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Examinations

Barbash, Breslow and Rozenblit Discuss Hedge Fund Allocations, Restructurings and Advisory Boards

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By Vincent Pitaro, *Hedge Fund Law Report*

Liquidity and performance presentation are only two of the myriad issues facing hedge fund managers. See "Liquidity and Performance Representations Present Potential Pitfalls for Hedge Fund Managers" (Mar. 31, 2016). Hedge fund and private equity managers must also be wary of numerous issues that can trigger conflicts of interest or anti-fraud violations, including expense allocations, restructuring and the use of advisory boards. See "Full Disclosure of Portfolio Company Fee and Payment Arrangements May Reduce Risk of Conflicts and Enforcement Action" (Nov. 12, 2015).

During the "Issues of the Day for Alternative Asset Managers" program at the Practising Law Institute's recent 2016 Investment Management Institute, panelists discussed these and other topics. Barry P. Barbash, a former Director of the SEC Division of Investment Management and now a partner at Willkie Farr & Gallagher, moderated the program, which featured Stephanie R. Breslow, a partner at Schulte Roth & Zabel; and Igor Rozenblit, co-leader of the Private Funds Unit of the SEC Office of Compliance Inspections and Examinations. This article summarizes the panelists' discussion of these issues.

For additional commentary from Breslow, see "Schulte Partner Stephanie Breslow Discusses Tools for Managing Hedge Fund Crises Caused by Liquidity Problems, Poor Performance or Regulatory Issues" (Jan. 9, 2014). For further insight from Rozenblit, see "SEC's Rozenblit and Law Firm Partners Explain the SEC's Enforcement Priorities and Offer Tips on How Hedge Fund and Private Equity Managers Can Avoid Enforcement Action (Part Three of Four)" (Jan. 15, 2015).

Overview of the Private Funds Unit

As is customary, Rozenblit cautioned that the views expressed were his own and not those of the SEC or any of its Commissioners. Rozenblit explained that the Private Funds Unit (PFU) is a small team of about 20 individuals within the Office of Compliance Inspections and Examinations that focuses solely on hedge funds and private equity (PE). Its examiners have developed the skills to identify issues more quickly. Its examinations are more focused, and may be "more detailed and more thorough" than other SEC exams. They may also be faster, when the PFU does not spot an issue it is focusing on. For more on the PFU, see "Current and Former Regulators Advise Hedge Fund Managers on How to Prepare for SEC Exams" (Feb. 18, 2016).

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The PFU looks at incentives that drive manager behavior and takes a thematic approach to examinations. It spends time with industry professionals to conduct "top down, bottom up" analyses, focusing on the overall market at the "top," and individual managers at the "bottom." Rozenblit explained the SEC's National Exam Analytics Tool enables PFU personnel to analyze trade blotters to spot cross trades, valuation changes and other potential red flags.

The PFU has noticed less talk among managers about capital raising and more about "keeping the clients that they have," said Rozenblit. It also sees continuing pressure on management and performance fees. This year is shaping up to be no better than 2015, he added, with particular pressure on credit strategies and funds of funds.

Poor manager performance, a "glut" of hedge funds, capital draw-downs and decreasing demand for hedge funds are viewed by the PFU as key drivers of hedge fund manager behavior. On the PE side, the PFU has found a bifurcation between PE managers that have no trouble raising capital and those that have "serious problems." It expects the latter category to face the most pressure. Finally, the unit is seeing significant pressure in the high-yield market.

Expense Shifting

Expense shifting is more of an issue for PE funds than for hedge funds, said Rozenblit. See "Current and Former SEC, DOJ and NY State Attorney General Practitioners Discuss Regulatory and Enforcement Priorities" (Jan. 14, 2016). In the hedge fund context, one fund may generate all of a manager's soft dollars, but the manager uses those dollars to benefit other funds.

Breslow said that conflicts concerning expenses arise between fund and manager; between fund and fund; and even between classes of the same fund. See "RCA Compliance, Risk and Enforcement Symposium Examines Ways for Hedge Fund Managers to Mitigate Conflicts of Interest" (Jan. 21, 2016). A traditional expense disclosure, she said, was that the manager bore its own overhead and that the fund bore all other expenses, "including, but not limited to" a list of specific types of expenses. In response to SEC concerns, that list has become much more detailed over time.

When a manager desires to change its expense practices, Breslow explained, it must first determine whether it requires investor consent. If an expense is a type that an investor would expect to be included in the list provided in existing disclosures, the manager can simply add the expense to the list. If the expense is something that investors would not have expected, the manager must follow the fund's process for obtaining consent. In some cases, managers will notify investors of the proposed change before a redemption date passes, thereby giving them an opportunity to "vote with their feet." See our series on "How Should Hedge Fund Managers Approach the Allocation of Expenses Among Their Firms and Their Funds?": Part One (May 2, 2013); and Part Two (May 9, 2013).

Managers should also consider the reasonableness of specified expenses, said Breslow, even in funds that pass through all expenses. Rozenblit noted that a "manager-pays-everything" scenario is the easiest situation to evaluate, because there can be no harm to the fund.

Fully passing through expenses raises red flags due to the temptation to put things "that don't belong" into expense buckets. Rozenblit explained that the PFU would certainly take a close look at a fund that paid the cost of the manager's apartment; on the other hand, it might not spend much time considering whether a Bloomberg terminal is used solely by the fund that pays for it. See "ACA Compliance Report Facilitates Benchmarking of Private Fund Manager Compliance Practices (Part Two of Two)" (Oct. 11, 2013).

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Fund Restructurings

Fund restructurings often occur when a manager is no longer able to raise new capital, said Rozenblit. Managers may offer investors an opportunity to be bought out at a discount, while seeking capital for new investments. These transactions create significant conflicts of interest because without them, the manager is out of business.

One way to effect these transactions is for the manager to sell all of the assets of one fund to a new fund. Another is for limited partners of one fund to sell to other limited partners. An even more difficult situation, said Rozenblit, is when the manager itself buys fund assets, which raises valuation issues and issues under Section 206(3) of the Investment Advisers Act of 1940 (which prohibits principal transactions).

Asset sales are “even more treacherous waters” than tender offers, said Rozenblit, and raise numerous fiduciary duty issues. Such sales are used less frequently. See our two-part series on asset manager M&A transactions: “Initiating and Structuring M&A Transactions” (May 7, 2015); and “Taxation, Regulatory and Business Integration Issues” (May 14, 2015).

Managers have an incentive to keep valuations in restructurings as low as possible, said Rozenblit. Selling investors are often willing to sell at par, and buyers have a great deal of transparency into the portfolio and can more easily value their purchase. A buyer who is getting a “great deal” on assets may be more willing to give the manager a higher fee or more capital to invest.

Breslow tries to ensure that buyers and sellers have access to the same information. A competing concern is that managers may not want to hurt their portfolios by revealing too much information about them. Other concerns, said Rozenblit, include a manager charging a fee on its own restructuring; misrepresentations regarding the health of the portfolio, valuations or the circumstances of the sale; and manipulation of advisory boards.

Advisory Boards

Because a restructuring creates conflicts of interest, a manager may have to seek advisory board approval. See our series on “How Can Hedge Fund Managers Use Advisory Committees to Manage Conflicts of Interest and Mitigate Operational Risks”: Part One (Apr. 11, 2013); and Part Two (Apr. 25, 2013).

One “troubling” situation, said Rozenblit, is when the composition of an advisory board changes prior to the transaction in order to facilitate approval. Breslow noted that, while some managers may try to stack a board with sympathetic people, restructurings may also cause some board members to “flee,” because they do not want to be involved in the process.

Rozenblit concurred that pension funds often do not want “to take the liability of making hard decisions.” Breslow noted that pensions like the idea of participating in advisory boards because they get a better handle on what is going on at the fund, but they may not want to stay “when things get ugly.”

Advisory board composition is a contractual issue, not a regulatory one, said Breslow. Fund documents usually provide that advisory board members may act in their own interests and are not liable to the fund except for bad faith acts.

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A board is not usually composed of the manager's "friends and family"; its members tend to be representatives of a fund's largest investors, which often insist on a seat. In Breslow's view, this is a way that "real investors with real skin in the game get to face the manager and deal with conflicts."

The interests of large investors may not be aligned with those of smaller investors, Rozenblit cautioned. Large investors may be seeking other opportunities with the manager – such as co-investments or mezzanine lending – which might make them more willing to approve a new expense pass-through (or other matters) than other investors.

Over-Disclosure and Form ADV

The PFU has noted some "over-disclosure" by PE firms on Form ADV, said Rozenblit. Many funds make disclosures, apparently on the advice of their counsel, as to practices in which they do not engage and have no intention of engaging.

Other issues concern Item 2 of Form ADV Part 2, which is disclosure of material changes. Some firms make changes to their brochure without disclosing the change in that Item. Others move Item 2 with bad news all the way to the back of Part 2.

Enforcement Actions vs. Guidance

In recent years, Breslow noted, SEC enforcement actions have been brought not only against firms that intentionally engaged in illegal behavior, but also against legitimate firms that did not believe that anything they were doing was improper at the time they were doing it. She said industry participants were "wistful" for a time when "the rule would come first and the enforcement [would] come later."

Rozenblit defended recent SEC actions, arguing that many addressed longstanding industry practices that were never properly disclosed to investors. Enforcement cases, he said, have pushed discussion of "uncomfortable" issues, such as acceleration of monitoring fees, to the forefront. Breslow observed that if the SEC simply provided guidance on some of these issues, it could have had the same impact, without leaving any managers "hanging in the public square." Rozenblit said he would defer to the Division of Enforcement on that issue.

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