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Emerging Manager
Desk Reference Manual

Emerging Manager Guide
Desk Reference
Manual

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Introduction

Starting an alternative investment fund is a challenging endeavor, especially for those who don't have any experience in doing so. It takes a multi-year commitment to refine your strategy, build a team, and find both trading and marketing niches where your firm can profitably operate. Many funds fail or close down each year, and countless others are half-started, abandoned or reshaped into private investment pools for friends and family.

This guide is meant to address the key areas that each emerging manager should consider. The manual is divided into two sections:

"Starting From Scratch" — for instances where you have not yet consulted with an attorney or tackled any tax considerations, and need assistance with every aspect of the fund launch.

"Legal and Tax Under Your Belt" — for instances where you have already consulted with your attorney and have your governing documents in place, and need assistance with other aspects of the fund launch.

Some of the areas included in this guide may not apply to every emerging manager, and some of the areas may not be as complex or as simple as discussed in the following pages.

Section 1:
Starting From Scratch

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Legal

Launching a fund involves a significant amount of legal considerations that need to be addressed in order to properly structure the new entity. The use of an attorney that is familiar with all aspects of fund formation is critical.

Forming Your Fund

The first decision you will need to make as a new fund manager is to determine how you will structure your fund. This decision will be influenced significantly by the types of investments you plan on investing in as well as your anticipated flow of capital.

Open-ended vs. Closed-ended

An open-ended fund is an entity investors can get in and out of at their discretion over the life of the fund subject to notification requirements. Mutual funds and hedge funds are the most common example of an open-ended fund. A closed-ended fund is a fund where the investors do not have the ability to leave the fund; they are committed to remaining in the fund until it is liquidated. Private equity funds are the most common examples of a closed-ended fund. Once you have made this determination, the next step is to choose the type of entity and type of fund structure you will be using (see Tax for further details).

Limited Partnership Agreement (or Operating Agreement)

After you have selected your structure and entity type, you will need your attorney to draft your limited partnership agreement (otherwise known as the LPA) or operating agreement if an LLC. This document will be the governing document for your fund and will define what can and cannot be done. It will define the role and responsibilities of the general partner (or managing member). It will lay out the terms of any capital contributions and capital withdrawals. It will clearly define all fee arrangements between the fund and its investors. As this is the document that will govern the fund during its existence, it is crucial that the time is taken at this stage of the formation process to ensure everything in the document is clearly conveying your intent when forming your new fund.

Formation

Once your limited partnership agreement or operating agreement is drafted, your attorney can then complete the legal process of forming your entities in your state of choice. Due to its favorable legal and judicial structure, Delaware is the state most often chosen by fund managers.

Offering Materials

Once the formation process is complete, you will then need to begin preparing all of the offering materials, which primarily consists of the private placement memorandum and the subscription agreement. The private placement memorandum, or PPM, describes the offering in detail; it summarizes the LPA or operating agreement, it provides background information on management of the fund, it provides discussion on the strategy of the fund, and it also discusses any minimum investment amounts. An important part of this document is a section on the risks associated with making this investment, which is required under current antifraud provisions of current securities laws. In addition, this section protects the fund against future litigation should the fund not be successful. The subscription agreement is an application by an investor to join a limited partnership. All limited partners must be approved by the general partner of the partnership. As part of this document, the limited partner also fills out a form documenting the investor's suitability for the investment in the partnership.

Section 3(c)1 Fund vs. Section 3(c)7 Fund

Differences

- A 3(c)1 fund may not be beneficially owned by more than 100 shareholders.
- A 3(c)7 fund must be owned by a person, company owned by close family members or trust with no less than $5 million in investments or an investment manager with no less than $25 million in assets under management, (a "Qualified Purchaser"). A 3(c)(7) fund may have more than 100 investors, but typically limit the number of investors to 499 to avoid registration under the Securities Exchange Act of 1934.

Investor Outline

- Both 3(c)1 and 3(c)7 funds are to offer their interests in private offerings limited to "accredited investors" as defined by Rule 501 under the Securities Act of 1933. An accredited investor must either (a) meet an income test ($200,000/year or $300,000/year with spouse), or (b) meet a net worth test ($1 million individually or jointly with spouse).
- The 3(c)7 fund is commonly referred to as a "QP" fund because of its' qualified purchaser thresholds.

Tax

As with the formation of any business, there are various tax issues related to the formation of an alternative investment fund. Such issues include, but are not limited to, the fund structure and type of entity to be used, management compensation, taxability and deductibility of benefits, state and local tax implications and income/loss allocation.

Types of Fund Structures:

Onshore fund — Usually organized as a limited partnership and is structured for investors that reside in the United States. Investors that purchase an investment in an onshore fund become a limited partner of the partnership.

Offshore fund — Typically organized as a corporation and is structured for investors residing outside the United States or tax exempt investors that reside in United States.

Both Onshore and Offshore funds can be set up in various structures such as a stand-alone structure, a master feeder structure and a side-by-side structure.

Stand-alone structure — A single investment vehicle that is either onshore or offshore in nature.

Master feeder structure — Allows both investors residing in the United States and investors residing outside the United States to invest indirectly into the same investment vehicle known as a "master fund" through a corresponding onshore or offshore feeder fund.

Side-by-side structure — In this structure, United States investors typically invest in an investment vehicle organized in the United States and offshore investors invest in an investment vehicle organized outside of the United States. All investments are then typically allocated between the onshore fund and the offshore fund pro-rata based on the assets under management.

Types of Entities

Typically, there are three different entities that are set up when forming an alternative investment fund: a vehicle to purchase and hold the investments, a vehicle to house the management

company, and a vehicle to house the individuals or entities that comprise the general partner of the fund. There are several choices to choose from, and a manager should first understand the characteristics of each type of entity:

Limited Partnership (LP)

- Most common
  - Only the general partner has unlimited liability, all limited partners enjoy limited liability Single level of taxation, at the partner level (i.e., no entity level tax) [Note: new partnership audit rules which begin in 2018 will permit an entity level tax in certain situations but it will still be a single level of tax]
- No limitation on number or type of owners (i.e., individuals, entities, foreigners, etc. are permitted)
- Flexible income and loss allocations are permitted
- Multiple classes of equity are permitted
- No Self-employment tax related to income allocations / distributions to limited partners (GP allocations do attract self-employment tax in certain situations)
- Tax-free distribution of appreciated property (subject to certain limitations)
- Tax-free liquidations (subject to certain limitations)

Limited Liability Company (LLC)

- Same as LP, EXCEPT:
  - Limited liability for all equity owners
  - Self-employment tax will apply to all equity owners who receive allocations of ordinary business income

General Partnership

- Same as LLC, EXCEPT:
  - There is unlimited liability for all equity owners

"C" Corporation

- All shareholders enjoy limited liability
- Two levels of taxation (i.e., corporation pays an entity level tax and then the shareholder pays another level of tax when it receives a dividend)
- No limitation on number or types of equity owners
- No income or loss allocations to owners
- Multiple classes of stock are permitted
- Self-employment tax is not applicable, however payroll taxes will apply to any salaries paid (including salaries paid to shareholders)
- Distribution of appreciated property incurs two levels of taxation
- Taxable liquidations (generally)

"S" Corporation

- Same as the "C" corporation, EXCEPT:
  - Single level of taxation (generally), at the shareholder level
  - Maximum of 100 shareholders
  - Shareholders are limited to U.S. citizens, resident aliens and certain types of trusts and estates
  - Single Class of stock only
  - Special allocations of income / loss are not permitted
  - 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 are not permitted)
  - Shareholders that perform services for the corporation must receive a salary (subject to payroll taxes) of a reasonable amount

Generally, state and local tax regulations mirror those on the federal level, with notable exceptions being New York City and Illinois, which has a separate tax for any flow-through entities. Consequently, if one does decide to locate your new alternative investment fund in New York City, you will need to consider separate tax planning in order to potentially reduce your local tax liability. An example of an alternative tax plan would be to separate the management company and general partner entity.

Vehicles that will purchase and hold investments are typically set up as limited partnerships to take advantage of the single level of taxation, the flexibility of special allocations of income and loss, the permissibility of any type of partner (individual or entity), and the limited liability to its partners. Limited liability companies also possess these same characteristics but are less frequently selected for the investment vehicle.

Vehicles that are set up as management companies are usually set up as limited liability companies to take advantage of the single level of taxation, the limited liability to its members, the flexibility of special allocations of income and loss, the permissibility of any type of member (individual or entity), and the lack of a single class of membership requirement.

Takeaways

- It is imperative that you have your attorney prepare all of your legal documents.
- Have your accountant review the fund's documents that are prepared by your attorney for both economic and tax allocations.

Section 2:
Legal and Tax Under Your Belt

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Common Mistakes

- Fund manager not engaging an attorney during structure and tax setup — a well experienced fund attorney can help avoid unpleasant tax outcomes and structural pitfalls.
- Fund Managers can't justify the results that they publish in their marketing materials.
- Fund manager tries to perform their own back-office accounting — while it may seem like a good idea and an easy way to cut some of the costs as a "start-up", it actually may take the manager and their key resources away from their manager's primarily goal of investing, trading and researching new investments. Additionally, investors typically feel more comfortable when an independent third party service provider is engaged to perform such services.
- Not controlling costs — fund managers should be aware of what services are included as part of executed contracts with third party service providers and what is deemed "an additional cost". Third party administrators assist in the preparation of the fund's day-to-day accounting but often the preparation of financial statements and supporting schedules is not included in their contracts and is an additional fee. When engaging service providers be cognizant of what services are included, what services come with an additional fee, and what the service providers fee structure is if additional fees are required.
- Adequate capital — fund managers need to be aware of how much capital they truly need to start and fund the business.

Custody Rule

Effective March of 2010, the Securities and Exchange Commission ("SEC") adopted Rule 206(4)-2 or as commonly known in the industry, the "Custody Rule". The focus of the Custody Rule is to protect investors. Custody under the rule is defined as "an adviser directly or indirectly holds client funds or securities, or has any authority to obtain possession of them."

"Custody" includes but is not limited to:

- Possession of client funds or securities, even for a brief period. However, this excludes the inadvertent receipt by the adviser of client funds or securities, so long as the adviser returns them to the sender within three business days of receiving them.
- An adviser with power of attorney to sign checks on a client's behalf, to withdraw funds or securities from a client's account, or to dispose of client funds or securities for any purpose other than authorized trading.
- An adviser that is authorized to deduct advisory fees or other expenses directly from a client's account that they have access to, and therefore has custody of, the client funds and securities in that account. These advisers might not have possession of client assets, but they have the authority to obtain possession.
- An adviser that acts in any capacity that gives the adviser legal ownership of, or access to, the client funds or securities. For example, fund management that acts as both general partner and investment adviser to a limited partnership. By virtue of its position as general partner, the adviser generally has authority to dispose of funds and securities in the limited partnership's account and thus has custody of client assets.

Requirements of the Custody Rule:

Qualified Custodian — The Custody Rule requires advisers who are determined to have custody of client funds and securities are to maintain those assets with a qualified custodian in an account under the client's name or under the adviser's name as agent or trustee for its clients.

Account Statements — An adviser that is determined to have custody of clients' funds or securities is to have a reasonable belief that the qualified custodian holding the assets provides account statements directly (not through the adviser) to those clients at least quarterly. If a client does not receive account statements directly from the qualified custodian, the adviser must continue sending quarterly account statements to that client and to undergo an annual surprise examination by an independent public accountant to verify the funds and securities of that client.

Exemptions from the Custody Rule:

Advisers do not need to comply with the Custody Rule if they are registered with the SEC as a registered investment company. Registered investment companies and their advisers must comply with the strict requirements of section 17(f) of the Investment Company Act of 1940 and the custody rules adopted under that section.

Advisers that oversee pooled investment vehicles with assets under management of over $150 million that are registered with the SEC as a registered investment adviser can use the "audit exemption". This requires the adviser to obtain and distribute audited financial statements for each of the pooled investment vehicles, prepared in accordance with generally accepted accounting principles, to all clients within 120 days of the end of its fiscal year, or 180 days if the pooled investment vehicles qualify as a Fund of Funds.

If an adviser is deemed to have custody under the Custody Rule and does not undergo an annual audit that covers those accounts they are required to receive an annual surprise custody examination. The scope of the surprise custody examination should comprise of the following:

- Confirmation of the existence of the client funds or securities held at a qualified custodian.
- Confirmation that client funds or securities are maintained in separate accounts under the client's name or in accounts in the adviser's name as agent or trustee for its clients.
- Confirmation of contributions and withdrawals of funds or securities from the account.
- Reconciliation of custodial records to the investment adviser's records.

Takeaways

- Many advisers of private equity funds historically only held cash at a qualified custodian; however, under the Custody Rule all client cash and securities, even though illiquid in nature, must be placed with a qualified custodian.
- For accounts not meeting the audit exemption, the adviser should ensure the qualified custodian are preparing and sending at least quarterly statements to clients.
- For accounts not meeting the audit exemption, the adviser should engage an independent public accountant (firm) to perform a surprise examination.
- Determine and document if there is a reasonable belief that the audit exemption will be met for each pooled investment vehicle for the year.

Disaster Recovery and Business Continuity

Importance

Disaster recovery involves a set of policies and procedures to enable the recovery or continuation of vital technology infrastructure and systems following a natural or human-induced disaster. Disaster recovery focuses on the IT or technology systems supporting critical business functions. Business continuity involves keeping all essential aspects of a business functioning despite significant disruptive events. As IT systems have become increasingly critical to the smooth operation of a company, the importance of ensuring the continued operation of these systems and their rapid recovery has increased. Based on history, almost one-half of companies that had a major loss of data never reopen, and almost one-third of companies close within two years. As a result, preparation for continuation or recovery of systems needs to be taken very seriously; this involves a significant investment of time and money with the aim of ensuring minimal losses in the event of a disruptive event. Every $1 spent on hazard mitigation saves society $4 in response and recovery costs.

Control measures

Control measures are steps or mechanisms that can reduce or eliminate various threats for companies. They should be included in your disaster recovery plan ("DRP"). A DRP would include planning for the resumption of applications, data, hardware, electronic communications and other IT infrastructure. A business continuity plan ("BCP") includes planning for non-IT related aspects such as key personnel, crisis communication and reputation protection and facilities.

Disaster recovery control measures are classified into three types:

1. **Preventive measures** — Controls aimed at the prevention of an event from occurring.
2. Detective measures — Controls aimed at the detection or discovery of unwanted events.
3. Corrective measures — Controls aimed at the correction or restoration of a system after a disaster or an event.

A sound DRP dictates that these three types of controls be documented and tested regularly.

Many due diligence questionnaires from potential investors will inquire about these three types of controls.

Strategies

Before the selection of a disaster recovery strategy, an organization must first develop the key metrics of a recovery point objective ("RPO") and recovery time objective ("RTO") for various business processes. Failure to create proper RPOs and RTOs can quickly disrupt a DRP. Once these metrics have been decided upon, an organization can then determine the most suitable recovery strategy for each system. An important item to consider is that while most organizations would love zero data loss and zero time loss, the costs associated with these levels of protection may render such goals impractical; a cost-benefit analysis should be performed to arrive at protection levels and cost outlays that are more pragmatic to the emerging manager.

Common strategies for data protection include:

- Backups made and sent off-site at regular intervals.
- Backups made directly to off-site location, or data replication to an off-site location.
- Private Cloud solutions or hybrid Cloud solutions.
- Outsourced disaster recovery provider to provide stand-by site and systems rather than using organization's own remote facilities.

In addition to preparing for the need to recover systems, companies should also implement precautionary measures that may prevent a disaster from occurring. Such measures include:

- Surge protectors.
- Use of uninterruptible power supply or backup generators.
- Fire prevention/mitigation systems.
- Anti-virus and other security software.

Funds registered with the Securities and Exchange Commission ("SEC") as registered investment advisers ("RIAs") should be alerted to the fact that the SEC has proposed new rule amendments under the Investment Advisers Act of 1940 that will require RIAs to implement written business continuity and transition plans. RIAs should go over their current policies and procedures to determine if they address the key components highlighted by the SEC. The proposed rule is a reiteration of the SEC's continuous efforts to make certain that RIA's adopt and implement written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser's operations. This includes

but is not limited to natural disasters, cyber-attacks, technology failures, the departure of key personnel, etc. that could prevent the RIA from meeting its fiduciary duty to clients and/or cause investor harm.

The proposed rule will require the RIA's plan to be constructed around the specific risks associated with their operations. The plan should address various aspects such as the following:

- Maintenance of critical operations and systems and the protection, backup and recovery of data.
- Pre-arranged alternate physical location of the RIA's office and/or employees, communications with clients, employees, service providers, and regulators, identification and assessment of third-party services critical to the operation of the RIA and a plan of transition that accounts for the possible winding down of the RIA's business.
- The transition of the RIA's business to others in the event the RIA is unable to continue providing advisory services.

RIA's will need to detail their plans to be specific to their organization based upon the complexity of their business operations and the risks related to their particular business activities. The RIA will need to review the adequacy of its business continuity and transition plan and the effectiveness of its implementation at least annually. The review generally should consider any changes to the RIA's products, services, operations, critical third-party service providers, structure, business activities, client types, location and any regulatory changes that might suggest a need to revise the plan.

Estate Planning

The primary focus of traditional estate planning is the orderly and systematic transfer of one's wealth to heirs and beneficiaries. Managers (or principals) of private equity, hedge, and venture capital funds face an unusual set of estate planning challenges and opportunities, as a substantial portion of their new worth may consist of illiquid, unmarketable and hard to value assets with significant upside potential. Navigation of the complex intersection of estate, gift, and income tax rules is essential in order to effectively perform transfers of fund interests and other related estate planning techniques.

Gifting Interests

Carried Interest is an attractive candidate for gifting due to its huge growth potential, with the goal being to transfer such an asset before it explodes in value. This interest may qualify for valuation discounts due to potential clawbacks, transfer restrictions and vesting schedules. An appraisal will be necessary to substantiate the value of the transfer.

A capital interest in a fund (exclusive of carried interest) is also a highly attractive candidate for gift due to their growth investment nature. Attributes such as illiquidity, lack of marketability, lack of control and lock ups may also result in suppression of value when gifting. As with a carried interest transfer, a valuation will be necessary to substantiate the value.

Transfers of management company interests are less frequent in occurrence and have their own set of income tax issues.

Common Transfer Techniques

Grantor Retained Annuity Trust ("GRAT") — A GRAT is an estate planning technique that minimizes the tax liability existing when intergenerational transfers of estate assets occur. Under these plans, the grantor gifts assets into an irrevocable trust. Under provisions set forth in the trust agreement, the grantor would receive/retain an annuity from the trust for a certain number of years, known as the retention period. The annuity may be paid in a fixed dollar amount or as a specific percentage of the initial fair market value of the trust's assets. If income from the GRAT each year is not enough to pay the annuity, trust principal must be used to make the payments. When the retention period ends, assets in the trust (including appreciation) pass to the beneficiaries estate & gift tax free.

When the GRAT is initially funded, the Internal Revenue Service considers it to be a gift in trust. The value of the gift, however, is reduced by the so-called "actuarial value" of the annuity that the grantor retains (which is based on various factors). If the grantor survives the GRAT's term, none of the assets in the trust will be subject to federal estate tax upon his or her death. If the grantor dies during the annuity term, the trust property or a portion of the trust property may be included in the grantor's estate.

Intentionally Defective Irrevocable Trust ("IDIT") — Here the grantor creates a trust and selects the beneficiaries of this trust (typically the grantor's descendants). Next, the grantor funds the trust with cash or other assets ("seed money" of approximately 10% of purchase price). The funding of the trust will be a taxable gift and the grantor may use some or all of his/her estate/gift exemptions. After the trust is funded, the grantor sells selected assets to the trust in exchange for a cash down payment (the seed money) and a promissory note representing the balance of the purchase price. To qualify as a sale rather than a gift, the purchase price must be for the fair market value of the transferred assets, and the note must bear interest at the appropriate applicable federal rate (AFR).

The estate and gift tax savings of this transaction results if the assets held by the trust have a total net return (i.e., income and capital appreciation) that exceeds the interest rate on the note. At the end of the term, whatever is left in the IDGT passes to the beneficiaries tax free.

Family Limited Partnerships and Family Limited Liability Companies ("FLP" or "FLLC") — A type of partnership designed to centralize family business or investment accounts. FLPs and FLLCs pool together a family's assets into one single family-owned business partnership that family members own shares of. FLPs and FLLCs are frequently used as an estate tax minimization strategy, as shares in the FLP or FLLC can be transferred between generations, at lower estate/gift cost than would be applied to the underlying partnership's holdings. An FLP or FLLC is different from a conventional trust, as family members actually own a share in a business.

Shares can be gifted to family members (or in trust for family members) over years, thus taking advantage of gift tax exemptions on an annual basis. The assets held in an FLP or FLLC impact the level of estate tax savings that can be realized by using an FLP or FLLC. In general, the more illiquid and complex the asset mix, the more difficult the FLP and FLLC is to evaluate, and the larger the potential for estate tax savings

Related Tax Issue

"Vertical Slice" Rule — Section 2701 of the Internal Revenue Code currently governs the transfer of carried interest. It generally requires managers to transfer a fractional share of all their interests in a fund (carried interests, capital interests, and synthetic capital) in order to avoid adverse gift tax consequences.

There are other creative estate planning techniques available. In recommending all planning techniques, it is important not only to consider the potential estate/gift taxes savings, but also the income tax implications. Currently the world of estate planning has a dark cloud of uncertainty hovering over it. The Trump Tax Plan is in favor of estate tax repeal which would certainly impact on these planning techniques. In addition, the IRS has recently issued proposed regulations that may impose major restrictions on valuation discounts in estate/gift tax planning.

Information Technology

A secure technology platform is vital for the long term success of any fund. Each fund has their own unique factors associated with it and should consider the appropriate technology for the current environment as well as longer term. There are essential technology considerations that funds of any size should address during the initial set up stage including but not limited to: security, data protection telecommunications and archiving.

Communications and data systems must be in place to support the exchange of information both internal and external of the fund. 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. An all-inclusive approach to security should be taken to ensure all of these crucial systems and tools are fully protected from unwanted and potentially costly attacks.

Some small steps that may seem obvious but are sometimes overlooked are as follows:

- Laptops should be locked up if left in the office overnight and should be equipped with hard disk encryption solution.
- Computer rooms should be physically locked with limited access.
- Have a defined computer and internet usage policy that defines acceptable behavior for employees as it related to technology usage.
- Restrict access to applicable software to only those employees that need it.
- Secure user authentication protocols that include assigning unique user ID's to each employee and individual computer stations are password protected and the password should be changed every 90 days.
- Keep a record of all visitors and monitor their access while on the premises to ensure they do not access unauthorized areas.
- Develop guidelines for the use of firm issued and personal "bring your own device" mobile devices in the work place.
- Educate employees on securities practices.
- Put in place security measures that have the ability to remotely wipe clean devices.
- Utilize encryption tools to transmit information electronically.
- Secure servers, laptops and workstations using industry standard anti-virus and anti-malware solutions.

Cybersecurity

Cybersecurity has become the latest buzz word and focus of funds. The regulators realize that funds are using technology more and more in everyday business, and the need to protect sensitive and confidential information as it relates to these activities from third parties is at all all-time high because of the ever-changing nature of cyber threats. The fund's need to identify their obligations under the law to assess their ability to prevent, detect and respond to cyber-attacks.

In recent years there has been a wide range of financial service firms exposed due to the lack of cybersecurity, which highlights the need for funds to review and update their cybersecurity procedures. The funds management should specifically identify risks and design controls to mitigate and address their specific cybersecurity procedures. Regulators have warned funds that they will face heightened penalties if they fail to report cybersecurity breaches for fear of investigation. Damage awards from regulators have become exponential when the demonstration of due care is not evident. Further, states like NY have proposed regulation that requires financial institutions to establish and maintain a cybersecurity program designed to protect consumers and ensure the safety and soundness of New York State's financial services industry. This pending legislation is over and above current regulations.

There are a number of areas that a fund could spend their time focusing on to diminish the threat of cybersecurity attacks. Some of these include:

- Performing a periodic assessment of location and vulnerability of the information the fund collects, how it is processed, and the technology it uses to obtain the data.
- Review current controls and processes that are in place and test them for vulnerabilities. More than likely, Penetration Tests and Vulnerability Scans are required.
- Assess the impact should various systems be compromised.

Funds should create a strategy that is designed to prevent, detect and respond to cybersecurity threats. Strategies could include:

- Making systems less vulnerable to unauthorized intrusions by having proper firewalls in place and ensuring user credentials are needed to access systems.
- Data encryption.
- Restricting the use of removable storage media and deploying software that monitors technology systems for unauthorized intrusions.
- Disaster recovery plan.
- Develop an incident response plan.
- Routine testing of plans could also enhance the effectiveness of any strategy.
- Ask your third parties for Service Organization Control "SOC" 2 Type II report which is a report performed by independent CPA firm to evaluate third party security controls and operating environment essentially.

Funds should implement written policies and procedures and train all levels of the firm about threats and measure how to prevent, detect and respond to such threats. Firms may also wish to educate investors and clients about how to reduce their exposure to cyber security threats concerning their accounts. Improving your "human shield" has significant payback. We also suggest testing employee knowledge via Phishing as a Service programs and retrain employees who still succumb to rogue information.

The above insight includes suggested measures that funds can use to think about cybersecurity and is not intended to be a comprehensive list. Other measures may be more suitable depending on the operations of a particular RIA. Each RIA should determine whether these or other measures need to be considered in connection with addressing cybersecurity risks. Firms should start to think about hiring service providers to perform penetration tests to see if areas of their systems are inadequate and how they can reinforce them.

In closing, for our more confident RIA who have come away after reading this message that you're well prepared, there are professionals called Certified Ethical Hackers who can help to validate defenses.

Insurance

In order to manage the risks associated with starting and running your new fund, a fund manager needs to address its business insurance requirements, as well as its insurance requirements as it relates to its employees.

Business Insurance

- Directors and officers liability. Often called D&O, this is liability insurance payable to the directors and officers of an entity, or to the entity itself, as indemnification for losses or advancement of defense costs in the event an insured suffers such a loss as a result of a legal action brought for alleged wrongful acts in their capacity as directors and officers.
- Employment practices liability. This is liability insurance coverage is designed to protect an entity and its owners from employee lawsuits for acts such as wrongful termination, sexual harassment, discrimination, invasion of privacy, false imprisonment, breach of contract, emotional distress, and wage and hour law violations.
- Professional liability. This is a form of liability insurance that helps protect professional advice and service providing individuals and companies from bearing the full cost of defending against a negligence claim made by a client, and damages awarded in such a civil lawsuit. It is commonly known as "errors and omissions" (E&O) insurance, as the coverage focuses on alleged failure to perform on the part of, financial loss caused by, and error and omission in the service or product sold by the policyholder.
- Commercial property and liability. Commercial property insurance covers your buildings and the contents of those buildings in the event of loss. It provides protection against losses from theft, accidents, fire, and some weather damage. Commercial casualty insurance provides protection to a business against lawsuits for injury, property damage or negligence caused by the business. Property and casualty insurance are often combined (also known as "P&C" insurance) because most businesses need both types of coverage to be adequately protected.
- Fidelity bonds. This is a form of insurance protection that covers policyholders for losses that they incur as a result of fraudulent and/or dishonest acts by its employees.

Other types of insurance may be required, depending on the types of clients that you may work with. If some of your fund's investors are ERISA plans, you may be required to obtain additional insurance such as a surety bond. There may also be specific requirements in certain states in which you may do business.

Employee Related Insurance

- Health. The insurance policies that are usually offered that would cover the costs of an employee's medical, dental and vision expenses.
- Disability. A form of insurance that insures an employee's earned income against the risk that a disability creates a barrier for the employee to complete the core functions of their work.
- Group life. Group life insurance is a type of life insurance in which a single contract covers an entire group of people. Typically, the policyowner is an employer, and the policy covers the employees or members of the group. Group life insurance is often provided as part of a complete employee benefit package. The employer usually pays for most (and in some cases all) of the premiums. The amount of your coverage is typically equal to one or two times your annual salary.

Office Space

One of the most significant costs an emerging manager may be faced with as the fund launches are the costs associated with the rental of office space. Looking for office space can also be a time consuming project. An emerging manager has four basic options to choose from:

- Subleasing space from another organization
- Having a virtual office – no specific physical space is needed
- Renting commercial office space
- Using an "executive suite" service

Virtual Office

A virtual office provides communication and address services for a fee, without providing dedicated office space. It blends home and work to gain efficiencies in both. While office expenses are low, the organization's professionalism portrays the image of a traditional high-cost office. A virtual office allows for a low-cost expansion with no long-term commitments. Virtual office service typically include:

- Professional or mailing address — a professional address alleviates the personal security and privacy concenrs of having a home-based business. An organization can expand into new markets by contracting with a virtual officer provider with multiple locations to establish a presence in the desired markets. This address is capable of accepting, sending and forwarding mail.
- Reception — receptionists at this business address are able to receive and sign for incoming deliveries and packages, and provide document drop-off and pick-up services. A live virtual receptionist is also an option to answer and route incoming calls.
- Mail scanning — a handler can open mail, scan the contents, and forward the documents to your organization or transfer the files to a cloud based storage system. The opened physical mail could then be shredded if so desired or stored for later retrieval.
- Meeting space or casual workspace — on-demand use of conference rooms or offices available on short notice or on a "drop-in" basis.
- Phone answering service and voicemail services.

Renting Own Space

Probably the most expensive of all of the options above, but it also has its own advantages, primarily in that it provides the most freedom to plan and design your organization's space. It will require, however, that your organization commit to a lease term, which in most commercial office buildings is usually three to five years. You will need to either contact a real estate broker or deal

directly with the landlord of a commercial office building to find your office space and negotiate the terms of the lease. It is prudent to have your attorney review the lease to ensure you have secured the most favorable lease terms possible. Certain key elements of the lease that you need to consider include:

- The term of the lease
- The request by the landlord for a personal guarantee
- Ability to secure additional space if necessary
- Responsibility for repairs, improvements, and replacements
- Rent escalations
- Renewal options in the lease
- Improvements made by the tenant
- Security deposit / Letter of Credit

It is also essential that your organization considers future growth and primary uses of the office space in its assessment of spacing needs. You wouldn't want to secure space that wasn't able to provide conference rooms if you plan on conducting most of your client business on-site where such rooms would be crucial. Lastly, location, location, location. Unfortunately the most desirable of office spaces and the most desirable of locations often come with hefty price tags.

Executive Suite

This option is appealing to many emerging managers as it has significant advantages:

- Cost — a typical set up for one professional can cost under $1,000 per month, depending on the other services chosen.
- Flexibility of lease term — anywhere from month-to-month to up to two years is often available.
- Ease of effort — an emerging manager can often be up and running quickly as the office space is usually move-in ready.
- Technology — the suite provider usually has IT personnel on-site and services that are available under this arrangement often include high-speed internet, disaster recovery, secure file servers, e-mail services, and telecommunications.
- Location — ability to potentially secure fully-equipped offices in high-cost and desirable locations.

- Support — many suite providers provide minor amenities such as kitchens, conference rooms, and a reception area which allow your organization to present a professional image to your clients and visitors. In addition, an administrative assistant or receptionist is also sometimes available as part of a leasing arrangement to assist your organization with various administrative tasks.
- Menu of services — often suite providers offer various additional services to be charged separately or per use such as courier service, video conferencing, multiline phone service, etc.
- Business growth — choosing this option allows your organization to assess your infrastructure and space needs as your fund gets off the ground without having to commit to a long lease term period.

Subleasing

While similar to the executive suite option in mays ways, it also has some distinct benefits, which include:

- Shared common areas (kitchen, reception area, conference rooms)
- Potential to use certain administrative and support staff from the organization you are sharing space with
- Avoid certain start-up and installation costs (phone, internet, other)
- Ability to customize your leasing arrangement instead of selecting off a “menu” provided by an executive suite provider
- Ability to potentially cohabitate with an organization that operates in a complimentary line of business to your own which potentially could result in new business

Outsourcing

In organizations with hundreds of employees, the human resources function is often set up as a separate department within the administrative side of the business. When starting your own fund, you will quickly learn that it may be you who is responsible for many of the functions that fall under "human resources", as well as any legal ramifications that come with the hiring of employees. As these skills are typically not core competencies of emerging fund managers, you may wish to consider outsourcing as many of these functions as you can so that you can devote as much focus as possible into launching the new fund.

A professional employer organization (PEO) is a firm that provides a service under which an employer can outsource employee management tasks, such as employee benefits, payroll and workers compensation, recruiting, risk/safety management, training and development, among others. These types of businesses essentially assume the role of your human resources department, and are able to provide you with many levels of support. Often outsourcing can be a cost-effective solution to building a human resources capability within your fund.

Registration

A registered investment adviser ("RIA") is an investment adviser registered with the SEC or a state's securities agency. An RIA is defined as an individual or firm that is in the business of giving advice about securities. An investment adviser must adhere to a fiduciary standard of care laid out by the US Investment Advisors Act of 1940. In general, RIA's who manage $150 million or more in client assets must register with the SEC. In general, RIA's managing assets totaling less than $100 million must register with the state securities agency in the state where they have their principal place of business.

Form PF

Form PF is a form that was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act which required the SEC to establish reporting and recordkeeping requirements for advisers to private funds. An investment adviser must file Form PF if it:

- Is registered or required to register with the SEC.
- Advises one or more private funds.
- Had at least $150 million in regulatory assets under management attributable to private funds as of the end of its most recently completed fiscal year.

Most private fund advisers are required to complete and file Form PF once per fiscal year. Certain fund advisers, notably hedge fund advisers, are required to report on a quarterly basis.

Venture Capital Exemption from Registration

Section 203(1) of the Investment Advisers Act of 1940 provides that an investment adviser that solely advises venture capital funds (as defined in the Investment Advisers Act of 1940) is exempt from registration. This exemption is available without regard to the number or size of such venture capital funds.

Form ADV

Form ADV is a required submission to the Securities and Exchange Commission ("SEC") by a professional investment adviser that specifies the investment style, assets under management (AUM) and key officers of the firm. A company managing over $25 million must update the form annually, and the form must be made available as public record.

Officially called the Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Adviser, Form ADV serves as a registration document that must be submitted to the SEC and to state securities authorities. The North American Securities Administrators Association ("NASAA") reviews and approves changes made to the document, and it is supported by the Financial Industry Regulatory Authority ("FINRA").

Form ADV is divided into two parts. The first part discloses specific information about a RIA that is important to regulators, such as its name, the number of employees, the form of the organization and the nature of the business.

The second part acts as a disclosure document for clients of the business and includes information, such as services provided, fees levied, and whether the investment adviser acts as a broker-dealer and transacts securities. Part 2 also requires the creation of a narrative brochure, which provides information to interested parties in plain English. These brochures are made available to the public and contain details regarding any conflicts of interest that are present, any disciplinary actions that have been taken, current educational and business background information, and other items deemed critical to clients of the RIA.

Form ADV filings are required on an annual basis for the firm to be considered to be in compliance. This ensures that all pertinent information is recorded properly. Annual filing is required even if the firm made no changes during the previous year. If no changes are required, filers must attest to the accuracy of the information currently on file.

If an adviser fails to file as required per state and federal regulations, it is subject to administrative action. This can include the suspension or revocation of the adviser's professional license as well as fines for noncompliance.

Retirement Benefits

Nowadays, some type of retirement benefit, most commonly a 401(k) plan, has become a standard part of any firm's benefits and compensation package. Some of the key concepts you will need to address should you consider establishing a 401(k) plan are as follows:

Types of plans. You have various options when establishing your 401(k) plan. They are a traditional plan, Savings Incentive Match Plan for Employees (SIMPLE) and safe harbor plan. Each plan has its own tax advantages and employer responsibilities which should be carefully researched before adopting a written plan.

Plan trustee. You will need to select a plan trustee for your new plan. This is a crucial decision as the security and integrity of the plan's assets are of the utmost importance. In certain cases, your plan administrator can also serve as your plan trustee.

Administrator vs. **self-managed.** You will need to determine whether you want to bear the burden of establishing your own 401(k) plan and the related administrative procedures and guidelines, or if you want to hire a third party service provider to administer the plan, such as an insurance company, bank, or mutual fund firm.

Employer match. Another significant decision you will need to make is whether you will include an employer contribution (or "match" as it is commonly referred to as) as part of the plan. It may not be feasible for your "start-up" operation to fund such contributions without potentially putting the business into a tight cash flow situation. It may be more prudent to add this feature to the plan at a later date in time.

Roll-out. You will need to have a summary plan description prepared, which is then distributed to all plan participants. This document is intended to educate all participants about the characteristics of the plan.

Service Provider Selection

Selecting the right service providers such as an attorney, prime broker, administrator and auditor for the size and complexity of your fund is imperative to ensure smooth and efficient operations. Each of the service provider selections should be seen as an investment in the longevity of the fund. Often, these service providers can recommend other service providers.

Attorney

Hiring an experienced fund attorney from the initial start of a fund is vital to ensure compliance with the ever-changing landscape of the alternative investment universe. They will prepare the fund documents correctly and assist in avoiding regulatory snags. Attorney's will assist funds in determining the appropriate fund structure and prepare the legal documents necessary to form, operate and market your fund. These documents include, but are not limited to: the limited partnership agreement, offering memorandum, operating agreement, side letters, subscription agreement, and private placement memorandum.

Prime Broker (Hedge Funds only)

Fund managers should view selecting a prime brokerage firm as an integral part of how the fund trades and operates. This should be a well thought-out decision weighing the costs and benefits of doing business with various brokerage firms. It is in the fund's best interest to partner with a brokerage firm that is motivated to serve its needs and is familiar with the investment strategy of the fund. Typically, prime brokers will offer custody service and access to financing and securities lending. However, the fund should make sure the brokerage firm is sizable enough to meet all the required trading and brokerage needs.

Custodian

A custodian is typically a financial institution that holds an adviser's investments for safekeeping and additional assurance to minimize the risk to their investors that investments could be lost or stolen. When selecting a custodian the advisers should identify a qualified custodian under the rules set by the Securities and Exchange Commission.

Administrator

A third-party administrator is not required to successfully operate a fund. However, they can relieve a significant amount of the burden from the manager and improve the consistency with which certain tasks are handled. The first step in choosing a fund administrator is deciding what functions will be done internally and what will be outsourced. The fund should analyze which

fund administrators are a good fit for their needs and factor in their reputation in the industry. The next steps a fund should take are to examine whether each administrator has the right technology to meet the fund's trading strategy. At this point, it is a good idea for the fund to perform their due diligence by speaking to some of the administrator's clients, both those that are similar in size and strategy to the fund and those that are different. By doing this, the fund will get a realistic picture of how the administrator performs and deals with various clients. Many fund managers use administrators to act as their outsourced accounting department and handle anti money laundering procedures. Services that administrators typically perform include but are not limited to: Monthly accounting and net asset value calculations, performance fee calculations, capital calls and capital distributions, record keeping of investors and management fee calculations.

Auditor

Engaging an accounting firm can be a daunting task since there are many accounting firms across the United States that offer audit and tax services for funds. Going with a Big 4 accounting firm can offer name recognition to funds looking to appeal to institutional investors; conversely, choosing these firms regularly comes with a higher price tag that is not always appealing to a start-up fund and can be a significant expense that reduces overall fund performance. Start-up funds typically find themselves in the middle-market audit firm arena, which features significant experience and knowledge of the industry, affordable costs, and more personalized services in relation to the larger firms. Ultimately, new funds should choose an accounting firm that has substantial industry experience and knowledge, superior client service, and a good reputation within the alternative investment industry. The fund should meet with all members of the engagement team with whom it will be working to understand the depth and expertise at each level.

The accounting firm can assist with reviewing initial documents drafted by your attorney before they are finalized to offer advice on the tax implications associated with entity selection and manager compensation to ensure they are consistent with industry standards and include industry specific clauses. The main deliverable from an accounting firm is the audit opinion on the fund's annual financial statements and the annual fund tax returns with investor K-1's.

As part of the annual audit process, the accounting firm will be assessing the appropriateness of accounting policies and will consider the internal controls that are put in place by the management of the fund to ensure that accurate accounting, operations and trading procedures are being followed. The accounting firm will review the books and records of the fund to obtain reasonable assurance that the annual financial statements are free from material misstatement.

Takeaways

- It is always a good idea to evaluate multiple providers in order to get a thorough understanding of the capabilities that they have, and to evaluate market pricing
- When selecting one of your providers, ask them for recommendations on your other service providers as undoubtedly they will have worked with many other service providers and could provide valuable advice and potentially make your search easier.
- Keep in mind that your fund's reputation can be hindered or helped by your ultimate service provider selection.
- Service provider fees are not always representative of the quality of service and support that you will receive – factors such as technical skills, responsiveness and trust should be key components of your decision.
- Growth – your needs on day one of the fund's life will not be the same as in year five of the fund. Make sure the service provider you select can continue to provide services to the fund and you continue to grow and your needs become more complex.
- Counterparty risk – the risk that your service provider will not be able to live up to their end of any agreement which in turn will affect the fund's ability to properly serve its constituents. Consider the reputation and history of any service provider in your selection process.

Staffing

One of the biggest challenges a new fund manager may face is how to determine staffing. When starting a new fund, there is the opportunity to design your staffing model to fit the unique needs of your business.

Front-office Employees

Include individuals such as the chief investment officer, portfolio manager, deal makers, analysts and traders. These are the individuals responsible for developing and implementing your new fund's investment strategies.

Back-office Employees

Back-office employees include any individual who supports the front-office employees or the fund itself. Administrative assistants, office managers, accounting staff, investor relations and compliance staff are examples of the different types of back-office employees. In new funds, sometimes individuals handle various roles and "wear multiple hats". The back-office is where most of the staffing decisions take place in a new fund. A new fund manager will need to consider the following:

- What is the target size of the fund, and how many investors do you plan to have (the larger the fund, the more likely you are to need increased staffing for support)?
- What back-office functions are essential to the fund's operations?
- What back-office functions are more "complimentary" and can be added at a later date?
- Can one individual handle various functions?
- What tasks can be outsourced to a third party service provider?

Regardless of the size, the common mentality of a new fund manager is usually to begin operations with a lean organizational structure to minimize expenses.

About The Contributors

Thomas Angell, CPA — Tom is a Partner based in Withum's New York office. He is a leader in the Firm's Private Equity and Venture Capital Practice, and specializes in providing audit and tax services for domestic and offshore alternative investment vehicles, investment advisors and their related management entities. Tom assists clients with initial organizational structure, audit processes and the management of operational and tax matters. Tom is a certified public accountant in New York and New Jersey.

E: tangell@Withum.com P: 212.829.3239.

Joseph M. Cassano Jr, CPA — Joseph is a Senior Manager located in Withum's New York office. Joseph specializes in providing financial reporting, tax and accounting services to hedge fund clients. Joseph has experience working with a variety of clients including domestic and offshore investment funds, fund of funds vehicles, investment advisors and related management entities. In addition, Joseph serves as a key contributor to the Firm's Financial Services Best Practices Group. Joseph is a certified public accountant in New York and New Jersey.

E: jcassano@Withum.com P: 646.604.4194.

Peter Lubcker, CPA — Pete is a Senior Manager based in Withum's New York office. Pete specializes in providing audit and tax services for private equity and venture capital funds, including fund of funds vehicles. Pete assists clients with the audit processes, internal control assessments and implementation and maintenance of accounting procedures. In addition to servicing clients, Pete is a leader of the Firm's Financial Services Best Practices Group. Pete is a certified public accountant in New York and New Jersey.

E: plubcker@Withum.com P: 646.604.4199.

About Withum

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New York, NY
1411 Broadway, 9th Floor
New York, NY 10018
212.751.9100

Boston, MA
155 Seaport Boulevard
Boston, MA 02210
617.227.3333

Morristown, NJ
465 South Street, Suite 200
Morristown, NJ 07960
973.898.9494

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