

Starting a Hedge Fund Management Business

Stars in Transition: A New Generation of Private Fund Managers

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The economic events of 2008 and 2009 resulted in significant displacement of star talent from market-leading investment banks and similar financial institutions, some of which have ceased to exist. Some of those stars have moved on to their own ventures, and are launching their own investment management firms to raise hedge or private equity funds. For most of their careers, some of these individuals, or entire teams of talent, may have thrived in larger institutional environments; however, now many are facing new challenges with practical issues they never had to address, or be bothered with, in the past. Basic questions can range from something as fundamental and potentially complicated as “do I need to register with the SEC and what rules apply to me?” to something much more basic like “are the terms of this office lease a good deal for me?” Any manager starting a hedge fund or private equity fund advisory business, whether an experienced veteran or first-timer, will need to think about many issues that could be broadly grouped within the following five categories:

1. Seed investors/compensation arrangements;
2. Registration requirements for the investment manager and its funds;
3. Other regulatory issues impacting private funds;
4. The fund’s offering and operating documents; and
5. The investment manager’s business operations and service providers.

Negotiating with Providers of Seed Capital and Key Investors

If a new manager is fortunate enough to receive an investment of seed capital or a significant investment from a similar key investor, the manager will need to carefully structure and document such a relationship. Tax planning, for example, is an essential element required for any seed investment to be fully effective. A manager may, in the heat of the moment and faced with the potential for cash inflows sufficient to launch a new fund vehicle, agree to terms that are less than ideal. Taking a step back and working with counsel to structure an appropriate contractual arrangement with its seed capital provider based on market data and the latest drafting terminology is important. The terms of the relationship should provide the manager and any related funds with an appropriate amount of flexibility to accommodate future operations. For example, a manager should bear in mind that in the future the amount of an early seed investor’s initial commitment may be eclipsed by later investments. Also, the structure and terms of any seed investment or preferential relationship with a key investor may impact the drafting of any fund’s offering documents.

Compensation Arrangements for Senior Members of the Management Team

Compensation schemes for investment managers will vary depending on a number of factors, including whether

the funds being advised are hedge or private equity funds, the size and seniority of the management team, the fund's investment strategy and time horizon for portfolio realization and jurisdiction(s) in which the management team members and portfolio investments will be located. As would be expected in the context of hedge and private equity funds, the tax planning with respect to compensation arrangements is extremely complex and has the potential to create significant benefits (or significant harm) for the manager. As discussed below, any employment agreements between an investment manager and its personnel should not only be carefully drafted to comply with applicable law, but also should permit the manager to remain competitive in the employment market by tracking market trends with respect to contractual terms such as non-competes, clawbacks and vesting provisions.

Registration Requirements/Exemptions for the Investment Manager

New investment managers relying on the currently available exemptions from registration under the Investment Advisers Act of 1940 (Advisers Act) are building their new shops on shifting ground. While most practitioners in the private funds arena believe that mandatory registration under the Advisers Act for most investments advisers is inevitable, the final form of the regulations is still unsettled. Therefore, new managers will need to be prudent in structuring their operations consistent with the requirements of the Advisers Act, including the rules applicable to advertising materials, while also preparing for new or altered regulations. A manager spinning out of a larger institution may have been able to rely on that institution's legal department to ensure Advisers Act compliance; the spin-out manager will now need to work with outside counsel to both educate himself or herself with respect to the relevant rules and review

documents before distribution to investors. In addition, the manager should also turn to counsel for assistance during the process of registration with the SEC. Form ADV, Form 13F and similar filing requirements apply to investment managers regardless of whether the funds they manage are registered or exempt from registration under the Investment Company Act of 1940 (40 Act) or the Securities Act of 1933 (Securities Act).

Registration Requirements/Exemptions for the Fund(s)

Maintenance of exemptions from registration under the 40 Act and Securities Act for hedge funds and private equity funds is an issue of great importance for managers of any private investment funds, not just those started by talent spinning out from larger institutions. Anyone starting a hedge or private equity fund will need to understand the basic 40 Act exemptions (such as those provided under Section 3(c)(1) or 3(c)(7)) and work with outside counsel to ensure each fund qualifies for and maintains such exemptions. In addition, the marketing and sale of interests of a new fund will need to be undertaken carefully to ensure a valid private placement and availability of an exemption from Securities Act registration.

Other Registration or Regulatory Regimes

There is a seemingly endless list of rules and regulations that a new manager and its related fund entities will need to understand or, at least, become familiar with. These rules and regulations vary depending on the manager's jurisdiction, investment strategy and investor base (among other things) and include (but are certainly not limited to) short selling restrictions and reporting requirements, registration requirements applicable (or exemptions available) to commodity pool operators or trading advisors, privacy

rules of the Federal Trade Commission, restrictions on the use of “soft dollars,” FINRA rules relating to “new issues” of securities, Advisers Act rules regarding principal transactions, SEC filings relating to large trades or an issuer’s “insiders,” anti-money laundering regulations, insider trading restrictions and broker-dealer laws. “Pay-to-play” regulations at the local, state and federal level impact the fundraising process for any new investment manager regardless of its track record, and certain institutional and pension investors will be impacted by government regulations or internal policies either banning or requiring the disclosure of the use of placement agents by private fund managers. Also, like all private fund managers, new managers will need to be aware of the requirements of the Employee Retirement Income Security Act of 1974 (ERISA) and either (i) structure the fund and its operations (and its investor base) to qualify for exemptions from ERISA or (ii) understand the duties imposed on the manager by ERISA should the manager choose to manage funds holding plan assets under ERISA.

Drafting the Fund Offering and Operating Documents

Even an experienced manager with a strong performance record and potential investors lined up around the block would be doing himself or herself a disservice by using fund offering and governing documents that are not “state of the art” and that do not reflect recent regulatory and market developments. Off-the-shelf fund documents rarely work for anything other than the most plain vanilla investment strategies and, even then, those documents will likely include provisions that do not adequately protect the fund, its investors and the investment manager in times of distress. In response to economic events dating back to 2007, experienced counsel to hedge and private equity fund

managers have drafted new provisions for fund documents or made adjustments to many provisions historically present in fund documents. One size definitely does not fit all, and an incremental increase in the amount of time and attention paid to a fund’s constituent documents can save many headaches down the road.

The Investment Manager’s Business Operations

A manager operating on its own after thriving for a significant period at a larger institution will need to face the day-to-day challenges that arise in connection with running any small business. Like any business with employees, the manager will have obligations under laws pertaining to withholding and other taxes, workers’ compensation, unemployment insurance and similar issues. The manager should work with counsel to structure any employment arrangements or draft any employment agreements with key employees in a manner that not only complies with applicable law, but is also in line with market standards necessary to attract the right professional talent. Any new investment manager without in-house counsel should rely upon experienced outside counsel to navigate the complicated regulatory landscape in which the manager and its funds will be operating.

Selecting Appropriate Service Providers

Fund managers leaving a large institution may never have had to select third party service providers like prime brokers, placement agents, auditors, administrators and law firms. Spin-out managers without billions under management often work with an “introducing” prime broker to gain access to services of larger broker-dealers. The services provided by a fund’s administrator can vary significantly depending on

the fund's investment strategy and investor base, frequency of permitted withdrawals/redemptions and other factors. A fund's auditors should be versed in the accounting and tax rules applicable to private investment funds, and many of those rules are in a continuing state of flux. Managers that work with placement or introducing agents will need to pay attention to an ever-changing legislative landscape at the local, state and federal level. Star managers launching out on their own will likely require a law firm with a deep enough bench to provide lawyers with experience counseling hedge and private equity funds regarding tax, ERISA, labor, litigation and government relations issues.

The last two years have taught the investment community one very important lesson: there is no substitute for experienced counsel for investment funds and their managers. This message could not be more true for star

traders as they become first-time managers of hedge funds or private equity funds during an era of great financial and regulatory change.

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