US Hedge Fund Services 2016

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Managers move to partner service providers

Interview with Christine Waldron

Service providers are becoming more of a strategic partner to their hedge fund clients as they look to provide a suite of services that go beyond a single solution proposition.

In the past, an administrator’s primary function was to strike the fund’s NAV and provide investor statements. Times, though, have changed.

“Service providers are viewed by managers much more broadly today and we are really aimed at becoming a partner with our clients. Not only are we able to help managers overcome the myriad of regulatory filings they may face, but we want to help them evolve which has required us to expand our suite of services,” says Christine Waldron, global head of the Alternative Investment Solutions team at U.S. Bancorp Fund Services.

To meet this challenge and become a strategic partner with their clients, U.S. Bancorp Fund Services has focused on providing clean data for managers’ systems to make them more efficient, offering middle office, regulatory reporting and investor servicing tools, along with tax reporting solutions that collectively help to create a more involved and inclusive relationship.

When asked what the primary drivers are behind this need to lean more on service providers, Waldron suggests:

“The primary factor is that fund managers are trying to streamline their operations to become leaner and more efficient. Another key factor is that the regulatory burden is increasing. There’s been a fairly rapid evolution of the regulatory environment and as a result managers have sought to find the right partners to help support them and their products.”

To highlight the pressure that managers are under, a recent Preqin survey published this summer found that 86 per cent of fund managers feel that regulation has increased the costs of business.

Another important driver of outsourcing is fee compression. Average fees this year have fallen to a 1.57 per cent management fee and 19.29 per cent performance fee. The more the management fee compresses, the less wiggle room emerging managers (in particular) have to commit capital to operations.

“That pressure is driving fund managers to be more operationally efficient compared to how hedge funds operated historically. What is the best utilisation of the manager’s resources and what do they feel comfortable with outsourcing to a third party? Managers have to think about this more carefully.

“We do a lot to support our clients from a regulatory perspective. It is a continuously evolving space and it is probably the number one investment that we are making right now. We have a long history of supporting our clients’ regulatory filings in the registered funds space and have a deep breadth of experience to draw upon,” says Waldron.

Providing outsourced tax support is another area of focus. As tax evolves – FATCA, CRS – making sure that the fund’s tax solution remains viable is important, confirms Waldron. “Our tax team works closely and consults with our clients to make sure they understand what they need to be doing and how we are able to support them,” she says. “I would say the third area of focus centers around data services and middle office. When fund managers outsource more their need for more data increases substantially.

“Having robust data management and reconciliation capabilities around data points is absolutely critical. We reconcile thousands of data points to ensure that our clients get cleansed data back in to their environment,” concludes Waldron.
Outsourcing reduces costs but HFIs still need to manage risk

Continued fee compression, the need for institutional-quality systems and processes, and a desire to reduce the regulatory and compliance burden are just some of the drivers that are pushing hedge fund managers to embrace outsourcing. By James Williams

“Data management has become a critical task for us. When you take everything into consideration, it’s about giving clients access to data coupled with a wide set of tools to help manage that data. It really is important to managers, especially as they increasingly move towards an outsourced model,” says Christine Waldron, global head of the Alternative Investment Solutions team at U.S. Bancorp Fund Services.

In her view, outsourcing is a natural evolution of the hedge fund operating model.

“In my mind it is definitely a logical evolution of the alternative funds space to migrate to that model, especially now that regulations such as Form PF have become more formulated. Managers have done a number of filings and feel pretty confident about what they need to be. This is helping them to become more comfortable with the idea of having an outsourced provider help them manage the process,” notes Waldron.

Service providers (prime brokers, fund administrators, risk specialists, etc) are necessarily adapting their product offering to bring a wider level of support to their hedge fund clients. This is happening at a time when alternative fund managers are migrating into the traditional fund market, launching ‘liquid alternatives’ to run alongside their offshore fund(s). But as managers are finding out all too quickly,
the compliance demands of running a ‘40 Act alternative mutual fund are completely different to running a hedge fund.

The rise of ‘RegTech’
To help its clients keep on top of risk management (including regulatory risk) and compliance, Imagine Software – one of the industry’s leading real-time portfolio, risk management and regulatory systems providers – has introduced a new system called Real Time Risk and Compliance (‘RRC’).

“Imagine was built to provide real-time data and analytics from day one,” says Scott Sherman, Co-Founder and Global Head of Business Development & Sales. “It is the foundation on which we have created the industry’s most important financial solutions. In the years following 2008, as regulatory compliance became one of our clients’ most important challenges, creating a solution to help them address this need became our most important focus.

“Societe General Prime Services was our first RRC client, and we have enabled them to post millions of trades per day across thousands of accounts in real time and manage their global limits monitoring.”

Using RRC, Imagine’s client can simultaneously manage compliance and position limits and run stress tests and scenarios to understand the impact of market shocks and determine whether a trade or series of trades would result in compliance breaches. “RRC allows firms to remain compliant in shifting markets and look ahead to stress test, for example, the outcome of the US election,” says Sherman.

For the last two years, Imagine has been running the Imagine Financial Platform (IFP), which is unique in the industry in that it allows users access to all of the analytics and data in Imagine’s system. Using a simple Java script, users can build their own applications to create bespoke financial calculations. More than 20 factors can be stressed within IFP to model in excess of 250 stress tests. When Brexit happened on 23rd June, Imagine enabled its clients to model the impact across all of their portfolios.

Once they model it, clients can go one step further with the RRC platform and determine what impact that would have on compliance. Imagine is able to take those stress tests and tie them in to portfolio limits or restrictions that a client might have on a liquid alternative or a segregated managed account.

“Risk managers are contending with a significant number of evolving risk considerations that are touching every part of the business.”
Scott Sherman, Imagine Software
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Scott Price
+1 312 623 9681
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Outsourcing the EU regulatory burden to ease fatigue

By Scott Price

It is fair to say that regulatory fatigue has set in when it comes to the European Union market. This has been brought about in particular by the Alternative Investment Fund Managers Directive (AIFMD).

Yet the EU remains attractive to US alternative investment managers, particularly post-Brexit. Many investors in the EU and the UK are seeking opportunities to invest in US funds and US strategies – and demand is likely to remain high during a protracted period of uncertainty following Brexit.

So how can US managers access the lucrative EU market and reduce the barriers to entry? Specifically how can they manage the costs, resources and risk concerns that come with complying with the AIFMD?

Growing outsourcing trend

The answer is to consider partnering with a trusted third-party service provider as a way of testing the waters before developing a full-fledged alternative investment fund manager (AIFM) presence later. The more regulatory risk and compliance functions that can be outsourced, the less managers have to worry about what changes to make to their operations and business models – and the better chance they have to focus on delivering alpha.

Maitland was the first fund administrator to come to market (in 2014) with a powerful end-to-end AIFMD compliant solution in Luxembourg. The solution comprises a Management Company (ManCo) and fund product platform.

As a US manager, you partner with Maitland which becomes the external AIFM to your funds; we delegate the portfolio management back to you, while as ManCo we assume responsibility for all of the other duties envisaged in the AIFMD including risk management, compliance monitoring, regulatory reporting and investor due diligence; and we appoint a depositary as required.

We also provide an umbrella fund platform under which you can obtain a "cell" on the ManCo platform, allowing you to passport your fund throughout the EU and raise capital in a complaint fashion.

Advantages

For managers without a European presence, the ManCo delegated model is the quickest and easiest route to market, and the speediest way to establish the required level of transparency. It avoids the uncertainties that come with setting up a new office.

The other big appeal of the delegated model is that it allows fund managers to focus purely on their core specialty of generating returns for their investors and raising capital while allowing us to focus on the administration and reporting need.

The RAIF game-changer

US Managers will also be interested to hear about the Reserved Alternative Investment Fund (RAIF), a new investment fund product passed by the Luxembourg Parliament in July 2016 which makes the EU “fortress” a whole lot less intimidating.

The RAIF is a game-changer as it vastly shortens time-to-market, brings certain tax advantages and provides easy access to the marketing passport provided by the AIFMD.

Aimed specifically at “well-informed investors”, the RAIF removes the double layer of regulation imposed at both the ManCo and fund level.

With a 40-year history in Luxembourg and its AIFMD infrastructure already in place, Maitland is well positioned to provide a client solution for the RAIF.
The Axioma regulatory reporting solution covers Form PF, CPO-PQR, Annex IV, Open Protocol, etc, and as well as providing the straight-through processing technology to simplify the reporting process, fund managers can leverage Axioma’s team of specialists to ensure filings are complete.

Whilst investors want their managers focusing on the investment process, at the same time they are also concerned with the fact that managers are reducing risks in their operations.

“They’ve expanded their view of risk beyond market risk. Regulation opens up a whole other door of operational risk that they want to see being addressed; and by far the easiest way for managers to do this is to outsource it to someone who focuses on it full time.

“We provide everything from just a straight technology solution (managers wanting to retain the process in-house) to a fully outsourced managed service solution; I’d estimate 80% of our clients use our managed service solution. We are there every step of the way for these clients. It’s up to the client how much they want us to be involved in the process,” explains Wishnick.

Wishnick confirms that Axioma are seeing demand across the board: “A lot of the larger managers are reviewing their internal operations and realising that maybe what they have in place is not sufficient to handle the multitude of reporting.”

The outsourced CCO

One of the most popular outsourced functions is the Chief Compliance Officer (CCO). Financial regulators are getting wise to this and are now starting to pay much closer attention. As far back as December 2012, the FCA issued its ‘Dear CEO’ letter, in which it raised its concerns that many asset managers do not have in place adequate recovery and resolution plans in relation to the functions which they outsource to suppliers.

Fast forward to 2016, and the SEC has stipulated that within Form ADV, registered investment fund advisors will, as of October 2017, provide more details on separately managed accounts, aggregate data on the use of borrowings and derivatives, and disclose more information on other aspects of their advisory business. More importantly, it has updated Form ADV to get managers to provide more details on outsourced CCOs.

“We are seeing an increase in outsourcing, especially for emerging managers. With respect to running a smaller fund, does the fund manager want to be responsible and spend the time for all the compliance? Probably not. If they can’t afford a full time, in-house CCO they choose to go the outsourcing route. That’s one reason the SEC wants more information in Form ADV on who is performing the CCO role,” explains Jeffrey I. Rosenthal, CPA, Partner- in-Charge of Anchin Block Anchin’s Financial Services Group.

Rosenthal says that when the SEC does examinations and they find deficiencies in compliance, they will likely want to see “whether it is more (or less) prevalent with managers using an in-house CCO or an outsourced CCO. Or perhaps they will look to see how many investment advisors an individual outsourced CCO is working for; are they overextending themselves?

“If the SEC does find that there are issues with outsourced CCOs, they might start to impose regulation. We’ll have to wait and see.”

Ultimately, when it comes to outsourcing, fund managers have to strike the right balance between the risks and the rewards. It may make their lives easier, and reduce their overall operating costs, but managers should always be mindful that the more they outsource, the more risk controls they need to have in place to ensure that their appointed outsourced provider is doing exactly what they should be doing.

“Managers tend to be outsourcing more of their compliance activities and this introduces a number of risks that managers have to control.”

Barry Eisenberg, EisnerAmper LLP
Much is made of ‘40 Act alternative mutual funds but with their myriad investment restrictions and daily liquidity provisions, the lesser-known registered private fund could be a more compelling proposition for hedge fund managers.

This is the view held by Tony Fischer, President of UMB Fund Services, whose Registered Fund Services platform provides a full turnkey solution for establishing and running a registered hedge fund.

“We put the turnkey platform together over four years ago and there has been steady demand for these types of structures. Liquid alternatives haven’t exactly lived up to people’s expectations. The can only hold up to 15% illiquid securities, for example.

“The thinking among some hedge fund managers now is, if they could run their portfolios like they do their private funds, they would be better able to deliver returns as they feel they should be able to,” says Fischer.

Alternative mutual funds delivered -2.77% in 2015 (2016 Preqin Global Hedge Fund Report). As the Financial Times reported 27th November 2015, performance issues led to twenty alternative mutual fund closures (citing data provided by Preqin) last year, and a contraction to USD310 billion, having doubled to USD314.67 billion between 2010 and 2014.

Interest in registered private funds – also referred to as ‘interval funds’ – is building among wirehouses and independent broker-dealers, and as financial intermediaries begin to better understand the benefits of the structure, Fischer believes the next few years could see increased growth in fund formations.

“At the one end of the spectrum you’ve got US mutual funds and at the other end you have private funds; limited partnerships that are designed for a limited number of accredited investors and have limits in terms of how much money they can take in certain categories such as ERISA.

“In between is the interval fund. These registered private funds provide a lot of the benefits of a US mutual fund in terms of unlimited numbers of investors, the type of investments the fund can accept, but also allows the fund manager to hold high levels of semi-liquid or illiquid securities in the portfolio so that they can meet performance objectives.

“Also, rather than redeem every day managers redeem on a quarterly basis,” explains Fischer. “We continue to see reports of intermediaries planning to increase allocations to alternative products and I believe many will be open to understanding the interval structure and its benefits.”

Rather than being confined to liquid hedge fund strategies, the interval fund can be used for a wide range of strategies such as bank loans, peer-to-peer lending, CLO/CDO strategies, private equity, etc, and gives investment managers the opportunity to use leverage.

“Our turnkey solution lowers the barriers to entry through shared costs and service providers. We handle all of the regulatory and financial requirements. We understand what is needed to successfully run one of these products and can offer a more streamlined and centralised approach to launching these funds,” confirms Fischer.

An interval fund turnkey solution provides the full infrastructure to handle: administration, accounting, auditing, legal counsel, chief compliance officer support, and a board of directors to provide oversight.

“With more than 9,000 mutual funds it’s hard to differentiate yourself. The mutual fund structure can be challenging for hedge fund managers. In some cases, the strategy will be a better fit for the interval fund structure,” concludes Fischer.
Solutions at EisnerAmper LLP. “At the end of the day, no matter how much a manager outsources, the responsibility (and risk) ultimately lies with them. Even if you’ve got an outsourced CCO, or your fund administrator is doing certain compliance activities, risk still lies with the advisor.”

**Outsourcing requires risk controls**

As a result, managers need to manage and control those risks and do a cost benefit analysis of outsourcing functions and managing those associated risks, versus what they can keep in-house.

“Anti-money laundering, for example, is becoming a relevant regulatory issue for managers and most will outsource the AML function to a service provider such as a fund administrator. The proposed rules from FinCEN, however, require that policies and procedures exist with the asset manager, despite the fact that their fund administrator might be conducting the AML activities. Sufficient governance and controls must exist with the manager as they are ultimately accountable,” explains Eisenberg.

There is a risk that some managers might take outsourcing a bit too far, which is no doubt why the SEC is taking a more proactive stance as it relates to Form ADV. If it makes economic sense for managers, Eisenberg says that as long as they can manage the risks and outsource in a controlled fashion, they should consider it.

“Compliance should be thought of less as a burden and more as an investment in strengthening the firm. By helping a firm reduce their regulatory and operational risk, it can result in reducing costs over the long term from any unexpected regulatory actions, and also by helping the firm create a well-run, well-controlled business that makes them more appealing to investors,” opines Eisenberg.

**Outsourced trading desks**

Outsourcing touching our personal lives in many different ways. Why wait in a long queue at JFK airport when you can book an Uber? Why let your home gather dust if you go on vacation for three weeks when you can advertise it on Airbnb and generate cash flow?

In the automotive and aviation industries, for example, the notion of outsourcing has been in place for decades. When Airbus builds the A320 family of aircraft they outsource across the supply chain; they use Pratt & Whitney engines. They don’t try and build them.

Surprisingly, the outsourcing model has taken a while to be widely adopted within the alternative funds industry but momentum is building. For smaller and emerging managers, outsourcing the trading infrastructure and having a full compliment of services, with professional traders working on their behalf, is an attractive proposition. It means they can not only reduce headcount but the number of Bloomberg terminals, the amount of office space, and so on.

One firm that is seeing a lot of demand for its outsourced trading desk is Cowen Prime Services.

“It is becoming a more acceptable alternative among asset allocators, as well as managers,” says Jack Seibald, Global Co-Head of Prime Brokerage, Cowen Prime Services. “We offer the full complement of all of our services regardless of whether the client engages us for full PB or outsourced. The only difference is that they have their account primed at one of the bulge bracket firms as opposed to being introduced by us to one of our clearing firms.”

Importantly, the executing broker knows the client’s portfolio and receives the order in the name of the client and settles the transaction directly into the fund’s account. From the executing broker’s perspective, this is a better model as they know the client at the time the order is received and transacted.

“The client further benefits by having our team support them when there are trade breaks as a result of incorrect pricing, quantity, or commissions reported by the executing broker,” confirms Seibald. “We deal with all of that first thing in the morning.
and make those corrections on behalf of the client. We also do portfolio reporting, separate and distinct from what they are getting from their fund administrator or prime broker. It’s an extra set of eyes that we provide – a shadow set of books and records, so to speak – for the client to compare against the official books and records.

“All of this is consistent with our PB offering, but very different from other outsourced trading solutions provided on the Street.”

Cowen is also able to offer outsourced trading in London to European hedge fund managers. Kevin LoPrimo joined in June as Managing Director, Head of International Prime Brokerage. It already has two traders in place who previously worked at Brevan Howard and Tudor Investment Corporation. It’s unlikely that many start-up managers would have access to that kind of talent and once again underscore the benefit of outsourcing.

Seibald says that the client pipeline improved noticeably in early spring. “We have been onboarding a lot of those new clients in the past few months and have several more large ones scheduled for the next couple of months.”

Picking the right outsourced partner is vital. Eisenberg suggests that managers should do a detailed review of the outsourced provider’s governance structure, including policies, procedures and controls, “and ensure that the contract between both parties allows for scrutiny of their operations on a regular basis. The manager needs to do their homework to ensure that they are selecting the right provider, at all times, and that they are not exposing themselves to any undue risk.”

**The turnkey solution**

One final outsourcing option is for managers to avail of a turnkey solution to get a fund to market. Simply put, this involves interacting with one point of contact that helps with every aspect of setting up a fund and making sure it remains in compliance.

Whereas a few years ago, managers were jumping into the ‘40 Act mutual fund market to either launch standalone alternative mutual funds or become sub-advisors to multi-manager products operated by the likes of Fidelity, the fact is that there are so many restrictions on these funds that trying to replicate a hedge fund strategy – or even a diluted version of it – is difficult.

With performance lagging (the average alternative mutual fund returned -2.77% in 2015 according to Preqin), a more effective alternative is the registered private fund; also known as an interval fund. Over at UMB Fund Services, its Registered Fund Services platform gives managers the opportunity to launch one of these products that are able to take daily subscriptions but only have to redeem once a quarter (and even then this is limited to between 5% and 25% of the fund’s assets).

“As managers expand their product offering they are increasingly considering the interval fund structure. New managers are often those who have spun out of existing companies and are already familiar with how private fund structures work, they know where the asset opportunities are, and they decide to start their business with one of these funds,” says Tony Fischer, President of UMB Fund Services.

He concludes by saying that there has been so much regulatory change that it’s incredibly difficult for managers to keep on top of everything: “Part of what we do as an administrator is provide both the insight and oversight to make sure we support our clients’ regulatory obligations.”
You mentioned in your last article that ‘Governance is not a game’ – can you expand on what you meant by that statement?

Unfortunately, in the past few years fundamental governance related issues such as capacity (numbers), substance over form (form over substance), and board composition (split boards), have been used as marketing pitches. These are fundamental governance issues yet the sales side of the issue is increasingly the focus of attention.

Yes, these continue to be topical issues in the media. Could you provide us with your perspective on each of these? Shall we start with capacity?

There certainly has been an extraordinary focus on capacity since the credit crisis and rightfully so, as capacity is a critical governance issue. Unfortunately though, for some time, an arbitrary number or cap had become analogous (and arguably in some cases the sole identifying factor) in determining the capacity of a director. Numbers are unquestionably relevant and therefore it is an important question to ask, but if it is the only query raised in assessing a director’s capacity it will be of limited value. Questions are fortunately far more thoughtful and thorough now and people now realise that numbers in isolation, without context or completeness, can be incredibly misleading.

So what are people asking now that is different from before?

Queries now go beyond numbers to determine what a director does day-in and day-out and how they spend their time, as well as assess the individual’s ability. Simply put, capacity is a function of time and ability. People also now consider: the composition of the clients the director serves; their role within their company; what other responsibilities they have beyond serving in a personal capacity on fund boards; their model, support infrastructure; their individual and firm capacity constraints; whether the director has any excess capacity for times of stress, and perhaps most importantly, how they personally view their role as a fiduciary.

Another debated issue is whether it is about the individual or the institution. What are your thoughts on this?

Although most consideration should be given to the capabilities of the prospective director, I don’t think it is necessarily as simple as one or the other. At the end of the day there is a component of both. That said, it is a ‘personal’ appointment and there is ‘personal’ liability that comes along with that. The personal nature of the relationship certainly is paramount, as ultimately the individual, not the institution, has the fiduciary duties to the fund. Therefore it cannot be completely ‘institutionalised’ away. Achieving the right balance is important.

You mentioned “form over substance” as well, can you give an example?

There are numerous examples from templated reports, agendas, to written resolutions versus meetings, etc. With respect to board meetings, if they are held just to tick a box where the constitutional documents, regulatory guidance notes, or institutional policies and procedures dictate, meetings being held for the sake of having meetings (i.e. form over substance) are of limited benefit.

It seems as though many have lost perspective that the underpinning of fundamental good governance is about substance, not solely form. Well thought out, planned and attended, discretionary versus mandated, meetings that are timely and properly minuted (i.e. substance over form) are incredibly important. Meetings certainly have their place and should be encouraged as appropriate, provided there is a measured and balanced approach in the decision making process.

It could be argued that matters can be documented in more detail by emails and written resolutions than they would by verbal phone conversations, meetings, and corresponding minutes. Regardless of the form of governance, it is important that there is always sufficient evidence documented to support the decisions taken by a board.
The latest trend of having Split Boards has also received a lot of attention in relation to governance. What is your take on Split Boards?

Split Boards have been the trend for the last couple of years now with investors in particular becoming increasingly interested in board composition and appointing directors with complementary skillsets from different service providers. My take is that an effective and diverse board requires competent individuals with complementary skillsets who can work collectively, irrespective of whether they come from the same shop or not. The collaborative aspect is equally as important as the individual expertise. There should ultimately be synergies gained so that the board’s collective value equates to more than the sum of its individual members. Good governance and the right board composition is really what it is all about.

What should people focus on when constructing a board and how do investors, funds, etc go about this process? Constructing an effective, diverse board does not have to be an arduous, time-consuming process. However, the decision should not be taken lightly. Given the directors are accountable for leading and directing the fund’s affairs, effective corporate governance is critical and therefore the appointment of experienced and qualified independent directors who collectively provide a diverse and complementary board composition is essential.

The industry needs to ensure the focus remains on the underlying fundamentals of good governance and the right board composition and not simply focusing on retaining directors from different fiduciary firms. Where the main consideration is only to engage independent directors from different fiduciary firms, this narrow focus, for the most part, misses the fundamental objective of establishing an effective, diverse board. So they should go beyond the ‘Split Board’ sales pitch and have a thoughtful, measured, balanced approach and give all aspects due consideration.

Are there enough directors available with the requisite experience?

There has been an influx of individuals with varying skillsets into the fiduciary space, which is a positive development, and there is certainly a greater depth of high quality directors in the space to choose from than there was a few years ago. Most are senior people who have excellent experience, qualifications, pedigree, etc and are able to seamlessly make the transition from being an administrator, lawyer, auditor, regulator, risk or investment professional, etc to being a director. Others, however, have difficulty making the transition, as although they have impressive technical skills, they are unable to transition into a leadership and oversight role that goes beyond their area of expertise. Individual personalities can come into play as well.

Why have we seen an influx of new directors and what do you mean by that latter comment about individual personalities coming into play?

The credit crisis was really the inflection point where governance started to be taken more seriously. As a result, there has been a flood of new entrants into the fiduciary space, which can be partially attributed to a supply shortage as long standing individuals are reaching capacity. Other newcomers are being opportunistic as they are looking for a career transition. In respect of individual personalities coming into play, some people are too passive or lack the intellectual curiosity, or gravitas, to effectively challenge management or their fellow directors, while others have domineering and controlling personalities or simply lack the aptitude to participate in a collective approach. As it is for many things in life, the right balance of individualism and collectivity is also paramount to an effectively functioning board.

In your opinion, what are the key characteristics & considerations of a good fund director?

There is a wide range of attributes and characteristics to consider from backgrounds (i.e. accountant, lawyer, ex-regulator, investment or risk expert), independence, qualifications, stage of career/life, level of engagement, technical abilities, personality and interpersonal skills, jurisdictional residence/familiarity/knowledge of and experience within the industry, capacity, support infrastructure, etc. The list goes on. I would, however, emphasise it again, perhaps most importantly is how the individual personally views their role as a fiduciary.

There is a lot of talk about directors having the right skillset. What skillsets should a director ideally have?

One important skillset that is often overlooked is corporate governance in itself. Possessing one or more of the aforementioned attributes in isolation does not necessarily make someone a good director. Perhaps even more important than having a director with a specific skillset, expertise, or being from a different fiduciary firm is to select directors who have a broad range of experience, have the innate ability to ask intelligent and probing questions, and know when and where to find expert advice when needed.

It is often more effective to engage someone with specialised expertise when needed rather than recruit it onto the board. The ability to put issues into the appropriate context is also very important – sometimes the board has to provide high level oversight and other times a more detailed approach is required. Effective and experienced directors will be able to maintain perspective and context in such situations, regardless of their specific skillset.

USA Hedgeweek Special Report Oct 2016
Despite the so-called uniformity of the EU, the pan-European Alternative Investment Fund Managers Directive (AIFMD) is still being interpreted and applied by individual EU Member States. In theory it is meant to act as a standard framework to oversee the activities of AIFMs, but with National Private Placement Regimes still running, overseas fund managers are finding that navigating the different reporting requirements is a minefield. Different regulators simply have different takes on the Directive.

In musical terms, AIFMD is less an ordered symphony with everyone playing to the same tune, and more a jazz ensemble. “Some countries are saying that when they have the passport in place for overseas managers they will end private placement altogether. There is a lack of clarity still among EU regulators, and it is therefore unsurprising that US managers find AIFMD rather confusing. It’s not because they are on the other side of the Atlantic, it’s simply the fact that there are still lots of grey areas. Each country has a slightly different take on the Directive, which further adds to the confusion,” comments Marianne Scordel, Founder, Bougeville Consulting, currently working out of the United States.

Ingrid Pierce is Global Managing Partner at Walkers, one of the industry’s leading offshore law firms. She says that some US clients have determined that “Europe is not for them” but for those who want to attract European investors they are having to decide what best to do; should they set up an EU vehicle or should they stick to using their Cayman vehicle and market it using private placement regimes?

“We’ve been doing a lot of advisory work relating to AIFMD. Given Brexit, US managers are thinking about where to have their EU Member State of reference. The UK is no longer the default option.

“I do think there is still a degree of confusion with respect to AIFMD. For the last year or two, whilst acknowledging that at some point private placement regimes are...
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Partner-In-Charge
Financial Services Practice
jeffrey.rosenthal@anchin.com
Form ADV amendments increase compliance demands

Interview with Jeffrey Rosenthal

The SEC has recently adopted amendments to its Form ADV. Included are provisions that attempt to get a clearer handle on the extent to which Advisers are using outsourced chief compliance officers, placing even greater scrutiny on smaller managers who are more inclined to outsource the CCO function.

Whereas previously Form ADV only required the identity of the CCO to be listed, item 1J on the newly updated Form ADV stipulates that fund managers must confirm whether or not they are using an outsourced CCO, and if so what their name is, the name of the firm they work for, and their IRS number.

“The amendments place an increased burden on the manager. They need to provide more information on the CCO and maintain additional records and support with respect to the calculations of rates of returns and written communications provided to any person. The burden and cost of compliance just keeps on increasing. That’s not what fund managers need in an environment where they are struggling to generate performance,” says Jeffrey Rosenthal, CPA, Partner-in-Charge of Anchin, Block & Anchin LLP’s Financial Services Group.

“Adopting best practices early on is not only beneficial from a compliance standpoint, but also helps with investor relations. Something we always preach to our start-up clients is, ‘Don’t act like a USD20mn fund on day one, act like a USD200mn fund’,” says Rosenthal.

He says that whilst some start-up managers are “ready to go to battle” and have the right mindset to run a hedge fund, others can be tentative. With amendments to Form ADV and further regulatory and compliance demands coming down the pipe, wannabe hedge fund managers cannot be under any illusion as to how hard it is to grow a successful business.

One option Rosenthal discusses with clients is to create a single member LLC with just their own capital. Perhaps they trade it for a year and generate a solid return, proving that their investment strategy works.

“At that point, the manager might decide they want to convert the single member LLC into a limited partnership and open it up to other investors when they feel confident and ready to commit to running a fund. We can perform a full audit for that year and generate a solid return, proving that their investment strategy works.

“On the other hand, if, after a year or two, performance is flat (or negative), the manager might decide to shut down the single member LLC. Whilst not ideal, at least they would have avoided the compliance and regulatory costs of running a partnership,” concludes Rosenthal.
going to be turned off, managers have been advised that aside from setting up a fully-compliant EU fund, these regimes are the best way to access European capital.

“For the average US hedge fund manager contemplating raising assets in Europe, they need to know that not all of the EU is currently accessible via private placement. They will need to be selective about marketing only in those jurisdictions which are both attractive sources of capital, and have a manageable private placement regime,” says Pierce.

Research conducted in early 2016 by IFI Global (‘Impact of AIFMD on the European & US alternative fund industries’), sponsored by fund and corporate service provider Crestbridge, looked at how AIFMD has impacted US managers running the gamut of alternative fund vehicles. What it found was that the AIFMD has not caused US managers to take a strategic decision to expand into Europe or stay out of it.

Instead, said the report, US managers continue to take an opportunistic, investor-led approach to Europe. Most US managers are focusing on just one or two European markets (e.g. the UK and the Netherlands) and private placement is overwhelmingly the preferred option.

“Some US managers are happy to put Europe on the back burner, some say that it is too complicated. They don’t know what to do from a capital raising perspective and are happy to wait on the sidelines. It’s not a huge burden, having said that. US managers need to register and report to each EU Member State that they wish to privately place their fund(s) in to, and there are plenty of law firms and consultants that can help them with this,” says Scordel.

Whilst pursuing private placement might be the preferred option, US managers have to get their heads around filing annually with local regulators, often in the local language. In that sense, the NPPR option is a bit of a minefield.

To support non-EU managers, London-based Lawson Conner, a market leader in investment management solutions for the hedge fund industry, has built a solution referred to as “EU Access”.

In short, EU Access provides a full-service approach to private placement compliance. Lawson Conner assists managers to attain all the relevant regulatory licenses with the regulators and provides all reporting, notifications and necessary disclosures both during and after the marketing phase.

“The EU market has a total of $19 trillion in investable assets and so it is worth developing a solution. The market is just too hard to ignore. London not only serves as a hub for European capital, but also from capital from the Middle East and Asia. Serving these regions from New York is almost impossible,” comments Gerhard Grueter, co-founder of Lawson Conner. He says that US managers should consider:

• Where are the target investors? Most of the investors will be in key countries like the UK, Germany, the Nordic countries and maybe Switzerland. A passport may not always be necessary.

• Marketing is not a short-term commitment to the region. Successfully raising capital in Europe requires a long-term commitment to build trust with investors. One or two flights over from New York are not enough.

“Key concerns from US based managers seeking access to Europe are timing, costs and complexity,” says Grueter.

If the NPPR option is pursued, US managers should try to focus on a limited number of core markets.

“We have some larger clients who say they want to take in European capital. In order to make that work, they will typically run a parallel fund or market in some of the more flexible jurisdictions such as the UK and Denmark, but stay clear of markets such as Germany and France, which are more difficult to access,” explains Pierce.

There are other options available. One is reverse solicitation but this is increasingly being avoided given the ambiguity over who contacted who in the marketing process. Another option is to charge head-on and
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Circle Partners is a global financial services specialist that provides its clients with a range of fund administration services and one-stop-shop services for start-up managers looking for the most efficient route to market.

Heading up the firm’s US office in Orlando, Florida is David Payne in his role as Head of Business Development for the Americas. Payne was formerly Director of Circle Partners (BVI) before relocating to the US in August this year and prior to working in the BVI and Cayman Islands, he was a director and legal counsel at Circle Partners’ London office.

Payne says that the near-term strategy is to grow Circle’s business profile in the US and raise awareness among US managers. “We won’t only focus on those running offshore funds but will also look to provide administration services to those running US onshore funds. It’s still early days with respect to the latter,” says Payne.

“Over the last couple of months we have been busy meeting with prime brokers, custodians, banks, law firms, accountancy firms to explain who we are and what we do. For US onshore funds, we are looking to establish strategic alliances with US law and accountancy firms.”

“We are partnering with organisations such as the Florida Alternative Investment Fund Managers Association to start hosting events and introduce ourselves and our ideas to US managers. We are still in the early stages of raising our profile,” adds Payne.

There are numerous benefits to start-up managers who decide to appoint a turnkey solution provider; principally, the fact that they can draw upon the experience and network of a single service provider rather than spending time (and money) appointing each service provider to the fund.

“What we see are opportunities to help managers set up funds with a small number of investors and we’ve been quite successful this year. We are currently in the process of setting up 10 funds in the BVI and Cayman Islands, which is encouraging given that it has been quite a slow market this year. Some clients prefer to have light regulation and will opt for a BVI Approved Fund. Other clients aren’t too concerned with this and will tend to go with a Cayman fund,” says Payne.

In terms of how the turnkey solution works, he adds: “We help put in place a legal team to draft all of the prospectuses for the fund (Offering Memorandum, Investment Management Agreement, etc), open bank accounts for the manager, and once the fund is set up, Circle performs all of the administration work and transfer agency services work.”

Payne notes that interest is building not just among US-based managers but also those based in Latin America who view Miami as a gateway into the US fund market.

“In both instances, we have seen more interest in the offshore model this year. Latin American clients, in particular, find offshore jurisdictions easier to work with because there is not a heavy burden of regulation and lower costs if compared to traditional onshore jurisdictions. Managers want to keep costs down and prefer to launch with a lightly regulated or non-regulated fund to begin with, and then perhaps afterwards go to Europe to set up a regulated fund structure,” explains Payne.

With its ability to structure offshore funds and provide structuring solutions and advice to US managers who looking at Europe, Payne sees the US as a big opportunity.
become a fully authorised AIFM. This is an expensive option and only really open to large established US managers with the resources and budgets to make this adjustment. The benefit here is that the US manager can fully avail of the AIFMD passport.

Several prominent US hedge fund managers have been quick to recognise the opportunities on offer under AIFMD regulation in Europe and have set themselves up as AIFMs in Europe, benefiting from first-mover advantage.

Another option is to consider using a Management Company platform, or ‘ManCo’. This works well for some US fund managers who effectively become sub-advisors to the platform and piggyback on the AIFM’s fund passport. The research report produced by IFI Global found that 36% of US managers active in the European market were using or were considering using a ManCo platform.

“US managers do not wish to undertake the burden of applying for the regulatory approvals to become an AIFM in Europe themselves,” says Grueter. “As such, appointing a third party AIFM works particularly well for mid-sized managers, as they have a quicker route to market and have a trusted partner who understands the European regulatory landscape.”

It is worth pointing out, however, that the platform option is culturally more accepted in Europe than the US.

“US managers want their own brand and even when you’re a start-up with a good level of AUM the whole point is you want to have your name on the door. We have found that the platform option is really on suitable for a certain type of manager,” says Pierce.

Circle Partners has operations in both the Americas and Europe and is able to assist US managers in determining the best European jurisdiction to set up an EU regulated fund. Circle has a platform in Luxembourg and can also help establish funds in The Netherlands and Malta.

David Payne, Head of Business Development for the Americas at Circle Partners makes reference to one particular client who was thinking about Europe.

“They thought it would be a lot easier than it actually is to market their fund across Europe. When they got in touch with a

“US managers do not wish to undertake the burden of applying for the regulatory approvals to become an AIFM in Europe themselves.”

Gerhard Grueter, Lawson Conner

London-based law firm and they saw the price of setting up a European regulated fund (they wanted an Irish QIF), it simply wasn’t attractive to them,” says Payne.

He explains that when helping non-EU clients think about Europe, Circle Partners will initially ask them to complete a fund questionnaire. “This gives us an idea of what they are looking for and it allows us to advise them on the best European vehicle based on the contents of the questionnaire. We talk about the different jurisdictions and requirements and it’s then up to the manager to decide how to proceed,” adds Payne.

Looking ahead, ESMA recently published its advise on extending the AIFMD passport to 12 non-EU countries including the US, citing that there were “no significant obstacles regarding investor protection and the monitoring of systemic risk which would impede the application of the AIFMD passport”.

This could mean that US managers will be able to passport their funds into the EU in the next couple of years but even when they do get the passport it is not expected to be a smooth process; at least in the near-term.

“The UCITS passport was difficult to implement initially because each jurisdiction tried to impose their own take on the rules. If you had a UK UCITS, typically the Spanish regulator or the Italian regulator would not let you passport the fund that easily. It took many years for the UCITS passport to really work properly. For AIFs, I don’t know how easy it will be to passport them initially. The model still has to be tested,” opines Scordel.

Pierce agrees. She says in conclusion: “The point is you can’t make an assumption that merely having the pan-European passport is the end of the story because it’s not. There’s still more work to do.”

As with any great jazz rendition, there are myriad ways to interpret it. In that sense, it seems, AIFMD is no different.