Lowell Milken Institute
for Business Law and Policy

UCLA | SCHOOL OF LAW

Private
Fund

2017 | REPORT

Does "TWO and TWENTY" Have a Future?

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Introduction

Joel A. Feuer, Executive Director, Lowell Milken Institute for Business Law and Policy at UCLA School of Law

The Lowell Milken Institute for Business Law and Policy at UCLA School of Law is pleased to present its fourth annual Private Fund Report. Our focus this year is on the structure of remuneration paid by investors to fund managers. Remuneration is about more than the total price charged to invest with a fund. It is also one of the most important markers for determining alignment of interests between the investors and the fund managers. Thus, the long-time "two and twenty" structure in which investors pay an annual 2% management fee on funds invested and 20% success fee on profits obtained (or some variation) has been under attack as too expensive and favoring the interests of fund managers over the interests of the investors. Yet, at the same time, fund managers are finding it increasingly expensive to deliver alpha, the excess returns of a fund relative to a relevant benchmark index. In order to succeed, fund managers need access to big data, including esoteric databases, and must pay the high-priced talent to scrub the data and then analyze it quickly and accurately in order to benefit from the information. For example, at a recent conference, I heard a fund manager discuss the cost and efforts required by the fund's analysts to review and analyze satellite photos of mall parking lots in connection with their investment decisions relative to mall owners.

For this year's Report, we solicited articles from participants in and knowledgeable observers of the private fund industry and asked them to consider the issues that surround remuneration structures. We were interested in both the existing remuneration structures and in the current thinking of how those structures are changing and may change in the future. In addition, keeping with our tradition for these Reports, we solicited articles on trends in regulations and compliance. Short biographies of the contributors to this Report are set forth at the end of the Report.

Our **2017 Private Fund Report: Does "Two and Twenty" Have A Future?** and companion Private Fund Conference on May 18, 2017 at UCLA School of Law are intended to provide a forum for a conversation about the many and important issues surrounding private fund remuneration and alignment of interests between investors and fund managers. We look forward to your participation. And, we thank our sponsor for the 2017 Private Fund Conference, the law firm of Andrews Kurth Kenyon LLP.

Private Funds Economics 101: A Short Primer on Management Fees and Performance-Based Remuneration

Timothy P. Spangler, Director of Research, Lowell Milken Institute for Business Law and Policy at UCLA School of Law, and Partner, Dechert LLP

Hedge fund and private equity fund investors can earn high returns on their investment when these funds outperform the market. On these high returns fund managers will typically take a portion of profit and as a result will be highly rewarded for the success that they bring investors. However, regardless of how the funds perform, these same managers also take a recurring management fee based on the amount of money entrusted to them by their investors. This fee is payable regardless of whether the fund has performed well and regardless of whether there were any profits to be shared with the manager.

In recent years, questions have been raised about whether these two separate streams of revenue adequately align the interests of manager and investor, or instead undermine the ability of investors to earn returns commensurate with the risks they are taking when they invest in volatile hedge fund and private equity fund strategies.

Even though the headline rates are often the initial focus of negotiations between fund managers and fund investors, the actual mechanics contained in the underlying legal documentation for calculating these amounts are now also receiving increased attention. To understand the forces currently driving fees in private funds it is useful to start with a clear and thorough understanding of what these fees are meant to cover and how they are currently documented in conventional fund structures.

To begin, an annual management fee is charged to the fund (and therefor ultimately its investors) based on the size of its assets. In addition, performance-based remuneration is payable on increases in the investments value over time. The particular percentage of gain or profit reallocated to the fund manager will vary, but 20% has emerged as a de facto standard across a variety of asset classes. A typical private equity or hedge fund will earn a 2% annual management fee, paid against the assets in the fund, as well as a 20% profit participation, this is often known as "Two and Twenty."

Management Fees

Management fees are calculated in reference to the entire sum of money in, or committed to, a fund and are typically paid quarterly. Traditionally designed to permit the struggling manager to "keep the lights on" until the performance fees are paid, a 2% management fee has been for many years the de facto standard for private equity and hedge funds. However, with the rise of "mega funds" and the continued presence of significantly smaller start-up managers entering the market to focus on niche opportunities, 2% is often too large for large funds and too small for small funds. The math is straight-forward and compelling. For a $1 billion fund a 2% management fee would see the fund manager earn $20 million every year, regardless of whether the investment strategy actually performs.

The math is straight-forward and compelling. For a $1 billion fund a 2% management fee would see the fund manager earn $20 million every year, regardless of whether the investment strategy actually performs.

Importantly the annual management fee is not a replacement for the fund paying its costs as they occur. Day-to-day fund expenses are still its responsibility. As a result, certain costs associated with identifying and executing the various transactions (in the case of a hedge fund, for example, brokerage commissions) will be charged to the fund and its investors as well, rather than being paid by the fund manager.

Different types of funds approach the mechanics of calculating and paying these fees in slightly different ways. In a hedge fund, to ensure that fees are only paid on money actually at work, mechanisms are put in place to take into account fund subscriptions and redemptions within the quarter. For private equity funds, with drawdown and harvest of potential investments within a particular investment period, it is common to see the management fee be charged, after the investment period has passed, only on actually invested capital. As a result, the total amount payable decreases as underlying investments are harvested. In addition, management fee rates might also decline upon the launch by the fund manager of a follow-on fund. This is due to the additional revenue stream coming in from the new commitments obtained, often by many of the same investors who have "re-uped" into the new fund.

Given the significant sums of money that can be paid by investors as the years go by, limits on and carve-outs to management fees have evolved to protect investors. For example, management fees are frequently offset by other revenue received by the fund manager in connection with the fund's operation. In the rapidly evolving world of modern finance, there are a surprising number of ways Wall Street investment bankers have devised to get paid along the way while a deal is getting done. Many of these payment streams have migrated into private equity deal-making, including transaction fees, monitoring fees, investment banking fees, director's fees and break-up fees. The receipt of these additional revenue streams creates a potential conflict of interest requiring disclosure in the offering memorandum to the fund and its investors. The amount of offset can range from 50% to 100% and is often a point of negotiation at the fund's launch.

In addition, certain large investors will often be able to negotiate sufficient management fee offsets and rebates across their portfolio of fund investments to materially lower their overall costs of investment in alternative investment funds. Bulk buying can have the same economic benefits in money management as in most other industries. As a result, the investors in the same fund can have materially different returns because of discounts obtained against fees.

The amount of money a fund manager will earn in management fees from a particular fund is determined by simply multiplying the management fee rate by the size of the fund. As a result, over the past few years, fund size has become a more frequent topic of negotiation, particularly in the private equity and venture capital area. Unlike hedge funds, which earn their performance compensation on an annual basis, these funds typically receive a carried interest fee only upon the realization of the underlying investment. As a result, for many private equity funds, management fees have become an important source of profit, independent of the success of the fund manager in delivering the promised outsized returns.

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Performance-Based Remuneration

Performance-based remuneration can be viewed as a call option that permits a fund manager to benefit from a rise in the value of the fund. The purpose is to incentivize managers for absolute returns, rather than simply tracking (and periodically beating) a benchmark like the S&P 500 or the FTSE 100. However, performance fees and carried interest can also have a potentially negative influence on risk-taking. As overall performance of a fund declines, for example, a particularly greedy fund manager may be motivated in the short term to increase the risk of investments to move his call option back "in-the-money." Steps can be taken, however, to mitigate this risk-taking behavior. For example, in both hedge funds and private equity funds, the fund manager traditionally invests a certain amount of money alongside the limited partners. This is done in order to ensure the interests of all partners are adequately aligned. Absent a significant investment in the fund by the fund manager, the concern of many prospective investors will be that the operation of the carried interest will be to present the general partner with a "heads I win, tails you lose" scenario.

Hedge funds and private equity differ in how the profit share is ultimately paid out to the successful fund manager. This has important consequences to the recipients. The performance component of a fund manager's remuneration is commonly called a "performance fee" in connection with hedge funds and a "carried interest" in connection with private equity funds. Generally, the structure of a hedge fund's performance fee is simpler than a private equity fund's carried interest. The performance fee is typically paid on both realized and unrealized gains, with no clawback for downturns in aggregate performance over the life of the fund.

As overall performance of a fund declines, for example, a particularly greedy fund manager may be motivated in the short term to increase the risk of investments to move his call option back "in-the-money." Steps can be taken, however, to mitigate this risk-taking behavior.

Where the fund manager serves as a general partner of a partnership, these payments can be structured as an allocation of profits within the partnership, either to the general partner itself or to a special purpose "carried interest partner" acting as a type of limited partner. Structured as a reallocation, rather than as a fee, the performance component can provide far more favorable tax treatment for individual managers. To the extent that the performance component includes unrealized gains, they can be reallocated from the investors to the fund manager without incurring tax until the gain is realized.

Importantly, in the case of private equity, these individuals also have access to a particularly beneficial tax treatment - long-term capital gains. The amounts reallocated retain their character as capital gains rather than converting to ordinary income by payment to the fund manager as a fee.

The overarching drive for performance immediately distinguishes the sponsor of a private fund from other traditional asset managers who charge their clients solely on the basis of assets under management. Many mutual funds, for example, must deal with the allegation that they are simply "asset aggregators", seeking out new money from investors, almost indifferent to the actual investment returns. The metric of assets under management (AUM) is, of course, one of the principal meter sticks against which all money managers, whether traditional or alternative, are measured. AUM increases either when the assets overseen by the manager increase in value, or when subscription money from existing or new investors pouring into the fund is more than the redemption money being pulled out of the fund. On the other hand, AUM will decrease either when the assets decrease in value or redemption requests outnumber new subscriptions. When a manager only charges a management fee on the assets it invests for clients, AUM is the sole determinant of its revenue. When a performance fee is charged, larger AUM can in fact be a burden by acting as a drag if there are insufficient high-yielding investment opportunities at any one time.

Does Size Matter?

Given the 2% management fee, that many managers earn off their assets, the initial answer might be "no!" However, on closer reflection, most managers and investors often agree that being too big creates more problems than it solves. The reason is relatively straight forward - every new dollar in a fund must be put to work in such a way as to earn a return at least as high as was being earned on the earlier dollars. Otherwise, the overall performance of the fund will be dragged down quickly. For example, if a fund is earning a fourteen percent return on its investments and new money coming in must sit in a bank account or in Treasury Bills, earning only 2% until new investment opportunities are identified, then the fund's overall performance may drop, for argument's sake, to 13%. The drop in performance will impact the calculation of the performance fee and may result in the manager earning less money than on the earlier (lower) investment amount.

The winter of 2008-09 demonstrated very clearly the potentially fatal damage that a flood of redemption requests can inflict on otherwise healthy hedge funds.

Many investors prefer managers who "stick to what they know" rather than being forced to make investments in different sectors or styles just to keep the money in motion. Investors will generally invest their money with several different managers at any one time, and rather than see a portfolio manager focused on equities begin dabbling in mortgage bonds in search of returns, investors will typically prefer that the manager do less, but do it very, very well.

A fund manager with too much money, therefore, may be in a position where the best thing to do is to simply return some money to investors. Another approach is to shut the door on any further subscriptions and allow the fund to continue investing only its current investments. This strategy can avoid a slide in performance.

In addition, a particularly dangerous side effect of growing too fast is that new money in a hedge fund, which has not in the past benefitted significantly from the manager's skill, may bolt immediately should the fund suffer a significant loss. Sudden large redemptions can be devastating to a fund in the best of times. The winter of 2008-09 demonstrated very clearly the potentially fatal damage that a flood of redemption requests can inflict on otherwise healthy hedge funds. As a result, fund managers often deliberate long and hard about the best size for their funds, as well as the most appropriate investor demographics, in order to ensure that they are optimal.

An important distinction can be made between hedge funds and private equity funds, when it comes to fund size. Due to private equity funds drawdown structure, un-invested money does not have the same potential to create a drag on performance as excess capital does in hedge funds. Over the past decade, many private equity funds have chosen to raise larger and larger funds, on which lucrative management fees will be earned with reference to all of the undrawn committed capital. As buyout funds now routinely raise funds measured in billions of US dollars, the fee revenue stream to the fund manager can be substantial.

However, prospective investors in private equity funds are increasingly voicing concern over the prospect of ever larger funds. Of particular concern are situations where management fee revenue levels exceed the fund manager's carried interest payments. The fear is that the guaranteed income stream provides too many mediocre managers with too great a reward for simply doing nothing.

In light of these concerns, and the difficult fundraising environment since the global financial crisis first arrived in 2008, some funds have shown a willingness to reconsider the size of their funds and the impact on management fees. This can be accomplished either by reducing undrawn capital commitments for each investor or by negotiating down fee levels.

Misaligned Incentives?

A similar problem relating to the relative incentives provided by management fees and carried interest arises in circumstances that are not related to fund size. When a private equity fund is in a position where carried interest is no longer a viable possibility, their dependency on management fees may become overwhelming. The concern here is that reasonable offers from prospective buyers of their underperforming investments may be waived off by the fund manager in order to preserve the management fee revenue stream. Rather than risk the loss of fee revenue when the proceeds of such a realization are then distributed out to investors, fund managers may prefer to wait for the life of the fund to wind down.

Increasingly, investors are applying the painful lessons they learned during the early years of the global financial crisis to their investments in new funds today. Investors are requesting more detailed information about the fund managers' operating expenses and overheads, as a way of tying the management fee calculation to something more tangible. In order to make certain fee mechanisms are appropriate and not excessive, investors are asking better questions of their fund managers about cash flows needs and budgeted expenses. For example, where investors in a private equity fund are pressing for a step-down in the rate of management fees once all the committed capital is invested, more thought is now being given to the potentially perverse incentive that this creates to draw all but the final amount of capital.

Investors are requesting more detailed information about the fund managers' operating expenses and overheads, as a way of tying the management fee calculation to something more tangible.

High water marks protect investors from paying performance fees twice when there has been a decline in the value of a hedge fund, followed by a further rise. This is an issue for hedge funds because performance fees are typically paid on both realized and unrealized gains.

The principle underpinning the high water mark is a very simple premise: a fund manager should not be paid twice for the "same" performance. When losses have followed a period of gains, in which a performance incentive has been paid, a further payment would not be made by the fund simply for gains that return the fund to its prior, higher, level. Such a payment seems intuitively unfair. At a fund's launch, the high water mark is set at the initial net asset value and is subsequently increased at each performance period-end when an incentive payment is made.

A side effect of using high water marks is that after a significant decline in net asset value, due to market corrections or other factors, the fund manager (and the senior investment professionals who show up to work every day) may no longer feel incentivized to manage the fund. The period necessary to "earn out" the loss and get back up over the high water mark could simply appear too long. This is especially problematic for fund managers with large staffs who depend on the performance fee to motivate their teams.

Recently, some fund managers have begun to include explicit reset mechanisms in their new funds as a way to deal with this commercial point in a less costly and time-consuming manner.

In the past, it has not been uncommon for some fund managers to wind down an "underwater" fund and relaunch a new fund, granting existing investors the opportunity to invest in the new vehicle. The practical effect of this elaborate exercise is to reset the high water mark in reference to current market conditions. Recently, some fund managers have begun to include explicit reset mechanisms in their new funds as a way to deal with this commercial point in a less costly and time-consuming manner. For example, a limited loss carry forward can be adopted to reset the high water mark. After a certain period has passed following large losses, the high water mark will be reset and a performance fee will be earned from any growth in net asset value that follows.

Balancing Acts

Without a doubt, money is the primary driving factor in the establishment and operation of private equity and hedge funds – for both fund managers and investors. Lucrative fees are paid to talented fund managers by investors eager to earn high returns on their investments. As a result, the economics of private funds are a worthwhile topic for detailed study.

The question of what combination of performance-related remuneration and management fees best aligns the interest of fund manager and fund goes to the core, in many respects, of why the private fund was established in the first place. The two concepts are also linked in the minds of fund managers, who have operation costs to cover and employees to pay. Simply put, any attempt to alter one leg of remuneration will impact the fund manager's position with regard to the other.

During the late 1990s and early 2000s, allocations to private equity funds by investors (and the size of these funds themselves) grew steadily. Now, however, the market has entered a much more difficult fundraising environment. The marketing process for new funds is taking considerably longer. Existing funds are requiring more time to fully invest their committed capital. As a result, there is a large "overhang" in the market limiting the ability of many limited partners to re-invest their returned capital in other funds.

Enter the savvy investors. Institutions, with their advisers, are now significantly more sophisticated in their understanding of these asset classes, the documentation and the fee structure. Such investors presently have more power in their hands to push for terms (both economic and non-economic) that are more to their liking.

Simply put, any attempt to alter one leg of remuneration will impact the fund manager's position with regard to the other.

It is useful to remember once again that certain provisions that now warrant the coveted term "market standard" were only adopted in the last few decades. To point out one example in particular, in the case of private equity funds, the not-wholly irrational point that carried interest should be calculated on an aggregated basis (i.e. across all investments made) rather than only with respect to the ones that show a profit comes to mind. In the early days of private equity as we recognize it today, carry was paid separately on each investment, regardless of how many losers preceded or followed the home-run hit that earned the big money. Eventually, investors were able to move the consensus on this point to have winners and losers netted out against each other. Now such aggregation is taken for granted as a market term.

Examples such as this should give us confidence that we can expect continued evolution in private fund fee structures in the years to come.

The Texas Teachers' "1-or-30" Fee Structure[1]

Jonathan P. Koerner, Partner and Head of Implementation, Albourne Partners

"How can investors more consistently retain 70% of the alpha generated by their hedge fund managers?"

This was the question I received last July that started the whole "1-or-30" fee structure phenomenon. By August we had a working 1-or-30 model and by September the it was complete. On a Friday in October, we first proposed it to a hedge fund manager and by Monday the manager had agreed.

Fast forward six months for a count exceeding forty institutional hedge fund managers offering either a 1-or-30 share class, or an "or" structure based on the same model.

The 1-or-30 fee structure introduces three distinct concepts, each of which has its own merits.

First, it reframes the fees conversation toward a lower management fee and suggests a willingness to pay a higher performance fee (e.g., 30% instead of 20%), but only if total fees are more closely correlated to total performance and predictably fair.

Second, it reintroduces the concept of paying only on alpha (or as we like to call it, "de-beta'ized fees").

Finally, it develops the revolutionary concept of "or" – and this is where you find the real magic. Just as 2-and-20 does not fit all managers, neither does 1-or-30. But "x-or-y" just might, where 'x' represents the regular fee revenue a manager needs to adequately operate their strategy, and 'y' represents the share of total profits (or alpha) that the parties agree the manager is worth being paid.

The result of 1-or-30 is exactly what we set out to achieve: a more predictable consistent share of total profits (or alpha) between the investor and manager.

Introduction

The Teacher Retirement System of Texas (TRS) are implementing what they call a "1-or-30" fee structure. As this fee structure is rapidly gaining the attention of both managers and investors, we are releasing this case study to introduce the "1-or-30" and to explain our opinion of its basic merits, mechanics and general effects on the expected shape of fees over multiple periods.

Purpose

The objective of "1-or-30" is to more consistently ensure that the investor retains 70% of alpha generated for its investment in a hedge fund. Put another way, "1-or-30" is designed to reduce the risk of total fees paid to a manager exceeding 30% of alpha, tested at both annual and cumulative intervals.

Beyond De-beta'ized Fees

Other investors may not view fees in the context of alpha retention, but rather by the total share of net profits with the manager or the total share of profits over a fixed or variable non-beta hurdle. The fee structure described in this concept paper is equally relevant for these investors, who can replace "Beta Expected NAV" discussed below with the result of their desired hurdle (or no hurdle).

Starting Point

The simplest way to consistently meet an investor's 70% alpha share objective would be a fee structure with no management fee and a 30% performance fee, paid only on alpha.

Management fee = 0%
Performance fee = 30%*alpha
Total fees = 30% of alpha

Such a fee structure, however, could result in significant business risk to the manager during any prolonged period of underperformance – as there could be long periods without any certain revenue for the manager from either management or performance fees. We recognize that this risk is not ideal for the long-term interests of either the manager or investor.

Modified Solution

To eliminate this risk, the "1-or-30" structure guarantees regular management fee income to the manager on a consistent ongoing basis, identical to current traditional management fee mechanics. A reduction of the same amount is then made to the performance fee to return total fees to equilibrium at 30% of alpha.

Management fee = Mf
Performance fee = 30%*alpha – Mf
Total fees = 30% of alpha (with exceptions explained below)

Put Another Way

1-or-30

This structure has been referred to as "1-or-30" because it will always pay a 1% management fee, which the manager trades in for a 30% (of alpha) performance fee when the latter is greater. The only exception to this is when an investor is catching up to its 70% share of alpha, following periods when the 1% management fee exceeded its 30% share of alpha (see "Situation #2" below).

Management Fee as an Advance on Performance Fee

The 1% management fee in this structure can be described as an advance against the next eventual performance fee, so that the otherwise payable performance fee is reduced by the exact dollar amount of current year management fees paid, as well as prior year management fees not previously deducted from a prior year performance fee (see "Situation #2" below).

Secondary Hurdle
The dollar value of the deduction of management fees paid, as described in the preceding paragraph, can also be defined as a second independent hurdle (in addition to Beta Expected NAV), with an accrual equal to NAV* (management fee rate / performance fee rate), prorated and calculated on the same timing as the payment of the management fee. For example, with the 1-or-30 structure on a fund that charges a 1% management fee annually in advance, the manager needs to outperform year-end Beta Expected NAV + [year beginning NAV * (0.01/0.3)].

This is comparable to a 3.33% hard and cumulative hurdle on gross performance (or 2.33% hard hurdle on a net performance basis). In order to ensure that the long-term alpha share between the investor and manager tracks the targeted 70:30 split, this secondary hurdle must carry forward to subsequent years to the extent any prior years' performance does not offset it (see "Situation #2" below).

Breaking It Down

The result is that the manager always receives a predictable and guaranteed management fee revenue stream, and the investor achieves an exact 70% retention of alpha, except in two limited circumstances:

Situation #1: If 30%*alpha is less than Mf
The manager receives greater than 30% of alpha in total fees when 30% of the alpha generated for a performance period is less than the management fees paid (or alpha is negative).

This occurs because the management fee in this fee structure is essentially an advance against the next performance fee amount. If the total management paid throughout the course of a performance period ultimately exceeds 30% of alpha (as determined at the end of the performance period), the "advanced" amount exceeds the 30% target.

In this situation, no additional performance fee is due and any management fees not recouped to the investor should carry forward into the subsequent year to be recouped against a future performance fee, dollar-for-dollar.

Situation #2: Performance period(s) immediately following a Situation #1 performance period
The investor will only retain greater than 70% of alpha in the years immediately following Situation #1 while returning to a 70:30 alpha share equilibrium.

This occurs because in addition to reducing the manager's current period 30% alpha share by current period management fees paid, any un-recouped management fees from prior periods are also recovered from the manager's 30% alpha share, dollar-for-dollar.

Situation #2 will only occur in a period immediately following a Situation #1 period, and will only last beyond one period if 30% of alpha is again less than the amount of current period management fees plus any prior period unrecovered management fees.

Defining Alpha

For purposes of discussion and modeling, we have defined "alpha" as equal to:

> **Alpha** = NAV + management and performance fees (or accruals) – Beta Expected NAV

Because management fees will serve as an offset to the 30% of alpha calculation of the performance fee, this model uses gross alpha, with advanced management fees added back in. The term "alpha" used throughout this paper refers to gross alpha.

We calculate Beta Expected NAV as a custom VAMI benchmark with an initial value equal to the invested amount, and adjusted monthly to reflect performance equal to a mutually agreed upon publicly available index multiplied by a mutually agreed upon beta. The Beta Expected NAV resets at the beginning of every performance period to equal the greater of prior year ending NAV and prior year ending Beta Expected NAV.

Structured this way, the Beta Expected NAV acts as a replacement to the traditional high water mark (HWM).

Simple Example

Example #1:
Market up, fund up more than expected beta would predict.

Assumptions:
- Initial investment of $100 in the hedge fund.
- 1% management fee, charged annually in advance.
- Gross fund performance of positive $20 for the period.
- Pre-agreed beta of 50% of the MSCI ACWI TR.
- MSCI ACWI TR has returned positive $20 for a $100 investment.
- For simplicity, disregard intra-period performance incentive accruals.

Under the "1-or-30" model, the Beta Expected NAV begins at the same level of the initial investment, or $100. Beta Expected NAV is adjusted during the period by the pre-agreed beta, or 50% of MSCI ACWI TR.

> **Beta Expected NAV** = $100 + (50% * $20) = $110

Alpha is calculated as:

> **Alpha** = NAV + management and performance fees (or accruals) – Beta Expected NAV
>
> Alpha = $119 + $1 - $110
> Alpha = $10

To achieve a 70:30 split of that $10 gross alpha, the manager would receive $3 in total fees and the remaining $7 would go to the investor.

The proposed fee structure would calculate the 70:30 alpha split as follows:

Management fee = $1 (paid on January 1st by the investor)
$10 alpha determined on December 31st
Performance fee = 30% * $10 - $1 = **$2**
Total fees paid = $1 + $2 = $3

Example #2:
Market down, fund down less than market beta would predict.

Assumptions:

- Initial investment of $100 in the hedge fund.
- 1% management fee, charged annually in advance.
- Gross fund performance of negative $10 for the period.
- Pre-agreed beta of 50% of the MSCI ACWI TR.
- MSCI ACWI TR has returned negative $40 for a $100 investment.
- For simplicity, disregard intra-period performance incentive accruals.

Beta Expected NAV = $100 + (50% * -$40) = $80

Alpha is calculated as:

Alpha = NAV + management and performance fees (or accruals) – Beta Expected NAV
Alpha = $89 + $1 - $80
Alpha = $10

Despite the overall loss of $10, alpha is calculated as positive $10, and the expected share of that $10 alpha would be $3 to the manager and $7 to the investor.

The proposed fee structure would calculate the 70:30 alpha split as follows:

Management fee = $1 (paid on January 1st by the investor)
$10 alpha determined on December 31st
Performance fee = 30% * $10 - $1 = **$2**
Total fees paid = $1 + $2 = $3

Paying Performance Incentives In Loss Years

Example #2 illustrates the possibility of paying a performance incentive in a period where absolute performance is negative. Because this fee structure seeks to achieve a consistent 70:30 share of alpha between the investor and manager, it will reward the manager in periods of positive alpha despite negative absolute performance. By that same rule, in positive performance years, it only rewards managers on positive alpha.

Albourne recognizes that not all investors embrace de-beta'ized performance fees. Most investors agree it would be ideal to pay only for alpha, but face a more difficult question when faced with paying for that alpha in a loss year (despite the positive alpha). As suggested in the introduction to this paper, this "1-or-30" can be applied to total positive performance instead of alpha. However, that would eliminate certain improved alignment and shape of fees benefits the de-beta'ized fee achieves.

Treatment of Negative Alpha

Where the manager generates negative alpha (regardless of whether absolute performance is positive or negative), no performance incentive is due and the alpha shortfall is built into the moving HWM-like Beta Expected NAV hurdle, and will carry forward for the manager to make-up before earning its next performance incentive.

Management Fee Recoup and Carryforward

Both examples above result in scenarios where 30% of alpha exceeds the management fees paid, therefore entitling the manager to an additional performance fee payment to bring the manager's total alpha share to 30%.

To ensure that the investor and manager maintain a 70:30 split of alpha over the long-term, all management fees must be carried forward until they have been applied against the performance fee as a reduction.

Example #3:
Market up, fund up more than market beta would predict, but 30% of alpha is less than management fees paid.

Year 1 – Situation #1 occurrence

Year 1 Assumptions:

- Initial investment of $100 in the hedge fund.
- 1% management fee, charged annually in advance.
- Gross fund performance of positive $10 for the period.
- Pre-agreed beta of 50% of the MSCI ACWI TR.
- MSCI ACWI TR has returned positive $18 for a $100 investment.
- For simplicity, disregard intra-period performance incentive accruals.

Beta is calculated as:

Beta Expected NAV = $100 + (50% * $18) = $109

Alpha is calculated as:

Alpha = NAV + management and performance fees (or accruals) – Beta Expected NAV
Alpha = $109 + $1 - $109
Alpha = $1

$1 of alpha is generated for the investor's account, and the expected share of that $1 alpha would be $0.30 to the manager and $0.70 to the investor.

The proposed fee structure would calculate the 70:30 alpha split as follows:

Management fee = **$1** (paid on January 1st by the investor)
$1.00 alpha determined on December 31st
Performance fee = 30% * $1 - $1 = $0.30 - $1 = **$(0.70)**
Total fees paid = $1, reflecting an overpayment for the year by $0.70

In this case, the manager has received 100% of the alpha share. As that exceeds the expected 70:30 split, no performance fee would be paid. Rather than true-up or claw back the amount the investor paid to the manager in excess of 30% of alpha ($0.70), that amount is carried forward into the subsequent year to be recovered from the next performance fee.

Year 2 – Situation #2 occurrence

To extend this example into the second year, assume the following for Year 2:

Year 2 Assumptions:

- Year 1 ending NAV = $109.
- 1% management fee, charged annually in advance.
- Gross fund performance of positive $10 for the period.
- Pre-agreed beta of 50% of the MSCI ACWI TR.
- MSCI ACWI TR has returned positive $8 for a $100 investment.
- For simplicity, disregard intra-period performance incentive accruals.

Beta is calculated as:

Beta Expected NAV = $109 + (50% * $8) = $113

Alpha is calculated as:

Alpha = NAV + management and performance fees (or accruals) – Beta Expected NAV
Alpha = $117.91 + $1.09 - $113
Alpha = $6

$6 of alpha is generated for the investor's account.

Normally, the expected share of that $6 alpha would be $1.80 to the manager and $4.20 to the investor. In this case, however, we must carry forward the $0.70 overpayment of fees from the prior year.

With the $0.70 overpayment of fees carried forward from the prior year, the "1-or-30" fee structure would calculate the 70:30 alpha split as follows:
Management fee = **$1.09** (paid on January 1st by the investor)
Management fee recoup carry forward balance = $0.70
$6 alpha determined on December 31st
Performance fee = 30% * $6 - $1.09 - **$0.70 = $0.01**
Total fees paid = $1.09 + $0.01 = $1.10

	Year 1	Year 2	Aggregate
Gross alpha	$1	$6	$7
Management fees	$1	$1.09	$2
Performance fees	$0	$0.01	$0.10
Total fees	$1	$1.10	$2.10
Manager share of alpha	100%	18.33%	30%

Notice that the manager's total fees for the second year is less than 30% of alpha ($1.10/$6 = 18.33%), in order to bring the 70:30 alpha share back to equilibrium over the entire period

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Anatomy of Private Fund Fees: An Industry Insider's View

Robert S. De Leon, General Counsel and Chief Compliance Officer, Rimrock Capital Management, LLC

Billionaire Warren Buffett recently said that "2 and 20" private fund fees "border on the obscene."[1] In fact, the U.S. private fund industry, which includes hedge funds, private equity funds, and venture capital funds of all types, remains in an economic vise. On one side, institutional investors continue to press, and have been successful in pressing, fund managers to lower their fees. On the other hand, sophisticated investor demands for greater transparency and service, and greater regulatory demands, mean that fund costs, and barriers to entry, have increased. It is thus not a surprise to see many private funds close.[2]

What is "2 and 20"?

The term "2 and 20" refers to the classic fee structure charged by private funds. The "2" refers to an annual 2% asset-based management fee. The "20" refers to an additional "incentive fee" or "carried interest" of 20% of profits earned, sometimes, but not always, as measured above a hurdle rate or so-called "high water mark." The lore on this is that the performance fee provides a strong incentive to the manager to provide strong returns, by allowing the manager to earn a percentage of the profits. The 2% base fee exists because, try as it might, the manager may not be successful, and the manager may not actually earn any profits for years. So the base fee allows the manager to keep an office, pay its employees and otherwise "keep its lights on."

As is commonly said in the private funds industry, "It's all about the people."

As a practical matter, very few funds charge "2 and 20" anymore - the percentages tend to be lower, particularly for funds that do not have a private equity or venture capital strategy. According to one survey, hedge fund management fees have declined in each of the past four years; average fees are approximately 1.6 percent base and 18 percent performance fee.[3] Another recent hedge fund-focused survey of industry participants, by Credit Suisse, found that two in five participants observed reduced management fees or a sliding fee model where fees decrease with asset size. Nearly one quarter saw funds with more of a pass-through cost structure, and 16% saw "loyalty" features where investor fees are reduced for longer lock-ups or investment periods.[4]

What Do You Get For Your Management Fees?

Although complaints about private fund fees likely will never go away completely, given that they are materially higher than fees for other investment products and services, it is useful to look at them in context, and consider what investors get and don't get for their fees.

Adviser Salaries/Compensation

Salaries and bonuses make up, and should make up, the largest proportion of where most management fees go. As is commonly said in the private funds industry, "It's all about the people." A private fund manager wants to get the right people, who will (hopefully) make very smart, if not brilliant, investment decisions that lead to great investor returns. To put that slightly differently, investors want returns that are not correlated with other investments and/or "alpha," an abnormal rate of return in excess of what would be predicted for a benchmark. Generally, portfolio managers, analysts and their support staff, who help generate those returns, need to be paid as much or more than their equivalents at investment advisers who manage mutual funds and separate accounts. Many private fund managers are managing assets that are illiquid;

Expense	Typically Included?
Research	Some or all research may be included. Soft dollar research is separately paid by investors.
Adviser Office Space and Utilities	Usually included
Marketing/Promotion/Fund Distribution	Usually included, unless there is a third party placement agent.
Placement Agent's/Referral Fees	Varies
Investor Relations/Due Diligence	Usually included
Brokerage and Transaction Fees	Separately paid by investors
Cash Management	Varies
Consultants	Separately paid by investors
Audit Fees	Separately paid by investors
Tax Preparation Fees	Separately paid by investors
Custody/Prime Brokerage Fees	Separately paid by investors
Fund Administrator Fees	Separately paid by investors
Organizational Costs - Initial and Ongoing	Varies
Regulatory Filings and Registrations for the Fund (Form D, PF, etc.)	Separately paid by investors
Directors Fees and Expenses	Separately paid by investors
D&O Insurance	Separately paid by investors
Legal Fees	Varies

can be extremely complex; trade (if at all) in less than efficient markets; are start-ups (or, in real estate, new construction), distressed, buy-outs, or in bankruptcy or reorganization; may use activist strategies; and/or are able to use significant leverage and derivatives in ways that, for example, a mutual fund manager legally cannot. There is tremendous demand for managers who can successfully deal with one or more of those factors, and very limited supply. Portfolio manager "rock stars" who earn premium returns for their investors will earn premium compensation.

Other Expenses May or May Not Be Included
Investors need to focus on total costs, because an adviser's fees may or may not cover various other costs. Some advisers, for example, will pay for a fund's organizational expenses, as opposed to having the fund (and indirectly, investors) pay for those costs. The chart on the prior page lists certain other expenses that may or may not be covered by the management fee.

Whether or not an expense is paid by the manager is typically decided by the manager, but is sometimes subject to negotiation between the parties. Some funds do appear to have lower fees, but then pass along every conceivable cost to investors.

Importantly, investment research and due diligence on investments can be expensive, but can significantly enhance private fund returns. Many private fund managers pay for all or a portion of those expenses out of their management fees.

Overall, fund operating costs have been rising, and there is no sign this trend will change. Sophisticated investors like greater transparency and reporting, and investor relations personnel to respond to their due diligence and monitoring questions, which has a cost. On the regulatory/compliance front, costs are increasing as a result of Dodd-Frank, FATCA/CRS requirements, additional SEC disclosure and regulatory mandates, State lobbyist registration and local pay-to-play requirements, costs of complying with enhanced foreign disclosure and regulatory requirements (where the fund is distributed outside the U.S.) and greater regulatory scrutiny on cybersecurity.

Investors Obtain An Opportunity to Participate in a Collective Investment
Private fund fees also pay for the collective investment opportunity, permitting like-minded investors to share potential costs and investment risks among themselves. This benefit is easy to overlook, but private funds are often the most efficient way for investors to access certain investment strategies. Many private fund investors could not afford to invest in separate accounts with similar investment strategies to those of private funds, because of the related costs and resources involved. As an example, if a particular investor had $10 million to invest in a particular strategy, the cost of hiring portfolio managers, a fund administrator, a custodian and/or prime broker, auditor, and a minimum of other necessary personnel to manage that sum would simply be uneconomical, or the investor would likely find it is receiving very poor service! Some types of investments have large investment sizes. If, for example, you want to invest in 144A securities, you must satisfy the requirements of Rule 144A of the Securities Act of 1933, which require most investors to have securities investments of at least $100 million. Many institutional investors also would prefer to spread their investments, and their risk, among multiple funds and managers, rather than concentrating their investments. Collective private funds are only possible because fund managers have investor relations, marketing, and (generally) broker-dealer registered personnel who help to gather investors. The cost of those services is typically paid out of the private fund's management fees.

Many private fund investors could not afford to invest in separate accounts with similar investment strategies to those of private funds, because of the related costs and resources involved.

Is There A Competitive Market for Private Funds?

The market for private funds is far from monopolistic or oligopolistic. There are thousands of private funds and thousands of investors. According to Preqin March 2017 figures, there are over 47,000 private funds and over 26,000 private fund managers worldwide. Meanwhile, Prequin tracks over 14,000 private fund investors.[5] An estimated 3,000 funds were marketing themselves to investors in the first quarter of 2017.[6] There is ongoing discussion and negotiation of fund terms, including fees, during fundraising. In fact, those fees have declined over time according to industry surveys.

There are, however, some factors that potentially limit competition that are worth exploring in further detail

No General Solicitation/Advertising
Most private funds are prohibited from advertising by various SEC regulatory provisions. General solicitation and private fund advertising are only permitted under Rule 506(c) of the Securities Act for a limited group of private funds, subject to certain restrictions, and are used by some smaller funds, particularly real estate funds. However, information is available to sophisticated investors through databases and subscriptions. State laws, such as California's AB 2833, may also require state pension plans to publicly disclosure the fees of private funds they own. There are also periodic third party surveys of fund fees that can help set guidelines or benchmarks.

Some Funds Have AUM Caps or a Limited Number of Investors
Once a sophisticated investor has completed what can be months or years of due diligence and found a wonderful manager, they sometimes feel that they are "lucky" to be able to participate in certain limited investment opportunities. Many managers have ceilings on the amount of capital they will accept, for a variety of reasons: they may have a set number of employees, limited ability to manage a large number of investments, the size of potential investments may be small, and expected returns to investors may be high, limiting the potential investment universe. Often private fund investors do not want to raise fees as an issue, because the manager has limited capacity and can potentially accept another investor who will pay the full fees.

Closed-end Funds are One-time Decision Opportunities

Once an investor has invested in a closed-end fund, there is little or no opportunity or leverage to negotiate or renegotiate fees. Occasionally, at least with private equity funds, co-investment vehicles may be created, which can lead to lower fees on a blended basis.

Herd-like Investor Behavior

There is a natural tendency for institutional and other investors to chase investment performance, investing with managers who have recently experienced exceptional returns. They will also leave private funds, if they can, when they are perceived to have underperformed, or avoid investing in new funds sponsored by managers whose existing funds are perceived to have underperformed. Unsurprisingly institutional investors talk to one another. These investors and their consultants frequently are receiving the same information and data from private funds, and they tend to make investment decisions the same way. Investment consultants' recommendations of private funds and withdrawal of recommendations generally are communicated to more than one client, which creates waves of fund subscriptions and withdrawals. When demand for their services is strong, managers have no incentive to lower fund fees. When investors are itching to depart, managers' offers to reduce fees, and potentially extend lockups, are not attractive. The rare, true contrarian investor, who sees that a particular manager's strategy may just be temporarily not working in a particular investment environment, or who has stumbled in making investments that are temporarily out of favor, will have leverage and sometimes can score a good deal on fees.

Barriers to Entry Are High

Finally, it is very difficult, time consuming and expensive to start a new firm to manage private funds. Then, even if you start a new manager, it can be very difficult to raise capital unless you already have an established track record that you can show to prospective investors.

Legal Requirements

Regulatory Focus Is On Full Disclosure

Regulatory requirements[7] for private funds focus on full disclosure. Rule 206(4)-8 of the Advisers Act is particularly stringent. It says that any untrue statement of material fact or any omission of material fact that is misleading under the circumstances made by a fund manager to an investor or prospective investor is a fraud, deceptive or manipulative act.[8] There's no required "scienter," such as intent or recklessness; negligence is sufficient.[9] If fees are miscalculated, or inaccurately described, that alone could give rise to a Rule 206(4)-8 claim.

There is ongoing debate and ambiguity around what information is and is not "material" in the context of fees. A misrepresentation or omitted fact is "material" if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to make an investment decision.[10] Industry representatives often view materiality from a numerical, as opposed to a qualitative, standard. Regulators and investors often take the opposite approach, seeing any actual or potential breach of the duty of loyalty as per se "material." Taking unwarranted fees is "misappropriation" and a breach of the duty of loyalty.

The rare, true contrarian investor, who sees that a particular manager's strategy may just be temporarily not working…will have leverage and sometimes can score a good deal on fees.

Other SEC Regulatory Requirements

The SEC has several other regulatory requirements applicable to fees, which are discussed below. Importantly, only the SEC (not any investor, or prospective investor) is able to bring a civil action to enforce these requirements.

- 1. Rule 206(4)-7

Rule 206(4)-7 of the Advisers Act requires, among other things, an investment adviser adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules. In the adopting release for this rule, the SEC included "fee assessment" as a critical area for which an adviser must have adequate policies and procedures.

- 2. Rule 205-3

The Advisers Act and SEC rules only allow wealthy (and arguably sophisticated) investors to pay managers a performance-based fee (i.e., the "20%" in the "2 and 20%"). Specifically, Section 205(a)(1) of the Advisers Act generally prohibits the payment of performance-based compensation to investment advisers. Rule 205-3 provides an exemption from that prohibition for "qualified clients." Currently the dollar threshold is $2.1 million in net worth, excluding the value of a natural person's primary residence up to the value of the residence, as well as the indebtedness secured by that residence. On one hand, the performance fee incentivizes managers to do a good job for their clients, by tying their compensation to client returns. On the other hand, Congress and the SEC believe that performance fees are potentially dangerous for less sophisticated investors because they can encourage advisers to take inappropriate risks with client funds to increase their advisory fees.

- 3. Rule 204-2

Rule 204-2 requires an adviser to keep accurate records of all client disbursements and expenses, as well as records of clients' investment performance and rates of returns. If an investment adviser does not keep adequate records related to fee calculations, or charges more than is reflected in its records, the adviser will have violated this rule.

Private Fund Managers Have No Fiduciary Duty To Negotiate Fees

Although investment managers have fiduciary duties to their clients, there is no direct, private right of action for private fund investors to sue their investment managers for breach of fiduciary duty relating to unwarranted or high fees. In connection with the release of Rule 206(4)-8, the SEC threatened that it could bring actions under that Rule for breaches of fiduciary duty that rise to the level of a prohibited act, practice or course of business that is fraudulent, deceptive or manipulative within the meaning of Section 206(4). It has yet to do so.[11]

According to the U.S. Supreme Court, an investment adviser registered with the SEC is a fiduciary to its "clients."[12] However, an investment fund is the adviser's "client," not the underlying investor(s).[13] If a private fund is organized as a corporation, the fund directors are generally responsible for approving the fund's investment management agreement, which typically specifies the fees paid to the adviser. If those directors do not properly carry out their duties, a fund investor generally cannot directly sue them. Instead, the investor must usually commence a derivative suit on behalf of the fund itself, and derivative suits are subject to various substantive requirements that make them difficult to bring. If the fund is a limited partnership or limited liability company, it may have an advisory committee consisting of unaffiliated limited partners or LLC members responsible for considering changes to the general partner's compensation. Even in the context of a fund with only one investor, or a separately managed account for one client, an adviser has no duty to offer an actual or prospective client the lowest possible or even a fair fee. An adviser's fiduciary duties encompass a duty of care, a duty of loyalty, and a duty of full disclosure. Investors and managers recognize that fee negotiations are arms' length. When an investment manager is pitching a fund or its services, it is not acting as a fiduciary or making an investment "recommendation" that would be covered by its fiduciary responsibilities. Another principle supporting this approach is the same rationale behind the "business judgment rule" applicable to corporate directors and officers - courts do not want to be in the business of determining what is a "fair fee" between sophisticated investors and sophisticated investment managers.

The federal securities laws do not create a right of action for unregistered private funds or their investors to sue investment managers for excessive fees. Section 36(b) of the Investment Company Act provides for a private right of action, in the nature of breach of fiduciary duty against the investment manager of a *registered* investment company (e.g., a mutual fund or publicly-traded closed-end fund) for manager compensation. The case law around Section 36(b) permits suit against the manager when the fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[14] Even there, courts do not want to determine what is "fair" with respect to fees. Section 36(b) does not currently extend to private funds.[15]

...an adviser has no duty to offer an actual or prospective client the lowest possible or even a fair fee.

Conclusion

Although the private funds industry faces challenges, including lower management fees and rising costs, it still remains vibrant. As David Swenson, the long-time manager of Yale University's endowment has noted, "The important metric [for institutional investors] is returns, not gross fees." Yale's endowment, which has been heavily invested in private funds, has beaten a passive 90/10 portfolio made up of stock and bond indices by 3.3 percentage points annually over 30 years. Seven private funds can meaningfully enhance the returns of institutional portfolios. As long as that remains the case, private funds will remain popular institutional investments.

1 "Hedge Funds 'Obscene' Fees Make People Rich - Just Not Investors, Says Buffett, CNBC, Feb. 27, 2017.

2 See for example, Mary Childs, "Hedge Fund Closures Set For Worst Year Since 2008," Financial Times, Dec. 7, 2016.

3 Charlie Marlow, Deutsche Bank Alternative Investment Survey Details Hedge Fund Fee Rates, Negotiation Strategies and Structure Trends (Part 2 of 2), The Hedge Fund Law Report, April 6, 2017.

4 Charlie Marlow, Credit Suisse Investor Survey Finds Steady Demand for Hedge Funds and Growing Demand for Less Liquid Products, The Hedge Fund Law Report, April 13, 2017.

5 Preqin Hedge Fund Spotlight (March 2017).

6 "Private Capital Fundraising Momentum Continues in Q1 2017," ValueWalk, April 4, 2017.

7 See, e.g., Rule 206(4)-1(a)(5), Rule 206(4)-8, Section 207 of the Investment Advisers Act.

8 Rule 206(4)-8(a)(1).

9 See SEC Release No. IA-2628, Sept. 10, 2007, at 13.

10 See, e.g., TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

11 See SEC Release No. IA-2628, Sept. 10, 2007, at 13-14.

12 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

13 See, e.g., Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

14 Jones v. Harris Associates L.P, 559 U.S. 335 (2010), quoting Gartenberg v. Merrill Lynch Asset Mgt, Inc., 694 F.2d 923 (2d Cir. 1982).

15 The Supreme Court has stated that "there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment adviser's contract, but the Act confers no other private causes of action, legal or equitable." Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979).

16 "Yale's Faith Not Shaken by Stirring of Low Fees," Bloomberg, April 12, 2017.

Private Fund Fee Structure and Blockchain Applications

Wulf A. Kaal[1], Associate Professor and Director, Private Investment Fund Institute, University of St. Thomas School of Law

The traditional 2/20 fee structure of private investment funds has come increasingly under pressure in the last ten years. Several market factors help explain the pressure on the fee structure of the private investment fund industry. Private fund investors withdrew $70.1 billion from the private investment fund industry in 2016. In 2016 a total of 1,057 private investment funds closed down, exceeding the 1,023 liquidations of private investment funds in 2009, and falling just shy of the record 1,471 closures in 2008. According to some observers the market is oversaturated which increases pressure on private investment fund managers' performance and results in compromise fee arrangements, such as paying fees on invested capital only. Other factors that help explain the pressure on fees in the industry include the inadequate performance of the private investment fund industry, the ability of large investors to negotiate special terms, the withdrawal of private investment fund investments by large institutional clients and public retirement funds, and the consolidation of the industry, among several other market-driven factors.

A factor contributing to the market pressure on the fee structure that has not been examined by commentators pertains to the increasing use of blockchain technology, artificial intelligence, and big data by private fund advisers. Anecdotal evidence suggests that the majority of private fund advisers that use blockchain technology, artificial intelligence, and big data in different aspects of their operations or strategy have a substantially lower fee structure than those who do not use them. Prominent examples of lower fee structures driven by the use of blockchain technology include those of LendingRobot's, LendingRobot Series, and platforms for blockchain-enabled fund management, such as those offered by Melonport or Drago, among others.

Using a dataset of 98 private investment fund advisers that utilize blockchain technology in their investment strategy or internal operations, this article shows that the fund advisers who use the new technology are able to charge overall lower fees. The article explores the reasons for lower fees in those funds and examines possible future applications of the technology in the private investment fund industry. While the overall proportion of strategies of private investment funds that apply modern technologies, including blockchain technology, is still small, as the use of blockchain technology grows in the private investment fund industry, the pressure on the fee structure is likely to continue to grow.

In 2007 Warren Buffet entered into a wager with Ted Seides of Protégé Partners, betting $500,000 that a purely passive investment strategy, that is passively tracking the S&P 500 Index, over a ten-year period would beat any hedge fund portfolio over the same time period.

Changing Fee Structure

The fee structure of private investment funds has changed substantially in the last ten years. Traditionally, the hedge fund industry has charged fees to investors based on the so-called "2/20" formula. This means that most fund advisers were paid a monthly or quarterly annualized 2% management fee based on assets under management and a 20% annual performance or incentive reallocation based on net fund profits. Similarly managers of private equity funds generally used to charge an annualized 2% management fee based on committed capital and most commonly received a 20% commission on returns over a designated amount (referred to as the carry) as incentive compensation. However, the historical fee of 2% of commitments through the reinvestment period, then 2% on the cost basis for the investments/value of fund has shifted in recent years closer to 1% for new managers and 1.5-1.8% for established managers with an adequate track record. It has become increasingly common in recent years for investors to negotiate fees with fund managers, particularly with newer fund managers who may be more willing to engage in such negotiations to induce seed investors at the time of fund formation. Alternative fee arrangements include but are not limited to modified highwater marks, incentive hurdles, and triggers, as well as clawbacks.

First-time or new managers are particularly affected by the new fee structure. Unlike in the recent past, first-time managers are now often forced to share the business budget (rent, employee salaries, etc.) to justify the 1.5% management fee. Moreover, the industry is increasingly seeing contested track records for new managers, i.e., the new firm cannot get a consensus from the new manager's old employer about the manager's track record with that employer. Another phenomenon that affects first-time managers pertains to early limited partnership investors who increasingly throw their weight around to negotiate tough terms on fees.

Factors Creating Downward Pressure on Fees

For the better part of the last ten years, the inadequate performance of the private investment fund industry created substantial pressure on its traditional 2/20 fee structure. A prominent example, exemplifying the pressure on the fee structure given the performance of the industry, is the wager between Warren Buffet and Ted Seides. In 2007 Warren Buffet entered into a wager with Ted Seides of Protégé Partners, betting $500,000 that a purely passive investment strategy, that is passively tracking the S&P 500 Index, over a ten-year period would beat any hedge fund portfolio over the same time period. Buffet asserted that the fees of the private investment fund industry (2/20) were too high for hedge funds given the returns of the industry and did not justify the fees continuing existence. To show his commitment, Buffet selected a Vanguard S&P Index Fund, passively tracking the S&P 500 Index, while Seides chose five hedge funds of funds. Seides's hedge funds of funds had collectively invested in over 100 hedge funds. The wager was on the higher of the respective funds' compounded annual return for ten years (2008-2017) net of fees. Seides entered into the bid despite a huge disadvantage—hedge funds have a much higher fee structure and the wager pertained to compounded annual interest net of fees. A year before the end of the wager, Buffet's nine-year result is a 7.1% compounded annual return compared to Seides's 2.2%. Buffet has opined that the great majority of managers are not skillful enough to outperform the S&P 500, noting that "a good record quickly attracts a torrent of money . . . huge sums invariably act as an anchor on investment performance [and that] most managers will nevertheless seek new money because of their personal equitation – namely, the more funds they have under management, the more their fees."

The increasing pressure on the traditional fee structure manifests itself in several new fee-related outcomes affecting private investment fund managers. In recent years, private investment fund management fees can deviate from the market rate of 1.5%–2% of the fund's capital commitments because affiliates or other employees of the investment manager who invest in the fund are not charged management fees, and funds with fewer oversight and monitoring requirements typically charge lower management fees. The new fee structure is also the result of fund managers foregoing market rate management fees, larger investors requiring reduced management fees to induce investment, side-by-side vehicles attracting investors in the co-investment entities by charging less than 2% management fees, real estate funds charging management fees based on the amounts invested in properties, and different investors in the same fund being charged different management fees. Charging different management fees because of the aforementioned pressures on the industry can make it more difficult for fund advisers to market a fund, especially a fund where investors receive "most favored nations" rights.

Several market factors help explain the pressure on the fee structure of the private investment fund industry. Private fund investors withdrew $70.1 billion from the private investment fund industry in 2016. In 2016 a total of 1,057 private investment funds closed down, exceeding the 1,023 liquidations of private investment funds in 2009, and falling just shy of the record 1,471 closures in 2008. According to some observers the market is oversaturated which increases pressure on private investment fund managers' performance and results in compromise fee arrangements, such as paying fees on invested capital only.

Other important factors for the downward pressure on the incentive fee side include blackened carried interest and changes in the calculation of hurdle rates. Some industry observers are now talking about a movement towards blackened carried interest, meaning a private investment fund manager cannot collect carry until all limited partner investors have had their capital returned within the lifetime of the private equity model. A similar trend is observable in the hedge fund industry.

...blockchain's security measures make blockchain validation technologies more transparent and less prone to error and corruption.

Moreover, hurdle rate calculations have changed substantially. Inflation-indexed hurdle rates are now calculated on a monthly not a quarterly basis. For managers with pension plan limited partners that often means instead of an 8% hurdle rate the manager gets 5% plus inflation.

Blockchain Technology

Blockchain technology has been defined in many different ways, and no truly uniform definition seems to exist. Some refer to it as a giant worldwide, distributed, immutable "google spreadsheet" for transactions. Others define blockchain by focusing on its central elements, e.g., it is a transaction ledger, electronic, decentralized, immutable, and provides cryptographic verification, among several others.

Rather than attempting to agree on a mutually acceptable phraseology for a definition, a description of the core elements of ledger technology can help define the blockchain. As such, a blockchain is a shared digital ledger or database that maintains a continuously growing list of transactions among participating parties regarding digital assets – together described as "blocks." The linear and chronological order of transactions in a chain will be extended with another transaction link that is added to the block once such additional transaction is validated, verified, and completed. The chain of transactions is distributed to a limitless number of participants, so-called nodes, around the world in a public or private peer-to-peer network.

Blockchain technology removes fraudulent transactions. Compared with existing methods of verifying and validating transactions by third-party intermediaries, blockchain's security measures make blockchain validation technologies more transparent and less prone to error and corruption. While blockchain's use of digital signatures helps establish the identity and authenticity of the parties involved in the transaction, it is the completely decentralized network connectivity via the Internet that allows the most protection against fraud. Network connectivity allows multiple copies of the blockchain to be available to all participants across the distributed network. The decentralized, fully-distributed nature of the blockchain makes it practically impossible to reverse, alter, or erase information in the blockchain. Blockchain's distributed consensus model, e.g., the network nodes verify and validate chain transactions before execution of the transactions, makes it extremely rare for a fraudulent transaction to be recorded in the blockchain. That model also allows node verification of transactions without compromising the privacy of the parties and is therefore arguably safer than a traditional model that requires third-party intermediary validation of transactions.

Cryptographic hashes further increase blockchain security. Cryptographic hashes are complex algorithms that use the details of all previous transactions in the existing blockchain before adding the next block to generate a unique hash value. That hash value ensures the authenticity of each transaction before it is added to the block. The smallest change to the blockchain, even a single digit/value, results in a different hash value. A different hash value makes any form of manipulation immediately detectable.

Smart contracts and smart property are blockchain-enabled computer protocols that verify, facilitate, monitor, and enforce the negotiation and performance of a contract. The term "smart contract" was first introduced by Nick Szabo, a computer scientist and legal theorist, in 1994. An often-cited example for smart contracts is the purchase of music through Apple's iTunes platform. A computer code ensures that the "purchaser" can only listen to the music file on a limited number of Apple devices. More complex smart contract arrangements in which several parties are involved require a verifiable and unhackable system provided by blockchain technology. Through blockchain technology, smart contracting often makes legal contracting unnecessary as smart contracts often emulate the logic of legal contract clauses.

Private Investment Funds' Use of Blockchain Technology

A recent trend in the private investment fund industry pertains to the increasing use of blockchain technology to facilitate investment and process optimization. Several private investment funds have spearheaded the implementation of blockchain technology and smart contracting in their business model. While some funds simply focus on trading bitcoin and other cryptocurrencies to avoid market fluctuations, others invest in and/or acquire companies that use blockchain technology to provide synergies to their other portfolio companies. Yet others go much further by fully automating a hedge fund secured by blockchain technology, using blockchain technology to improve administrative procedures of private equity deal making, or using cryptocurrencies as incentives for data scientists' competitive models that facilitate investment analysis efficiencies. Examples include private investment funds such as Polychain Capital, the Northern Trust in cooperation with IBM, Numerai, LendingRobot, and Intellisys Capital LLC, Melonport, among many others.

Several private investment funds have spearheaded and continue to expand the implementation of blockchain technology and smart contracting in their business models. In February 2017, Northern Trust and IBM entered into a partnership for the commercial use of blockchain in the private fund industry. The partnership provides an enhanced and efficient approach to private equity administration. The implementation of the Northern Trust and IBM blockchain is intended to increase the efficiency, transparency, and speed of private equity transactions, improve security, and bring innovation to the private equity market by simplifying the complex and labor-intensive transactions in the private equity market. While the current legal and administrative processes that support private equity are time-consuming, expensive, lack transparency, and involve lengthy, duplicative, and fragmented investment and administrative processes, the partnership's solution delivers an enhanced and efficient approach to private equity administration. More specifically, unlike the current deal practice in private equity, which requires parties to reconcile multiples copies of the documents that form the deals to understand the greater picture, the blockchain program announced by Northern Trust and IBM allows all involved parties in an equity deal to look at a single compiled version of the transaction and all other data relating to the deal.

...blockchain is intended to increase the efficiency, transparency, and speed of private equity transactions, improve security, and bring innovation to the private equity market

Another example of the use of blockchain technology for private investment funds is Numerai. Numerai is a private investment fund with a global equity strategy that will go live on the blockchain later this year. Numerai operates on the Ethereum blockchain, utilizing a cryptocurrency called "Numeraire." Numerai uses artificial intelligence to convert financial data into machine learning problems for data scientists. On February 21, 2017, Numerai, announced: "[Today] 12,000 data scientists were issued 1 million crypto-tokens to incentivize the construction of an artificial intelligence hedge fund." Using data scientists for investment analysis creates efficiency through a synthesis of data. Data scientists working in this model work to solve the same problems in their own unique way with different strategies. Numerai synthesizes these models to create a meta-model out of all the predictions from the data scientists. In the Numerai model, the use of artificial intelligence ultimately helps achieve the goal of efficiency and optimum capital allocation by reducing overhead costs because there is no cost of human capital. In addition, Numerai eliminates barriers to entry because users do not need capital or any special finance or data knowledge.

LendingRobot's, LendingRobot Series is a fully automated hedge fund secured by blockchain technology. Unlike other blockchain-based hedge funds that invest specifically in cryptocurrency, such as Global Advisers and Polychain Capital, the LendingRobot Series invests in lending marketplaces—Lending Club, Prosper, Funding Circle, and Lending Home. Its trading is determined by an algorithm based on the investor's risk preferences. Once the investor has created a trading profile, LendingRobot selects and executes trades that are recorded in the blockchain public ledger on a weekly basis. Unlike traditional hedge funds that are rather secretive, the LendingRobot ledger shows detailed holdings and provides a "hash code" signature as evidence that the data is tamper-proof in the blockchain.

Established private investment fund managers may consider implementing blockchain technologies in the foreseeable future. Most large fund advisers in the private equity and hedge fund industry have not yet considered implementing blockchain technology in combination with big data applications and artificial intelligence. This, however, may change in the foreseeable future if and when larger managers realize that their smaller competitors who utilize these technologies gain substantial operational efficiencies and cost savings and are able to substantially diversify their portfolio holdings via such technologies. The threshold for change for bigger managers may be dictated by the implementation cost of such new technologies. If and when the long-term benefits of using the technologies exceed the implementation cost, which are much larger for larger managers than for the smaller managers who are currently experimenting with such technologies, larger managers are incentivized to start the innovation process as well.

Blockchain-Enabled Pressure on Fee Structure

Blockchain technology enables managers to charge per-transaction fees which undermines the existing 2/20 fee model. Blockchain technology facilitates a seamless and efficient calculation of management fees per transaction. In contrast to the traditional settlement and calculation of fees in a per-transaction model that created a prohibitive amount of work making such operations very difficult to execute, blockchain technology overcomes all of these restrictions. It enables the fully automated allocation of the appropriate fee to the correct executed trade and associated client account without any manual reconciliation or settlement. While normally the use of this type of fee is prone to human errors that occur during manual calculation or settlement, these errors are removed through the use of blockchain technology which performs the required calculations and settlement procedures automatically and seamlessly. The blockchain enabled per-transaction fee can be pre-determined or modified by the manager in cooperation with clients. It also can be publicly available which allows the private fund adviser to determine the applicable fee in a competitive market. Accordingly, clients who invest in a more transaction-prone strategy will be able to agree upfront to higher fees whereas clients who invest in a less transaction-rich strategy will pay overall lower fees.

While not all blockchain-enabled private investment funds charge per-transaction fees, the majority of private fund advisers that use blockchain technology are able to charge their investors lower fees. Prominent examples of lower fee structures driven by the use of blockchain technology include those of LendingRobot's, LendingRobot Series, the Logos Fund, and platforms for blockchain-enabled fund management, such as those offered by Melonport or Drago, among many others.

Investors in LendingRobot's, LendingRobot Series, the fully automated hedge fund secured by blockchain technology, unlike investors in traditional hedge funds, can withdraw funding on a weekly basis at no additional cost to the investor. Because LendingRobots' business model removes the investment adviser, overhead costs, and legal fees associated with each investor agreement, LendingRobot is able to charge a mere 1% management fee and a maximum 0.59% fund expense fee per year. Other factors that help keep the fee low include the increased transparency that allows LendingRobot to expense fewer resources on auditing the fund. LendingRobot claims an average performance of from 6.86% to 9.66% depending on the investment strategy selected by the clients. As of March 2017 an analysis of a broad range of traditional hedge funds shows an average of 8.89% annualized return. The increased transparency, reduced costs, and competitive performance enabled by LendingRobot's use of blockchain technology may give it a competitive advantage in the private fund industry that could continue to exert pressure on fees charged by competitor funds.

The Logos Fund is an alternative investment fund that invests in blockchain and cryptocurrency-related investments. It aims to make blockchain-based currencies accessible to professionals and a broad range of investors by investing in the mining of blockchain-based cryptocurrencies as well as into such currencies directly. To cover base costs and administration, the Logos Fund charges an administrative fee of between 1.2% and 1.92% depending on the size of the investment. The fund management also charges a performance-related fee of from 9% to 21% plus investment surcharges and redemption surcharges in accordance with market practices.

Blockchain-enabled platforms for setting up a private investment fund cause significant pressure on the existing fee structure of the private investment fund industry. Platforms such as Melonport or Drago enable competitive gains for their clients through fewer costs and time barriers to setting up and running a private investment fund. While such competitive gains will benefit the majority of private investment fund managers and investors, the lower operating costs enabled by the platform models will especially enable new and future managers to enter the market because the start-up costs and compliance costs can be significantly reduced. By enabling low set-up requirements and low costs of running a portfolio, platform models may be able to create an unprecedented competitive environment for asset management strategies.

...the majority of private fund advisers that use blockchain technology are able to charge their investors lower fees.

The cost of running a private fund adviser portfolio on the blockchain equals the core usage fees, modular commissions, and the infrastructure costs to be paid on the Ethereum platform. The usage fees are determined by the protocol, and the modular fees are set by the module developers and are a fraction of a cent or a fraction of the trade volume for each usage.

Conclusion

The meteoric rise of blockchain technology and the abovementioned prominent applications of blockchain technology utilizing artificial intelligence and big data serve as prominent examples of the impending seismic shifts in the private investment fund industry. The paper has illustrated that the rise of blockchain applications in private investment funds has an impact on the already changing fee structure of the industry. Private investment funds that use blockchain technology in combination with other technologies, such as artificial intelligence and big data, among others, are able to lower their fees. As the use of blockchain technologies increases in the industry, the fee structure will be subject to increasing pressure.

1 The author is grateful for outstanding support from librarian Ann Bateson.

SEC Enforcement Actions Involving Private Funds and Their Advisers

Eva Ciko Carmen, Managing Partner (New York office) and Co-Chief of the Securities and Futures Enforcement Group, Ropes & Gray LLP

Summarized below are some of the significant SEC enforcement activities that may impact private funds and their advisers in the near future.

These enforcement activities are organized as follows:

- Allocation of Fees and Expenses—Disclosure; Improper Allocation
- Conflict of Interests
- Valuation and Performance
- Chief Compliance Officer Respondents
- Failure to Adopt Proper Cybersecurity Policies and Procedures
- Non-Disclosure and Breach of Fiduciary Duty
- Fraud for Improperly Retaining Fees
- Cross-Trades - "Parking"

Allocation of Fees and Expenses—Disclosure; Improper Allocation

In the Matter of SLRA Inc., and Scott M. Landress, Rel. No. IA-4641

On February 7, 2017, the SEC settled an action brought against Scott M. Landress, a private equity adviser, and SLRA Inc., a California-based investment advisory firm, in which the SEC alleged that Landress had withdrawn improper fees from private equity funds under his management. As a result of the settlement, Landress is permanently barred from the securities industry and must pay the SEC a $1.25 million penalty.

The Order finds that Landress created certain funds in order to invest in various real estate trusts comprised of property investments throughout the UK. SLRA's management fees were tied to the net asset value of the underlying properties. When the property values declined during the financial crisis, SLRA's fees decreased while its management costs increased, resulting in an operating loss. Consequently, between 2009 and 2011, Landress asked for additional compensation from the limited partners of the Funds to cover the shortfalls, but they declined his requests. In 2014, Landress withdrew 16.25 million pounds from the Funds, describing the money as service fees owed to an affiliate for services previously provided to the Funds. Landress claimed that the service fees were permitted by the Funds' Limited Partnership Agreements and under a related oral agreement Landress entered into in 2006, where he acted both on behalf of the Funds and on behalf of the affiliate. Landress then transferred the money to his personal account. Respondents failed to disclose the service fees or the related-party transaction to their clients or the Funds' investors until after the money was withdrawn. There is no evidence indicating the affiliate was actually hired to perform services, and the Funds' audited financial statements did not reflect the service fees. Following the SEC investigation, SLRA returned over $24.4 million to the limited partners. As a result of this conduct, the Order finds that Respondents willfully violated Sections 206(f), 206(2), and 206(4) of the Advisers Act, as well as Rule 206(4)-8 promulgated under the Advisers Act. Landress agreed to cease and desist from committing any future violations.

First Reserve Management, L.P., Rel. No. IA-4529

On September 14, 2016, the SEC settled an action brought against First Reserve Management, L.P. ("First Reserve") in which the SEC alleged that First Reserve did not adequately disclose certain financial conflicts of interest. The SEC alleged that at various times between 2010 and 2015, First Reserve allocated expenses to the funds without making appropriate disclosures or receiving effective consent, including (I) certain fees and expenses of two entities formed as advisers to a Fund portfolio company; and (2) certain premiums for a liability insurance policy covering First Reserve for risks not entirely arising from its management of the funds. The SEC also alleged that First Reserve negotiated a legal fee discount from a law firm for itself for certain services, while the funds did not receive a discount on the same services. The SEC alleged that this conduct was a violation of Sections 206(2) and 206(4) of the Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder. As part of the settlement, First Reserve agreed to cease and desist from committing or causing any violations and any future violations of the Advisers Act provisions at issue, and agreed to pay a civil money penalty of $3.5 million.

In the Matter of WL Ross & Co. LLC, Rel. No. IA- 4494

On August 24, 2016, the SEC settled an action brought against WL Ross & Co. LLC ("WL Ross") in which the SEC alleged that WL Ross did not disclose its fee allocation practices to certain private equity funds it advised and their investors, which resulted in these funds paying higher management fees between 2001-2011. The Limited Partnership Agreements of certain WL Ross funds provided that WL Ross would receive management fees from fund investors, which "shall be reduced" by an amount equal to 50% (or 80%) of "any" transaction fees received by WL Ross in connection with fund investments and transactions. The governing fund documents did not disclose how transaction fees would be allocated when multiple funds and co-investors were invested in the same portfolio company. The SEC alleged that WL Ross allocated transaction fees that it earned from portfolio companies to the funds based upon their relative ownership percentages of the portfolio company without disclosing this practice. This resulted in WL Ross retaining the portion of the transaction fees that was based upon co-investors' relative ownership of the portfolio company, without subjecting such fees to offsets. The SEC alleged that WL Ross retained $10.4 million in additional fees as a result of its historical transaction fee allocation methodology. WL Ross voluntarily reimbursed the funds for the additional fees ($11.8 million with interest) prior to the conclusion of the SEC's investigation. As part of the settlement, WL Ross agreed to cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder and paid a civil monetary penalty of $2.3 million.

In the Matter of Apollo Management V, L.P., Apollo Management VI, L.P., Apollo Management VII, L.P., and Apollo Commodities Management, L.P., Rel. No.IA-4494

On August 23, 2016, Apollo Management V, L.R, Apollo Management VI, L.R, Apollo Management VII, L.P., and Apollo Commodities Management, L.P (collectively "Apollo") agreed to settle an action brought by the SEC for alleged breaches of fiduciary duty. The SEC alleged that Apollo improperly accelerated monitoring fees. While Apollo had disclosed its ability to collect monitoring fees prior to investors' commitment of capital, the SEC alleged that Apollo did not adequately disclose its ability to accelerate future monitoring fees. The SEC also alleged that, in June 2008, Apollo Advisors VI, L.R ("Advisors VI"), the general partner of Apollo Investment Fund VI, L.P., entered into a loan agreement with other Apollo funds (the "Lending Funds"), pursuant to which Advisors VI borrowed $19M and had to pay interest until the loan was terminated in 2013. The Lending Funds' financial statement disclosed the accrued amount of interest, but did not disclose that the accrued interest would be allocated solely to the Advisors VI account—which the SEC alleged rendered the disclosures in the Lending Funds' financial statements materially misleading. The SEC also alleged that, from January 2010 through June 2013, a former senior partner improperly charged personal items and services to Apollo-advised funds and the funds' portfolio companies, which Apollo failed to reasonably supervise. Apollo also allegedly failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. As part of the settlement, Apollo agreed to cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. Additionally, Apollo agreed to pay $37,527,000 in disgorgement and $2,727,552 in prejudgment interest. Further, Apollo agreed to pay a civil monetary penalty of $12,500,000.

In the Matter of Cranshire Capital Advisors, LLC, Rel. No. IA-4277

On November 23, 2015, Cranshire Capital Advisors, LLC ("CCA") agreed to settle an action brought by the SEC for improperly using fund assets to pay for the adviser's legal, compliance, and operating expenses in a manner that was not disclosed in the fund's organizational documents. The SEC claimed that CCA's failure to adopt and implement an adequate compliance program for determining expenses properly chargeable to the fund contributed to the negligent misallocation of expenses to the fund. Because CCA was already in the process of unwinding itself, it agreed as part of the settlement to retain the services of a compliance consultant to provide guidance on its compliance policies and procedures until it no longer had assets under management. Further, CCA agreed to pay a penalty of $250,000.

The SEC alleged that certain operating partner affiliates received fees from portfolio companies that should have been offset against the management fees….

In the Matter of Fenway Partners, LLC, Rel. No. IA-4253

On November 3, 2015, private equity fund adviser Fenway Partners, LLC ("Fenway Partners") and three current and one former executive agreed to an SEC settlement stemming from allegations that they failed to disclose to investors certain conflicts of interest. The SEC alleged that certain operating partner affiliates received fees from the portfolio companies that should have been offset against the management fee paid to Fenway Partners by one of its funds. The SEC further alleged that Fenway Partners and its executives caused the portfolio companies to end their payment obligations to Fenway Partners and to enter into agreements with an affiliated consulting entity owned by three of the executives that allegedly provided services similar to those provided under the original agreements. According to the settlement order, in which Fenway Partners neither admitted nor denied the allegations, Fenway Partners did not disclose to fund investors the conflict of interest caused by the termination of the agreements with Fenway Partners and the payment of fees to the affiliated consulting entity and its employees without the benefit of a management fee offset. As part of the settlement, Fenway Partners and the executives agreed to pay more than $8.7 million in disgorgement and interest and a $1.5 million penalty.

In the Matter of Blackstone Management Partners L.L.C., Rel. No. IA-4219

On October 7, 2015, the SEC settled an action brought against Blackstone Management Partners ("Blackstone") for failing to adequately disclose to its funds, and to the funds' limited partners prior to their commitment of capital, that it may accelerate the payment of future monitoring fees upon termination of certain portfolio company monitoring agreements if the companies were sold in a private sale or went public. While a portion of the accelerated monitoring payments reduced management fees otherwise payable by limited partners, the net amount of the payments also reduced the value of the portfolio companies when sold or taken public, reducing the amounts available for distribution to limited partners. In addition, it was alleged that over the course of several years Blackstone did not disclose to its funds or the funds' limited partners a discount in legal services it had secured for itself, but not for the funds, in a single legal services arrangement among itself, the funds, and legal counsel. As part of the settlement agreement, Blackstone paid $28.9 million into a disgorgement fund and a penalty of $10 million.

In the Matter of Kohlberg Kravis Roberts & Co. L.P., Rel. No. IA-4131

On June 29, 2015, the SEC settled an action brought against Kohlberg Kravis Roberts Co. ("KKR") for misallocating broken deal expenses between its flagship private equity funds and certain KKR co-investors in breach of its fiduciary duty as investment adviser. Between 2006 and 2011, KKR incurred $338 million in diligence and similar expenses related to unsuccessful buyout opportunities ("broken deal expenses"). KKR allocated these broken deal expenses to its flagship private equity funds, but not to the KKR co-investors, which included KKR executives, even though the executives participated in and benefited from KKR's sourcing of private equity transactions. The SEC alleged that KKR violated its fiduciary duty by not disclosing to its flagship private equity funds that the KKR co-investors bore no share of the broken deal expenses. KKR agreed to pay $18.6 million in disgorgement and prejudgment interest and a $10 million penalty.

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Conflict of Interests

In the Matter of Centre Partners Management, LLC., Rel. IA-No. 4604

On January 10, 2017, the SEC settled an action against Centre Partners Management, LLC ("CPM") in which the SEC alleged that CPM failed to disclose potential conflicts of interest to its private equity fund clients and the adviser's material misleading statements to the funds' investors. Specifically, from 2001-2014, CPM allegedly failed to disclose relationships between certain of its principals and a third-party information technology service provider, and the potential conflicts of interest resulting from those relationships. Although CPM provided extensive disclosure of its use of the service provider in the investment due diligence process and presented its business relationship with the service provider as a competitive advantage to investors, it did not disclose the relationship between CPM Principals and the service provider.

CPM and its Principals did not financially profit from their relationships with the service provider, but the SEC alleged that CPM nonetheless breached its fiduciary duty to its fund clients and made material misleading statements by failing to disclose these potential conflicts of interest. As part of the settlement, CPM agreed to cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder. CPM also agreed to a censure and to pay a civil money penalty of $50,000.

Stilwell caused a series of undocumented loans to be made by some funds to certain other funds for the purpose of financing the borrower funds' investment strategies.

In the Matter of JH Partners, LLC, Rel. No. IA-4276

On November 23, 2015, JH Partners, LLC ("JHP") agreed to settle with the SEC allegations that it negligently breached its fiduciary duty to several private equity funds for which it served as investment adviser. Specific breaches of fiduciary duty alleged included (i) undisclosed loans from JHP to the funds' portfolio companies, in some cases giving JHP interests in the portfolio companies senior to the equity interests held by the funds, (ii) inadequate disclosure that JHP caused some funds to invest in the same portfolio companies with differing seniority or priority levels, potentially favoring one fund over another and (iii) inadequate disclosure to the funds' limited partners and advisory board members that JHP had exceeded the concentration limits for investments in any single portfolio company without attempting to obtain written waivers from all limited partners, as contemplated under the funds' Limited Partnership Agreements. As part of the settlement agreement, the SEC censured JHP, and required it to pay a penalty of $225,000.

In the Matter of Joseph Stilwell, Rel. No. IA-4049

On March 16, 2015, the SEC agreed to settle an action against Stilwell Value LLC, a New York-based investment adviser, and its owner and managing member Joseph Stilwell ("J. Stilwell" and collectively, "Stilwell") for failing to adequately disclose the existence of inter-fund loans made between certain private funds managed by Stilwell, as well as the conflicts of interest arising out of such loans. Stilwell caused a series of undocumented loans to be made by some funds to certain other funds for the purpose of financing the borrower funds' investment strategies. No terms were established at the time the loans were made, and Stilwell set the interest rate after the fact. The funds' marketing materials or governing documents did not disclose the possibility of such loans, and only one loan was disclosed in audited financial statements after it had been repaid. The SEC claimed that the loans presented a conflict of interest because Stilwell was solely responsible for directing the funds to make the loans, determining their terms, and deciding whether and when the borrower funds repaid the loans. Moreover, it claimed that the lack of documentation exposed the lender funds to the risk that they would have no recourse in the event of default. In addition, Stilwell caused several funds that it managed to make a series of loans to another fund ("SVP-III"), personally guaranteed by J. Stilwell, with proceeds from one loan used to repay a prior loan. The SEC alleged that the loans—and the conflicts of interest—were not adequately disclosed to the investors because, although notice was provided in the funds' audited financial statements, few investors actually received financial statements. Further, the SEC claimed that neither the lender funds' nor SVP-III's financial statements adequately disclosed the fact that SVP-III eventually defaulted on the last of the series of loans and J. Stilwell did not make good on his personal guarantees. As part of the settlement, the SEC required Stilwell Value LLC to pay almost $240,000 in disgorgement of management fees, as well as prejudgment interest and a $250,000 penalty, and required J. Stilwell to pay a $100,000 penalty.

The funds' marketing materials or governing documents did not disclose the possibility of such loans, and only one loan was disclosed in audited financial statements after it had been repaid.

Valuation and Performance

SEC v. Summit Asset Strategies Inv. Mgmt., LLC, No. 2:15-cv-01429 (W.D. Wash.)

On September 4, 2015, the SEC filed a lawsuit against Summit Asset Strategies Investment Management, LLC ("SASIM") and its CEO/CIO, Chris Yoo ("Yoo") for an alleged misappropriation of assets from a private investment fund they advised, Summit Stable Value Fund, LLC ("SSVF"). SASIM and Yoo's compensation depended on the value of SSVF's assets and was tied to the unrealized gains and losses in those assets each year. They were allowed to withdraw estimated net fund profits each month, but were supposed to "true up" and return any distributions in excess of actual net fund profits reported in SSVF's annual audit. In 2012 and 2013, Yoo allegedly included a fictitious valuation for an illiquid investment that SSVF did not possess, and removed from the balance sheet one that SSVE did possess, resulting in a materially overstated asset value for the fund. In subsequent years, Yoo continued to withdraw "net fund profits" even though the fund began to default on its obligations to investors. The SEC alleged that Yoo and SASIM made materially false and misleading statements to prospective and existing SSVF investors by misrepresenting how Yoo was withdrawing fees from the fund and by over-stating the fund's asset values. In addition, SASIM and Yoo allegedly misrepresented that SSVF had an independent financial representative review related party transactions. The SEC seeks to permanently enjoin Yoo and SASIM from continuing securities violations, as well as disgorgement of profits, prejudgment interest, and civil penalties.

The auditor eventually asked to speak to one of the sources to explain large divergences between the actual market prices for the mortgage-backed securities and the ones they supplied, and the adviser agreed. But the adviser gave the source a script to read when fielding the auditor's questions

In the Matter of AlphaBridge Capital Management, LLC, Rel. No. IA-4135

On July 1, 2015, the SEC settled an action brought against AlphaBridge Capital Management, LLC ("AlphaBridge") and two of its executives for fraudulently inflating the valuations of mortgage-backed securities held in the portfolio of private investment funds managed by AlphaBridge and ultimately inflating the management and performance fees received by the principals. AlphaBridge originally told the funds' investors, administrator, and auditor that it obtained legitimate price quotes for the mortgage-backed securities from legitimate sources. But over time, the adviser gave its own valuations to the no-longer-legitimate sources that then passed them off as their own to the funds' administrator and auditor, allowing them to inflate the prices above their real market equivalent. The auditor eventually asked to speak to one of the sources to explain large divergences between the actual market prices for the mortgage-backed securities and the ones they supplied, and the adviser agreed. But the adviser gave the source a script to read when fielding the auditor's questions, allegedly "further misleading and deceiving the auditor and ultimately the funds' investors." The settlement alleged that AlphaBridge filed Forms ADV with the SEC that overstated the fund's net assets and AlphaBridge's assets under management, and AlphaBridge failed to (i) implement written policies and procedures that would help to prevent violations of the Advisers Act and rules thereunder and (ii) implement its own valuation policy that would have required "independent price quotes or otherwise comply with fair value standards in valuing the mortgaged-backed securities in the funds' portfolio." As part of the settlement, the SEC censured AlphaBridge and one of the executives, and barred the other executive from advisory work for three years. AlphaBridge and the executives agreed to pay $4.25 million in disgorgement of profits, as well as additional civil monetary penalties.

In the Matter of Lynn Tilton, Rel. No. IA-4053 (March 30, 2015)

On March 30, 2015, the SEC charged an investment adviser, Lynn Tilton ("Tilton"), and several investment companies indirectly owned and managed by Tilton ("Patriarch Partners") with breaching their fiduciary duties and defrauding clients by misstating the value of the assets of the collateralized loan obligation funds managed by Tilton and Patriarch Partners. The funds raised over $2.5 billion from investors and used these investments to make loans to distressed companies. For several years, the distressed companies performed poorly and made no interest payments or partial payments to the funds. The SEC alleged that, despite the poor performance of many of the funds' assets, Tilton and Patriarch Partners reported their values as unchanged. Tilton retained subjective control over the valuation methodology and had the final say on when to stop "supporting" a distressed company. The SEC alleged that Tilton and Patriarch Partners preserved their management fees by not lowering an asset's valuation. Had Tilton and Patriarch Partners applied an appropriate valuation methodology, the management fees and other compensatory payments to Tilton and Patriarch Partners would have been reduced by almost $200 million. In addition, the SEC alleged that Tilton repeatedly and falsely certified that the funds' financial statements were prepared in accordance with GAAP, and Tilton's discretionary valuation of the funds' assets and the conflict of interest this posed were not disclosed to the investors.

Chief Compliance Officer Respondents

In the Matter of BlackRock Advisors, LLC, Rel. No. IA-4065

On April 20, 2015, the SEC settled an action against a fund adviser, BlackRock Advisors, LLC, and the adviser's CCO based on the alleged non-disclosure of a conflict of interest created by the outside business activity of a portfolio manager. The settlement order states that the portfolio manager was the general partner and substantial investor in an energy exploration partnership that formed a joint venture with a publicly traded coal production company. Shares of the coal company were held by funds and accounts managed by the portfolio manager. The SEC alleged that the adviser knew and approved of the portfolio manager's involvement with the partnership and joint venture, but failed to disclose the conflict of interest to either the funds' boards or to its other advisory clients. It also alleged that the adviser's CCO, who knew about the portfolio manager's violations of the adviser's private investment policy, caused the funds' violation of Rule 38a-l by failing to report the situation to the funds' chief compliance officer, who was unable to report a "material compliance matter" to the funds' board. The SEC ordered Blackrock to pay a civil money penalty of $12 million and to hire an independent compliance consultant. The former CCO further agreed to pay a $60,000 penalty.

Failure To Adopt Proper Cybersecurity Policies and Procedures

In the Matter of R.T. Jones Capital Equities Management, Inc., Rel. No. IA-4204

On September 22, 2015, the SEC announced that it had agreed to settle enforcement proceedings brought against an investment adviser, R.T Jones Capital Equities Management ("R.T Jones"), in connection with a cybersecurity breach that compromised the personally identifiable information ("PII") of the firm's clients. According to the SEC settlement order, the adviser stored PII on its third-party hosted web server, which was attacked in July 2013 by an unknown cyber-intruder. The intruder gained access and copy rights to the data on the server, compromising the PII of more than 100,000 individuals, including thousands of the adviser's clients. After the breach was discovered, R.T Jones hired cybersecurity consultants and the origin of the attack was traced to China. It provided notice of the breach to every individual whose PII may have been compromised and offered free identity theft monitoring through a third-party provider. According to the settlement order, the adviser failed to adopt written policies and procedures reasonably designed to safeguard its clients' PII, as required by Rule 30(a) of Regulation S-P. The SEC noted that the adviser's policies and procedures were not "reasonably designed" in that they did not include provisions for conducting periodic risk assessments, employing a firewall to protect the web server containing client PII, encrypting client PII stored on that server, or establishing procedures for responding to a cybersecurity incident. While none of R.T. Jones' clients were shown to have suffered any harm, the adviser agreed to pay a penalty of $75,000 as part of the settlement.

The intruder gained access and copy rights to the data on the server, compromising the PII of more than 100,000 individuals, including thousands of the adviser's clients.

Non-Disclosure and Breach of Fiduciary Duty

In the Matter of Guggenheim Partners Investment Management, LLC, Rel. No. IA-4163

On August 10, 2015, the SEC settled enforcement proceedings brought against Guggenheim Partners Investment Management, LLC ("GPIM"), an investment adviser primarily to institutional clients, high net worth individuals and private funds, for breaching its fiduciary duty by not disclosing that a GPIM senior executive received a $50 million loan from a client that allowed the executive to participate personally in a deal led by GPIM's corporate parent. As a result of the loan, the SEC alleged that GPIM had a potential conflict of interest whereby GPIM might have placed the lending client's interests over the interests of other clients. The SEC noted that GPIM did not disclose the loan when GPIM placed certain of its other clients in two transactions on different terms from the client who made the loan. In settlement of these alleged violations, GPIM agreed to pay a civil monetary penalty of $20 million.

Cross-Trades—"Parking"

In the Matter of Morgan Stanley Investment Management Inc. and Sheila Huang, Rel. No. IA-4299

On December 22, 2015, the SEC settled enforcement proceedings brought against Morgan Stanley Investment Management Inc. ("Morgan Stanley"), a registered investment adviser, and one of its portfolio managers, Sheila Huang ("Huang"), for unlawfully conducting prearranged trading known as "parking" that favored certain advisory client accounts over others. The SEC alleged that Huang effected prearranged transactions for five sets of bond trades. She sold them to a brokerage firm, SG Americas, at the highest current independent bid price available for the securities, and executed the repurchase side of the cross trade at a small markup over the sale price. The prearranged cross trades resulted in undisclosed favorable treatment to the purchasing clients, even though the purchasing and selling clients were owed the same fiduciary duty. In another set of prearranged trades, to avoid incurring losses in certain accounts, Huang orchestrated a scheme to sell the bonds at above-market prices to SG Americas, while at the same time selling two bonds from the unregistered fund she managed to SG Americas at below market prices for no legitimate purpose except to offset the above-market prices of the other bonds she sold. Through these trades, Huang moved approximately $600,000 in previously unrealized losses from the selling accounts to the unregistered fund. As part of the settlement, Morgan Stanley agreed to pay a penalty of $8 million and to reimburse $857,534 to certain client accounts harmed by Huang. Huang consented to paying a $125,000 penalty and was barred from the securities industry for five years.

New SEC Enforcement Action Gives Force to Ongoing Safeguards Requirements

Elizabeth P. Gray, Partner and Co-Chair of the Securities Enforcement Practice Group, James E. Anderson, Partner, William Stellmach, Partner and Ashley Singletary-Claffee, Associate, Willkie Farr & Gallagher LLP[1]

On June 8, 2016, the Securities and Exchange Commission (the "SEC") announced charges against Morgan Stanley Smith Barney LLC ("MSSB"), following a cyber breach involving MSSB customer data, for failing to adopt written policies and procedures reasonably designed to protect customer records and information under the Safeguards Rule of Regulation S-P. MSSB, a dually registered broker-dealer and investment adviser, paid a $1 million civil money penalty and agreed to a censure to settle the administrative proceeding.[2] Together with a prior settlement involving a data breach at R.T. Jones, the MSSB settlement signals the SEC's willingness to pursue punitive measures to ensure compliance with the Safeguards Rule and also suggests that any informal grace period for implementing its views on effective cybersecurity protocols by financial institutions previously outlined in Staff guidance will soon expire, if it has not already. This enforcement action also provides critical insight into the SEC's evolving interpretations of the Safeguards Rule and reinforces the SEC's recent messaging regarding cybersecurity and the safeguarding of customer information.

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The Safeguards Rule requires registered broker-dealers and investment advisers to adopt written policies and procedures reasonably designed to: (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

The MSSB case reinforces SEC Chair Mary Jo White's May 17, 2016 remarks in which she noted that cybersecurity is the biggest threat facing the global financial system.[3] The settlement is the second SEC enforcement action in the past 12 months alleging a violation of the Safeguards Rule on the basis of an investment adviser's weak cyber controls.[4] Previously, the SEC's views on effective cybersecurity protocols were articulated in a series of Staff guidance updates and examination findings.[5] In announcing the settlement, SEC Enforcement Director Andrew Ceresney reiterated that "the dangers and impact of cyber breaches" make data security "a critically important aspect of investor protection."[6]

The SEC's Cybersecurity Initiative

The MSSB settlement marks the latest in an escalating pattern of regulatory actions targeting cybersecurity controls among investment advisers and broker-dealers. In 2014 and 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") conducted targeted examinations of broker-dealers and investment advisers that focused on cybersecurity governance and risk assessments, access rights and controls, data loss prevention, vendor management, training, and incident response.[7] As a result of the OCIE Cybersecurity Initiative in 2014, the SEC staff examined 57 registered broker-dealers and 49 registered investment advisers. In a Risk Alert summarizing its observations, OCIE noted that the vast majority of examined firms have adopted written information security policies and procedures and that most conduct periodic audits to determine compliance with these policies.[8] OCIE further identified that the vast majority of examined firms conduct periodic, firm-wide risk assessments to identify cybersecurity threats, vulnerabilities, and potential business consequences, that almost all of the examined firms make use of some form of encryption, and that most of the examined firms reported that they have been the subject of a cyber-related incident.

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Impact of Cybersecurity on Financial Services Firms

In September 2015, the SEC alleged that R.T. Jones Capital Equities Management, Inc. stored sensitive personally identifiable information of clients on a third-party-hosted server without adopting any written policies and procedures to ensure the security and confidentiality of the information and to protect it from anticipated threats or unauthorized access. Ultimately, the firm's web server was attacked in July 2013 by an unknown hacker who gained access and copy rights that rendered the personally identifiable information of more than 100,000 individuals, including thousands of R.T. Jones's clients, vulnerable to theft. In settling the case, the SEC also noted that R.T. Jones did not conduct periodic risk assessments, employ a firewall to protect the client information, encrypt the client information on the server, or establish procedures for responding to a cybersecurity incident.

Also, in August 2015, the SEC filed fraud charges against 32 defendants for participating in an international scheme in which hackers allegedly infiltrated newswire services and traded on corporate earnings announcements before they were released publicly, generating more than $100 million in illicit profits. According to press releases, the SEC coordinated its investigatory efforts with the Federal Bureau of Investigation, the Department of Homeland Security, the Financial Industry Regulation Authority, U.S. Attorney's Offices, and the United Kingdom Financial Conduct Authority, among other regulatory entities. The financial services sector, in particular, has been a popular target for hackers over the last several years. Most recently, in May 2016, the hacking collective, Anonymous, launched an attack against the Bank of Greece's website and threatened to target similar websites of other central banks around the world.

Here, the SEC alleged that from 2011 to 2014, an MSSB employee, Galen Marsh, misappropriated data concerning 730,000 customer accounts associated with 330,000 different households. The data included customers' full names, phone numbers, street addresses, account numbers, account balances and securities holdings. According to the SEC, MSSB maintained hundreds of computer applications to store the sensitive personally identifiable information, but Marsh importantly accessed only two portals, the Fixed Income Division Select Portal and the Business Information System Portal. Both portals suffered a similar flaw: neither limited Marsh's access to only information for customers for whom he was properly authorized. As a result, Marsh could run reports that contained the confidential information of vast numbers of customers throughout MSSB.

Although MSSB had written policies and procedures addressing customer information safeguards—including a policy restricting employee access to confidential information for a limited number of customers, the authorization modules described above, which operationalized the policy's restrictions, and technology controls that prevented employees from copying data onto removable storage devices and from accessing certain kinds of websites—the SEC found that MSSB failed to ensure that these policies and procedures were reasonably designed to meet the objectives of the Safeguards Rule. In particular, the SEC highlighted that: (1) the authorization modules were ineffective in limiting employee access to data; (2) MSSB failed to conduct audits or tests of the modules at any point in the 10 years since their creation; and (3) MSSB did not monitor user activity in the firm's applications that stored the personally identifiable information of its clients.

By the time MSSB discovered the breach during one of its routine Internet sweeps, Marsh had already transferred the customer data to a personal website. Subsequent forensic analysis identified that a third party likely hacked into that website's server and copied the customer information that Marsh had downloaded. The hacker then posted portions of the confidential data on the Internet with offers to sell larger quantities of the information.

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In a separate SEC order, Marsh agreed to an industry bar with the right to apply for re-entry in five years. He was also criminally convicted for his conduct last year, sentenced to 36 months of probation, and was required to pay $600,000 in restitution.

In light of the SEC's heightened and increasingly aggressive scrutiny, broker-dealers and investment advisers who have not already done so should take care to make cybersecurity governance a key priority. Firms should institute robust written policies and procedures for safeguarding client information, specifically addressing the performance of regular cybersecurity risk assessments, strategies for preventing cybersecurity threats such as through the use of firewalls and encryption, and responses to data breaches and other cyber incidents. This recent enforcement action provides a partial road map for tailoring an effective and regulatory compliant data safeguard program, but firms need to conduct a timely self-assessment to evaluate both the technical and regulatory risks.

1 Elizabeth P. Gray, James E. Anderson and William J. Stellmach are partners and Ashley E. Singletary-Claffee is an associate in Willkie Farr & Gallagher LLP, and all are resident in Willkie Farr's Washington, D.C. office.

2 MSSB neither admitted nor denied the SEC's findings. See Morgan Stanley Smith Barney LLC, Investment Advisers Act Release No. 4,415 (June 8, 2016).

3 See Lisa Lambert and Suzanne Barlyn, SEC Says Cyber Security Biggest Risk to Financial System, Reuters (May 18, 2016).

4 See R.T. Jones Capital Equities Management, Inc., Investment Advisers Act Release No. 4,204 (Sept. 22, 2015).

5 See IM Guidance Update, Cybersecurity Guidance (April 2015), available here; OCIE, National Exam Program, Risk Alert: Cybersecurity Examination Sweep Summary (Feb. 3, 2015), [hereinafter "Sweep Summary"]; see generally Cybersecurity Roundtable, SEC, (last modified May 11, 2016).

6 See SEC Press Release, "Morgan Stanley Failed to Safeguard Customer Data."

7 See OCIE, National Exam Program Risk Alert: OCIE's 2015 Cybersecurity Examination Initiative (Sept. 15, 2015), available here; OCIE, National Exam Program Risk Alert: OCIE Cybersecurity Initiative (Apr. 15, 2014).

8 See Sweep Summary.

Contributor Biographies

Eva Ciko Carman is a Managing Partner of the New York office of the law firm, **Ropes & Gray LLP** and Co-Chief of the firm's Securities & Futures Enforcement Group. She is Chambers ranked and nationally recognized for her work in securities regulation and enforcement. She has 25 years of experience representing investment advisers in connection with Securities & Exchange Commission examinations, investigations and litigated actions. Her focus includes private equity and real estate fund defense, having worked with over twenty PE and real estate firms in connection with the SEC's focus on that industry. She obtained her J.D. from Georgetown University Law Center.

Robert S. De Leon is General Counsel and Chief Compliance Officer of **Rimrock Capital Management, LLC**. Rimrock is a California-based hedge fund manager with over $8 billion in assets under management. Mr. De Leon's career has been in financial services, serving as general counsel of Tradewinds Global Investors, LLC and Covariance Capital Management, a unit of TIAA-CREF. He also served as associate general counsel of TIAA-CREF and as counsel of AllianceBernstein. Mr. De Leon served three years as Senior Counsel for the U.S. Securities & Exchange Commission. He also practiced law at several Biglaw firms and is a 1990 graduate of Harvard Law School.

Elizabeth P. Gray is a Partner at the law firm **Willkie Farr & Gallagher LLP**, and she is Co-Chair of the firm's Securities and Futures Enforcement Group. She is Chambers ranked. She is nationally recognized in the area of securities regulation and enforcement, with significant experience in asset management, broker-dealer, cybersecurity, FCPA and accounting matters. She represents investment advisers, investment companies and their boards, broker-dealers, and other institutions and senior executives. Prior to private practice, Ms. Gray served for 12 years at the U.S. Securities and Exchange Commission, including as Assistant Director in the SEC's Division of Enforcement. She received her J.D. from the University of Virginia School of Law. Her co-authors for the article in this Report, **James E. Anderson and William J. Stellmach** are Partners and **Ashley Singletary-Claffee** is an Associate at the Willkie Farr firm.

Wulf A. Kaal is an Associate Professor and Director of the **Private Investment Fund Institute at the University of St. Thomas School of Law**, Minneapolis, Minnesota. Mr. Kaal is a technologist and studies the intersection of law, business, and technology. His research focuses on innovation, technology, smart contracts, hedge funds, dynamic regulatory methods, and blockchains. Mr. Kaal is a leading expert on private investment fund regulation and compliance and private investment fund innovation in finance. His scholarship constitutes over 85% of the empirical and theoretical scholarship on private fund regulation in the United States. Before entering the academy, he was associated with Cravath, Swaine & Moore LLP, in New York, and Goldman Sachs in London,. Mr. Kaal has a Ph.D. from Humboldt-Universitaet zu Berlin; a J.D. and LLM from the University of Illinois College of Law and an MBA from Durham University, U.K.

Jonathan P. Koerner is a Partner at **Albourne Partners** and serves as its Head of Implementation. Albourne Partners is an international provider of independent research and advice on complicated assets. He has a J.D. and MBA from the University of Utah. Prior to joining Albourne in 2015, he served as investment analyst and investment counsel for Utah Retirement Systems. Mr. Koerner has also been an adjunct professor in venture capital finance at the University of Utah David Eccles School of Business.

Timothy Spangler is the Director of Research at the **Lowell Milken Institute for Business Law and Policy at UCLA School of Law** and a Partner at **Dechert LLP's** Orange County office. Mr. Spangler focuses his practice on the formation, structuring and negotiation of investment vehicles across numerous jurisdictions both domestic and international. He counsels advisers, investors, managers and promoters on a wide range of matters relating to the development and launch of new funds of funds, hedge funds, private equity funds and venture capital funds. He regularly advises fund sponsors and promoters with respect to their co-investment arrangements, internal partnerships and personal investments, and, on a selective basis, he advises potential investors in private investment funds. Mr. Spangler also has particular experience counseling clients on the ongoing compliance obligations of investment management firms.

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