



reporter

MANAGED FUNDS ASSOCIATION

January/February 2007

Planning Your Work and Working Your Plan – A Guide to Achieving a Tailored and Scalable Operational and Compliance Infrastructure

CAROL R. KAUFMAN, FOUNDER/CEO, ALTERNATIVES TLC, LLC,
AND KATE DRESSEL, PRESIDENT, STRATEGIC COMPLIANCE SOLUTIONS, LLC

Whether a firm is an emerging manager, a mid-sized CTA/CPO or an enormous, registered, or unregistered, hedge fund, one of the biggest difficulties facing all firms is creating tailored operational and compliance systems and procedures scalable enough to meet the changing needs of a firm.

Firms that plan poorly can expect, at best, to incur substantial expense, both monetarily and in man-hours, updating their infrastructure. At worst, inadequate systems and personnel can result in operational failures that are catastrophic for the firm. The Capco report, first released in March 2003, states that approximately 50% of hedge fund failures are due to operational issues, suggesting all industry firms are at risk. Thoughtful planning, however, can mitigate, if not eliminate completely, many of the pitfalls commonly experienced by emerging, growing and even established businesses.

The bad news is that a lot of effort is required to produce a well thought-out plan. The good news is that there are so many service providers, software programs and consultants available in today's marketplace that it is likely one or more will offer the capabilities and tools a firm requires, while staying within a reasonable budget.

Anticipating Current and Future Needs

Objectives change. Businesses morph into new and unexpected product lines in accelerated timeframes, all of which must be considered when planning. Firms should begin their operational and compliance planning by developing a requirements list. What does a firm really need? This "needs assessment" phase is key. It is the foundation for a resulting "gap" analysis; itemizing what functionality a firm has versus what it needs.

Thoughtful planning can mitigate, if not eliminate, many of the pitfalls commonly experienced by businesses.

Below are some basic, high-level, "must have" requirements for a firm in our industry:

- An organized, physical environment with ready access to information
- Clearly defined responsibilities delegated to specified, appropriate personnel
- Documented operational work flows and procedures for the following activities:
 - Client Services Fulfillment (offering memorandums, communications, client relationship management – "CRM")
 - Trade Order Management
 - Portfolio Accounting
 - Risk Management
 - Investor and Fund Accounting and Reporting
- Documented compliance process that considers the following areas:
 - Registration Management
 - Written Supervisory Procedures
 - Code of Ethics
 - Business Continuity, Successor and Disaster Recovery Plan
 - Anti-Money Laundering
 - Supervision of Personnel/Branch Offices
 - Training of Personnel

Planning Your Work

Equally as important, firms must consider the impact of growth or success on future needs. Will current systems/solutions easily expand to accommodate new product lines and functionality? If not, how difficult (and expensive) will it be to migrate to another platform? When does staffing need to expand? What solution will be flexible and scalable enough to allow a firm to grow gracefully?

What Products and Services are Available?

Unfortunately, there is no “silver bullet,” no magic formula, no single system that will satisfy 100% of a firm’s requirements. Word and Excel or similar products will always be needed to supplement COTS (consumer off-the-shelf) products. This must be considered in the gap analysis, in the documented work flow processes and when researching solutions. Once a firm has determined its needs, it must then identify all options available which may fit its requirements. The trend toward outsourcing within our industry has spawned a myriad of products and services tailored to alternative investment firms of all types and sizes. Many firms are so overwhelmed with the day-to-day operational issues that they may never have even considered alternative options to what they are currently doing. They may have no idea what options are even available – from low cost to high cost; from in-house to external solutions. Speaking to peers helps discover what products and services they decided to utilize as well as what they feel are the strengths and weaknesses of those solutions. Internet searches may also prove helpful and allow a firm to research alternatives in greater detail.

The concept that over 50% of all hedge fund failures are due to operational issues indicates that not enough attention is being given to developing adequate infrastructure.

Researching Available Products – RFIs, RFPs and TCOs

An effective and efficient way to research solutions is to request a brief conversation or demo from an identified vendor(s), while conducting a formal request for information (RFI), or request for proposal (RFP). RFIs and RFPs are documents sent to prospective vendors of services that generally have two components; a quantitative section that asks a firm to detail, usually via a checklist, items such as features and functionality of their offering, information about pricing, support, technology, etc., and a qualitative section that may ask for detailed explanations regarding compa-

ny background, process flow, training and implementation plans. Structuring the RFI or RFP is critical, since it is used to compare features and functionality across various systems and services, and benchmark them against the firm’s requirements list.

While researching potential products and services, all firms should consider total cost of ownership (TCO). TCO is the amount of time, converted to money and actual money necessary to research, buy, learn, convert, implement and maintain a solution, factoring in the number of people, software systems and other resources needed – in this case, for an operational and compliance solution – over a three- to five-year timeframe. Performing a TCO can have a direct impact on a firm’s solution decision. A new manager may start out with very few people and may, quite appropriately, only use products like Microsoft Suite’s Word, Excel, Outlook, and PowerPoint. As a firm grows, however, with more clients and increased personnel, the lack of controls within Excel spreadsheets allows anyone to change formulas, accidentally erase data, and create different versions of spreadsheets which can begin to cause inconsistencies and even errors in calculations. At some point, the cost of people’s time to, for example, learn the process or roll forward a year’s worth of changes or trace an error in a spreadsheet, can be more expensive than relying upon a low-to-medium cost software solution or employing outsourcing for certain tasks.

A few specific comments regarding compliance manuals: consideration should be given to the audience. Documents must be written to the level of understanding of the user and must accurately reflect the firm’s operation. While a global compliance manual that articulates law and discusses legal opinion and issues at a thirty thousand foot point-of-view may be appropriate for a savvy compliance person, a step-by-step, “how-to” procedural guide is more likely to be comprehended and followed by end-users within a firm. Most importantly, don’t sign on for a “canned” manual as you may inadvertently commit to complying with things that aren’t applicable to your firm! Most firms, again, make extensive use of programs such as Microsoft Office Suite to create and maintain their own personalized manuals.

Summary

Before putting on a discretionary trade, a responsible trader thoroughly researches the instrument to be traded, considering the potential upside and downside risk to a portfolio. Firms freely spend time and money developing an edge that will help a trading program make money in uncertain market environments, but the concept that over 50% of hedge fund failures are due to operational issues indicates that not enough attention is being given to developing adequate infrastructure.

The key to increasing a firm's survival rate substantially, as well as smoothing its growth curve, is realistic, proactive planning for the future.

A firm may have outstanding performance, but if assets grow ahead of infrastructure, the resulting breakdown can cause losses in assets due to client concerns and even regulatory action. 2007 will be a year of intensified operational scrutiny on the part of investors and regulators. The key to increasing a firm's survival rate substantially, as well as smoothing its growth curve, is realistic, proactive planning for the future. "Planning your work and working your plan" will help firms achieve their goals for success seamlessly, keeping risk where it should be — in the trading program, not in the business operations.

To further aid the reader in finding a viable solution while staying within its budget, an extensive list of Web sites, vendors and software programs, which may be used to initiate or supplement research, will be available at "Plan Your Work and Work Your Plan," being presented by the authors at MFA's *Network 2007* on Monday, February 11 from 2:15 – 3:15p.m. at The Ritz-Carlton Key Biscayne. ©

Carol R. Kaufman is founder/CEO of Alternatives TLC, LLC, a consulting firm to alternative investment firms, specializing in training, accounting, operations and project management. Ms. Kaufman can be reached at ckaufman@alternativestlc.com.

Kate Dressel is president of Strategic Compliance Solutions, LLC, a regulatory compliance and operations consulting firm working with alternative investment firms. Ms. Dressel can be reached at Kate@StrategicComplianceSolutions.com.