LAUNCHING A NEW FUND? START HERE.

The emerging manager's guide to starting a new fund, planning your priorities, aligning with investors, and structuring your fund for success

CohnReznick
ADVISORY • ASSURANCE • TAX

WELCOME

Launching a fund is an exciting time.

You've proven your ability to produce returns. You've earned the opportunity to build your own business from the ground up, and you've decided to take the leap. Now, you'll need to expand your skill set beyond your investment acumen to build an institutional-grade fund.

You have arrived, and you'll need to evolve your role from investment manager to business owner. With that comes a whole new set of responsibilities – building an institutional-grade infrastructure, negotiating management and performance fees, developing an ESG strategy, and more. By achieving your investment objectives and managing a solid business, you'll be in a unique position to build the trust and confidence of your stakeholders.

Our Emerging Managers Resource Guide has been developed as a jumping-off point for new managers. The insights, observations, and suggestions featured here were gathered from professionals across our Financial Services team. We're delighted to share them with you. Our team members have helped emerging managers launch thousands of funds across the alternative investment fund industry.

We wish you well in your new endeavor, and stand ready to help you with answers, guidance, and industry-leading insight and technical know-how.

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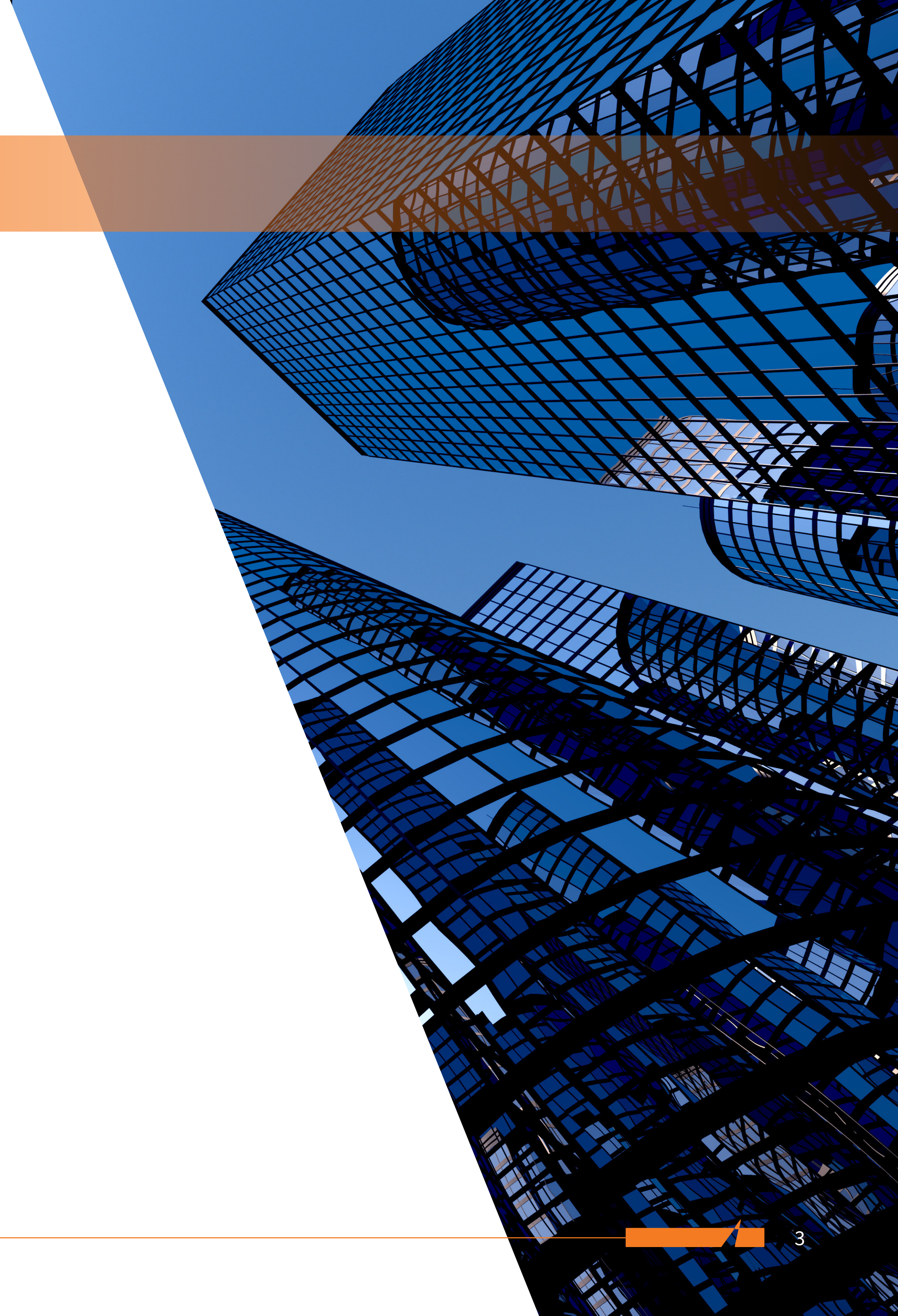


CHAPTER 1

BUSINESS PLANNING

Build a strong foundation with a comprehensive business plan

For emerging fund managers, a strong, comprehensive business plan can serve as a valuable tool to guide decisions and facilitate conversations in a range of key areas: fund infrastructure, marketing, capital raising, operations, cash management, compliance, reporting, and more.

Your business plan will be put to good use right away, during the initial phases of launching your fund, as you communicate your track record (if portable), objectives, and investment strategy to prospective stakeholders. Think of it as a clearly written and easily understandable guide – each section featuring a different component of the story of your business.

Although your business plan is mainly a strong tool for internal decision-making, seed investors, allocators, and service providers will also expect to see this information in writing. By laying out all the details in a formal plan, you'll both enable your team to make consistent decisions and improve your chances of aligning with and/or raising capital from the individuals who read it.

Plan to include these standard components in your business plan:

- Executive summary
- Organizational description
- Market analysis
- Marketing and sales information
- Financial projections

But launching a fund is unique. You'll also need to include information about:

- Your performance record (if portable), fund structure, and investment strategy
- How you plan to raise capital
- How you plan to achieve your investment objectives while running the business

Include details about the business operations you'll need to launch the business:

Administrative, compliance, trading, IT, risk management, and so forth. How much will those functions cost, and how will you go about building them?

(Read more about this in Chapter 5.)

Prospective investors will want to know where your working capital is coming from and whether current cash flow can support operations.

Will you have a seed investor in the management company, or a line of credit, or are you prepared to bootstrap operations personally? A solid financial foundation will be critical to operating your fund at an institutional level from the start. Your plan should include details about your debt level, your fund's value proposition, and how the fund will sustain its first 12-24 months.

A thorough business plan can also help emerging managers negotiate terms with investors.

Seed investors will be particularly interested in your vision for raising capital, how you're going to market, how you plan to manage expenses, and how much debt you'll be carrying. By coming to the table with these and other important points in writing, you'll be showing people that you know not only how to trade, but also how to run a successful enterprise that has the potential to perform well and produce positive returns to investors.

Remember you're doing more than running a portfolio; you're running a business.

Investing is the purpose of the business, but looking beyond the portfolio to fortify the bigger-picture health of the business is key to launching and managing a successful fund.

CHAPTER 2

FUND STRUCTURES

Align fund structure with investment strategy and investor profile

There are several factors that should inform your decisions about the structure of your fund: your anticipated investor base (i.e., U.S.-based or foreign investors), investment strategy, growth objectives, and tax considerations, to name a few. Emerging managers often choose to start with a domestic fund to keep operations simpler and save the additional costs involved in supporting an offshore fund. But these additional components should be discussed with stakeholders and service providers before the ultimate decision is made.

The anticipated size of the fund (in assets under management, or AUM) will naturally attract a specific group of investors. Whether you plan to market your fund to institutional investors with relatively large minimum investment requirements, or you envision your investor base as a mix of family, friends, and smaller allocators, you'll need to structure the size and type of your fund accordingly.

Investor base

Investment strategy

Growth objectives

Taxes

Additional considerations include:

Fund domicile preferences	Typically, taxable U.S. investors only invest in domestic funds, whereas international and nontaxable entities may only invest in offshore funds.
Investment strategy	Consider who your strategy should be marketed to, as different types of investors may have different return and risk expectations. They also may already have sufficient allocations to your strategy.
Allocation of investments	Some investors spread their money across several fund types and strategies according to specifically written guidelines (e.g., 35% private equity, 25% hedge, 25% real estate, and 15% debt).
Open-end or closed-end	With an open-end fund, money can be added or withdrawn in accordance with the Private Placement Memorandum. Closed-end funds don’t allow investors to withdraw funds as easily, if at all. And there are also hybrid funds, which are a mix of the two.

Five main types of fund structure:

Standalone domestic	Standalone offshore	Master-feeder	Mini-master	Side-by-side
The standalone domestic structure is used by U.S. managers who expect capital allocations from U.S. investors or U.S. taxable investors. When compared to other structures, the standalone domestic structure is the least complex and most economical to support, making it most common. This fund structure contains 1) the fund, 2) the general partner, and 3) the investment manager. The general partner is an owner in the fund and receives an incentive allocation, while the investment manager does not have ownership and receives a management fee.	**The standalone offshore structure** is used by offshore managers who expect capital allocations from non-U.S. investors or U.S. tax-exempt investors.	**Master-feeder structures** are generally used when the investor base is composed of tax-exempt, offshore, and U.S. taxable investors. Tax-exempt and offshore investors will invest into the offshore feeder, resulting in various tax benefits. *(See Chapter 9.)* This structure is used more often than the mini-master structure because offshore investors typically prefer investing solely in offshore funds. The offshore investors' capital flows to the master fund, which is typically a Cayman entity, instead of to a U.S. master entity, which is used typically in the mini-master structure.	**The mini-master fund structure** includes a U.S. master trading entity and an offshore feeder. The offshore feeder is a partner in the domestic fund. The offshore entity is taxed as a corporation, thus benefiting U.S. tax-exempt entities and non-U.S. investors. The pros of a mini-master structure are that there's one fewer entity to manage, one fewer audit and tax return, one fewer administrator fee, and less in foreign jurisdiction fees than you would find in a master-feeder structure.	**The side-by-side structure** includes a domestic and offshore fund, which make direct investments based on the agreed-upon investment strategy. The former is usually a limited partnership or LLC, while the latter is organized outside of the U.S. The onshore and offshore fund each do their own trading. This type of fund structure creates unique challenges, such as trading at least two accounts and potential differences in performance, but also offers the advantage of allowing the funds to trade differently when tax considerations that may benefit the U.S. investors become available.

CHAPTER 3

CAPITAL RAISING

Know your audience

Lining up your new fund's initial capital is critical to fundraising success, as it's generally easier to raise capital once you have it. Other than your past track record, your best fuel for creating lift-off will be your ability to drill down on the characteristics of your potential investors and understand if your strategy aligns with their needs. While the challenges associated with raising capital can vary according to market conditions and current investor appetite for your investment strategy, the basic tenets of raising capital remain.

Define your investor base.

Start by identifying those investors who are in the best position to say "yes." Look for those whose preferences match your investment strategy, fund structure, business objectives, infrastructure, and fund size, and/or align those characteristics of your fund with your ideal investors' preferences.

Have "skin in the game."

In addition to providing the funding needed to support the business before outside capital starts to come in, putting a significant amount of your own liquid capital into the fund can help assure early investors that the fund is a viable investment opportunity that you yourself believe in.

Who has the time and talent to best tell your fund's story?

If it is you, then you should be the person communicating with prospective investors. If marketing isn't your strength, remember that your time will be divided among many responsibilities as you're launching your business, and look for better candidates to lead your capital-raising efforts. You may want to hire an in-house marketer or investor relations specialist to take on this responsibility, or you could consider outsourcing some or all of this important task to a reliable third-party marketer. Regardless of how you approach it, you'll need to allocate ample time and energy to marketing and getting assets in the door during the early stages of your fund.

Operate and communicate like an institutional-grade fund.

Investors in your new fund will want to know you have built an institutional-grade business. We mention throughout this guide to be sure to treat your new fund like a business, and that cannot be overstated when it comes to raising capital. Prove that you are doing so by coming to fundraising meetings prepared to share your value proposition and differentiators. Additionally, you'll need to create confidence in your organization and operations. If budget allows, hire an in-house CFO and/or COO plus a team of reputable, industry-recognized service providers. As a more affordable option, outsourcing has become an acceptable way to build a team. *(Learn more about all this in Chapter 5.)*

Keep it simple and industry-standard during fundraising.

Respect your audience's time, and focus on forging long-term relationships. An investor may not be interested in your early-stage fund or strategy, but may want to get involved later. Plan to keep these potential investors updated on your fund's progress and then approach them down the road, when the timing is right.

Additional considerations include:

Be prepared to communicate the economics of your business. Investors may ask.

Schedule initial capital raising meetings with those who know you or who you have been referred to. Ask your prime broker how they can help you get meetings with investors.

Be open to negotiating fees, while staying mindful of your business needs. *(More on this in the next chapter.)*

Consider making some early presentations to your “reach” capital-raising targets. By the time you get to the targets in your sweet spot, you’ll be practiced and polished.

Potential sources of capital

- You
- Institutional allocators
- Past employers
- Friends and family
- Family offices
- Seed investors
- Capital introduction specialists at prime brokers

CHAPTER 4

FEES

Aligning interests: Management and performance fee considerations

Historically, fund managers have received a standard 2% fixed management fee based on assets under management (AUM). They would also receive 20% of the profits earned by the fund as a performance allocation or fee, generally subject to a highwater mark. (This arrangement is often referred to as “2 and 20.”)

The management fee is intended to provide working capital for the management company or investment advisor – to help “keep the lights on” by covering overhead costs, such as payroll, rent, and other basic business expenses. Managers should generate their profits on the incentive or performance fees.

Both fees are negotiable, generally when a large or early capital contribution is anticipated, but also tend to follow whatever the current industry standards may be. Downward pressure on management fees has pushed the fee down to about 1.5%, on average, with some larger funds using a sliding scale that drives the management fee as low as 1%. Performance fees are averaging 17%. The goal is to keep the investor’s and the manager’s interests “aligned,” so that the manager can run the business and be fairly compensated for generating performance.

For best results, emerging fund managers should coordinate with legal counsel and focus on keeping all parties and fees in alignment as they establish their structures. That means aligning all fees, terms, and conditions with your specific investment strategy and then being able to explain your approach to potential investors in a way that makes the most sense.

Fee structures are a function of:

- Fund structure
- Investment strategy
- Resume of the manager (past experience and performance)
- The composition of your investor base
- Market conditions
- Your ability and willingness to personally fund any shortfalls between operational expenses and management fees

Key points to keep in mind as you negotiate fees, terms, and conditions:

Know exactly how much money it takes to run your firm.

You can compute the number as part of the budgeting plan that you included in your overall business plan, or you can break this out into a separate exercise. Either way, you need a solid number to work with. Try to avoid over-negotiating at this stage of the game; you need to keep your lights on, and that's exactly what your fixed management fee is designed to do.

Come to the negotiation table prepared to do business.

Know what ticket size (the amount invested into a fund) you are asking for. There's a big difference between a $1 million and a $25 million investment in terms of the commitment on the investor side and the expectations of the emerging fund manager. Additionally, it's always smart to know the investment preferences and history of your prospective investor.

Encourage early investors.

- A new fund will typically have a **founder's class** and a **standard/general class**. The founder's class is used to entice investors to put up capital as the fund starts up by seeking larger capital commitments with lower fees and a longer lockup. Other investors coming in after Day 1, or even on Day 1 with less capital, will fall into the standard class, and will have a higher management fee and a higher incentive fee.

- Some larger funds may offer a **sliding scale** for management fees, where the management fee is reduced to a lower percentage as certain NAV levels are reached. (Or, similarly, they may offer a **tiered structure** where investors making larger financial commitments see lower fees.)

- When it comes to **liquidity**, some funds may offer a lower fee structure in exchange for a lockup of the initial investment (i.e., 2 years). But be careful that the terms of your fund still match the strategy: An investor is going to invest in the strategy they want to invest in, but they'll be deterred if the liquidity profile does not match that strategy. Typically a long-short fund will be pretty liquid; a credit fund less liquid, with more of a lockup; and a private equity fund will have no liquidity.

CHAPTER 5

BUILDING OPERATIONAL INFRASTRUCTURE & SELECTING SERVICE PROVIDERS

Institutionalize your business from Day 1

As you start to build your business's operational infrastructure and assemble a team of service providers, aim to construct a foundation that will support the fund not only through its early stages, but also as it matures and grows.

For best results, you'll want to establish the right infrastructure for your business and strategy, including putting the right systems in place, aligning with solid service providers, establishing appropriate documentation practices, and developing valuation policies, **before** you start talking to investors about raising capital. Other than a solid track record, they are going to want to see that you've set up an institutional-grade infrastructure right from the start.

Inside your business

The key when putting together your starting roster is to make sure all aspects of your business are covered. Ask yourself questions like:

- How will I build out my **middle and back office?** Should I build out my own systems or outsource these functions?
- Who will manage the **front office?** Hiring the right COO is a critical factor in determining the success of your business.
- Do I need a **marketing firm** to help articulate our investment strategy to potential investors? (i.e., Should I hire someone to help write our pitchbook?)

Hiring individuals to fill all of the positions needed can be expensive. You may have to increase your asset base before you can begin to operate profitably. This is somewhat of a Catch-22, but also a reality of life for emerging managers, many of whom start out with their own funding plus "friends and family" investment. It might be beneficial to start by outsourcing, which is a popular and increasingly acceptable choice that allows emerging managers to act and operate institutionally without having to hire too many employees at the outset. Not only can outsourcing be advantageous for cost reasons, it also helps you build out a bigger bench and tap into a larger knowledge base as you grow your fund.

Regardless of which hiring approach you take, focus on surrounding yourself with the best possible people, processes, and systems from Day 1.

Alongside your business

- An experienced **attorney** will help make sure your fund documents are properly written.
- A reputable **accounting firm** can guide you through various financial, compliance, tax, and operational considerations.
- If you're hiring a **fund administrator,** choose one that has experience with your fund structure and investment strategy.
- Some **service providers** you select will depend on the type of fund you're launching.
- **Prime brokers** often have advisory or consulting groups that will make introductions to accountants, attorneys, insurance companies, bankers, and other service providers, in addition to providing capital introduction services.

When selecting service providers, look to partner with those that have experience and expertise with your fund structure and investment strategy. Choose providers that are reputable, that are the right size for you based on your AUM, and that provide the depth of service you need. Selecting the right partners the first time will help you avoid having to replace them later – and having to tell your investors about these pivots. Set your fund up for success by putting the right infrastructure in place right from the start.

Other possible providers to hire

- Outsourced trading
- Outsourced CFO
- Outsourced compliance
- Placement agents
- Third-party marketing
- IT providers
- Professional employer organization (PEO - outsourced HR)

MANAGING AUDITS

Put the right policies & procedures in place – lean on your auditor and tax provider

In the investment world, audits of your fund's financial statements provide assurance to your stakeholders that you're complying with the financial reporting framework you have selected. Investors will expect a high-quality and timely audit.

Auditing tends to be a very technical, specialized subject area, and many fund managers haven't been exposed to exactly how their investments need to be accounted for. Especially as an emerging manager, you will need an accounting firm that will take the time to work with you and provide a full understanding of the fine points and their implications for your business and investors.

From the moment you launch your fund, an experienced accounting firm can:

- **Review and provide guidance on your fund's governing documents and your policies and procedures.**
- **Help you understand and appreciate the implications of your audit.**
- **Help you meet reporting deadlines.**
- **Identify deliverables and coordinate timelines with your fund administrator.**
- **Provide review and feedback on your valuation policies, models, and memos.**
- **Help ensure the books and records are accurate and complete to help facilitate timely delivery of K-1s and other tax reporting to your investors.**

Work with your auditor to establish the best policies and procedures for managing the audit process and other requirements, and then pair that auditor up with the fund administrator, who can provide the necessary books, records, and draft financial statements (at minimum). Together, they'll create a workable timeline and facilitate the timely delivery of information, to complete the audit.

Be ready to answer these questions:

- **What is your trading strategy?**
- **Will you invest in publicly traded securities or privately held companies?**
- **What are your expectations from a timing standpoint?**
- **Are you registered with the SEC and/or the National Futures Association (NFA)?**
- **What's the composition of your investor base, and who are you targeting?**

As you're setting up your audit procedures, take the opportunity to also make sure you have the support you need when it comes to valuations. Any managers that will be investing in private companies must be able to calculate the fair value of those companies; those that don't have the capabilities and/or bandwidth to do so will need to engage an appropriate valuation firm to provide that expertise. Your auditor should be able to introduce you to experienced, reputable valuation firms.

CHAPTER 7

RISK MANAGEMENT, COMPLIANCE, & REGULATORY CONSIDERATIONS

Minimize risk and stay compliant

As you consider how to position your fund for success, don't forget to watch for and guard against common hazards and pitfalls. Cyberattacks have been on the rise, new compliance requirements are introduced every year, and regulatory requirements are always changing. It is increasingly important for emerging managers to make sure that they have these important aspects of running a business covered.

When it comes to risk management and compliance, make sure that the policies that you're adopting are compliant with regulatory body standards. Hire people who will help you write your policies and then make sure they are followed, or outsource the work to someone who can.

The many safeguards put in place to protect investors complicate risk management for emerging and established fund managers alike. In most cases, experienced compliance groups and attorneys can help you address these requirements and create a solid risk mitigation plan. Third-party marketing groups can work on your pitchbooks and make sure that you're telling your story correctly and compliantly. Ask your attorney to review all policies and documentation to confirm that they include all of the necessary disclosures, and that they are not misleading or inappropriate.

And remember: Risk management and compliance are never a one-time activity. Build an ongoing review process into your practice.

Be prepared to address these key areas:

Cybersecurity	Trading risks	Sharing marketing information with potential investors	Regulatory and jurisdictional compliance
With well-publicized breaches and ransomware attacks looming large in everyone's minds, cybersecurity has become an area of heightened concern for the SEC and the investor base. Managers need to have the proper infrastructure in place to detect, address, and thwart such threats. Investors nearly always include cybersecurity as part of their due diligence questionnaires (DDQs). And it's not just your own business's defenses you have to be mindful of: Be sure that the service providers you're working with also have the right cybersecurity and privacy policies.	Emerging managers should be doing their own risk reporting from a trading standpoint. If there's an "outlier" to a prescribed trading strategy, for instance, or a significant downturn or uptick, you'll need systems in place that monitor for and alert you to those variances. This should fall under your broader risk management program, along with your order management system and portfolio management system.	There are rules and regulations governing what you can and can't say to potential investors about your firm (e.g., information about your individual performance while you were employed by other firms). There are other rules related to the information that's shared with investors. Look to leverage your attorney to help you navigate these complexities and avoid risk in this area.	In addition to the SEC, there are myriad other regulatory bodies to take into consideration when starting and running a fund. There are also state-by-state requirements to consider. Blue sky laws, for example, serve as safeguards for investors against securities fraud and are established at the state level. Foreign trading and jurisdictional requirements can be tricky. Even if you are not an SEC Registered Investment Advisor, you might be required to register with the National Futures Association (NFA) and Commodity Futures Trading Commission (CFTC) if you are trading regulated futures and commodity contracts.

CHAPTER 8

DUE DILIGENCE

Document your plans and processes, and be ready to talk about them

Once your business plan is written and infrastructure decisions are made, one of the last key steps before going to investors will be documenting and reporting your work. Eventually, you'll be asked to take all of this documentation and place it in the form of a Due Diligence Questionnaire (DDQ), a document typically filled out by the fund manager that's critical to properly document the investment process, operational infrastructure, and other critical business items to provide to investors, prospective investors, and other stakeholders.

Before investing capital into any fund, investors will want to know that it is a sound investment choice. In most cases, due diligence is conducted on the fund's investment strategy and track record by a due diligence team – either in-house or outsourced – working on behalf of an investor. These teams use the DDQ to go through a fund's finances and operations with a fine-tooth comb.

The due diligence process illustrates how critical it is for an emerging fund to be well-planned and well-executed and be able to demonstrate its differentiating strengths. Say a pension fund has $50 million to invest and is considering four different managers across four different hedge funds to allocate that money to. Before a decision is made, the due diligence team works through a complex DDQ, and any point could make the difference in which manager gets the allocation.

To best prepare for the due diligence process, emerging fund managers should focus on filling out a general DDQ to the best of their knowledge, enlisting help from advisors as needed. The Alternative Investment Management Association (AIMA) and Institutional Limited Partners Association (ILPA) each offer an industry-standard version that you may want to use. Know how to communicate required information about your fund's structure, as well as any other details that may set you apart.

For example: ILPA DDQ categories

- General firm and fund information
- Succession planning/key persons
- Investment strategy and process
- Co-investments
- GP-led secondaries/continuation funds
- Credit facilities
- Alignment of interests
- Market environment
- Fund terms
- Firm governance/risk/compliance
- Track record
- Accounting/valuation
- Reporting
- Legal
- Data security/technology/third party(s)
- Environmental, social, and governance (ESG)
- Diversity, equity, and inclusion (DEI)

Two main areas to prepare:

While DDQs used and questions considered will vary from investor to investor, a good starting point for emerging fund managers would be to think of and prepare for two main categories of questions: financial and operational.

Financial

Focusing on the "dollars and cents" of operating a fund, financial due diligence addresses questions like:

- How much capital has the emerging manager invested in the fund?
- What is their past experience and performance in the financial services industry?
- How much money does the manager have to run the operation on a day-to-day basis?
- Does the manager have a financial plan and budget in place?
- What other financial sources are available to the manager (i.e., where is the capital coming from)?
- Does any single investor (or group of investors) make up a significant portion of the fund or capital managed by the advisor? If so, what are their liquidity terms; do they have a lockup or additional funding commitments?
- What is the fund's investment strategy, and how is the fund performing?

Operational

Operational due diligence takes a broader view of the fund's operations and pinpoints the strengths and weaknesses within its respective systems. At its core, this group of questions will examine your fund's backbone, infrastructure, and how you manage your business. This category generally covers (but isn't limited to):

- The fund's technology platforms
- How it manages data security
- Its service providers
- The prime brokers that the fund works with, and how it interacts with them
- Details on how trades are executed
- Operational and regulatory risk management
- Cybersecurity and disaster recovery

CHAPTER 9

TAX CONSIDERATIONS

Understand the implications

When you take the helm of your own fund, you'll need to develop a comprehensive understanding of the implications of taxation. Compared to fundraising, and activating your investment strategy, tax issues seem to garner less attention. That's unfortunate, as a well-thought tax strategy can have a significant impact on the returns of the fund. Read on for details on these top tax considerations to keep in mind as you launch your fund:

- **Tax, structure, and strategy**
- **Trader vs. investor hedge funds**
- **Tax implications to consider**
- **Loss deferral rules**
- **Carried interest**
- **UBIT/ECI**
- **Management entities**
- **Timely delivery**

Tax, structure, and strategy

Tax strategy impacts both fund structure and investment strategy. It's important to understand the tax implications of having either offshore investments or offshore investors in the fund. The fund may have a withholding obligation depending on how it's structured and what type of income it generates. Knowing this, and understanding your firm's strategy, goals, and target investors, may all have a direct impact on your fund's structure.

It is key to determine who your investors are going to be:

- **High-net-worth individuals?**
- **Offshore investors?**
- **Tax-exempt or taxable?**
- **Large institutions?**

The answers to the above questions will help you develop a tax structure that aligns well with your firm, its investment structure, and its investors. For example, if your fund is going to have only taxable investors and no foreign investors, you may want to consider a domestic-only fund. Or, if you are going to have a portion of tax-exempt plus some additional foreign investors, you may want to consider a mini-master or a full-blown master-feeder. *(See Chapter 2 for in-depth details on how each of these structures works.)*

Trader vs. investor hedge funds

Fund managers should be aware of the tax implications of taking the position of being a trader versus an investor. The tax rules have always been considerably more favorable for traders, and the *Tax Cuts and Jobs Act of 2017* (TCJA) has made the distinctions even greater.

- **The Tax Court laid out the distinction between these two positions in a 1955 decision, writing that in an *investment* account, "securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a *trading* account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis."**

- **Determining factors that come into play when it comes to trader vs. investor status include holding period, number of trades, percentage of trades held less than 30 & 60 days, size of trades, character of income produced, and consistent trading on most of the available trading days.**

Tax implications to consider include:

1. If a fund is classified as a trader, the expenses of the fund, including the management fees and operating expenses, including professional fees, would be fully deductible as business expenses and would offset the income generated from the securities trading, and other income earned by individual partners.
2. If the fund doesn't meet the requirements to be a trader and is considered an investor, the expenses will be nondeductible for individual partners, for tax years beginning before Jan. 1, 2026.
3. Interest expense incurred by a trader fund is treated as business interest expense, which is subject to the Section 163(j) limitation on business interest expense at the fund level for partners that are deemed to materially participate.
4. Interest expense incurred by an investor fund is treated as investment interest expense, which is subject to the Section 163(d) investment income limitation at the partner level.
5. Traders can make a Section 475(f) "mark-to-market" election, which would convert all the trading gains and losses from capital gain or loss to ordinary income or loss. As traders tend to have short-term gains/losses, they generally will not be disadvantaged by converting capital gain/loss to ordinary. Funds that make this election are generally not subject to wash or constructive sale rules.

Loss deferral rules

There are several trades/strategies that can have unintended negative tax results. However, with proper tax planning, they can often be minimized or avoided.

Wash sales

A manager may have unrealized losses in a position, and may want to recognize the loss but still hold onto the position, believing that it will recover. However, selling the stock and buying it back within the 61-day wash sale window will cause the recognized loss to be disallowed for tax purposes.

Straddle

A manager may have a position that they may not want to sell, but, due to volatility in the markets, may choose to hedge their position by entering an offsetting position. This may terminate the holding period of the position already held. Furthermore, if the offsetting position is sold at a loss, the loss will be suspended to the extent of any unrealized gain in the remaining position.

Constructive sales

Like straddles, these sales arise when the manager has an unrealized gain in a long position and looks to hedge by shorting against the box or similar transactions. Tax law requires the manager to recognize the gain on the long, immediately upon entering the short position.

Carried interest

Another item managers need to be aware of is the holding period requirements under Section 1061. Under general tax law, for a taxpayer to get the benefit of lower long-term capital gain rates, the taxpayer is required to hold a capital asset for greater than one year. Under Section 1061, generally, a fund manager who earns "carried interest" and receives an allocation for services provided can only obtain the benefit of long-term capital gain rates if the assets sold were held for greater than **three** years. (This does not apply to capital contributed by the manager to the fund; on such capital, the normal one-year holding period rules apply.)

Unrelated Business Income Tax (UBIT)/Effectively Connected Income (ECI)

Reviewing the tax status of limited partners is important when structuring a new fund. Certain partners that are normally not subject to U.S. income tax may invest in a fund under that assumption. Emerging managers should be aware of unrelated business income tax (UBIT) and effectively connected income (ECI) before structuring their fund vehicle(s).

UBIT is an income tax that may be imposed on tax-exempt investors. This situation arises if the fund invests in partnerships that are engaged in a trade or business. Traditional investment income (interest, dividends, capital gains, and rents, for example) are not generally subject to UBIT. However, if the fund's investments are debt-financed, the investment income will be subject to UBIT.

Foreign investors will be sensitive to being allocated ECI from a U.S. Trade or Business, which will create both withholding and a filing obligation at the investor level.

Many tax-exempt and foreign investors are sensitive to being subject to the above taxes. The fund may implement a domestic or foreign blocker structure to help mitigate such concerns. Some investors may want assurances that the fund will not invest in U.S. business partnerships or take on leverage. It is best to discuss these concerns with tax-exempt and/or foreign investors, and/or to disclose in the offering documents before the start of the fund.

Management entities

In addition to the more fund-specific considerations above, there are also tax considerations for emerging managers related just to how they will run their business and the structure of their management entities. Common items include:

- **Fund managers located in New York City will likely prefer a separate GP and management company entity to avoid New York City Unincorporated Business Tax on their carried interest.**
- **Structuring the management company as a limited partnership should be considered to avoid self-employment taxes for certain limited partners.**
- **How will you compensate key employees? Do you want to give them equity in the GP entity, management company, or both?**

Timely delivery

Proper tax planning can buoy investor relations, and this can be easily accomplished by scheduling tax work early to help ensure that deliverables meet investor expectations. Work to meet all tax-related deadlines. For instance, Partner K-1s should be distributed in a timely manner, with investors given a heads-up (as needed) so that they're not surprised by the potential impacts on their own tax returns and obligations.

Working backwards from the K-1 distribution deadline – in most cases, March 15 for the prior year's tax returns – come up with a plan for having tax returns completed on time. Map this out early in the life of your fund, let investors know the plan, and then stick to it.

CHAPTER 10

ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE

ESG is a journey, not a destination – and an opportunity

Stakeholders increasingly expect investment firms to incorporate environmental, social, and corporate governance (ESG) policies and procedures when managing their fund, making investment decisions, managing investments, and reporting progress against goals. Yes, investors expect fund managers to produce an acceptable return on investment, but now more than ever they're also expecting that they do so with a meaningful commitment to ESG.

Over the past two years, an increasing number of large institutional investors as well as non-U.S. investors have been requiring that the funds they are investing in have an ESG framework and reporting in place. If a manager is in the market to raise a new fund and is targeting public pension funds, large endowments, or sovereign wealth funds (just to name a few), they will have a very challenging time raising money from these sources if they have not started down the ESG path.

For emerging managers, there is no better time to start formulating your ESG journey than at the time of initial launch – it's a unique opportunity to incorporate it into your business model and fund documentation from Day 1. If planned and implemented correctly, your ESG journey can reflect your commitment to making the world a better place, and be a true way to differentiate your fund in conversations with prospective investors. As your fund matures and grows, a strong ESG record could help you build relationships with institutional investors and allocators, and other like-minded investment firms.

- **Environmental:**
  How an entity performs as a steward of the planet – what it's doing to protect, preserve, and/or enhance the environment
- **Social:**
  How the entity supports diversity, equity, inclusion, and belonging (DEIB)
- **Governance:**
  How the entity tracks, monitors, and reports both these goals and broader issues around audits, executive pay, shareholder rights, internal controls, and related factors

Not just investors…

A wide range of stakeholders have formed their own ESG priorities, and moving forward they'll be looking to support or work with managers who can help meet them. To name a few:

Employees
are increasingly drawn to businesses that can demonstrate they are good corporate citizens, and ESG efforts have become critical to successful recruiting and retention. People want to work for a company that positively impacts the global community.

Shareholders
want to drive long-term value, and view ESG strategies that promote stronger corporate governance, boost transparency, and improve society as value creators.

Consumers
want to support companies that have a social and environmental conscience, and to understand the company's political culture.

Plus, there are increasing risks to not being mindful of ESG, as **regulatory entities** are implementing (or planning to implement) compliance requirements to be met around ESG. Funds will need to make sure not only that they are meeting those benchmarks, but that any third parties they work with are, too.

Getting started

Though different size firms and funds will have different capabilities in this area, ESG programs can be developed for all businesses, regardless of size or maturity.

The first step is for the manager to establish their own goals and objectives relative to ESG, and how they will be implemented then tracked and reported. ESG standards and reporting frameworks are still being developed, so it'll be important to establish your own priorities and metrics and what you and your investors want measured. Three helpful resources for getting started in building your policies are the Principles for Responsible Investment and the Institutional Limited Partners Association's (ILPA) ESG Assessment Framework and DDQ 2.0.

Based on those resources and our experience, some initial questions that emerging managers should ask themselves include *(but are not at all limited to)*:

1. What are our top priorities to support around environmental, social, and governance factors, and how do we address them?
2. What are our stakeholders' priorities/requirements, including any applicable regulatory standards?
3. Do we have formal written ESG and DEIB policies/statements/strategies, and Codes of Conduct?
4. How do ESG risks and opportunities affect our investments and our investment process? How do we determine whether our ESG approach will impact our investments' financial performance either positively or negatively?
5. How do we drive and monitor sustainability within our firm and with each of our investments?
6. How will we support matters of DEIB?
    a. Internally, do we have a formal process for recruiting and retaining diverse staff/underrepresented groups? What is our family leave policy?
    b. Externally, how do our investments support underserved communities?
7. What diversity metrics should we use – both at the fund and the investment level? (Employees, ownership, investment committees)
8. How do we engage our employees in ESG efforts? (ESG committees, formal trainings on DEIB and compliance, etc.)
9. And, how do we track, report on, and communicate ESG-related information to our various stakeholders?

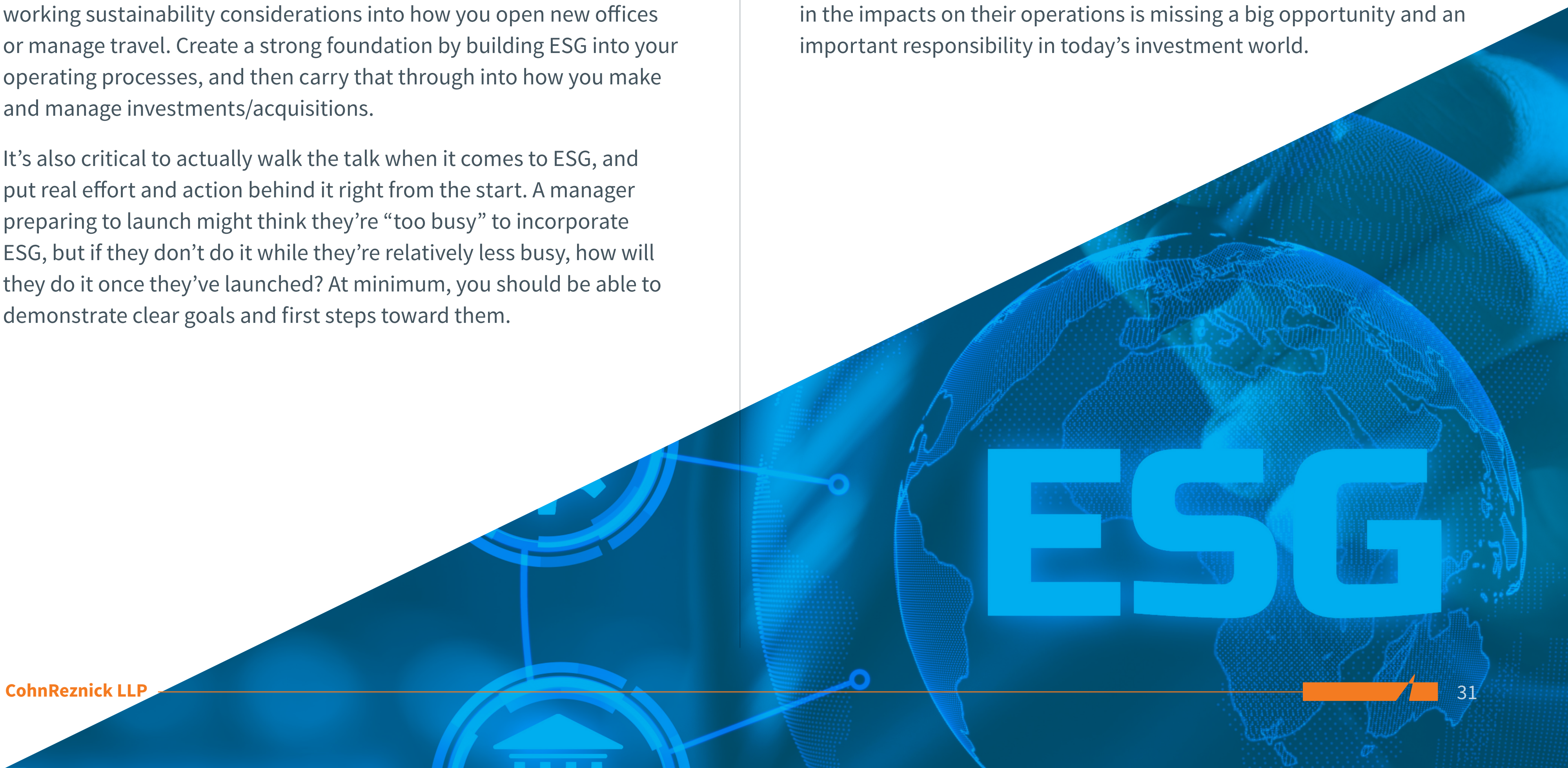
Potential pitfalls

ESG can be more complicated for a fund than for other businesses, because while these objectives are important, the fund's #1 responsibility is still fiduciary, producing a return on capital. Don't just do ESG for the sake of doing ESG; think about how each piece ties into the investment thesis. But don't forget that there are also strong ways to support ESG that are unrelated to investments altogether, such as working sustainability considerations into how you open new offices or manage travel. Create a strong foundation by building ESG into your operating processes, and then carry that through into how you make and manage investments/acquisitions.

It's also critical to actually walk the talk when it comes to ESG, and put real effort and action behind it right from the start. A manager preparing to launch might think they're "too busy" to incorporate ESG, but if they don't do it while they're relatively less busy, how will they do it once they've launched? At minimum, you should be able to demonstrate clear goals and first steps toward them.

An ongoing priority

There is no specific destination for ESG. It's an ongoing journey that will take many turns as you move through the lifecycle of the alternative investment industry: Raising more and larger funds, bringing on new and different investors, operating in different geographies, investing in different industries. But any fund that's **not** incorporating their ESG stance into their business plans and factoring in the impacts on their operations is missing a big opportunity and an important responsibility in today's investment world.



CONCLUSION

The opportunity to launch a new fund comes with a lot of new considerations and responsibilities, but at the heart of it all is a simple idea: Remember that you're now running a full, independent business, and you'll need to budget time and attention for well-rounded, thorough planning. Starting with the 10 areas we've outlined in this guide should give you a solid foundation.

- **Develop a comprehensive business plan.**
- **Choose your best fund structure.**
- **Polish your strategy for pursuing capital.**
- **Establish optimal fees, terms, and conditions.**
- **Build a strong roster of service providers.**
- **Prepare for effective audits.**
- **Set up policies and procedures for risk management and compliance.**
- **Be ready to respond to due diligence questions.**
- **Understand your tax responsibilities.**
- **Make a meaningful commitment to ESG.**

Any questions? Give us a call. Our team of experienced Financial Services professionals is here to help as you take this next step in your journey.

Good luck!

OUR FINANCIAL SERVICES PRACTICE

CohnReznick's Financial Services professionals help fund managers achieve their vision through all stages of growth. We understand the industry, we understand today's market conditions, and we listen hard to understand our clients' specific goals and objectives. Our team develops and shares market and regulatory intelligence to inform clients' decisions regarding their funds, the ever-evolving regulatory environment, and risk mitigation. We are dedicated to addressing clients' needs, requests, and questions.

Our **clients** include:

- Hedge funds
- Private equity funds
- Venture capital funds
- Fund of funds
- Private lending funds
- Cannabis funds
- Real estate funds
- Hybrid funds
- Registered investment advisors (RIAs)
- Investment management companies
- Business development companies (BDCs)
- Regulated investment companies (RICs)
- Special purpose acquisition companies (SPACs)
- Securitization conduits
- Small business investment company (SBIC) funds
- Broker-dealers
- Family offices

Our **services** include:

- Audit of financial statements
- Audit of Form 468 for SBICs
- Audit of Internal Controls over Financial Reporting SOC-1 (SSAE 16)
- Audit of securitization conduits
- Surprise examinations to comply with Rule 206-4(2) under the Investment Advisers Act of 1940
- Reporting under U.S. GAAP and International Financial Reporting Standards (IFRS)
- Agreed-upon procedures (AUPs)
- Consultation on and review of fund offering documents
- Domestic and international tax planning and entity structuring
- Performance examinations
- Preparation of partnership tax allocations
- Preparation of tax returns and partners' Schedule K-1s

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