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Industry and Regulatory Updates

Highlights

Industry Trends

Trends and Challenges in Hiring Middle and Back-Office Talent

John J. Lane, co-founder of Landing Point Search Group, analyzes trends and themes of human capital management in the hedge fund space

As we head into the second quarter, the job market within the back and middle office space remains strong, especially at the junior and mid-levels. The competition for talent has been fierce over the last year and shows no signs of slowing as the demand for accounting, operations, investor relations and administrative professionals continues to outweigh the supply of quality candidates.

There are four factors that have contributed to the imbalance of supply and demand in the talent market:

• Increasing investor demand for more robust reporting and transparency leading to increased hiring in both the Accounting and Investor Relations spaces,

• Proliferation of Separately Managed Accounts (SMAs) and fund-of-one structures increasing the work-load across the back-office world,

• Larger funds continue to grow in size and complexity and thereby continue to soak up talent to meet the challenges of that growth, and

• More firms of all sizes continue to diversify their strategies, i.e. hedge vehicles launching private equity vehicles and vice versa. These firms continue to "hire up" at the junior and mid-levels to handle the increased accounting, operations and investor reporting demands created by that diversification.

As the demand for talent continues to grow while the candidate supply continues to tighten, the hiring process has presented most firms with a series of challenges as they attempt to properly staff their middle and back offices.

At the start of the hiring process it is critical for a firm to understand three key pieces of information:

• Who is actually available: Firms need to understand the influence of timing – accountants are difficult to hire during audit and tax season – and be realistic about the candidate. Looking for a back-office individual with a CPA, CFA, an Ivy-league education and programming skills is most likely going to lead to a never-ending wild goose chase because the fact is that very few of those candidates exist.

• Understanding and adjusting hiring processes: The market for quality back and middle office talent moves quickly. The strongest candidates get multiple offers and get snapped up shortly after they begin interviewing. Firms with a 6-round interview process that need to meet 25 candidates before zeroing in on someone are going to be at a disadvantage and risk losing out on the strongest candidates.

• Balance the short term and the long term: Everyone wants to hire a candidate who is plug and play and will require very little coaching. On the flip-side, most also want to hire someone who's going to be a long-term player and won't be looking for their next move 1-2 years after joining. Unfortunately, those two goals don't tend to work well together. Hiring someone who has "been there, done that" in the role will only increase the likelihood that the person you're hiring will be looking to move up the food chain in a shorter period of time. Sometimes less experience means more runway and less turnover.

Once a firm has settled on the experience level and background they are searching for, there are several things to remember through the interview process as you try and win the war for talent:

• Manage your message: Make sure that everyone you have meeting candidates is on the same page in terms of the experience level you're looking for, understands the role and positions the company in the correct light. Don't send candidates out the door having received mixed messages about the day-to-day responsibilities, the long-term growth potential or the chain of command.

• Choose the right interviewers: All it takes is one disgruntled employee to scare off a potential superstar hire by letting their displeasure come through in their time with the candidate. A firm that prides itself on its culture won't seem as attractive as it should if the interviewers aren't properly representing that culture.

• Respect the interview process itself: Strong candidates are going to be in demand and will wind up with multiple offers. Don't lose the candidate you want because the interview process was sloppy and left a poor impression. Don't leave candidates in interview rooms for 20+ minutes waiting for interviewers, don't be on your phone during the interview and try not to cancel on short notice when the candidate has already arranged to be out of their office to meet your firm.

Once you've successfully identified the candidate you want to hire, make sure to manage the offer process correctly so you don't lose your target at the finish line. Top talent will most likely have several options and a firm's process during the offer stage can go a long way towards winning them over.

• Be mindful of the candidate's priorities and don't assume they only care about money. Title, benefits, culture and flexibility can all be integral to a candidate's final decision so make sure you have spoken to them about what's important to them in their decision-making process.

• Don't put too much stock into individual compensation surveys. Use the surveys as guideposts but be mindful that every situation is unique and understand what isn't factored into those numbers – work/life balance, actual job duties, potential for growth etc.

• Counter-offers are a very real risk. If you want to hire the candidate due to their abilities, it's a good bet that their current firm doesn't want to let them go. Make sure that you keep communication lines open and consider including the candidate in the firm's social outings during the transition period between the candidate's time at their old firm and their starting date with your firm.

One final point to discuss: compensation. While compensation at the senior levels has remained relatively flat in the middle and back office areas, that is not the case for junior and mid-level talent. The intense competition for top performers has seen initial offers rise and has forced firms to pay their junior talent up in order to keep them off the market. Identifying and hiring superstars is harder than ever – your best bet is to keep the ones you already have.

Potential Impact on the Asset Management Industry of Proposed Reforms in U.S. Retirement Accounts

The Business Consulting group speaks with Charles Millard, managing director at the Kiski Group, about his thoughts on trends in US retirement accounts and their impact on the asset management industry

Of the $27.1 trillion of U.S. retirement assets as of the end of 2017, roughly 60% were held in individual retirement accounts (IRAs), 401(k)s, and other defined contribution (DC) plans that aren't able to benefit from the effects of pooling that are achieved within defined benefit (DB) pension plans.[1] Furthermore, unlike DB plans, DC plans are limited in their investment choices, and therefore aren't able to invest in alternative asset classes.

As we explore in this article, if there were more pooling of individual retirement accounts, the broader asset management industry may benefit, while greater security for retirement savers may be achieved.

We interviewed Charles Millard, a managing director with Kiski Group Inc., a firm offering customized analytics and portfolio solutions, and formerly director of the U.S. Pension Benefit Guaranty Corp. under President George W. Bush, on his views of the potential benefits of collective DC plans and the implications for the asset management industry.

Before we get into the benefits of greater pooling in retirement plans, let's explore the lack of retirement savings for so many Americans. With the decline of company-offered DB pension plans, many Americans saving for retirement have had to rely upon employer-sponsored plans such as 401(k)s or IRAs. However, the retirement savings of many Americans is either underfunded or non-existent.

According to an AARP Public Policy Institute paper issued in 2014, roughly 55 million working Americans (which is nearly half the number of American private sector employees) have no workplace retirement plan, and many states are developing "Secure Choice" legislation, creating publicly run defined contribution systems to address this problem. Those who have no retirement savings at all usually lack access to a 401(k) at work and succumb to inertia when it comes to starting an IRA. Secure Choice legislation is a step in the right direction, but it is not as powerful as a collective system.

That's a good start, but it seems that these Secure Choice plans will have the same shortcomings as more traditional defined contribution plans. Tell us about the concept of collective defined contribution plans, and how they combine the features of DC and DB plans.

Like traditional defined contribution plans, Collective DC (CDC) systems are funded through contributions. Those contributions can be made by the employer or the employee, or both. The employer, as is the case in a DC plan, is no longer on the hook for any liabilities once the contribution is made. But, as is the case in a DB plan, assets and future payment obligations are pooled. CDCs pool assets and investments; they pool investment policy and gain scale in asset management; they pool longevity risk; they pool sequence of payments risk (the risk that the markets will be terrible when an individual retires); and they pool the benefits of a long-term investment policy even after the participant turns 65. These plans already exist in the Netherlands, to some extent Australia, and elsewhere — and they work.

So tell us more about the benefits of pooling. Let's start with longevity risk.

The power of pooling longevity risk is simple: Those who die early subsidize those who live long.

When a chief investment officer invests the assets of a DB plan, she is using actuarial formulas to target a final payout. She can confidently estimate, through actuarial large numbers analysis, how long individuals in her plan will live.

This allows her to plan properly what her needs will be for liquid assets when payments are due, and for less liquid riskier assets that can be used to meet liabilities that are further away.

On the other hand, when you are in a DC plan, you are on your own. You could take time to look up actuarial tables and see that the average age of death is 85, but what if you live to be 85 and are in good health? You took the time to plan actuarially but you weren't in an actuarial situation. You were in an individual situation. You need to plan to live to be 100! And if you do get to 100 you'll have to plan for 110!

What other risks are mitigated by the effects of pooling?

DC plan participants face another risk, the sequence of payments risk.

This is the risk that every individual in a DC system faces: What if the markets crash right before he retires? Many individuals faced this very question at the end of 2008 and the beginning of 2009. According to the Employee Benefit Research Institute, the average 401(k) account balance of those aged 55-64 with more than 20 years in their plan decreased by 25% in 2008. Someone who retired then would have 25% less to live on in retirement.

But in a CDC plan, a professional CIO and staff would have stayed focused on the long term, so they could pay benefits to the 2008 retiree and to the thousands of participants who were still decades away from retirement.

The plan would pay the 2008 retiree the pension he was due. Just as the "risk" of living too long can be pooled for everyone, the risk of retiring at the "wrong" time can be pooled and shared equally. The pooled plan is not going to pay more to the person who is lucky enough to retire when markets are up, nor will it pay less to the person who retires when markets are down.

Can you contrast the shortcomings of a traditional defined contribution plan (such as a 401(k) or an IRA) to the benefits of pooled investments.

Imagine an individual who just turned 65 and takes her $100,000 and buys an annuity. This gives her the benefits of actuarial pooling with others who have also bought annuities from that insurance company. It is surely safer than going it alone. But her funds will be invested in mostly bonds, and she will receive a payout of approximately $6,000 a year. She can receive it for life because she is pooled with others who did the same thing.

Now contrast that scenario with the benefits of a pooled long-term investment policy in a DB or collective DC plan. Instead of going to "all bonds" when this individual retires, the CIO is still investing for the long term. He is still investing on behalf of employees who are 30 years old and may have 40 years of accumulation ahead of them.

In contrast, the CIO of a DB or of a collective DC plan is a perpetual long-term investor. So when an individual retires, he keeps investing for the long term. If returns are weak when the retiree is in her 70s, the CIO has decades of market ups and downs still to go before the 30-year-olds retire. And when they retire, there will be more 30-year-olds behind them.

What are the implications in terms of the range of investment choices that are available to the CIO of either a DB or a collective DC plan?

In a 401(k), participants are on their own, deciding asset allocation and rebalancing time frames. Managers must be selected from the platform the employer has selected. And when participants reach a certain age, they must begin depleting the savings whether or not they need to do so.

Of the $5.3 trillion in 401(k) assets as of the end of 2017, $3.5 trillion of these were held in various mutual funds, with the balance spread out mostly across money market funds and company stock.[2] There is almost no exposure to hedge funds or other alternative assets.

In a DB plan, the CIO and investment team pool assets and investment policy. They invest with an outcome in mind: not a pot of money, but the ability to pay each retiree a pre-determined pension, usually something like 60% of average pay over a period of years.

To achieve this, the CIO of pooled retirement assets isn't limited to liquid investments such as mutual funds that comprise the majority of 401(k) plan investments. Rather, collective DC plans and traditional DB pension plans can allocate investment capital across the capital structure. These investments can include allocations to diverse asset classes such as private equity and credit, as well as alternative asset classes including infrastructure, real estate, and hedge funds.

What potential does this evolution of the nation's retirement program have on the broader asset management industry?

In the US as of the end of Q1 2017, there were $15.5 trillion in retirement assets controlled by individuals[1]. The vast majority of those assets are either not invested in alternative assets at all, or they have very limited exposure to that important asset class.

So, as we grapple with underfunded pensions, and begin to address those Americans who don't have access to a workplace retirement plan, what should our legislators keep in mind?

The most powerful characteristic of defined benefit pension plans is not the sponsor guaranty; it is the profound benefits of pooling.

There are three important areas of policymaking that can affect this situation.

First, many states and municipalities have begun to move away from DB plans, as they are concerned about long term liabilities. For public plans that are considering a move away from classic DB plans, CDC plans are a far better alternative than leaving public employees on their own, acting as CIOs and pension actuaries.

Second, as states and municipalities adopt Secure Choice legislation to fill the retirement savings gap for workers with no retirement savings, CDC plans should be adopted or at least offered as an alternative.

Third, there is legislation pending in Washington that would expand the availability of multiple employer plans (MEPs). MEPs allow a very significant degree of pooling of assets and risks. This legislation would enhance retirement security for many thousands of workers.

If any of these policies were to be adopted, there would be an important opportunity for alternative asset managers to offer diversification and important investment opportunities to these pools of capital that serve retirees.

[1] https://www.ici.org/policy/retirement/plan/401k/

IT 3.0: Public Cloud in the Hedge Fund Space

John Shen, President of Metro CSG discusses the evolution of IT capabilities in the hedge fund space.

As IT capabilities have evolved over the years, hedge funds have followed suit, evolving their technology infrastructure along the way. However, while new hedge fund launches can immediately take advantage of the latest advances in infrastructure, existing firms need to adopt a thoughtful approach to enhancing and upgrading their platform. The older the hedge fund, the more likely that it is hosting servers on-premises. As hardware becomes obsolete, hedge funds will sometimes migrate components of their infrastructure to a private cloud environment, or increasingly, to a public cloud environment. For those hedge funds that already are leveraging a private cloud environment, they may explore migrating a discrete function, such as email or disaster recovery, to a public cloud environment. John Shen, the President of Metro CSG, an IT Integration firm, discusses the evolution of technology infrastructure as it pertains to the hedge fund space.

Evolution of Technology Infrastructure

IT 1.0

During the early days of the industry, many hedge funds opted to host data completely on-site, in order to retain control. The main drawback of this set-up is that funds need to maintain the hardware, which can draw resources away from their core business. In addition, each fund is responsible for the security of its own infrastructure – and as there is no set standard, each firm must establish its own protocol. This is the traditional method of hosting, which we call IT 1.0.

IT 2.0

As private connections became more affordable and virtualization (or the ability to carve up a server into many machines) matured, many of the on-site burdens could be alleviated by transitioning to off-site hosts, also known as private cloud environments. In this setup, firms could host infrastructure behind an external firewall and outsource infrastructure management. This was a major step forward, which we can think of as IT 2.0, and which helped pave the way for new possibilities.

Current State of Technology Infrastructure: IT 3.0

In recent years, many have approached public hosting with skepticism due to concerns regarding security and compliance. Today, however, the public cloud has matured to a point where many of its capabilities are surpassing that of the private hosting model, offering funds an attractive alternative for hosting: IT 3.0.

Cost

One of the biggest draws of public cloud is its cost effectiveness. Operating under a utility model, costs are associated with usage, meaning if a cloud server were underused one month it would cost less in that pay cycle. This contrasts with 1.0 & 2.0, in which total costs consider many other factors (service fees, upgrades, electricity, etc.).

Disaster Recovery

The differences between active and inactive computing in 3.0 are one of the key reasons funds can cut costs so significantly when they adopt cloud-based disaster recovery. Where 2.0 maintains a server replica operating at capacity, 3.0 stores backups as virtual machine files. It is only when disruption occurs that a cloud backup will activate and consume resources at a similar rate as active computing. Assuming no major disruptions, in 3.0 a fund may see their monthly disaster recovery costs at around $1,200. In 1.0 and 2.0, disaster recover costs were closer to around $9,000.

Automation

The flexible nature of public cloud platforms leaves funds better equipped to adapt to the trends that influence their investment. As needs change, servers can dynamically adjust resources on a sliding scale, on demand. In a 3.0 environment, new servers can be provisioned within minutes from an online portal. Conversely, adding hardware capacity in 1.0 & 2.0 is still very much a manual process that can take days, if not weeks, to accomplish.

Security

As the cyber threat evolves, heavy spending in security has been necessary to harden defenses, and like any conflict, the battle has come down to resources and allocation. In this case, it's a matter of how much a provider devotes toward improving security. Looking at the numbers, public clouds such as Amazon's AWS, Google's Cloud Platform, and Microsoft's Azure are coming out ahead.

Starting in 2015, for example, Microsoft committed $1 billion per year towards research & development in cybersecurity. Much of this has gone towards improving its system's ability to recognize and block threats.

Due to their size, cloud providers alone have the capacity to extend resource-heavy AI processes to their products to create intelligent data protection. Such defenses include real-time behavior analysis and automated data labeling, on top of more common controls like anti-virus and device management. Overall, incorporating intelligence into security enables public clouds to provide far more proactive defenses than traditional hosting.

Such a level of insight into operations also informs a robust set of auditing capabilities, offering a holistic view of the full environment, including device inventories and comprehensive activity logs. Leveraging machine learning, audits can flag potential risks supported by actionable data.

Resilience

Business continuity is another area where the scale of the public cloud comes out as a major strength funds can leverage. Comprised of a worldwide network of datacenters, public clouds have a level of resilience that previous methods could not provide. Any given firm's email in Office 365, for example, is spread across six separate datacenters in the U.S., affording funds virtually guaranteed access (Microsoft's SLA lists this availability at 99.95%). Furthermore, a server in the Azure cloud is both local- and geo-redundant, offering a similar assurance on availability.

As a consequence of the evolution of technology platforms, IT 3.0 presents funds with an opportunity to host environments with more utility and security at a lower cost.

Regarding investment, consistent innovation goes hand-in-hand with success, and requires consideration for not just strategy, but technology as well. For those seeking to modernize operations, funds may look to the public cloud as the next logical step.

Fintech Part III: The Maturation of the Crypto-currency hedge fund segment

The Business Consulting group speaks with Chris Momsen, CEO and Founder at Summa Financial Technology, about crypto-currency focused hedge funds

The need to institutionalize the crypto-currency hedge fund space has grown along with the assets under management of this nascent segment. Maturity has yielded interest from institutional investors, who require an infrastructure typically associated with more-established hedge funds. However, the need for institutionalization is also related to regulation: U.S.-based funds managing outside capital in excess of $150 million are required to register with the SEC.[1] One of the provisions of registration is the need for a qualified custodian.

This has raised a basic question: what is a qualified custodian for a crypto-currency? To help us explore this topic, we've interviewed Chris Momsen, the founder of Summa Financial Technology, Inc., a digital platform provider to asset managers (including crypto funds), and an advisor to Digital Asset Custody, a new entrant in the crypto-currency qualified custodian space.

Chris, tell us how your past experience has informed your understanding of the need for institutional infrastructure in the crypto-currency space.

Having spent almost 20 years with Advent Software, where I ran global sales and product, I got to see the hedge fund industry mature in terms of its need for providing a proper infrastructure to meet the demands of their institutional investors. We're witnessing history repeating itself in the crypto-currency space; the growth of this asset class, and the growth in terms of number of funds and the assets that those funds are now managing has led to interest from institutional investors with the same demands.

Speaking of hedge funds, are you seeing 'traditional' hedge funds getting into this emerging asset class? Who else is expressing interest in this space?

Whereas the first wave of crypto-currency funds have been launched by technology experts with a deep understanding of all things blockchain, bitcoin, ethereum, and related ICOs (initial coin offerings,) I have seen increased interest from established hedge funds, who are looking to expand into crypto-currency strategies. Also, I'm seeing some venture capital firms looking into ICOs and other investments around this world. Meanwhile, banks are making investments into blockchain and related technologies, and institutional investors and their consultants are trying to determine how to gain exposure while mitigating the operational risks associated with crypto-currency investing.

These firms are looking for service providers that can adapt their model to address the unique properties of crypto currencies.

Exactly. We are beginning to see some of the larger crypto-currency hedge funds express interest in adopting tools internally to help them track and value their holdings so that they can better manage their positions, and also provide better exposure and risk reporting to their investors. Also, given the volatility of the markets, we are working with many funds to improve data capture and analysis so that they can continually upgrade their trading algorithms.

In terms of seeking out counterparties that can act as a qualified custodian, managers are looking to mitigate the risk of a crypto-currency exchange getting hacked, and their crypto-currency getting stolen. Potential investors including family offices, endowments and foundations, and consultants are also concerned with this risk, and want to understand what percentage of their crypto-assets are in hot, warm, or cold storage.

Teach us about hot and cold wallets, and how the ecosystem works between the exchange, the qualified custodian, and the fund.

The first thing to understand is that each wallet has its own encryption key. The hot wallet exists at the exchange, while a warm wallet can exist off the exchange at the fund itself. The qualified custodian has the cold wallet. This is air-gapped (off the internet), on segregated hardware. Biometric security is needed for access, after clearing other physical security measures that include armed guards. Also, the encryption keys get sharded, so that no single operator has the whole key. The custodian and the fund work together to establish appropriate procedures for approval when the cold wallet needs to be accessed. Other security protocols may be put in place.

It seems that if crypto-assets are in cold storage, it will be time-consuming to get access to – and to trade – those assets. How do crypto-currency funds deal with this?

For crypto-currency hedge fund firms with buy-and-hold strategies, they can leave the majority of their assets in a cold wallet at a qualified crypto-currency custodian, but use futures to manage their exposure on a day-to-day basis. Today, these futures are limited only to bitcoin, but it's an important step in the right direction from an institutionalization perspective.

Chris, you've been very helpful in helping us understand some of these emerging techniques to addressing the needs of institutional allocators and professional investors as they increase their interest in crypto-currency investing. Any closing thoughts on the topic?

A variety of sub-strategies have emerged as the sector has matured. There are funds that buy and hold bitcoin, but there are also funds that are more similar to VCs, choosing which of the many ICOs are the most promising. Then there are arbitrage-style funds that are trading crypto-currencies across multiple exchanges. Given the diversity of sub-strategies and the general growth of the segment, investors across the globe have taken interest. This is now driving more traditional asset managers and established hedge funds to take an interest in crypto-currency, as they realize that they may need to explore crypto-currency related products to meet the demands of their investors.

1 https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf

Legal & Regulatory Trends

MiFID II Post-Implementation Update: Focus on Futures

The Business Consulting Group explores implications of MiFID II implementation

MiFID II, the directive implemented this January by the European Commission in order to offer greater protection for investors, provides a variety of implications for investment managers depending upon their domicile, assets traded, and markets in which they transact. While there has been much discussion about the potential impact of unbundling research from execution costs, this has impacted European-based managers much more so than managers based in the U.S. who are transacting mostly equities with U.S counterparties. That said, one area in which some U.S. managers have been affected is the futures market.

If a U.S.-based manager trades futures only in U.S. markets, then there should be no impact. However, there have been implications for any clients who trade various contracts in European markets, including:

• Eurex: e.g. Bund/Bobl/Schatz/DAX

• ICE EU: e.g. Coffee, Cotton, Cocoa, Energy

• ICE LDN: e.g. Gilts, FTSE

Post the January 2018 implementation date, requirements that managers should have been aware of include[1]:

• Registering for a Legal Entity Identifier (LEI) and ensuring it is associated with their trading activity

• Updating trading and execution platforms to ensure this data can be passed along to the exchanges and other counterparties

• Updating their portfolio systems to also track the decision making process and accountable persons.

This resulted in a knock-on effect for brokers, who in response to these updates have witnessed an increased amount of work required in the following areas:

• Reconciliation of trade data on an increased number of data points (especially trade times)

• Significantly more detailed documentation around processes and procedures surrounding algorithmic trading development, testing, support and monitoring.

While MiFID II's scope is broad, it is important to deconstruct the implications of the directive across a variety of dimensions. The most direct impact that we have seen thus far is for U.S.-based managers transacting futures in European markets.

1 https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifi

Recent SEC Developments Provide Guidance for Crypto Asset Trading Platforms

Vivian Maese, Wenchi Hu, and John Sikora, partners, and Timothy Pisacreta, associate, at Latham & Watkins LLP, highlight recent developments in the SEC's regulation of the cryptocurrency market as it relates to trading platforms

The SEC continues to send messages to the nascent cryptocurrency market. In a recent development, the SEC brought an enforcement action[1] and issued a public statement[2] that provide insight into the agency's views on how the federal securities laws apply in the digital or crypto asset market, especially for those participants currently operating or seeking to operate a crypto asset trading platform or exchange that facilitates trading in crypto assets that are securities.

On February 21, 2018, the SEC filed an action against BitFunder, an online trading platform, alleging violation of the exchange registration and securities offering registration requirements under the Securities Exchange Act of 1934 (Exchange Act) and Securities Act of 1933, respectively, as well as securities fraud, and also charged BitFunder's founder with "control person" liability under Section 20(a) of the Exchange Act. Separately, on March 7, 2018, the SEC Divisions of Enforcement and Trading and Markets issued a public statement pronouncing that many crypto asset trading platforms may be required to register with the SEC as a national securities exchange or be exempt from registration. The SEC's charges in the BitFunder case and the SEC's statement on crypto asset trading platforms send several important messages to crypto market participants:

Crypto asset trading platforms may need to register with the SEC as an exchange or as an alternative trading system (or ATS).

Under the Exchange Act, any organization, association or group of persons that maintains or provides a market place or facilities for bringing together buyers and sellers of securities or otherwise performing the functions commonly performed by a stock exchange would be required to register with the SEC as a national securities exchange, or would need to rely on an exemption from registration (such as operating as an ATS pursuant to Regulation ATS). By characterizing the assets traded on the BitFunder platform as securities, the SEC looked into BitFunder's operations in light of the legal definition of an "exchange" and found that BitFunder met the criteria for an exchange because, among other things, BitFunder's electronic system allowed users to buy or sell assets by entering limit orders or market orders on the platform, which would then match against orders resting on the system from other users and automatically execute the orders upon a match.

Operators of crypto asset trading platforms should determine whether the assets traded on their platforms are securities, and if they are, further determine whether the activity of the trading platforms fall within the definition of an "exchange". Whether an asset (e.g., a token or coin) is a security is a matter of substance, not form. The test for whether assets are securities is whether purchasers invested in a common enterprise with reasonable expectations of profits generated through the efforts of others.

A crypto asset trading platform should consider disclosing material cybersecurity breaches to users.

The BitFunder case makes clear that the SEC believes cyber theft is material to investors in securities that are traded on a crypto platform and expects prompt disclosure to investors of all material facts related to their investments.

Operators of crypto platforms that permit trades in securities need to assess the quality of their systems and determine whether those systems and their risk management need to be enhanced to come into compliance with US securities laws.

The crypto trading market currently lacks a resilient market infrastructure similar to the traditional securities market infrastructure. None of the platforms are yet registered as a national securities exchange or are operating as an ATS. The developing crypto trading platforms also appear to be vulnerable to cyber-attacks and other operational risks. In addition, a platform's lack of a robust "know-your-customer" and operational risk management process would expose the platform and the custody of crypto assets to security threats. The regulatory requirements for national securities exchanges and certain ATS impose systems requirements regarding capacity, integrity, resiliency, security, and compliance. If crypto trading platforms fall within the definition of an exchange, their operators should consider the regulatory compliance obligations regarding systems security, integrity and resiliency.

Individuals who control crypto asset trading platform may have personal liability for the platform's violations of US securities laws.

Under the Exchange Act, a person who directly or indirectly controls an entity liable under any provision of the Exchange Act or SEC rules may be liable jointly and severally with, and to the same extent as, the entity under such person's control. The individual operators of crypto platforms should be aware of their potential personal liability if the trading platform violates US securities laws.

The SEC will continue to apply the existing securities regulatory framework to the crypto market and use the agency's enforcement power to hold platforms and the individuals who operate them accountable under federal securities laws. Operators of crypto trading platforms need to be aware of the SEC's regulatory framework and take steps to ensure compliance with federal securities laws.

[1]See Securities and Exchange Commission against Jon E. Montroll and BitFunder, 1:18-cv-01582, filed February 21, 2018, available at https://www.sec.gov/litigation/complaints/2018/comp-pr2018-23.pdf.

[2]See Statement on Potentially Unlawful Online Platforms for Trading Digital Assets, March 7, 2018, available at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

Impact of new centralized partnership audit regime to hedge funds and recent developments

Seda Livian, partner, and Indre Trinkunaite, senior manager, from Ernst & Young explore how IRS partnership audits of hedge funds will be impacted by new provisions in the centralized partnership audit regime.

Hedge fund managers and investors should be mindful of how the new provisions of the centralized partnership audit regime (CPAR) can impact them. CPAR governs IRS partnership audits and is effective for tax years beginning after 2017.

Unlike the prior regime, the Tax Equity and Fiscal Responsibility Act (TEFRA) — in which the tax liability from any audit adjustment would reside with the ultimate taxpaying investor — under CPAR, tax underpayments may be collected directly from the partnership.

On March 23, 2018, additional provisions of CPAR were signed into law as part of the Consolidated Appropriations Act of 2018 (the Act). While these provisions are generally beneficial to taxpayers, in some cases, they can expand the scope of an audit.

Under CPAR, a partnership subject to an adjustment has a few options from which to choose. Each comes with its own pros and cons, and short of the partners amending their returns or entering into closing agreements, the partners may not necessarily get the same result as if the partnership had correctly filed its original return. A partnership can (1) pay the imputed underpayment ("default rule"), (2) elect out of the centralized partnership audit regime under Section 6221(b), (3) make a Section 6226 election ("push-out election"), or (4) utilize a hybrid approach, which may include the "pull-in" election. Each of the choices is unique and will depend on partnership facts and circumstances. Fund managers will need to consider the adjustment amount and character of affected income or expense items, as well as the tax status of affected investors. Different investors may be impacted differently under the various options.

Only partnerships with 100 or fewer eligible partners qualify to elect out of the centralized audit regime. The eligible partner definition does not include partnerships; thus, a majority of hedge funds will not be able to make this election.

The push-out election was recently clarified, confirming that adjustments may be pushed through multiple tiers to the ultimate taxpayer from the reviewed year. A partnership makes this election within 45 days of the final partnership adjustment. The Act also expands a push-out election to include both favorable and unfavorable adjustments; previously, it was only available for unfavorable adjustments. The Internal Revenue Service (IRS) will view each adjustment on a gross basis where a partnership might have multiple adjustments. Adjustments of differing character (i.e., qualified vs. non-qualified dividends) cannot be netted by the partnership in determining an imputed underpayment. Partnerships are given flexibility to make the push-out election on some adjustments and pay others. Partnerships can also utilize the pull-in procedures. The pull-in procedures allow a review year partner to pay tax due and modify the partnership's underpayment amount without requiring individual partners to file amended returns.

The Act also provides for new Section 6232(f), which allows the IRS to pursue collections against both the partnership and a partner. Therefore, the push-out election may not absolve the partnership of all liability. If a partnership makes a push-out election but its partners do not pay the liability in time, the partnership may still be liable. The IRS has issued proposed regulations that address how audit adjustments affect book and tax basis of the partnership, as well as provide coordination with the withholding tax rules governing income allocable to foreign partners. The statute allows for a partnership to reduce any liability for amounts allocable to tax-exempt partners, provided the partnership can establish that none of the income was unrelated business taxable income. When deciding whether to make a push-out election, partnerships should consider their investor base and the net impact across favorable and unfavorable adjustments.

Under the new audit regime, the Partnership Representative (PR) replaces the Tax Matters Partner and has sole authority to act on behalf of the partnership. The PR must be a person with substantial US presence but is not required to be a partner in the partnership.

If the partnership does not designate a PR, the IRS will do so at its own discretion. Fund managers should, to the extent they have not already done so, add provisions to their fund documents that address the procedures for selecting, terminating and replacing a PR. Generally, a PR does not have an obligation to notify the partners of the audit proceedings; however, partnerships may choose to address items such as notifying the partners of proposed and final adjustments, a decision to make a push-out or pull-in election and whether it requires the approval of existing partners, and indemnification of the Partnership Representative.

Fund managers should also consider adding provisions to governing documents addressing how an adjustment would be viewed by a partnership from an accounting perspective, its impact to incentive calculations, and the allocation of such adjustments. It will also be important for fund documents to address the responsibilities of the partners and former partners in cooperating during an audit. The cooperation of the partners can impact the liability of other partners and the partnership as a whole.

Aided by Recent Court Decisions and Data Analytics, SEC Poised To Turn Up Heat on Insider Trading Enforcement

Carmen Lawrence, partner, and Joseph L. Zales, associate, at King & Spalding, discuss trends and themes with insider trading enforcement

In the last four years, the Second Circuit and the Supreme Court have addressed the significant question of what constitutes a personal benefit in determining whether an insider has breached a fiduciary duty in insider trading tipping cases. After taking a circuitous route, it appeared that the law ended up exactly where it started thirty five years ago, with the Supreme Court decision, Dirks v. SEC.[1] In Dirks, the Supreme Court held that the test for determining whether an insider has breached a fiduciary duty is "whether the insider personally will benefit . . . from his disclosure."[2] In addition to those clear-cut cases where a pecuniary benefit is actually exchanged, the Dirks Court found that "the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend"[3] because the tip and trade resemble trading by the insider himself followed by a gift of the profits to the tippee. However, a subsequent Second Circuit decision late last summer seems to have put the law on personal benefit back in play.

While the law of insider trading has been somewhat in flux, the SEC has been steadfast in its effort to detect and investigate insider trading cases and is using state of the art analytical tools to do so. After exploring the current state of the law as to the personal benefit requirement, this article explores the SEC's use of data analytics in building such cases.

State of Insider Trading Law

The Second Circuit's 2014 decision in United States v. Newman[4] held that in order to establish that the insider received a personal benefit by disclosing confidential information to a trading relative or friend, the government must prove that the insider and the tippee have "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[5] In reversing the convictions of two hedge fund managers, the Newman Court found that the original tipper and tippee did not have a close relationship but were merely casual acquaintances—even though they had known each other for years and had been classmates.[6] As such, the court held there was insufficient evidence to prove the insider received a personal benefit when he disclosed the information to the tippee.

Following Newman, the Supreme Court in Salman v. United States[7] reemphasized its earlier holding in Dirks that a personal benefit can be inferred where a tipper makes a gift of inside information to a trading relative or friend. The Salman Court added, "To the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, . . . this requirement is inconsistent with Dirks.'"[8] Because Salman involved tipping between brothers who had a close relationship, the court did not address Newman's "meaningfully close personal relationship" standard.

The very next year, however, the Second Circuit in United States v. Mathew Martoma, stated that in light of the Supreme Court's decision in Salman, Newman's "'meaningfully close personal relationship' requirement can no longer be sustained" and is "no longer good law."[9] In affirming Martoma's conviction, the court held that "an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed 'with the expectation that [the recipient] would trade on it,' . . . and the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and tippee."[10]

While the Eastern District of New York recently recognized that the Second Circuit in Martoma "emphatically restored the Dirks 'gift-theory' regime,"[11] Martoma appears to be broader in that it suggests that any gift of insider information given with the expectation that the recipient will trade on it is sufficient to satisfy the personal benefit requirement in determining whether an insider has breached a fiduciary duty. Indeed, although the Martoma Court stated that its decision "does not eliminate or vitiate the personal benefit rule,"[12] its decision has raised concerns, as expressed by Judge Rosemary Pooler's dissent, whether the personal benefit rule now has any limitations at all.[13]

Data Analytics in Insider Trading Actions

The SEC's use of data analytics in identifying and bringing insider trading cases is very much the "new frontier."[14] By using state of the art analytics,[15] the SEC is no longer reliant on tips, complaints, and referrals to build insider trading cases.

The SEC has gone on the offensive.

By mining historical information collected during investigations and trading data reported under the new Consolidated Audit Trail, the SEC's Market Abuse Unit's Analysis and Detection Center ("ADC") comprised of industry specialists, uses analytics to detect suspicious patterns such as improbably successful trading across different securities over time and relationships among and between traders. According to Co-Chief of the Unit Joseph Sansone, such analytics "give us confidence to invest resources into investigations."[16]

To date, the ADC is responsible for opening between ten and twenty insider trading cases. Highlighting their efficacy, the SEC's analytical tools have uncovered illicit trading despite traders' use of shell companies, code words, and an encrypted, self-destructing message application;[17] attempts to avoid detection by providing in-person tips and cash payments;[18] and, attempts to hide control over accounts.[19]

Conclusion

Only time will tell how, if at all, Martoma will impact the law on personal benefit. It is not altogether clear that the evidentiary burden has been lightened but rather it seems to have shifted from a focus on facts and circumstances related to the nature of a relationship to those establishing the tipper's state of mind.[20]

With the SEC's growing sophistication in analyzing big data for insider trading comes the expectation that market participants should be conducting the same type of big-data driven review in connection with.

[1]Dirks v. SEC, 463 U.S. 646 (1983).

[2]Id. at 662.

[3]Id. at 664.

[4]United States v. Newman, 773 F.3d 438 (2d Cir. 2014).

[5]Id. at 452. The court also held that the government must prove that the tippee knows of the tipper's breach of duty: "he knew the information was confidential and divulged for personal benefit." Id. This holding was not disturbed by Salman.

[6]Id. at 451 - 452.

[7]Salman v. United States, 137 S. Ct. 420 (2016).

[8]Id. at 428.

[9]United States v. Mathew Martoma, 869 F.3d 58, 69 (2d Cir. Aug. 23, 2017).

[10]Id. at 70 (quoting Salman, 137 S. Ct. at 428; Dirks, 463 U.S. at 664).

[11]Daws v. United States, 17-cv-6668, 2018 U.S. Dist. LEXIS 8201, at *28 (E.D.N.Y. Jan. 3, 2018); see also id. at *22 (In denying an application to vacate an insider trading plea, the court acknowledged that the petitioner's plea had satisfied the Dirks gift theory, as the petitioner had "been aware of the close relationship between [the tipper] and [first-level tippee] and understood that it was questionable at best for [the tipper] to be sharing sensitive information with his 'best friend' who in turn might use it to make trading decisions.)

[12]Martoma, 869 F.3d at 71.

[13]Id. at 83.

[14]Nate Raymond, Newest weapon in U.S. hunt for insider traders paying off, REUTERS (Nov. 1, 2016), https://www.reuters.com/article/usa-insidertrading/rpt-insight-newest-weapon-in-u-s-hunt-for-insider-traders-paying-off-idUSL1N1D20OU (last visited March 28, 2018).

[15]The SEC has home-grown program called Artemis, and has awarded a five-year, $90 million dollar contract to Palantir Technologies.

[16]Raymond, supra note 14.

[17]SEC v. Daniel Rivas, et al., 17-cv-06192 (S.D.N.Y. Aug. 16, 2017).

[18]SEC v. Steven V. McClatchey and Gary J. Pusey, 16-cv-4029 (S.D.N.Y. May 31, 2016).

[19]SEC v. Fei Yan, 17-cv-05257 (S.D.N.Y. July 12, 2017); SEC v. Shaohua (Michael) Yin, et al., 17-cv-972 (S.D.N.Y. Feb. 10, 2017).

[20]One thing that is clear is that conscious avoidance (disguised as ignorance) of the circumstances of the disclosure will not protect tippees from liability. Southern District of New York Judge Rakoff, in a 2016 decision denying defendants' post-trial motions, held that remote tippees are unable to escape liability by consciously avoiding learning the circumstances by which confidential information had been obtained. SEC v. Payton, 219 F. Supp. 3d 485, 492 (S.D.N.Y. 2016). This decision was recently affirmed by the Second Circuit. SEC v. Payton, 17-cv-290 (2d Cir. 2018)

Compensation Developments in the Alternative Asset Space

Michael J. Album, Esq., a partner at Proskauer LLP, specializing in executive compensation matters and part of the firm's Private Equity & Hedge Fund Litigation Group, discusses recent litigation developments in the executive compensation space.

What is happening in the compensation arena these days?

One development worth noting is the increased litigation over forfeited carry, incentive compensation and equity interests. While hard to measure, because many claims are settled privately, and others are subject to confidential arbitration, there appears to be an "uptick" in compensation claims by portfolio managers and managing directors in the alternative asset space. Targets include asset managers, hedge funds and private equity firms.

Why the "uptick"?

There are a number of factors. The type of compensation claim can be categorized depending on the status of the claimant. At the top of the pyramid are claims between founders or partners solicited to start new investment vehicles. The prototypical case is Foster v. Kovner (a 2006 New York State case) where a prominent executive who had been solicited to form a new health care investment platform sued for his claimed equity interest.

Public litigation involving partners at this level is still unusual.

Litigation seems to be growing at the next level, which involves claims by portfolio managers or managing directors. These plaintiffs now seem less concerned over adverse publicity and damage to their reputation. In addition, changes in the legal community feed into this litigation. New boutique law firms, often started by talented refugees from big firms, do not have the conflict and policy issues that might prevent them from taking a claim against a sponsor. There are also a number of experienced executive compensation attorneys who have split off to form their own law practices, and who may partner with litigators at these boutique firms. The retainer arrangements often provide counsel with a percentage of any recovery above a fixed amount, so counsel is motivated to pursue these claims.

Do you have a recent example?

Yes, there was an interesting case recently involving a former partner at a private equity firm who was terminated and sued for forfeited carry and other claims.

The damages claimed exceeded $10M. The case, Shaia v. Saw Mill Capital LLC involved a lengthy bench trial before a New York State court judge, and in August 2017, the judge issued a fifty page opinion ruling in favor of the sponsor (the decision has been appealed).

What type of claims did the plaintiff raise in Saw Mill Capital?

The plaintiff's claims included (i) the forfeiture of carry upon termination, (ii) the shutdown of a leveraged co-invest facility and set-off of amounts due the plaintiff to repay his co-invest loan, and (iii) the failure to allow the plaintiff to inspect financial records.

Why did the plaintiff think he had a chance to win?

These cases usually involve three type of claims: (i) breach of contract claims, alleging the parties had an oral agreement - or even that their behavior "implied" an agreement- to give the plaintiff the claimed compensation, (ii) the existing documentation (if there is any) is ambiguous and should be supplemented by an oral agreement or the conduct of the parties supporting the plaintiff's claim or (iii) that as a matter of fairness the plaintiff should be compensated for services or value he/she conferred on the sponsor, based on his/her reliance on promises of additional compensation.

Aren't those claims self-serving and easy to defeat?

Not so fast. The best way to defeat these claims is by having clear and unambiguous documentation; that provides the sponsor with the best leverage to have the claims dismissed at the earliest point in the litigation and avoid expensive and possibly damaging discovery. The problem is that sponsors may be focused on their "lower tier" documents that interface with their LP's (e.g., the LPA) and the documentation for the investment team is often overlooked and not finalized for years. In the Saw Mill Capital case it appears that the final "upper tier" carry documentation was not rolled out until well after the fund commenced operations. Even if the documentation has been prepared, sometimes a portfolio manager or executive might delay signing, to maintain optionality (perhaps to avoid the arbitration non-compete and/or non solicit obligations in the agreement). In Saw Mill Capital, the plaintiff never signed the upper tier partnership agreement that had the final vesting provisions.

If a sponsor is facing a Saw Mill Capital type claim, what is the best defense?

The sponsor has to construct a web of defenses. First, it is unlikely a claim could arise if executed documents exist-that goes to the point raised above. There are situations, however, where even if the documentation is executed the documents may be contradictory. One example would be an earlier incentive award (e.g. promising a percentage of annual net profits) that was "supposed to be" superseded by a subsequent broad carry grant under an LP agreement covering a range of investments.

In these situations there will be a "fight" over documents and the sponsor must make sure that the later document has a broad "merger" clause clearing stating that awards under the LP agreement "supersede" all prior arrangements. A broad and properly drafted "merger" clause is also an important defense against claims that other compensatory arrangements exist that benefit the plaintiff.

Another part of the defense web is to review the tax filings and "DDQ" (due diligence questionnaire) provided to the LPs.

In the Saw Mill Capital case, the sponsor was able to use references in the plaintiff's 83(b) filing for the carry award (which was filed by the plaintiff to establish an advantageous tax position) to undermine and contradict the plaintiff's claim that he was fully vested when terminated. The sponsor also used the description in the firm's DDQ regarding vesting which the plaintiff had reviewed and not changed – to undermine the later position taken by the plaintiff on vesting.

Anything else for a sponsor to be concerned about when facing a Saw Mill Capital type claim?

Yes. If the indemnity and advancement provisions in the upper tier documents are too broad, then the plaintiff may try to force the sponsor to advance attorney's fees incurred by the plaintiff in the very litigation the plaintiff commenced to recover more compensation. Sponsors should have counsel review their indemnification provisions to make sure they generally exclude actions bought by executives against the sponsor for these type of claims.

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