Investment Management and Hedge Funds: What's Happening Now

Gregory J. Nowak, Pepper Hamilton LLP
Adam DePanfilis, KPMG
Sean Gleason, KPMG
Jeffrey Lindenbaum, CQS

Pepper Hamilton LLP
Attorneys at Law

September 27, 2016 | New York, NY

Agenda

- Recent Developments
- Enterprise Risk Management

Recent Developments

- Blackstreet
- Adoption of Capital Allocation Broker Rules
- Recent Developments in Insider Trader Jurisprudence
- Whistleblower suits
- Overstatements of AUM
- Selective prosecution by the SEC
- Bond sales – markup
- Personal expenses charged to funds and acceleration of monitoring fees

KPMG

cutting through complexity

Enterprise Risk Assessment

What the CCOs and CFOs of funds and advisers need to know

Current Risk Management Trends & Opportunities

- Increasing business ownership of risk-management process and demand for meaningful information to drive risk-based decision making
- Pro-active and separate (three) lines of defense balanced with integration and collaboration of converging disciplines
- Increasing awareness and expectation from multiple constituencies around sustainable risk-management capabilities
- Increasing focus on probability, emerging risks, and alignment to strategy
- Common risk language driving better collaboration, communication, aggregation, and reporting
- Program refinement based on expectations of SEC and rating agencies

Why ERM is Increasingly Relevant Today

A number of external bodies involved with asset managers are increasing their public comments on the need for risk management practices, including:

- Regulators
  - SEC – proxy rules regarding the disclosure of risk decisions made in connection with compensation policies, director qualifications and governance structure and 10-K description of "Risk Factors" in plain English
- Ratings Agencies
  - S&P – "no surprise" culture and expectation of risk identification and mitigation as well as disclosure
- Investors
  - Increased investor demands for transparency and justification of fees
- Self Regulatory Organizations – To address heightened investor expectations and scrutiny, standards have been established by 3 industry groups to establish a benchmarks of strong governance and risk management practices:
  - Managed Funds Association (Published Best Practices for Hedge Funds)
  - UK Hedge Fund Working Group (Published Best Practices for Alternative Asset Management)
  - Presidents Working Group (Managers and Investors Published Best Practices)
- Bankers
  - Credit Officers – expectations for FS firms follows banking regulators as leading practices
- Third Party Marketing Firms

Principles

Potential Outcomes

Principle	Potential Outcomes
1 One view of risk through a common language	Common language, methodology and policy that drives risk assessments and enables holistic risk picture
2 Holistic view of risk aligned to strategic business values	Robust risk information considering all stakeholders' requirements within context of strategic objectives
3 Identify specific roles and responsibilities (see "3 lines of defense")	Clarification/enhancements of roles and responsibilities, including establishment of embedded business risk units
4 Structured process to support firm-wide view of risk	Enhancement of risk-management process including identification, management and reporting
5 Risk management as a culture	Risk-savvy culture and embedded competencies in performance cycles, training, and communication
6 Continuous proactive improvement	Formal periodic monitoring of industry trends and constituencies needs

3 Lines of Defense

Risk Governance

3rd LINE OF DEFENSE — Assurance Providers

RISK PROCESS AND CONTENT MONITORING

- Liaise with senior management and/or board
- Rationalize and systematize risk assessment and governance reporting
- Provide oversight on risk-management content/processes, followed by second line of defense (as practical)
- Provide assurance that risk-management processes are adequate and appropriate

2nd LINE OF DEFENSE — Standard Setters

RISK PROCESS OWNERSHIP/CERTAIN MONITORING

- Establish policy and process for risk management
- Strategic link for the enterprise in terms of risk
- Provide guidance and coordination among all constituencies
- Identify enterprise trends, synergies, and opportunities for change
- Initiate change, integration, operationalization of new events
- Liaison between third line of defense and first line of defense
- Oversight over certain risk areas (e.g., credit, market) and in terms of certain enterprise objectives (e.g., compliance with regulation)

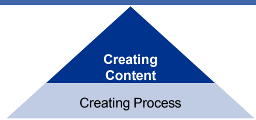
1st LINE OF DEFENSE — Business Owners

RISK CONTENT OWNERSHIP

- Manage risks/implement actions to manage and treat risk
- Comply with risk-management process
- Implement risk-management processes where applicable
- Execute risk assessments and identify emerging risk

Approach

1. Scope and prepare



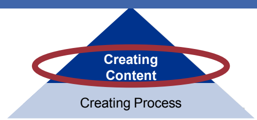
Activity

- Conduct an ERM visioning session to determine program purpose and priorities
- Establish a working committee and agree management participation
- Define project governance structure
- Agree on risk definitions, categories, ranking criteria, and control assessment criteria
- Develop project briefing materials (e.g., sponsors note, interview toolkit)
- Agree format for deliverables

Deliverables

- Project plan
- Project briefing materials
- Risk definition, categories, ranking criteria, and control assessment criteria

2. Review current state risk inventory



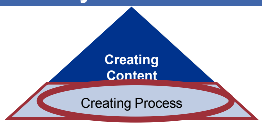
Activity

- Review existing risk assessment documentation (strategy plan, Internal Audit plan) and identify risks
- Conduct meetings with identified management to identify and rank risks
- Aggregate the risks and debate the risk positioning to result in key risk and top 10 risk inventory
- Conduct sensitivity analysis on the risks to allow prioritisation and assessment of controls required to manage risks
  - Controllable vs. Uncontrollable risks
  - Discrete vs. Ongoing risks
  - Modified impact of risks for business units
  - Interdependent risks

Deliverables

- Risk inventory (including risk prioritisation)
- Sensitivity analysis on the key risks

3. Assess current state of risk management for key risks



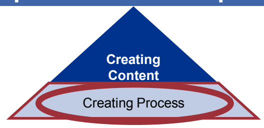
Activity

- Review current risk management process and actions for key risks using existing documentation
- Conduct meetings with identified senior management to identify, current state risk management process owners and monitors
- Assess current risk management process using the control assessment criteria scale (0-5)
- Recommend enhancements to the process

Deliverables

- Assessment of current state risk management process effectiveness for key risks with recommendations

4. Agree desired-state of risk management process and blue print



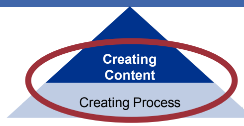
Activity

- Conduct meetings with identified senior management to identify and discuss desired-state risk management process for each risk framework element
- Apply better practices knowledge to the overall framework
- Recommend enhancement to the process

Deliverables

- Desired-state blue print with recommendations

5. Implementation



Activity

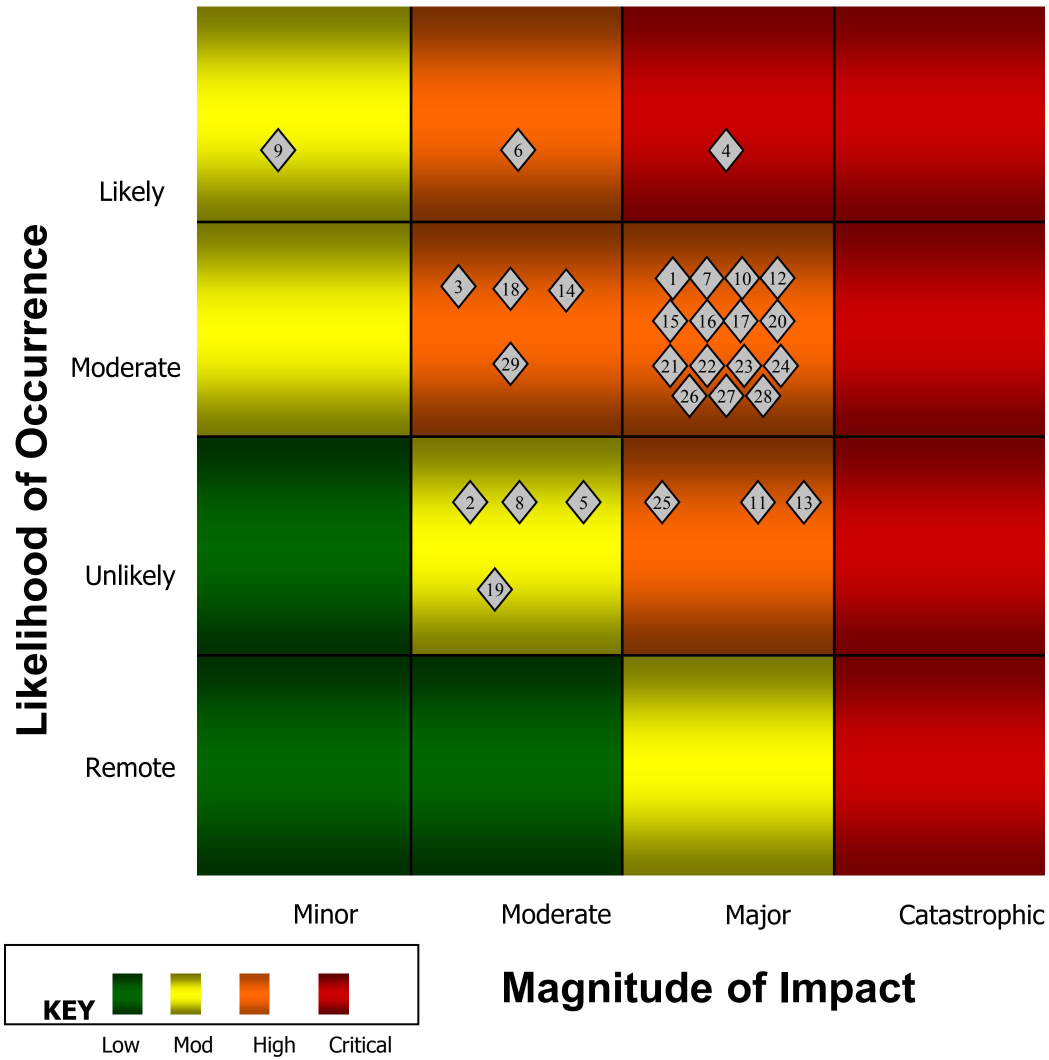
- Determine resource model
- Agree timescales
- Agree performance and success criteria (e.g., reporting tools)
- Develop training programs for risk management
- Create Risk Accountability/Responsibility
- Formalize policies and procedures

Deliverables

- Implementation Plan
- Training
- Policies and procedures
- Reporting tools

Heat Map

Example Only



Compliance

1 Risks associated with the ambiguity and interpretation of compliance and regulatory changes. Failure to ensure that the processes are in place and followed.

Fiduciary

2 Failure to provide appropriate recommendations and give proper investment advice. Failure to ensure that ABC is acting in the best interest of its clients.

Human Capital

3 Lack of employee development including:
A. New employee training
B. Existing employee cross training and continuing education
C. Failure to keep employees and tools up to date regarding new products and services
D. Failure to manage the development of supervisors and managers

4 Risk of employee stress due to high pressure environment of daily processing and customer servicing. Operations is a same day processing environment so as volumes increase so does the stress level of the staff - "the pressure cooker".

5 Lack of data security at the employee level.

6 Risk of a failed, incomplete or inaccurate project implementation due to project managers not possessing the appropriate skill set to ensure project oversight and success.

7 Risk resulting from the reliance on employee judgment and the possible failure of employees to recognize and act appropriately in servicing and processing customer accounts.

8 Inability to attract and recruit new employees. Risk of knowledge transfer and the loss of knowledge of systems and processes if key employees leave.

9 Potential loss of employees including key personnel. A severe loss of knowledge could occur if key employees leave. The Group is not currently experiencing problems retaining people, but environment is changing and staffing issues could become a challenge for management in the future. Staffing function is performed for three U.S. locations.

Market

10 Failure to execute customer requests in a timely manner. Risk is most apparent with the high dollar trades performed for U.S. institutional clients. There is also a risk of allowing market timers to trade in ABC funds and the subsequent exposure to the funds' NAV.

Operational

11 Failure to ensure business continuity as it relates to system availability.

15 Inability to maintain service levels with sustained increasing volumes. Concern was expressed over meeting regulatory obligations during volume peaks. Increasing volume strains customer service and increases the operational cost to process the increased workload due to the hiring of temporary employees.

16 Lack of a formal policy with the Fund Board to oversee unique processing features such as as-of transaction processing. Currently, an agreement does not exist outlining how Operations should capture and report these types of transactions.

17 Lack of contract administration over vendor relationships especially as it relates service level agreements ("SLA's").

18 Transaction errors by employees or customers including:
A. Employee could process a transaction or customer request incorrectly
B. Client could inadvertently fill out wrong

19 Failure to execute daily processing on a timely basis.

Reputation

20 Risk of fraud including employee and customer. Employee fraud could result in identify theft and/or asset theft of clients.

21 Failure to execute customer requests in a timely manner. Risk is most apparent with the high dollar trades performed for U.S. institutional clients. There is also a risk of allowing market timers to trade in ABCfunds and the subsequent exposure to the funds' NAV.

22 Failure to effectively manage the vendor relationships including: the integrity of the systems, security of the data, and timeliness of the information supplied to ABC to ensure ABC's reputation is not adversely impacted. Vendor relationships are not limited to IT vendors, but also include the U.S. Postal Service and other service providers.

Strategic

23 Failure to provide the appropriate level of customer service.

24 Failure to stay abreast of market trends and Operations ability to execute ABC strategic initiatives related to the changing market.

Technology and Data Security

25 Failure to ensure the security of data at the customer level to access accounts via internet, IVR and statements.

26 Technology risks associated to the Business Unit's lack of familiarity with IT system specification requirements, and IT's lack of familiarity with Business Unit's core processing. The disconnect between these two groups creates an expectations gap for technology initiatives. and business unit does not have enough IT knowledge. Could prohibit the success of these initiatives.

27 Risk associated to the uncertainty when migrating to new technologies.

28 Failure to appropriately plan for capacity constraints and techonology obsolescence.

Risk Assessment

Example

Risk	Risk Description	Strategy Link (Strategy Objective#)	Risk Inter-relationship (Risk#)	Risk Direction	Overall Current Score (*)	Board Oversight
1	Negative publicity regarding company's business practices adversely impacting company's brand / image.	All	6,10	→	2	Com A
2	Inability to process and support the investment managers and clients.	All	6	↑ A	2	Com B
3	Potential financial loss arising from legal action, contractual breaches or adverse statutory modification.	Investment compliance	13	↓	2	Com B
4	Inability of back-office operations to cope with increase volume of more complex financial instruments (e.g., derivatives) – backlogs and increase in error rate	Operational effectiveness	16, 22	↑ B	2	Com A
5	Potential financial loss from adverse market movements or liquidity constraints as a result of investments in SIV and CDO with underlying sub-prime exposure.	Liquidity	15	↑ C	3	Com B
6	Extended use of Excel spreadsheets and manual calculations to support the business.	All	1,2	→	4	Com B
7	Lack of proactive product innovation that anticipates customer demands (e.g., outcome-oriented products for baby boomers, higher-alpha products with incentive fees, etc.)		11, 12	↑ D	2	Com C
8	Loss of key infrastructure and/or buildings leads to significant disruption of business operations		25, 30	↓	3	Com D
9	Potential financial loss arising from incorrect or missed information from the due diligence process.		15, 21, 25	→	3	Com D
10	Inability to attract or retain top talent		1, 18	→	2	Com D

(*)	*Assessment of Actions to Manage Risk*
0	**Exceed Requirement** – The risk management processes have been over-engineered for the level of risk involved.
1	**Meet Requirement** – The risk management processes are appropriate for the level of risk identified.
2	**Need Strengthening (Minor)** – Minor improvements in the risk management processes are necessary to reach "meet requirements."
3	**Need Strengthening (Important)** – Risk management processes need to be strengthened in important ways to reach "meet requirement."
4	**Need Strengthening (Critical)** – Risk management processes are clearly deficient in critical ways.
5	**Unestablished** – Risk management processes have not yet been established. This will most likely be the situation in the case of a new business initiative.

Definitions of Risk Direction:	
→	No change in risk direction
↑	Risk is increasing
↓	Risk is decreasing

Emerging Risk Source	
A	Retirement of baby boomers
B	Pressure on investment return
C	Current credit crunch
D	Changing customer needs

Risk Typology: Degree of Risk

Risk magnitude descriptors typically deal with the potential for impact on cash flow, profit, brand image, alliances and/or market share based on subjective and objective criteria. Likelihood descriptors typically deal with probability and time estimates

Impact on Business Processes		
Level	Description	Risk Description
1	Minor	• No potential impact on market share • No impact on brand value • Issues would be delegated to middle management and staff to resolve
2	Moderate	• Market share and/or brand value and market share will be affected in the short term • Cash flow may be affected • The event will require senior management intervention
3	Major	• Serious diminution in brand value and market share with adverse publicity • Cash flow may be adversely affected • Key alliances are threatened • Events and problems will require board and senior management attention
4	Catastrophic	• Imminent cash-flow problems • Loss of key alliances • Sustained serious loss in market share

Probability – Risk, Threat, or Likelihood of Occurrence Without Controls		
Level	Description	Risk Description
1	Likely	• Event would probably occur within the next two years • Event would probably occur in no more than 75% of cases
2	Moderate	• Event could occur at some time during the next five years • Event could probably occur in no more than 50% of cases
3	Unlikely	• Event could occur at some time in the next 10 years • Event could occur in no more than 15% of cases
4	Remote	• Event may only occur in exceptional circumstances—once in 50 years • Event may only occur in less than 5% of cases

Risk Typology: Probability

Likely	Exists where the activity is significant in relation to the Company's resources, where there are a substantial number of transactions, or where the nature of the activity is inherently more complex than normal. Inherently, the activity potentially results in a significant and harmful loss.
Moderate	Exists where activity is average in relation to the Company's resources, where the volume of transactions is average, and where the activity is more typical or traditional. Thus, inherently the activity potentially could result in a loss to the organization; however, the loss could be absorbed in the normal course of business.
Unlikely	Exists where activity is less than average in relation to the Company's resources where there are a below average number of transactions, or where the activity is very common. Inherently, the activity could potentially result in a loss to the organization; however, the loss could be absorbed with minimal impact.
Remote	Exists where the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote, or if a loss were to occur, it would have little negative impact on the overall financial condition.

Risk Categories

Strategic Risk

- Corporate Governance Risk
- Execution Risk
- Innovation Risk
- Client Risk
- Fiduciary Risk
- Reputational Risk

Operational Risk

- Succession Planning
- Human Capital Risk
- Information Technology
- Information Security
- Business Continuity

Compliance Risk

- Legal Risk
- Regulatory Risk
- Conflict of Interest
- Fraud Risk

Financial Risk

- Reporting Risk
- Credit Risk
- Liquidity Risk
- Market Risk
- Execution Risk
- Performance Risk

✓ Reputation
✓ Fraud
✓ Information Security
✓ Information Technology
✓ Business Continuity

Risk Categories (con’t)

The categories should be granular and practical enough to meet the needs of business units but facilitate summarization for the board, executive management, and regulatory reporting and analysis

Risk	Definition
Investment Risk	Risks arising from adverse or unanticipated deterioration in credit or liquidity; adverse movements in interest rates or secondary market trading relationships or liquidity; failure to execute; or adverse relative performance of portfolios versus benchmarks and peers; or deterioration of absolute portfolio performance.
• Credit Risk	Risks arising from the probability that a borrower or counter-party will fail to perform on an obligation, or a change in market perception of that probability.
• Liquidity Risk	Risks arising from the impact of the inability of an institution to meet its obligations as they come due, because of a failure to liquidate assets or obtain adequate external funding.
• Market Risk	Risks resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices.
• Execution Risk	Risks arising from trade errors, high transaction costs, failure to execute investment decisions, timing or control of trading activity, and manager or trader communication shortfalls.
• Relative Performance Risk	Risks arising from adverse trends in portfolio performance relative to benchmarks and/or peers.
• Absolute Performance Risk	Risks arising from sharp declines in market value of investments held in common across groups of portfolios—such market declines resulting from credit, interest rate, liquidity, or market risk.
Operational Risk	Risks arising from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
• Technology & Data Security Risk	Risks relating to the failure of the entity’s electronic data processing environments to effectively process and deliver information to management or clients. Risk arising from the inability to manage adequately the confidentiality, integrity, and availability of informational resources.
• Business Continuity Risk	Risks attributable to the inability of an entity to recover on a timely basis from unforeseen events.

Risk Categories (con't)

Risk	Definition
Financial Risk	Risks to the enterprise resulting from actions causing deterioration in the financial condition of the enterprise.
Regulatory, Legal, and Compliance Risk	Risks arising from violations of state, federal, or industry self-regulatory rules; regulations, law, or a shift in the level or intensity of regulatory activity; or sharp change in the regulatory environment and Risks arising from violations of or nonconformance with laws, rules, policies, regulations, prescribed practices or ethical standards, or client mandates or guidelines, or the failure to adopt or implement appropriate policies and procedures.
Conflict of Interest/Fiduciary Risk	Risks arising from a failure by the Firm to recognize or fully serve the primary interests of clients, whether as formal fiduciary investment agent, or other relationship. Risks may arise from a failure to recognize that THE CLIENT COMES FIRST.
Reputational/ Client Risk	Risks arising from negative publicity regarding enterprise business practices, causing inability to attract new business, a contraction in the customer base, costly litigation, revenue deductions, or deterioration in the Firm's financial condition. Reputational risks increase client risks: for example, a deterioration in the relationship with, or loss of a major client or any action, development, event or trend which impairs a client's interest.
Growth and Strategic Risk	Risks arising from changes in industry macros; from adverse business decisions or improper implementation of business decisions; competitor challenges; product innovation or substitution; changes in business mix; failure of strategic or business planning. Other examples include: ineffective corporate governance, poor execution of firm strategy, inability to innovate and loss of client confidence.
Human Capital Risk	Risks arising from people and compensation issues or actions resulting in loss of key personnel, morale problems, decline in trust and confidence, diminished effectiveness of senior management, and inability to execute.

Adam DePanfilis

Director, Advisory
Asset Management

KPMG LLP

203.406.8506
adepanfilis@kpmg.com

Adam is a Director in KPMG's Stamford based Asset Management practice. He has over 15 years of comprehensive management, operations and reporting experience within the Financial Services industry. Prior to joining KPMG in December 2014, Adam was the Director of Specialty Operations at Silver Point Capital, a $9 billion multi-strategy opportunistic distressed credit hedge fund located in Greenwich.

Adam has experience with new fund launches and established fund infrastructures, including staffing, training and managing, overseeing the operations of various asset types, including primary and secondary bank debt, corporate and convertible bonds, CDS, interest rate swaps, equities, preferred equities, private equity, options, trade claims, asset backed securities, real estate and life settlements. Adam has deep expertise with trade, cash, position and accrual reconciliations. He also has implemented and maintained "shadow" books and records with an external third party administrator and maintained relationships with many service providers.

Sean Gleason

Director, Advisory
Asset Management

KPMG LLP

203.406.8147
seangleason@kpmg.com

Sean is a Director in KPMG's advisory practice. He has experience in capital markets and asset management. Most recently, he was the global head of IT audit, risk and control for a multi-national private equity firm managing over $300 billion. He also worked in various management capacities assessing process and control risk for a top tier international investment bank.

While at his previous fund he was responsible for all day-to-day global functions of IT audit, risk and control. He oversaw all global IT audit, risk, advisory and SEC compliance programs across the firm's alternative asset management, private equity, real estate, credit, hedge fund, and advisory businesses. Sean helped to assess and mitigate risk across the firm's business/environmental, legal and regulatory, operational, financial, technology, fraud, human resources, strategic and brand/reputational risks. He was integral in the development of internal policies and procedures including quarterly continuous risk monitoring, key performance indicators, quality assurance reviews and work paper management.

Gregory J. Nowak

Partner, Financial Services Practice Group

215.981.4893
212.808.2723
nowakg@pepperlaw.com

- Concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940 and the related Investment Advisers Act of 1940, and broker dealers and commodity futures traders and pool operators
- Represents many hedge funds and other alternative investment funds in fund formation, investment and compliance matters, including compliance audits and preparation work
- Writes and speaks frequently on issues involving investment management, health care and other matters and is the author of four books on hedge funds

Jeffrey Lindenbaum

Chief Executive Officer, CQS

212.259.2613

Jeffrey.Lindenbaum@cqsus.com

- Jeffrey is responsible for managing CQS' US business including compliance and oversight of the local functions. He is also a Director of CQS (US), LLC.
- Prior to joining CQS in 2010, Jeffrey was with Ivy Asset Management, a global fund of hedge fund firm. He was with Ivy from 1992 through 2010 where he served in several capacities including Managing Director, Corporate Development, Managing Director, Client Development – Europe and Asia and Chief Financial Officer. Jeffrey was also a partner at Ivy prior to its sale to Bank of New York in 2000. Before Ivy, he was a manager with Arthur Andersen in their audit and business advisory group.
- Jeffrey earned his CPA while at Arthur Andersen. He graduated from the State University of New York at Albany where he majored in Accounting and graduated Summa Cum Laude along with other honors. He is a Chartered Financial Analyst

Questions & Answers