THE REGULATORY FUNDAMENTALS GROUP LLC

The Biggest Challenges Managers Face Today

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With unprecedented uncertainty on many fronts, RFG was curious about what industry experts viewed as the greatest challenges facing fund managers. Here are some thoughts provided to us over the past two weeks:

Between a Rock and a Hard Place? The Threat of the Index Fund Revolution and the Perils of Succession. Prakash Mehta of Akin Gump reports as follows: "Like all so-called 'active' managers, alternative investment fund managers are being forced now, more than ever, to justify their performance in comparison to low-cost, 'automatic' options. They have little choice but to create and capitalize on differentiated strategies, talented professionals and hard work—there is no short cut it seems. As important, as the industry matures, and the first and now second generation of managers reach a transition point, striking the right balance between continuity and change is the key to survival in an increasingly competitive investment world. Dealing not only with the economic but also with the emotional elements of such a profound transition is something managers should and do have top of mind."

Fundraising Is Clearly Challenging. Greg Fenlon, Head of Alternative Investor Services at Citco Fund Services (USA) Inc., says: "The hedge fund industry is at a key inflection point. Facing mounting investor pressures and a sustained period of muted performance, it is critical that hedge funds understand how to effectively raise money in this challenging environment." CITCO and HFW have prepared a survey that provides the hard to come by statistics relating to the fundraising process. Based on responses from 225 firms, the survey discusses fee pressure, the rise of managed accounts (which shows no sign of abating), a desire to keep distribution in-house, and the intent of over half of those responding to start a new strategy in the next year. The use of reverse solicitation to access the EU remains a staple. Worldwide, 58% of respondents rely on it—a percentage that grows to 62% for U.S.-based firms. Also, to attract investment nearly 58% of the responding managers offer customized portfolios, special liquidity terms and target returns. For a full copy of the report contact distributionsurvey@citco.com.

RFG comment: *Why does this matter to endowments? Allocations made in violation of local laws on solicitation run the risk of being rescinded. Read more here.*

The Impact of Tax Reform on Transactions. "PE funds are weighing what the net effect of anticipated tax policy reforms will be on both deal making and returns, particularly for buyouts – taken together, a lower corporate tax rate and the possibility for full expensing of capital expenditures for select sectors may offset expected deterioration to returns due to the proposed limits on deductibility of interest," says Jennifer Choi of the ILPA.

They're Called "Hedge" Funds for a Reason. After an eight-year bull market, asset withdrawals and fee pressures, John Servidio of McGuireWoods questions whether hedge funds should plan for a Trump recession by taking net-short or holding fully-hedged positions. Specifically, "When ETF or passive strategies fail, either due to a flash crash or sustained market correction, hedge funds could emerge as uncorrelated winners. However, if funds adopt bear market strategies, they may incur increased stock borrow rates, higher option premium payments and other additional costs. What's the optimal expense allocation and fee structure for 'hedge' funds?"

New AML Regulations. Venkat Rao of EisnerAmper LLP offers the following suggestion: ""While the expectation by some fund managers is less regulation in 2017 and beyond, they will likely have greater anti-money laundering compliance requirements. Money laundering and terrorist financing implicate national security, which the current administration has identified as a high priority." For his high-level description of an appropriate program, read here.

RFG comment: *Managers may be sorely pressed to address the cultural changes required if they are expected to file Suspicious Activity Reports (SARs).*

The Fiduciary Rule. Aegis Frumento of Stern Tannenbaum & Bell writes that the fiduciary duty rule "may be dead at the moment, but that doesn't mean the concerns behind it have evaporated. Those concerns don't really have to do with there being a fiduciary duty—that's already decided. The real devil in the fiduciary duty rule—what caused it to balloon to over 1000 pages in the DOL iteration—was the micro-level requirements for policies and procedures and documentation designed both to prevent potential breaches of fiduciary duties and to prove that managers had in fact been acting as fiduciaries in the past. One could well predict that under a formal fiduciary duty rule, violations would have involved non-compliance with policies, procedures and documentation mandates, much more often than true breaches of duty causing harm to clients."

Frumento suggests that "even without a formal fiduciary duty rule, managers will be smart to seize the opportunity to come up with their own effective but reasonable policies and procedures and documentation mandates that they nurture into 'best practices.' The best way to avoid regulation from above is to demonstrate that effective self-regulation from within already exists. In the wake of the fiduciary duty rule fiasco, managers should get serious and take ownership of these issues as true professionals."