The Hedge Fund Law Report
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Valuation

Business Issues with Legal Consequences: A Wide-Ranging Interview with Dechert Partner George Mazin about the Most Important Challenges Facing Hedge Fund Managers

By Jennifer Banzaca

The Hedge Fund Law Report recently had the privilege of interviewing George J. Mazin, a Partner at Dechert LLP, and a deservedly well-regarded member of the hedge fund bar. As evidenced by the text of our interview, which is included in this issue of The Hedge Fund Law Report, George has an aptitude for identifying the legal consequences of business issues, and explaining them clearly. He also has the kind of market color that only comes with years – decades – in the trenches, and experience across business cycles. Our interview was wide-ranging, reflecting the diversity of George's experience, which in turn reflects the range of legal issues relevant to hedge fund managers. In particular, our interview covered: valuation considerations in connection with affiliate transactions; valuations based on fraudulent sales and rigged dealer bids; manager overrides of third-party valuations; whether side pockets remain viable in new hedge fund launches; how even non-ERISA hedge funds can analogize the ERISA model of independent pricing; effective valuation testing programs; the interaction between GAAP and the custody rule; GAAP exceptions to audit opinions; use of counterparty confirmations by the SEC; delayed audits; custody of derivatives and limited partnership interests; insider trading policies with respect to market chatter and channel checking; how to grant side letters in light of selective disclosure considerations; how algorithmic or high-speed trading firms can prepare for regulatory examinations; legal considerations in connection with loans from a hedge fund to a manager; best practices in connection with principal trades; and whether side-by-side investing by manager personnel can pass muster under fiduciary duty and related principles. This interview was conducted in connection with the Regulatory Compliance Association's Fall 2011 Asset Management Thought Leadership Symposium, which is taking place today at the Pierre Hotel in New York.

Valuation

HFLR: For various reasons, valuation is one of the key current regulatory examination priorities. Valuation impacts many aspects of the hedge fund business – including fees, marketing, tax, regulatory reporting and others – and is fraught with opportunities for abuse. You have identified a number of sub-issues under the broader issue of valuation that are of concern to regulators, and we would like to examine a few of those sub-issues with you. First, how can valuation concerns arise in connection with sales to affiliates, and what do regulators look for with respect to such sales?

Mazin: As a general matter, any sale by a fund to the manager or an affiliate of the manager is treated as a principal trade for purposes of the Advisers Act. The Advisers Act requires client consent to the trade in advance of the trade, so the principal concern of regulators is going to be to make sure the manager recognized the transaction as a principal trade and obtained the required consent. Now, that requirement is not terribly practical in many instances

because trades happen in real time and if you have 100 investors in your fund, you can't go out to those 100 investors and ask for consent to a principal trade and expect they are all going to get back to you within 15 minutes. It's a bit of a struggle to figure out how to come up with an approach that is workable under the rules and doesn't grind the business to a halt. Because of this, most managers scrupulously avoid principal trades. But, where they are done they are generally done with an independent third party who can act on behalf of the fund and approve the principal trades.

Beyond the consent issue, principal trades by definition have not been negotiated on an arms-length basis. This calls into question the reliability of the valuations, especially if the security is hard to value.

HFLR: Similarly, you have identified fraudulent sales and unreliable or rigged dealer bids as areas of concern for regulators. Are there reliable ways for hedge fund investors to determine whether the NAV presented by a manager is based on fraudulent sales or unreliable or rigged dealer bids?

Mazin: One of the things that prompted my comments on this is an enforcement action brought by the SEC just in the last couple of weeks that involved valuation, among other things. It was a fund that invested in PIPEs and one of the allegations in the complaint was that in order to inflate the value of some highly illiquid microcap positions, they sold the position to a third party, but it was not a cash sale. The buyer was obligated to pay for the securities at a future date. It was effectively a sham transaction where the buyer had no intention and no ability to ever pay for the securities. In fact, a considerable time had passed and not a dime was paid for the securities, but the manager tried to give the appearance that it was a completed transaction and at the end of the year valued the position at the inflated price used for this sale. It was clearly just a fraudulent transaction. See "SEC Accuses Corey Ribotsky and Hedge Fund Manager NIR Group, LLC of Misappropriating Assets and Misleading Investors in Connection with PIPEs," The Hedge Fund Law Report, Vol. 4, No. 36 (Oct. 13, 2011).

In other circumstances where you have highly illiquid securities that don't trade and you don't have any recent transactions to compare it to – say you have Level II or Level III securities – and the theory is that a manager shouldn't be able to just pick a number out of the air but must get indicative bids from third party brokers. The traders may have buddies on the Street and they can go to their favorite firms and maybe get back whatever number they asked for in valuing these securities. If you're an investor, you have to have the ability to do operational due diligence on the manager on a regular basis to really dig down, particularly if it's a fund that has a significant amount of illiquid securities. You have to really get your arms around those transactions that can give rise to fraudulent or inaccurate valuations.

HFLR: On the topic of manager overrides, which you have identified as another area of concern for regulators: If a portfolio manager arrives at a good-faith valuation that differs from the valuation provided by another party or another division within the management company (such as accounting or operations), how can the manager use and document its own valuation in ways that can anticipate and accommodate the SEC's concerns?

Mazin: I think it's critical that manager overrides be appropriately documented. What that means is having

some objective basis for reaching a decision that is different from pricing that you received from a third party. If you're the chief compliance officer, you have to have a history of reviewing manager overrides to get a sense of how often they occur and whether they are both upwards adjustments and downwards adjustments – if you had a pattern where you saw that the manager overrides were frequent and only upwards adjustments, that would clearly be a problem because you have to conclude that the manager either is improperly inflating the value of the securities or just is not being honest with himself or herself about the value of the securities.

HFLR: We have heard the argument that the credit crisis occasioned a bifurcation in post-crisis hedge fund launches along liquidity lines. That is, hedge funds launched post-crisis would have frequent liquidity where the strategy could accommodate liquidity (for example, equity long/short) and longer lock-ups where the strategy required longer commitments (for example, distressed debt). Side pockets, the argument went, would have no place in such a bifurcated liquidity world because investors would want liquid managers to stick to liquid investments. Has your experience borne out this argument, or are there circumstances in which side pockets are still being used in new fund launches?

Mazin: If you are a new manager trying to launch a fund and the fund has a side pocket, the fund is pretty much going to be dead on arrival. The investors will generally differentiate and be more receptive to lockups and restrictive redemption terms for strategies that are less liquid. If the fund is investing solely in highly marketable securities, the manager is just not going to be able to justify a long lockup and restrictive redemption terms.

HFLR: If a hedge fund manager determines the NAV of its own funds and that NAV is not confirmed by an independent party, does the absence of independent pricing itself constitute a red valuation flag from the SEC's perspective? If so, how can hedge fund managers that strike their own NAV give comfort to the SEC and investors that their valuations are accurate?

Mazin: There are an increasing number of funds that are plan asset funds – that is, funds that have more than 25% ERISA money. In those cases, under ERISA, you must have independent pricing. The manager just can't price the portfolio or it is in violation of ERISA. [See "How Can Hedge Fund Managers Accept ERISA Money Above the 25 Percent Threshold While Avoiding ERISA's More Onerous Prohibited Transaction Provisions? (Part Three of Three)," The Hedge Fund Law Report, Vol. 3, No. 24 (Jun. 18, 2010).] Increasingly, managers are moving to that model for non-ERISA funds and it creates a dilemma for difficult to value securities. For funds that invest solely in marketable securities, it's a no-brainer because you can have a procedure in place where the administrator gets pricing feeds from recent transactions, they feed it into a system, they spit out values and they generate NAV. That's very non-controversial. In cases where you don't have recent sales, someone has to exercise some amount of judgment or discretion, and if the manager is not going to exercise that judgment, then who is? As a general rule, administrators refuse to do so. What that leaves you with is two options: the first is the route that some firms have gone, which is to develop a fairly rigid valuation methodology that identifies the acceptable sources, pricing information and the mechanics for establishing value. You don't necessarily get the best prices or the most reliable valuations but you do get objective valuations free of manipulation by the manager. The valuations may have

no bearing on what you can sell the securities for, but at least you know it's an objective third-party price. Maybe it's better, maybe it's worse, but at least it's free of manipulation. For example, a purchase where the methodology may say that if it's a security like a loan, you go to three sources and get pricing. If you get bids from all three sources, the price would be the average of the three. If you can only get two bids, it's the mid-market price of the two. Those kinds of methodologies exist.

The other option is to just bring in a third party valuation firm. There are a large number of firms that are entering the market, the problem is, it's just expensive.

HFLR: More generally, how can hedge fund managers design an effective testing program to ensure the accuracy and validity of their valuations and to detect any valuation irregularities?

Mazin: To the extent the manager is big enough to have a separation of functions, it's best to have a valuation committee that is not controlled by people who are part of the portfolio management team. That would be highly desirable. Another option would be to have the chief compliance officer review the valuation file on a periodic basis and make sure values are supported by the backup that is in the file, that there is evidence that bids were obtained from third parties and that the valuation methodology was followed. Finally, it's always useful to do some back testing and look for some period of time after the valuation date during which there were some sales of the types of securities in question – either by the fund or by other market participants – to see how close the price was to the value that you picked. If there was a significant deviation, try to understand why.

Custody

HFLR: Turning to custody: As you well know, the SEC finalized amendments to the custody rule on December 30, 2009. In the almost two years of experience since those amendments, what is the most complicated issue that you have seen hedge fund managers face in complying with the amended custody rule – and how have managers addressed that issue?

Mazin: There are several intractable issues under the custody rule where the rule just doesn't work terribly well. The SEC is aware of it but they haven't been very flexible in granting relief. The first issue is a rigid adherence to GAAP. That is, the typical way managers comply with the custody rule is to provide an audit to investors within 120 days of the end of the fiscal year if it's a trading fund and 180 days if it's a fund of funds. That audit has to be in compliance with GAAP. There are a variety of reasons why a financial statement may have a qualification, and a qualification does not mean the financial statements are fraudulent. For example, funds that invest primarily in Europe and have significant European investors may do financial statements in accordance with international accounting standards, and that approach doesn't work. Also, if you amortize organizational expenses and you have a GAAP exception then you are not in compliance. If you are a fund of funds and you invest in private equity funds or real estate funds and the audits by a significant number of your underlying managers are prepared in accordance with income tax principles, your auditor won't be able to do a GAAP compliant audit. There are significant reasons why a manager would have difficulty generating GAAP compliant financial statements – and then you're out of compliance with the rule.

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Another issue is if that if you're a funds of funds, you may have one or more underlying managers that are material to your fund, and if one of those funds blows up or has a problem and you can't get an audit, that is going to delay your audit. For example, funds that had Madoff exposure and that cannot complete their audits are not in compliance with the custody rule.

Third, if you're a fund that invests in certain types of instruments that are certificated or papered – for example, bank loans and there are promissory notes – those promissory notes have to be held by a third party custodian and it is actually very difficult to find custodians who are willing to hold them because they are not book entry, marketable securities.

HFLR: With respect to examinations, you have identified three custody-related concerns for regulators: GAAP exceptions to audit opinions; use of counterparty confirmations by the SEC; and delayed audits. Can you briefly describe why regulators are concerned about each of these areas?

Mazin: On the GAAP exceptions, I think the problem that the regulators are concerned with is that it is a slippery slope. They don't really know how to allow exceptions in some cases and not in others and they don't know where or how to draw a line to say that one exception is okay but another exception is not.

It's the same thing with the inability to comply with either the 120- or 180-day rule: there may be some mechanism to get either a 30 or 60 day extension but they are not going to be willing to give indefinite extensions.

HFLR: Under the amended custody rule, how is custody determined for assets that are evidenced by contracts, as opposed to stock certificates – assets such as derivatives or limited partnership interests?

Mazin: If the interests are recorded on the books of the issuer or underlying fund, as long as the underlying fund has made that notation, there's really nothing that needs to be custodied. You can comply with the custody rule without having to do anything special. Now, having said that, a lot of funds of funds are increasingly using a third party custodian to give investors comfort and registering the interests in the underlying funds with a bank custodian.

Insider Trading

HFLR: Regarding insider trading, should a hedge fund manager have policies and procedures with respect to market chatter or market rumors, and if so, what are one or two elements that should be included in such policies and procedures?

Mazin: Market chatter and market rumors are a critical part of daily trading activity. You would be doing your investors a disservice if you don't listen to them. It's one way of gauging market sentiment and it's very difficult sometimes to figure out how to draw the line between what is just harmless market chatter or useful market chatter talking about market sentiment as opposed to very specific rumors about a particular company, so you don't want to have policies that cut off the traders and portfolio management team from talking to other market participants. Information flow is critical to trading. I think all you can do is educate your traders and help them be sensitive in distinguishing between what is general market chatter and what rises to the level

of potential material nonpublic information. You have to have procedures in place so that any time a trader receives any questionable information, the trader has to immediately come to the chief compliance officer or senior management of the firm and have a determination made as to whether you can trade on that information or not. I think, ultimately, an important ingredient in the firm's overall surveillance program to detect the use of material nonpublic information is to review e-mails and instant messages on a regular basis to see if you see any evidence of improper market chatter. [See "Key Elements of Electronic Communications Policies and Procedures for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 3, No. 44 (Nov. 12, 2010).]

HFLR: Along similar lines, is there a rule of thumb or practice for hedge fund managers in determining when channel checking or supply chain research verges into the acquisition of material nonpublic information? We know that you can trade based on counting the number of trucks leaving a warehouse, but you probably cannot trade based on asking a store manager for nonpublic sales figures? Between those two activities, how can hedge fund portfolio managers and analysts determine where the line is?

Mazin: That's one of the most difficult questions these days because there is a disconnect between what the market thought was improper and what the SEC seems to think is improper. It all comes down to a materiality determination. Market participants used to think it was fine to do virtually any type of channel checking, and as long as the information was not clearly material information coming from senior management about the company then you were free to use whatever investigative techniques you thought made sense and you could piece together the various pieces of information you received. We now know that it is not okay to check with either suppliers or purchasers in situations where they are either the sole source or there are a limited number of outlets. For example, if you are trying to check iPhone sales and you determine that Best Buy accounted for 25% of iPhone sales and you were able to get the numbers from Best Buy on their orders of iPhones, we now know that such information would be a problem. If, on the other hand, you went to some small retailer who accounts for less than 1% of iPhone sales and you wanted to talk to the owners of that business about what they thought of iPhones and whether they had increased their purchases, I think that would be perfectly permissible. I don't know if there is any clear answer at this point as to how you draw the line between talking with the person who accounts for less than 1% of sales and a significant distributor who accounts for 25% or more. Where in that grey area does it become material?

HFLR: You have noted that in the course of examinations, the SEC is concerned with selective disclosure of material information to certain investors. But the terms of certain side letters call for precisely that – the disclosure of material information to certain investors. How can hedge fund managers grant preferential information rights in side letters without running afoul of selective disclosure principles?

Mazin: There have been a few recent enforcement cases that have been brought by the SEC in this area. The one that I found most interesting was a case that was brought against a mutual fund manager and the facts were that the fund was invested in mortgage-backed securities and it was during the period of the worst market illiquidity – the 2008-2009 timeframe – and the fund had received massive redemption

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requests from investors, that were going to force a liquidation of the fund. The portfolio manager's daughter and some other family members were investors in the fund and the daughter called her father and expressed nervousness about the markets and wanted to redeem from the fund and the father agreed knowing that at that time she would be able to get out ahead of all the redemptions that were coming in. The SEC brought an insider trading case against him for sharing material nonpublic information with his daughter. [See "SEC Administrative Decision Holds That, For Insider Trading Purposes, Fund-Level Information, as Opposed to Investment-Level Information, May Constitute Material Nonpublic Information," The Hedge Fund Law Report, Vol. 4, No. 14 (Apr. 29, 2011).]

Those facts happen to be in the context of a mutual fund but are not dissimilar from what we see every day in the hedge fund industry in providing information to large institutional clients, giving them superior access to information about the fund. Managers are really struggling with this issue in trying to decide whether to limit the information they provide and if the manager provides material information to one investor whether they must provide it to all investors. The way that managers will generally try to get comfortable with this is to conclude that the provision of routine information about the fund that is just showing sector exposure or flash reports showing performance where it's not possible for the investor to act on the information ahead of other investors is not a problem. But, it really comes down to facts and circumstances. Any time you're providing information to an investor that is material, the other investors do not have it and the investor that has the information has the ability to act on it ahead of other investors, you're asking for trouble.

Algorithmic or High-Speed Trading

HFLR: On algorithmic or high-speed trading and examinations: we have heard from examiners and examined parties that examiners may talk to anyone at a management company, whether high or low. But at a hedge fund manager with an algorithmic or computer-driven strategy, it is likely the case that some people understand the strategy and technology, and others do not. How can such managers prepare for an examination in which the SEC may ask someone who does not understand the strategy to explain it?

Mazin: As an initial matter, it's the job of the chief compliance officer to orchestrate the exam. I don't think it serves the SEC well to speak with someone in the mailroom and ask them to explain how a particular algorithm works. What the SEC is looking to do and what you, as the chief compliance officer, want to do is to figure out who the SEC wants to talk with, why they want to talk to that person, what kind of information they are hoping to get and make sure the SEC understands before the interview what the person's responsibilities are and what they may and may not know. If there is a particular area the SEC is looking to address, you want to make sure you put the right person in front of them.

The second thing you could do is, before the SEC arrives, as part of the training you provide employees is to explain that it is okay to tell examiners that a particular issue is not something you know anything about and it's not an area you have expertise in or is not included in your job responsibilities rather than trying to volunteer information or explain things you may not be familiar with.

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Conflicts of Interest and Self-Dealing

HFLR: If a hedge fund manager or one of its principals wishes to take a loan from one of the manager's hedge funds, are there steps that the manager can take – for example, with respect to documentation, disclosure, collateral or other areas – to make the terms of the loan more palatable to the SEC and to investors?

Mazin: Disclosure is obviously the key. We've seen in the case of one manager that has received some attention in the press that the SEC was not happy that he took a loan without providing disclosure to all investors. He did provide disclosure to investors in the fund he borrowed from, but he didn't provide disclosure to investors in other funds. I think it's clear the SEC would view just the taking of the loan as material, even though, arguably, it doesn't impact investors in other funds. In the SEC's view, it reflects on the financial condition of the manager and is something that should be disclosed to all investors.

It would be highly desirable to have the loan approved by some third party. If it's an offshore fund and you have independent directors, the independent directors could approve it. If you don't have independent directors, you could go to a committee of limited partners for approval. When you have that type of transaction with an affiliate, it's critical to seek consent and have the terms vetted by third parties.

HFLR: Can you identify one or two best practices with respect to principal trades, in addition to those you identified at the beginning of this interview, in particular with respect to any of: the circumstances in which such trades may be warranted, what fund documents should say with respect to when such trades may be entered into, any required investor consent thresholds or documentation requirements?

Mazin: The first thing is to make it clear in fund documentation that you reserve the right to do principal trades and perhaps describe circumstances in which principal trades may be appropriate. In a PPM you obviously can't provide information about the specifics of any particular trade because when you're writing the PPM you don't really know what may happen in the future and what, if any, principal trades you will do. You can signal that there could be principal trades and you could certainly describe to investors the mechanism put in place to have the principal trades approved. If you are actually going to do one, it's critical to document it, to have a file that explains why it made sense to engage in a principal trade rather than going to third parties or to the market for that particular trade. In some cases it makes good sense. For example, if you are an investor who wanted to get out of the fund and no one else wants to buy your interests or everyone else is willing to pay you 65 cents on the dollar for your interest and the general partner is willing to buy it for 75 cents, then it may make good sense to engage in the principal trade. There are circumstances where a principal trade could make some sense but there are clearly opportunities for abuse, so you want to make sure you provide full disclosure to investors about the details of the trade and that you document why it made sense for the principal trade to occur.

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HFLR: Along similar lines, are there steps a hedge fund manager can take so that the management company or any of its principals can invest alongside a fund or managed account while minimizing the fact or appearance of a conflict of interest, and avoiding claims of usurping investment opportunities?

Mazin: If the principals of the manager are going to invest alongside the fund, it's generally a bad idea. You have to ask the question: why invest alongside the fund and not in the fund? It's rare that you get a persuasive answer for why it's being done. You have to be apprehensive that there could be cherry-picking going on where the managers want to overweight investments that they think are the most promising and reduce its exposure to other investments.

If the rationale for side-by-side investing is that the manager may see some great opportunities and the only way to take advantage of that opportunity is to make a larger commitment than is appropriate for the fund, investors may be more agreeable to these arrangements. The manager may put the maximum amount that is appropriate into the fund and then take any excess for himself. How you distinguish between those two scenarios is not always easy. It's based on the good faith of the manager and whether they are taking the best opportunities for themselves or whether they are, in fact, benefitting the fund by giving the fund access to deals the fund may not otherwise be able to invest in.