hedgeweek

# US Hedge Fund Startup Guide

SPECIAL REPORT 2020

**FUND ADMINISTRATION**
Automation key to high quality service

**TECH INFRASTRUCTURE**
Vision and technology work hand in hand

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Robust systems needed to bolster security

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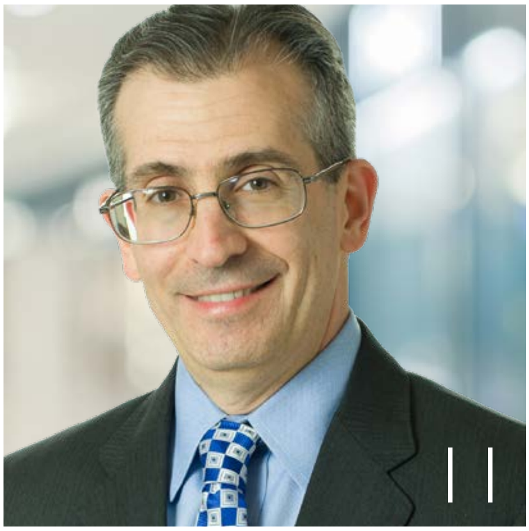




**Published by:** Global Fund Media Ltd, 8 St James's Square, London SW1Y 4JU, UK
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# Clear objectives critical in paving the way for startup hedge funds

By A. Paris

"A lack of clarity could put the brakes on any journey to success" – these words, uttered by behavioural scientist Steve Maraboli, offer concise advice for any aspiring hedge fund manager. Although the road to success is far from straightforward, startup hedge funds need to have clear objectives and a definite, coherent understanding of who they are as investors and more importantly, who they want to be.

The academic paper entitled, Dollars versus Sense: Investor Demand, Managerial Skill, and Hedge Fund Startups, argues that new hedge funds which are skill driven, rather than created on the back of investor demand deliver better performance. The paper finds skill-driven inceptions outperform demand-driven ones by 4-5 per cent per year in terms of risk-adjusted return.

A key aspect of emerging hedge funds which was not included in this study is the vital role played by infrastructure, technology and third party partners in a startup's journey to success.

All investment managers have numerous priorities to juggle at any one time – from compliance with regulation, to keeping up to date with new technologies and ensuring their investors a smooth experience, from an operational perspective. These all chip away at the time they have to perform their title role of managing money.

### Striking a balance

Industry experts say startup hedge fund managers need to understand how they're going to allocate their time. There are so many hours in the day and for a new launch, figuring out how they're going to allocate their time between raising money, running the portfolio and running the operations is a tricky one to balance. The ideal situation for them is one where they've picked providers who can help them do this effectively.

Picking the right providers to assist is crucial. Bob Shaw, VP of Technical Architecture at Eze Castle Integration notes: "As a hedge fund startup, you need to choose the right managed service providers to work with; someone who knows your industry. A firm outside the industry could get you up and running but they may omit critical security layers required by regulators and investors which could increase the probability of an outage or security event where data is lost or stolen."

"Most funds would agree that their experience with a fund administrator primarily comes down to client service, accurate and timely delivery of services and cost," says Jorge Hendrickson, SVP Head of Sales and Marketing at Opus Fund Services. "Automation and Straight-through-processing ("STP") are what allows, or prevents, these from happening."

Appointing third party partners harks back to the importance of having clarity. Although at the outset a startup hedge fund may not need much in terms of technology infrastructure, or fund servicing and administration requirements, this will change. As the fund gathers assets, its needs are bound to become much more complex and that complexity needs to be accounted for at inception.

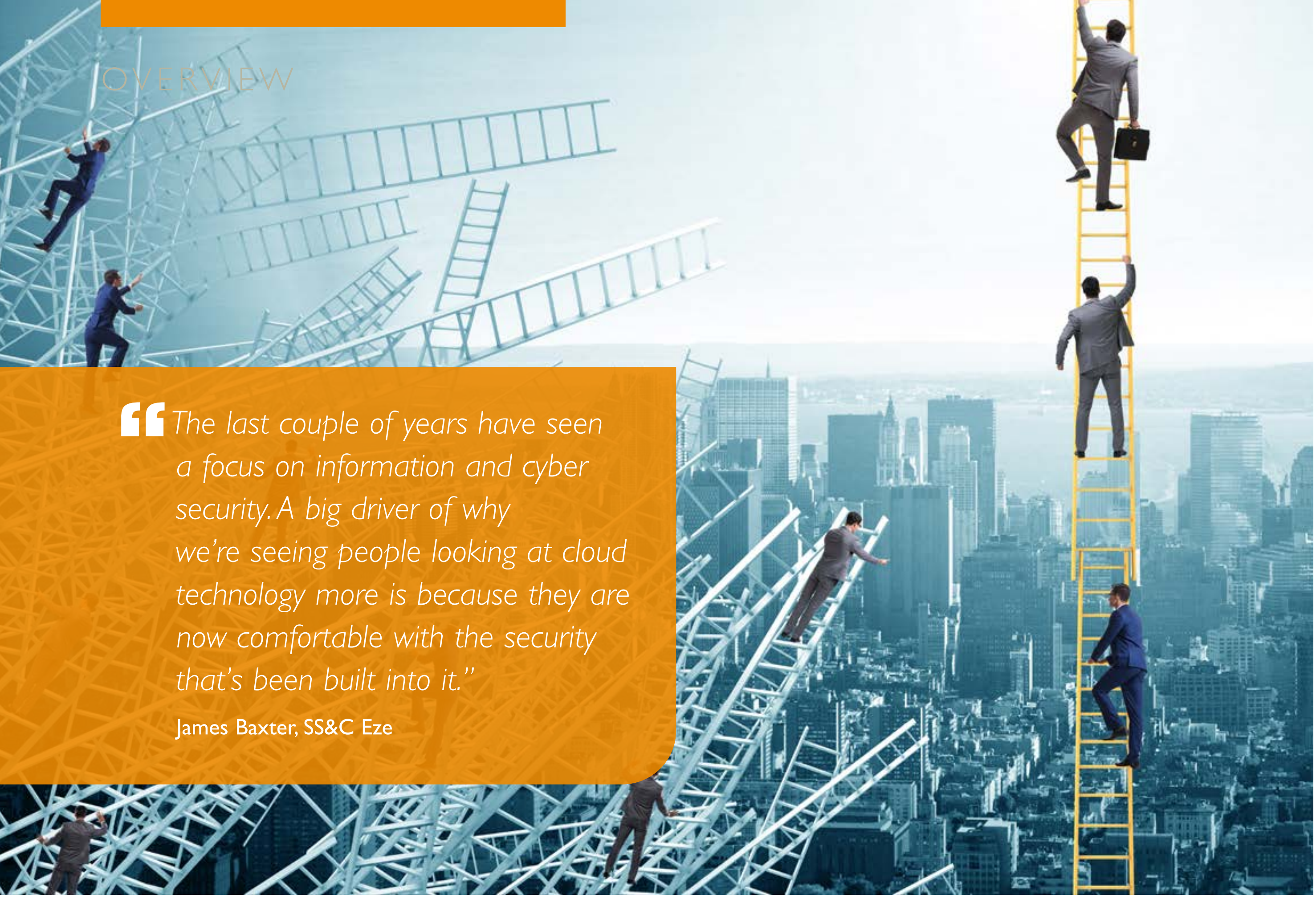
### A matter of scale

"In terms of technology, startup managers want to be able to partner with a vendor able to scale with their business. Their partners need to deliver what they need now and continue to meet those needs as their business changes, over the next five to ten years," stresses James Baxter, head of institutional sales efforts at SS&C Eze.

Hendrickson, at Opus adds: "Managers are realising that handling fund administration tasks internally no longer makes sense from a time, resource, cost and independence perspective. Their investors are also realising that they prefer to invest with managers who are working with technology driven fund administrators."

> *"As a hedge fund startup, you need to choose the right managed service providers to work with; someone who knows your industry."*
>
> Bob Shaw, Eze Castle Integration

One of the main components in the ability to scale a hedge fund business is technology. Shaw, at Eze Castle Integration elaborates: "People should decide which way they want to lean in terms of technology – should they start simple but secure with less bells and whistles or something more complex with advanced security features. Clients are often concerned about cost and scalability, but a scalability doesn't always come with a high cost. While protecting your sensitive data is key, you need to focus on building a secure foundation which can be scaled upon. You can build a technology platform, typically fully managed in the cloud, which is secure with flexibility to grow. To meet this challenge, managers can balance



*"The last couple of years have seen a focus on information and cyber security. A big driver of why we're seeing people looking at cloud technology more is because they are now comfortable with the security that's been built into it."*

James Baxter, SS&C Eze

the price against what they need to get done now and what can be done later. All while keeping their company secure."

### Technology overlay

Security should be at the top of an emerging hedge fund's agenda and advancements in cloud technology are allowing this to be the case. Baxter explains: "The last couple of years have seen a focus on information and cyber security. A big driver of why we're seeing people looking at cloud technology more is because they are now comfortable with the security that's been built into it."

The cloud industry has developed considerably in the past five to 10 years. "Hedge funds wouldn't have had the access to this tech a few years ago. The cloud industry has evolved. Going back 10 years, the advancements around the technology out there didn't exist. And it's only going to get better," Baxter continues.

When considering cloud technology, Shaw warns that managers originating from larger hedge funds should be wary of trying to replicate the systems at their previous place of employment: "In some cases the legacy items would see managers implementing a convoluted and expensive cloud solution when they may be able to benefit more from a lower cost SaaS based or public cloud alternative.

### Targeted intentions

The potential cost of having service providers who can't meet a growing fund's needs could lead to considerable pain at a later date.

No fund wants to change providers in the future, so getting this right is key. Startup managers need to understand where their operational risks lie – the third parties they appoint should have a synchronised relationship.

To hark back to the notion of clarity, hedge fund managers can risk making the mistake of reducing their costs at the outset while failing to fully capture the requirements of their fund. This can leave them to do something most would dread – making changes once they're established. Most industry commentators agree that big operational changes are the last thing a manager wants to do once a fund is up and running.

The growth of outsourcing has been driven by the need for money managers to focus on their core strength – that is, their investment expertise. All other aspects of their business can be delegated to professionals in their respective fields. ■

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# Offshore legal and fund structure considerations

By Ian Gobin & Philip Graham

2020 is a presidential election year in the US. Economists generally forecast a period leading up to it which avoids any major US financial market upsets. However, this time it's building up to be anything other than a normal election year. Against the backdrop of President Trump's impeachment, we are not only left considering how this will play out domestically in the US, but also on the wider international stage. The macro picture is exceptionally complicated right now. While the UK seems to be finally stepping towards a conclusion on the Brexit debacle, political instability is rife and the US is certainly no exception. But however it plays out from here, it is interesting to see that the overwhelming majority of financial commentators are not expecting an imminent recession or US financial market meltdown. Irrespective as to your feelings towards President Trump, the US economy has flourished during his reign and for us in the Cayman Islands and British Virgin Islands, the investment funds industry has also thrived, despite all of the legislative changes which have circled the industry.

These major offshore centres have proved to be incredibly robust and over the years have both introduced new legislation, often ground breaking in the offshore world and often to a higher standard than adopted onshore, to overcome, for example, so called "blacklists" imposed by certain countries or supranational/international organisations, such as the CFATF, EU and the OECD. As and when there is a challenge, the Cayman Islands and the BVI react nimbly with a measured and professional approach. We're absolutely sure we'll see more of this in 2020.

### Structural considerations

One of the most common scenarios we encounter offshore, is a US-based manager who initially, and logically, establishes a domestic fund to attract US taxable investors. With the performance and track record going in a healthy direction, the manager begins to turn their attention to US tax-exempt investors, such as charities, pension funds, and university endowments, as well as investors based outside of the US, who like the strategy as set out in the pitch book and want to invest.

To avoid potential US tax exposure that could result from direct investment in a US pass-through entity such as a US limited partnership or US limited liability company, US tax-exempt and non–US investors will want to come into an offshore "blocker" vehicle. This is where we enjoy speaking to managers and discussing the options available to them. The three most widely-used options are "side-by-side", "master-feeder" and "mini-master". Taking each in turn:

### Side-by-side

With a side-by-side structure, the US fund and the offshore fund both make investments directly, with trade tickets allocated between them. Given the extra administration involved and the potential for a conflict of interest, we rarely have managers opt for side-by-side funds, unless there is a specific reason to keep the relevant investor bases entirely separate.

### Master-feeder

Probably the most popular and traditional route is to set-up a master-feeder structure. Here, we would create two new offshore vehicles, an offshore feeder and an offshore master. The existing US fund will contribute its assets into the offshore master upon the launch of the new structure. In turn, the offshore feeder will take in the US non-taxable investors and the non-US investors and "feed" into the offshore master. The offshore master will make all of the investments on behalf of both feeder funds (the US fund and the offshore feeder) from this point forward, creating a collective investment offering in the most tax efficient manner.

### Mini-master

In a mini-master structure, a single offshore fund is established which is taxed as a corporation to benefit US tax-exempt investors and block UBTI and non-US investors.

The very fact of only needing to create one new offshore vehicle saves cost, both on formation and also in terms of upkeep and therefore has proven popular with startup and emerging managers. The offshore fund invests directly into the existing US fund, which will then act as the master fund for the US non-taxable and foreign investors. It will also remain the fund into which the US taxable investors will continue to invest. This provides two additional benefits; firstly, the existing US-taxable investors will not need to be moved and secondly, the existing assets of the domestic fund can also remain where they are. Both factors vastly reduce the administration around the restructuring and subsequently reduce the cost as well. While there are some tax consequences to be discussed around the use of this structure, it has proved to be appealing to those looking to dip their toe in the waters of offshore vehicles.

### Conclusion

In all models, it's also important for the US manager to consider how they will be paid in the most tax efficient manner. It is crucial that US managers discuss how this may be structured with their US counsel. At the moment, the current preference is for US managers to take their performance fee as an allocation from the relevant master fund, be it the offshore or in the case of the mini-master, the onshore (master) fund.

While there are many other options available to a US manager in this situation, both of these cover a large segment of the market and should give anyone reading this article a solid platform to begin their discussions with their US and offshore legal service provider. One aspect that should be noted, as a final point, is that if managers are considered marketing into the EU, they will need to seek advice on the marketing restrictions within this region. While both the Cayman Islands and BVI vehicles continue to operate under the long-standing EU national private placement regimes, managers need to be very clear regarding their EU marketing strategy, especially with the position of the UK being somewhat a grey area right now. With that in mind, Harneys can also assist with the structuring of investments funds in Luxembourg, which is undoubtedly the pre-eminent European funds jurisdiction and has a wide range of structuring solutions for a manager looking to attract EU investors, as well as the possibility of more cost-effective solutions in Cyprus. Whilst the lack of stability and certainty can be daunting, we see it as an exciting challenge and look forward to helping guide you through yet another year of change. ■

**Ian Gobin**
Partner, Harneys

Ian Gobin is joint global head of Harneys Investment Funds and Regulatory groups. Ian advises on the legal and regulatory treatment of investment funds, private equity funds and management companies established in the Cayman Islands and the British Virgin Islands. He also advises on structured finance, fund finance, IPOs, digital assets/blockchain technology and digital security offerings.

**Philip Graham**
Partner, Harneys

Philip Graham is joint global head of Harneys global Investment Funds and Regulatory groups. Phil is a leading advisor on all aspects of British Virgin Islands and the Cayman Islands investment funds, including pre-formation strategy, regulatory compliance and restructuring. Phil has over fifteen years of experience advising in connection with all types of fund vehicles, including private equity and hedge funds, limited partnerships, and startups operating in the FinTech space.

# Don't underestimate costs and need for planning

Interview with Jeffrey Rosenthal

Despite hedge funds having a good year in 2019, returning over 9 per cent on average, the task of launching a hedge fund remains a challenge.

"Until we have a major correction, it will continue to be difficult for emerging managers to raise capital," says Jeffrey Rosenthal, Partner-in-Charge of Anchin's Financial Services Practice at Anchin Block & Anchin LLP, a full-service accounting, tax and advisory firm.

"Some managers lose conviction and may second-guess themselves if the fund starts losing money early on. They worry about retaining capital if they have one or two down months. My advice to startups is 'Stick with what you know (and what your documents permit). Keep your investors updated and be true to your investment convictions'."

Launching a hedge fund can be daunting, but not if managers do the necessary preparation and planning, and ask the right questions.

"When I first meet with a startup manager," says Rosenthal, "I want to understand their business plan, their vision, what their investment objectives are and how much they know about running a fund.

"We seek to guide and educate them on topics such as fund structure, regulatory matters and making sure they understand the tax ramifications; the aim is to make them aware of issues they will encounter and questions their potential investors will likely be asking."

One important aspect of these early discussions centres on budgeting. Has the individual planned the budget not only for the fund itself but for the cost of running the management company, as well as their personal living expenses as the initial management fee may not cover all of the expenses? Ultimately, can they afford to launch a hedge fund?

Another matter that needs to be addressed early on, says Rosenthal is the manager's capital raising capabilities. Do they have potential investors lined up? How much do they think they will raise? What are their methods for raising capital? What are their plans if they don't reach their targeted raise? This is probably the most challenging task for new managers.

"I also ask them to run their pitch presentation by me – tell me your story, what makes you different to other fund managers?" adds Rosenthal.

Failing to budget properly can easily trip up a manager, regardless of how well their investment strategy might be performing. It is expensive to run a hedge fund; not just to cover office rent and payroll but all other ancillary services needed to operate the fund.

"You can't rely on generating a performance fee," stresses Rosenthal. "I would advise that any new manager budget for at least two years' worth of expenses."

He agrees that outsourcing non-investment functions is worthwhile considering to keep costs down. "Utilising an outsourced CCO, CFO, etc, costs less than hiring your own employees but be cognisant that they aren't there full time and are not going to be focused on your business 100 per cent of the time.

"That said, investors like seeing it, in fact prefer it. They feel there is an additional safeguard in place to help avoid things potentially going awry."

Even if the fund is below the SEC registration threshold of USD150 million, it is worth adopting best practices from the start, such as a code of compliance, so that the manager can acclimate themselves to operating under the regulator and appeal to investors.

Additionally a manager should be cognisant of proper tax planning. During the formation stage and before each year end, Rosenthal and his team meet with their clients to discuss what tax strategies may be most beneficial to the fund and its investors.

"At Anchin, we get close to our clients. We are very hands-on and we've worked with a significant number of US startups over the last 40 years. We help clients to focus on what is needed to successfully launch a fund," concludes Rosenthal. ■

**Jeffrey Rosenthal**
Partner-in-Charge, Financial Services, Anchin Block & Anchin LLP

Jeffrey I. Rosenthal, CPA, CGMA is the Leader of Anchin's Financial Services Practice. Jeffrey specialises in providing accounting, tax, and business advice to a wide array of financial services entities including broker/dealers, investment partnerships (domestic and offshore), funds-of-funds, mutual funds, private equity funds, and investment advisers. He has extensive experience advising newly formed entities and assisting with startup considerations such as form of practice, structure of agreements, compensation arrangements, compliance, and regulatory matters.

# Looking for an independent director?

Formed in 1974, International Management Services (IMS) is one of the longest established offshore company management firms in the Cayman Islands. Our Fiduciary Team focuses on the provision of directors and trustees to hedge funds. We have over 200 years of collective experience in the fund industry and provide services to some of the largest global hedge fund organizations.

Senior staff members of IMS are all professionally qualified and are recruited from household names in the funds industry. IMS staff are not only independent of the investment manager, but also independent of the fund administrator and other service providers.

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# Automation as a key to high quality service

Interview with Jorge Hendrickson

Smart, repeatable and "hands off" technology plays an ever-growing role in the delivery of fund administration services. Two primary drivers of a fund administrator's success are automation and straight-through processing ("STP").

"Most funds would agree that their experience with a fund administrator primarily comes down to client service, accurate and timely delivery of services and cost," says Jorge Hendrickson, SVP Head of Sales and Marketing at Opus Fund Services. "Automation and Straight-through-processing ("STP") are what allows, or prevents, these from happening."

Opus Fund Services is focused on scaling its proprietary technology to achieve these requirements and doing so in a way that ultimately makes sense for both startup and established funds. They focus on automation and eliminating any human interaction on any part of the workflow wherever possible. This automation feeds into delivering services in a timely, efficient manner. The idea of STP is not something new, but achieving it is difficult and takes time, requires significant investment, and a high pedigree team who understands every detail. Having gone the "build versus buy" route has given Opus a unique advantage in this race, as it is not relying on other third parties.

To illustrate, one of their innovative and intuitive STP products is Opus JET, which creates "straighter" through processing. A key component and traditionally manual aspect of fund administration is determining and then processing the accounting entries needed to generate a Net Asset Value. JET allows the generation of NAVs at a previously unthinkable level of speed and efficiency. Utilising proprietary technologies previously implemented across its Shared Service teams, JET automatically retrieves data from multiple external sources and normalises the information into tens of thousands of accounting entries per month. Technology like JET enables more streamlined audit trails, risk mitigation, and business intelligence for Opus clients.

Everyone wants the best provider they can get at a cost that makes sense to them today. If you want to be in the launch space as a provider, you need to consider how to service funds at a price point which makes most sense. The solution is going to come purely from STP and automation. The goal is to help funds get into business, not to become a barrier to entry.

Part of the process for fund admins entails knowing which services are going to be most applicable for a specific fund and as they grow and evolve, what that means for the admin and the "inputs" that we will be receiving. Fund admins are going to be asking questions like: are inputs going to be submitted on time each month? Who submits inputs? This information feeds into STP; if information is entered late or incorrectly, the process is hindered, and technology put into place cannot function properly. In the instance of JET, if inputs aren't entered in a timely fashion, the product cannot automate the process.

In addition to hedge funds, Opus is working with launch managers across real estate, venture capital and private equity. "These managers are facing similar operational challenges and rely on their providers to scale alongside them. Interestingly, PE/VC/RE is a bit behind their hedge peers and it is not uncommon for them to be learning about fund administration for the first time and are seeking to understanding how it fits into their world," notes Hendrickson. "They are realising that handling fund administration tasks internally no longer makes sense from a time, resource, cost and independence perspective. Their investors are also realising that they prefer to invest with managers who are working with technology driven fund administrators." ■

**Jorge Hendrickson**
SVP, Head of Sales & Marketing,
Opus Fund Services

Jorge Hendrickson is based in our New York City office. Prior to joining Opus in February 2013, he worked in Prime Brokerage Sales and Capital Introductions at Concept Capital Markets (now Cowen Prime Services). Previously, Jorge worked at Bay Head Capital allocating seed capital, managed accounts and infrastructure services to launch managers. Prior to this, he also held a variety of operational, trading and marketing roles at Intrepid Capital Management in NYC and Bridgewater Associates in CT.

# Independence of fund directors and material conflicts of interest

A conversation with Karl O'Reilly

Every day we wake up to news about trade wars, terrorism, natural disasters and major political events that all greatly affect our personal lives and the investment world. There are also serious issues facing the fund governance industry which cannot be avoided but can be managed by the funds industry. Change cannot be escaped and within the funds industry, change must occur sooner rather than later for it to thrive.

Karl O'Reilly, fund director at IMS discusses the independence of fund directors, which is a key consideration when selecting independent directors of Cayman Islands funds.

"Last year, I spoke about the importance of the residency of the fund directors. Since then, there have been some high-profile funds were the independent directors were not truly independent and the issue around conflicts of interest has come to the fore once again. Here, I outline my thoughts on the current board composition and the significant conflicts of interests that remain in the funds industry.

Institutional investors are taking a more proactive approach in reviewing the directors of hedge funds, so it is essential that investment managers take the appointment of directors very seriously. Currently, the common composition of a fund's board is to have three directors typically consisting of one from the investment manager and two independent directors. The majority of a fund's directors should be free from any conflicts of interest. The investment manager will naturally have a conflict of interest which will be clearly disclosed in the offering memorandum and will be disclosed at each board meeting. However, best practice dictates that employees of the investment manager should not have the majority of votes at a board meeting. Therefore, they will not have the power to make any decisions which are not in the best interest of all investors and this can help prevent/manage potential conflicts.

A practice that continues to be inadequately addressed by the market, to its detriment, is the continued appointment of directors from the fiduciary arm of some offshore law firms who act as legal counsel to the fund. In my view, this is a very material conflict of interest which should be avoided by all funds and especially avoided by newly launching funds. The industry has listened to the weak arguments of the offshore law firms regarding the appointment of directors from its fiduciary arm; the magical information barriers and the great efficiencies that will benefit the clients to name a few. This conflict of interest is very significant and is a clear red flag for investors. It should be avoided by investment managers setting up funds and attempting to attract investor capital. A fund should not have its entire board conflicted; this then makes the entire concept of a fund's board and its independent directors potentially ineffective and redundant. Due to the common ownership of the fiduciary arm and the law firm, this a very clear and obviously a material conflict of interest. A true 'independent' director comes in to his or her fore, with their review of the documents which is designed, among other things, to spot any material items of conflict or concern. A director acting for the fiduciary arm of the law firm that assisted in the drafting of the fund documentation may not be as inclined to raise issues which might conflict with drafting advice provided by counsel.

During a financial crisis, the advice of any law firm to the directors must be in the best interests of all the investors in the fund, especially not to a single investor or the investment manager. We should quickly remind ourselves that one of the key parts of a director's role is the protection of all investors interests by exercising oversight of the activities of the fund and its service providers. Only truly independent directors can act on such advice from all industry experts and act impartially at the required times to effectively prevent or manage conflicts. There is no issue/conflict of interest with the offshore law firms providing administration services such as registered office, FATCA/CRS and board support services along with acting as legal counsel to a fund.

In relation to investors, to avoid any potential conflict of interests, no single investor should have the ability, directly or indirectly, to appoint their preferred independent directors, unless it's a single investor vehicle. Investment managers may face problems later down the road when attracting institutional investors. They may recognise the material conflict of interest as an obvious red flag and will more than likely request a change of directors before allocating capital to the fund. It is best practice to avoid material conflicts of interest from inception, so all investors can see that an investment manager has displayed a high regard for fund governance since inception of the fund. Since the financial crisis, generally, the administrators have continued to not allow their staff to act as independent directors on funds where they also act as the administrator. This practice has been strongly encouraged by the market and reflects a desire to avoid material conflicts of interest. Friends and family members of the investment manager (a la Weavering) should never be considered as independent directors. This is an obvious red flag for investors, although potentially difficult to detect.

The Cayman Islands government is in the process of introducing the Mutual Funds (Amendment) Bill, 2020 and the Private Funds Bill, 2020 (together the "Bills") which will strike a balance in strengthening investor confidence and ensuring the Cayman Islands remains the jurisdiction of choice for the formation of investment funds. With such a desire from the leaders of the country to enhance its reputation, it should be expected

that industry participants look in the mirror and ask themselves some serious questions on this important fund governance issue. If the funds industry wishes to grow sustainably over the long-term, then we must act quickly and embrace the concept of continual improvement of our standards, with the aim of removing material conflicts of interests from all fund structures. The investment manager and its onshore advisors should ensure that the fund structure, the majority of its directors and the service providers are truly independent of each other.

My advice to investment managers launching their fund in a difficult market environment would be to take the time to appoint qualified and experienced independent directors who are truly independent of all service providers. This will result in an effective board in which the investors can have a high degree of confidence. My advice to investors is to inform the investment manager and its advisors that they will only invest in a fund that represents a new era in raising the bar of fund governance." ■

**Karl O'Reilly**
Fund Director, IMS

Karl O'Reilly is a fund director at International Management Services Ltd. ('IMS'), one of the leading providers of governance and directorship services to the investment fund industry in the Cayman Islands.

# Understand your vision and build tech to support it

Interview with Bob Shaw

Emerging hedge fund managers looking to succeed in the industry should consider what is most important to their firm and the vision they have for their fund. Then, with this set, the fund should partner with a managed service provider to build the technology infrastructure needed to secure it. Hedge funds can then find the technology components that best suit their business rather than pouring time and money into a complex structure which may not fit their purpose.

"Each manager has a unique footprint and you have to treat them as such," explains Bob Shaw Vice President of Technical Architecture at Eze Castle Integration. "When a startup hedge fund is spinning out of another shop, they sometimes try to mimic what that other shop did, which can be very costly or misaligned with their funds strategy. Success will come from understanding that you don't have to chase what someone else is chasing. You need to know what you want to accomplish, stick to your business or trading model and find a technology solution that makes you successful."

At the other end of the scale are those managers who, in an effort to keep cost down, make use of an unspecialised, small IT company to get up and running. Shaw warns against this approach: "Firms often find they outgrow this support model. When managers ask for the bare minimum to get up-and-running quickly, they commonly make compromises that require a future IT change or reconfigure to support investor requirements once the firm grows. This change results in the firm duplicating IT onboarding costs as well as introducing risk during the migration process as they move to a more secure and scalable solution."

To help avoid this scenario, Shaw advises managers to look into the future and have conversations with their IT partner on where the firm will be in 2, 3 or 5 plus years. "What may appear to save a firm money on Day 1, can end up costing considerably more Day 2," says Shaw, "Not just from a straightforward cost perspective, but also, switching managed service providers or platforms can introduce operational and availability complexities or risk as you move into a whole new environment which addresses the advanced security and technical needs of the firm."

In addition to selecting a managed service provider (MSP) that understands a firm's current and future requirements, it is also critical to partner with a company with deep security expertise. "Choose the right MSP to work with. There is considerable value in working with an IT partner who knows your industry and understands the security and regulatory needs. Someone outside the industry may omit critical security layers required by regulators and investors," Shaw cautions.

This does not mean all hedge funds should start off with complex structures. Rather, Shaw outlines: "Protecting your sensitive data is key, you need to focus on building a secure foundation which can be scaled upon. You can build a technology platform, typically fully managed in the cloud, which is secure with flexibility to add additional "bells and whistles" in the future. Taking a consultative, security-first approach is something we do for all our clients to ensure they are fully covered." ■

**Bob Shaw**
VP of Technical Architecture, Eze Castle Integration

Bob Shaw is VP of technical architecture at Eze Castle Integration, where he is responsible for working with clients to design and implement their technology infrastructure solutions, including creating technology budgets, evaluating and recommending infrastructure needs and address operational priorities. Bob has over 20 years' experience serving as trusted technical consultant to firms in financial vertical.

# Robust systems needed to underpin hedge fund businesses

Interview with James Baxter

When considering hedge funds to invest in, asset allocators place a high value on controls around cyber security, information security and compliance. Therefore, startup hedge funds need to ensure they not only deliver on their investment promises but also that the technology systems underpinning their business are robust.

James Baxter, head of institutional sales efforts at SS&C Eze, elaborates: "Startup hedge funds need to make themselves attractive to the asset allocators. Cyber security, information security and compliance are the top three items allocators are evaluating when considering investment with a specific manager, so it's critical that managers choose vendors that help them, not hurt them, in these areas."

From a technology perspective, hedge funds need a solution capable of addressing their needs in all areas–front, middle and back office. Baxter explains they need technology that connects them to their broker or gives them insight into their portfolios in real time. Further, the solution also needs to deliver pre- and post-trade compliance, a full audit trail, and be able to easily reconcile data with prime brokers and administrators. He says: "This is one thing we're discussing with newer managers – how do you leverage technology to deliver all of these things in a single solution?"

The Eze Eclipse platform is an all-in-one solution that allows hedge funds to manage the entire investment life cycle on one platform. It is a front-to-back office investment management platform, native to the Amazon Web Services cloud. Baxter outlines the rationale behind building the platform in the cloud: "Eze took this approach for pure scalability. Amazon Web Services is one of the best public clouds out there in that allows us to grow and scale our business at speed. When we launched the platform, we knew it was going to take off quickly and we needed to partner with a cloud vendor who would withstand this."

In fact, the platform has grown significantly over the past three years, having signed on more than 100 clients since its launch in 2017.

The all-in-one nature of the Eclipse platform is one of the key factors in its attraction, and developments that further support the trend for managers outsourcing non-core elements add to its appeal. Baxter notes: "Many managers are looking to be very slim in terms of their operational overheads. Therefore, we are layering middle and back office services into our technology through Eclipse Operational Services. Managers who outsource their trading functions are also looking to outsource their middle and back office services. These additional services are a vital component of what makes Eclipse attractive."

Baxter believes having a technology platform that can minimise the components within a hedge fund manager's eco system is essential. "Hedge fund managers should aim to choose a solution that can deliver as much as they possibly need in one single database," he adds.

Cloud technology is particularly beneficial to startup hedge funds due to its straightforward attributes. Hedge funds that are just starting out need simple infrastructure and Baxter says cloud technology delivers this for them: "It keeps their overall infrastructure cost down and also allows It to be uncomplicated because the cloud is very simple in terms of how its deployed and where it sits."

Startup hedge funds also need to be aware of how their needs may change in the future and choose a long-term partner that's investing in development and can provide extensive expertise alongside technology offerings. "In terms of the technology, startup managers want to be able to partner with a vendor such as Eze because we can address their needs today and are built to grow. They aren't at risk of outgrowing the platform in two years. We can deliver what they need over the next five to ten years. Eze Eclipse can scale with their business as it changes," Baxter highlights.

Just a few years ago, startup hedge funds would not have had access to such technology. The world of cloud computing has gone through significant change in the past 10 years. The greatest development has been the role it plays in investment management. "We've seen a greater focus on cloud technology and how businesses are looking to either migrate portions or all of their business into the cloud. This is happening now because investment management professionals have become more comfortable with the information security around the cloud technology," Baxter comments

Cloud usage has evolved significantly. Whereas historically it was only considered to be related to data storage and record keeping, nowadays investment managers are placing larger portions of their business on the cloud. Baxter says: "Having portions or all of their business on the cloud means investment managers have inherent disaster recovery built-in. If there is an outage, the cloud allows for an automatic fail switch over."

The primary challenge startup hedge funds face when looking to implement technology systems is around cost. Baxter acknowledges: "There is cost associated with having the best technology available and therefore you need to spend money to make money.

"This is the biggest struggle we discuss with newer managers – they want to be attractive to the biggest allocators out there, so they want to be able to have the best technology in place to provide comfort to investors. This allows those allocators to check that box and move on. However, this means that some of these managers will have to upfront that cost in order to attract funds and successfully launch a business. This is why we designed Eclipse to be cost-effective."

To guarantee the strength of its business and systems Eze invests in subjecting its security programmes to an extensive audit by an external third-party auditor. In December 2019, the firm announced it successfully maintained ISO 27001 certification, including an expanded scope that encompasses ISO 27017 and ISO 27018 for Cloud Security and Cloud Privacy. Eze is looking to expand the scope even further in 2020.

Baxter cautions startup hedge funds to take stock of the providers they work with. "Startups should not only be considering vendors and technology platforms that are scalable for their business but should also be looking at vendors that have the proper certifications. Eze goes through this stress testing each and every year. We invest a lot of resources in ISO certification to show we've gone through the proper infiltration testing with our business because after all, we are managing clients' data, which cannot be taken lightly. This is something hedge fund managers should be looking at with all their vendors; to make sure they have their certification and they go through the appropriate third-party audits and every year," he concludes. ■

**James Baxter**
Director, Institutional Sales, SS&C Eze

James Baxter leads institutional sales efforts at SS&C Eze. He joined Eze Software in 2013, working from Dallas to grow market share and pipeline across the Midwest and then expanding his territory to the East coast. He transitioned to New York in 2015, and now covers the New York, Connecticut and Massachusetts sales efforts. Prior to joining Eze in 2013, he led sales efforts in the Alternative Investments group at Morgan Stanley Wealth Management and Gain Capital.

# Operational due diligence considerations

By Frank Napolitani

Given today's challenging capital raising environment, it is more important than ever to ensure that key, non-investment functions of an investment management firm are being addressed and managed properly. Operational Due Diligence (ODD) plays an integral role in the allocation of institutional capital.

According to the 2019 JP Morgan Institutional Investor Survey which collected responses from 227 allocators with a combined USD706 billion in capital invested across hedge funds globally, 33 per cent of investors stated they had chosen not to allocate to a specific manager because that manager did not pass ODD. Once an investment manager has been vetoed, the odds of being reconsidered by that institutional investor are extremely low.

For an institutional allocator, ODD is the back-end of the investment process meant to hedge operational risk. The focus of ODD is to gain an understanding of an investment manager's operational infrastructure and to protect investors from potential losses resulting from operational failures in the firm. Generally, it is not just one item that will cause a manager to fail ODD, but rather a handful of violations that when looked at in aggregate, are too risky for an ODD practitioner to disregard.

### Reasons why a manager may be vetoed

There are a number of reasons why an investment manager may be vetoed by an ODD practitioner. These may include, but not be limited to:

- Self-administered funds;
- Poor segregation around cash controls (e.g. at least two signatories for cash movements);
- Unwillingness to provide transparency or uncooperativeness during the ODD process;
- Insufficient operational and technological infrastructure to support the fund's investment strategy;
- Weak or unclear valuation policies combined with deviations of estimates of NAV, restated NAV and/or audited financial statements;
- Unsatisfactory service provider engagement during the ODD process;
- Regulatory and compliance issues;
- Lack of integrity.

### Deliverables required for an ODD exam

An investment management firm can assume that a number of items will be requested for the on-site portion of an ODD exam. These items may include, but not be limited to:

- Fund marketing materials;
- DRBC manual;
- Organisational chart;
- Code of ethics;
- Monthly accruals summary;
- Risk policy;
- Form ADV (if registered);
- Due diligence questionnaire (DDQ);
- Fund offering docs;
- Trade flow diagram;
- Valuation policy;
- Personal trading policy;
- Fund audits;
- Compliance manual;
- Executive biographies;
- Daily report samples;
- Cash controls policy.

### Preparing for an on-site ODD exam

An institutional allocator will generally spend between four and six hours preparing for the on-site exam. ODD practitioners take a practical approach to these on-site exams, and providing the requested deliverables outlined above ahead of time will help their pre-exam preparation. The on-site exam will often vary by size and complexity of the investment management firm's investment strategy.

As the investment management industry continues to evolve, managers who choose to adopt a Best Practices operational infrastructure will fare far better in the capital raising process than those who do not. Institutional allocators have accepted taking on investment risk, however, they will not accept operational risk, and successfully passing ODD is the key hurdle in this process. ■

**Frank Napolitani**
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Prior to joining Constellation in 2019, Frank Napolitani was a Director and National Head of Business Development for the financial services practice at EisnerAmper LLP for several years. Prior to EisnerAmper, he served as Managing Director, Prime Brokerage Sales at Concept Capital Markets, LLC, the predecessor company to Cowen Prime Services, from 2008 to 2015.

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