This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Valuation

ACA 2017 Fund Manager Compliance Survey Addresses Investment Allocations, Conflicts of Interest and Valuation (Part Two of Two)

Feb. 1, 2018
By Vincent Pitaro, *Hedge Fund Law Report*

ACA Compliance Group (ACA) recently discussed the findings of its 2017 Alternative Fund Manager Compliance Survey (Survey) in a webinar featuring Colleen Marencik and Brian Lattanzio, director and consultant, respectively, at ACA. This article, the second in a two-part series, discusses the Survey's findings with respect to investment allocation practices by private equity and real estate managers, including co-investments; cross transactions; best execution and fees; conflicts of interest; and valuation. The first article examined the Survey's findings regarding recent SEC examination experiences, along with hedge fund trading and counterparty issues, including best execution; soft dollars; principal transactions and cross trades; dark pools; and trade errors.

For additional commentary from ACA, see our two-part roadmap to maintaining books and records: "Compliance With Applicable Regulations" (Nov. 2, 2017); and "Document Retention and SEC Expectations" (Nov. 9, 2017); and our two-part series "A Roadmap for Advisers to Comply With Marketing and Advertising Regulations": Part One (Aug. 3, 2017); and Part Two (Aug. 10, 2017).

See also our coverage of ACA's 2016 Compliance Survey; 2015 Compliance Survey; 2014 Compliance Survey; and 2013 Compliance Survey.

Illiquid Fund Manager Transactions

Allocation of Investment Opportunities

The allocation of investment opportunities by private equity and real estate fund managers (together, illiquid fund managers) remains a hot topic during SEC exams, Marencik said. Results of the Survey indicated that half of illiquid fund manager respondents do not allocate portfolio company investments among multiple funds. Two-fifths of respondents said they allocate investment opportunities to more than one fund, provided that these funds are still in their investment periods, while one-fifth said they allocate investments when the fund that initially invested is out of its investment period and does not have capital for an add-on investment. See "Investment Conflicts Arising Out of Simultaneous Management of Hedge Funds and Private Equity Funds (Part One of Three)" (May 7, 2015).

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Co-Investments

Eight percent of illiquid fund manager respondents reported that they allow unaffiliated investors in a fund to co-invest in all of the fund's portfolio companies, while more than one-third of illiquid fund managers have formed investment vehicles to permit unaffiliated investors to co-invest in one of a fund's portfolio companies. More than two-fifths permit affiliates to co-invest in one or more of the fund's portfolio companies, while two-fifths of respondents reported that they offer co-investment opportunities to participate directly in illiquid investments rather than through a firm vehicle. One-fifth indicated that they do not offer any co-investment opportunities.

The vast majority (86%) of illiquid fund managers said they offer co-investment opportunities to investors in the fund that is making the primary investment in the illiquid investment. One quarter offer co-investment opportunities to investors in other funds managed by the adviser. About one-seventh offer co-investment opportunities to portfolio company management, while 13% of those surveyed offer those investment opportunities to their own investment professionals. Some illiquid fund managers also indicated that when offering co-investment opportunities, they give priority to financing partners on the transaction (17%), operating partners (17%), the general partner (17%) and prospective limited partners (14%), Marencik said.

Nearly three-quarters of illiquid fund manager respondents said they have written policies regarding allocation of co-investment opportunities. About seven-in-ten formally document the rationale for offering these opportunities. Documentation of this nature is important because the SEC may ask a manager about a particular co-investment years after it occurs, Marencik explained.

See "Private Equity in 2017: How to Seize Upon Rising Opportunity While Minimizing Compliance and Market Risk" (Jun. 8, 2017); and "Private Equity Firms From Across the Industry Spectrum Advise on Trends and Terms in the Current Co-Investment Market" (Aug. 11, 2016).

See also our three-part series on co-investments in the hedge fund context: "Pursuing Illiquid Opportunities While Avoiding Style Drift" (Feb. 21, 2014); "Structuring Considerations and Material Terms" (Feb. 28, 2014); and "Fiduciary Duty Concerns, Conflicts and Regulatory Risks" (Mar. 7, 2014).

Third-Party Financing

Of the nearly two-thirds of illiquid fund manager respondents that secure third-party financing for transactions, about half reported they always obtain multiple bids, while most of the remaining respondents obtain more than one bid in at least some cases. Nearly three-fifths of respondents maintain formal documentation on the counterparty selection process, Marencik said.

Cross Transactions

Only 18% of illiquid fund manager respondents said they engage in cross transactions. Of those that engage in cross trades, more than one-third effect the transaction at the end of a valuation period based on internal valuations, while almost half reported using external valuation experts. Given the potential conflict posed by internal valuations, Marencik expressed surprise that more firms failed to use external valuation agents.

Best Execution

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
More than one-third of illiquid fund managers said they assess best execution on a transaction-by-transaction basis and document that assessment, compared with only one-quarter in the 2016 study, Marencik said. One-tenth of illiquid fund managers also assess best execution on a transaction-by-transaction basis but do not document the assessment. Nearly one-quarter have a formal committee or group to assess best execution, while one-third said they have no best execution duties.

Transaction Fees

Nearly 30% of illiquid fund manager respondents reported that they charge transaction or acquisition fees, Marencik said. Of those that do, over two-thirds charge for facilitating financing; 63% charge for negotiating the deal terms; half charge for sourcing lenders; two-fifths charge for document preparation; 38% charge for sourcing prospective buyers or sellers; and one-quarter charge for sourcing or disposing of real estate assets.

See "Absent Proper Disclosure, Allocation of Manager Expenses to Funds May Bring Significant SEC Penalties" (Sep. 29, 2016); and "SEC Enforcement Director Highlights Increased Focus on Undisclosed Private Equity Fees and Expenses" (May 19, 2016).

Valuation

More than three-quarters of respondents overall have formal valuation committees – an increase over the prior study, Lattanzio noted. Both hedge fund and illiquid fund managers reported that they frequently include investment, compliance, operations and finance personnel as voting members of the committee.

Notably, the proportion of illiquid fund managers reporting that compliance personnel serve as voting members rose dramatically from last year. This could be the result of SEC expectations that advisers include compliance in valuation decisions, Lattanzio opined. Advisers should structure valuation committees to include individuals who can provide "objectivity and independence during the valuation process." ACA often recommends that the chief compliance officer be a member of the valuation committee, Marencik said.

See "Three Pillars of an Effective Hedge Fund Valuation Process" (Jun. 19, 2014); and "Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees" (Aug. 16, 2012).

The most common responsibility among valuation committees – cited by more than four-fifths of both hedge fund and illiquid fund managers – is the review and approval of valuation policies and procedures, Lattanzio noted. Two-thirds or more of hedge fund respondents said that the valuation committee is involved in fair valuation of certain individual investments, while 73% reported that their committees partake in reviewing pricing challenges, exceptions and errors. More than four-fifths of illiquid fund managers said that the valuation committee is involved in approving the fund's valuation (*e.g.*, net asset value).

Meeting minutes, portfolio valuation summaries and backup documentation for valuation assessments remain the most common types of records maintained by valuation committees, Lattanzio said. Other commonly retained documents include the committee charter, meeting agendas and signed valuation approvals, he added.

The frequency with which managers value their entire portfolios has been fairly consistent over the years, Lattanzio said. Hedge fund managers most commonly value on a daily (35%) or

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
monthly (41%) basis, and more than three-quarters of illiquid fund managers value their portfolios quarterly.

Roughly three-quarters of hedge fund managers said they use pricing services to value their portfolios, while 73% reported using a third-party administrator for valuations. About half use broker-dealers, and 30% use fair valuation firms.

Nearly four-fifths of managers that employ third-party valuation service providers use them to value assets, a significant increase from just 46% in 2016, Lattanzio said. About one-quarter use them to confirm internal valuations. More than three-quarters of these managers have a process to challenge third-party pricing, but only 12% have actually restated a fund valuation, he added.

About two-thirds of hedge fund respondents said that they hold “Level 2” or “Level 3” illiquid assets. Of those managers that do, about one-third said that they use both internal valuations and third-party services to value them, Lattanzio explained. Significantly fewer reported always using third-party services or internal valuations. Half of hedge fund managers that hold Level 2 assets value them by collecting two or three bids, Lattanzio clarified. See “DLA Piper Hedge Fund Valuation Webinar Covers Fair Value Methodologies, Valuation Services, Valuing Illiquid Positions and Handling Valuation Inquiries During SEC Examinations” (Aug. 7, 2013).

Nearly half of illiquid fund managers said that they regularly use third-party valuation agents to value portfolio investments, while approximately one-fifth reported using them on a one-off basis. One-third said they have never engaged a third-party valuation service. About three-fifths of illiquid fund managers that regularly use valuation agents use them to value more than three-quarters of their portfolios. See “Is the Use of an Independent Valuation Firm Superior to a Manager’s Internal Valuation Process?” (Apr. 23, 2015).

Common valuation methodologies include the market, income and cost approaches. Nearly three-quarters of illiquid fund managers said they blend those methodologies, an increase over last year, Lattanzio noted. There was a significant increase in the number of managers that said they use the cost approach in the first year after an acquisition, he added. Four-fifths said they have controls in place to identify changes in valuation methodology, which is important because these changes are a red flag for the SEC, he cautioned. See “Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations” (May 11, 2017).

Most hedge fund and illiquid fund managers (83% each) maintain written valuation policies and procedures. The most common testing methods cited by hedge fund respondents with valuation committees include testing documentation that supports valuation (37%), ensuring independent review of pricing decisions made by the investment function (34%), conducting daily reviews to check for stale prices (31%) and making sure that compliance or the fund administrator is copied on quotes received from broker-dealers (26%). The most common testing mechanisms used by illiquid fund managers are testing valuation documentation (39%), ensuring independent review of pricing decisions by investment personnel (28%) and conducting a retrospective review of whether investment exit prices were consistent with carrying values (24%).

About half of managers that have advisory boards indicated that the board is involved in the valuation process, Lattanzio noted. See “Proper Use of Advisory Committees by Private Fund Managers May Mitigate Conflicts of Interest” (Dec. 17, 2015).

Conflicts of Interest

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
Only 12% of respondents indicated that they have any sort of conflicts committee, Marencik noted. More than three-quarters of respondents said that they monitor for conflicts by tracking gifts and entertainment (82%); requesting certifications from employees (80%); and using employee questionnaires (76%). More than one-third track trades. Only one-fifth track soft dollars, and merely one-seventh track various broker or employee incentives, she noted.

Testing by managers for conflicts of interest was most prevalent in the following areas:

- gifts and entertainment (85%);
- outside business activities (85%);
- political contributions (85%);
- personal and proprietary trading (80%); and
- employees' outside financial interests (76%).

Approximately half of respondents reporting testing trade execution and allocation of expenses for conflicts of interest, while only 27% test for allocation of investment opportunities, Marencik noted.

See "RCA Compliance, Risk and Enforcement Symposium Examines Ways for Hedge Fund Managers to Mitigate Conflicts of Interest" (Jan. 21, 2016).

Gifts and Entertainment

Virtually all respondents said that they have a formal gifts and entertainment policy, Marencik said. More than three-quarters of respondents require pre-approval of gifts given, while a slightly smaller amount require pre-approval for gifts received. Nearly 60% require pre-approval of entertainment received, while 56% reported requiring pre-approval of entertainment provided.

Of those that require pre-approval for the giving or receipt of gifts or entertainment, more than half in each instance set the pre-approval thresholds between $100 and $499. Only a small percentage of respondents allow gifts or entertainment to be given or received when the value of such benefit exceeds $1,000, Marencik noted. Some managers require preapproval for all gifts given (22%) or received (14%). When it comes to entertainment, some managers reported not setting a dollar threshold, but required preapproval for the provision or receipt of entertainment that may be deemed lavish or excessive. See "SEC Settlement With Investment Adviser Highlights Perils of Undisclosed Conflicts of Interest" (Aug. 27, 2015).

Outside Business Activities

More than nine-in-ten respondents said they have a policy regarding outside business activities, Marencik said. Nearly three-quarters of those that have a policy require preapproval of all outside activities, and most of the remaining respondents require preapproval for some activities. See "SEC Settlement Highlights Circumstances in Which Hedge Fund Managers Must Disclose Conflicts of Interest" (Apr. 23, 2015).

Political Contributions

For purposes of Rule 206(4)-5 of the Investment Advisers Act of 1940 (the so-called "pay to play" rule), 85% of respondents deem all employees to be "covered associates" as defined under the

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
rule. Firms are becoming more conservative in this area, in Marencik's view. Only 12% apply the technical definition of covered associate.

Nearly two-thirds require pre-approval of all political contributions, while just one-third said they check the political contributions of potential new hires, which is low, given the look-back period under the pay to play rule, Marencik noted. About one-sixth require preclearance for contributions above a specified threshold. More than one-eighth bar all contributions. See "Pay to Play, Revenue Sharing and Wrap Fees Remain on the SEC's Radar" (Apr. 20, 2017).

Regarding indirect political contributions, respondents reported maintaining policies and procedures concerning:

- contributions by family members and family-owned organizations (53%);
- contributions to political action committees and state and local parties (34%);
- pre-clearance of the coordination or solicitation of contributions (31%); and
- participation in political volunteering activities (21%).

About one-quarter of respondents reported having no policies on indirect contributions.

For more on the pay to play rule, see "What the Outcome of BlackRock's Petition Could Portend for the SEC's Stance on Pay to Play" (Nov. 2, 2017); "K&L Gates Program Addresses State and Local Lobbying; Pay to Play; and Gifts and Entertainment Limitations (Part One of Two)" (Mar. 23, 2017); and "Campaign Contributions As Small As $500 Could Draw SEC Enforcement Action for Pay to Play Violations" (Jan. 26, 2017).

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL