Complexity Continues to Trigger Regulatory Violations
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Capital Dynamics, Inc. ("CDI") disclosed in its September ADV filing a $275 thousand fine levied by the Securities and Exchange Commission ("SEC") for "improper allocation of certain expenses to a private equity fund client." Improper, inappropriate and inconsistent fund expense practices have long been on the SEC's radar screen and Convergence has published several research papers on how "complexity" increases operating risk levels in Advisers. Current subscribers to Convergence's Complexity Profiling™ Service are aware of the high levels of operating risk in firms like "CDI" who carry a "HIGH-WATCH" Complexity Profile.

Convergence uses the terms "Complexity Profiles and Factors™" to describe business conditions within an Adviser's business model that create operating risk. We identify and actively monitor operating risk based on 40 business conditions gleaned from their responses to questions filed in the SEC Form ADV. These responses, coupled with Convergence's expertise managing operating risk, provide key insights into how operating risk are changing at the Adviser. Operating risks may be well-controlled by the Investment Adviser's staff and their group of third party service providers. However, investors should verify that appropriate controls have been implemented by the Adviser to reduce or eliminate financial and reputational ramifications.

We reviewed the changes in "CDI's" Complexity Profile™ for the last 3 years based on our careful review of their ADV filing history. Below is a sampling of "red flags" giving rise to CDI's "HIGH-WATCH" Complexity Profile™:

1. Related Party Ownership within CDI's funds increased from 1% to 34% while PFRAUM decreased from $3.8 billion to $2.4 billion. If redemptions created the shift in ownership percentages then the Adviser would receive lower management fees, placing pressure on the Adviser's PL. Furthermore, lower management fees could lead to reductions in staffing since the operations of the management company are paid out of the management fees.
2. "CDI" disclosed in their ADVs numerous changes to key control executives, referred to as "C-Suite". C-Suite roles changed 8 times over the last 3 years with 3 different individuals holding the CCO title during this timeframe. Changes were also observed in the CEO and CLO role. If these disclosures are evident of turnover, they can increase operating risk because of the loss of knowledge created by the departing leader leaving. It can also take time to fill open roles, thereby creating capacity issues as well as the time and cost to on-board the new C-Suite individual.
3. CDI disclosed moving twenty funds from an internal administration model to a 3rd-party provider, which is a positive move toward independence. However, its choice of Administrator created a "Business Concentration Risk) with this Administrator because CDI represents 100% of the Administrator's book of private fund business with SEC Registered Advisers. Conflicts of interest can arise when an Adviser represents greater than 10% of an Administrator's book of business. The use of 3rd party Administrators is typically positive because of the perceived independence they provide on processes including valuation, operation and accounting processes. The specter of undue influence by the Adviser over the Administrator arises in these circumstances and should be discussed and reviewed by the Advisers "Conflicts Committee" and possibly disclosed to investors.
4. Over the last 3 years, the number of Conflicts of Interest reported by CDI increased from 10 to 13, then decreased from 13 to 11 and is currently 10. This type of volatility can suggest a lack of clarity or

insufficient compliance procedures. Changes to the Conflicts of Interest disclosed by the Adviser can introduce additional and different compliance reporting, can increase investor due diligence, increase operational policies and procedures and increase investor disclosures.

5. In April 2017, CDI added a Broker-Dealer Affiliate, which requires greater disclosure, additional compliance procedures and enhanced Best Execution analysis.
6. Over the last 3 years, the number of office locations reported by "CDI" increased from 2 to 5, then decreased to 4. More office locations can introduce additional and different staff levels, compliance requirements and accounting requirements.

Convergence has back-tested its Complexity Profiles against Advisers that disclose regulatory violations and "Other than Unqualified Audits" within their funds. More than 75% of these Advisers have Medium-High Complexity Profiles™. We invite investors, service providers and Advisers to call us to learn more about the factors and conditions that can lead to operating risk. Working together, we can help you identify and monitor operating risk. For more information on the factors preceding a manager's decision to change Administrators, please contact George Evans at 215-704-7100.

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