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Wells Fargo Prime Services Business Consulting

Industry and Regulatory Updates

Highlights

Industry Trends

Alternative Datasets: Use Cases Across Different Types of Buy-side Firms and Asset Classes

Emmett Kilduff, founder of Eagle Alpha, explores how alternative data is being utilized

Alternative data is increasingly being incorporated in the investment process of buy-side firms. These include both discretionary and quantitative hedge funds as well as traditional asset managers who employ a broad array of strategies and asset classes such as equity, credit, macro, and private equity. This is a timely and recent phenomenon: just last month, Greenwich Associates published a survey that stated "seventy percent of investment professionals...are either currently using alternative data or plan to do so in the next 12 months".[1] In this article, we will explore how different types of non-traditional data sets, including satellite, consumer transaction, and employment data are being utilized across the spectrum of asset management firms and asset classes.

Use cases for quantitative funds, discretionary hedge funds and traditional fundamental asset managers

Quantitative Funds

Many larger quantitative funds have been working with alternative data for at least the last five years.

When measuring the clickviews in Q2 2018 for quantitative hedge funds across Eagle Alpha's database of 780 data sets, the most accessed of the 24 categories were: 1) business insights (e.g. data specific to a sector); 2) employment data; 3) web crawled data; 4) trade/shipping data; and 5) consumer transaction data.

To illustrate a use case for quant funds, there are currently seventeen datasets within the employment category, drawn from payroll data and data crawled from job portals. Several of these have long history and are mapped to more than one thousand tickers. This depth of data is especially important for quant funds, who need a robust history across a broad universe of names in order to accommodate their back-testing and data modeling needs.

Regarding trade data, the hedge fund WorldQuant, in its paper 'Discovering the Hidden World of Alternative Data', gave an example of a use case when it stated that "acquiring diverse shipping data can be used to better understand the costs and health of companies' supply chains".[2]

Discretionary Hedge Funds

Discretionary hedge funds, particularly the innovative 'quantamental' funds, are major users of alternative data. In Q2 2018 the five categories that obtained the most clickviews by discretionary investors in Eagle Alpha's database were: 1) business insights; 2) consumer transaction data; 3) web crawled data; 4) ESG (environmental, social, and governance); and 5) employment data.

One example of a dataset that gives insights into a business activity is JetTrack. This is a corporate aviation dataset that tracks corporate jets to provide insights into activity regarding suppliers, customers and potential M&A activity.

Similarly, RevCast is a focused consumer transaction dataset. This dataset was built in conjunction with a leading consumer transaction data company, providing revenue predictions for sixty-two US consumer stocks.

More broadly, most hedge funds use multiple categories to complement existing investment processes. For example, at a conference in June 2016, the head of a data analytics team at a leading alternative asset manager stated, "If you want to understand what is going on with McDonald's, you are going to have to look at credit card transactions data, you are going to look at geo-location data, at app downloads and a handful of other things. And suddenly you are going to have a very robust picture of how McDonald's is doing".

Traditional Fundamental Asset Managers

Traditional fundamental asset managers were slower to adopt alternative data. However, in the last 12-18 months that has changed significantly.

Typically, firms leverage dashboards to interpret alternative datasets and / or engage firms for bespoke projects in order to demonstrate the value of alternative data.

That said, some of the largest traditional buy-side firms have been incorporating alternative data into their investment process for a few years now. In its 2015 annual report, the global asset manager Schroders stated that "analysis of 'big data' could become a key differentiator... this year we set up a Data Insights team, representing a significant new initiative for the Group. The team is focused on developments in data analytics for investment and research, to enhance and complement the existing skills of our fund managers and analysts". The report went on to say "the quantity of information available for investment research purposes is increasing at such a rate that traditional industry practices and skillsets are unable to absorb and process it. Global trends in digitalization, social media, open data and technology are all creating vast streams of alternative data that are often highly unstructured and extremely obscure. However, they contain valuable and often unique insights".[3]

Based on our experience, the five most common applications of alternative data sets by traditional fundamental asset managers are (in no particular order):

1. Identifying consumer trends and preferences: new products (e.g. Samsung S8), geographic expansion (e.g. Monster Beverages, Netflix), brand strength and customer demographics.

2. Assessing corporate quality from employee and customer reviews, social media commentary and government complaints. Along these lines, there is increasing interest in ESG datasets.

3. Monitoring industry competition: pricing, promotions and capital investments.

4. Evaluate corporate execution via website changes, store growth, employment data and trade data.

5. Gauging pace of secular industry trends (e.g. the electronifcation of automobiles and real-time payments.)

Use cases for equity, macro, credit, and private equity asset classes

Equity

Equity investors are the primary users of alternative data. Whilst the consumer and technology sectors are the most common, there are alternative datasets available for every sector. For example, there are currently over eighty datasets that are relevant to the industrials sector. Use cases for industrials stocks include:

• Trade data that enables analysts to track industrial company shipments such as specialty glass or autoparts. It also allows analysts to track the impact of trade tariffs and duties.

• Geo-location data that provides real-time information on passenger air traffic.

• GPS and trade data that tracks the activity of ships and ports.

• Satellite data firms that can monitor large factories and key infrastructure projects which may add production efficiency or capacity.

• Survey data that reflects the views of industrial conglomerates focused on niche markets that can be tracked by aggregating responses from experts and business customers. Due to technological changes, surveys have become significantly less expensive to administer.

Macro

A research report by Wells Fargo entitled "Big Data Applications in the Economics/Financial World Part 1: Opportunities and Challenges" gave a useful summary of use cases related to macroeconomic analysis. It stated, "Big data could help analysts solve many modern-day puzzles, such as productivity growth and its living standard relationship, micro-foundations of macroeconomic models, consumer/firm/investor behavior and many more".[4]

A good example of a macro use case involves the Bank of England, which uses a dataset of online residential housing listings in the UK to provide a more-timely and region-specific picture of real estate activity compared to traditional sources. The dataset also provides a more real-time indication of residential real estate financing. Similar datasets, and ones that capture rental rates, are available for numerous countries.

Credit

In the last six months, interest in alternative data by credit funds has increased substantially. We have observed credit investors using consumer defaults data to gauge consumer credit, geo-location data to track distressed situations of retailers and analysis of news and social media for municipal bonds investing (e.g. local government bankruptcies).

Private Equity

The private equity approach to alternative data bears similarities to that of public equity managers. Additionally, we see overlap with the requirements of credit managers that are focused on single name credits and distressed debt. Fundamental public equity and private equity managers are asking similar questions regardless of the fact that they typically have varied holding periods and influence or insights into a company.

Investors in private and public companies may ask questions of alternative data such as: "can alternative data help us with the due diligence of a company? can it support risk management of an existing fundamental process? can it provide us with insight that we don't get as a shareholder? can it provide us with insight that we don't get as non-executive directors? does alternative data assist me with my fiduciary duties as a director?" The answer to these investment-related questions is almost always "yes".

[1]https://www.thomsonreuters.com/en/press-releases/2018/june/half-of-institutional-investors-expect-to-rely-more-heavily-on-ai-to-help-inform-investment-decisions-in-next-5-10-years.html

[2]https://www.weareworldquant.com/en/thought-leadership/discovering-the-hidden-world-of-alternative-data/

[3]https://www.schroders.com/el/sysglobalassets/schrodes/sites/global/pdf/schroders-ar15-web-ready.pdf

[4]"Big Data Applications in the Economics/Financial World Part I: Opportunities and Challenges", Published on April 06, 2017.

Marketing Matters in Every Business... and Hedge Funds are No Exception

Ira Berg, Managing Director at Ext. Marketing, explores how marketing can help you tell your story more effectively and increase the odds that your message will resonate with existing and prospective investors.

With so many priorities pulling hedge fund managers in different directions on a daily basis, marketing can tend to fall fairly low on the list of priorities. But marketing really does matter.

That's because the people who know their story best aren't always able to tell their story best. Oftentimes, hedge fund managers out raising money need professional help to create a compelling story that cuts through the clutter and positions their firm in the best-possible light for prime brokers, institutional allocators, investors, centers of influence, partners – and even prospective talent.

> Did you know?
>
> In **2017, 735 hedge funds launched, 784 went out of business.** [1]
>
> It's more important than ever to position your fund properly to ensure that you stay top-of-mind after your sales meetings.

Three ways that marketing can help

1) **Simplifying (and sharpening) your message** – Today's hedge funds are quite a bit more complex than they were a decade ago. The alternatives space is now awash with myriad new strategies and asset classes, and even the most sophisticated institutional investors might not be totally clear on the particulars of your strategy. Professional marketers can help you tell your story in a way that is not only understandable and targeted to various investor types, but also designed to help you stand out from your peer group. This means that even after you've left their offices, you've made a meaningful impression that will allow them to open your pitchbook and still know what you do – and how you do it.

2) **Maintaining engagement** – Marketing is all about supporting the sales process and getting the next meeting. It's about keeping in touch with allocators (through ongoing communications, including regular newsletters). You need to stay top-of-mind with the right people, and marketing is the right tool to do so.

3) **Making any sized firm look more institutional and professional** – On any given day, investors can see a lot of different managers – potentially across a variety of strategies and sizes. One of the best-possible ways to stand out is to look more professional than the other firms they are speaking with. A polished pitchbook, stationery, website, factsheet, etc. that have an institutional "look and feel" and all tell a compelling and cohesive story will make your firm more credible. These extra marketing dollars often translate into an initial meeting. This may lead to more callbacks from allocators and other investors, providing a great return on investment.

In a crowded market with limited capital to allocate, good marketing can make all the difference.

And now, the straight goods

It's easy to simply say that marketing matters, but it's more important to prove it. An August 2017 report by The Chartered Institute of Marketing found that, on average, a majority of respondents to its research believe marketing generates 19% revenue growth.[1] And with more hedge funds closing than opening in 2017, giving yourself an edge has become more important than ever.

Although marketing's quantifiable value is sometimes hard to ascertain, especially when it comes to the hedge fund and private equity space, many leading experts agree that marketing is a key component of a company's success. In a recent article in Acuity Magazine, Patrick Barwise, emeritus professor of management and marketing, London Business School, was quoted as saying, "If you don't invest in [your] brand or in the business, in the long term the competition will eat your lunch."[2]

"Many of the hedge fund managers our firm has worked with tell us the value of marketing is often underestimated," says Jillian Bannister, co-founder and CEO of Ext. Marketing Inc. "Going out to sell your story tends to be a lot easier when you're confident that your materials have an institutional look and feel and help you frame your story in the most professional light."

Not all partners are created equal

Although a firm always has the choice to either hire an individual to handle marketing or build its own marketing department, putting together a team of marketing strategists, writers, editors, and designers (both graphic & web) who also understand the hedge fund and private equity spaces can be very time consuming and expensive, especially for emerging managers. But even large, established managers want to leverage the expertise of a service provider to complement internal marketing capabilities. "Even beyond a hedge fund's initial capital raise, there is always more brand building, communication and sales support that needs to take place on a consistent basis as the business grows", says Bannister.

1https://www.reuters.com/article/us-hedgefunds-flows/more-hedge-funds-closed-than-started-globally-in-2017-idUSKBN1GZ33B

2https://www.acuitymag.com/finance/the-value-of-marketing

Outsourcing: Views from Managers and Investors

The Business Consulting Group shares insights on outsourcing from conversations with managers and investors

Wells Fargo Prime Services Business Consulting reached out to managers and investors to gauge their views on outsourcing of various roles and functions. We focused on their comfort level with outsourcing, distinguishing between emerging and established managers.

We also asked about the drivers behind a decision to outsource a function or role.

Of the managers we reached out to, 40% manage less than $50mm, 27% manage between $50mm and $100mm, 20% manage between $100 and $500mm, and 13% manage greater than $1B. Sixty percent of the hedge funds we interviewed run various equity hedge strategies, including fundamental long /short, market neutral, and activist sub-strategies. The remainder of the participants manage assets across a variety of strategies including event driven equity and credit, global macro, and structured credit. On the investor side, the institutional investor categories consisted of family offices, funds of funds, and consultants.

Investor views of outsourcing

Investor acceptance of outsourcing functions for established and emerging managers, listed in order of most acceptance to least: technology (including cybersecurity and IT support); middle office, regulatory reporting, compliance, trading, CFO / COO. We found it interesting that when we surveyed managers about their perception of investor acceptance of outsourcing various functions, they were very similar in terms of the order of acceptance. Managers generally thought that outsourcing was more acceptable than investors thought (managers gave higher acceptance scores.)

Manager Drivers for Outsourcing

We also asked managers to rank their reasons for outsourcing. One of the most common answers was the transfer to a fund expense. While there is nothing inherently wrong with this approach, charging expenses to the fund must not be in contravention of any applicable advisory agreements, operating agreements, or disclosures. Along with investors, focus on fees and expenses, the SEC has long been focused on fee and expense allocation. The Office of Compliance Inspections and Examinations' (OCIE) April 12, 2018 Risk Alert noted that fee and expense compliance issues were routinely identified in its examinations of investment advisers.[1] Managers should consult with their legal counsel and refer to their fund documentation when determining expense allocation policy.

Another frequently cited reason for engaging an outsourced service provider is the ability to convert a fixed cost to a variable cost. This can be an effective strategy for a smaller and/or a newly launched fund. This allows for a lower up front outlay of capital and converts the expense to an operating one. Conversely, this approach can also work for larger managers who have lost AUM but need to maintain institutional quality infrastructure. Larger organizations may seek to outsource functions to providers that charge based on AUM, which in turn can reduce the size of the firm's operating budget in response to a lower-revenue environment.

Other reasons cited for engaging an outsourced service provider include ramping up a new capability quickly, and allowing internal resources to focus on higher-value tasks.

When a manager diversifies into a new strategy that requires asset classes not covered within their current operational infrastructure, the manager may decide to engage a third-party to handle the processing of such asset classes. Examples of this may include an equity manager transacting in the OTC markets, or a fixed income manager beginning to trade structured products. Additionally, the leveraging of outsourced service providers may free up an existing employee from a low-value – but critical – task such as reconciliation, and allow them to focus on a higher-value function such as optimizing the fund's use of cash and collateral.

Other Considerations

Lastly, when selecting an outsource service provider, managers should consider investor perception, as well as how that provider will integrate into the manager's existing operation. Pursuant to this, we asked investors about the factors they consider when evaluating a manager's outsource service providers. Reputation of the provider was the number one criteria, but investors also consider the internal team size relative to the function being outsourced. Said another way, investors are accepting of a function being outsourced, but are more comfortable when that outsourcing is complemented by an internal capability within the firm. Similarly, investors may be comfortable with a given function being outsourced to a third party, but they also consider the absolute amount of tasks and functions that are being outsourced. Therefore, a manager should consider the impact in terms of investor perception with each incremental function outsourced to a third party.

Finally, we have seen a shift by institutional investors towards greater accepting of outsourcing (subject to the above). In particular, investors recognize the benefit to having a higher pedigree/more advanced skill in a role versus hiring someone of less caliber and/or more junior candidate.

[1]https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf

Tackling Liquidity Reporting: What are Your Options?

Erol Dusi, Founder and President of Imagineer Technology Group, explores the challenges and opportunities for enhancing a fund's ability to flexibly assess liquidity at the investor and fund level.

Monitoring liquidity by tracking complex redemption terms is a necessary lever for portfolio managers to protect their investment thesis from potentially short-sighted decisions. However, configuring and maintaining those terms can be an operational nightmare for investor relations (IR) and operations professionals. Besides the investor driven demand to know liquidity, regulators have also played a role in increasing the need for IR teams to quickly understand each investor's liquidity profile across all of their funds.

Take Form PF, for example. One of the questions on this regulatory filing that fund managers are required to answer relates to the liquidity of its funds.

Knowing potential liquidity requirements is also critical for a portfolio manager to match the liquidity of portfolio investments to the expected and potential liquidity demands from investors. Given these requirements, how can an IR professional stay on top of investor liquidity? Here are some practical strategies that may help:

every fund's go-to tool: spreadsheets on top of spreadsheets on top of spreadsheets

To have liquidity information on demand, many funds choose to keep it in-house. Maintaining an internal spreadsheet with each investment tranche allows the firm to track both the redemption rights and account values of each tranche for each investor. Because this is a manual process for most funds, it requires a truly herculean effort to create and maintain. The value of each tranche needs to be updated on a regular basis, and all the redemption and transfer activities have to be meticulously logged. Not only is this method troublesome and prone to error, it often results in duplicative work.

leverage your fund administrator

Since fund administrators are most often considered to be the official books and records for a fund, they should maintain an accurate accounting of investor liquidity and have the capacity to provide this information to clients. Many hedge fund investor relations teams outsource liquidity reporting, depending wholly on their admins to report investor liquidity on a regular basis. Many smaller to mid-sized IR teams who are often spread thin view this strategy as advantageous because it frees them up to focus on their core competency: investor relationship management.

This process may not work for everyone however, and there are a few gotchas to keep in mind. In particular, funds with multiple admins, or admins that don't report this information in a clear and regular fashion may face some challenges in collating the information they need in a similar format. Further, the dependence on reporting from an external vendor, like an administrator, can create a lag in getting a needed response. In turn, any such delay would be transferred to the investor or regulator who is looking for these details in a timely fashion.

take advantage of asset management-specific software

When tracking investor and fund-level liquidity, leveraging industry-specific software like Imagineer's Clienteer CRM can provide IR teams with efficiencies and flexibility. Not only does using a commercial product enable managers to take control of liquidity reporting in-house, it also helps them to ensure their processes are streamlined, riskless, and easy to manage. Some hedge fund specific CRMs have native features like investor management, compliance tracking and fund and account level balance and transaction import tools which centralize all investor relations and reporting activities into a single place. Additionally, some of these hedge fund industry-specific CRM systems can be utilized for complex liquidity reporting for funds meeting the following conditions:

1. Given that liquidity often depends on specific investment tranches, tranche level data for each investor/account needs to be input into the system. Most often, fund administrators provide this data as an extract. The ideal situation is to have the data flow from the official books and records of the fund – either the fund administrator or third-party accounting firm – directly into the software. Many liquidity terms have lockups based on the anniversary date of the investment, so having tranche level data (such as the date of the investment, and the current valuation of that tranche) make the liquidity calculation possible.

2. Investment redemption terms must be accurately stored in the software for each investment class and transaction. Even as terms increase in complexity, systems need to be able to handle hard lockups, soft lockups, gates, a wide range of redemption frequencies and more. When investment terms are captured accurately, the system can calculate the availability of funds and amounts based on fund level gates.

Inasmuch as liquidity terms and tranche level data is properly captured, a robust hedge fund CRM will allow users to generate a liquidity schedule that looks out from the current date, while assuming all accounts are redeeming when eligible. Such a system should also include a section for each month or redemption period detailing liquidity for each investor account. This information would need to be aggregated at the firm, fund, and class levels to ensure the most accurate reporting.

In order to match the funds' official books and records, a hedge fund liquidity calculator should also support the most granular accounting levels (lot or tranche) as well as the seamless importing of those numbers from a fund administrator or partnership accounting system. Shadowing an administrator's reporting provides a level of comfort in the accuracy of the calculations while helping to minimize the burden of having to try and calculate the information haphazardly on a one-off basis, which can often lead to conflicting results that create more confusion than clarity.

Deploying software to manage liquidity reporting decreases the amount of and need for human manipulation of the data, resulting in a less error-prone process and more control over the data. There are many challenges to having all the answers to questions you or your clients may have about liquidity at your fingertips, but with the proper planning and the right systems in place, this seemingly daunting process can turn into one that's manageable for any investor relations team.

Compensation, Talent, and Culture

Stanley K. Friedman, founder and principal at Alpha HC Consulting, analyzes the impacts of compensation, talent, and culture

Recently, I was riding the elevator when the video screen in the elevator had the following message: "Happy employees are 20% more productive than unhappy employees". It prompted me to think. What makes an employee happy? Some CEOs would say, "I need my employees to be happy enough not to leave. Which means paying them enough to stay and tolerate whatever pain they're bearing."

My next, thought was, what makes the CEO or founder of a fund happy? Is it paying less? Clearly, you can't please all the people all the time. And there is a direct correlation between the compensation of employees and the profit margin of the firm.

But is it just about compensation? While in our industry cash is king, there are two other components that are not typically considered when thinking about the overall compensation proposition. Talent and culture are typically second tier topics in most firms

Let's talk about talent first. There's a common assumption that if you're willing to pay for it you can get the best talent. I would suggest that is not necessarily an accurate assumption. I believe what you'll get is the best talent who's primary motivation is compensation. Which leads to a number of observations in our current hiring market:

• "Mercenaries" (they do exist) may start out as great hires but can quickly impact the attitudes of those around them in a non-constructive way. They also tend to be self focused and not worried about the rest of the firm.

• Millennials, defined as 22 – 37 years old, are our current work force. Studies have identified that money is not their primary motivation.

• Talented employees want to work with other talented employees and will see that as a key criterion when choosing a new firm.

• Firms that have a talent agenda, which takes planning and time to develop, tend to retain employees longer because they're appropriately challenged.

Now let's talk about culture. Some believe a culture forms on its own, organically. Indeed this is the case in many firms; the culture is allowed to develop over time. The truth is, either by default or design a culture will exist. Here are some basic facts about culture.

• Culture is a collection of norms typically interpreted as behaviors that guide people in how to act within an organization.

• Culture is derived from an individual in authority who has someone subordinate to them. In other words, all you need are two to tango.

• If you have a CEO or individual in charge that has a strong personality coupled with specific ways and expectations of how things will work, the culture is typically shaped by and reflective of that individual.

• You can also have sub-cultures within a firm. It develops from managers that have specific beliefs about how people should behave that differ from the most senior authority.

• Cultures can be designed. However, they can't be designed successfully without understanding the gap between what the employees experience and what the leaders believe the culture to be. This is called a cultural gap analysis and you'd be surprised at how big that gap can be.

• Cultures when defined are usually defined by identifying values. The biggest mistake is stopping there. Translating the values into actionable behaviors that employees understand is critical.

Interestingly, while culture is usually thought of last, it influences directly how a firm operates. For example, if the culture of a firm has a general practice of not communicating, you can pretty much expect management not to talk to employees about career paths or future opportunities. And, how compensation is derived will be a "black box". While many firms can survive with this approach, the negative impact is longer term. Employees not seeing a path will often seek another place that can show them one. Compensation black boxes only last as long as employees trust that you are paying them fairly. One crack in the box and trust in the leadership of the organization starts to erode.

There is no question that when talent, compensation and culture are integrated, a more positive outcome will result. An organization that is known for having a great culture, managing and challenging its talent well, and is relatively transparent regarding their compensation, will develop a reputation as an employer of choice. The end result: happy employees and you may not have to spend top dollar to acquire top talent.

Four Steps to Owning Your Brand

Bill Beaman, Co-Founder presentations coach and media trainer at JephsonBeaman, highlights effective steps in developing a brand.

We all know that raising capital for hedge funds continues to become more difficult. There's competition from an ever-increasing amount of investment options while, at the same time, there's added pressure from regulatory restrictions and heightened scrutiny. To shore up their business, hedge fund managers are spending a lot more time and energy focusing on marketing and raising brand awareness. That's well and good—as long as these managers understand the reality behind their brand identity and how to communicate its distinctiveness. Too many don't. So here are key steps to take when developing and positioning your brand for business success:

Step One: Understand what your brand is *not*.

Those of us who coach branding, messaging and presentation skills like to start with a truism: Your brand is not what you say or think it is; it is how you are perceived in the minds of others. This is a common trap because we tend to buy into our internal propaganda. Portfolio managers, for instance, might put the best possible spin on their numbers while talking up new strategies in pursuit of future out-performance. Over time an internal narrative emerges: "We've done well, considering what we were up against…" or "We've brainstormed new strategies that are sure to bring in more business…" Whatever the narrative, it gets reinforced within an echo chamber that can lull a firm into a false sense of its brand identity. The narrative outside their walls may be completely different.

Step Two: Understand what your brand truly *is*

You often hear hedge funds say that they don't really have a brand identity, and that most other funds don't have one either in this opaque industry.

But that implies that it takes overt marketing, along with a lengthy track record, to create brand awareness. The truth is, your brand identity—which is to say, your reputation in the marketplace—is determined by others if not by you. There's a narrative in your numbers, and it's a big problem for you if the market's interpretation of that narrative is not the story you want to tell. For better or worse, that's the state of your brand as of today.

So how do you discover your current brand identity? One way is through the Cap Intro teams at Prime Brokers, which can quickly find out how a hedge fund is regarded by institutional investors. Their conversations and results are a brand barometer. So too are the recommendations of institutional investment consultants who often determine where large pools of money get invested. Tap into that network to find out to what extent you're on the radar screens of various types of investors and, if not, why not. Find out what they might be saying about you.

Step Three: Become the brand you want to be

For our purposes here, let's assume you have favorable and credible ways to position your firm that you simply haven't communicated to the outside world effectively. In other words, you don't have to engage in sleight of hand to present a better narrative.

The key to re-framing your brand is to understand the power in combining data and story. Numbers, by themselves, are like cold facts without a context. People, even investors, think in terms of stories and so they will instinctively connect your numbers to a narrative.

It's critical, then, that you seize control of your story by connecting dots in ways that investors might not do on their own. Where in your data is there an opportunity to point to something that is distinctive and complimentary about your firm? Do the numbers indicate a special expertise in an industry or sector that is poised for future growth? Have your investors benefited from your willingness to buck the herd and invest in lesser known assets? Consider, too, any storylines that are outside of the numbers. Have you been especially skillful in navigating the changing regulatory requirements when others have put clients at risk by running afoul of complex rules? Are you expanding the firm or changing its talent profile with impressive new hires?

If you don't get the word out on any of this, it is not part of your brand. How, then, do you communicate a flattering narrative in the most effective way possible? Larger firms might hire a PR agency to tackle this, and if it's a good one they may move the needle. But most firms need a more modest way to market their brand, and there is one. I'm convinced that the best marketing comes through industry influencers—people who have unquestioned credibility when they speak highly of your firm. Again, it's a matter of leveraging networks that have developed over time. Investors with clout might talk up someone who has newly joined your firm based on their earlier association with them. As mentioned earlier, Cap Intro teams have a clear role to play, too. Then there are opportunities to further build out your network of influencers through invitations to sponsored events and other gatherings.

As for media outreach, be very careful. I don't advise trying to get your firm profiled because you have no control over the journalist's ultimate story. Who else might be quoted about you, and saying what? Would you wind up part of a "bigger" story that takes unflattering swipes at your industry, tarring you in the process?

Instead, stay in control of your message by offering up your firm's principals as thought leaders. Submit bylined pieces for publication that position your top people as unusually insightful or innovative. Keeping in mind the media caveats covered earlier, be available on a case by case basis to reporters who need quotes from "experts" to fill out their stories. Consider generating blog posts that you distribute to a highly selective list. Speak at conferences that attract the kinds of clients you most want. The idea is to give potential investors additional reasons to set you apart from the pack.

Step Four: Communicate your brand with eloquence and confidence.

The three previous steps naturally lead to a final one that really requires its own in-depth article. Once you get your arms around your brand and devise messaging to convey a strong story, you absolutely must communicate it with eloquence and confidence. As a public speaking coach, I regularly see how people undermine even the most powerful message by delivering it poorly. No one who is considering giving you their money will feel comfortable doing so if you come across as unsure of yourself. Awkward body language, poor eye contact, a weak and monotone voice—the ways that you can signal uncertainty run the gamut. The investor might even assume you are being deceptive.

The lesson here is a simple one: Take the time to learn strong presentation skills. When you become an increasingly strong presenter, you can raise the odds significantly that you'll close your deals.

Remember above all else that your brand is in your control—but only if you decide to act. So get real about your brand identity. Shape and promote it by presenting your numbers to support the narrative you want, and then learn to tell that story powerfully and memorably.

AIMA Expense Allocation Guide

Wells Fargo Prime Services has sponsored and chaired the working committee for the creation of AIMA's Expense Allocation Guide. The guide is the most recent of many guides to sound practices that AIMA offers to its members. On July 17th, we hosted a launch event with a panel discussion on the topic.

The following is excerpted from the Executive Summary of the Expense Allocation Guide:

Asset management is not a cost-free exercise. As a result, allocation of expenses to alternative asset funds has become one of the most discussed and examined topics in the alternative investment industry. It has attracted the scrutiny of both investors and regulators driving the alternative investment manager community and fund governing bodies to increase their focus on this area and implement clearer policies and procedures around expense allocation including investor transparency and disclosure. Regulators have also taken action against what they view as unfair or unreasonable allocations of expenses to funds and, by extension, fund investors.

The allocation of the expenses of asset management is a key concern for investors, investment managers, fund governing bodies and regulators. Each of these stakeholders will have a point of view regarding the most appropriate allocation of expenses. The purpose of the Guide is to provide investment managers and fund governing bodies information about the perspectives of investors and regulators on the appropriate allocation of the diverse types of expenses they will incur.

The Guide is organized into the following sections:

Section 2 - General principles — identifies the generally accepted principles for expense allocations, as well as some practices which many consider inappropriate;

Section 3 - Expense allocation policies and procedures — outlines the key factors that the investment manager should consider when establishing expense allocation policies and procedures and how they should periodically test, review and update those policies and procedures to ensure they remain fit for purpose;

Section 4 - Governance and oversight — addresses the role of the fund governing body and its approach to deciding whether to adopt the investment manager's expense allocation policies and procedures as the fund's or to require a fund specific set of policies and procedures, outlining the key role that the fund governing body, the investment manager, the fund administrator and the fund auditors each will play in this process;

Section 5 - Disclosure and transparency — provides guidelines on how investment managers and funds should disclose to investors information regarding (i) fund expenses and their expense allocation policies and procedures as well as governance practices, and (ii) how the investment manager will demonstrate compliance with such policies and procedures;

Section 6 - Investor expectations — outlines common investor expectations with respect to the treatment of individual types of expenses that investment managers should consider in defining and implementing their expense allocations policies and procedures; and

Section 7 - Types of expenses — provides a brief description of many common types of fund expenses and provides views from investors and regulators on the acceptable treatment of each of those types of expenses.

For access to the full Summary and Guide, visit AIMA's website at: https://www.aima.org/asset/30FF1A7C-A3D6-4238-8BC57D43DC7B4910/

Legal & Regulatory Trends

Addressing the SEC's Examination Priorities and Focus Areas with Technology

Burt Esrig, Managing Director at ACA Technology Solutions, discusses the SEC's current focus areas

Earlier this year, the SEC released its examination priorities and focus areas for 2018. For many of these areas, having the right technology solutions in place will allow investment adviser firms to be prepared, flexible, and responsive if the SEC's document request list (DRL) arrives at the door, avoiding a "fire drill" that can disrupt operations.

The SEC continues to demonstrate its commitment to developing state-of-the-art technology, an investment that is paying dividends in investor protection. In June, the SEC released its 2018-2022 Draft Strategic Plan, which confirms the SEC's focus on surveillance technology. The SEC's National Exam Analytics Tool (NEAT), which enables examiners from the Office of Compliance Inspections and Examinations (OCIE) to efficiently access and analyze years of trading data, has been expanded to support blotter data validations, anti-money laundering, options, and reviews of broker-dealer information.

By leveraging technology and building upon its analytics capabilities through the Office of Risk and Strategy (ORS) and Division of Economic and Risk Analysis (DERA), the SEC continues to demonstrate that it uses specialized skills and examination experience to conduct examinations. As a result, investment adviser firms need to adopt the latest technology solutions to keep pace with regulators and meet their regulatory obligations.

Surveillance Technology

ORS and DERA continue to develop customized analytics tools and analyses to proactively detect market risks that indicate possible violations of federal securities laws.

The SEC uses analytics programs designed to detect patterns that identify risks and uncover suspicious trading involving MNPI using structured trading data, communications (phone, email, chat, social networks, etc.), and other data. The goal is to identify relationships and the source of the information. Recently, the SEC has requested both portfolio trading and employee transactions data via a standardized template.

To match the SEC's surveillance capabilities, investment adviser firms must adopt technology as part of their compliance program. The ability to capture all activity (not just a sample) and build a trading and allocation testing program to fulfill global insider trading and market manipulation checks is now essential.

Several technology solutions are available that can manage investment adviser firms' code of ethics (employee activities) reviews and trading surveillance, but only a few systems can consolidate this information to provide a complete presentation of additional insights.

E-communications analysis platforms exist, and various firms are working to connect this data to their other surveillance efforts. Platforms that provide comprehensive employee supervision across all activities across the firm (and cross-reference all data) will become commonplace in coming years.

Automated or Digital Investment Platforms

Automated or digital investment platforms, including digital or robo-advisers, have all the responsibilities of other investment advisers but with an additional focus on the oversight of computer program algorithms, marketing materials, investor data protection, and disclosure of conflicts of interest. A robo-adviser's compliance team must not only track traditional adviser duties, but also use available technology to ensure that the computer model is generating the expected results and forensically testing the algorithm's results with respect to portfolio mapping, best execution, fairness in allocating, and proper rebalancing as described in the firm's client agreements.

Never-Before-Examined Investment Advisers

The SEC selects never-before-examined or newly created investment advisers using a risk-based assessment. Small or new registrants can cost-effectively fulfill their extensive supervisory obligations by implementing the latest technology.

SEC Commissioner Michael S. Piwowar, in a March 2018 speech at the RegTech Data Summit, said of one the systems the SEC is developing, "But that system is just one of many advanced technologies, both internally developed and in partnerships with the private sector, that we are deploying in our efforts to root out fraud in the securities markets and protect investors. These investments in cutting-edge data analytics are allowing our enforcement staff to be more efficient in their investigations and more aggressive in uncovering fraud in hard to detect areas."

Best Execution Obligations

Best execution obligations are also in focus, requiring firms to be able to produce records of transactions, allocation tracking, and monitoring for best execution.

Trade surveillance technology platforms offer a first line of defense for best execution analysis. The ability to use a quantitative approach to analyzing trade prices against daily market data will identify consistently good/bad execution and highlight potential relationships between traders and brokers, allowing for more efficient flagging and remediation work. Other technology capabilities include commission analysis, allocation analysis using key measures such as pro-rata deviation, performance dispersion, exposure dispersion, and unfair trade allocation (cherry-picking).

Performance Marketing

The SEC highlighted performance marketing, including valuation concerns, in an OCIE Risk Alert on September 14, 2017. The alert provided a list of compliance issues related to Rule 206(4)-1 under the Investment Advisers Act of 1940.

Technology solutions are available that can provide for a full management workflow for submitting, reviewing, approving, and archiving approved marketing and advertising materials, and that include a full audit trail and WORM-compliant archive.

To Keep Pace with Regulators, Technology is No Longer Optional

The SEC continues to invest in the development of the data sets and analytics technology used to uncover violations. Not only does the SEC use these tools as part of investment adviser examinations, but the SEC expects firms to use technology themselves to proactively uncover issues. Compliance departments that have the proper technology solutions in place will help protect their firms as well as boost the firm's bottom line through increased operational efficiencies.

Application of Carried Interest Rules to GP Capital Accounts

James D. McCann, partner at Kleinberg Kaplan, reviews the application of Section 1061 to investments earned through carried interest

Tax reform added Section 1061 to the Internal Revenue Code. For "carried interest" holders, Section 1061 extends the long-term capital gain holding period from one to three years, and so reduces or even eliminates the income tax benefit of carried interest for many hedge fund managers. This article briefly reviews a related issue: how does Section 1061 apply to an investment earned through a carried interest, such as a general partner's capital account balance?

Overview of Section 1061

Section 1061 has been the subject of much commentary and analysis. It is not a model of clarity, and there is substantial uncertainty as to how it applies (or is intended to apply) to even relatively simple and common fact patterns. For example, consider a manager with a carried interest in a hedge fund. There are different views as to whether the three-year requirement applies to the manager's holding period in the carried interest, the fund's holding period in its assets, or both. (It is the author's view that, for purposes of characterizing income flowing through the fund to the carried interest holder, the three-year requirement is applied to the fund's holding period in its assets.) The Treasury Department has promised regulations clarifying certain aspects of Section 1061.

GP's Capital Account

One area of uncertainty is the treatment of an investment earned through a carried interest, such as a general partner's capital account balance (which is typically primarily attributable to prior carried interest allocations).

Is such an investment subject to Section 1061's three-year requirement? If it is (or a portion of it is, or may be), what might a manager do to mitigate this result?

There are not clear answers to these questions. In the context of hedge and other private investment funds, Section 1061 generally applies to an interest in such a fund that is "directly or indirectly … transferred to … the taxpayer in connection with the performance of substantial services". Thus, Section 1061 should apply to carry, which the GP receives by reason of rendering investment management services. (The fact that these services are often provided by an affiliate is likely irrelevant.) Whether it applies to the GP's capital account depends on whether that capital account is "indirectly" attributable to services rendered. Section 1061 uses "indirectly" four times, apparently with four different meanings; it does not define the term.

There is a reasonable argument that the GP's capital account is not "indirectly" attributable to services rendered, and thus is not subject to Section 1061. But there is also a reasonable argument that the GP's capital account is "indirectly" attributable to services rendered. Alternatively, that the untaxed portion of the GP's capital account (the "unrealized") should be so considered. Thus, pending further guidance, the conservative view is that some or all of the GP's capital account is subject to Section 1061.

There is an exclusion from Section 1061 for "capital interest[s] … commensurate with … the amount of capital contributed". While the GP's capital account should be a "capital interest", in general it would not appear to qualify for this exclusion because its balance is generally derived from prior-year carried interest allocations rather than capital contributed.

Steps to Consider

It may be possible to mitigate these risks by replacing a potentially tainted GP capital account with an untainted asset. Whether these steps are effective depends upon their particulars and, possibly more important, future guidance and interpretation of Section 1061.

1. Simply reclassify the GP capital account as a limited partnership interest in the fund, still held by the GP. (Note that such a purely cosmetic change probably has no effect on the application of Section 1061.)

2. The general partner's GP capital account is transferred to an affiliate, and reclassified as a limited partnership interest. This may be effected in a number of different ways, which may have different income tax consequences and may provide different degrees of protection from the "taint" risk. For example, such a transfer may occur through the distribution and recontribution of cash, which (in form) is a taxable transaction and so may provide a better argument that Section 1061 is inapplicable to the ultimate "LP capital account" than certain other alternatives.

3. Variations on the prior steps. Example 1, the new investment may be in a different entity, whether a different fund or different vehicle within the same fund (e.g., replacing a GP capital account in the domestic feeder fund with an LP capital account in the master fund). Example 2, there may be some delay from the time a cash distribution is received and when it is recontributed to the fund.

4. The GP receives an in-kind distribution of securities from the fund, e.g., of stocks and bonds. Section 1061 facially does not apply to such assets, as it only applies to partnership interests, but it is possible that future guidance might seek to extend it to such a fact pattern.

Some of these approaches may not be possible or appropriate, and managers may wish to accept potentially greater tax risk in order to accommodate non-tax concerns. Thus, in the author's experience, for economic and investor-relation reasons, managers have foregone leaving capital "out" of their funds in the course of converting from GP to LP capital accounts.

Initial Margin (IM) Regulatory Requirements – Get Ready!

Michele Navazio, Partner at Sidley Austin, discusses the impacts of regulatory initial margin requirements

The implementation of regulatory initial margin (IM) requirements will concern increasing numbers of investment managers and their clients over the next 12 to 24 months. Compliance dates for the IM requirements are phased depending on the "material swap exposure" of the trading principal (be it an investment fund or institutional investor). It is expected that for most investment funds and institutional investors with material swaps exposure, compliance with the IM requirements will not be required until September 1, 2020, although some accounts with larger exposures will be required to comply by September 1, 2019.

Meeting these IM requirements will take significant time, preparation, and efforts to make sure that appropriate systems, processes and documentation are in place.

I. IM Requirements – Overview for Buy Side Participants

• Funds and institutional investors with "material swaps exposure" will be required to post and collect initial margin to/from their dealer counterparties.

• A fund or investor will have material swaps exposure if it, together with its affiliates (defined using accounting consolidation principles), has an average daily aggregate notional amount of non-cleared swaps with all counterparties for June, July and August of the prior calendar year of US$8 billion or more. For institutional investors who invest across multiple investment managers in separately managed accounts, the material swaps exposure will be the aggregate exposure across all those investment managers.

• As an example, for the period between January 1, 2020 through December 31, 2020, a fund would determine whether it has material swaps exposure by reference to June, July and August of 2019. Note that although FX swaps and FX forwards are included in the material swaps exposure calculation, they are not subject to the requirements of the IM rules.

• Compliance date of September 1, 2019 applies where material swaps exposure exceeds US$750 billion.

• Compliance date of September 1, 2020 applies where material swaps exposure exceeds US$8 billion.

• Swap dealers will be permitted to adopt an initial margin threshold amount of up to US$50 million, applicable when they both collect and post initial margin. This may mitigate the impact of the IM rule requirement that buy side participants post and collect initial margin.

• Initial margin must be segregated and may not be rehypothecated. Funds and accounts required to post/collect initial margin will need to establish tri-party custody arrangements to hold initial margin. This will create new costs and require operational changes. It will also entail managing risk exposure to the custodian bank.

• Initial margin levels are established either by reference to a standardized initial margin look-up table established under the IM rules or by use of an approved risk-based model. Most swap dealers are expected to use the Standard Initial Margin Model (SIMM) that has been developed by the International Swaps and Derivatives Association, Inc. (ISDA).

• Eligible collateral is generally consistent with current market practice, and may consist of cash, gold or certain securities, including U.S. Treasuries, securities of certain government-sponsored enterprises and certain corporate debt or equity securities.

• ISDA documentation used in current market practice (i.e., the ISDA Master Agreement and Credit Support Annex) may require changes. An ISDA working group is developing a template IM CSA that parties can use to comply with the IM requirements in the U.S. and certain other jurisdictions. ISDA intends to publish the IM CSA in the coming months.

II. Preparing for Implementation of the IM requirements

The following steps should be considered in preparation for implementation of the IM requirements:

1. Identify which entities are in-scope.

• This will entail determining whether any particular fund or institutional investor has material swaps exposure.

• Investment managers who trade separately managed accounts for institutional investors will need to communicate with their clients to assist in making the exposure determination.

• Final determinations can only be made between March and May for a September implementation, but estimates will need to be made long before in order to have sufficient time to prepare.

2. Reach out to your swap dealers.

• Early disclosure and communication will be essential.

• Participation in ISDA or other working groups can assist in sharing information and learning about industry best practices.

3. Provide compliance information to your counterparties.

• What custodians will be used?

• How will IM be calculated?

• What minimum transfer amount and IM

• What eligible collateral can be used, and what haircuts will apply?

4. Are there special circumstances to consider?

• For example, the impact of non-netting jurisdictions, local law, stamp tax or registration of security interests, entity specific regulatory requirements (e.g., UCITS).

5. Select a custodian

• Allow time for KYC checks and onboarding

• Even if there are current custodial relationships, new segregation accounts will need to be opened to accommodate IM posting

• All parties will need to provide information about their relevant custodians

6. Negotiate appropriate documentation

• This will include the IM CSA, and tri-party account control agreement(s) for each counterparty and the relevant custodian.

What's in Your Docs?

Sarah Payne, consultant to T-H Tracker Solutions, and GuyLaine Charles, Partner at Teigland-Hunt, walk through important considerations for managing documents

We are all familiar at this point with the catchy ad for Capital One asking consumers, "What's in your wallet?". Well, we feel it applies equally well to buy-side market participants and their trading documentation. After all, **what is in your documents?**

Most hedge funds managers invest a considerable amount of time and money in negotiating their trading agreements including, to name a few, futures trading, prime brokerage, repos and ISDA master agreements. However, they invest comparatively little in managing these agreements once executed. When a question or concern about the agreements comes up, it can be a time consuming and expensive exercise to get to the right answer. In a world where headline risk is routine, knowing exactly whom you are trading with and what terms govern the relationship, is invaluable; especially when internal and external stakeholders want answers to their questions quickly.

Whether you are assessing the impact of a Net Asset Value ("NAV") decline or a key person departure, evaluating a new prime broker against an existing provider, or determining how and when margin requirements might increase, mastery of documents is critical.

Accordingly, we recommend that managers:

(i) know where their documents are,

(ii) know whom they trade with,

(iii) monitor all key terms and obligations contained in their trading documents, and

(iv) compare terms across documents with one counterparty as well as terms across counterparties.

(i) Know where your documents are.

This may seem fairly basic; however, it is not uncommon to find that a manager does not know the location of 35-40% of their trading documents. Documents are not saved with consistent, identifiable names; pages are missing; agreements are partially executed; ancillary documents such as guarantees or confidentiality agreements are missing and amendments are not tracked in an effective manner. We encourage managers to perform a periodic document audit to ensure that their trading documents are fully executed, include any amendments and ancillary documents and are stored in a centralized location where they are easily accessible to all the relevant people within the organization.

(ii) Know whom you trade with.

When we ask a hedge fund client, "Who do you trade with?" we typically get a generic answer like "Morgan Stanley". A less readily available answer is "Our Prime Broker is Morgan Stanley and Co. LLC, a US broker dealer, and our ISDA counterparty is Morgan Stanley Capital Services LLC, which while unrated is guaranteed by Morgan Stanley." In addition, some trading agreements, and specifically prime brokerage agreements, have multiple sell-side parties to the agreement. The additional parties typically benefit from cross liens, rights of collateral transfer and cross default. Knowing exactly whom you trade with and what affiliates are in play is essential in monitoring headlines, responding to regulatory and jurisdictional changes as well as managing counterparty credit risk.

(ii) Know your key terms and obligations.

Trading documents impact every aspect of a hedge fund's business, from operations to collateral management, credit risk, market risk, portfolio management, liquidity management and more. While managers may be tracking their NAV or similar triggers, most likely this is done via a spreadsheet that may or may not be up to date and may or may not contain triggers across all trading documents (hint: NAV and other similar triggers are not necessarily contained solely in ISDAs). We have identified between 50 to 80 terms, depending on the type of trading agreement and the type of client, that we believe managers should monitor on a regular basis. These terms range from reporting requirements to valuation procedures, collateral terms such as transfer timing and haircuts, as well as events of default and cross default provisions.

(iv) Know how your documents compare.

If you are like most hedge funds, your trading agreements were negotiated at various times during the lifecycle of your fund.

Some were negotiated at launch, some may have been signed "as is" for commercial reasons, and some may have been negotiated or re-negotiated when the organization had increased market power. Whatever the circumstances, terms tend to vary across documents, even across counterparties in the same family. You may have cross acceleration in some ISDAs but not all. Or perhaps you have a provision for notification for an increase in margin with two future commission merchants but not the third. Knowing how your documents differ is crucial to effectively managing and mitigating operational, liquidity, market and credit risk. It is also an excellent negotiation tool if you are looking to renegotiate documents or add additional providers.

Monitoring your trading agreements is not an easy task. It requires professionals intimately familiar with trading documents, their terms and how they may impact one another as well as the legal entities involved. However, we believe completing a document audit, term extraction and legal entity profile exercise is well worth the investment. We also recommend that market participants implement an IT solution, to ensure that once an agreement has been concluded, the document, its key terms, and trading counterparty data, are centrally located and available to key people within the organization. This investment in monitoring trading documentation will pay dividends in the form of better informed trading decisions and management of documentation risks.

Enhanced Anti-Money Laundering Regimes

One of the hottest topics recently has been changes around the Cayman AML Regulations. To provide a comprehensive overview of the topic we have included the perspectives of both a law firm and fund governance firm

Part I

Ingrid Pierce, Global Managing Partner at Walkers

It seems as though everyone is getting hot under the collar about AML. That is, new and improved regulations and guidance on anti-money laundering and counter-terrorist financing. As well they should. In addition to the obvious requirement that those conducting relevant financial business ought properly to know their customers and apply the appropriate level of due diligence to those with whom they do business, managers operating in multiple jurisdictions must take into account cross-border issues and determine how best to navigate the rules in each jurisdiction.

One option is to adopt a jurisdiction by jurisdiction approach. Executed correctly, this will enable a business to operate to the standards of the relevant jurisdiction and not undertake more than is required in any given circumstance.

For most businesses however, this can be an onerous and costly task which requires a careful gap analysis and ongoing monitoring of the changes taking place in each jurisdiction. An alternative approach which is equally effective and may be easier to administer, is to apply a global standard across all jurisdictions, operating to the highest requirements across the board. This would also fit with the recommendation of the Financial Action Task Force for financial institutions. While easier to adopt, in practice this may trigger organisational changes to the way in which work is done and could have the effect of creating new roles and responsibilities which may not technically be required, but need to be implemented to achieve the 'one standard' approach. There is no easy answer to this and much will depend upon the nature and size of the business, the level of existing infrastructure and the capacity of internal resources with sufficient seniority and experience in the relevant regulatory compliance area.

Those conducting relevant financial business in the Cayman Islands will be aware of recent revisions to the Anti-Money Laundering Regulations, 2017, codifying a risk-based approach. In adopting such an approach, private equity funds and hedge funds must identify, assess and understand the AML risks in relation to their respective customers and the geographical area in which such customers reside or operate. While there are specific requirements in relation to record keeping, training of staff, reporting suspicious activity and maintaining internal control procedures, the risk-based approach means that no one size fits all. It may therefore be entirely appropriate for funds to adopt quite different policies and procedures, depending on their overall business and customers.

New Requirements for Cayman Islands Funds

One requirement for all Cayman Islands funds, is to designate a natural person as Anti-Money Laundering Reporting Officer (**MLRO),** Deputy Anti-Money Laundering Reporting Officer **(DMLRO)** and Anti-Money Laundering Compliance Officer (**AMLCO),** (collectively, **AML Officers).** Any delegation should be documented, and for new funds, the launch resolutions would be an appropriate place to record the delegation.

British Virgin Islands Funds

BVI Funds have been required to designate an individual to act as MLRO Since 2009.

At a minimum, such person must hold a diploma and have 3 years' experience with knowledge of AML laws generally and an understanding of BVI AML laws in particular. Fund directors are typically appointed to this role although any qualified and competent third party individual inside or outside the BVI may be appointed. There is no requirement to appoint a deputy MLRO. The BVI AML Code recognises that funds typically do not have employees and while a fund must satisfy certain compliance requirements, it may do so through outsourcing to an appropriate third party in a jurisdiction with equivalent AML measures. BVI funds typically outsource compliance to fund administrators in jurisdictions deemed to have equivalence in terms of AML.

Bermuda Funds

In Bermuda, since 2016, the operator of a fund has been required to designate an individual to act as "Reporting Officer" (akin to the MLRO) who must be adequately trained and have sufficient resources to undertake the role. Depending on the size and structure of the regulated financial institution, a deputy Reporting Officer may be required. An individual Compliance Officer (who may be the same person as the Reporting Officer) must also be appointed provided such person is employed at managerial level in the relevant regulated financial institution. The Compliance Officer must have adequate training to ensure that there is a compliance program with the requisite procedures and controls in place to satisfy the requirements of the Bermuda AML regulations, and must conduct ongoing monitoring of the program and compliance with the relevant regulations.

As with any evolving area of regulation, advice should be sought from suitably qualified counsel on the interpretation and practical application of the AML regulations in each jurisdiction.

Part II

Cassandra Powell, Director, The Harbour Trust

On 6th April 2018, the Cayman Islands Monetary Authority ("CIMA") published a notice clarifying new requirements arising from the Anti-Money Laundering Regulations (2018 Revision) ("AML Regulations"), which were issued in October 2017 and the associated Guidance Notes on the Prevention and Detection of Money Laundering and Terrorist Financing in the Cayman Islands ("AML Guidance Notes"), which were issued in December 2017. Together the AML Regulations, AML Guidance Notes, the Proceeds of Crime Law (2018 Revision), and the Terrorism Law (2018 Revision) form the revised AML regime ("AML Regime"). The AML Regime introduces new requirements for all Cayman Islands domiciled investment funds, whether registered with CIMA or not.

The most significant change is that all Cayman Islands domiciled investment funds must now appoint natural persons to serve as the fund's Anti-Money Laundering Compliance Officer ("AMLCO"), Money Laundering Reporting Officer ("MLRO"), and Deputy Money Laundering Reporting Officer ("DMLRO"). The same person can act as the AMLCO and either the MLRO or DMLRO, however, the MLRO and DMLRO must be two separate people. There are no restrictions on appointing an AMLCO, MLRO and/or DMLRO on the basis of an existing relationship with the fund or its service providers. The individuals serving in these AML officer positions must however, have sufficient skills, experience, seniority, and authority to perform the roles.

Examples of persons that can be appointed include:

- employees of the administrator;
- employees of the investment manager;
- the directors of the fund; or
- employees of other service providers

CIMA has advised that, in the event of outsourcing of the AMLCO and MLRO functions, the funds must conduct a risk assessment, including an assessment of country risk if the functions are outsourced outside of the Cayman Islands, and must maintain appropriate policies and procedures. CIMA has also advised that existing funds must appoint the AML officers by 30th September 2018, with the names of the appointed AML officers being submitted to CIMA by such date. Any fund launching on or after 1st June 2018 must comply with these new requirements from inception with the names of the appointed individuals being provided to CIMA at the time of the submission of the registration.

It is important to note that the compliance obligations of the investment funds under the AML Regime cannot be transferred therefore each investment fund will still retain ultimate responsibility for complying with its obligations in relation to the prevention of money laundering and the countering of terrorist financing.

The requirements and responsibilities of the AML officer roles are detailed below:

AMLCO

Requirements for the role

- to be suitably qualified and experienced to perform the role;
- to be of sufficient seniority to deal effectively with issues that arise;
- to monitor the fund's compliance with the AML Regime;
- to have unfettered access to all information necessary for them to perform the role; and
- to have sufficient resources, including sufficient time and, where appropriate, support staff to perform the role.

Responsibilities for the role

- ensure that appropriate AML processes have been adopted, in accordance with the AML Regime;
- perform periodic audits of the AML processes;
- act as a point of contact for the relevant competent authorities, and respond promptly to any requests for information;
- ensure a gap analysis is conducted to confirm that the AML processes comply with the applicable Cayman Islands requirements;
- ensure an annual representation is received confirming the above mentioned procedures remain in place and are consistent with the requirements of the Cayman Islands, and addressing any breaches;
- advise the fund's Board of any AML compliance issues;
- report periodically to the fund's Board, so that the Board is able to satisfy itself that the fund's statutory obligations are being met; and
- ensure the Board has received adequate training relating to its AML responsibilities.

MLRO

Requirements for the role

- to be suitably qualified, experienced and have sufficient time for the efficient discharge of the function;
- to be well versed in the different types of transactions which may give rise to opportunities for money laundering;
- to be autonomous (meaning the MLRO is the final decision maker as to whether to file a Suspicious Activity Report);
- to be independent (meaning no vested interest in the underlying activity); and
- to have access to all relevant material in order to make an assessment as to whether the activity is or is not suspicious.

Responsibilities for the role

- ensure that procedures are in place for escalating and evaluating suspicious activities.
- ensure that all relevant parties are aware of these procedures;
- promptly review the relevant information of any suspicious activity escalated and make the decision as to whether to file a Suspicious Activity Report on behalf of the fund;
- if a Suspicious Activity Report is filed, liaise further with the competent authorities as necessary; and
- maintain a register of Suspicious Activity Reports.

DMLRO

Requirements for the role

- same as for MLRO.

Responsibilities for the role

- discharge the MLRO functions in the absence of the MLRO.

Don't Stop Believin'- Holding on to that Management Fee-lin': The Post-Tax Reform Journey

Amanda H. Nussbaum, partner at Proskauer Rose, and Martine S. Agatston, associate at Proskauer Rose. analyze impacts of the recently passed tax reform.

Extensive tax reform passed at the end of 2017, commonly known as the "Tax Cut and Jobs Act" (the "TCJA"), made significant changes to the U.S. Internal Revenue Code.

One of those changes is the suspension of all miscellaneous itemized deductions, which include investment expenses such as management fees and certain payments pursuant to the terms of swap agreements. While there has been some concern that this suspension has the potential to cause a significant impact on certain investors in hedge funds, the reality is that actual impact will be much more limited.

The following Q&A will consider this change in law and its impact on hedge fund investors.

How has the deductibility of management fees changed under the TCJA?

Prior to the passage of the TCJA, a non-corporate investor in a hedge fund could deduct from taxable income certain investment expenses, including management fees, where and to the extent that the investor's total miscellaneous itemized deductions were in excess of 2% of such investor's adjusted gross income. The deductible portion, if any, of such expenses became part of the investor's total itemized deductions, which total was subject to further reduction (generally an amount equal to the lesser of 3% of the investor's adjusted gross income over a threshold level or 80% of the investor's otherwise allowable total itemized deductions). In addition, such expenses were not deductible in computing the investor's alternative minimum tax liability.

The TCJA suspended the availability of all miscellaneous itemized deductions for tax years beginning in 2018 through 2025. This change in law means that, for certain investors, to the extent that management fees and other investment expenses were previously deductible (despite the limitations described above), such expenses will no longer be deductible, which will decrease the overall after-tax return to such investors.

For taxable years beginning in 2026 and later, the law will revert back to the rules that existed before the TCJA was implemented (assuming that Congress does not act to extend this suspension).

Which fund investors will be affected by these changes?

Not all hedge fund investors will see a difference in their after-tax returns from the suspension of miscellaneous itemized deductions.

Generally, investors that will be impacted are those that: (i) hold interests in hedge funds that are considered "investors" for U.S. federal income tax purposes, and (ii) have miscellaneous itemized deductions (including from the hedge fund) that exceed 2% of their adjusted gross income.

First, under the prior law, only investors in hedge funds that were treated as "investors" for U.S. federal income tax purposes (and not as "traders") treated expenses as miscellaneous itemized deductions.

In contrast, investors in hedge funds that were treated as "traders" were not treated as having miscellaneous itemized deductions; they were not subject to the limitations on deductions under prior law, and therefore are not affected by the suspension on deductibility, and may continue to deduct trade or business expenses allocated to them. Whether a fund is treated as a "trader" or an "investor" is not always clear, but is determined in part by considering a fund's trading activity, including the volume, regularity, continuity and frequency of trading, and whether the fund looks for short term price movements or long term appreciation. As a result, investors in hedge funds that are considered "traders" are not impacted by the elimination of miscellaneous itemized deductions (whether or not such funds have made a "mark to market" election for tax purposes) because they continue to be able to deduct their expenses, as business expenses, directly from gross income.

Second, as mentioned above, even prior to the TCJA, miscellaneous itemized deductions were subject to a 2% floor and other limitations. As a result, only taxpayers whose adjusted gross income exceeded this threshold and were not subject to the other limitations were previously able to benefit from the deduction and will be affected by its suspension.

How might a hedge fund investor restructure its investment to be able to deduct management fees?

One solution for hedge fund investors that stand to be significantly impacted by the loss of miscellaneous itemized deductions may be to invest through the hedge fund's offshore feeder (which is treated as a corporation for U.S. federal income tax purposes), rather than its onshore feeder (which is treated as a partnership for U.S.

federal income tax purposes), rather than its onshore feeder (which is treated as a partnership for U.S. federal income tax purposes), and to make a "qualified electing fund" ("QEF") election in connection with such investment.

Generally, the offshore feeder will be treated as a "passive foreign investment company" for U.S. federal income tax purposes ("PFIC"). Many expenses and losses that would be denied or restricted for an individual investor in the onshore feeder would be deductible for purposes of computing a PFIC's earnings and profits, including the management fee. Further, an investment in a PFIC may come with additional advantages, such as the possible deferral of state tax and the avoidance of the straddle rules and the wash sales rules.

However, certain disadvantages to this structure may outweigh the benefits of retaining the deduction of management fees.

First, in order to ameliorate certain adverse tax consequences associated with an investment in a PFIC, a U.S. taxable investor generally would need to make a QEF election to currently include in such investor's income its pro-rata share of the offshore feeder's earning and profits. In order to make this election, investors must receive certain information from the offshore feeder, and the offshore feeder may be unwilling to provide this information. Second, if the offshore feeder also is treated as a "controlled foreign corporation" for U.S. federal income tax purposes, that characterization (and the associated tax consequences) will trump its treatment as a PFIC for U.S. investors that are (or hold interests through) 10% shareholders of the offshore feeder. Third, there are additional filing requirements associated with an investment in a PFIC. Fourth, unlike a partnership, losses do not flow through a PFIC. Therefore, losses in one year will not be available to offset income in a subsequent year. Finally, U.S. source dividends received by the offshore feeder will be reduced by a 30% U.S. withholding tax. Therefore, an investor needs to carefully consider the potential consequences before making its investment in an offshore feeder, rather than an onshore feeder.

How can an investment manager restructure its management fee so that the fee can continue to generate a tax benefit for hedge fund investors?

An investment manager may consider restructuring all or a portion of its management fee as an additional incentive allocation to the general partner of the hedge fund.

This structure shifts income or gain from the investors to the general partner in respect of its additional incentive allocation.

This shifting has the economic effect of a tax deduction to the hedge fund investors without giving rise to an actual miscellaneous itemized expense that would no longer be deductible under the TCJA.

Hedge fund managers may also benefit from this change in compensation structure because the general partner may be able to defer income inclusion with respect to the incentive allocation and the incentive allocation may be taxable at the lower long-term capital gain rate, rather than the applicable ordinary income rate.

However, this latter tax benefit is much more limited post-TCJA because of the change in law that provides that gain allocated with respect to an incentive allocation that is attributable to the sale or disposition of a capital asset will be recharacterized as short-term capital gain to the extent the capital asset giving rise to the gain has been held for three years or less. More significantly, hedge fund managers may be resistant to this restructuring because of the added economic risk associated with an incentive allocation (which is contingent on future profits) as opposed to a management fee (which is guaranteed). Since most investment managers are dependent on the revenue from management fees to pay their operating expenses, it is unlikely that there will be a major shift in compensation arrangements.

About Wells Fargo Prime Services and Contacts

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Wells Fargo Prime Services offers comprehensive prime brokerage services and solutions for alternative asset managers. Through our multi-asset class platform, we help managers with their operational and financial goals through our service offerings including:

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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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