

Risk Considerations for Private Funds: *Identifying and Mitigating Risks for Alternative Funds*

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Introduction

There was a period of time when hedge and private equity funds (collectively “private funds”) enjoyed a high degree of independence from any regulatory scrutiny and even more freedom, given to them by their own investors, to run their firms in almost any manner they chose. This philosophy arose from the thought that private fund managers, entrepreneurs themselves, would perform well only if unfettered from any oversight.

For a while, this was true until the alternative fund industry began experiencing a series of unprecedented financial disasters beginning with Long-Term Capital Management¹ (“LTCM”) in 1994 and culminating in 2008 with Bernard Madoff (“Madoff”).²

Both cases shared common themes not only while they were active but also in why they failed. In the LTCM scenario, investors were enamored with John Meriwether, a famed Salomon Brothers bond trader who assembled the best talent that Wall Street and academia could provide. At its height, LTCM had billions of dollars of assets under management and, less than four years later it was the recipient of a Federal Reserve rescue package.

In the Madoff case, his “option arbitrage” strategy of producing consistent returns regardless of prevailing market conditions became attractive to institutional and eleemosynary organizations who believed that his “low volatility” strategy could be their panacea of achieving alpha generating returns with little to no risk since the portfolio was composed of blue-chip equities and options written on these long positions. Madoff became a victim of an economy that resulted in lower inflows and substantial redemptions that his Ponzi Scheme could not support. In the end, billions were lost and its impact is still being realized by investors, the Street and the Bankruptcy Courts.

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The lessons to be learned from both crises are similar and rooted in Risk:

- For example, there were several Risk “red flags” associated with the Madoff scheme. First, investors failed to conduct any operational due diligence which would have revealed the lack of segregation of service providers; that is the traditional prime brokerage, administration and custodial functions were performed internally with no third party oversight. Additionally, Madoff’s accounting firm was obscure and there was rarely any mention of him in any of the Fund’s offering memorandum. These factors combined with Madoff’s almost obsessive secrecy normally would have prevented most institutions from investing with him from a risk-based perspective.
- Valuation is a concern for both the Fund’s portfolio management and investors;
- Liquidity itself is a risk factor;
- Models must be stress-tested and combined with judgment;
- Financial institutions should aggregate exposures to common risk factors; and
- Portfolio Managers and investors share common risk concerns; that is private funds must provide transparency and investors must demand it in order for operational due diligence to be conducted initially and be maintained throughout the relationship.

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This article will attempt to explore how private funds can identify and mitigate risk factors inherent in their structures (and based on their strategies) and how investors can ensure that this internal risk function is robust enough to provide assurances within our increasingly regulatory environment in which they both continue to operate.

The Three Tenets & Mitigation of Risk: Valuation, Transparency and Liquidity³

It is my contention that identifying and mitigating risks is not only based on the unique structure of the private fund being managed but also is greatly influenced by history. It would be considered a cliché to state that those who ignore history are destined to repeat it, but in the context of the alternative investment community this age-old maxim does ring true. And the determination that the three tenets of risk are valuation, transparency and liquidity is as much investor driven as it historically derived.

The economic uncertainty beginning in 2008 was disastrous to many private funds and investors primarily because valuation (in the pre-FASB 157⁴ world) was considered a routine function for the Administrator to deal with and not important enough to be relegated to the level of the portfolio manager. Transparency was rarely addressed since the Wall Street superstars running money at this time were extremely secretive and discreet, and did not want to be copied or scrutinized. They thus strived to keep their “recipe” secret, and liquidity was only important to the long-short manager since even in the absence of “lock-ups” distressed and less-liquid managers always thought in terms of “in-flows” not outflows.

Risk: Valuation

Valuation is one of the most important risks that need to be identified and mitigated by private fund investment managers. There may be additional legal exposure if valuation policies and procedures are not in place or, in the worst case scenario, if the private fund shares are mispriced resulting in misstated Net Asset Values (“NAVs”) whereby subscribers enter the fund and redeemers leave the fund at the wrong prices.

Regulators are now entering the picture since private fund managers typically charge a 2/20 fee; that is a 2.00% management fee and a 20 basis point performance fee assessed annually based on assets under management. If the fund is valued incorrectly and if, as is most likely, the valuation favors the manager, the investor could be paying fees (especially performance fees) that the manager is not entitled to receive. Or even more egregious, if the manager is deliberately

inflating the value of the fund, this disadvantages the investors and places criminal liability upon the managers themselves. An example is the recent Lancer Fund case⁵ in which the SEC alleged and won a conviction against the portfolio manager for overstating the Fund's value and reaping millions in ill gotten gains from performance fees. It is expected that many more cases will be forthcoming either driven by regulatory zeal or investor concerns. Therefore sound valuation policies, procedures and protocols are recommended for portfolio managers to adopt and implement in order to identify and mitigate valuation risk.

Valuation Risk Mitigation⁶

Portfolio Managers first need to establish a "Valuation Governance" framework to identify and then to mitigate risk. The most effective mechanism would be to establish a "Valuation Committee" which would be composed of individuals within the portfolio manager that have functional responsibility for this area. This Committee should include traders, the Chief Operations Officer, the Chief Financial Officer, the Chief Compliance Officer and the General Counsel who collectively will have the responsibility for reviewing and confirming the pricing of the portfolio and the monthly NAVs (or however frequently they are produced) from the administrator and the establishment and implementation of the valuation policies and procedures. The Committee should meet at least monthly and minutes of these meetings should be made.

The mandate of the Committee should also include reviewing and approving the protocols for classifying the portfolio securities within the FASB 157's valuation hierarchy, conducting the appropriate due diligence on third party service providers that assist in the valuation process, and establishing the appropriate procedures for valuing securities with no readily ascertainable market value.

By creating these internal valuation controls, the investment manager may be able to identify and mitigate valuation risk and have assurances that the fees being assessed to investors and received by the manager are accurate and can be verified.

Risk: Transparency

Lack of Transparency is a risk for both the portfolio manager and the investors themselves. First,

portfolio managers, especially those who manage at least \$100 million in assets, may have to register as Investment Advisers with the Securities and Exchange Commission ("SEC").⁷ Once registered, they have to verify and attest to several items relating to transparency: determining whether they have "custody" over client assets and, if they do, establishing how they verify it annually and, most importantly, now providing their investors an enhanced "Brochure" ("SEC Form ADV Part 2A")⁸ which details their operations, risks and disclosures of conflicts of interests. This "Brochure" must also be uploaded to the SEC Investment Adviser Public Disclosure ("IAPD")⁹ and available to anyone with Internet access. Material misrepresentations or omissions relating to the "Brochure" may subject the investment manager to civil and possibly criminal liability. Therefore, increased Transparency benefits the investors but investment managers must be prepared to address it internally.

(Lack of) Transparency Risk Mitigation

Portfolio Managers must first consider establishing a Due Diligence Committee composed of the same individuals who make up the Valuation Committee with the addition of those who work directly in the area of investor relations. Portfolio Managers will come to realize that Transparency is a "bargain for event," that is, investors will negotiate with the Fund for a level of transparency which is acceptable to them in order to invest, and managers must understand and accept what level and type of information they are willing to publicly disclose if they are already or need to be registered as an Investment Adviser.

Unlike other types of risk that require detailed policies and procedures to identify and mitigate, dealing with Transparency Risk is more straightforward. The mandate of the Transparency Committee will include determining with the assistance of internal and external Counsel the proprietary information that must be protected and not disclosed in order to maintain the integrity of the Fund. The mandate will also consider the level of transparency that will be offered to investors in exchange for their financial commitment to subscribe into the Fund, and the structure of the required regulatory disclosures including the ADV Part 2A be structured to comply with the regulatory requirements and to protect any confidential information or arrange-

ments. Finally, to the Committee must determine whether the portfolio manager for the Fund has actual custody of investor assets. If the Fund does have actual custody of assets then it must have policies and procedures in place to comply with the Custody Rule. The Custody Rule was enacted to prevent further Madoff type frauds from occurring.

As the Alternative Investment industry matures, issues of Transparency will continue to be significant along with the next area of risk discussion, those questions surrounding liquidity.

Risk: Liquidity

The problem of liquidity is really a risk inherent to all private funds. Historically, some funds with less liquid strategies inadvertently (and I would say negligently) did not really pay great attention to the liquidity and redemption provisions found in their Confidential Offering Memorandums (“COM”). Therefore, during the early days of 2008 when investors needed cash to satisfy their other financial obligations and applied for their redemptions based on the terms found in the COM, they and the portfolio managers were surprised when their funds were not able to meet all the redemption requests received. Some funds triggered their “gates” whereby they were only responsible for satisfying a proportion of redemptions received. Others simply did not pay and were forced to “wind-down.” Still others engaged in the insidious (though allowed) procedure of paying redemptions “in-kind,” that is in “specie” by certificating securities in the portfolio and sending them to investors. *As was shown then, failure to recognize liquidity as a risk can potentially hamper a fund, and in some cases force a fund to close.*

The risk of liquidity should not be viewed only from the investor perspective but also from the perspective of the normal operation of the fund. Portfolio managers must (and in some respects are required to) know and understand the hierarchy of the securities they manage from a FASB 157 perspective. The need for liquidity (other than just to pay redemptions) to purchase other securities or its relationship to leverage must be recognized by the portfolio manager. Lost opportunities may occur when there is no money to purchase securities. The portfolio manager needs to understand and recognize liquidity on a daily basis as well as the fund’s access to markets to sell and purchase all the types of securities that are part of the fund’s portfolio, the

adequacy of those outside firms that provide access to markets, and the constraint that other types of arrangements such as directed brokerage and “soft-dollar” may place on liquidity.

Liquidity Risk Mitigation

Basically, liquidity is a Fund’s ability to meet its need for cash. Portfolio managers should have in place policies and procedures that will enable them to monitor and manage liquidity levels in a manner reasonably designed to ensure that their Funds will be able to meet their obligations. This satisfies both investor and regulatory requirements.

The portfolio manager should take into account the following factors when managing liquidity:

- Any funding provided by counterparties, leverage, derivative swaps and margins and credit. Included in this factor is monitoring the various available levels of liquidity and the manner in which margin calls or “triggering” events under ISDA agreements will be satisfied. Internal counsel should be intimately familiar with the terms of all counterparty credit, leverage and derivative agreements;
- The terms of redemption rights by investors and the amount of investor capital that is subject to these redemption rights; and
- Changes in market liquidity conditions that may alter the ability of the portfolio manager to manage the liquidity requirements of the fund.

The portfolio manager should also consider the following practices which should be incorporated into the Fund’s policies and procedures:

- The portfolio manager should consider conducting regular liquidity stress and scenario analyses on the fund in order to understand and better manage the fund’s ability to meet its obligations.
- The portfolio manager should assess the cash and borrowing capacity of the fund in consideration of the potential for large draw-downs and conditions of severe market stress (including the likelihood of increased redemption requests during periods of severe market stress).

In conclusion, portfolio managers must remember the “Three C’s” when considering and managing liquidity risks. The first is Committee. As described previously, a Committee should be formed internally that can identify and address liquidity risks and meet as frequently as possible. The Second C’ is the Confidential Offering Memorandum. The portfolio

manager should ensure that any redemption rights provided by the COM to investors are tailored to the strategy being deployed and are realistic. The portfolio manager should manage the fund's liquidity keeping these redemption rights in mind at all times. The Third C' is Counterparties; the portfolio manager should know and understand the liquidity requirements and restraints of counterparty credit and leverage providers, and ensure that the fund is poised to meet any counterparty requirements including margin calls generated by predictable and unforeseen market conditions.

Other Systematic Risks

Aside from those risks explored above, the portfolio manager should also consider implementing controls in the form of policies and procedures to address other types of risks that may be found in a private fund complex.¹⁰

- **Market Risk.** Market risk is the financial risk brought about from changes in the market price of investments within the fund. The portfolio manager should regularly evaluate market risk, incorporating some or all of the following risk measures: size and direction of its exposures to major market risk factors (*e.g.*, equity indices, interest rates, credit spreads, foreign exchange rates, and commodities prices). Exposures should be considered both on a gross basis (longs plus shorts) and a net basis (longs less shorts), and should be examined both within individual strategies and portfolios and across the entire Fund. Periodic stress testing and scenario analysis should also be conducted to capture both market conditions and situations regarding market liquidity.
- **Counterparty Credit Risk.** The portfolio manager should monitor the fund's exposure to counterparty credit risk (including administrators, banks, prime brokers, custodians, leverage providers) and contemplate the possibility of loss of counterparty liquidity or failure of the party itself. The portfolio manager should also conduct the appropriate initial operational due diligence on all liquidity counterparties and providers and seek to obtain from them, at a minimum, recent audited financial statements and SAS 70 (if available), as well as check their registrations with any domestic or foreign regulators.
- **Operational Risk.** The portfolio manager should have a robust operational infrastructure that is

tailored to the complexity of its business, to manage and mitigate operational risks resulting from the inadequacies of its internal infrastructure or the personnel supporting it. The Fund's Chief Operating Officer along with other competent personnel should oversee this function.

- **Legal and Compliance Risk.** The portfolio manager should adopt Written Supervisory Procedures and a Compliance Manual¹¹ that establishes the compliance requirements and expectations for all employees associated with the Fund in order to mitigate the risk of regulatory non-compliance. The portfolio manager should also appoint a Chief Compliance Officer ("CCO")¹² to ensure that all compliance policies and procedures are implemented and maintained, and that annual training for all employees is conducted. The CCO (who in some cases may also have dual roles as Chief Financial Officer, Chief Operations Officer or General Counsel) should act as a resource for the fund and portfolio manager in regards to internal compliance and regulatory questions and external inquiries. The CCO should be the "gate-keeper" for outside counsel and the main point of contact for regulatory inquiries.

Conclusion

There is little doubt remaining in the alternative investment (private fund) community that, whether you are operating onshore or offshore and regardless of whether you are registered, identifying and mitigating risk within your organization is simply good business practice. Portfolio managers can no longer simply ignore risk (as they have done historically with the compliance function, for example) since now current and prospective investors ask about it and it is routinely examined by the regulators. Therefore, now risk management should be a "best practice" for all private funds and should enjoy the same level of respect as other functions in order for the portfolio manager to act with confidence in running the portfolio and be in line with their peer group. Risk will change as the markets and regulation do, and a successful risk management program will track those changes and build in capacity to ensure that it is sufficiently robust to endure and to deal with them.

ENDNOTES

- ¹ See Sungard AMBIT ERISK, Case-Study: LTCM Long-Term Capital Management, available at: <http://erisk.com/Learning/CaseStudies/Long-TermCapitalManagement.asp>.
- ² See IBS Center for Management Research (ICMR), The 'Bernard Madoff' Financial Scam Case Study, available at: <http://www.icmrindia.org/casestudies/catalogue/Finance/FINC055.htm>.
- ³ Some of the conclusions presented in the section are based upon the Koger Roundtable: Hedge Fund Transparency and Liquidity Roundtable conducted on September 16, 2010 at the Yale Club in New York City and in which Mr. Edwards participated. The Roundtable explored how investor requirements for greater transparency and improved management of liquidity are fundamentally altering the alternative investment industry. This resulted in Liquidity & Transparency: How They are Changing Alternative Investing: A survey by Koger and International Fund Investment, September 2010 and available at www.kogerusa.com.
- ⁴ Financial Accounting Standards Board Statement No. 157, Fair Value Measurements, This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. It requires GAAP compliant private funds to segregate their portfolios into three "tiers," based on their liquidity and their ease of being valued. That is Tier I securities are the most liquid and easiest to value since these are primarily exchanged traded securities. Tier III securities are the least liquid, and the hardest to value since there may not be a readily available market for these securities. More information is available at <http://www.fasb.org/st/summary/stsum157.shtml>.
- ⁵ SECURITIES AND EXCHANGE COMMISSION v. MICHAEL LAUER, LANCER MANAGEMENT GROUP, LLC, and LANCER MANAGEMENT GROUP II, LLC, Defendants, and LANCER OFFSHORE, INC., LANCER PARTNERS, LP, OMNIFUND, LTD., LSPV, INC., and LSPV, LLC, Relief Defendants, Case No. 03-80612-CIV-ZLOCH (S.D. Fla., filed July 8, 2003). See SEC Litigation Release No. 18226 / July 10, 2003 available at <http://www.sec.gov/litigation/litreleases/lr18226.htm>. In this case, the portfolio manager colluded with an affiliated broker-dealer in order to drive up the prices of thinly traded securities in order that it appeared that the Fund was profitable and that performance fees could be earned.
- ⁶ An excellent primer on the "best practices" for portfolio managers is from the Managed Funds Association ("MFA"), Sound Practices for Hedge Fund Managers, 2009 Edition, available at <http://www.managedfunds.org/mfas-sound-practices-for-hedge-fund-managers.asp>.
- ⁷ See "Dodd-Frank Wall Street Reform and Consumer Protection Act", Title IV available at: <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>. Title IV - Regulation of Advisers to Hedge Funds and Others also known as the Private Fund Investment Advisers Registration Act of 2010.
- ⁸ See SEC guidance on the FORM ADV: <http://www.sec.gov/answers/formadv.htm>.
- ⁹ At the Investment Adviser Public Disclosure website: <http://www.adviserinfo.sec.gov>, individuals can search for an investment adviser firm and view that firm's Form ADV. Investment advisers file Form ADV to register with the SEC and/or the states. Form ADV contains information about an investment adviser and its business operations. Form ADV also contains disclosure about certain disciplinary events involving the adviser and its key personnel. Individuals can also search for an individual investment adviser representative and view that individual's professional background and conduct including current registrations, employment history, and disclosures about certain disciplinary events involving the individual. The information about investment adviser representatives that appears on this website is collected from individual investment adviser representatives, investment adviser firm(s), and/or securities regulator(s) as part of the securities industry's registration and licensing process.
- ¹⁰ The term complex is meant to imply that many private funds also are composed of various other registered and non-registered onshore and offshore entities. For example, an onshore private fund complex may be composed of a SEC Registered Investment Adviser, FINRA member broker-dealer and (unless qualified by an exemption) National Futures Association ("NFA") Commodity Pool Operator ("CPO"). The offshore component of the complex may be a Cayman Island Mutual Fund registered with either the Cayman Island Monetary Authority ("CIMA") or in the British Virgin Islands with the Financial Services Commission ("FSC") and with the Financial Services Authority ("FSA") based in the United Kingdom. The onshore complex is usually the onshore feeder fund structured as a LLC or LP for U.S. taxable investors. The offshore complex is usually an offshore feeder structured as a LTD. for non-US and non US taxable investors. Generally, the "Master Fund" is also domiciled in an offshore jurisdiction.
- ¹¹ Rule 204A-1 (as found under the Investment Advisers Act of 1940) requires registered investment advisers to adopt codes of ethics. The rule requires an adviser's code of ethics to set forth standards of conduct and require compliance with federal securities laws. Codes of ethics must also address personal trading; they must require advisers' personnel to report their personal securities holdings and transactions, including those in affiliated funds, and must require personnel to obtain pre-approval of certain investments. The SEC requires the adviser under the Advisers Act's recordkeeping rule to keep copies of their codes of ethics and records relating to the code. The Commission has amended the client disclosure requirements under Part 2 of Form ADV to require advisers to describe their codes of ethics to clients and offer to provide to investors upon written request.
- ¹² Rule 206(4)-7 (as found under the Investment Advisers Act of 1940) requires each adviser registered with the Commission to designate a chief compliance officer to administer its compliance policies and procedures. An adviser's chief compliance officer should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm. Thus, the compliance officer should have a position of sufficient seniority and authority within the organization to compel others to adhere to the compliance policies and procedures. The Fund should identify an internal person to act as the Chief Compliance Officer, outsourcing this role is not advisable.

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