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Due Diligence

Seward & Kissel Partner Steven Nadel Identifies 29 Top-of-Mind Issues for Investors Conducting Due Diligence on Hedge Fund Managers

By Jennifer Banzaca

On March 25 and 26, 2014 at the Princeton Club in New York, Financial Research Associates held the most recent edition of its annual Hedge Fund Due Diligence Master Class. During an opening "fireside chat," Seward & Kissel LLP partner Steven Nadel identified 29 areas of concern for investors engaged in due diligence of hedge fund managers. Many of these concerns overlap with concerns of regulators examining hedge fund managers. This article lists the issues identified by Nadel and relays his market color on each.

1. Backgrounds of manager principals. Nadel emphasized that due diligence with respect to backgrounds typically ranges widely, sometimes including items as seemingly far removed from the day-to-day business of hedge fund management as grades in school – or, more specifically, consistency of educational claims with actual educational track records. See "Six Critical Questions to Be Addressed by Hedge Fund Managers That Outsource Employee Background Checks (Part Three of Three)," The Hedge Fund Law Report, Vol. 6, No. 40 (Oct. 17, 2013).
2. Network of service providers. "We are seeing a lot of managers being asked who their service providers are, how long they've been with the manager and whether the allocators can speak with the service providers," Nadel said. In short, service providers play a role in the due diligence process, and more than average frequency of turnover in service providers creates a negative presumption. See "How Should Hedge Fund Managers Select Accountants, Prime Brokers, Independent Directors, Administrators, Legal Counsel, Compliance Consultants, Risk Consultants and Insurance Brokers for their Funds?," The Hedge Fund Law Report, Vol. 6, No. 24 (Jun. 13, 2013).
3. Registration requirement. As a broad rule of thumb, Nadel explained that if a hedge fund manager has more than $150 million in regulatory assets under management, the manager is required to register with the SEC. See "Impact of the Foreign Private Adviser Exemption and the Private Fund Adviser Exemption on the U.S. Activities of Non-U.S. Hedge Fund Managers," The Hedge Fund Law Report, Vol. 4, No. 16 (May 13, 2011).
4. Benefits of registration. However, Nadel clarified the registration is not all downside. The primary benefit of registration, he explained, relates to ERISA. "If you are registered with the SEC, it's easier for you to take on pension-type money because you can become a qualified plan asset manager. If you're not registered, you're limited to no more than 25 percent of any class in your fund being ERISA money." On how to become a qualified plan asset manager and consequences of the designation, see "How Can Hedge Fund Managers Managing Plan Asset Funds Comply with the QPAM and INHAM Exemption Requirements?," The Hedge Fund Law Report, Vol. 6, No. 38 (Oct. 3, 2013).
5. Broker-dealer registration and licensing. Nadel cautioned that hedge fund managers need to consider

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whether they, their marketing departments or any affiliates are required to register or become licensed as broker-dealers. See "How Can Hedge Fund Managers Structure Their In-House Marketing Activities to Avoid a Broker Registration Requirement? (Part Three of Three)," The Hedge Fund Law Report, Vol. 6, No. 37 (Sep. 26, 2013).

6. CPO or CTA registration. Similarly, Nadel mentioned that hedge fund managers with any nexus to the worlds of commodities or derivatives should determine whether they are required to register as commodity pool operators or commodity trading advisors. See "Do You Need to Be a Registered Commodity Pool Operator Now and What Does It Mean If You Do? (Part Two of Two)," The Hedge Fund Law Report, Vol. 5, No. 19 (May 10, 2012).
7. Disclosure of conflicts of interest in fund documents. Nadel indicated that the SEC is focused on disclosure in fund documents generally, and specifically attuned to disclosure of relevant conflicts of interest. See "Identifying and Addressing the Primary Conflicts of Interest in the Hedge Fund Management Business," The Hedge Fund Law Report, Vol. 6, No. 3 (Jan. 17, 2013). He also clarified that certain conflicts are generally impermissible even if disclosed, for example "usurping opportunities from the fund or taking fees for consulting-type services and having them paid to the manager instead of the fund." See "How Should Hedge Fund Managers Approach the Allocation of Expenses Among Their Firms and Their Funds? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 19 (May 9, 2013). Loans from the fund to a manager may be permissible in the presence of sufficient disclosure, but as a rule of thumb, there should be a presumption against such loans. See "Important Implications and Recommendations for Hedge Fund Managers in the Aftermath of the SEC's Settlement with Philip A. Falcone and Harbinger Entities," The Hedge Fund Law Report, Vol. 6, No. 33 (Aug. 22, 2013).
8. Consistency of representations. Nadel emphasized the importance of saying the same thing the same way across documents, including compliance policies and procedures, accounting procedures, NAV calculation procedures and various forms (ADV, PF, etc.). Investors during due diligence and regulators during examinations will identify discrepancies and ask questions about them – questions that typically will not have good answers.
9. Side letters. Nadel made four noteworthy points with respect to side letters. First, he noted that managers are increasingly setting up funds with multiple classes of interests rather than granting asymmetric rights to investors via side letters. Second, where side letters continued to be used, one of the most common rationales is to secure "most favored nation" rights for the investor that is the side letter beneficiary. See "Eight Recommendations for Hedge Fund Managers That Utilize Most Favored Nation Provisions in Side Letters," The Hedge Fund Law Report, Vol. 5, No. 22 (May 31, 2012). Third, another purpose for which side letters continued to be used is to effectuate state law-specific requirements such as equal opportunity guarantees, privacy rules and sunshine laws. See "Ten Strategies for Preventing Disclosure of Confidential Hedge Fund Data under State Sunshine Laws," The Hedge Fund Law Report, Vol. 5, No. 18 (May 3, 2012). Fourth, the SEC looks disfavorably upon side letters that grant an investor both privileged transparency rights and preferential liquidity. See "Mike Neus, Managing Partner and General Counsel of Perry Capital, Discusses Practical

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Solutions to Some of the Harder Fiduciary Duty and Other Legal Questions Raised by Side Letters," The Hedge Fund Law Report, Vol. 6, No. 8 (Feb. 21, 2013).

10. Performance advertising. Nadel reminded audience members that any communication that originates with the manager is subject to the antifraud provisions of the federal securities laws. Therefore, even a small or informal communication should be subject to analysis for accuracy and consistency with law, regulation and – per point 8 above – other manager documents. "Every piece of information the manager is sending out falls under the antifraud provisions," Nadel said, "whether it's a one-page letter, DDQ or a PowerPoint, they all must comply with the Advisers Act in terms of how you present performance information." See "How Can Hedge Fund Managers Market Their Funds Using Case Studies Without Violating the Cherry Picking Rule? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 47 (Dec. 12, 2013).
11. Clearly delineated investment policies. Regulators and investors want to see investment policies that strike the right balance between manager discretion and investor protection. An investment policy must be sufficiently detailed to enable investors to understand what they bargained for, and to enable investors and regulators to ascertain when a manager has drifted beyond its stated investment policy. See "Co-Investments Enable Hedge Fund Managers to Pursue Illiquid Opportunities While Avoiding Style Drift (Part One of Three)," The Hedge Fund Law Report, Vol. 7, No. 7 (Feb. 21, 2014).
12. Licensing of third-party marketers. Nadel mentioned that the SEC will look to hedge fund managers to confirm that any third-party marketers used by managers are appropriately licensed or registered. See "Third Party Marketers Association 2011 Annual Conference Focuses on Hedge Fund Capital Raising Strategies, Manager Due Diligence, Structuring Hedge Fund Marketer Compensation and Marketing," The Hedge Fund Law Report, Vol. 4, No. 43 (Dec. 1, 2011).
13. Manager "skin in the game." "I'm always nervous when I talk to a manager that is not putting much money in the fund," Nadel said. "To me, that's one of the biggest red flags. If a manager isn't putting a significant portion of his or her net worth in the fund, that is a problem. There needs to be good reasons for that." See "Investments by Hedge Fund Managers in Their Own Funds: Rationale, Amounts, Terms, Disclosure, Duty to Update and Verification," The Hedge Fund Law Report, Vol. 3, No. 21 (May 28, 2010).
14. Calculation of NAV. Nadel indicated that a manager's methodology for calculating NAV – and valuation more generally – are headline issues for regulators and investors. See "Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees," The Hedge Fund Law Report, Vol. 5, No. 32 (Aug. 16, 2012).
15. Minimizing staff turnover. "It is very important to have stability in the firm," Nadel said. "From an operational due diligence standpoint, you don't want the COO or the CFO turning over every couple of years. That is typically a signal that something is wrong with that enterprise."
16. Clarity of disclosure regarding liquidity. According to Nadel, "Language in fund documents has become much clearer as to when hedge fund managers can put up gates or suspend redemptions." On suspensions, see "How Can Investors in Cayman Hedge Funds Maximize Protection of Their Investments When the Fund Is Near or At the End of Its Life? (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 46 (Dec. 5, 2013).

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17. Leverage. Material leverage is permissible, Nadel said, so long as it is consistent with disclosure in fund documents regarding leverage. See "Rothstein Kass 2013 Hedge Fund Outlook Highlights Managers' Perspectives on Performance and Economic Trends, Leverage, Capital Raising Strategies, Due Diligence, Staffing, Operational Changes and Regulatory Concerns," The Hedge Fund Law Report, Vol. 6, No. 19 (May 9, 2013) (in particular under subheading, "Leverage").
18. Fund governance. Nadel related that we've seen "tremendous concern" in the area of fund governance over the last few years. As he explained on this topic: "In your typical hedge fund structure, if you have a U.S. and an offshore fund, you usually have a master-feeder structure with a U.S. fund for U.S. taxpayers and an offshore fund for foreign investors and tax-exempt investors. Oftentimes, both those funds are investing in a master fund. If the U.S. fund is structured as a limited partnership (LP), it has a general partner, which is affiliated with the manager, so there isn't really any independent governance on the U.S. side, at least at the feeder level. The offshore feeder is usually a corporation with an independent board. If it's a master-feeder and the portfolio is held at the master level, what sort of structure is the master fund? Accountants and administrators often prefer an LP at the master fund level because it is easier to deal with from a books and records standpoint. The problem with setting up an LP is that you can't have a board of directors in an LP. This means the general partner, who is affiliated with the investment manager, is running the show at the LP. So, it's very hard to create independent governance in an LP structure. We've created synthetic or contractual board equivalents to a corporate board, but they are not typical. I prefer a corporate master fund that is treated as a partnership because you can have an independent corporate board with that structure." On synthetic or contractual board equivalents, see "How Can Hedge Fund Managers Use Advisory Committees to Manage Conflicts of Interest and Mitigate Operational Risks? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 17 (Apr. 25, 2013).
19. Custody. The level of concern occasioned by custody issues is related to strategy, Nadel suggested. "If you're investing in a long/short equity fund or something with publicly-traded instruments, custody should not be too big a deal. Those assets are going to be held with the prime broker. When you get into less liquid assets like distressed debt or trade claims, where things are held becomes a big question – especially for managers who have subsidiary SPVs or other instruments that are held outside the main fund." See "Implications for Private Fund Managers of the SEC's Recent Custody Rule Guidance and Relief Relating to 'Privately-Offered Securities'," The Hedge Fund Law Report, Vol. 6, No. 32 (Aug 15, 2013).
20. Form ADV as a source of information for investors and regulators. According to Nadel, Form ADV "is like a Bible in terms of getting a lot of good information about managers." In particular, Nadel cited the following five parts of Form ADV as potentially revealing: (1) Form ADV, Part 1A, Item 6 requires disclosure of other business activities, including whether the manager is actively engaged in business as a broker dealer. (2) Form ADV, Part 1A, Item 7B asks if the manager serves as an adviser to any private fund. If the answer is yes, the form calls for significant additional disclosure on Schedule 7 (in Section 7.B.(1)). (3) Form ADV, Part 1A, Item 11 requires disclosure of disciplinary history.

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"Hopefully the answers are all 'no' in this section," Nadel cautioned. "If there is a 'yes,' that's a red flag." Cf. "How Can Hedge Fund Managers Rebut the Presumption of Materiality of Certain Disciplinary Events in Form ADV, Part 2?," The Hedge Fund Law Report, Vol. 5, No. 1 (Jan. 5, 2012). (4) Form ADV, Schedule A requires a listing of all direct owners and executive officers of the management company – information, Nadel said, "that is not necessarily disclosed in the offering memo." (5) Form ADV, Part 2A – the firm "brochure" – contains a free text description of the management company that, Nadel said, "is kind of like an offering memo," including information about "fees, types of clients, disciplinary information, conflicts of interest, codes of ethics, brokerage issues, client referral channels, investment strategy and more."

21. Form PF. In Nadel's experience, "when asked, many managers will either provide Form PF to potential investors or give a summary version of it." See "SEC's First Report on Initial Form PF Filings Offers Insight into How the Agency Is Using the Collected Data for Examinations, Enforcement and Systemic Risk Monitoring," The Hedge Fund Law Report, Vol. 6, No. 34 (Aug. 29, 2013).
22. Form 13F. Nadel highlighted other forms that are publicly available and that are therefore routinely scrutinized by regulators and investors. He cited Form 13F as an example of a type of public filing that is routinely made by private fund managers. See "Greenlight Capital Action against Seeking Alpha Illustrates the Benefits and Limitations of Obtaining Confidential Treatment of Quarterly Reports on Form 13F," The Hedge Fund Law Report, Vol. 7, No. 12 (Mar. 28, 2014).
23. Social media. "Most managers have some type of social media presence," Nadel said, "whether it's LinkedIn, Twitter or Facebook." He suggested that managers analyze these sites to understand their own online reputations, and he noted that investors and regulators are undertaking the same exercise. See "Understanding the Regulatory Regime Governing the Use of Social Media by Hedge Fund Managers and Broker-Dealers," The Hedge Fund Law Report, Vol. 5, No. 47 (Dec. 13, 2012).
24. DDQs. Managers should have a completed due diligence questionnaire at the ready to provide to investors. Nadel suggested that any such manager form should conform with the AIMA DDQ, "which is pretty comprehensive."
25. Collaboration among regulators. "The regulators now are very much working together, the FBI now has people sitting in the Division of Investment Management, and CIMA is working closely with the SEC, as is the FSA." This diminishes opportunities for so-called regulatory arbitrage – the perceived ability to act with less oversight in the ostensibly less regulated jurisdictions. See "Top SEC Officials Discuss Hedge Fund Compliance, Examination and Enforcement Priorities at 2014 Compliance Outreach Program National Seminar (Part Three of Three)," The Hedge Fund Law Report, Vol. 7, No. 9 (Mar. 7, 2014).
26. Investor letters. Nadel indicated that investors and regulators are also asking for investor letters, in addition to DDQs and other documents. See "Hedge Fund Manager Elliott Management Withdraws Petition Seeking Discovery from Absolute Return + Alpha Regarding Identity of Source of Leaked Investor Letter," The Hedge Fund Law Report, Vol. 3, No. 35 (Sep. 10, 2010).
27. Knowledgeable employees. Nadel alluded to the Division of Investment Management's February 6, 2014 no-action letter which, he said, generally broadened the scope of

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persons that may qualify as knowledgeable employees and who therefore may invest in funds managed by the manager for whom they work. See "SEC Clarifies Scope of the 'Knowledgeable Employee' Exception for Section 3(c)(1) and 3(c)(7) Funds," The Hedge Fund Law Report, Vol. 7, No. 8 (Feb. 28, 2014). In Nadel's view, this is a good development because, as indicated in point 13 above, investment by manager personnel in a manager's funds is typically perceived by investors as a vote of confidence by the manager in its own offering – as evidence of a bona fide alignment of interests.

28. Bad actor disqualification. Nadel referenced the "bad actor" rule which, he explained, can undermine a manager's ability to engage in a private placement in reliance on Rule 506. See "SEC Provides Guidance on When the Bad Actor Rule Disqualifies Hedge Fund Managers from Generally Soliciting or Advertising," The Hedge Fund Law Report, Vol. 7, No. 9 (Mar. 7, 2014). "The problem," he said "is that the bad actor rule really only applies to securities law violations." Other types of violations may bear on the character of the manager but would often fall outside of the scope of the rule. See, by analogy, "When Are the Personal Legal Disputes of a Hedge Fund Manager Principal 'Material' and Therefore Required to Be Disclosed in Fund Offering Documents?," The Hedge Fund Law Report, Vol. 6, No. 35 (Sep. 12, 2013).

29. Limited use of expanded advertising rights under the JOBS Act. Few managers are taking advantage of the JOBS Act, Nadel said. Rather than more aggressive explicit marketing, Nadel said he is more often seeing more information on public websites of hedge fund managers, more calls to potential investors to whom the manager has not yet been introduced and targeted sponsorships of events. See "How Can Hedge Fund Managers Identify and Navigate Pitfalls Associated with the JOBS Act's Rollback of the Ban on General Solicitation and Advertising?," The Hedge Fund Law Report, Vol. 6, No. 10 (Mar. 7, 2013).

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