Launching a Hedge Fund:

10 Keys to Success

from marketing to technology, the top tips for achieving startup success

EzeCastle INTEGRATION

It may be a dream for most, but the desire to start a hedge fund is a real one for many aspiring and emerging managers. And while many new hedge funds launch each year, the unfortunate reality is that almost as many firms close each year. The ability to sustain a new launch beyond the first year is a challenging feat, and the barriers to entry are higher than ever.

The list of decisions facing a startup firm can be seemingly endless. How will I structure my fund? Where and how will I raise capital? How many employees can I support? Will I outsource my technology or hire a CTO? How do I comply with regulations? The answers to these questions cannot be made in a matter of days. They require months of preparation, thought and care and will have a tremendous effect on the success of the firm.

Beyond making legal, operations and technology decisions to support the business function, new startups are also entering an environment that is more demanding than ever. Competition for investments is high, investors are savvier than ever, and they expect startup firms to operate at an enterprise level from day one. Transparency is critical, and operational excellence is non-negotiable. If you aren't building your investment firm to succeed beyond the confines of the trading floor, then your success will be short-lived if achieved at all.

With this culture shift in mind, we've identified 10 critical considerations for new managers to address as they enter the startup phase. Our insights addresses marketing, operations, and of course technology and should serve as a guide for firms seeking launch success.

#1: Do your legal homework.

One of the first decisions you'll need to make as a new investment manager is how to set up your hedge fund. Your organizational structure will typically reveal itself as a limited partnership (LP) or limited liability company (LLC). You may also consider a master-feeder fund structure, which could provide favorable benefits, and a domestic or offshore choice may also come into consideration. Many of these decisions will be impacted by the assets you plan to launch with or if you're using or planning to solicit seed or acceleration capital.

Based on these structural decisions, you'll need to determine your tax implications as well as regulatory requirements. In the United States, the Securities and Exchange Commission (SEC), under the Dodd-Frank Act, requires asset managers managing more than $150 million in AUM to register and hence meet a host of reporting requirements.

#2: Create a marketing plan.

Once upon a time, hedge fund marketing was generally frowned upon, and in some cases, illegal. It wasn't until the JOBS Act was enacted in 2013 that hedge funds finally had the opportunity to shed their fears of noncompliance and publicly market and advertise their funds. There are a variety of communication options firms can use to solicit investors – from traditional print and websites to social media, video and email marketing. Regardless of how, firms should build comprehensive marketing plans that will support their business beyond the launch phase.

During the initial marketing phase when a new launch is looking to secure startup capital, it's important that firms understand their key selling points. Ask yourself: who am I and what makes my firm stand out? Determine what exactly your marketing pitch will be and how you plan to go about promoting it. During this initial period, consider investing in a customer relationship management (CRM) tool to help you monitor and track investor communications.

Post-launch, you'll want to stay in close contact with those early-stage investors (here's where the CRM system becomes critical). Your success at this point – or lack thereof – will help you determine if you need to tweak your marketing pitch moving forward.

Long-term, you should plan to implement a comprehensive marketing plan. Identify your targets and marketing/advertising venues so you don't have to make decisions on the fly. Again, your CRM system comes into play here and will assist you in tailoring your messaging for future communications.

#3: Select the right service providers.

Every successful hedge fund needs smart partners on their side, therefore deciding what service provider your firm is going to engage with is one of the most critical decisions your new startup will make. As a new firm, you won't be able to manage all aspects of your operations internally. The due diligence process plays an important role here; you should thoroughly vet service providers to ensure you have the information necessary to assist you in the decision process.

You'll want to select vendors and service providers your firm can grow with. If you outgrow your vendor quickly, it can be a significant operational disruption to transition to a new one. On the technology front, for example, migrating your data from one provider to another can be a tedious and time-consuming effort – one you likely won't want to spend time on.

Positively, using best-in-class vendors will say a lot to investors about the value you place on your firm. You recognize you can't do it all alone and have selected reputable service providers to entrust with your firm's needs. From a technology perspective, investors will appreciate that you've made an investment in systems and processes that support your business and trading operations, and it will give them peace of mind knowing your IT vendor is equipped to handle any issues that may arise.

#4: Develop an IT budget for your first 2-3 years.

Operating capital may be limited in the first few years after your launch, so careful budgeting and long range planning will serve your firm well. Your information technology budget should include priorities and figures for at least two to three years, including infrastructure/hardware and software requirements. Some questions you'll want to consider:

- How many offices are you launching with? Do you plan to open additional offices in the near future?
- How many users do you have on day one? How many can you expect to have in years 2 and 3?
- Where are your offices located? Are there cost differences between domestic and international offices?
- What are your trading practices and how does this impact your budget?
- What kinds of systems do you need? (Order Management, Portfolio Accounting, Risk Management, CRM, etc.)

Ensure your technology budget coincides with your firm's growth plan. Do you expect to grow quickly? Open new offices? Expand internationally? You will need to account for these changes.

#5: Understand hedge fund regulations and how they affect your firm.

Governmental oversight of the financial industry has evolved dramatically in the last decade. Hedge funds, private equity firms and registered investment advisers now operate in a world where they are beholden to regulatory bodies with growing expectations and requirements. When launching your hedge fund, you'll need to be clear up front with any responsibilities you may have to any applicable agencies – in the United States, that means the Securities and Exchange Commission (SEC). Are you required to register? If so, represent your firm accurately and be descriptive of your operations. If not forthcoming, you may open up your firm to serious regulatory and criminal prosecution.

Apart from registration, you should also determine if there are any legislative implications for your new firm. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which redefined the registration requirements for hedge funds, also set forth new reporting requirements and standards for safeguards. For example, system safeguards such as data protection, disaster recovery measures and email archiving are requirements under Dodd-Frank.

Since 2014, cybersecurity preparedness is also a critical area of focus for regulatory bodies. With the prevalence of cyber threats and attacks, the SEC's Office of Compliance and Examinations (OCIE) has incorporated cybersecurity into its examination targets. Having released two extensive questionnaires and several risk alerts focused on security, the SEC has made it clear to investment firms that they will be investigating the practices employed at firms and increasing expectations for the future. Regardless of the assets your firm is launching with, you will be expected to have sophisticated and comprehensive policies and procedures in place from day one to combat cyber threats. Be sure to enable your firm's processes to comply with SEC recommendations including risk assessments, infrastructure practices, policy documentation, etc.

#6: Remember that when it comes to technology, you have options.

It wasn't too long ago that a new hedge fund faced a significant technology hardship: investing in hardware and building out an expensive and

complicated Communications Room. Fortunately, times have changed. Startups have a variety of options when it comes to settling on their technology infrastructure. With the birth of cloud technology, firms can save on upfront capital expenditures and host their infrastructure in the cloud – providing flexibility within those startup budgets.

Cloud services offer more flexibility than traditional infrastructure models and, beyond cost-savings, can reap rewards for new launches. Firms can add users nearly instantly – a welcome benefit for startups looking to ramp up quickly. Users can gain access to email, file services and applications from virtually anywhere, and built-in disaster recovery provides confidence that everything is protected from the inside out.

Of course, one of the greatest benefits to using an outsourced cloud service is professional management and monitoring. As a new firm, your priority is on the investment side of the business, as it should be. And while it's imperative to build a strong operational fortress, working with trusted service providers means you don't have to sweat the small stuff. A reputable cloud services provider not only provides world-class infrastructure and resiliency; it also assumes responsibility for the management and daily maintenance of your cloud environment. If you don't want to staff an IT department, no need. Your cloud services provider should act as your trusted technology adviser and, as such, give you the flexibility and time you need to focus on your investment priorities without worrying about security updates and patch controls.

#7: Implement safeguards to protect your firm and investor assets.

Today's new startups are entering an environment riddled with challenges. Among them is the perpetual objective of mitigating operational risk. As already mentioned, the SEC – and other regulators including FINRA and the FCA – are monitoring firms closely and conducting examinations focused on cybersecurity preparedness. Investors also have high expectations, and before they will even consider allocating money to your firm, they want to understand what protections you've put in place to protect their assets. With hackers savvier than ever and financial firms as known targets, it's critical that firms establish a comprehensive approach to security to not only meet investor and regulatory demands but also to protect firm assets and mitigate business risk.

To start, you should understand your firm's specific risks and exposures. After assessing your technology safeguards, you should be able to identify gaps.

- Has your firm implemented intrusion detection and prevention systems?
- Do you have robust firewalls in place?
- Are you planning to conduct regular vulnerability testing?

Beyond infrastructure safeguards, it is critical that firms implement policies and procedures to protect firm and client assets. Your hedge fund should employ Access Control, Incident Response and Personal Information Security policies (among others) to ensure sensitive and confidential data and systems are not compromised by internal or external security threats.

Lastly, as you launch your firm, make it clear that security is a priority. You can do this by conducting employee awareness training to keep all users informed and educated about the cyber environment and the threats that may arise. Users should understand how security threats may present themselves (phishing schemes, social engineering, etc.) as well as how they can become cybersecurity assets to your firm.

#8: Take the time to build a real business.

Investment firms often place too much emphasis on managing portfolios and not enough on managing the business as a whole. Particularly for startups entering a competitive marketplace, expectations are high. That means you have to demonstrate to investors that you take your business seriously and that you've made investments in your operations, technology, etc. that will fortify your firm and provide a solid foundation for investment success.

The decisions you make from the outset will define how your firm is regarded within the industry, by both investors and competitors. By taking into account all aspects of your firm and relying on trusted service providers to support operations, you prove to the greater investment industry that you should be taken seriously and can operate successfully in a challenging environment.

#9: Transparency is of critical importance.

Since the 2008 economic collapse and scandals caused by the likes of Madoff, transparency has become a key requirement for investors. Nothing less than full disclosure is expected of firms from the newest launches to the most established investment firms. As such, fund managers should take this to heart and make strong efforts to comply with increasing investor expectations.

The simplest reminder? Document everything. From your legal paperwork to security practices and technology safeguards, the importance of documentation cannot be understated in today's environment. Tools such as risk management or document management systems can give extra peace of mind to demanding investors with high expectations.

#10: Remember that raising capital is a non-stop process.

The ultimate goal for your new hedge fund is to raise capital and launch successfully. And while that goal is certainly reachable, the process does not stop on your go-live date. Marketing your hedge fund cannot be merely a step in your launch process. It must be a step in your overall business process. With competition for investor allocations at an all-time high, you'll have to work to determine what sets your firm apart from the others. If you don't learn how to differentiate yourself, your chances of getting lost in the crowd are much higher.

By investing upfront in operational and technology systems that can support your business and propel operations, you provide your firm with marketing tools that will far surpass the capabilities of a presentation or pitch book. These decisions can put your new firm on equal footing with established firms and demonstrate to investors that you are built to succeed.

ABOUT EZE CASTLE INTEGRATION

Eze Castle Integration is the leading provider of IT solutions and private cloud services to more than 650 alternative investment firms worldwide, including more than 100 firms with $1 billion or more in assets under management. We provide one global financial cloud platform that is complimented by exceptional service and operational excellence.

Our Eze Private Cloud is built to deliver the high performance, applications and exceptional user experience demanded by the hedge fund and investment industry.

To learn more about Eze Castle Integration, contact us at 800-752-1382 or visit www.eci.com.

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