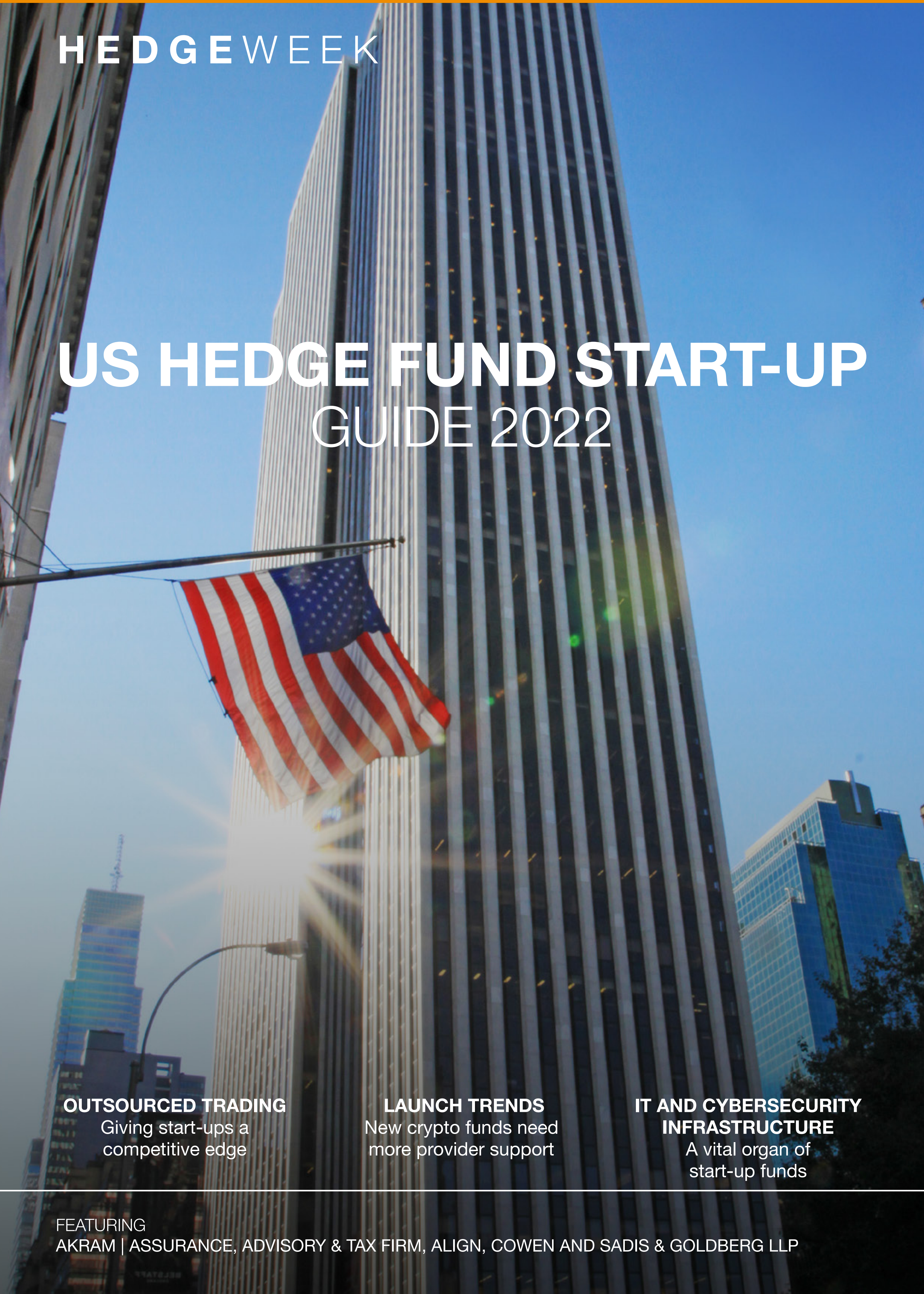

HEDGEWEEK

US HEDGE FUND START-UP
GUIDE 2022

OUTSOURCED TRADING
Giving start-ups a competitive edge

LAUNCH TRENDS
New crypto funds need more provider support

IT AND CYBERSECURITY INFRASTRUCTURE
A vital organ of start-up funds

FEATURING
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GROWING COMPLEXITY AMID RISING VOLATILITY

Emerging hedge funds stand their ground

BY ANGELE PARIS

The hedge fund industry began 2022 on a high note, with more than USD4 trillion in capital as managers steered the volatility and uncertainty of the protracted Covid years and the growing inflationary environment.

Launching a fund against this background is not always straightforward, especially considering the additional complexity of rising regulatory scrutiny. However, given the right support and carefully selected partners, emerging managers can succeed in building out their investment strategy and raising the funds necessary to go to market.

Data from provider Hedge Fund Research shows the last quarter of 2021 favoured mid to smaller funds. Larger groups dominated inflows over the previous five quarters by Q4 2021 saw this trend reversing with the largest firms experiencing an estimated net outflow of USD7.4 billion, according to HFR.

Although the market environment may be considered challenging for some, Mark van der Zwan, Chief Investment Officer and Head of AIP Hedge Fund Solutions at Morgan Stanley notes in an article: "Rising volatility and performance dispersion create a fertile field for hedge fund managers, who found their footing again in 2021."

However, he also cautions that, "the biggest challenge to hedge funds in 2022 will be the changing nature of market risk. Hedging unwanted market exposure has always been key to protecting alpha, but doing so has become more complicated and nuanced… In our view, investors would benefit from considering hedge funds constructed with diversified alpha sources and a strong risk management process."

REGULATORY HURDLES

In addition to the shifting market environment, start-up managers must contend with the additional regulatory focus on these vehicles. Although this can be a challenge, according to a report by KPMG, "Regulation is also

enabling new market opportunities. New fund vehicles are being introduced as jurisdictions compete for share of market growth, private and real assets are being accommodated to aid economic recovery, and newer capital markets are opening further to foreign investment and firms." This, for example, includes developments in domiciles like Ireland and Singapore where new structure for private capital funds are being showcased.

But managers who wish to keep their vehicles in the US and those active in the market here may be in for some significant change. Earlier this year, the US Securities and Exchange Commission (SEC) announced it will be raising scrutiny of hedge funds. SEC chair Gary Gensler further confirmed it will be pushing for greater disclosure regarding several activities including cybersecurity risks and attacks.

Should these rules be enacted, start-up managers will have a heavier regulatory burden to contend with. Though not immediate, emerging managers must keep a close eye on the shifting regulatory framework.

In the firm's regulatory outlook for 2022, Deloitte outlines: "firms should remain alert and engage with policymakers while their efforts can have maximum impact (before the final rule stage).

"Since firms are likely to live with the rules that are proposed in 2022 for potentially years to come, it is well worth their effort to engage with the process early and often.

Similarly, firms must not lose sight of their ongoing and impending obligations. In conjunction with new rulemaking, we expect regulatory enforcement to be more vigorous than in recent years. Given the gravity of some of the areas under regulatory consideration, 2022 might frame the business and regulatory environment for financial services in the United States for the foreseeable future." ■

OUTSOURCED TRADING
can give startups a competitive edge

Start-up managers have always had to fight for attention, but in an environment which now champions virtual due diligence, standing out from the crowd has become even more of a challenge. These groups have been partnering with outsourced trading firms to help them gain insight which can give them an edge in a crowded market. More emerging managers are also engaging the services of outsourced trading providers as they begin to understand the value such a service can provide.

"The past two years have certainly added a level of difficulty when it comes to accessing capital, as allocators have largely been unable to engage in face-to-face due diligence with startup managers and have tilted more to known entities," observes Jack Seibald, Global Co-Head of Prime Brokerage & Outsourced Trading* ("Cowen"), "Outsourced trading firms such as Cowen, which have a global Capital Introduction and Consulting team, can provide helpful insights to startup managers as they prepare to pitch their investment fund to new investors and assist with the introduction to allocators with an interest in strategies the manager has to offer."

In Seibald's view, through the additional capabilities and services some firms have made available, managers are becoming more confident that outsourced services providers can progress alongside them, as the funds grow and their needs evolve. He notes: "This process of broadening and enhancing the solutions made available to startup managers will continue to be both the challenge and opportunity for service providers. As a general matter, we at Cowen view a manager's decision to build and develop solutions – in our case, trading - internally as the principal competition and our focus continues to be on evolving the solutions we offer managers."

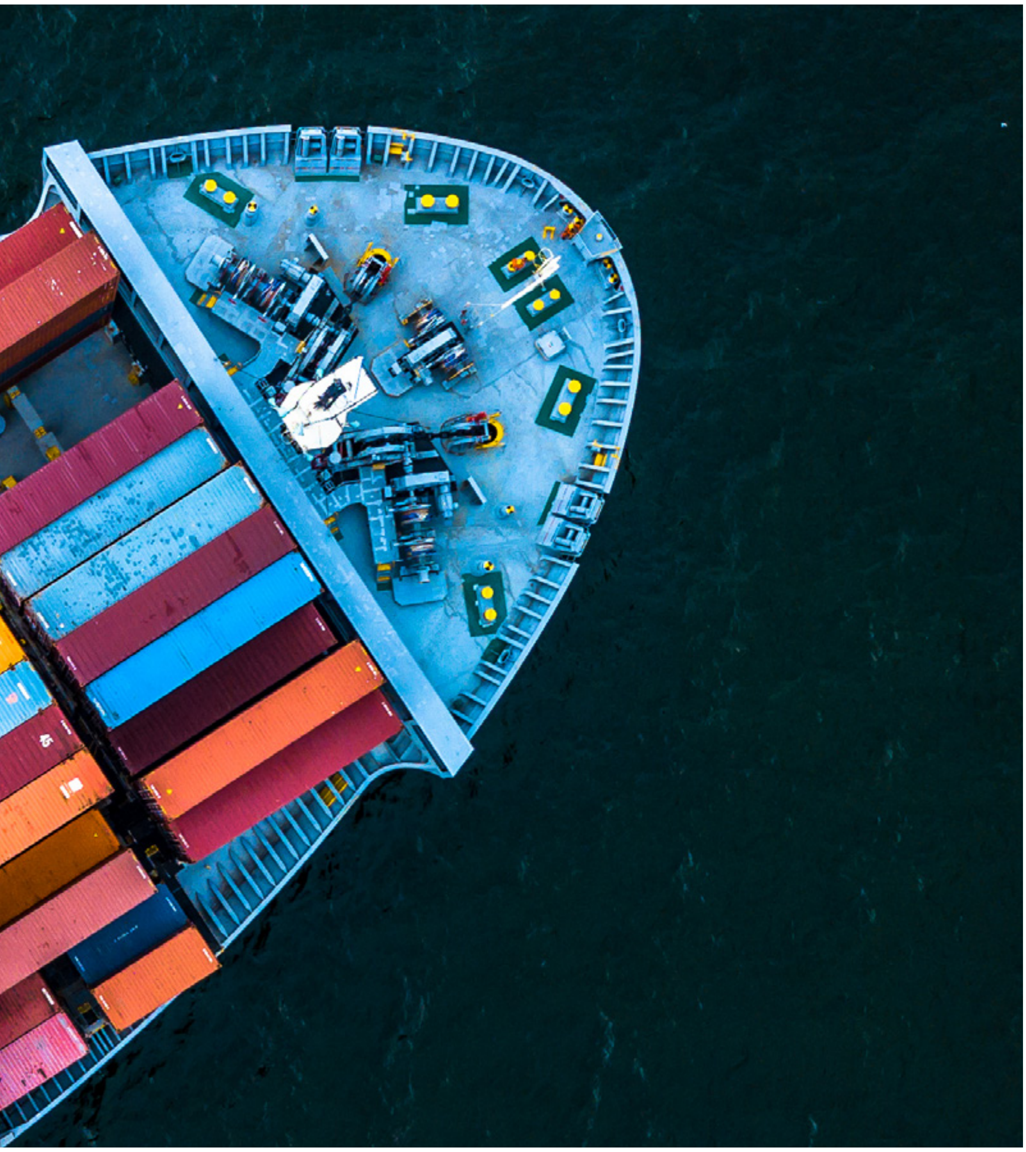
To this end, over the past two years Cowen has launched outsourced trading solutions in FX and Fixed Income to complement its longstanding offering in global equities. It has also further extended the trading technology solutions the firm can put in place for managers.

ACCESS ACROSS GLOBAL MARKETS AND ASSET CLASSES

This reach across asset classes and geographies is rising in importance as is the technology and operational support provided by outsourced trading teams.

"Unlike in years past, when it was the exception for a startup manager to invest in international markets, today it's become the norm," Seibald highlights, "Professional trading access to global markets has thus become a "must have" for managers, and outsourced trading solutions with experienced local professionals in zones across the globe can play an important role in satisfying this need."

Seibald adds Cowen has also witnessed an uptick in the demand for trading solutions across asset classes



among startup managers.

These developments are leading to growing demand for outsourced trading services overall, and this is driving an acceleration in demand for support across markets as well as as trading technology solutions that service such markets and asset classes.

Seibald recognises this emerging trend which has been gaining traction – start-up managers engaging outsourced trading solutions. He says: "Perhaps because it's the function nearest to the investment decision, managers have been least willing to let go of portfolio trading. Originally, outsourced trading was considered to be a cost saving move. However, start-up managers have increasingly come around to understanding that engaging the right outsourced trading solution can add a great deal of value, in addition to the cost saving associated with the service."

Depending on the manager, this value can manifest itself in the size and expertise of the outsourced trading desk, its reach across global markets and asset classes, the technology and operational support provided, enhanced market colour, improved execution, or any combination thereof.

Cowen's global Outsourced Trading team provides managers with unconflicted, buy-side trading capabilities and support. This service allows them to outsource their entire desk or supplement an existing trading operation – with a shared ambition to outperform.

By outsourcing their trading capabilities, start-up managers can expand their trading operations with Cowen's multi-asset class offering, delivered by highly experienced traders. As Seibald detailed earlier, coverage includes Equities, Fixed Income, Foreign Exchange, Derivatives, Futures & Options.

By and large, start-up funds now acknowledge the benefits of outsourcing the non-investment related functions related to their businesses. Seibald concludes: "For the most part, it's a forgone conclusion that newly launched funds outsource operational, financial, technology and compliance responsibilities to firms specialising in the respective areas. It's been well documented that doing so allows such funds to avail themselves of a level of expertise at a reasonable cost. That expertise is not likely one that they could afford to develop and maintain internally, except in those few circumstances when new funds launch with an exceptionally large amount of capital. Outsourcing the trading function is rapidly being recognised by start-up managers as another value-added option." ■

JACK SEIBALD

GLOBAL CO-HEAD, PRIME BROKERAGE & OUTSOURCED TRADING, COWEN

Jack Seibald is Managing Director and Global Co-Head of Prime Brokerage & Outsourced Trading. Seibald co-founded Concept Capital Markets, LLC and, until its acquisition by Cowen, served as a Managing Member of the firm. During his tenure with Concept Capital, Seibald was involved in the management of all aspects of the firm's operations, with a particular emphasis on business and client development and legal matters

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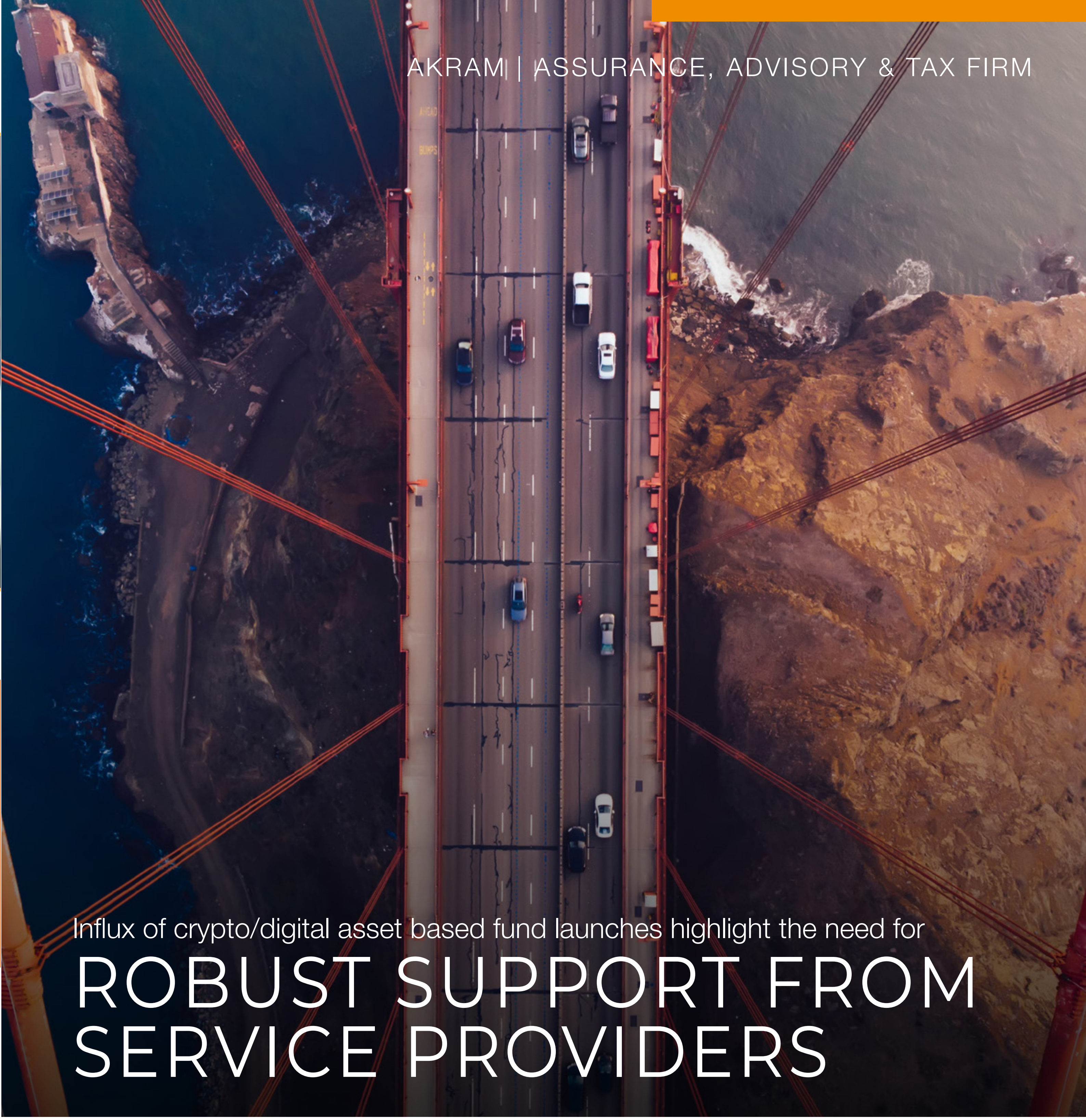

Influx of crypto/digital asset based fund launches highlight the need for

ROBUST SUPPORT FROM SERVICE PROVIDERS

The hedge fund industry in the US has witnessed a surge in crypto currency and digital assets funds being launched by experts in the technology sphere but who often have little experience of the financial and fund management world. This emphasizes the need for extensive support from service providers and the additional guidance these businesses may need to steer a successful launch.

"The majority of the start-ups we have seen being launched are in the crypto/digital asset space. A differentiating factor here is that many of them are being run by individuals who do not have a finance background but have a technology pedigree," comments Steven Rosen, Senior Manager, Akram & Associates.

Discussing the nuances in service this translates into, Muhammad Akram, founder of Akram & Associates, outlines: "We have been servicing crypto/digital asset funds since 2014, but now that we have more clients in that space it means we need to be ahead of the curve to service them effectively.

"The whole crypto/digital asset industry and eco-system is evolving and the best practices used two years ago are no longer consider best practices. This means we have to constantly learn and train our team in this regard. Our biggest challenge is making sure we understand the risk in this area."

Rosen explains that coming from a technology background, most professionals launching these crypto/digital asset funds lack a basic understanding of the service providers and support they need in order to successfully run a hedge fund: "They need the right legal counsel and the right auditor; they need to have all of these processes in place which is something many do not realise they need. Our initial conversations with many of these funds show they often might not understand the time, effort and cost needed to launch a fund."

Raising capital is a challenge for any new fund, however when the professionals involved have little institutional background or knowledge, they are likely to lean more heavily on their service providers. "They're learning about all the hoops they need to jump through to raise capital while at the same time trying to understand the best practices in the space," Akram notes, "This is where we can step in and walk alongside them to show them what steps they need to take in order to make this successful venture."

He advises that, just like in any other sector, having a business plan and best practices to follow are crucial for any fund to have hopes of success.

Partnering with service providers who are knowledgeable about the developments in crypto/digital assets is also important. "If they're hiring a service provider who doesn't know the space and doesn't understand where this world is going, they will not get the best service which means ultimately, neither will their investors. They need to work with firms and people who know the regulatory and tax challenges for example, because that will clear many hurdles for them," highlights Rosen.

PROFITABILITY CHALLENGES AS COSTS RISE

Both Akram and Rosen caution managers starting out that monetary policy decisions can impact their ability to generate returns. "When the Federal Reserve was printing money, the market was very fertile for everyone to make money. People were under the impression that making money is easy; but as this year began and we went through some volatile periods, some may have realised that it's not a game for everyone to play. Launching and managing a fund requires a lot of discipline and attention to get it right," Akram says.

In Rosen's view, the biggest challenge for start-up managers will be how to make a profit in light of ever-increasing regulation: "To be compliant with the SEC regulations, managers need to pay service providers which, in turn, will impact their bottom line. In terms of compliance regulations, if even half of what has been proposed is enacted, even small funds will need to hire in a compliance expert, whether that be someone in house or as an outsourced service. This will eat away at the performance and the profit of the fund."

These changes considered against a background of rising inflation could also lead to managers having to increase their fees as they pay out larger salaries to staff on top of the aforementioned growing regulatory burden.

"What they need to do is run a tight ship," Akram stresses, "they should look to lock in a fixed fee with their service providers to allow them to project their expenses out into the future. The worry is that although the regulatory changes are being introduced to protect investors, they might be the ones who end up bearing the growing costs. Improving transparency and accountability is a positive development but everyone needs to be a bit cautious and not go overboard."

ASIA GROWTH

Amid these changes, Akram Associates has identified room for expansion and has opened two offices in Asia to capitalize on the growing alternative investment management industry in the region. "The hedge fund and alternative investment industry is flourishing in Singapore and Hong Kong and we expect to benefit from this momentum of development," explains Amir Mahmood, CEO of Akram's Asia Offices. As the offices has only recently been launched, Mahmood underlines the importance of having the right professionals be part of the team: "The quality of a firm is directly dependent on the quality of its human resources, and we are confident in the excellent team we have built." ■

MUHAMMAD AKRAM

FOUNDER, AKRAM – ASSURANCE, ADVISORY & TAX FIRM

Muhammad Akram is a Certified Public Accountant in the state of California (License #114908), New York (License #122344), and North Carolina (Certificate #37968) and leads the Firm's overall practice. He is a member of the AICPA and North Carolina Society of CPAs. He has worked with Big 4 and National Accounting Firms, where he worked on the audit, tax and consulting engagements for onshore and offshore alternative investment funds. He has also been responsible for advising investment companies on structuring and compliance processes, and for providing consultation on tax matters.

STEVEN ROSEN

SENIOR MANAGER, AKRAM – ASSURANCE, ADVISORY & TAX FIRM

Steven earned a Bachelor of Science with a major in Accounting from the City University of New York. He has worked with regional and local CPA Firms on audit, review, compilation, tax and consulting engagements for non-public entities within the financial services industry, having extensive experience with Investment Partnerships. Steven is also integrally involved with training employees, and reviewing audit procedures and documentation performed by the staff before it is sent to quality control for review.

IT AND CYBERSECURITY INFRASTRUCTURE

is a vital organ of any fund launch

The IT and cyber security infrastructure of a start-up fund is instrumental to its fate and can be key to determining whether it fails or succeeds. Therefore, a consultative approach in this regard can ensure their framework is fit for purpose and can effectively support the fund's growth objectives.

"Both investors and managers have become a lot more involved and informed in relation to IT and cybersecurity, which, in turn, allows them to be more engaged with their providers and the solutions they implement," explains John Araneo Managing Director and General Counsel of Align Cybersecurity.

Vinod Paul, Chief Operating Officer at Align, highlights how, although the end-user of IT solutions has always been sophisticated, the last two years have demonstrated a growing realisation of how important an IT platform is in the ultimate success of a firm: "The operational due diligence, but more importantly, the regulatory landscape has changed so much, that players are now taking an active, participatory lead in wanting to understand their personal threat landscape and minimise the risk."

Until a few years ago, fund managers were satisfied to have service providers simply monitor their IT and cyber environment. Now, they want to understand their data footprint, they ask to see reports and want to understand how their risk profile is changing and what can impact it.

The greater scrutiny potential investors are applying when conducting operational due diligence (ODD) exercises is also driving this enhanced interest. Araneo notes: "Managers get one bite of the apple in an ODD meeting with investors. If they miss one question, there are 20 other fund managers waiting to take their place. This has contributed to managers being more informed and therefore engaged with these matters."

UNDERSTANDING THE RISKS

Elevating this engagement even further means ensuring managers understand that cybersecurity is not a project, it's a process. "The idea is that start up managers do not need to invest USD$100,000 into a cyber program before they launch. Rather, they need to demonstrate to their potential investors that they understand what their risks are and that they are making reasonable and methodical efforts over time to mature their cyber program," Araneo outlines.

This paradigm, therefore lends itself very well to a co-sourcing relationship between managers and a service provider like Align. According to Paul, the reason for this growing consultative dimension is that managers now understand that they need to have the proper building blocks in their foundation from day one: "The strongest house is built on robust foundations. You need to include many layers of additional protection and understand these need to be monitored regularly to make sure everything is still fit for purpose. It's not just about building the house, but about maintaining it as well."

He adds that although managers can choose to purchase software themselves, simply procuring the program is not sufficient to create a robust IT environment: "The 'secret sauce' is in configuring the software correctly, in

monitoring it effectively and ensuring the platform itself is always available. Doing this yourself is like buying a Tesla, then building an electric charging station yourself and trying run the maintenance alone - which no one would ever do. Therefore, managers should not try to do this with their IT which is one of their most critical assets."

Araneo adds: "Cybersecurity is a truly a multifactorial challenge that requires a multidisciplinary response. It's complicated enough for managers to navigate through the appropriate IT and technology infrastructure licenses and configure them to meet the prevailing industry standards and, unfortunately, cybersecurity adds an additional plane of complexity to this IT/ cyber matrix.

"All fund managers, especially start-ups need to make sure they have a trusted adviser in this space. They need to embrace the fact that cyber requires a percentage on the budget and they need to set aside a responsible, realistic budget for doing this. The service providers in the space have all evolved enough to give good advice and making the right decision is crucial for emerging managers."

The right partners will also help guide start up managers through any regulatory changes. Araneo points out the recent proposals issued by the Securities and Exchange Commission in February 2022 on cybersecurity: "We are 12 or 18 months away from required regulatory change and although this represents a significant uptick in maturity, quality and content of cybersecurity policies across the industry, it is something fund managers will need to contend with for the rest of the year and into the coming year."

Therefore, it is helpful for those looking to launch in the current environment to have access to providers with their finger on the pulse; those who understand what changes will be ushered in by these proposals and can assist and support the start-ups in this regard.

LEVERAGING RELATIONSHIPS

Choosing a provider with the right fit will further elevate the consultative relationship signposted earlier. Paul observes: "I have been working in this industry for 20 years and historically, the relationship between manager and IT provider was strictly a vendor-client one. This has evolved and the partnership between the two has become the central nervous system of a fund launch; it's a vital organ which can be directly tracked to the eventual success of that fund."

Araneo believes the industry is at the beginning of a new era: "Never before has IT and cyber security been so important. The security threats and controls are going to continue evolving – just like they shifted dramatically when people moved from working in the boardroom to their dining room table. Fund managers looking to launch need to think about meaningful risk management of cyber threats as a whole function of their business from day one." ■

JOHN ARANEO

GENERAL COUNSEL & MANAGING DIRECTOR, ALIGN CYBERSECURITY

John Araneo possesses a broad corporate legal background, encompassing investment management law, data privacy and cybersecurity law, corporate governance and employment law. John is an published author, established cybersecurity expert and a well-known thought-leader on the legal, regulatory, governance and employment law issues related to cybersecurity. Previously, John practiced law in the investment management space for over 20 years, most recently as a partner of Cole-Frieman & Mallon, LLP, a firm that represents over 2000 asset management clients.

VINOD PAUL

CHIEF OPERATING OFFICER, ALIGN

Vinod Paul brings over 20 years of in-depth financial services and technology experience to his role as Align's Chief Operating Officer. Vinod's responsibilities include the oversight and strategic development of Align's Managed Services offerings, including Align Cybersecurity™, the company's comprehensive cybersecurity risk management solution. In his current role, Vinod is also responsible for managing senior client relationships with alternative asset managers, providing ongoing guidance with respect to industry best practices and forward-looking trends in Managed Services. Vinod serves on the Forbes Technology Council, a collective of invitation-only communities.

BEYOND COST

avoiding pitfalls when selecting law firms

Hedge fund managers just starting out can sometimes underestimate the significance of selecting a law firm to assist in their fund launch. Selecting a firm solely based on cost can set a fund back and potentially turn out to be a more costly exercise, if the initial advice is fails to understand the manager or the market place – it's not just about getting the law right.

"Emerging managers often make the mistake of commoditising legal services," outlines Ron Geffner, founding partner, Sadis & Goldberg LLP, "Making the decision which primarily depends on a low budget is penny wise but pound foolish and may lead to unrealistic expectations and bad results."

The quality of legal work will affect the ability of a manager to attract and assets and avoid liability, some of which may not be able to be fixed or mitigated by switching legal counsel later on.

His advice to managers looking to launch a hedge fund is to select a law firm with which they can foresee a long-term relationship: "You need to feel appreciated and understood. Managers should not feel like their lawyers are simply ticking the boxes. They should have a longer conversation with prospective law firms to ascertain whether they are getting correct responses to their questions and that the lawyers are also asking the right questions."

In view of this, in addition to issues around cost, emerging managers would do well to ask about capacity, typical turnaround times as well as the particular subject matter experts they expect to be involved in different projects. Suitable counsel has lawyers under one roof who can advise on commercial, tax, ERISA and provide regulatory guidance on a wide range of issues affecting private funds.

Geffner also cautions early-stage managers to not try to do too much themselves on the legal side: "Some clients get lost in the weeds and risk failure because they become fixated on one or two items and miss the launch window. At the other end of the spectrum, there are some managers who are absent from the process and either do not read documents properly or do not respond to requests for information accurately or in a timely manner."

Building a consultative relationship with a legal team can help startup managers avoid making certain missteps. Understanding commercial terms and maintaining meaningful relationships in the industry is equally as important as the knowledge of the law. The right lawyer will assist a client's selection of the most suitable service providers. Geffner highlights that practical knowledge in the legal field is key: "Whether a firm has a team of people all under the same roof is another very important consideration for managers to make. This makes the common goal more obtainable and far more efficient."

Outlining launch trends, Geffner says he has witnessed significant growth in crypto funds, with more traditionally trained institutional managers looking to bring digital assets funds to market. In the last 60 days, he and his firm have also been involved in the launch of two inflation funds and has tracked greater interest in open-end fund formation over the last 18 months. ■

RON GEFFNER
PARTNER, SADIS & GOLDBERG LLP

Akram is a trusted adviser to alternative fund managers – the cornerstone of our business. Our laser focus on this industry allows us to provide highly specialized accounting and tax services that are accurate and affordable. Our team of professionals is well versed in the nuances of hedge fund, private equity fund, venture capital fund, CTA and family office entity structures and strategies, positioning Akram as an expert resource to both emerging managers and sophisticated managers overseeing multiple funds. Always one step ahead of the evolving needs of our clients.

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Align Managed Services offer cutting-edge solutions to the financial services and alternative investment industry, encompassing everything from cloud delivery to cybersecurity. Driven by an elite team of experts in Technology, Cybersecurity and Regulatory Compliance. Leading firms around the world trust the Align team to build and operate secure cloud infrastructures. Align Managed Services provides our customers with a flexible, secure, cost-effective and unified cloud experience.

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