Operational Due Diligence Overview

November 2018
DISCLAIMERS

PRIVATE AND CONFIDENTIAL: This presentation is strictly confidential and/or legally privileged. These materials are intended only for the use of the individual or entity to which Aksia LLC (“Aksia”) has provided these materials (“Intended Recipient”), per the Intended Recipient’s request, and may not be reproduced or distributed, transmitted to third parties, or posted electronically without the prior written consent of Aksia. If you are not the Intended Recipient you are hereby requested to notify Aksia and either destroy or return these documents to Aksia. The Intended Recipient shall not use Aksia’s name or logo or explicitly reference Aksia’s research and/or advisory services in any of the Intended Recipient’s marketing materials.

NO OFFERING: These materials do not in any way constitute an offer or a solicitation of an offer to buy or sell funds, private investments or other securities mentioned herein. These materials are provided for educational purposes only. These materials shall not constitute advice or an obligation to provide services.

NOT TAX, LEGAL OR REGULATORY ADVICE: The Intended Recipient is responsible for performing his, her or its own reviews of any private investment fund it may invest in including, but not limited to, a thorough review and understanding of each fund’s offering materials. The Intended Recipient is advised to consult his, her or its tax, legal and compliance professionals to assist in such reviews. Aksia does not provide tax advice or advice concerning the tax treatments of a private investment fund’s holdings of assets or an investor’s allocations to such private investment fund.

PRIVATE INVESTMENT FUND DISCLOSURE: Investments in private investment funds involve a high degree of risk and investors could lose all or substantially all of their investment. Any person or institution investing in private investment funds must fully understand and be willing to assume the risks involved. Some private investment funds may not be suitable for all investors. Private investment funds may use leverage, hold illiquid positions, suspend redemptions indefinitely, modify investment strategy and documentation without notice, short sell securities, incur high fees and contain conflicts of interests. Private investment funds may also have limited operating history, lack transparency, manage concentrated portfolios, exhibit high volatility, depend on a concentrated group or individual for investment management or portfolio management and lack any regulatory oversight. Past performance is not indicative of future results.

RECOMMENDATIONS: Any Aksia recommendation or opinion contained in these materials is a statement of opinion provided in good faith by Aksia and based upon information which Aksia reasonably believes to be true. Recommendations or opinions expressed in these materials reflect Aksia's judgment as of the date shown, and are subject to change without notice. Except as otherwise agreed between Aksia and the Intended Recipient, Aksia is under no future obligation to review, revise or update its recommendations or opinions.

INFORMATIONAL PURPOSE: This presentation is provided for informational purposes only and is designed to assist the Intended Recipient in understanding aspects of Aksia’s operational due diligence process. Aksia may continue to develop, modify, and/or change its operational due diligence process and Aksia does not commit to any particular report format or content. This presentation represents only a portion of the information investors should use in fully assessing their investments or potential investments.
OVERVIEW – PURPOSE AND APPROACH
**PURPOSE OF OPERATIONAL DUE DILIGENCE**

Operational due diligence (“ODD”) aims to detect operational risks, including:

- **Fraudulent Activity** – are certain indicators present? It can be very difficult to identify fraud; however, red flags like non-market-standard practices or a manager’s refusal to answer standard questions could indicate fraudulent activity.

- **Business Risk** – is the business set up in a way where non-investment risks can cause a drawdown? Such risks may include unqualified personnel, poor operational infrastructure, unqualified services providers, valuation risks, improper systems, poor cash management, weak disaster recovery and inadequate compliance processes.

- **Conflicts of Interest** – besides the standard management and performance fee, how else is the manager making money through clients’ investments in the fund?
BACKGROUND – SOME FAMOUS FRAUDS

HISTORY REPEATS ITSELF – HOW WERE THESE FRAUDS MADE POSSIBLE?

Bayou Fund (2005) – failed because of fraudulent behavior of the two principals. Investors may have been spared if early warning signs had been heeded. Early warning signs included:

- Background checks on the founders could have revealed relevant information
- No independent auditor
- Lavish lifestyles and excessive fund expenses
- Having an affiliated broker-dealer

Petters (2008) – failed because of fraud – Ponzi scheme. Early warning signs included:

- Background checks on the founders could have revealed relevant information – Petters cheque fraud
- Failure to research underlying investments
- Returns too good to be true and high Sharpe ratio

Madoff (2008) – failed because of fraud – Ponzi scheme. Early warning signs included:

- No independent auditor
- An atypical fee arrangement
- Secrecy
- Illogical 13F filings
OPERATIONAL DUE DILIGENCE VETO

AN ODD TEAM IS ONLY AS STRONG AS IT IS INDEPENDENT

Allowing the ODD team to veto a manager approval is important because:

- Investment analysts may:
  - Want to invest in a friend’s fund
  - Like the manager/strategy
  - Be biased by past performance
  - Not understand the importance of business risks

- It balances the risk of missing out on potential performance against the possibility of losing everything

- Can mitigate headline risk
RED FLAGS

IS IT WORTH TAKING THE RISK?

Some of Aksia’s red flags:

- Responses that seem intentionally vague
- Lies or omissions of material information
- Unknown service providers
- Non-independent administrator
- Expense trends – who is the manager working for?
- Regulatory sanctions/breaches
- Unwillingness to sign a background check release form
- Incompetent key personnel who don’t seem to understand their business risks
- Overly involved PM – may compromise independence of back-office

Not all of these are enough to stop an investment but they certainly require more analysis … only one is enough to stop an investment immediately: lies or deceitful omissions. Why? Because then you can’t trust anything they say.
OPERATIONAL DUE DILIGENCE BEST PRACTICES

Best practices for conducting ODD:

- Onsite visit with key non-investment personnel; include more than one Aksia analyst in the meeting
- Independent call with key service providers
- Due diligence on unknown service providers
- Independent background check on key investment personnel
- Detailed review of fund documentation: PPM, Audited Financial Statements, ADV and other Regulatory Filings
OVERVIEW – OPERATIONAL DUE DILIGENCE PROCESS
INDEPENDENTLY CONFIRMING THE NON-INDEPENDENT

TRUE VALUE LIES IN INDEPENDENTLY CONFIRMING NON-INDEPENDENT SOURCES OF INFORMATION

Non-Independent Sources - onsite meeting with management

- Usually 2-5 hours long depending on complexity
- Typically meet with a combination of the following: COO, CFO, Head of Operations, Head of Fund Accounting, Chief Technology Officer, Chief Compliance Officer, General Counsel
- Cover business topics:
  - Operations and infrastructure
  - Regulatory and compliance

Independent Sources - analysis conducted outside of the meeting (the majority of the time and work)

- Review documentation
  - LPA / PPM
  - Financial statements
  - ADV
- Call service providers
- Confirm regulatory registrations and disciplinary history
- Initiate background investigation
NON-INDEPENDENT SOURCES – THE ONSITE MEETING

Operations & Infrastructure
- Management Company Overview
- AUM & Investment Programs
- Non-Investment Personnel & Staffing
- Service Providers – overview of and changes in:
  - Administrator
  - Trading Counterparties & Custodian
  - Auditor
  - Legal Counsel
- Pricing Policy & Procedures
- Systems & Technology / Trade Flow
- Cash Management
- Disaster Recovery & Data Security

Regulatory & Compliance
- Regulatory Registrations, Regulatory Visits
- Compliance Staffing
- In-house Compliance Procedures
- Affiliated Entities & Conflicts of Interest
- Lawsuits & Investigations
INDEPENDENT SOURCES

Regulatory Registrations / ADV Review
- Regulatory Registrations
- ADV Review for SEC-Registered Managers

Background Investigation
- Conducted Every 2-3 Years on Key Personnel
- Covers Education & Employment History, Media Checks, Court Checks, & Directorships

PPM and LPA Review
- Covers Capital Management Controls & Procedures, Fees & Expenses, Conflicts of Interest, and Investor Protections
- Key items of interest:
  o Terms that are not market standard
  o Potentially unfavourable terms
  o Ambiguous terms (or drafting errors) requiring clarification from the investment manager and improvement or correction by the fund’s lawyers
  o Omission of key terms
  o Consistency of terms across share classes

Financial Statements Review
- Balance Sheet & Income Statement
- Net Capital
- Schedule of Investments & ASC 820 Classification
- Footnotes

Administrator Call
- Verification of manager-supplied information
CONCLUSION

Operational due diligence is a time-consuming, detailed, and multi-faceted analysis that, if performed skillfully, can result in a sound understanding of the operational risks associated with a particular fund investment and thereby better inform a decision to invest in such fund.
Creating a Culture of Compliance

by Michael C. Neus

Many constituents have a vested interest in determining a firm’s culture of compliance: regulators, investors, prospective employees, among others. Investment advisers registered with the Securities and Exchange Commission must demonstrate their compliance culture during periodic examinations by the Office of Compliance, Inspection and Examinations. Current and former SEC examination staff often state that the primary indicator of a healthy compliance culture is the “tone from the top.” There are a number of steps that a firm can take to demonstrate that top management fosters an effective compliance culture.

Continue reading →

This entry was posted in Compliance, Corporate Compliance, Deterrence, Financial Institutions, Governance, Hedge Funds, Securities and Exchange Commission (SEC) and tagged Michael C. Neus on January 16, 2018 [https://wp.nyu.edu/compliance_enforcement/2018/01/16/creating-a-culture-of-compliance/] by Michelle Louise Austin.

Roadmap to an Effective Annual Review

by Michael C. Neus

As the year ends, SEC registered investment advisers to private funds start considering how to assess their firm’s compliance culture. The Advisers Act of 1940 requires a formal annual review of the adequacy of “written policies and procedures reasonably designed to prevent violation of securities laws.”[1] In other words, every year Chief Compliance Officers ask themselves how they can actually demonstrate their effectiveness.
Rather than viewing this process as a comprehensive narrative report identifying all deficiencies, perhaps a more useful construct is to think of the annual review as a way of collating and assessing activity throughout the year. Paradoxically, assembling information used throughout the year makes the process easier than attempting a comprehensive one-shot evaluation. Effective annual reviews are more like a movie than a photograph. Continue reading →

Mitigating Legal and Regulatory Risks in Winding Down Funds

by Michael C. Neus

A fund manager typically spends most of its time not only contemplating how to maximize returns for investors, but also navigating the array of compliance and regulatory concerns involved in running a private fund. Because the manager is so caught up in thinking about these daily considerations, it may lose sight of the multitude of issues that arise when it comes time to wind down that same fund. If the manager exercises some foresight regarding the fund's eventual wind-down and puts proper procedures in place, however, the whole process can be both smoother and less fraught with legal and regulatory risks. Once a manager decides to wind down a fund, it must navigate myriad considerations and decisions during the process. Continue reading →

Proactive Insider Trading Compliance Procedures After Salman

by Michael C. Neus
In light of the recent unanimous Supreme Court decision in *Salman v. United States* (PDF: 101 KB), savvy investors can assume that the Securities and Exchange Commission, as well as the Department of Justice, will continue to seek out cases of insider trading. Much has been written about whether or not *Salman* dramatically changed the jurisprudence existing prior to the Second Circuit's opinion in *United States v. Newman*. Whether or not the landscape has changed in the wake of the *Salman* decision, how can in-house counsel and compliance officers manage and avoid potential insider trading issues? Continue reading →

Creating a Culture of Compliance

by Michael C. Neus

Many constituents have a vested interest in determining a firm’s culture of compliance: regulators, investors, prospective employees, among others. Investment advisers registered with the Securities and Exchange Commission must demonstrate their compliance culture during periodic examinations by the Office of Compliance, Inspection and Examinations. Current and former SEC examination staff often state that the primary indicator of a healthy compliance culture is the “tone from the top.” There are a number of steps that a firm can take to demonstrate that top management fosters an effective compliance culture.

1. **Unitary Policies and Procedures.** Healthy firms have rules that apply to all employees, regardless of seniority. The Chief Compliance Officer should be able to demonstrate that senior management is subject to all the same company rules. For example, if a firm requires preapproval of employees’ securities trades, the CCO should maintain a list of trades of each senior manager with the appropriate preapproval form authorizing the trade.

2. **Penalties and Recidivism.** Compliance policies and procedures need to have teeth in order to be effective. Compliance violations should carry consequences. When violations have no effect, employees will violate policies if they view violations to be in their interest. Penalties should escalate for the seriousness of the violation, as well as for repeated violators. For example, a warning may be the appropriate penalty the first time an employee fails to preapprove a trade if it is an inadvertent oversight. However, if an employee deliberately front-runs his own portfolio, or habitually fails to seek preapproval, the penalty should be more severe, such as a monetary fine or even termination.

3. **Hiring Practices.** Recruiters and hiring managers should overtly understand that personal integrity is a key attribute for any successful recruit. Potential employees should be asked hypothetical compliance questions to gauge their ethical compass. All employees should undergo background checks, including internet searches to determine unusual patterns of behavior. Personal reference checks should seek to evince the applicant’s attitudes toward compliance policies as well as core competency and cultural fit.
4. **Training.** Employee training should be effective and frequent—not rote and unimportant. New employees should have a compliance training session on their first day. That ensures that no employees can say that they didn't know the rules, didn't think the firm cares about its policies and procedures, or didn't know whom to ask about how compliance rules apply in specific situations. Training should be tailored to the specific risks identified by the compliance department—for instance a firm specializing in fundamental securities research target training on avoiding insider trading. Employees should see that senior managers are subject to the same training policies. Failure to take compliance training seriously should have consequences.

5. **Incentives.** People tend to do what they are incented to do. Corporate culture must incentivize compliance with firm policies. For instance, employees should be penalized for failing to seek guidance from the compliance department over a questionable tip, rather than penalized for getting the firm restricted in a security. Annual and semi-annual employee evaluations should give a rating on employee cooperation with the compliance department. And that rating should actually matter when considering bonuses and promotions of employees.

6. **Resolving Conflicts of Interest.** In every firm, there will be conflicts of interest: Conflicts between laws and rules of different jurisdictions (GAAP vs. Investment Advisers Act). Conflicts of principles (duty to disclose vs. fiduciary duty to protect clients' interests). Conflicts among clients (trade allocation decisions). Often there are conflicts where there are no clearly good answers. Sometimes it is a question of which is the least bad outcome. The Chief Compliance Officer should document the thought process and legal advice received when resolving the most vexing conflicts.

7. **Aligning Interests.** If senior management truly want a culture of high integrity, they have to “walk the walk" as well as “talking the talk.” When employees are singled out positively for contributing to a compliant culture other employees notice. Similarly when firms promote and reward highly productive employees well known for ethical lapses, other employees instinctively understand what management truly values. There is no short-cut to creating a culture of compliance. The tone from the top, is exactly that. What do top management truly value, and how do they communicate those values to the rank-and-file.

---

**Michael C. Neus** is a Senior Fellow with the Program on Corporate Compliance and Enforcement at New York University School of Law. He is the General Counsel of ExodusPoint Capital Management, LP. In addition, Mike teaches a course entitled “Investment Management Regulation and Compliance” at Fordham Law School.
Disclaimer

The views, opinions and positions expressed within all posts are those of the author alone and do not represent those of the Program on Corporate Compliance and Enforcement or of New York University School of Law. The accuracy, completeness and validity of any statements made within this article are not guaranteed. We accept no liability for any errors, omissions or representations. The copyright of this content belongs to the author and any liability with regards to infringement of intellectual property rights remains with them.

Share this post:

This entry was posted in Compliance, Corporate Compliance, Deterrence, Financial Institutions, Governance, Hedge Funds, Securities and Exchange Commission (SEC) and tagged Michael C. Neus on January 16, 2018 [https://wp.nyu.edu/compliance_enforcement/2018/01/16/creating-a-culture-of-compliance/] by Michelle Louise Austin.
Mitigating Legal and Regulatory Risks in Winding Down Funds

by Michael C. Neus

A fund manager typically spends most of its time not only contemplating how to maximize returns for investors, but also navigating the array of compliance and regulatory concerns involved in running a private fund. Because the manager is so caught up in thinking about these daily considerations, it may lose sight of the multitude of issues that arise when it comes time to wind down that same fund. If the manager exercises some foresight regarding the fund’s eventual wind-down and puts proper procedures in place, however, the whole process can be both smoother and less fraught with legal and regulatory risks. Once a manager decides to wind down a fund, it must navigate myriad considerations and decisions during the process. The manager needs to disclose the wind-down to investors at the outset without triggering liabilities to service providers or diminishing asset values, and the fund needs to retain appropriate personnel and working capital to perform a wind-down that could take months or even years to complete.

The biggest pitfalls in closing a fund include:

1. Be aware that the wind-down will be played out publicly, and try to anticipate the reaction of the public, press and investors as much as possible when planning the wind-down.
2. Make sure you have continuity of employees who will manage the process and who can address the essential elements that are required.
3. Remember that during the wind-down process, you are still a registered investment adviser with specifically enumerated obligations to the fund.
4. Err on the side of providing more disclosure to investors about what you’re doing and why, because that will help reduce friction as the process unfolds over time.

To address these and other issues that arise when winding down a fund, I was recently interviewed by The Hedge Fund Law Report. The first article in a two-part series presents thoughts on the factors leading to the decision to wind down a fund, which personnel should lead that process and
how it should be disclosed to investors and service providers. Winding Down Funds: How Managers Make the Decision and Communicate It to Investors and Service Providers (Part One of Two) The second article explores what types of fees and expenses investors should be charged during the wind-down, as well as how managers can maximize the value of illiquid assets during a liquidation. Considerations When Winding Down Funds: Navigating Illiquid Assets, Unanticipated Windfalls and Fees and Expenses During Liquidation (Part Two of Two).

Michael C. Neus is a Senior Fellow in Residence with the Program on Corporate Compliance and Enforcement at New York University School of Law and former Managing Partner and General Counsel of Perry Capital, LLC.

Disclaimer

The views, opinions and positions expressed within all posts are those of the author alone and do not represent those of the Program on Corporate Compliance and Enforcement or of New York University School of Law. The accuracy, completeness and validity of any statements made within this article are not guaranteed. We accept no liability for any errors, omissions or representations. The copyright of this content belongs to the author and any liability with regards to infringement of intellectual property rights remains with them.

Share this post:

Proactive Insider Trading Compliance Procedures After Salman

by Michael C. Neus

In light of the recent unanimous Supreme Court decision in *Salman v. United States (PDF: 101 KB)*, savvy investors can assume that the Securities and Exchange Commission, as well as the Department of Justice, will continue to seek out cases of insider trading. Much has been written about whether or not *Salman* dramatically changed the jurisprudence existing prior to the Second Circuit's opinion in *United States v. Newman*. Whether or not the landscape has changed in the wake of the *Salman* decision, how can in-house counsel and compliance officers manage and avoid potential insider trading issues?

When defending an insider trading allegation, one would use every opportunity to demonstrate that the trader was not aware of a personal benefit, that the personal benefit was not sufficient to impose liability, and any manner of additional defenses. By definition, investment advisors engage in fundamental research in order to discover factual information that is unknown to the market. Indeed, such investors have a fiduciary duty to profitably (and legally) trade for their clients. Notwithstanding this obligation to conduct in-depth securities research, no self-respecting trader would willingly court an SEC, or worse yet a DOJ, investigation into whether their research pushed them over the edge into illegal behavior. When counselling traders on avoiding insider trading investigations, it is best to establish clear, easily understood, bright line rules of engagement. To that end, every investment advisor utilizing fundamental research should have an effective insider trading compliance regime comprising a three phase approach: training, procedural safeguards, and post-trade analytics.

**TRAINING.**

The vast majority of traders want to stay on the right side of the law, but training is essential as insider trading prohibitions can appear counter-intuitive. On the first day on the job, every investment advisory employee should sit through a formal training session which clearly identifies
the firm’s insider trading procedures. By scheduling a training session on the first day, it conveys the firm’s priorities, prohibits employees from claiming that they didn’t know the rules, and permits the firm to counteract any “bad habits” from previous employers. The firm should make clear that if there is any question about whether some particular information could lead to a trading restriction, each employee has an obligation to consult with the legal/compliance department. Since insider trading is essentially a fraud-based prohibition, consultation with in-house counsel significantly minimizes an insider trading claim; conversely, failing to consult could imply an intent to deceive. The firm should periodically reinforce this message, for example, whenever a significant insider trading case is in the news. At least annually, all investment professionals should be retrained in a dedicated session, potentially with outside counsel, former prosecutors, or others who can captivate employees with real “war stories.” All employees should manually sign an annual confirmation that they have attended the training session.

**PROCEDURES.**

Investment advisors must have compliance procedures tailored to the risks inherent in their individual business. Having off the shelf procedures purchased from a consultant or downloaded from a law firm’s precedent library are unlikely to provide any real protection. There is no “one size fits all” protection—a firm with one decision maker who executes his own trades will require significantly different procedures than a multi-billion-dollar firm with dozens of individual portfolio managers each of whom have investment discretion. Some of the procedures that investment advisors should consider include:

1) maintaining a restricted list of securities that only a compliance officer can add to or remove;

2) authorizing only a compliance officer to execute confidentiality or consulting agreements that may result in material, non-public information;

3) creating a blocked security list in the firm’s order management system which only a compliance officer can lift;

4) ensuring that research vendors represent and warrant that they will not provide material, non-public information to the firm’s analysts without pre-approval from a compliance officer first;

5) requiring every research vendor invoice to be approved by a compliance officer before payment;
6) prior to higher risk conversations, requiring analysts to read a disclaimer that the analyst does not want to receive material, non-public information;

7) counselling analysts to keep detailed notes and documents validating the mosaic theory of individual investment theses; and

8) given the increased risk of obtaining impermissible material, non-public information from the use of expert networks, investment advisors should have additional procedures which may include:
   i. all consultants must be pre-screened;
   ii. employees are not permitted to speak with consultants who anytime in the previous six months have been an employee, director or consultant for a public company;
   iii. consultant must prove that their employers have approved their participation in a paid expert network program;
   iv. a compliance officer may periodically chaperone calls unannounced;
   v. all expert network consultations must be scheduled through a compliance officer, or in accordance with a protocol approved by a compliance officer; and
   vi. after five consultations with the same consultant within 12 months, any additional consultation must be pre-approved by a compliance officer and the reasons for approval noted.

POST-TRADE ANALYTICS.

Every investment advisor should analyze whether insider trading procedures are effective. For example, daily tests could include reviewing trading records against the firm’s restricted list, expert network consultations, and same day/same way or same day/opposite way trades. Monthly tests should include a list of the firm’s most profitable trades analyzed in light of market-moving public reports, communication with expert network consultants, contact with “value-added investors” such as firm investors who work for public companies, and other high risk information sources.

CONCLUSION.

An efficient marketplace is a laudable public policy goal. An issuer should not be the sole determinant of its stock price—in the extreme, no one wants a Bernie Ebbers to determine the price of a Worldcom until it implodes. Without rigorous fundamental research, security prices would be more volatile, exacerbating the boom/bust cycle. Investment advisors conducting fundamental
research have a fiduciary obligation to utilize the most effective research tools. Banning expert networks, for example because they require more oversight by the legal/compliance department, could well be viewed as an abrogation of the advisor's fiduciary duty. However, given regulatory focus on insider trading, it is imperative that advisors have a well-thought out regime to prevent unlawful trading.

**Michael C. Neus** is a frequent lecturer on securities, compliance, hedge fund and private equity topics at industry events and for global regulators. Until recently, Mike was responsible for all legal, compliance, human resource and administrative matters as Managing Partner and General Counsel of Perry Capital, LLC. Prior to joining Perry Capital in 2005, Mike was the Chief Operating Officer and General Counsel at RHG Capital, L.P., Chief General Counsel at Andor Capital Management, L.L.C., and General Counsel of Soros Private Funds Management LLC. Mike began his professional career as an associate at the law firm Coudert Brothers, in both the Singapore and New York offices. Mike is a Senior Fellow of the Regulatory Compliance Association, and was formerly a director, chairman of the Investment Advisory Subcommittee, and member of the Executive Committee of the Managed Funds Association. Mike received his J.D. from Columbia University School of Law, where he was a Harlan Fiske Stone Scholar, and his B.A. cum laude from the University of Notre Dame.

**Disclaimer**

The views, opinions and positions expressed within all posts are those of the author alone and do not represent those of the Program on Corporate Compliance and Enforcement or of New York University School of Law. The accuracy, completeness and validity of any statements made within this article are not guaranteed. We accept no liability for any errors, omissions or representations. The copyright of this content belongs to the author and any liability with regards to infringement of intellectual property rights remains with them.

---

Mike Neus, Managing Partner and General Counsel of Perry Capital, Discusses Practical Solutions to Some of the Harder Fiduciary Duty and Other Legal Questions Raised by Side Letters

By Jennifer Banzaca

At their core, side letters are about defining specific rights and obligations with respect to a specific investment. Accordingly, the legal and practical issues raised by side letters, and best practices for addressing those issues, are often context-specific. This theme of specificity – the idea that effective solutions must be narrowly tailored to specific problems where side letters are concerned – was a leitmotif in our recent conversation with Michael Neus, Managing Partner and General Counsel of Perry Capital LLC. We posed some of the harder questions generally raised by side letters to Neus, and his answers – transcribed in this article – were typically nuanced, insightful and informed by current market practice. In particular, we covered trends in the use of and rights granted in side letters; the advisability of and approach to selective disclosure; concerns related to modification of fund redemption terms through side letters; the impact of different regulatory regimes on side letter drafting; strategies for drafting effective most favored nation (MFN) provisions; strategies for gracefully declining side letter requests; the approach to using single-investor funds and managed accounts to address side letter requests; strategies for monitoring obligations in side letters; the proper party for executing side letters; and trends in negotiating capacity rights. See also "Proskauer Partner Christopher Wells Discusses Challenges and Concerns in Negotiating and Administering Side Letters," The Hedge Fund Law Report, Vol. 6, No. 5 (Feb. 1, 2013).

Our interview with Neus was conducted in connection with the Regulatory Compliance Association’s upcoming Regulation, Operations & Compliance 2013 Symposium, to be held at the Pierre Hotel in New York City on April 18, 2013. That Symposium is scheduled to include a panel on side letters entitled "Navigating the Side Letter Negotiation & Due Diligence Process." For a fuller description of the Symposium, click here. To register for the Symposium, click here. Subscribers to The Hedge Fund Law Report are eligible for a registration discount.

HFLR: What trends are you seeing in regard to the use of side letters in the
hedge fund industry?

Neus: Side letters have always been a part of the industry. Historically, they were more prevalent in private equity, but as institutional investors have invested more in hedge funds, they have brought their desire to have side letters into the hedge fund area. In the hedge fund area, there are additional challenges, some of which are not applicable in the private equity area because of the open-ended nature of a hedge fund. So, I would say the longer-term trend is for more institutional investors to request more detailed side letters than in the past.

HFLR: What are some of the more noteworthy rights that significant investors are requesting in side letters, in particular with respect to transparency and liquidity?

Neus: I think investors tend to ask for transparency, liquidity and reduced fees through side letters, but there is enormous variation in rights requested depending upon the size and longevity of the hedge fund and the relative bargaining power with the investor. For example, it is more prevalent for start-up managers launching new funds to grant more extensive rights through side letters than it is for well-established hedge fund managers. I do not think you can say that there is a typical issue or set of issues that arise. It is more that the entire range has elongated in terms of what is asked for and what is ultimately given.

HFLR: If a hedge fund manager agrees by side letter to provide material information to a significant investor – for example, information regarding material litigation, a change in control of the manager, a default under a prime brokerage agreement, etc. – is not the undertaking in that side letter redundant of the manager’s obligation to disclose material information to all fund investors?

Neus: I think the best practice is to provide material information to all investors. If you grant transparency obligations that can back into a preferential liquidity benefit to certain investors, I think there is a fiduciary duty concern. Let’s say you have a fund with quarterly liquidity: if you provide preferential information about negative issues in the fund to certain investors in advance of a notice period for liquidity, then you run the risk of not having satisfied a fiduciary duty to other similarly situated investors. If, in a side letter, you give transparency, I think the best market practice is to provide either a fiduciary out or to simply provide the same material information to all similarly situated investors. Committing in advance to provide certain information to a single investor without contemplating how, at the time the information is provided, could prejudice other investors and may give rise to liability concerns for the manager.

HFLR: Can a manager, consistent with its fiduciary duty, agree to provide
material information to certain investors before it provides the same information to other investors – and does the answer depend on whether the first recipients of that information have privileged liquidity rights?

Neus: There are actually two questions here. The first one is whether a manager can provide transparency on certain issues. The answer is yes, as long as you deal with the issue of fiduciary duty and favored treatment.

The second question is whether you can commit to provide greater transparency to an investor through a side letter prior to providing it to other investors. I do not think that is wise as a general matter. However, if you sufficiently disclose your practices, you can do a lot of things as long as your other investors know that you have undertaken these obligations. I think that, in practice, it is difficult to provide specificity with respect to what side letter obligations you have incurred in sufficient detail to use effective disclosure as a defense to preferential treatment claims. It is fraught with peril on both sides.

HFLR: Is there language that a manager can include in a fund PPM that would expand the manager’s ability to grant privileged transparency rights to certain investors but not others, or is a manager’s disclosure obligation governed by fiduciary duty principles rather than by contract?

Neus: Conceptually yes. In any given situation the proof is always in the actual language. You have to be pretty comfortable that if you were on the other side, you would not be claiming unfair advantage. The analysis is always fact specific. In general, it is preferable to try to create a mechanism that enables you to meet investor needs and desires without implicating the manager’s obligation to the fund as a whole or to other investors. For instance, some investors want position-level information which can be problematic for a manager. An alternative to side letter transparency may be the use of an aggregator to whom you can provide the fund’s portfolio. The aggregator then combines the fund’s portfolio with two or three other portfolios of other managers with whom that investor has invested and then provides a composite portfolio to the investor without identifying which positions are in which investee fund. In that way, you may satisfy some of the needs of that investor so that, on an aggregated basis, they can run their own risk reports while still protecting the funds’ confidential information and trading records. As long as you would be willing to provide the information to aggregators of all investors on a similar basis, you avoid a claim of favorable treatment while solving your investor’s concern. So I would think the better way is to find a creative way to meet the need of the investor while not subjecting the manager or the fund to a claim of preferential treatment.

HFLR: If a hedge fund manager agrees via side letter to provide a significant investor with information regarding adverse regulatory actions or the departure
of a key employee – and the manager has not agreed to provide such
information to other investors – would performance under that side letter
constitute the sort of “selective disclosure” that gives the SEC pause?

Neus: I think the key issue relates to the actual provision of that information rather than
the inclusion of the obligation in a side letter. For example, if you agree with a certain
investor that you will give them notice of a key departure within X number of days, and a
key departure occurs, provided you actually give that same information to all other
investors at substantially the same time, I am not sure that having a side letter obligation
to do so has any negative impact. If you had, in fact, provided the same information to
everybody else, then you did not provide a selective disclosure to that investor. I have
not seen any action or claim by regulators related to entering into this type of provision
through a side letter where it has not in fact prejudiced anybody.

HFLR: What are the chief legal and practical concerns raised by side letters that
modify, for the benefit of one investor but not others, the liquidity or
redemption provisions of a hedge fund’s governing documents?

Neus: I think there are a number of significant issues in providing undisclosed
preferential liquidity rights. There are enforceability issues in some jurisdictions,
particularly some of the English law based offshore jurisdictions which would find this
problematic. Some of the Companies Acts of those countries would not permit a side
letter to alter fundamental shareholder rights enshrined in the fund’s constituent
documents (the partnership agreement or the articles of association). There are also
issues related to fundamental fairness to all investors. There is an ongoing Wells notice
investigation by the SEC where a hedge fund manager allegedly provided preferential
treatment with respect to a redemption from a hedge fund that was exercised at the
height of the financial crisis. In the same vehicle you can have lots of different
combinations of fees and liquidity as long as it is disclosed and everyone knows that all
the various agreements exist in the same fund. It is the undisclosed secret issues that
people do not like. I think the better approach is to disclose the alternatives so that all
investors know, and that you treat similarly situated investors similarly.

HFLR: Our understanding is that the U.S. SEC looks more favorably (relatively
speaking) on side letters than the U.K.’s FSA, which looks quite askance on
them. Does your experience bear this out? And, if so, how do the differing
views of regulators affect the drafting of side letters?

Neus: I am not sure I completely agree with that. There have been speeches by senior
SEC staff describing their disquiet with conflicts of interest in side letter practices. The
impression of more FSA concern may be because the FSA has specific rules about
disclosing the existence of side letters in great detail where the SEC does not have a
specific rule applicable to hedge fund managers. Nevertheless, I think you have to satisfy
the lowest common denominator. You need to make sure that if you have, for example, a Cayman fund, a U.K. investor and a U.S. manager, that the proposed side letter it is enforceable and permitted under all applicable rules. It is best practice. It makes it a lot more difficult for managers to make sure they are complying with the rules regarding side letters from each regulator.

**HFLR**: If a hedge fund manager with global operations has agreed by side letter to notify a large investor of the inception of “any investigation” and the Hong Kong SFC (which prohibits disclosure of pending investigations) initiates an investigation of that manager, what should that manager do – comply with Hong Kong law and breach the side letter; comply with the side letter and violate Hong Kong law; or something else?

**Neus**: I think it is preferable to anticipate in advance. So if you are going to give someone a right or notification for, as you say, a regulatory investigation, you want to have a caveat in your side letter that you will only do so to the extent you are legally permitted. This is one of the problems with committing to certain investor notifications in side letters as you cannot anticipate all situations – sometimes the rules change over time or market practice changes. In your hypothetical, there is no good answer. If the Hong Kong authority will not permit the disclosure, perhaps the manager would have to call the investor to let them know that a situation has come up, but that you are not in a position to give the investor detailed information because you are not permitted to do so. That is not a particularly good situation to be in, particularly if the investor wishes to redeem or subscribe for additional shares while the information is not provided to other investors.

**HFLR**: Can you identify two or three strategies for drafting or structuring a most favored nation provision in a manner that limits the scope of the provision and thereby minimizes the manager’s compliance burden?

**Neus**: I would say the first strategy is to minimize side letters to the extent possible. If your disclosed policy is to provide only liquidity and fee terms that are available to all other similarly situated investors at the time they invest, it is less relevant or necessary to give MFNs.

Secondly, if you enter into an MFN, it has to be tailored sufficiently so that it is not overly broad and does not pick up unintended consequences.

Thirdly, and this is not just for MFNs, but for any agreement, you have to have a robust system for monitoring what rights you give to which investors.

**HFLR**: Can you identify one or two specific strategies that a hedge fund manager can use to gracefully decline a request for a side letter without
alienating the potential investor?

Neus: Your best bet is to have policies that are generally investor friendly and consistent so that you can provide comfort to the investor on much of what they are concerned about. You have to be willing to refuse an investment if it is on terms that you think will be problematic for your other investors or your business going forward. Sometimes, it is hard to say no, but it can be the best thing to do.

HFLR: Are single investor funds or managed accounts a preferable way to accommodate the concerns underlying requests for side letters, or do these structures create more problems than they solve – or does the answer depend on the existing infrastructure of the entity to which the side letter request is made?

Neus: I think this requires case-by-case consideration. Sometimes, it can be helpful, but in certain situations, I think it can be more problematic. For example, some strategies would not support the infrastructure of a managed account or a fund of one. If you are just trading public equities, it may be easier to do a managed account or a fund of one. If you have a complex trading strategy or you have multiple counterparties with multiple ISDA agreements, it may not be economic or logistically possible to have multiple small accounts. So, it really depends on the strategy and the size. There is no panacea.

HFLR: What are one or two best practices for tracking and monitoring obligations in MFN provisions and other side letter terms?

Neus: There are different systems available. You can have a hedge fund with a couple dozen investors where it is easy to use a spreadsheet or you can have multiple fund complexes and hundreds of investors, many with different terms in side letters, which makes it very complicated to track. It requires a system designed for the specific complexity of the fund. So, there is no single or easy answer.

The only thing I can say is that you have to make absolutely certain that you catalog what you have agreed to and know how you can put it into effect.

HFLR: Are side letters typically entered into by the fund or the management company, and if the management company, what happens to side letters in the event of a change in control of the management company?

Neus: There’s no standard. Sometimes it is the management company; sometimes it is the fund; and sometimes it is a tri-party agreement. It really comes down to the type of information or requirements in the side letter. For example, if the side letter is purely regarding information, it may be the management company that enters into the side letter. If it relates to redemption rights, it would have to be the fund because the fund,
and not the management company, has the authority to execute it. You have to understand who has the authority and obligation to take whatever actions are agreed to in the side letter.

**HFLR:** Have you seen trends of late with respect to the negotiation of capacity rights in side letters by seed investors or other significant hedge fund investors?

**Neus:** Terms with seed investors, including capacity rights, are typically included in the offering documents as, by definition, they are negotiated right at the launch of a fund. This is not something that is typically negotiated afterwards, although it can be.