2017

OUTSOURCING: THE NEW NORMAL?

OBSERVATIONS ON THE ALTERNATIVE ASSET INDUSTRY'S EVOLVING TREND

INDUSTRY THESIS

Over the past several years, the alternative asset industry has increasingly turned to outsourced service providers to fulfill critical, non-investment related business functions. Evolving industry best practices and market data suggest this trend is here to stay. This article will examine the outsourcing trend with a focus on the historic role of outsourcing and outsourcing's impact in today's market. It will conclude with a framework designed to assist managers when approaching the decision to outsource elements of their business.

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PART I: HISTORY OF OUTSOURCING AND THE CURRENT MARKET REALITY

The alternative asset industry is no stranger to regulatory and operational challenges impacting wealth advisory firms, hedge funds, private equity funds, mutual funds, and structured products (among others). Over the past few decades, the operational aspects of running an investment management business have become increasingly complex and costly. The reasons for this are many, including a significant increase in the number of market participants[1] and therefore increased competition; increased regulation, notably under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”); increased demands from the investor community regarding operational controls and transparency;[2] increased complexity of investment products and strategies;[3] significant market dislocations and changes in market behavioral patterns;[4] and significant and highly public financial fraud cases that have severely damaged the industry’s reputation.[5] Simply put, investment firms in today’s market are held to higher standards than ever before, and meeting these standards has created both operational and expense burdens on managers seeking to compete in today’s demanding environment.[6]

As managers have adapted to the current market environment, they have increasingly relied on outsourced providers to cover numerous critical business functions, including—among others—accounting, regulatory compliance, IT management, tax compliance, marketing, business development, and human resources. In this section, we will look at the historical rise of the outsourcing trend in the alternative asset industry, as well as examine the current state of outsourcing in the industry through an evaluation of the prevalence of manager’s use of outsourced service providers in today’s market.

The Growth in Outsourcing Mirrors the Growth in Fund Administration

Today, the alternative asset industry is one of the largest global industries, managing approximately $7.9 trillion in assets, and anticipated by some to reach between $13–16 trillion by 2020.[7] The industry began, however, at much more modest levels. There is disagreement as to when the private fund industry began: some academics point to funds managed by Alfred Winslow Jones in the late 1940s, and others cite examples as far back as 1926.[8] Regardless of the specific date of origination, the fund industry was still in its infancy in the 1970s, with only an estimated 150 funds, which collectively managed assets of approximately $1 billion.[9] The industry didn’t start gaining significant scale until the late 1990s, with alternative assets under management reaching approximately $1 trillion in 1999.[10]

> The outsourcing trend began around non-critical business functions, since growing to encompass most non-investment related functions.

As a function of the timing of the industry’s growth and the technology available at the time, investment management firms originally established a business model involving internal management of all key business functions (including accounting, operations, marketing, human resources, and regulatory compliance). Since the late 1990s, however, the industry has experienced a growing outsourcing trend—initially, slowly and around non-critical business functions, but now, encompassing most non-investment related functions.

A pertinent example of this outsourcing trend is evidenced by the growth in the domestic fund administration business (i.e. fund accounting, trade settlement and reconciliation, and investor reporting), where outsourced administrators are now a standard component of the hedge fund business model and a quickly expanding component of the private equity business model.[11] U.S. domestic fund administration has evolved from a very small industry in 2000 to a $6.7 trillion industry in 2016.[12]

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The shift from in-house accounting to outsourced administration services has been driven by a variety of events that occurred over the past two decades, including the 2008 global financial crisis and large financial frauds (most notably illustrated by the Bernie Madoff scandal),[13] which triggered a wave of new regulations applicable to the U.S. banking and financial services industries (including investment management) and significantly increased the operational burdens on alternative asset managers. Concurrently, these events placed alternative asset managers under heightened expectations from investors—particularly institutional investors—about their middle and back office capabilities.[14] Institutional investors began to demand greater transparency and investor reporting. Due diligence began to emphasize a detailed review of the checks and balances on the movement of assets and other internal controls, with investors placing greater scrutiny on the capabilities and desirability of managers' internal accounting procedures and cash controls.

Through a series of mergers and acquisitions, in combination with a high level of investment in technology, domestic administrators grew in staff size, and subject-matter expertise. This allowed administrators to offer independent institutional-level accounting, operational, and investor reporting services.[15] Outsourced administrators mitigate both regulatory risks and investor concerns because the independent cash and operational controls provide purposeful redundancy, which affords both regulators and investors with the assurance that fiduciary duties are being properly carried out. In fact, a survey of institutional investors reveals that 96% of institutional investors indicate that independent cash controls are "extremely or somewhat important."[16] Consequently, alternative asset managers have increasingly leveraged the resources offered by administrators. The ability to address operational, regulatory, and investor demands in the alternative asset space has caused outsourced administrators to become commonplace—and often universal, depending on the business model (for instance, 95% of hedge funds now utilize outsourced administrators).[17]

Like the growth in fund administration, the practice of outsourcing other critical business functions was a natural progression in light of the growth of the alternative asset industry. The same industry-wide events mentioned previously—the 2008 financial crisis, historic levels of financial fraud, heightened investor expectations and further regulation—triggered demands for outsourced alternatives in other, non-accounting, back office functions. Managers recognized that a firm with a strong middle and back office was not guaranteed to win an investor, but a firm was almost guaranteed to miss out on obtaining a prospective investor's business if the firm had a weak middle or back office. Thus, even the middle and back office functions of investment management firms (such as regulatory compliance, CFO services, and information technology) that had historically been performed in-house, over time, have transitioned to being managed by outsourced service providers.

Heightened investor expectations and increased regulations were not the only reasons that maintaining quality middle and back office capabilities had become more challenging. As the alternative asset industry evolved into an increasingly competitive environment, managers employed complex products and strategies to generate alpha (e.g. derivative products, swap arrangements, and asset securitizations).[18] Naturally, these complex products and strategies presented both operational and regulatory challenges, thereby creating significant distractions from a manager's core competency of investment management. This issue was exacerbated by the fact that the average investment management firm consisted of a relatively small staff (with the median staff size of an SEC registered investment adviser consisting of only eight employees[19]), further emphasizing the need for such staff to focus on their core competencies as opposed to operational demands.

> Specialized outsourced service providers have committed substantial resources to particular aspects of the asset management business model, allowing managers who outsource to reap the benefits of economies of scale, namely, **obtaining high-quality specialized services at significantly lower costs compared to employing in-house personnel.**

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Over time, specialized outsourced service providers have committed substantial resources to particular aspects of the asset management business model, thereby allowing managers who outsource business functions to specialized providers to reap the benefits of economies of scale—namely, obtaining high-quality specialized services at significantly lower costs compared to employing in-house personnel. Furthermore, outsourced service providers offer the benefits of a collective knowledge base—a resource that is generally unavailable to internal staff working at individual investment advisory firms. Outsourced service providers have built a collective knowledge base through lessons derived from their experiences with numerous clients that are managing a variety of investment structures and asset classes, which in turn, creates an unprecedented breadth and depth of market knowledge. For instance, if a firm specializing in regulatory compliance has a client with an upcoming SEC audit, the outsourced provider has a plethora of resources at its disposal, including, but not limited to: (i) experience gained from its other clients' SEC audits, including both recent and ongoing; (ii) recent SEC enforcement actions and guidance on areas of focus; and (iii) relationships with other service providers, such as prominent law firms, that are also assisting their own clients with SEC audits. This collective knowledge base allows outsourced providers to anticipate the types of firms the SEC is looking to examine, predict the types of questions that the SEC will ask, and triple check that other clients with similar businesses do not have regulatory shortcomings. This macro-level view of the alternative asset industry is further enhanced by the subject-matter expertise acquired by the experience of a specialized service provider's internal personnel. For example, Blue River's staff largely consists of C-level executives who have previously worked at prominent alternative asset managers across many different asset classes.[20] These individuals use their personal experience to bolster the institutional knowledge throughout Blue River, in turn, giving it the capability to provide its clients with the benefit of collective subject-matter expertise.

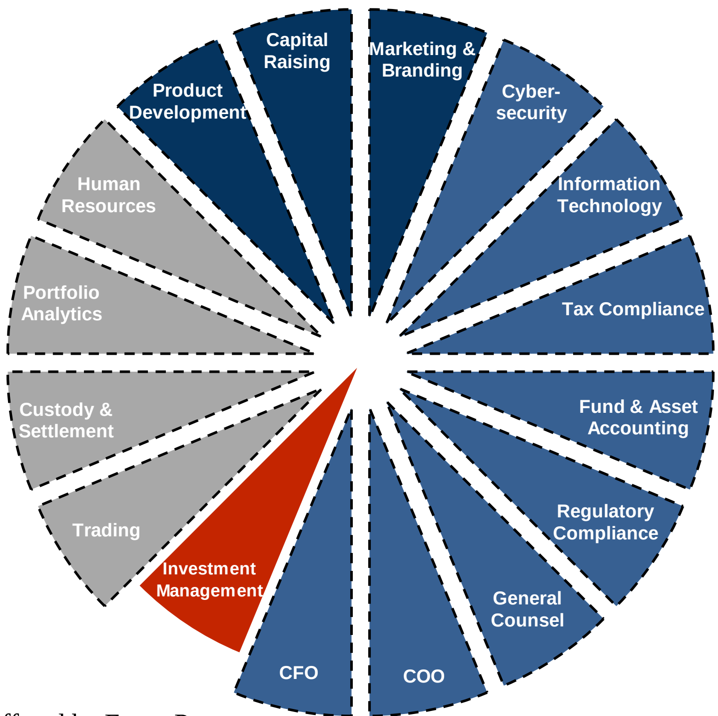
Together, these factors have driven the industry to increasingly turn to the high quality, specialized services of outsourced providers. Surveys show that, as of 2016, the majority of alternative asset managers engage outsourced service providers.[21] In fact, the use of outsourced service providers has become so widespread that managers encounter expectations from both regulators and investors that certain areas of their business will be outsourced.[22]

The Current State of Outsourcing in Today's Market

Alternative asset managers' increasing reliance on specialized third-party service providers has not happened behind closed doors: in recent years, highly publicized media articles have touted the advantages and rapid growth of outsourcing in the alternative asset space.[23] Claims in the articles are borne out of market data. Industry surveys show that administrators experienced a 24% increase in private equity and real estate fund assets from 2013 to 2014 alone.[24] In 2013, a survey of 200 hedge fund managers across the globe encompassing approximately $910 billion in assets under management noted that hedge fund managers almost unanimously answered that their use of service providers assisting with regulatory compliance would either increase or stay the same.[25] Two years later, Deloitte confirmed the accuracy of this prediction during its 2015 hedge fund symposium when it observed that hedge funds are "increasingly outsourcing back office support functions."[26]

This media and market data has led some to believe that alternative asset managers' use of outsourcing, in general, is a new concept. However, this belief is far from the truth: the alternative asset industry has been outsourcing for decades and managers have used specialized third-party service providers to either assist in-house staff or fully outsource critical business functions since the 1990s.[27] Historically, outsourced business functions have included trade settlement, asset custody, fund accounting, marketing, market research, and human resources. The only 'new' aspect of outsourcing is the continued expansion of business functions that have become available on an outsourced basis; notably, regulatory compliance, middle office services, operations, and CFO services. In addition to the expansion of functional services being outsourced, certain specific areas have seen a significant increase in the rate of outsourcing over the past several years. Below are a few brief discussions of particular outsourced functions that have been experiencing heightened demand in the current market environment.

TYPICAL BUSINESS FUNCTIONS



Outsourced functions
Outsourced functions offered by Eaton Partners
Outsourced functions offered by Blue River
Managers' core competency

MARKETING, BUSINESS DEVELOPMENT, AND CAPITAL RAISING

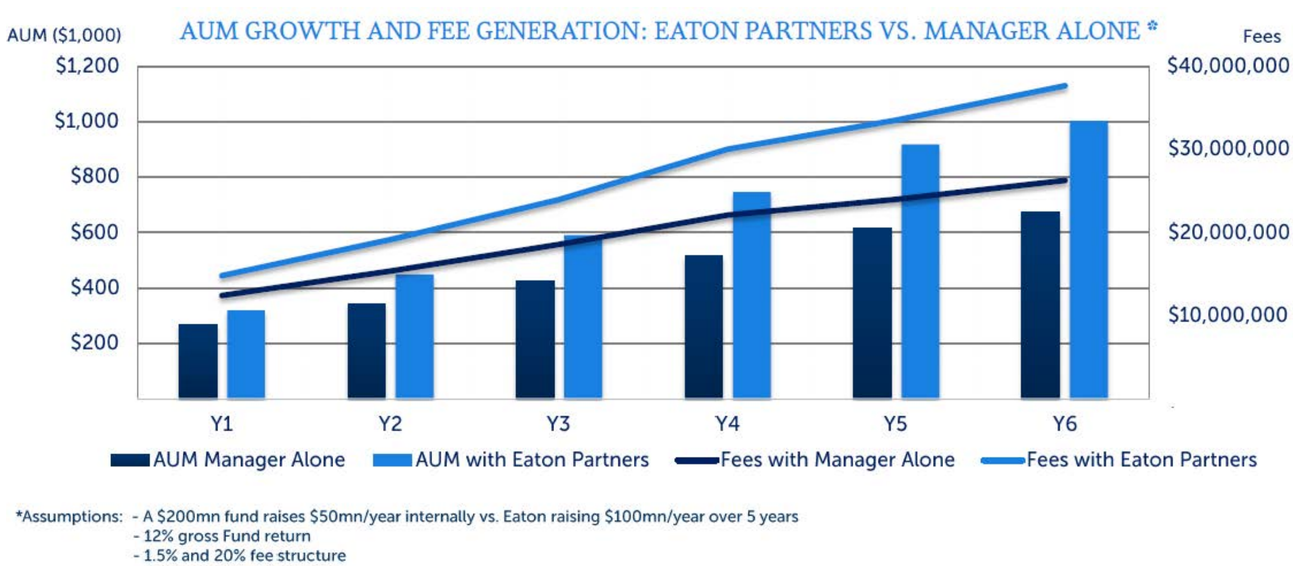
Probably the most well understood industry fact is that raising investment capital has remained very difficult since the 2008 financial collapse. Prior to the financial crisis, many firms were able to leverage internal sales teams to successfully raise investor capital. Typically, one or multiple senior executives of an alternative asset manager (such as the firm's principals) would take primary responsibility for fundraising efforts. As firms grew in size and complexity, such senior executives typically would become saturated with their core responsibilities, and eventually seek to hire a dedicated internal business development professional. However, in the post-2008 environment, many firms have either been unsuccessful in raising capital using that traditional internal sales model, or at least have realized that an internal sales team is not the optimal solution for raising capital in the current market. As a result, firms have increasingly looked to established, third-party placement agents as an alternative to compete for capital.

A notable reason for this change is that building an internal sales team is very expensive—an experienced sales professional with a track record of raising capital and an established investor network will demand a base salary well into six figures per year, plus, in many cases, a guaranteed bonus and share of equity. Due to such expensive price tags, firms may find themselves in the difficult position of choosing to make a business development hire over another critical hire, such as an investment analyst. Also, with internal hires, a manager never truly knows how successful an individual will be until after they have made the hire. If fundraising efforts are not successful, the manager incurs substantial expenses due to the fixed compensation arrangement—even though there is no offsetting revenue produced by the internal hire. Third-party placement agents, however, provide an advantageous compensation structure, in which both the investment firm and the placement agent's interests are aligned. For example, Eaton Partners uses a variable cost structure, in which it only receives the bulk of its compensation after it raises capital for a firm. This not only aligns interests between Eaton Partners and the firm, but also removes the potential mismatch of paying an internal business development professional upfront and either receiving outside capital at a much later date or never experiencing a successful fundraising effort at all.

Additionally, an internal sales professional can also have inherent operational limitations in comparison to third-party placement agents. For example, an internal sales professional is unlikely to have as robust of a network as a seasoned placement agent. The internal professional will generally be stronger in one region or channel than in others (e.g. a strong network with northeast endowments, but not with pensions and consultants), which narrows the scope of the manager's fundraising capabilities. The reach of third-party placement agents, however, offers a larger scale network unavailable to internal sales professionals. For instance, Eaton Partners' staff consists of senior-level business development staff with established relationships broken down by region and investor types (e.g. high net worth individuals, family offices, institutions and sovereign wealth), thereby expanding the breadth of Eaton Partners' network of potential investors.

Lastly, internal sales professionals are inherently limited in the number of avenues through which they can access investors. Such teams can only contact a potential investor so many times before they become white noise and can no longer effectively communicate an investment opportunity to the potential investor. On the other hand, third-party placement agents use numerous touchpoints, which organically advances the dialog with potential investors. For example, Eaton Partners' staff has long-term relationships with potential investors—not only from networking in the industry for extended periods of time, but also due to rapport generated from recent marketing efforts related to other investment opportunities. The long-term relationships with potential investors, combined with numerous sales professionals working collaboratively to fundraise, tremendously increases touch points with investors. Given that institutional investors can take an average of 13 months before choosing to invest in a fund, cultivating these relationships through a third-party placement agent's numerous touch points is a significant advantage—ultimately enhancing the firm's ability to bring in capital.[28]

These benefits have not gone unnoticed by the industry. Since 2008, investment managers have increasingly turned to third-party placement agents to help them raise capital.[29] In fact, one third of asset managers today engage placement agents to assist with fundraising.[30]



Outsourcing: The New Normal?

REGULATORY COMPLIANCE

Laws and regulations applicable to the alternative asset industry continue to grow in number and complexity—examples include the Dodd-Frank Act, the Alternative Investment Fund Managers Directive, and the Foreign Account Tax Compliance Act. Increased regulation creates operational burdens and new reporting obligations, including, but not limited to, monitoring personal political contributions (Pay-to-Play), disclosing portfolio reporting (Form PF), increasing regulatory obligations in the derivative and swap markets, and reporting relating to cross-border transactions. This expansion of regulatory obligations and oversight has created a challenging environment for managers to remain compliant during their day-to-day businesses, which causes them to seek help from specialized compliance providers.

Concerns about regulatory compliance are particularly salient for private equity firms, which, prior to the passage of the Dodd-Frank Act, were, for the most part, exempt from the requirement to register with the SEC. The Dodd-Frank Act extended certain regulations to private equity firms in a cookie-cutter fashion, imposing regulatory requirements that are difficult to translate to the private equity business model. A 2016 survey of private equity firms highlights these concerns: respondents indicated regulatory reporting was "equally aligned" in ranking of importance with critical functions such as investor reporting and management reporting—causing the surveyors to conclude that "regulatory oversight has permanently altered the landscape."[31]

COMPLIANCE: approximately 75% of managers outsource

three-quarters of alternative asset managers engage outsourced providers for compliance

Alternative asset managers looking for affordable solutions to address dynamic and increasingly complex regulations have engaged outsourced providers specializing in legal and regulatory compliance. While law firms can certainly provide input and education relating to applicable laws and regulations, they are often very expensive and not structured in an optimal way to stay attuned to the daily business activities of investment managers. As a result, over the past 15+ years, the market has witnessed a robust compliance consulting industry develop to assist in this area. Within the compliance industry, service offerings have developed to extend beyond traditional reactive consulting models to proactive models allowing for the management of a firm's compliance program, including full outsourcing of the entire daily compliance function. Given the breadth of services available, it is no surprise that approximately three quarters of all alternative asset managers today engage outsourced service providers to provide compliance services.[32]

INFORMATION TECHNOLOGY

The world has witnessed incredible developments in technology over the past 25 years, and the speed of development continues to grow exponentially.[33] As with most industries, the alternative asset industry has benefitted greatly from, and continues to increasingly rely on, new technology. With technological advancement comes the need to manage technology. Thus, managers must deal with a variety of systems implementation, management and updating, hardware management, data management, reporting, and cybersecurity.

Managers' use of technology imposes obligations from both a fiduciary and regulatory standpoint. If electronic information is not adequately maintained and safeguarded, managers may be accused of violating their fiduciary duty owed to investors. The SEC has honed in on this concern. In 2014, the SEC conducted a sweep examination in which it audited 49 investment advisers with a focus on the adequacy of their cybersecurity program.[34] This focus continued, and the following year, the SEC announced its cybersecurity initiative, which was designed to continue auditing fund managers to ensure cybersecurity practices are reasonably designed to protect both investor assets and nonpublic personal information.[35]

Establishment, testing, and enhancement of cybersecurity programs is no easy task. For instance, when the SEC released a sample list of proposed cybersecurity measures that may be examined during an audit, it proposed over 30 items, including not only onerous and expensive measures, but also practices that had not previously seemed applicable to most fund managers' businesses, such as penetration testing.[36] Thus, managers may find themselves traversing a path of uncertainty, searching for what elements of a cybersecurity program are adequate from both an industry and regulatory standpoint. Despite this uncertainty and lack of guidance, a manager that lacks an adequate cybersecurity program will be the subject of enforcement. In September 2015, R.T. Jones Capital Equities Management, Inc. was censured and required to pay $75,000 for failure to adopt written policies and procedures reasonably designed to safeguard investor information.[37] In June 2016, Morgan Stanley Smith Barney ("MSSB") settled with the SEC and agreed to pay $1 million for deficiencies stemming from MSSB's cybersecurity program.[38]

The current regulatory environment means that fund managers must now invest significant resources to analyze their existing IT infrastructure and build out regulatory compliant cybersecurity programs.[39]

IT: approximately 75% of managers outsource

three-quarters of alternative asset managers engage outsourced providers for IT support

Outsourced providers specializing in IT have stepped in to assist with this dilemma. These specialized third-party service providers work with numerous managers and have developed an understanding of what is considered a reasonable cybersecurity program based on a particular manager's business. These providers offer a variety of services, such as cybersecurity assessments, which review access controls, procedures, and identify both internal and external risks; as well as assistance with performing due diligence on third-party vendors to ensure the vendors' cybersecurity programs do not compromise information provided by managers. As managers encounter IT demands and look towards specialized providers for their subject matter expertise, the industry has increasingly embraced outsourced service providers. Today, approximately three quarters of alternative asset managers engage outsourced service providers to assist with IT needs.[40]

The market's outsourcing of various business functions is a natural response to the demanding, dynamic, and complex state of the alternative asset industry. The examples provided above are only a subset of the total services outsourced to specialized third-party service providers—other common examples include human resources, investment research, trading, tax compliance, and asset custody. However, as evidenced by the few examples above, it is clear that alternative asset managers have turned to outsourcing to assist or manage a wide range of critical business functions.

PART II: EVALUATING WHETHER TO OUTSOURCE

There are several misconceptions in the marketplace about the use of outsourced service providers, which may make managers hesitant to outsource vital business functions. This section intends to address some key questions that managers should consider when evaluating whether to outsource areas of their business.

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How do I know which outsourced service provider to choose?

Answering this question involves both an analysis of your firm's internal resources as well as an evaluation of the outsourced service provider's substantive expertise, capabilities, reputation, and approach.

When conducting an internal evaluation of your firm, focus on the strengths and weaknesses of your internal resources. Look for areas of your business that could be improved, and consider whether it makes more sense to hire additional internal resources or look for an outsourced solution. For example, if your firm is reviewing its compliance program and consistently identifies regulatory or internal deficiencies, it may be appropriate to consider engaging an outsourced service provider that can assist with your firm's regulatory compliance. Alternatively, if your firm has not been successful with fundraising, it may make sense to engage outsourced marketers who already have a network of potential investors that trust their recommendations about choosing managers. If the decision is made to explore outsourced solutions, then identify the community of providers and select a few to evaluate.

When conducting an external evaluation of an outsourced service provider, it is essential to conduct adequate due diligence. As a specialty business, you will want to make sure that the provider and its staff are truly experts in the area in which they operate. Ask detailed questions about their substantive expertise. Ask for examples of recent successes. Inquire as to the backgrounds of the individuals that will be supporting your account. Ask the outsourced service provider for references from comparable managers to ensure that it has the experience and capabilities that you are looking for, as the services offered by providers vary greatly in quality. Also, inquire as to the financial viability or profitability of the outsourced provider. If there is a risk that the outsourced firm may not be around in a couple of years, then they are likely a poor candidate to support your firm's infrastructure needs. Another consideration in evaluating providers is the approach that the provider takes to delivering services to their clients. Some outsourced service providers rely on a highly reactive, consultative type of business model. These firms may be very helpful when a manager knows when to ask a question, but can often provide very poor support in situations when events occur unexpectedly. Other outsourced service providers offer a more proactive approach to managing their clients' businesses, whereby these providers take responsibility for monitoring their clients' businesses and both anticipate and identify issues as they occur in real time. Due to these and other benefits of this approach, a proactive model is preferable.

How can outsourcing go wrong?

Outsourcing can go wrong if you choose a bad provider, whether as a result of poor advice, lack of substantive expertise, inadequate or untimely deliverables, insufficient support resources, substandard responsiveness, or unrealistic expectations. Outsourcing is a good solution only when the right outsourcing firm is engaged.

For example, some compliance providers offer generic deliverables (e.g. off-the-shelf compliance manuals, regulatory reviews, and trainings) that are not tailored to a firm's business. This can lead to two significant problems. First, regulators are keen on identifying template manuals that have not been tailored to a manager's business, and as a result, may deem a compliance program to be insufficient if the firm's compliance manual does not reflect actual business practices. Second, if a compliance manual contains non-applicable policies or procedures, the provider creates a landmine for the manager. Regulators expect universal compliance with the policies and procedures contained within the firm's compliance manual, regardless of the technical applicability of any specific policy or procedure. Accordingly, the manager can be cited for not complying with a policy solely because it was included in their compliance manual, even when it does not apply to their firm. Similar examples of poor outsourcing extend outside of the scope of regulatory compliance and can take place with any poor provider—whether it is IT, tax, payroll, marketing, etc.

Another issue that can be problematic is a provider's billing scheme. There are outsourced service providers that market themselves as being low-cost because they have a low initial fee, but then bill at an hourly rate thereafter or limit the number of hours available to the client. On the face of the offering, the services may appear to be less expensive than those of a competing compliance provider charging a flat monthly fee. However, a firm that provides quality services will typically bill a large number of hours, in part because of the time the outsourced service provider needs to communicate with the firm to create a collaborative product, and in part because of the time required to produce a high-quality deliverable. In many cases, hours can mount higher than anticipated, which can make low-fee/hourly billing schemes very costly to the manager. This eliminates a significant benefit commonly derived from outsourcing business functions: cost savings.

Will my firm outgrow outsourcing?

A common misconception is that outsourcing is only valuable to start-up businesses and that a firm will ultimately "outgrow" the need to outsource. Alternative asset managers may find that they can dedicate more resources to in-house personnel, but given the benefits of outsourcing referenced above—namely, subject matter expertise while keeping expenses low—firms of all sizes can derive benefits and improve efficiency from outsourced service providers. A perfect example of this point is the fund administration industry. Fund administration is simply outsourced fund accounting. As investment firms grow, they tend to increase their reliance on their administrator as a critical resource. It is not common to see firms grow out of their administrator and choose to build large internal accounting teams.

> Firms of all sizes can derive benefits and improve efficiency from outsourced service providers.

That said, the scope and scale of services that a firm chooses to outsource may change as the firm's business develops, regulations evolve, and personnel changes take place. Generally, smaller alternative asset managers are focusing on expanding their investor base, whereas much larger managers, such as managers with assets over $10 billion, already have an established investor base and are focused on selling new products and offering new investment strategies.[41]

Do I have to have a Chief Financial Officer?

Not necessarily. This comes down to a business decision and is influenced by factors specific to each firm. There is no regulatory requirement to have a CFO. Despite this, many managers are convinced that they must have a titled CFO on staff to compete for capital, regardless of whether that individual has sufficient work to justify their full-time position. Experience shows that this decision should be based on the actual operational needs and workload to justify the expense of an experienced CFO. Ultimately, investors won't be influenced by form over substance. Therefore, to the extent that a manager's business operations is relatively simple, choosing a more cost-effective outsourced solution over an internal CFO is completely suitable. If a firm chooses not to have an in-house CFO, however, it is highly recommended that the firm identify a single employee to both serve as a point of contact for the outsourced service provider as well as have the authority to sign-off on accounting and operations related items. This individual should have the authority to sign-off on financial statements, cash movements, and finalize arrangements with service providers such as prime brokers and banks.

Do I have to have a Chief Compliance Officer?

Yes. If your firm is registered with the SEC, you are subject to what is commonly referred to as the "compliance program rule," which requires an SEC registered investment adviser to designate an individual as a CCO.[42] Some outsourced service providers offer the option of using

> We do not recommend using an external Chief Compliance Officer.

their personnel as an external CCO. Blue River does not recommend using an external CCO. In fact, the SEC issued a highly critical risk alert to this effect in the fall of 2015.[43] A registered investment adviser should maintain an internal CCO. This said, by using the right compliance provider, a firm's titled CCO can leverage the provider to maintain the daily compliance responsibilities of the firm and report up to the CCO with respect to any critical issues or decisions. Under this model, the CCO role is converted from an administrative role to a management role, which is less demanding on the time of the individual taking the CCO title. This model has developed into an acceptable (even preferable) alternative to hiring a fully experienced CCO, which is very costly and hard to find in the current market. Similarly, with respect to non-registered, exempt investment advisors, the investor community will expect to see that these managers have both a written compliance manual, as well as an internal person responsible for compliance.

How will investors and regulators respond if I allocate expenses related to outsourcing to clients?

An alternative asset manager can allocate expenses related to outsourced service providers without repercussions from both investors and regulators—as long as the allocation of expenses related to outsourced service providers is made in a manner that is clearly disclosed in offering documents and has a clear rationale. Allocation of service provider expenses to a fund or investor is nothing new. Standard fund expense disclosure has always included legal fees, accounting fees, printing fees, audit fees, travel, and entertainment expenses, among others. Within the past few years, however, with the proliferation of additional outsourced providers and services, allocation of these additional expenses has been highly scrutinized by the regulators, who will closely examine expense disclosures and allocations in connection with routine regulatory examinations. Managers generally face regulatory enforcement action in circumstances where the manager's expense allocation practices run contrary to its expense allocation disclosures, or where its expense allocation disclosures are not sufficiently clear. If an outsourced service provider is engaged to assist with both fund-related services and investment adviser-related services, then it is extremely important that the manager's investor expense disclosure completely and adequately describes how such expenses will be allocated and identifies any material conflicts of interest that could develop from the stated expense allocation. Recent enforcement actions, such as the settlement order against Cherokee Investment Partners, LLC and Cherokee Advisors, LLC (collectively, "Cherokee"), demonstrate that regulators view expensing costs associated with third-party service providers as acceptable, but they require that disclosures must be prominent and explicit. Full and complete disclosure is the key. Offering materials that contain a general disclosure of expenses, such as "legal and compliance expenses will be expensed to a fund in the good faith judgment of the general partner of the fund," without an itemized description of such expenses, is generally not acceptable to regulators.[44]

Disclosures must be prominent and explicit. Full and complete disclosure of expenses is the key.

It is also important to note that a firm should strongly consider how the allocation of expenses will impact investor relations, especially if the cost is likely to be trivial. The tradeoff of losing a potential investor or damaging a relationship with a current investor due to the allocation of an expense is unquestionably an item the firm should take into account. To avoid losing perspective, it is important to remember that the salary for in-house personnel would be completely expensed to the firm, but the bill for outsourced service providers—depending on the service provided—can be fully or partially expensed to a client. It is no surprise that investors are commonly fixated on fee and expense arrangements when choosing which manager has the privilege of managing their assets.[45]

FINAL THOUGHTS

As the alternative asset industry changes—whether due to increased regulation, innovation of investment strategies, or ever increasing expenses—managers have sought new approaches to adapt to a changing marketplace. Increasingly, managers have turned to outsourcing critical business functions as a cost-effective and high-quality alternative to more traditional in-house structures. In light of our observations and market data on the current state of the industry, we believe the outsourcing trend is here to stay.

ABOUT US

Blue River Partners

Blue River Partners, LLC is a preeminent service provider to the alternative asset industry. By leveraging Blue River's team, investment advisory firms are able to implement a best-of-breed, integrated, institutional back office at a fraction of the cost of internal hires. Blue River works with managers in multiple capacities ranging from:

- hedge fund, private equity fund, and mutual fund launches
- private equity fund administration
- outsourced CFO services, financial controls, and operational support services
- outsourced regulatory compliance (SEC, CFTC, and 40 Act)
- outsourced CFO/controller and administration services to private equity fund investments – portfolio companies, real estate assets, and energy assets
- outsourced IT and cybersecurity services
- tax compliance and advisory services
- advisory firm formation, regulatory registration, and compliance program design
- compliance and operational related projects, due diligence, and reviews

Blue River currently supports over 250 clients managing over $170 billion in assets. Blue River Partners, LLC is not a CPA firm. Blue River Partners, LLC is not a law firm.

For more information about our service offerings and resources, please visit us at www.blueriverpartnersllc.com or contact us at info@blueriverpartnersllc.com and 214-996-0937.

Eaton Partners

Eaton Partners, a Stifel Company, is one of the oldest, largest, and most experienced fund placement agents in the world, having raised more than $75 billion across 96 highly differentiated funds. Founded in 1983 with over 60 professionals across seven offices in North America, Europe and Asia, Eaton is a full-service fund advisory and placement firm, raising institutional capital for investment managers across a full range of alternative strategies – private equity, private credit, real assets, real estate, and hedge funds/public market strategies – in both the primary and secondary market. Partnering with a select number of the highest-quality fund managers, Eaton Partners has represented some of the most innovative funds of the last three decades. With extensive institutional relationships, deep sector knowledge, fresh insights, and a partner-driven approach, Eaton Partners is dedicated to every client's success. In January 2016, Eaton Partners became a wholly owned subsidiary and affiliate of Stifel Financial Corp., a leading middle-market investment bank, to further ensure Eaton's success at the highest level of the global placement business.

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