BEST PRACTICES
HEDGE FUND AND
PRIVATE EQUITY OPERATIONS

CalALTs Best Practices Committee

2017
Q1 HIGHLIGHTS

California Alternative Investments Association
General Operational Best Practices

The private funds industry has developed significantly in operational sophistication over the past 10 years. Today, the investor wish list includes the existence of an independent administrator, an internal CFO, segregation of duties, employee background checks, centralized operations, documented policies and procedures, a fiscal budget, an internal CCO, an external regulatory consultant, a clean regulatory history, formal compliance training, a tested disaster recovery plan, a cyber security plan, and related staff training.

**IN TERMS OF INTERNAL STAFFING, BEST PRACTICES CALL FOR**

1. a seasoned fund accountant to act as Chief Financial Officer (typically a CPA with prior fund audit training),
2. a securities lawyer or regulatory professional acting as Chief Compliance Officer,
3. an experienced operations person with knowledge of settlement, reconciliation, and trade break issues, and
4. coverage for back office personnel when they are on vacation.

Outsourcing certain functions such as regulatory compliance, IT, and in some cases CFO/middle office operations has become more common and deemed more acceptable as competition in these areas increase and counterparties see the value of outsourcing to specialists.

**PORTFOLIO VALUATION BEST PRACTICES INCLUDE**

1. the existence of written pricing policies and procedures,
2. a formal valuation committee with minuted meetings,
3. a back office controlled month end price verification process, and
4. an independent month end fund administrator price verification process.

**FUND EXPENSE PAYMENT PROCEDURES**

These practices are expected to be employed at all types of hedge funds, but present much higher risk when not employed at a credit or fixed income hedge fund trading in level 2 or level 3 assets. For private equity funds, valuation pricing models should be vetted, and the fair valuation process should be conducted by the back office. Level 3 assets should be vetted throughout the year by a reputable valuation firm, either quarterly or semi-annually.

Fund cash should be safeguarded by a dual signature requirement at the prime broker, custodian, or bank; coupled with sound oversight at the financial institution. The dual signature requirement should be obliged by the financial institution, and not just be a “practice” put in place at the fund manager. Fund expenses should be oversee by both the fund manager and the administrator, to ensure that both parties have vetted the validity of the invoice, and have approved the appropriateness of the expense. Ideally, fund expenses should be paid out of the fund’s bank account, and not the prime brokerage accounts, which should be set aside for trading and investing. Today, many fund managers conduct annual background checks on any employee touching cash or acting as a signatory for their funds.
FUND ACCOUNTING AND NAV CALCULATIONS
Fund accounting best practices call for a qualified CFO in-house coupled with a recognized fund administrator maintaining the official books and records for the fund. The fund manager should have a portfolio accounting system and a general ledger in-house, and have a shareholder allocation system or a set of allocation records maintained in parallel with the administrator. Lastly, having a process in place at the manager to review all monthly client statements prior to distribution has proven valuable in catching errors. All of these controls help to reduce the risk of NAV errors or shareholder activity reporting errors, which if not caught, could result in significant financial and reputation risk for a fund manager.

FUND ADMINISTRATION KEYS
In terms of fund administration, best practices include a global SOC 1 covering all aspects of the operation, daily three way reconciliations, 100% price verification, transparency reporting, oversight and approval on expenses, and daily AML checks.

CYBERSECURITY MANAGEMENT
Cyber security risk is proving to be a threat to any organization. Fund managers should consider engaging a third party IT specialist to assess their vulnerabilities and that of their key service providers, and conduct various ongoing tests related to potential intrusions and employee errors.

Regulatory risk is one of the highest exposures a private fund can face. One of the more notable trends in mitigating regulatory exposure is the use of regulatory consultants, and keeping them on retainer. Funds of all sizes, into the tens of billions, see the value of utilizing third party consulting services, so this is not just an outsourcing option for smaller funds. The regulatory landscape is constantly changing, and relevant and valuable compliance resources can strengthen one’s compliance framework. This is a growing “must have” for the institutional investor.

“REGULATORY RISK IS ONE OF THE HIGHEST EXPOSURES A PRIVATE FUND CAN FACE.”

While there are limited requirements related to operations, we are moving into an era where more operational resources are needed for managers to comply with their obligations as fiduciaries. The industry continues to be self regulated in this manner, but working together, the investors, managers, counterparties, and consultants can greatly lower operational risks to acceptable levels. While the best practices outlined here are not an all inclusive list; we believe they represent current views shared by institutional investors and consultants that help them gain comfort over their private fund investments.
Prime Broker and Hedge Fund Relationships

Over the past several years, bank regulations under Basel III have been implemented with the goal of ensuring banks are better situated to absorb financial and economic stress, have improved risk management and governance and have improved transparency. The focus of these regulations has been to increase the amount and quality of capital required, decrease leverage and improve the liquidity profiles of the banks. These regulations have required the banks to take a sharp look at their balance sheet usage resulting in a focus on their prime brokerage units. Consequently prime brokers have been caused to evaluate their portfolio of clients in the context of various metrics, including but not limited to, return on assets and risk weighted assets. This has caused prime brokers to be less inclined to grow balances and take on new business but rather to run their businesses strategically to meet clearly defined long-term targets. This pressure on the prime broker units has directly impacted the hedge funds that utilize their balance sheets.

Each prime broker has their own unique client portfolio mix and risk and return profile and thus their own metrics of what makes an optimal hedge fund client. They also have their own unique suite of service offerings and operational capabilities. Likewise, each hedge fund manager has their own unique strategy, operational infrastructure, client portfolio mix and unique opportunities and challenges in managing their business.

The relationship of the hedge fund business and the prime broker is of mutual benefit. The hedge fund manager looks to the prime broker for certain services specific to their profile such as financing, securities lending, access to balance sheet, capital introduction, research, etc. The prime brokers now look to the hedge fund client not to use all of their services to the max, but rather to manage their use of balance sheet, financing and service offerings in the most efficient and profitable manner. Both parties spend a great deal of time working to understand how to optimize the relationship using the levers at their disposal to increase profitability while minimizing additional risk to their portfolios and their organizations.

Not to be lost in this analysis, both parties need to continue to keep counterparty risk in mind. It remains critical that hedge funds understand where their assets are held and continue to diligently monitor the financial health and stability of their counterparties.

In order to maintain a successful relationship, the hedge fund and the prime broker need to have transparent communication on what the primary drivers are for each side. These conversations need to be frequent and need to look at the holistic client relationship tracking all resource consumption and revenue generation.

As the prime broker and hedge fund businesses as well as the market and regulatory environments evolve, this will be an area of continual change. Continued management of these relationships and transparent communication will continue to be imperative.

IN ORDER TO MAINTAIN A SUCCESSFUL RELATIONSHIP, THE HEDGE FUND AND THE PRIME BROKER NEED TO HAVE TRANSPARENT COMMUNICATION ON WHAT THE PRIMARY DRIVERS ARE FOR EACH SIDE.
Expense Allocations

With the escalation in oversight of private fund advisers since the passing of the Dodd-Frank Act of 2010, the SEC has pursued enforcement actions against fund managers for an array of improper fee and expense allocations.

In his May 2016 keynote speech, Andrew Ceresney, the SEC’s former director of enforcement, emphasized the role of an adviser as a fiduciary and discussed three categories of conduct by fund managers that resulted in enforcement actions relating to improper expense allocations: (i) advisers that receive undisclosed fees and expenses; (ii) advisers that impermissibly shift and misallocate expenses; and (iii) advisers that fail to adequately disclose conflicts of interests, including conflicts arising from fee and expense issues.

These enforcement actions frequently alleged inadequate disclosure or deficient policies and procedures. In determining whether disclosures were appropriate, the SEC looked at whether the disclosures made by managers in fund documents, marketing materials, regulatory filings (e.g., Form ADV) and other investor communications were accurate, consistent, comprehensive and unambiguous.

In many instances, the types of expense allocations the SEC challenged were not necessarily impermissible. Often, they would have been permitted if the manager had appropriately disclosed them to investors in the fund. This disclosure would need to have occurred prior to the launch of the fund, or at least prior to a violation, in order for investors to have been deemed on notice and in agreement with the manager’s expense allocation policies and practices.

According to Andrew Ceresney, the rise in enforcement has had a positive impact on investor behavior. He noted that there has been a significant uptick in investors seeking additional transparency concerning managers’ fee and expense practices, and that this increased transparency has fostered a healthy dialogue between investors and managers on what types of fees are appropriate and who should receive the benefits of those fees.

This increased scrutiny of expense allocations has led to a shift in the way fund managers approach disclosing expenses. While historically a lot of managers favored more general, broader disclosure in order to retain discretion in how to allocate expenses, now managers are more cautious and have started enhancing their expense disclosures to make them more detailed, in particular for newly formed funds.

Questions often come up, however, regarding how fund managers should address disclosures for existing funds. The approach managers take varies based on the specific facts and circumstances that trigger the need for enhanced or more detailed disclosure. Some managers may choose to amend existing disclosures and seek investor consent, while others may choose to enhance existing broad or generic disclosures to add more details or specifics without seeking investor consent. Of course, some managers, upon review of their fund offering and governing documents, may conclude that their existing expense disclosures are appropriate and that the associated allocation policies and procedures track those disclosures and do no warrant any updates.

Given the SEC’s intensifying focus on fund fees and expenses, as well as the rise in scrutiny and the need for transparency with fund investors, managers would be wise to review their offering and governing documents, regulatory disclosures, financial statement disclosures, investor communications, and the associated policies and procedures to ensure that they are sufficiently detailed, in line with the managers’ fee and expense allocation practices and that appropriate controls are in place to monitor fee and expense allocations going forward.
The New Fund Governance

Governance of hedge funds took center stage as a result of the financial crisis in 2008. Certainly many investors in hedge funds were already pushing on these issues and demanding appropriate fund governance but for some this became an investment imperative post-2008. Subsequently, investors began to push for onshore and offshore funds alike to have governance structures in place that provide for independence from the investment manager. For many, this simply meant that the fund needed to be controlled by a majority of independent directors. Fast forward to today and a new fund governance model has taken shape along with the increasing emergence of managed accounts.

TODAY’S INDEPENDENT DIRECTOR MODEL

There have been continued improvements and developments in the area of fund governance across the hedge fund industry over the past few years. Investors still require that funds be controlled by a majority of independent directors but there have also been improvements to this model. Three of the biggest developments are the use of multiple directorship firms, diversity of expertise in the directors’ skill set, and the time spent by the directors.

In many cases, investors now expect that independent directors are not all from the same directorship firm. Many refer to this as a “Split Board.” Having directors from two different firms ensures that they are truly independent from each other, making them less likely to vote as a block. Further, it encourages each director to seek to understand the issues separately from the other directors and to uphold the fund documents. This board structure further encourages directors to seek to do what is in the fund’s and the fund investors' best interest.

There is also a push toward expecting the directors to come from varied disciplines and expertise.Traditionally, an offshore fund’s independent directors were individuals based in Grand Cayman with a legal background. Today's board will likely still have a person with Cayman fund law expertise but it is now expected for the makeup to be more varied. Other common disciplines or professional backgrounds found on boards are hedge fund operations, accounting, administration, portfolio management, risk management, banking, regulation, and operational due diligence. It is also more common for independent directors to be based in a variety of locations (versus all being Cayman-based).

A large general criticism of the old model was the number of boards an individual could sit on (in past times, an individual director might have served on hundreds of offshore fund boards). Most investors admit that there is no magic number on this and acknowledge that there are varying firm structures and styles by directors. However, in the new model, directors sit on fewer boards and allocate more time and attention to each fund than in the historical model.

MANAGED ACCOUNTS

For some investors the new approach to fund governance is the Separately Managed Account (“SMA”). For many investors, independent fund governance served as a type of insurance against the investment manager putting their own interests ahead of the investors. Appropriate fund governance in the new director model should be reasonably effective in doing this. But for large investors, many have decided to not put their fate into an independent director’s hands but rather simply move to an SMA. The SMA places the control of the fund into the investor’s own hands and out of the investment manager’s power. SMA’s have continued to grow in popularity in the industry and for large allocations, increasingly more hedge fund managers have been willing to accept them.

Fund governance has evolved over the past few years and a new model has taken shape. Despite the strengthening of the new model, an SMA remains the strongest form of fund governance for the investor.
IN-HOUSE VS. OUTSOURCING:
Striking the right balance

INTRODUCTION
Operating an alternative investment manager requires so much more than investment strategies alone. The scope of operations within an alternative investment manager can include very broad and deep functions within the front office (research, trading and marketing), the middle and back office (accounting, booking and settlement), information technology (all computerized resources), executive (legal, compliance, governance) and other functions which could use a category of their own, depending upon the unique needs of that manager.

Every manager faces a question with regard to developing and supporting these functions within their firm. They can hire and/or build internally, or they can turn to the many service providers offering support in virtually all operational functions.

We explore some considerations, particularly for alternative investment managers, for approaching the decision to outsource operational functions.

DEFINING IN HOUSE VS. OUTSOURCING
The notion of “in-house” is straight-forward in that it describes a function that is performed and managed entirely by the investment manager.

“Outsourcing” is a concept that exists on a bit of a spectrum, from complete delegation of a functional responsibility to a service provider to shared responsibility between the service provider and the asset manager.

The two main criteria to evaluate an in-house versus outsource decision:
• expertise
• cost-efficiency

As we will discuss further in identifying ‘core competencies,’ if an ancillary task requires highly specialized skills, or can be performed more efficiently by an outside vendor, that function might be a candidate for outsourcing.

How does a firm make the most of outsourcing’s advantages while minimizing its risks? The analysis begins with an evaluation of core competencies.

GUNS VS. BUTTER AND CORE-COMPETENCIES
The macroeconomic concept of ‘guns versus butter’ provides a simplistic but useful starting framework. Essentially, every business manager has finite operational resources, so they must therefore look at their relative advantages across each of the functional areas of operations.

One key question is, “what are your core-competencies?” Another way to ask this is, “what differentiates your service?” Do investors think (and do you want investors to think) about your firm for its investment performance, for the customer website, for the client services personnel, etc.?

Identifying these differentiators is the first step to organizing the operational tasks and functions which directly support your core-competencies and which are ancillary.
Functions within an investment manager for potential outsourcing:
- Back-office / Middle-office
- IT infrastructure / Support
- Marketing / Investor Relations
- Risk / Compliance

As a general rule, do not outsource your core competencies.

CONSIDERATIONS FOR ALTERNATIVE INVESTMENT MANAGERS
In addition to expertise and cost-efficiency, Alternative Asset Managers have additional considerations to factor in their decisions regarding outsourcing.

- Regulatory limitations
- Investor perspectives
- Security

Regulatory limitations:
Due to the fiduciary and regulatory duties of an alternative investment manager, most outsourcing still requires some level of shared responsibility between the manager and the service provider. Alternative asset managers need to be able to demonstrate management and control of their operations to the relevant regulatory body. Regulators will want to see the policies and procedures documents that ensure the manager is exercising appropriate supervision over the service provider. Additionally, they require notification when a manager delegates responsibility for a critical function.

Investor perspectives:
Investors will ask themselves what risks they are taking on based on your firm’s outsourcing decisions. They will appreciate the rationale of finding operational efficiencies, but investors also require some level of comfort in the process used to select key outsourced service partners. For this reason, the scope of due diligence in selecting and working with service providers is critical for alternative asset managers.

Security has always been a concern with regard to outsourcing, and it is amplified by the intersection of sensitive financial information and computer systems which are central to all asset managers’ operations. Regulatory and investor requirements are evolving, mandating documentation of the due diligence reviews of those service providers who have access to all sensitive client data.

MANAGING OUTSOURCING
Once a manager has decided to outsource a function, managing the process has a significant impact on the success of the engagement. Clearly defining the scope and deliverables of the outsourcing project is key to managing cost and satisfaction with the engagement.

ONE FREQUENTLY OVERLOOKED CONSIDERATION IS HOW TO EXIT THE ARRANGEMENT.

Due diligence is something all investment managers are familiar with, but usually they are the subject of the inquiry. In this case, investment managers need to perform that same process on their service providers, particularly those that manage critical and/or sensitive functions. Managers should use a questionnaire template or design their own list of diligence questions to forward as a request for proposal (RFP).

One final important, yet frequently overlooked consideration when entering such an arrangement is how to exit the arrangement. If possible, include your current vendor in outlining the necessary steps and their support in transitioning away from them, if that event should need to take place.

CONCLUSION
With the broad selection and availability of service providers, Alternative Asset Managers can exploit the potential benefits of cost-efficiency and expertise through outsourcing in a risk-appropriate way. In addition to analyzing a firm’s unique core competencies, successful outsourcing decisions include giving consideration to the scope and deliverables of the engagement on the way in and on the way out. Performing due diligence in key vendor selection and vendor reviews is a requirement. Regulators and investors demand it.
VENTURE CAPITAL VALUATION:
The Increasing Role of Option Pricing Models

Venture capital managers have historically applied little value to the “mark-to-market” valuation of their portfolio. It has long been viewed that the best indication of value is through an M&A transaction or IPO, which would convert a privately held portfolio company into either cash, a public security, or a combination of both.

• In order to conform to US Generally Accepted Accounting Principles (“GAAP”), venture capital managers must record the appreciation or depreciation of its assets to fairly represent the financial position of the portfolio.

• Limited Partners (“LPs”) need some basis to evaluate their venture capital investments. Investing in a venture capital fund and waiting seven to ten years to evaluate its performance is not a recommended practice. Additionally, venture capital fund investors with an underlying LP base may also need to provide periodic reporting, liquidity, or have a basis to calculate their fees.

HOWEVER, HOLDING A PORTFOLIO COMPANY AT COST UNTIL A REALIZATION EVENT OCCURS IS NOT A WIDELY FOLLOWED PRACTICE FOR THE FOLLOWING REASONS:

1. Last Funding Round: This can be a fairly simplistic approach where the venture capital manager values the underlying portfolio company by taking the last funding round valuation and applying it to the value of its shares. This is an overly simplistic approach as venture capital managers would generally need to take into consideration its liquidity preference when there are multiple funding rounds.

2. Market Comparables/Multiples Model: For portfolio companies that are generating a substantial amount of revenue, the venture capital manager will develop a set of comparable public companies within the same industry that are generating a similar amount of revenue. A financial metric is then assigned (revenue multiple) to obtain the portfolio companies valuation.

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More recently, venture capital managers have utilized an Option Pricing Model (“OPM”) to value its seed/early stage investments that may not generate sufficient revenue to utilize a comparables/multiples approach. OPM is a Black-Scholes model that provides an indication of value based on treating each share class as a call option on the equity value of the entire portfolio company. While the math can become complex, there are a number of third-party providers that can assist with the calculation.
The reaction to OPM in the venture industry has been mixed. Certain venture capital managers have incorporated the methodology into their valuation framework, while others continue to use more conventional approaches. The push to incorporate OPM appears to be driven by certain Big Four auditors that have taken the position that applying a mathematical model to non-control private investments is an appropriate valuation approach. Adopting OPM likely makes the year-end audit process run smoother when valuations are supported by mathematical models.

However, using OPM does not necessarily indicate whether value has been created or whether value has eroded, which is the fundamental question one is trying to answer when valuing a private investment. Additionally, while OPM is certainly more of a science than an art, there is a fair amount of discretion that venture capital managers can use with two of the key drivers of the model:

1. **Time (Theta):** Venture capital managers must determine the anticipated exit date of the portfolio company, which is basically unknown given all of the variables that may come into play.

2. **Volatility (Vega):** Volatility of a private asset is not a readily available statistic. To compensate, venture capital managers will use sector specific volatility figures; however, the relevance to the portfolio company may be limited.

As the venture capital industry continues to evolve its valuation approach, OPM appears to have gained enough ground to become one of the three most widely accepted valuation methodologies. Three observations of OPM that should be considered are:

- OPM valuations are typically 30% below the next funding round valuations, which may work for a manager in a frothy market; however, will venture capital managers be willing to use OPM once venture capital valuations normalize?

- A venture capital firm using OPM is at a marketing disadvantage if a portion of its portfolio is valued 30% below its peers who are using a different valuation methodology.

- There is a risk of venture capital managers replacing their Big Four auditor to an audit firm that does not “encourage” the use of OPM, thereby, arbitraging the valuation process.
CalALTs Best Practices Committee

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On March 1, the California Hedge Fund Association became California Alternative Investments Association “CalALTs” thus expanding its outreach to address the needs of managers across the investment spectrum, not just hedge funds. Originally founded in 2010 as the California Hedge Fund Association (CHFA), CalALTs continues the mission of fostering meaningful connections among its members and a vast network of thought leaders, influencers and peers who share investment ideas, best practices and industry intelligence that drive tomorrow’s success. The organization hosts education and networking events for members and its digital and social platforms provide members with the relationships, information, and opportunities to generate better outcomes.