

Let's Be Clear: To Raise Capital, You Need Transparency

November 8, 2017

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Introduction

- It is generally agreed that the first hedge fund was established in 1949 by A.W. Jones. Mr. Jones employed a hedge concept in which he used short selling as a way to protect his portfolio from misjudgments on the general trend of the market. He also leveraged his long positions in order to neutralize general market risks and to tie performance more clearly to his stock selecting ability. The last decade has seen a dramatic change in the investor/manager dynamic.
- In our presentation Today, we will review:
 - Why such clarity is necessary to attract investors
 - What types of information must be disclosed in order to attract and keep those investors

Historical Perspective

The 2008 financial crisis

- caused massive decline in wealth
- resulted in a loss of confidence in the equity and debt/credit markets
- Devastated the hedge fund industry.

The Treasury Department

- called for greater accountability for hedge funds
- pressed fund managers to detail their investment activities

Regulatory authorities followed suit requiring the disclosure of certain information.

Historical Perspective

The push for hedge fund transparency was bolstered by the growing number of institutional or sophisticated investors, which has already resulted in a significant change to how managers report to their investors.

Investors have acknowledged they would reject a fund if it did not meet their compliance (i.e., transparency) demands.

Meaning of Transparency

Due Diligence

Investors have always requested information to conduct initial due diligence-
Now they are demanding delivery of information to conduct ongoing due diligence even after they have invested.

Information usually available to investors:

- offering documents pertaining to investment strategy and liquidity
- performance data
- model specifics
- valuation fees
- expense allocation
- annual -reports

Investors are pushing for more detailed information with respect to these areas as well as with respect to operational controls and compliance management

Meaning of Transparency

Investment Strategy

Strategy shifts or style drift, can occur for many reasons and to varying degrees of materiality.

- to limit losses and protect against a market that is going in a different direction.
- to take advantage of a market opportunity in order to meet the expected returns.

Certain strategies may lend themselves to a greater likelihood of style drift, for example, a strategy focused on small-cap investments will drift as market capitalization changes.

Meaning of Transparency

Liquidity

As a result of managers being unable to sell illiquid investments during the meltdown, investors are requiring fund strategies contain some liquidity.

Investors want terms of liquidity to be consistent with the liquidity of the fund's underlying assets.

Less liquid assets should allow for less frequent withdrawals:

- distressed debt
- real estate
- private equity/venture capital

More liquid assets should allow for more frequent withdrawal:

- Stocks
- Futures
- Options

Investors want frequent reporting.

Meaning of Transparency

Performance Data

- Primary criterion for selecting a manager according to most investors
- Managers have a legal obligation to provide accurate performance data and to disclose any information that would have a material impact on the data

Relevant information:

- whether the data has been ported from a prior firm (which requires the prior firm's permission)
- if the manager responsible for the track record will have a continuing role in managing the product offered
- if product being offered is similar to the product in the track record
- use of proxy performance, and any other material differences in the products

Validation by third party auditor is best practices.

Meaning of Transparency

Model Specifics; Research

- Investors are scrutinizing the methods by which a manager develops and executes ideas
- Currently there is pressure to abandon the “black-box” model
- Managers should be able to pull specific research or a forensic link as to why every position is in a portfolio and when it was acquired.

Meaning of Transparency

Model Specifics; Research

- Quantitative, fundamental strategies are more naturally transparent
- Algorithm-reliant high-frequency trading strategies are more complicated and proprietary

Investors will be more willing to withstand the ups and downs of volatile returns provided the manager's performance is explainable and consistent with the range of reasonable return expectations.

Meaning of Transparency

Valuation

NAV calculations described in a fund's offering material been in such offering material are too generic.

Even where offering materials contain specific valuation methods and pricing models, there is inconsistency in their application among managers.

By their very nature, proprietary models will differ from one fund to another

There are currently three basic pricing methodologies:

- mark-to-market
- mark-to-broker
- mark-to-model

Meaning of Transparency

Valuation

Inconsistencies exist within each methodology; however, the model-based pricing is most problematic.

Model-based pricing is most typically used to value illiquid or OTC instruments that are not exchange-traded and therefore do not have a reported market price.

The risks of inaccurately or inconsistently pricing securities may impact a manager's ability to measure a fund's exposure as well as its historical performance

Documenting formal pricing and performance reporting policies and strictly adhering to such policies is critical.

Meaning of Transparency

Fees and Expense Allocation

The average management fee for new funds launched in 2015 has dropped to between 1.5% and 1.8%.

- Concept of sliding scale management fees (reduction of fees once the AUM of the fund reaches a certain size) gaining popularity

Although 20% performance fee still is industry norm, managers are making more accommodations with respect to certain investors that ultimately result in the reduction of fees.

Meaning of Transparency

Fees and Expense Allocation

Large or seed investors offered performance fee breaks and other more favorable terms in “side letters”. Alternatively, more favorable terms may spelled out in the RFP process with institutional investors.

Less liquid fund managers also use:

- multi-year performance periods
- claw backs
- fees paid on realized appreciation

Managers trying to recoup fee decrease by passing expenses to the fund

Meaning of Transparency

Reporting

Investors now expect more frequent and more granular reporting

Prime brokers should consolidate reporting if there are multiple brokers executing trades.

Investors want to see independent service providers and specialist firms with good market reputations.

Managers should be transparent regarding the identity of such service providers.

Meaning of Transparency

Operational Controls

Non-investment risk: investors want to know that a manager has an operational infrastructure sufficient to protect shareholder assets.

Areas of interest to investors include

- level of experience of the personnel
- existence of internal controls
- methods for selecting and supervising service providers
- cash controls
- quality and security of the information technology used

A substantial amount of hedge fund failures is caused by operational issues alone. Fraud has been a prevalent factor in such failures.

Meaning of Transparency

Operational Controls

Investors want information regarding managers' internal operations, including:

- Conflicts of interest
- Data security systems
- Anti-money laundering policies
- Reporting
- Auditing/surveillance efforts

Meaning of Transparency

Complying with Regulations

Registration with the SEC (for managers with greater than \$150mm in AUM) benefits managers by raising their credibility.

The SEC has been coming down hard on big hedge funds primarily for insider trading.

- In March 2013, SAC Capital run by star manager Stephen A. Cohen agreed to pay a \$616 million civil penalty for not enforcing rules that would prevent insider trading at the firm. Cohen was charged by the SEC in July with failing to supervise SAC employees accused of insider trading.
- The SEC conducted a parallel civil case in coordination with federal prosecutors against Raj Rajaratnam, reaching a \$92 million settlement with the former head of Galleon Group. Rajaratnam was convicted in the criminal case and sentenced to 11 years in prison.

Meaning of Transparency

Complying with Regulations

Other areas of interest to SEC examiners include

- false advertising
- performance claims
- custody
- calculation of fees
- financial controls
- overvaluing assets to charge excessive fees
- favoring some investors over others and using private funds for the benefit of fund employees
- cybersecurity

Meaning of Transparency

Complying with Regulations

Investors want to see:

- Formal, updated and comprehensive Compliance Manual
- Dedicated and qualified Chief Compliance Officer (and/or a reputable third-party compliance consultant)
- Strong and adequate policies and procedures that address key compliance topics
- Compliance testing frequency and results
- Current regulatory registrations for the firm and the fund
- Information regarding past examinations/communications by a regulator.

Meaning of Transparency

Challenges of Transparency

Managers need to find balance where investors and regulators get the information they need while managers are able to retain the control of their systems and methods.

Managers need an infrastructure to develop and report more data and analytics as well as to maintain implemented compliance measures and internal operational controls.

Burden will be on smaller funds, as they have had to engage experts, third party service providers, additional employees and technology tools order to meet these needs.

Additional expenses could mean an increase in fees. Are clients willing to pay an estimated 1-3% basis point increase in management fees in exchange for more transparency?

Conclusion

Despite these concerns around increased cost and complexity due to investor demand and regulations, hedge fund manager transparency has become a prerequisite for building trust.

A high level of transparency is also becoming of almost equal importance as positive returns when assessing whether to invest in a particular hedge fund.