

# Starting a Fund: Keys to a Successful Launch



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OPERATIONAL, FINANCIAL AND COMPLIANCE CONSIDERATIONS

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# About Our Presenters:

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**Rafael Beck | Managing Director, Fund Accounting and Administration**

Integrated Solutions

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Grant Thornton LLP

# Agenda:

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1. Examples of potential challenges
2. Steps to Launch your Fund
3. Overview of typical Fund structures
4. Fee Structures
5. Raising Capital/ Seed investors
6. Service Provider Selection
7. Technology Infrastructure
8. Regulatory Compliance

# Examples of potential challenges

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- Raising capital
- Unclear strategic vision
- Inadequate implementation of technology solutions
- Dependence on manual systems, lack of integration and limited flexibility of systems
- Lack of diligence when selecting third party vendors (e.g., fund administrator, prime broker)
- Lack of appropriate oversight of third party services (e.g., shadow books)
- Undefined reporting structure and unclear lines of accountability/segregation of duties
- Inadequate documentation and poorly defined policies and procedures
- Resource constraints to support oversight

# STEP 1: Define the Strategy

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What is the long term vision of the Fund?

- Determine trading strategies to be used by the Fund
  - Equity Hedge, Market Neutral, Global Macro, Relative Value Arbitrage, Convertible Arbitrage, Distressed
- Which Financial Products are used to achieve the strategy?
  - Stocks, Bonds, Derivatives, Privates
- Anticipated Trading Volumes
- What are the Benchmarks for the Fund?
  - Track record of Fund Manager

# STEP 2: Design the Operating Model

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- People: → Define business functions
  - Trading and Operations
  - Accounting
  - Compliance
- Process: → Identify and map out key processes
- Data Technology: → define in-house vs. outsourced functions
- Organization Structure → create organization chart

# STEP 3: Select Service Providers

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- ✓ Select outside counsel/compliance consultant
- ✓ Select prime broker
- ✓ Select fund administrator
- ✓ Select auditor and tax preparer
- ✓ Select technology solutions- pro/con analysis of various technology vendors

# STEP 4: Determine/Formalize operating model

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→ Determine and document processes around internal procedures, controls and systems that support the business.

Core areas of documentation are:

- Legal structure of funds
- Registration (onshore/offshore)
- Regulatory requirements (what are the required filings? manuals)
- Functions with the fund administrator and “shadowing” administrator activities
- Documentation of the oversight function



# Fund Structures

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## Stand-Alone domestic partnership-

- ✓ Attractive to U.S. Citizens or U.S. taxable investors.
- ✓ Typically set up as a Limited Partnership, with a limited liability company acting as the Fund's General Partner.

## Offshore corporation

- ✓ Attractive to non-U.S. investors and U.S. tax-exempt investors
- ✓ Most popular structure is a Cayman Islands exempted company

## Master-Feeder structure

- ✓ Utilizes both a domestic and an offshore fund
- ✓ Enables the manager to target diverse capital sources while allowing for the efficient management of the portfolio at the master-level

## Fund of Funds

## Role of Investment Manager

# Fee Structure- Manager Compensation

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## Management Fee

- ✓ Often 1-2% of the Fund's net assets to cover the Investment Manager's on-going expenses in running the Fund, such as rent, salaries and computer equipment.

## Incentive Fee/Allocation

- ✓ Industry standard is 20% of any realized or unrealized profits over realized or unrealized losses.
- ✓ Typically structured as an allocation of the Fund's income to the General Partner (calculated on an investor-by-investor basis) rather than a fee on the entire assets of the Fund.

# Fee Structure- Manager Compensation

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## High-Water Mark

- A high-water mark is the highest peak in value that an account has reached. The high-water mark ensures the manager does not get paid large sums for poor performance. If the manager loses money over a period, he must get the fund above the high-water mark before receiving an incentive allocation.

## Hurdles

- Typically require the fund's performance to exceed a certain minimum rate of return before a performance allocation to the General Partner is to be made.
- The performance allocation may take place on a monthly, quarterly or yearly basis. Some hurdles are calculated on an annual basis (with each year's return measured against the hurdle applicable to that particular year). Others are calculated on a cumulative basis.

# Fund Expenses

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## Typical Fund level expenses

- Manager compensation – management fee/incentive (includes compliance costs)
- Interest expense
- Trading costs/commissions
- Professional fees (legal, audit, admin)
- Market data

## Typical Fund manager expenses

- Office overhead expenses
- Employee compensation
- Technology
- Travel

# Raising Capital/ Seed Investors

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Develop a profile of your target investors – potential sources of investors include

- Seed-capital providers
- Family and friends
- High net-worth individuals
- Financial advisors
- Fund of hedge funds
- Pensions

Consider using Third Party Marketers/Private Placement broker-dealers

- David W. Blass, Chief Counsel, Division of Trading and Markets, U.S. SEC- 2013 speech

Side letters

- Most-favored-nation provision (MFN) – must be disclosed in Fund documents

# Side Letters

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Grant special rights and privileges to important investors (e.g., seed investors, strategic investors, large investors, employees) or subject to special government regulation (e.g., ERISA, Bank Holding Company Act)

## Risks

- monitoring costs;
- administration;
- litigation claims: breach of contract and/or fiduciary duty;
- regulatory;
- inadvertent side letters: agreement to supplement Fund governing documents verbally or through email

# Service Provider Selection

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## Legal Counsel

- ✓ Proper Fund structure
- ✓ Proper drafting of Fund's operating and offering documents
- ✓ Compliance with regulatory requirements

# Service Provider Selection (continued)

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## Administrator

- ✓ Provide daily, monthly and annual accounting services
- ✓ Portfolio accounting and reporting
- ✓ Recording of all transactions in the accounting records
- ✓ Subscription and redemption accounting services
- ✓ Calculate Management and Performance fees/allocations
- ✓ Prepare partner allocations, distribute capital statements
- ✓ Support year-end audit, prepare draft financial statements



# Service Provider Selection (continued)

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## Prime Broker

- ✓ Custody of Assets
- ✓ Trade Execution
- ✓ Trade clearing/settling
- ✓ Portfolio Financing & management
- ✓ Reporting

# Service Provider Selection (continued)

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## Auditor

Questions to ask when selecting an external auditor:

- ✓ Does your auditor have the right accounting and auditing skills necessary for your business?
- ✓ Does your auditor demonstrate an understanding of your business?
- ✓ Does your auditor possess the necessary communication skills?
- ✓ Is your auditor collaborative in an objective way?
- ✓ Does your auditor provide insights into your business?
- ✓ Is the audit firm recognized in the industry?

# Technology- Infrastructure

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- Internal controls
  - Cyber security
  - Technology support
  - Disaster Recovery
  - Business Continuity
- Who at your firm can pull the plug if under cyber attack?

# Technology- Infrastructure (continued)

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Archiving (emails, instant message & social media communications) – Revised Form ADV 1

System selection considerations & implementation challenges

1. Portfolio management/order management
2. Portfolio accounting
3. Partnership accounting
4. Data warehouse
5. Collateral management
6. Reporting tools

# Entities Regulated under the Advisers Act

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Investment advisers (managed money using securities)

Hedge Funds

Private Fund Advisers

Real Estate Funds

Venture Capital Funds

Family Offices

Commodity Funds

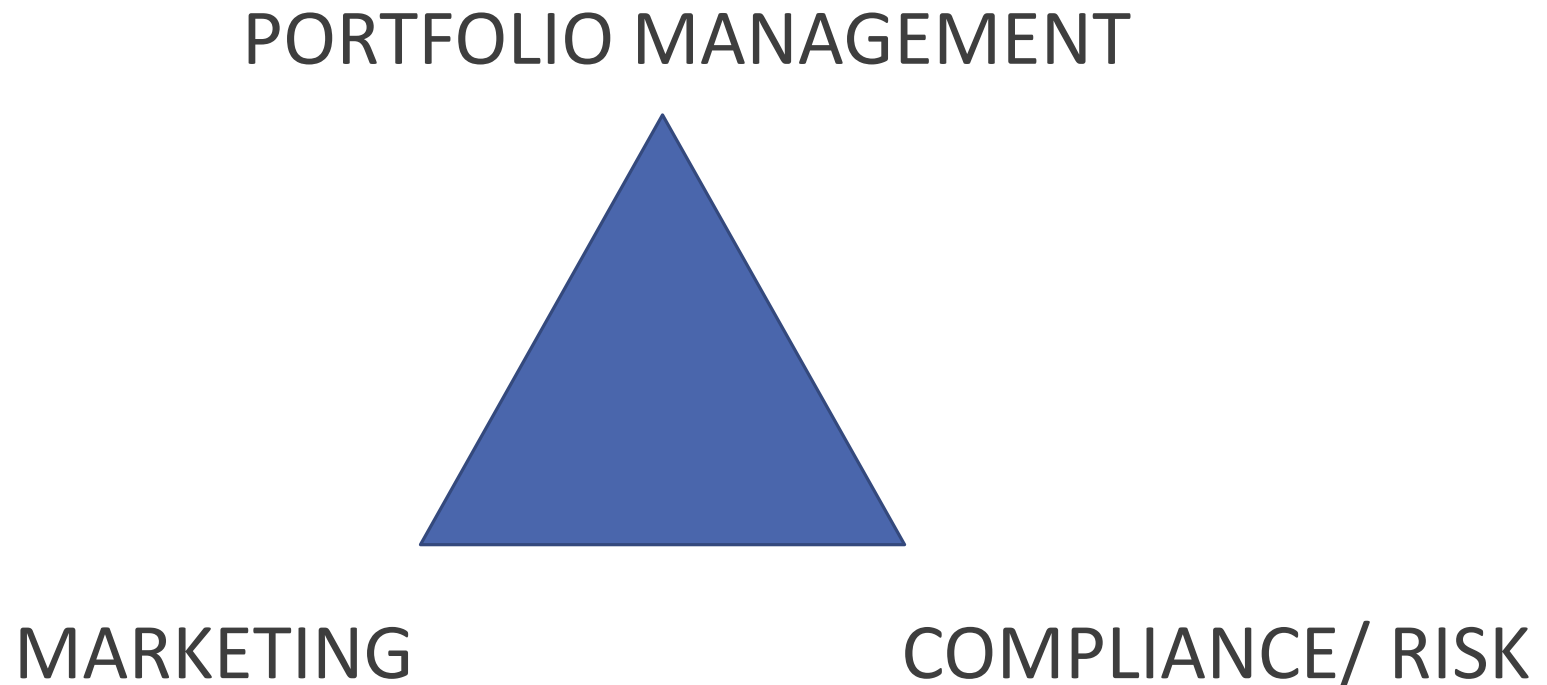
# Advisers Act Exemptions (federal, not state)

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- Private fund advisers under \$150 MM in AUMs
- Venture capital funds
- Exempt Reporting Advisers (“ERAs”) - \$25M-\$150M in AUMs
- Family offices
- Foreign private advisers
- Small advisers: less than \$25M AUMs

# The Triangle of Disclosure Compliance

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# Internal Governance

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## MANUALS

- Mandatory
  - Code of Ethics: mandatory designation of Chief Compliance Officer (“CCO”)
  - Business Continuity
- Best Practices
  - Policies and Procedures
  - Supervisory Controls
  - AML

## FUND DOCUMENTS AS A SOURCE OF COMPLIANCE DUTIES

## TRAINING



# Code of Ethics

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- ❖ Fiduciary Standards
- ❖ Personal Trading
- ❖ Outside Business Activities
- ❖ Material Nonpublic Information



# Registration with Regulators

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Open IARD account

Determine where you need to register

Register with industry regulators

Prepare and File Form ADV

# Marketing/ Advertising

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## Compliance with the Advisers Act and SEC Guidelines

- Testimonials
- Graphs
- Performance results

## General solicitation

# Regulatory Compliance: Form ADV Parts 1 and 2

## ADV 1: Statistical Information

ADV 2: Brochure – must be delivered to each client (with limited exceptions) before or when you enter into an advisory agreement with that client (even if advisory agreement is oral) AND deliver a free updated brochure to each client annually within 120 days of the end of your fiscal year that either includes:

- (1) a summary of material changes or is accompanied by a summary of material changes, OR
- (2) a summary of material changes together with an offer to provide a copy of the updated brochure and information on how a client may obtain the brochure.
- Narrative Format: 19 sections
- Plain English
- Filing

OBJECTIVE: Disclosure to clients of all material facts relating to the advisory relationship, particularly with respect to conflicts of interest and disciplinary history.

FORM ADV 1 Changes: effective date Oct. 1, 2017 – additional disclosures on separately managed accounts, branch offices and use of social media

# SEVEN DEADLY SINS

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- (1) Calculation of fees/RAUMs
- (2) Conflicts of interest
- (3) Personal trading issues
- (4) Custody
- (5) Marketing/Advertising compliance
- (6) Cybersecurity
- (7) Trading issues



# Speaker Bio – Rafael Beck, CPA

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## **Managing Director, Fund Accounting and Administration– Integrated Solutions**

Rafael Beck is based at Integrated Solutions’<sup>SM</sup> Boca Raton, Florida office. Among his responsibilities, Rafael coordinates and supervises a specialized team of CPAs, portfolio accountants and bookkeepers who handle the financial activities and reporting of the firm’s asset management, broker-dealer and outsourced accounting clients. He has extensive experience serving domestic and offshore hedge funds, private equity funds, funds of funds and broker-dealers. He provides advice on fund start- up issues including organizational structure, economic issues and general business consultation. Rafael also leads the firm’s financial statements preparation group, as well as manages key client relationships.

Prior to joining the firm, Rafael was at Ernst & Young, as a supervising senior accountant, where his work concentrated on audits of asset management clients. Previously, he was a senior hedge fund accountant at International Fund Services (N.A.) L.L.C., a fund services company providing accounting and administration services to asset management clients. Rafael started his professional career at Rothstein, Kass & Company P.C., CPA’s, specializing in audit and tax compliance engagements for hedge fund and broker-dealer clients.

Rafael received a B.B.A in Accounting from Pace University in 2000. He is a Certified Public Accountant and is a member of the American Institute of Certified Public Accountants (AICPA) and serves as a member of the Investment Management Committee of the New York State Society of CPAs (NYSSCPA). He also holds a Series 27 license.

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# Speaker Bio - Cassondra E. Joseph, Esq.

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## **Managing Director, Compliance— Integrated Solutions**

Cassondra E. Joseph provides compliance advice to both broker-dealers and investment advisory firms on all aspects of SEC, FINRA, CFTC, other SROs and state registration, guidance on establishing a compliance program, preparation of compliance manuals, preparation of regulatory filings with FINRA and the SEC, assistance with audits and resolution of ongoing compliance issues, including, without limitation, Form NMA/CMA, Materiality Consultations, underwritings, private placements, AML compliance, Rule 15a-6 compliance, Reg M compliance, advertising regulations and commission arrangements. Her investment advisory clients range in size from start-ups to \$6.5 billion in assets under management and include investment advisers, hedge funds, commodity funds, private equity funds, CPOs and CTAs. These firms provide investment advice to both individual and institutional clients.

Ms. Joseph has been with Integrated Solutions<sup>SM</sup> since 2010. She was formerly General Counsel at a NYSE-registered, full service brokerage firm whose operations included several substantial investment advisers; she held the Series 14 license. As an attorney admitted in New York, she has extensive experience in advising financial services firms as well as drafting fund formation documentation and transactional documents for a broad range of transactions that involve securities, investment advisers and various categories of alternative investments funds. She was formerly a tenured law professor who taught securities law, among other subjects. She has an LL.M. from Columbia University and her J.D. and B.A. degrees from Washington University (St. Louis).

In the investment adviser field, she has lectured on how to set up investment adviser compliance programs, investment adviser Code of Ethics and drafting the Form ADV, Part 2. She has also lectured on soft dollar arrangements, suitability, the JOBS Act and AIFMD. In addition, she has served on several Bar Association Committees that issued reports affecting the financial services industry.

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# Speaker Bio - Shawn Mostal, CPA

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## **Managing Director, Audit Services– Grant Thornton LLP**

Shawn is an audit director with more than 15 years of experience in public accounting.

### **Experience**

Shawn’s experience includes supervising and coordinating all services rendered to privately and publicly-held clients. Within these areas he has significant involvement with in-depth work in audit and accounting, Initial Public Offerings (IPOs), complex partnership matters, consulting, acquisition evaluations, and various other services.

### **Industry experience**

Shawn’s industry experience includes expertise in real estate/hospitality, employee benefit plans, and financial services/private equity.

### **Professional qualifications and memberships**

American Institute of Certified Public Accountants (AICPA) – Member

Florida Institute of Certified Public Accountants (FICPA) – Member

### **Education**

Shawn graduated from Nova Southeastern University with a BS in accounting

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# The END

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