Maitland

Fund Governance:

A look at today's risk and oversight ecosystem

July 2017

A meeting of the minds to capture the unique perspectives of industry experts in the alternative space.

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Editor's note

On behalf of the panelists from Convergence, DMS, Investcorp, KPMG, Sadis & Goldberg and TRS, welcome to the second edition of "Maitland Roundtable." This reporting series is designed to capture the unique perspectives of subject matter experts in the alternative space.

In this July 2017 issue, we examine the always topical, ever-evolving and increasingly thorny topic of fund governance. Why is it important? What are the trends, what should you know or be doing whether you an investor, manager or even a service provider?

Keeping up & doubling down

From **cottage to institutional industry,** alternatives are growing in numbers, along with diversifying in strategies and more pre-screening examinations by investors. With that, unsurprisingly, a need for stricter fund governance, reporting and regulatory support is taking center stage.

With the **overturning by the Cayman courts of the Weavering Case,** the need for more insights into how to mitigate a growing multi-dimension risk is on the rise. And as we examine the Convergence Annual ODD Survey, technology may be within our arsenal to manage risk in an industry that is growing by leaps and bounds.

It starts at the top

Even beyond the typical discussions of what are perceived key risks faced by managers and checklists of red flags – the collective conclusion is that successful oversight and due diligence is predefined based on the **"tone-from-the-top."** As with a parent laying out the rules to lend guidance to its children, we explored the responsibilities of a CFO or CIO in setting the stage for the myriad of activities to keep proper checks and balances in place.

Resoundingly, the panel agreed that if management doesn't set the right tone of taking governance seriously or encouraging its analysts to question the grey areas, then nothing else that has been put into place will matter – even if you have the most well-staffed team.

What's the cost?

Literally and figuratively, we're seeing a price tag placed on what funds are and are not doing to support governance efforts. While one would think that corporate governance at a large fund is very different than that of an emerging fund - mainly because of the dollars needed to maintain such operations – **the real cost is the mindset and how the importance of governance is viewed.**

These days, multi-hat wearing CFO/CIO/CCOs to run the oversight needs is not enough. Increasingly, we see the need of the fund to carve out a dedicated resource for its compliance function. As you will read, managing complex levels of governance requires a focus that **cannot be part of multi-tasking operation.**

There's not a problem until there's a problem

We agreed that the **biggest risk is the unknown.** As the power and authority of the board has eroded while the emphasis on governance has gone up, we had a wry chuckle over an analogy of how directorship is now akin to motorcycle insurance within a motorcycle repair shop. Before you can take a new motorcycle off the lot, you've got to have that insurance.

Similarly, it would be wise for managers to **not just tick all the governance boxes** in selecting the right vehicle, but also to invest in the insurance – the involvement of a directorship or the lawyer early in the process – instead of blindly chasing return while letting leverage slip away. Truth be told - it is easier to be fully covered in the event of a problem than try to cobble it together post-incident.

Kicking the tires

What was unique about our discussion was the spread of stakeholders, all offering different perspectives. What clearly emerged is that one size does not (yet) fit all and it is hard to know how to standardize governance when there are so many different alternative structures and strategies.

What does seem certain however is that two of the main risks - apart from the ever-present risk of cyber attacks - are liquidity mismatched to portfolio construction, and valuation. But through continual collaboration and discussions such as this, among industry partners and investors, there's no doubt that we will build a stronger blueprint towards best practice.

The following robust content was made possible by the energy and generous time of the following panelists:

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Our hope is that this second Maitland Roundtable series offers valuable insights that you can use in your planning*. Please feel free to contact me or any of the participants directly if you have any queries.

Sincerely,

Scott Price

Maitland | Head of Business Development & Client Relationship Management – North America

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*The following content in this Maitland Roundtable series does not constitute advice. The opinions expressed are perspectives to advance further conversations. Furthermore, these views and positions of the panelists are their own and do not necessarily represent their respective firm.

Panelist profiles

Gary Berger

KPMG | Partner

I am a senior audit partner and head up the Emerging Manager Platform nationally for KPMG LLP. Prior to KPMG, I helped start the hedge fund practice at Rothstein Kass. I have 25 years of experience serving domestic and offshore hedge funds, private equity funds and fund of funds, I have provided advice on fund start-up issues including organizational structure, economic and tax issues and general business consultation.

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John D'Agostino

DMS Fund Governance | Managing Director

I am the Managing Director in the US for DMS Governance. We are a fund governance, bank and third party AIFM/UCITS/MIFID firm currently sitting on thousands of fund boards. I am part of the firm's global governance and risk committees and I sit on a small portfolio of large and generally complex funds. In addition, I also manage the firm's institutional LP and regulatory relationships, working with large global pension funds and regulators to share information and determine industry best practices. My niche is high-frequency and quant trading strategies, as well as anything in the derivatives space.

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George Evans

Convergence | Co-President

I am one of the two founders of Convergence - a data analytics firm that is focused on the alternative industry. The mission that my co-founder John Phinney and I share is to provide a different level of transparency into the alternative markets. It's a culmination of my 60 years' worth of experience developing market leading, innovative and forward thinking solutions to assist traditional asset management, alternative, banking, and insurance firms to capitalize on short term opportunities while staying focused on long term success.

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Ron Geffner

Sadis & Goldberg LLP | Member

I oversee the Financial Services Group. Our firm organizes an average of 50 and 70 private funds each year. We represent in excess of 1,000 funds and our clients are located across the globe. Agnostic to strategy we cover opened-ended and closed-ended funds: private equity, real estate, venture capital, commodity pool and hedge. The firm represents about 250 broker-dealers, as well as accounting firms and administrators. We provide legal services in connection with tax, regulatory, corporate, financial services and litigation. We are proud to be routinely ranked in various hedge fund industry databases in the top five in the United States. My legal career began with the SEC, where I investigated and prosecuted violations of the Federal securities laws with an emphasis on enforcement in connection with violations of the Investment Advisers Act of 1940 and the Investment Company Act of 1940.

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Panelist profiles

Jonathan Joyce

Investcorp | Head of Operational Risk

I head up Operational Risk at Investcorp for the Alternative Investments business line. On the hedge fund side, we run about $4 billion in assets. Across the firm we have $23 billion in AUM across private equity, real estate, hedge funds and a recently purchased credit/CLO business. With OpRisk, I'm responsible for ODD of hedge funds and seeded managers, as well as various other internal operational focused functions. Prior to Investcorp, I was at Man FRM for about six years, also focusing on ODD on hedge fund managers of all strategies across the industry globally. I was also previously with Ernst and Young for four years as a Senior Associate serving hedge fund clients of all sizes.

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R. David Kelly

Chairman | Teacher Retirement System (TRS) of Texas | StraightLine Realty Partners | Founder & Managing Partner

StraightLine is actually a small, family office that has a series of holdings, one of which is an asset management platform that does cross-border Asian investment, specifically Asian capital into the U.S. We also offer consulting in private equity investing and venture capital. Prior to that, I was a real estate developer with a group that was focused in the Southwest, from Texas to New Orleans, and Arizona up to the Midwest. Previously, I was a director at Trammell Crow Company and an associate at Goldman Sachs. For the last ten years, I've been a trustee at the Teacher Retirement System (TRS) of Texas, the 17th largest pension plan sponsor in the world, with more than 1.4 million members/retirees and nearly $138 billion under management. And I've been chairman there for the last eight years.

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Scott Price

Maitland Group | Head of Business Development & Client Management, (NA)

I've been with Maitland just over two years running the North America business development and client management team here in New York. Maitland provides fund administration to a couple of hundred hedge funds and private equity funds across the country. We are starting to add to our portfolio hybrid funds, a clear rise of such offering in the changing alternative investment landscape. As one component of this entire ecosystem that supports managers and investors as the AI continues to evolve, I wanted to bring together the key subject matter experts in the field to discuss trends in supporting fund governance activities.

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Roundtable discussion

SP: The alternative asset industry has been in a great level of flux since Madoff, with rising fund governance pressure from investors to up the game. The first question I pose to the group is what are the key risks facing managers today from a governance perspective?

RG: The first thing to point out is that we went from a cottage industry, to an institutional industry. That is, we've seen incoming allocations from high net worth individuals and family offices change over to institutions. This started to occur in a meaningful way around 2007 to 2009 and it has only been increasing ever since. That's been the predominant driving force as to why we've seen corporate governance - the demand and expectations of it - materially change. When you look at the risks, there are really three key risks.

The first and most obvious one is performance - the portfolio construction. The second key risk is operational. The starting point is a structure that is driven by the lawyers with input from the manager. When you think about pre-2008, we had many illiquid strategies solely in hedge fund structures because there was a material mismatch between liquidity and valuation mechanisms and the portfolio construction. Investors at that time had a preference for hedge fund liquidity - either due to lack of proper diligence, lack of transparency or style drift. Operational risk also included engaging reputable and knowledgeable service providers to establish comprehensive internal controls and reduce turnover of key principals and employees.

The third key risk is around investor relations which relates to communications with prospective investors, as well as ongoing investor communications. In short, managers need to coordinate language in regulatory filings, offering documents, marketing materials and routine communications.

GE: To add to Ron's comments about the industry: despite all of the negative headlines, the industry's growing in leaps and bounds. There are more alternative advisors registered with the SEC than there have ever been. There are approximately 16,000 advisors registered with the SEC currently – which would equate to about 52,000 to 53,000 funds – and it's growing rapidly. The other major recent change is the ecosystem and how that has grown: 580 administrators, 400 plus audit firms, about 270 prime brokers and 1,200 custodians. There's almost 2,000 third-party marketers focused on capital raising. What that means is that there are roughly 5,000 or 6,000 service providers chasing 16,000 advisors – resulting in a fragmented ecosystem. And it hasn't consolidated the way industry experts had expected.

All of this ties into Ron's point about investor relations: the SEC has done a great job in the last few years of alerting advisors that they are being reviewed for filing behaviors, drilling into the consistency and completeness of filings, and demanding full disclosure of material changes. But it's the institutional investors who are now demanding that regulatory overlay and expect best practices – that is, stepping up and telling managers that they are not just reading the PPM – they are also diving into the ADV, examining the brochure and saying that they expect all those pieces of information to tie together. So, while we think that filing behavior right now is probably better than it's ever been, that's not enough for the investor. There's still a lot of work to do and that has set a very serious tone for governance and the entire risk management conversation in the market.

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>
> – George Evans

SP	Scott Price
RG	Ron Geffner
GE	George Evans

Roundtable discussion

SP: George, Convergence provides operational due diligence surveys to various stakeholders within the industry and your firm analyzes changes in ADVs and reports on that data set. Are you having more conversations with institutional investors about data points? Are they more interested now, more so than ever before?

GE: Absolutely. We're propelled in this direction for two reasons. First: everybody's doing some kind of investment due diligence, selection and all the work that comes with that. But there's such a great variation in ODD models - we've seen both excellent, best-in-class models and ones that would keep a CIO awake at night.

But over the last two years, there have been greater strides - all for the better - in terms of operational due diligence, process methodology, and capacity bandwidth. Essentially, we're starting to see a whole process get formalized with a focus on defining investment due diligence, operational due diligence, and assigning head-count to teams – responsibilities that may all roll up to the CIO.

Second: Investors are all looking for tools to stay on top of it all because the difficulty tends to be what happens after the initial selection - when things change. So the question is how do you stay abreast of material changes at these firms you're working with?

To the point about operational risk - what if it comes down to selecting one of two advisors? It's a horse race for alpha - a tie because both have great track records. If one advisor has a highly complex model to support the investment process whereas the other has built a less complex model, which one do you pick? There's a noticeable trend of investors putting more emphasis on the investment due diligence - more than ever.

RG: I want to highlight another variable that went into some of the changes - namely Dodd-Frank. Advisor registration was mentioned as the trigger for the regulatory requirement of certain-sized managers to register, which has changed the playing field for the marketplace. We're specifying to some degree hedge funds but it really calls into question all alternative funds. And the answer will be different whether we're talking about hedge funds versus private equity funds. Even looking just at hedge funds, there are variations. Boards of directors are common with offshore funds, but domestic funds which are structured as limited partnerships rarely, from a population count, have directors.

And it's also different whether the hedge funds and the private equity funds are targeting high net worth investors versus institutional investors. That changes expectations concerning corporate governance. With some of our family office clients who have allocated to closed-end funds, at times we see that the mechanics of the limited partnership agreements are lacking. When we negotiate certain aspects of the terms, we are surprised to learn that many - if not most - prior investors have not sought to negotiate non-commercial terms of the limited partnership agreement. Either they are not reading it or they don't feel empowered to address or negotiate through it. We're also seeing that same inertia with the portfolio companies. While it's better than it was, we still have a long way to go.

Almost every directorship firm acknowledges and recognizes that PE funds are the undiscovered territory for corporate governance in that regard.

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>
> **– Jonathan Joyce**

SP	Scott Price
GE	George Evans
RG	Ron Geffner

Roundtable discussion

GB: From an audit firm perspective, we look at risk through a different lens. In many ways our risk analysis is aligned with the fund investors. When we analyze the audit risks of a client or prospective client, we're generally going to focus on several factors including the experience of the manager, hard-to-value assets, the fund's internal control structure and the quality of the fund's other service providers. If the fund has a significant amount of hard-to-value assets we gain a thorough understanding of the valuation process and procedures. For example, we may inquire as to the level of valuation expertise, whether an outside valuation specialist will be utilized and whether a recognized administrator will be used to independently value the portfolio. We have to be comfortable with all the answers to these questions. If not, we may not accept the engagement.

SP: It's interesting because what we're saying is that the service providers around are being more cautious about who they do business with for multiple reasons. But I would like to get the view from the allocators' perspective.

JJ: One of the things that I would add to the industry conversation is that the overall cost to run a hedge fund business today has gone up exponentially. Let's assume that there are 50 operational or business related elements that must be in place before the manager can pass an institutional ODD process. If the manager follows through and implements all of the necessary elements or makes the appropriate changes, there's a cost associated with this. So, although I agree the number of funds and the assets in the industry are growing, the expectation of the level of infrastructure and controls that needs to be in place to make institutions happy is much higher than it has been in the past.

RG: Are there any drawbacks to that? Or is that universally a good thing?

GB	Gary Berger
SP	Scott Price
JJ	Jonathan Joyce

Roundtable discussion

JJ: In terms of service providers, you need a reputable administrator as well as a reputable auditor. And one could argue that there is a checklist of requirements that must be in place on the operational side, so ticking the boxes would be one easy way to account for that. But the problem is discerning what's going to be the next fraud and you must move away from a checklist approach in order to find it, determining whether you are doing enough work to find it or how comfortable are you that you're not missing anything. And that's the risk - that you're falling back on some of these things that are becoming standard and in doing so, you could potentially be missing a fraud.

SP: You're talking from an institutional, allocator perspective, and yes, you expect managers to whom you're allocating to only be engaged with reputable providers and have a high standard of governance in place. But, on the other side of the spectrum, if a manager has under $500 million AUM, it's a very different world. They're very cost sensitive and therefore, they can't institutionalize their business, in the same fashion.

JJ: True, but, I counter that you can have an absolute standard and a relative standard. If you're looking at an emerging manager, you can't compare an emerging manager to the largest hedge funds out there. They're two completely different businesses and you therefore have to look at them through a different lens. That said, in the case of an emerging manager, that's why a reputable auditor is so much more critical and not something a new launch hedge fund can avoid.

JDA: What are some of the red flags? And are they immediate killers of an opportunity, or rather something you monitor?

JJ: Yes, in some circumstances certain red flags would be an immediate killer of an opportunity. For instance, reputable service providers are a requirement for us to invest. That's not to say that we would never invest if a manager was using a small boutique administrator for example. What that means is we would employ a more detailed level of review on the service provider that we are less familiar with. As an example, if it's an administrator, we would meet the administrator onsite to understand them, learn how they do business and learn more and assess their controls in place. We would also assess their overall business stability. But to do that requires a serious amount of time and capital given the work involved of underwriting a new administrator.

Another example is the compliance environment and oversight at each manager. These days you need a real compliance function. It can't be a COO that's also the CFO, that's also the CCO, and running a $500 million business. It's important to have a dedicated resource to compliance that must be factored into the overall cost of running these businesses. And that compliance component drives up the cost.

SP: What about the emerging manager who can't quite afford that outlay?

JJ: On the fund administration side, the investors are paying this expense - it's not coming out of the manager's pocket, and the same applies for the auditor. As it relates to the compliance function, at $500 million of AUM, a compliance resource is very affordable given the management fees generated.

RG	Ron Geffner
JJ	Jonathan Joyce
SP	Scott Price
JDA	John D'Agostino

Roundtable discussion

GE: I'd like to expand on the point about red flags. We have a complexity service where Convergence actually scores and profiles every advisor's operating model in terms of complexity. Based on 40 factors, you are ranked as "high complexity", "medium complexity" or "low complexity." Those 40 factors were identified based on scenarios that John Phinney and I have encountered throughout our careers that we felt could be troublesome in a middle- or back-office. Among the critical factors we weigh that can be potential red flags are as follows:

First: decisions made around the infrastructure. For example, service provider best fit. Say that I'm a debt-diverse manager looking for a service provider. If I choose Maitland because 70% of Maitland's book is debt-diverse that's considered a good decision.

Second: self-administration, especially in the hedge fund world. And this is kind of moving its way down into the PE world, with real estate to follow.

Third: internal valuation – looking at how much of the securities the managers are valuing themselves. If you're a hedge fund and you're valuing 90% of your securities yourself, I might question that.

A few others: conflicts of interest reported to the SEC as well as criminal, civil, regulatory violations. Or the multi-hat C-suiter who holds the role of both CFO and CCO. Or qualified audits - believe it or not there are non-PCAOB auditors doing work out there. Or the control person turnover and staffing levels - how do they compare to the mean of the industry and peer groups?

When we back-tested our "high complexity" profiling, our findings concluded that 80% of the advisors that were "high complexity" had either a regulatory infraction or a qualified audit.

SP: These checklists and models are great validators to work off. Are there any intangible considerations that must be weighed against that?

GE	George Evans
SP	Scott Price

Roundtable discussion

JDA: Any reasonable investor who's going to establish a position and take on risk will want to make sure those things are there. But the qualitative element is also important. Hedge funds are types of entities where the power resides in a very limited number of people. Even a CCO is generally reporting to the primary equity owner who is usually the portfolio manager. So, you have a "top of triangle" type power model.

If that "top of the triangle" doesn't set the right tone, the culture becomes toxic. Nothing else that has been put into place will matter – even in a well-staffed organization. In my experience, it's pretty clear which organizations have strong tone-at-the-top versus ones that are either silent or skewed towards more risky behavior. One fund I know creates top-down culture very well. The all-powerful founder is so paranoid about losing his franchise over something like an SEC investigation that he creates a culture of fear around doing anything close to unethical, and forces his employees to discuss and ask questions when confused about ethical or regulatory issues. This is crucial. When I talk to funds, I always ask the CCO: "How many times in a given week does one of your analysts come into your office and say "I just got off the phone with a broker or I just got this note or email. This seems a little weird?" The right response is "constantly."

A CCO at a fund that creates the right tone is not going to hesitate in weighing the pros and cons of the potential revenue generating power of that piece of information. That CCO knows his career is over if he makes a call that puts the firm at unnecessary risk. Some might say this will skew him towards too conservative a view. However, virtually every other influence leans towards the riskier position – for example, the nature of the fund economic model, the credibility afforded traditional research sources, etc. So to have a strong counterbalance is essential. Everyone at the firm should be as paranoid as if they own the equity of the firm. Because the tone-at-the-top has made it very clear that squeezing an extra 1% or 2% percent in the portfolio doesn't matter if you've stepped anywhere near the line. The CCO's job is to help the team interpret the regulatory guidance and clarify where that line exists.

Otherwise, without that culture being created from the top down, you are simply creating the optics of compliance.

SP: This segues nicely into the next point regarding the Weavering case – the focus of which was the fallout from a very overbearing principal. Jonathan, could you talk to the group in terms of what we learned from that case and the potential ripple effect for the rest of the industry?

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– John D'Agostino

JDA	John D'Agostino
SP	Scott Price

Roundtable discussion

JJ: It's unfortunate that the Cayman courts overturned the ruling because in the end, the directors were not held liable at any measurable standard, and if they're not going to be held to any real standard, it's hard to place all that much reliance on a board, generally. From an investor's perspective, it's enough to cast doubt on relying on the board structure and it's raised questions about their role in the fund.

SP: John, looking at it from the directorship perspective, what's your view?

JDA: Ultimately, the fact the ruling was overturned doesn't matter.

Ask the people at Arthur Andersen if it matters that most of the Enron convictions were overturned? The Weavering case will always be a lesson in accountability.

With regard to governance, some of the problem is the commoditization of the product. I find myself competing against random individuals attempting to build their own portfolios of directorships for very small amounts of money. You get what you pay for.

Secondly, as Ron alluded to, some investors do not seem to care, at least in their preliminary investment negotiations, about governance. They focus their fight on fees and liquidity. And then, at the end, the manager generally selects the board. The documents and language surrounding governance are written by the manager's attorneys. By the time I get the call, the investor has generally signed off on the document without considering the implications of that language.

SP: So you are somewhat stuck between a proverbial rock and a hard place?

JDA: Director authority flows from the governance standards as outlined in the offering documents. I'll give you a very specific example. I have a situation where an investor invested in a fund 10 years ago. The fund became distressed, and the investor sought to redeem. After three years, the investor put pressure on the manager to fire the board because in their view the board wasn't doing enough. Lawsuits were threatened, etc. The investor reached out to me to replace a board member.

In reading the documents, it became clear that board's powers were strictly limited due to the structure of the fund complex. I had to be blunt in saying that while I can go on the master and the feeder, there's little structural control or leverage we can exert.

However, I can use moral suasion. We ultimately were able to improve communication between the LPs and manager and create a liquidity plan that made everyone comfortable. We're lucky that this manager was amenable. Keep in mind the manager was angry as well, and had his view of events. After years of fighting, everybody's angry and the facts and circumstances are in dispute. But ultimately people want to do the right thing, or at least choose a path that is the least painful. The bottom line: the authority and power comes from the articles, which comes from the manager's attorney and which can be negotiated by the investor.

I find it ironic that the power and authority of the board has been continually eroded over time while the emphasis on governance has gone up.

JJ	Jonathan Joyce
SP	Scott Price
JDA	John D'Agostino

Roundtable discussion

DK: You're motorcycle insurance that also happens to own a motorcycle repair shop. From the perspective of an institution producing capital, we're under tremendous pressure to actually produce returns in an underfunded environment. We're trying to get into the hottest fund. And we have the least amount of leverage to effect change. So instead, we're ticking boxes, figuring out which documents to review, wondering what else you need to check. But if John advises that the proper governance requires something else or something is missing from having it work in such a way – from the investor's viewpoint, we're being kept from getting capital allocated!

So it's like motorcycle insurance. Before they let you take it off the lot, you've got to have that insurance. If the thing crashes, it's really not worth much. You've got a twisted piece of metal and basically now you either have full coverage replacement that may or may not be valuable, or you've got nothing.

One of the conundrums when it comes to governance is this: there is not a problem until there's a problem. And then, once the problem has manifested itself, you gave away the right to try and resolve it in an earlier period to try to chase return. So, we've tried to solve it by using our most powerful asset, which quite frankly, is time. And so, we don't make direct investments into anybody. Everybody goes through a qualification process - an investment review, a strategy review. This operations and due diligence process is akin to what we colloquially call the Texas Way. This multi-sided, multi-tiered review is like waiting for a meal to cook – making sure that we follow the recipe, and then letting it sit and season. For someone like John, who's been sitting on the bench, he's just watching this cure.

We have something that we call a CUSUM approach, which looks at metrics in each of the areas to make sure they stay on pace. So, are you drifting from something? Have you changed administrators? Have you changed strategy? Have you changed geographies? Have you lost a key man? We're trying to do the work right through this process of discernment. But, more importantly, we're going to use time. And the hope is that our return parameters are low enough where you can get in before or after the original buy and you still have enough return left. It's about chasing return while making sure that you have the proper systems and security around it.

JDA: The two biggest myths in the industry are that only small investors have poor negotiating leverage and that the best managers don't market. They tell everyone they don't market, that they hate the press. Not true – the majority have PR people on speed dial. They market all the time. As for negotiating leverage, managers call me all the time complaining about investors "crushing them" with fee or other demands, and they are petrified they are outside of market on their counter demands. At the same time, investors express concern about pushing too far. It's like that couple that likes each other but they're each scared of overplaying their hand or showing neediness. The investor usually thinks the manager has more people waiting to get in than he actually does. And that manager usually thinks the investor has more options than they generally do.

GE: There's an interesting dynamic we've seen with some of the allocators. One is the number of alternative managers that they're selecting – the sheer number – making the ODD process a large undertaking. More and more, we're seeing Chief Investment Officers doing two things. One: they have both a head of IDD as well as ODD reporting into the CIO. And while we're all chasing alpha, what the CIO is worrying about every night is reputational risk. The CIO can explain somebody not delivering alpha and can decide to change managers. But, it's kind of hard to explain that the middle- and back-office blew up and as CIO, he didn't know anything about the early warning factors.

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DK	David Kelly
JDA	John D'Agostino
GE	George Evans

Roundtable discussion

DK: George, you're exactly right. To carry the insurance analogy further, this whole thing is malpractice insurance. The triggering event is that something happens. Poor return is actually not a triggering event – at least not in a pension fund. Style drift, fraud, malfeasance and mismanagement are triggering events.

Once an event is triggered, it almost doesn't matter what existed beforehand. All that matters is now you've risen to a level of visibility that can't be contained. You know you're 50 basis points out of your benchmark consistently, and switching costs may keep you right where you are forever.

You actually have a back-office due diligence fraud or you have an integrity issue. And, once that occurs, that there's a governance question, there's a style drift concern to address. And part of that could be avoided by appropriate investor management – that is, staying where you were supposed to stay and staying below the radar, and reducing the number of managers. Referring back to George's statistics on the industry's tremendous growth, it begs the question of what is the C20 ratio? Because you're either small and specialized or you're large and optimized. And many of the larger guys are saying the best way to generate alpha is by reducing cost. And so, if I can get up market to somebody who's got better economies, then I'll stay there. And that's pure alpha.

SP: That's operational alpha, right?

DK: Correct - the only thing I can count on is, if I've got 50 basis point fee reduction, I can put that in my pocket. If a manager tells me that they can generate another 50 basis points, I don't know whether I believe that.

Yet when there is a problem surely someone like John will get the call and be asked why he didn't do you a better job of monitoring this?

DK	David Kelly
SP	Scott Price

Roundtable discussion

GB: This brings us back to John's earlier point about how "the tone-from-the-top" is so important. I attend many year-end board of director meetings and what's interesting to me is that the PM typically does not attend the meeting.

JDA: I have a unique book of business – comprised mostly from referrals from large investors. As a result, I usually serve on both domestic advisory boards or boards of managers, as well as the offshore board of directors because these investors generally have exposure to both. And that PM knows that this investor sees me as their advocate even though I represent all the investors. I try to be engaged. If managers or investors don't want that level of engagement from their board, I'm not the right person for the job.

Some PMs are reticent about participating in the governance process - or anything non-trading related. However, I would argue that taking an hour or an hour and a half once a quarter is critical because it's about having the key service providers (admin, auditor, legal) and the PM all together to hear each other speak.

This minimizes the probability of confusion down the road. Some participants find this process inefficient and redundant. But redundancy is, to a certain degree, necessary in the system. Where, if you make it incredibly efficient, we remove some of the checks and balances. Checks and balances are by their nature somewhat redundant. You've got to slow things down to catch mistakes.

SP: It certainly appears that it's no secret as to what it takes to minimize risk given the regulatory and governance frameworks, but to return to an earlier point David made – how do we pre-empt when we don't know the risk is until after it surfaces?

JDA: It's interesting that when we discuss risks in the alternative asset space, inevitably the conversation focuses on things like fraud. And that's actually rare in our industry. Risk is the probability of something occurring times the severity of it happening. And .001 percent chance of a shark attack is enough to keep people out of the water. This paralyzing fear of a very unlikely event causes investors to seek a "safer" hedge fund – which means bigger with more overhead.

As the cost structure for operating these businesses rises, and markets have become so efficient, the bigger becomes - in options terms - theta or decay. What happens if nothing happens? What happens if you barely underperform for a long time? We're reaching a point where the probability of that occurring is very high.

The VC model, on the other hand, seems to embrace risk. Managers expect that if they invest in ten startups, five are going to be big failures. They aren't embarrassed by it because they know they are either going to break even or make tons of money on the a few gems in the portfolio. But as a pension fund, you can't tolerate that in your hedge fund portfolio. I've seen examples of investors getting pilloried for just one fund that blew up even though they may have had a great month because their portfolio did fantastically otherwise.

Similarly, how do you tell a CIO or head of ODD that you can pick 15 winners, but the one time there is a large failure (even if you sized it right) you can lose your job or get demoted? That's an impossible standard to set for investors and due diligence professionals.

GB	Gary Berger
JDA	John D'Agostino
SP	Scott Price

Roundtable discussion

DK: John's theta analysis is exactly right. Another way to look at it is "death by a thousand cuts." It's the casino trade that didn't play out well, but you made money in the fund. It's the large, public display of wealth that comes from you buying into something after it's happened.

There's a style-drift issue while the hedge fund manager actually tries to capture return when he realizes he's gotten too big. You can either underperform or there's strategic drift that doesn't make sense while you try and capture return that wasn't in your core strategy or your core presentation. And it all stacks up over time - no one usually gets hit for one bad investment. But it's sort of like the load of one public event followed by another public event, and then another. We now need to take action.

JJ: From an investor perspective, as we move further and further away from Madoff, given the pressure for returns, an allocator's willingness to absorb more operational risk has increased over time.

DK: The pendulum is swinging back?

JJ: Yes, it's swinging in the opposite direction. Immediately after the 2008 crises, somebody sitting in my chair had greater influence in the investment process. Whereas today we still do not want to take on added operational risk - and have not forgotten the lessons learned from the past - however people want to know less about it.

SP: When we look back, especially pre-Madoff, we see how the industry was structured – self-administrating or managers owning their own broker dealer. Are there any things now that are kind of quasi-unacceptable that you think in five or ten years we're going to look back and say, "How did we allow that?" Or do you think it's gotten pretty tight?

JJ: That's a good question – and a difficult one. To the earlier point about whether all of those major red flags are checked off, it's the ones that I don't know about, the "unknown-unknowns" that give me more concern. So, I don't even know exactly where that risk is today. I'm trying to find it. But I don't necessarily know where it is.

DK	David Kelly
JJ	Jonathan Joyce
SP	Scott Price

Roundtable discussion

RG: One of the biggest risks still is liquidity mismatched to portfolio construction and then valuation. I think those are the two biggest risks. We're still seeing so much internal valuation. And very little real, controlled valuation by a third party where their valuation carries weight. They're almost as stripped of power as some of the directors.

GB: If there is a mismatch between liquidity and portfolio construction, we will likely view that as a red flag and major audit risk. In those cases, we may discuss the matter with the client and/or the fund's service providers to gain a deeper understanding of the mismatch risk. Essentially, the fund needs to make sure it doesn't end up with an open-ended hedge fund structure when the underlying portfolio is better suited for a private equity closed-end structure.

RG: My point is not with the manager that starts that way. It's the manager that goes down the slippery slope and becomes that way.

As a lawyer meeting with the client to talk about portfolio construction, I ask what might it be a year from now or even three years from now. The question is often dismissed because the thought is: it is what it is today so there's every reason to believe this is what will it be three years from now and five years from now.

And when we talk about carrying costs and operational costs, many are not willing to spend the proper money, in particular with lawyers, to revisit the structure. This is not a function of what their AUM is. It's a function of their mindset – one of which is the cost component. They're also loathe to go back to their investors for consent. So, if they don't have to, even though it's in their best interest and everybody's best interest to revisit the slate and get it clean, they don't want to.

> **"We're talking about operational alpha…to some degree, the consumers of the product bear as much responsibility. For example, it's my responsibility when I ask a question of somebody that I know the answer is purple. And if the person answering my question tells me the answer is white, and I accept white as the answer, it's my fault just as much as theirs for giving me the wrong answer. So my point is that everybody has a hand in the responsibility."**
>
> – Ron Geffner

RG	Ron Geffner
GB	Gary Berger

Roundtable discussion

SP: What drives that mindset that you just described, Ron?

RG: Why is it a ten-year old doesn't worry about falling down the hill whereas a 50-year old does? It's because the ten-year old simply hasn't lived through the experience.

We're talking about operational alpha. So, to some degree, the consumers of the product bear as much responsibility. For example, it's my responsibility when I ask a question of somebody that I know the answer is purple. And if the person answering my question tells me the answer is white, and I accept white as the answer, it's my fault just as much as theirs for giving me the wrong answer. So my point is that everybody has a hand in the responsibility.

But it comes in ways even due diligence I don't think will uncover. As an example, Rothstein Kass merges into KPMG. The fund documents are now stale because the placement memo says Rothstein Kass. The manager doesn't tell the investor, not because they are hiding the information, but rather they just go into their own placement memorandum, change the name from Rothstein Kass to KPMG, put the current date on the place memo, and never go back to the law firm. And yet, all the information in their document that should be effective as of the date on the cover placement memo, doesn't match up to the tax and the ERISA section - their regulatory provisions, their subscription documents. We still uncover that so many times in the course of the year. It's like that seal on an electronic device - if broken, the warranty is not covered.

Another component that I question is why when there are director meetings, is it that the lawyer is not involved on the calls? By being a part of the call, we may listen to something that we know does not match up with the offering documents that everybody else has overlooked.

DK: I can't help but go back to the insurance analogy - in order to make sure the safety equipment works, you've got to wreck the car. And by wrecking the car, you've destroyed the utility of the vehicle. Now, driving it around you feel like you're safe. But you've got to wreck it to make sure it's going to work. And by wrecking it…

RG: You presume somebody else has tested it out.

DK: Here's the point about all this documentation. Part of it is to demonstrate that you use proper discernment in making the decision – that you are using a prudent man's. But when you look at the size and scale of loss, it's not like that of JP Morgan or Bank of America. It's usually a bad outcome rather than just a kind of consistent underperformance and if it's so bad, you're not recovering anything.

SP	Scott Price
RG	Ron Geffner
DK	David Kelly

Roundtable discussion

RG: We talked about reputational risks and how that could be more harmful than the economic damage. Let's look at some very large asset managers – for example, their C-suite with conflicts of interest, the CCO and the COO being the same person. Some have their internal lawyers ask only the asset manager, so their conversation comes solely from one source. The internal lawyers draft the documents, which forces their external counsel to rubber stamp the documents, almost putting them in the same position the directors are, so they can retain them as a client.

I was representing an investor and I was on the call with another law firm representing the manager. I needed to understand the document I'm reviewing because it was clearly deficient. It was poorly worded and certainly not matching what I would have thought the reputational value of that firm. So my questions were rather unorthodox: Did you draft this entire document? Did your client have a hand in drafting it? Do you know what other lawyers might have had a hand in it? It's important to drill down to that level because if that's who I think their outside counsel is, how real is their role? When you see and talk about service providers and how important they are, I would tell you that a portion of those service providers who have been listed in the book may not be the ones actually doing the work even though that's what you think you're buying.

DK: Do you think that's general sloppiness? Or lack of clarity and accuracy in stale documents that builds up into a material systematic risk?

RG: It's a component of it. It's also indicative of the mindset of who does your hiring.

GE: It also reinforces the point about the culture. One of the things we actually talk to advisors about is their ADV filing behavior. If they are filing once a year they are telling the SEC they had no material changes in their business for a year – that may or may not be true.

We start to look at completeness or consistency, and are disclosures best practice? There are clear differences in the advisor market around people who do that very well, that triangulate an ADV with a brochure, with a PPM, and others that don't.

I think that there'll be somewhat of a separation between the firms and the advisors that move to more of a best practice model, and institutional investors who are still figuring it out and will only over time begin to recognize the value of the model.

SP: Are there any other best practice models or room for improvement that we should discuss further?

JJ: One issue with the industry is related to how lawyers fit into the equation. They're hired by the manager. And yet it's the investors that are paying the lawyers via the fund. The lawyers are hired on behalf of the fund and in many cases the documents tend to be drafted all in favor of the managers, which is counter-intuitive.

GE: We have a product called "fund expense practices". And what we look at are the expense disclosures and compare that to industry practices. We've seen law firms changing in the last few years - from the old model of "throwing everything in there and the kitchen sink and you're covered", to expenses now starting to align with the real practices of the firm. Ron, do you find that to be the case?

RG	Ron Geffner
DK	David Kelly
GE	George Evans
SP	Scott Price
JJ	Jonathan Joyce

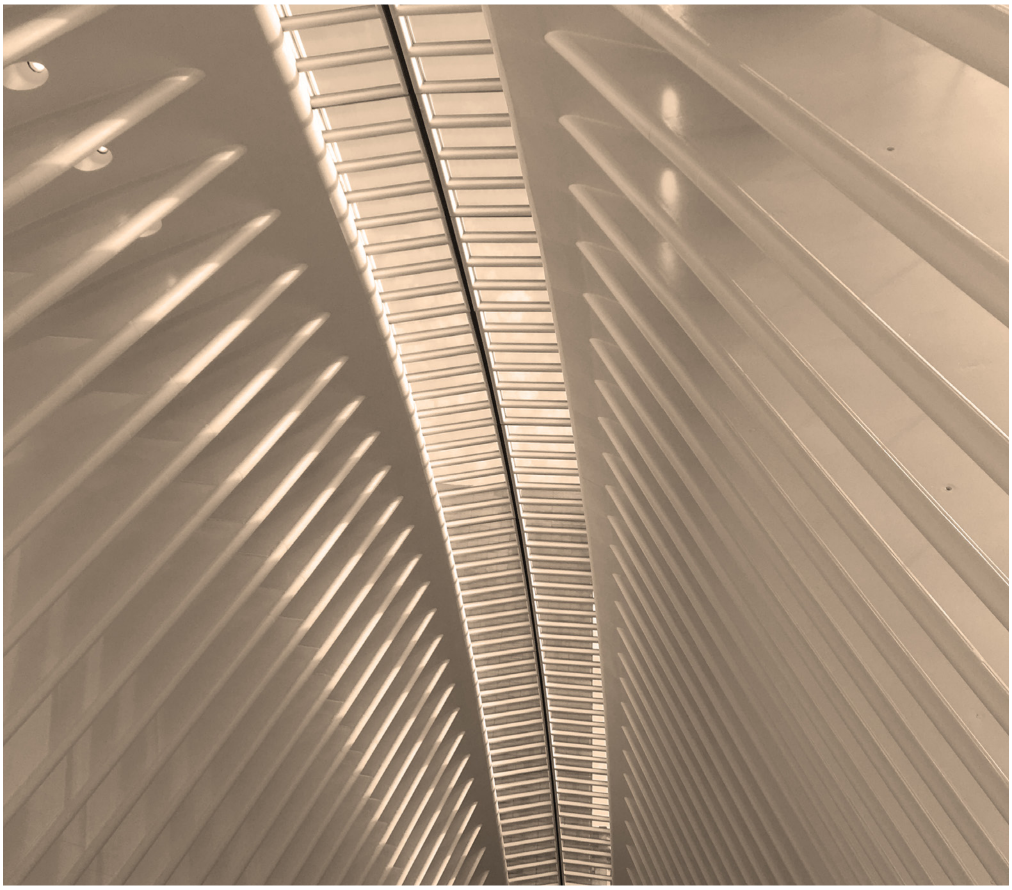
Roundtable discussion

RG: Keeping it broader means we have to revise it less, which reduces the legal expenses for the investor. We're trying to devise a document for a living, breathing, dynamic business. Today, we are seeing a reduction in fees – management, incentive, hurdles, and even expense caps. Looking back 20 years, it was common to see caps at maybe a 100 basis points to 200 basis points. As hedge funds became hotter, the cap went up until eventually they disappeared. Now we're starting to see it occasionally coming back in with regard to administrative expenses not related to trading and the true day-to-day practical expenses you would expect.

JJ: Yes, which I think is the right way to do it.

GB: Expense caps can create a liquidity issue for the management company. Some managers think they will raise capital faster than it actually occurs. So when you combine a lower capital base with the obligation to fund expenses above the cap, the management company will need to be subsidized by its owners. At the outset it may appear to be a good idea, but I've seen it backfire.

GE: We're seeing institutional investors paying more attention to the componentry of the fee more than ever right now. I'll hear: "Advisor ABC is charging me for Bloomberg terminals and printing expenses." And guess what, 10% of the industry does that and 90% doesn't.



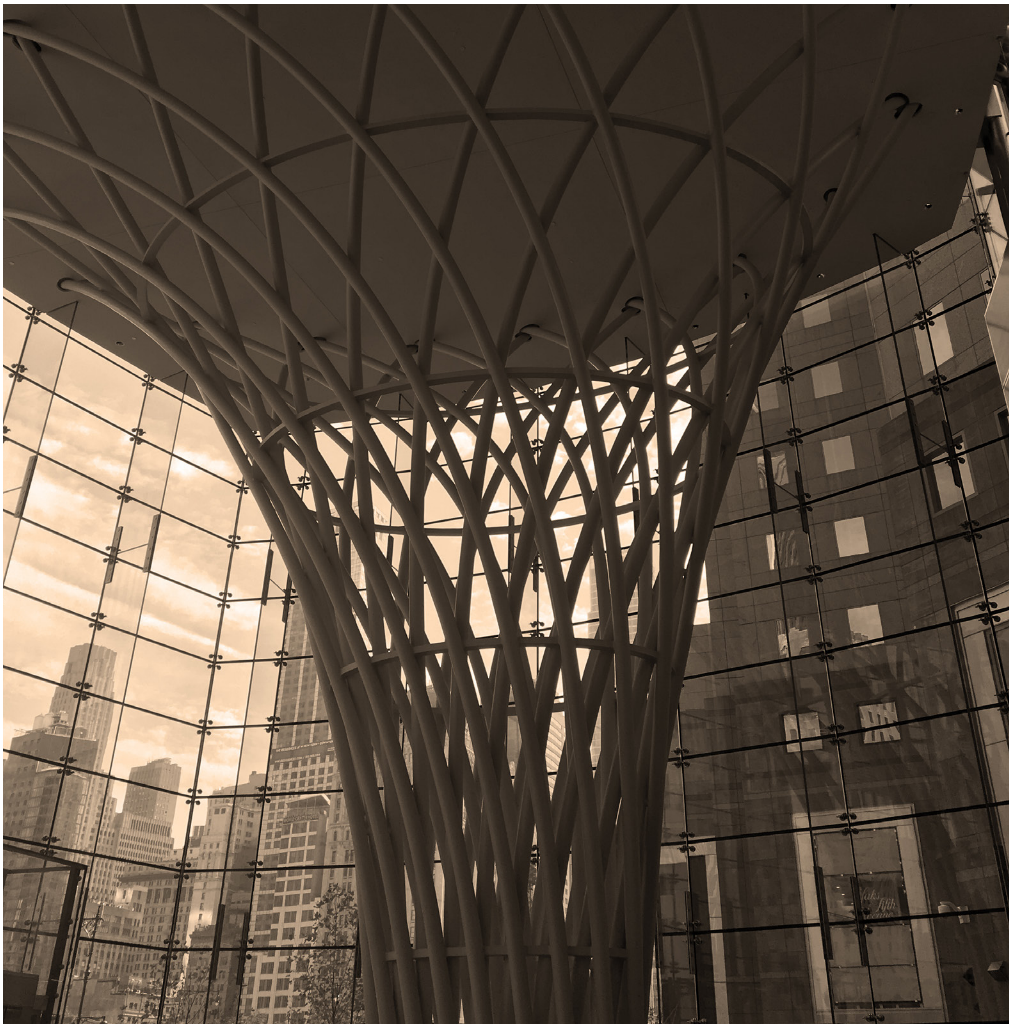
RG	Ron Geffner
JJ	Jonathan Joyce
GB	Gary Berger
GE	George Evans

Roundtable discussion

GB: The board of directors asks me this all the time: did you match up all the expenses in the audited financial statement to the offering documents? And the answer is: I'm not required to. We issue an opinion in accordance with professional standards indicating that the financial statements are fairly stated - not exactly stated. Many times the expenses fall below our materiality threshold.

DK: This comes to the question of transparency: how much can you accommodate and how much you want to afford. We're seeing some managers who are hyper-cautious or hyper-vigilant and it shows when we run audit on the portfolio. And it's a secular trend especially in private equity with how we examine their investment banking, monitoring, and director's fees, reviewing where those dollars were charged and how they're actually netted against fees. That's a perfect example of how transparency can lead to productive conversations which in turn leads to a change in behavior for them.

SP: John, I'm quite curious about your view regarding other jurisdictions. Many of your colleagues sit on boards, in Luxembourg and for Irish funds to name a few. It's a very different governance framework to a certain degree.



GB	Gary Berger
DK	David Kelly
SP	Scott Price

Roundtable discussion

JDA: In terms of the actual function, what we do all day and what we do on calls, is not that different. I would say there's more variability in individual directors than there is in thematic or geographic types. If you took a video of ten different directors, you would see such a huge range from, you know, tick the box to the hyper-aggressive attorney who challenges every word, to a guy like me that's going to dive way more into the portfolio than somebody else. Everybody brings their skillset.

Many directors are former administrator or auditors, and they're highly skilled at tearing through the financial statements, understanding every nuance. But ideally, an investor should demand a board that has a diversity of skillsets. You want a person with an audit or admin background. You want one with a portfolio background, perhaps legal. And between the three of them, they're going to have the ability to be a good canary in the coalmine.

SP: In this discussion, we have a great representation of industry experts – directorship, allocators, due diligence, technology and audit. We've touched earlier on fund administrators, but what about the role of the third-party valuation firm and how that fits into our ecosystem? Jonathan, starting from a due diligence standpoint, what do you do when a valuation conflict arises?

JJ: When looking at our external fund investments, my view is that outside of a CTA or a long/short equity strategy, if there is ever a valuation issue that for example requires an asset to be fair-valued or manager-marked, the board should get involved in order to understand why that's happening. The same is true for the audit firm when it makes sense from a timing perspective.

GB: On an interim basis clients usually get us involved if there are material valuation issues. Obviously, at year-end we will perform audit procedures as we deem appropriate to support our audit opinion. When dealing with the major outside valuation firms we look at them as an extension of management. The valuation firms basically take much of management's inputs and run them through an appropriate model.

KPMG has its own valuation specialists that support our audit engagement teams and we challenge the outside valuation firms analysis by running our own models.

JDA: You can have a scenario the valuation checks out mathematically but there is no market. Nobody wants it. The theoretical value is based on accepted methodologies, but the exit value at that time is radically different.

SP: So where do we go from here if all we have is either stale pricing information, or pricing information that doesn't reflect the market value?

JJ: We still have the illiquid positions from 2008 that aren't marked by third-party agents. And again, for our portfolios, we review the valuations on at least a quarterly basis as part of our internal valuation committee. Based on discussions with our auditors, in extenuating circumstances, we could potentially discount the valuation further if the appropriate support is available.

JDA: Does your auditor push back on you sometimes?

JJ: Yes. All of these positions are discussed with the auditor and appropriate support is provided.

> "There is no doubt that clients are focusing on valuation policies and procedures. Proper valuation affects so many things, such as allocation of income to investors' NAV calculation, management fees and incentive fees/allocations."
>
> – Gary Berger

JDA	John D'Agostino
SP	Scott Price
JJ	Jonathan Joyce
GB	Gary Berger

Roundtable discussion

JDA: I get frustrated calls from investors because we all know the security is worth less but the auditor is sticking with the NAV.

SP: Gary, have you seen the whole tone regarding valuation change, or at least over the last few years become more aware of the sensitive nature of this issue?

GB: There is no doubt that clients are focusing on valuation policies and procedures. Proper valuation affects so many things, such as allocation of income to investors' NAV calculation, management fees and incentive fees/allocation.

We have seen clients prepare detailed valuation policies and procedure memorandums that spell out the type of assets traded and the specific procedures used to value them. Many firms have established valuation committees to document the valuation process especially when the fund has hard-to-value assets, when a quoted price in an active market does not represent the fair value at the measurement date (after market activity) and the general partner overrides to the normal valuation policy. These procedures get more detailed and complex as you move away from level 1 securities.

JDA: For level 3 assets the valuation is as much art as science. And my concern is that investors may misread third-party valuations and believe it's the other way around.

That's unfair to the valuation agents, that's unfair to the managers, the investors, the auditors, everyone. All I want is for everyone to understand that, often, the valuation is a best guess, for that moment.

SP: Last question - and it relates to cyber-security given how topical it is at the moment. Warren Buffet actually calls cyber-attacks a greater weapon of mass destruction than say, a nuclear threat. I'm curious to find out either from a legal, directorship or due diligence perspective and whether allocators are also looking into cyber-security policies?

JDA	John D'Agostino
SP	Scott Price
GB	Gary Berger

Roundtable discussion

JDA: The fear over cyber-security is justified, mostly because the attacks are ubiquitous and will only increase. But the other thing that scares us is that we know our susceptibility to cyber-attacks is a function of our own flaws – namely, our tendency towards taking the easy road. It's like being fit. We all know that, in general, if everyone ate a boring diet of vegetables with a little lean protein in moderate amounts and avoided all bad foods and walked for an hour a day, most of us would be in decent shape. But who wants to do that? Rather, we have multi-billion dollar industry to address this effectively solved problem. We have Zumba; we have vitamin supplements, trendy workout equipment. Why? Because the solution is boring and nobody wants to do that.

It's similar to cyber-security, at least on a personal level. You can protect yourself by following basic best practices. But how many people use dual-factor authorization? How many use strong and different passwords? There's a list of things that we know we can all do but we don't because it makes our lives inconvenient.

It's a balance between convenience and security. The tools that people use to hack have been commoditized themselves. Today, someone with little technical skill can launch a sophisticated attack by simply buying these tools on the dark web.

If you want to really scare yourself, ask your IT chief to show you the log of how many attacks or probes have happened that day. I always ask managers if they have considered how much convenience they are willing to sacrifice for security. It goes back to tone-at-the-top. Those managers who don't care that their research analyst is annoyed because he has to VPN in to upload his notes versus using a cloud-based system are less likely to have problems.

SP: Jonathan, during your due diligence process, is that getting pushed to the top?

JJ: Yes. It's definitely a key topic with every meeting that we attend these days. Again, to borrow John's phrase, it's the tone-from-the-top. We know that a manager has to be doing something as it relates to cyber. And the range of what people are doing is going to vary. My expectations of what an emerging manager is doing are going to be very different from the larger managers of the world. There's no one size fits all for the entire industry, but the managers need to be thinking around this, and it needs to be at the top of their minds – and more importantly the tone needs to be that it's being taken seriously.

JDA	John D'Agostino
SP	Scott Price
JJ	Jonathan Joyce

About Maitland

Maitland is a global advisory, administration and family office firm providing seamless multi-jurisdictional legal, fiduciary, investment and fund administration services to private, corporate and institutional clients.

Founded in Luxembourg in 1976, the firm is privately owned and fully independent. It has 17 offices in 13 countries, over 1,400 employees and over $280 billion in assets under administration.

We leverage our strong values and a collaborative culture to develop and maintain trusted relationships with our clients. By combining our talent and one-firm approach, built on our best-of-breed multi-jurisdictional platforms, we provide tailored end-to-end solutions that embrace complexity and deliver simplicity.

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