Introducing Sturgeon Buchanan Partners

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There are a number of consultancy firms in London that help hedge funds get going. The exact footprint of the firm, which areas they assist with, varies according to the background of the principles and the sort of people they are. Some firms started by accountants are very focussed on administrative systems and routines and audits. For firms where the principals have a legal background the start-up consultancies get involved in fund structuring. Seonaid Mackenzie's background is as a stockbroker with a deep and abiding interest in private equity, so her firm, Sturgeon Ventures, does not look quite like others in the sector.

Sturgeon Ventures was established in 1998 and became authorised in 1999, making it one of the longer established companies that help nascent hedge fund managers. Sturgeon has three spheres of activity. The core activity is compliance and commercially focused monitoring for firms that are regulated by the UK's Financial Services Authority (FSA). Sturgeon Ventures also operates as a hub for a series of expert consultants in other functions, but all within the financial services sector. Sturgeon has experts in venture capital and fund raising, it gets involved in corporate development work, and Sturgeon Ventures can call on experts in risk management and portfolio construction for asset management companies of all types.

The third sphere of activity is to operate a regulatory umbrella, enabling firms and individuals that are unknown to the FSA to commence regulated activities in the UK. That Mackenzie is particularly adept in this area was demonstrated when her firm became the first sole trader firm to be granted authorisation by the FSA to offer corporate finance advice. For most of Sturgeon Ventures' existence the people and firms that Seonaid Mackenzie and her team have helped have been based in Continental Europe or the UK. A new development is the formation of a joint venture with American compliance consultancy Buchanan Associates, headed by its President Vincent Buchanan. Buchanan Associates is a recognized expert in financial industry regulations and compliance, and one of America's largest regulatory compliance outsourcing firms. The New York based Buchanan Associates provides broker dealers and investment advisers – including hedge fund managers – with services that support compliance with Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) regulations and requirements. With the recent February deadline for the registration of hedge funds with the SEC, the issue of compliance has taken on a heightened significance across the pond.

It is not widely appreciated that the American system of regulation in the financial sector has been very much focussed on the advisors, typically stock brokers. The brokers offer advice on individual securities and financial products such as funds, and the individual brokers and the brokerage firms are regulated by the NASD. The providers of those products may or may not have been regulated, depending on whether they engaged in other regulated activities such as the provision of insurance. Under the new rule advisers to certain private investment pools ("hedge funds") are required to register with the SEC under an Amendment to the Investment Advisers Act of 1940. The second point of relevance about US financial sector supervision is that the NASD is empowered to visit overseas branch offices of firms it regulates domestically. Put these two points together and the rationale for trips to London by Vince Buchanan becomes clear.

Buchanan Associates acts as a consultant to over 100 New York City brokerage firms and some of them have operations in London – were they ready for an NASD visit here? Then there are UK brokerage firms that have operations in the States. They had to comply with NASD reporting requirements, and Buchanan Associates now helps 7 or 8 of those with their returns. Showing foresight and some commercial nous, Vince Buchanan started coming to London a year ago and visited every firm that was engaged in compliance consultancy in the city. He came to find out what the state of readiness was of UK businesses for the changes to come. It also gave him a chance to take a view on firms in London with a corresponding business to his. It turns out that Vince Buchanan was himself a former trader, and Seonaid Mackenzie, when at a number of investment firms, including Bear Stearns and Prudential Securities, had brokered American stocks for some 15 years. They spoke the same language, and could relate well to one another. Further they each had an entrepreneurial streak, and Seonaid Mackenzie responds to her creative side through starting up and building businesses – something that she has done in financial services and in other sectors.

The natural consequence was the formation of a joint venture, Sturgeon Buchanan Partners. The new joint venture will help American firms set up and operate in the UK in a way that satisfies FSA requirements. It will also help UK and European-based managers of hedge funds with registration with the SEC and then assist them in fulfilling their American reporting requirements. Not all hedge fund managers, whether American or not, have to register. Advisers (hedge fund managers) have to register if they have more than 14 American clients plus they have more than $25m under management. If that money is locked up for more than two years the advisers do not have to register. Whilst some hedge fund managers have created artificial structures to avoid registration, and many have ignored the requirement as yet, pending the first fines for non-registration, in the end it will become a routine part of managing a hedge fund to register with the SEC.

The stream of business that comes from America into London for Sturgeon Buchanan Partners is somewhat more difficult to describe, and the key is the standing of Seonaid Mackenzie and her experience in working with the FSA to achieve the desired commercial outcomes for her clients. Her experience in the period since the formation of the Financial Services Authority in 1999/2000 has been about bringing traders and portfolio managers into the regulator's bailiwick. In the UK regulatory regime for financial services, firms and individuals have to be approved. Firms have a scope of permissions – these are the activities that are regulated in the UK: investment management, or corporate advice, say. Individuals have to be approved, and have to be given explicit permission to carry out roles

within approved financial services firms that are designated as Controlled Functions. These range from being a director of a financial services firm (CF1) through carrying out Money Laundering Reporting (CF11) to Finance in a financial services firm (CF13). An FSA-regulated firm has to apply for an individual to carry out a Controlled Function, importantly an individual cannot apply on their own behalf.

The mushrooming of the hedge fund industry in London started in 1998/9 at the time of the launches of Marshall Wace's Eureka and Thames River's Kingsway Fund. Setting up a hedge fund management company (investment advisor) and the offshore fund was new, and the service providers, lawyers and accountants, were finding out how to do it themselves. So the setting up costs reflected the costed time of the service providers – £250,000 to set up and maybe a similar amount for the operational cost of a small start up's first year. Since then the path has become deeply grooved with use: a potential manager can buy a book on how to set up a hedge fund in Europe; he /she can attend seminars about how to do it; and there are trade fairs where service providers will parade and present for start-ups. New teams can elect to join an existing hedge fund management company like RAB Capital or Polar Capital. They can try to hop on board a hedge fund platform like Vega Plus (where the portfolio managers own the fund management company), or they can try semi-detachment on a platform like PCE Investors (where the platform is the legal manager of the fund). For the most entrepreneurial proto-hedge fund managers the ideal is probably an independent fund management company - their own firm.

The costs of setting up a hedge fund management company in London have come down since 1999. They may have halved, but it is still quite a chunk of capital to find and sink into a new venture for a sole trader or small team. A lot of the costs are unavoidable, such as the costs of occupying premises, and accounting and portfolio management systems and market data feeds. In other areas Sturgeon Ventures can help. "We aim to source or provide several slices of the pie, " say Seonaid Mackenzie. "We can provide the compliance consultancy and on-going monitoring. We work with Bourne Financial in providing high quality office space suitable for hedge fund teams. We have links with service providers that enable us to ensure that our clients have very competitive rates for book-keeping and auditing, and for legal services. Often I've found that a prop trader leaving an investment bank knows only the name of a first tier and very expensive law firm or audit practice. We give them a broader range of options than that," says the wily Sturgeon principal.

"But what we are really excited about," continues the effusive Mackenzie, "is our new FSA umbrella route for start-up traders and hedge fund managers." A typical client for this service is a prop trader or a sole trader CTA. "The prop trader will have been a CF26 (called "Customer Trading" but the capital belongs to the firm) for FSA purposes," she explains carefully. "You need to be a CF27 (Investment Management) to manage a hedge fund. So what we do is have a regulated firm that has scope to manage money take on the trader as a CF26. They will typically be running a single managed account at this point in order to start to build a real track record. After three months or so of monitoring by us and by taking the regulatory paper of the IMC (Investment Management Ceritificate), we will look to have the trader designated as a CF27 when we are satisfied that they are competent. By simply taking the exam, you cannot upgrade without being inside a regulated firm. You need two CF27s to start your own authorised hedge fund, we can often find a locum arrangement for a newly created CF27, to aid in the process."

In the meantime the new corporate entity (NCE) controlled by the trader-client will have been made an appointed representative of a firm that has the permission of the FSA to carry out marketing (that is for the investment management firm), thus beginning their own track record and branding. Then the trader-client can become active inside the regulated entity carrying out controlled functions such as investment management (CF27) or investment advice (CF21) and their NCE can be used for marketing and building a brand. There is a further complication in that the NCE cannot initially be seen to act as the investment manager of the (offshore) fund, so via a portfolio management agreement the NCE may provide another investment service (investment sub-advice, or risk management advice) to the offshore management company.

This may seem like an extra layer of corporate structure behind the hedge fund/management company. But the more tax-conscious hedge fund management companies sometimes put in place an offshore investment management company anyway, so there is not necessarily more complexity than many structures. To go through these steps there have to be advantages. "I think the biggest advantage is time-to-market," declares Sturgeon Ventures CEO Mackenzie. "Using this approach can cut the time from leaving an employer to actually managing money to a few weeks. There is the advantage of a real track record. The client is also being nurtured by us as they make the tough transition from the closeted environment of a bank to independent operation – we find clients really appreciate this element." There is also flexibility in this mechanism of setting up – the whole arrangement can be terminated with three-months notice and/or upon FSA authorisation. The flexibility may be important as Sturgeon is paid under the scheme at a monthly rate.

There are also some avoided costs in the Sturgeon umbrella. The client does not have to put up the regulatory capital that the FSA requires of investment management firms - €50,000 – €125,000. Unlike leaving some platforms, the managers can attain independence quickly and cleanly. The client owns the named entity that is written in to documentation such as the Investment Management Agreement and Prospectus. There is no need for a messy divorce.

"In some ways I see this as a way for prop traders or even people running money for their friends or contacts to get into a regulated environment and find out how good they really are at running money without the substantial capital commitment that that usually takes," says Mackenzie. "Unfortunately some start-ups take that test and fail, and have to bear all the expensive consequences themselves." Sturgeon Ventures thinks that the umbrella structures they work with can help overseas firms and non-EU nationals come into the UK regulatory fold in an efficient way. So with the newly formed Sturgeon Buchanan Partners tapping into an American client base Ms. Mackenzie could be in for a busy time.