U.S. Edition I Version 1 I January 2012

Prime Finance Business Advisory Services

# Hedge Fund Start-Up Guide

Citi Prime Finance

citi

# Executive Summary

The Citi Prime Finance Hedge Fund Start-Up Guide is being published at a time we believe represents a new inflection point in the evolution of the industry and the **emergence of a new model** for managing a hedge fund. In our view, the infrastructure and software choices enjoyed by a manager in today's environment deliver a 'virtual' set of services and products that we are describing internally and to our clients as **'Hedge Fund 3.0'**.

In this guide, we articulate a **unique framework** for start-up hedge fund managers in the United States and highlight where this framework offers potential to employ the new Hedge Fund 3.0 approach. The purpose of this guide is to help a manager understand and navigate the end-to-end set of service providers and vendors that will allow a new fund to operate in a business model that reduces risk, reduces expense, and allows a fund manager to deliver an institutional quality infrastructure as a vehicle for their investment product. The framework also ensures an optimum **speed to market** for ordering key start-up tasks and decisions so that the process of launching the new fund and the management company is highly efficient.

This document is **essential reading** for anyone having recently launched or considering launching a hedge fund in today's industry landscape, and Citi Prime Finance can help you interpret the key decisions that need to be made when launching the firm.

# Table of Contents

The guide is designed to provide a detailed understanding of how to launch and develop a hedge fund in the new world of software, infrastructure, and services outsourcing that combine to deliver the foundation for managing a hedge fund. The framework applies on a global basis for a new fund launching in any market or jurisdiction, and is intended to cover the entirety of services and functions needed to manage a successful hedge fund.

Given the diverse nature of hedge fund business requirements and the ever-changing product offerings of service providers and vendors, we will update the document periodically. This is the first edition of the start-up guide and we hope it acts as a useful planning tool and relevant framework for a new hedge fund manager, whether the reader is a founder of the firm or a new employee looking to address one particular area of the business.

## The Start-Up Framework

The Citi Prime Finance hedge fund start-up framework covers five core areas that need to be addressed in order to launch a successful fund management organization. The core areas and sub-tasks are ordered specifically to tackle the key decisions effectively and enable an efficient process for launching the fund.

### Chart 1: Overview of Hedge Fund Start-Up Framework

The framework is dynamic and can be used either as a **holistic guide** to all required tasks or as an a la carte reference point for specific areas of focus when developing a fund management organization. The framework can be used as a **project management tool** by the founding partners or by a project manager from our advisory team to oversee the key start-up steps.

Underlying each major section and each sub-section is a global and regional list of premier providers who are offering services to hedge funds—we have completed a level of due diligence on each firm to ensure they are 'best in class'. The list contains a range of companies who all offer some degree of outsourced services so that an entire **virtual company** can be constructed with the **right combination of service providers and vendors.**

If you are a service provider or vendor and wish to be included in our shortlist of providers, please contact prime.advisory@citi.com to introduce your product or service to our team for consideration.

## Start-Up Services

Within our Business Advisory team in Prime Finance we offer a comprehensive start-up service, beginning with educating a new hedge fund manager on the full scope of what is required to launch the fund and introduce the framework. Our Business Advisory team have consulting backgrounds and have worked on fund launches of different sizes and complexities so can offer a broad perspective on how to apply the framework in each situation. The team member assigned to each start-up will be the Business Advisory point person for the client and work with them throughout the start-up phase. Often, the Citi sales person will be part of the initial meetings to ensure continuity with the early stage discussions.

The first meeting with the client is typically a 1–2 hour introductory meeting and an initial discussion on where the fund is in terms of progress with different areas and making key decisions. At this meeting we will provide an overview of the leading service providers and vendors offering 'virtual' or hosted services and agree a short list of firms to meet in the second meeting. Business Advisory has already preselected **the leading firms** who are offering services and products that focus on the hedge fund industry and from this list we work with you to refine your selection.

This consultation meeting is then followed by a series of **service provider and vendor workshops** where funds are introduced to the chosen service providers and vendors. These sessions are fully coordinated by the start-up project management team and can be hosted within a Citi facility if desired by the client. Depending on the stage of development and the number of introductions required these workshops can range from 1–3 business days. As these sessions will cover many different disciplines, we include different specialists from our Business Advisory team to facilitate the discussions and highlight the differences between different services and products. *(A full list of our Business Advisory services is included in the appendix of this guide.)*

We will assist you with detailing key notes and actions arising from the workshop and help create a first draft of the start-up project plan, which will be reviewed at the conclusion of the workshops.

At the conclusion of the workshops, we will discuss the need to provide project management services to manage all aspects of the fund development and setup. Depending on the client and their internal bandwidth, this service can be tailored to fit the needs of the client.

As the list of service providers is narrowed and key choices are made we offer support in making those critical decisions, helping to evaluate different options and the overall goals of the organization. We are experienced at negotiating terms and conditions with software vendors and service providers, and can provide benchmark data on different infrastructure and support services.

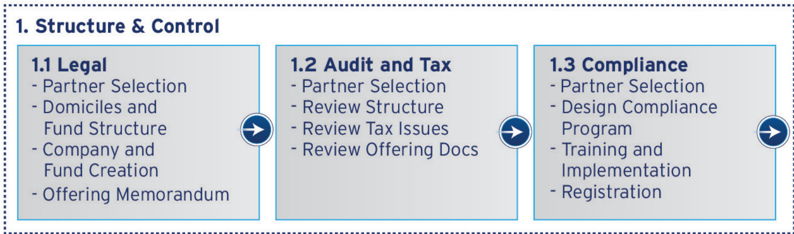
The Business Advisory team has an **experienced consulting background** and can help define the requirements and overall strategy for how to build out the firm. This can include support on designing the optimal organizational structure, defining roles and responsibilities, creating a governance framework, and building a functional architecture to guide the selection of technology solution choices. All of these services will be discussed in depth in the coming sections. A new launch can choose to engage with the team on many different levels, from full project management support through to acting as an advisor on specific areas.

### *Core Team - "Section 0"*

Although not a specific set of tasks and decisions we include a 'Section 0' when discussing the start-up framework to highlight the importance of having a core management team in place from the outset of your hedge fund launch process. This is critical in today's environment where the business infrastructure is regarded as equal to the investment strategy in terms of developing a serious and appealing hedge fund company.

We recommend that at least the CIO and COO/CFO are in place before dialogue with service providers begins. You will benefit greatly from having this team approach as you enter into the broad array of conversations and meetings that this process will entail.

**The following sub-sections are considered part of the structure & control work stream:**




## 1.1 Legal Services

Determining the legal partner and outside counsel for the fund manager is a **critical early decision** when beginning the process of starting the company. The outside counsel will need to be involved in all conversations about the company and fund structure and will review all key servicing agreements for both the management company and the fund. Having legal counsel in place allows the principals to navigate an early maze of options and variables relating to where the different companies need to be incorporated and the implications of those foundational decisions. The choice of legal partner is critical to making the right decisions from the outset.

Typically, legal partners work on a retained basis, charging either a monthly or annual fee for their services. At the beginning of the relationship, however, time and materials (T&M) is often the approach to charging for the service. T&M can often be expensive with professional services firms, in particular legal firms, so you should be aware of the engagement approach and terms and conditions of the service.

Your legal partner will work with you closely on the following steps to create the fund and the management company:

### *Naming Your Fund*

An initial step in forming your firm is choosing a name for your fund and your management company. Have your legal counsel confirm that the desired name is available and can be registered. It is worthwhile also confirming the Internet presence for the name and the availability of websites and emails with the name included or abbreviated. Your legal counsel will run a check on the name and any Intellectual Property ("IP") rights associated with it, or with any affiliated names.

### *Fund Structures & Domiciles*

The domicile you choose will largely be a factor in who your investors are and their specific tax status. Funds with investors in only the country of origin can establish an onshore company but the vast majority of funds set up as both an onshore limited partnership (LP) or limited liability company (LLC) and an offshore corporation, which both feed an offshore 'Master Feeder' or 'Parallel' fund structure. The vast majority of hedge funds in the U.S. choose the Master Feeder Structure and the benefits are listed in Chart 2.

In the United States the most common onshore state in which to register the LP or LLC is Delaware, whereas in Europe, onshore typically refers to Dublin or Luxemburg, and in Asia the domicile can vary widely. For the offshore entity, the most common registrations are the Cayman Island, British Virgin Islands, Isles of Man, Bermuda, or Mauritius for the Asia-based funds.

While offshore jurisdictions all provide low-cost, low-tax environments for the principle fund vehicle to reside, the tax jurisdiction of the investor is equally important in order to determine the full implications of making a domicile decision.

The onshore management company, typically an LLC or LP, offers its members limited liability and more importantly flow-through tax treatment in the same way that a partnership passes the tax obligation back to the partner. Operating agreements for the management company are typically drawn up between the managing partners in order to provide for resolution of any governance or oversight issues.

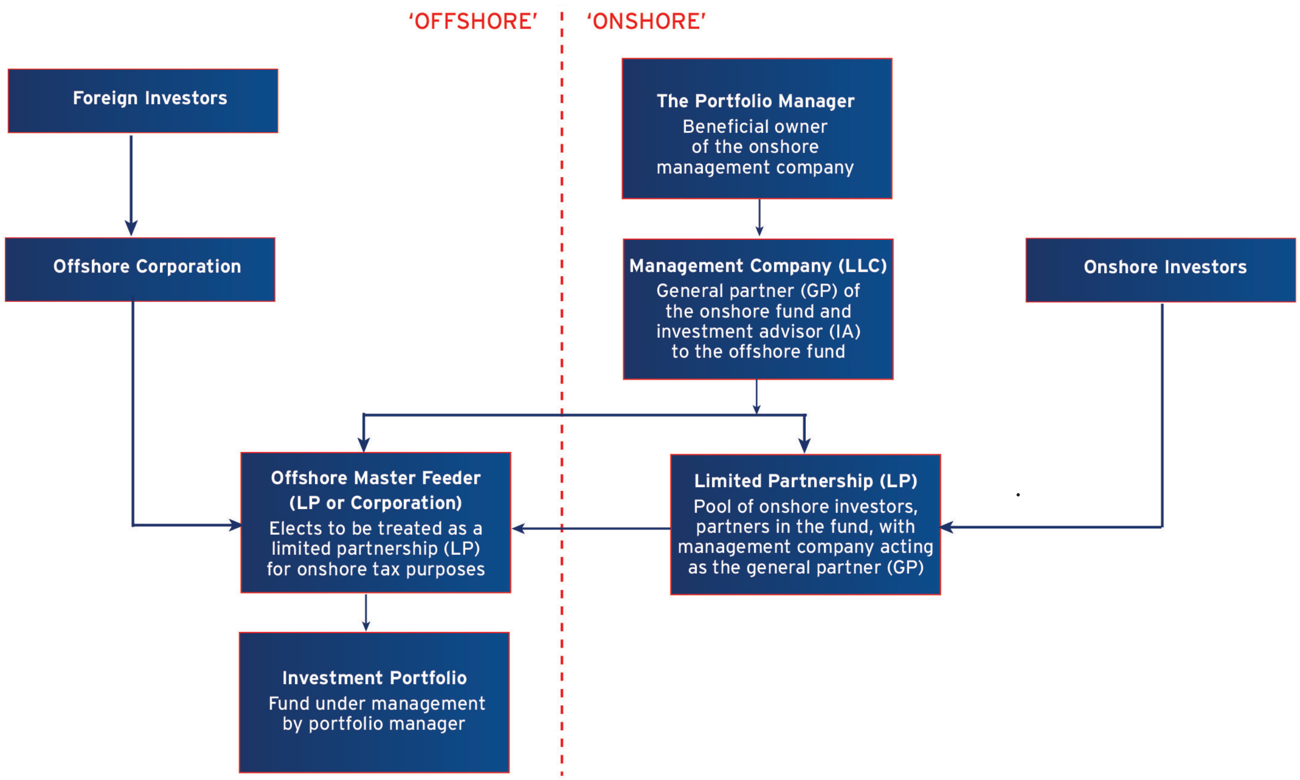
Your legal counsel will offer advice on all possible structures and this structural decision is one of the first required in establishing the fund and the company.

The following chart illustrates a typical U.S. Master Feeder fund structure with both the onshore and offshore sides of the fund. Foreign investors invest in the offshore corporation and take a Limited Partnership interest in the offshore company, and the investment portfolio is legally overseen by the offshore company. The management company is registered onshore (typically Delaware) and acts as the investment adviser to the offshore fund. The onshore LP is managed by the management company, which acts as the General Partner (GP) to the investment company for onshore investors.

### Chart 2: Comparison of Parallel and Master Feeder Fund Structures

| | Parallel Funds | Master Feeder Fund |
|---|---|---|
| **Description** | The onshore and offshore funds are not linked in any way to protect the offshore investors from any liabilities linked to the onshore fund. | The onshore and offshore funds link to a 'Master' fund which is the legal face to counterparties and regulatory authorities. |
| **Pros** | The two funds can use different year-end cycles so incentive fees can be staggered.<br>There are no tax conflicts among investors and the onshore investors can take advantage of the U.S. tax treaty network for U.S. partnerships and investors.<br>For distressed credit funds where some liabilities may be physical ownership of the asset, the separation from the onshore liability can be important to the offshore investors. | Lower trading costs as portfolio management is kept in one vehicle and trade tickets do not need to be split or allocated between two different funds.<br>Single counterparty relationship with prime brokers and broker-dealers.<br>Returns of separate onshore and offshore funds will be similar as they link to just one single portfolio of assets (i.e. no tracking error). |
| **Cons** | Portfolio manager and trader is required to 'split tickets' between the two funds and each fund is viewed as a separate counterparty for prime broker and broker-dealer relationships.<br>Keeping the portfolio balanced and avoiding any tracking error is burdensome, and the reconciliation of both funds to prime broker and administrator is more intensive. | Tax-driven transactions are not effective for all investors/feeders, and if the fund is investing in distressed credit assets, these liabilities need to be discussed in detail with your legal counsel. |

### Chart 3: Example Master Feeder Structure



The Master Feeder fund will need to decide whether to register as a '3c7' or '3c1' private investment pool, a U.S. classification that determines the nature of the investors and which regulatory authority will oversee the activities. A '3c1' private investment fund is limited to only 100 'accredited investors', defined by the Securities & Exchange Commission (SEC) as individuals with greater than $2 million USD net worth (excluding real estate and art). This type of investment firm is regulated by both the SEC and the Commodities & Futures Trade Commission (CFTC), which introduces a level of regulatory complexity greater than that of a '3c7' company. The '3c7' definition requires that every U.S. investor in either the onshore or the offshore fund have greater than $5 million USD if an individuals, or greater than $25 million USD if a corporation. This type of fund is only overseen by the SEC and is therefore exempt from CFTC regulations. Partners of the management company can also invest as 'knowledgeable employees' and can fall below the $5 million net worth requirement as individual investors.

In order to determine the right filing and classification for the Master Feeder fund, your legal counsel will want to understand the goals of the fund and which investor segments are being targeted. If institutional money is being sought, it is likely that the '3c7' filing will be more appropriate, as the ticket size is likely to be significant, meeting the $25 million threshold for institutional investment.

For the offshore company, if registered as a Corporation, you will be required to identify the Directors of that company—this is another topic for discussion with your legal counsel. There are various options for identifying and securing outside Directors for the corporation and in recent years this has come under increased regulatory scrutiny. We recommend that you consult your legal counsel on the most appropriate option for your fund.

## *Fund Terms & Conditions*

As you define the fund domicile structure you will need to determine your terms and conditions, which include the fund fees, liquidity, lock-up period, minimum investment amount, capacity and any special fund gates or hurdles that you wish to propose to investors. These terms and conditions form the investment profile for your fund and will be incorporated into the formal **Private Placement Memorandum (PPM)** or offering documents. These offering documents will need to be in place before formal marketing activities commence, and your legal counsel will advise you to finalize the following details before having investor conversations:

### Fees

The traditional hedge fund model has been referred to as '2 and 20', which outlines both the management fee of 2% of assets under management and 20% of fund performance and profit. This model is widely used around the globe but has in recent years been challenged by many investors looking for either a lower fee structure or better alignment of interest between the investors and the manager. Offering varying fees to different investors can typically be justified if the level of service to the client is different or the size of the capital commitment is significantly different. Also, fees may vary if the vehicle offered to the clients is customized such as in a separately managed account. The economics of lower fee structures may become restrictive to managing a firm and overseeing a fund without the correct business structure and organization.

The other dimension regarding fees is the frequency at which they are paid and the many different approaches that are used. The typical frequency is to accrue both management and performance fees monthly, but to pay management fees quarterly and pay incentive fees annually after the fund audit. However, there are examples of two-, three-, and five-year terms for some strategies and investor groups. The frequency of payments and length of the term is a three-way dialogue between the founding partners, legal counsel, and the investor base and will likely reflect the commitments on both sides to enter into a healthy business relationship.

### Liquidity, Lock-Ups, and Capacity

The liquidity terms offered by hedge funds vary greatly and are subject to many factors including, but not limited to, investment strategy pursued, the liquidity of the underlying assets traded, experience/pedigree of manager, and the investor type.

For subscriptions to the fund, the process will be defined with your legal counsel and your fund administrator, but funds typically offer monthly subscriptions access with a set notice period. Minimum investment amount by investor will also need to be documented in the offering documents and will help to define which type of investor your fund may attract. For onshore investors, a number of background checks have to be performed, and these will be described in the PPM and are typically performed by the fund's administrator.

For fund redemptions, a notice period will be proposed to investors to observe when redeeming their shares from the fund. In addition, you will need to determine the frequency at which investors can redeem their shares, such as monthly, quarterly, annually, etc. Primary factors driving these decisions will be the fund's investment style, market liquidity, and the nature of the underlying securities traded. The redemption frequency and notice period will need to be included in the fund's offering documentation.

Your fund may choose to impose a lock-up on investors, which is intended to limit their redemption liquidity. A 'hard lock-up' will dictate that an investor cannot redeem from the fund until after a certain time period, such as one or two years. A 'soft lock-up' states that an investor will be charged a redemption penalty if they redeem prior to a certain investment period.

As the fund nears capacity, an investment adviser may choose to close it to new investors ('soft-close') or to all investors ('hard-close'). Capacity limits vary based on the market size and trading strategy employed. These decisions will likely be made before establishing the various LLC and LP vehicles and will become part of the offering documentation for potential investors.

Our Capital Advisory group can provide insight on current trends with these core terms, and help you define a set of terms that are appropriate for your fund strategy and investor base.

**Gates and Hurdles**

**Investor gates** are designed to limit investor liquidity at predetermined intervals around redemption dates, such as quarterly or annually. **Fund-level gates** limit redemptions on the fund to a certain percentage of the fund's net assets at each redemption date. Investor-level gates are designed to limit redemptions by each investor to a certain percentage of their investment in your fund. Investor-level gates can be imposed independently or in conjunction with fund-level gates and are implemented to alleviate the risk of investors attempting to 'game' fund-level gates. The decision to impose gates on your fund may influence investor sentiment towards your fund, as the gates can be viewed as a referendum on the liquidity of the fund's underlying assets and your investment strategy. Many investors are receptive to fund-level and an investor level gate's, as long as the gates are reflective of the liquidity of your funds underlying investments. Other investors, however, may view gates as a negative factor, depending on their experience during the recent financial crisis.

Some managers specify a hurdle rate and receive a performance fee percentage only on the fund's annualized performance in excess of a benchmark rate or a fixed percentage. A 'soft' hurdle performance rate means the performance fee is calculated on the entire annualized return when the hurdle rate is cleared. A 'hard' hurdle performance fee is calculated exclusively on those returns above the hurdle rate.

**Day 1 and Early Investors**

There are several methods to incentivizing early investors into your firm and fund at or soon after launch date. Your fund can offer an institutional share class to early strategic investors, which typically offers both reduced management and performance fees. These concessions are offered to these strategic investors that may be willing to lock up their investment for two or more years and reserve capacity above a certain size (typically $100m). Some of these early-stage investors are considered "seeder,", or "seed", investors and this type of investor will request a percentage of the management company top-line revenue in exchange for the early fund investment and will look to benefit from the funds growth and success. To facilitate capital raising early in your growth, you may also consider offering reduced fees to investors in a "Friends and Family" share class. You should be transparent and carefully manage the requirements for access to this share class so as not to imply favoritism to some "external" investor.

If clearly defined and strictly imposed concessions offered to early-stage investors (often referred to as 'Most Favored Nation' ('MFN') clauses) are typically agreeable to subsequent investors. That being said, if you begin to offer these concessions to subsequent investors using different criteria, it may become problematic with your existing investor base while also signaling weak business principles to these prospective investors.

**Side Pockets**

Where a hedge fund holds assets that are hard to value reliably or are relatively illiquid (in comparison to the redemption terms of the fund itself), the fund may employ a "side pocket". A side pocket is a mechanism whereby the fund segregates the illiquid assets from the main portfolio of the fund and issues investors with a new class of shares that participate only in the assets in the side pocket. The shares cannot be redeemed by the investor and once the fund is able to sell the side pocket assets, the fund will generally redeem the side pocket interests/shares and pay investors the proceeds. Many investors will react adversely to funds expecting to implement a side pocket because of its uncertainty and limitations on their overall liquidity.

## *Fund Structures*

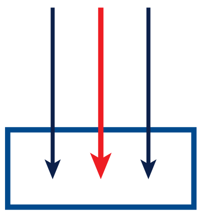
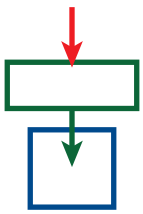
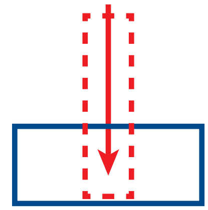
The most common hedge fund structure is a co-mingled fund, where each investor is a separate limited partner (LP) of the partnership. This allows each investor to buy units in the partnership for a fixed capital investment and to take profits (or losses) as a pass-through tax item from the fund to either corporate or personal tax jurisdictions.

Other structures being utilized include 'Fund of One' and 'Separately Managed Accounts' (SMA), both largely driven by an investor's desire to keep its investment separate from other co-investors and maintain a level of ownership and transparency for the asset pool. Size of investment will also influence structure as the costs associated with SMAs are incremental to the baseline infrastructure cost. It is typically not economical to manage under $100mm USD in an SMA structure, but this may vary depending on the platform used and the fees negotiated.

As the investor base for hedge funds broadens to include more corporate and public pension plans, sovereign wealth funds, and institutional investors, the requirement to segregate and manage assets under special terms and conditions is increasing.

Chart 4 details some of the drivers behind your choice of fund structure. Your legal counsel will be your primary relationship when deciding on the right structure for your investors and portfolio managers.

### Chart 4: Example Hedge Fund Investment Structures

| | Co-Mingled | Custom FoF 'Fund of One' | Seperately Managed Account |
|---|---|---|---|
| |  |  |  |
| **Investor Risk Profile** | Adjacency risk with other investors | Greater control of assets / reduced adjacency risk | Full control of assets / eliminates adjacency risk |
| **Investor Transparency** | Dependent on terms offered by LP and reporting available | Look through to asset mix (sectors, risk etc) | 100% transparency to underlying security positions |
| **Ticket Size** | Typically up to 25% of total AUM by investor | Custom allocation | No limit |
| **Operational Scale** | Build to support trading and strategy | Build to support trading and strategy | Build to support trading and strategy |
| **Infrastructure Cost** | Software and infrastructure development to connect to PB and Fund Admin | Software and infrastructure development to connect to PB and Fund Admin | Software and infrastructure development to connect to PB and Fund Admin |

Sources: Citi Prime Finance Analysis based on primary research

**Key Legal Questions:**

- How will your terms & conditions compare to your peers', and how will the terms impact different investor types looking to gain exposure to your strategy?
- Can your legal partner offer you services in all of the markets where you may consider having a physical office?
- Do you need an offshore firm to provide directorship services to the Master Feeder if it is registered as a Corporation?
- Does the fund name articulate and represent the vision of the firm? Will it resonate with the target investor and client base?
- Is the name unique and not associated with anything that could harm the positioning of the firm?
- Have you checked the Internet Domain in multiple countries and have you checked with the copyright bureaus in each country you intend to operate in?
- Have you considered what additional operational complexities may be involved in a SMA structure?
- Will you be willing to share a level of reporting and position level detail on your portfolio to alleviate concerns about transparency?

## 1.2 Audit and Tax Services

Determining your Audit and Tax partner is a prerequisite to any formal marketing or promotion of the fund, but falls behind deciding on your legal counsel in terms of immediate importance. Your Audit partner will have feedback and input on the selection of domicile, the definition of terms & conditions, and the selection of optimal fund structure, but will only act as an advisor in these decisions.

The general responsibilities of an Auditor include verification of the funds Net Asset Valuation (NAV), preparation of annual audit report on the overall financial position of the fund, and publication of the report to investors. The main auditors also offer comprehensive tax services, which typically include the filing of fund and management company taxes, the preparation and mailing of fund 'K1's' (investor profit and loss statements for LP interests in onshore and offshore funds), and overall tax planning for the fund structure. A fund manager may use a different auditor for the onshore and offshore funds, and often have one of these firms audit the management company. In many cases the firm's founding partners will have their own personal tax advisors so the tax services are more specifically focused on the actual fund, but the extent of services is often discussed at the initial meeting.

The majority of the major audit firms have separate divisions for audit and tax but the service relationship is typically with the overall entity. Many of the law firms have developed tax servicing departments, so you may want to align tax and legal with one partner and audit with an alternate firm, but there is no industry standard in this regard.

The most important factor is that the reputation of the audit firm is solid and that the services are clearly identified as part of the business infrastructure and ongoing management of the firm. Investors will rely on the auditor for timely and accurate verification of assets, profits, and losses at the fund level, and therefore this partner selection is key.

**Key Questions:**

- Does your audit partner have knowledge of all jurisdictions in which your fund companies will be registered and in which investors will have their primary relationship with the fund?
- Can your tax partner offer any other broader value-added services such as estate planning, advice on dynasty trusts, or general advice on personal tax implications for guaranteed income?

## 1.3 Compliance Services

A relatively new discipline in the hedge fund industry is the development of a formal compliance program. This includes the engagement of a **compliance consultant** to assist the management team with meeting local regulatory guidelines that make up a compliance framework. While these requirements will differ by region and by regulatory authority, there are common aspects of control that require understanding and a formalized approach.

A compliance partner will also assist you with an overall interpretation of the regulations specific to your country and region of primary domicile, and the cross border rules that apply to investors from foreign countries or offshore corporations. As hedge fund industry regulation is constantly evolving it is important to identify a well-informed and pro-active compliance partner who is well informed on regulatory developments and their implications for hedge funds and investors. Your legal counsel and your auditor will have views on regulatory requirements, and in some cases, will work with your compliance consultant to clarify options and implications for your fund. The relationship is one to be clear on as each firm is providing you advice and in some cases this can differ. Be sure to review your partner choice with the other service providers you select to identify any concerns early on.

### *Developing a Compliance Program*

Defining and implementing a **robust compliance program** is closely related to the local regulations that apply to the hedge fund industry and should be led by your compliance partner. The program will likely include definition of a compliance manual for staff, documentation of all key policies and procedures, creation of a code of ethics document, designation of a **Chief Compliance Officer (CCO)**, establishing rules and controls over employee personal trading, and establishing technology to record and archive employee communications (both emails and instant message communications).

The program will also need to be implemented before the fund launches if the fund is going to register with the local regulator. The program should optimally be tested via a mock exam on an annual basis to ensure compliance with the agreed controls and guidelines.

We recommend that the compliance partner is engaged early in the start-up process, but selection of a partner usually happens after the selection of legal counsel and audit/tax partner.

### *Hedge Fund Regulation*

Regulation of the Hedge Fund industry is a dynamic and complex topic that has developed rapidly since the crisis of 2008. It is important that your Legal partner, your Audit & Tax partner, and your Compliance partner are all connected to the market in a way which brings you the most recent rulings and implications from the various jurisdictions that oversee the operation of your fund. Below is a brief introduction to regulatory oversight in the primary fund locations, but we advise all clients to work closely with their service providers.

### *U.S. Regulation*

Hedge funds within the U.S. are regulated by the Securities & Exchange Commission (SEC) at the federal level, and also by state jurisdictions, under the Registered Investment Advisor (RIA) Act originally made law in 1940 but since revised on numerous accounts. Recent revisions to the rules on which type and size of hedge fund needs to register have been proposed under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") which addressed hedge funds in Title IV, 'Regulation of Advisers to Hedge Funds and Others'.

Title IV of Dodd-Frank requires that all private fund managers with greater than $150mm assets under management register with the SEC as RIAs before the end of March 2012 (a date previously set as July 2011 but then revised). The only exemptions from this law are for private funds classified as a Family Office , a Private Equity Fund, or a Real Estate Fund. For fund managers that are required to register, the requirements include the development of a full compliance program, the introduction of a Chief Compliance Officer (CCO), regular reporting of portfolio information including position level data, and regular public statements of the funds offering and strategy.

In Q1 of 2011 Prime Advisory in the U.S. published a detailed document explaining the various aspects of the Dodd-Frank ruling. It  is available at the following link: https://primebroker.citigroup.com/public/home.html

### *European Regulation*

Within the European Union (EU), as with the U.S., hedge funds are primarily regulated through advisers who manage the funds. In the United Kingdom, which is the hedge fund center of the EU, hedge fund advisers are required to be authorized and regulated by the Financial Services Authority (FSA), the national regulator. Historically, there have been different regulatory approaches within each country in the EU. Some countries in the EU have specific restrictions on hedge fund activities, including controls on use of derivatives in Portugal and limits on leverage in France.

In 2010, the EU approved a law to require hedge funds to register with national regulatory authorities. The EU's Directive on Alternative Investment Fund Managers (AIFMD) was passed by the EU Parliament on November 11, 2010, and is the first EU directive focused on "alternative investment fund managers", including hedge fund managers.

The scope of the AIFMD is broad and encompasses managers located within the EU as well as non-EU managers that market their funds to European investors. Countries within the EU are required to adopt the directive in national legislation by early 2013.

### *Asian Regulation*

In Asia, Singapore mandates fewer licensing requirements and regulations for hedge funds than Hong Kong and other financial capitals in the region. Singapore's oversight of hedge funds will increase following the introduction of new rules and regulations in 2011, but small funds will be able to continue operating without a license. Hedge funds based in Hong Kong are subject to the same licensing requirements as mutual funds.

Local market regulations for Japan, Taiwan, Korea, Australia, India, and the other major capital market centers that make up the region, are all subject to ongoing shifts and developments, so for an accurate assessment it is important that your legal, tax, and compliance partner has a global practice if you are actively involved in these markets.

## *Latin America*

The primary hedge fund market in South America is Brazil, which is regulated by the local Securities & Exchange Commission *(Comissao de Valores Mobiliarios – 'CVM')*. The fund management industry in Brazil is heavily regulated and there are many requirements that need to be understood with relation to custody of assets and investor transparency. For U.S. funds trading Brazilian assets, there are significant taxes imposed on profits passed offshore and in recent years various products have evolved to access the market.

The other emerging markets in South America include Chile, Peru, and Argentina, and all have specific local regulations to understand in relation to hedge funds.

For the most current interpretation of regional and global regulation for hedge funds **you will need to seek guidance from your legal, tax, and compliance partner.**

**Key Legal Questions:**

- Does your compliance partner have a current and proactive engagement with policy makers and regulatory authorities in your region? Is the firm recognized as a contributor to the regional dialogue regarding hedge fund regulation?
- Can your compliance partner introduce or facilitate any of the technical aspects of the program, such as data management, personal trading broker statement systems, or best execution monitoring systems?
- Will your fund need to register in more than one global jurisdiction?
- Are there special aspects to your trading strategy that will require additional compliance oversight, such as High Frequency Trading (HFT)?
- Have you thought through the delivery of trade and risk information for regulatory reporting requirements?

**The following sub-sections are considered part of the infrastructure work stream:**


## 2.1 Real Estate

The first item to address when considering fund infrastructure is the physical location and office space the fund management organization will require. This, of course, is dependent upon both the projected number of initial employees and the preferred location for those employees to commute to and from. It is also important to think about the location in terms of where investors typically visit and recognize as a stable hedge fund residence. As the firm grows and you look to attract talent, the location will also be a consideration, so it is a strategic decision not to be overlooked in the planning process.

Each major hedge fund center has its own area of hedge fund manager concentration, whether it be midtown in Manhattan, Mayfair in London, or Central in Hong Kong, and each location has many brokers focused on the type of trading environment that a hedge fund desires.

The main difference in the type of broker is the division between those who represent just the tenant and those who represent both the tenant and the landlord. As part of the start-up process, we recommend that you meet with two to three different brokers in the primary market in order to understand the different brokerage approaches and hear about the latest trends in hedge fund real estate.

Types of real estate and lease term options vary in each location but we have seen the emergence of more flexible options that allow funds to start small and then add space as they grow. These are typically short-term lease agreements with some aspect of shared space and access to common facilities such as meeting rooms, video conference capabilities, and break-out areas for ad hoc meetings. The landlords offering these arrangements will look to develop a relationship with the fund manager and encourage them to take a longer term lease on bigger space as they grow throughout the years. The advantage for the fund manager is that the address stays consistent for clients and key contracts.

Price for real estate is typically by the square foot and presented as an annual cost for the lease, with certain security deposits required to secure the space. For advice on price trends in the major centers, the real estate brokers will have analysis in hand to explain the different market dynamics, and high- and low-cost areas.

**Key Questions:**

- Do you have a projected organizational size for year 1 to year 3 of operation that needs to factor in to your real estate decision?
- Is there an area of your local market that attracts regular traffic from investors and is perceived to be the center for hedge fund managers?
- Do you have a specific trading floor layout and design in mind that can be articulated to a real estate broker?
- What is your envisioned division of space between private offices and trading areas?

## 2.2 System Selection

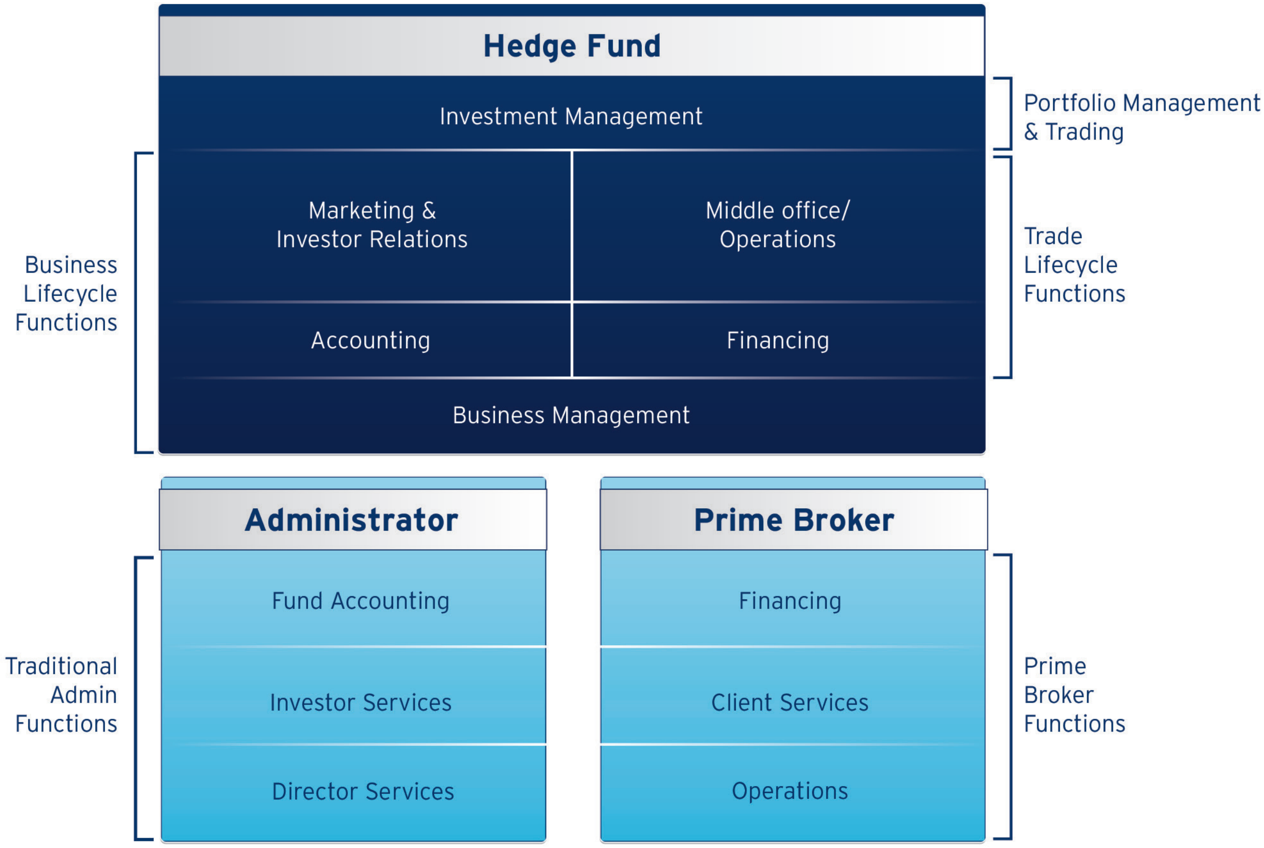
Selecting the technology systems you need for the first phase of the hedge fund's development is a complicated and sometimes overwhelming task that requires guidance from your prime broker or consulting partner. The universe of systems available to the buy-side, and specifically to the alternatives industry, is constantly evolving and understanding the differences among different systems can be a difficult task.

We recommend that once the organization chart is complete, or at least in final draft (see section 6), that the roles and responsibilities are translated into a **functional architecture** (See Chart 5) to be used in comparing the different system options. Citi Business Advisory will provide an example functional architecture to begin this process, and although it will vary by strategy and size of firm, these documents in general use standard terms and definitions. The majority of functions are broken into the following logical groupings, which cover the bulk of the hedge funds daily activity:

- Investment Management
- Marketing & Investor Relations
- Middle Office & Operations
- Financing
- Accounting
- Business Management

For each of these major functions within the hedge fund there exists a variety of system options, some covering multiple groupings, and some focused specifically on just one area. Within each functional area exists a detailed set of business functions that will all have business requirements specific to the fund. This detailed list of functions is available to clients of Citi Prime Finance, and our advisory team can help align requirements to your customized organizational structure. Once business functions are agreed, then the different capabilities of each system can be overlaid on the functional architecture to provide a visual representation of how the different software packages can support your funds activities.

**Chart 5: Example Functional Architecture**



Selecting the right vendor and understanding how it will support the daily functions of the fund should be a methodical process of evaluation, systems demonstrations, technical discussion, and then negotiation on price and terms. All of this can be facilitated by our technology consulting services. Many of these vendors now offer virtual "software as a service" access to their products and leveraging this approach can speed up the initial setup and testing time for establishing the infrastructure. We see the majority of start-up funds in 2011 engaging with this approach, which is one of the central parts of our Hedge Fund 3.0 concept for new fund launches.

## 2.3 Network & Hardware

Following your selection of real estate, you will begin the discussion on the best approach to hosting the hedge fund's various system and infrastructure needs. While developing a physical infrastructure (servers, server racks, wiring etc.) was the only option for new launches in the 1990s, there now exist many hosting and off-premise options for a fund launching.

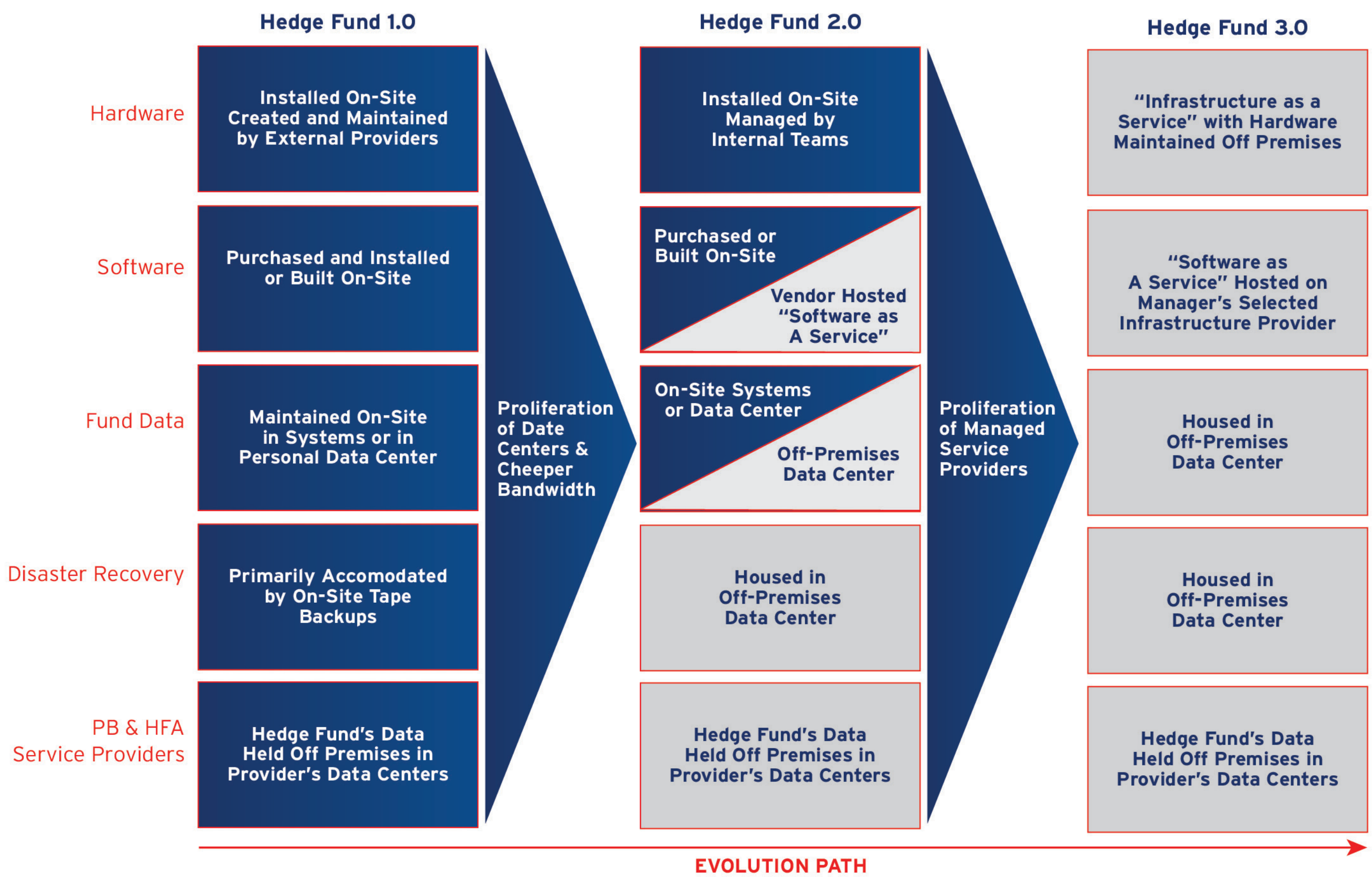
The evolution of these infrastructure models is outlined in Chart 6 below. The "Hedge Fund 1.0" model indicates a heavy reliance on self-hosted technology capabilities, while the "HF 3.0" model demonstrates a reliance on outsourced technology; "HF 2.0" indicates a mix of internal and external technology providers.

Combinations of these options for infrastructure can be applied to both production and disaster recovery/continuity of business environments. Further description of these options is listed below.

- **On Premise** – building your own physical infrastructure of servers and supporting it with your own IT staff
- **Hosted** – leveraging a specialist infrastructure hosting firm to manage your hardware and provide support for the systems. In this example, you may own the physical servers but they are housed within a third party data center.
- **Cloud** – leveraging 'infrastructure as a service' (IaaS) and 'software as a service' (SaaS) providers for virtual computing services. In this example, your hardware, applications, file servers, and email systems can all be hosted and housed within third party data centers. These providers can also provide telephony services for your physical space so that 100 percent of your pure technology needs are met by a virtual environment.

There are pros and cons to each approach and our technology advisory team can help you understand how to engage and negotiate terms with these different business models. For a more in-depth discussion on the different approaches, we also recommend a discussion with a specialist IT infrastructure firm and include the leading firms in our supplier guide.

**Chart 6: Infrastructure Outsourcing Evolution in Hedge Fund 3.0**



## 2.4 Build-Out

Once decisions about your software and hardware solutions are reached, and contracts and terms negotiated, you will begin a phase of installing and integrating the various systems that make up the trading and support infrastructure for the fund. The time frame for this activity can vary depending on many factors. Deploying an integration project team that is assigned to manage all tasks and integration deliverables will create an efficient means of expediting the set-up process.

Some common build-out tasks include:

- **Hardware:** Procure the firm's equipment by working with an IT integrator (file/print servers, desktops, application and database servers, domain controllers, email/messaging). Decisions about on- versus off-premises solutions will affect this task.
- **Network:** Determine LAN/WAN needs for existing offices, including procurement of ISP connectivity and related equipment (switches, routers, etc.).
- **Software:** Installation, configuration, and training of relevant software packages. These can include a variety of trading-related and business-support functions, including execution management, order management, portfolio accounting, risk, finance, collateral management, general ledger, client relationship management, etc.
- **Data:** Market and reference data power an organization. Once data feeds and terminals have been installed, data needs to feed multiple proprietary models and vendor systems to facilitate various trading, portfolio management, and risk-related functions.
- **Systems integration:** The mix of vendor and proprietary systems need to communicate with one another, and need to be accessible within and without the office(s). This can entail simple file transfers or sophisticated API calls for real-time transfer of data among systems. Messaging can be employed to facilitate FIX drop copy of trades among systems.

## 2.5 Counterparty Integration Testing

Testing your systems is essential before active trading. You will be required to test with both your prime broker counterparties, your execution broker, and your administrator before you can begin the daily management of the portfolio.

- **Executing Brokers:** Once trading agreements have been established, electronic execution desks will perform FIX connectivity tests with your trading software to ensure that routes are open and trading algorithms are available.
- **Prime Brokers:** Trade file formats will be provided by your prime broker counterparties and these should be passed on to any applicable Order Management System vendors, so that they can code sample trade allocation files for testing with your Prime Broker Integration team. T+1 files, such as those containing positions, transactions, and balance information should also be considered for automated reconciliation purposes, or to populate start-of-day position blotters within trading systems.
- **Administrators:** Trade files should be transmitted to your Fund Administrator on a daily basis, even if you are leveraging them for monthly NAV work. Likewise, Administrators should collect daily positions files so that they can reconcile their books against those of your Prime Brokers.

It is useful to keep copies of all test plans to demonstrate the connectivity and resiliency of the architecture to investor due diligence teams when they review the trade life cycle of the fund. We advise all start-ups to retain these records and leverage them as artifacts in the firm's documentation.

**Key Questions Regarding Technology Approach:**

- How extensive an infrastructure will you require at launch? What decisions can be deferred until the fund has increased its capabilities?
- Have you documented your workflow, such that investors will be comfortable with the operational controls afforded through your technology infrastructure?
- Will your technology capabilities differentiate your firm, and if so, for which functions and how?
- Have you linked all of the services you require in the most efficient way, to avoid functional overlap and create an optimal structure?
- What is the proper mix of vendor solutions, outsource partnerships, and service provider technology?

# Section Three: Service Providers

**The following sub-sections are considered part of the service providers work stream:**

**3. Service Providers**

**3.1 Execution and Prime Brokers**
- Select Prime Broker
- Select Trading Counterparties

**3.2 Administrator and Operations**
- Select Administrator
- Select Middle Office Provider

**3.3 Documentation**
- Prime Broker Terms and Documentation
- Prime Broker Credit
- Execution & Trading Documentation
- Administrator Services Contract
- Middle Office Services Contract

**3.4 On-boarding**
- Work with transition teams to establish fund
- Interface Design and Testing to PB and Admin
- Front to Back Trade Testing
- Reporting and Daily Process Review

## 3.1 Execution & Prime Brokers

**Prime Brokers:** Prime Brokerage is the provision of custody and financing services by a bank to a hedge fund, and has evolved to include a broader definition of 'Prime Finance' that for most firms includes:

- Custody & Asset Servicing
- Margin Finance
- Stock Lending
- Synthetic Market Access or Stock Lending (via 'Derivatives' or 'Swaps')
- Derivative Clearing

The leading Prime Brokers offer these services across all financial asset classes (Equities, Fixed Income, FX, Commodities) and can facilitate clearing, custody, and financing in all major global markets.Hedge Funds are charged a basis point fee for clearing and custody of assets, financing provided via margin, and then charged trade fees for borrowing securities and trading derivatives. These fees are negotiated with the prime sales team who will be proposing the hedge funds business to internal risk, credit, client service, and trading teams.

Since 2008 and the financial crisis, the majority of hedge funds have more than one Prime Broker, a structure referred to as 'Multi-Prime'. In this model, the hedge fund has two or more prime brokers and separates balances between the counterparties in return for level of service and provision of broader services within the bank. The move to Multi-Prime has been driven by a requirement to spread exposure and risk across different counterparties and not have all assets held with just one Prime Broker.

Prime Brokers also provide additional non-trade related services such as **Capital Introduction** and **Business Advisory** to help hedge funds raise capital and develop their businesses across all of the required disciplines. For a list of Citi Business Advisory services see the appendix of this guide.

**Execution Broker:** At the outset of the fund launch you will need to identify which executing brokers you require in order to execute your fund strategy. The majority of the large broker-dealers are registered in all major markets and can provide global access to all products as you determine your trading requirements. You will begin negotiating terms on execution fees and margin requirements with each trading counterparty and your legal counsel will be involved in this process. Key trading and collateral documents will be required to be completed alongside forms for credit and background checks for the firm and the partners.

## 3.2 Fund Administration & Middle Office Operations

**Fund Administration:** Fund Administration services are provided by either a bank-owned administrator (such as Citi Securities & Fund Service—'SFS') or an independent firm, and the services provided include:

- Fund Accounting
- Investor Services
- Administration of fund bank accounts
- Production of financial statements & tax documents
- Regulatory reporting services

Each Master Feeder fund will have a single administrator, but there are examples of the investment advisor using different administrators for different funds under management. The majority of U.S. fund managers have a single relationship but there is no defined standard.

Across the providers there is a level of commoditization of the services provided and the decision on administrator often comes down to price and level of client service being proposed. Different Investors will look for different qualities in your choice of Administrator and it is important to understand your audience as you make this selection. Global Custodian produces an annual Fund Administration survey which provides benchmarks for the industry and a commentary on the performance of leading firms offering this service.

**Middle Office Services:** Most administrators also offer a set of outsourced middle office services for those funds trading OTC derivatives, or just with a complex operation that would be costly to run inside the firm. These middle office services include trade matching and settlement, affirmation and confirmation of trades, margin call and collateral management, trade and position valuation, and all aspects of market data management required to support the portfolio. It is now more commonplace for funds to outsource these aspects of the post-trade life cycle as the set of outsourced services becomes more comprehensive and delivers at efficient cost levels.

Typically, the middle office service is priced alongside the general administration service but this can be separated. There are examples of hedge funds using one firm for middle office services and a different firm for general administration, but there is not an industry standard or regulatory requirement for one model over another.

## 3.3 Documentation

The on-boarding of a new fund to a prime broker involves providing the prime broker with a variety of fund documentation. For example, constituent documents, marketing materials, NAV information, tax forms, and authorized signatory lists are typically required by prime brokers in order obtain credit and KYC approval. In addition, you will need to complete legal agreements for each of your prime brokerage relationships. Reviewing, negotiating, and signing various counterparty documents is a time-consuming process that will require the involvement of your legal counsel and the partners of the fund. Some agreements, such as securities lending, are standard throughout the industry. Others, such as prime brokerage agreements, will vary across counterparties.

**Examples of Key Document Requirements:**

- **Executing Broker:** Trading Agreement, KYC
- **Prime Broker:** Prime Brokerage Agreement, Securities Lending Agreement, ISDA, KYC, Tax
- **Administrator & Middle Office:** Administration Agreement, Middle Office Servicing Agreement

The time to review, negotiate, and complete these documents needs to be included in your start-up project plan, and you will rely heavily on your legal counsel to help with this process and ensure terms and conditions match your discussions with the service provider sales teams. Our Prime Broker Transition team can provide a comprehensive list of all documents required for on-boarding.

## 3.4 On-Boarding

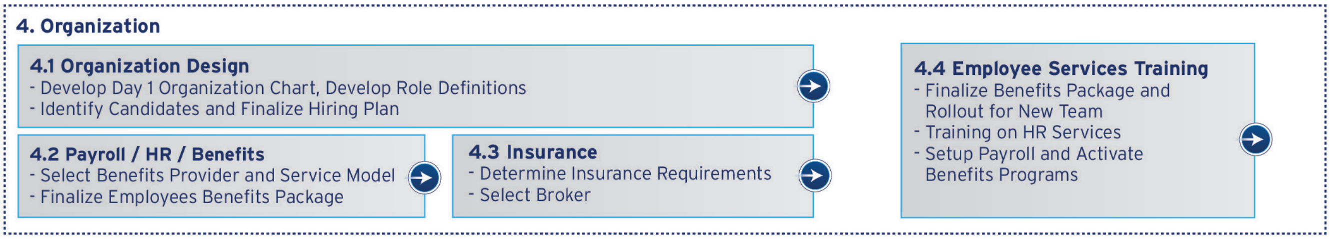
All Prime Brokers and Administrators provide services to help you with the integration of your infrastructure to the prime broker and fund administration platform. Connectivity to executing brokers is also handled by respective on-boarding teams and then testing coordinated with the prime broker and administrator for trade files to be passed to the respective parties. On-boarding also includes training and education on the various reports and tools offered by both the prime broker and the administrator. The service also includes the project management support to navigate through these tasks.

Our start-up consulting team will work closely with transition teams in Prime Finance, SFS, and the Executing Broker, in order to complete the setup and testing of your complete infrastructure. For those leveraging Hedge Fund 3.0 delivery models, this also involves working closely with the outsource infrastructure provider to ensure that the architecture is connected and resilient.

**Key Questions:**

- Do you have the right selection of providers to achieve your trading and portfolio management goals?
- Have you leveraged the relationship between the different providers to deliver best price and optimal service proposal?
- Are you clear on the project management support you will get from the different providers and how this can be coordinated?
- Are you clear on the exact documents required for each counterparty relationship?
- Have you factored in the time it will take to negotiate and agree each document?

**The following sub-sections are considered part of the organization work stream:**




## 4.1 Organizational Design

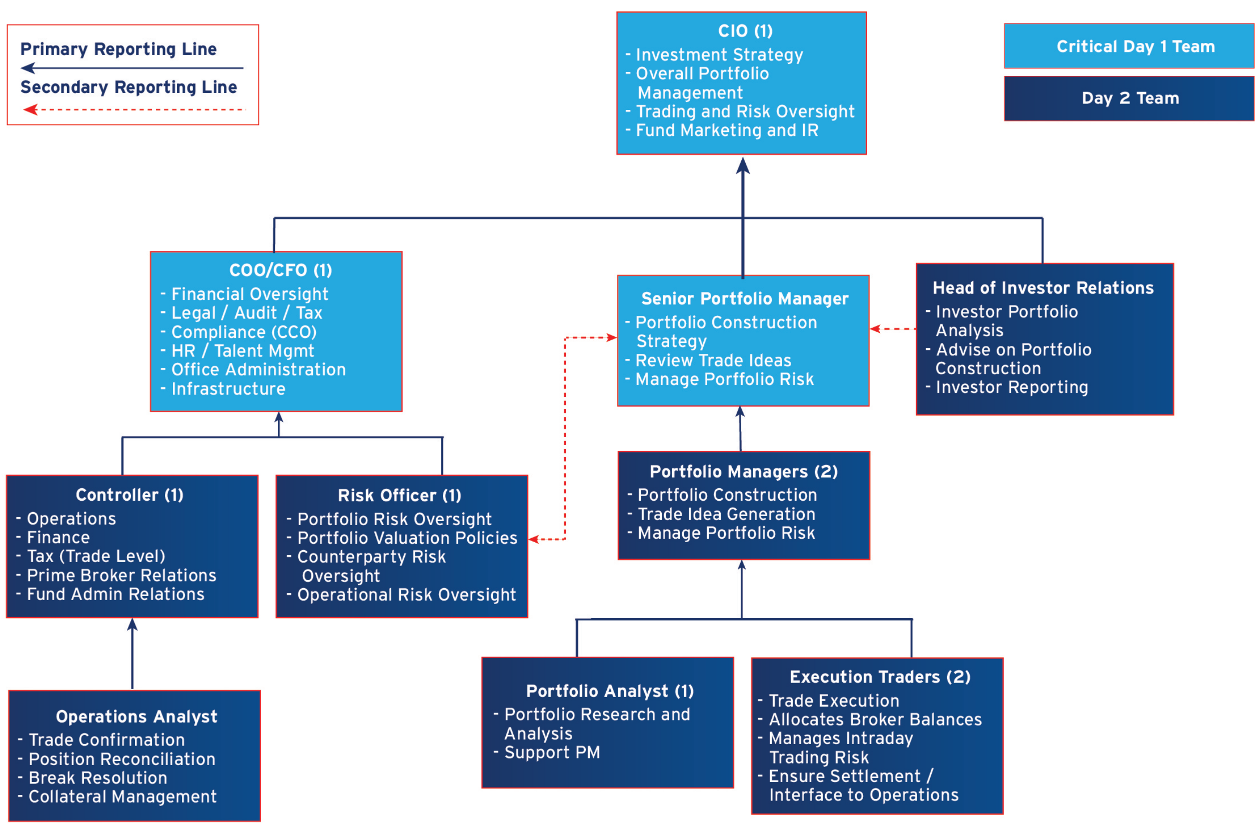
There are many factors that influence Day One organizational design, some of which include:

- Investment Strategy & Trade Type
- Fund Products (Co-mingled, SMA etc.)
- Investor Mix
- Level of outsourcing to service providers

Once these parameters are understood, it is possible to create a draft organizational chart for the firm and this will allow you to determine the key Day One personnel.

One principle factor informing all good organizational design is the separation of duties between investment management on the one hand, and risk, operational control, and compliance functions on the other. Typically, this leads to an organization which is split between the COO/CFO-related functions and the CIO/PM functions:

**Chart 7: Example Day One & Day Two Organizational Design**




Understanding your goals for year two and three may also influence the organizational design of your firm. Organizations should be seen as flexible and likely to change over time, so indicating future roles expected as the fund grows is a good practice and can help with investor discussions.

## *Corporate Governance*

Although corporate governance would seem to be a topic for discussion later on in the life cycle of a hedge fund, a growing number of start-ups are looking at aspects of corporate governance as investors become increasingly focused on the business control aspects of the company. Irrespective of legal structure, all start-ups will look at the structure of internal committees required to provide oversight for the money management activities of the fund. These facets of the organization will be highly scrutinized by incoming investors. Chart 8 provides an example of some of the typical governance committees that hedge funds should create from the outset to establish an appropriate level of governance.

### Chart 8: Example Fund Governance Committees

| | Description | CIO | COO | CRO | PM | Head of IR | Controller |
|---|---|---|---|---|---|---|---|
| **Management Committee** | Overall firm management, strategy and hiring decisions | Chair | Member | Member | | | |
| **Investment Committee** | Investment strategy and key investment decisions | Chair | | Member | Member | Member | Member |
| **Risk Committee** | Valuation policy and risk oversight<br>Market Risk Counterparty<br>Risk Operational Risk | Member | Member | Chair | Member | | Member<br>(Reports on counterparty & ops risk) |
| **Compliance Committee** | Compliance Exceptions Review<br>Form PF Sign-Off<br>Audit Reviews | Member | Chair<br>(assumes role of CCO) | Member | | | Member |
| **Compensation Committee** | Performance reviews and compensation decisions | Chair | Member | Member | | | |

Prime Advisory recently published a Hedge Fund Maturity Model which provides a detailed guide to organizational growth and maturity. It can be accessed via the following link: *www.primebrokerage.citigroup.com*

Our advisory team can help you use this maturity model to map out your Day One and Day Two needs based on the goals that you have for the firm.

**Roles & Responsibilities** – Determining Day One roles and responsibilities will map to your organizational chart. Creating specific job descriptions will allow you to better determine individual responsibilities. Our team can provide examples of every position you will need to fill.

Understanding the required job characteristics for each role is important as you begin identifying additional employees for Day One operation. These will not only be included in your compliance manual but will also be included in the appendix of your marketing brochure.

Within our Advisory team we also offer a leading Talent Management service which can help identify high quality individuals and define detailed job descriptions for each position. This service is available to all fund launches who engage with our Prime Finance team.

**Chart 9: Example Role Description Template**

| **Role: Chief Operating Officer** | |
|---|---|
| Responsibilities | |
| **Reporting To** | - Chief Investment Officer |
| **Investment Committee** | - Controller<br>- Chief Risk Officer |
| **Committee Chair** | - Compliance Committee |
| **Committee Membership** | - Management Committee<br>- Risk Committee<br>- Compensation Committee |
| **Functional Responsibilities** | - Responsible for all non-investment operating issues<br>- Compliance<br>- GC<br>- Manage all service provider relationships<br>- Directly signs off all bill payments<br>- Go-to person for all personnel issues<br>- Oversight of six operational ares: finance, operations,legal, human resources, investor relations and office management<br>- Responsible for all aspects of firms compliance<br>- Manage all aspects of fund level management company accounting, finance treasury, investor reporting, regulatory compliance and fiscal year audit and tax engagements<br>- Manage relationships with service provider, including prime brokers, fund administrators, regula tory consultants, ISDA counterparties, auditors and tax preparers<br>- Responsible for daily compliance oversight, SEC regulatory filing and registration requirements and the creation and enforcement of policies and procedures<br>- Actively manage and mitigate counterparty risks and exposures across a multi-prime broker platform; negotiate financing arrangements and service level agreements with all service providers<br>- Interpret, establish, implement and maintain effective financial controls, policies and systems<br>- Assist the firm's partners with special projects and presentations as required<br>- Keep up-to-date on overall activities of the team, identifying problem areas and taking corrective actions<br>- Responsible for managing and training the staff, reviewing the output, as well as performing some of the same functions along side the staff<br>- Develop industry contacts and keep up to date on industry best practices |

## 4.2 Benefits, Payroll, & Human Resources

There has been a major shift in the way a small financial services company can provide the necessary employee support services to accommodate financial service professionals coming together in a new fund launch. Many of these employees will be leaving larger organizations and will be used to high quality services for benefits (healthcare coverage, dental, life insurance), pension services, payroll services, and overall human resource support.

The shift has come in the way a hedge fund can pool their buying power with other funds to aggregate demand for benefits and achieve both economies of scale and high quality service delivery. Firms referred to as **Professional Employment Organizations** (PEO) provide a service to businesses in which they co-employ individuals. Co-employment is when another firm steps in as employer of record, which allows them to bundle their employees with a broader network of individuals and provide their network preferential pricing on insurance and other benefits. They will also provide other human resource benefits which employees receive at larger organizations, including 401k plans, health insurance, payroll assistance, as well as other services.

The alternate option of having one-to-one relationships with different specialist providers is viable and in some cases can be combined with what a PEO is able to provide. Clients may choose to use different specialist brokers if they have specific needs and want to customize their benefits. For example, a new business can outsource their payroll, healthcare, and insurance needs to separate firms which handle specific needs and can offer a variety of options which may not be available in a PEO model.

Our Talent Management service can explain the different options and introduce the fund to different types of providers across the range of fully outsourced to direct provider relationships. You can get more detailed information from our primer on Hedge Fund benefits: www.primebrokerage.citigroup.com

## 4.3 Hedge Fund Insurance

Hedge Fund insurance is an increasingly complex subject and institutional investors are paying close attention to different coverage and coverage limits in place for the fund and the management company. Insurance can form a part of the overall compliance program, offering some assurances against regulatory action, and this has led to the development of insurance products for all aspects of non trading risk within a firm.

Hedge Fund insurance can be separated into three broad categories of risk:

1. **Management and Professional Liability** coverage (which includes protection for Directors and Officers ('D&O') and for staff 'Errors and Omissions' ('E&O')
2. **Employment Practices Liability** coverage (which covers aspects of Title VII of the U.S Employment Act)
3. **Crime Insurance** (which covers risks related to fraud and criminal activities of employees of the fund)

The first two categories are often included under one insurance policy as **General Partnership Liability (GPL)**. Coverage under this type of policy will address professional liability for the registered investment adviser, the funds under management, the directors and officers, and the distributors of the fund. The policy can cover the cost of corrections, investigative costs, and punitive damages. Types of claims may include style drift, improper valuation, failure to perform proper due diligence, and breach of fiduciary duty. Excluded from the policy will usually be items related to criminal fraud, any pending or prior litigation, and any illegal market timing activities.

The third category, **Crime Insurance,** is offered separately from GPL and specifically covers the risk of assets being fraudulently removed from the fund under a criminal act. This is a newer form of insurance and has more recently become popular in light of some of the high profile losses incurred as a result of criminal behavior. This type of coverage is offered as a financial insurance bond which provides collateral for the coverage and deductible. The **Financial Institution Bond** provides coverage for direct financial loss due to dishonest acts of its employees. Losses may arise through embezzlement, false invoices, kickbacks, and other crimes. Transit, Forgery or Alteration, and Computer System Coverage.

Insurance in all markets is offered by brokers who then present the fund profile to a small number of financial risk underwriters, who in turn bid for the business. Our advisory service has a relationship with the leading brokers in each region and can facilitate introductions to those firms.

## 4.4 Employee Services Training

**Employee Training Manual** – Once employees are on-boarded, it is essential to have each employee read a firm training manual and/or attend a firm training course to ensure that they are aware of the firm's goals and mission statement. In firms of all sizes, it is vital that all employees understand the short and long term goals of the firm and the best practices that have been established. Local employment regulations will vary by country and we advise new hedge funds seek employment advice from an employment lawyer if they are planning to open an office outside of the U.S.

**Goal Setting and Performance Management** – Having each employee draft a series of goals will allow each person to be accountable for their performance at the year's end. It is important that each employee sets measurable goals that their manager can use to assess their performance. Periodic reviews should also be put in place so that there is a formal discussion around performance and compensation.

**Key Questions:**

- Do you have the right selection of benefit providers to cover your personnel needs and requirements?
- Have you linked all of the benefit and insurance services you require in the most efficient way, to ensure you and your employees are fully protected?
- Have you leveraged the relationship between the different providers to deliver best price and optimal service proposal?
- Are you clear on what your objectives are after year one and how to best implement a structure to ensure your goals are met?
- Is your organization structured in manner so that the workload is scalable for each employee?
- Does your employee manual have a description for each employee, with a list of duties and responsibilities that they will be held accountable for?
- Do you have appropriate training in place for each of your employees?
- Do you have a system in place to evaluate your employees?
- Do you have a procedure in place to address situations where your employees are not meeting their goals and their manager's expectations?
- Do you understand the rules and regulations for terminating an employee

# Section Five: Marketing

**The following sub-sections are considered part of the marketing work stream:**

**5. Marketing**

**5.1 Developing a Marketing Strategy**
- Develop Marketing Plan and Fund Profile
- Capital Advisory
- Peer Analysis
- Review Marketing Pitch with Cap Intro team
- Begin Road Shows

## 5.1 Developing a Marketing Strategy

Prime brokers offer hedge fund clients access to **Capital Introduction** services to assist in your asset raising process. Capital Introduction and **Capital Advisory** services (see Appendix) will assess your firm and fund strategy and determine the appropriate universe of investors at every stage of your firm's life cycle. These teams employ a consultative approach to deliver tailored solutions and strategic introductions which will help your firm meet your capital raising objectives. The teams will provide post-meeting and road show feedback to help guide your marketing efforts, ensuring they are as effective as possible.

Having a clear, accurate and consistent message to relay your firm's investment philosophy is critical to the growth of a start-up hedge fund. Developing and designing informative marketing materials, including pitch books and due diligence questionnaires, is likely to be the primary method by which clients and counterparties will be introduced to your firm. These materials should, among other things, highlight your firm's people and resources, thoroughly explain the investment strategy, describe the investment and risk management processes, including decision-making protocols, and outline the fund's terms, liquidity, and fee structures. As part of this process, your firm needs to be cognizant of its branding and image that will be presented to clients.

Depending on resources and staffing, the firm needs to decide who internally will be representing the fund and assess if a third party marketing firm should be engaged. An institutional investor's typical due diligence process can span several months and consist of multiple meetings with many individuals within the firm. It should be understood that investor allocation decisions and investor decision timelines have increased in recent years to several quarters and may span over 12 months or more. Consideration should be made around who within your firm will present to clients at each stage of investors' due diligence process (first meeting, follow-up meeting, Operations Due Diligence, etc.). Ensuring the appropriate individuals are in the right meeting discussing their areas of responsibility is critical to keeping an investors' due diligence process moving forward toward an allocation.

Knowing the competition is critical for your business to succeed, which will allow your firm to appropriately position itself within the marketplace. A comprehensive peer review analysis will allow your firm to assess its relative strengths and weaknesses, in addition to knowing what investment terms, fees, and liquidity are being offered to investors by other firms with a similar investment profile.

Several elements are critical to ensure a productive and effective road show. Your firm's message and story needs to be clearly presented in the marketing materials. The appropriate individuals in your firm need to be in attendance on the road show to be able to meet investors and discuss their respective roles within your firm. Investor meeting schedules and travel itineraries need to be efficiently coordinated to maximize employees' and investors' time. Appropriate follow-up contact and discussions needs to be maintained and monitored so investors' due diligence process can progress to its next stage, ending in an eventual allocation to your fund.

Our Business Advisory team can assist you with all aspects of developing a marketing strategy and beginning the fund raising process. We provide many useful tools and templates for creating the key marketing materials and understanding the fund's positioning and profile.

**Key Questions:**

- What is your firm's AuM objective at launch and what is the overall capacity of your investment strategy over time?
- Is your firm's investment philosophy, process, and edge clearly articulated?
- Is the liquidity of your portfolio consistent with your fund's liquidity terms offered to investors? How does this compare to other funds in your investment space?

## *Timelines*

Many of the initial start-up discussions will include a discussion on timeframe as both fund managers and investors are working on various assumptions about the launch of the fund. The ability to accurately plan for a launch date has many variables, and our start-up framework breaks down the keys phases into related tasks and milestones. The following should be used only as a guide and each plan will be different based on the situation.

### Chart 10: Indicative Start-Up Timelines

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **1.1 Legal** | | | | | | | | | | | | | | | | |
| **Select Legal Counsel** | ■ | ■ | | | | | | | | | | | | | | |
| **Establish Management Company** | ■ | ■ | ■ | ■ | | | | | | | | | | | | |
| **Determine Fund Structure (s)** | | | ■ | ■ | | | | | | | | | | | | |
| **Offering Documents/ Subs. Agreements** | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| **1.2 Audit & Tax** | | | | | | | | | | | | | | | | |
| **Select Auditor / Tax Advisor** | | | ■ | ■ | ■ | ■ | | | | | | | | | | |
| **Review Fund Structure** | | | | | | | ■ | ■ | ■ | ■ | | | | | | |
| **Review Offering Documents** | | | | | | | ■ | ■ | ■ | ■ | | | | | | |
| **1.3 Compliance** | | | | | | | | | | | | | | | | |
| **Develop Policies & Procedures** | | | | | | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | |
| **Formalize Compliance Manual** | | | | | | | | | | | | ■ | ■ | ■ | ■ | |
| **Develop Training Materials** | | | | | | | | | | | | ■ | ■ | ■ | ■ | |
| **Prepare Registration Forms** | | | | | | | | | | | | ■ | ■ | ■ | ■ | |
| **Provide SEC Forms for Review** | | | | | | | | | | | | ■ | ■ | ■ | ■ | |
| **2.1 Real-Estate** | | | | | | | | | | | | | | | | |
| **Select Office Space** | | | ■ | ■ | ■ | ■ | | | | | | | | | | |
| **Negotiate Lease** | | | | | ■ | ■ | ■ | ■ | | | | | | | | |

### Chart 10: Indicative Start-Up Timelines (continued)

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2.2 Software Vendors** | | | | | | | | | | | | | | | | |
| Select/Source Trading Systems | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | | | | | |
| Select/Source Portfolio Accounting | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | | | | | |
| Select/Source Risk Systems | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | | | | | |
| Select/Source Compliance Systems | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | | | | | |
| Select/Source Market Data | ■ | ■ | ■ | | | | | | | | | | | | | |
| Select/Source Research Management | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | | | | | |
| Implementation | | | | | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ |
| **2.3 Infrastructure Hosting** | | | | | | | | | | | | | | | | |
| Establish Network Infrastructure | | | | | | | ■ | ■ | ■ | ■ | ■ | ■ | | | | |
| Create Disaster Recovery Plan | | | | | | | | | ■ | ■ | ■ | ■ | | | | |
| **3.1 Execution & Prime Brokers** | | | | | | | | | | | | | | | | |
| Select Prime Broker(s) | ■ | ■ | | | | | | | | | | | | | | |
| Select EE Broker | ■ | ■ | | | | | | | | | | | | | | |
| Documentation / Agreements | ■ | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | | | | |
| Credit / KYC | | | | | ■ | ■ | ■ | ■ | | | | | | | | |
| **3.2 Admin & Operations** | | | | | | | | | | | | | | | | |
| Select HF Admin | ■ | ■ | | | | | | | | | | | | | | |
| Select MO Outsource Provider | ■ | ■ | | | | | | | | | | | | | | |
| Documentation / Agreements | ■ | ■ | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | | | |

## Chart 10: Indicative Start-Up Timelines (continued)

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 | 16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **4.1 Team** | | | | | | | | | | | | | | | | |
| **Design Day 1 Organization Plan** | ■ | ■ | | | | | | | | | | | | | | |
| **Define Job Descriptions** | | | ■ | ■ | | | | | | | | | | | | |
| **Perform Interviews & Recruitment** | | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | | | | | | |
| **4.2 HR / Benefits** | | | | | | | | | | | | | | | | |
| Meet HR / Benefits Providers | ■ | ■ | | | | | | | | | | | | | | |
| Review Proposals | | | ■ | ■ | | | | | | | | | | | | |
| Select Provider | | | | | ■ | ■ | | | | | | | | | | |
| Rollout Program | | | | | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | | | |
| **5.1 Marketing** | | | | | | | | | | | | | | | | |
| Draft Marketing Materials | | | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | | | | | |
| Present to Capital Advisory Teams | | | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | | | | | |
| Plan Road Shows | | | | | | | | | ■ | ■ | ■ | ■ | ■ | ■ | ■ | |
| Ongoing Investor Meetings | | | | | | | | | | | | ■ | ■ | ■ | ■ | |

**Key Questions:**

- What is driving your timeline? Understand what goals you have and whether they are driven by market opportunity, investor interest, regulatory constraints, or self-imposed milestones.
- How much can you leverage your Prime Broker consulting group to provide project management assistance for the key phases?
- Can you fast track any decisions by bringing providers together in a 'beauty parade' type format? Can your Prime Broker facilitate these sessions and host the venue for the introductions?
- Are there vendors or service providers offering outsourced (Hedge Fund 3.0) services that you could leverage to speed up your time to market?

## *Developing a Budget Forecast*

As you may have assessed at this point, managing a hedge fund is much more than just managing money and trading. You are also **running a small business** and need to budget for revenues and expenses for both your fund as well as your management company.

Some of the expenses will be fixed costs while others will be variable costs based on factors such as number of employees, assets under management, and chosen technology solutions. As part of the budget forecasting process, you will also need to model out various revenue assumptions for your management company that can adjust for fee schedules, target return assumptions, multiple share classes, assets under management, revenue sharing offers, and partnership equity splits. After modeling the various factors involved, you will get an estimate of the economic value in your company's equity that can be valued by the firm's partners.

Citi's business advisory team has developed a **budget forecasting model** which leverages our knowledge of service providers and vendors to help you understand various cost and expense implications for your fund and your firm. Chart 11 below shows a projection of revenue and expenses for a fund with a 20% seeder stake in the revenue of the management company.

Indicative costs for your Fund and your Management Company can include:

**Fund**

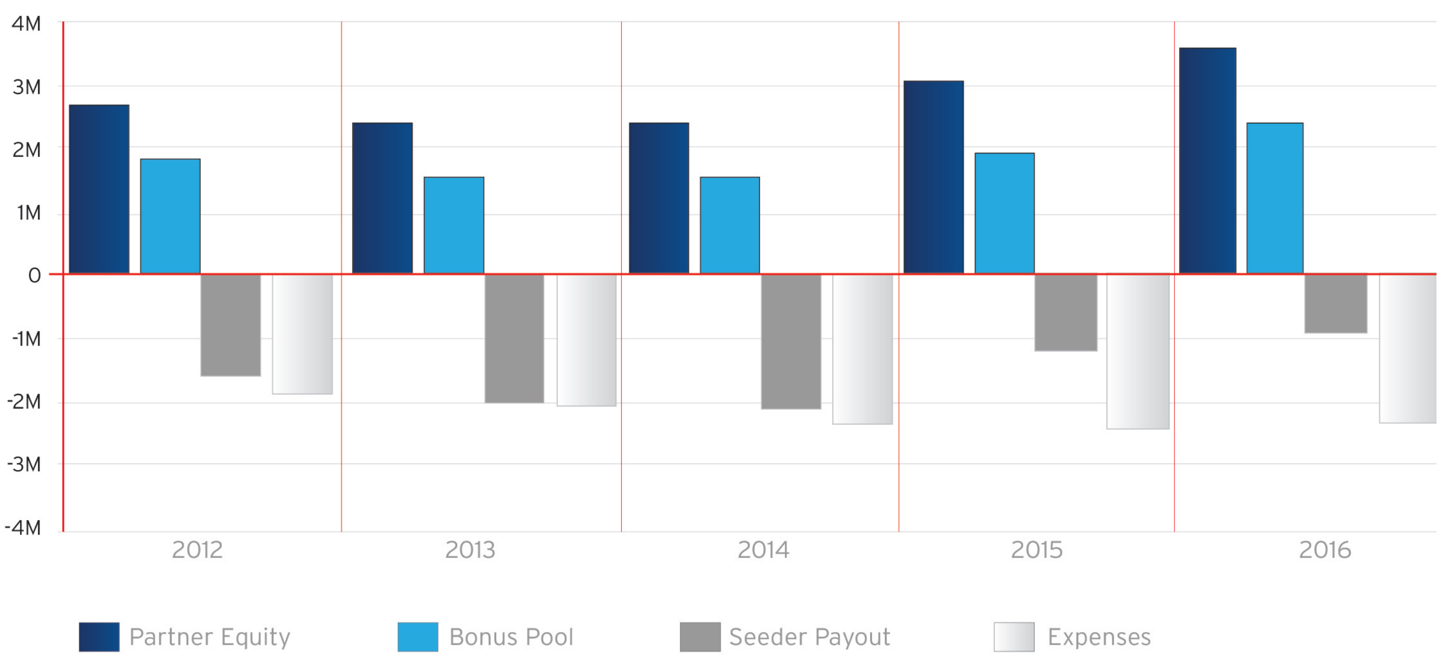
- Fund Administrator (fixed/variable)
- Middle Office provider (fixed/variable)
- Execution/trading fees (fixed/variable)
- Prime Brokerage fees (fixed/variable)
- Audit & Tax fees (fixed)
- Compliance fees (fixed)
- Legal fees (variable)

**Management Company**

- Employee salaries (fixed)
- Benefits providers (fixed/variable)
- Technology services (fixed/variable)
- Marketing expenses (fixed/variable)
- Real Estate expenses (fixed)
- Legal fees (fixed/variable)

**Chart 11: Example Revenue and Expense Forecast Using Citi Budget Forecast Tool**

Annual Managment Company Projections



# Summary

Information provided in this Start-Up Guide should help our clients and prospects realize a solid launch foundation that positions them for growth. Our holistic approach spans organization, infrastructure, governance, marketing, and key relationships. We have leveraged Citi's vantage point as a counterparty and service provider to isolate those factors that characterize the most successful firms in the industry. *Using the insights provided in this primer should optimally position emerging managers to attract and pass investor scrutiny.*

Wherever possible, we have also tried to point out more flexible delivery models you can use to speed your time to market and realize the potential of the emerging Hedge Fund 3.0 operating framework. This approach will allow you to streamline investment in non-core functions and keep your new company firmly focused on your investment process and capital raising.

What is important to understand, however, is that your launch approach is one that will—by necessity—evolve over time. As your firm and AUM grow, there will be new challenges that must be addressed and new facets of the business that you should be prepared to deliver. This guide can also serve as a checklist of business infrastructure components that will need to evolve as your business develops.

It is important to understand that your start-up plan and launch approach will need to be flexible and different aspects will evolve over time. We have designed our Business Advisory services around a Hedge Fund Maturity Model that identifies how firms change over time as their AUM grows and their global reach expands. Just as we helped you navigate the challenges of this start-up phase, we have industry insights, key industry benchmarks, and practical hedge fund templates that will help you remain at the forefront of your peers.

Congratulations on your exciting new path. We look forward to being your partner long into the future.

### *Citi Prime Business Advisory Services for Hedge Funds*

Within our global Prime Finance organization we have developed a full suite of hedge fund advisory services that, when combined, cover all disciplines required in starting a successful hedge fund and helping managers understand where there are opportunities to leverage our Hedge Fund 3.0 framework. These services are available in each major region to current and prospective clients of the firm, and are provided as an offering alongside our prime brokerage and financing products.

### *Capital Advisory Services*

Our Capital Advisory service will profile a client's strategy vis-à-vis the marketplace and conduct peer analysis using both quantitative performance measures and qualitative due diligence assessments. The service will help to highlight a firm's unique selling proposition and perceived differentiators, working with our Capital Introductions team to advise clients on how to best convey their message to institutional investors. As required, our Capital Advisory service can also assist clients in developing the right structures and products to best align to shifting investor appetite.

The service includes:

- Peer Group Analysis
- Presentation and Marketing Advice
- Product Development Consultation
- Vehicle and Structure Analysis
- End Investor Sentiment and Insight

### *Business and Operational Consulting Services*

Our business management and operational consulting practice provides both established and growing clients with advice on all aspects of building and growing a fund franchise, including the requirements and constraints encountered when opening an Emerging Market regional office, the impact of domestic and regional regulations, and managing expenses and infrastructure costs. Our consultants will help clients address their overall organizational design while moving into new investment products and markets, and will provide connectivity to a global network of industry experts to address challenges faced when expanding a business.

The service includes:

- Regulatory Analysis & Advice
- Organizational & Governance Best Practices
- Operational Best Practices, including Compliance & Procedures Reviews
- Process Optimization & Streamlining

### *Technology Services*

Our technology consulting service offers clients insights on how comparable funds address business issues through the provision of various technology solutions across a range of vendors and service providers. The Hedge Fund Maturity Model details the different stages of infrastructure evolution, from a start-up leveraging ASP delivery models through to an institutionalized fund managing its own fully scaled technology architecture. At each stage of development, different vendors and software tools become important, and our team has deep experience with the majority of the industry products and software companies. Our team has a mix of Sell-Side, Buy-Side, and Third Party experience and can provide advice on all aspects of a client infrastructure.

The service includes:

- Vendor Analysis & Benchmarking
- Target Architecture Definition
- Business Workflow Optimization
- IT Infrastructure Advice
- Disaster Recovery & Contingency Planning

### *Talent Management Services*

Our talent management service provides our clients with assistance in finding high quality individuals across the entire breadth of their operations. The function works with both candidates and hiring managers to help define role requirements and match the best talent to the role. This service maintains a private database of high quality talent. Introduction to the service is provided to current Prime Finance clients and candidates personally referred from the broad Citi institutional network.

The service includes:

- Role Definition & Descriptions
- Candidate Search & Introduction
- Human Capital Thought Leadership
- Talent Management Guidance

Citi Prime Finance


| | |
|---|---|
| New York | 1.888.274.4650 |
| Boston | 1.617.346.9335 |
| San Francisco | 1.415.617.8554 |
| EMEA | +44 (0) 207.986.3359 |
| Hong Kong | +852.2501.8353 |
| Singapore | +65.6432.1223 |
| Sydney | +612.8225.6424 |
| Tokyo | +813.6270.3165 |

primefinance.citi.com