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Considerations for Illiquid Managers launching Liquid Strategies

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Introduction

The structure and function of compliance programs for hedge fund managers can be vastly different, and in most cases more expansive, than the compliance programs for managers of more illiquid asset classes such as private equity, real estate, and venture capital (collectively, "illiquid managers"). As illiquid managers explore additional service offerings for existing investors or ways to adjust risk profile and potentially enhance returns, they may consider the launch of a liquid strategy. While the diligence process of pursuing a liquid strategy will likely include a rigorous evaluation of its economic benefits, firms must also consider the various inherent operational and compliance implications of managing a liquid strategy. For example, a liquid strategy involves the more frequent operational responsibilities of fund asset valuation and trade reconciliations as well as additional compliance monitoring obligations such as monitoring for various public filing requirements.

This article will highlight certain considerations for traditional managers of illiquid strategies that may act as fiduciaries to both a liquid and an illiquid strategy, such as additional compliance control development, employee training, operational enhancements and potential challenges.

Information Barriers

Section 204A of the Investment Advisers Act of 1940 ("Advisers Act") requires the adviser to enforce its policies and procedures designed to prevent misuse of material nonpublic information ("MNPI" or "Inside Information").[1]

When setting up a liquid strategy, illiquid managers will need to consider the methods they will employ to control and monitor their possession of inside information. One option pursued by advisers is to establish information barrier programs that are designed to segregate the information possessed by the illiquid side (or "Private Side") of the business from the liquid side (or "Public Side"). Segregating the businesses may assist advisers in rebutting the presumption of widespread MNPI, and avoiding the imposition of certain trading restrictions on either side of the business. Alternatively, other advisers have opted to develop firm-wide controls across both the Private Side and Public Side of the business. Under this approach, Inside Information received by either the Public Side or Private Side would restrict everyone from trading in any relevant issuers. Both practices may be reasonably designed to prevent the misuse of MNPI, but each has its own unique set of considerations that will need to be evaluated prior to implementation.

As noted, illiquid managers can develop information barrier programs designed to establish certain physical, operational, legal and technological information controls in order to protect and monitor its possession of Inside Information. The Private Side is often in the business of obtaining MNPI whereas the Public Side may endeavor to avoid it. In these cases, the normal everyday business activities of the Private Side may restrict the Public Side from transacting in certain securities, including blocking it from accessing the securities of a specific issuer, or preventing it from exiting a position that is already in its portfolio. Certain advisers that want to rebut the presumption of widespread MNPI and avoid the associated trading restrictions may choose to develop an information barrier program. Alternatively, other advisers may choose to adopt or enhance its controls at a firm-wide level.

Building the Structure

If an illiquid manager chooses to develop an information barrier program, they will need to trifurcate employees

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1. https://www.sec.gov/rules/final/ia-2256.htm#P66_10657

into Private Side, Public Side and supervisory roles. Supervisors are positioned atop of the structure with visibility into both the Private Side and Public Side, and will be tasked with monitoring the interaction of both groups. Afterward, illiquid managers will need to apply the physical, operational, legal and technological information controls to each group as described in greater detail below. If an adviser chooses not to build an information barrier program, similar controls will need to be adopted at a firm-wide level.

Physical Barriers

Creating space between the Private Side and Public Side is essential to mitigating the risk of inadvertently exposing all employees to Inside Information. If possible, illiquid managers should consider physically separating Private Side and Public Side employees by assigning them to different floors or wings of its office. Gaining access to the Private Side or Public Side of an office should be limited to only the employees in those respective groups, and those in a supervisory role. In addition, illiquid managers should consider setting up separate equipment rooms for copy and fax machines as an added control to limit the risk of inadvertently exposing others to MNPI.

Physical separation of employees and equipment can also be important for illiquid managers that choose to adopt firm-wire controls rather than an information barrier program. Although trading restrictions related to the possession of Inside Information will be in place across the firm, physically separating employees will help firms mitigate the risk of inadvertently disclosing specific details relating to any MNPI maintained by the adviser to a larger group of employees, or having such information leak outside of the firm. If physical separation of employees or equipment is not possible, illiquid managers may consider implementing a “clean desk” policy that requires all employees to lock filing cabinets, shred any material that contains MNPI, or promptly collect and/or remove any sensitive information from publicly accessible areas such as personal desks, printer or copier equipment, or other shared spaces such as conference rooms.

Technological Barriers

In addition to creating physical barriers, an illiquid manager’s electronic network should also be segmented and secured appropriately when designing an information barrier program. Specifically, illiquid managers should review its network structure and assign access rights to employees based on their role on the Private Side or Public Side of the business. In addition, illiquid managers should also consider implementing electronic communication controls, including periodically reviewing correspondence sent between Private Side and Public Side employees, to monitor information flow between the two groups. Lastly, illiquid managers should also consider restricting access to third-party portals that store MNPI and using an active directory service when implementing an information barrier program.

For advisers opting to not develop an information barrier program, it is still important to segregate Private Side and Public Side employees from a technological perspective in order to mitigate the risk of inadvertently sharing specific details relating to the MNPI held by the firm with a broader group internally, or third-parties, as discussed above.

Restricted Lists

One of the benefits of developing an information barrier program is that it allows the Private Side and Public Side of the business to operate without restricting the other’s trading activities. This is typically done by managing two separate restricted lists, one for the Private Side and another for the Public Side. While maintaining dual lists requires additional scrutiny and heightened information barriers, the benefits may outweigh the challenges, especially if the Private Side’s and Public Side’s investment mandates may include similar industries, markets, or issuers.

As contemplated by this article, the approaches for creating physical and technological barriers are similar regardless of whether or not an illiquid manager decides to adopt an information barrier program. However, the importance of determining how best to escalate the receipt of MNPI may be more complicated, and arguably more important for illiquid managers that choose not to develop an information barrier program.

Illiquid managers may periodically obtain Inside Information as an ordinary part of their business practices. In such cases, employees generally follow a straightforward escalation procedure designed to notify the responsible parties of MNPI possession. For example, illiquid fund investment professionals may include compliance representatives when executing confidentiality agreements. However, the addition of a liquid strategy may add additional procedures to the mix. Specifically, promptly escalating Inside Information at the moment MNPI is received, adding that issuer to the restricted list, and alerting the Public Side are critical steps for preventing the Public Side from unknowingly transacting in that same issuer while the firm was in possession of Inside Information.

In addition, investment personnel on the Public Side may have a need to know when the Private Side is considering entering into a confidentiality agreement with an issuer in order to determine whether they have any proposed or current positions in that issuer. Consideration will need to be given when determining to move forward with executing a confidentiality agreement, including evaluating the effect a trading restriction will have on the Public Side.

Takeaway

Generally, the structure of information barrier programs can vary depending on the size, complexity and strategies of an adviser. As noted previously, illiquid managers that do not intend to develop an information barrier program will still need to implement or enhance certain physical, operational, legal and technological information controls. Because each approach yields different benefits and drawbacks, advisers must evaluate firm resources, and fund strategies, before reaching a final decision.

Managers Owe a Fiduciary Duty to All Clients

The U.S. Securities and Exchange Commission ("SEC") stated in the adopting release for Rule 204A-1 of the Investment Advisers Act of 1940 ("Advisers Act") that an adviser's fiduciary duty of loyalty to its clients may require it to take steps to protect clients from abuses by the adviser's personnel. As such, illiquid managers should also consider the fiduciary duty owed to their clients, and the challenges that may be presented when launching a liquid strategy. For example, the Private Side and Public Side may invest in the same issuer across different points in its capital structure, whereas a specific issuer might be held in different funds managed by both groups. As a result, illiquid managers may face challenges when determining how to structure their investments. In addition, illiquid managers may also face challenges when voting proxies, as their decisions may have an impact on the entire investment. Illiquid managers should consider implementing additional policies and procedures, and enhancing existing disclosures to address these potential conflicts of interest and how the firm will handle them.

Operational Challenges when Launching a Liquid Strategy

Managers of liquid strategies who transact in public markets must (i) have a deep understanding of the intricacies of financial rules and regulations as they relate to trading in public securities; (ii) develop controls to monitor for compliance with such financial rules and regulations; and (iii) assign resources to manage the completion of compliance monitoring and testing activities. As such, illiquid managers should be prepared to adopt additional operational procedures when launching a liquid product. Given the types of securities that may be traded under this strategy, illiquid managers should expect to complete more frequent public filings, including Section 13 filings (e.g., 13F, 13D, 13G, and 13H) and various foreign filings relating to foreign transactions, as well as have a process in place for monitoring these filing thresholds.

Illiquid managers ought to have a thorough understanding of various trading requirements, including rules regarding short sale transactions, Rule 105 of Regulation M, and seeking best execution for liquid securities. Illiquid managers will also need to implement a process for reconciling the firm's trading activities with its various brokers and potentially valuing the securities on a more frequent basis.

In recent years, ACA has observed that the SEC has emphasized the importance of developing robust policies and procedures to govern client expense allocation methodologies. As a result, investment advisers have enhanced internal practices in order to demonstrate that expenses attributable to clients are allocated in a manner that is demonstrably fair and consistent with disclosures. Illiquid managers must also address their expense allocation process when adding a liquid product to a traditionally illiquid platform, and seek to allocate expenses in a fair and equitable manner.

Strategy Shifts Affect the Culture of Compliance

Reasonably designed policies and procedures can establish a strong foundation for an effective compliance program, but without the support of senior management, that potential may not be fully realized. According to former SEC Commissioner Luis Aguilar, "an effective compliance program begins at the top."[2] Your employees should already be accustomed to your compliance program, and we would expect that they will not be surprised to hear that making changes to the compliance program and creating additional controls will be necessary when you launch a liquid product. However, illiquid managers must be cognizant of the potential culture shock that may resonate when implementing controls required for managing a liquid strategy. An example of this may be found when changing a firm's personal trading procedures. While many illiquid managers often permit employees to buy securities for their personal accounts, such activity may be problematic when managing a liquid strategy because these transactions may involve similar securities. As always, compliance personnel should encourage senior employees to embrace compliance program enhancements in order to set the tone at the top.

Conclusion

The launch of a liquid product can offer diversified benefits for an illiquid manager's clients. However, an illiquid manager should carefully evaluate the potential effects of a liquid strategy on their existing compliance program, employee obligations, and fiduciary duty. In addition, firms should explore policy and procedural enhancements to align with the unique complexities of their evolving strategies. ★

2. https://www.sec.gov/News/Speech/Detail/Speech/1365171515784