Alternative Investments: Investment Allocations | 5 Questions to Ask

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Introduction

Enclosed is the second edition of our white paper mini-series on due diligence red flags in alternative investments. As previewed in the introductory paper, this edition will focus on the process managers use to allocate investment opportunities, i.e., how managers decide which investments go into which funds or accounts. This process, referred to as the investment allocation process, or "allocations" for short, is a critical component to the due diligence process because the interests of the manager and investors are not always aligned. The paper's case study will delve into BlueCrest Capital Management Limited ("BlueCrest," "the Manager," or "the Firm") and the conflicts of interest that existed as a result of inadequate compliance processes governing the allocation of resources between the Firm's flagship fund, that held external client capital, and an internal, employees and affiliates only, fund that ultimately resulted in the Firm agreeing to a $170m settlement with the SEC.

Investment firms typically manage multiple funds where the underlying strategies of those funds have some degree of overlap. For example, a manager may manage, on the one hand, a fund focused on investment opportunities in Europe, and on the other hand, a fund focused on investment opportunities globally. Continuing with this example, the manager must decide, in a fair and equitable manner, how to allocate investment opportunities in Europe between A) the European fund, and B) the global fund, which would also include Europe as part of its investment mandate.

The industry standard, or default, is to allocate investments based on the proportional demand of the underlying strategies. This allocation methodology is commonly referred to as "pro-rata." Sticking with our current example, if the manager identifies an investment opportunity in Europe with $10m of capacity, and the European fund desires $15m of that opportunity and the Global fund wants $25m of that opportunity, then the European and Global fund will receive allocations of $3.75m and $6.25m, respectively[1].

It is imperative for investors to understand the investment allocation process when performing due diligence on an investment manager because interests between the manager and investors can, and often do, conflict within this area. These conflicts of interest can create misalignment between manager and investor, potentially resulting in negative investor outcomes. For investment managers that are registered with the Securities and Exchange Commission "SEC", they are legally bound by their Fiduciary Duty to fairly allocate trades, and where conflicts of interest may exist, must fully disclose those conflicts.[2] Provided below are scenarios where conflicts of interest, as they pertain to investment allocations, often come to light:

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[1] The prorate allocation is defined as the Fund's demand as a proportion of the total demand for all funds ($40m in this example) under the purview of the manager times the capacity of the opportunity. European Fund Allocation: ($10m*($15m/40m))= $3.75m. Global Fund Allocation: ($10m*($25m/$40m)) = $6.25m.
[2] See "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Advisers Act Release 5248.

- <u>The manager charges higher management fees in Fund A vs Fund B</u>: Therefore, the manager is possibly incentivized to place assets with higher expected returns into Fund A vs. Fund B.
- <u>The manager charges an incentive fee in Fund A, but not Fund B</u>: Fund A might be an unregistered limited partnership, a.k.a. a hedge fund, and Fund B might be a mutual fund or UCIT fund version of the hedge fund. In this scenario, the manager can charge significantly higher fees in Fund A vs Fund B, and because of the potential for higher fee income, may be conflicted in equitably allocating investment opportunities between the funds.
- <u>The manager may have a higher proportion of his or her personal capital invested in Fund A rather than Fund B</u>: Alternatively, the firm may have set up a separate investment vehicle specifically for employees and affiliates of the firm. In either situation, the manager may be conflicted in equitably allocating the investment between funds where they have differing ownership levels. In the latter situation, where a manager has created a separate, employee only investment vehicle, the manager may have a material conflict of interest in allocating investments between a fund where they have A) an indirect ownership given the fees they collect and B) the vehicle where they directly own the underlying assets (more on this scenario in our case study!).

Questions to Ask

Given this backdrop, what are some questions that investors can use to either 1) identify scenarios where the allocation of investment opportunities may be an issue, or 2) if an investor has already flagged allocations as an issue, to then determine the severity of the problem? The [introductory paper](), noted some of these questions. They are reproduced below with potential remedies that we have used when conducting due diligence:

1. Q: How do you ensure that the vehicle you are invested in is getting its fair and equitable allocation of investment opportunities?
   - *Request and review the manager's trade allocation policy. For SEC registered investment advisors, this will likely be disclosed in the manager's ADV materials. Additionally, review the allocations of real trades with the manager to see if the actual allocations of various trades are consistent with the policy. When possible, do not let the manager choose the example transaction(s). Instead, pick a trade(s) at random, or, if practical, review the entire trade book.*

2. Q: How do you ensure that the General Partner, or investment manager, is not cherry picking its best ideas and placing those trades in an employee Fund?
   - *First and foremost, you need to ascertain whether an employee vehicle exists. As we will see in our case study, there is no surefire method to accurately answer this question. However, one can use a combination of the following methods:*
     - *Ask the question directly to the manager,*
     - *Examine the manager's regulatory filings for any vehicles that don't contain investors unaffiliated with the investment manager, and*
     - *Review an allocation of actual trades with the manager to see how it was allocated (as described above).*

3. Q: Does the Fund's Limited Partnership Agreement dilute the General Partner's Fiduciary Duty to the Fund? If so, how does that potentially impact deal allocations?
   - *There is an ongoing and non-investor friendly trend in the alternative investment space where the limited partnership agreements ("LPAs") that govern non-registered funds include language that dilutes the manager's fiduciary duty to its investors by disclosing that the manager may act in its own best interest, rather than its*

clients' best interests, in areas where the manager's interests may conflict with those of its clients or limited partners. Any dilution of a manager's fiduciary duty is inconsistent with ILPA guidelines. [3] *Furthermore, the SEC is actively looking into these types of activities and may introduce legislation to limit these practices.* [4]
  - *Where applicable, use legal counsel with expertise in fund structure and operations to review private fund LPAs. Furthermore, it is helpful to continually educate your manager due diligence team on changing rules.*

4. Q: Does the General Partner manage funds with overlapping investment strategies, e.g., a best ideas fund, global fund vs geographic-specific? If so, how are trades allocated amongst these vehicles?
   - *Review the audits or holdings for the funds where strategies overlap and identify common positions. Then review the trade allocations for trades where a manager traded in commonly held names. This exercise can be particularly helpful when funds either initiate or liquidate a position in a given security or company.*
   - *Obtain the specifications of what is deemed a "best idea." Specifically, is labeling a position as a "best idea" made ex-ante on empirical data, or is the manager cherry picking winners on an ex-post basis?*

5. Q: Does the General partner have the right to create parallel funds and other investment pools that might provide preferential treatment to certain trades for a particular investment class?
   - *It is common for LPAs to provide the investment manager with the right to create parallel funds. These vehicles may trade in the same investments as the primary fund. Therefore, it is important to understand how investments are allocated between the parallel and primary funds. In accordance with the ILPA guidelines, the parallel vehicle should have language and provisions, including those regarding fees, that are materially the same as the original fund.* [5] *As we will see in our case study below, it is also important to determine the timing of investments between vehicles.*

Case Study: BlueCrest Capital Management Limited

BlueCrest Capital Management Limited represents a very clear example of the conflicts of interests and negative outcomes that can arise when a manager creates a separate investment vehicle for the exclusive use of employees, or affiliates of the manager, and the manager does not have an adequate compliance infrastructure to ensure prudent investment allocation policies are being followed.

BlueCrest, a London-based hedge fund that, at its peak, managed $36 billion, was forced by the SEC to return $170 million to its investors after the Commission said it prioritized an internal, employee / affiliates only hedge fund, named BSMA, over its flagship fund, referred to herein as BCI, where it managed capital for its outside clients. The following issues are central to understanding the conflicts of interest inherent in this case study[6]:

- BlueCrest's human traders generated most of the firm's historical performance. From 2011 to 2015, defined herein as the "Relevant Period" of the wrongdoing, the Manager reassigned a majority of its existing best performing traders from BCI to BSMA, and then assigned its most promising new hires to BSMA rather than BCI.
- While BlueCrest allocated its high performing human traders to BSMA, it replaced those traders in BCI with an algorithm, called Rates Management Trading, or RMT for short. RMT implemented the trades initiated by the human traders, on behalf of BSMA, on a 1-day trading lag. As you will see when we dig further, RMT materially underperformed the human traders.

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[3] *See* *ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners*.
[4] See "Prepared Remarks At the Institutional Limited Partners Association Summit", Chair Gary Gensler.
[5] *See* *ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners*
[6] Please see *BlueCrest to return $170m to former investors after SEC settlement*, Financial Times, December 8th, 2020; and *The SEC Says your Algorithm is Not Good Enough*, Compliance Building, December 10th, 2020.

- BlueCrest employees and affiliates invested significantly more of their own money in BSMA rather than BCI. Insider ownership of BSMA peaked at $1.79 billion during the Relevant Period, versus $619m in BCI.
- Most surprisingly, and central to the SEC's order, BlueCrest failed to adequately disclose 1) the existence of BSMA, 2) the movement of traders from BCI to BSMA, and the use of RMT within BCI. Furthermore, BlueCrest's executive committee specifically instructed the Firm's Investor Relations department to not proactively disclose BSMA's existence.

To summarize, 1) BlueCrest allocated its best traders from BCI to BSMA, 2) it replaced the human traders in BCI with an algorithm, RMT, that traded on a 1-day lag relative to BSMA, 3) employees of the firm allocated a significant portion of their personal capital to BSMA, and 4) none of these activities were clearly disclosed to investors or regulators. In 2014, due diligence consultants discovered BSMA and RMT, and once they clearly understood the conflicts of interests at play, they recommended that clients redeem from BCI. As a result, BCI suffered significant redemptions, and BlueCrest ultimately liquidated BCI and returned capital to investors. Today, BlueCrest does not manage outside capital.

Let us now delve a bit further into each of the key elements of this case study. The fact pattern displayed below is based upon the SEC's order:

The Allocation of Traders Between BCI and BSMA: When BlueCrest launched BSMA, it transferred six traders from BCI to BSMA. Subsequently, the Manager continued allocating existing, high-performing traders to BSMA from BCI, and as the Manager hired new traders, it assigned the most promising of those traders to BSMA rather than BCI. By the end of the Relevant Period, nearly half of BlueCrest's traders had been transferred from BCI to BSMA[7].

BCI's Allocation to RMT: RMT was designed to replicate the risk profile and profits of BlueCrest's live traders on a T+1, or next day, basis. However, RMT underperformed the live traders both in terms of profit generation and volatility of returns, i.e., RMT had lower absolute returns combined with a higher standard deviation of returns. For example, BlueCrest's own reports showed that RMT's slippage relative to live traders was 60%-75% since inception. In dollar terms, the slippage was $198 million during just the first half of 2014 and $116m during the first five months of 2015[8]. Despite the underperformance, BCI's allocation to live traders decreased from $12.5b in January 2012 to $7.4b in June 2015, and the Fund's allocation to RMT increased from $0b to $7.2b during that same period. Simultaneously, BSMA's allocation to live traders increased from $4.5b to over $22b[9].

BlueCrest's compensation structure created a further incentive for the Manager to allocate investor capital in BCI to RMT. Taking a step back, hedge fund managers typically charge investors 20% of the annual profits generated by a fund. This fee is called the carried interest. BlueCrest paid its live traders approximately 15%-18% of the trading profits they generated as part of their annual bonus. However, BlueCrest did not have to allocate part of BCI's carried interest to their personnel that managed the RMT trade replication process. As a result, BlueCrest could retain a greater percentage of performance fees[10].

Lack of Disclosures: Prior to 2014, BlueCrest did not disclose the existence of BSMA, nor did they disclose BCI's increasing reliance on RMT in any of the firm's due diligence questionnaires ("DDQs"), investor letters, investor presentation or other marketing materials[11]. Instead, the Manager advertised the performance of its live traders to prospective BCI investors but failed to disclose that many high

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[7] Please see paragraphs 15-17 of the SEC order.
[8] Please see paragraph 43 of the SEC order.
[9] Please see paragraph 24 of the SEC order.
[10] Please see paragraph 28 of the SEC order.
[11] Please see paragraph 49 of the SEC order.

performing traders had been transferred from BCI to BSMA. For example, BlueCrest's 2012 DDQ stated that "traders actively manage portfolios and dramatically adjust positions in real-time," while in actuality, 24% of BCI's capital at the time was managed through RMT[12].

In terms of regulatory filings, BlueCrest did identify BSMA in Parts 5 and 10 of its Form ADV Part 2A brochure. BlueCrest then omitted BSMA in its next brochure filing on July 10th, 2012 and continued to omit BSMA in all subsequent filings during the Relevant Period. BlueCrest followed a similar pattern of disclosing BSMA in its Form ADV, i.e., it initially disclosed the Fund in March and July of 2012 but then omitted the Fund from all subsequent filings[13]. The reasoning behind the decision by BlueCrest to initially disclose BSMA and then omit the Fund from its regulatory filings is unknown.

Unearthing of BSMA: A due diligence consultant working on behalf of an institutional investor discovered BSMA while conducting an onsite examination of the Manager in January 2014. A BlueCrest employee told the consultant that BMSA was a "partner retention vehicle" with roughly $1.5b in AUM. BlueCrest declined to respond to the consultants follow up questions regarding BSMA's traders and historical performance, and as a result, the consultant downgraded their rating of BlueCrest on the grounds that 1) BlueCrest failed to disclose BSMA, 2) the potential conflicts of interest presented by BSMA, 3) the *possibility* that high performing traders were being allocated to BSMA, and 4) the potential that investors in BCI were not receiving the full benefit of BlueCrest's investment expertise, even though, they were paying for their expertise via market rate management fees, carried interest and fund expenses[14].

RMT was subsequently discovered by a second due diligence consultant in March of 2014, as part of BlueCrest's response to that consultant's concerns that high-performing traders were being allocated to BSMA. BlueCrest, however, failed to disclose to that consultant that BlueCrest had indeed transferred numerous traders from BCI to BSMA and that RMT had lower returns and higher volatility than live traders[15]. Both consultants communicated to clients that they were unable to sufficiently assess the conflicts of interest posed by BSMA and downgraded BlueCrest to "uninvestable." As a result, investors submitted redemptions. AUM in BCI dropped from $13.9 billion to $9.4 billion during 2014. After further redemptions in 2015, assets declined to $2.2 billion, and BlueCrest decided to ultimately shut BCI down and stop managing external client money[16].

The BlueCrest case study highlights several items of note from a due diligence perspective. Provided below are our key takeaways:

- Onsite Reviews: Onsite reviews are still important, particularly in open end hedge funds. Due to COVID-19 and the advent of video technology, many managers and investors are increasingly relying on "virtual" due diligence meetings. While meeting virtually is more convenient, and often sufficient, the onsite examination should remain an important part of the due diligence process, particularly in terms of initial investments in hedge funds.
- GP Commitment: Understand and, to the degree possible, obtain access to where the top employees and portfolio managers of an asset manager have invested their capital. Is their capital invested alongside yours? As we saw with BlueCrest, this question was central.

[12] Please see paragraphs 52 and 53 of the SEC order.
[13] Please see paragraph 45 of the SEC order.
[14] Please see paragraphs 55 and 56 of the SEC order.
[15] Please see paragraph 60 of the SEC order.
[16] Please see paragraph 62 of the SEC order.

- Analyze Trade Allocations: The due diligence process should include a thorough examination of actual trade allocations. Sitting with a trader or middle office professional and seeing actual trade allocations is invaluable.
- Changes to Regulatory Filings: Investors should closely monitor changes to regulatory filings. Thankfully, services now exist that can easily identify the changes to a manager's ADV filings.
- Trust, but Verify: While this is cliché in due diligence, you shouldn't take the word of the manager or their IR department as gospel. Review the materials and ask the questions. Due Diligence is hard work, but valuable to a level that can't always be priced until something goes wrong.

Upcoming Paper - Valuation

"*All successful investment involves trying to get into something where it's worth more than you're paying.*" – Charlie Munger.

From the words of famed investor, Charlie Munger, valuation is central to the investment process. Accordingly, it is important to understand the process a manager undertakes to determine that valuation and how that valuation is used in the operation of the fund. In our next segment we will dive into valuation methodology, review Fair Value Measurement, discuss best practices, walk through a few case studies and arm you with questions to consider in your due diligence process so you can better identify potential investor/manager conflicts related to valuation.

If have any questions or would like to learn more, please contact us.

Disclosure

This article was written for and published on the CAIA blog.