SERVICE PROVIDER SELECTION AND CO-SOURCING:
THE KEYS TO ESTABLISHING A COST EFFICIENT AND INSTITUTIONAL QUALITY HEDGE FUND INFRASTRUCTURE

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INTRODUCTION

What is the Hedge Fund Operational Working Group?

The Hedge Fund Operational Working Group (HedgeFundOWG) is a group of hedge fund CFOs and COOs and service providers who have come together with a purpose: to provide guidance for current and prospective hedge fund managers to effectively launch and grow their businesses. The founders of HedgeFundOWG seek to build a community of participants and a forum to share ideas and information, which should significantly help both emerging and established hedge fund managers address the challenges of building and sustaining their business.

About the following white paper

The current state of regulatory affairs and investor due diligence and transparency demands (particularly in the aftermath of several high-profile frauds) has created an onerous and potentially expensive environment in which to manage a hedge fund. As a result of these increasing demands, new and established hedge fund managers have to develop institutional quality infrastructure if they want to grow and attract new monies. Meanwhile, the amount of capital available to develop the infrastructure at most hedge fund managers has vastly diminished. Fees have compressed and the AUM available at launch is typically a shrinking fraction of what it once was.

The authors of "Service Provider Selection and Co-Sourcing: The Keys to Establishing a Cost Efficient and Institutional Quality Hedge Fund Infrastructure" sought to create a document to help current and prospective hedge fund managers assess and understand the requirements needed to develop an institutional quality infrastructure. Many documents are available that purport to do this; however, they are typically published by a single service provider and are often little more than marketing pieces. This document was the brainchild of market participants and experienced professionals who run hedge fund operations. They leveraged their relationships with individuals at trusted service providers to develop the content of the individual sections of this document. To avoid conflicts of interest, the authors have maintained editorial control and avoided overt references to individual companies and products.

The challenge presented to the contributor group involved two parts. The first was to define the questions that a hedge fund CFO or COO should ask service providers in order to gauge whether a provider is the correct fit for their organization and to help them make key determinations about how to structure and organize their company. The second was to discuss the potential answers that they might receive. The net result of this collective exercise is the following white paper, which is designed to serve as an outline or playbook for managers who are launching a new fund, managing the business' growth, or simply interested in making sure that the infrastructure they have in place is consistent with the message, mandate and mission of the firm. It is typically during one of these phases that firms could endure complications that put the overall business in jeopardy.

This document is not intended to convince hedge fund entrepreneurs of the need for a strong institutional quality infrastructure — it assumes they recognize the need and that a strong infrastructure will benefit their business, the investment process and the investor. It is instead meant to offer a better understanding of the nuances of finding the right balance between "co-sourcing"[1] and in-sourcing, and, when these entrepreneurs opt to co-source, to guide them through vendor selection.

[1] Co-sourcing is a practice of service in a business where a service is performed by staff inside an organization and also by an external service provider. It is based on a long-term relationship and emphasizes values traditionally associated with partnering rather than with vending. It may focus on one or more aspects of the internal operational functions of a hedge fund. The advantage of co-sourcing versus outsourcing is that it can reduce risks by bringing transparency, clarity and better control over the processes outsourced.

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THE PROBLEM: HOW TO ESTABLISH A COST EFFICIENT AND INSTITUTIONAL QUALITY HEDGE FUND INFRASTRUCTURE

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Hedge Fund Infrastructure: The Practitioner's View

We polled a number of hedge fund practitioners including portfolio managers, chief operating officers, chief compliance officers, risk managers, and operations professionals on how to create the optimal blueprint for a hedge fund manager's infrastructure. Our objective was to obtain the real users' perspective on the infrastructure that is required to establish a hedge fund manager's platform rather than relying solely upon the views of the chief technology officer or the IT team. The poll started with the following question: "What infrastructure capabilities would you need to run the front-to-back of the hedge fund operation?" Once we gathered the answers, we wrote them on sticky notes and then posted them on a wall. The outcome can be best described by the picture below:

At first glance this "practitioner's view" may seem to be a chaotic articulation of ideas and may not offer much by means of cohesive thought as to how each "sticky note" element needs to work together to run an efficient and cost effective business. This randomness, as represented by this smattering of ideas, represents the lack of cohesion of thought which often goes into the formation stages of the hedge fund manager's technological and infrastructure platform. Workflows remain mostly in people's heads and are not articulated or shared and are sparsely documented. This randomness often spans to client servicing and impacts the subscription process, the hedge fund's nimbleness and ability to provide timely regulatory compliance follow-ups and monthly reporting.

Domain Model: From Chaos to Organization

As we organized a hedge fund manager's technology and infrastructure needs in groups of related areas or domains, things began to make more sense.

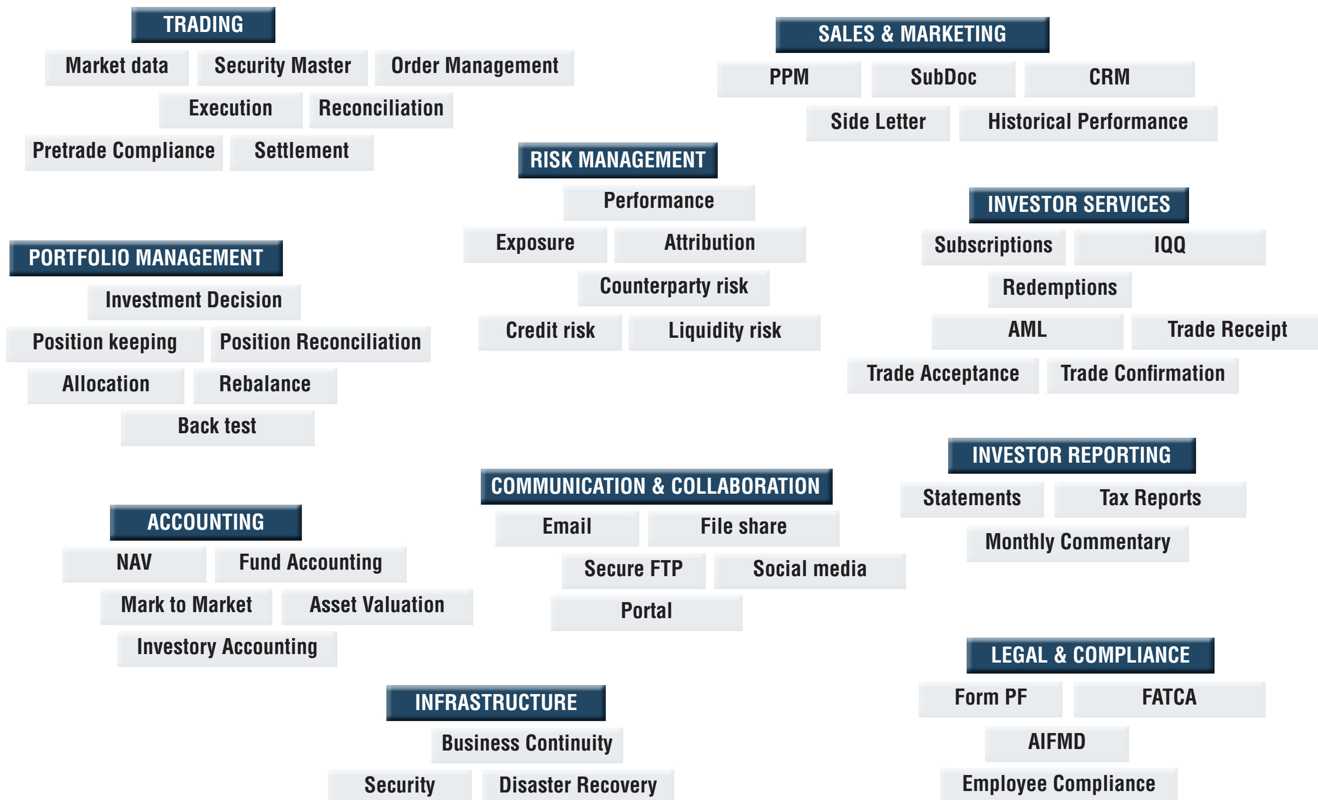


Diagram 2: Hedge fund infrastructure needs, grouped by domains.

The above diagram (or "domain model") contains a mix of data, documents, information and workflows. By looking at the hedge fund manager's required infrastructure picture holistically, we can identify potential overlaps or gaps, eliminate sources of inefficiency and manual processes and thereby reduce operational risk to the business. It can also enable a hedge fund manager to address increasing regulatory and transparency demands and streamline day-to-day operational processes within the firm. To achieve this, the hedge fund manager needs to develop a "domain model" like the one above to determine the best source (service provider, technology, in-house employee) for each solution.

Way of Thinking: Data, Documents, Information and Workflows

While a domain model significantly helps to articulate the different business functions and the technology and infrastructure needed to perform them, it is not completely sufficient to shape the blueprint and the sourcing process required to acquire the needed components. The addition of other dimensions is necessary. For instance, thinking in terms of data, documents, information and workflows provides structure to the blueprint. At the end of this exercise the hedge fund manager should have one such technology and infrastructure blueprint that defines the hedge fund manager's specific needs, and maps the data, documents, information and workflows with the required technology solutions, service providers and internal responsible parties.

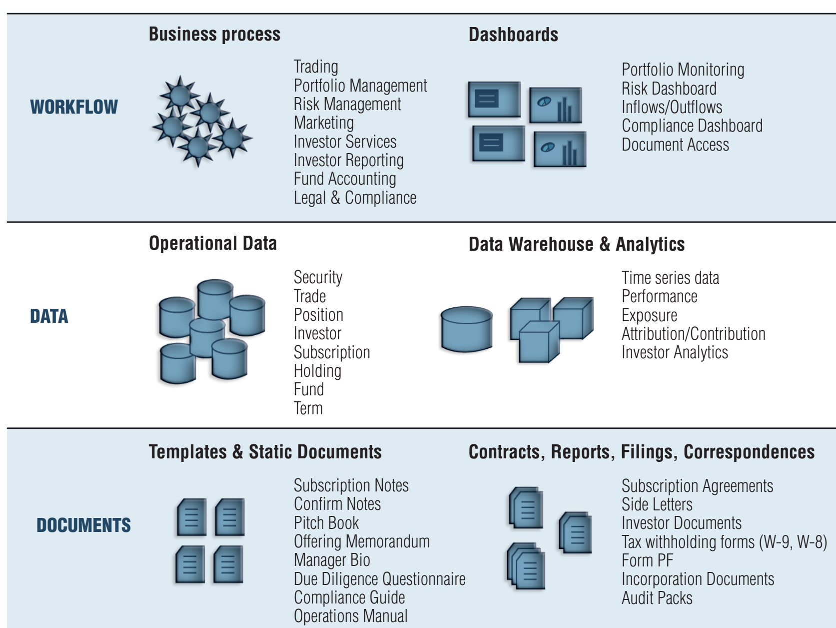


Diagram 3: Data, documents, information and workflows (illustrative and not exhaustive)

The source map helps to identify gaps and overlaps, and the integration requirements between technology applications, infrastructure and service providers. It can also enable a hedge fund manager to address increasing regulatory and transparency demands and streamline day-to-day operational processes within the firm. Once a sourcing map is created, the next step is to determine how to go about building the technology and infrastructure.

Approaches to Developing the Blueprint

Launching a hedge fund in days gone by involved far greater assets under management (AUM) at the time of launch, and higher fees than funds can collect today. As a result, hedge fund managers could embrace massive infrastructure projects in one of two ways: (1) build in-house technology and develop specialized knowledge; or (2) hire outside consultants to coordinate the full infrastructure build and manage vendor relationships.

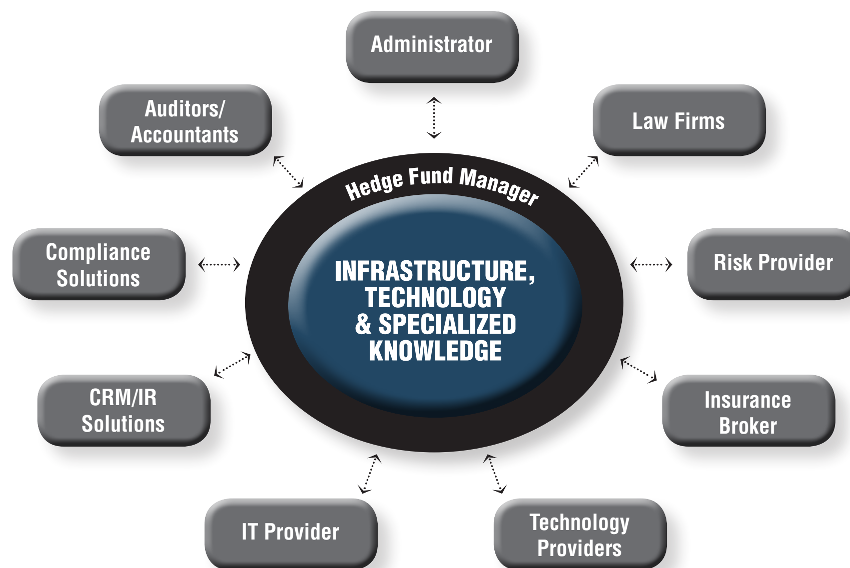
Building in-house systems from scratch and hiring teams to manage those systems is both time consuming and cost prohibitive in today's marketplace. In addition, outsourcing the entire project to a third party is no longer a feasible solution. Not only because it is expensive, but

also because hedge fund managers in today's world are accountable for every aspect of their business to both investors and regulators. They need to understand how their systems work and to be able to articulate this to regulators, investors and prospective investors. They need to have their own relationships with providers they trust who offer both the best technology for their needs and the specialized knowledge to go along with it. They need solutions that are affordable and that can scale with them as they grow.

The Role of Service Providers Today and the Development of a Co-sourcing Environment

In today's environment, where the costs of running a hedge fund are increasing dramatically and the average AUM at launch is significantly less than it used to be, newly launched hedge fund managers are being forced to do more with less[2]. This reality is not likely to change any time soon as the demands associated with regulatory reporting and investor transparency and due diligence will only continue to grow more onerous and complicated. As a result, hedge fund managers (new and established) need to find new ways to develop their technology and infrastructure solutions to meet these demands.

Through the proper selection of service providers and the development of co-sourcing arrangements with its providers, a hedge fund manager can develop and manage an institutional quality infrastructure in both a cost-efficient and operationally sound manner. Co-sourcing is about building a partnership with each service and technology provider. The provider's team becomes an extension of the hedge fund manager's own staff, rather than acting as a completely separate entity, which establishes accountability and ownership on the part of the provider, and an open dialogue and collaboration between the provider and the hedge fund manager. The co-sourcing model emphasizes the involvement of both parties while allowing a firm to take advantage of best-of-breed technology and the specialized knowledge that its service providers offer. This access can be acquired at a fraction of a cost of trying to maintain and build the technology in house and employing teams of relevant subject matter experts.



[2] According to a recent survey conducted by Citi Prime Finance, managers need between $250 million and $375 million of AUM in order to break even and survive off management fees alone. According to the survey, increased regulatory demands (e.g.; compliance with AIFMD, FATCA, mandatory clearing, Form PF, CFTC registration, Solvency II, MiFID II and the FTT) and investor due diligence and transparency requirements are the main reasons for the increase in operational expenses. (See, Citi Prime Services, "2012 Hedge Fund Business Expense Survey: Industry-Wide Benchmarks for Managing a Hedge Fund Organization", 2012.)

LEGAL ISSUES RELATING TO FORMATION OF A HEDGE FUND

AUTHOR: CHRISTOPHER WELLS, PROSKAUER ROSE LLP

Q: What is the typical legal structure of a hedge fund?

The typical hedge fund is usually organized with an onshore fund and an offshore fund. The onshore fund is typically organized as a Delaware limited partnership or limited liability company, and is intended primarily for U.S. taxable investors, who typically prefer to invest through a vehicle that is treated as a partnership for U.S. tax purposes. The offshore fund is typically organized in a no-tax jurisdiction, such as the Cayman Islands, and is intended primarily for non-U.S. investors, who want the benefit of investing through a tax "blocker," as well as for U.S. tax-exempt investors, who want to invest through an offshore corporation that is not treated as a partnership in order to avoid "unrelated business taxable income."

Q: When should a master-feeder structure be used?

In a "master-feeder" structure, the onshore and offshore funds co-invest as "feeder funds" through a jointly owned "master" fund. This structure has several advantages for the typical hedge fund manager. Generally, it is easier to administer, since all trading is done through a single master fund account, and the manager therefore does not need to allocate trades between two or more parallel funds. On the other hand, a manager of parallel onshore and offshore funds has greater flexibility to engage in tax-driven strategies in one fund that may benefit the investors in that fund, without incurring the costs of the strategies in the other fund. However, most managers decide that the convenience of a master-feeder structure outweighs the possible tax benefits of a parallel fund structure.

Q: How is a typical hedge fund management company organized?

The structure of a hedge fund manager will depend on the location of its business operations and owners. The typical U.S.-based hedge fund manager will be organized as a limited partnership or limited liability company. A limited partnership or limited liability company avoids a second level of corporate income tax that would apply if a corporation were used. Frequently, especially if the hedge fund manager is based in New York City, a second entity will be organized to receive incentive-based compensation paid in the form of an "incentive allocation," or special allocation of profits.

Q: When is SEC registration required?

A fund manager based in the United States must register with the "Securities Exchange Commission" (SEC) as an investment adviser if it has at least $110 million in gross assets under management (before deducting indebtedness), or at least $30 million in the case of an adviser based in New York or Wyoming. However, there is an exemption for a manager who only acts as adviser to one or more private funds with aggregate gross assets of less than $150 million, and who does not have any separate managed account clients.

Q: When is CFTC registration required?

A manager of a fund that trades futures or certain kinds of swaps may need to register with the "Commodity Futures Trading Commission" (CFTC) as a "commodity pool operator" (CPO) or "commodity trading advisor" (CTA). However, registration as a CPO is not required if either (1) the aggregate net notional value of futures and swaps subject to CFTC jurisdiction does not exceed 100 percent of a fund's net assets or (2) the aggregate margin and premiums for futures and swaps subject to CFTC jurisdiction do not exceed 5 percent of a fund's net assets.

Q: What rules apply to employee benefit plans subject to ERISA?

A fund manager can manage assets for employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA). However, if employee benefit plans and certain similar entities, including IRAs and 401(k) plans, represent 25 percent or more of any class of interests in a fund, then the fund is deemed to constitute "plan assets" under ERISA, and additional requirements apply. Among other things, the manager will need as a practical matter to be registered with the SEC, and will be prohibited from engaging in any form of related party transaction, including cross trades with other managed accounts.

Q: What other reporting obligations might apply?

Don't ask. The federal government seems to have been working overtime recently to come up with new reporting and filing obligations that are potentially applicable to hedge fund managers. These may include SEC Form ADV Parts 1 and 2 (the basic form for registering with the SEC as an investment adviser); CFTC Forms 7-R and 8-R (the basic forms for registering as a CPO or CTA with the CFTC); SEC Form PF (to be filed by SEC-registered advisers with more than $150 million in gross assets under management); CFTC Forms CPO-PQR and CTA-PR (for CFTC-registered advisers); SEC Form D (to report a private placement of interests in a fund); SEC Schedules 13D and G (to report a 5 percent position in a U.S. public company); SEC Form 13F (to report management of at least $100 million in U.S. listed equities); SEC Form 13H (to report trading of U.S. listed equities equal to at least 2 million shares or $20 million in one day or 20 million shares or $200 million in one month); SEC Forms 3, 4 and 5 (to report a 10 percent ownership interest in a U.S. public company); Treasury International Capital System Forms; Bureau of Economic Analysis Forms; and Financial Crimes Enforcement Network Suspicious Activity Reports.

Q: Any other practical advice?

Get good legal advice. U.S. rules are very complex. In this regulatory environment, do not risk getting any part of the process wrong.

LAUNCHING AN OFFSHORE HEDGE FUND IN THE CAYMAN ISLANDS

AUTHOR: INGRID PIERCE, WALKERS

Q: How long does the launch process normally take from start to finish?

This is usually the first question people ask, and timing depends on various issues, including the structure and its complexity, how many third parties will be required to examine and sign documents and whether any strategic investors will be offered special terms by way of a separate class of shares or a side letter.

The typical timeframe is approximately six weeks, although if the other service providers are already in place — for example where they are already acting on behalf of the domestic fund — things can move more quickly. This is because the relevant parties are already familiar with fee structures, service contracts and the usual methods of working.

Negotiating commercial terms with independent service providers can be one of the most time-consuming elements of the process, particularly where a preexisting relationship is not already in place. Managers will want to match their fund strategy with an administrator that has the right technology in place. Additionally it will be important to confirm that the administrator (or another service provider) will ensure compliance with the relevant anti-money laundering regulations.

An audit firm will need to be retained as all regulated Cayman Islands funds must have an approved auditor sign off on the fund's financial statements. This is quite straightforward as most of the established auditors are present. Where managers have no preexisting relationship, the domestic or Cayman audit firm will need to undertake an assessment of and due diligence on the manager before agreeing to a retainer.

Prime broker and custodian relationships are usually established early on in the process and we often receive questions regarding when bank and brokerage accounts can be opened. Accounts cannot be set up in the name of the fund until it has been incorporated and directors have been appointed. It goes without saying that name of the fund must first be confirmed and be available for use.

Q: What structures and vehicles need to be put in place for the fund?

It is important to seek legal and taxation advice on whether it is appropriate or necessary to establish an exempted limited company (the typical hedge fund structure in the Cayman Islands), an exempted limited partnership or an exempted unit trust. In most cases it is the types of investors participating in the fund that will dictate its structure.

Forming the fund itself is actually one of the quickest steps in the process. Assuming the proposed name of the fund is available, the company can usually be incorporated within 24 hours.

Where an exempted limited partnership is used, the partnership must (under current law) have at least one general partner that is formed in or registered as a foreign company in Cayman. This means that the formation or registration of the qualifying general partner will need to take place before the exempted limited partnership can be established.

An exempted unit trust is established by declaration of trust by the trustee. It is quite unusual for the trustee to declare a short form declaration of trust that does not include all of the fund terms merely to facilitate the establishment of the trust, although this can be done if time is of the essence. In most cases, the unit trust is established towards the end of the launch phase, but obviously prior to execution of any of the service provider agreements that must be entered into by the duly appointed trustee.

Q: Will the fund offer voting or non-voting shares?

Participating interests offered to investors may have full or limited voting rights and this is a key question at the formation stage. Where participating interests are "non-voting," typically the fund will be established with a class of voting interests which will control the right to vote on all matters (except for any material adverse change in the rights attaching to the investors' interests).

For example in a corporate structure, the holders of the voting shares can pass resolutions to amend the fund's articles, control the composition of the board of directors and pass other shareholder resolutions. A decision will therefore need to be made about who holds the voting shares. In many cases, the voting shares are held by the manager or an affiliate. However, there may be tax and other considerations which dictate that the voting shares should be out of the control of the manager or the manager's group of companies and held by an independent third party. In those circumstances, a Cayman Islands charitable or STAR trust may be established to hold the voting shares.

Even if investors are offered voting shares, it is possible to structure the fund such that non-voting shares can be created and issued to a particular investor or class of investors at some future date.

Q: Will independent directors be on the board?

The Cayman Islands Monetary Authority (CIMA) requires that regulated funds have at least two directors, however many funds have three-person boards. According to research conducted by Walkers on the regulated funds established for our clients in 2012, approximately 72 percent of new funds featured an independent director, up from 64 percent in 2011, so this is a growing trend with most new funds having a majority of independent directors. Many clients have noted the benefits of having directors with diverse backgrounds so that each has some relevant experience to bring to the table. For example, directors with a fund administration background, an accounting background, and experience in industry or in the legal field all have different strengths to offer and the right choice can result in a balanced board.

Q: What is the role of offshore counsel?

The role of offshore counsel is centered on the establishment of the fund structure, drafting constitutional documents, providing advice on the Cayman legal and regulatory issues and preparing the documents required for launch. Once the fund is established, offshore counsel typically acts for and advises the fund.

Assuming the manager has onshore counsel, the onshore firm tends to prepare the offering document, particularly if a U.S. feeder fund is involved. When starting up, most managers spend a lot of time engaging with their onshore counsel and tax advisers, which is perfectly proper. It is also important to retain offshore counsel at an early stage to help advise and assist on some of the issues outlined in this article. Managers should think about whether the key terms of the offering should be fully set out in the fund's articles of association, being the principal governing document of the fund, or whether the articles should be drafted more broadly to give greater flexibility and describe the more detailed terms of the shares in the fund's offering document. There are some advantages to having the latter approach as hardwired provisions may be difficult to change at short notice once the fund is up and running. On the other hand, some directors prefer to have clear and detailed provisions in the articles so that there can be no argument about what course the fund should take in particular circumstances. These are issues that should be discussed with counsel before the drafting process begins.

Prior to launch, the directors and each of the key service providers need to review and approve the relevant provisions in the offering document and sign off on the description of their firm and the services they are providing to the fund.

Also prior to launch, offshore counsel will prepare the launch packs, including the draft form of board minutes for the initial launch meeting, and liaise with the regulator regarding the registration of the fund.

Q: What costs are typically involved?

There is always great pressure to contain costs when setting up a new fund so this is an important issue for any manager. The complexity of the structure and the number of entities involved will have a major bearing on the costs involved. Other factors include the extent to which the fund documents require bespoke drafting while fees for directors and service providers can vary widely so managers should do their homework before committing to an annuity cost.

Each Cayman Islands-domiciled entity must have a registered office in the Cayman Islands and must therefore pay annual registered offices fees to an approved provider. The fund will also incur annual government fees and regulatory fees (if CIMA registered).

Q: What else should be considered?

It makes great sense for new managers to also speak with their colleagues in the industry. Many managers have gone down this route before and can share their experiences about what worked well for them in the process.

CHOOSING AN ACCOUNTING/AUDITING FIRM

AUTHOR: JEFFREY KOLLIN & JEFFREY STOMSKI, ROTHSTEIN KASS

If you ask an auditor how to select the best audit/accounting firm, be prepared for a detailed analysis, supported by independently obtained and verified information. In the interest of everyone's time, that detailed analysis boils down to a few key questions that stratify the auditor population:

Q: Can I grow my business and not outgrow my audit or tax firm?

Cheaper and bigger is not always better; in fact, it very well may be a paradox. Service provider selection must be aligned with your business plan and growth model; select an auditor and tax accountant that will help you convert your vision into reality.

WHAT TO LOOK FOR:

- **Brand recognition.** Investors demand high-quality service providers. Inquire whether the firm is a "check-the-box" on institutional investors' due diligence questionnaires.

- **Breadth of service.** You may never need the firm's litigation support, business advisory or family office group, but it's reassuring to know they are there if you need them. Inquire about what other service offerings are available; by doing so you will also learn about the depth of the organization.

- **Client base.** Industry leaders typically have substantial practices dedicated to the alternative investment industry. Key statistics include the number of alternative investment clients and the number of clients that are registered investment advisers (RIAs). Always ask for references.

- **Public Company Accounting Oversight Board (PCAOB) registrant.** Registration with the SEC, from a growth perspective, is a good thing; it means your assets under management have grown to a substantial amount. RIAs are required to engage an auditor that is registered with and inspected by the PCAOB. Not engaging a PCAOB registrant in initial selection process guarantees that a successful fund complex will have to change auditors in the future.

- **Offshore Capabilities.** Depending on your investor base, domiciling one or more entities in a foreign jurisdiction may be required. Regulations in the Cayman Islands, Ireland and Luxembourg require audit firms have a physical office in the specific country.

Q: Do they understand my business and do they have the resources to properly service it?

You are not just selecting an auditor or accountant, you are selecting an adviser. This trusted adviser must understand your business and have the resources and industry-specific knowledge to guide you through each stage of your business' life cycle.

WHAT TO LOOK FOR:

- Engagement staff: low turnover and dedicated to alternative investments. Firms with professionals and resources specifically dedicated

to the alternative investment space are better suited to service your engagement, answer your questions, and offer guidance. Accounting and audit firms are not immune to attrition or turnover; firms with professionals dedicated to the industry make the transition less painful. Firms with lower-than-industry-average turnover rates are typically home to happier employees. Inquire about the firm's core values and determine if they align with your business' core values.

- Access to senior practice leaders. Few things are more excruciating than waiting for a service provider to return a call regarding a sensitive accounting or tax issue. You are looking for a firm with accessible practice leaders, and assurance that the first time you speak with the engagement principal during the proposal process will not be your last. Inquire about each team members' roles and responsibilities as they relate to key deliverables and ask for references from current clients.

- Thought leadership. The firm should provide you with "market intelligence" around a variety of topics as well as "plain-English" advice and practical strategies for implementation:

    - Maximizing tax efficiency by selecting the proper legal structure and making the most beneficial Internal Revenue Code (IRC) elections

    - Utilizing tax strategies and financial products to minimize tax exposure

    - State and local tax issues and developments

    - Regulatory requirements such as Form ADV, Form PF, Form CPO-PQR (CFTC), and FATCA as well as the expertise to guide you through the process

    - Impact of ever-evolving GAAP and financial statement disclosure requirements

    - Impact and industry practice response to recent regulatory actions and enforcements

    - Best practices regarding regulatory requirements and examinations, internal controls and valuation policies and procedures (to name a few)

- Superior (use of) technology. Like it or not, technology plays a significant role in our daily lives. When used correctly at an audit or accounting firm, it can improve overall efficiency and delivery. If technology is overleveraged, the overall learning process and "human element" associated with a firm's team members is greatly diminished. You are looking for the right balance where the firm's team members are able to provide a meaningful explanation behind a specific procedure and process, not just answer, "I hit the button."

Q: How will my accountant/auditor interact with my other service providers?

No matter what the deliverable, all of your service providers must work together. Communication and ownership of specific steps in the process are the keys to success.

HOW TO MAKE IT HAPPEN:

- **Planning meetings:** When done correctly, planning sets the pace and tone of the engagement. Invite all key players at all interested service providers. Discuss areas that present a challenge to your business: those areas are what will most likely slow down the process.

- **Timing is everything.** Create a timeline for key deliverables that is realistic and agreed upon by all interested parties.

- **Status calls:** The perfect combination of micro-management and market efficiency. The goal here is to hold people accountable for the deliverables outlined in the timeline, understand variances and ensure any issues are timely communicated.

CHOOSING A PRIME BROKER

AUTHOR: FRANK NAPOLITANI, CONCEPT CAPITAL MARKETS, LLC

Q: What are the key characteristics and capabilities to look for when choosing a prime broker?

• Multiple custodian choices

New launches are often precluded from working with large prime brokers due to smaller asset bases, so many new launches obtain high-quality prime brokerage through an "introducing broker" (IB) relationship. The IB introduces hedge fund managers to the custodian(s) and provides the middle-/back-office roles on behalf of the custodian. The hedge fund's securities remain at the custodian, which provides custody, clearing and execution of trades. Because the IB aggregates accounts on behalf of the custodian, the large minimum levels often required by the large prime brokers do not come into play. Often a hedge fund manager can become "multi-primed" at a small asset level to adhere to best practices often required by institutional investors.

• Securities lending

Depending upon your investment strategy, you may need a prime broker that is able to provide securities lending across many different asset classes and geographies.

• Financing

Depending upon your investment strategy, you may also require various types of financing to achieve your objectives. You will want to choose a prime broker that has knowledge and experience in these areas and is capable of providing the type of financing you require.

• Technology for trade data and portfolio analytics/reports

The prime broker should have an online portal where all of your trade data is captured and that provides robust portfolio analytics and reporting. Ideally, the portal should be able to gather trade files from all prime broker/custodial relationships so that aggregated reports can be produced to calculate performance and risk analytics. At a minimum, their system should provide profit and loss (P&L), performance attribution and risk analytics, with the ability to provide much more robust reporting upon request. Also inquire as to the ability to link the prime broker, internal customer relationship management (CRM) and administrators' systems to give the firm the ability to create its own portfolio and risk management for its investment and marketing efforts.

• Trading and trading technology

Depending upon your investment strategy, you may require an electronic trading model or a full-service outsourced trading desk. It is important that your prime broker has a robust offering of the trading platform and execution management systems you need across the asset classes and in the markets in which you trade. There is no "one size fits all" and having options to choose from should provide your team with the right solution.

• Business consulting services

Your prime broker should be staffed with professionals who understand your business and can implement solutions across all of the key areas of your business. The consulting services and solutions should not only address the current problem, but also be scalable if the organization executes its business plan and grows to a larger size.

• Client service

Your prime broker should be "right sized" to meet your needs as a new launch and as you grow and become a large hedge fund with multiple custodial relationships. You do not want to feel like a "number" as a client, and you should work with professionals who understand your business and have experience growing with new-launch hedge funds like yours.

ROLE OF INDEPENDENT DIRECTORS

AUTHOR: GEOFF RUDDICK, INTERNATIONAL MANAGEMENT SERVICES LTD.

One of the first considerations when looking for an independent director is the underlying reason behind your search. In today's environment, corporate governance is no longer a luxury, but a necessity, and often a requirement. Regulators and exchanges are increasing their scrutiny and investors are demanding it — and so should you. Aside from corporate governance, one of the driving factors is often tax-related and therefore independent directors may be appointed in a tax-neutral jurisdiction.

Introduction

The runner-up questions to selecting an independent director are:

"How much?" (referring to "How much do you charge for the provision of independent directorship services?"); and

"How many boards do you sit on?" (translated as "How many manager relationships do you service and do you have the capacity to effectively service another one?");

However, the grand prize-winning question is:

"What do you do?" (meaning "What role do you play and what value will you add if appointed to the board of directors of the fund?")

The main purpose and underlying theme of this article is to address the third question, then briefly address the other queries in turn. Prior to addressing these queries, it may be helpful to first delve into a bit of background and address a couple of related questions.

Duties: What are a director's duties?

The basic role of the directors is to oversee the business and affairs of the fund, with the fundamental task of being diligent in representing the interests of the investors. In most common law jurisdictions, such as the Cayman Islands, there are specific legal duties underlying the role of directors. Although beyond the scope of this article, these duties can broadly be summarized as follows:

1) Fiduciary duties — loyalty, honesty, and good faith

2) Duties of skill, care and diligence

In summary, directors must act in what they believe are the best interests of the fund itself, and avoid putting themselves in a position where they are conflicted between their personal interests and the duties owed to the fund.

Terminology: What do "independent" and "non-executive" mean?

In the context of a hedge fund director, the term "independence" generally refers to someone who is independent of all service providers — the investment manager, administrator, registrar and transfer agent, prime broker, custodian, auditor and legal counsel. The term "non-executive" stems from the typical hedge fund structure, as the fund itself will rarely have any direct employees or, if you will, "executives," when referring to the upper echelons. As such, non-executive directors are not employees of the fund and they are not involved in the day-to-day management of the fund's affairs.

Role: What do you do?

An independent director has only an intermittent involvement with a fund's affairs. Provided the fund is investing in conformity with the investment strategies and restrictions as outlined in its offering document, an independent director's role predominantly consists of periodically reviewing the performance of the fund and its service providers, reviewing and executing agreements, attending directors' meetings and dealing with any extraordinary issues, such as approving side letters and resolving conflicts.

Value-added: What value will you add?

Below are a handful of areas in which independent directors add value:

INDEPENDENCE

Independent directors add value by being free of any relationships with service providers. Such independence helps ensure that the fund abides by the fundamental principles of effective corporate governance. If a director is not independent, conflicts of interest will inevitably arise and interfere with the director's ability to act in the best interests of the fund.

REGULATORS, EXCHANGES AND TAX AUTHORITIES

The trend towards increased scrutiny by tax authorities, exchanges and regulators is clear, and additional scrutiny appears probable in the future. If the investment adviser to the fund is regulated by the Financial Services Authority or the Securities and Exchange Commission, the representation of independent directors on the boards of investment funds is seen quite favorably. Regulators and exchanges of other jurisdictions now go as far as to require independent board representation.

INVESTOR CONFIDENCE

Increased vigilance by investors, particularly institutional investors, makes effective corporate governance a top priority. When investors perform their due diligence, independent board representation builds investor confidence as they gain comfort by the increased independence and resulting enhanced corporate governance. Investors know that independent directors will provide the credible decision-making on behalf of the fund that is required in today's environment. Independent board representation not only increases investor confidence, but also can indirectly assist with the marketing of the fund, thus attracting or retaining investors.

SERVICE PROVIDER CONFIDENCE, MONITORING AND CONFLICT RESOLUTION

Part of the independent director's role is to monitor the performance of all service providers, including the investment manager, in accordance with the terms of their agreements. Without service provider independence, a director may have to confront a conflict of interest, whether at initial establishment when contracts are being negotiated or during the ongoing operation of the fund, regarding issues that may arise as part of:

- Monitoring service providers' performance
- Adherence and changes to investment strategies and restrictions
- The valuation of assets
- Extreme events

Individual investors' and service providers' interests often diverge further during extreme market conditions. Issues such as the pricing of the illiquid securities themselves, the knock-on effects of the suspension of NAV calculations, the invoking of gating provisions and the suspension of redemptions have all made headlines as of late. An independent director can assist in making an unbiased determination in the best interests of the fund, its investors and creditors, during such uncertain times. As such, comfort is gained in the knowledge that the independent directors will monitor the performance of the fund and all service providers in both normal and extenuating circumstances.

Approval of documentation and agreements

The approval, oversight and negotiation of the fund's documents and agreements with service providers are a key component of the role of an independent director.

As an example, independent directors usually spend a significant amount of time reviewing the offering document to ensure that material details, such as those below, are fully and accurately disclosed:

- The fund's structure
- Investment manager and key personnel
- Identification of other service providers
- Investment objective, strategy, universe and restrictions
- Targeted investor base
- Frequency of dealings and valuations
- Anti-money laundering and compliance issues
- Accounting principles
- Risk factors
- Whether the fund will be listed

Ultimately, the director accepts responsibility for the contents of the offering document and agreements, and any corresponding omissions, so the process is taken seriously.

Jurisdictional/corporate governance knowledge and experience

Independent directors resident in the fund's jurisdiction possess specific knowledge and experience of the jurisdictional requirements therein, and have a thorough understanding of the principles of effective corporate governance. Many independent directors work full time to provide this service. They sit on numerous boards and, therefore, have a great deal of pertinent knowledge and experience.

Where do you start, and what should you be asking?

Your legal counsel and administrator are a good starting point and can provide a shortlist of individuals they recommend. Once you have their recommendations you should make additional inquiries to find the individual who is right for the fund. The process of looking for an independent director is somewhat analogous to the search for a new employee and corresponding interview. There are obviously no hard and fast rules or an all-encompassing list of questions you should ask; however, a suggested “top ten” for consideration follows. Add and subtract as you will; it is by no means all-inclusive but will hopefully point you in the right direction:

1) Independence: Independence is the “Holy Grail” of effective corporate governance. If a director is not independent, conflicts of interest will inevitably arise and interfere with the director’s ability to act in the best interests of the fund.

2) Experience: You can glean a good idea of experience from a person’s bio, which will eventually appear in the offering document of your fund. You may also want to ask if candidates have sat on boards with similar strategies. Independent directors do not need to be experts; however, a general understanding of the fundamentals of the underlying strategy is essential.

3) Qualifications: A legal, accounting, compliance, investment or other relevant qualification, combined with experience, will provide a good indication of where a candidate’s specific expertise lies and how he or she will add value.

4) Capacity: “Capacity” is a key concern in any line of work and, arguably, more so in the context of the role of an independent director. The directors oversee the affairs of the fund, and time and effort is required to effectively fulfill their duties. An independent director who has too many appointments will likely be passive in nature, not add much value and should, therefore, be avoided. On the other hand, an independent director who services a reasonable number of manager relationships will possess a great deal of knowledge and experience to the benefit of the fund.

5) Back-up/coverage: Confirm whether your director has a support organization of long standing, with sufficient support infrastructure to cover these contingencies, and if his or her colleagues could be appointed as an alternative should the need arise. Selecting your director from a director services company can carry distinct advantages in such situations.

Ascertain whether a director, or directorship services company, has a formal and documented disaster recovery plan in place. Confirm whether it has ever been put to the test and whether it was a success. The reality is that “what ifs” do happen, and it is critical to know that a director will be able to continue to serve the fund.

6) Regulatory approval or refusal: An individual, or entity, who is approved and subject to a regulatory body’s ongoing scrutiny, can offer the reassurance and credibility that he or she is not only fit and proper, but also familiar with the jurisdiction’s legal and regulatory regime.

7) Charges/convictions/investigations: Adverse events such as fund blow-ups or fraud that generate negative publicity do happen. By itself, it does not mean that a director implicated is incapable, or guilty of any wrongdoing. Confirm whether the candidate has ever been censured, disciplined or criticized by any professional bodies. If so, ascertain the underlying reasons and confirm whether there was a satisfactory resolution.

8) Insurance: Directors’ and officers’ liability insurance is becoming increasingly necessary given today’s litigious environment. Depending on the individual candidate and the specifics of the fund, some directors require that insurance be provided by the fund. Others maintain their own policies. Confirmation that insurance coverage is maintained will provide an indication of the financial standing of the individual and organization, as well as provide comfort that they have an understanding of the litigation risks prevalent in today’s environment.

9) Remuneration: Directors oversee the affairs of the fund, and time and effort are required to effectively fulfill their duties. Directors have personal liability, and the penalties associated with a failure in fulfilling their duties will far exceed the fees received from their post.

Remuneration may comprise an annual fee and compensation for time spent, or it may be a fixed annual charge. Out-of-pocket expenses will also be incurred, which may include standard administrative expenses in addition to travel, lodging and other expenses properly incurred attending meetings or in connection with the business of the fund.

10) References: You are halfway there if your lawyer or administrator has put in a good word for the candidate. It would, however, be prudent to receive some positive feedback from clients who utilize the candidate's services or who serve on the board with the individual. Ask for a couple of references and follow through with these.

Conclusion

Looking for an independent director does not have to be an arduous, time-consuming process; however, the decision should not be taken lightly. Remember, the directors are accountable for promoting the fund's success by leading and directing its affairs. It is an important decision, so take your time, be thorough and ask questions. Effective corporate governance is imperative, and some of the issues, scenarios and outright collapses in recent news should highlight this point. As regulators and investors continuously increase their focus on corporate governance, the requirement for the appointment of independent directors is becoming more essential. In today's environment, corporate governance is no longer a luxury but a necessity, and often a requirement. The days of directors with inherent conflicts of interest or passive (nominee) directors are effectively over.

KEY CONSIDERATIONS WHEN CHOOSING AN ADMINISTRATOR

AUTHOR: JOHN KUSHNER, NORTHERN TRUST HEDGE FUND SERVICES

Q: What does an administrator do?

Full-service administrators are increasingly offering true middle-office operational services that supplement traditional back-office and accounting services. Effectively integrated operational models include processes that enhance data quality, reconciliation, accuracy of daily trading P&L and accruals, and enable managers to scale their business without an additional operations headcount.

WHAT TO LOOK FOR:

• Same-day T+0 trade affirmation services via industry utilities (Omgeo OASYS/CTM, Traiana, DTCC and MarkitWire)

• Fail tracking and resolution, break resolution and expiration services

• OTC derivatives processing and best practice support for central counterparty clearing requirements

• OTC collateral management and independent margin calculation

• Cash wire execution, processing and standing instruction controls

• Interest, dividend, corporate action and entitlement tracking and processing

• Automated daily cash and position reconciliation to prime brokers, ISDA counterparties, custodian and bank

• Daily independent pricing and P&L reporting, and monthly manager price substantiation

Q: How important is technology to an administrator?

Technology is a critical part of everyday processes. The average administrator leverages external software providers and multiple databases to support different products and processes across multiple geographies. This siloed approach can lead to multiple internal methodologies for accounting, P&L attribution and reporting. Internal reconciliations between systems at asset-servicing firms can add operational risk to their service and product delivery. Single databases that are product-agnostic enhance an administrator's internal controls and increase operational execution.

From a communications perspective, the standard administrator receives files from the manager daily and produces a static set of reports once per day based on overnight batch processes. Push technology or web-based services accessible intra-day provide real-time transparency, and interactive capabilities give the manager a direct and customizable view into their books and records. Technology can increase the engagement and enable administrator operations to become fully integrated with the funds' operations.

WHAT TO LOOK FOR:

- Industry-leading, scalable technology
- Single system that supports all products, strategies, and trade and operations lifecycle events
- Single data set across every function and all role players
- Limitless strategy- and attribution-tagging capabilities
- Interactive, real-time transparency into all trade and operational activities
- Automated trade capture with real-time processing across all products
- Downstream back-office accounting automation and controls that assure data integrity
- Flexible platform that can support all single manager, fund of funds, private equity and real estate funds, and managed account structures

Q: What do investors look for when performing due diligence on operations and administrators?

Investor demand continues to shape many of the changes in the administration space. Increased transparency, frequency of reporting and due diligence requirements have driven positive change in operations, reporting and service delivery.

WHAT TO LOOK FOR:

- Full AML/KYC services and controls that are transparent to the manager
- Risk reporting, exposure and P&L by asset class, industry group, geography and other post-trade compliance attributes
- ERISA Monitoring
- SSAE 16 (SAS 70 Type II) certification and ASC 820 (FAS 157) offering
- Fully independent valuation and clear valuation policy for manager pricing
- Administrator control of subscription and redemption accounts
- Systematic controls ensure that all payments are instructed by authorized individuals and straight-through-payment processing via SWIFT without manual intervention
- Investor audit and tax support
- Form PF and FATCA offerings

Q: Do culture and values matter at an administrator?

Culture and values are critical to operational excellence and a strong partnership approach to client service. The expertise and capabilities of an administrator often stem from its shared values and culture. As an extension of the fund's business model, it is important to understand the organizational values of the administrator as they will drive product development and ensure that client goals and direction are aligned over the long term.

WHAT TO LOOK FOR:

- Global footprint, fiscal strength and organizational stability
- Management team of industry-leading professionals
- Domain expertise at the staff level
- Demonstrated integrity and commitment to clients
- Flexible, consultative approach to relationship management and client service
- Investment in technology and people to drive processes

WHAT TO CONSIDER WHEN LOOKING TO BUILD YOUR TECHNOLOGY INFRASTRUCTURE

AUTHOR: ART MURPHY, ABACUS GROUP, LLC

Q: What technology do I need day one?

New and emerging hedge funds and private equity funds are looking more and more to cloud systems to house and manage their data. The debate is often whether a private and dedicated system is necessary. A technology platform should be designed, with the help of service providers, to run all IT as a service in the most cost-effective manner available. Firms should have the flexibility to host any application, the scalability to add resources as needed and the assurance that their data is always available, secure and protected.

Q: At what point does it make sense to outsource infrastructure?

What are you doing now? Where do you think you'll be in one year? In five years? If everything works as is, and you're not planning to change or size up, then perhaps you don't need to change anything. But if you're planning to grow, or you're concerned about performance, reliability and escalating equipment costs, then you really need to consider infrastructure that can scale with you — without breaking the bank.

Security should be another critical consideration — 90 percent of security breaches are someone taking a tape or a computer. A cloud server, with multiple biometric scans and security parameters just to get to the cage, offers more advanced intrusion protection and stronger safeguards than locally hosted data.

In light of the onslaught of emerging regulatory reporting requirements, funds have begun organizing workflow around keeping everything. It used to be that they just kept the messages – email, IM – but now, particularly with some of the new initiatives like Form PF, hedge funds are retaining every document in a historical archive. This drastically increases the file storage demand. Rather than buy expensive servers to keep in-house, funds can use scalable data platforms to store their performance or non-performance data at different price tiers.

Q: What can a private cloud offer vs. a public cloud?

A private cloud can deliver robust and tailored security and risk management safeguards to assuage concerns around access to sensitive data and systems, as well as compliance requirements. A private cloud can also offer a more cost-effective option without sacrificing performance, availability or reliability, and allow your provider to deliver more attentive and specialized customer service and support.

Q: Why do hedge funds opt to go with private cloud model?

It gives hedge funds a secure, flexible, hosted solution to reduce their infrastructure costs while simultaneously enhancing IT availability and performance. This scalable, redundant and highly available platform empowers firms to accurately predict future IT expenses, ensure business continuity and disaster recovery, and leverage the on-demand scalability needed to match current and future growth.

Q: What are some of the most popular private cloud services hedge fund clients' request?

We often see clients begin with IT infrastructure outsourcing, financial application hosting and general back-office services, and then add custom infrastructure and application services to their private cloud.

Q: What should hedge funds look for when selecting a cloud service provider?

Security policies and procedures will always be top of mind for hedge fund IT managers, so it's imperative to work with a provider that is committed to providing clients with the highest levels of security and reliability. You should also look for a partner that has both extensive domain expertise of hedge fund operations and technology, and a clear vision for the future of cloud computing and how it will impact your business. Along those lines, you also need a provider with the capacity to scale on demand and grow with your business to meet your current and future customization, storage and compliance requirements.

Q: Why not just leverage Dropbox, Gmail and Amazon cloud?

The public cloud doesn't differentiate between a child's video game and a hedge fund's data. It's available for anyone who wants to use the resources, which means processors, memory, etc., are shared. If you're a hedge fund hosting through Google and your email goes down, what can you do? Service is shared among users the same way that bandwidth is.

On a private cloud, if there's an interruption — which is rare, but can happen — a hedge fund focused provider will have the tools in place to be alerted to the problem immediately so that they can get service back up and running quickly.

Another thing to note is that companies like Dropbox, Gmail and Amazon have bigger targets on their back especially when it comes to the hacker community, as they are much more known than a more specialized hedge fund IT service provider.

Q: What would happen to data in the case of a natural disaster?

The private cloud should be SSAE 16- and SAS 70-certified and include disaster recovery service that replicates clients' data and applications in near-real time to tier-three data centers that are geographically diverse from their primary office and/or primary data center. The service would need to provide clients with multiple levels of technology to remove single points of failure to minimize the effects of catastrophic outages, including clustered servers for zero application downtime, advanced security protection and prevention monitoring, multi-level snapshots to quickly restore any lost or corrupted data, and multi-site backup of all files and databases.

CHOOSING QUALIFIED LEGAL COUNSEL FOR A HEDGE FUND'S TRADING DOCUMENTATION

AUTHOR: LAUREN TEIGLAND-HUNT, TEIGLAND-HUNT LLP

Q: Do we need counsel if many of our trading agreements will be based on industry standard forms?

Yes. Although certain trading agreements are based on standardized forms, many were either published in a form that does not take full account of a hedge fund's concerns (as experience during the recent financial crisis has shown) or are modified by sell-side counterparties to include terms that a fund may find unacceptable. As a result, these agreements must be negotiated and revised to ensure a balanced set of terms. Plus, nearly all of them contain important credit, legal terms and elections that must be negotiated to protect a hedge fund's interests and better ensure liquidity and stability of trading arrangements during times of market stress.

It should also be recognized that prime brokerage and futures clearing arrangements, the lifeblood of many hedge fund portfolios, are not based on industry standard forms at all. Rather, these agreements are developed by individual brokers and tend to provide the broker with a high degree of discretion in managing the trading relationship with its client so as to minimize any risks associated with the client's trading.

The key takeaway here is that trading documents are critical credit agreements, and the credit and risk management provisions included in a fund's trading documentation can significantly impact the stability of the fund's trading relationships with its counterparties. The proper negotiation of trading agreements will provide a fund manager greater certainty regarding its fund's financing arrangements and margin obligations and reduce its vulnerability to hasty attempts by a counterparty or broker to force a portfolio liquidation during times of market stress or poor performance. Experienced counsel will be able to advise the fund manager regarding the extent to which trading agreement terms are negotiable and ensure that a fund obtains the best terms possible while avoiding traps for the unwary.

Q: When hiring legal counsel for trading arrangements, what are the key questions that a fund manager should be asking?

When interviewing trading lawyers, a fund manager should make the following inquiries:

• Does the firm participate actively in industry working groups? If so, which ones and in what capacity?

The effective negotiation of trading agreements, such as ISDA master agreements, master confirmation agreements, repurchase agreements, securities lending and forward agreements and swap-clearing documentation, requires expertise in the legal provisions of these particular agreements as well as proficiency in the fundamentals and economics of the underlying products. These agreements and products are often subject to ongoing industry dialogue and development among sell-side and buy-side industry participants. The more engaged a firm is in trade association working groups relating to such documentation, the more informed they will be about industry developments and trends for specific products, as well as the evolving "market standard" for particular terms in such documentation. In assessing a law firm's reputation and expertise, a fund manager may also wish to assess the extent to which members of the firm are recognized industry speakers and authors. If prospective advisers state that they participate regularly in certain industry initiatives, ask for specifics about the capacity in which and the extent to which they participated. Many industry working groups are open to general participation, and mere membership in a working group may not necessarily mean that an adviser actively represented client interests in that process.

• Does counsel have good working relationships with the major dealer counterparties and, in particular, those through which the fund manager expects to trade or clear business?

A firm is only as good as its reputation, both with clients and counterparties. A counterparty is more likely to respond positively to counsel with which it has established a cordial and productive working relationship. Therefore, hiring counsel that has completed numerous negotiations in a professional manner with various dealers and brokers on behalf of different clients will facilitate the efficient completion of trading documentation.

• What background and experience do attorneys in the practice group have?

Attorneys with a background in the financial services industry and attorneys with extensive experience with trading arrangements will be better suited to meet a fund's trading documentation needs. Issues that arise during the negotiation process often stem from counterparty credit risk issues or the economics of a trade or relationship. Counsel that understands the interplay between the economic reality of the trading relationship and the legal documentation will be a more effective advocate.

• Does counsel represent many similarly situated entities?

A firm that negotiates on behalf of hedge funds on a regular basis will be more effective in addressing issues that are important to a hedge fund and knowledgeable about market practice and standards. By representing funds that vary in size and strategy, counsel will be aware of what a newly formed fund may need and can expect to achieve in its documentation and how that will compare to what a larger and more mature fund can demand. Counsel that understands a fund's negotiating power vis-à-vis its counterparty will be able to provide the fund manager insights as to what types of terms it can expect to obtain. In this regard it will be helpful to ask the firm to provide a client list or examples of similarly situated clients that they have represented.

• How will the law firm staff negotiations with banks and counterparties?

Understanding at the outset how a negotiation will be staffed will allow the fund manager to assess the potential costs it may incur and provide a sense of how efficiently a firm operates.

Q: Why is it important that a fund obtain favorable terms in its trading documentation?

Strong terms in a fund's trading documentation contribute to the stability and liquidity of the fund, particularly in volatile market conditions or periods of declining performance. A fund that has negotiated documentation with favorable terms will be better placed to protect both itself and its investors, and, in the wake of Lehman's collapse and other market incidents, investors have become increasingly savvy about the risks associated with having weak trading documentation. For example, the provisions of a trading agreement will often dictate whether a fund's collateral and other assets are protected in a dealer insolvency and whether the fund can prevent trades from being closed out if its performance declines by certain levels.

Q: Which trading agreements should the fund seek to put in place?

The trading agreements a hedge fund executes will depend on the fund's investment strategy. Initially a fund will often seek to put in place some combination of the agreements below:

• ISDA master agreement (for "over-the-counter" (OTC) derivatives, uncleared);

• Prime brokerage agreement (for securities; may include a securities-lending component);

• Futures & options clearing agreement (for exchange-traded futures & options on futures, plus cleared swaps);

• Repurchase agreements (for repos/reverse repo trades).

Q: Should a fund execute trading documentation with more than one counterparty?

Yes. It is prudent for a fund to have trading documentation in place with multiple brokers and trading counterparties. Having the ability to compare trade pricing and margin methodologies, as well as position limits and other terms, across counterparties and brokers will allow the fund manager to optimize the economic and legal terms that are applicable to their portfolio. The use of multiple prime brokers can also mitigate funding risk and create backup capabilities for processing items such as corporate actions. A fund manager may also use favorable agreement terms obtained with one counterparty as leverage in a negotiation with another counterparty. Perhaps most significantly, diversifying a fund's counterparty/broker base will facilitate a fund manager's ability to quickly move a fund's positions should one of its counterparties or brokers experience liquidity or other credit issues and help to minimize the fund's exposure to losses should one of its counterparties become insolvent.

Q: What regulatory concerns should I consider?

• Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) has dramatically changed the OTC derivatives landscape. New rules and regulations are constantly being passed that affect a fund's compliance and documentation requirements. Most recently those rules have addressed mandatory clearing, required documentation, business conduct standards, recordkeeping, reporting, margin requirements and position limits. Counsel should be up to date on all Dodd-Frank regulations and initiatives so it can correctly advise the fund manager on its trading compliance queries.

• Securities and commodities regulations

The trading of securities and commodity instruments other than OTC derivatives are also subject to extensive regulation by the SEC and the CFTC. Counsel should be qualified to advise as to the implications of such regulation for a fund's trading documentation.

Q: Can I rely on in-house counsel (if available) to negotiate trading documentation?

While certain in-house fund counsel may be experienced with hedge fund trading documentation, many have more experience with fund formation and structuring or litigation and may not be knowledgeable enough about market practice in trading agreements and current industry developments to obtain favorable terms for a fund. Furthermore, in-house counsel may not have the capacity to single-handedly negotiate several trading agreements simultaneously in advance of a launch, for example. On the other hand, having a dedicated in-house documentation attorney may not make economic sense during times when there are not many ongoing negotiations. By leveraging experienced outside counsel for the negotiation of trading agreements, a fund manager will be able to benefit from their expertise while controlling costs by calling upon them only as circumstances require.

Q: Should I forego trading counsel if I am trying to minimize my expenses?

While costs may be of particular concern at a fund's launch, a fund manager should consider the advice of experienced legal counsel on trading documentation as a long-term investment in the stability and viability of the fund it manages. Funds often trade under the terms negotiated by its counsel upon launch for several years, and those terms will govern the fund's relationship with its counterparty or broker for as long as they trade with each other or until they are renegotiated. In this regard it should be noted that weak trading agreements are often more difficult and costly to renegotiate and will likely end up costing a fund more than legal fees charged by experienced and effective counsel at the outset.

Conclusion

A fund manager should seek established counsel that offers substantial expertise in the area of trading documentation and is adequately staffed to cover its needs on a timely basis. Investors are increasingly aware of the risks presented by weak trading documentation and the impact it can have on a fund's viability and the value of its assets during periods of stress, so the investment in sound advice on a fund's critical trading agreements should be viewed as an important commitment to the fund's future.

BUILDING AN EFFECTIVE MARKETING STRATEGY AND PHILOSOPHY

Q: What should a firm try to remember on a regular basis?

A hedge fund is a product. No matter how a firm spins it, slices it or presents it, at the end of the day, there is a strategy, a philosophy, a process and a team that executes all the elements to create a portfolio. To convert prospects to clients they need to be excited about the way you are going to make money for them going forward. Investors want to know what is in the portfolio now, how it got there, what it will take to extract value (good or bad), what is on deck, and why.

One oft-forgotten factor is that hedge fund managers, and thereby the hedge funds themselves, work for the investors. Investors pay fees to have their money invested. Fund managers and their teams need to remember that when considering the risks they take and their approach to communication with investors.

Q: Are the roles of marketing/business development and investor relations different, or are they interchangeable?

Marketing/business development is about raising capital. Investor relations is about communication and retaining capital. They are mutually dependent and integral to one another but not interchangeable.

Marketing executives should take it as their role to:

- Identify appropriate potential investors based upon size and risk/return appetite.

- Provide critical information that the investor will need to make an informed decision.

- Educate potential investors with enough depth that when they finally meet the investment team in person it is to discuss salient details, not process or philosophy.

- Have the competency to conduct solo marketing trips. Portfolio managers are not paid to travel; their job is to manage money. Limit portfolio manager travel to capital introduction events or perhaps group dinners.

- Pre-qualify investors, conduct initial meetings and vet investors so as to only present the portfolio manager with investors who have a higher likelihood of investing.

- Train junior investment team members to participate in meetings to share part of the portfolio manager's burden; however, don't create the "Wizard of Oz" syndrome. This is when the portfolio manager expects investors to invest in his fund purely based on his résumé and returns, and will not take the time to meet with them and answer questions in person.

Investor relations executives and activities of the firm must take into consideration that investors want to feel that they are part of a partnership with their hedge funds. Investors want to be aware, and don't want surprises. Previously, this level of transparency and relationship only existed with some of the larger pension funds and hedge funds, but it is now being adopted more broadly and by smaller and newer funds as well.

Where the two functions become completely integrated is in the continuous need to manage contact lists and relationships and communi-

cations, and produce informative reports for both current and prospective investors from a central source of data. Simply put, when things are going well and the fund is performing well, these kinds of systems and tools make marketing and capital-raising efforts that much more effective. Conversely, when the fund goes through a difficult patch, the portfolio and risk management tools that are part of the system help the investor relations team to provide investors with an added level of transparency. This will ultimately determine a firm's effectiveness in both its capital-raising efforts and its capital-retention efforts.

Q: What are examples of a sales tactic or technique that is not as effective anymore?

A hedge fund marketing executive should not use the same level of phone activity and technique that is used in institutional sales. The hedge fund sales process is longer, more thoughtful and more deliberate than buying a corporate bond. Extensive details about the portfolio manager's résumé should be in an appendix of bios or in the due diligence questionnaire (DDQ). Investors get excited about investing with a fund due to the fund's view of the world and how the investment team will make the investors money, not where the portfolio manager worked or went to school.

Q: What mistakes are frequently repeated, and how can we avoid as many as possible?

Running an asset management business is not the same as being a portfolio manager. The best firms have professionals running the business so that the portfolio manager can run the fund. Unfortunately, portfolio managers themselves are the most to blame for these repeated errors. A good marketer will be able to manage the portfolio manager to make sure that he is not his own worst enemy. The biggest mistake that hedge funds make is targeting investors that are not appropriate for their fund. It is best to focus on the kinds of investors that can invest now and can get you to the next milestone.

Q: What are the most important marketing materials/deliverables and what should they contain?

- The DDQ is the most important marketing document since it contains a detailed description of strategy, risk limits, hedging disciplines, performance history, investment terms, investor concentration, biographical information of team, basic counterparty information, and much more. The Alternative Investment Management Association has a template that can be followed.

- For initial discussions, the pitch book/marketing deck provides a summary of the DDQ and highlights the firm's qualitative and quantitative characteristics. It should be around 25 pages at most.

- The quarterly investor letter provides a history of performance and supporting commentary; additionally, a quarterly conference call with a brief Q&A can give investors added insight and can be an efficient use of the investment team's time.

- A one-page tear sheet can be used for monthly reporting and marketing if it contains a summary of the investment strategy, monthly net performance, risk/reward analysis, peer group analysis, benchmark analysis, current AUM, service providers and contact information.

- Depending on strategy, some managers choose to have a few examples of research reports. This highlights idea generation, analysis process, thesis of investment, expression of the trade and expected outcome.

- When possible, a fund should be able to produce a document to show a current portfolio snapshot and exposure data. Protective measures can be taken to insure against broad circulation of information.

Q: What role will my capital introduction team play? How can I best utilize them?

Your capital introduction team at your prime broker is available to you to make introductions. They are not allowed to raise money. Having a good relationship with your direct contact in a cap intro team can be vital to arranging meetings. The focus should always be to utilize their diverse relationships to identify the right investors. Prime brokers often hold events where fund managers can meet face to face with groups of investors over the course of a couple days. Many hold a few of these events per year in different parts of the world, for different size funds or for groups of funds in specific strategies. These are the kinds of gatherings portfolio managers should attend and give presentations. When a marketer is organizing his own road show to meet investors in other cities or countries, the cap intro team should be a resource to reach out to arrange meetings. However, cap intro groups, can only be successful helping funds that are performing well and have all the components that are attractive to investors. Having two or more prime brokers can provide a fund with a broader relationship base.

Q: When should I consider using a third-party marketer?

Internal marketing efforts and “third-party marketers” (TPMs) can work well as long as there is constant communication, a defined scope of expectations, and a clear list of who the TPM is permitted to contact. Since TPMs do not serve an ongoing role in investor relations, the firm must always have the infrastructure to manage current investors without the TPMs involvement.

IMPORTANCE OF CRM

AUTHOR: GEOFF SURKAMER, BACKSTOP SOLUTIONS GROUP, LLC

Q: What role does an integrated CRM system play today in marketing and IR, and how early should a firm begin to utilize them as part of their internal culture?

Traditional CRM systems simply manage contacts and track communications. However, investors and regulators today are demanding more transparency and greater clarity. Advances in hedge fund-specific CRM systems have given firms the ability to consolidate multiple layers of the business to create new levels of efficiency. These platforms combine traditional CRM, investor relations and account management, and streamlined reporting capability. Putting these systems in place early on will add credibility with investors, increase efficiency during a period of limited resources and multi-tasking and allow your marketing and investor relations programs to grow in a structured and organized fashion. Additionally, having a single source of investor information will simplify coordination of efforts when adding new members to the client-facing teams. Also, as dedicated hedge fund systems, these platforms are more likely to stay ahead of “commodity” CRMs.

Q: Should cost be the main driver when considering a CRM solution?

A common mistake many new managers make is to settle on a sub-optimal CRM due to cost. Many of these commodity CRMs lack industry-specific capabilities including, but not limited to, tracking subscriptions, redemptions, liquidity, compliance and more importantly, the ability to handle ever-expanding regulation through custom-field creation. A manager should weigh the benefits of the enhanced functionality of a hedge fund-specific CRM system against the costs. In addition, the manager should consider how the CRM system fits into the fund’s business model and how it will grow with the firm. (There is a not-insignificant cost to switching systems down the road.) Finally, selecting a CRM system is a crucial business decision which should not be made without significant research. As you would when selecting any service provider, you should seek the guidance of knowledgeable industry participants, including other managers and your prime broker’s consulting services team.

Q: How can CRM software help a hedge fund and improve contact with its client base?

Many different areas of your company touch the client directly and indirectly including accounting, legal and compliance, investor relations, the administrator and (of course) sales and marketing. In addition to giving the sales and marketing team a convenient place to store contact information and track correspondence, phone calls, meetings and follow-up, giving the rest of the firm access to that software and thereby the content that has been delivered to each client allows for a consistent message and enhanced efficiency. The consistency of message is critical. There are few ways to better alienate a current or potential investor than by providing conflicting information from two different sources within your organization. In addition, CRM software can be compartmentalized to allow different users access to different levels of client data, thus safeguarding confidential information.

Q: How can a good CRM system help with better customer profiling and opportunity management?

From a sales and marketing standpoint, a CRM should complement your workflows, increase your productivity, and ultimately help you gather and retain more assets. Tools within that CRM system that make it possible to filter through prospective and existing investors by metrics such as location, investment mandate or even relationships with other investors, can help to simplify the client profiling process and streamline the overall marketing approach. In addition to storing and slicing and dicing prospect data, a robust CRM should make it easy to create marketing campaigns, send and monitor correspondence via email or an integrated website, plan marketing trips and track capital inflows and outflows.

Q: To what extent do regulatory requirements affect how CRM software is used?

A sound CRM platform, properly utilized, allows managers to meet many of their requirements under global regulatory regimes. The Financial Service Authority, SEC and other government agencies have mandated that fund managers protect the confidentiality and integrity of personal information. In addition, a CRM platform makes it easy to demonstrate the nature, length and full extent of client relationships to regulatory agencies during an audit.

Q: How else can a CRM be of service to a hedge fund?

Many managers are discovering that a good CRM can be as effective in the front office as it can in the middle and back offices. For example, over the past several years, some firms have deployed complicated and expensive research management solutions for assisting their portfolio management teams track notes, meetings and research. What many of them have discovered, after failed implementations and sub-par adoption, is that what their teams really need is core CRM functionality: notes, meetings, email and contact tracking with the added ability to hook into portfolio accounting systems. Robust CRM tools can be deployed across entire firms to bridge the gaps between the investor relations, sales and marketing and research management teams.

Q: Is there only one CRM version offered for hedge funds irrespective of role and responsibility?

One of the common mistakes a manager makes when buying a CRM for their firm is believing that a commercial, off-the-shelf solution should work for all employees. It doesn't. The IR team needs to see everything including all qualitative and quantitative data of current and prospective investors. On the other hand, an administrative assistant, junior analyst or intern does not. So why pay for a solution without a tailored approach of functionality per employee type?

Q: When should the CRM be purchased and implemented?

If the manager has one contact and plans to grow the firm/fund, there is no better time than the present to establish foundational lynch pins by way of technology, just as they would be by hiring a rock-star research analyst or trader. A hedge fund CRM is equally as important.

IMPORTANCE OF ENGAGING A COMPLIANCE CONSULTANT

AUTHOR: HEATHER MOUNT, KINETIC PARTNERS

In response to the number of breaches of law which have occurred at advisory firms during the past few years, regulators and governments around the globe have forced new legal and regulatory constraints on investment advisers, making the running of their business more demanding — and arguably more expensive — than ever before. From the passing of the Dodd-Frank Act, which requires advisers to implement measures aimed at tightening internal and external controls over risk factors affecting advisers' businesses, to the launching of the SEC's and CFTC's new initiatives to increase investment adviser transparency, the scales seem to be tipped towards greater regulatory compliance. Most importantly, investors themselves, whether they are individual investors seeking to establish new relationships or institutional investors seeking to allocate significant tranches of capital to carefully selected advisers, have begun to push investment advisers for greater transparency and for information about the internal and external controls the adviser has in place to avoid dangerous conflicts that can create risk to the advisory firm and thus to the investor's capital.

Q: How would hiring a compliance consultant benefit me and my business?

The primary role of a compliance consultant is to work with the adviser's management team to create a compliance focus at the firm, often referred to as a "tone at the top," by organizing and implementing compliance policies and procedures, as well as by encouraging best practices that the employees should follow to most effectively support the investment adviser's business. Most often, a consultant is brought on board as a quarterback engaged for the purpose of creating an overall compliance program for the firm — separating out the duties of counsel, audit, fund administration and the role of the chief compliance officer (CCO) — and providing a second level of oversight to monitor the work that the CCO and the firm's management team do to manage the firm's compliance risk.

For the emerging or the established investment adviser, partnering with a compliance consultant provides numerous compelling benefits to the business:

- The expense of compliance is not nearly as costly as the potential cost of non-compliance: Avoid the costly potentiality of unexpected and mandatory audits; regulators' inquiries (and the associated legal fees), which could drag on for months on end; and penalties that could be imposed for lapses in compliance efforts and possibly even culminating in the loss of business.

- Compliance builds credibility and is attractive to investors: The more serious the investor and the larger the potential investment allocation, the more demanding the investor will be and the more questions he or she will have about how the firm's operational activities and security protocols provide protection for the investor and his or her assets.

- Having a compliance plan in place contributes to well-planned strategic growth: An integral component of growing one's business is protecting the business along the way and providing a path for the business' development of the business. A compliance consultant will point out the activities and deliverables that need to be produced for compliance reasons. On an ongoing basis the consultant can also address and remove as many impediments as possible to the business's growth plans. Another way of stating this point: advisers and CCOs who engage a compliance consultant may sleep better at night feeling that their business is being monitored and that the rudders are in place to guide the firm forward.

Q: What are the risk factors to my business that an effective compliance consultant will help me to address?

A compliance consultant can help you to address operational risks and regulatory risks. By examining the firm's existing operational procedures, the consultant will point out areas of deficiency which, if left unaddressed, could leave the business exposed to potential risks. Such risks at the employee level may include insider-trading or conflict-of-interest risks that could culminate in lawsuits and expensive legal fees or sanctions. At the regulatory level, advisers risk the possibility that a regulatory examination may run considerably longer than anticipated if the firm's compliance regime is not tightly organized and regularly managed. Once regulators find cause during an examination to doubt the integrity of an adviser's responses or records, more and more questions may be asked, leading to a longer examination.

Among the many risk factors that are regularly addressed by thorough ongoing compliance regime, the following are of primary concern for the SEC:

- Errors in portfolio trading and lapses in risk management
- Conflicts in brokerage practices
- Breaches of rules related to marketing, advertising and investor communications
- Failures to oversee investor suitability and the management of subscription documentation
- Failures in reporting requirements
- Failures to appropriately maintain records
- Risks of insider trading related to employee trading and conflicts stemming from outside business activities
- Failures of the business continuity plan
- Failures on the part of the firm to adhere to stated policies and procedures

Q: At what point does it make sense for me to hire a compliance consultant?

The question of when exactly to hire a compliance consultant is best answered by determining the adviser's objectives and budget. Compliance consulting engagements are often arranged on an annual schedule (quarterly, semi-annual or once per year) and are typically priced either by the hour or through a flat fee contemplating a certain number of hours per annum of client work provided. Having a relatively good handle on the type of work that your advisory firm needs to be done will be very helpful towards making the decision ultimately on when to engage the consultant.

Depending upon the maturity and the complexity of the adviser's business, and whether your advisory business currently involves (or contemplates getting involved with) international expansion into other jurisdictions, one of the following scenarios may apply to your situation to describe "trigger points" when the adviser may seek consulting support:

- Emerging managers seeking new investors: The stakes are high for the manager as new rules and regulations, such as those found in Regulation D of the Securities Act of 1933 or in the Foreign Corrupt Practices Act, may prevent certain investors from investing. As a rule of thumb, advisers with at least $25 million in assets should seriously consider engaging a compliance consultant to ensure that best practices are being followed and best habits are being developed at the firm and employee level.

- Established managers seeking compliance support: As an adviser's business grows, additional resources are often required to meet the increasing demands and complexities of new regulation. An adviser may suddenly feel overwhelmed with the legal and regulatory aspects of running the business. A compliance consultant is often engaged to provide support not only for the CCO and the management team, but also as a means of ensuring that the firm's fiduciary responsibilities to its investors are being carried out responsibly and responsively.

- Investment advisers seeking a second opinion: Often compliance consultants are engaged by an investment adviser's attorney to provide a comprehensive compliance review, or a "mock audit," which by definition is a thorough examination of the firm's operational and regulatory compliance arrangements, including a documentation review. Mock audits have become increasingly popular recently, as the SEC has redoubled efforts and added resources to increase the frequency and the precision of its examinations of newly-registered and recently-registered advisers (the initiative is referred to as the "National Examination Program" or "NEP"). On a relative basis, a more attuned investment adviser seeks to get ahead of the competition by ensuring through a mock audit that any deficiencies are addressed early on.

Q: Why is price not the only variable that I should consider when evaluating a compliance consultant?

The rise in compliance as a priority for investment advisers has opened the door for multiple "vendors" of compliance services to enter the marketplace. One of the key benefits of hiring a credentialed and experienced group as a compliance consultant is their wealth of aggregate experience, gained by living through many examples of how other advisers have handled matters in the right way or in the wrong way. Take advantage of all that your consultant knows and learn from others' successes and mistakes.

Seek out the right compliance partner with whom you can share your business concerns and develop a long-term relationship built upon trust and understanding. Seek out a responsive service partner who delivers the work that was expected and does not shy away from supporting you when questions or needs arise over time. If and when the SEC comes knocking at your door with a list of questions and requests, you will be glad to know that your compliance partner is there for you, already understanding your business and able to provide guidance and support.

Q: If I decide to hire a compliance consultant, what should I look for in terms of credentials and expertise?

The right compliance consultant is one that offers in-house expertise with the legal aspects of regulatory compliance and with the transactional and business aspects which are relevant to running an advisory business. Speak with the compliance consultant's team and get a sense from the initial meeting or call as to the team's responsiveness, the size and composition of the team who would be serving your firm, and find out more about each team member's background. There is no set rule on how many years experience in law, regulatory work, brokerage or hedge funds, banking or administrative services that a consultant team's members may bring to the table. As always, it is helpful to check with industry peers for a reference or a qualified referral.

CHOOSING A QUALIFIED RISK CONSULTANT AND RISK SYSTEM

AUTHOR: DAN CONNELL & WILLIAM LIVINGSTON, CONCEPTONE, LLC

As investment markets continue to operate under elevated, highly unstable and unpredictable risk and regulatory conditions, one of the few trends that can be clearly identified is the massive and growing need for money management enterprises to develop, implement and manage significantly enhanced top-down risk analytics and data architecture platforms, designed to meet an increasingly diverse and ever-expanding set of internal and external constituencies. Prolonged market instability, growing investor demands for transparency, and reporting requirements imposed by regulators, have combined to place myriad new reporting burdens on investment firms. Moreover, these reporting mandates must be disseminated to an expanding audience, but also need to feature a high level of consistency across associated information distribution silos.

Q: How would hiring an outsourced risk solution benefit my business?

Implementing a robust risk solution starts with data management. A risk solutions provider should be responsible for establishing and maintaining a work-flow that will support accurate and timely reporting output. You are not just buying "software" but leveraging a team that will produce the actual content you will review each day/month. Secondly, risk providers can help you determine which types of analytics are potentially applicable to your asset and strategy classes, and to assist the client in data interpretation of the content.

Q: At what point does it make sense to hire an external risk consultant?

There are generally two reasons a client would engage a risk consultant. The need for quality risk analytics is typically driven by a combination of internal (portfolio decision support) and external (investor- or regulatory-driven) factors. While some of the early stage internal reporting needs can be handled by members of the clients own technical staff, there is often an added benefit of engaging external third-party professionals to assist in the investor reporting and transparency process. These benefits include having the perspective of external risk professionals who are working with many different types of investment companies, both direct investment platforms and allocators into those funds. The consultants should be able to help you more clearly define your end goals including, instituting best practice risk measurements applicable to the individual strategies deployed and focus core decision makers on key concepts and metrics that directly relate to internal/external objectives and constraints (e.g., return targets and max loss tolerance).

Q: Can your risk service provider aggregate data from multiple sources, including custom tagging and classification?

Data aggregation is the first and most critical step in creating any centralized data repository. Providers should have a strong working knowledge of all of the common sources of data (prime brokers, fund administrators, order management systems, shadow accounting systems). The ability to customize classifications of securities to reflect the organizations structure and methodologies should be a required component of the offering. These classifications include sectors, strategies and various types of derived calculations (e.g., beta).

Q: How does your risk service provider support the evolving regulatory reporting landscape?

The ability to produce an ever-expanding set of regulatory filings has become a key consideration in choosing a risk provider. It is inevitable that private funds will not only have multiple U.S. requirements but also will fall under the jurisdiction of one or more foreign regulatory requirements. The alignment of these disclosure documents becomes critical. The industry can also assume that these filings will become standard due-diligence requests from prospective investors and might possibly replace many of the existing transparency requests.

Q: What level of support is provided for interpretation of analytics?

There are a multitude of risk software solutions out in the marketplace. To gain the most insight out of the vast amounts of data available, a firm must understand what each metric is measuring and how it is typically utilized in the risk management process, and communicate the key take away items to the fund management team. Without this, you can potentially reduce the amount of clarity and confidence in the risk measurement tools available to the team.

Q: Does your risk service provider have an integrated data warehouse?

Typically, there is a need to produce risk and performance metrics for multiple purposes including internal portfolio management, external investor transparency, and numerous regulatory filings. A centralized data warehouse can provide for a repeatable and consistent source of information allowing the organization to align all third-party disclosures with internal analytics. It is important to note that a flexible data warehouse is very different from a shadow portfolio accounting system.

Data stored in a relational database allows for the creation of future analytics and extractions of data around specific periods or events. The rapid ability to produce these types of ad-hoc metrics can be very valuable during periods of market stress or negative performance, or time critical requests for information from investors.

Q: How can a new or existing firm establish a comprehensive, cost effective data management system to provide for all of the internal and external reporting requirements required in the current environment?

To meet the expanding reporting demands imposed by regulators and investors, managers' only rational approach is to develop, implement, and manage a data capture and analytics architecture with the ability to evolve with the demands of the market and regulatory changes. This presents an ideal opportunity to address the demands that arise with expanded reporting to diverse audiences in a holistic manner. There are a number of reasons for this, but perhaps the most important to consider is that ALL audiences will, within very short order, have access to ALL reporting content. There is an ever increasing pressure to institute what is described as "formal risk management" reporting by the investor community and regulatory authorities as is evident in standards such as OPERA reporting and Forms PF and CPO-PQR.

Each organization must determine the right blend of internal and external resources to create the above data management structure. External providers/systems include fund administrators, order management systems, "shadow" portfolio accounting software, and external risk analytics providers. Each organization must also establish the appropriate internal resources in each of the critical control functions discussed above (internal risk reporting, third-party investor disclosures, regulatory filings) and take "ownership" of the processes and accuracy of the output.

Q: What are the key elements of this reporting structure?

PRIMARY DATA SOURCES:

- Internal accounting systems
- Fund administrative data
- Information from custodians, prime brokers and counterparties
- Internal management reports
- Order management systems

"Descriptive" position/transaction information: This includes all information needed to characterize exposures, including such descriptors as bond terms and conditions, sectors, "greeks," internally generated strategy codes, etc.

Risk analytics engine: All of the inputs described above would be mapped to one or more analytics engines and used to calculate such metrics as value at risk (VaR), stress/sensitivity analyses and other measures of forward-looking exposure.

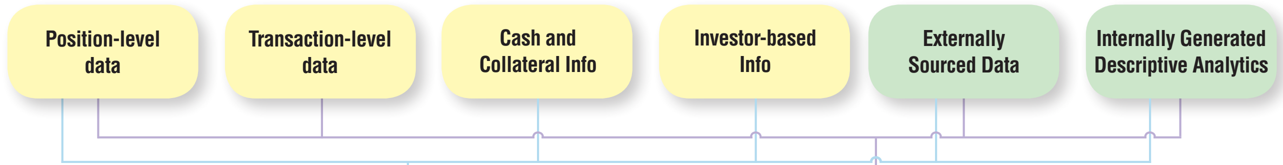
Historical data warehouse: This is perhaps the most critical of all. Capturing all input data, derived calculations, formatted reports and associated intermediate data aggregations. Data warehouse should support storage of the following output:

- Internal daily reporting content
- Regulatory reporting: Form PF, CPO-PQR, AIFMD
- OPERA/investor reporting

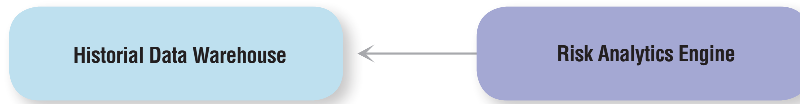
Report production and quality assurance: The goal is to produce a suite of reports customized to the various and multi-faceted reporting needs of a money management enterprise. However, once the analytics are in place and mapped against the appropriate data sets, report production can be a very complex, labor-intensive operation. There needs to be quality assurance at every step of the process, and places a particular emphasis upon reviewing the output in pre-report production format to ensure not only accuracy, but as indicated above, consistency across reporting silos.

Reporting output: Regulators, investors, and internal management are all beneficiaries of the various reporting output that is available. Well-designed systems and data architecture, along with implementation procedures managed by competent staff and overseen by high-level management entities, will help firms produce comprehensive, accurate and consistent results in a much more efficient and cost-effective manner than any approach which features a silo-based strategy for report delivery.

DATA TIER



ANALYTICS TIER



PRODUCTION TIER

REPORTING TIER

WHAT TO CONSIDER WHEN IMPLEMENTING BUSINESS INSURANCE FOR HEDGE FUNDS

AUTHOR: JACK JENNINGS, WILLIS NORTH AMERICA

Fundamental risk in a hedge fund dwarfs insurance-type risk. While a lawsuit by a messenger who slipped in your office won't sink a fund, inability to raise enough capital to cover costs or poor returns will. This is not to suggest however that the important (and necessary) topic of insurance should be neglected — quite the opposite. A sound insurance program is compulsory by law for certain coverages, required in the normal conduct of commerce for others and a prudent part of the operations profile of all reputable investment professionals.

Q: When should a fund consider insurance?

The short answer here is during the phase when the principals are vetting their concept against a budget of some sort.

This is the best time because:

- You will have an opportunity to build in better cost projections than would be contained in some all-inclusive cost estimate
- You will be making an investment of time in understanding (or revisiting if you've done this before) the specific types of insurance you'll need/want
- As part of this, you'll be formulating an action plan — which insurances will we have in place at what time?

The most expensive coverage, directors and officers/professional liability, is often ignored until AUM reaches a level where the premium is supported. Despite the expense, it's best to arrange this coverage as early as possible, perhaps by buying a lower amount of coverage and stepping it up as the fund grows.

Q: What should I find in an insurance adviser/partner?

The most important issue is deciding early on to address insurance. The next most important issue is your selection of a partner with insurance expertise. Most major insurance brokers have financial institution practices that include hedge fund clients. If you select one of these firms, the important factor is to have individuals on your day-to-day service team who have or who can get at the expertise, and who are proactive and responsive. There are also smaller boutique insurance brokers that have this expertise.

Look for the following signals that your broker service team matches the firms' expertise:

- Extensive market knowledge and relationships
- Claims resolution expertise

- Ability to develop multi-year strategy

- Ability to advise on internal insurance related issues (premium allocation between manager and fund)

- Ability — and willingness — to deal with issues large and small

This is very important at the start-up phase. The more mundane coverages with the small premiums are those that you need the earliest — think workers' compensation or a package policy covering office contents and general liability. Many insurance brokers get excited when it's the big premium, intellectually driven directors and officers' liability or professional liability policies, but meanwhile you'll need the basic coverages in place and in order.

A final thought on a partner — your attention will naturally move toward investors and results. Much of the detail offered here is thus forgotten by you but not by a solid partner. That makes the choice of partner perhaps the most important take away from this article.

Q: In general terms, what purpose does insurance serve for a hedge fund?

The rationale for hedge funds maintaining insurance might be summarized as:

- Covering allegations of managerial malpractice

- Complying with legal requirements (in the case of certain insurances)

- Meeting generally accepted business practices (in the case of all insurances)

- The economic efficiency of financing moderate to large losses through the insurance mechanism

DESCRIPTION OF COVERAGES & BUSINESS RATIONALE

TYPE OF INSURANCE	EXAMPLES OF WHAT'S COVERED	BUSINESS RATIONALE
Package policy Typically Includes: Property Business Interruption/Extra Expense General Liability Personal & Advertising Injury Damages to Premises You Rent Medical Payments to Others Non-Owned & Hired Automobile Liability & Physical Damage	• Property, usually office contents and electronic equipment (fire, all risk perils, etc.) • Premises Liability — a visitor slips and falls and brings a suit. • Non-owned Auto Liability — the firm is sued for an auto accident — excess coverage over employee/rental insurance.	• Required by lease agreements (office, equipment leases, etc). • Overwhelmingly common business practice.
Umbrella Liability	You are on the losing end of a $3mm lawsuit for Premises Liability or Auto Liability.	The $1mm that is the typical limit of a Package Policy's Premises and Non-Owned Auto Liability coverage may not be enough.
Workers Compensation	Any workplace related injury to an employee including injuries resulting from an auto accident on the way to meet an investor.	Required by law (certain states also require State Disability Insurance in addition to Workers Compensation).
Fidelity Insurance Typically Includes: Employee Dishonesty Forgery or Alteration Counterfeit Money Computer System Theft ERISA Bond	An employee embezzles funds; a hacker transfers money to accounts outside the firm.	• Protection from theft in a money business. • Some investors may request evidence of this as a credential. • ERISA rider covers the statutory obligations related to your sponsored retirement plan.
Fiduciary Fidelity Bond	Crime losses to ERISA plan funds held by you on behalf of other plan sponsors.	May be required by investors.
Network Security/Technology	Privacy breach	Satisfy regulatory requirements following a breach.
Management Liability Package Typically Includes: Directors & Officers Liability Professional Liability Investment Company Coverage Private Fund Coverage Employment Practices Liability Fiduciary Liability	• Investors sue the IA &/or the Fund Board/ GP. • Defense costs for certain regulatory and criminal proceedings.	• Buffer in disputes. • Requirement of board • Some investors may request evidence of this as a credential.
Employee Benefits	Health/ Dental/ Vision Ins, Life Ins, Disability Ins, 401K.	Attract and retain associates

Q: How is this insurance priced?

Cost is a short term point of analysis. Value requires more thought, especially because we pay the premium today in return for a contingent promise to pay.

The factors that we suggest you consider are:

- Financial Security — just as is the case with any counterparty, can they pay?
- Coverage terms & conditions — is the coverage reasonably broad?
- Strategic match — can this insurance carrier support me as I grow?
- Premium — what is the cost? How does it compare with other proposals? Are payment terms offered?

Another word of caution — pricing on most of these coverages is somewhat subjective. Obtain actual proposals, preferably at least a few competing from top-tier insurers, and discuss them thoroughly with your adviser.

PRICING OF INSURANCE COVERAGES

TYPE OF INSURANCE	RATING BASIS	RANGE & COMMENTS
Package policy Typically Includes:	Property Values Square Footage Leased Number of Employees	Single leased location for 10 people $1,500 - $5,000.
Umbrella Liability	Underlying (General Liability & Automobile Liability Premiums)	$1,000-$2,000 per million purchased.
Workers Compensation	Annual payroll multiplied by a state promulgated rate + taxes	Office employees are generally charged .25-.50 per $100 of annual payroll.
Fidelity Insurance	Number of employees Controls AUM	Range $3,000 to $5,000 per $1,000,000 of coverage.
Fiduciary Fidelity Bond	Flat premium, AUM.	Approx. $1,000 per $1,000,000 of coverage.
Management Liability Package (D&O and E&O/ Professional Liability)	Subjective — typically per $1m of coverage purchased. AUM.	Approx. $5,000 to $40,000 per $1,000,000
Employee Benefits	Number of employees	Varies greatly by benefit level and % of cost paid by employees — rule of thumb 10 percent of payroll expense.

Q: Are there any commercial benefits to maintaining insurance?

Sometimes investors ask if you maintain professional liability insurance. This can be a make-or-break point for them. That you've passed muster with a professional underwriter of a major insurer has some weight.

As more qualified plans invest in funds, ERISA bonds are being required. This special version of fidelity (a.k.a. crime) insurance can help land this type of investment.

On the negative side, ignoring basic insurance could be embarrassing. If there were ever publicity around, say, an uninsured workers' compensation claim, that would not inspire the confidence of investors.

Q: Six months from now, I'll have forgotten most of the details offered here. What — in a nutshell — should I take away, not to be forgotten?

Insurance is not a panacea. It does not address the biggest risks facing a hedge fund. It does however fulfill important requirements. It might even help raise capital with certain investors. Pick a competent and caring partner and put in place an insurance program that stands in support of your business.

BIOGRAPHIES

Marshall Terry

South Ferry Capital Management, LP, Managing Principal, Chief Operating Officer, and Chief Compliance Officer

Mr. Terry is a Managing Principal, the Chief Operating Officer, and the Chief Compliance Officer of South Ferry. From April 2010 to October 2010, Mr. Terry was an Associate Principal at eClerx LLC providing operational and legal risk management consulting services to the firm's buy side clients. From June 2009 to February 2010, Mr. Terry was the Chief Operating Officer and Chief Compliance Officer at DW Investment Management, LP., a spin-out of Brevan Howard US Asset Management LP. From October 2008 to June 2009, Mr. Terry was the Chief Operating Officer for Credit Products at Brevan Howard US Asset Management LP. From May 2007 to October 2008, Mr. Terry was Head of Derivative and Loan Operations and Derivatives Counsel at Sandelman Partners, LP. From 2001 to 2007, Mr. Terry served as the Director of Derivative Operations and Derivatives Counsel at Moore Capital Management. Prior to this, Mr. Terry worked in the legal and operations departments of HypoVereinsbank, Citibank, N.A., and Bankers Trust.

Mr. Terry graduated from the University of Vermont in 1991 with a Bachelor of Arts in Economics and earned his J.D. from the Boston University School of Law in 1995. Mr. Terry is a member of the New York State Bar Association.

Timothy Hughes

Oakum Bay Capital, LLC, Chief Operating Officer, Chief Financial Officer and Chief Compliance Officer

Mr. Hughes joined Oakum Bay in June 2012 and is the Chief Operating Officer, Chief Financial Officer and Chief Compliance Officer. Prior to Oakum Bay, Mr. Hughes was the COO and CCO of Libra Advisors, a $2B long short equity fund focused on investments in energy and mining. From 2009 to 2011, he helped launch BHR Capital, a special situations strategy, and served as COO, CFO and CCO. Prior to BHR, Mr. Hughes was the COO and CCO of Bay Harbour Management, a $1B distressed manager. In 2004, he co-founded Bigger Capital, a volatility arbitrage hedge fund manager. Prior to 2004, Mr. Hughes spent several years as a derivatives specialist at Citigroup. Mr. Hughes received a B.A. in Mathematics and Economics from Bowdoin College. He received a JD from the UNC's School of Law and an MBA from UNC's Keenan-Flagler Business School. He is admitted to the bar in New York and Massachusetts and has earned the Chartered Alternative Investment Analyst designation.

Art Murphy

Abacus Group, LLC, Director of Client Development

With a distinct focus on company growth and customer engagement, Art Murphy combines over a decade of business development and client relations experience with a deep understanding of the hedge fund and financial technology markets. Before joining Abacus, he was the vice president of business development at Linedata Services, a global solutions provider focused on the investment management and credit communities. At Linedata he helped design and build the company's profitable business infrastructure and launch its software-as-a-service (SaaS) offering. Throughout his career Murphy has held leadership roles at emerging and established financial software and infrastructure companies such as Nirvana Solutions, NorthPoint Solutions and Eze Castle Integration. Murphy is based in New York.

Nathan Muller

NSM Advisors, LLC, President and Chief Executive Officer Subhra Bose Finomial Corporation, Co-Founder and Chief Executive Officer

Mr. Muller is the President and CEO of NSM Advisors LLC, a company that provides Marketing/Investor Relations, Legal, and Operation services to Hedge Funds. From 2002 to March 2012, Mr. Muller was a Director in the Prime Finance group at Deutsche Bank Securities. From 1990 to 2002, Mr. Muller was a Director and Senior Counsel in the legal Department of the Deutsche Bank AG New York Branch working with the Asset Management, Derivatives, AssetBacked and Futures groups.

Mr. Muller graduated from the University of Pennsylvania in 1985 with a Bachelor of Arts in Economics and International Relations and earned his J.D. from Cardozo School of Law in 1988. Mr. Muller is a member of the New York and Connecticut Bar Association.

Subhra Bose

Finomial Corporation, Co-Founder and Chief Executive Officer

Subhra is recognized as the face of Cloud Computing for the buy-side. His vision and multi-party workflow implementation on the Cloud fundamentally changes the interaction model in the buy-side ecosystem. At Finomial Subhra connected the investors, fund managers and administrators by launching electronic subscriptions to hedge funds, as a result providing regulatory compliance and operational efficiency. In his role as CTO for Credit Suisse Alternative Investments, Subhra created and rolled out front-to-back platforms managing hedge fund investments, index tracking portfolios and ETFs totaling US$250 Billion in Assets under Management. He has been responsible for the overall architecture of the Credit Suisse Alternative Investments platform. Subhra was the ChiefArchitect of the Reuters next generation equities trading platform. He has over eighteen years of experience in strategy and architecture of transaction systems including foreign exchange, equities, derivatives and commodities trading systems. Subhra has a Bachelor's degree in Physics from University of Calcutta and a Master's degree in Computer Science from State University of New York at Stony Brook. He has published several papers and he is an avid speaker in leading conferences in the area of transaction processing and workflows for Financial Services. He has patents in business process automation engines and messaging over internet.

Christopher Wells

Proskauer Rose LLP, Partner

Christopher M. Wells is a Partner and head of the Hedge Fund Group of Proskauer Rose LLP. Chris advises hedge funds, funds of funds and other pooled investment vehicles and their managers on all aspects of fund formation, operations and compliance.

Chris was nationally ranked by Chambers USA 2012 for Hedge Funds, and was noted for being a "first-rate business lawyer, both technically and practically." He has also been named a Leading Lawyer in his field by US Legal 500 and recognized in The International Who's Who in Private Funds Lawyers, the Best Lawyers in America and other publications.

Chris is a frequent speaker at conferences on investment funds and money managers, and is the author of various articles.

Before joining Proskauer in 2005, Chris was a partner at Coudert Brothers LLP, where he was head of the Global Investment Funds Practice and a member of the Executive Board.

Ingrid Pierce

Walkers, Global Managing Partner

Ingrid Pierce is Walkers' Global Managing Partner. She is based in the firm's Cayman Islands office where she also heads the Investment Funds Group.

Ingrid regularly advises some of the largest financial institutions on their stable of Cayman Islands funds and has acted as counsel to significant investors and managers in connection with the restructuring and winding down of various high profile funds. Ingrid regularly advises on directors' duties and responsibilities, indemnities, confidentiality laws and issues related to electronic communication. She has particular expertise in advising funds on managing distress in volatile markets.

Jeffrey Kollin

Rothstein Kass, Principal

Jeff Kollin is a principal based in Rothstein Kass' New York office. Leading the Financial Services Advisory practice at Rothstein Kass Business Advisory Services, LLC, Jeff advises clients, including hedge funds, fund of funds, mutual funds, private equity managers, broker-dealers, RIAs and family offices, on all matters, such as business strategy, new product development, infrastructure, operational, technology and risk assessments, service provider evaluation, and project management.

Jeff has over 20 years of experience in the financial services industry. On the buy-side, he was the head of business development for a multi-billion dollar, global credit-focused hedge fund, responsible for implementing and managing the organization's operational and technology infrastructures. On the sell-side, Jeff worked at Lehman Brothers, Inc., where he was the Global head of hedge fund consulting in Prime Brokerage and the COO for Global Finance in Investment Banking.

Jeff holds a Bachelor of Science degree in Industrial Engineering from Lehigh University and an MBA in Finance/International Business from NYU Stern School of Business.

Jeffrey Stomski

Rothstein Kass, Senior Manager

Jeffrey Stomski is a senior manager in Rothstein Kass' alternative investment practice. He has over 10 years of experience serving domestic and offshore hedge funds, private equity funds, and fund of funds. He is responsible for coordinating, managing, and performing audit and tax services for various alternative investment vehicles. Jeff participates in developing the firm's best practice initiatives, is a member of the firm's valuation committee, and instructs various in-house professional development seminars. Jeff is a certified public accountant and earned a Bachelor of Arts degree in economics and accounting from Muhlenberg College.

Frank Napolitani

Concept Capital Markets, LLC, Managing Partner

Frank spent the past 16 years in the Financial Services Industry, primarily with a focus on Hedge Funds. The first half of his career was spent on the Buyside as a hedge fund analyst and portfolio manager working at a Fund of Funds and Family Office, respectively. Both firms allocated capital primarily to Emerging Managers which had < $250mm AUM and < 3 year track record. In 2005, Frank switched to the Sellside and continued to work specifically with Startup/Emerging Hedge Fund Managers on managing their businesses more efficiently.

As a Prime Services Group Relationship Manager at Concept Capital Markets, Frank often acts as a business consultant to his clients during the prelaunch stage by helping them budget their prelaunch and Year 1-3 expenses, choosing service providers (e.g. legal, audit, fund administration, outsourced compliance services, etc.), general infrastructure items (e.g. office space, IT, etc.), and developing marketing materials to present to prospective investors. After a successful launch, Frank remains very active with his clients as they tackle the ongoing issues of running their business, not just running a portfolio. Frank has successfully helped dozens of entrepreneurs launch their new hedge funds since 2005 and continues to work with some very talented, highly pedigreed teams on their planned launches.

Geoff Ruddick

International Management Services Ltd, Fund Director and Head of Business Development (Funds)

Geoff Ruddick is employed by International Management Services Ltd. ("IMS"), a firm that specializes in fund governance and fiduciary services, where he serves as an independent director on the boards of alternative investment funds and special purpose vehicles. Additionally, Mr Ruddick is part of the senior management team and heads up client and business development for IMS' fund services division. Prior to joining IMS he was the Managing Director of HedgeWorks Fund Services Ltd. (now Deutsche Bank (Cayman) Limited) and before that, he was a Director and Compliance Officer with Derivatives Portfolio Management Ltd. (now DPM Mellon Limited). Prior to entering the commercial side of fund management, Mr. Ruddick worked with KPMG in Vancouver auditing mutual funds, banks, and insurance companies and later with KPMG in the Cayman Islands, where he worked in the Corporate Recovery department involving the liquidation of hedge funds and other regulated entities. He has extensive knowledge of the commercial side of fund management as well as with compliance, corporate recovery, and audit.

Mr. Ruddick is a Chartered Accountant, a member of the Institute of Chartered Financial Analysts, a member and fellow of the International Compliance Association, and a member of the Institute of Chartered Secretaries and Administrators of Canada. Other academic achievements include Honours standing and the Award of Excellence for outstanding academic achievement in the Canadian Securities Course as well as Honours standing in the Investment Funds in Canada course. Mr. Ruddick is also a member of the Cayman Islands Society of Public Accountants and a founding member of both the Cayman Islands Directorship Association as well as Restructuring & Insolvency Specialists (Cayman) Association.

John Kushner

Northern Trust Hedge Fund Services, Vice President

John Kushner manages the New York Relationship Management Team at Northern Trust Hedge Fund Services. As a Relationship Manager, John is both advocate and advisor to clients, working to support day to day servicing and coordinating the activity of operations and accounting teams to help customize deliverables to meet client needs. Prior to joining Northern Trust, John was an Account Manager at Omnium LLC, and has worked in various roles in the asset servicing space at Citadel LLC and Brown Brothers Harriman & Co. John holds a Bachelor of Arts from the University of Pennsylvania and Master of Science from University College London.

Lauren Teigland-Hunt

Teigland-Hunt LLP, Managing Partner

Lauren Teigland-Hunt is Managing Partner at Teigland-Hunt LLP. Her practice focuses on both OTC and listed derivative transactions as well as physical commodity and securities trading. She has extensive experience representing multinational financial institutions, hedge funds, exchanges and trade associations in a wide range of trading matters, with a focus on equity, credit, fixed income, foreign exchange and commodity instruments.

Having represented multiple clients in the development of OTC clearing platforms, she is one of the industry's leading experts in OTC clearing. She also has been actively advising clients on the implications of the Dodd-Frank Act and other matters related to derivatives reform and U.S. commodities law and regulation. She currently acts as counsel to several ISDA drafting com-mittees and is chair of the OTC Derivatives Subcommittee of the American Bar Association.

Prior to founding Teigland-Hunt LLP in 2002, Lauren was an attorney at Sullivan & Cromwell LLP in the firm's Commodities, Futures and Derivatives Group (1996-2002) and worked as a futures trader and banker in New York and Paris (1986-1993). She graduated with honors from both Stanford Law School (J.D. 1996) and Georgetown University (A.B. 1986).

Geoff Surkamer

Backstop Solutions Group, LLC, Global Head of Sales & Marketing

As the Global Head of Sales and Marketing, Geoff is responsible for overseeing Backstop's sales and marketing efforts across all platforms. Geoff brings over 20 years of experience leading global business efforts in the Software-as-a-Service (SaaS) industry.

Before joining Backstop in 2009, Geoff held several executive leadership positions at ASAP Software and founded License Technologies Group (LTG) which transitioned to Dell after their acquisition of ASAP and LTG in November 2007. Geoff earned his MBA from Lake Forest Graduate School and his BA from Colorado State University. Geoff also earned a certificate in International Business from Cambridge University.

Heather Mount

Kinetic Partners, Associate

Heather is a consultant in the Regulatory Compliance Group of Kinetic Partners in New York. She is responsible for advising clients on regulatory matters and assists with business development. Heather has managed the SEC registration process and assists with ongoing compliance projects for hedge funds, funds of funds and private equity clients. She also provides guidance for clients throughout the SEC examination process. Her compliance work focuses on the areas of personal trading, marketing materials, best execution and mock SEC audits.

Prior to joining Kinetic Partners, Heather spent 8 years as a private banking adviser for Wachovia Wealth Management, Wells Fargo Private Bank and Citi Private Bank. In her role as a private banker, Heather provided investment management, financial planning, credit and lending and trust arrangements for high-net worth individuals and families, law firms and other institutions.

She earned her MBA degree in Finance and Marketing from DePaul University's Kellstadt School of Business in 2003, and her BA from Oberlin College in 1993. Heather is currently a candidate for the CAIA certification as an Chartered Alternative Investments Analyst and carries her FINRA Series 7, 63 and 65 licenses.

Daniel Connell

ConceptONE, LLC, President

Daniel was a co-founder of Risk Resources and RiskONE. Previously he was the president of ETRADE Professional Trading LLC, where he was a member of the corporate risk and credit committees and managed over 150 proprietary traders. He was also a founding member of Tradescape, which was acquired by ETRADE for $100mm in 2002. He began his professional career at Accenture Consulting LP where he was a C+ programmer and management consultant. In 1995 he graduated with a B.A. from the University of Pennsylvania.

William Livingston

ConceptONE, LLC, Chief Operating Officer

William joined Risk Resources in 2009 as a Managing Director focusing on credit products and analytics. He is responsible for overall firm operations and project management. Previously, he was a Vice President at Goldman Sachs in the Global Securities Services division where he was responsible for credit-related instrument funding for prime brokerage and proprietary desks. While at Goldman, he was part of a team that developed formulaic pricing models and systems for portfolio margining and lending. He began his career at Citigroup where he was a strategist in credit research, where he advised on fixed income portfolios and strategic allocations for clients. In 1996, William received a B.A. in Psychology from Hobart College.

Jack Jennings

Willis North America, Executive Vice President

With thirty six years of experience, Jack oversees a Willis (www.willis.com) risk management practice group which designs and ervices risk management and insurance programs for noteworthy organizations across the country and around the world. Jack formed and managed two boutique insurance brokerage and risk services firms, the latter of which was merged in 2000 into what is now Willis. Previously he held various executive and technical positions in the insurance brokerage and risk management fields.

Jack has expertise in management and professional liability insurance programs along with significant experience in alternative risk finance, complex casualty, property, marine, international, political/credit risk insurance programs and employee benefit programs. Jack was graduated from St. John's University School of Risk Management, with a B.B.A. cum laude (Insurance, 1981) and a MBA cum laude (Insurance and Risk Management, 1988).