Chapter 1

Fundamental Concepts

1.1 Introduction

Alternative investment funds come in many shapes and sizes. They invest in a diverse range of asset classes and pursue a myriad of different investment strategies. However, sufficient structural similarities exist between the different types of alternative investment funds (hedge funds, venture capital funds, buy-out funds, real estate funds and ever more esoteric vehicles) that a general description can be given of how they are established and operated. As a result of these similarities, regulatory responses to these vehicles tend to be similar in certain fundamental respects as well.

In an ideal world, each investor who desired the services of a particular investment adviser would have the minimum amount of money necessary to entice such an adviser to enter into an individually managed account with him. The investment objective and remuneration for such account would be determined based on the needs of both parties. This, however, is not an ideal world.

A number of investors, both individuals and institutions, lack the necessary assets to meet typical account size minimums on their own. Funds are therefore created as a means to aggregate these individual allocations into a single portfolio which can be managed efficiently and effectively. Each investor in the fund would be entitled to a portion of the proceeds from the fund in proportion to the amount of assets initially contributed, net of fees provided to the fund manager.

Investment funds enable the collectivisation of investment management relationships. Through a fund, the professional services of an investment manager can more efficiently be

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provided to a large number of prospective clients pursuing similar investment objectives. In order to provide these services, an intermediate vehicle is placed between an investment manager and a group of potentially disparate participants which serves concurrently as: (i) a means of pooling the investors' monies; and (ii) a single client for whom a single investment objective can be pursued. The use of such vehicle provides access for investors with smaller sums to invest to managers who would not otherwise be commercially motivated to take them on as clients. Additionally, these vehicles can provide managers with administrative efficiencies where multiple clients wish to retain the firm to perform substantially similar services.

Alternative investment funds constitute private pools of capital, with investors meeting certain net worth or sophistication requirements. Unregulated by the Financial Conduct Authority (FCA), the Securities and Exchange Commission (SEC) or other relevant onshore regulators (as the case may be), alternative investment funds are not subject to the limitations and restrictions imposed on their public fund brethren, such as mutual funds or authorised unit trusts. However, the managers of these funds have come under increasing scrutiny in recent years. It is also common for alternative investment funds to charge a performance fee in addition to an asset-based fixed management fee. Finally, the capacity constraints imposed by certain investment strategies means a limit may exist on how much capital can be employed by a particular alternative investment fund without negatively impacting its returns and, thereby, the performance fee accruing to the fund manager.

Generalising about alternative investment funds can be difficult at times. They vary greatly in size and complexity from small entrepreneurial start-up funds to complex fund structures with billions of dollars in assets. Alternative investment funds also differ in terms of the assets in which they invest, the strategies that they pursue, the legal form in which they are structured and the types of investors from whom they seek contributions.

Alternative investment funds allow a select group of investors to provide much needed capital to address particular requirements of the financial markets. In the case of venture capital funds, the need is to provide financing to emerging growth companies. In the case of hedge funds, the needs include holding illiquid assets or removing pricing inefficiencies. In the case of private equity funds (PE funds), the need is to make available the capital necessary to restructure the balance sheets of mature companies and to foster consolidation and rationalisation in industry sectors.

Despite these differences, their similarities establish a meaningful common ground between them. The same fundamental issues are repeatedly addressed by structurers, promoters, managers and investors in hedge funds, PE funds and real estate funds (among others), although they may be resolved in vastly different ways.

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1.2 Regulatory concerns

One common characteristic that has historically been shared by all alternative investment funds is that they have been structured in such a manner as to minimise to the greatest extent practicable the amount of regulation with which they must comply. In both the initial aggregation of assets within the fund and the subsequent investment efforts, the primary goal has been to maximise flexibility and minimise constraints. In the modern financial regulatory environment, this entails identifying and perfecting a number of different exemptions and safe harbours while simultaneously maintaining an optimal tax treatment for investors.

Most developed countries, including the UK and the US, have detailed and prescriptive regulations imposed on funds marketed to the general public. These regimes result from concerns that retail investors would otherwise be subject to unacceptable risks for fraud and abuse. Such regulations typically preclude absolutely, or place significant limitations on:

(a) illiquid investments (e.g. real estate, minority interests in private company);
(b) short selling;
(c) leverage (e.g. buying securities on margin);
(d) highly concentrated positions; and
(e) derivative strategies.

When structuring an alternative investment fund it is essential to ensure that the fund avoids such substantive regulations, while simultaneously providing for investors to be in no worse tax position than if they had invested in the assets directly.

In parallel with a rapidly evolving regulatory environment is the continuing drive to identify and open new distributing channels for alternative investment funds. Each attempt to introduce these products to new customer segments brings with it new sets of investor requirements to be met.

1.3 Taxation concerns

It is essential that the fund vehicle, regardless of its legal form, should not itself pay taxes. Where income and gains will be taxed twice—first, with the fund and secondly, in the hands of the investors—then the proposed structure will no longer be acceptable to most investors. All such income and gains must pass through the vehicle in as tax efficient a manner as possible. *See* Chapter 12: "Taxation principles and concepts".

Double taxation at the entity level can be avoided in onshore jurisdictions by the use of fiscally transparent vehicles such as limited partnerships and in offshore jurisdictions by the use of "nil tax" companies that are exempt from taxes on income and gains in that jurisdiction.

Too much transparency however, can lead to other difficulties. A parallel concern that arises from the collective nature of a fund is the need to limit the potential liability for investors to the amount that they have contributed to the fund. This situation may arise where a fund incurs borrowings from third

parties to supplement the assets provided by investors. Upon an insolvency, the creditors of the fund may attempt to call upon investors to provide further contributions to honour the fund's obligations. The tax transparency of the structure cannot be such that unlimited liability is assumed by an investor.

The Scylla and Charybdis of fund structuring is the need to provide investors concurrently with "pass through" taxation treatment and limited liability. As a result, the vehicles suitable for fund structures have always been limited. Each new type of vehicle created by legislators is therefore eagerly awaited.

1.4 Structures

An alternative investment fund will consist of one or more vehicles in which the investors have received interests or unit or shares in exchange for their capital contributions. *See* Chapter 4: "Structuring alternatives". The structure of a fund will require decisions to be made regarding:

(a) whether to establish the vehicle onshore or offshore (or both);
(b) how the interests in the fund will be marketed;
(c) what the on-going compliance requirements will entail; and
(d) how the proceeds of the fund may be distributed to investors and managers in as tax efficient a manner as possible.

A taxonomy of alternative investment funds could be compiled along a number of different parameters. Such distinguishing characteristics could include, for example:

(a) the types of investments that will be made;
(b) the types and domiciles of investors;
(c) the legal vehicle chosen for the fund;
(d) the domicile of the fund; and
(e) the domicile of the managers.

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In addition to preparing and agreeing the various constituent documents, related agreements with service providers (e.g. administrators, sub-advisers, prime brokers) and offering documentation, much thought will be given to structuring remuneration arrangements that optimise, to the greatest possible extent, how any performance-related compensation will be received by the manager and its principals. *See* Section 11.3: "Performance fees".

1.4.1 *Management vehicles*

One or more vehicles established and owned by the fund manager will also be participating in the structure in order to provide investment advice, execute resulting investment decisions and receive fees from the investors for such services. A fund manager may act as a general partner to a fund formed as a limited partnership or may simply enter into a bilateral agreement with the fund formed as a company to provide advice in return for fees. *See* Section 2.2: "Fund manager".

Multiple management entities may be required as a result of:

(a) particular tax concerns relating to the characteristics of the remuneration being received;
(b) the commercial relationships between the promoters of the fund and the ultimate portfolio managers; or
(c) the regulatory status (or lack thereof) of the management company.

A management entity established by the sponsors of the fund will advise the fund on which investments to make and will be compensated accordingly for such services. The fund manager will be legally separate from the fund itself, although the management entity may serve as the general partner for a fund organised as a limited partnership or as managing member for a fund organised as a limited liability company (LLC). Where offshore structures are involved, a variety of affiliates and third party service providers can become involved.

1.4.2 *Fund vehicles*

Most types of alternative funds, having originated and developed in common law jurisdictions such as the US and the UK, initially took the form of limited partnerships. This remains a common vehicle to this day. Under certain circumstances, however, other vehicles may be used, such as companies or trusts. Importantly, certain basic partnership concepts are frequently translated, however imperfectly, into these other structures.

Limited partnerships are treated as tax transparent in many, but not all, jurisdictions. As a result, partners are required to include in their taxable income their pro rata share of the partnership's net income. One of the primary virtues of this type of vehicle is that it allows more flexibility in establishing capital accounts for each participant to calculate and reallocate performance-based fees back to the fund manager. *See* Section 4.2.1: "Limited partnerships".

Companies, on the other hand, offer a simple and familiar structure that is easier to organise and run than a limited partnership. However, since companies are potentially subject to entity level taxation, "exempt companies" are typically established in familiar offshore jurisdictions. Company laws, even in such offshore jurisdictions, are generally more highly evolved and definitive answers to questions regarding the rights and obligations of parties are more easily obtained. *See* Section 4.2.3: "Offshore exempt companies".

Where an alternative investment fund fails to deliver the return expected, investors face either the opportunity cost of underperformance or the loss of some or all of their capital. Properly structured, an investor should not be required to contribute further on an insolvency, in addition to his original investment, regardless of the legal form selected.

Alternative investment funds may be either open-ended or closed-ended. Open-ended funds issue and redeem units or shares directly with investors based on the net asset value of

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the units or shares on a particular day. Notice requirements and limitations on dealing days may be applicable. *See* Section 10.1.2: "Open-ended funds". On the other hand, the units or shares of closed-ended funds are not eligible for interim liquidity and, as a result, must either be held until liquidation or may be traded from investor to investor in secondary transactions. Such transactions may be facilitated by a listing on a securities exchange, although such a listing in itself can be no guarantee that an active trading market will develop. *See* Section 10.1.1: "Closed-ended funds".

Practice point

The amount of assets in regulated funds, such as authorised unit trusts in the UK and mutual funds in the US, is significantly greater than in alternative investment funds. One issue, therefore, that is often addressed is whether a regulated fund is not a preferred option, based on the broader ability to market such fund to investors. Requirements for flexibility in investment strategy and confidentiality for investors, however, usually pushes towards unregulated funds.

All alternative investment funds seek to address similar issues regarding:

(a) choice of entity;
(b) choice of domicile;
(c) compensation of the fund manager; and
(d) the rights and obligations of investors.

The suite of legal documents prepared for a new fund (typically comprising an offering memorandum, constituent documentation, service provider documents and lengthy subscription packs) will attempt to address these issues thoroughly and without ambiguity.

A recurring feature of alternative investment funds is the interplay between onshore and offshore vehicles. Offshore vehicles are often used to remedy regulatory and taxation problems that impede purely domestic structures and to address the taxation needs of certain classes of domestic and

foreign investors. The methods by which onshore and offshore vehicles participate in the same fund vary greatly. *See* Section 4.3: "Onshore or offshore".

1.5 Legal and regulatory issues

Despite their reputation as being "unregulated", in point of fact, numerous legal and regulatory issues arise continuously in the structuring and operations of alternative investment funds, touching on a variety of substantive legal disciplines, in addition to a number of potential foreign jurisdictions.

As in many areas, the legal solutions posed follow the commercial propositions proposed. Alternative investment funds are no more and no less than a means to establish a long-term relationship, based upon trust and pre-agreed economic drivers, between a fund manager and a potentially disparate group of investors in a compliant and fiscally efficient manner.

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To understand the legal environment in which these funds operate, it is often necessary to identify and analyse the larger policy concerns that resulted in the particular exemptions of which they are attempting to avail themselves. The fundamental policy concerns of financial regulators in this area include both systemic risks to financial markets and investor protection. Regulatory responses to unforeseen developments tend to seek to correct perceived shortcomings in one of these areas.

Some commentators claim that alternative investment funds are particularly vulnerable to fraud. Each business cycle demonstrates, however, that the capability for criminal activity exists throughout the financial markets. A sufficient desire to defraud will circumvent regulatory prohibitions regardless of their breadth and detail.

Regulated funds and alternative funds have co-existed for decades. As the latter continue to grow in size and prominence, underlying questions of competitiveness are being

re-examined. Any efforts, however, to level the playing field between these types of funds (and the financial institutions that sponsor and market them) should not attempt to do so by regulating alternative funds out of existence. Rather, the necessity of prescriptive restrictions on regulated funds should be re-examined more frequently.

Regardless of their regulatory status, managers of alternative investment funds have fiduciary duties to the investors in their funds. These duties are taken seriously by courts. *See* Section 5.5: "Fiduciary duties and other obligations to funds".

Generally, sponsors of alternative investment funds attempt to minimise the extent of their regulation. In the UK, this means they will not seek authorisation for their funds, which would curtail their freedom of investment, and consequently, they will restrict their marketing efforts to certain permitted categories of institutions and individuals. *See* Chapter 7: "Marketing in the United Kingdom". In the US, exemptions will be secured under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 (the 1940 Act) and the Investment Advisers Act of 1940 (the Advisers Act). *See* Chapter 8: "Marketing in the United States". These exemptions are provided to address circumstances where regulation has been deemed unnecessary, either because of the sophistication of the individuals involved or because of the limited scope of activities conducted.

Listing an alternative investment fund on a stock exchange can be viewed by investors as a means to provide further regulatory oversight and transparency, both in terms of initial standards that must be met and on-going obligations that must be fulfilled. In addition, listing on a recognised exchange may enable certain investors to participate in the fund who would otherwise be precluded from doing so. *See* Section 6.5: "Listings".

Practice point

The differences between alternative and public funds have historically been substantial. Alternative funds are less regulated and their marketing is highly restricted. At a very fundamental level these two concepts are linked. As a result of this trade-off, alternative funds can be less transparent, charge substantial performance fees to their investors, provide less liquidity, engage in more leverage and maintain more concentrated holdings.

The primary goal on the regulatory side when structuring an alternative investment fund is therefore to avoid the regulations applicable to authorised or registered funds in the jurisdictions in which the vehicle will be marketed. Principally, this is accomplished by only permitting certain categories of investors to participate in the fund. As the price for forgoing the numerous constraints designed to ensure that investors are treated fairly, most onshore regulators require comfort that these funds will only be marketed to acceptable investors.

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1.6 UK regulatory landscape

1.6.1 Financial Services and Markets Act 2000

The FCA regulates financial services and markets in the UK. The Financial Services and Markets Act 2000 (FSMA), which is the cornerstone of the UK regulatory regime, sets out four objectives for the FCA:

(a) market confidence;
(b) public awareness;
(c) the protection of consumers; and
(d) the reduction of financial crime.

In pursuance of these objectives, the FCA is mandated to have regard to these principles of good regulation:

(a) efficient use of its resources;

(b) the responsibilities of those who manage authorised persons;
(c) proportionality;
(d) facilitating innovation;
(e) maintaining the competitive position of the UK in international financial services;
(f) minimising adverse effects on competition; and
(g) facilitating competition.

1.6.2 *Regulated activities*

1.6.2.1 *General concepts*

Section 19 of the FSMA contains what is known as the "general prohibition", stating that "no person may carry on a regulated activity in the UK, or purport to do so, unless he is an authorised person or an exempt person". The consequences for breaching the general restriction include:

(a) the perpetration of a criminal offence;
(b) agreements being unenforceable unless a court orders otherwise; and
(c) injunctions.

Regulated activities constitute activities of a specified kind carried on by way of business and relating to investments of a specified kind. The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) as amended (the "Regulated Activities Order") includes within the specified activities the following types of investment activities:

(a) dealing in investments as principal or agent;
(b) arranging deals in investments;
(c) managing investments;
(d) safeguarding and administering investments;
(e) establishing, operating or winding-up collective investment schemes (CISs); and
(f) advising on investments.

Specified investments are contained in Pt III of the Regulated Activities Order and include both investments and rights to or interests in investments.

Excluded activities are precisely defined and include activities carried out:

(a) in the course of a profession or non-investment business;
(b) in connection with groups and joint enterprises;
(c) in connection with the sale of a body corporate; and
(d) by overseas persons.

In compliance with Directive 2000/31 on electronic commerce in the Internal Market [2000] OJ L178/1 (the Electronic Commerce Directive), which is designed to remove restrictions on on-line activities, there is an exemption from each regulated activity where the activity consists of the provision of certain information services from a state in the European Economic Area (EEA) other than the UK.

Whether or not the activities described above will constitute "by way of business" is ultimately a question of judgment and will be determined by reference to a number of factors including:

(a) degree of continuity;
(b) commercial element;
(c) scale of activity; and
(d) proportion to other unregulated activities.

Only a limited number of persons will qualify as exempted persons for purposes of s.19 of the FSMA, such as:

(a) appointed representatives;
(b) recognised investment exchanges and clearing houses; and
(c) members of professions.

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Derivatives or debt instruments are frequently used to overcome these impediments and provide the necessary exposure.

The exposure provided by the product can either be full participation in the gains or losses of the target fund or limited participation, where in exchange for downside limitations upside gains are restricted. Leverage may also be woven into the structure either on a static (fixed amount) or dynamic (adjusted) basis. A single structured product may also provide exposure to a portfolio of funds, providing for diversification. These structured products may also be listed on recognised stock exchanges, which in certain instances may facilitate broader distribution in particular countries.

4.8 Secondary funds

Many funds (such as PE funds and real estate funds) are structured based upon periodic drawdowns and harvesting of investments. *See* Section 10.3: "Drawdown and harvest". Unfortunately, they can suffer from the potential risk of holding investments at the end of their anticipated life-span that they are unable to realise profitability. This can create unwillingness on the part of the fund manager to wind up the fund.

Secondary funds now exist which offer exit possibilities to both investors and fund managers; the former by providing them with interim liquidity for their interest in the fund and the latter by means of taking over the running down of final investments.

The increase of secondary market players could lead to increased liquidity for such funds. Currently interim liquidity can demand a high price, due to lack of competition among secondary funds and high transaction costs.

Chapter 5

Management and Advisory Relationships

5.1 Introduction

Recent turmoil in the global financial markets has accelerated several concurrent trends unfolding around alternative investment funds:

(a) increasing demands from investors for further transparency and stronger governance provisions;
(b) an institutionalisation of the market, as managers become larger in scale and scope and as more categories of investors make allocation to these asset classes; and
(c) disparate regulatory responses to address the perceived consequences of the above.

Regardless of asset class, prospective fund managers face similar challenges:

(a) creating and managing an advisory business;
(b) structuring and organising a fund;
(c) developing and overseeing a successful investment process;
(d) raising capital from investors and maintaining effective investor relations throughout the life of the fund; and
(e) supervising the day-to-day administrative and operational needs of the fund.

A fund manager can be established as either a limited company or a partnership or a LLP. The tax and regulatory needs of the principals involved will be relevant to this decision. Based on where the fund will be domiciled and marketed, an offshore management company may be utilised, serving as the fund's

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investment manager and delegating sub-advisory responsibility to an onshore management company regulated by the FCA. *See* Section 12.6: "Fund manager".

Where offshore management companies are used, special consideration should be paid by onshore management companies located in the UK to the so-called "investment manager exemption". *See* Section 13.4: "Resident in the UK for tax purposes". Failure to comply with the exemption, through deferrals of performance fees, for example, could inadvertently subject an offshore fund to UK taxation. Transfer pricing of services between the offshore and the onshore management companies must be examined and monitored.

First and foremost, a fund manager must ensure that it complies with all the legal and regulatory requirements of the country where it operates, as well as the domiciles of the funds where it advises and operates. Closely related to this is the requirement that fund managers should comply with any agreements reached with investors in connection with their participating in the fund. These agreements may be found in the constituent documents of the fund (e.g. a limited partnership deed) or in bilateral contracts (e.g. side letters, subscription applications).

As an FCA authorised person, a UK-based fund manager will have to implement and oversee systems and structures sufficiently extensively and robustly to provide for on-going compliance with the rules contained in the *FCA Handbook*. Reporting structures should be implemented in order to facilitate the provision of adequate information up to a senior personnel and ultimately the board of the fund manager.

Every fund raises potential tensions between the fund manager and the investors in two areas:

(a) conflicts of interest; and
(b) informational asymmetries regarding the assets of the fund.

For funds that are authorised for retail distributions, rules are imposed to address, among other things, governance mechanism fees, the manner in which shares are issued and redeemed, self-dealing, periodic reporting and capital structure. The same concerns exist with regard to unauthorised funds. However, the decision is taken that due to the nature of the participants, prescribing these matters will not be necessary and that investors in such funds have the knowledge and ability to negotiate with the fund manager those aspects of investor protection that are appropriate in a given circumstance. *See* Chapter 9: "Investment process and fund governance".

Once a policy judgment is made by appropriate regulations that sophisticated investors should be allowed to invest in innovative investment products, impediments to this arrangement may, therefore, be removed and, where appropriate, exemptions available on the marketing and operation of such products by fund managers.

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5.2 FCA status

5.2.1 Introduction

When the decision is first reached to form an investment management firm, the two immediate questions that follow are:

(a) whether or not authorisation will be required; and
(b) how taxation on fees received by the manager can be minimised on both the corporate level and on the individual level.

Although in certain circumstances it may be possible to establish and operate the management company in an offshore financial centre, personal and professional requirements may prevent this in practice. Investors may also express a strong preference for onshore regulatory supervision.

Although the initial process of securing authorisation from the FCA can be time-consuming, where a management company limits itself to offshore clients and either "eligible counterparties" or "professional clients" in the UK, they may be subject to a relatively limited compliance burden.

The UK is not a high tax jurisdiction for most investment managers, when both corporate and personal taxes are considered. For resident, non-domiciled individuals in the UK, who make up a significant number of alternative investment fund managers, only UK sourced income and gains and foreign income and gains remitted into the UK are subject to UK taxation. Unlike Germany and France, the UK has well established rules to avoid an onshore investment manager from being deemed a branch or agent of an offshore fund, thereby subjecting the fund to UK taxation. *See* Chapter 13: "UK taxation issues".

5.2.2 *Application procedures*

Alternative investment funds and their managers face a bifurcated regime in the UK. Under FSMA, firms conducting "designated investment business" require authorisation from the FCA. As a result, fund managers are generally regulated since they manage investments and/or advise on the buying and selling of investments, while the funds themselves are typically unregulated CISs.

Because of their small scale of operations and lack of retail customers, managers of alternative investment funds can expect relatively low levels of oversight from the FCA, based on their risk based approach to regulation. Regardless, as authorised persons, fund managers are subject to detailed rules contained in the *FCA Handbook*, including the COB rules governing financial promotion, accepting and reporting to customers and client assets.

Practice point

Where initially only a handful of investors have been identified, it may be worthwhile postponing the establishment of the fund and managing the investors' money on a segregated account basis. Although the persuasiveness of track record accumulated during this initial period may be slightly less, the deferral of start-up costs may make the overall endeavour more viable.

Through the authorisation process, the FCA ensures that persons conducting regulated activities in the UK are "fit and proper" to do so. The application, although time-consuming to prepare, is the means by which a fund manager demonstrates that they have the necessary experience, internal procedures and controls, and regulatory capital. Typically, a fund manager will retain either a lawyer or a specialised consultant to prepare the application. The other costs include professional advisers' fees in relation to the authorisation process, structuring establishing the management company and any related tax advice.

Practice point

The ability of principals within the fund manager to receive a salary in the months following launch is impeded by the FCA's capital requirements for the fund manager, which is based on anticipated expenditure. As a result, to lower the amount of capital required, individual principals may need to consider forgoing salaries in this initial period.

The FCA is responsible for authorising all firms that are to carry on regulated activities within the UK. The authorisation process is time consuming, taking four months in many cases to prepare and file the application and receive the FCA's final approval. At least one month can be spent in identifying and collecting the relevant documentation. A business plan will need to be prepared and detailed biographical information obtained from each principal. In addition, lawyers and auditors will play discrete roles in connection with, for example, regulatory queries that arise and certification of financial resources.

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In the context of initial fund launches, where FCA authorisation is concurrently being pursued, the question of what marketing activities may be conducted pending authorisation frequently arises. Such persons must ensure that they do not inadvertently conduct regulated activities in contravention of either the general prohibition contained in s.19 of the FSMA or the applicable restrictions on financial promotion. *See* Chapter 7: "Marketing in the United Kingdom".

In particular fund managers should not extend their marketing activities beyond the issuance of financial promotions in compliance with the Financial Promotion Order (FPO). Activities such as arranging deals or advising on the merits of an investment would be potentially problematic. *See* Section 7.5: "Consequences of breaching the financial promotion restriction".

Practice point

Fund managers in the UK are generally required to obtain regulatory approval prior to the launch of their funds. This is not currently the case in the US where a significant number of managers of alternative investment funds qualify for exemptions from registration.

The final stage of the application process will include an onsite interview with the FCA. If acceptable, the application may then be approved, subject to regulatory capital requirements being fulfilled. Afterwards, regulated activities may then be performed by the fund manager.

5.2.3 *On-going compliance*

Authorisation is, of course, only the first step down a very long road of compliance with FCA rules and regulations. Fortunately, many independent managers of alternative investment funds must concern themselves with only a limited sub-set of provisions contained within the *FCA Handbook*. Fund managers typically have only a small number of fund and managed accounts clients, either "professional clients" or "eligible

counterparties". The lack of "retail customers" significantly limits their compliance burden, as does the practice of not holding client money. The lack of direct relations with fund investors generally exempts fund managers from money laundering requirements.

Fortunately, most of the other requirements imposed by the FCA are also subject to the principle that their implementation by a particular firm may take into account its size and complexity. Procedures adopted to address training and competence, senior management arrangements and controls and other applicable rules should therefore be developed in light of the actual activities of the firm. The monitoring that then follows will need to be equally appropriate to the firm's size and complexity.

5.2.4 *Operator of a CIS*

Establishing, operating or winding up a CIS is a regulated activity. As a result any person acting as an operator must be an authorised person. The operator of a CIS is the person responsible for the management of the scheme's property. Operators of unregulated CISs are subject to a lighter regime than operators of authorised CISs.

The requirement that an unauthorised CIS must have an authorised person serving as its operator is not the only reasonable approach that may have been taken. The US model has been based on exactly the opposite approach. *See* Section 8.3: "The Investment Advisers Act of 1940". The involvement of an authorised person, however, brings with it various tools of investor protection, including among other things access to the Financial Ombudsman Scheme, the Financial Services Compensation Scheme and the direct involvement of the FCA.

Unlike in the US, where a private investment company not distributed to the public is not an "investment company" for purposes of the 1940 Act, a CIS will still constitute a CIS for purposes of FCA oversight (e.g. the requirement to have an operator) regardless of whether it is regulated or not.

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A CIS operator in the UK must be authorised by the FCA, which will entail that he be determined fit and proper by the FCA and be adequately capitalised rules on fair dealing and safe custody of assets will apply. Where the fund is located offshore, the focus of the FCA will be primarily on the activities of the fund manager occurring within the UK.

Where a limited partnership structure is used, typically the general partner is a vehicle of limited prior history or assets, so an authorised person will be appointed as the manager of the partnership. If the general partner is an authorised person, then it may serve as operator.

Where an unauthorised general partner is used, either such partnership must be resident and operated offshore or an authorised person in the UK must be appointed as operator to the CIS. The latter is accomplished by providing in the partnership agreement that the administration and the management of the partnership will be conducted by the authorised person, who would become the operator of the CIS. The general partner would be left with unlimited liability for the debts of the partnership.

Typically, the scheme is treated as the client of the operator, not the scheme's participant. Where an operator appoints a specialist adviser, such adviser will be acting as agent for the participants of the scheme. As a result, each participant could be deemed a customer of the specialist adviser because indirect customers are included under the FCA's definition of "customer". Fortunately, where the operator is authorised with respect to the services provided by the specialist adviser, such adviser is allowed to treat the operator as its customer.

Practice point

As a result, when seeking FCA authorisation, the scope of permission should include the provision of any advice for which the firm anticipates appointing specialist advisers. Furthermore, the language used in the appointment of the specialist adviser should clearly state that the operator is its customer, not the scheme's participants.

5.2.5 Onshore/offshore managers

A common structure in the UK which limits the need of an offshore entity to secure FCA authorisation is for a fund to be managed by an offshore manager who is in turn advised by an onshore investment adviser. In circumstances where the onshore adviser is an affiliate of the offshore manager, the adviser may benefit from the "group exemption" contained in the Regulated Activity Order.

For such structures to work in practice, it is essential that the onshore adviser remain within the boundaries of the group exemption. Further, the offshore manager must not simply rubber-stamp the advice of the onshore adviser and, as a result, must have the substance and personnel that independent decision making requires.

5.2.6 FCA Restructuring

On December 8, 2014, the FCA announced a major internal restructuring, which would affect not only its organisational structure but also the manner in which it would supervise authorised firms. Firms that benefited from a "light-touch" supervisory approach in the past would receive going forward a more thematic scrutiny from the FCA.

In 2012, the FCA committed to a three-pillar model of supervision. Shortly before its inception, every firm or group the FCA regulates was assigned to one of four categories of conduct supervision (C1, C2, C3 and C4). The vast majority of

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regulated firms—including most private equity and hedge fund managers—fall into the C3/C4 categories.

The three-pillar model is based on:

(a) Pillar 1—proactive firm supervision
(b) Pillar 2—event-driven, reactive supervision; and
(c) Pillar 3—issues and products supervision (Pillar 3).

The conduct categories are based on commercial size, retail customer numbers and wholesale presence with C1/C2 firms judged as having a more significant market presence than C3/C4 firms. Typical examples of C1/C2 firms include banks, insurance companies and larger investment firms. One of the consequences of these categories is that C1/C2 firms are supervised more intensively across all three pillars, while C3/C4 firms receive significantly less scrutiny.

For example, many C3 firms lost a dedicated contact at the regulator when the FCA took over for its predecessor, the Financial Services Authority. Now, FCA's Pillar 1 supervision based usually on annual returns and outliers identified in periodic peer group assessments. Meanwhile, C4 firms receive even less scrutiny with a telephone call or online assessment occurring only every four years. On the whole, this lighter touch approach to supervision of smaller firms has been reactive or based on certain thematic trends.

The FCA has eventually admitted that its lighter touch approach to supervising C3/C4 firms was coming under strain. As a result, it announced its intention to refocus its supervision of smaller firms by removing the distinction between C3 and C4 firms and ceasing most Pillar 1 activity with C3/C4 firms. This change in focus also will be accompanied by structural reforms at the FCA. These will include the integration of the FCA's risk and supervisory oversight functions into a dedicated Risk Division and the FCA's supervision and authorisation functions into a new Supervision Division.

This shift by the FCA should mean that many firms that benefited from a "lighter touch" strategy in the past could receive greater supervisory scrutiny in the future. This would typically depend on the activities they carry out and the key risks of the day. While not a entirely new for the FCA, this change in focus should see a shift away from supervisory interaction driven by quantitative factors (e.g. financial size and number of customers) to an emphasis on qualitative factors such as the activities carried on, the markets participated in and the types of customers and counterparties impacted. For many firms, this will mean that their supervisory interactions with the FCA will become more event-driven and based on thematic work.

To avoid being caught out and be able to judge where interactions with the FCA are likely to arise, it is more important than ever that firms stay on top of the messaging coming out of the FCA. This includes reviewing FCA press releases and the FCA's annual risk outlook and business plan.

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5.3 SEC status

5.3.1 Introduction

Any investment adviser who has, directly or indirectly, US clients, must consider whether or not they are required to register under the Advisers Act. Registration would be required, absent an exemption, for any person who advises others on the purchasing, selling or valuation of securities for compensation.

Registering as a US investment adviser would entail periodic inspections by the SEC as well as substantive restrictions on performance fees and advertising, together with detailed record keeping requirements.

Section 202(a)(11) defines an investment adviser to include any person who for compensation engages in the business of advising on the value of securities or the advisability of

investing in securities. Absent an exemption, registration of investment advisers under the Advisers Act is required pursuant to s.203(a).

Registration as an investment adviser brings with it fiduciary duties owed to clients, as well as substantive requirements that must be fulfilled. Whether or not registered with the SEC, all investment advisers will be subject to the anti-fraud provisions of s.206 of the Advisers Act.

Fortunately, the SEC provide an exemption from the registration requirements for investment advisers with less than US $150 million in assets under management. This exemption, however, applies only to investment advisers who act solely as advisers to private funds and have assets under management in the US of less than US $150 million. The SEC also exempts venture capital fund advisers from registration under the Advisers Act. To qualify for the exemption, an adviser must act as an investment adviser solely to one or more venture capital funds. Finally, the SEC exempts from registration any investment adviser that is a "foreign private adviser", which is defined as any investment adviser that:

(a) has no place of business in the US;
(b) has fewer than 15 clients and investors in the US in private funds advised by the investment adviser;
(c) has aggregate assets under management attributable to clients in the US and investors in the US in private funds advised by the investment adviser of less than US $25 million, or such higher amount as the SEC may set by rulemaking; and
(d) neither holds itself out generally to the public in the US as an investment adviser, nor acts as an investment adviser to any registered investment company.

5.3.2 Umbrella Registration

On January 18, 2012, the SEC's Division of Investment Management issued a no-action letter (the "Letter") in response to a letter submitted by the Subcommittee on Hedge

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Funds of the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association (the "Request Letter"). The Letter confirmed certain conditions under which a related investment adviser of a registered investment adviser (a "Filing Adviser") may rely on the Filing Adviser's registration under the Advisers Act rather than file its own separate Form ADV.

The Letter addresses the use of the umbrella theory of registration, subject to specified conditions, in two general situations:

(a) the use of certain special purpose vehicles (each, an "SPV") acting as a general partner or managing member of a private fund (i.e. a fund that relies on the exclusion from the definition of "investment company" provided by s.3(c)(1) or 3(c)(7) of the Investment Company Act); and
(b) groups of related advisers (other than SPVs) to private funds and certain separately managed accounts (SMAs), where the Filing Adviser and the related advisers are in a control relationship and conduct a single advisory business subject to a unified compliance program.

5.3.2.1 *Background*

Historically, certain related advisers of Filing Advisers have not filed their own separate Form ADV, relying instead on the Filing Adviser's registration based on an "umbrella theory". The Letter affirms and expands upon positions expressed by the SEC staff in a December 8, 2005 letter addressed to the American Bar Association's Subcommittee on Private Investment Entities (the "2005 Letter").

The 2005 Letter permitted a special purpose vehicle formed for the purpose of serving as the general partner or managing member of a private fund and that has a registration obligation under the Advisers Act to rely on the Filing Adviser's registration, subject to certain conditions. Certain Filing Advisers and their related entities also have relied on the umbrella theory in situations where the related entity was not a true SPV

(e.g. when the related entities are sister subsidiaries under common control but do not serve as general partners or managing members). The Request Letter was submitted in the wake of the repeal of the exemption from registration previously provided by s.203(b)(3) of the Advisers Act and new rules and amendments adopted pursuant to the Dodd-Frank.

The Letter affirms the guidance provided by the 2005 Letter in respect of SPVs, provides additional guidance in respect of SPVs; and expands the universe of affiliates of Filing Advisers who may rely on a Filing Adviser's registration (Relying Advisers) beyond SPVs. While the Letter confirms the SEC staff's prior position on SPVs stated in the 2005 Letter, it notes that reliance on the position is subject to the following conditions:

(a) all of the investment advisory activities of the SPV would be subject to the Advisers Act and the rules thereunder, and the SPV would be subject to examination by the SEC;
(b) the Filing Adviser would subject the SPV, its employees and persons acting on its behalf to the Filing Adviser's supervision and control (including the Filing Adviser's code of ethics as required by r.204A-1 under the Advisers Act and other written compliance policies and procedures (the "Compliance Manual") as required by r.206(4)-(7));
(c) the SPV is established by the relevant registered investment adviser to act as a private fund's general partner or managing member; and
(d) the formation documents of the SPV designate the registered investment adviser to manage the private fund's assets.

Further, the Letter confirms that a single registered adviser may have multiple SPVs, and that each may rely on a single Filing Adviser's registration. The Letter also addresses situations where SPVs have directors who are independent of the registered adviser or a related SPV. The Letter states that the fact that such independent directors would not be subject to the supervision or control of the Filing Adviser (as would be

required by the 2005 Letter), will not require an SPV to register separately, assuming the other conditions are met.

Of note, the Letter also states that the SPV is itself a registered investment adviser, despite the fact that it relies on the Filing Adviser's registration. Conversely, the Letter does not purport to affect the status of an SPV that has no registration obligation under the Advisers Act because it is not acting as an investment adviser.

The Letter also provides guidance on the ability of a related advisory entity other than an SPV to rely on a Filing Adviser's registration as a Relying Adviser. Such related entities may be formed in other jurisdictions to provide support for persons located in those jurisdictions or for tax reasons. Further, a Filing Adviser may form related entities to advise different private funds based on different investment objectives or strategies or for liability insulation or income sharing purposes.

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5.3.2.2 Conditions

The Letter states that Relying Advisers may rely on the Filing Adviser's registration and do not need to register separately provided that:

(a) the Relying Adviser is controlled by or under common control with the Filing Adviser; and
(b) the Relying Adviser, together with the Filing Adviser, "collectively conduct a single advisory business."

Relief is subject to the following conditions:

(a) the Filing Adviser and each Relying Adviser may advise only private funds and SMAs that pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds. Further, the clients for such SMAs must be: (i) qualified clients as defined in r.205-3 under the Advisers Act; and (ii)

otherwise eligible to invest in the private funds advised by the Filing Adviser or the Relying Adviser;

(b) each Relying Adviser, its employees and persons acting on its behalf "are persons associated with" the Filing Adviser and must be subject to the Filing Adviser's supervision and control;

(c) the Filing Adviser must have its principal office and place of business in the US. As a result, the Filing Adviser and each Relying Adviser will be subject to the full array of Advisers Act requirements, even in respect of non-US clients;

(d) the Filing Adviser and each Relying Adviser must be subject to a single code of ethics and a single Compliance Manual, in both cases administered by a single chief compliance officer; and

(e) the Filing Adviser must disclose in its Form ADV that it and any Relying Advisers are filing a single Form ADV and must identify each Relying Adviser by completing a separate s.1.B. Sch D for each Relying Adviser including the notation "(relying adviser)". Section 1.B. asks for names under which the Filing Adviser does business and requires the Filing Adviser to "[l]ist on Section 1.B. of Schedule D any additional names under which you conduct your advisory business."

The Letter does not provide explicit guidance on what other facts may suggest that a related entity may be conducting a different business than the Filing Adviser, but does indicate that a Filing Adviser and a related entity may be conducting a single advisory business if they:

(a) use the same or similar names; or

(b) hold themselves out to current and prospective private fund investors and advisory clients as conducting a single advisory business because, for example, they share personnel and resources.

It is unclear what additional facts may cause a related entity to be deemed to be conducting a different business than the Filing Adviser.

5.3.2.3 *Implications for Relying Advisers*

Relying Advisers are deemed to be registered investment advisers subject to all of the provisions of the Advisers Act and rules and regulations thereunder. Therefore, the single Form ADV must include information about both the Filing Adviser and each Relying Adviser (such as disciplinary information for the Relying Adviser's employees and ownership information for each Relying Adviser). Furthermore, the Letter confirms that Filing Advisers must include information related to each of their Relying Advisers when filing other mandated reports and filings (such as Form PF).

5.3.2.3.1 Independent Qualification for Registration

The Filing Adviser and each Relying Adviser must not be prohibited from registering with the SEC by s.203A of the Advisers Act. Each related entity must independently qualify for registration (for example, an adviser seeking to qualify based on the regulatory assets under management (RAUM) test must have RAUM of at least US $100 million). Alternatively, related entities may rely on an exemption from the prohibition on registration set forth in s.203A of the Advisers Act, such as Advisers Act r.203A-2(b) which permits a related entity in a control relationship with a Filing Adviser to register if it has the same principal office and place of business as the Filing Adviser.

5.3.2.3.2 Private Funds Required

The relief is available only to those advisers that manage private funds. The Filing Adviser and the Relying Adviser also may manage SMAs, but those accounts must pursue investment objectives and strategies that are substantially similar or otherwise related to private funds advised by the Filing Adviser or another Relying Adviser. Thus, advisers that manage any registered investment companies may not rely on the relief. Further, to the extent that SMAs are advised by a Filing Adviser or its Relying Adviser, the clients for such SMAs must be "qualified clients" as defined in Advisers Act r.205-3

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and may be required to meet other eligibility standards applicable to the private funds advised by the Filing Adviser and the Relying Adviser. For example, if a Relying Adviser manages a private fund that relies on s.3(c)(7) of the 1940 Act, any SMA clients in accounts related to that fund will be required to be "qualified purchasers" as defined in the Company Act.

5.3.2.3.3 US Principal Place of Business

The Filing Adviser must have its principal office and place of business in the US. Furthermore, by relying on the US-based Filing Adviser's registration, non-US Relying Advisers become subject to the full requirements of the Advisers Act (as if they were located in the US) including in respect of their activities relating to non-US clients. As a result, non-US Relying Advisers may not take advantage of "Adviser Lite" treatment that would limit the application of the Advisers Act in respect of their dealings with non-US clients. Adviser Lite treatment, however, would be applicable if the related non-US entity filed its own registration.

5.3.3 *Annual Reporting and Compliance*

Investment advisers registered with the SEC have certain annual requirements under the Advisers Act, some of which also either apply to ERAs or warrant consideration as best practices for ERAs.

5.3.3.1 Form ADV

Each registered adviser must file an annual updating amendment to its Form ADV. The annual amendment must be filed within 90 days of the adviser's fiscal year end. Accordingly, an adviser with a December 31 fiscal year end must file its annual amendment by March 31 of the following year. Part 1A and Part 2A (the adviser's "brochure") are filed electronically with the SEC via the Investment Adviser Registration Depository (IARD) and are publicly available. Part 2B, the brochure

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supplement, is not required to be filed with the SEC, but must be preserved by the adviser and made available, if requested, to the SEC for examination.

Within 120 days of its fiscal year end, a registered adviser must deliver to each client for which delivery is required either:

(a) its updated Pt 2A brochure and a summary of material changes to the brochure, if any; or
(b) a summary of material changes, if any, accompanied by an offer to provide the updated brochure (which, if requested, must be mailed within seven days or delivered electronically in accordance with SEC guidelines).

The brochure is required to be delivered to "clients," which the SEC staff has acknowledged does not include fund investors. However, many fund advisers voluntarily deliver the brochure to fund investors. Annual delivery of an updated brochure supplement to existing clients is not required. An updated supplement must be delivered only when there is new disclosure of a disciplinary event or a material change to disciplinary information already disclosed.

Inaccurate, misleading or omitted Form ADV disclosure is a frequently cited deficiency in SEC examinations. Moreover, Form ADV and Form PF are linked electronically, and disclosure in the two forms must be consistent.

Disclosure points of particular importance include, among others:

(a) an adviser must accurately calculate its RAUM. RAUM must be calculated on a gross basis, without deduction of any outstanding indebtedness or other accrued but unpaid liabilities;
(b) an adviser to private funds must provide specific information regarding those funds on Form ADV. Accurate identification of the fund type(s) advised, according to specific definitions provided in Instruction 6 of the Pt 1A

Chapter 9

Investment Process and Fund Governance

9.1 Introduction

The need for more elaborate and robust fund governance procedures is, in part, inversely proportional to the amount of liquidity provided by the fund. Where any investor is confident that, upon the arising of a potential disagreement with the fund manager, he will be able to realise in a reasonable period the fair valuation of his participation in the fund, such an investor may require only rudimentary mechanism for overseeing the activities of the fund manager. *See* Chapter 10: "Liquidity".

On the other hand, where due either to the structure of the fund or the assets held by the fund or a combination of both, an investor faces a prolonged reliance on the fund manager to oversee and ultimately harvest the investments before he will be able to get back some or all of his investment, great attention will be focused on how decisions are made, when investor approval will be required and how a fund manager may be replaced.

Of all the terms in the typical constituent documents of an alternative investment fund, the economic provisions have historically been the subject of most negotiations between fund managers and potential investors. *See* Chapter 11: "Fees". However, recent market developments—and a small but growing number of well informed investors—have focused increased attention on the remaining provisions, which can be described generally as "fund governance". By this we mean those provisions dealing with the operation of the fund vehicle—be it a limited company or a company or a unit

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trust—from launch to wind-up. The rights and obligations of all parties bear increased scrutiny.

Investors in alternative investment funds, however, are a higher dispersed group with diverse motivations. Coordinating action with regard to certain issues can be difficult. Trends in connection with issues of fund governance have been intermittent as a result.

9.2 Investment objectives and strategies

Each fund has an investment policy which determines the type of assets in which it may invest. An investment policy may be defined in terms of:

(a) asset classes;
(b) types of instruments;
(c) market sectors;
(d) geographic region; or
(e) valuation approach.

A fund's ability to pursue a particular investment policy may be limited by either its constituent documentation or applicable law and regulation. *See* Section 1.8.3: "Constituent documents".

In a blind pool fund, the investors will find their principal protection against style drift in the scope and detail of the investment restrictions. The investment objective of a fund may be included directly within the fund's constituent documentation or incorporated by reference from the fund's offering documentation. *See* Section 1.8.2: "Offering memorandum". Investment restrictions will need to provide investors with the comfort that they require prior to committing money, while simultaneously giving the fund manager the flexibility to pursue investment opportunity in a rapidly changing environment.

Such restrictions may include any or all of the following:

(a) the dates and frequency with which the fund will accept investors;
(b) the life of a fund, whether it is for a fixed term or has an indefinite life;
(c) the removal of the fund manager where the fund manager serves as the general partner in a partnership or holds a class of founders shares in a exempt company;
(d) any prohibitions on the raising by the fund manager of further funds;
(e) transfers and withdrawals by participants from the fund; or
(f) periodic reporting requirements to participants.

In periods where particular asset classes and/or investment strategies are in high demand, investors will benefit from fewer contractual constraints on the investment activities of highly sought-after fund managers. Conversely, when particular funds are out of fashion, investors may have the ability to negotiate more comprehensive and exacting investment restrictions. However, the link between elaborate concentration and diversification limits and higher funds return has yet to be clearly demonstrated.

9.3 Performance

9.3.1 General concepts

To measure the performance of a fund, information on the following are required:

(a) commitments made by investors;
(b) drawdown of committed capital (e.g. all at once or in stages) and how the cash was used (e.g. investment or management fees);
(c) distribution of cash and investment held; and
(d) valuation of each unrealised investment currently held.

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Valuation of unrealised investments can be the most problematic and leads to potential differences in practice. *See* Section 9.4: "Valuation".

9.3.2 *Internal rate of return*

The key concept in measuring performance in PE funds is the internal rate of return (IRR). The IRR is the net return earned by investors over a particular period, calculated on the basis of cash flows to and from investors, after the deduction of all fees (including carried interest). Practice is divided regarding the frequency of valuation. Currently it is generally quarterly in the US, while in Europe practice has moved from annual to semi-annual.

As IRR is a time based concept, as holding periods for investments lengthen, this performance measurement will fall significantly. It is therefore not sufficient to simply know the increase in value of an investment between acquisition and realisation (e.g. 2X). One must also know the length of that period (e.g. two years or five years). This fact goes some way towards explaining certain differences in the investment preferences and behaviour of financial buyers, such as PE funds, and trade buyers.

Practice point

Recent research has focused on an interesting trait of successful PE funds. Apparently, the most successful investments of a fund account for a significant amount of its ultimate IRR. As a result a small number of exceptional realisations can be more important to a fund's success than more consistent performance across the portfolio.

In the case of PE funds, a number of US investors have begun publishing the performance of their fund participation. A string of US legal cases may compel such disclosure in the future where the investors are US public entities, such as public employee pension funds. The accumulation of such piecemeal

disclosure may drive the overall shift towards increased consistency in reporting performance and ultimately benchmarking.

The fact that these changes emanate from the US will not diminish their impact on the European markets. A significant number of commitments to alternative investment funds managed in Europe originate from the US.

Practice point

The ability of PE funds to distribute shares to investors in specie can have certain potentially negative impacts on the IRR calculation. Upon an IPO, despite a lock-up period restricting the ability of holders of a security to sell in the market, the value of the security at the time of its distribution is the value used by fund managers in calculating IRR. Investors may receive significantly less than that amount at the end of the lock-up period when the shares are freely traceable.

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The distinction between gross IRR and net IRR is crucial for an investor. From gross IRR must be deducted the asset-based management fees, any expenses paid by the fund and, most importantly, the cost of "cash management" relating to the money not yet drawn down by the fund. *See* Chapter 11: "Fees". As the ultimate return to investors will be the net IRR, knowledgeable investors will attempt to focus fund compensation arrangement to the greatest extent possible on net, rather than gross, performance. Effective cash management, which is ultimately in the investors' control, is also crucial to achieving desired rates of return.

IRR is calculated in a similar manner as the yield-to-mature for a fixed income security. The IRR is the discount rate used to equate the initial cash outflow with respect to a particular investment with the cash inflows resulting from the investment. Only then when the investor's capital commitment is actually invested, is it covered by the IRR.

Little insight, therefore, is typically gained from comparing the funds at different points in their life cycle. As a result, funds are

frequently compared against other funds which launched in the same year, giving rise to the concept of "vintage year". Funds with the same vintage year are thought to have experienced similar economic environments, making comparisons amongst them more meaningful.

9.3.3 *Indices*

Indices of alternative investment funds are growing both in terms of their absolute number as well as the number of the funds that they include. In both hedge funds and PE funds, there exists a reluctance in some quarters to providing the transparency needed for such indices to be compiled. This leads to a "self-reporting bias". In other words, funds that do not wish to be included in an index (or indices generally) are not required to do so, thereby raising concerns about the utility of these indices.

There are also specific obstacles that may limit the use of any index in this area. In the case of hedge funds, survivorship biases would have to be eliminated. In the case of PE funds, approaches to valuation would need to be harmonised as would the idiosyncrasies of IRR calculations during a fund's life.

9.3.4 *Comparing performance*

Benchmarking can be useful to investors, both as a means of understanding what is happening to an asset class over time and as a tool to assist in the decision making process leading up to an investment decision.

The phrase "top quartile" is used frequently in the world of PE funds. Due to the nature of both alternative investment funds and the underlying investments themselves, there is a great opacity and arbitrariness with regard to performance measurements. Similar concerns exist across all alternative investment funds.

9.3.4.1 *Imported track records*

Where the principals within a fund manager have worked together at a prior firm, it is not uncommon to use the track record of their prior work together. Investors may express concern, however, where the individuals worked previously for different firms, yet a composite of their performance is constructed for the purpose of providing a "historical" view of the current team.

9.3.4.2 *Appropriate peer groups*

The question of whether a fund's performance is "top quartile" is always based on a comparison of the particular fund to a universe of other funds. Defining that universe is a task of great importance. Inappropriate comparisons are of little use to prospective investors. However, the precise boundaries of the universe to which a fund manager's performance is being compared should be clearly outlined.

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9.3.4.3 *Strategy changes*

Where a new fund is to be established that differs in its investment strategy from earlier funds, a fund manager may wish to present the prior performance of only those transactions that fall within the new strategy. Similarly, clear disclosure should be used to indicate how particular selections were made.

9.4 Valuation

Funds must be in place to effect procedures for valuing the investment that they hold. As a result of lack of appropriate knowledge or controls, errors in valuation can arise that materially affect a fund's net asset value. In extreme situations, these inconsistencies can lead to the collapse of a fund. In addition to being in accordance with market practice, valuation policies must be consistently and rigorously applied.

Where the underlying assets are illiquid (e.g. interests in private companies) the need for standardised valuation is crucial for building investor confidence in the alternative investment funds buying and selling such assets. In the absence of an agreed valuation approach, investors in the same asset can receive different values for their interests based on the method applied by their fund manager.

The goals of any valuation guidelines will include:

(a) transparency;
(b) comparability; and
(c) consistency.

However, the role of the fund manager's judgment will always play a key role in the valuation process. As a result, specially constituted valuation committees are increasingly established to adopt and monitor the valuation policy to be followed by the fund manager. *See* Section 9.6.1: "Advisory committees".

While prices for listed securities will be generally accessible, unlisted securities and derivatives can be more problematic. In certain situations, quotes from third parties may be required.

Unlike PE funds, hedge funds typically hold highly liquid, readily valued investments. However, at times they may instead hold thinly-traded illiquid investments. In such instances, these investments may be held in separate accounts known as "side pockets", which can impact the timing and amount of redemption proceeds returned to investors over the course of their investment.

Practice point

For any fund holding assets that are not freely transferable, whether that is illiquid, thinly traded securities held by a hedge fund or investments by PE funds in companies that have not yet been exited, this "unrealised portion" of the fund's portfolio is a crucial factor in ultimately determining both the past and the future performance of the fund.

Importantly, on April 16, 2014, the Judicial Committee of the Privy Council (the final court of appeals for British Overseas Territories, including the British Virgin Islands), issued an opinion in the liquidation proceedings for Fairfield Sentry Limited, which was a "feeder" fund for Bernard Madoff's fraudulent securities scheme that has wide application for funds that calculate a NAV. The Privy Council held that the NAVs calculated by the fund at the time of redemption were final and binding, and that investors who had received redemption payments based on such NAV determinations prior to the discovery of Madoff's fraud would not be required to pay back those amounts to the fund under the theory of restitution.

The fund, through its liquidators, argued that the fund was entitled to recover the redemption proceeds paid to investors because the NAVs were allegedly incorrect in light of Madoff's Ponzi scheme. The fund argued that the NAV determinations on which the redemption payments to investors were based were not final and binding on all parties. If the NAVs were final and binding, the investors would be deemed to have received the correct amount upon redemption and the restitution claims would fail. The fund also argued that the investors had not given consideration for the redemption proceeds when they surrendered their shares in the fund. Proper consideration would also defeat the fund's restitution claim. The intermediate appellate court held that the NAVs calculated at the time of the redemption were not final and binding on the fund and its investors, but ultimately upheld the trial court's dismissal of the restitution claim based on its determination that supplying the shares being redeemed was consideration for the redemption payment. On appeal, the Judicial Committee of the Privy Council affirmed, without discussion, the intermediate appellate court's opinion on the consideration issue, and further held that the appeal of the decision on the redemption finality issues should be allowed.

The Privy Council held that the case turned on the question of whether the fund was obligated to pay: (1) the "true" NAV "ascertained in the light of information which subsequently

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