Launching a hedge fund – building the operational foundation for success

By Samer Ojjeh, Koma Gandy Fischbein and Courtney Murray

The alternative asset management industry is undergoing a period of change as a result of investor demand, product innovation, regulatory scrutiny, cost pressure and asset inflows. These drivers, along with an increased investor appetite for opportunistic strategies, have contributed to new hedge fund launches. To launch a successful fund, asset managers will need to address many operational questions to build a sustainable infrastructure capable of meeting both short-term needs and long-term goals. Asset managers that launch funds without considering operational requirements risk putting an unbalanced operating model in place, increasing the chance of failure over time. Asset managers must understand the major operational considerations that can contribute to success or failure when launching a fund. This paper highlights the key operational steps asset managers should take, and what mistakes they should avoid, when embarking on this journey.
Many asset managers tend to focus their time on the strategy, capital raising and marketing of the fund. While these are important components, they will not be sustainable without the appropriate technology platforms, third-party vendors, business processes and human capital. It is critical not to underestimate the importance of planning and building out the infrastructure of the fund. Developing a scalable, sustainable operating model is a requirement to support long-term growth and diversification of products. However, asset managers must remain vigilant for challenges that present themselves when building out the operating model, and prepare accordingly. Examples of potential challenges include:

- Unclear strategic vision
- Inadequate implementation of technology solutions
- Dependence on manual systems, lack of integration and limited flexibility of systems
- Lack of diligence when selecting third-party vendors (e.g., fund administrator, prime broker)
- Lack of appropriate oversight of third-party services and undefined shadow model
- Undefined reporting structure and unclear lines of accountability/segregation of duties
- Inadequate documentation and poorly defined policies and procedures
- Resource constraints to support project management and oversight

To minimize the impact of these challenges, asset managers should allocate significant time in developing an operating model that aligns with the strategic vision of the fund.

**Key operational considerations overview**

Asset managers must address key operational issues supporting the business, including strategy definition, tax considerations, operating model design, organizational structure, internal controls, third-party vendor selection and investor due diligence. Design of a comprehensive operating model will prove critical in addressing these issues. Asset managers must tackle these issues (and others that will emerge) using a well-defined approach and appreciate the many aspects of the effect of the operating model on human capital, organizational processes and required technology solutions. Managers must carefully consider key decisions that impact the build-out of the operating model.

A representative operational checklist and a sample operational framework are provided to assist with the early planning process.

**Operational checklist (not in order of priority):**

- Strategy and planning
- Service provider selection
  - Fund administrator
  - Prime broker
  - Outside counsel
  - Accounting firm
- Technology selection and implementation
- Employee hiring, compensation and retention
- Tax matters and structuring
- Management company setup
- Domicile selection
- Regulatory matters (Dodd-Frank, AIFMD, FATCA, etc.)
- Internal controls
- Investor due diligence
- Office space needs
- Definition of roles and responsibilities
- Segregation of duties
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<table>
<thead>
<tr>
<th>Stage</th>
<th>Define operating models (initial and long term)</th>
<th>Select service providers</th>
<th>Determine initial operating model roadmap</th>
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</table>
| Confirm fund strategy | Design long-term operating model (people/process/data/technology)  
  - Define business functions  
  - Identify and map out key processes  
  - Define in-house vs. outsourced functions  
  - Design initial operating model (people/process/data/technology)  
  - Refine the list of functions and processes and co-develop a formalized initial operating model  
  - Document high-level business process workflows  
  - Design high-level organization structure  
  - Define governance structure  
  - Identify roles and responsibilities  
  - Create organization chart  
  - Define initial organization structure  
  - Refine roles to support initial operating model  
  - Create initial organization chart | Select fund administrator  
  - Identify providers, conduct demos and develop high-level RFP  
  - Analyze results  
  - Select prime broker(s)  
  - Select outside counsel  
  - Select auditor  
  - Select technology solutions  
  - Develop RFPS per system  
  - Identify points of system integration  
  - Document vendor assessments | Document road map to achieve initial operating model that includes:  
  - Onboarding of selected fund administrator  
  - Onboarding of selected prime broker  
  - Implementation of selected system vendors (OMS, portfolio management, risk management, portfolio accounting)  
  - Onboarding of outside counsel  
  - Onboarding of auditor  
  - Document detailed operating procedures  
  - Develop regulatory framework |
| Tools | | | |
| | High-level project plan  
  - Initial and long-term operating model  
  - High-level process flows for initial operating model  
  - High-level organization chart with skill set requirements  
  - Initial organization chart | Fund administrator high-level RFP  
  - Fund administrator selection pro/con summary  
  - Prime broker pro/con summary  
  - Technology vendor assessments | Road map for initial operating model  
  - Detailed operating procedures  
  - Regulatory framework |
“A streamlined technology infrastructure that minimizes the need for manual intervention provides support for a data management strategy and allows the business to remain flexible to changing needs.”
Designing the operating model: strategy definition

The starting point for the fund launch process is to build out and share the long-term vision for the fund and obtain buy-in from all key stakeholders. This includes agreement on the trading strategies, growth targets, financial products and anticipated trading volumes. Often, fund managers move forward with launching the fund without finalizing the strategy or fail to consider the operational impact of changes to the strategy in the future. Failure to adopt a longer-term view can lead to selecting technology applications or third-party service providers that cannot scale to accommodate future needs. Once the long-term vision is determined, the manager can begin to build out the business, function by function, and agree on which functions should be kept in-house vs. outsourced. It is critical to thoroughly document the operating model to set the road map for the strategic vision.

To support the defined operating model, asset managers should establish an organizational structure with clearly defined (and documented) roles and responsibilities to support the operational effectiveness of a newly launched fund. It is critical to identify gaps in key resource needs and develop a hiring plan. The manager will need to align resources in a manner that facilitates clear accountability and oversight, implements segregation of duties, promotes coordination across groups and scales with the organization as it responds to the needs of the market. As part of the development of the fund’s management, fund managers must establish a strong and transparent governance structure to perform proper oversight and to drive the decision-making processes. The organization should be structured in such a way that allows for maximum synergy and scalability of related functions.

Constructing the operating model: service provider selection and the “buy vs. build” paradox

During the initial stages of a fund launch, the fund manager will need to define a technology infrastructure and then select and implement technology applications that are critical to supporting the business. Selecting technology capable of meeting current requirements and supporting the future vision is of the utmost importance. Front, middle and back office systems should be selected with a vision of supporting multiple products and enabling the business to scale and grow. Additionally, managers need to consider the ability of technology to provide transparent, consistent and timely reporting to respond to both internal and external business needs. Based on the business requirements of the asset manager, the systems that managers should consider include:

- Order management
- Portfolio management
- Portfolio accounting
- Partnership accounting
- Collateral management
- Customer relationship management (CRM)
- Data warehouse
- Reporting tools
- Risk analytics

A streamlined technology infrastructure that minimizes the need for manual intervention provides support for a data management strategy and allows the business to remain flexible to changing needs. Any technology selection and onboarding involves the documentation of business and technical requirements for the system, an identification and analysis of potential solutions, user testing and training, potential customization and the eventual implementation of the technology. One area not to underestimate is the time and effort needed for the implementation of any technology and third-party service providers required to support that effort.
Another area of focus for new hedge fund launches is the selection of third-party service providers, such as fund administrators, prime brokers, custodians, payment banks, external auditors and external legal counsel. As part of the selection, a fund manager should establish standard processes to select and onboard external service providers. Service providers are not “one size fits all” solutions; due care and diligence are required to select the right partners to support the business as it grows and adapts to changes in the industry. Failure to apply a rigorous selection process to find the fund administrator capable of meeting current requirements and future growth often leads to expensive and lengthy re-assessments in the future.

Once a service provider has been selected and onboarded, the manager will need to actively manage the relationship on an ongoing basis to monitor the level of service provided and adequately address challenges and situations as they arise.

**Formalizing the operating model: processes and controls**

In order to build out a robust, fully functioning operating model, a fund manager should develop and document processes around internal procedures, controls and systems that drive and support the business. Core areas for documentation include:

- Legal structure of the funds
- Registration (onshore/offshore)
- Regulatory requirements (e.g., required filings)
- Policies and procedures from front to back office
- Functions with the fund administrator and “shadowing” administrator activities
- Documentation of the oversight function

The manager should document policies, processes and controls associated with the day-to-day business operations of the fund, from front to back office, and mitigate any potential risks or gaps with enhanced controls. As part of the ongoing relationship with the fund administrator, the fund manager will need to determine the extent to which to “shadow” the administrator. Additionally, in order to review and gain comfort around the administrator’s role, the fund manager will need to build an oversight function that is in line with the level of data and analytics provided by the fund administrator and the amount of control that the manager desires to exercise over the functions performed by the administrator. Thorough documentation of policies and procedures, from fund formation documents to functional processes and supporting procedures, will provide the necessary foundation to support the firm’s operating model.

Fund managers must also keep in mind the importance and emphasis investors place on operational due diligence. With the increase in institutional investors investing in hedge funds, operational due diligence has become more prominent, especially in the wake of many high-profile failures. It is important to have the operating model defined, documented and implemented. In addition, it is necessary to show a well-thought-out process and approach in selecting technology and third-party vendors to prospective investors.
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Road to success

Launching a successful hedge fund requires detailed planning, dedicated resources and a well-thought-out approach. It is critical for asset managers to view a holistic, well-integrated operating model as a foundation to form a scalable and successful fund. With a focus on human capital, defined processes and controls, the right technology applications and partnering with well-chosen third-party providers, new funds will be well positioned to operationally support the strategic vision of the fund.

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