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FEATURE

M&A and Private Equity Investments in Asset Managers: An Introduction to the Deal Process and Due Diligence

SIDNEY WIGFALL, ESQ. (FOUNDING-MANAGING PARTNER, SC ADVISORS/SBF CORPORATE ADVISORS) &
STACIE YATES (MANAGING DIRECTOR-GENERAL COUNSEL, PROCTOR INVESTMENT MANAGERS)

I. Background & Industry Context

Asset management firms that manage institutional assets in the form of pension funds, mutual funds, and hedge/alternative funds have again become active M&A and minority-stake investment targets in recent years. One need only review the M&A and investment deal reports and surveys which are periodically produced by those M&A and strategic advisory firms that focus on the investment management sector, including Berkshire Capital, Putnam Lovell, Grail Partners, Colchester Partners, Cambridge International, and, on a more limited basis, Freeman & Co. with its alternatives/hedge focus. For 2006, the year set the new all-time high-water mark for M&A and investment deals in asset management which involved \$44 billion spent to acquire, merge with or invest in 191 asset management firms with more than \$2.6 trillion in assets under management. While it is acknowledged that two deals—Legg Mason/Citigroup and BlackRock/Merrill Lynch—accounted for a significant portion of 2006’s record-breaking deal stats, asset management deal activity during the first half of 2007 shows no signs of slowing with the best ever half-year deal levels of 110 asset manager transactions with a combined disclosed deal value of \$32 billion (Berkshire Capital, *Investment Management Industry Review—2007*; Putnam Lovell NBF Securities, *Rolling Out the Red Carpet: A Blockbuster Year for Fund Management M&A, 2006*).

Significantly, the level of M&A and minority-stake investing deal activity primarily reflects strategic and financial investors in the asset management industry executing one of the five viable asset manager business models as identified in industry reports over the last four years from industry consultants, Casey Quirk and McKinsey & Co. (Casey Quirk & Merrill Lynch Financial Institutions Group (MLFIG), *Success in Investment Management—2003 (Oct. 2003)*; McKinsey & Co., *The Asset Management Industry: A Growing Gap between the Winners and the Also-Rans (Oct. 2006)*). Also, acquirors and investors are enticed by the opportunity to tap and leverage an increasingly prevalent preference for specialized and boutique-driven money management services as the “alpha-beta separation” accelerates and as various types of institutional funds and targeted asset pools continue to grow. Adding to these dynamic trends is an expanded pool of potential target asset managers fueled by larger numbers of boutique and smaller-midsized adviser firms that are in need of additional resources to grow and would benefit financially through partnering with another asset management firm or significant investor to generate greater economies of scale.

Despite the various deal motivations on both sides, M&A and minority-stake investment deals involving asset management firms pose special issues that go beyond the typical M&A or investment transaction given the unique, complex nature of the advisory business. Any acquirer or investor engaging in such deals must recognize and understand: (a) the inherent fact that an adviser firm's primary assets are advisory contracts with clients that may be terminated by the client at will generally and may only be assigned or transferred in the context of most deals via client written consent; (b) that an advisory business is a fiduciary-focused, personal service business with revenue and earnings primarily dependant on the efforts of individual investment professionals or small teams of such professionals; and (c) the overlapping and complex regulatory and compliance framework governing investment adviser firms and registered investment companies (or mutual funds) under the Investment Advisers Act of 1940 (Advisers Act) and the Investment Company Act of 1940 (ICA).

II. Deal Format Groundwork

Creating a clear view of what each party is seeking and willing to accept will make the completion of the deal and ongoing relationship more successful and rewarding.

In our experience, the term sheet is the most important document of any acquisition deal. The reason for this is that a clear and comprehensive term sheet lays the framework for the drafting of your deal documents and the relationship you are about to begin with your new manager or investor. When both parties hammer out those issues it believes are important at the beginning of the discussions, you will save money in legal fees and time as well as understand what role each party will play once the deal is consummated.

Most asset management professionals tend to rush through this phase of their discussion to get closer to a closing and the actual investment, but, by rushing through this phase of your discussions, there will be ambiguity in your documents once you reach the drafting phase of the deal. For example, an asset manager agrees to pay distributions on a quarterly basis of up to 45% of its net income. Most people would say at the end of the quarter I am owed 45% of the profits, but when and how much of a profits-payment is to be made can be intended differently. The language says up to 45% of the profits; the manager could decide to only pay out 10% or 30%. He or she is not required to pay 45%. In addition, is the payment to be made within 30 days of quarter end or is it 45 days or is it whenever they decide to pay you? The language above is not clear and can lead to discontent among the two parties, especially when the investor is expecting a financial payment each quarter for 45% of the profits and such investor does not receive payment. If, however, it was agreed that the manager pays distributions to all investors on a quarterly basis of no less than 45% of its net income within 30 days of quarter end, there is no misunderstanding as to how much the investor will receive and when the payment will be made. Clarity in your terms means less time and money spent at a later date on what you agreed to with the other party.

Although it is easy to say that you should hammer out all the terms of your agreement in the term sheet, depending on your position in the deal or the timing, you may not be able to be as comprehensive as you would like. Therefore, there are, at a minimum, three key terms that must be clearly defined before a term sheet is signed and drafting begins. They are valuation, timing and calculation of distributions, and governance.

1) Valuation. This seems like a straightforward point, but both parties are going to have different ideas on how a company is valued. There are inherent conflicts on how the two parties value a company. The asset management firm will almost always believe its company is worth more than what the M&A buyer or minority-stake investor is willing to pay and the investor will almost always want to more of a

company for a lesser price. As such, both parties need to truly understand how the value of the company is being determined. Is the value determined as a multiple of EBITDA (earning before interest, taxes depreciation and amortization) or is by using asset-base vs. performance revenue streams? Each means something different and will be reflected in how the investor classifies its investment in its portfolio and how the manager values itself for future events. This is critical especially if there is an option for the investor to purchase more of the company at a later if certain hurdles are met.

2) Timing and Calculation of Distributions. How and when a distribution/payment is made seems like an easy conversation, but it usually requires some negotiation between the two parties to come to an agreement as to when the payment should be made. Again there is an inherent conflict between the two parties' goals. The asset manager wants to retain as much money in the company as possible, whereas the acquiror/investor wants to show a return on the investment as quickly as possible. Therefore when you are negotiating your term sheet, it is necessary to clearly define when distributions will be paid and how these distributions are calculated.

As discussed in our example above, clearly defining the amount of a distribution to paid, whether it is up to a certain amount or a minimum amount will allow both parties to properly plan for its financial budgets and working capital. If a manager knows that it has to pay out 45% of its profits to its investors, the manager will be able to properly plan on the remaining profits will be used by the company. For example, it allows the manager know how much capital it has to make additional hires, software and hardware upgrades and/or building of working capital reserves. Similarly, the investor will be able to properly budget its revenue stream on its investment. In both cases, the two parties will be able to determine whether the deal is beneficial from a business point of view. If either party is required to either pay out too much or receive too little, it may not make sense for one or both of the parties to enter into the agreement; therefore averting a lot of discontent later down the road.

3) Governance/Management: As an investor are you passive or active? As an asset manager do you want an investor to have a say in your company? These are important concepts that must be hammered out before the deal is done. If one party is expecting to have day-to-day input and the other is not, then there will likely be problems.

The ability to obtain governance or management rights typically depends on the size of the asset manager and the investment. An investment in a newer manager will generally allow an investor to obtain greater governance rights, whereas a more established asset manager with a stable asset base is most likely to negotiate less involvement by the investor in the way a company is run.

Regardless of the size of the asset manager or investment, there are certain governance rights for which an investor should require its written consent. They are:

- ❖ Materially changing the nature of the business;
- ❖ Liquidating or dissolving the Company except as described in the dissolution section of the company's operating agreement;
- ❖ Alter employment agreements for key personnel (including replacement of terms, increase in compensation and non-competes);
- ❖ Authorization of additional stock/interests that would cause dilution of the investor's investment;
- ❖ Increase in the company's operating budget over a certain percentage; and
- ❖ Actions that would materially adversely affect the rights, preferences or privileges of the investors in the company.

Other areas that should be addressed in your term sheet are:

- ❖ Key personnel employment agreements;
- ❖ Exit strategies (what is the min/max amount of time the investment will stay in the company);
- ❖ Non-competes/non-solicitation of clients and employees;
- ❖ Timing on when the close is expected to occur; and
- ❖ Determination of whether additional products for investment and/or distribution capabilities are part of the deal.

There are many other items that could be considered, however, those items will be dependent on the nature and structure of the deal.

III. Key Legal/Regulatory Matters & Related Deal Considerations

Buyers/Sellers of asset management firms as well as significant minority-stake investors in such firms must have a basic knowledge and understanding of the special legal and regulatory requirements governing such investment firms and their businesses and operations. In particular, the Investment Advisers Act of 1940 (Advisers Act) and its related rules and regulations as adopted by the SEC are of paramount importance along with any SEC rule interpretations via its no-action letter guidance and/or exemptive application/order process. In the situation where mutual/registered funds are involved in the acquisition/investment deal, the Investment Company Act of 1940 (ICA) becomes relevant, and similarly where commodities, futures and certain derivative investments are involved, CFTC-NFA rules and regulations governing commodity trading advisers and commodity pool operators need to be accounted for in early stage deal structuring and planning.

One key early and ongoing consideration is to fully evaluate and understand the legal consequences and scope of impact of a “change in control” of the target adviser so that all necessary actions are taken and the timeframe for the transaction is properly developed. Also, asset manager deals may raise special legal and regulatory issues on the buy-side, which will need to be addressed and managed on a parallel deal track. Lastly, due diligence reviews must be thoroughly performed, especially in light of ongoing SEC scrutiny of investment advisers compliance programs, conflicts-of-interest, and related policies and controls.

A. Advisory Contracts/Assignment, Change in Control & Client Consents

Given that adviser firms are personal service businesses and advisory contracts are fiduciary-based personal service contracts, M&A or investment deals involving asset management firms frequently trigger an “assignment” of its investment advisory contracts to the new owner or ownership group. Whether an assignment has occurred or will occur typically turns on the presumptive SEC investment threshold change of 25% or more of economic or beneficial ownership of the asset manager. Where there will be a transfer or change of financial interest of 25% or more, an assignment occurs and then consideration must be given to the language in the assignment section or clause of all of the asset manager’s advisory agreements. If the assignment language contains “written consent”, then the adviser must obtain the affirmative written consent or approval of each client whose advisory contract provides for such as part of closing the M&A/investment deal. However, where the assignment language does not contain an express reference to “written consent,” verbal consent and/or consent by silence and inaction may suffice to complete the transfer of an advisory contract as part of an asset manager deal.

Where such 25% change or transfer of ownership is not the case, no assignment is triggered and no advisory client consent or approval is necessary, whether written or otherwise. Also, in the scenario where there is a 25% or greater change in beneficial ownership of the adviser firm, the SEC has some limited discretionary leeway through its no-action letter or exemptive relief request-process to find that there is still not an “advisory contract assignment” triggering the need for advisory client consent. The SEC exercised such leeway and interpretive guidance in the JP Morgan 45% strategic alliance/partnership with American Century Investments.

This overall, threshold evaluation and planning process is key in M&A/investment deals involving asset management firms because not adhering to these related standards could trigger several adverse deal impacts. Such effects include breach of advisory contract or fiduciary duty, violation of SEC rules governing advisory contracts, non-transfer of the advisory contract to the new adviser firm, likely re-pricing of the deal and slowdown of deal timetable to close, and potential deal abandonment/unwinding.

B. Advisory Contracts: Mutual-Registered Fund Clients

Under the ICA, an advisory contract with a mutual fund or registered fund (investment company) terminates automatically where an assignment occurs, and an acquired adviser firm is generally precluded from continuing as the adviser to client mutual funds after a change in control. However, the adviser firm would be able to continue as funds adviser where both the funds’ board of directors and fund shareholders first approve a new fund advisory contract after the drafting, filing and distribution of an SEC-compliant funds shareholder proxy and information statement. Such proxy-information statement must disclose the M&A/investment deal and its general parameters and seek fund shareholder approval of the new advisory contract upon the approval and recommendation of the funds’ board.

Also, given the longstanding prohibition against a fiduciary (such as an adviser firm) from selling its office for personal gain in light of the nature of the fiduciary relationship, consideration is warranted as to whether to structure the deal to bring it within the safe harbor under the ICA which permits keeping profits from selling a fund adviser firm.

C. Distribution Arrangements: General & Fund Clients

As with advisory contracts, distribution agreements should be reviewed generally with a view towards assignment and/or change in control language in order to plan for and secure any necessary approvals or consents in connection with the deal closing. In the case of distribution/12b-1 or underwriting agreements with client mutual funds, such agreements terminate automatically upon assignment or a “change in control” of the adviser firm, and new fund distribution or underwriting agreements must be approved by the funds’ board of directors (but not the funds’ shareholders). However, the termination of the funds’ 12b-1 distribution plan itself is not required, and such fund distribution plan may be continued in its current form.

D. Key Employment Agreements and Client Retention/Protection Agreements

Terms and general structure of key employment agreements are not impacted by governing adviser regulations as a general matter and are typically subject to negotiation and state contract law. Related retention and incentive programs and structures, such as restricted stock, earn-outs, unrestricted shares coupled with liquidated damages, retention pools and other “golden handcuffs,” may be driven mainly by tax law issues.

Conversely, client retention or protection agreements in the form of non-competition or non-solicitation agreements may be deployed. Such agreements should be reasonable as to time, scope and geography to be able to withstand any legal challenges and provide the desired advisory business benefits.

E. Protection of Proprietary Investment Management Processes and Intellectual Property

To the extent that the asset management firm relies upon proprietary and/or patentable investment management methods and processes, the terms of any firm and staff confidentiality agreements, related descriptive materials, and any filings or submissions to the government's patent-trademark agency will need to be understood early in the deal process. If such agreements are not in place or are not sufficiently constructed, an assessment should be made of whether this is a deal breaker or merely a valuation discount item to address the risk of the firm's proprietary investment methods walking out the door with the firm's human capital at the end of a market day and being used as part of launching a new firm or diversifying the portfolio-product platform of another existing, and potential competitor, asset manager.

F. Investment Performance Presentation & Portability

Linked to the business side issues of marketing and operations are investment performance presentation and portability of that performance. Performance presentation is generally governed by GIPS (Global Investment Performance Standards), the CFAI (Chartered Financial Analyst Institute), and SEC rules, interpretations, and cases relating to performance advertising or marketing.

Portability of investment performance in general—including the “lift-out” of a portfolio management team or portfolio manager to a new or existing adviser firm—presents several significant issues which ultimately tie back to key deal considerations. Such issues that need to be grasped and mastered promptly in the deal structure and timetable are numerous conflicting duties, fiduciary obligations, SEC/regulatory requirements, and the CFAI standards, including its Code of Ethics, Standards of Professional Conduct and GIPS. Further complicating such an M&A deal is the general principle that investment performance is earned and therefore owned by an asset management firm, not an individual. Accordingly, in order for the acquiring adviser firm that claims GIPS compliance to use the investment performance track record earned at the firm from which the investment team or professional was acquired and/or “lifted out,” the acquiring firm must meet all of the performance portability requirements of both the SEC and CFAI's GIPS standards, which can present some high hurdles. However, appropriate early-stage deal structuring and planning can ease the process of managing such portability of performance standards.

G. Disclosure Brochure/Document and Fiduciary/Ethics Code

A thorough review and understanding of the target adviser firm's current disclosure brochure/document (or Form ADV—Part 2) is warranted to fully appreciate the adviser firm, its business model, actual/potential conflicts-of-interest, its client base and related disclosures. Also such a review will allow for a preview of what the combined post-deal firm will look like, and the disclosure brochure or ADV-2 provides the best window to obtain this preview. While it is not required for the asset manager's disclosure document to be filed with the SEC, all asset managers are required to maintain internally a reasonably current disclosure brochure. To a lesser extent, an asset manager's code of ethics or fiduciary code of conduct plays a similar role

in providing a partial window into a manager's understanding and appreciation of its inherent fiduciary culture and commitment.

H. Investment/Financial Industry Affiliations

Where an investment or financial services firm is the M&A partner or minority-stake investor, consideration should be given to both pre-deal and post-deal investment firm corporate affiliations. At a minimum, such affiliations and potential conflicts-of-interest must be disclosed in Form ADV-1 and ADV-2 (or disclosure brochure). More importantly, with heightened SEC compliance program rule requirements, such matters must now be made part of all adviser firms risk assessment process and then related conflicts-of-interest must either be eliminated or mitigated and managed within the post-deal advisory firm structure, operations, and internal controls.

I. Compliance/Risk Management & Compliance Representations, Warranties and Covenants

The adoption of the SEC's comprehensive compliance program rule has significantly raised the stakes in appropriately gauging deal interest and related deal planning. If compliance or risk management issues exist in an asset management firm, full, comprehensive disclosure and early evaluation are warranted given that such issues can potentially curtail deal interest, impact deal closing, and affect deal pricing/valuation where material compliance matters are involved. Even where deal interest remains strong, compliance representations, warranties, and covenants are becoming more prevalent as part of the deal negotiations and documentation, and are being increasingly tied into customary risk/liability allocation mechanisms, such as indemnification, reserve pools, escrow baskets, and other similar structures.

IV. Acquisition Agreement

Once the term sheet outlining all of your important deal points has been agreed to and the legal structure of the deal has been decided, it is then time to begin drafting your acquisition agreement otherwise known as the purchase agreement. The acquisition agreement sets out in a legal document all of your rights and obligations as either the seller or buyer. If there is ever a question as to what was purchased, how much was purchased, or what you were promised as part of the deal, this is the definitive agreement that will address those issues and act as the roadmap to determine one's rights and obligations.

The acquisition agreement traditionally consists of the following sections: Purchase and Sale; Representations and Warranties of the Seller and Buyer; Conditions to the Purchase and Sale; Covenants; and, Indemnification. Each section will outline each party's obligations.

Purchase and Sale: This section of the agreement will typically outline (i) price; (ii) amount purchased (what the seller is giving in return for the buyer's payment), (iii) what is being purchased (voting or non-voting interests or both), and (iv) how the payment is to be made (wire transfer, check, etc).

Representations and Warranties: This section is usually more important to the buyer than the seller. The reps and warranties section gives the buyer assurances from the seller on certain aspects of the business or deal. Traditional items that the buyer will ask the seller to represent and warrant are the following: (i) the interests/shares the buyer is receiving in return for an investment is free and clear of

any liens or other claims; (ii) the transaction is authorized by the company and its officers and/or board; (iii) the seller is a company of good standing; (iv) the information provided to the buyer is accurate and complete (specifically due diligence materials such as financials and client account information are proper representations of the company's financial condition); (v) the seller has not made material changes to its business model or increased its expenses (i.e., increase salaries for various personnel); (vi) no known fraudulent activities; and (vii) there are no known material changes anticipated prior to purchase that may make the buyer question the purchase and/or the price (i.e., anticipated or known loss of seller's largest client).

The buyer typically assures the seller that it is a legitimate entity or investor that can legally and readily invest in the company as agreed to in the term sheet and the acquisition agreement.

Conditions to Purchase and Sale: Each party will generally require the other to provide certain information before the actual "closing" or transfer of money for interests. At this time the Buyer will outline a list of items that it wants before or at the time of the closing. Typical items that a buyer will require the seller to complete prior to closing are the following items:

- Represent that all of the Representations and Warranties are accurate;
- Performance in all material respects with the agreements and covenants;
- Confirmation that the Seller is not aware of any changes to the condition of the business;
- Authorization to enter into the agreement;
- How the money will be used;
- Changes to all organizational documents are complete (i.e. the Operating Agreement, Limited Partnership Agreement or By-Laws);
- Employment Agreements are in place for key personnel of the Seller;
- Key Man Insurance for key personnel of the Seller;
- All compliance documents are updated and in place (i.e., compliance manual, business continuity program and ethics training policy);
- Obtaining any releases from former partners or investors, if any; and,
- Appointment of any board member or officer.

The seller will typically want the Buyer to affirm that its reps and warranties are accurate; that it will perform and comply with all agreements in all material respects; and that it will enter into any needed organizational documents such as signing the operating agreement or limited partnership agreement.

Covenants: This section is a list of promises that the seller will perform as needed. This is also where a party may require the other to perform certain actions after the closing date due to time constraints or feasibility of the action such as annual audits, on going financial information and performance information.

Indemnification: This is probably one of the most important sections of the agreement. The indemnification section outlines at what point a party is required to compensate the other party for a breach of contract. This section will also lay out what your level of care is within the agreement. This section will address whether a party is liable for negligence, mistakes or willful misconduct or gross negligence.

A final area that should also be closely reviewed is the definitions section. Not all agreements define terms within the body of the agreement. There are times, when certain terms are defined elsewhere in the agreement. Using the term sheet as guidance, your definition section will include standard terms and their definitions, but will also have agreed upon variations of certain terms. For example,

the definition financial statements may mean audited or un-audited statements. Similarly, does knowledge mean an officer's knowledge or that of an employee?

Either party to an acquisition agreement will have its own concerns that must be addressed. To help alleviate some of the stress and costs that will come with the drafting of an acquisition agreement, the parties to the contemplated deal should make sure the deal's term sheet is clearly drafted and accurately reflects the deal points. This will allow the first draft of the acquisition agreement to be drafted more quickly and comprehensively (usually by external legal counsel to one of the parties). It is important to note that once the acquisition agreement is signed, it takes the place of the term sheet; therefore it is very important to make sure that the deal points agreed to in the term sheet are properly reflected in the acquisition agreement.

V. Due Diligence Review & Key Topics

Given the extent and complexity of the asset management business and the related complex overlay of investment adviser, registered fund, and commodities adviser regulation, due diligence is an increasingly critical phase in the overall M&A/investment deal process. Due diligence review should be conducted generally based upon the following three drivers:

- ❖ business, operational, financial, and risk-compliance management matters
- ❖ pricing/valuation matters
- ❖ general legal and risk-liability evaluation.

Due diligence typically focuses on the following areas or topics with respect to asset management firm deals:

- SEC rules/regulations and Advisers Act and ICA compliance, including review of target adviser firm's SEC examination letters and related materials;
- Comprehensive review of the target asset management firm's compliance program, including compliance manual and periodic/annual compliance reviews and reports;
- Where firm is commodities adviser, CFTC-NFA rules/regulations and related compliance, including review of target adviser firm's CFTC-NFA examination letters and related materials;
- Compliance with other federal securities laws;
- ERISA matters;
- Litigation, regulatory action or client complaint matters;
- Disclosure brochure/document, Form ADV-2 and SEC and CFTC/NFA registration matters;
- Advisory contracts and related matters;
- Distribution and marketing agreements;
- Management and employment agreements and client protection agreements;

- Code of ethics and regulatory disqualification matters;
- Intellectual property (patent and trademark) matters;
- Marketing/Advertising and performance presentation matters;
- Legal and tax qualification of proprietary mutual-registered funds or unregistered hedge/alternative funds;
- Financial matters and records.



The M&A-buyer of and significant minority-stake investor in an investment adviser firm must probe and master an interlocking and interwoven set of typical and unique issues to ensure that the investment deal is worth the price and the related business benefits and risks. Such buyers and investors must be alert to and plan for these matters as early as possible in the deal negotiation and structuring process, which includes continued adherence to adviser legal and regulatory (SEC) requirements, continuing business with existing advisory clients, retaining and motivating key management/staff through and after deal consummation, and conducting thorough due diligence to assist in informing the deal and its terms.

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AUTHOR BIOGRAPHIES

Sidney Wigfall is a Chicago-based founding-managing partner of Strategic Consulting Advisors (SCAdvisors) and SBF Corporate Advisors(NY), a multi-disciplinary management/operational, strategic, and regulatory/compliance consulting group focused on advising asset management firms, other investment/securities firms, investment professionals, and buyers/sellers of investment firms, including private equity firms. Sidney is also managing principal/attorney-advisor with Barge Consulting-SCA, a national, boutique asset management-compliance consultancy. He has held senior level legal-compliance positions with asset management firms, including serving as senior vice-president and chief regulatory/compliance officer for a NY-based multi-billion-AUM institutional asset management firm and affiliated mutual funds group managing equity, fixed income, hedge/alternative, and private equity investments. He has also served as chief legal officer and chief compliance officer for a Midwest-based multi-billion-AUM fund-of-funds investment firm and funds group. Sidney has also had securities-corporate attorney roles with large corporate law firms, including global-100 law firm Morgan Lewis LLP, and in such roles, handled investment management, securities/commodities, M&A/corporate, hedge fund, private placements, and private equity/VC matters. Sidney was also with the SEC, having served as a managing counsel and branch chief with the SEC's New York Office which handles the regulation of asset managers, hedge fund managers, funds-of-funds, mutual/closed-end and registered 40-Act funds, securities firms, and other investment adviser and pension consulting firms. He earned a B.A. in political science from the University of Rochester (NY) and a J.D. from Touro-Fuchsberg Law School (NY). Sidney is also a frequent speaker and writer in the field of investment management, and has spoken and written articles about numerous regulatory/compliance topics and the "business of asset management." He has been a regular panelist at Opal Financial conferences and also a contributing writer-commentator for Emerging Manager Focus e-Magazine, The Monitor Magazine (Investment Management Consultants Association/IMCA), Financial Investment News (FIN), FINalternatives, and Emerging Manager Monthly. He has also written and spoken on private equity/VC topics for national publications and private equity/VC groups, including American Venture Magazine and the Emerging Venture Network-EVN Group.

Stacie Yates has several years of legal experience in the field of alternative investments. As General Counsel and Chief Compliance Officer of Proctor Investment Managers LLC, she is responsible for all of Proctor's legal, regulatory and compliance oversight. Prior to joining Proctor, she provided all legal support to Credit Suisse's fund of funds group that manages over \$20 billion. In addition to her regular duties, Yates also spearheaded the launch of Credit Suisse's registered fund of hedge funds platform, a five strategy master-feeder structure regulated by the Investment Company Act of 1940. She began her career as an associate with Kramer Levin Naftalis & Frankel LLP, a law firm in New York City, where she specialized in investment advisory issues for both registered and unregistered investment advisors. Yates earned her B.A. in International Studies from Trinity University in Washington, D.C., an M.A. in International Political Economy and Fordham University and a J.D. from Benjamin N. Cardozo School of Law.