Professional Perspective

Performance Testing Guide for Private Fund Managers

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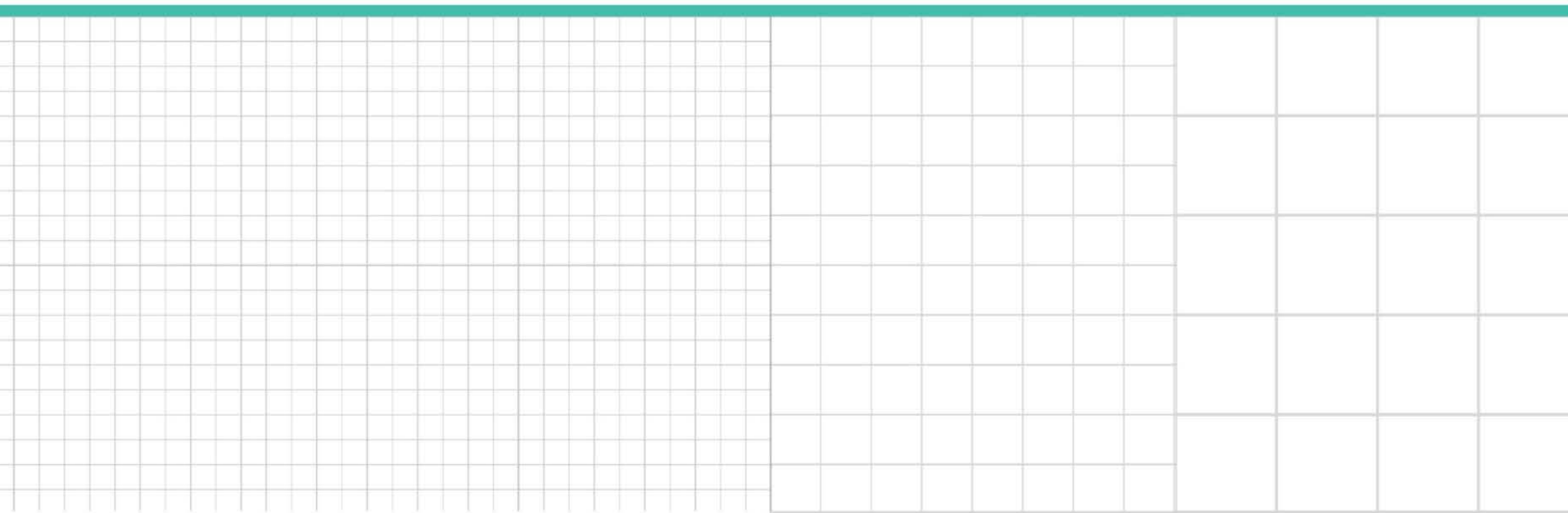

Performance Testing Guide for Private Fund Managers

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While regulators' expectations of legal and compliance officers are heightened across the board during the pandemic, one consistent area of focus has been the internal reviews of fund performance carried out by a manager's compliance team. Concerns exist that distributed workplaces, such as those resulting from the Covid-19 quarantines, could become environments ripe for the transmission of material non-public information (MNPI). These concerns were expressed in March by the Co-Directors of the Division of Enforcement of the U.S. Securities and Exchange Commission, who, in a statement regarding how the Covid-19 pandemic could impact market integrity, reiterated that "…investment advisers, and other registrants must comply with policies and procedures that are designed to prevent the misuse of material nonpublic information."

The rigor of regulators' assessments of internal performance reviews are likely to match these concerns. Given the volatility of Covid-19 markets and the resulting dispersions of performance among private fund managers, an internal reassessment of trading-related compliance measures may be prudent.

Background

Section 204A of the Investment Advisers Act of 1940 (15 U.S.C. 80b-4a) requires that every investment adviser, even if not registered with the SEC, "establish, maintain, and enforce written policies and procedures reasonably designed" to prevent the misuse of MNPI. The SEC indicated in the 2003 adopting release for the Compliance Rule, Rule 206(4)-7, that such policies and procedures should address the various ways MNPI can be misused. However, outside of that guidance and the specific requirements in the SEC's Code of Ethics Rule, Rule 204A-1, no policies or processes are expressly mandated under Section 204A. As a result, as with many other functional compliance areas, fund managers are expected to understand the risks specific to their firm and fashion policies and procedures tailored to those risks.

The SEC, for some time, has formally and informally focused its insider trading investigations on transactions and managers with unusually good performance or returns. The SEC Staff formally married that effort with high-tech forensic tools in 2009, when it inaugurated a data-driven "Aberrational Performance Inquiry" effort designed to "proactively identify atypical hedge fund performance." That effort resulted in numerous successful enforcement actions and gave rise to the sophisticated algorithmic tools routinely employed by today's examiners, specifically the National Exam Analytics Tool (NEAT).

The SEC examination staff, however, also expects that the compliance professionals within the private fund industry are conducting forensic testing and following up on potential issues they identify. SEC examiners regularly review managers' MNPI policies and procedures, and are increasingly asking compliance teams to describe or provide relevant documentation regarding their forensic testing of profitable trades, often referred to as "winners testing." In fact, the SEC examination staff recently identified in a Risk Alert that deficiencies under Section 204A of the Investment Advisers Act are among the most common examination findings for private fund managers.

Typical Inquiries

At the start of an SEC examination, the exam staff will typically request:

- The manager's MNPI-related policies and procedures, specifically or as part of a general request for all of the manager's compliance policies
- A trade blotter identifying transactions made on behalf of client accounts for a specified period.

In many such cases, the SEC examination staff also will request that a manager provide reports and documentation demonstrating the manager's implementation of its MNPI-related policies and procedures and, in some cases, will request documentation related to any winners testing assessments. Examiners will often analyze the manager's trade blotters, using NEAT and other statistical tools, to identify aberrational performance. The examiners may request further documentation surrounding those trades, including research files, investment thesis presentations, and related electronic communications.

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Compliance personnel who have identified and responded, or plan to respond to, at least some of these aberrational performance trades before an examination is commenced will be better prepared for a critical assessment of their oversight process. Deficiencies in performance testing that are commonly cited by the examination staff, but managers that take steps to develop their trade testing programs have a better chance of avoiding being cited for deficiencies in this area or even avoiding a deficiency altogether.

The contours and parameters of a winners testing program, such as testing triggers, testing frequency, trade review, and recordkeeping, will vary in accordance with and will be primarily driven by the investment strategies employed. There are, however, several steps managers of all stripes can consider taking to develop or enhance their testing and prepare for examination requests in this area.

Scoping

The threshold issue in winners testing is determining what trades a manager should review, as the SEC staff will scrutinize trades that provided advisory clients with large benefits or "aberrational performance," whether realized or unrealized. Unfortunately, effective scoping can be harder to achieve than one might expect.

Performance reviews solely based on absolute dollar gains or on rates of return can result in blind spots, as they can overlook smaller investments with high percentage gains or, conversely, exclude from review larger investments with less impressive percentage gains but that generated significant profits in dollar terms. In other words, a single-factor performance review trigger can result in overlooked trades that an examiner later deems to be obvious red flags.

One obvious way to avoid this shortcoming is to have a multiple-factor review filter. However, there is no one-size-fits-all formula. For some managers, it may be appropriate to have a review triggered by the existence of a combination of factors relevant to a given transaction, while for others a review may be appropriate if any one of several factors exists. Irrespective of the scoping criteria ultimately adopted, it is important that compliance personnel be able to demonstrate that they did so with reference to the manager's investment program, to the clients' portfolios, and to the specific MNPI risks inherent in the manager's investment program.

Loss Avoidance

Winners testing often focuses on trades that generate large profits. However, the SEC examination staff , in numerous recent matters, has criticized managers for not examining trades that caused a client portfolio to avoid significant losses.

Identifying loss avoidance, however, can be challenging. Among other things, it can require tracking the performance of securities after the client portfolio has exited a position and also require one to make a number of unconstrained assumptions, such as determining the appropriate duration of the review window and the hypothetical sizing of the position during the review window. Even more challenging is deciding which disposition transactions to review. Active trading firms could generate dozens or even hundreds of potential candidates each month, and a compliance group may simply not have the resources to perform loss avoidance analyses on all of them.

One approach to isolating potentially significant loss avoidance trades is to identify portfolio positions fully exited or reduced by more than a threshold dollar amount or percentage during the relevant review period and to compare the trading activity in that security against the timing of its component's price movements. While this task can be aided by some clever computer programming, compliance personnel still need to be able to demonstrate the rationale behind settling on the parameters for each factor.

Testing Frequency and Sample Size

When reviewing the strength of a winners testing program, examiners typically look at how often managers conduct such testing and how many transactions are reviewed. As noted above, examiners commonly request a manager's trade blotter and will then evaluate whether the testing regime is reasonable in light of the associated trading activity.

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Unfortunately, there are no safe harbors and there is no formal guidance that can provide comfort to managers in establishing the frequency or breadth of their performance reviews. Examiners have, for example, questioned the robustness of a quarterly testing regime for managers that actively trade on a daily basis. Compliance personnel, therefore, need to consider a variety of factors, such as:

- The investment strategies being employed
- The number of trades in unique names in a trading day, not simply the number of executions in a day, which may provide an inflated number
- The amount of overall trading conducted
- The risk of the receipt of MNPI

The compliance department should thoroughly document this determination process, review with legal staff and internal supervisors, consider consulting with outside experts, and reference those consultations in its documentation. It may also be useful to share a summary of the determination process with a private fund's board of directors, or a limited partner advisory committee, in order to obtain the thoughts of an interested, but independent, third party.

Review Process

At its core, the purpose of reviewing noteworthy trades is to confirm that the relevant investment decisions were made pursuant to the manager's investment process and not on the basis of MNPI. Winners testing is meant to serve as an additional check on the substantive controls a manager has in place to prevent and detect the misuse of MNPI, and not to generate stand-alone conclusions.

To that end, legal and compliance professionals should consider the winners testing process to be part of a larger undertaking of confirming the basis on which impactful trades are made. Specifically, the process should assess whether the rationale given for the trade is consistent with the trading levels and timing and with the firm's stated investment program and if any other sources of information, such as meetings with officers or directors of public companies, political consultants, or third-party experts, seem to be implicated in winning trades. Electronic communications of the relevant investment professionals involved in the trade, leading up to the relevant trade dates and for a few days thereafter should be reviewed. In many cases interviews of the relevant investment and trading personnel may be prudent as well. Compliance personnel should consider, as necessary, discussing any anomalous findings with firm management, and potentially outside counsel.

Documentation and Recordkeeping

Maintaining a record of these reviews is important for a variety of reasons. As described above, managers are often required to demonstrate their compliance with Rule 204A-1, and a record of this testing is a strong control in that regard. Examiners expect managers who conduct winners testing to memorialize this process in their policies and procedures, so managers should consider incorporating an overview of their testing regime into their policies regarding the prevention and detection of the misuse of MNPI. Testing records can also serve as a useful reference when analyzing a firm's compliance controls pursuant to the annual review requirement in Rule 206(4)-7.

There is no standardized format with respect to the records maintained for these reviews, but at a minimum they should include:

- Information regarding the trades selected, such as transaction date and amount, gain made or loss avoided
- A summary of the review of the relevant documentation
- Any findings or conclusions, and if applicable, any remedial measures taken

All documents should be generated and, ideally, reviewed by senior personnel in the compliance and legal departments, as well as with the relevant internal supervisors or managers.

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Conclusion

In today's regulatory environment, any manager that is engaged in active trading of listed securities, futures contracts, or swaps should take the time to examine its winners testing and broader performance reviews. Managers without such a program should give consideration to whether establishing such a program is appropriate.

A well thought-out forensic testing regime has a variety of other benefits. It can provide utility in evaluating style drift and aid in ensuring consistency across marketing and investor reporting materials. Developing a testing regime that is tailored to the manager's investment strategies and trading risks will help satisfy the regulators' expectation and provide protection for the firm and its various control functions.

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