliance on short-term wholesale funding and incentivize banks to depend on reliable short-term and long-term funding sources. Nominal changes have been made to the existing LCR rule, notably the ability for certain investment-grade, U.S. general obligation state and municipal securities to be counted as HQLA up to certain levels if they meet the same liquidity criteria that currently apply to corporate debt securities

The new U.S. Administration and Congress have made financial de-regulation a focus of their agenda, which includes revisions to the LCR, other liquidity requirements, and the applicability of these requirements. Various Administration reports and legislation exist that points to reform on this front, but U.S. bank regulators, the U.S. Administration, and the U.S. Congress have not implemented any final and binding changes to the LCR and other liquidity requirements.

Has Basel III and/or the changing interest rate environment made it easier for smaller and/or non-bank entrants to the space to capture market share?

AF: It can be argued that community banks are better positioned to capture market share or gain certain types of deposits, such as non-operational deposits, since the applicability of most post-crisis liquidity regulations do not apply to these institutions. But because most large banks view relationships with counterparts on a holistic basis, large banks are able to "absorb" the negative impact of certain unfavorable exposures and deposits from an LCR perspective through other services and revenue provided to / from the client.

GP/KM: A few years ago, when rates were near zero and larger banks were determining their LCR requirements; several banks pulled back from the cash management space for hedge funds or significantly increased pricing. As rates have recently increased and banks have largely determined LCR requirements, we are beginning to see more competition in the cash management and depository business amongst banks of all sizes.

The primary goal of cash management at hedge funds is safety and preservation of capital. Over the last 10 years the concept of "cash management" has expanded the Treasury function to "active cash management." What are the alternative products competing for client cash and how are funds using these products to obtain incremental yield for their cash portfolio?

GP/KM: purchasing highly liquid securities as a cash alternative (treasuries, money markets, etc.) Where funds and managers hold their cash is typically dictated by the company's investment policy. Most policies require cash to be available on an overnight basis. Some companies have investment policies prohibiting leaving cash in bank accounts over the FDIC insured amount ($250,000). Other managers are prohibited from investing in non-treasury money market funds (MMFs) due to potential investment risk. The majority of managers we speak with explore purchasing 100% treasury MMFs, prime MMFs, and directly buying treasuries as an alternative to bank deposits as rates on treasuries and MMFs have recently increased. As rates have recently increased, managers are focusing more on yield coupled with counterparty risk when determining the best cash management solution

What impact does the prevalence of these products/rates have on cash management?

GP/KM: As rates have risen over the past few months, deposits have become more attractive for banks as they are able to earn higher net interest income. However, this is partially offset by increased compliance requirements to open and maintain bank accounts. Pricing on accounts has come down slightly over the last two years; however, more recently banks are offering higher earnings credit rates (ECR) to offset bank fees.

What should hedge funds be thinking about in terms of risk management when selecting a counterparty for cash management?

AF: Hedge funds should consider the overall financial condition in addition to risk management when selecting a counterparty for cash management. From a financial condition perspective, a hedge fund should consider the level and volatility of pre- and post-crisis profitability of the firm. Other leading indicators of financial health, such as asset quality (non-performing assets as a percentage of assets, net charge-offs as a percentage of average loans, etc.) should also be considered and monitored.

From a risk management perspective, the hedge fund should evaluate the counterparty's current capital levels in relation to its required minimums and compliance with other applicable post-crisis regulations (LCR, TLAC, etc.). Hedge funds should also evaluate and monitor consent orders and other regulatory measures that indicate non-compliance with other regulatory and supervisory requirements that, while not necessarily directly related with liquidity, speak to the quality of the bank's overall risk management framework.

What new products have been developing as a liquidity alternative?

AF/GS: In the financial institutions space, with the reduction in liquidity available through large money center banks, one liquidity alternative may be developing in the bi-lateral repo market. With the DTCC receiving regulatory approval to expand the number of counterparties able to directly access the repo market via the DTCC's Centrally Cleared Institutional Tri-Party Service, a new alternative source of liquidity and investment has been created. On June 29, the first trade in the CCIT was cleared, involving Morgan Stanley and Citadel. The platform is allowing non-traditional repo counterparties to be cash lenders into the FICC repo service. As a place to hold cash, CCIT repo is interesting in that all securities eligible for the CCIT service must be Fedwire eligible, which only includes Treasuries, Agencies and Agency MBS. The credit risk profile, then, of this short-term investment alternative would be similar to the credit risk of the securities underlying the transaction, i.e. U.S. Treasury and related securities. This may be viewed similar to having a deposit account at a financial institution over-collateralized by government securities. Not only does this take away the counterparty credit risk of the unsecured deposit, but it diversifies the risk of the investment across multiple counterparties on the central-clearing platform.

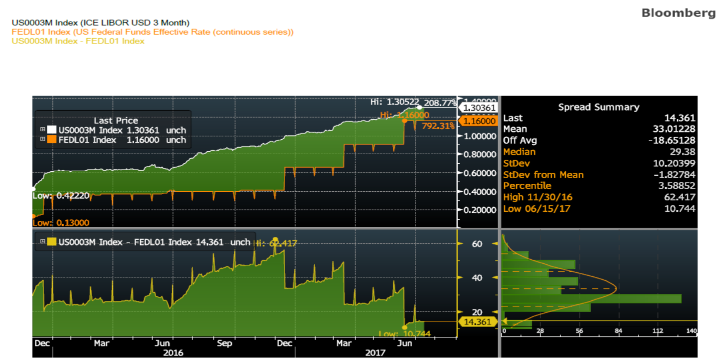
Money Market Reform: Investors on the Move

Contributing Author: ***Sean McCormack****, Director, Funding Capital and Liquidity, Wells Fargo Securities*

The flow of money into US prime money market funds has begun to accelerate in the last 3 months.

As detailed in our last quarterly update, the question was not if but when investors would return en masse to the short-term funds hammered with over $1.0 trillion in redemptions as new regulations took effect last October. The most recent data from the Investment Company Institute indicates that time might be rapidly approaching. Institutional and Retail prime funds have seen inflows of roughly $45bn since AUMs bottomed out in the 4th quarter of 2016, with approximately half of that move coming since the start of 2nd quarter of 2017[1]. In a recent article on the Wall Street Journal, Peter Crane, president and publisher of Crane Data, predicted that a historical trend of net inflows in the second half of the year is likely to return in 2017, giving the funds' AUM a further boost[2]. As for the gains already logged, portfolio managers note investors' increasing comfort with the floating NAVs, with the "volatility" often rooted four places to the right of the decimal point, as a factor. In addition, two rate hikes so far this year have helped generate increasingly attractive returns.

Market professionals and investors (existing and potential) will now focus on the Fed and the year's remaining meetings to determine if the prime funds can continue to deliver a noticeably superior yield relative to their competitors in the government bond fund space without having to extend duration beyond comfort levels. The behavior of short term rates post the June 14th hike indicate this may be difficult and last week's release of the minutes from that meeting did little to change popular opinion that another hike was not likely before December.



Since the Fed began raising rates back in December of 2015, the average spread between 3 month Libor and the Fed Funds Effective Rate has averaged approximately 33 basis points, with the widest gaps coming in the run up to meetings with the potential for another hike. Since the June meeting however, the spread has dropped to just 14 basis points. In addition, the September Eurodollar contract has settled into a fairly tight price range predicting a 3m Libor fixing of @ 1.34% on September on September 18th, < 4 basis points higher than this week's high.

So if the Fed, as indicated, starts to trim its balance sheet towards the end of this quarter, the question will become whether or not the contraction in money supply can put sufficient pressure on short term rates to ensure prime funds can further extend spreads over government bond funds' returns and lure more investors back into the fold.

The Top 10 Mistakes of New Managers

Contributing Author: ***Steve Nadel****, Partner, Investment Management Group, Seward & Kissel*

#10: Not dealing with past employment restrictive covenants.

Unfortunately, we often see instances where a manager has either neglected or misinterpreted an existing restrictive covenant from a prior employer that may impact the manager's new business. This typically comes up in the context of either use of a prior track record or bringing on prior employees or clients from the old employer firm. Sometimes, the results of this can be quite devastating, as we have seen instances where managers have been enjoined from using information or from poaching personnel. This is especially difficult when the dispute rises to the level of a litigation, in which case it becomes a public matter, and can

[1] Source: Investment Company Institute; [2] Wall Street Journal

stall the efforts of the new manager before they even really start.

#9: Not knowing your audience.

Before a manager begins to structure investment vehicles and devise the terms of investment therein, it really needs to have a firm understanding of its audience. For a variety of reasons ranging from tax to economics, different investors will be drawn to different products. Beyond the basic issues relating to taxable, tax-exempt and foreign investors, there needs to be an understanding also of the more subtle business points that often arise. For example, certain investors may be more insistent on lower fees, while others may be more concerned with better liquidity terms. Similarly, for risk control reasons, some allocators prefer a separately managed account over investing in a collective investment vehicle.

#8: Hiring a CFO/COO without people skills.

Since most managers starting a new fund try to begin with a leanly staffed enterprise, the CFO/COO becomes a vital hire as a jack of all trades. Unfortunately, we have seen numerous instances over the years where managers have become enamored with candidates who have off the chart technical skills, yet are severely lacking in people skills. Not surprisingly, this often comes back to bite the manager, either because the manager has alienated investors with whom the CFO/COO has been interacting or has caused other staff at the firm to leave due to a hostile work environment. Managers are therefore advised to check references not just for technical skills but also the softer social skills.

#7: Not thinking creatively.

The current state of the capital raising market has been particularly challenging. With this in mind, managers need to think outside the box in terms of creative ways to attract investors. Among the novel approaches that managers have undertaken are bespoke fee structures, customized managed accounts and specialized reporting. The best received ideas are typically those where the manager speaks with its investors, understands their needs and concerns, and develops a viable proactive solution.

#6: Not practicing your pitch in front of others.

Managers are typically a very confident lot when it comes to investing money. However not all of them are created equally when it comes to pitching their product. Accordingly, it is vital that managers practice their pitch with a varied group of people ranging from their friends to their advisers to their brokers. Presentation styles and weaknesses generally can be addressed, if caught early enough, however we have seen instances of managers who went into a pitch and were not able to answer important questions that they hadn't expected or cursed or did something else to turn off an investor.

#5: Trying to build the perfect mousetrap.

In a market where investors do not like surprises, we repeatedly see managers who choose to disobey this mantra, and often come to regret it. The most common scenario where we have seen this arise involves coming up with a highly complex liquidity or fee provision that may have never been seen before, and that typically creates a fair amount of discomfort with the investors. While a slight deviation resulting in a familiar surprise will often be OK, trying to reinvent the wheel, usually will not.

#4: Not caring about the firm name.

There are usually two issues that the manager should be cognizant of when selecting a potential name for the firm. The first issue involves whether the name violates any pre-existing trademark rights, while the second issue relates to whether the name may be confused with others. If the name is very unique, the primary concern will be whether there is any other name out there like it that could assert priority trademark rights. On the other hand, where the name is so commonly used that it cannot be trademarked, the startup manager needs to be sensitive to the possible confusion that could arise if one of the other people using that same name gets into trouble.

#3: Misstating facts about the PM.

In the year 2017, there are many ways for investors to check key information about the PM before making an investment. Yet despite this, there are often instances where managers misstate their roles at prior shops or some other vital point such as a prior honor or title. Managers should carefully fact check any information they provide to investors to ensure 100% accuracy. Failure to do so may be something that is difficult to overcome once detected, as oftentimes investors will talk to each other.

#2: Failure to do thorough background checks on personnel.

In addition to the points raised in the preceding entry, if a proper background check is not done, and an employee fails to disclose certain issues, not only could it be embarrassing, but there could be legal issues raised, if for example the employee had disciplinary history in its background.

#1: Being a kid in a candy store.

Managers need to be particularly sensitive in the early days to the costs they may incur. Time and time again, however, we continue to hear stories of managers who have entered into personal guarantees for leases of fancy office space, or given out large guaranteed bonus compensation. It is imperative that the manager minimize its liabilities at startup, and there are numerous ways to structurally do so through good guy guarantees, vesting schedules and other similar devices.

Investor Trends

Trends in Hybrid Structures

Wendy Beer and Jasmaer Sandhu *speak with* ***Blayne Grady****, Partner, Akin Gump Strauss Hauer & Feld LLP;* ***Joshua Williams****, Partner, Akin Gump Strauss Hauer & Feld LLP*

Hybrid products have been on the rise since 2008. More recently, we have seen investors showing increased acceptance and interest of these more complex structures. To what do you attribute the increasing popularity of hybrid structures?

BG/JW: There are a couple trends coming together that might explain part of the increasing popularity. Asset classes like credit and infrastructure that tend to lend themselves to hybrid funds have seen a lot of interest in recent years. Hybrid funds are often well-suited to address the needs of credit funds, and there has been an explosion in credit fund strategies since 2008 as traditional bank lending has pulled back significantly due to regulatory pressure. Alternative investments funds have rushed into the void to fill that lending shortfall. Much of the "shadow banking" lending that has emerged via credit funds is in illiquid medium-term structured credit instruments, which aren't always well-suited as the main investment program for a hedge fund that needs to provide LPs with periodic liquidity.

What are the most common investment structures and what assets are most conducive to these vehicles?

BG/JW: We're still seeing the traditional partnerships serve as the fund vehicles for hybrid funds, with appropriate feeders and blockers as needed for the specific investor base and fund strategy. But it's more a function of those closed-end/PE fund partnerships beginning to incorporate elements of hedge funds, and vice versa.

Is the master feeder structure a natural fit for hybrid strategies and if not, why not?

BG/JW: I'm not sure it would be a natural fit any more so than other structures, but master-feeders could certainly work for a fund with hybrid terms.

What are some of the tax implications of the use of multiyear performance allocations

BG/JW: Depending on the annual performance of the fund, there may be risk that a multiyear performance allocation could be recharacterized as a fee for US tax purposes. For example, assume that a performance allocation is measured over a three-year period and, although the fund has significant income and gains over the entire period, there is no gain in year three. Thus, technically, the fund has no income to allocate to the sponsor in year three, even though the sponsor is economically entitled to a performance allocation. It may be difficult in such circumstances to avoid having the allocation treated as a fee for U.S. tax purposes, which means that the character of the fee could be entirely ordinary (as opposed to a mix of capital and ordinary, depending on the fund's underlying income). This also could lead to potential adverse consequences under sections 409A and/or 457A of the Internal Revenue Code, and could give rise to deductibility issues for U.S. taxable investors.

While private credit seems to be the predominant asset class for these vehicles (real estate would be another), what are some of the other most common assets and some of the pros and cons that lend or another asset class to these structures? Are there differences in the trends between the different illiquid asset classes?

BG/JW: Private credit, infrastructure and core real estate are frequent asset classes for hybrid vehicles. The characteristics that these classes share include underlying assets that are generally illiquid but that generate a decent amount of periodic current income/yield distributions during the ownership of the assets. Additionally, there is often not a great deal of increase in asset value over the hold period – whether as a result of the private credit being paid back in full at maturity, or whether due to the stability of the markets for infra or core office properties.

Are there differences in trends you are seeing from a structuring and/or fee perspective, for the different classes?

BG/JW: Sometimes different strategies will have different hurdle rates in their yield waterfalls, depending on return profile of the asset class. A higher yield strategy might have a higher hurdle rate, for example.

Why would an investor choose a hybrid structure over just investing in a PE firm?

BG/JW: I'm not sure investors are necessarily choosing funds based on structure – investor commitment decisions are still very much focused on the manager and its track record and investment approach, regardless of whether the fund is structured as "pure" closed-end private equity or whether it incorporates some hybrid element. However, all other things being equal, hybrid elements (for example, LP liquidity features in a closed-end fund or multi-year performance periods in a hedge fund) are often viewed positively by the investor community as responsive to LP needs, and can facilitate fundraising success.

What are structural considerations a manager should consider when evaluating whether a co-investment structure, side-pocket, or hybrid (or other) structure best suits their investment objectives?

BG/JW: Many of the considerations to be taken into account by a manager when arriving at a fund structure revolve around the expected hold period or maturity/duration of the portfolio – considerations like how investor liquidity (if any) could be managed and how long would a manager need to wait in order to receive incentive compensation from the portfolio. Managers also will take investor needs and preferences into account as well, which can feed into hybrid features like built-in extension/

liquidation rights or hedge fund multi-year performance periods.

In the comingled fund if an investor has an MFN, could this have any implications for a manager launching a hybrid fund?

BG/JW: MFNs are normally limited to a particular fund (and its parallel funds), rather than successor funds or funds with different strategies. So if a hybrid fund is being formed that is not part of a specific fund strategy "family" of the same vintage, typically the MFN rights wouldn't cross over between funds.

How do the fees around hybrid structures compare to traditional hedge fund structures and private equity structures?

BG/JW: Hybrids have been fairly similar in terms of the fee rates, in my experience. The distinctions if any would be more structural in the existence of features like a separate waterfall for current income/yield distributions or hedge fund multi-year performance periods.

Have certain investor types been more willing to invest in hybrid structures?

BG/JM: We've seen the more sophisticated institutional investors be willing to invest in hybrid structures, as they are often serving as anchor investors that work with the sponsor at the early stages of fund formation to develop a product that meets the needs of both the investor and the sponsor. Also, these larger institutional investors have typically seen more funds in the market and are coming across more fund structure creativity these days, so that the "scare" factor of a non-traditional or unfamiliar fund structure is much less.

Do you see hybrid structures as a temporary trend or one with staying power?

BG/JW: We're already getting close to the point where the term "hybrid" has such a wide range of meanings in the market that it isn't very useful as a descriptor. I wouldn't be surprised at all to see hybrid structures become common in a growing number of asset classes and develop over time such that the lines between traditional closed-end and open-end structure become fairly blurred. There might be a day in the not-too-distant future when a fund structure that is pure closed-end or pure open-end, and is still currently considered the market standard, actually becomes the exception in the industry. The convergence of many PE and hedge funds into some form of hybrid funds seem like a natural evolution of the increased creativity and collaboration we're seeing between sponsors and their investors.

Trends in Side Letters and Third-Party Valuation Firms

Contributing Author: ***John D'Agostino****, Managing Director, DMS Governance Ltd.*

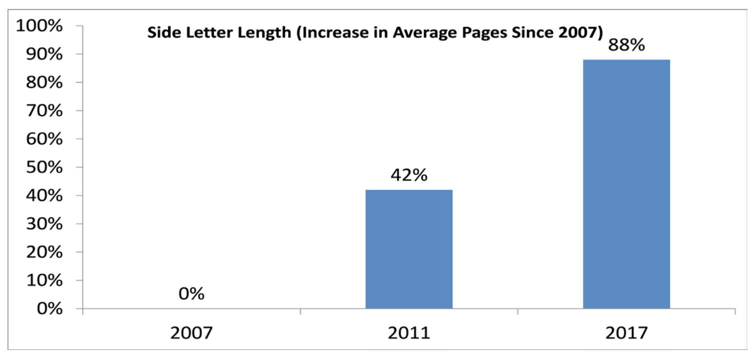
While analyzing current trends within the industry, two areas in particular stand out: the increasing complexity of side letters and the increased reliance on 3rd party valuation firms for complex assets.

Side Letters:

Less costly than a new series or share classes, side letters are without question legitimate tools for raising capital. Assuming the terms are objective, achievable, clear and do not create embedded fiduciary conflicts under distressed scenarios, a well drafted side letter (when monitored properly), should not pose a significant governance or compliance problem.

However, perhaps in response to the fact that (standard) offering documents for hedge funds have not changed materially since the liquidity crisis (with respect to the rights and protections offered to investment managers as it pertains to issues like gating), it seems that both the complexity and reach of side letters has grown exponentially over the last 10 years.

The simplest measure of complexity, length, shows this clearly:



Source: DMS

A sample of randomly selected funds with side letters going back to 2007 shows an 88% increase in the length of side letters.

There is a correlation between the length of a contract and the probability its meaning will be subject to debate at a future point. The ever increasing complexity of side letters (especially those falling outside of standard concessions) can also have unforeseen impacts on a US manager and the fund's service providers. As a legal document, the fund and its manager will be legally bound to observe the rights bestowed to an investor and this will require regular monitoring and potentially higher costs. In such circumstances it is important to engage service providers, who may be impacted, early in the investor negotiations and ensure what is being considered in the letter agreement can be practically managed and enforced in the real word.

An examination of 5 examples of lengthy side letters (upper quartile in average length) showed that approximately

60% of the language was dedicated to liquidity provisions in distressed scenarios. This is problematic for several reasons. The first is that managers (who generally lead the negotiation for side letters and include Directors towards the end) are highly motivated to accept onerous (and potentially unenforceable) liquidity provisions for future distressed scenarios as opposed to say, fee reductions. The majority of this language does little to change the fact that the final decision on gating will fall to the Directors; who will rely on the investment manager's recommendation assuming he/she is in good standing.

When analyzing a side letter, managers should ask the following questions:

1. Is the intent understood and codified in the document?
2. Can it be objectively monitored/measured?
3. Is it enforceable under the conditions referenced?

If these queries aren't satisfied, there may simply be too much risk to engaging the side letter; even considering the short term rewards. If side letter usage is not fully disclosed in the OM or alike, and an investor perceives there has been unequitable behavior due to favoring of one or more investors, then it creates unknown litigation risk down the road against the fund and its management.

3rd Party Valuations:

Issues arise with 3rd party valuations when the valuation itself is heavily weighted with a single or "Level III" variable, (i.e. a variable that itself is extremely difficult to price). An example of this is a valuation where a major factor in terminal value stems from the outcome of a lawsuit or regulatory ruling. Litigation financing has produced some element of market pricing/predicative value for these outcomes – but has not evolved to the point where a predictive price (value) can be extracted or hedged. Therefore, results are largely guesses, which is why reasonable valuation firms will put a 50% delta on the outcome.

This methodology isn't the issue. The problem arises when LPs rely too heavily, or perhaps more accurately with too much blind faith, on this valuation, and do not distinguish its variable nature from one that is weighted more on observable factors. Even a commodities futures curve; which is of course not necessarily predicative of future prices, can fairly be relied on because those futures prices can be locked in through hedges.

This tendency to not look through to the underlying variables can be exacerbated by LP auditors who themselves (and to be fair, they are simply correctly applying GAAP) apply pressure on the LP to stick with the third party valuation agent price, even if the LP recognizes the variability and seeks to haircut the value for their own book.

This ends poorly more often than not, as it effectively hides volatility in a supposedly stable price, resulting in a significant mark to market correction at a later date. Perhaps GAPP won't allow for judgement to look through third party valuation methodology – but at least LPs should be aware of the embedded valuation risk in these "Level III" assumptions.

Legal & Regulatory Update

Big Data and Hedge Funds: An Emerging Trend with Its Own Legal and Compliance Issue

*Contributing Authors: **Jeffrey D. Neuburger,** Partner at Proskauer Rose; **Josh Newville**, Partner at Proskauer Rose; **Robert G. Leonard**, Partner at Proskauer Rose; and **Michael F. Mavrides,** Partner at Proskauer Rose*

With "big data" comes big opportunities for hedge fund managers to collect and analyze reams of "alternative data" into useable investment insights, that is, tradeable information and market-beating "alpha." These data are gleaned from non-traditional sources and supply chains, offering a complement to company reports and other traditional financial data. Ideally, managers using so-called "quantamental" strategies detect supply/demand imbalances or company or industry information before traditional market indicators do so. In short, the use of big data is the digital-age version of a "channel check" – deep due diligence on investment targets, but on a real-time, larger scale.

Managers can create an in-house data science team to collect and analyze big data and/or commission the data from the growing number of tech firms and data aggregators that process such data into useable reports for financial companies. Regardless of the potential competitive advantage, not all data will yield valuable insights – some predictions will be prescient, some low-value, and some simply wrong. And, as with many tech services, vendor diligence is important because not every provider is equal.

Indeed, the collection of and/or trading on big data comes with its own legal concerns, including intellectual property infringement, privacy concerns, and securities law violations, among others. Hedge fund managers and other financial services firms wading into this new environment should therefore understand the legal risks and fashion appropriate policies and procedures (both internal and with respect to vendor diligence). After briefly explaining the types of data in play, this article will offer a high-level overview of the salient legal issues in the use of big data by hedge fund managers.

Sources of Data and Methods of Collection

What types of alternative data are being used to gain new insights? Sources include: meteorological and agricultural data; energy supplies and usage (e.g., oil tankers and storage levels); shipping/freight activity; construction activity; sensors from internet-connected machines or "smart" devices (IoT sensors); pharmacological prescription data; e-commerce receipts and credit-card transaction data; government data; and retail brick and mortar activity (e.g., parking-lot photos). In addition, a large source of data consists of the information that web services and mobile apps already receive from users and the "data exhaust" from many tech companies (e.g., Foursquare = GPS foot traffic), as well as social media and social sentiment data, geolocation information, and online pricing and inventory data.

Such data are collected by hedge fund managers and third-party providers using a variety of tools. While anonymized data can be provided to customers through contractual arrangements or an online services' application program interface (API), such data are also gathered through various methods, including aerial surveillance (e.g., microsatellites, drones and thermal imaging), beacons, and radio-frequency identification (RFID) sensors, and further analyzed using sophisticated software and AI deep-learning technology.

Most notably, online data may be collected via "screen scraping" (or "web scraping" or "spidering"), which is a technique by which a program or automated script obtains information by extracting text from web pages. Web users are generally presented, in various ways, with terms of service that outline what a user is and is not permitted to do when using the site or accessing data from the site's pages and ultimately provide a basis for redress for misuse of content. Notably, terms of service often preclude users from certain unwanted uses, including the commercial use of data-mining tools, "robots," or similar data-extraction tools. Moreover, website owners often use "robots.txt," "crawl delays," and other technical means to communicate their intentions to search engines and others regarding desired limits to scraping and spidering activities. Yet, the law on scraping is still not fully developed, so the push for more and more online data moves forward on uncertain ground.

Potential Liability

Contracts relating to big data require special consideration, as a violation of laws or breach of agreements could result in civil liability and possibly trigger securities law violations. Fund managers and compliance officials should fully understand the latest developments and anticipate potential industry-specific risks surrounding web scraping and automated data collection, as a kitchen sink of potential claims awaits the unwary:

- *Breach of contract:* A violation of a site's terms of service or user agreement can form the basis of a claim for breach of contract.
- *Computer Fraud and Abuse Act (CFAA):* This federal statute prohibits acts of computer trespass by those who are not authorized users or who exceed authorized use; many states have parallel or similar computer fraud statutes. Claims may arise if a data scraper ignores a cease-and-desist letter or circumvents technical measures that block access.
- *Privacy concerns:* Vendors and in-house data science teams that acquire such consumer data such as e-commerce receipts typically work with anonymized data that have been scrubbed of consumers' personally identifiable information (PII), the wrongful collection or use of which can trigger sector-specific federal and state privacy laws. Also, the Electronic Communications Privacy Act (ECPA) provides a private right of action against any person who intentionally intercepts any "wire, oral, or electronic communications" (note: the ECPA allows for "use" and "disclosure" liability).
- *FTC enforcement*: Violations of privacy and data-security promises or related omissions have formed the basis of multiple FTC privacy-related enforcement actions in recent years.
- *Copyright*: Automated data collection may infringe upon a site owner's copyright. Circumvention of technological control measures, such as "CAPTCHA" challenge-response tests or "I am not a robot" measures to block automated access, could create the basis for liability under the Digital Millennium Copyright Act ("DMCA).
- *Trespass*: If data collection causes a site outage or overburdens a site's operational capacity, this could constitute a trespass to chattels.
- *Commercial drone regulations*: Beyond federal regulations for operators of commercial drones, there are also state and local laws regarding drone usage.

Securities Law Concerns

The use of automated data collection for investment research purposes may also give rise to insider trading violations under securities laws. Hedge fund managers that obtain or receive data collected as a result of web scraping or automated data collection might obtain material nonpublic information ("MNPI"). Receipt of such information could conceivably lead to liability under the "misappropriation theory" of insider trading, which holds that a person commits fraud in connection with a securities transaction – and thereby violates § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 – when he, she or it misappropriates confidential information for securities-trading purposes in breach of a duty owed to the source of the information. The source need not be an insider of the issuer whose securities are being traded. Accordingly, if data are collected in a manner considered "deceptive," then there is a risk that trading on such information may be considered part of a fraudulent scheme in violation of the anti-fraud provisions. For example, insider trading could conceivably occur if a hedge fund manager or, perhaps, its agent "deceives" a website into allowing the manager access to the site so that the manager can obtain material nonpublic information about a third-party issuer for trading purposes.

In short, when a fund manager collects big data and/or commissions the data from third parties, the ultimate question for securities law purposes is: was access to information obtained legitimately? Because the use of alternative data for investment purposes is a nascent practice, and the pertinent case law mainly concerns web scraping, there are many open issues and legal compliance quandaries. For example, is obtaining data in violation of a website's or API's terms of service a "deceptive" act? Are evasions of technological restrictions or similar measures deceptive? Does misleading a website by masking the user's IP address involve deception or a breach of duty? Is the user of the data on firmer ground if the data are used in accordance with a vendor's contract terms and restrictions?

Final Considerations/Best Practices

To minimize legal and compliance risks in the use of big data, hedge fund managers should follow documented policies and procedures as part of their investment research process. Often, a manager will obtain data through a vendor. As a rule, vendor due diligence is essential, since what might be acceptable risk to the vendor may not be acceptable risk for one's own company, and mere reliance on contractual protections may not be enough to shield a manager from liability (or adverse publicity).

The due-diligence process should include the following basic questions:

- Who is the vendor? What are the vendor's data sources? How are the data collected? Is the vendor a collector, packager, analyzer and/or aggregator? Is the vendor licensed to deploy drones and/or microsatellites?
- Do the data raise immediate flags (e.g., PII, children's data, sensitive information, MNPI, etc.)?
- Is the vendor collecting the same data for anybody else? Or could the vendor be argued to be acting as your agent?

- Does the vendor have the right to provide the data to you? Does the contract contain appropriate contractual reps/ warranties/indemnities?

If the vendor or in-house team engages in web scraping, additional questions should be asked:

- Do the targeted websites have restrictive terms of use?
- Does the vendor or fund use technology to simulate the creation of any user accounts?
- Does the vendor or fund circumvent any “captchas” or similar technologies?
- Does the vendor or fund respect the “robots.txt” parameters and honor requests to cease scraping activity?
- How does the vendor or fund structure IP addresses for spidering?

Similar policies, procedures and due diligence efforts that scrutinize the types of data collected and the methods used to collect such data should be followed with respect to a fund manager’s in-house collection and use of big data.

A Focus on Expense Allocations

*Contributing Author: **Ingrid Pierce**, Global Managing Partner, Walkers*

There has for some time been regulatory focus on both the manner in which fees and expenses incurred by investment advisers are allocated and the level of disclosure provided to investors regarding the nature and allocation of such expenses and potential conflicts of interest relating thereto. We have seen the majority of investment advisers pay close attention to this issue and develop detailed policies, procedures and internal controls to review and manage what has become an increasingly complex area. However, it remains a challenge in the industry and one that is not going to get easier to manage without significant infrastructure or external support.

The U.S. Securities and Exchange Commission has brought several cases against US investment advisers for alleged violations of the U.S. Advisers Act and has long expressed its concern regarding the proper allocation of expenses and in particular disclosure of conflicts of interest when entering into arrangements with affiliates that benefit them at the expense of fund clients.
Private equity advisers have also been receiving a lot of attention of late, on the theory that in certain circumstances investors do not have sufficient transparency into how fees and expenses are charged to portfolio companies or the funds. Regulatory actions have concentrated on one or more of the following overlapping areas: undisclosed fees and expenses received by the adviser; shifting or misallocating expenses and failing adequately to disclose conflicts of interests arising from fee and expense issues.

While private fund advisers have been first in the firing line, where the fund itself is regulated (for example by the Cayman Islands Monetary Authority (CIMA), the general partner and/or the directors will have overall responsibility for supervising the affairs of the fund, disclosing and managing conflicts of interest and monitoring the investment manager’s activities. Thus, where the fund complex involves both onshore and offshore funds, the issues are relevant to a broader range of ‘fund fiduciaries’.

Important considerations

The allocation of fees and expenses is clearly a risk area for fund fiduciaries. Policies should describe how costs are allocated across funds, co-investment vehicles and the extent to which they are borne by affiliates or employees of the manager who participate in investments.

Fund documents and disclosures should regularly be reviewed and updated. It should go without saying that the disclosures in an offering document must be consistent with other materials that are regularly produced or filed such as due diligence questionnaires, Form ADV and the like.

The level of specificity with respect to expenses which may be borne by the fund has dramatically increased in recent times. Some may argue that the sheer length of the disclosures has become a burden not just for managers but for investors attempting to digest the disclosures, often in a short period of time prior to making an investment decision. Mere repetition of information in an offering document, which is already a substantial time, is not the answer. However, detailed disclosure is an important fiduciary matter and can also serve as a protection for the fund’s fiduciaries when their practices are scrutinized to determine whether they fell squarely within the disclosures provided to investors.

Even if the documents do not provide a clear roadmap for the allocation of particular fees or expenses, it is important to demonstrate the methodology behind a decision made in any given case. Were the manger’s policies and procedures followed? If those too do not sufficiently address the protocol for the situation at hand, what process did the manager adopt at the time? Typical practices include escalating the decision to a senior person within the organization with authority for decision-making, recording the rationale for the decision taken and, in the case of an offshore fund, discussing the matter with the fund’s board of directors and if necessary, obtaining board approval. Assuming the board of directors (or at least the majority of the board) is independent from the manager, it can serve as an important check and balance to assist in ensuring that appropriate allocations and disclosures are made to investors. An advisory board or a committee of the board of directors may also be mandated specifically to deal with expense allocation issues.

This issue is not going away. While regulators are constrained by priorities and limited resources, the quantum of an expense improperly allocated or not disclosed may not of itself avoid enquiry or indeed regulatory action. Even if the manager considers the amount to be immaterial compared to overall expenses or the size of the fund, an investor or regulator may not share the same view. Even if no action is brought, why risk the potential loss of trust by investors, not to mention the potential reputational damage?

DOL's Fiduciary Rule Applies as of June 9th
- Private Investment Fund Managers and Advisers May Want to Take Action

***Ira Bogner**, Partner Employee Benefits & Executive Compensation Private Investment Funds, Proskauer and **Adam Scoll**, Senior Counsel, Tax, Employee Benefits & Executive Compensation, Proskauer, discuss highlights of the DOL Fiduciary Rule*

What is the new DOL Fiduciary Rule and when did it go into effect?

IB/AS: On April 6, 2016, the U.S. Department of Labor (the "DOL") issued its final rule (codified at 29 C.F.R. 2510.3-21, the "Fiduciary Rule") significantly expanding the situations when a person is considered to be a "fiduciary" under the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the U.S. Internal Revenue Code of 1986, as amended (the "Code") as a result of providing investment advice to (or with respect to the assets of) an employee benefit plan or other plan subject to Title I of ERISA and/or Section 4975 of the Code (including, an individual retirement account ("IRA")) or its participants or beneficiaries. The Fiduciary Rule became applicable at 11:59 PM (local time) on June 9, 2017.

The Fiduciary Rule was initially set to become applicable on April 10, 2017, but the DOL delayed the rule's applicability date for sixty days, until June 9, 2017.

When the DOL issued the Fiduciary Rule it also issued new prohibited transaction exemptions (including the Best Interest Contract Exemption or "BICE") and amendments to existing prohibited transaction exemptions, which were aimed at easing the potential prohibited transaction impact of the Fiduciary Rule. The DOL also delayed the applicability date for most of the new requirements of the BICE and such other new and amended exemptions until January 1, 2018. However, the BICE's "impartial conduct" standards (acting in the client's best interest) apply as of June 9th.

Is there a transition period under the Fiduciary Rule?

IB/AS: Yes. The DOL has issued a temporary enforcement policy for the transition period commencing on June 9th and ending on December 31, 2017. During the transition period, the DOL will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the Fiduciary Rule and the related exemptions.

The temporary enforcement policy also includes confirmation from the Treasury Department and the Internal Revenue Service that Section 4975 of the Code (which provides excise taxes relating to prohibited transactions) and related reporting obligations will not be applied during this transition period with respect to any transaction or agreement to which the DOL's temporary enforcement policy would apply.

What is the 50,000 foot view as to how the Fiduciary Rule applies to private investment fund managers and advisers?

IB/AS: The Fiduciary Rule affects common marketing and other related activities involving ERISA plan and/or IRA investors, prospective investors, clients and/or prospective clients ("Targeted ERISA/IRA Parties"). Certain common marketing or offering activities for private investment funds and separately managed accounts involving ERISA plans and/or IRAs could be considered "investment advice" under the Fiduciary Rule.

Similarly, some fund managers' and investment advisers' periodic newsletters or other communications could be viewed as a "recommendation" to remain invested in a fund or continue a separately managed account arrangement.

Discussions with Targeted ERISA/IRA Parties might be considered "investment advice" and fiduciary in nature if they are considered tantamount to a "recommendation" to invest (or maintain an investment) in the fund or establish (or maintain) a separately managed account arrangement, even though, in the case of a prospective investor or client, a fee will not be charged until after the investor invests in the fund or the separately managed account is established.

If such marketing materials, pitch practices and/or periodic distributions are considered a "recommendation", such as a recommendation to purchase or hold a security (e.g., an equity interest in a private investment fund) or continue a separately managed account arrangement, then the fund manager or investment adviser would most likely be considered to be providing fiduciary "investment advice" to Targeted ERISA/IRA Parties to purchase or continue to hold an interest in the fund manager's or adviser's own funds and/or establish or continue a separately managed account arrangement with the fund manager or adviser (and to pay any related management or other fees), as the case may be. This advice could be treated as "conflicted," resulting in a violation of fiduciary duty and/or a prohibited transaction absent an exemption.

How helpful is the "hire me" exclusion in this context?

IB/AS: A request to "hire me" to provide investment management services by touting the quality of an individual's or entity's advisory or investment management services that is not combined with a "recommendation" on how to invest or manage ERISA plan or IRA assets might not constitute "investment advice."

Unfortunately, the line between "hire me" communications and advice that triggers fiduciary obligations is not clear. The "hire me" exception generally will not work for marketing of specific funds and preset investment strategies.

What about the exclusion for "transactions with independent fiduciaries with financial expertise"?

IB/AS: Fund managers and other investment advisers might be able to avail themselves of an "expert fiduciary exclusion" when dealing with most ERISA-covered investors and clients. However, this exclusion is not available for recommendations to IRA owners, small plan fiduciaries or plan participants and beneficiaries that are not separately advised by fiduciaries. This "expert fiduciary exclusion" will generally apply if the fund manager or investment adviser:

- i. Knows or reasonably believes that the independent fiduciary of the ERISA plan or IRA is a US-regulated bank, a US-regulated insurance carrier, a registered investment adviser, a registered broker-dealer, or an independent fiduciary that holds, or has under management or control, total assets of at least $50 million (and it may rely on written representations to satisfy this requirement);

- ii. Knows or reasonably believes that the independent fiduciary of the ERISA plan or IRA is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies (and it may rely on written representations to satisfy this requirement);
- iii. Fairly informs the independent fiduciary that it is not undertaking to provide impartial investment advice, or to give advice in a fiduciary capacity, in connection with the transaction and fairly informs the independent fiduciary of the existence and nature of its financial interests in the transaction;
- iv. Knows or reasonably believes that the independent fiduciary is a fiduciary under ERISA or the Code, or both, with respect to the transaction and is responsible for exercising independent judgment in evaluating the transaction (and it may rely on written representations to satisfy this requirement); and
- v. Does not receive a fee or other compensation directly from the ERISA plan, ERISA plan fiduciary, ERISA plan participant or beneficiary, IRA, or IRA owner for the provision of investment advice (as opposed to a fee for other services) in connection with the transaction.

What should private investment fund managers and advisers do now?

IS/AB: Private investment fund managers and other investment advisers that determine that their typical marketing activities would (or could) be treated as "investment advice" under the Fiduciary Rule should decide whether or not to continue to pitch their products to IRAs or small plans, or to alter such activities so as to not constitute "investment advice".

Similarly, managers and advisers of open-end, liquid private investment funds and separate accounts that have IRAs or small plan investors should determine whether to permit such investors to remain in their funds or whether to continue such separate account arrangements. The BICE (including certain provisions grandfathering existing investors) might be available in certain cases to permit the status quo for IRAs and small plans, but the conditions for the exemption may prove too complicated or impractical (even with certain requirements of the BICE not applicable until January 1, 2018).

With respect to any commitments to be accepted from, or separate account arrangements to be entered into with, Targeted ERISA/IRA Parties after June 9th, fund managers and investment advisers should determine whether or not to revise any offering materials and/or require additional written representations from such investors. For example, fund managers and investment advisers might want to confirm the availability of the "expert fiduciary exclusion" with respect to any potential "investment advice" that may be provided to such investors in connection with the commitment/ engagement and/or throughout the term of the investment/ engagement.

With respect to open-end, liquid private investment funds that have Targeted ERISA/IRA Parties as investors and existing separate account arrangements with Targeted ERISA/ IRA Parties, fund managers and investment advisers should consider requiring the Targeted ERISA/IRA Parties to make additional written representations to confirm the availability of the "expert fiduciary exclusion" with respect to ongoing communications (including pursuant to so-called "negative consent letters") and/or confirm the understanding that communications to such Targeted ERISA/IRA Parties about performance and developments is not intended to be fiduciary advice to remain invested in the fund or account.

With respect to closed-end, illiquid private investment funds that are no longer fundraising as of June 9th, fund managers and investment advisers should determine whether any action is necessary under those circumstances (including, for example, sending Targeted ERISA/IRA Parties so-called "negative consent letters" confirming the availability of the "expert fiduciary" exclusion).

Tuesday, August 1st - Manager Survey Launches

The Business Consulting Team will be launching an industry survey (the first in a series of surveys) on **Tuesday, August 1st.**

Respondents' data will compiled and distributed based upon their respective peer groups.

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Business Consulting services include: business development (from launch to franchise management), best practices, peer analysis and benchmarking, and thought leadership. By leveraging our knowledge of industry service providers we aim to facilitate key introductions and discussions with the goal of achieving the right operational fit for our customers' business. We help hedge funds think through strategic business decisions at launch and throughout their life cycle based on a customized approach to meet a client's specific needs.

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