CUMMINGS PEPPERDINE ON MANAGED ACCOUNTS

INTRODUCTION

Managed account structures have been in demand for a number of years in certain markets, including commodities, for the benefits they provide in terms of greater transparency and liquidity.

In recent years there has been an increasing activity in the world of managed accounts, including with new players coming in from the world of crypto/

Managed accounts offer investors an opportunity to invest in particular assets and particular strategies on a customised basis, while retaining control over their own assets.

The move to managed accounts has led to a rise in managed account platforms as a new investment structure, as the extra reporting and controls provided by the platforms address investor demands for flexibility.

Below we look in more detail at managed accounts.

MANAGED ACCOUNT STRUCTURES

Managed accounts structures often fall within the following:

- dedicated or separately managed account;
- co-mingled managed account; and
- managed account platforms

(i) Dedicated or separately managed account

Dedicated managed accounts are set up for a single investor, either by the investor themselves or by a managed account

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provider. The managed account can be tailored to the investor's requirements on matters such as legislative framework, domicile, regulation, legal arrangements, taxation and local service providers.

The investor opens accounts with independent third party service providers and employs a manager to make and execute the investment decisions on their behalf. The account is then traded by the manager subject to the terms of a managed account agreement entered into by the investor and the manager and the agreement will set out the investment objectives and restrictions imposed by the investor.

The design of the managed account will need to take into account the legal structure of the account, governance, a detailed overview of roles and responsibilities of all parties involved, risk appetite and the availability of resources. Although the lead-time to launch a dedicated managed account can vary, it can generally take up to three months to negotiate the managed account agreement and to appoint (and negotiate the terms of appointment of) the other service providers.

(ii) Co-mingled managed account

The co-mingled account looks more like a traditional hedge fund structure, as a number of investors buy interests in a vehicle which is managed overall by an independent third party responsible for overseeing all operational aspects, with portfolio management delegated to and provided by the manager. As all investors invest in the same vehicle, the investments of the investors are effectively co-mingled. As the managed account is a separate legal entity, the assets are ring-fenced and there is no risk of contamination across other managed accounts.

Important considerations for the managed account holder include the reputation of the provider, the creditworthiness of the provider and its parent (if applicable), the governance of the provider, the operational set up, coverage of strategies, risk management and reporting.

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iii) Managed Account Platforms

A managed account platform is operated by a managed account platform provider which puts in place agreements for portfolio management with managers, and then markets the funds of those managers to investors. As with the different managed accounts structures available, different types of managed account platforms are available:

- customised managed account platforms, similar to the traditional fund of fund model;
- co-mingled managed account platforms; and
- platforms offering a selection of pre-selected, due diligence-screened managers from which investors may choose for their investment.

UCITS managed account platforms are available, but the added value of a UCITS platform compared to a non-UCITS managed account platform does not always attract investment since fortnightly liquidity, transparency and advanced risk management are already deemed to be the advantages of a UCITS fund.

The platform provider operates the platform and manages the various service providers and managers, thereby reducing the expertise and manpower needed by the investor.

Each managed account will normally have the same market counterparties as the reference fund, but the platform provider will generally have the same operational set-up and arrangements in place with all managers and service providers, the same pricing policy and the same service level agreements. This can lead to fee reductions due to economies of scale, limitation of operational risk and more efficient and effective monitoring of the service providers.

If structured correctly, it is possible for managed accounts to fall outside the AIFMD, in which case MiFID II may be applicable legislation in the UK.

ADVANTAGES OF MANAGED ACCOUNTS

The main advantages of investing via a managed account can generally be regarded as follows:

(i) Governance and control

The managed account is governed by the managed account holder rather than the hedge fund manager, which means that the holder retains control over the assets and potential conflicts of interest, such as fraud, liquidity and transparency, are mitigated as the trading of the assets is segregated from the valuation, accounting and custody of those assets. Some investors favour this, viewing it as attractive following fraudulent cases such as Madoff, which raised serious questions about, among other issues, the level of control investors had over their investments. The holder or an independent third party is responsible for managing the operational aspects of the account, such as risk management, monitoring investment limits and cash management, which provides additional oversight and thereby reduces potential operational risk.

(ii) Increased transparency

Most managed accounts offer transparency which may be greater than that offered by hedge funds, and this allows the holder to monitor the performance of the portfolio, including daily profit and loss and net exposures, and provides the holder with the opportunity to detect issues such as any potential style drift and increase in leverage. It can also enable investors to have a better understanding of their investments and, where the information is accurate, reliable and comprehensible, to be more aware of the potential operational and management risks.

(iii) Enhanced liquidity

In recent years the issue of the reduced liquidity of some hedge funds has caused investor concern, in particular where activating gates has prevented investors from redeeming the investment for certain periods of time. Managed accounts generally have the flexibility to offer more liberal liquidity terms, often with daily redemptions. In addition to this, the holder is generally able to replace the manager and liquidate the portfolio in emergency situations, depending, of course, upon the liquidity of the actual investments.

(iv) Flexibility

The structure of the managed account can be customised to suit the investor's needs and this flexibility continues to be an important issue for investors. In addition to the factors above, such as increased transparency and enhanced liquidity, a managed account enables the holder to select its own service providers, set its own risk parameters and, depending upon the assets under management, can provide the possibility of negotiating reduced management fees. The introduction and development of managed account platforms has also meant that investors have the opportunity to invest in a diverse variety of hedge fund strategies.

(v) Notional funding

An important characteristic of managed accounts is the use of notional funding, which allows investors to leverage their investment. A managed account offering notional funding permits an investor to put up only a portion of the minimum investment, which will generally range between 25% and 75% of the minimum investment, with a trading level to be mutually agreed. As a result, however, notional funding can add significant risk to a managed account and investors who wish to use such funding are usually required to sign disclosures stating that they understand the risk involved.

DISADVANTAGES OF MANAGED ACCOUNTS

(i) Cost

A disadvantage often cited in relation to managed accounts is the additional costs involved, which vary depending upon the type of managed account structure adopted and the strategy traded within the managed account. For example a dedicated managed account will incur higher operational costs than a commingled managed account. If investing via a managed account platform, the platform will charge a platform fee, though some platform providers are able to negotiate lower service provider fees which can provide a counterbalance. In addition, a dedicated managed account may be able to negotiate lower management and performance fees, whereas a platform provider may be able to apply different fees for large institutional investors.

(ii) Tracking errors

A common downside of managed accounts is the risk of tracking error between the managed account and the reference fund. This may arise as a result of difference in investment restrictions, timing in the launch of the managed account and fund hence differences in positions held, management and performance fees, pricing/valuation policies, cash management policies or as a result of operational issues, such as administrative errors or settlement issues.

(iii) Most Favoured Nations

The flexibility of managed account structures means that many investors seek "most favoured nation" clauses in their managed account agreements. These may give greater rights to managed account holders than investors in the reference fund, in particular regarding the supply of information and the right to redeem, which investors in the reference fund might feel disadvantages them, causing problems in asset raising for funds. In addition, the use of "most favoured nation" clauses may have regulatory implications which need to be considered carefully.

(iv) Operation of functionaries

One of the main disadvantages of the managed account is the shift of responsibility to the managed account holder. In a traditional hedge fund, the manager generally controls or co-ordinates all the functions needed to operate the fund, liaising with the other service providers, such as the administrator, auditor and prime broker and custodian, as necessary. In a managed account, if the manager takes on a pure portfolio management role, then the functional role passes to the holder, which creates new risks that need to be managed by the holder and requires the holder to understand the hedge fund management process and what is required of them in establishing and overseeing the programme.

(v) Challenges for the manager

From the manager's point of view, being part of a managed account platform can present a number of challenges, for example: (a) having to accept certain limitations on their ability to use leverage or gain exposure to certain derivatives or illiquid securities or to engage in OTC derivatives trading; (b) adopting the platform's pricing policy in place of their own internal pricing policy which may have evolved over a period of time with the fund administrator; (c) in some situations assuming liability for the NAV calculations if they have to sign off the NAV produced by the administrator; and (d) if not already in place, introducing pre-trade compliance checks to prevent a breach of investment limits.

Finally, some hedge fund strategies may simply not be appropriate for a managed account structure, particularly illiquid strategies or strategies that invest in SPVs which can not offer full transparency.

MANAGED ACCOUNT PROVIDERS

As the managed account market is growing, so the number of providers of managed accounts are growing, but they can generally be categorised as follows:

- banks;
- independent asset management companies;
- administrators or custodians; and
- fund of hedge funds (i.e. funds of hedge funds which initially invested in dedicated managed accounts set up by themselves, which are then opened up to other investors).

CONCLUSION

Managed accounts are becoming an increasingly sizeable part of the hedge fund arena, largely as a result of their inherent flexibility, strong operational oversight and the benefits of enhanced liquidity and greater transparency. Managed accounts do, however, require a significant change in approach from both the investor and the manager. Investors should be aware of the shift in responsibility on the operational side from the manager to them and the need to fully understand their requirements and their own capabilities, while managers may have to accept tighter controls around trading, liquidity and investment allocation placed upon them.

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