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Inception

Managers can no longer launch a sizable hedge fund with just one or two people

BY KELLI L. MOLL

In the post–financial crisis world, navigating the terrain to a successful launch of a hedge fund has become more complicated. Good planning and smart decisions in critical areas will help ensure a successful debut.

With the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, plus the significant increase in recent years of institutional investor participation in the hedge fund market, the ability of a manager to start a hedge fund of significant size with one or two people has mostly come to an end. Given this state of affairs, at the planning stage decisions will need to be made about budgeting for startup costs and sourcing the necessary capital needed to build out infrastructure and technology. Also, attracting key personnel needed for day one is important both from an operational and investor perspective.

Because the capital-raising environment has remained difficult since the financial crisis of 2008, and managers must have sufficient resources in place to address the new regulatory regime, a threshold issue in launching a new hedge fund is whether a manager will need, or find, a seed investor. There are a variety of seeders in the marketplace, including funds specifically formed for seeding arrangements, family offices, sovereign fund investors and other institutional investors. Seeders often provide the initial startup investment for a hedge fund, and some may also provide financing to the manager for its initial costs. The length of time committed for seed arrangements varies, but from a hedge fund manager's perspective, a seed deal should be viewed as a long-term partnership with the seed provider. Seed arrangements not only provide a manager with sufficient capital to address the initial startup costs, but can also lend credibility to a manager, which goes a long way in raising capital from new investors. Moreover, some seeders will provide additional marketing support as part of the seed arrangement.

On the flip side, seeding arrangements can be costly. The manager is giving the seed provider a share of its revenue, typically both the management fees and performance compensation for a number of years, while the seed provider often has opportunities to withdraw its investment both after a limited commitment period, which may be shorter than the revenue share, and upon the occurrence of key events. Key event withdrawal rights cover a variety of circumstances, including changes to personnel, significant drawdowns on the performance of the hedge fund and regulatory events involving the manager or the hedge fund. Seed arrangements also often have prenegotiated buyout arrangements after a period of years that are based upon a multiple of earnings. The structure of such buyout arrangements is often the most difficult aspect of the seed negotiation, since the structure often has significant tax implications on both sides as well as potential financing issues for the manager in connection with the buyout of the seed provider.

Dodd-Frank has ushered in a new regulatory environment for hedge fund managers resulting in a longer lead time to put in place the legal structure and necessary registrations. Staging the formation process carefully, particularly identifying the elements with the longest lead time, is important in managing the legal process and communicating investor expectations as to the timing of a launch. For example, a manager who initially wants to be based in New York and London, trading in securities and commodities, will need to consider whether it will be subject to registration with the Securities and Exchange Commission, the Financial Services Authority in the U.K. and the U.S. Commodity Futures Trading Commission. Although there is some overlap in the information sought by these regulatory agencies, they also have very different requirements that necessitate additional coordination to ensure a smooth launch process.

Finally, since the capital-raising environment continues to remain competitive, anchor investors often seek to negotiate better terms on their investment (typically lower management fees and/or performance compensation) that may result in changes to a fund's disclosure and organizational documentation. Addressing such issues up front in the marketing process can help avoid last-minute changes to legal documentation and any corresponding delay to launch.

There are many other issues that a hedge fund manager will address in connection with a new launch. But the key areas explored here impact the ultimate success of the launch, its timing and the ongoing resources needed to comply with a new regulatory environment. ■

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