DON'T PLAY FAVOURITES WITH YOUR INVESTORS

How are firms managing a range of conflicts of interest when running different types of investment vehicles?

BY JEN BANZACA

As investor tastes evolve an increasing number of hedge fund managers are offering multiple products, such as managed accounts, funds of one or co-investment vehicles, alongside commingled funds.

However, in meeting demands for customisation, there are a variety of potential conflicts that managers must mitigate, including the allocation of investments, allocation of expenses, cross trades and liquidity rights. Given the importance regulators place on this subject (*the SEC published a new risk alert on fee expenses last week,* *p9*), *HFMWeek* speaks to managers, lawyers and investment bankers to ask what firms should be doing to identify, manage and accurately disclose potential conflicts of interest.

ALLOCATION OF EXPENSES

For managers offering multiple products with similar investment strategies, how expenses are allocated presents a clear conflict that needs to be managed.

"You can have investors in one managed account who negotiate terms that exclude them from paying certain expenses and then you have to make sure other investors aren't stuck paying more than their fair share," notes the COO and general counsel at a $7bn hedge fund.

Robert van Grover, co-head of Seward & Kissel's investment management group, says the allocation of expenses is a growing concern for managers, investors and regulators and advises managers to "come up with a fair and equitable policy on how you're allocating expenses".

He adds: "You need to consider carefully what expenses you want to allocate to your fund vehicles, managed accounts and other fund offering and the management company. You need to clearly disclose what your practices are and then you need to adhere to your stated policies and procedures."

Schulte Roth & Zabel investment management partner Daniel Hunter says that to prevent conflicts managers should present a managed account or fund of one investor with the exact same list of expenses the commingled fund pays when negotiating the bilateral agreement.

"However, if the investor insists on not bearing certain expenses then the manager needs to make sure that those costs shift up to the manager and not over to the flagship fund," Hunter says.

The CFO of a $1.2bn global equity hedge fund says that among his firm's various investment products, expenses are allocated among similar accounts based on their participation in a particular investment and their respective net asset values. "You do have some investors who will negotiate not to pay certain expenses so we will absorb those costs at the manager level and make sure any remaining costs are equitably distributed," he says.

The GC/COO adds: "We allocate expenses pro rata based on the size of the investment. Where certain expenses are not allocated to a particular client account or investor then those costs will be borne by the manager, not allocated to the remaining clients and investors."

"While certain accounts may have negotiated not to pay a particular expense, best practice would be for the manager to calculate the pro rata expense as it relates to that particular managed account and absorb those cost reductions, rather than charge them to the commingled fund," adds Sai Gadwale, lead of the operational risk due diligence function at Stifel Financial Corp.

Disclosure of potential conflicts and how a manager addresses the issue is also critical, Gadwale adds. "As long as there is adequate disclosure about certain expenses being allocated to that particular pool or fund vehicle, then it's up to the investor to assess whether that is acceptable."

INVESTMENT ALLOCATIONS

The allocation of investments is another conflict, particularly where managers seemingly allocate favourable opportunities to accounts with higher fees and/or greater GP participation, or allocate trades based on any other preferential terms. If a firm offers more than one product, it must have detailed procedures for how it allocates

investments to the funds. Particular scrutiny is given to practices where investments are not allocated pro rata across comparable funds.

The global equity CFO says his firm has procedures to ensure that all investment opportunities are allocated among all fund clients fairly and equitably. He says allocation decisions are based on the specific needs of each client, tax considerations, cash availability, liquidity requirements and Erisa restrictions, among other considerations. "We want to prevent conflicts of interest and we don't want to unfairly favour any client over any other client," he says.

The general counsel of a large quant manager running a range of vehicles says investment allocations are a particular concern for his firm as it offers commingled vehicles, funds of one, managed accounts and registered funds. "We get a lot of questions from investors about trade allocations and how we monitor those," he says.

In particular, investors and regulators want to be sure managers are not cherry-picking the good trades to allocate to one fund and not another, he says.

The GC/COO adds: "You have to be able to explain why certain investments are being provided to some accounts and not to others."

"There may be legal or regulatory requirements, tax restrictions or particular investment mandates that preclude certain investments from being allocated to certain clients," adds the global equity CFO, but these reasons must be clearly flagged to and understood by investors.

Managers need to clearly disclose their allocation practices when certain investment opportunities are in short supply, says Schulte's Hunter.

"The problem comes with implementing trades where there isn't enough of a certain asset to allocate across all of your fund products," he adds. "You need to determine how to best allocate the investment, whether it's based on a particular fund's investment mandate or similar holdings or limitations of investors in another fund, co-investment or managed account."

The quant manager GC adds that as each vehicle may have "different tilts, certain country or currency overlays or managed to a different volatility level", these differences must be considered when allocating trades. "The key is to be as fair and equitable and where possible, that you tell investors how you allocate investments and that you explain why you may need to deviate from that policy."

Allocation practices should be addressed in a firm's written policies and procedures. The quant GC says firms will often include very general disclosures in a Form ADV that outline allocation practices but allow managers to "exercise discretion and due care to ensure that investment opportunities are allocated equitably among all clients regardless of the product or its fee structure".

CROSS TRADES

Cross trades present another potential conflict that must be disclosed and mitigated. Typically, cross trading occurs when a manager has two accounts and wants to transfer the assets of one account to another, whether for rebalancing purposes or for best execution.

"The manager may find that one product is overweight in one security that may be hard to get, and may want to move some of the assets from one vehicle to another," says Schulte's Hunter.

Gadwale says there are inherent conflicts when a commingled fund is providing liquidity to the managed account. "That is a key concern because you need to establish whether it is appropriate for the commingled fund to increase its position size in those relevant holdings. Portfolio manager and compliance oversight are necessary to evaluate if the trade and the transaction pricing are appropriate," he notes.

Hunter says best practice for engaging in cross trades is to require traders and portfolio managers to check with the CCO to be sure that a particular cross trade is permissible and that the trades will be done at fair market value.

The hedge fund CFO says his firm will only engage in cross trades when the transaction is in the best interests of both clients and that the deal is consistent with the investment objectives and policies of both. "We also require that all cross trades be pre-approved by the CCO," he adds.

Managers are required to disclose in Form ADV and various fund documents that cross trades can and may be executed. The hedge fund GC/COO says cross trade disclosures should also be made in the operating agreements between the manager and the fund and in the limited partnership agreements.

LIQUIDITY

Varied liquidity terms in different products also present a conflict, because on demand redemptions or portfolio liquidation available to managed accounts or other vehicles could have a negative impact on the firm's commingled fund.

"It's a conflict from day one when you decide to allow a managed account, which may have faster liquidity, to trade alongside your commingled fund," Hunter adds. "One concern is that the managed account holder could fire a manager at any time and then sell all of the assets. If the account and the fund are in less liquid instruments and the managed account holder decides to fire sale the assets, it could hurt the price of the assets held in the commingled fund."

"If you have a managed account investor that decides to close down the account, closing those positions could have a negative effect on the investors in the commingled fund or any other products offered by the manager," the quant manager GC agrees.

Hunter advises managers to disclose to all investors that the firm is running multiple types of products and that some may have more frequent liquidity than others.

"We disclose that we offer various investment products with similar trading strategies that offer different levels of liquidity," the quant GC says. "It's important for investors to understand the risks the different investments present so you have to disclose when you have this potential conflict. Always be open about these situations." ■