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Industry and Regulatory Updates

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Industry Trends

Trends in Seed Deals

By: C. David Lee, Partner, and David S. Hong, Counsel, at Munger, Tolles & Olson LLP

Overview

The fundraising environment for private fund managers continues to be challenging, particularly for emerging managers that lack established, portable track records or highly compelling pedigrees. Moreover, the costs of launching a private fund are higher today due to investor expectations of institutional-quality infrastructure and increased compliance costs. As such, seed capital may be more important than ever for emerging managers seeking to ramp up operations. Due to this increased demand, new market participants such as family offices, venture capital-style incubation firms, private equity funds, aggregators, endowments and funds of funds, are increasingly providing seed capital to emerging managers.

Structuring

Seed investment structures that we commonly see include seed investments into (i) the manager itself, (ii) a commingled fund managed by the manager, (iii) a separately managed account managed by the manager, (iv) a "satellite fund" sponsored by the seed investor but over which the manager is granted some discretionary authority, or (v) any combination of the foregoing. Each of these options helps provide the manager with a larger operating/investment budget such that it can take a longer term view of its business and investment approach, but each also has its own benefits and drawbacks. By example, an investment into the manager's commingled fund (which in our experience continues to be the most common structuring option) contributes to the growth of the fund but may also raise potential fiduciary concerns depending on the preferential terms granted to the seed investor in return for its anchor investment. By comparison, an investment into a separately managed account or satellite fund could mitigate fiduciary concerns and may help with fundraising if the seed investor's reputation can be leveraged, but it would not contribute to growing the assets under management of the manager's flagship product.

Common Seed Investment Terms

Seed investment negotiations are highly bespoke and depend to a great extent on the manager's and the seed investor's relative bargaining power. However, there are commonly negotiated seed terms, certain of which are discussed below.

Profit Share. Seed investors typically receive profit shares in return for their seed investments. Such profit shares can be broadly categorized as either revenue shares or equity stakes, which are profit shares that are gross and net of a manager's expenses, respectively. Because revenue shares are gross of a manager's expenses, negotiations tend to be less protracted, and the revenue sharing arrangements tend to be simpler and less restrictive. By comparison, because equity stakes are net of a manager's expenses (and as such, seed investors will typically require certain governance rights to monitor the incurrence of such expenses), negotiations tend to be more protracted. Moreover, equity stakes tend to be more operationally intrusive for the manager due to such governance rights. Our experience has been that traditional seed investors still tend to prefer revenue shares because they allow such seed investors to remain mostly passive, which, in turn, reduces concerns about potential liability, regulatory and reporting issues and potential tax consequences that may result from a seed investor's active participation in a manager's business.

A seed investor's profit share can be in respect of (i) a particular fund or strategy, (ii) across multiple funds or strategies, or (iii) across a manager's entire business. Seed investors typically seek to receive a profit share on the manager's entire business as they view their capital as being critical to the establishment of the overall business, rather than a specific fund or strategy. In addition, a seed investor's profit share may be structured to participate only in management fees, in only performance compensation, or in both. Moreover, profit shares can be perpetual, subject to limited termination rights (e.g., subject to put/call options), or finite (e.g., subject to a sunset provision). We are currently seeing profit share percentages in the 10% to 30% range, though we have on occasion seen profit shares as high as 50%, most commonly when, in addition to seed capital, the seed investor is also providing certain support and resources to the manager (e.g., office space, operational/back-office support).

Seed Investment Amount. The amount that a seed investor is willing to invest depends on, among other factors, (i) the seed investor's available capital, (ii) the amount that would constitute a meaningful investment for the seed investor (e.g., large, institutional seed investors typically seek to invest at least $50 million), and (iii) the amount of capital needed to launch the manager's strategy. For example, distressed credit strategies are generally viewed as being more capital intensive relative to long/short equity strategies and thus generally attract larger seed investments.

Lock-Up. Managers typically require seed capital to be locked up for a period of time (e.g., one to three years is common), subject to limited early withdrawal rights due to the occurrence of certain events such as key person events, performance-related triggers, investment strategy changes, investment guideline breaches, and regulatory/reputational concerns.

Consent Rights. Seed investors typically seek consent rights over certain manager actions such as material changes to the fund's terms (particularly any reductions in fees in respect of which the seed investor is receiving a profit share), changes to key service providers, and other actions that may impact their profit share (e.g., governance over the manager's incurrence of expenses if the profit share is a net revenue deal).

Preferential Terms. Seed investors typically receive preferential terms including MFN rights, capacity rights, fee discounts, drag/tag rights, transparency and reporting rights, and indemnification in favor of the seed investor.

Restrictive Covenants on Certain Key Persons. Seed investors often require certain key persons of the manager to agree to various restrictive covenants (e.g., non-compete and non-solicit provisions) designed to prevent such persons from competing with the manager or otherwise negatively impacting or circumventing the seed investor's revenue share.

How to Comply with New York City's New "Cooperative Dialogue" Requirement

By: Jason Habinsky, Partner, HaynesBoone LLP

In 2018, hedge funds, like other employers in New York, have been busy keeping up with the rapid-fire developments in both the New York City and New York State employment laws. While the new laws combating sexual harassment in the workplace have been taking up much of the spotlight, it may have been easy to miss an important new modification to New York City law requiring a "cooperative dialogue" in response to workplace requests for reasonable accommodations.

For many years, the New York City Human Rights Law (NYCHRL) has required New York City employers to provide reasonable accommodations for employees with disabilities, or for reasons related to pregnancy or childbirth, religious needs, or domestic violence, unless such modifications would create an "undue hardship." Reasonable accommodations may include, for example, modifying equipment or a work schedule, or providing time off. However, as of October 16, 2018, the NYCHRL now imposes a strict procedure employers must follow in response to any such accommodation requests.

The amendment defines a "cooperative dialogue" as a good-faith "written or oral dialogue" between an employer and the employee who has requested or requires the reasonable accommodation. The law now specifically sets forth the issues that must be addressed during the dialogue, including, the employee's specific accommodation needs, the types of accommodations available and alternatives that may address the employee's needs, and any difficulties the accommodations may pose for the employer or the employer's business. It is important for employers to understand that the cooperative dialogue may consist of several exchanges, either verbal or written, as the parties continue to discuss and assess these issues. An employer may not determine that an accommodation imposes an undue hardship or that no reasonable accommodation exists that would enable the individual to perform his or her job, until the employer has both engaged in and completed the cooperative dialogue process.

Perhaps the most striking component of the amendment is a requirement that a New York City employer issue a "written final determination" following the completion of the cooperative dialogue. This concept of documentation is neither required by the current version of the New York City law or by the federal Americans with Disabilities Act which also requires an interactive process. That means that once the employer has reached a final determination, it must provide a written document to the requesting employee identifying whether the accommodation has been granted or denied.

Significantly, failing to engage in a cooperative dialogue or to provide a written final determination each will be an independent violation of the NYCHRL. Any such non-compliance could expose an employer to civil damages, penalties and other legal repercussions.

All New York City employers, including hedge funds, should fully understand their obligations to provide reasonable accommodations to employees with workplace challenges. In the face of the new NYCHRL requirements, employers should review and update their policies and procedures addressing such workplace accommodations to ensure compliance with the requirements to engage in a cooperative dialogue and issue written determinations. In addition, New York City employers also should make certain that all decision-makers, supervisors, and human resources staff are fully up to speed on the new requirements and understand these expanding obligations.

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Alternative Data Due Diligence: AIMA Panel Discussion

Bill Saltus, Director, Wells Fargo Prime Services, Business Consulting provides a recap of AIMA's panel discussion on their Alternative Data Due Diligence Questionnaire

As the hedge fund industry is increasingly incorporating alternative data sets into their investment management process, the compliance function may be playing catch-up in terms of vetting these emerging providers. To that end, the Alternative Investment Management Association (AIMA) published on August 24th a due diligence questionnaire for alternative data vendors, which is available to all AIMA members via their website. To formally discuss the factors influencing the release of the DDQ, on September 28th, AIMA assembled a panel of senior compliance and legal personnel from hedge funds and law firms. The following is an overview of the topics discussed during the panel.

Rationale for putting together an alternative data DDQ

Given the increasing press coverage and regulatory scrutiny on the topic of alternative data, it's more important than ever to have sound policies and procedures around the vetting, procurement, and usage of alternative data. This heightened awareness led the AIMA member firms to participate in the assembly of the Alternative Data DDQ. This participation was seen as an effort for hedge fund compliance departments to better address an area of the business that is clearly growing.

Compliance teams noted that alternative data providers don't often understand the questions being asked of them by financial services firms, including questions related to material non-public information (MNPI). Therefore, this DDQ was seen as an opportunity to help educate the overall community. From a hedge fund perspective, a Greenwich Associates survey recently found that it can take 85 to 200 hours of due diligence per data set. Due to the limited resources that are available within most hedge funds, there is a clear need to standardize and streamline this process. In an effort to streamline this alternative data onboarding process, it was noted that some vendors have been cited as offering a standardized trial agreement.

Developing a compliance process for alternative data

To reinforce the point about developing a process, AIMA took an informal audience poll, asking questions related to data policy. While no one in the audience had a formal data budget, a few had a data policy. Only two audience members had been asked about their use of alternative data on an investor request for proposal (RFP). This line of questioning was followed up with a statement that there needs to be an owner of the alternative data due diligence policy within the hedge fund organization. Furthermore, this owner needs to be aware of the compliance policies of any such firms they engage for the procurement of alternative data.

Two regulatory hot-button issues are Material Nonpublic Information ("MNPI") and privacy, and the SEC is currently in watching mode with regard to how alternative data might run afoul of these issues. Having a process could help mitigate issues related to these and other topics. It was also discussed that since the Investment Advisors Act references negligence standards, and the SEC has a theory of liability and standards of care, having a process could help demonstrate to a regulator that a firm has standards.

Example of issues with alternative data

Panelists cited some interesting instances where the use of alternative data by the investment management community has been called into question.

One example discussed is web scraping. There's not a lot of clarity at the moment, but a law from the 1980s known as the Computer Fraud and Abuse Act (CFAA) may potentially govern some of the issues related to this topic, including: circumventing screen blocks; copyright law; and terms of use. In addition to federal law, there are various state laws that may also govern web scraping. Outside the US, a European airline sued companies that scraped their site for airfare information. So the takeaway here is that there is no legal certainty around this topic.

Engaging an alternative data provider

When engaging with an alternative data provider, it is increasingly important to follow a standardized due diligence process that is governed by the compliance team. There are, however, some instances which may be simpler if it is clear that the information is publicly available, such as a government website.

For other types of data sources, when undertaking a trial based on stale data, it may be less critical to immediately engage the compliance team. However the formal due diligence process will need to be invoked once that trial period expires, if the engagement with the data vendor will become a commercial one. Lastly, when considering the commercial terms of an arrangement with an alternative data provider, panelists noted that although their firms weren't using commission sharing agreements to help offset the cost of alternative data analytics, there wasn't an obvious case for why such an arrangement would not be permissible.

What managers should ask their Professional Employer Organization (PEO)

The Business Consulting Group speaks with Lou D'Agostino, Principal at Iron Cove Insurance / FinCare, LLC (a firm that specializes in PEO brokerage), to hear his opinions on where he is seeing managers gain efficiencies in their human resources management.

One of the resources PEOs provide is health insurance. This is offered either as a pass-through model or as a self-insured model. What is the difference between the two models?

The pass-through model is when the PEO functions as the intermediary between a health insurance company and your firm and the insurance company takes your premium to cover employees for medical expenses. The PEO passes through the cost and risk of health insurance.

On the other hand, if a PEO collects your premium and keeps it until they have to pay your medical expenses, that's a self-insured model. In this setup, the PEO utilizes the medical network of a major health insurer (e.g. Aetna, United, Oxford) in order to provide a vast network of doctors. However, the true insurance risk still falls on the PEO.

The danger of working with a self-insured PEO comes when occasional cycles of extraordinary claims occur. This phenomenon not only depletes the cash reserves (aka float), but also puts the balance sheet of the PEO at risk – this in turn degrades the PEO's financial health. In order for the PEO to recover (and meet Wall Street expectations), it will need to increase its revenue drastically.

In a pass-through model, the PEO's financial health is immune from an extraordinary year of bad claims.

In a manager's analysis, they should consider the fact that a self-insured PEO may sustain much more financial impact in a bad claims year than a pass through model.

What are some of the large service charges a manager should pay attention to in terms of pricing efficiency from their PEO?

The three major areas are 1) health insurance, 2) worker's compensation insurance, and 3) monthly administrative fees.

With regards to healthcare, what is the average increase a manager should expect?

Nationwide, we typically see an average of 3% increase annually in health insurance costs. The NY Metro area averages 6-8%. If a manager observes increases above 10%, they should thoroughly investigate the increase; although do not expect to receive much loss related data or supporting information from the PEO provider.

If a manager determines they are being charged disproportionate healthcare increases how can they conclude if the increase is attributable to medical plans or administration of the plan?

Disproportionate increases are commonly a result of two reasons: 1) your employees have higher than average medical expenses, or 2) the PEO is charging you higher than normal rates. Insurance brokers should be tracking market price movements and thus be able to decipher why healthcare costs are abnormally increasing.

If a manager feels they may be receiving higher-than-average healthcare increases, do they have negotiating power? What can a manager do to mitigate these situations?

Managers always have negotiating power. If their employees exhibit higher than average medical expenses, they could: have the PEO position them in a different tiered plan, consider another insurance carrier, consider multi-year averages versus just one year's claims, or convert an after-tax payment to a pre-tax payment. There are ways for the manager to pay a lower premium, while paying their employee's higher deductibles, and still realize cost savings.

If employees exhibit below average medical claims, and the manager sees 10%+ increases in premium, there is a chance they are being over charged. Their broker can help confront the issue, as well as shop for another PEO. Insurance pricing is an algorithmic process and a broker should be able to tell if you are being unfairly charged.

Workers compensation insurance is another large expense for managers. This fee is often hard to discover due to bundling. What questions should a manager ask to uncover this charge and get a clear view into the fees they are being assessed?

Managers can quickly find this information from their payroll reports under names such as "Payroll Register" or "Detailed Payroll Invoice." Some PEOs bundle bill, hence combining charges and leaving you to determine the various monthly costs. Managers can run an off-cycle bonus payment and attempt to reverse engineer worker's compensation charges. In some cases, PEOs just refuse to be transparent and as a result, leave the manager with little information.

What are standard industry charges for workers compensation and how high have you seen charges reach? Are there specific terms managers should ask for to gain efficiencies in workers compensation pricing?

Worker's Compensation insurance is charged as a percentage (bps) of each dollar that is run through W2 payroll. There are ranges of acceptable rates on a per state basis based on classification of employees (e.g. Clerical Employee = 8810). As an example, in NYS, the rate per $100 of payroll that flows through the W-2 for the 8810 Class Code ranges from .17 to .18 cents per $100 of payroll. If you include related taxes and surcharges it may increase to .22 - .23 cents. For example, $20,000,000 in payroll for all 8810 employees in NYS should be calculated as follows:

> $20,000,000/$100 = $200,000 x .18 = $36,000 in annual premium or 18 bps

In our opinion, anything over 30 bps begins to be too high. We quite often see 50 bps being charged, but the manager doesn't know that is too high. In rare cases, I've even seen 70 to 90 bps in states like CA.

Please remember that worker's compensation insurance is for the rare occasions where employees have work-site accidents. Since the financial services industry is a white-collar environment, loss ratios are historically extremely low (<4% annually) and to the extent that the PEO has self-insured this risk, this becomes a major PEO profit center.

There are generally two types of billing methods: Fixed Fee and Percentage Fee. Where do you see advantages in one billing method over the other? Are there key provisions managers should either ask for or be wary of?

Since most hedge fund employees receive bonuses in excess of base salary, the preference would be to have a fixed fee over a percentage of total payroll. Otherwise when employees receive a bonus the PEO does as well.

When a manager is reviewing their service charges they should pay attention to the monthly administration fee they are charged, but often this fee is hard to determine. How can a manager determine their administration fee and what are general industry ranges they should expect?

If a PEO doesn't bundle their pricing, a manager can find these administrative charges in the payroll reports. That being said, some PEOs simply refuse to offer transparency. We often see a rate of $250 per employee per month. In our experience, a reasonable administrative charge should be in the range of $78-$95 per employee per month.

Managers have the right to negotiate this fee down toward industry norms and their broker should be able to help them approach the PEO, and/or shop for another PEO.

Hedge fund management companies usually operate as a partnership or an LLC. This structure can create a scenario where working partners/members are not eligible for benefits coverage (as they are not technically "employees"). What service arrangements do you recommend working partners/members utilize to avoid unnecessary worker's compensation and unemployment tax charges?

There are PEOs who accommodate K1 partners and integrate benefits coverages seamlessly. For the PEOs that are more difficult, some managers pay the partners the amount equivalent to minimum wage via W2, so that they can be "included" for benefit purposes. With respect to Workers Compensation, each state has different requirements as to allowing exemptions or compensation caps for owners, partners and executives. In most states, owner/partners can be exempt from Workers Compensation by simply executing a waiver. As for executives, attestation forms can be signed to ensure that their salaries are capped for the purposes of determining workers compensation premium.

Is there a best time of year for a manager to change their PEO?

Year-end is always the best time to change PEOs. Changing PEOs mid-year may force resets on payroll taxes, medical deductibles and flex spending accounts. While there are mechanisms to ensure that a firm receives adequate credits, it creates some additional administration and possible disruption that needs to be managed. From a state and federal tax perspective, certain PEOs have a special IRS certification that enables them to credit payroll tax resets. Managers should consider, and ask for, a PEO that is IRS certified.

Communication Matters

By: Andrew Bergin, Managing Partner, Speaking Virtually

Launching a new hedge fund is like being the 700th coffee shop in a neighborhood full of Starbucks. How do you carve out a differentiated space for your fund and attract capital that has a multitude of global deployment options? After coaching at 22 hedge funds and 80 other firms from the CEO level down, I can suggest 3 simple methods to try as individuals and teams to communicate more effectively with investors.

- **Revisit the core stories of your fund.** Give yourself 350-500 words at your desktop and try re-crafting 2-minute versions of every business story. Once you type it out – then edit it down by shortening sentences, eliminating filler words and making it more conversational. Then verbalize these stories, with the material and without. Practice aloud for a loved one, colleague, friend or smartphone camera. Practice while jogging or walking the dog or in the car in traffic. The goal is to internalize the messages so you can tell them to strangers in any venue at any moment with no notes. It's going back to school on your business. Sounds like a pain in the neck – it is. Once done though, it's done for good, or until the story changes. Then, when you improvise in front of investors, you're not improvising off bullets in a pitch book. You're riffing off a solid story – your own – because you wrote it. In 38 years on the Street including 15 as a coach, I've observed that the best communicators are not creative – they're repetitive. Create a language for your fund and a vault of well-worn messaging for every PM, quant, researcher, analyst, manager in the firm to use. They'll speak in their own style but investors will get consistent, repeatable messages. They'll see you as a seamless team.
- **Before you hit the prospecting road, spar as a team**. Most teams don't have time for full blown dress rehearsals, even for a finals pitch. Sparring doesn't take that long. You take the team into a conference room for 30-60 minutes. You lay out the investor situation and then half the team does the pitch while the other half role-plays as the investors. They pepper the pitchers with questions and challenge their experience, track record, fee structure, team talent, numbers, etc. After 15 minutes of sparring, the team recaps what happened and discusses options. They may suggest that the pitchers reorder slides in the book, emphasize key points harder or change some verbal or nonverbal mechanics. In my experience, it's the best team practice you can do. Like any athlete in any sport, you get your game on before you perform. Too many teams in our business depend on their prior experience or serendipity to prep for investor meetings that could mean multiples of millions in new assets under management. Why go before prospective

investors and individually succeed yet collectively fail as communicators? Build sparring into your team's rituals. Make it a must-have instead of a nice-to-think-about. Be like Michael Jordan though. Practice the way you're going to play the game. It raises the ante on practice to a higher level of team commitment and beats the heck out of pro-forma practice.

- **Favor conversation over presentation**. Who came out of their mother's womb saying "thanks for coming – it's great to be here." Presentation is an unnatural act. By contrast, conversation is something we've done from toddler time on and we're really good at it. Do we have to be able to navigate our way through a deck of dense material in a finals pitch with investors or clients? Of course. I'm simply suggesting you approach the material as organized talking – not as a presentation. When we get into our presentation voices, we revert to being reporters, not leaders or subject matter experts. We operate below our pay grade, talent level and communication capabilities. Here's how to get out of that trap. In investor meetings, you may lead off the meeting or be handed off to by a colleague. In either case, set (or reset) the table, off-book, eye to face with investors around the table, in your 'leader' voice. Frame what you'll cover in the slides ahead and then state your intent. (e.g. "What we'd like you to walk away with from this section is a fuller understanding of our investment process and why it's substantially different from other funds you may meet." Otherwise you might jump right into the material, head down and disconnected from your audience. In that 30-60 second 'leader' voice moment you establish ownership of your message, yourself and the room before you go into 'presentation' mode. It sounds minor, but in practice in front of real investors, it can be major. Investors aren't just buying a book or a model or a process. They're buying you and your team. They have to believe in you and what you do. The slides aren't the star – you are!

There are no magic bullets. There is simply doing the work. Like sports – do the reps, get the results. Small investments like these can produce outsized returns. Of course, the ideal situation is to leave the book home and just have a conversation. Nice work if you can get it.

Legal & Regulatory Trends

Co-Investments in the Hedge Fund Space

By: Kelly Zelezen, Partner, and Rita Fitch, Associate, Kleinberg, Kaplan, Wolff & Cohen, P.C.

In line with investor demand, hedge fund managers have been increasingly utilizing co-investment vehicles, structures traditionally associated with the private equity industry. Co-investment vehicles are typically used to participate in single ("best idea") investments, usually alongside a manager's "main fund." Co-investment vehicles not only offer hedge fund managers an opportunity to meet investor demand and build relationships, but also to invest in less liquid assets or different strategies than may be permitted under their main fund's investment strategy, to further invest in an attractive opportunity when their main fund has reached capacity, to create a track record with another vehicle, and to offer more products to differentiate themselves. Below we will address some of the various considerations in raising co-investment vehicles, including (i) structuring, (ii) key terms, (iii) offering issues and (iv) other conflicts and regulatory issues.

Structure

One standard co-investment structure is an "one-off" Delaware or Cayman Islands limited partnership ("LP") or limited liability company ("LLC"). However, if a manger is expecting to participate in numerous co-investment opportunities with different investors, then this structure, which requires a new entity and related documentation for each separate investment, can create an administrative burden.

An alternative structure is a Delaware Series LLC or Cayman Islands segregated portfolio company (collectively, "Series Structures"), which allows a manager to simply create a new series within the same entity for each new co-investment opportunity. Under Delaware and Cayman Islands law, each series/portfolio in these Series Structures is treated as a separate legal entity, so the assets and liabilities of each series/portfolio are segregated from the assets and liabilities of other series/portfolios.[1] No formation filings are required to create a new series in a Series Structure, however, because each series is treated as a separate legal entity, there are regulatory and administrative requirements associated with each new series, as managers generally make separate tax (e.g., EIN), Form D and blue sky filings etc. for each series. Thus, while a Series Structure is beneficial because the actual entity and framework (e.g., term sheet with the core terms) is already established, the time and cost savings are not as great as may initially appear.

A manager can always just add a series or class to an LP or LLC (without utilizing a Series Structure) for each subsequent investment it makes, but if there are different investors participating in different investments this may be unattractive to investors because they would potentially have exposure to the liabilities of other series/classes/assets (unless, for example, the different series/classes just hold different tranches of shares of the same company).

Another alternative is to have a co-investor invest directly in the asset and potentially give a proxy or power of attorney to the manager. However, in our experience, this is more common in the private equity context where managers sometimes need co-investors in order to consummate a deal.

Key Terms

Co-investment vehicles tend use certain private equity style terms since underlying assets tend to be less liquid and harder to value. For example, the term of a co-investment vehicle holding an illiquid asset will often match the life of that investment, and investors will usually have limited (or no) withdrawal rights.

Additionally, the incentive allocation, in our experience, will often be a private equity style waterfall, where carried interest distributions are made upon the disposition of the asset, with or without a preferred return to investors.

Management fees rates are often lower than rates charged by a manager's main fund(s), and managers sometimes waive management fees altogether (especially if co-investors are investors in the main fund). Management fees can be calculated based on net asset value, but sometimes, because of the hard to value nature of an illiquid co-investment asset, they are based on the lower of cost and net asset value.

When a co-investment asset has reduced liquidity or is restricted, managers must also use alternative means to "pay" for the management fee, such as setting up "reserves" funded by initial contributions or using capital calls which would force investors to make additional contributions to cover management fees. Similar issues arise in paying ongoing expenses, and the foregoing solutions (reserves or capital calls) can also be utilized to cover expenses.

Offering and Selecting Co-Investors

An early stage decision, along with structure and terms, is to consider who will be offered the opportunity to participate in the investment. Managers often offer co-investment opportunities to investors in an existing main fund, but may also approach third parties depending on the size of the co-investment opportunity, the investors' level of sophistication and ability to act quickly, the manager's desire to build a relationship with and/or attract certain investors, tax/regulatory or legal considerations and other concerns such as side letter arrangements.

The offering of co-investment opportunities can raise fiduciary concerns along with issues of favoritism and conflicts of interest. This has been an area of particular focus for the Securities and Exchange Commission ("SEC"), which has specifically cited co-investment allocations as an example of favoritism and noted that "Rule 206(4)-8 of the Investment Advisers Act of 1940, as amended ("1940 Act"), and other antifraud provisions might be violated without adequate disclosure."[2] The SEC has recommended that managers let investors know when, and on what basis, co-investment opportunities will be offered, so that investors are able to "complain" about a manager's process.[3]

Importantly, the SEC has not required managers to allocate co-investment opportunities among investors pro rata or in any particular manner, but rather to carefully disclose to investors "where they stand in the co-investment priority stack." Based on this guidance, standard practice is to establish a co-investment allocation policy (listing factors a manger will consider when making allocations) and include detailed disclosure on such policy in the fund documents.

Other Conflicts and Regulatory Issues

Expense allocation also raises conflicts of interest concerns, but, similar to the conflict discussed above, can generally be cleansed through a formal policy and sufficient disclosure. For example, when expenses relate to an investment held by both, expense allocation also raises conflicts of interest concerns, but, similar to the conflict discussed above, can generally be cleansed through a formal policy and sufficient disclosure. For example, when expenses relate to an investment held by both a main fund and a co-investment vehicle, especially broken deal expenses, the default rule is to allocate expenses pro rata (or, if a co-investment vehicle's operative documents do not permit certain expenses, have the manager bear the vehicle's pro rata share of such expenses). However, a manager should be able to allocate in a different manner so long as it is sufficiently disclosed to investors.

Managers that are registered investment advisers ("RIAs") should also be aware of certain additional regulatory considerations. Co-investment vehicles are typically considered "clients", so an RIA will generally need to disclose these vehicles on its Form ADV. Furthermore, an RIA must comply with the Custody Rule (Rule 206(4)-2 under the 1940 Act), including the requirement for the vehicle to undergo an annual audit (or otherwise be subject to surprise examination).

While certain elements of co-investment vehicles mirror those of traditional hedge funds, there are many unique issues and considerations that managers need to address, including unique conflicts, not all of which are covered in this article. Managers are encouraged to consult with their tax and legal advisers throughout the co-investment process.

1 Note, however, that there is little to no precedent available on the treatment of Series Structures by Delaware, Cayman Islands and other foreign courts, so there is no guarantee that such segregation would be upheld in all instances.
2 https://www.sec.gov/news/otherwebcasts/2014/complianceoutreachns013014.shtml
See FN 1.
3 https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html

Institutionally Managing Your Trading Relationships

By: Devi Koya, Principal, Koya Law, LLC

Is it really that important to spend time and money negotiating the terms of my trading and financing agreements? Why? It's really all about relationships, isn't it? Are some terms more important than others?

On a day-to-day basis, clients aren't looking through their trading agreements. If they have a question, they call their contact at the dealer who susses out the answers by calling his or her legal or ops team. This may not be an option in times of uncertainty but such times are when a firm's knowledge of the terms of its relationship is critical. The uncertainty can be market-related or could be due to something that happens within a firm.

For example, when Lehman filed for bankruptcy, firms needed to quickly understand the terms of their agreements, from the most basic information to a more nuanced understanding of their collateral rights. Their contacts at Lehman weren't there to answer their questions – in fact, no one was answering their phones at all. First, there was a scramble to find agreements and then, to locate attorneys that could review hundreds of pages to answer questions such as: *What entities am I facing under these contracts? Where are my assets held? Can I get my collateral back? What is my exposure to these entities? Can the bankrupt entity grab the collateral held under the other agreements with other Lehman entities?*

Other less-world-changing events can also impact your relationships. For example, If LIBOR – OIS spreads widen out, can a dealer change your financing rates or terminate your relationship? At a firm level, inflection points, such as the departure of a key person or an SEC investigation, can trigger termination rights and notification obligations.

If you have one or two PB relationships, a few ISDAs and a couple of futures accounts, you can have your attorney provide you with a detailed summary of your more important provisions. It's a little expensive, but your information will be there when you need it. You just have to remember to update and maintain these summaries as your relationships with dealers evolve.

If you have multiple entities with many trading relationships, the spreadsheet option is no longer a viable solution. A fund manager with four trading entities, each of which have three or four PB agreements, ten or more ISDAs, three or four futures agreements, and several repurchase agreements, options agreements, total return swaps and execution agreements will have hundreds or thousands of documents across possibly dozens of dealer relationships to track. Additionally, based on the strategies and jurisdictions of each trading entity, the agreements with a dealer can differ from entity to entity. Manual summaries are unreliable and the upkeep of this information without structure becomes unmanageable.

I receive a phone call several times a year where a client describes some event and ask us to look into its impact on their agreements. Our team drops what we are doing and pull all of the agreements that we and the client can locate. We then pore over each agreement to determine the applicable provisions and impact of the event to provide the client with an update. This process sometimes takes days or weeks and I worry about missing something. This type of review is expensive and time consuming.

The events of 2007 and 2008 also evidence the importance of promptly accessing and negotiating the terms of these agreements. Market events and firm events occurring at once require a good grasp of agreement triggers, which is critical to maintaining and strategically managing a firm's stability. In my prior life at a hedge fund, during such times, knowing and consciously negotiating the terms of our agreements enabled us to push back on actions that could have hurt the business. Our terms gave us bargaining power that we otherwise would not have had.

Seeing this need for information quickly and how opaque these agreements can be (similar in substance, but often varying in form from dealer to dealer), our firm has developed a web based application to store, track and organize the material terms of trading and financing agreements. Our tool, Koya DocuTracker, was developed with a focus on industry terms and is not specific to any one dealer. The functionality stores and organizes over 25 trading and financing agreements. It also tracks and provides reporting on hundreds of material economic, credit and legal terms in these agreements and across dealers. The answers are summarized into plain English answers and available at the click of a button.

To be institutional and truly manage the stability of a trading firm's business, it is crucial in the most extreme times to know and quickly access the terms of the agreements that form the foundation of your business. Whichever way you choose to do this, it should be reliable, readily available, and comprehensive.

Eight Common Best Execution Deficiencies and How to Prepare for Your Next Exam

By: Christopher Riccardi, Partner, and Nicholas Miller, Associate, Seward & Kissel LLP

Earlier this year the SEC's Office of Compliance Inspections and Examinations issued a Risk Alert providing examples of common deficiencies found in advisers' compliance with their best execution obligations. By highlighting these deficiencies, the Risk Alert provides advisers with a roadmap to assess both the effectiveness of their best execution policies and procedures and the adequacy of their disclosures so that they can be prepared for their next SEC examination.

The deficiencies highlighted in the Risk Alert, along with key takeaways for advisers, include:

- *Not performing best execution reviews.* An adviser should maintain documentation demonstrating that it systematically evaluates execution performance.
- *Not considering materially relevant factors during best execution reviews.* As part of its best execution

reviews, an adviser should consider qualitative factors such as execution capability, financial responsibility and responsiveness, and traders and portfolio managers should be involved in the review.

- *Not seeking comparisons from other broker-dealers*. In utilizing a particular broker-dealer, an adviser should consider the quality and costs of services available from other broker-dealers. It is not enough for an adviser to simply rely on a review of its current broker-dealer's policies and prices.
- *Not fully disclosing best execution practices*. An adviser should fully disclose its best execution practices, including that certain types of client accounts may trade the same securities after other client accounts (if applicable) and the potential impact of this practice on execution prices. In addition, an adviser should periodically check to ensure that its best execution disclosure accurately represents the adviser's practices.
- *Not disclosing soft dollar arrangements*. An adviser should fully disclose its soft dollar arrangements, including the use of such arrangements, that certain clients may bear more of the cost of such arrangements than other clients, and that certain products and services purchased with soft dollars may not fall within the Section 28(e) safe harbor.
- *Not properly administering mixed use allocations*. A "mixed use" item refers to a product or service that is obtained with client commissions that only partially relates to the making of investment decisions. An adviser must make a reasonable allocation of the costs of a mixed use item according to its use and keep adequate books and records concerning such allocation.
- *Inadequate policies and procedures relating to best execution*. Best execution policies and procedures should take into account the current business of the adviser. In addition, it is critical to maintain proper internal controls to monitor execution performance.
- *Not following best execution policies and procedures*. In addition to maintaining adequate compliance policies and procedures, an adviser should ensure that it actually follows those policies and procedures. For example, an "off-the-shelf" compliance manual that includes an exhaustive list of factors to consider when determining and testing best execution will hurt an adviser in an SEC examination if the adviser is not actually following its procedures.

The Risk Alert identifies the types of inquiries that are likely to come up in an SEC examination. We believe advisers should consider taking the following actions now in order to be prepared:

- *Review existing best execution policies and procedures*. The key question an adviser should ask itself is whether its procedures fit its current business. Failing to review and revise procedures as the business evolves (or having procedures that are not followed) will lead to issues on examinations. Advisers should make sure their procedures include, at a minimum, a review of the qualitative factors (e.g., execution capability, financial responsibility, responsiveness) and quantitative factors (e.g., price and commission rates) identified in the Risk Alert, as well as conflicts. Also, if an adviser is not periodically comparison-shopping with other broker-dealers or if its portfolio managers are not involved in the review process, the adviser should make appropriate changes to its procedures. Further, advisers may want to consider establishing a best execution committee because although not required, many institutional investors consider it best practice. Lastly, advisers need to confirm all best execution reviews are properly documented.
- *Review existing disclosures*. Advisers should ensure their disclosures are accurate and consistent across Form ADV, offering documents and DDQs. Maintaining adequate and tailored policies is important, but it is also critical to fully disclose such practices and any related conflicts.
- *Review Mixed Use Allocations*. The Risk Alert makes clear that the staff will continue to scrutinize mixed use allocations, both on a process and a results basis. The key issue facing an adviser is whether there is a reasonable basis for each allocation and whether there is proper documentation. To make the strongest case to an SEC examiner, some advisers may want to consider building in the use of objective criteria to the allocation determination (e.g., determining the average usage time of a mixed-use item on non-investment decision making matters, and allocating costs on that basis).

In light of the Risk Alert, advisers are strongly advised to take steps now to carefully review the adequacy and effectiveness of their best execution policies and procedures and review their current disclosures for accuracy and consistency.

SEC Focus on Valuation – Policies and Practices for Asset-Backed Securities

By: Joshua M. Newville, Partner, Proskauer Rose LLP

Every year the SEC announces that valuation is one of its key areas of focus. More recently, the SEC exam staff has paid particular attention to fund managers' valuation of illiquid mortgage-backed securities and other asset-backed securities. Anecdotally, it appears that some staffers have criticized valuation practices to the extent they use historical data to predict collateral losses. Instead, they have suggested that a more rigorous discounted cashflow analysis based on future cash flows would be appropriate.

If a documented and disclosed valuation process is followed by a manager, it would seem inappropriate for the SEC to substitute its judgment for the manager's. This is particularly true when a methodology has been consistently disclosed, audited and is compliant with GAAP. However, problems may arise in situations where the valuation process for Level 3 assets may not be fully compliant with GAAP. In light of the SEC's focus on valuation policies and procedures, fair valuing illiquid assets should always be a key concern for fund managers. Although valuation can be more art than science, there are heightened regulatory risks in the following areas:

1. breakdowns in controls/policies/procedures,
2. violations of Generally Accepted Accounting Principles (GAAP); and

3. incomplete or inaccurate disclosures to fund investors and auditors.

Setting aside egregious cases, it is uncommon for regulators to challenge a fund manager's valuations as wrong *per se*. Instead, they tend to focus on issues "around" valuation practices. For example, a manager's failure to comply with its disclosed valuation policies (or failure to satisfy GAAP), will be more likely to draw the attention of enforcement. The next layer of inquiry might be a challenge to the actual assumptions underlying a model.

Recent enforcement actions highlight the importance of following GAAP rules consistently and applying disclosed valuation practices.

LendingClub Asset Management:

The SEC's focus is demonstrated by a September 2018 settled action against LendingClub Asset Management (LCA) alleging, among other things, that the manager improperly valued asset-backed securities held by its funds. LCA disclosed that the relevant funds exclusively owned ABS backed by consumer credit loans, and that it would periodically determine a fair market value for those assets using Level 3 inputs. As is typical for Level 3 assets, they lacked observable market inputs and were valued based on management estimates or pricing models. LCA used a discounted cash flow model to predict the future performance of the loans discounted to present value.

However, the SEC took issue with two categories of management adjustments to the model. First, the SEC alleged that the manager improperly incorporated a "floor" for monthly returns that was not based on supportable assumptions. Second, the SEC alleged that the manager made an unjustified change to the discount rate used for its DCF model, which had the result of increasing fund returns. Although LCA later took a series of remedial measures, including outsourcing its monthly valuation to an independent third party, recalculating fund returns and reimbursing investors, the SEC ultimately determined to pursue an enforcement action against the fund manager and certain individuals affiliated with it.

Enviso Capital:

The SEC brought an interesting valuation case in July 2017 based on issues with a discounted cash flow analysis and compliance with GAAP. The settled order against a fund manager, Enviso Capital, alleged that the manager overstated the value of two private funds it advised by overvaluing a loan where it was probable that the full value would not be collected. The SEC was focused on an alleged failure to use reasonable assumptions and estimation of future cash flows when preparing a DCF model. For example, the model assumed significant amounts of energy would be sold generating cash flow within 24 to 30 months, which the SEC alleged was unreasonable. As a result of these valuation issues, the SEC asserted that the funds' performance was overstated and that its financial statements were not GAAP-compliant.

Covenant Financial Services:

The SEC's March 2017 case against hedge fund manager Covenant Financial Services demonstrates how SEC enforcement might approach a typical valuation matter. Covenant used a pricing service to value certain municipal bonds. According to the order, the manager's valuation policy appeared consistent with GAAP, but its execution fell short. Covenant's policy recognized the principles of Accounting Standards Codification 820 ("ASC 820"). Consistent with ASC 820, the policy prioritized the use of Level 2 inputs ("inputs other than quoted prices . . . that are observable for the asset or liability, either directly or indirectly.") over Level 3 inputs ("unobservable inputs for the asset or liability.").

The problem arose because the pricing service used by Covenant estimated values based on a model that used Level 3 unobservable inputs, rather than Level 2 inputs. Covenant allegedly used this model despite being aware of Level 2 indicators that were inconsistent with the model's valuations, including actual trades it made in the same or similar bonds, and broker quotes and marks it obtained. The SEC determined that because Covenant allegedly overstated its funds' performance during those time periods, it violated the anti-fraud provisions of the Advisers Act.

Broker Quotes

The government has investigated and prosecuted a series of cases over the years involving the improper use of third-party broker quotes by fund managers to value illiquid debt securities. The common fact pattern involves an analyst or trader soliciting predetermined or improper quotes from "friendly" brokers, and using those estimates to inflate their own valuations of thinly-traded mortgage bonds.

Although the alleged use of "bogus" marks to inflate the value of a trading book is an extreme example, the regulatory attention to valuation should not be ignored. Problems typically arise when a fund fails to follow its disclosed valuation policies to the letter, turning internal control issues into disclosure issues or potential violations of the anti-fraud provisions.

Fund Finance: Subscription Lines

By: Matthew K. Kerfoot, Partner, Dechert LLP

Overview

A subscription line, or capital call facility, is a type of credit line used by closed-end funds typically to bridge capital calls when purchasing portfolio investments. While real estate funds and private equity funds have traditionally used subscription lines, private credit funds structured as drawdown capital vehicles – particularly direct lending funds – have been increasingly entering into subscription lines.

Collateral

The fund will pledge the capital commitments of its investors as collateral under the subscription facility. The general partner will also pledge its contractual rights to call capital, and the fund will pledge the deposit accounts into which investors wire their contributions.

Borrowing base

Lenders typically permit a fund to borrow up to a specified percentage of the aggregate capital commitments of investors. For example, if a fund has $100 million in unfunded, committed capital, the fund may borrow up to 80% of the value of that amount, or $80 million. This amount is commonly referred to as the "borrowing base". Lenders, however, do not treat all investors equally. Subscription facility documentation often includes a provision identifying which investors qualify as "included investors." The capital commitments of these investors will be included in the calculation of the borrowing base. These investors, which often include pension plans or other similar institutional investors, generally have better creditworthiness than natural persons or family offices, whose commitments are often not included in the borrowing base.

Repayment terms and use of proceeds

Historically, subscription lines were short-term, uncommitted facilities with a maturity of up to one year but with repayment of any drawn amounts required within 60-90 days. In the past several years, however, subscription lines have been more commonly structured as committed, revolving credit facilities, with a term of one to three years. Repayments of drawn amounts, though, are often still required within 90 or 120 days.

Limited partners often have up to ten business days or more to fund capital calls from general partners. A general partner that is considering an acquisition in the next day or so, however, can draw down under the subscription facility and receive loan proceeds in 24-48 hours. When the capital calls are funded by investors, the general partner can then repay the outstanding subscription facility loans. In some instances, institutional limited partners have asked that a fund enter into a subscription facility to consolidate multiple capital calls into fewer and larger calls. This is more common with private debt funds, which originate or acquire debt instruments that are significantly smaller in size than portfolio companies purchased by private equity funds.

In addition to acquiring portfolio investments, general partners have been using subscription facilities for day-to-day cash management purposes, including paying management fees, taxes and fund expenses. General partners have also been using these lines to satisfy recently required daily margining for foreign exchange hedging transactions.

Recent trends

More recently, however, general partners have been keeping drawn amounts outstanding for longer periods of time before calling investor capital, thereby effectively providing semi-permanent portfolio-level financing. In most cases, the interest rate on the subscription facility will be substantially lower than an asset-based facility collateralized by a portfolio of private debt. In addition, a subscription facility may also allow the general partner to delay the payment of management fees by the fund and accelerate distributions to investors. Together with a delay in calling investor capital, these cash management measures may also increase the internal rate of return of the fund.

Considerations for general partners

Transfers by investors

Some investors and general partners have expressed concerns about certain terms commonly found in subscription facility documentation. Lenders will ordinarily include covenants to restrict the ability of included investors to transfer their interests in the fund. A lender is relying upon the creditworthiness of a set of limited partners for the ultimate repayment of the facility. Accordingly, the documentation may permit only a small percentage of included investors – e.g., 5% – to transfer their partnership interest. Any amount above the threshold will typically require lender consent.

Consent from investors

Lenders also may require that the limited partners expressly consent to the general partner's pledge of their capital commitment. The general partner may try to negotiate instead a simple notification to the investors, which could be provided as part of a periodic communication – such as in an account statement – or included in the next capital call. Note that in some jurisdictions, notice to the investors is required to allow the lender to perfect its security interest.

Restrictions on portfolio investments

Lenders may also seek a lien on the fund's portfolio investments. While this is more common in a hybrid subscription facility/asset-based line, some managers have been willing to allow for a pledge on portfolio investments in exchange for better pricing, advance rates or other terms. General partners in these deals have at times had difficulty obtaining portfolio-level financing while the subscription facility is outstanding. The subscription facility lender will ordinarily restrict the ability of the fund to incur additional portfolio-level debt and grant a pledge on portfolio investments.

Certain Tax Advantages of Hedge Funds over SMAs Widened as a Result of Tax Reform

By: Joseph M. Paral, Partner, Sidley Austin LLP

The tax reform legislation enacted in 2017, commonly referred to as the Tax Cuts and Jobs Act (TCJA), introduced changes that amplified certain tax advantages to a non-corporate taxpayer of investing in a hedge fund rather than a separately managed account (SMA).

Deductibility of Investment Expenses

Hedge funds and SMAs often incur substantial expenses, including investment advisory fees, net payments on swaps, and other amounts. For example, hedge fund managers are typically compensated via both a management fee, calculated as a percentage (e.g., 2% per annum) of net asset value, and incentive compensation, calculated as a percentage (e.g., 20%) of any increase in net asset value. The ability of an investor to obtain the benefit of a tax deduction for these expenses can therefore have a material impact on the investor's after-tax returns.

Prior to the TCJA, non-corporate taxpayers (individuals, trusts, and estates) were able to deduct many of these investment expenses, subject to certain limitations if the expenses were incurred in an investing activity. In particular, investment advisory fees, net payments on certain swaps, and certain other deductions were considered "miscellaneous itemized deductions," which were deductible only to the extent miscellaneous itemized deductions exceeded 2% of the taxpayer's adjusted gross income. In addition, an individual taxpayer's total itemized deductions generally were subject to a reduction equal to 3% of the individual's adjusted gross income in excess of a certain threshold amount. These limitations did not apply, however, to expenses incurred in a trading business.

Whether a taxpayer is considered to be investing (an "investor") or trading (a "trader") for this purpose depends on the nature and extent of the taxpayer's trading and investment activities. For individuals, the case law generally provides that mere oversight of independent investment managers who trade assets of the individual in an SMA is insufficient to qualify the individual as a trader, regardless of the frequency and nature of the trades effected in the SMA. See Mayer v. United States, 32 Fed. Cl. 149 (1994). On the other hand, hedge funds that regularly and continuously trade with short holding periods often determine that they are traders, rather than investors, in light of the nature and magnitude of their operations.[1] Expenses incurred by a hedge fund partnership in connection with a trading business retain that character when they pass through to investors.

The TCJA magnified the distinction between investing expenses and trading expenses by suspending all miscellaneous itemized deductions of non-corporate taxpayers for tax years 2018-2025. The resulting impact on returns can be substantial, as the following examples illustrate.

Example 1: Assume Individual X invests $100,000 in an SMA and is considered an investor. During the year, the SMA generates $22,000 of short-term capital gain and the manager is entitled to a $2,000 management fee and $4,000 incentive fee. Under the TCJA, X cannot deduct any of those fees and thus has $22,000 of taxable income from the SMA. Assuming a 40% federal income tax rate, X has an $8,800 federal income tax liability, resulting in $7,200 of after-tax income ($22,000 - $2,000 - $4,000 - $8,800), a 7.2% return.

Example 2: Assume instead that X invested the $100,000 in a hedge fund partnership that qualifies as a trader but otherwise has the same terms and performance. Following the TCJA, management fees incurred in the trading business continue to be deductible. Accordingly, X can deduct the $6,000 of fees from its $22,000 of gains, resulting in only $16,000 of taxable income from the fund and only a $6,400 federal income tax liability. X thus has $9,600 of after-tax income ($22,000 - $2,000 - $4,000 - $6,400), a 9.6% return.

Structuring Incentive Compensation as a Profits Interest

Another advantage of a hedge fund over an SMA is the ability to structure the manager's incentive compensation as a profits interest, rather than a fee for services. With a profits interest, income that would otherwise be allocated to the investor is instead allocated to the manager, reducing the taxable income of the investor regardless of whether the fund is considered an investor rather than a trader.

Example 3: Assume the same facts as Example 2, except that the incentive fee is replaced with a profits interest and the fund is an investor. The manager is allocated $4,000 of gains with respect to its profits interest, and X is allocated only $18,000 of gains. X is also allocated a $2,000 deduction for the management fee but is unable to deduct it under the TCJA. Accordingly, X has $18,000 of taxable income from the fund and a $7,200 federal income tax liability, resulting in $8,800 of after-tax income ($18,000 - $2,000 - $7,200), an 8.8% return.

The result in Example 3 is not as favorable as the result in Example 2 because the management fee is not deductible for an investor fund. However, it is still considerably better than the result in Example 1 under an SMA because the profits interest provides a benefit akin to a deduction for the investor.

1 The determination is made annually and may change based on differences in facts from year to year. Moreover, the Internal Revenue Service may challenge the fund's determination.

New York's Anti-Sexual Harassment Legislation: What You Need to Know

By: Allan S. Bloom, Partner, Proskauer Rose LLP

In April 2018, Governor Andrew Cuomo signed into law several significant measures intended to address and prevent sexual harassment in the workplace. As of October 9, 2018, all New York State employers were required to adopt written sexual harassment prevention policies. And starting on that same date, New York employers are required to institute annual anti-harassment training for employees, with all current employees to complete initial training by October 9, 2019. The requirements apply to all employers, regardless of size.

Policy Requirements

To satisfy the new policy obligation, employers may (1) adopt the State's model sexual harassment prevention policy and complaint form (available at here) or (2) implement their own policy and complaint form that equals or exceeds the minimum State standards. The policy must:

- prohibit sexual harassment consistent with guidance issued by the State;
- provide examples of prohibited conduct that would constitute unlawful sexual harassment;
- include information about federal and state harassment laws, remedies available to victims of sexual harassment, and a statement that there may be applicable local laws;
- include a complaint form;

- include a procedure for the timely and confidential investigation of complaints that ensures due process for all parties;
- inform employees of their rights of redress and all available forums for adjudicating sexual harassment complaints administratively and judicially;
- clearly state that sexual harassment is considered a form of employee misconduct and that sanctions will be enforced against individuals engaging in sexual harassment and against supervisory and managerial personnel who knowingly allow such behavior to continue; and
- clearly state that retaliation against individuals who complain of sexual harassment or who testify or assist in any investigation or proceeding involving sexual harassment is unlawful.

Employers must provide employees with a copy of the policy in writing or electronically, and if made available electronically, employees must be able to print a copy for their records.

Training Requirements

All New York employees must complete sexual harassment prevention training that meets or exceeds the State's minimum standards by October 9, 2019, after which future training must be completed on an annual basis. New hires must receive training as soon as possible after their start date. The training must:

- be interactive;
- include an explanation of sexual harassment consistent with guidance issued by the State;
- include examples of conduct that would constitute unlawful sexual harassment;
- include information about federal and state sexual harassment laws and remedies available to victims of sexual harassment;
- include information about employees' rights of redress and all available forums for adjudicating complaints; and
- include information addressing conduct by supervisors and any additional responsibilities for such supervisors.

To satisfy the "interactive" training requirement, training need not be "live," but some form of employee participation is required. Examples given of such participation include:

- if the training is web-based, it has questions at the end of a section and the employee must select the right answer;
- if the training is web-based, the employees have an option to submit a question online and receive an answer immediately or in a timely manner; and
- in an in-person or live training, the presenter asks the employees questions or gives them time throughout the presentation to ask questions.

To satisfy the training requirements, employers may either: (1) adopt the State's model training materials (which are available for download online); or (2) provide other live training or interactive online/video training that meets or exceeds the law's minimum training standards.

All full-time and part-time employees, seasonal employees, and temporary employees must receive training, as must employees who work a portion of their time in New York State (even if they're based in another state).

What About New York City Requirements?

All employers in New York City are required to comply with the State laws described in this article. In addition, effective April 1, 2019, New York City employers with 15 or more employees (including interns) will be required to institute annual anti-harassment training for employees and interns.

While the training requirements under the State and City laws overlap in many areas (and both are required to be "interactive"), there are some differences (e.g., the City will require the training to cover "bystander intervention"). The City has yet to issue its model training materials and guidance—we expect to see those sometime in early 2019.

So What To Do Now?

First and foremost, make sure you have prepared and distributed a sexual harassment prevention policy to all employees and new hires that reflects the new State standards. Second, consider how you will satisfy both the State and City annual training requirements, either by using the publicly-available materials or by designing your own training program.

Finally, consider what other steps you can take as an employer to minimize the likelihood of sexual and other harassment claims arising in the future. While policies and training are crucial components of an overall employment risk-management strategy, a thoughtful examination of your corporate culture, employment practices, and history of employee relations issues may well reveal other measures you can take to promote a safe, inclusive, and harassment-free workplace.

Protecting Confidential Information

By: Ron S. Geffner, Partner and Head of Financial Services, and Nicholas Federici, Associate and member of Financial Services and Corporate Groups, Sadis & Goldberg LLP

"The most valuable commodity I know of is information."
-Gordon Gekko, Wall Street

While Gordon Gekko may have been referring to illegal inside information, the larger point is that "information" is the most valuable asset for the investment management industry. Ever since Nathan Mayer Rothschild arranged to receive advance notice of Wellington's victory at Waterloo via carrier pigeon, the acquisition, development and protection of valuable, exclusive and actionable information has been essential to successful investing.

The investment management industry is extremely competitive. Investment managers expend great resources to develop, enhance and maintain differentiated investment strategies and assemble teams of pedigreed professionals to successfully execute these investment strategies. Managers also routinely have to balance sharing information with their investors to manage investor expectations, and to comply with their legal obligations, with the potential risk to their businesses should such information become public. With the advancement of technology, protecting information is not only more critical, but also more complicated, than in the past.

Managers share information either in the ordinary course of business or in response to a crisis. Managers routinely disseminate quarterly investor letters in the ordinary course of business. Investor letters often include discussion regarding the fund's major investments, as well as the manager's perspective regarding the global environment. At other times, due to material negative developments, such as the departure of a key person, the decision to shutter the fund or an action threatened by a regulator, a manager can be compelled to communicate information to investors on an expedited basis. While the degree of actionable proprietary information contained in these investor letters varies, managers have gone to great lengths to prevent the public dissemination of these communications.

Occasionally a letter is leaked to the media and its contents become public. Although the media's right to publish information is generally constitutionally protected, this has not prevented managers from bringing actions to enjoin the publication of their letters' contents or attempting to compel the media to reveal the source of the leaked information.

In 2010, Elliot Management filed a "motion to compel" against Institutional Investor to reveal its source following the publication of the manager's quarterly letter. After brief legal wrangling, Elliot ultimately withdrew its motion. Other managers have also commenced legal action to prevent the public dissemination of proprietary information. In 2014, Greenlight Capital brought suit against Seeking Alpha for revealing Greenlight's previously undisclosed stake in Micron Technology. Greenlight claimed that by publicizing the position it was building in Micron, Seeking Alpha had made it more expensive for Greenlight to accumulate the position. Greenlight ultimately withdrew the lawsuit.

In response to these and other unauthorized disclosures, managers have begun employing new technologies to prevent the dissemination of the information contained in investor letters. These technologies include digital watermarking, technologies which prevent printing or downloading letters or which permit readers to view only a few lines of the letter at a time, password protected emails and secured investor portals. While these technologies make it more difficult to disseminate the content of investor letters, they do not prevent someone using a digital camera or smart phone from taking screenshots. However, there are expensive software options that render screenshots unreadable.

Investor letters are not the only source of confidential information. Employees are the greatest potential threat to leak or misappropriate actionable confidential information. This is especially true with regard to portfolio managers and software developers responsible for developing the investment strategy and portfolio positions. If these employees leave to join a competitor, they can expropriate the manager's most actionable confidential information. To address this potential threat, managers usually include certain provisions in their employment agreements, such as confidentiality clauses, provisions for "gardening leave", non-competition and non-solicitation provisions and technology assignment clauses.

Confidentiality agreements are essential for almost any employment contract. They are often broad in scope and seek to prevent employees from disclosing confidential information regarding the manager, investment strategy, investors, portfolio construction and counter parties. Nonetheless, courts have declined to enforce confidentiality agreements to the extent that the confidentiality obligation applies to communications with the U.S. Securities and Exchange Commission ("SEC"). Such provisions were often found to be a violation of laws intended to protect whistleblowers or impede individuals from communicating with the SEC about possible securities law violations.

Non-competition clauses also serve to protect confidential information by prohibiting a departing employee from joining a competitor employing a similar investment strategy. Although a few states, such as California, are reluctant to enforce employment related non-competition restrictions, most state courts will enforce restrictions which are reasonable in geography, scope and duration. The scope should specifically relate to the particular investment strategy. A one year term is common for duration, however, some restrictions extend up to two years or more. A 2016 National Labor Relations Board ("NLRB") inquiry revealed that a Bridgewater Associates' employee was subject to a two year non-competition agreement. The NLRB ultimately withdrew its complaint following a confidential settlement between the employee and the company. In addition, when Chris Rokos, the former Brevan Howard star trader left his employer to launch his own hedge fund, Brevan Howard attempted to enforce the terms of his five year non-compete under UK law. The matter eventually settled out of court.

As managers continue to seek to acquire, develop and secure information which enables them to outperform their competitors and benchmarks, software developers and attorneys will continue to devise increasing sophisticated technology and legal devices to help protect manager's confidential information.

About Wells Fargo Prime Services and Contacts

About Wells Fargo Prime Services

Wells Fargo Prime Services offers comprehensive prime brokerage services and solutions for alternative asset managers. Through our multi-asset class platform, we help managers with their operational and financial goals through our service offerings including:

- Integrated financing solutions
- Technology and operational solutions
- Capital Introduction
- Business consulting services
- Risk management solutions

About the Business Consulting group

Business Consulting services include: business development (from launch to franchise management), best practices, peer analysis and benchmarking, and thought leadership. By leveraging our knowledge of industry service providers we aim to facilitate key introductions and discussions with the goal of achieving the right operational fit for our customers' business. We help hedge funds think through strategic business decisions at launch and throughout their life cycle based on a customized approach to meet a client's specific needs.

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