2016

Hedge Fund Insights

Navigating the challenging landscape in alternative asset management

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

Alan Alzfan
Hedge Fund Practice Leader,
RSM US LLP

ADJUSTING TO A NEW WORLD

When an industry matures, it comes under greater scrutiny from regulators and the public and must become more standardized in its operations. Investors have $3T invested in hedge funds—triple the total from 2005, when the industry passed the $1T mark for the first time. This increase also means more regulation, greater investor demands for transparency, and tighter standards for all aspects of fund governance and security.

When I began working with hedge funds in the late 1980s, managers would say, "Don't ask me questions about my investments, don't ask about the governance of our business, and this is my fee structure. Take it or leave it."

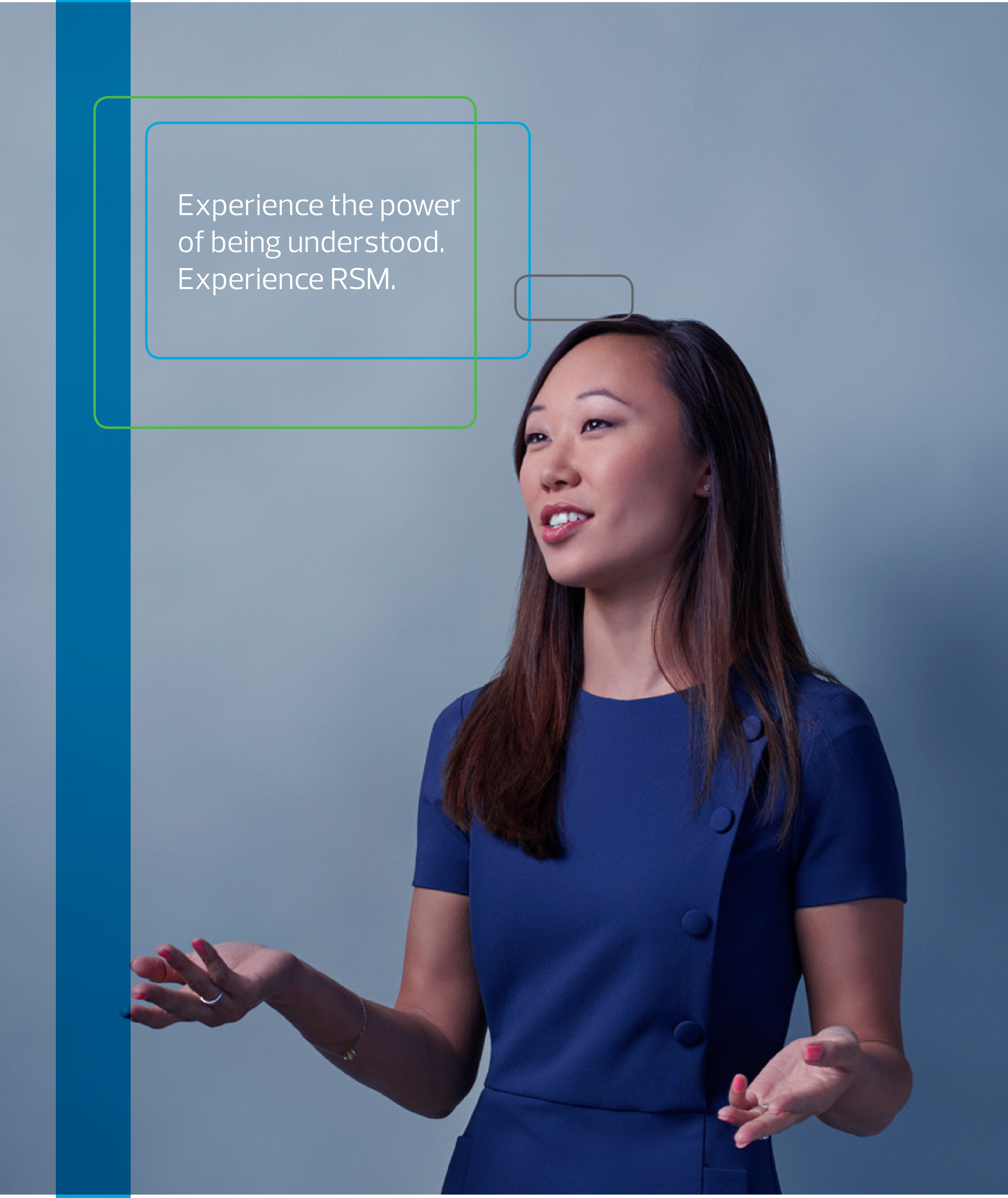
That time is long past. The SEC and IRS have invested time and training to oversee an industry that's managing a great deal of money. The frequency of an SEC audit has changed, along with the focus on specific areas. IRS rules for auditing investment partnerships place greater responsibility on the partnership itself, not on individual partners. We're likely to see more of those types of changes in the years to come.

Investors, too, are asking more of their alternative-asset managers. Their concerns include the security of an organization's computer systems, performance reporting practices—particularly regarding fee structures and disclosures—and governance and compliance matters. For newer managers, "institutional-quality" governance is no longer a goal—it's the price of admission.

The hedge fund industry still has a very bright future, and many strong advisory firms are being formed and finding success, despite challenges. Business models may need to adapt to changing times, but the industry as a whole will remain an essential part of a balanced investment portfolio.

Enjoy the report,

Alan D. Alzfan


Experience the power
of being understood.
Experience RSM.

About RSM US LLP

RSM US LLP (formerly McGladrey LLP) is the leading provider of audit, tax and consulting services focused on the middle market, with more than 9,000 people in 86 offices nationwide. It is a licensed CPA firm and the U.S. member of RSM International, a global network of independent audit, tax and consulting firms with more than 38,300 people in over 120 countries. RSM uses its deep understanding of the needs and aspirations of clients to help them succeed.

RSM provides industry insight, advice and solutions to financial services organizations across the country and around the world. Whether your business operates on a national or global scale, we have the resources to consistently deliver personalized attention across your organization. That's what you can expect from RSM. Experience the Power of Being Understood.SM

For more information, visit www.rsmus.com, like us on Facebook at RSM US LLP, follow us on Twitter @RSMUSLLP or @RSMUSFINSVC and/or connect with us on LinkedIn and Instagram.

Published in partnership with Privcap.

About Privcap

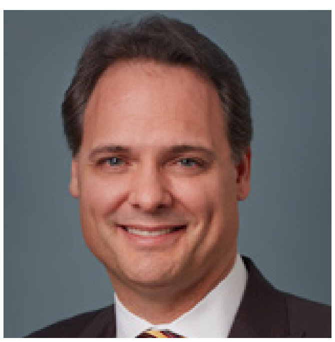
Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

www.privcap.com

TABLE OF CONTENTS

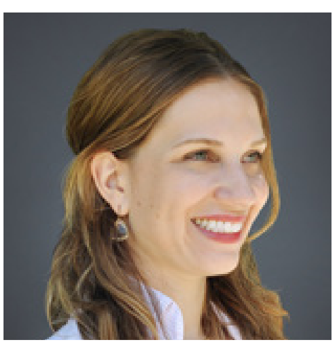
HOW TO BULLETPROOF YOUR PERFORMANCE REPORTS

IN TODAY'S REGULATORY ENVIRONMENT, SIMPLE PERFORMANCE NUMBERS ARE NO LONGER ENOUGH

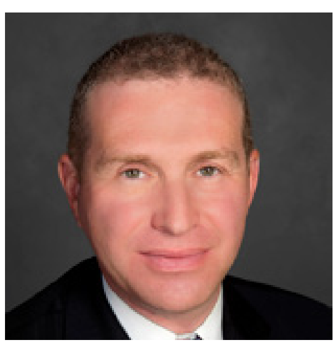


Dan Viola
Partner,
Sadis & Goldberg

Antonella Puca
Sr. Manager,
RSM US LLP



Michelle Noyes
Chief Operating Officer,
AMIA New York



Dan Gulko
Head of U.S. Performance Measurement & Client Reporting,
HSBC Global Asset Management

Correctly reporting investment performance in an era of increased regulatory scrutiny is no simple exercise. As the Securities and Exchange Commission is likely to increase the number of cases it brings against hedge funds and other investment managers, RSM US LLP Sr. Manager Antonella Puca says that while the Global Investment Performance Standards (GIPS) provide good guidelines, today's tighter regulatory environment increases the level of complexity.

"The return number that is presented as fund performance under U.S. GAAP in a fund's audited financial statements is typically a blend of different individual investor returns and does not tell the whole story."

A thorough portrait of a fund's performance will also include risk metrics as well as additional information on its benchmark and other factors that reflect the fund's ability to comply with the fund's stated strategy. The way a fund accounts for fees is also critical. The GIPS standards provide a suitable framework to address in a comprehensive way the issues that fund managers have to face to present an accurate portrait of their overall performance, well beyond U.S. GAAP requirements.

As such, legal and regulatory experts, say there are some important things to know about what constitutes compliance. Here are some areas that deserve extra attention:

↓CONTINUES ON NEXT PAGE

MARKETING MATERIALS

Marketing materials are a common source of regulatory trouble, says Dan Viola, a Partner at the law firm Sadis & Goldberg. The 2014 case of F-Squared Investments, which paid a $35M fine for not informing prospective investors that results from a model portfolio it created were made through back-testing, remains the industry standard for caution, he says. Even cutting and pasting the boilerplate from one fund to another could potentially set up a violation in the eyes of the SEC.

SEPARATE ACCOUNTS

Managed accounts can create variations in performance versus a fund that is running the same strategy due to flows or fees. One way to broadly cover results of the strategy that includes funds and managed accounts is to make sure there's a disclaimer that allows for tracking errors or makes note of the standard deviation, says Dan Gulko, Head of U.S. Performance Measurement and Client Reporting at HSBC Global Asset Management.

To stay on the right side of regulators, never leave anything out, says Viola. "If you exclude an account, even inadvertently, the SEC will assume you've been cherry-picking in your performance reporting," he cautions.

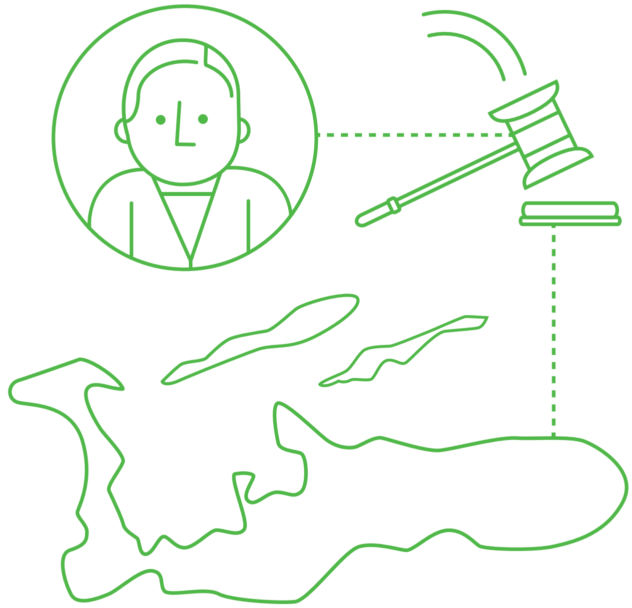
FEES

Fees, particularly the variations in fee structures that are now more common, require additional scrutiny when it comes to performance reporting, says Michelle Noyes, Chief Operating Officer at AMIA New York. Reports to individual investors may need to be customized to reflect specific management and performance fee solutions. Many hedge funds are using—or at least considering—tiered fee structures that vary by the size of the commitment, the lockup period, or increases in assets under management. "Two and twenty isn't gone, but it's just no longer the default assumption," Noyes says. "Funds have many tools at their disposal to set up a fee structure that is suitable for their strategy and meets investor demands."

In the current regulatory environment, an excess of caution is a virtue. While the SEC doesn't endorse GIPS as the absolute standard for performance reporting, the global standard helps establish a consistent process that's used to satisfy all stakeholders and provides a common reporting vocabulary that makes for easy, consistent explanations of fund investment performance, says Viola. The key, says Puca, is attaining a level of transparency that will allow a third party to verify those results. "The message that the SEC is really putting out there is that there needs to be more accountability," she says. ■

OFFSHORE FUND FOCUS:
THE CAYMANS GET UP TO SPEED

CHANGES IN LOCAL LAW MEAN MORE CONSISTENCY FOR U.S. INVESTORS



The U.S. isn't the only location to see significant changes to the hedge fund industry. In the Cayman Islands, the most popular offshore domicile for U.S. hedge funds, service providers, administrators, and regulators all describe adjustments that could affect some or all of the approximately 11,000 funds registered there.

The most significant change for private investments is the country's midyear passage of a law allowing the creation of limited liability companies (LLCs). The financial services industry had long sought the changes to allow Cayman products to be consistent with those registered in Delaware. Alex Bodden, Managing Partner of RSM Cayman Ltd., says this provides U.S. investors with added comfort and familiarity.

Max Karpel, a Partner at Kleinberg, Kaplan, Wolff & Cohen, a New York law firm, believes this designation will lead to an increase in Cayman LLC registrations.

GOVERNANCE & REPORTING GETS AN UPGRADE

As investors pay closer attention to fund governance, the role and importance of outside directors for investment companies continues to grow, as have demands for governance committees. The Caymans have a deep pool of experienced outside directors and advisers to fill those roles. Most new investment companies now incorporate these committees, and the increased oversight has added value, says Bodden.

In a time where a global push for increased regulation of hedge funds and other private investment partnerships is making an impact in a leading offshore financial center, Bodden says that adherence to more rigorous compliance methods should be beneficial.

As part of this trend, the Cayman Islands late last year joined about 80 other countries by adopting the OECD Common Reporting Standard for the global automatic exchange of tax information. That's required most Cayman financial institutions to update or create policies and procedures to identify reportable accounts and make changes to their information management based on these adjustments.

RAPID CHANGE MEANS STEADY BUSINESS

All the changes are keeping service providers busy, says Ronan Guilfoyle, Co-founder of Fund Governance firm Calderwood.

A current—and constant—challenge for auditors and service providers is keeping up with the Cayman Islands Monetary Authority, which may soon be granted authority to impose civil fines of up to $1M for serious offenses. Guilfoyle notes that the agency has been fairly active in the last 18 months, sometimes implementing rules and regulations that leave service providers scrambling to comply with new requirements.

Bodden says the network of service providers, like auditors and administrators, are in frequent consultation to ensure shared understanding of any regulatory changes.

As the global hedge fund industry adjusts to a shift in market conditions, it's only natural that the Cayman Islands' regulatory scrutiny increases too, says Alan Alzfan, a Partner and Head of the Hedge Fund Practice at RSM US LLP.

"From both a regulatory point of view and an investor point of view, the need for good governance is clear, and the push for it is stronger and stronger," Alzfan says.

KEEPING ON TOP OF TECHNOLOGICAL CHANGE

ADOPTING A PRACTICE OF "PRAGMATIC INNOVATION" CAN HELP YOU STAY UP-TO-DATE, SAYS RSM'S PAUL CALAMITA

Given the constant, frenetic pace of technological change, hedge funds must regularly evaluate the systems that support both their investment strategies and their daily operations.

RSM US LLP Partner Paul Calamita calls it "pragmatic innovation"—a blend of creativity and relevance that keeps hedge fund IT an integral part of growth, progress, and security.

"A lot of midsized hedge funds see the IT function as just keeping the lights on," he says. "The baseline application should do that and help you remain competitive in the market."

When a fund manager is thinking strategically about his or her business, it's about making the right IT changes to reach the next stage of the growth cycle. That's more than mastering an investment strategy, says Steve Jugan, a Partner at RSM US LLP. Using information technology to manage risk, address potential cybersecurity threats, and maximize both back-office and investment efficiency can give a small to midsized hedge fund operator room to grow and compete.

"Many of our clients are at the stage now where they need rapid access to that level of detail to manage the business more effectively," he explains.

More stringent and detailed reporting requirements and more aggressive regulators are the leading reasons for small or midsized funds to seek out IT help, says Calamita. Smart firms take the opportunity not just to catch up, but to be prepared for future growth.

"Ideally, you can use the principles of pragmatic innovation to formulate a three-to-five-year strategy for operational—and investment—growth," Calamita says.

While many trading models are built on complex algorithms, there's plenty of room for hedge funds to incorporate the use of corporate performance management tools in other parts of the business. Some examples include:

- Getting increased visibility into monthly performance results, to better hone reporting and investing processes
- Increasing the transparency of back-office functions, which play an important role in investor relations
- Using data analytics to better understand fund operating costs and keep management aware of changes

"We are in a competitive environment where it's especially important to know how a business is performing today—not when monthly results are finally collected," Calamita says, adding, "Why limit your ability to react immediately and effectively?"

HOW TO BUILD A CYBERSECURITY 'THREAT MODEL'

Daimon Geopfert
National Leader of Security & Privacy Services,
RSM US LLP

By performing a fund-level threat assessment, a hedge fund firm can get a little closer to knowing the unknown enemy behind a potential breach, says RSM's Daimon Geopfert

Cyberthreats aimed at hedge fund firms are coming from multiple directions, and pressure is growing to increase preparedness. The Securities and Exchange Commission has issued regulations intended for the alternative asset class, following in the footsteps of the payment card industry, says Daimon Geopfert, National Leader of Security and Privacy Services at RSM US LLP. The challenge is that each cyberthreat or attack requires different strategies depending on the firm, and no two situations are alike.

GET OUT IN FRONT OF A THREAT

One of the most important things a hedge fund can do is a fund-level threat assessment. Geopfert says it's important to delve into how someone would attack a fund.

"You have to sit down with someone who hacks and have them tell you, 'If I was going to hack you, here's how I would do it.' If you can force the attacker to get out of their comfort zone, if you can defeat their first two to three attempts, they will move on."

There are other low-level cyberattacks. In many cases, Geopfert says, when a breach is attempted, it's done simply: via an email or phone call asking for financial information, or a fake executive or third-party contractor asking an employee to wire them money.

For these kinds of low-tech hacks, actively monitor financial activity so you can act quickly should a suspicious money transfer occur, Geopfert says. "If you can move fast enough, you can get the money back. They try to move the money, and the second it hits, they have someone waiting to withdraw it. It's a race between you and the attacker."

GET THE RIGHT PEOPLE AND THE RIGHT TOOLS

Cybersecurity threat assessment can be bolted onto a firm's existing risk-management policies and actions, but security expertise that goes beyond the basic knowledge is required. Specifically, a hedge fund needs professionals who understand the technical dimensions of threat planning, detection, and response.

"How do you control third parties? When you share data, how do you protect it?" asks Geopfert. He notes that hedge funds complain that the cybersecurity people they do find often have a narrow focus and are only interested in selling tools and software, rather than helping proactively prevent a breach or mitigating fallout when one occurs. "They often say, 'Stop trying to sell me a thing, and tell me how to actually control security over time.' The pool of people to do that is very shallow."

THE GREAT TIMES ARE OVER, THE GOOD TIMES MAY YET RETURN

SEVERAL FACTORS MAKE MANAGING A SUCCESSFUL HEDGE FUND A MORE UNCERTAIN VENTURE THAN IN THE PAST. RSM CHIEF ECONOMIST JOE BRUSUELAS AND HEDGE FUND RESEARCH PRESIDENT KEN HEINZ EXPLAIN WHY.

Joe Brusuelas
Chief Economist,
RSM US LLP

Ken Heinz
President,
Hedge Fund Research

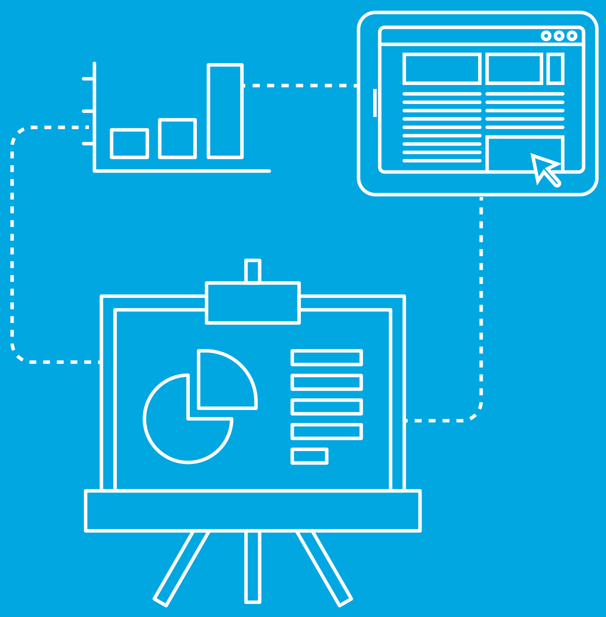
The hedge fund industry may not be dead, but RSM US LLP Chief Economist Joe Brusuelas says the wildest times are certainly over.

"We have reached the end of the first era of hedge funds, but that doesn't mean we've reached the end of hedge funds," Brusuelas says. "We are moving on to a more sustainable model, and we can see now that there are too many funds in business. That will change as the mutual funds masquerading as hedge funds move on."

The golden age is over for many reasons, including post-crisis markets that remain upended by the global oil price collapse; the impact of an interventionist Federal Reserve that spent $3.8B on quantitative easing and continues to suppress U.S. interest rates; the appreciation of the dollar; the lack of inflation; and central banks in Europe and Asia that have set negative interest rates.

Factor in a huge increase in the number of funds in the last two decades, along with the global stampede to invest in them, and it's no surprise that this era is at an end, Brusuelas says. In an industry that's grown from 610 hedge funds managing $39.8M in 1990 to more than 1,000 funds managing $2.9T today, he says the returns of past decades simply aren't attainable.

↓ CONTINUES ON NEXT PAGE



"One can only come to the conclusion that there's just not enough skilled individuals who understand the new post-crisis economy and policy tools that are being implemented and used in financial markets," Brusuelas says.

But some managers simply won't be able to keep pace—or won't want to navigate the new, rigorous regulatory climate. While hedge funds didn't cause the financial crisis, they've proved to be an easy target for governmental indignation and popular opprobrium, along with the major banks, which bear a greater responsibility for the 2008 crisis. Managers that can't provide superior performance may close up shop, or convert to family offices and run their own money, Brusuelas predicts.

CURRENT PERFORMANCE, FUTURE POTENTIAL

The recent numbers are stark. By the end of August, the HFRI Fund Weighted Composite Index showed hedge funds up 3.46 percent year-to-date and trailing the S&P 500 by more than half. Hedge fund withdrawals reached $15.1B in the first quarter of 2016, according to Hedge Fund Research, an industry research firm. That's the largest total since 2009.

But Brusuelas and Ken Heinz, President of Hedge Fund Research, say global economic conditions offer opportunities that aren't necessarily obvious to the casual observer.

"Many firms are able to respond to the general macroeconomic climate of uncertainty that's upon us," Brusuelas says. "Political and policy risk has really increased the difficulty of managing capital, but there are people in the hedge fund industry who are positioning themselves in realistic ways to adequately address these challenges."

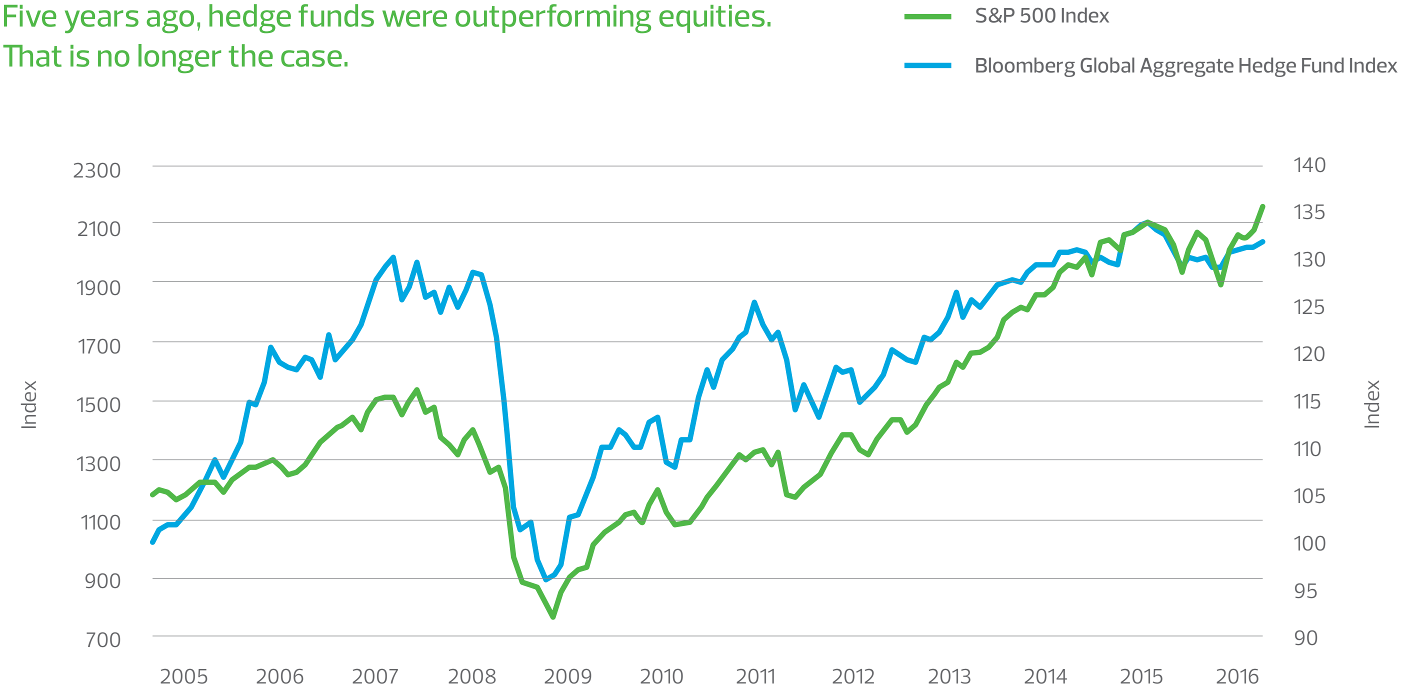
He points to the impact of the Brexit referendum in June, when voters in the United Kingdom opted to leave the European Union. In the short-term stock market plunges that followed, hedge funds were better prepared than many other investors, and that degree of preparation has also shown up in recent performance.

Heinz says that the HFR Indices will finish the year ahead of the S&P 500—it's already ahead of the MSCI World Index. However it happens, the return to a normal economy will be bumpy. Factors that could amplify the current period of distortion might include rising U.S. interest rates, further global market gyrations when the mechanics of Brexit start to take effect, additional European or Asian central banks adopting negative interest rates, and inflation.

↓CONTINUES ON NEXT PAGE

HOW EQUITIES STACK UP AGAINST HEDGE FUNDS

Five years ago, hedge funds were outperforming equities. That is no longer the case.



Sources: RSM, Bloomberg

Rising interest rates, in particular, have strong historical correlation to improved hedge fund performance, and so the outlook for hedge funds and the economy in general remains largely in the hands of the Fed, which will decide the pace of interest rate increases.

"It's going to be a wild end to the year," Heinz says.

THE SHAPE OF FUNDS TO COME

But even successful surviving hedge funds must operate in a sharply different environment, marked by aggressive regulation and more discerning, discriminating investors. The sharp rise in enforcement actions by the Securities and Exchange Commission and new audit rules from the U.S. Treasury Department mean funds must work harder to meet compliance requirements. At the same time, investors are less willing to simply pay a 2 percent annual management fee and 20 percent of trading profits in a period where many funds aren't outperforming the broader market.

"There's a new reality, and there's an inevitable adjustment to what comes after 2 and 20," Brusuelas says.

That won't be due solely to market forces, though, as increased regulatory pressures limit financial innovation in what Brusuelas calls the "age of financial repression." That includes the uptick in SEC cases against hedge funds, the new audit rules for partnerships, which make it easier for the Internal Revenue Service to audit hedge funds, and the possibility that the carried interest tax rate will be abolished after the 2016 election. He also points to the reach of Dodd-Frank financial reforms, which raise the possibility that some very large hedge funds might be designated as "systemically important" by the government and thus limited in the risks they can take.

"Many people in the business don't seem to understand that this isn't going to go away anytime soon," Brusuelas says. "Rightly or wrongly, hedge funds have been labeled one of the problem children in the broader financial community."

In five years, he predicts, there will be a far smaller number of funds, many of which will rely on sophisticated quantitative strategies, using high-frequency and algorithmic trading operations. It will be "a much truer, more honest, more holistic hedge fund industry," says Brusuelas.

THE FIVE NEW RULES OF HEDGE FUND IR

THREE EXPERTS EXPLAIN WHAT INVESTOR RELATIONS PROFESSIONALS SHOULD BE AWARE OF IN THE AREAS OF TRANSPARENCY, BACK-OFFICE TASKS, AND CYBERATTACKS, AND WHY ALLOCATORS—AND NOT MANAGERS—ARE NOW THE STARS

1 INCREASING INVESTOR SOPHISTICATION IS DRIVING TRANSPARENCY

The hedge fund industry has changed dramatically over the past decade or so, largely as a result of enhanced SEC regulation, but also due to increasing investor sophistication.

"One of the biggest changes is transparency," says Ed Coyne, Executive Vice President at Sprott Asset Management. "Clients and investors want to see managers who are willing to open up their books."

The strongest driver of this trend is not investor sophistication at the institutional level—that has always been there. "Smaller accounts are coming in now, and their level of sophistication clearly is higher," Coyne says. "In fact, almost every client is viewed as an institutional client. It's not completely new and shocking to the system, but you are hyperaware of it—and your ducks better be in a row. Everyone's got to take it up a notch and be very organized, because everyone is looking."

Jeff Silverman, President of AlphaParity, agrees. "The level of sophistication among small and medium investors is much higher and their level of due diligence is far deeper than it ever was. And that has changed the industry. Launching a fund with two guys and a dog in a garage, those days are behind us. They'd need a very large garage for their COO and their compliance officer and all the proper personnel."

2 THE BACK OFFICE MUST NOW BE FRONT-FACING

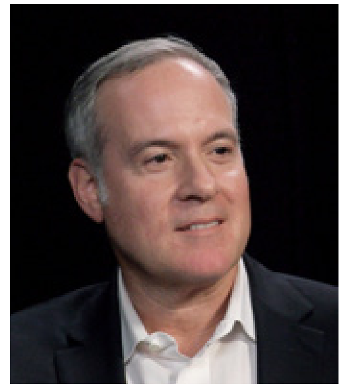
What goes on in the back office can no longer be shrouded in secrecy, because due diligence is being performed on an ongoing basis, and the responsibility extends well beyond the CFO suite. "Investors are talking to the assistant controllers and the people who are actually pushing the buttons and executing the trades," says John Hague, a Partner at RSM US LLP.

For example, many hedge funds make longer-term, illiquid investments that are difficult to value. Investors are not satisfied with being told that the fund has a fair-value methodology. "They're asking what the details of that methodology are," Hague says. "They're asking if you have a valuation committee or any oversight as it relates to the independence of that function. They're getting into the details. They could care less if you've got a cash flow model. They want to know what the variables are and how you get the completeness and accuracy of the variables."

↓ CONTINUES ON NEXT PAGE

Ed Coyne
Executive Vice President,
Sprott Asset Management

John Hague
Partner,
RSM US LLP



Jeff Silverman
President,
Head of Business Development,
AlphaParity

3 CYBERATTACKS ARE A REAL AND GROWING THREAT

A cyberattack can happen to any organization—a major medical center in L.A. or the local police department in Idaho Falls. Hedge funds are a lucrative target. Hackers might go after a fund's portfolio information, or they might steal details of investor accounts.

"There are stories out there about hacks of fast-trading firms," Hague says. "There's a rumor that a cybersecurity breach is actually getting ahead of some of these orders before they even hit the exchange floor and taking advantage of that. It hasn't been confirmed, but there's a good theory out there, authored by the FBI, that this is happening. So you've got the investment side, and you also have the confidentiality of the investors' information."

The damage a trading hack can do is significant, particularly with thinly traded securities. "Having instantaneous access to that information is a huge advantage from a trading standpoint, when these stocks can move multiple points off a single trade order," Coyne says. "That's a real concern, obviously, as you open up your books, if the people who see what you own are people getting ahead of your trades, whether it's through fraud or just through looking at your balance sheet."

4 THE BLACK BOX IS NOT A STRATEGY ANYMORE

Hedge funds have traditionally kept their proprietary trading strategies secret—and investors have traditionally not complained. In fact, the more impenetrable the strategy, the more investors tended to be attracted to it. A very mysterious black-box methodology suggested managers with privileged access to the dark arts of investing.

That was then. Now, with hedge funds underperforming equities and bonds and regulators armed with crowbars and their flashlights, the door is being thrust open.

So is the black-box fund model a thing of the past? Yes, more or less. "The black box, even the star manager phenomenon that we had 10 or 15 years ago, has largely fallen by the wayside," Coyne says.

Investors simply won't tolerate it. "The black-box mentality directly conflicts with today's need for transparency in the investor universe," Silverman says. "Investors need to understand the process. They need to understand the risk-management process, the decision process, the sizing of positions. It is just not palatable to the investor to sit across the table from someone who might have some very splashy midterm profile but hides behind the black box."

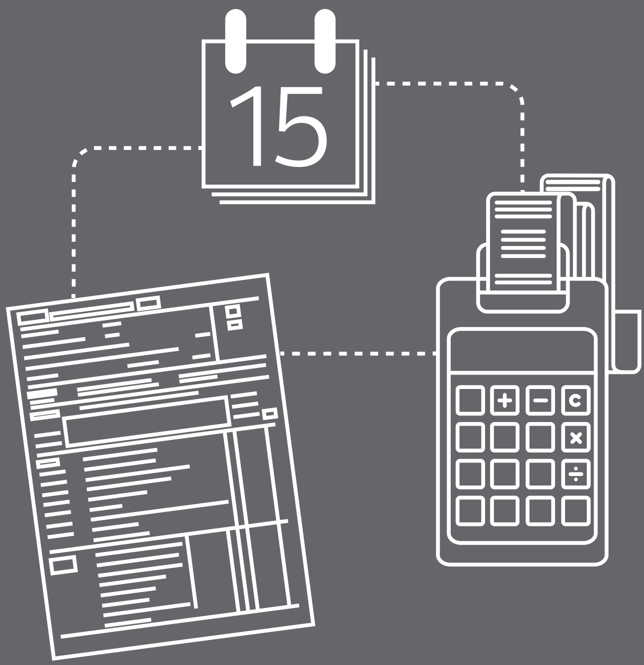
5 ALLOCATORS, NOT MANAGERS, ARE NOW THE STARS

Another tectonic shift in the hedge fund industry is the move away from star managers. It's no longer enough to show up to a pitch meeting with a big investor and introduce the new star manager: "This guy is going to be on our team. How much would you like to invest?"

"Pre-crisis, we lived in a world where it was about star managers," Silverman says. "The allocator would pull together a collection of star managers in filling each bucket and he'd think he had a diversified portfolio. But the crisis taught us that the portfolio often wasn't diversified—many of these star managers had a great deal of overlap. Now it's about the star allocator. The allocator has the mandate from his investment committee to go build a truly diversified portfolio."

Another shift has been a return to fundamentals, to more collegial relationships with clients. This is another part of the trend toward transparency. "Your ability to reach out to the client with good news or bad is very important—really accepting the idea that they do need that transparency," Coyne says. "That client-service role has become elevated substantially—it's over and above 'Hey, we can deliver the numbers.'"

THE TAX ISSUES YOU NEED TO KNOW NOW



CHANGES TO TAX AND COMPLIANCE RULES AND GUIDELINES CAN LEAD TO PROBLEMS IF YOU'RE NOT PREPARED. EXPERTS FROM RSM US LLP EXPLAIN HOW TO AVOID THESE POTENTIAL HEADACHES.

As the year draws to a close, hedge fund managers and their investors must deal with a host of unwelcome tax and compliance issues. These potential problems include regulatory changes that will require many partnership agreements to be rewritten, global tax reporting standards that will increase the compliance burden, and presidential election results that could result in higher personal tax bills.

Jerry Musi, an RSM US LLP Partner, says that with careful planning, the regulatory and reporting changes are manageable. The personal tax considerations, however, are another story. Both candidates for president have put the so-called carried interest loophole back into play, and, much like the election, the outcome is too unpredictable to call.

Here's a brief rundown of what hedge fund managers and investors need to know.

CARRIED INTEREST

A potentially dramatic increase from the current rate—20 percent tax on net capital gains plus the 3.8 percent investment tax—is something investment managers watched closely during the lead-up to the presidential election, says Musi. Both President-elect Donald Trump and Democratic nominee Hillary Clinton kept carried interest in play as a point of political contention, suggesting that carried interest should be taxed as ordinary income, at rates as high as 39.6 percent plus potential self-employment taxes.

"Because carried interest has been something of a political football—one that affects hedge funds and private equity funds, specifically—it's been a front-burner issue for the investment community," says Musi.

Jerry Musi
Partner,
RSM US LLP

Trump's views are difficult to decipher. In 2015, he said that "the hedge funds guys are getting away with murder" with regard to the carried interest rate. Yet the tax plan he unveiled in the summer of 2016 called for a completely new tax rate of 15 percent for individuals who get income from business partnerships—a definition that covers hedge fund managers. That's actually lower than the prevailing capital-gains rate currently applied to most carried interest income.

↓ CONTINUES ON NEXT PAGE

While raising or eliminating the carried interest tax rate is an easy way for presidential candidates to score political points, recent efforts at changing the status quo have failed. RSM US LLP Partner Rich Nichols says passing such a bill is much easier said than done.

PARTNERSHIP AGREEMENTS

New rules passed in late 2015 will make it easier for the IRS to audit private partnerships. In the past, IRS auditors had to deal with all members of the partnership, meaning that for funds with many limited partners, it had to negotiate and deal with each one. Beginning in 2018, partnerships must appoint a "partnership representative" who will speak for the entire partnership.

The changes also create potential conflicts between current and past members of partnerships. In effect, the new rules make the partnership liable for any taxes due, and that tax gets assessed on the return for the year in which the IRS does its audit, not the year that gets reviewed. One possible result: Former limited partners could be held liable for a tax bill, even if they are no longer invested in the fund.

"Carried interest has been the focus of many bills over the last five or six years, and they've never made it out of the gate."

Rich Nichols
Partner,
RSM US LLP

"That means that limited partners will probably have more demands in new partnership agreements," says Ahuva Indig, RSM US LLP Sr. Manager. "Of course, they will not want to pick up someone else's tax liability."

As such, it's inevitable that many existing partnership agreements will need to be rewritten, and limited partners will demand relevant language in new LPAs.

So the time to plan is now, says Indig. While 2018 is the required date of implementation, a partnership can elect to be subject to these rules for any partnership year beginning on or after November 3, 2015. What's more, under certain conditions partnerships can opt out of the new rules.

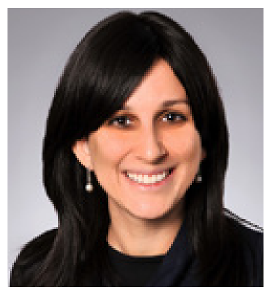
In theory, the law also allows partnerships to avoid any entity-level tax by "pushing out" the liability to the taxpayers who were partners in the year of a partnership understatement. But it is not entirely clear how those rules will operate, particularly for multiple-tier arrangements.

"They'll have to know how it works, and...some partnerships won't have time to educate themselves" if they wait until 2018, Indig says. "There may be some advantage to understanding how these rules work ahead of time."

THE COMMON REPORTING STANDARD

Another adjustment for U.S.-based global hedge funds will be compliance with the Common Reporting Standard (CRS), a global regulation to facilitate the exchange of tax information. The regulations were drafted in the spirit of the U.S. standards set forth in the Foreign Account Tax Compliance Act (FATCA) but don't match them exactly. In other words, many hedge funds will have to spend more time on compliance, says RSM US LLP Sr. Manager Josh Johnson.

The CRS, developed by the Organization for Economic Cooperation and Development, will affect offshore investors, Johnson says.



"The rules are changing, and partnerships will have to learn how to deal with this."

Ahuva Indig
Sr. Manager,
RSM US LLP

"The whole world grumbled when the U.S. came out with FATCA. Essentially the rest of the world then copied FATCA, and now it's the U.S.' turn to figure out those regulations."

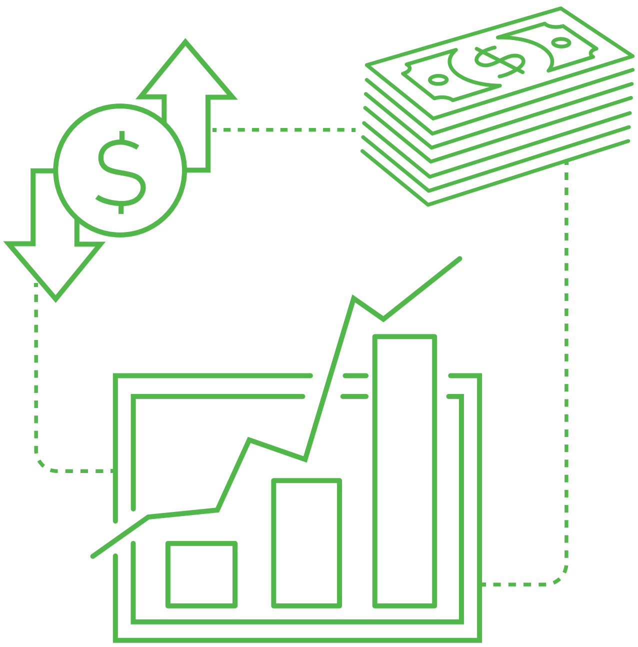
Josh Johnson
Sr. Manager,
RSM US LLP

Investors in the United States may have to meet CRS standards by a December 31 deadline, and CRS rules also call for foreign investors in U.S. funds to comply. While the reporting won't be especially difficult, it will be time-consuming, which could prompt an uptick in hedge funds' hiring of third-party service providers versed in both FATCA and CRS compliance.

"The whole world grumbled when the U.S. came out with FATCA," says Johnson. "Essentially the rest of the world then copied FATCA, and now it's the U.S.' turn to figure out those regulations."

DRIVING HEDGE FUND SUCCESS

SMART INVESTING IS ONLY ONE PIECE OF THE PUZZLE



In today's crowded hedge fund market, where unique strategies and talent are increasingly scarce, it's more important than ever to tend to the basics.

"A great trader may have a deep understanding of their market and be highly skilled at trading their own money, but running a fund as a business is a whole different ballgame," says Lynne Weil, a Partner at RSM US LLP.

Indeed, new managers often struggle to scale a successful investment strategy. Industry data suggests the hedge fund runs between three and five years, and it appears that more managers who don't beat the averages are leaving. Hedge Fund Research reports that 530 hedge funds folded their tents in the first half of 2016, and only 406 launched, putting the industry on pace for the second-largest number of fund liquidations since 1996, and the fewest number of new funds launched since 2009.

So new managers have to beat worsening odds, and in addition to staying on top of their trading strategies, they must attract investors, understand an increasingly complex regulatory and compliance environment, and establish a business infrastructure. If they can set up a sustainable business, they then need to know when they have the right mix of assets and investors to maximize their strategy—often the most difficult thing for a rapidly growing fund.

"The managers that know how their strategies play into what they see in the market, and know when to pull back, are balancing their strategies with their business needs, and that's critical," she says. "Those [managers] that don't have turned their investing strategy into a commodity.

"Just getting launched is a challenge," Weil says. "But it's a smoother process when managers have the right service providers to help."

Preparedness also helps on the operational side, particularly on cybersecurity issues and strong compliance—both criteria that institutional investors focus on when making the kind of commitments that bring starter funds to the next level.

OLD INVESTORS, NEW EXPECTATIONS

Walter Clark, Partner and Chief Operating Officer at RMB Capital Management, a Chicago-based Registered Investment Adviser with $5.2B in assets under management, says the bar continues to rise in a competitive market. Investors want clear indications they're getting the performance they've paid for, and many of them want to negotiate those fees.

"It's getting harder and more expensive, but all these areas need to meet institutional investors' standards," he says. "You now find many more hedge funds that have

↓CONTINUES ON NEXT PAGE

Lynne Weil
Partner,
RSM US LLP

Walter Clark
Partner & COO,
RMB Capital Management

David Bradley
President,
Huizenga Capital Management

institutional-quality businesses, but [only] have adequate performance, or may be charging too much. The funds that are successful are the ones that can thread that needle."

Truly aligning a fund manager's interests with a limited partner's is also a key to success. Using management fees to build and sustain the business side and taking performance fees based on successful investing strategies still strikes Clark as the right model. It's easy enough to discern this by talking to managers about their views and how they line up with prospective investors, he says.

He tries to get a sense of whether a manager is using fees to build a growing business, or simply lining his or her pockets. If they're willing to negotiate fees, it's a good sign that they're stable and well-organized on the business side—and confident enough in their trading strategy to drive growth through performance.

"Half are willing to give you the answer you want to hear right away, but some thoughtful discussion usually demonstrates whether they are genuine," Clark says.

COMMUNICATIONS FOR THE LONG TERM

David Bradley is President of Huizenga Capital Management, a family office and boutique investment firm in Chicago that allocates money to a range of hedge fund managers. His firm engages in frequent discussions with—and about—the managers in which they've invested, testing their investment theses and making sure they're confirmed, both by results and by managerial focus.

The stronger the connection and communication between a fund manager and an investor gets, the more likely they are to foster long-term commitments, re-ups of existing commitments, or additional allocations.

A more sustainable business is able to retain the talent needed to find great investments, which Bradley says is an increasing concern in a competitive market.

"There's a lot more competition for available expertise," he says. "So in addition to focusing on returns, you have to look at the focus of the firm, their ability to stay consistent, and the quality of their process."

Clark says that quality can often be assessed by how a manager reacts to adverse market conditions.

In a crowded, range-bound market, it's rare for a particular investment strategy to yield runaway outperformance. Perfect conditions don't last, but strategic steadiness is a prerequisite for institutional investors, who provide 43 percent of all hedge fund investments, according to Hedge Fund Research. The wisest managers blend focus and flexibility, and those that can operate with strategic leeway to capture market advantages, while hewing to basic disciplines, tend to succeed longer-term, he says.

"Of course, they have to convince you they know what they're doing—a U.S. manager jumping from a long-short, large-cap strategy to emerging markets wouldn't be reasonable, but shifting to small-cap equities might be a good response to a changing market."

RSM's Weil says her experience with new and growing mid-market hedge funds hasn't created a detailed road map for success, but the funds that fare better identify the difference between running investments and running a business, and allocate the right resources to perform each function well.

"The ones who succeed find support and expertise that complements their own. That's the difference between running money and running a business."


We're up to speed, so you can go full speed.
SEE CHALLENGES BEFORE THEY'RE CHALLENGING.
To make confident decisions about the future, middle market leaders need a different kind of advisor. One who starts by understanding where you want to go and then brings the ideas and insights of an experienced global team to help get you there.
Experience the power of being understood. Experience RSM.
rsmus.com

WHY EVERY PARTNERSHIP AGREEMENT NEEDS TO BE REWRITTEN

CHANGES TO U.S. TAX LAW LIKELY MEAN MORE AUDITS OF ALTERNATIVE ASSET CLASS PARTNERSHIPS. DON SUSSWEIN, PRINCIPAL IN THE WASHINGTON NATIONAL TAX OFFICE OF RSM US LLP, TALKS ABOUT THE CONSEQUENCES.

Partnership tax law has undergone significant changes. What's the background?

Don Susswein, RSM: Partnerships and LLCs, or what we call pass-through entities, have really gone through incredible transformation over the last 30 years. Back in the early 1980s, they were a backwater. The only entities that were set up as partnerships were either professional service corporations—lawyers, accountants, because they had to be—or tax shelters.

And a very cumbersome set of audit rules existed primarily to attack tax shelters. However, tax shelters were virtually eliminated in 1986. So for the last 20 or 30 years, we were left with this vast, very complicated infrastructure of rules that actually made it very difficult for the IRS to audit partnerships or LLCs. Part of the problem is that partnerships have not only proliferated, but they have become multitiered entities.

It was almost impossible for the IRS to audit them—and those are words that Congress doesn't like to hear. Everybody knew they had to do something.

What is the biggest change, and when does it take effect?

Susswein: Beginning with the 2018 tax year, the cost and burden to the IRS of initiating an audit of a partnership has dropped precipitously.

Until the new law takes effect, the hurdles for the IRS to successfully and efficiently audit a partnership remain formidable. In theory, the partnership has always been subject to one set of tax rules, and there was only one right answer. But in practice, every partner could take a different position or could hire their own attorney or accountant to negotiate on their behalf.

Beginning with audits of the 2018 tax year, that is no longer the case. The partnership must speak with one voice. It must be represented by one party, and any settlements made with the IRS by that representative bind the partnership and every one of its partners.

The law will require simple technical changes to existing partnership agreements. But are there more fundamental changes that members of partnerships, particularly investors, should consider?

Susswein: There's a whole new set of business issues that are presented, because not only do you have a single representative of the partnership, but that representative may have different interests than you do as an investor.

Let's say you leave the partnership after a couple of years. [Looking at] the interest of current investors and the interest of former investors, it may be the former investors who are going to be hit with a tax bill if the partnership is audited today, because you're audited for past tax years.

So if there's an audit in 2020, they're looking at whether the 2018 tax return was done correctly. You may no longer be a partner at that point, and yet somebody is there making decisions, cutting deals with the IRS as to what your ultimate tax liability is going to be.

Is this all bad news?

Susswein: No, there were some major improvements adopted in the final legislation. It could have been much worse. In theory, the entity can avoid taxation entirely by issuing new K-1s to its partners. But we need to wait for IRS regulations to know how helpful that option will really be.


RSM's financial services practice provides practical, customized solutions to help investment management entities navigate today's challenging economic and regulatory environment.

For more information on RSM, please visit **www.rsmus.com**.

For media inquiries, please contact Terri Andrews, National Public Relations Director, +1 980 233 4710 or Terri.Andrews@rsmus.com.

TL-NT-ALL-FS-1016