Setting the stage for future growth
Hedge fund spin-off considerations

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Introduction

In July 2010, the Volcker Rule, which limits proprietary trading by banks, was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The provisions were expected to be effective by July 2012, but the Federal Reserve later extended the deadline to July 2014, providing banks with additional time to meet the requirements. In the meantime, the industry witnessed several high profile spin-offs of bank-owned hedge funds and proprietary trading desks in anticipation of the Volcker Rule.

This growing trend has created a pool of hedge fund managers who have substantial portfolio management experience and a performance pedigree, but lack of experience in managing operations, technology and compliance. With institutional investors and regulators demanding an unprecedented level of transparency and regulatory compliance, focus on middle and back-office functions is emerging as a key priority for the spin-off fund managers.

In such circumstances, managing a stand-alone fund can be a daunting task. Fund managers need to strike a balance in allocating resources across investor relations, ensuring regulatory compliance and building out technology and operations infrastructure, all while continuing to maintain focus on portfolio management and establishing a performance history.

Spin-off considerations

To succeed, a holistic approach is needed to set-up a stand-alone fund that takes into consideration five unique characteristics of the future enterprise.

A structured review of these characteristics helps provide management with an understanding of the go-to-market alternatives that meet both business and regulatory requirements.

Figure 1: Key considerations for spinning-out a proprietary trading desk or hedge fund

A structured review of these characteristics helps provide management with an understanding of the go-to-market alternatives that meet both business and regulatory requirements

1. Target operating model considerations

- Identify and categorise operational functions and develop model alternatives
  - Consider options to insource and outsource functions and the costs and benefits of each
  - Consider which functions the parent company may continue to support
  - Consider the impact of the Volcker Rule on model design option
- Assess capabilities of key service providers, including prime brokers and administrators

As a first step, the fund being launched should define its target operating model based on its strategic needs, growth plan and technology capabilities. For each of the functions in the target operating model, the fund should consider the functions that will be performed in-house as well as the functions that will be performed by third-party or affiliated service providers. The fund needs to decide for which functions it may still rely on the infrastructure of the parent company from which it has been spun-out and if this reliance is a short-term or long-term solution.

In defining its target operating model, the fund should weigh its alternatives, including: centralised vs. decentralised, internal vs. external, functionalised vs. productised. Further, the operating model should be customised based on the alternative chosen.

In the case of a functional model, the fund should incorporate a location strategy, including the advantages and disadvantages of centers of excellence as well as the time zone coverage required for each function. Moreover, the fund should perform a functional gap analysis that will provide descriptions of the current state processes, future state activities and areas for consideration as the fund implements the future state design. Areas for consideration are typically grouped by the associated impact to people, processes and technology.

For outsourced functions such as technology, the fund should define and execute a service provider selection and oversight criteria. Once a third-party relationship has been identified, the fund should define the Service Level Agreements (SLAs) and a comprehensive governance structure in terms of a Responsible, Accountable, Consulted, Informed (RACI) matrix.

2. Organisational design considerations

- Leverage operating model to identify human capital needs
  - Establish plan for bringing onboard any key resource gaps for launch
- Develop organisational structure alternatives

As a next step, the fund will need to define its organisational structure in line with investor, business and regulatory requirements. The organisation structure selection should be based on the fund's immediate and long-term business needs. It should also include a governance framework based on the target state operating model, with respect to its internal operations and various service providers (e.g., service providers or sub-advisors).

At this stage, the fund will need to appoint leadership and assess the staffing requirements for the new entity. This assessment includes identifying staffing needs for functions that may not currently exist or for which the fund has relied on the parent company (e.g., HR services, accounting, operations and IT). Moreover, management should consider which positions are required to be part of the entity spun off from the parent company and which positions should be incorporated into the Transitional Service Agreement (TSA).

The organisation structure selection should be based on the fund's immediate and long-term business needs

3. Technology architecture considerations

- Develop data strategy and consider technology architecture alternatives
- Consider what data management needs to insource vs. outsource to service provider
- Consider specific system needs and develop plan for vendor selection

Once the target state operating model and organisational structure have been identified, the fund needs to develop a technology architecture—which aligns with the current and future operating model. The technology architecture should document data and system requirements, including identification of data providers as well as data transformation, enrichment and integration needs for insourced processes. Meanwhile, reporting and data feed requirements for outsourced processes also should be considered.

The fund should also develop an overarching data strategy to help ensure data integrity and security from day one. Management should consider what systems and data will be required as well as what data should be managed internally vs. data that may be managed by a service provider.

Overall, the strategy should minimise data movement, identify the golden copy for key data, such as pricing data and security information, and provide a framework for controlling and sharing information. For data and systems required in-house a vendor shortlists and selection plan should be developed.

4. Regulatory and compliance considerations

- Determine what legal entities may need to be created
- Select solutions and develop Form PF solution architecture
- Establish relationship with legal counsel, consider future fund structure options and their specific regulatory requirements
- Establish a plan for registration, development of fund documents and a compliance programme

The next step is to identify the regulatory considerations. The fund may need to register as an investment adviser with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940 (Adviser's Act) and should understand the reporting, governance and recordkeeping responsibilities of a registered adviser.

To begin with, the fund should determine and create appropriate legal entity and fund structures. Moreover, processes need to be set up to coordinate through various regulatory requirements, including:

- Preparing Form ADV filing
- Developing Form PF solution architecture
- Designating a Chief Compliance Officer to administer the firm's advisory program
- Establishing a compliance program under the Adviser's Act and related policies and procedures to comply with Rule 206 (4)—7 of the Adviser's Act
- Setting-up a compliance training programme under the Adviser's Act

In addition, the fund will need to set up appropriate oversight and supervisory controls based on investor and regulatory requirements. Management will also need to assess the fund's readiness for an SEC inspection and establish appropriate data through a recordkeeping and documentation policy, such that records are easy to verify, explain or clarify and are prepared in a timely and standard manner. Moreover, if the fund plans to market to EU investors, it should evaluate the impact of the Alternative Investment Fund Managers Directive.

5. Roadmap for spin-off off considerations

- Establish Transitional Services Agreement (TSA) needs
- Develop launch plan with timeline and key milestones
- Identify launch risks and develop mitigation strategy and contingency plan

The activities and timeline should take into account the regulatory environment, target operating model, technology architecture and organisational design

Finally, the fund needs to have a roadmap for executing the spin-off to facilitate identification and mitigation of potential risks and challenges. The plan should provide a timeline, call out milestones and assign ownership to activities, giving the team a common understanding of the timing for requisites for the spin-off.

The activities and timeline should take into account the regulatory environment, target operating model, technology architecture and organisational design. Capabilities and constraints of all stakeholders should be incorporated in the plan, including outside service providers.

The plan should include any TSA considerations, including how the fund will decouple key functions and systems from the parent company. Finally, the roadmap should reflect the balance that management wishes to achieve between time to market, cost of spin-off and the degree of target state completeness on day one of the launch post spin-off.

Conclusion

For a smooth transition post spin-off, management should work through the five stages and align processes to regulator and investor priorities. Often, fund managers may find the entire process time-consuming and cost-prohibitive—given their limited experience in handling non-core operations. In such cases, leveraging a service provider may be more feasible.

One of the options available to management is to outsource non-core functions to the parent company. However, the choice between a third-party service provider and the parent company should be based on their capability to support the fund through its current and future growth plans; synergies between fund's and service providers' strategy and structure as well as locational and regulatory considerations. Management should also consider the costs and benefits of relying on the parent's systems, including investor and regulator perception.

A solid operational foundation is necessary for the success of a stand-alone fund in the long-run. It is only when the fund identifies and fills the regulatory, operational, technology and human capital gaps that need to be addressed based on current state capabilities and future state requirements that a strong operational foundation for future growth can be laid.

To the **point**:

- A holistic approach to spin-off a hedge fund should involve five distinct characteristics:
  1. Define its target operating model based on its strategic needs, growth plan, and technology capabilities
  2. Lay-out an organisational structure in line with investor, business, and regulatory requirements
  3. Develop a technology architecture which aligns with the current and future operating model
  4. Identify regulatory considerations, and select and develop compliance solution structure
  5. Develop a spin-off roadmap to identify and mitigate and potential risks and challenges

Management should also consider the costs and benefits of relying on the parent's systems, including investor and regulator perception