

HEDGE FUND ROUNDTABLE

Investment Management and Hedge Funds – *What's Happening Now?*

Life Cycle Series 2018

Session 2: Outsourcing Options --Trading, CID, Compliance, CFO

October 23, 2018

Gregory J. Nowak, Partner nowakg@pepperlaw.com
Ausra Ragauskaite, Associate ragauska@pepperlaw.com

Pepper Hamilton LLP
Attorneys at Law

Life Cycle Series 2018

Tuesday, September 25, 2018

- ▶ Choosing the Right Structure

Tuesday, October 23, 2018

- ▶ **Outsourcing Options --Trading, CID, Compliance, CFO**

Tuesday, November 27, 2018

- ▶ SEC / FINRA / DOJ – Enforcement Update

Tuesday, December 18, 2018

- ▶ Exit strategies for fund managers – Rollups, ESOPs, Sales

What is Outsourcing?

- ▶ What functions are firms outsourcing?
 - legal and compliance
 - information technology (IT) and cybersecurity
 - operations (human resources, internal audits, etc.)
 - accounting/finance (payroll, expense account reporting, etc.)
 - investment management, research and algorithm development
 - trading

Outsourcing and Compliance Responsibilities

- ▶ Under Rule 206(4)-3 of the Investment Advisers Act of 1940, an investment adviser is generally prohibited from paying a cash fee, directly or indirectly, to a third party (a “solicitor”) unless certain conditions are met, including that the solicitor has delivered to the client a statement describing the nature of the relationship between the solicitor and the investment adviser and the compensation that the solicitor will receive. The investment adviser has an obligation to supervise the activities of solicitors.
- ▶ Under the SEC’s “custody rule,” with certain limited exceptions, an investment adviser is required to maintain client funds and securities with a “qualified custodian.” Qualified custodians can be banks, registered broker-dealers, futures commission merchants, or certain foreign entities.

Outsourcing and Compliance Responsibilities

FINRA Guidance

- ▶ NASD Notice to Members 05-48 – July 2005 reminded NASD (now FINRA) members that, (a) in general, any persons conducting activities or functions that require registration under NASD rules are considered associated persons of the member, and (b) outsourcing an activity or function to a third-party service provider does not relieve members of their ultimate responsibility for compliance with applicable law and regulation.
- ▶ In 2011, FINRA issued Notice 11-14, in which it proposed a specific rule (3190) to clarify the scope of a member's obligations and supervisory responsibilities for activities or functions outsourced to a third-party service provider. This proposed rule has not yet been finalized.
- ▶ FINRA has developed a Compliance Vendor Directory as a resource for firms searching for vendors that offer compliance-related products and services.

Outsourcing and Compliance Responsibilities

SEC Guidance

- ▶ Outsourced Chief Compliance Officers
 - Communications
 - Resources
 - Empowerment
 - Meaningful Risk Assessments
 - Following Compliance Policies and Procedures
 - Annual Review of Compliance Programs

- ▶ Outsourced Cybersecurity Functions
 - Reasonably tailored policies and procedures
 - Maintenance of an inventory of data, information, and vendors
 - Detailed cybersecurity-related instructions

Outsourcing and Compliance Responsibilities

SEC Guidance -continued

- ▶ Outsourced Cybersecurity Functions
 - Maintenance of prescriptive schedules and processes for testing data integrity and vulnerabilities
 - Establishment and enforcement of controls to access data and systems
 - Mandating employee training
 - Engaged senior management

Outsourced Chief Investment Officers

- ▶ Primary reasons for outsourcing:
 - gain access to special expertise
 - achieve better investment returns
 - reduce costs
 - reduce regulatory and fiduciary risks
- ▶ Third-party service provider accepts responsibility for an institution's entire investment process
 - emerging trend is to outsource only a portion of the portfolio, for example, alternative investment strategies or other specialized parts
- ▶ What is the degree of control that an institution should retain
 - fiduciary risk
 - portfolio "laddering" to meet needs



Outsourced Trading
for Hedge Funds &
Investment Managers

Pepper Hamilton LLP
Attorneys at Law

Investment Roundtable Series

Dave Dalzell, CFA
DDalzell@DalzellTrading.com
(617) 340-5313

Dalzell Trading, LLC
20 Main St | Suite 203A
Natick, MA 01760
www.DalzellTrading.com



Dave Dalzell, CFA Founder & CEO Dalzell Trading



Associate Head of Equity Trading

Executed an average of 3.5 million shares/day (small cap)
Head of the Boston Desk executing 11 million shares/day



Principal

Proprietary Trading Fund

Hybrid of Block & HFT Trading Strategies monetizing inefficiencies of buy-side trading and equity market structure



CEO & Founder

Outsourced Trading

Equity and Options Trading
Boston and Philadelphia Trading Desks



Senior Equity Trader

Trinity Investment

Executed an average of 2 million shares/day



Current Trading Environment – What Happens to Your Trades?

Large Broker Dealers, Prime Brokers, Custodians

95% of Traders have less than 5 Years of Trading Experience

“Robotic” Electronic Trading – Algos, Broker Internalization, High Frequency Trading

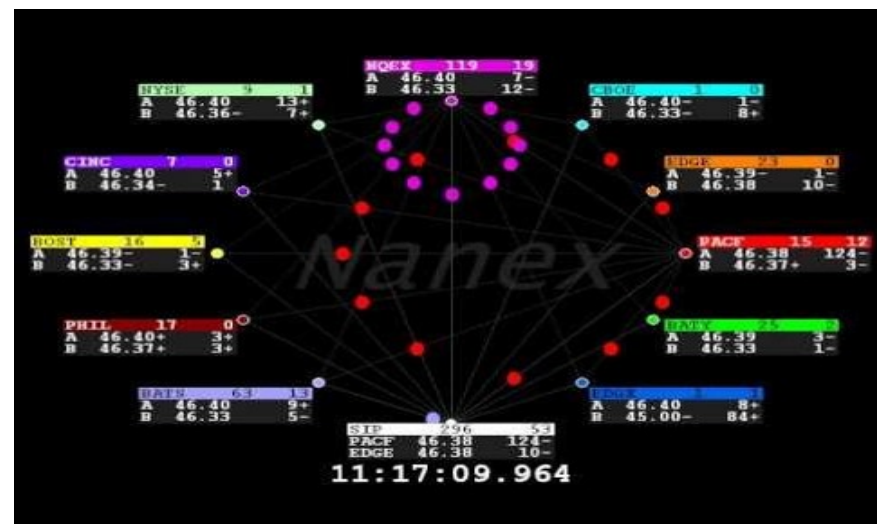
Broker Interest is in their Profit, not Your Alpha Preservation

Brokers & HFT Profit at Your Expense



What Happened? Why has Wall Street Abandoned You?

- Reg ATS & Reg NMS
- Goal – Efficient & Fair Pricing
- Result – Fragmented Markets
 - 15 Exchanges & 40 Dark Pools
 - Video – 10ms of MRK Quotes
- Opportunity to Profit from Your Trade Flow
- Broker Internal Dark Pools
- Public SIP vs Private SIP (HFT)
 - 25ms HFT Advantage
- HFT Pays Exchanges \$1 Billion/yr
 - Phantom Liquidity – Cancels



Interconnected Exchanges & Fragmentation
= Broker Role Facilitating Executions has Diminished



From the Buttonwood Tree... to 15 Exchanges & 38+ Dark Pools

1792



2013



Exchange

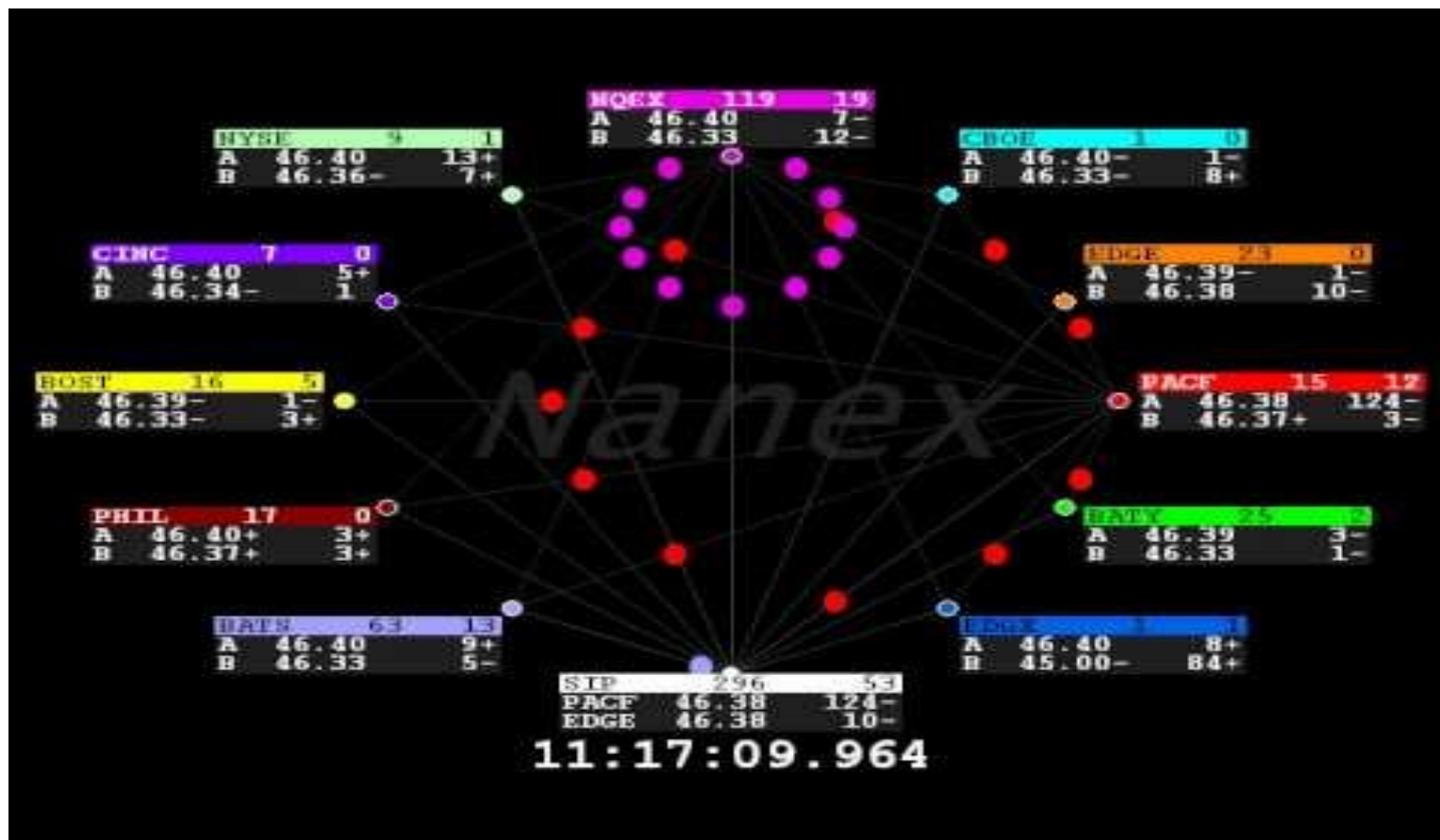
- BATS S
- BATS-Y
- C2 Options
- CBOE
- Chicago SE
- EDGA
- EDGX
- IEX
- ISE
- NASDAQ OMX BX
- NASDAQ OMX PHLX
- NASDAQ
- NYSE
- NYSE Arca
- NYSE American

Dark Pools

- Chi-X
- Instinet
- Liquidnet
- NYFIX Millennium
- Posit/MatchNow
- BlockCross
- RiverCross
- Crosspoint
- ETF One
- BIDS
- Level
- Luminex
- SPMX
- LX Liquidity Cross
- BNP Internal BIX
- BNY ConvergeEx
- Aqua
- Citi Match
- Citi Cross
- BLINK
- CrossFinder
- SuperX ATS
- Fidelity
- GETMatched
- SIGMA X
- Instinct-X
- MSPOOL
- Nomura NX
- UBS ATS, MTF, PIN
- ALPHA Y
- DRECT
- ASX Centre Point
- ISE
- NYSE
- BATS
- Turquoise



10ms of MRK Quotes





Phantom Liquidity – Cancels in 2ms

Order to Buy 20,000 when 24,800 Offered

Then 80 quotes per ms....

Market was Quiet for 2 Seconds before Order...

Only Bought 12,133 Including these 10,100

#	Time	Exg	Shares Avail	Add Cancel	Trade Shares	Trade #
			24,800			
2	09:47:56.570	BOS	24,700		100	4
3	09:47:56.570	EDGE	24,700		67	X
4	09:47:56.570	ARCA	24,600	-100		
5	09:47:56.570	NYSE	24,000	-600		
6	09:47:56.571	EDGE	23,000		990	6
7	09:47:56.571	EDGE	22,200		800	10
8	09:47:56.571	EDGE	21,400		843	14
9	09:47:56.571	NYSE	20,800	-600		
10	09:47:56.571	ARCA	20,600	-200		
11	09:47:56.571	BATS	20,100	-500		
12	09:47:56.571	BATS	19,700	-400		
13	09:47:56.571	BATS	19,200	-500		
14	09:47:56.571	ARCA	17,500	-1,700		
15	09:47:56.571	ARCA	17,100	-400		
16	09:47:56.571	NQEX	16,700	-400		
17	09:47:56.571	EDGX	15,700	-1,000		
18	09:47:56.571	ARCA	15,200	-500		
19	09:47:56.571	NQEX	14,800	-400		
20	09:47:56.571	BATS	14,600	-200		
21	09:47:56.571	NQEX	14,200	-400		
22	09:47:56.571	ARCA	14,100	-100		
23	09:47:56.571	EDGX	14,000	-100		
24	09:47:56.571	BATS	13,900	-100		
25	09:47:56.572	NQEX	12,900	-1,000		
26	09:47:56.572	ARCA	12,700	-200		
27	09:47:56.572	BATS	11,100	-1,600		
28	09:47:56.572	EDGX	10,800		300	9
29	09:47:56.572	NYSE	10,500	-300		
30	09:47:56.572	NYSE	10,100	-400		

2ms = 1/2 Offered Stock Cancels



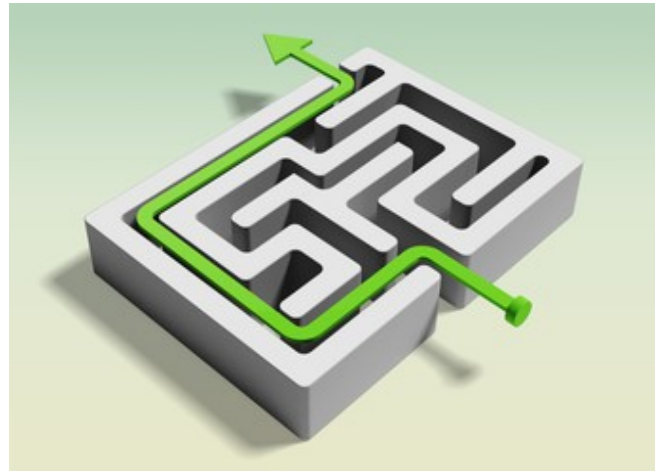
What is the Performance Cost to HF's and Investment Managers?

- Intermediaries Extract Billions of \$\$\$ in Almost Risk Free Profit
 - Brokers, Exchanges, HFT
 - Market Fragmentation = Smaller Trade Sizes, Higher Frequency of Trades
 - Payment for Order Flow, Internalization, Fast Moving Markets, Information Leakage
- The Role of BDs and PBs has Changed
 - No Longer Liquidity Providers or Execution Facilitator
 - Less Emphasis on Execution Quality & Market Color
 - Now Profiting from Managers' Trades
- Increased Demand for Professional Trading
 - Best Execution
 - Trading Cost Controls





Outsourced Trading Solution





Benefits of Outsourced Trading



- Manager's Focus is on Portfolio Management and Asset Gathering
- Reduce Performance Costs from Poor Trading
- Eliminate your Firm's Expense of Hiring In-House Traders
 - Outsource Trading Firms Bear all Costs of Trading: Trader Salaries/Bonuses/Benefits, Execution Costs, Clearing Costs, Fix Lines, Technology Infrastructure
- Access a Level of Trading Expertise and Infrastructure Superior to In-House
- Traders Acting as Your Buy-Side Desk – Custom Tailoring Your Coverage
- Best Execution – Independent, Conflict-Free Trading Suited to Your Needs
- Trader's Solely Focused on Execution Quality



How it Works



- You Make the Decision to Improve Performance, Lower Expenses, and Benefit from Outsourced Trading
- Brokerage Agreement and DVP Agreement
- Customize the Trading Process to Suit Your Needs
 - Meet with Traders to Learn Your Investment Process
 - Discuss Trading Needs, Achieving Best Execution & Value-Added Flow of Information
 - CSA/Research/Options Needs Fulfilled
- Seamless Workflow – Orders flow from Your OMS to Outsourced Trading OMS with Fills flowing back to Your OMS in Real-Time
- Trades Settle between Your Prime Broker and the Executing Broker



Aligned Interests



- Work with Exceptional Traders Focused Solely on You and Best Execution
- Independent, Conflict-Free Trade Execution Decisions
- Protect from Costly Information Leakage
 - Minimize Intermediation of Brokers, Exchanges, & HFT
 - No Proprietary Trading, No Shopping Orders, No Selling Order Flow
- Have Confidence and Be Comfortable with Your Trading Partner



TriNet

Powering Success with Extraordinary HR

October 23rd, 2018
Timothy V. Frazier, VP Sales
TriNet Financial Services

Agenda

Introduction

Timothy V. Frazier

15 years Banking, 4 years PEO experience, Small Business Owner

TriNet Fund Experience

1,200+ Hedge Funds, 1,000+ RIA's, 500+ PE Firms and 100+ Family Offices

37,000+ WSE's in the Financial Services Industry

Key Components of Outsourced HR

HR Compliance and Support

Employee Benefits

Technology Integration

Compensation & Benefits Benchmarking

Full-Service HR Solution (otherwise known as a PEO)



HR Task List



PAYROLL

- ✓ Payroll processing and management
- ✓ Online paystubs
- ✓ Federal, state, and local employment tax filing and remittance
- ✓ W-2 administration
- ✓ K-1 distribution
- ✓ Wage garnishment
- ✓ Payroll reporting
- ✓ Direct deposit



BENEFITS

- ✓ Medical (PPO, HMO, HDHP)
- ✓ Dental
- ✓ Vision
- ✓ Flexible Spending Account (FSA) and Health Savings Account (HSA) administration
- ✓ Life/AD&D insurance
- ✓ Short-term and long-term disability insurance
- ✓ COBRA administration
- ✓ 401(k) setup and administration
- ✓ Payroll contributions
- ✓ Benefits enrollment and administrative access
- ✓ Employee Assistance Program (EAP)
- ✓ Employee discounts and perks
- ✓ Commuter benefits
- ✓ Pet Insurance



RISK & COMPLIANCE

- ✓ Workers' compensation
- ✓ Employment Practices Liability Insurance (EPLI)
- ✓ Compliance expertise for applicable federal/state employment laws
- ✓ Sexual harassment awareness training
- ✓ Claims management
- ✓ Employee handbook
- ✓ FLSA and employee classification guidance
- ✓ Employee relations consultation
- ✓ Affordable Care Act compliance
- ✓ EEO-1 reporting
- ✓ Termination guidance
- ✓ Workplace employment posters
- ✓ Unemployment insurance claim administration



TECHNOLOGY PLATFORM

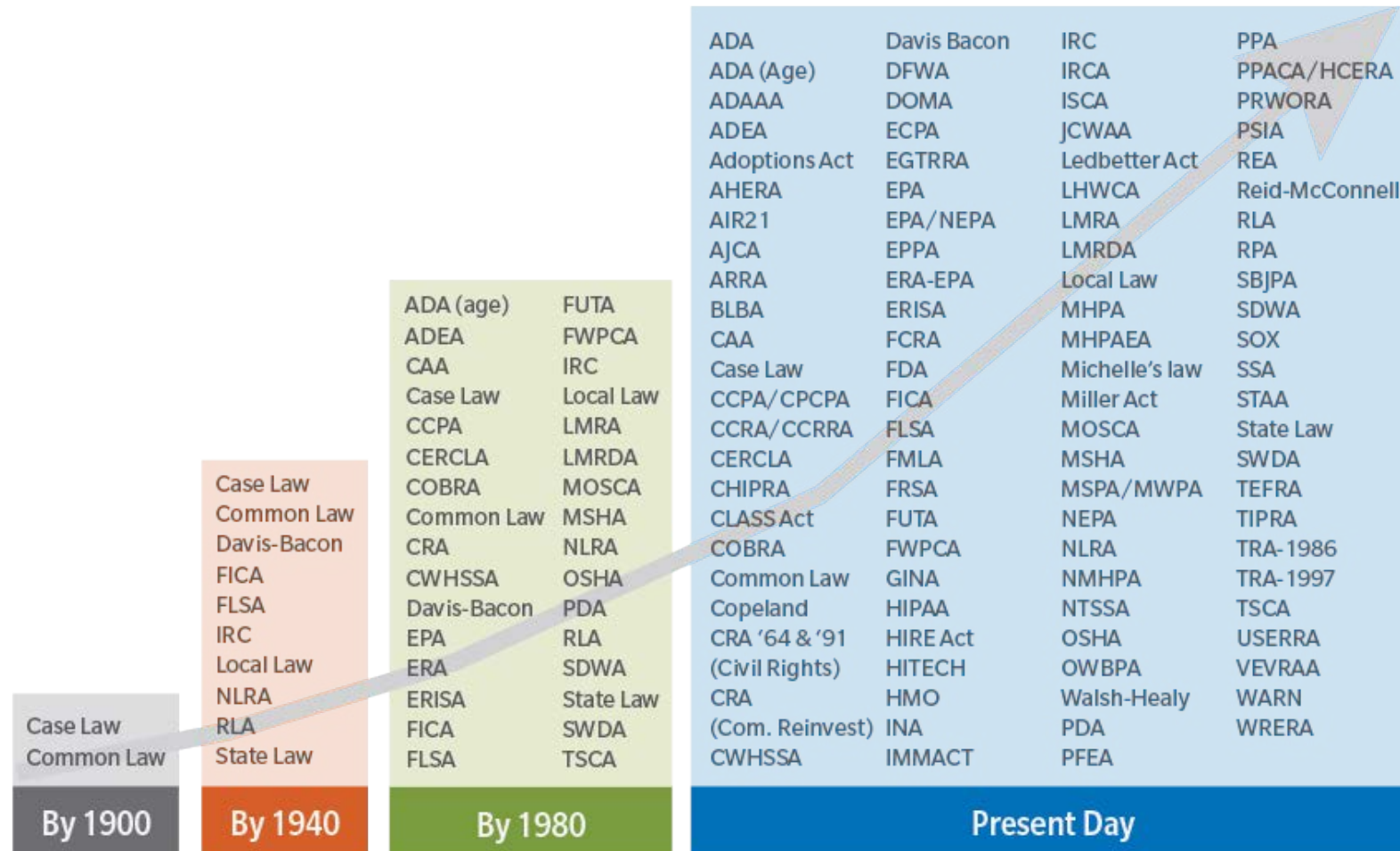
- ✓ Employee and manager self-service
- ✓ Online on-boarding and benefits enrollment
- ✓ Online payroll
- ✓ Time off tracking
- ✓ Database management and custom reporting
- ✓ Online training
- ✓ Performance management
- ✓ Expense management
- ✓ Applicant tracking
- ✓ Background screening
- ✓ Compensation benchmarks
- ✓ Total compensation statements
- ✓ HR reports (census, payroll, deductions, benefits, etc.)



HR TEAM

- ✓ ACA compliance guidance
- ✓ Employee onboarding and orientation
- ✓ Benefits funding guidance and strategy
- ✓ Employee resource center
- ✓ HR compliance best practices review
- ✓ Human Capital Assessment
- ✓ Retention tracking
- ✓ Support hiring / terminating
- ✓ Assists with reporting and analytics
- ✓ PTO policies and guidance
- ✓ Recruitment and interview training

Risk & Compliance: Comply with Confidence



42% of employee lawsuits brought against companies with less than 100 employees

33% of SMBs consider regulatory burdens a significant challenge to future growth

Protecting your Business

Employment-related claims are now a standard hazard of being an employer

- ~90K discrimination charges are filed with the EEOC alone, every year¹

Risk of employment-related claims starts at the interview

- Small businesses (<100) can expect an employment practices claim **once every three years**²
- Average **settlement costs** are **\$250K+**; average **judgments** are **\$450K+**³

A business built over a lifetime can be ruined by **1 employment claim**

1 Average over the last 5 years. Source: EEOC website (<https://www.eeoc.gov/eeoc/statistics/enforcement/charges.cfm>) accessed November 10, 2017

2 Source: Spotlight on the U.S. Employment Practices Liability Insurance Market, Advisen Ltd., Sept. 2014

3 Data presented is for all plaintiff verdicts collected for the years 2008-2014. Source: Employment Practice Liability: Jury Award Trends and Statistics, 2015 Ed., Thompson Reuters

Managing immigration for your people

> **700,000** work visas issued in the United States every year

> **1.2MM** international students studying in U.S. universities

> **500,000** international students enrolled in STEM programs at U.S. universities

- *Keeping track of renewal dates*
- *Project managing visas & green cards*
- *Helping to ensure proper tax compliance*
- *Ongoing immigration reporting and compliance*
 - *Public access files*
 - *Changes in status*
 - *Life events*
- *Best practices & benchmarking policies*
- *New hire feasibility and timeline analysis*
 - *Immigration law vendor review*
 - *Process optimization*
- *...and more*

Sources: Student Exchange Visitor Program Quarterly Report, November 2016; American Immigration Council Report, November 2016

HR Team: What a company needs

Client Services Associate

Primary point of relationship for you, your employees and their families

Certified and dedicated to financial services

Long history working with the industry

Operational HR

Includes a dedicated account manager for payroll, benefits and general HR needs

Relevant industry knowledge, dedicated to financial services

Manages setup of PTO policies, tax deductions

Assists with data analytics and reporting

In-house HR Experts and Legal Team

Direct resource for HR best practices and HR compliance guidance

Deep domain expertise in HR for financial services

In-person meetings with clients

Strategic HR

Expert HR guidance and strategic HR consulting

Relevant industry knowledge of financial services

Provides compliance guidance and HR best practices

Expert at executive compensation, workplace culture and talent management

Benefits: Attract and Retain Top Talent

Health Care

Medical
Dental
Vision
Flexible Spending Account

Life and Disability

Short-term Disability
Long-term Disability
Life Insurance
Supplemental Life/AD&D Insurance

Retirement and Voluntary Benefits

401(k)
Commuter Benefits



Automate HR with Centralized Data



Payroll Processing



Expense Management



Benefits Enrollment



Analytics & Reporting



New Hire Onboarding



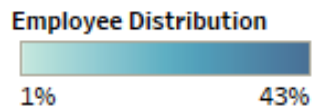
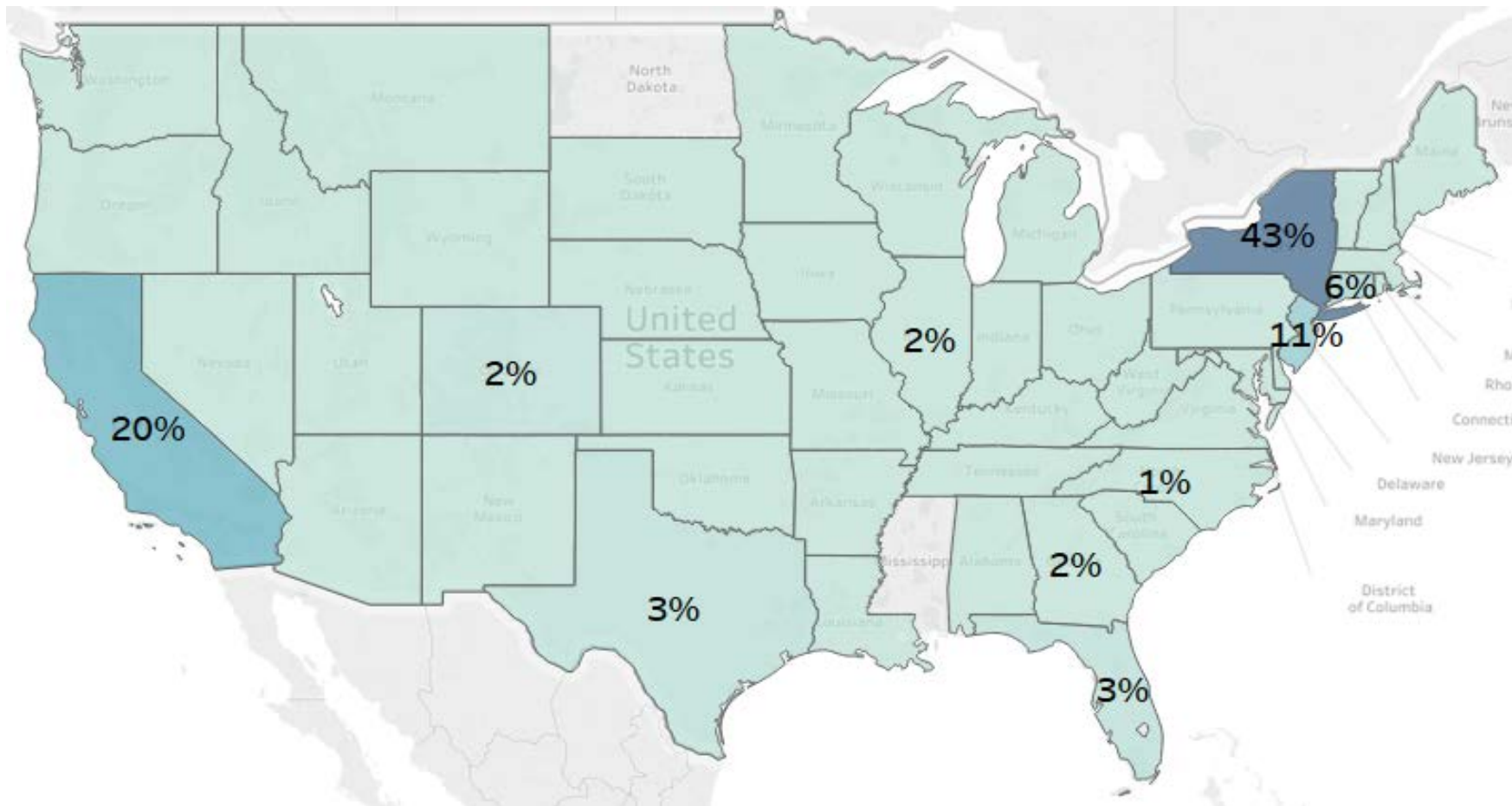
Mobile App

Alternative Investment Compensation:

About the Study

- The study is based on proprietary payroll data from TriNet's alternative investment clients.
- Alternative investment companies include hedge fund, private equity and venture capital.
- Full year 2017.
- Represents 1,400 firms and 14,000 employees.

Distribution by State

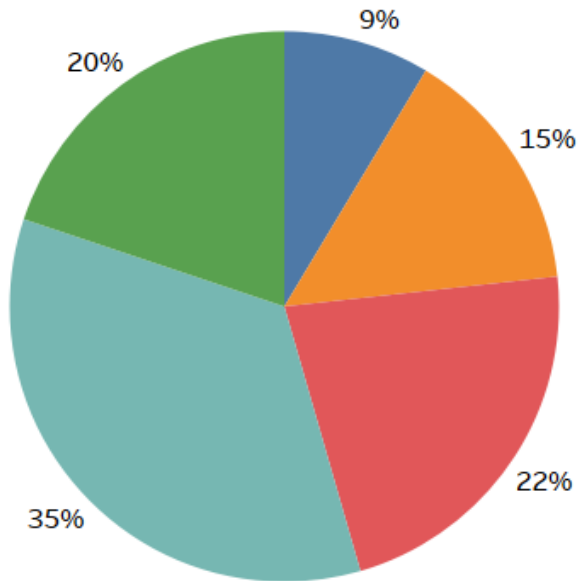


California: 20%
Tri-State: 60%
Rest of US: 20%

Non-labeled shaded regions have <1% employee presence.

Distribution by Company Size & AUM

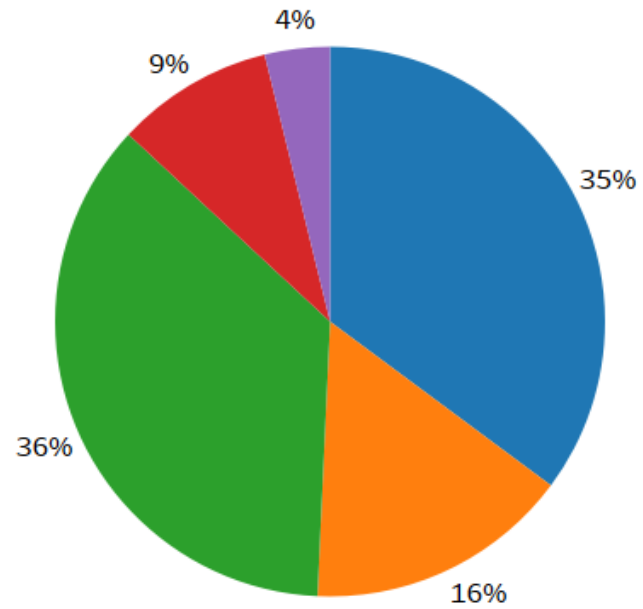
Company Size



Company Size

- <6
- 6-10
- 11-20
- 21-50
- 51+

AUM

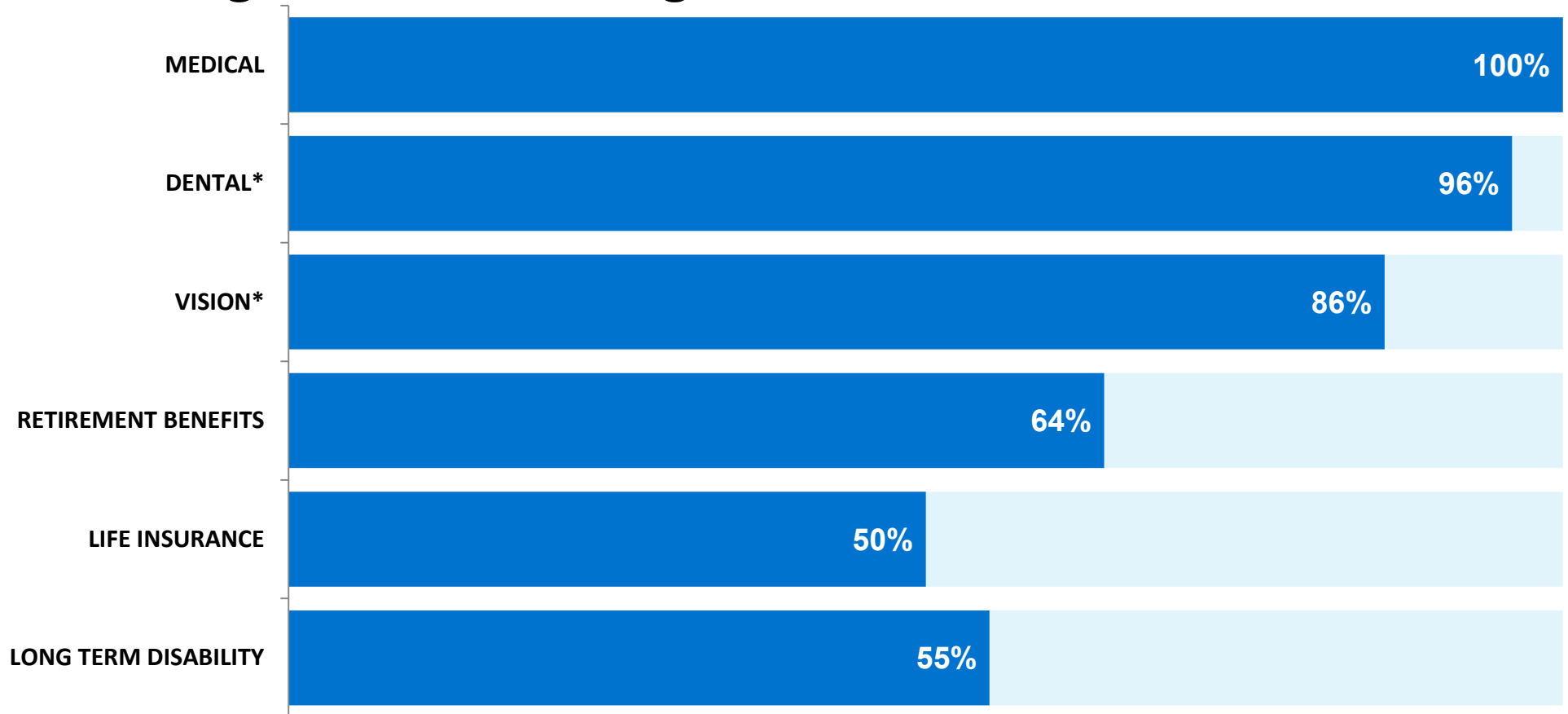


AUM

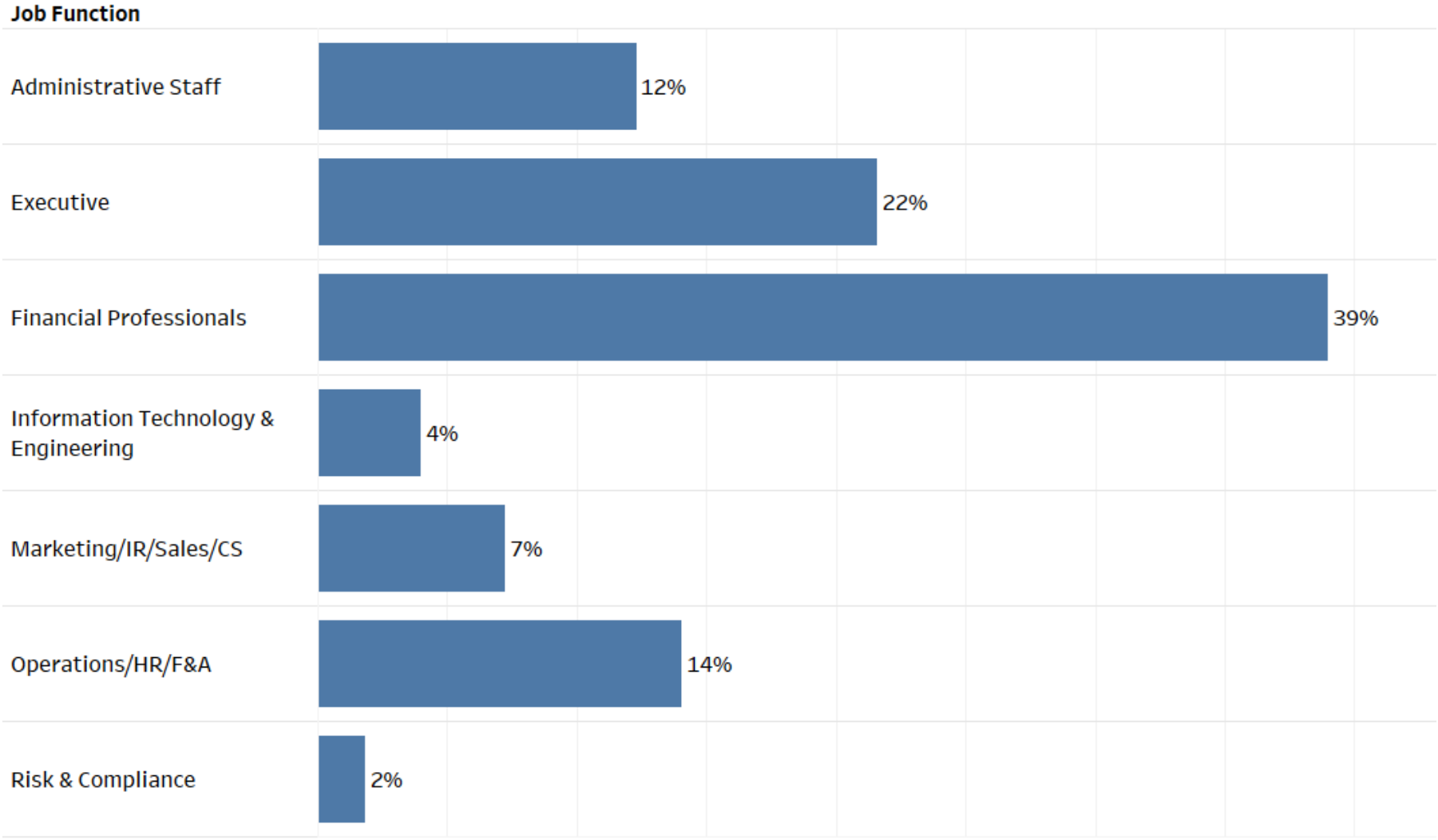
- \$0-500 million
- \$500 million to \$1 billion
- \$1-5 billion
- \$5-10 billion
- \$10 billion +

What benefits should I offer to my employees?

Percentage of firms offering each benefit

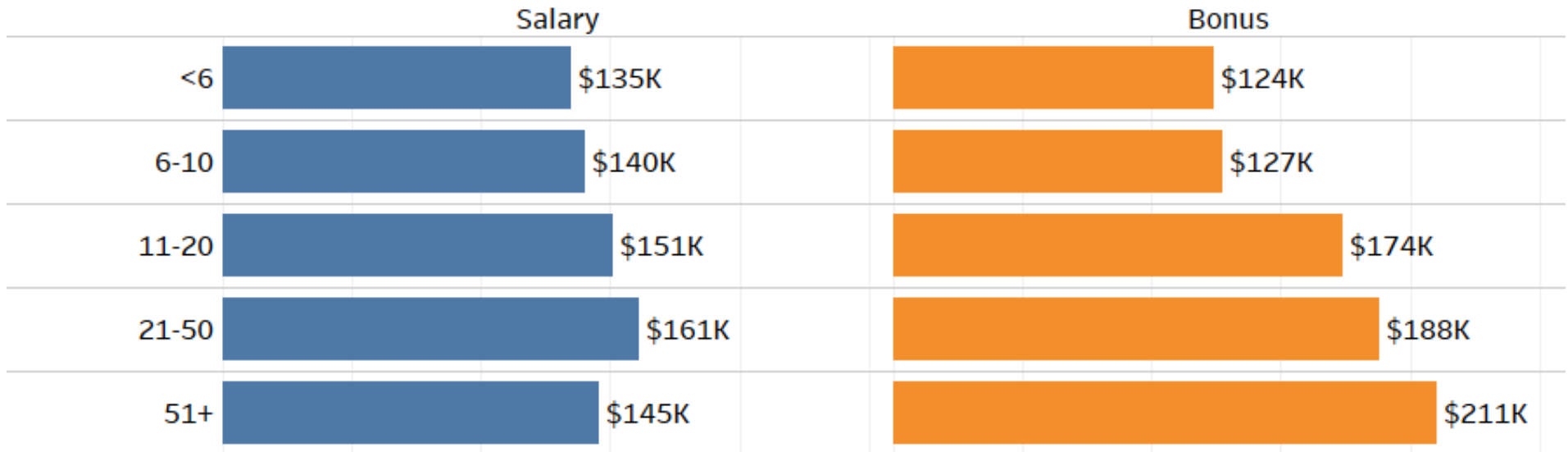


Distribution by Job Function

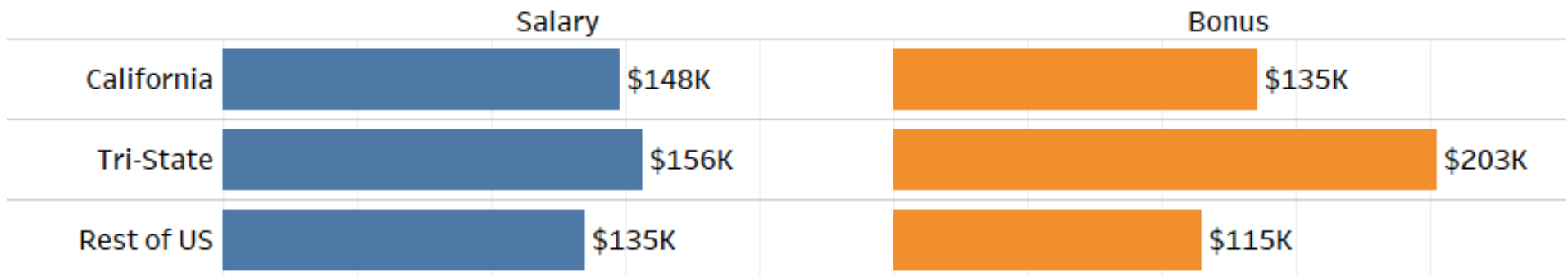


Compensation by Company Size & Region

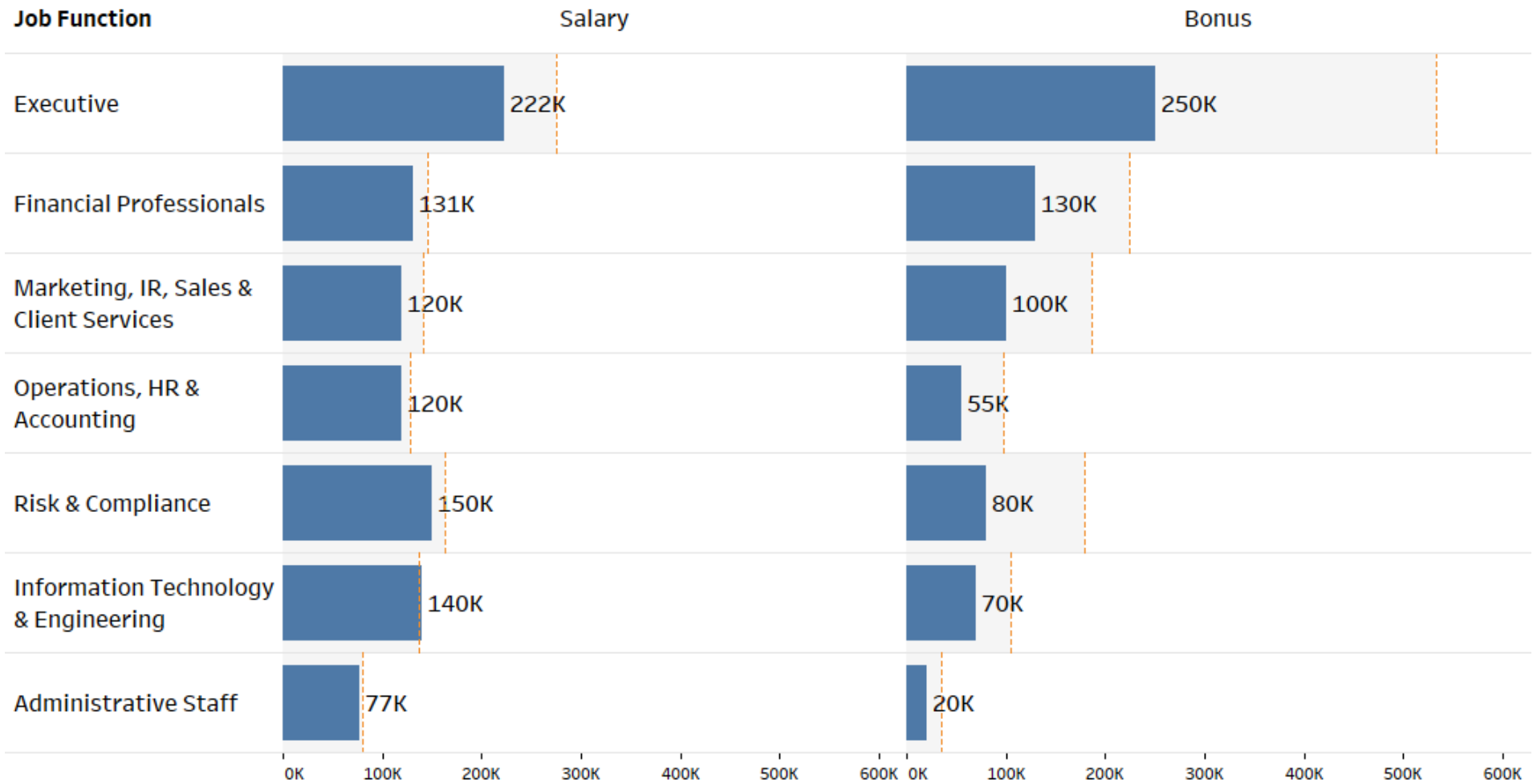
Company Size



Region



Job Function



Questions?

Timothy V. Frazier

Timothy.Frazier@TriNet.com

(o) 646-356-8673



Gregory J. Nowak

Partner, Financial Services & Technology

212.808.2723

nowakg@pepperlaw.com

- ▶ concentrates his practice in securities law, particularly in representing investment management companies and other clients on matters arising under the Investment Company Act of 1940 and the related Investment Advisers Act of 1940
- ▶ represents hedge funds and other alternative investment funds in fund formation and investment and compliance matters, including compliance audits and preparation work
- ▶ writes and speaks frequently on issues involving investment management, health care and other matters, and is the author of five books on hedge funds, the most recent published in February of 2018
- ▶ Adjunct Professor of Law, Cornell Law School, Ithaca, NY



Ausra Ragauskaite

Associate, Financial Services

212.808.2753

[@pepperlaw.com](mailto:ausra@pepperlaw.com)

- ▶ Associate in the Financial Services Practice and resident in Pepper's New York office
- ▶ represents fund sponsors in connection with the formation and offering of domestic and offshore funds
- ▶ counsels clients on legal and regulatory compliance matters applicable to the investment management business, including registration with the SEC
- ▶ advises clients on organizing and structuring investment manager and general partner entities



Capabilities

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INTELLECTUAL PROPERTY
INTERNATIONAL
LITIGATION

INDUSTRIES

CONSTRUCTION
ENERGY
FINANCIAL
FOOD, ALCOHOL AND BEVERAGE
HEALTH SCIENCES
HIGHER EDUCATION
INVESTMENT FUNDS
LIFE SCIENCES
MEDIA, COMMUNICATIONS AND ENTERTAINMENT
NONPROFIT ORGANIZATIONS AND FOUNDATIONS
PHARMACEUTICAL AND MEDICAL DEVICE
RETAIL
TECHNOLOGY
TRANSPORTATION

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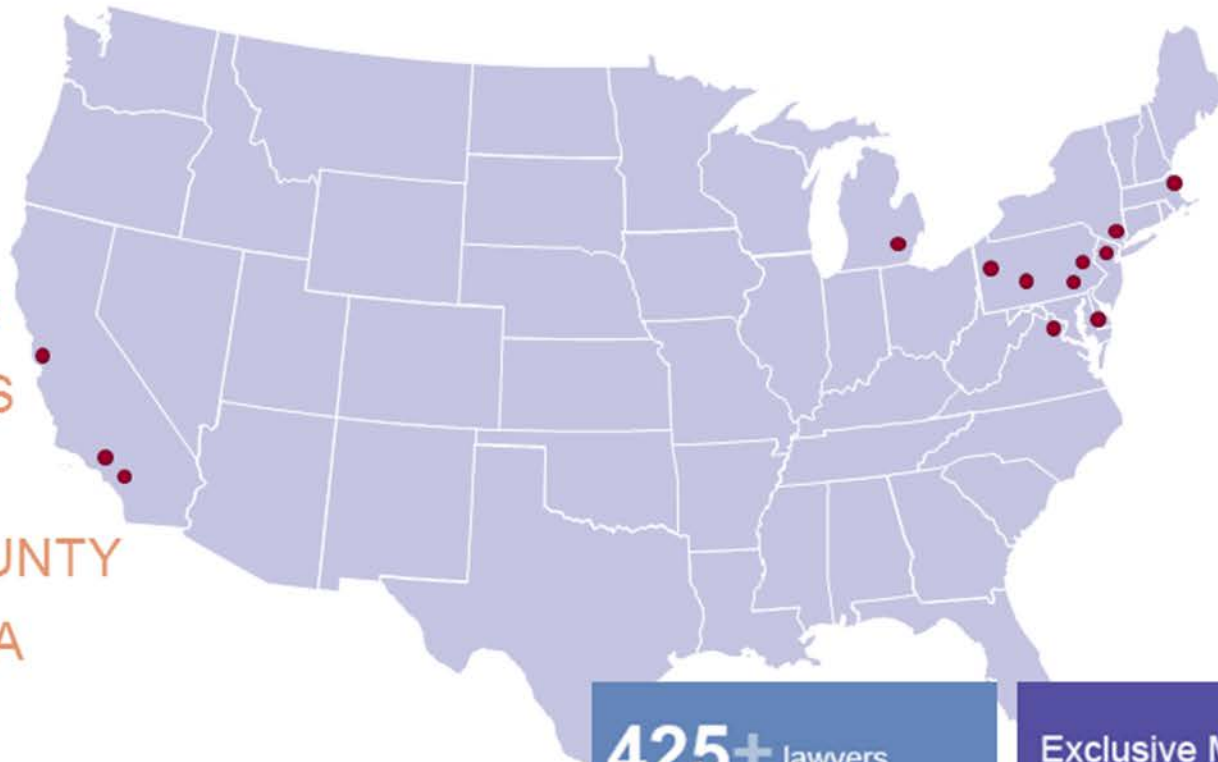
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13 offices in U.S.

125+ years of
serving clients

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Firm for
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