A Manager’s Guide to Establishing a Hedge Fund
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Launching and operating a successful hedge fund can be both personally and financially rewarding. It is a thoughtful and time-consuming process that requires skillful considerations and supportive collaborations to drive success. Launching a new fund can also be quite challenging and sometimes overwhelming experience. How should you structure your business? What service providers do you need? What do you need to do first?

Fortunately, you are not alone in this process. A broad network of industry experts is available to help new fund managers like you get their businesses off to a promising start. This guidebook aims to offer you a framework of practical options, knowledge and resources to help you make informed business decisions.

This guidebook addresses the key areas that every hedge fund manager should consider:

**Legal and tax considerations.** A number of decisions must be made before a hedge fund can be successfully launched. First and foremost is your fund's strategy. While this guidebook will not help you pick a strategy, it will give you the necessary framework of a hedge fund's formation by providing relevant information on the key legal and tax information affecting hedge funds. Stark & Stark, Attorneys at Law, will help you navigate the legal landscape, and Sasserath & Zoraian LLP will provide an overview of the tax environment and other necessary considerations.

**Technology.** In today's financial services industry, technology plays a major role in defining a firm's capabilities and competitive advantages. If you previously worked in a larger, full service organization, you may have been constrained by the choices made by a separate information technology (IT) department. Now that you will be making these decisions for yourself, you are free to implement a technology environment that supports your personal business vision. With that freedom, of course, comes the responsibility for every decision, including technology outsourcing, purchases, development, maintenance and enhancements. Here at Eze Castle Integration, we have deep experience assisting new hedge fund managers as they tackle the task of building an effective and efficient IT environment. In this section we will walk you through the decision-making process for selecting the most appropriate options for your firm's technological building blocks: the systems, processes and tools available and necessary for organizing the workflow within your firm.

**Service providers.** Third-party service providers will play a major role in your hedge fund’s success. This section provides information about the service providers typically used by hedge funds and offers criteria that can be used in the selection process for your new fund.

**Human resources.** There are a number of human resources considerations to keep in mind as you prepare to launch and operate your new hedge fund. Generally, the single largest expense category for a fund relates to compensation for the individuals operating it. This section includes information on compensation and some of the associated costs, such as benefit packages and equipment allocated per staff member.

**Insurance.** Before beginning any work to establish your fund, it is necessary to address all the insurance requirements that hedge your business risk. There are different types of business insurance and protection you will need to procure to minimize business risk and protect your personal and business assets. Employee insurance packages are another area in which decisions will have to be made before hiring staff for your firm.

**Operational infrastructure.** For a single-strategy fund with limited staff, the operations of the firm are relatively straightforward, as the manager is typically responsible for all tasks. A thoughtful approach to the structure of your operations will help you establish the most productive relationship with your service providers.
providers and maximize the time you have available for managing your fund. This section also covers the
decisions involved in finding the right physical location for your new firm, common types of leasing
arrangements available and ways to best estimate the amount of office space to meet your current and future
needs.

♦ Capital raising. The single largest component of success in the hedge fund industry is the ability to raise
capital. Having a plan that focuses on how capital will be raised and how performance will be recorded is
crucial to successfully establishing and growing your fund. Even with solid preparation, many managers find it
difficult to survive the first few years of operation. Prudent managers will take steps to ensure that they will
have the longevity to realize the results of their labor and investment. This section provides an outline for
formulating your own capital-raising strategy.

This guidebook, published in cooperation with our partners at Pershing Prime Services, is meant to help you
understand many of the issues you will face as you begin this new endeavor. Not every issue presented in this
guidebook will be applicable to your unique situation, and some may not be as complex—or as simple—as
discussed. Our goal is to share different considerations and provide a reference as you work through your hedge
fund’s start-up phase and to help you address key questions and concerns along the way.

Legal and Tax Overview

The path to establish a hedge fund comes with a host of decisions and responsibilities which will largely
determine your level of professional success. The first decisions that must be made are not about the legal
structure of your firm or finding someone to ask for help. They are about making a commitment to the fund’s
success, developing a thoroughly vetted and articulated investment strategy and creating a framework for raising
capital.

With the appropriate groundwork laid, the process for starting a hedge fund is fairly linear in nature. Completing
the first steps logically leads to the next decisions to be made. The start-up timeline on the following pages shows
the general process and timing of key milestones in the launch of a hedge fund. While the actual time to complete
each step may vary, it is important to remember that none of them will happen overnight. You will need to identify
and select numerous service providers—a lawyer, an accountant, an administrator, a prime broker, a technology
partner and more—before an infrastructure can be built, capital raised and the fund launched.

During the typical start-up period for a newly launched hedge fund, which is approximately 16 weeks in the
projected timeline, significant time and money must be committed to getting the fund up and running. It is
important for you and any potential partners to be prepared to expend both while not generating any revenue, at
least until the launch is complete. It is also likely that you will not be generating any significant revenue for the
fund’s first year or two of operation. The better prepared you are in understanding the process and managing
expectations, the greater your chance of success.
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Legal Overview
There are a number of legal considerations that should be taken into account when deciding how to best structure a fund. These include who can invest in the fund, how it is marketed to potential investors and how compliance with applicable laws is maintained throughout the entire process. The following overview of the hedge fund legal landscape has been prepared by Stark & Stark, Attorneys at Law.

Formation
The formation of a fund requires a consideration of the nature of the business operations and investments in which the proposed fund intends to invest. Most private equity funds are set up as general partnerships with a limited liability company (an “LLC”) installed as the general partner (although some form two LLCs, with one LLC acting as the managing member of the other). A general partnership is commonly known to be the better corporate structure. While an operating agreement will allow you to define the operation largely as you wish—to the extent an item is left undefined—statute will define it for you. Partnership statutes define a considerably lesser number of items, so the fund is far more unlikely to have a solution imposed on it by statute. More effort is also needed to define the ownership status of the managing member.

Once you have determined the type of vehicle, the next step is to form the entities and have an operating agreement created for the LLC and a limited partnership agreement drafted for the investment vehicle. The limited partnership agreement defines what the partnership can and cannot do. All the relevant control, operations and fees are defined by the limited partnership agreement. Consultation with counsel concerning the precise nature of the fund, its investment strategy and fee structure, the admissions and withdrawals of members and management of the fund are crucial at this early stage. At this time, the offering documents can also be prepared. The operating agreement sets forth the operation and duties of the general partner.

Once the limited partnership agreement and operating agreement are prepared, the incorporation process can take place, and counsel can form the entities in the preferred state. Delaware is most often chosen because of its favorable legal and judicial structure.

When the entities are formed, preparation of the materials for the offering can begin in earnest. Typically, the offering of the fund is done through the preparation of a private placement memorandum and a subscription agreement. The private placement memorandum describes the offering, the strategy of the fund, the minimum investment amounts, the background of the individuals involved and summarizes the limited partnership agreement or operating agreement. The private placement memorandum also contains the description of the risks of the investment, which is vitally important to the offering documents. Full disclosure of the risks is necessary in order to comply with the antifraud provisions of securities laws and as a protection against litigation in the event the fund is unsuccessful.

The Offering Process
The marketing of interests in the equity fund is considered a securities offering and is governed by the Securities Act of 1933 (the “1933 Act”). Additionally, the Investment Company Act of 1940 (the “Company Act”) is also implicated because of an equity fund’s nature as a company to manage investments. Fortunately, both have registration exemptions, although the exemptions do not free you from the antifraud provisions of the 1933 Act. Lastly, the Investment Advisers Act of 1940 (the “Advisers Act”) is implicated where there is a consideration of the kind of fees that may be charged.

In order to avoid registration under the Company Act, the fund must not exceed 100 investors. There is a registration exemption pursuant to Section 3 of the Company Act for all investment companies that have 100 or fewer investors. Because registration is costly and makes operation more expensive and difficult, registration is generally not preferred. Accordingly, no more than 100 investors should be allowed into the fund.

Avoiding the limit of 100 investors cannot be done by closing the fund to new investors while simultaneously opening a new fund that is identical to the first and having new investors invest in the new fund. In that event, the
US Securities and Exchange Commission (SEC) will likely take the position that the second fund was formed solely for the purpose of avoiding registration under the Company Act and “integrate” them, or treat both entities as one. The fund will then be above the investor limit and you may be charged with the sale and operation of an unregistered investment company without an appropriate exemption. Such a charge can lead to significant penalties, which makes it vital that, if multiple funds are being operated, the funds’ investment strategies are not identical.

♦ **The Securities Act of 1933: Full and Fair Disclosure.** The provisions of the 1933 Act require that the documents offering the fund fully and fairly disclose all material information about the documents, including the risks. Failure to disclose all material information, or to leave out information that would make the offering documents misleading, is considered a violation of Section 12 of the 1933 Act, which carries severe civil and criminal penalties. Disclosure of more, rather than less, information is usually advisable, especially negative information. A private placement memorandum should be prepared, which details all the material disclosures required. The private placement memorandum will describe the background of the individuals charged with fund operations, the investment strategy, the fee structure, withdrawal provisions, a description of the limited partnership agreement, certain tax considerations, and implications of the Employee Retirement Income Security Act of 1974 (ERISA), and, most importantly, full disclosure of the risks vital for adequate protection in the event the fund is not successful.

♦ **The Securities Act of 1933: Antifraud Provisions.** There are two considerations that relate to the 1933 Act. First, the fund is required to conform to the antifraud provisions of Section 12, even if it is offered pursuant to an exemption from registration. Therefore, full and fair disclosure of all material information is required. It is vitally important that the risks of loss be fully and completely described as part of these disclosures, as such disclosures provide significant protection from liability in the event the fund is not successful. Most offering memoranda have a significant number of “risk factors” listed for that reason. Specifically, Section 12(2) of the 1933 Act makes an offer absolutely, civilly liable for the offer or sale of a security, whether or not exempt, using statements or offering documents that “include an untrue statement of a material fact or omits to state a material fact necessary to make the statements, in light of the circumstances under which they were made, not misleading . . .” Risk factors are considered facts necessary to ensure that the more positive statements are not misleading.

In general, a greater disclosure of investment risks is always preferred to ensure compliance with Section 12 of the 1933 Act and, therefore, protect against potential liability. Accordingly, in addition to a description of the positive aspects of the fund, its strategy and its management, negative facts through risk factors should be disclosed.

♦ **The Securities Act of 1933: Registration Requirement.** The second aspect of the 1933 Act, which implicates the fund, is the requirement that securities offerings, unless exempt, must be registered. The SEC has promulgated Registration D, which is an exemption from the registration that is applicable to most private equity funds. The failure to register the fund or comply with the Regulation D exemption requirements can carry significant penalties. Regulation D provides an exemption from registration for “private placement offerings,” though this is subject to certain conditions. Offerings pursuant to Regulation D have relevant investor criteria designed to ensure that the investor is sophisticated enough to evaluate the investment or, if not, that the investor has assistance in such evaluation. Offerings to investors deemed to be sufficiently sophisticated or “accredited” have no limits on the number of investors, though the Company Act limits still apply. Accredited investors, as defined in Rule 501, are, in general, wealthy individuals or financially sophisticated entities such as banks. Specifically, accredited investors are defined as follows:

1) Any bank as defined in Section 3(a)(2) of the Act, or any savings and loan association or other
institution as defined in Section 3(a)(5)(A) of the Act, whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to Section 15 of the Securities Exchange Act of 1934; any insurance company registered under the Investment Company Act of 1940 or a business development company as defined in Section 2(a)(48) of that Act; any Small Business Investment Company licensed by the US Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, for the benefits of its employees, if such plan has total assets in excess of $5 million; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in Section 3(21) of such Act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5 million, or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

2) Any private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940;

3) Any organization described in Section 501(c) (3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5 million;

4) Any director, executive officer or general partner of the issuer of the securities being offered or sold, or any director, executive officer or general partner of a general partner of that issuer;

5) Any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds $1 million;

6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person’s spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

7) Any trust, with total assets in excess of $5 million, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 206(b)(2)(ii); and

8) Any entity in which all of the equity owners are accredited investors.

There is a limit of 35 “nonaccredited” investors—those who do not meet the above definition of accredited investor. It is advisable that such nonaccredited investors have an investment advisor. Although Regulation D does not specifically mandate an investment advisor, it contemplates one with an explicit description of what one is and its purpose. Such advisors can go a long way toward meeting the burden of demonstrating that the Regulation D exemption is appropriate.

It is the fund’s obligation to demonstrate compliance with the requirements of Regulation D, including a demonstration that the investors are either accredited, have an advisor or meet the requirements of sophistication. Accordingly, an investor questionnaire is generally provided to a prospective investor and, generally, the fund requires the investor to fill it out. In other subscription documents, which are usually also provided and required to be signed, the investor attests that the information he or she is providing is truthful, that he or she has read the offering materials and is not relying on anything other than those materials, and understands the risks of the offer. It is essential that such a document be provided, filled out and signed by investors. Within 15 days of the first sale, the fund must file the registration materials and a Form D with the SEC, as well as other documents and fees specified in “blue sky” statutes, within the state of residence of each investor.

Each state has its own securities laws, which must be complied with when selling to residents of that state. Although each state has different requirements that should be researched prior to any actions, the relevant department of the state government generally requires a filing of Form D, a Uniform Consent to Service of Process (or Form U-2) and a filing fee.
The Advisers Act: Investor Criteria. The Advisers Act also identifies who can invest in the fund, depending upon the fee structure of the offering. Where there is solely a management fee charged, the prescriptions of Regulation D are the only investor criteria that apply. However, where there is a performance fee, a special allocation fee, or a general fee tied to the performance of the fund, the Advisers Act requires that sales be made only to a “qualified client” or investor. As defined in Rule 205-3 of the SEC, a “qualified client” is:

I. A natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;

II. A natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:
   - Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1.5 million at the time the contract is entered into; or
   - Is a qualified purchaser as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940 at the time the contract is entered into; or

III. A natural person who immediately prior to entering into the contract is:
   - An executive officer, director, trustee, general partner or person serving in a similar capacity, of the investment adviser; or
   - An employee of the investment adviser (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

ERISA Considerations
Accordingly, when determining the fee structure, it is vital that you consider the nature of your investors. Small investors will restrict the fees charged and may make it impossible to offer the fund to a potential investor. Although the fund may be marketed to an IRA's pension funds and other ERISA pension vehicles (“ERISA funds”), there can be substantial issues with accepting more than a small amount of such investors. ERISA contains an exemption from its provisions for funds that have less than 25% of their assets as ERISA funds. If the fund exceeds such amounts for more than 14 days, the fund must follow the enhanced duties and restrictions required by ERISA and the Department of Labor (DOL), the agency charged with enforcing ERISA.

ERISA contains restrictions on the ability of the general partner to receive compensation, engage in transactions, compensate sister entities or engage in certain trading activities, such as “block trades.” Although, the DOL at one time severely restricted the ability to charge performance fees, it has taken a more flexible approach over the past two decades. Performance fees are allowed where:

- The performance-based fee formula takes into account both realized and unrealized gains and losses during a pre-established measurement period;
- The decision to enter into the performance-based fee arrangement is made by an ERISA fiduciary who is independent of the investment manager;
- The fee arrangement complies with the securities laws governing performance-based compensation arrangements;
- If the client’s portfolio contains assets for which market quotations are not readily available, the assets are valued by a person who is independent of the investment manager and who is appointed and, if necessary, replaced only by the pension plan; and
- The arrangements involve sophisticated investors having aggregate assets of at least $50 million.
Similarly, to the extent that any sister entity is providing services to the fund, ERISA prohibits the general partner or its managing member firm from receiving any compensation from the activities of the fund. ERISA also restricts the ability of the fund to “cross-trade,” or move securities from one fund to another. Other funds are managed by the same investment manager to certain very limited circumstances and transactions and require no commissions or compensation to be paid in such cross-trades. The DOL also reserves the right to inspect the operation of the fund to ensure compliance with ERISA.

In general, most funds seek to avoid the strictures of ERISA and stay under the 25% threshold, unless the intent of the fund is specifically tailored to the ERISA funds market and intends to operate under ERISA provisions under all circumstances, no matter the nature of the investor.

**Anti-Money Laundering Compliance**

You must also comply with anti-money laundering statutes. Under these statutes, the issuer is charged with having sufficient knowledge of the investor to ensure that the customer is not laundering money. Because private equity funds’ investments are illiquid, they are considered under the statutes to be low-risk endeavors for money laundering activity. Nonetheless, the issuer must take steps to ensure that the investor’s identity is verified. In general, some form of government-issued identification, such as a driver's license or passport, will suffice to comply with such laws.

**Offshore Funds**

Funds are frequently created in certain offshore locations that have tax and privacy advantages. When setting up an offshore fund, it is important to choose a location that has a sufficiently stable government and a regulatory structure that is rigorous enough to provide comfort to investors, yet flexible enough to be able to operate on a day-to-day basis. It is also important that the location have an adequate amount of financial and legal service providers to implement the fund. Typical locations include the Cayman Islands, the British Virgin Islands and Bermuda. Ireland and the Netherlands Antilles are also used as well.

The corporate structure of an offshore fund somewhat differs from a US fund in that the location statutes generally favor other corporate forms or do not have the typical US corporate forms at all—for example, an exempted investment company issued in the Cayman Islands or an international business corporation in the British Virgin Islands. Unlike a US fund, an offshore fund usually contracts with an investment manager located in its jurisdiction, who, in turn, typically contracts with a US-based subadvisor to manage the fund’s assets. The day-to-day administration of the activities is handled by the offshore investment manager.

Offshore funds may be marketed in the United States, but care must be taken to ensure that the fund’s activities, beyond the offering, remain offshore, so as not to trigger US laws beyond Regulation S, which provides a safe harbor provided that the securities “come to rest” outside the United States. Resale is similarly restricted with Regulation D as discussed earlier.

Each location also has its own anti-money laundering statutes that come into play for funds, most of which involve the “know your customer” types of rules. Money laundering issues in the current environment have taken on a greater life, and procedures should be in place to be able to discern the nature of the client.

Care must be taken to ensure that corporate structures are followed to maintain the fund’s offshore status. Offshore funds are primarily of interest to high-net-worth investors who have, or wish to have, assets outside United States’ jurisdiction. Frequently, there are tax implications to those who invest in offshore funds, and the offshore nature of the fund must be preserved in order to protect investors and the fund. Therefore, the offshore investment manager should be used in all transactions and not be ignored. Failure to follow proper procedures could create substantial issues for the fund and investor.
**Fund Operation**
The limited partnership agreement defines the fund’s operation and structure. The procedures set forth in the operating agreement should be followed. Typically, partnership agreements require quarterly reporting of the fund’s profitability to the limited partner, as well as a year-end audited report. These provisions should always be followed. In the event that the general partner wishes to change the fund’s investment strategy, partnership agreements generally allow for such a change without approval. However, investors must be informed of such a change in order to avoid a claim under the 1933 Act that the offering materials were false and misleading with regard to the description of the investment strategy. The fund should have a reputable accountant or accounting firm calculate and maintain the capital accounts of each investor. Such individual account information should be included in the financial reports. Care must also be taken to ensure that the fund remains below the 25% threshold previously described for ERISA funds. ERISA allows a window of 14 days to correct an inadvertent crossing of the 25% threshold. Accordingly, it is vital to monitor the percentage of ERISA funds under management to avoid the ERISA strictures and, if needed, change the investor makeup to comply. Generally, it is not advisable to cross the 25% threshold. Fees should only be paid in compliance with both the amount and timing procedures set forth in the limited partnership.

The general partner has a fiduciary duty to the fund and its investors. That duty generally requires the general partner to act in the best interests of the fund and its investors, even if it is to its detriment. Investment advisors and brokers are generally aware of and comfortable with this duty, as they owe the same or similar obligations to their clients.

**Tax Considerations**
There are a number of tax issues related to the formation of a hedge fund. Some of the general tax considerations are the selection of the type of entity to be used; state and local tax implications; tax basics; and the taxability and deductibility of benefits, management compensation and income allocation. The following information regarding the tax considerations associated with launching your hedge fund has been authored by Sasserath & Zoraian LLP.

**Fund Structure**
Your attorney will walk you through the choices that exist. However, an early decision you will make is who you are targeting as investors—people residing in the United States or residents of foreign countries. This decision will impact how your fund is organized.

♦ **Onshore fund.** For investors residing in the United States, an onshore fund is usually organized as a limited partnership. By purchasing an interest in the partnership, an investor becomes a limited partner of the partnership.

♦ **Offshore fund.** An offshore fund is organized to facilitate investments of capital from investors residing outside the United States. Offshore funds are typically organized in two ways:
  - **Master feeder.** This structure allows both investors residing in the United States and investors residing offshore to indirectly invest in the same offshore corporate entity commonly known as the “master fund.” Onshore and offshore feeders are used to invest assets in the master fund.
  - **Side-by-side.** In a side-by-side structure, US investors typically invest in a limited partnership organized in the United States and offshore investors invest in an offshore corporation. The prime broker typically allocates trade tickets between the domestic fund and the offshore fund.

**Entity Selection**
The entities that are normally formed to start a hedge fund are the entity for the investment vehicle and the entity (ies) for the management company(ies). These entities may be organized as a limited liability company, a “C” corporation, an “S” corporation, a general partnership, or a limited partnership.
In order to choose which entity will work best for your fund’s investment vehicle and which entity will work best for the management company(ies), you must first understand the characteristics of each type of entity. The section below highlights some of the characteristics of each type of entity:

- **Limited Liability Company (LLC)**
  - Limited liability for all members
  - Single level of taxation
  - No limitation on number of owners
  - No limitation as to type of owners (i.e., entity or individual permitted) or citizenship of owners
  - Income and loss allocation flexibility (i.e., special allocations as defined below are permitted)
  - Self-employment (payroll) tax on the distributive share of ordinary income applicable to active members
  - No single class of membership requirement
  - Tax-free distribution of appreciated property (subject to certain limitations)
  - Tax-free liquidations (subject to certain limitations)

- **“C” Corporation**
  - Limited liability for all shareholders
  - Two levels of taxation
  - No limitation on number of owners
  - No limitation as to type of owners (i.e., entity or individual permitted) or citizenship of owners
  - No income or loss allocations to owners
  - Payroll taxes applicable to shareholders and employees that receive salaries
  - No single class of stock requirement
  - Taxable distribution of appreciated property at the corporate and individual levels
  - Taxable liquidations

- **“S” Corporation**
  - Limited liability for all shareholders
  - Generally a single level of taxation
  - 100-shareholder ownership limitation
  - Ownership limited to US citizens, resident aliens or certain types of estates or trusts
  - Limitations on income and loss allocations and distributions, which must be in proportion to each shareholder’s interest in the “S” corporation (i.e., special allocations as defined below are not permitted)
  - Payroll taxes applicable to shareholders and employees that receive salaries
  - Single class of stock requirement
  - Taxable distribution of appreciated property at the corporate and individual levels
  - Taxable liquidations

- **General Partnership**
  - Unlimited liability for all members
  - Single level of taxation
  - No limitation on number of owners
  - No limitation as to type of owners (i.e., entity or individual permitted) or citizenship of owners
  - Income and loss allocation flexibility (i.e., special allocations as defined below are permitted)
  - Self-employment (payroll) tax on the distributive share of ordinary income applicable to active members
  - No single class of ownership requirement
  - Tax-free distribution of appreciated property (subject to certain limitations)
  - Tax-free liquidations (subject to certain limitations)
**Limited Partnership**
- Unlimited liability for general partners, limited liability for limited partners
- Single level of taxation
- No limitation on number of owners
- No limitation as to type of owners (i.e., entity or individual permitted) or citizenship of owners
- Income and loss allocation flexibility (i.e., special allocations as defined below are permitted)
- Self-employment (payroll) tax on the distributive share of ordinary income applicable to general partners
- No single class of ownership requirement
- Tax-free distribution of appreciated property (subject to certain limitations)
- Tax-free liquidations (subject to certain limitations)

Generally, state and local taxation rules follow federal taxation rules, except in New York City, which does not recognize flow-through entities. Accordingly, if the management of your hedge fund is located in New York City, there are separate planning ideas to minimize local entity taxes. These are discussed in more detail below.

Entities with a single level of taxation generally have no tax liability at the entity level. All of the income, loss, deduction and credit items flow through the owners of the entity either in their ownership percentage or, if permitted and agreed to within the entity operating agreement, in a percentage other than their ownership percentage, also known as a special allocation.

With a single level of taxation, flow-through income retains its character at the entity level. Accordingly, if there is a long-term capital gain at the entity level, such a gain will be reported to the owners as a long-term capital gain. The rule also applies to ordinary income, short-term capital gain and investment interest expense.

Benefits paid by the management company(ies) to the owner and employee are treated similarly to the benefits paid by any company to their owners or employees. Accordingly, retirement plans, health insurance plans and other benefit plans paid by the management company(ies) must comply with IRS and DOL rules and regulations. Generally, as long as the plan covers all employees of the management company(ies), a deduction will be permitted at the entity level and the owner and employee will not have to pay taxes on benefits. Owners and employees may be limited in the benefits they are permitted to receive from a plan depending on the type of plan.

Investment vehicles are typically organized as limited partnerships for the single level of taxation, limited liability for the limited partners, no limitation as to the type or citizenship of the partners and permission of special allocations. The only other permissible entity that could accommodate all of these characteristics is the LLC, though it is not normally chosen.

In a situation in which there are one or more management companies, separate entities are typically set up to receive the management fee and the incentive reallocation. For the most part, federal or state tax benefits cannot be gained from forming separate companies for the management and incentive reallocations. However, because New York City generally does not recognize flow-through entities, there is a local tax benefit to having separate entities for management companies that are doing business in New York City.

Management companies are typically organized as LLCs for the single level of taxation, limited liability to the members, no limitation as to the type or citizenship of owners, permission of special allocations and no single class of membership requirement. Additionally, in the event that, in the future, the members of the company(ies) decide to change from this entity, the liquidation of this entity is tax-free, though subject to certain limitations.

While some of the attributes stated above may be affected by using other entities, there are drawbacks to doing so. For example, if a “C” corporation was formed as the management company, special allocations could be affected by adjusting the salaries of the shareholders and employees. However, the IRS could deem such “salary adjustments” as “excessive” salaries.
As mentioned above, manager compensation takes two forms: the management fee and the incentive reallocation. The management fee is a fee paid to a management company, typically 1%–2% of the assets calculated on a monthly or quarterly basis. This fee is used by the management company to cover normal operating expenses.

Incentive reallocation is not a fee; it is a reallocation of the profits from the investment vehicle. Accordingly, the items of income, loss, deduction and credit retain their character. This incentive reallocation is typically 20% of the profits derived from the investment vehicle and is reallocated to the general partner of the investment vehicle. This treatment is generally advantageous to both the investor and general partner.

Neither the Internal Revenue Code (IRC) nor its regulations mandate a specific method for hedge funds to allocate profits or losses to their investors. Generally, any reasonable approach that is consistent with the partnership rules is permitted. However, once an approach is adopted, your fund should be consistent with the allocation methodology from year to year.

The aforementioned are the tax considerations that all hedge funds face. Below is a discussion of other considerations that your particular hedge fund may or may not need to address.

**Other Tax Considerations**

- **IRC Section 475: Election.** It may be advantageous for certain hedge funds to make an election under IRC Section 475. Such an election causes all gains and losses from securities and securities held at year-end to be marked to market, and gain or loss, as ordinary. Funds that could benefit from this election are funds that do not expect to generate much in the way of long-term capital gains. Also, volatile funds would generate ordinary losses in the years in which they created a loss, rather than capital losses that may or may not be able to be deducted by partners.

- **Offshore Funds: Entity Choice.** With offshore funds, the choice of entity question is more complex depending on whether there are taxable or tax-exempt US persons involved. In this case, your fund would most likely be a foreign corporate vehicle for offshore investors that require anonymity and freedom from making US tax filings.

**Checklist – Legal and Tax Overview**

- Evaluate whether you have enough capital to sustain you through the fund’s start-up phase.
- Create a timeline of events leading up to the launch of the fund.
- Identify your strategy and target investors.
- Have an attorney draft your legal documents.
- Have your accountant review the documents prepared by your attorney.

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**Technology Considerations**

Establishing a reliable, available and secure technology core is essential for an investment firm to achieve success. Each firm’s specific technology requirements will vary depending on the applications used, what the fund does, how it operates and other unique factors. Still, there are some fundamental technology considerations that
all funds must address during the launch process including infrastructure, security, data protection, voice services and archiving.

Establishing a robust network infrastructure is essential in carrying the valuable information that a fund uses to operate on a daily basis. A business continuity plan and a corresponding disaster recovery system have become essential in today’s marketplace, with investors and regulators expecting funds to be able to demonstrate how they will maintain operations regardless of external events. Additionally, a strong communications system must be in place to support the exchange of information within the fund and with critical external parties. Email, instant message and social media archiving to guard against loss of information are required from a legal standpoint. Having transactions archived will make it possible to refer back to what specifically took place and answer any questions that might arise. Finally, a comprehensive approach to security should be taken to ensure all of these crucial systems and tools are fully protected from an unwanted – and potentially costly – intrusion.

Infrastructure

In the past, investment management firms have followed a “traditional” path, managing IT in-house. In order to go this route, significant upfront investments in technology infrastructure were required. Firms needed to build out expensive Comm. rooms within their office space and rarely outsourced technology services to third-party providers.

Fast forward to present day, and you’ll see that times have changed dramatically. Thanks to the global adoption of new technologies (most importantly cloud computing) many hedge funds, especially startups, are re-evaluating their technology strategies and examining the cloud and IT outsourcing as viable options.

On-premise and cloud-based infrastructures can be equally as effective, depending on the size of the organization and other factors. In some cases, a combination of both may be best. To determine which is most suitable for your firm, be sure to thoroughly educate yourself on the benefits and considerations associated with each.

Cloud Computing

Cloud computing offers many advantages for investment firms. This technology enables the sharing of resources in a way that dramatically simplifies infrastructure planning. Let’s explore the major cloud computing infrastructures and the methods in which they are deployed.

With cloud computing technology, large pools of resources can be connected via private or public networks to provide dynamically scalable infrastructures for application, data and file storage. Additionally, the costs of computing, application hosting, content storage and delivery can be significantly reduced. Firms can choose to deploy applications on Public, Private or Hybrid clouds.

What are the differences between these three models, and how can you determine the right cloud path for your organization? Here are some fundamentals of each to help with the decision-making process.

- **Public Clouds**: Public clouds are owned and operated by third-party service providers. Customers benefit from economies of scale because infrastructure costs are spread across all users, thus allowing each individual client to operate on a low-cost, “pay-as-you-go” model. Another advantage of public cloud infrastructures is that they are typically larger in scale than an in-house enterprise cloud, which provides clients with seamless, on-demand scalability.

  It is also important to note that all customers on public clouds share the same infrastructure pool with limited configurations, security protections and availability variances, as these factors are wholly managed and supported by the service provider. Typically, security and service levels are inferior on public cloud platforms as compared to private cloud environments.
Private Clouds: Private clouds are those that are built exclusively for an individual enterprise. They allow the firm to host applications in the cloud, while addressing concerns regarding data security and control, which is often lacking in a public cloud environment. There are two variations of private clouds:

- **On-Premise Private Cloud:** This format, also known as an “internal cloud,” is hosted within an organization’s own data center. It provides a more standardized process and protection, but is often limited in size and scalability. Also, a firm’s IT department would incur the capital and operational costs for the physical resources with this model. On-premise private clouds are best used for applications that require complete control and configurability of the infrastructure and security.

- **Externally-Hosted Private Cloud:** This private cloud model is hosted by an external cloud computing provider. The service provider facilitates an exclusive cloud environment with full guarantee of privacy. This format is recommended for organizations that prefer not to use a public cloud infrastructure due to the risks associated with the sharing of physical resources.

Hybrid Cloud: Hybrid clouds combine the advantages of both the public and private cloud models. In a hybrid cloud, a company can leverage third-party cloud providers in either a full or partial manner. This increases the flexibility of computing. A hybrid cloud environment is also capable of providing on-demand, externally-provisioned scalability. Augmenting a traditional private cloud with the resources of a public cloud can be used to manage any unexpected surges in workload.

On-Premise Solutions

There are many crucial aspects of an on-premise IT build-out to consider. These include technology infrastructure concept development, construction administration, telecommunications and market circuit procurement and systems installation/implementation management. From start to finish this process can take six weeks or more to complete.

To maximize the efficiency of the project, it should first be broken down into carefully planned stages comprised of specific tasks and activities. Each task acts as a stepping stone or foundation on which the next task can begin, and pre-determined milestones should be built in to ensure each task is completed. Use this IT project plan template as a guideline for what you can expect during this process.
Task 1: Infrastructure Needs Assessment

The purpose of the IT Infrastructure Needs Assessment phase is to develop a set of baseline criteria necessary to plan the technology related aspects of the project. Some steps within this task group include:

- New building site assessment or existing office due diligence evaluation
- Technology infrastructure audit
- Connectivity issues and requirements
- Facility consulting and lease negotiation
- Future growth requirements assessment

Task 2: Design Development

During the Design Development phase the concepts and criteria developed during the Needs Assessment will be coordinated into an outline of IT implementation details, requirement specifications, room-ready criteria, timelines and reports. Some steps within this task group include:

- IT room/data center design
- Cabling/infrastructure design
- Network design
- IT systems elevation planning and design
- Base building telecom systems distribution design
- Floor planning to identify outlet requirements, cable routes, etc.

Task 3: IT Construction Administration

The objective of the IT Construction Administration phase is to proactively manage the technology infrastructure installation activities including cost containment and other considerations in order to facilitate a seamless systems integration. Some steps within this task group include:

- Select a cable administration contractor
- Develop, prepare and issue requirements for all frames, cables and outlets
- Review and approve contractor plans and component submittals to ensure compliance
- Manage site build-out, meeting regularly with contractor and conducting site inspections to verify compliance with design specifications

Task 4: Technology Integration

The objective of the Technology Integration phase is to procure, manage, configure, support and deploy the various technology systems and user workstations within the new office location. Some steps within this task group include:

- IT systems selection and procurement management
- Carrier selection, procurement and installation management
- Technology implementation management
- Service transition and go-live support
- Planning for ongoing, long-term user support
Security Best Practices and Policy Development

Regardless of whether your firm opts for an on-premise solution or the cloud, security is fundamental when considering a fund’s technology setup and network infrastructure.

Financial firms must be cognizant of potential internal and external security threats and take proactive measures against them. Newly established funds are particularly at risk because hackers seek access to the business secrets and intellectual property—such as business plans, trading programs, market forecasts and investment strategies—of small, rapidly growing funds. Therefore, a multi-layer security approach is essential to protecting the critical information that passes through the organization’s system every day.

This strategy, known as Defense in Depth, recommends that investment firms maintain up-to-date antivirus and anti-malware software as well as network firewalls, deep inspection proxy and IDS/IPS to reduce the amount of traffic on the network, thereby decreasing opportunities for an intrusion. In addition to these technical layers, firms should also implement the following policies and procedures to ensure their critical systems and data do not fall into the wrong hands.

♦ **Acceptable Usage Policy.** Define what acceptable behavior is for your employees as it relates to their technology usage. It is best to be specific within this policy regarding what activities and programs employees are or are not permitted to access. Firms can employ web filtering practices to block access to identified websites. They can also use third-party software to log activity around which employees are accessing what and what other actions they are taking (e.g. printing, copying, forwarding, etc.).

♦ **Principle of Least Privilege.** This involves restricting access to only those employees who need it. Keep access control lists on all applications and data and inbound/outbound Internet access to keep track of who can gain access to what. Also, log the use of audited one-time passwords and minimum privilege shared accounts.

♦ **Secure User Authentication Protocols.** Secure user authentication protocols include assigning unique domain user IDs to each employee, implementing strong domain password policies, monitoring data security passwords and ensuring that they are kept in a secure location and limiting access to only active users and active user accounts.

♦ **Information Management Security Policy.** Develop a plan that details how the firm will handle a security incident. The plan should outline who is in charge of managing a security incident, the required reporting and investigation procedures, communications policies for contacting clients and the post-incident remediation procedures.

♦ **Visitor/Contractor Premise Access Policy.** It is essential that firms keep track of all people who have visited the site through the use of physical security checkpoints and surveillance.

♦ **Mobile Device Policy.** Develop guidelines for the use of personal mobile devices in the workplace, and train staff on mobile device security practices. Employ security measures such as requiring passwords, having the ability to remotely wipe devices and employing encryption tools.

As the investment industry landscape continues to evolve, the importance of network and data security will continue to grow, as firms strive to meet investor demands and new regulations. Educating end users (i.e. your employees) on security best practices will be a crucial factor, especially as firms adopt new technologies and implement new policies to manage and monitor access and behavior.
Telecommunications has three key categories to consider: Internet service, phone and voicemail and market data services. Most firms view the Internet as a critical means of collecting and distributing market data, as well as communicating through the use of email. Several Internet options are typically available, including cable modems, DSL, T-1’s or Ethernet lines. Cable modems and DSL offer high speeds, can be installed rather quickly and are relatively inexpensive, but their reliability is low, especially when compared to other services. Internet T-1s are generally considered high in reliability and offer efficient speeds for smaller firms. Ethernet or fiber connectivity is becoming the gold standard as of late, offering high capacity service with speeds ranging from 5MB to 1GB at competitive prices. Many telecommunications providers have either built or upgraded their network to drive Ethernet connectivity to their customers. When selecting an Internet service provider, you should look for a company that bundles proactive monitoring and security features to achieve high levels of availability. To help ensure superior reliability, a firm should consider having two diverse providers and a router to establish automatic failover if one of the providers goes down.

For phone and voicemail services, a firm typically begins by purchasing a voice circuit called an ISDN PRI. An ISDN PRI can house large ranges of consecutive phone numbers along with providing the ability to conduct several inbound and outbound calls simultaneously. In addition to the ISDN PRI, a firm will purchase a phone switch, or PBX, which is connected to the ISDN PRI circuit and is installed in the data center or onsite in a company’s office. A PBX provides many options for routing calls and storing voicemails, as well as caller ID, an auto-attendant and integration with ring-down lines to various brokers. When reviewing your options, it is important to consider the number of users and required functionality of the system, including redundancy, voicemail to email setup, branch office, call accounting system and call recording system.

Some firms may also consider implementing a Voice over Internet Protocol (VoIP) system. VoIP services provide the same service as an ISDN PRI but use the Internet to pass call traffic. One advantage to VoIP solutions is that they can be a relatively inexpensive option for firms lacking upfront capital for the back office. However, these systems should be carefully selected, and a Service Level Agreement (SLA) should be delivered by the provider upfront to protect the end user should any quality issues arise. Static on inbound or outbound calls or other call quality issues may occur from time to time.

Ideally, your IT service provider will have strategic partnerships in place with trusted telecommunications companies and will help you select the appropriate system for your fund. Bear in mind that your final costs will be dependent both on the number of end users on the system as well as additional functions you may require.

For example, small- to medium-size firms with less than 40 employees can expect to pay roughly $20,000 to $40,000 for a solution that includes centralized call processes and solutions, such as voicemail and administration. Many hedge funds require and expect more advanced features from their voice solution, including modular messaging, advanced mobility capabilities and integration with trading systems. These features, as well as having more users, may increase the costs into the range of $30,000 to $80,000.

Selecting a market data vendor is based on the market and product coverage a firm requires, as well as cost, speed, reliability and client service. The cost of services is determined by the offering mix, the number of users, the remote access method and the real-time pricing requirements. Key market data providers include Bloomberg®, Thomson®, Reuters®, and Dow Jones®.

Data Protection – Disaster Recovery & Business Continuity Planning
Today, investors are extremely diligent in vetting a firm’s business and IT practices. They expect firms to have comprehensive, tested plans and procedures in place and often request to see them documented during routine, pre-investment due diligence audits. Additionally, the SEC and other regulatory bodies are becoming more stringent on disaster recovery and business continuity planning requirements, especially in the wake of Hurricane Sandy and other natural disasters.
It is important to understand the difference between a business continuity plan and a disaster recovery plan, as they deliver complementary, yet unique, capabilities to a fund. A disaster recovery plan encompasses the steps taken to implement and support the infrastructure (hardware, software and sites) necessary to make possible the full recovery of mission-critical services and applications (e.g., email, trading, voice, file and accounting). The steps to access up-to-date information and applications are established with a disaster recovery plan. A business continuity plan makes use of the infrastructure addressed in the disaster recovery plan, but focuses on business operations. It asks the questions whose answers are crucial to business functionality: what are the mission-critical processes, who are the key personnel, how are they going to be notified of an emergency and where or how will they continue to operate?

Developing both a business continuity plan and a disaster recovery plan that will be effective takes approximately two to three months. Completing this process will provide an understanding of what processes and personnel are essential, and will address documenting, planning, implementing, testing and maintaining the policies, procedures and infrastructure to ensure that these mission-critical processes and people can continue to operate or quickly return to operations after an unexpected outage.

When addressing your firm’s business continuity and disaster recovery needs, it is important to keep in mind that some practices which may seem appropriate for a fund are actually quite ineffective. Some ineffective methods include relying solely on physical tapes for backup or hosting a disaster recovery site at an employee’s home. The many important requirements, such as redundant power, HVAC systems, fire suppression systems and diesel generators make running a disaster recovery server out of a home highly impractical. Another ineffective method is hosting a disaster recovery site in the same geographic region as the firm’s primary office. This approach does not protect the data from regional outages, such as flooding or power outages, which would likely affect both locations and render the disaster recovery plan useless.

Effective practices include implementing procedures based on business and application availability requirements. Fund managers must determine the acceptable level of downtime for an application and then design the disaster recovery system to achieve that level of availability. This may vary from firm to firm depending on strategies employed and other factors.

Firms should also back up all essential documents and data offsite in an electronic format at least daily, if not in near-real time. Establishing a means to access critical information and applications in a remote manner will prove useful when an outage occurs by minimizing downtime and enabling the business to maintain operations at close to full capacity. Finally, firms should be sure to test and update both disaster recovery and business continuity plans on a regular basis to ensure that all personnel understand their roles and the technology is sufficient to meet all business needs. This will guarantee that when the time comes, the firm’s systems will function properly and employees will know how to get the business back up and running efficiently.

Archiving
Archiving of email, instant message (IM) and social media communications is essential to proving compliance with the many rules and regulations to which hedge funds are subjected. The Federal Rules of Civil Procedure relating to electronically stored information requires hedge funds to be able to supply things such as emails, IMs, Bloomberg Mail and IMs, documents, spreadsheets and PDFs if requested. All data should be saved for the amount of time prescribed by law. Data should be stored in WORM (Write Once, Read Many) format so that nothing can be altered or deleted. Records need to be indexed in searchable files to aid in providing only the specific information that is requested. The best way to store data is on its own offsite server, accessible via the Internet.

Recently, as social media has evolved into a mainstream vehicle for communication and information sharing, the SEC has likewise adapted its rules regarding what does and does not need to be filed and archived. According to SEC Rule 17a-4(b), registered investment advisers should archive all business communications on social media for a minimum of three years. As the frequency of discovery audits continues to rise, firms should ensure these
communications are easily searchable and can be recovered quickly in the event of an SEC inquiry.

Additionally, Section 24(b) of the Investment Company Act of 1940 requires investment firms to file all advertisements or other promotional materials to investors within 10 days of their release. A 2010 update to this regulation issued by FINRA declared that interactive content on social media platforms qualifies as advertising, and therefore falls under Section 24(b). The FINRA update also states that social media content falls under the jurisdiction of Rule 482 which requires firms to file registered investment company performance ads and promotional content.

In 2013, the SEC issued its first “Guidance Update” designed to express its views on emerging technologies and issues. The goal is to “increase transparency and enhance compliance with the federal securities laws and regulations.” This Guidance Update addressed the requirement of investment firms to archive content that is posted on real-time social media sites such as Facebook and Twitter. The SEC noted that many firms have been extremely thorough in their compliance efforts, and have routinely filed nearly all of their social media correspondences regardless of content or context.

The Guidance Update indicates that investment companies can relax this practice somewhat and need not file ALL social media content. Instead, consider the content, context and presentation of the communications in order to determine whether they are within the jurisdiction of the pertinent SEC rules and regulations. For instance, firms do not need to file social media correspondence that is simply a response to a question or sharing of existing content from another source. The SEC also officially stated that social media platforms are acceptable for company announcements, as long as investors have been alerted about which social media will be used to disseminate such information.

Common Technology Mistakes and How to Avoid Them

Establishing your own business is undoubtedly a challenging task, especially for those who have become accustomed to the standards and methods of analyzing and processing work through proprietary technology systems as an employee of a large firm. When confronted with the vast number of choices for your own firm, it is easy to become overwhelmed and end up with a less than optimal technology choice.

So far, we’ve provided a great deal of information regarding what fund managers should do. Knowing what you should not do is equally important. Following are five common technology mistakes that new funds make and what you can do to avoid them.

♦ **Looking for the perfect solution.** During the planning phase of your new fund, the idea that there may be one or more solutions that can meet 100% of your technology requirements can be an appealing thought. Some vendors are attempting to develop a turnkey platform to deliver on this promise. However, unless your business is narrowly focused, the chances that a single vendor will meet every aspect of your needs are very slim. Realistically, you will likely need to negotiate, purchase and deploy systems from multiple vendors and service providers. Selecting a single vendor and relying on it to be around in the years ahead may cause your firm to assume more concentrated business risk than you are willing to accept.

♦ **Insufficient planning for the future.** Without envisioning how your practice will look over the longer term—in three or five years—you may be setting yourself up for some short-sighted solutions. Despite your intense focus on completing the immediate tasks of launching your fund, understanding what your firm will look like in the future is important as well. If your fund grows significantly, will you have the necessary technological systems to support that larger business?

♦ **Failing to understand how much you rely on technology today.** Think about the work you currently do today and write down some notes on which systems you use to complete that work (email, reports,
phones, quote feeds, etc.). Now, consider the work that will need to be done in your new hedge fund and what systems you and your team will require to complete it. More than likely, you will need most – if not all – of the same systems, with some additional ones as well. Use this list as a shopping guide when building out your technology platform.

- **Overestimating your capacity to manage technology.** Managing technology is a profession unto itself. Unless you spend most of your free time building servers and managing networks, you will need help managing technology at your new firm. For project-related work (“one-and-done” jobs), you can use consultants and contractors. For ongoing interaction and maintenance of the technology, you can contract with a third party. Also, be sure to consider hiring support or administrative personnel that is skilled with technology.

- **Shortchanging the training options and resources.** Once you have all of your new systems lined up, you need to learn how to use them. Most vendors provide some sort of onsite or web-based training options. If it is reasonably priced, you will most likely want to take advantage of it. Often, the vendor’s professional services arm will know all the quirks of the software package so well that many important details are glossed over during the sales process. They can help you develop the correct workflow to maximize your investment, as well as get you past some of the inevitable challenges. Also, ask the vendor whether there are any established users groups for their software and systems. Often, these communities can be invaluable resources for getting up and running more quickly and with less frustration. Avoid rushing the installation in order to make a set deadline and address any subsequent issues that may arise.

**Technology Considerations Checklist**

**Office Space (requirements for both current needs and future growth):**
- Visit and secure space.
- Design office configuration with an architect and a designer.
- For on-premise environments:
  - Select a contractor for build-out.
  - Determine electrical needs.
  - Arrange for technology equipment room.
- For cloud-based environments:
  - Select a reputable cloud services provider.
  - Work with the provider to configure all systems to meet the firm’s needs.
- Schedule move-in date.

**Website:**
- Determine website and email host.
- Register website domain name.

**Email:**
- Create email addresses.
- Verify that email addresses are working correctly.

**Telecommunications:**
- Determine telecommunication needs, order equipment and schedule delivery and installation.
- Note existing wiring and cable configurations and determine any additional requirements.
- Determine phone numbers for main office and individual lines.
Operational Infrastructure

Coordinating the various functional aspects of your internal operations and third-party service providers is a necessary, but time-consuming task. As your business is formed and launched, you will make numerous decisions about your physical office space, as well as the roles and responsibilities of the people working within your business. As you transition from start-up to ongoing management, you will need to assess and refine your operations. Throughout this process, it is important to approach your operations as a business owner and be able to differentiate between mission-critical capabilities and those that are nice to have, but probably are not necessary.

The firm’s operating agreement will govern many of the high-level activities. However, you will need fully developed and documented policies and procedures for all aspects of your internal operations, from how you communicate with current and potential investors to how you work with your service providers, and from document management to reporting performance.

To create a procedures manual, start by documenting all of the tasks you perform as you complete them and have your colleagues do the same. Have this list compiled into a single document and logically group procedures.
together under common headers or sections. At this point, you can evaluate procedures as they currently exist and identify possible areas for improvement. After further refinement, you will have a working procedures manual that can be shared with others in the firm. This also helps reduce dependency on key individuals who possess the only working knowledge of the tasks they perform.

The approach employed by most hedge fund managers is to minimize the costs and resources associated with maintaining their operations. The cost structure of the firm is one thing that is under the immediate control of the manager, and leaner is better—in most cases, this means outsourcing. Explore the capabilities of your service providers and leverage their resources as much as possible. Some managers believe that, with scale, certain functions need to be kept in house. Others believe in outsourcing those functions so that the systems and people in house are minimized and structured to support the external providers. Whichever approach you choose, a documented plan for how processes are performed will allow you to focus on your investment strategies.

**Disaster Recovery and Business Continuity Planning**

Recently, natural disasters such as hurricanes, floods, earthquakes, fires and the like have hindered business activities around the world. Other unexpected events, like the death of a key individual, a terrorist attack or a loss of power within your office building, all have the potential to disrupt normal operations as well. While the unexpected will always be just that—unexpected—firms that are well-prepared to overcome such events will be in the best position to recover should they occur.

Disaster recovery and business continuity plans are crucial for sustaining operations during outages or disasters. A disaster recovery plan addresses how the business will resume normal operations in the event of a catastrophe. A business continuity plan is somewhat broader in nature, and deals with sustaining normal business operations during periods of disruption.

Both disaster recovery and business continuity planning are essentially means of systematically assessing the potential impacts of various unexpected incidences and determining the organization’s preparedness to deal with such events. During the planning process, firms should aim to ensure little to no business and project interruption during either a planned or unexpected event. In this planning phase, be sure to take the following steps:

1. Assess the business risk and impact of potential emergencies.
2. Prepare for possible emergencies.
3. Document a disaster recovery plan.
4. Outline the business recovery phase.
5. Train staff for the business recovery phase.
6. Test the plan with a realistic dry run.
7. Keep the plan timely.

**Disaster Recovery**

Disaster recovery is directly related to the technology and infrastructure that supports business operations. In developing a disaster recovery strategy, hedge funds typically examine what applications and services they have in production and which ones are mission-critical. File shares, email, accounting and trading applications and voice capabilities are often the first that come to mind, but firms should evaluate which are most essential to them.

The two most important factors associated with disaster recovery planning are the recovery point objective and the recovery time objective.

- **Recovery Point Objective (RPO).** The point in time to which the firm must recover data as defined in advance by the organization
- **Recovery Time Objective (RTO).** The duration of time within which a business process must be restored
after a disaster has occurred

Business Continuity Planning
A business continuity plan focuses on the development, planning and testing of the infrastructure plan designed to address the people, operational processes and business aspects. A hedge fund’s business continuity plan should identify the steps necessary to get operations up and running as they relate to business functions and personnel. These plans are intended to identify mission-critical services, communication strategies, employee recovery procedures and training methods.

There are four critical business continuity planning steps hedge funds must follow:

1) **Identify what you need to protect.** The simplest way to do this is to conduct a Business Impact Analysis (BIA). A BIA should include each functional area of your business (i.e. finance, operations, trading, human resources, etc.). This will help you acquire detailed information about each function’s business requirements – both during normal business hours and during a disaster.

2) **Determine how you are going to protect.** Developing recovery strategies is a great way to plan out your procedures. Identify two or three different scenarios and your corresponding responses. Establish specific communication strategies for each. Be sure to include strategies for both internal and external communications.

3) **Educate employees.** Set up employee information sessions and table top exercises so that everyone is on the same page and understands the policies and procedures. Develop resources to distribute, including emergency contact information, wallet cards and other vital materials.

4) **Validate and test.** Test your alternate site and remote access locations to ensure your business operations will resume quickly and efficiently.

As a new business, it will be necessary to first document your disaster recovery and business continuity procedures before you can begin to fully understand your firm’s needs. By starting from scratch, you will be in a unique position to develop your backup procedures at the same time as you develop your normal procedures. By developing your normal and emergency procedures concurrently, you will likely save time and effort in developing your business continuity and disaster recovery plans and the organization will benefit in the long run.

Office Location and Real Estate Considerations
As you prepare to launch your new company, you will undoubtedly face some overwhelming choices in the area of hedge fund real estate. Will you run the fund from your home office or a hedge fund hotel? Will you sublease space from another business? Will you secure impressive space on a prestigious address with an eye toward future success?

The selection of office space involves a consideration of the projected capacity of your business’ growth, its accessibility for your clients, and the economic expense of carrying a long-term lease on your financial statements. Rent expenses can be significant and vary depending on such factors as the location of the market (rural, suburban or urban) and region (Northeast or Southwest United States).

**Step 1: Explore Your Options**
Securing your office is not only one of the largest initial expenses you can incur as a business owner, but it also signifies a long-term financial commitment. Managers typically have three standard choices to consider:

a. Select an “executive suite” service
b. Join an existing business as a sublessee
c. Set up their own office by renting commercial office space

A. Executive Suite
Executive suites – also known as hedge fund hotels – are well-suited for managers who prefer to observe how their business is growing over a six- to twelve-month period after its inception, rather than commit to a long-term commercial lease. It is also appealing for managers who appreciate the “packaged” approach to running an office, with standardized services and office support included for a set fee. This “plug-and-play” option provides the ability to keep both budgets and lease terms predictable and to a minimum.

Common advantages of this approach include:

- **Leasing Flexibility**: Commercial leases typically require long-term commitments up to around three to five years. By contrast, hedge fund hotels are generally available in six-to-twelve-month leases. This flexibility can be especially attractive to new fund managers who prefer to gauge the firm’s success before locking into an expensive long-term real estate contract.

- **Rapid and Simplified Implementation**: With several of the largest aspects of a new fund launch conveniently bundled into a hedge fund hotel package, managers can expect to become fully operational much more quickly. This allows you to focus efforts on other top business priorities.

- **Technology Services**: Premier hedge fund hotels offer a state-of-the-art technology environment with a skilled IT support team onsite. Some technology services that are often available as part of this package are high-speed Internet access, email services, secure file servers for document storage and comprehensive disaster recovery protection.

- **Telecommunications**: Telecommunications services are typically included as part of an executive suite package. Local and long distance calling is standard, and premier managed suites may incorporate more advanced phone system services as well.

- **Location**: Many hedge fund hotels are located in high-cost real estate areas, such as downtown office complexes. This option provides managers affordable access to prime real estate.

- **Administrative Support**: Most executive suites contain fully-equipped offices, conference rooms, a kitchen and a reception area. These seemingly minor amenities go a long way in presenting a professional, well-established image to potential investors and other important visitors. Additionally, most suites provide a receptionist or administrative assistant to handle such activities as meeting facilitation and reservations.

As appealing as this option may seem, there are some drawbacks as well. Leasing arrangements and contracts will be standardized, leaving little room for significant customization. There may also be a number of hidden costs and fees written into the leasing contract, particularly in the event of a premature breach of the lease agreement. Rates may also be adjusted according to a predetermined and nonnegotiable schedule.

Cost is another consideration. An executive suite for one professional and one administrative staff member can cost between $800 and $1,200 per month, depending on location. Terms of the leasing agreement can be month-to-month, three months, six months or up to two years. Use of the facilities and services are usually charged separately, as the following table shows.
An executive suite is a viable and prudent solution for many new managers who are used to working as employees of large corporations. It can serve as an incubator space for your business, allowing you to observe and adapt your layout and infrastructure needs as you adjust how you and your staff work under your new business model. It is important to understand and clarify all of the costs and potential risks and reserve enough flexibility to accommodate your business expanding at a faster (or slower) rate than originally anticipated.

### B. Subleasing from an Existing Business

Some new managers find the packaged approach attractive, but are reluctant to relinquish the professional, collegial atmosphere of working in a larger office with a team of other investment analysts. Other new managers have extensive professional networks that present opportunities to share office space.

In many ways, this option mirrors the executive suite alternative but with a few critical differences. For instance, when subleasing space, the leasing arrangement is fully customized and you will be directly negotiating with another small business owner. This presents the opportunity to craft your own leasing contract language, but also requires that you thoroughly prepare and understand the terms and conditions of the arrangement.

Choosing to sublease from an existing business should not be a solely financial decision. By physically sharing space with an existing business, you are also implicitly acknowledging certain common characteristics between your business and the business from which you rent the space. Pursuing this approach can also be an opportunity to align with another company that offers complementary services to your client service offering. This is known as “clustering” or positioning your new office by other businesses attracting a similar type of clients.

Benefits of this approach include the following:

- Ability to utilize administrative and support staff from the other business
- Reduced overhead expenses, largely resulting from avoiding start-up and installation expenses for items such as utilities, phone or Internet services
- Shared common areas like meeting rooms, kitchens and reception areas

Because costs are typically negotiated between individuals, estimates will vary greatly. However, most managers should expect to pay the price per-square-foot estimate of the entire office space, with either a pro rata charge for use of common spaces, such as the reception and meeting rooms, or a fixed-fee arrangement.

### C. Leasing Commercial Office Space

For maximum freedom in designing and planning your own office, leasing commercial space may be the best option. While this affords the best opportunity for customization, it also means you will have to commit to a lease term, which typically is between three and five years in most commercial office buildings. Consequently, leasing
commercial office space can be the most expensive of the three options. However, this approach does have significant advantages.

You can either work with a commercial real estate advisor to find office space and negotiate the lease agreement, or undertake the search and selection process on your own. By directly contracting with the commercial landlord, your leasing contract can be very customizable. Regardless of how you choose your office space, having the paperwork reviewed by an attorney or real estate specialist is highly recommended. Also, it is crucial that you familiarize yourself with the commonly used lease terms in order to secure the most favorable lease arrangement for your new business:

- **Permitted use of the premises.** This clause sets forth the permitted uses of the leased space. If the landlord agrees to a broad range of uses, it allows you to be flexible in how you utilize your office space.

- **Lease term.** As a new manager, a conservative estimate of your business’ growth and need for the office space would result in a shorter-term lease with renewal options. If you want to remain in the office space for a longer period of time, commercial landlords will usually offer either discounts or some concessions, such as reduced parking lot fees or upgrades in exchange for the extended tenancy.

- **Rent escalations.** It is rare for a landlord to maintain a fixed-rent rate, so lease agreements contain percentage increases usually determined by the Consumer Price Index or another real estate index. If you are considering a lease period of three years or longer, you may be able to defer rent escalations for the first two years. Frequently, you can also negotiate a cap on the amount of annual rent increase.

- **Tenant improvements.** One of the most appealing aspects of leasing from a commercial landlord is adapting the office space to your vision of the firm. Most standard commercial leases prohibit you from making alterations or improvements without the landlord’s consent. Many businesses ask for a clause that permits them to make alterations or improvements with the landlord’s consent, so long as the consent is not unreasonably delayed or withheld. Also, consider including a separate clause for minor alterations or improvements that are nonstructural in nature, such as painting, without having to secure the landlord’s consent.

- **Repairs, improvements and replacements.** Generally, commercial landlords protect themselves by inserting a clause into the lease agreement stating that, at the termination of the lease, the premises must be returned to their original condition. If you are planning any customization of the office space, make sure to spend some time discussing this clause with the landlord.

- **Renewal options.** This clause is your opportunity to renew your rent at a fixed, predetermined price, rather than “fair market” value.

- **Right of first refusal or first offer for additional space.** As you contemplate your firm’s growth past the initial three-year time period, you may want to secure the right (but not the obligation) to rent any office space that becomes available before the landlord offers it to any other third parties. Usually, this means that the landlord would present you with the terms of the deal being offered to a third party and you would have the opportunity to match the deal. It may also be possible to negotiate for the landlord to pay for the moving and renovation costs associated with a relocation move, particularly if you end up leasing a larger office space.

- **Personal lease guarantees.** Some landlords may want to include a clause in the lease agreement that makes the business owner personally liable for any damages or overdue rent, even if the tenant is a
corporation or another type of business entity.

It bears repeating that it is essential to read and understand all of the terms in your lease. Also, carefully examine the “work letter,” a document that accompanies commercial leases and describes standard fixtures, upgrades and repairs for which your landlord is willing to pay. If you plan on updating the space, the work letter may include information about whether you or the landlord bears the cost of the improvements.

The cost of commercial office space depends on your regional location, the building’s location within the area, and the location of the office space within the building itself.

**Step 2: Determine Your Spacing Needs**

When determining office space, you may, at first, only consider your “professional” office space, or those areas used for client meetings. However, office space includes all areas that function for your business, or the total “usable space” from the hallways to the kitchen and supply rooms.

When calculating office space needs, keep in mind how you would like work to flow within your office and how you would like clients to perceive your space. If, for instance, you conduct all your client meetings at their residences or places of business, you may not require significant meeting space or large conference rooms. On the other hand, if your clients are accustomed to coming to your office, then you may need to select a layout that is conducive to client meetings and frequent visits.

**Step 3: Review Your Lease**

Before signing any lease agreement, be sure to have the paperwork reviewed by an attorney or real estate specialist. This last step ensures that you are aware of the implications and meanings of all terms and conditions within the lease.

**Additional Items for Consideration**

For the vast majority of new managers, leasing office space represents one of the largest capital outlays during the start-up phase of a new hedge fund. As you determine which office space fits your business requirements, be aware of the length of commitment and cash requirements. In your evaluation of office space, make sure it meets realistic financial forecasts and offers some degree of flexibility. Finally, be certain that the office space you select is one in which you can envision yourself working and meeting with your clients.

**Checklist – Operational Infrastructure**

**Processes and Procedures:**

- Document the systems in use.
- Compile job descriptions for each individual.
- Have every individual document the tasks and workflows they perform.
- Combine operational documentation into a procedures manual.
- Have your auditor review your procedures manual.
- Create business continuity and disaster recovery plans.

**Office Location:**

- Define the goals for the office space, such as client and colleague interactions, location, accessibility and personal expectations for workspace.
- Determine your preference for a short- versus long-term commitment.
- Develop a budget and timeline for making your decision and occupying the new office space.
- Research different options and narrow down your choices.
- Identify the common facilities, such as lobby and parking space availability.
- List any specific requests, including upgrades or changes to the office space.
Service Provider Selection Process

With initial plans determined, the next step to formulating a new hedge fund is selecting your service providers. Many individuals contemplating a hedge fund launch have pre-existing relationships with one or more service providers, and frequently these service providers can recommend others who may fit well with your new business. You will be relying heavily on these third parties to meet the needs of your business and partner with you as your hedge fund grows.

Here are some items to consider when selecting your providers:

♦ **Counterparty risk.** This is the risk that your service provider will not be able to live up to its obligations. A provider’s failure to perform can be a result of poor management or assuming too much credit risk, fraud or other bad business practices that often result in lawsuits—all of which can lead to poor service (or no service at all if the company fails). Given the recent turmoil at financial institutions, counterparty risk has never been a more relevant consideration. In evaluating potential service providers, you need to be able to ascertain the reliability of the ongoing service they can provide, as it is an extension of the service you provide to your own clients.

♦ **Ability to serve you as both a start-up hedge fund and a large, well-established one.** As a start-up fund, you have specific needs. While many of the processes and procedures will remain the same as the fund grows, the level of interaction will likely increase. Additionally, your needs may evolve and become more complex over time, so selecting providers that can support you now, as well as in the future, may keep you from outgrowing the services and support they can provide.

♦ **Support provided.** Support services may be particularly important during the initial phase of launching your fund. Many providers have additional services specifically targeted to start-up funds to help them plan, prepare and successfully launch their fund. Additionally, because you will be interfacing with some of your service providers on a daily basis, you will need them to be responsive when problems arise. Questions about how problems and other issues are resolved and how long resolutions typically take are good ways to assess the responsiveness of the support provided.

♦ **Additional capabilities.** Are any additional services or capabilities currently in development, and does the service provider have a reputation for being an innovator? The hedge fund industry is always in a state of evolution and having providers who see emerging trends and plan for your future needs can be an extra benefit for you.
Selecting Legal and Administrative Service Providers

**Lawyer**
Legal counsel will inform you about the various regulatory aspects of operating a hedge fund and the registration requirements and will help you determine the appropriate fund structure. A lawyer will also prepare the legal documents necessary to form, operate and market your hedge fund. These documents include, but may not be limited to, the following:

- Limited partnership agreement
- Operating agreement
- Subscription agreement
- Private placement memorandum
- Offering memoranda

**Accountant**
The numbers your firm generates are extremely important, and their accuracy is critical to your success. In addition to providing you with audit services and K-1 preparation for the fund’s partners once the fund is launched, your accountants can help you review the initial documents drafted by your lawyer before they are finalized. In their review, they can offer advice on the tax implications associated with entity selection and manager compensation. Additionally, if you choose an accountant with hedge fund experience, the accountant should also be able to coordinate with your administrator, prime broker and internal accounting staff.

Of particular significance and importance is the annual audit, which will be performed by your accountant. During the audit, your accountant will review your financial statements and the capital accounts of the investors (partners) of the fund. In this review, your accountant will be assessing the controls in place to ensure that accurate accounting, operations and trading procedures are followed. As part of this process, your accountant will provide a statement of account to each of the investors, as well as conduct a review of the partnership agreement to determine the partnership percentages.

**Prime Broker**
Your prime broker provides the fundamental services of custody of assets and access to financing and securities lending. Other services that are central to the offering of a prime broker include executing orders and portfolio reporting. The suite of services offered by prime brokers has greatly expanded in recent years beyond the core services they offer. Start-up assistance, technology and support services, capital introduction, operational support and even office space are some of the areas where prime brokers can assist you. As much or as little support as a manager needs is generally available with the goal of allowing you to focus on the core concerns of your business.

**Administrator**
A third-party administrator is not required to successfully operate a hedge fund. However, they can relieve a significant amount of the burden from the manager and improve the consistency with which certain tasks are handled. Many managers use administrators to serve their investors and effectively act as their outsourced accounting department. Monthly accounting and net asset value (NAV) calculations, performance fee calculations, record keeping of investors and management fee calculations are the services typically used. While these functions can certainly be done internally, it can be time consuming for the manager to do them and costly if staff is hired to perform them—particularly in the early stages of a fund.

In every instance, your reputation can be helped or hindered by the providers listed above, and cost is not always an accurate indicator of the quality of service and support you will receive. Technical skill, responsiveness, trust and expense should all be considered when evaluating providers. It will be necessary for you and your operations personnel to coordinate the operating functions among your accountant, prime broker and administrator.
Selecting Technology Services Providers

When selecting technology service providers for your new hedge fund, be sure to give careful consideration to these eight important factors:

- **Breadth of Solutions.** Does the IT provider offer all of the solutions and services necessary to encompass all aspects of the technology foundation required to help your firm operate effectively and efficiently? These can vary depending on your firm’s specific business requirements, but may include such solutions as backup & recovery services, business continuity planning, disaster recovery, email & social media archiving, telecommunication services, cloud services, application hosting, consulting and project management.

- **Depth & Quality of Staff.** When selecting an outsourced IT provider, it is crucial to understand with whom you will potentially be working. Is the organization led by a seasoned, reputable management team? Do they employ a skilled technical staff of engineers and analysts to assist with all stages of your infrastructure build-out and maintenance? What pertinent technical certifications do they hold? In addition to ensuring that the provider has a top quality team, it is also important to note the depth of that staff. In other words, do they have a team of engineers and analysts that is large enough to ensure that someone will be available to assist you 24x7x365 if necessary?

- **Experience in Deployment.** Does the service provider have deep experience in deploying these types of solutions and services in an investment management environment? Do they have experience working with funds of all sizes, from small start-ups to large, well-established firms? There are numerous outsourced IT providers out there, but be sure to select one that is experienced in deploying systems that are specific to your industry and has a solid understanding of your business environment.

- **Project Management Experience.** Will your firm receive the benefits of a dedicated project manager and accompanying staff to ensure that your initiatives are coordinated, designed and implemented to your exact unique requirements? For instance, if you choose to relocate offices, does the provider have the expertise and experience to facilitate this process?

- **Private Cloud Infrastructure Options.** Cloud computing has emerged as the prominent trend in investment technology. Look for a provider that offers a robust, scalable and secure cloud infrastructure model. Also, ensure that the infrastructure is maintained by a team of highly trained and certified professionals with experience in financial services operations. Tier III data centers (or higher) that are SAS70 or SSAE-16 certified should be used to host your firm’s critical data.

- **Disaster Recovery Policies & Procedures.** Does the provider maintain contingency plans or disaster recovery plans with proper risk controls designed to allow continued performance and availability at all times? How will the provider ensure that your data is secure, protected and accessible even in the event of a disaster?

- **Vendor Relationships.** Does the organization have strong vendor relationships in place that will allow them to leverage the benefits of best-in-class third-party providers on your behalf? Strategic partnerships with top-tier technology companies are crucial to maintaining a world-class IT environment for your firm.

- **Geographic Reach.** Does the provider have offices dispersed in different areas of the country and around the world? Do they employ staff in different time zones to ensure that assistance is available to you 24x7x365? If your firm has multiple offices, or is considering opening more in the future, ensure
that you will be able to use that provider to service all regions, thereby streamlining costs and increasing efficiency.

Evaluating a Cloud Technology Provider
If your firm has decided on a cloud-based IT environment, selecting the right cloud services provider to meet your unique business needs is crucial. Following is a detailed list of the most important questions to ask potential cloud technology providers to help guide your evaluations.

Questions Regarding Services and Practices:
- Is the provider’s cloud infrastructure built with an N+1 configuration to withstand equipment failure?
- What are the cloud provider’s backup and retention procedures? How long is data retained?
- What is the provider’s disaster recovery strategy, and how frequently is it tested?
- What type of security and monitoring practices are in place at the data center(s)?
- Who can access the provider’s data and at what level?
- Can the provider share an audit trail which logs who has accessed what?
- Is data encrypted at rest as well as in transit?
- What Service Level Agreements (SLAs) are in place for the infrastructure and applications? What is the agreed upon uptime?
- How are support requests handled, and what is the expected response time?
- Has the provider ever experienced a security breach? If so, how was it resolved, and what safeguards were implemented to prevent a repeat experience?
- Is the data center SAS70 or SSAE-16 certified?

Questions Regarding Internal Practices:
- How financially stable is the provider? Can they provide audited financials? Can they sustain business in the long run?
- When an employee leaves, what is the process for blocking access to applications to prevent data downloads?
- How does the provider prevent employees from sharing login credentials with unauthorized employees?
- How are user roles defined and enforced to control access levels?
- Who has the authority to add new users?
- How often are employees be required to reset passwords? Are there requirements around complexity standards for passwords?

Questions Regarding Application Hosting Services:
- Which application vendors have systems operating in the cloud?
- Does the application vendor confirm their product works in a hosted environment?
- Are there any issues associated with virtualizing the applications?
- How is the application deployed? Does the software run native over the Internet, or does it require a delivery mechanism such as Citrix?
- Are there any limitations with this type of deployment? Are there certain pieces of functionality that will not work if remotely deployed? Are there display limitations?
- How many clients for the specific application have a hosted implementation?
- What certification levels does the cloud provider have with these application vendors?
- Will the application vendor help with a “proof of concept”?
- Will there be any changes to the level of service if the application is deployed in a hosted environment?

When selecting legal, administrative and technology service providers, it is always important to evaluate multiple providers in order to get a thorough understanding of the capabilities they have, evaluate pricing and gain additional perspective on your needs. When selecting any provider, ask them for recommendations on your other
providers. Having worked with many hedge funds, it is likely that they will be able to give you valuable advice and potentially shorten your search. If you do not have an existing relationship with any service providers, you should begin your search by evaluating and selecting an attorney, then proceed with the others from there.

Human Resources Considerations

Hedge fund managers have varying backgrounds, but many have spent at least a portion of their careers working for large, full service firms. As a business owner, you will no longer be provided with resources like compliance, marketing materials and support, research and technology software and systems. Instead, you must now find these on your own or perform tasks yourself. The ability to tailor your in-house capabilities is one of the most significant attractions to owning your own firm, but can also seem overwhelming to create and implement. One of the biggest challenges for some new managers is to determine staffing.

When establishing your own firm, the idea of building a network of both processes and people may seem daunting, but this is an opportunity to design your staffing model to fit the unique needs of your business. Depending on your approach, the firm will require a combination of different types of staff.

There are two main types of staff addressed in this guidebook:

1) Front-office employees who design and implement the investment and business management strategies of the firm, and
2) Operations support and administrative staff who have the primary function of supporting the various operational aspects of the business.

Dedicated front-office employees are the individuals responsible for developing, designing and implementing the firm’s strategies in terms of business and investment management. The senior investment professionals, such as chief investment officers, portfolio managers, analysts and traders are included in this classification, along with the firm management (e.g. chief executives, financial, compliance and operating officers).

Operations support and administrative staff include any individual who supports the front-office employees or the business itself. To the extent necessary, operations support staff members also coordinate the compliance, operations, cashiering and trading functions to ensure that the transactions are settled in a timely and appropriate manner. Receptionists, administrative assistants and office managers provide administrative support by performing secretarial and clerical duties, such as screening and routing telephone calls, scheduling appointments and typing correspondence.

Selecting the Right Staffing for Your Firm

How complex should the staffing structure be in your new firm? What positions do you need to fill and how many individuals will occupy those positions? To a large degree, the answers to those questions depend on the initial size of your firm. Many managers who are just starting out do it alone without any staff. However, if you will have multiple people working in your firm, it is helpful to answer the following questions:
How many investors and how much capital will your fund have when it is launched? (If you will be serving a large number of clients at the time of launch, you will likely need a more robust organizational structure to ensure that you can deliver what you promise.)

Which functions do you think you will enjoy and be effective at? Which aspects of your job would you prefer to delegate to others?

Do you enjoy working independently or would you rather work in a team-oriented environment?

What are the essential functions at your firm? What would be complementary but not strictly necessary?

What are the values and culture that you want for your firm?

Most new funds are operated by the managers alone. In these cases, managers are required to perform every function within the firm (research, trading, management, etc.). But as a firm grows in size and scale, so does the scale of the functions being performed. Where the research, compliance, general office management and marketing functions were at one time easily performed by a single individual, a firm’s growth increases the scale of each job to a point where another individual may be needed to spread the workload.

With the management and financial responsibility of first finding and hiring all levels of staff, and then compensating them in salary, bonuses and benefits, it may be wise to begin with a lean organizational structure to minimize compensation expenses. This is the common mentality of most hedge fund managers, regardless of the size and scale of the fund. It is particularly common among start-up managers who often do not draw a salary in the months that immediately follow the launch of their fund. Any expenses will lower the performance of your fund and will likely have to come out of your own pocket. Conversely, you may be inclined to add staff from the beginning as an investment expense, which will ensure sufficient capacity for future growth.

Certain positions are mandatory. For example, any hedge fund that is not exempt from the Advisers Act is required by the SEC to have a designated chief compliance officer. You may fill this role as you set up your firm. If, however, your firm will start as a more complex organization with a large number of staff, you may need either to have an outside professional assist you with the responsibilities of the role (in which case you would still be the designated chief compliance officer), or hire an individual to work exclusively as the chief compliance officer and assume the title for SEC purposes. The chief compliance officer ensures the safety of client data, enforces adherence to federal, state and self-regulatory organization securities regulations and creates and supervises the firm’s code of ethics, policies and procedures. Many technology service providers have created compliance packages and solutions to assist you with developing and implementing a compliance system, but this does not eliminate the need for a chief compliance officer at your firm.

Estimating the Cost of Your Firm’s Staffing Structure

Each position has an associated cost. Initially, you might estimate those expenses as the cost of labor—salary and benefits, with perhaps some bonus or incentives—and end the financial consideration there. However, a number of affiliated costs accompany each staff position.

Calculating the financial expense of compensation is fairly straightforward. Cash compensation is comprised of an individual’s salary and bonus (incentive pay). When seeking candidates qualified for these positions, bear in mind that adjustments are always needed to make any compensation figure relevant to your geographic location and its cost of living. As a hedge fund manager, you may receive several forms of compensation. Typical manager compensation structures often include pay for investment performance on an annual basis, as well as a fee for managing the assets within the fund. Generally, the portion you retain is the net of these fees and the expenses of the fund.

Other staff members, however, will likely have base and incentive compensation components, meaning that part of their pay is performing their job and the incentive (or variable pay) rewards for individual or firm performance.
Retirement or 401(k) Benefits

A 401(k) plan has become a standard part of benefits packages and compensation schemes. It is perceived as a valuable option for firms considering a retirement plan, providing benefits to both staff and owners. When you consider establishing a 401(k) benefits plan, some key preliminary determinations must be made.

- **Should I self-manage or outsource?** Your firm can establish its own 401(k) plan with administrative procedures, guidelines and access to funds, or you can use a third-party institution, such as a mutual fund firm, bank or insurance company.

- **What kind of plan?** You need to select a type of 401(k) plan. The three types of 401(k) plans are Traditional, safe harbor and Savings Incentive Match Plan for Employees (SIMPLE). Many small businesses select the SIMPLE 401(k) plan, which is applicable for firms with fewer than 100 employees. Research the tax advantages and employer duties associated with each type and then adopt a written plan.

- **Who will be the plan trustee?** The next step is to arrange the trust fund for the plan’s assets. Because the financial integrity of the plan and its assets are paramount, your selection of who the plan trustee will be is one of the most critical decisions in this process. If you choose to use an insurance company for your plan administrator, typically you will not require a trustee.

- **How do I develop a record-keeping system?** A third-party administrator usually handles the accounting and record keeping of the plan assets. Remember that the financial record is a key part of the annual report that must be filed with the federal government.

- **How do I roll out the plan to employees?** Most plans have a summary plan description (SPD), which educates the participants and beneficiaries regarding the characteristics and mechanics of the plan. It is part of the plan document that is distributed to all participating employees.

- **Should I offer any added perks, like an employer contribution?** This is very much your own business decision, resting on both your willingness and financial capacity to make the 401(k) contributions. During your firm’s start-up phase, it may not be financially feasible to promise employer contributions. From a management perspective, it is easier to enhance a plan at a later date when the business can clearly afford it, rather than revoke a plan contribution in light of a tight financial situation.

Outsourcing Your Human Resources Administration

In large organizations, the human resources function is departmentalized within the administrative area of the business. However, as the manager of a start-up hedge fund, you will need to become familiar with many of the functions that fall within this arena, as well as the legal requirements you assume when you employ staff. Since human resources administration is typically not a core competency possessed by most new fund managers, you may want to consider outsourcing much of the oversight as you focus on launching your fund. Professional employer organizations (PEOs) provide many human resources-related functions including, but not limited to, the following:

- Employment administration
- Benefits management
- Retirement services
- Government compliance
- Employer liability management
- Recruiting and selection
These businesses essentially assume the role of your human resources department. From hiring to employment, and even termination, these companies can provide you with significant levels of support. Often times, a business may not have the funds, staff, time or expertise to manage the human resources functions that must exist within it. In these cases, outsourcing can be a cost-effective solution to building a human resources capability within the firm. In other cases, these businesses can provide experience and support in dealing with human resources-related issues, such as employment laws, and can assist in meeting all of your legal requirements and maintaining the appropriate paperwork. However, if you are not comfortable with an outsider handling your human resources functions or if the costs outweigh the perceived benefits, outsourcing probably is not your best option.

**The Critical Factor—Firm Culture and Values**

No organizational and staffing plan can be successful unless it has incorporated the firm’s culture and values. One of the most compelling reasons for setting up one’s own business is the opportunity to define its identity. Each individual who is part of your business will impact your ability to adhere to and exemplify those values.

If the total staff of your fund only consists of you and your partners, then establishing a culture for the firm will be of lesser importance. The management of your own time, schedule and values may be challenging, but is at least straightforward. As soon as other individuals are added to the team, however, culture becomes an important consideration for how you recruit, retain, develop and compensate employees.

When considering your firm’s ideal culture and values, you will likely identify the importance of the client relationship or adherence to standards of professional excellence as fundamental cultural principles. However, the definition of culture and values should also incorporate the following:

- What kind of behavior do you expect from your staff?
- What are the performance expectations for the staff?
- What kind of professional environment do you want to foster?
- What are the critical elements of the firm’s success and how do you articulate that in the cultural value statement of the firm?

Each candidate for a position at your firm should be gauged against your firm’s cultural statement and values. By doing this, you can see beyond the list of technical accomplishments on a résumé and delve into how that person will work within your firm.

Your staff represents one of the most significant investments you can make for the future success of the business. Selecting the right “fit” in terms of experience, technical skill, personality and alignment with the culture will define the ability of your business to consistently deliver its service to an ever-growing number of clients, while affording you the opportunity to realize the economic and personal fulfillment of a leveraged and productive organization. The following checklist outlines key points to keep in mind as you build your staffing structure.

**Checklist – Human Resources Considerations**

- Identify your organization’s operating and staffing model.
- Define the job positions and compensation structures, with roles and responsibilities for each position.
- Align the positions to the business’ internal workflow.
- Determine whether you will outsource your human resources administration to a third-party organization and, if so, select a provider.
- Develop a budget and timeline for making your decisions and prioritize key hires for your business.
- Create any employment contracts, such as non-compete agreements, and have an attorney review the documents where appropriate.
- Define your firm’s technical needs and cultural values.
Insurance Considerations

Launching your own hedge fund means that you are in total control of your business. While this can be empowering, exciting and rewarding, you also have the responsibility of managing the associated risks.

As a successful hedge fund manager, you know that every strategy is accompanied by both risk and reward. Just as you explain the risk and reward relationship of an investment to your clients, the risk of starting a business is just as important a consideration as the potential return. As you contemplate the ownership of your firm, be sure to effectively plan for your assumption of business risk so that you can more fully enjoy your business rewards. Before beginning any work to establish your fund, it is necessary to address all of the business insurance requirements that can help to mitigate your business risk.

There are five common types of business insurance that you may need for your firm:

- **Professional liability.** Commonly referred to as “errors and omissions” (E&O) insurance, this type of insurance plan protects your firm and your personal assets against legal liability resulting from any errors or omissions relating to your client service deliverable or process.

- **Commercial property and liability.** Obtained through a commercial insurance agent or firm, this type of insurance, also known as “property and casualty” (P&C) insurance, offers protection against most risks to property, such as fire, theft and some weather damage. This includes specialized forms of insurance, such as fire, flood, earthquake, home or boiler insurance. A casualty insurance policy covers losses that are directly caused by unforeseen events, such as natural disasters.

- **Fidelity bonds.** This type of insurance protects the firm from losses related to employee dishonesty. It covers those losses incurred as a result of fraudulent activity by a firm’s employees.

- **Employment practices liability.** This insurance coverage is designed to protect the firm and owner from charges such as discrimination in hiring, wrongful termination and other workplace liabilities.

- **Directors and officers liability.** As the officer or director of your firm, you will want to protect yourself and other firm directors and officers. This type of insurance provides indemnification claims brought against the firm’s officers and directors for breach of fiduciary duty.

Depending on the type of clients with whom you work, you may require additional, specific types of insurance. For example, if you plan on working with ERISA plans, you will likely be required to hold ERISA bonds. Individual states may also mandate surety bonds or a surety affidavit, which is designed to address the net capital and net worth minimums in each state.

**Employee Medical Coverage and Insurance Plans**

While the previous categories of insurance cover you and your business, your employees require separate types of insurance. In firms that have staff other than managers, the following types of insurance are usually offered:

- **Health.** The term “health insurance” refers to a range of insurance policies, such as those that cover the costs of doctors and hospitals and those that meet a specific need, including dental and vision coverage. Generally speaking, health insurance is designed to cover doctor bills, surgery and hospital expenses.
Capable Discriminating

**Group life.** For many firms, group life insurance is an attractive benefit to offer to prospective employees. Generally, the amount of life insurance coverage offered is equal to the employee’s annual salary. The firm usually pays for the premiums; alternatively, an insurance company may mandate a certain percentage of employees to participate in the plan. A group life insurance plan may be enhanced through coverage of additional items, such as travel protection or coverage for dependents and families, with the cost charged to the employee.

Managing your firm’s business risk is just as important as creating and implementing a strategy for its growth. The numerous considerations regarding liability and insurance may seem overwhelming, but there are a number of resources, from your commercial insurance agent to your attorney, banker and prime broker that can help you perform the research necessary to make informed decisions regarding these matters.

**Checklist – Insurance Considerations**

- Document the different kinds of insurance you will require for the business and for yourself.
- Develop a budget and timeline for making your decisions.
- Consult with insurance companies and other third-party resources.
- Align insurance coverage activation with the formation of your fund.

*Capital Raising*

A hedge fund’s success is heavily dependent on a manager’s ability to raise capital. As a fund manager, you need sufficient assets to manage to successfully implement your investment strategy. After rigorously developing and testing a strategy, you must raise money from potential investors. There are many important factors to consider when developing a plan to attract capital investment, including the types of investors to target, the materials needed to present your fund and important regulatory and legal requirements.

**Factors to Consider When Targeting Investors**

One of the first critical steps in developing a plan to raise capital is to determine what types of investors to approach. Potential investors evaluate several factors when deciding whether or not to invest in a hedge fund, including the manager’s pedigree and previous track record, as well as the longevity of the fund. Start-up hedge funds will generally target investors who are different from those that are targeted by funds with an established track record. Based on these parameters, determine what types of investors would be most appropriate and detail a plan to attract those specific groups accordingly.

- **High-net-worth individuals.** High-net-worth investors often invest on an individual basis or as part of a family office. Family offices consist of high-net-worth investors who have created partnerships and an institutionalized structure by which to invest. Family offices will generally invest in a mix of both start-up funds and established firms. They are more likely to invest in funds with fewer assets under management, and they tend to look for funds that will provide diversification in their portfolio and
have the potential to generate significant returns.

- **Institutional investors.** Institutional investors include pensions, foundations, endowments, funds-of-funds, consultants and banks. Institutional investors, especially those that manage money for other individuals, usually have fiduciary responsibility and are more likely to scrutinize a hedge fund’s size and track record. They often look for larger funds that have sizeable assets under management and have had a strong performance record for several consecutive years. As institutional investors have the potential to invest large sums of money, they usually are more conservative when making investment decisions. They seek returns, but tend to be more averse to risk than their high-net-worth counterparts.

- **Seed and incubator investors.** Seed and incubator investors can be either high-net-worth individuals or institutional investors. Seed investors usually invest during the early stages of a hedge fund’s development, including start-up. However, since these investors often provide some of the initial capital to help launch a fund, they might look for certain privileges, such as partnership rights or reduced fees associated with making an investment.

- **Funds-of-funds.** A fund-of-funds is a pool of money from multiple investors that invests in multiple hedge funds. A fund-of-funds will often diversify its investments and invest in both start-up and existing funds with different strategies.

**Allocation of Resources to Market**

After you have determined what types of investors to target, develop a strategy using the best approach to successfully market your fund. Your fund can choose to either hire internal staff or retain third-party vendors to promote the fund. If conducted in-house, your marketing team will generally leverage its network of friends and family and possibly third-party resources, such as prime brokers, to find potential investors. This approach can be beneficial in that you will not have to pay external vendors for marketing support and can have more control over the process. However, your staff may not have the necessary expertise or network to adequately market the firm. In this case, you will have to consider outsourcing the marketing function.

Third-party marketers are outsource firms that specialize in marketing start-up hedge funds to different types of investors. You may choose to outsource the responsibility to experts who focus on this service so you do not have to hire and manage an internal staff. However, hiring a third-party marketing firm can be costly and often entails some type of retainer, as well as a potential share of both your management and performance fees.

In addition to marketing your hedge fund, you may also elect to hire a public relations firm to help generate more publicity with the goal of gaining additional credibility in the marketplace and attracting more investment capital.

**Marketing Your Fund**

After you have decided which resource—in house, third-party, or a combination of both—to use to market your start-up hedge fund, the next step is to prepare marketing materials. Your fund will need to create several pieces of information, including a fund profile, a due diligence questionnaire, an investor presentation and an offering memorandum, among other documents. The materials should highlight the biographies of your principals, the fund’s strategy and any historical returns the fund has generated.

Once the materials have been finalized, you and the individuals you have chosen to share in the responsibility for marketing the fund should prepare the sales presentation to potential investors whom you have previously identified. In addition, your team should research speaking opportunities, such as third-party industry conferences and prime brokerage events, as potential platforms to gain exposure to the investor community. Your hedge fund should also explore inclusion in third-party databases, such as Eurekahedge. You can also leverage third-party capital introductions resources, such as websites that bring investors and managers together.
At a minimum, your marketing plan should include the following:

- A discussion of your strategy and why it is superior to other hedge funds that are currently launching
- A list of your marketing objectives, including:
  - Types of investors you will target
  - The amount of capital you are seeking to raise
  - Other objectives unique to your fund’s strategy
- A detailed marketing plan, including:
  - An outline of the specific itemized steps and timeline to be followed
  - Marketing materials to be created
  - All regulatory and legal requirements
  - An internal person who is responsible for making sure the marketing plan is implemented
  - The hiring of any appropriate third-parties to assist you in the capital raising and public relations efforts
  - Budget, including allocation of economic and personnel investment

Additional Items for Consideration

It is imperative that, as a hedge fund manager, you consider regulatory and legal requirements when preparing marketing materials for your firm. There are specific regulations about who a fund can and cannot approach (i.e., hedge funds can only market to accredited investors), and which vehicles you can use to promote your fund. Thus, it is important to consult with legal counsel when preparing marketing materials for your fund.

Checklist – Capital Raising

- Develop a profile of your target investors.
- Consider all regulatory and legal requirements.
- Outline a marketing plan.
- Plan a budget allocation.
- Determine internal and external resource requirements.
- Draft a pitchbook to guide your conversations with potential investors.

A Final Word

We hope that you have found this guidebook to be a useful tool for getting your new hedge fund off to a strong start. It is only an introduction to the exciting world of hedge funds, but it can serve as a roadmap to help you determine and organize your next steps. More help—from business consulting to technology outsourcing to innovative trading solutions—is available if and when you need it.

If you would like to learn more about Eze Castle Integration and how our team of experts can help make the launch of your hedge fund a success, contact us by calling 800-752-1382 or visit us online at www.eci.com.
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