MARINO PARTNERS LLP

Marino Market Minutes

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Events:

Business Breakfast
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here at Marino Partners!

By Paul J. Marino **Why Can't We Be Friends?**

Why Can't We Be Friends?

It's an age old question brought to life in a song by the 1970's band, War. It's an assessment that humans have pondered since the beginning of time. Why couldn't Cain and Abel be friends, Esau and Jacob, Joseph and his brothers, the other Beatles and Yoko Ono; it's a timeless question with only one answer—it's not you, it's me (read it's really you). The reality is we can all be friends but there are forces on the right and left that don't want us to be friends. Not to say that there is a conspiracy pitted against us common folk by the so-called elites; but what would a reverend be without a church and what would a church be without parishioners? The answer: Nothing. For many people on the fringes, their "religion" is the cause that they promulgate (as opposed to the super majority of people whose "cause" is to binge watch shows on Netflix, figure out how to pay for college and find the cheapest gas prices in town). Are these fringy people bad? The ones who preach hate and separatism clearly are, but the ones who push real issues are not necessarily so, as the edges often push certain ideas and ideals to the forefront and those ideas and ideals (or a variation thereof) often benefit society. The issue is that a spotlight is focused on those outer edge factions *vis-à-vis* a 24-hour news cycle that could be said to have the effect of fomenting such fringe ideologies as a result of sensationalizing to drive ratings (even George H.W. Bush would have been featured on a 24 hour loop by MSNBC for being so out of touch that he didn't know what a gallon of milk cost or that grocery clerks use these newfangled scanners). It feels like all these internal (and likely external) forces pulling at the frayed strings of society may cause the fabric of our society to come apart—but it won't.

This tension has caused dysfunction in Washington for centuries; and I don't buy the claim (from all sides of the media) that things have reached a NEW level of rancor, hostility and partisanship. Things have been worse. There are at least a few particularly memorable disputes on the senate floor: (Roger Griswold (D-CT) and Matthew Lyon (D-VT) engaged in a heated debate in 1798 involving a cane and fire tongs; Preston Brooks (D-SC)) beat Charles Sumner (R-MA) with a cane so severely that Sumner didn't return to the Senate for three years. And of course, we had a civil war.

So, although emotions are running high, in the end we have to remember that we are all just Americans trying to live our lives. I spent a lot of time traveling this summer (see below for an assessment) (Western PA, Chicago, San Francisco, Oakland, and Central (Orlando) and Northern Florida (Daytona and Jacksonville)—never did I feel that the people I met were against me for being from NY (how did they know I was from NY--5'9" Italian looking guy walking around with a Yankees hat) or did they express dissatisfaction with the USA (everywhere I went our flag was proudly displayed). We are more alike than different—we just need to focus on what matters and what makes us similar—God, Family and Country.

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Cybersecurity for the Investment Adviser

By Alexandra Lyras

The Securities and Exchange Commission's (the "**SEC**") is warning that many advisers are failing to perform steps critical to fighting cyber security attacks. An adviser's cyber security program needs to have certain critical components, without which, an adviser and its clients will be exposed to increased risk of a cyberattack.

The SEC recently completed a second round of cyber security exams under its 2014 exam initiative where the examiners focused on assessing cyber security preparedness and the protection of confidential client information. The SEC concluded that roughly one quarter of advisers are failing to conduct periodic risk assessments of critical systems to identify cyber security threats, vulnerabilities, and the potential business consequences. The recent exams have shown the failures to occur more often at advisers (including investment companies) rather than broker-dealers. The exams also revealed that cyberattacks are disproportionally aimed at smaller rather than larger advisers.

Penetration and Vulnerability Tests

Penetration testing is used to examine the security of an adviser's IT infrastructure. The SEC examination discovered that more than half of the advisers examined failed to conduct penetration tests and vulnerability scans on systems that the advisers considered to be critical. A cyber security penetration or vulnerability test is usually an authorized simulated attack on a network that looks for security weaknesses, potentially gaining access to the system's features and data.

The SEC has not provided guidance on specific parameters for penetration or vulnerability tests. The SEC is presuming that the Advisers engage IT providers or consultants, who to know what to test. However, the SEC will look for policies and records of such tests during an examination. In the 2015 risk alert, the SEC stated it will request during exams:

Information regarding the adviser's policies related to penetration testing, whether conducted by or on behalf of the adviser, and any related findings and responsive remediation efforts taken; and

Information regarding the adviser's vulnerability scans and any related findings and responsive remediation efforts taken.

In addition to penetration testing, the SEC recommends advisers (1) perform periodic assessments; (2) adopt a cybersecurity strategy; and (3) educate employees, clients and partners about the cybersecurity.

1. Periodic Assessments

Guidance from the SEC's Division of Investment Management in 2015 provide insight to the SEC's specific expectations when it comes to periodic assessments. The following are topics of interest to the SEC:

- The nature, sensitivity and location of information that the adviser collects, processes or stores, and the technology systems employed to do so;
- Internal and external cyber security threats and vulnerabilities to the firm's information and technology systems;
- The security controls and processes that the adviser currently has in place;

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- The likelihood and impact to the adviser and its clients if any information or technology systems are compromised; and

- The overall effectiveness of the fund's or adviser's ability to manage cyber security risk, including whether risks are identified and appropriately addressed.

The guidance does not address initial assessments; these periodic assessments are presumed to be for ongoing or continuing efforts subsequent to the adviser's initial cybersecurity assessment. A reasonable effort for an initial assessment, would include taking an inventory of devices, connections, software and sign-on capabilities that are at risk of cyberattacks.

2. Cybersecurity Strategy

In general, an effective cybersecurity strategy ensures advisers can prevent, and promptly detect and respond to, cyber dangers. A cybersecurity strategy should include: (1) data backup and retrieval measures; (2) the use of data encryption; and (3) controlling access to IT systems through established methods of authentication and authorization.

Advisers must document the following items in connection to their cybersecurity program:

- Information about the development and deployment of the adviser's cybersecurity structure and operating model;

- Details about cybersecurity policies and procedures;

- Cyber insurance documentation;

Details regarding any data breach or cyberattack and how it was remedies or addressed.

3. Educate Employees, Clients and Partners

Implementing a cybersecurity strategy and educating employees, clients and partners (and any other involved parties) about it can assist in having such groups coordinate to control cybersecurity risks.

The SEC views cybersecurity and an adviser's compliance obligations under the federal securities laws as closely connected. Cybersecurity threats can impact an adviser's ability to comply with certain federal securities laws and, as a result, firms should examine their ability to respond to cybersecurity threats in that context. Advisers should tailor their compliance programs on the nature of their businesses. Additionally, because advisers rely on a number of service providers in carrying out their operations, advisers may wish to assess whether protective cybersecurity measures are in place at relevant service providers.

Amended Form ADV: Increased SMA Disclosure

By Caitlin Harrison

Beginning on October 1, 2017, investment advisers must comply with and utilize the amended Form ADV (the "**Amended Form ADV**") that was adopted by the Securities and Exchange Commission (the "**SEC**") on August 25, 2016. Advisers with a fiscal year end of December will need to use and comply with the amended Form ADV no later than their annual update in March of 2018.

This article is part two of a series of three articles that discuss the most noteworthy changes to the Form ADV. This article reviews the additional reporting requirements for separately managed accounts ("**SMAs**"). In our August newsletter, we reviewed the incorporation of a method for multiple private fund adviser entities operating a single advisory business to register using a single form ADV ("**Umbrella Registration**"). In our October newsletter, we will discuss the additional disclosure requirements about investment advisers and their business.

Increased Disclosure Related to SMAs

The SEC promulgated the increased reporting requirements for SMAs in Item 5 of the Amended Form ADV (the "**Amendment**") in order to enhance the SEC's risk-based examination program and other risk and monitoring activities. The SEC also believes that the increased disclosure obligations will allow clients and potential clients to make more informed decisions about their selection and retention of advisers, leading to an increased competition amount advisers for clients.

The SEC declined to provide a definition of a "separately managed account", but the Final Rule states that the SEC considers advisory accounts other than those that are pooled investment vehicles (*i.e.*, registered investment companies, business development companies and pooled investment vehicles that are not registered (including, but not limited to, private funds)) to be SMAs.

The Amendment comprises three major disclosures: (1) asset categories; (2) borrowing and derivatives; and (3) custodians.

Asset Categories

The Amendment requires advisers to report the approximate percentage of their SMA assets invested in each of twelve (12) broad asset categories. All assets must be allocated to a category and are not to be double counted. The SEC did not provide a definition or illustration of each category, but instead permits the adviser to use their own reasonable methodologies (developed internally or based on the conventions of their service providers) to select the appropriate reporting category for assets. Advisers must ensure that such methodologies are consistent with those used for the adviser's internal and client reporting. Advisers should not look through to the underlying investments in funds or ETFs.

To minimize the reporting burden placed on small advisers, advisers with less than $10 billion in regulatory assets under management ("**RAUM**") attributable to SMAs ("**SMA RAUM**") will report only year-end percentages, whereas advisers with $10 billion or more will report both mid-year and year-end percentages.

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1 https://www.sec.gov/rules/final/2016/ia-4509.pdf

2(1) exchange-traded equity securities; (2) non-exchange traded equity securities; (3) U.S. government bonds; (4) U.S. state and local bonds; (5) sovereign bonds; (6) corporate bonds – investment grade; (7) corporate bonds – non-investment grade; (8) derivatives; (9) securities issued by registered investment companies and business development companies; (10) securities issued by other pooled investment vehicles; (11) cash and cash equivalents; and (12) "other".

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Borrowing and Derivatives

The Amendment requires advisers with at least $500 million in SMA RAUM to report information, on an aggregate basis, on the use of borrowing and derivatives in individual SMAs with at least $10 million in RAUM..[3]

Advisers between $500 million and $10 billion are required to report the amount of SMA RAUM and the dollar amount of borrowings attributable to those assets that correspond to three levels of gross notional exposures (less than 10%, 10—149% and 150% or more). In addition, advisers with at least $10 billion in SMA RAUM must also report the derivatives exposures across six derivative categories.[4]

The borrowing and derivatives information must be provided on a year-end basis by advisers with less than $10 billion SMA RAUM and a mid-year and year-end basis by advisers with $10 billion or more SMA RAUM.

Custodians

The Amendment requires advisers to identify: (1) any custodians, including their office location, that account for at least 10% of SMA RAUM; and (2) the amount of the adviser's SMA RAUM held at such custodian(s). This information is intended to assist the SEC investigate concerns raised about a particular custodian by allowing the SEC to easily to identify advisers whose clients use the same custodian.

Public Disclosure

Advisers should be aware that, unlike Form PF, which collects similar information in connection with private fund clients, the information related to SMAs provided under the Amendment in Item 5 will be publically available upon filing. The SEC received significant commentary in regards to confidentiality and revised several requirements. In the end, the SEC felt the value of the disclosures outweighed most concerns raised by the commentators and noted: (1) the information to be disclosed is aggregated across all SMA clients; (2) does not require disclosure of specific holdings; and (3) mitigates the risk of revealing proprietary investment strategies as a result of the limited number of data points (1-2 a year).

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[3] Advisers may, but are not required to, report for SMAs with less than $10 million RAUM.

[4] (i) interest rate derivatives, (ii) foreign exchange derivatives, (iii) credit derivatives, (iv) equity derivatives, (v) commodity derivatives, and (vi) other derivatives.

Impact of the New Connecticut Uniform Limited Liability Company Act on Existing Connecticut LLCs

By Robert Cromwell

The new Connecticut Uniform Limited Liability Company Act (the "**New Act**") took effect on July 1, 2017, replacing entirely the old Connecticut Limited Liability Company Act (the "**Old Act**"). What does this mean for limited liability companies formed in Connecticut under the Old Act? In part, this depends on the terms in a Connecticut LLC's existing Articles of Organization and operating agreement.

Like the Old Act, the primary operation of the New Act is to specify terms that govern a Connecticut LLC unless the LLC operating agreement sets out terms that differ from these statutory default terms. When in conflict, the terms set forth in the LLC operating agreement will govern, except for fourteen instances listed in the New Act where the operating agreement cannot override the statute.

In some instances, the New Act takes a different approach from the Old Act. For example, under the Old Act, the statutory default provisions specified that the required vote to admit a new member to the LLC was a majority in interest, while the New Act changes this to a unanimous member vote. Also, under the Old Act, the default provision to amend the operating agreement was two-thirds in interest of the members, while under the New Act, the default provision to amend the operating agreement is a unanimous member vote. (A similar change affects amending the Articles/ Certificate of Organization.) Connecticut LLCs that have detailed operating agreements may have provisions in the operating agreement that specifically address these situations—and so these LLCs are not impacted by the change in law—but a check of the operating agreement is worthwhile. Those with less detailed operating agreements may very well not have provisions addressing these situations, in which case these voting requirements changed when the New Act took effect on July 1, 2017.

The provisions of the New Act related to the duty of loyalty and standard of care are more detailed than the provisions of the Old Act and include flexibility to alter or eliminate the duty of loyalty, and alter the duty of care, provided this is accomplished in a manner that is not manifestly unreasonable. Other fiduciary duties may be eliminated; provided liability for bad faith, willful or intentional misconduct or knowing violation of law cannot be eliminated. The implied contractual obligation of good faith and fair dealing cannot be eliminated, but the operating agreement can prescribe standards by which performance of this obligation will be measured, if not manifestly unreasonable. A comparison of a Connecticut LLC's current operating agreement provisions to the New Act's provisions in this area may be worthwhile. When we recently performed this exercise for a client that was planning to amend its operating agreement, we found certain revisions that were advisable.

Under the Old Act, a Connecticut LLC was required to include in its Articles of Organization both a statement of the LLC's purpose and an indication of whether or not the LLC is manager managed(as opposed to member managed). The fact that these statements are no longer required does not mean the statements should now be removed from a previously filed Articles of Organization; however, a review of the old Articles is quick and easy and may be worthwhile. One of our clients that had chosen an unnecessarily restrictive statement of purpose at time of formation some years ago decided to now remove the restrictive statement from the Articles of Organization. Removal is accomplished by filing an amendment with the Connecticut Secretary of State.

At a high level, Connecticut's adoption of the New Act benefits our clients doing business through Connecticut LLCs, because it is modeled on the Uniform LLC Act, which has been adopted in many states, and which seeks to be flexible and pro-business.

Watch Out for Falling…Fees

By Nicholas Federici

Hedge fund fees are falling. Over the past couple of years some of the largest institutional investors in hedge funds, including a number of public pension funds, have reduced or terminated their hedge fund allocations. Other institutional investors have pressured funds in which they invest to lower their fees or alter their fee structure to better align the interests of the institutional investors and the investment manager. The most notable of these pension funds is the California Employees Public Retirement System or CalPERS.

As a result of this trend and other pressures being exerted by investors, the industry is starting to see an evolution of the relationship between investors and managers as funds begin to adopt new and unique fee structures designed to reward managers for delivering alpha while protecting investors from paying high fees for beta. In a series of future articles we will explore a number of the unique and innovative fee structures which hedge fund managers are increasingly adopting.

One such fee structure previously seen in private equity, but now gaining traction in hedge funds is the "hurdle rate." The concept of a hurdle rate is not new, however it is being increasingly demanded by limited partners as a way of ensuring that they are only paying performance fees for alpha. A hurdle rate is a minimum net return which a hedge fund must achieve before the manager can collect a performance fee. Upon achieving the hurdle rate, depending on the agreed upon arrangement, a manager can either be paid a performance fee based on the fund's total return or on just the portion of the return which exceeds the hurdle rate.

Traditionally a hurdle rate was tied to a fixed percentage return; however recently the hurdle rate is increasingly being tied to a benchmark rate, such as the return of the S&P 500 Index. For example, if the S&P 500 Index has a 5% return for a given accounting period, and a hedge fund returns 8%, then, assuming the fund's investment manager receives a 20% performance fee and the parties have agreed that the performance fee will be paid only on fund's return in excess of the hurdle rate, the manager's 20% performance fee will be calculated based on the 3% of the fund's profits which represent the fund's return in excess of the 5% return of the S&P 500 Index.

The actual benchmark against which a fund's performance is compared often depends on the fund's strategy. While a long-short equity fund might be benchmarked against the S&P 500 Index, a global macro fund may more appropriately be compared to the MSCI World Index.

Other incarnations of the hurdle rate can involve tiers, whereby instead of being paid a straight 20% of the fund's profits, a manager will earn 10% of the profits if the fund achieves a certain benchmark and an additional 10% if a second benchmark is achieved.

While historically hurdle rates have been common in private equity funds, their use by hedge funds has been limited. However, a recent survey by the Alternative Investment Management Association found that as much as 33% of hedge funds include hurdle rates in their fee formulas. As institutional investors continue to pressure managers to reduce fees, the percentage of hedge funds employing hurdle rates is only likely to increase.

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(Why Can't We be Friends?)

Who Are You?

That's the question the Who asked on their mega hit album Who's Next. A great song which is as much about self-realization than it is about discord. In that same vein, recently my father had his genetic code mapped and here's what he found: he's mostly of Italo-Greco ancestry, with a mix of Middle Eastern and Eastern European Jewish ancestry. Since my mother is deceased I can only go on his code; and it would appear that I have every organized religion and region covered but for Asia and the Micronesian Islands. Now I know the reason why I love pasta, gyros, couscous and matzah ball soup—it's in my genes.

Which leads me to my last point on Why Can't We Be Friends…let's celebrate unity. We all have a lot more in common than we think (as evidenced by my father's genetic code). Let's recognize how close we are and stop focusing on what makes us different; as I get older I realize more and more that indeed we are different but we are all the same.

The End of Retail

There is not a retail analyst who hasn't called for the end of retail as we know it; and there is definitely truth in that statement (when was the last time you actually went to a mall or department /electronics store); however, I wonder if people in Memphis said the same things about specialty food shops (*e.g.*, butcher, bakery, fishmonger and dry goods, in addition to a general store, and of course the milkman back in 1916) once they visited Clarence Saunders's Piggly Wiggly stores.

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Fee Compression Leading to Manager Exodus:

Let My Fees Go Free! As discussed elsewhere in this newsletter, fee compression and lower fee expectations are very real. So much so that many managers (especially (previously) successful managers) are choosing to exit the business altogether rather than continue to work for what they deem to be sub-par fees for par performance. In other words, you won't have me to kick around anymore. And who can blame them? Most managers who have been in the game since before 2009 (the meltdown) have done well enough and have the wherewithal to exit the business; for the remainder of managers there seems to be a rotation back into either registered products or separately managed accounts. In any case the future seems to be the past—people are paid on total AUM managed and if there is a performance fee attached you're going to have to beat a benchmark/hurdle and hit that bogie the old fashion way (as Smith Barney commercial would say) earn it.

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What I Learned on Vacation:

San Francisco is an awesome city; really hilly (if you're ever looking for a good leg and cardio work out, consider carrying a seven-year-old (like my daughter, Chloe) on your shoulders up and down those hills. It's also the coldest place I've ever been to in August.

Oakland is the tale of two cities but I'm pulling for the A's and their cement bowl stadium and for all of the people of Oakland—love the grit.

Jacksonville is a nice place and their minor league team the "Jumbo Shrimp" put on a great show! Had a great time sitting next to my son, John, during the end of game fireworks show—best $9 baseball game I've been to since ½ priced bleacher seats in 1995 at the Stadium.

Wrigley is awesome and everything built up around it is great. Chicago remains a favorite place of mine but I didn't venture too far off of the Magnificent Mile—enough said.

Sea World in Orlando was exciting. I learned that my older son, Luke, knows a lot about dolphins (bet you didn't know that dolphins shut off one-half of their brains and keep one eye open when they sleep). I also went on the craziest waterslide of my life (this is not a video shot by me but I found it on YouTube and it is a good depiction of this crazy slide https://www.youtube.com/watch?v=B2hyx95gb84).

Virginia was the absolute worse place to drive through on I-95. If you want to know how it feels to be stuck in apocalyptic zombie traffic drive through the area from a bit before Quantico through Fredericksburg (want to know what apocalyptic zombie traffic looks like: type in your search engine "walking dead traffic jam"—pull up Atlanta skyline picture—my car is three cars behind the bus).

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[2] To read more about Piggly Wiggly visit: https://en.wikipedia.org/wiki/Supermarket