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Considerations for starting a hedge fund in the US

Jeff Rosenthal provides a guide for setting up a fund in the US.

Hedge funds comprise the largest share of the alternative asset market. With this status comes large profit potential. Many talented traders consider launching their own funds during their careers. Getting a fund started is not easy or inexpensive but can be personally and financially rewarding. This article will guide you through some of the necessary steps.

Initial steps

In deciding to start a fund, you should create a business plan. What are your goals? What is your strategy? What makes you different and why will you succeed? You need to have clear answers to these questions before moving forward.

Budget

At the outset, you should develop a budget. Do you have enough available resources to fund operations and your lifestyle, and for how long? Though the fund is normally responsible for its own direct expenses, rent, salaries and other overheads are usually the responsibility of the manager. While the asset-based management fee paid by the fund is meant to cover these expenses, early stage capital may be insufficient to generate enough fees to cover all costs. Performance fees should not be counted on as they are not guaranteed.

Raising capital

Another consideration is your ability to raise capital. While your initial sources of capital will likely include friends and family, other sources such as hedge fund seeders, high-net-worth individuals, family offices, endowments, pensions, insurance companies and other institutional investors will want to see a favourable track record before they will invest. Potential in-

vestors expect you to invest a significant amount of capital to demonstrate that you have faith in yourself and your strategy.

Outline your marketing plan in a pitchbook. As you reach out to investors, expect to discuss your background and experience, your investment process and strategy, your track record and your expected returns for the fund. Be mindful of legal issues such as limiting your marketing efforts to accredited investors.

The amount you need to raise for a profitable fund depends on your costs and fee structure. While at least \$10m in AuM may get you started, \$100m is more appropriate if you want institutional investors to take you seriously.

Legal considerations

If you are confident that you can raise sufficient capital, the next step is to form your legal entity. Most hedge funds in the US operate as limited partnerships (though some are formed as limited liability companies) organised in Delaware. Your attorney will draft the limited partnership agreement for the fund. You will also need to set up a management entity and potentially a separate entity to act as the general partner of the fund. You may also need to register as an investment adviser and file for licences in the state(s) where you will be operating.

Also, you will need a private placement memorandum (PPM) that outlines the terms of your fund for prospective investors including, among many other things, the fund structure (e.g. onshore, offshore, master/feeder); fee structure (management and performance); lockup terms (how long investors must keep their money in your fund); redemption rights (how much notice they need to give before a withdrawal) and the potential risks of investing.

It is highly recommended that your documents be prepared by an attorney familiar with hedge fund regulations.

Start-up legal costs can run from \$35,000 to more than \$100,000.

Taxes and accounting

You will need to engage an accounting firm to perform an annual audit of your fund and prepare the fund's tax returns. It is prudent to meet with a firm familiar with start-up hedge funds before you finalise your legal documents, so you can discuss and understand the tax issues involved with your particular strategy. These include reviewing options, identifying necessary Federal and state tax filings, potential issues relating to foreign investors and retirement plans, beneficial tax elections, your plan for manager and employee compensation, and the overall tax impact of running your fund.

Ideally, hire a firm that not only covers the basics for your accounting needs, but is also capable of helping as you grow your fund. The firm should be actively working with you to minimise tax exposure and consult on your operations. Look for a firm with a strong reputation for working with emerging managers, as larger accounting firms may not be focused on small client needs. A coordinated team focused on your personal needs, as well as those of the fund, is ideal.

Setting up fund operations

Before you can formally launch, you also will need to hire other third-party service providers to handle specific aspects of fund operations. These service providers may include:

- A prime broker to execute the trades for your fund. They typically also provide custody and financing services. Look for a prime broker experienced with your target trading strategy, as the pricing, available services and execution can differ depending on which broker you use.
- A fund administrator to handle the accounting and back-office operations of your hedge fund. They typically maintain the books and records of the fund, including reporting to the fund's investors, calculating the fund's net asset value; tracking investor contributions and withdrawals; determining the fund's profit or loss for each period; and computing management and performance fees.
- Technology providers to assist with trading systems, infrastructure, hosting services, communications, business continuity and disaster recovery are crucial. A cyber-security provider is also now considered a critical partner.
- A compliance consultant to make sure that you follow

the applicable government regulations. Though you may not initially need to register as an investment adviser with the SEC, it is always prudent to adopt 'best practices' at the onset of the fund.

- Additionally, you will need to secure office space. These operational costs can run in excess of \$250,000 during the first year.

Registering with the government

The registration requirements that apply to your hedge fund depend on its size. If you have less than \$150m in gross AuM, you may only need to register with the state where your principal office is located. Once you have greater than \$100m in gross AuM, then it is time to get ready to register with the SEC.

Hiring your team

In addition to your third-party service providers, you should also consider how many employees you need to manage the fund, including your investment team, marketing staff and administrative support.

If you plan to oversee the investments, your first hiring priority should be finding someone to assist with operations and administrative work; otherwise, you will be taking valuable time away from the investment process. A ratio of one or two support people for each investment professional is commonplace.

As most start-up funds are conscious of costs, some are operated by the manager alone. While this might work initially, as the fund grows so do responsibilities. Larger investors will want to see a robust infrastructure including all checks and balances in place.

You can lower your salary costs by outsourcing these roles. The tradeoff is that these professionals would not be fully dedicated to your fund and may not be available to you when needed.

In conclusion

When you are just starting out, your AuM-based fees may not be enough to cover your expenses. Planning on little or no earning and the potential for relying on savings to handle some of the start-up and ongoing costs is prudent. Your goal is to prove your investment ability by generating good returns and surviving in the first few years as you continue to build your fund.

Launching a successful fund takes capital, a sharp investment plan, drive and some good luck. If you think you have what it takes, this guidance should help as you establish your fund.