While opinions differ on when the current economic situation will make a full recovery, there has already been renewed interest in launching hedge fund and private equity fund products, both from fund managers and investors. Some experienced, star managers displaced from troubled financial institutions are starting their own funds. Actually, despite the generally disastrous results of 2008, hedge funds outperformed the market generally during 2009, and many private equity fund managers see dealmaking potential in the near term. As the economy continues toward recovery, asset allocators will continue to focus on private funds, and private fund managers are gearing up for new investments. Therefore, any manager starting a hedge fund or private equity fund advisory business, whether an experienced veteran or first-timer, should focus on:

• Understanding which laws and regulations currently apply to managers and their funds, as well as which might apply in the future;
• Management fee and incentive compensation trends;
• Drafting an effective set of offering and governing documents;
• Carefully structuring arrangements with early, key investors;
• The investment manager’s business operations and service providers.

New investment managers relying on the current exemptions from registration under the Investment Advisers Act of 1940 will face some uncertainty. While some form of registration under the Investment Advisers Act for most investment advisers seems inevitable, the timing and final form of the proposed regulations are still unclear. Therefore, new managers will need to operate in accordance with the requirements of or exemptions from the Investment Advisers Act, while also preparing for new or altered regulations. Fund managers should work with experienced counsel during the process of registration with the Securities and Exchange Commission. Form ADV, 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 or the Securities Act of 1933.

Anyone starting a hedge or private equity fund will need to understand the basic Investment Company 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 exemption. In addition, to ensure a valid private placement and availability of an exemption from Securities Act registration, the marketing and sale of interests of a new fund will need to be undertaken very carefully.

A new manager will need to become familiar with a seemingly endless list of rules and regulations. These rules and regulations will vary depending on a number of factors, including the manager’s jurisdiction, investment strategy and investor base. These rules and regulations 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 advisers; privacy rules of the Federal Trade Commission; restrictions on the use of “soft dollars;” Financial Industry Regulatory Authority Inc. rules relating to “new issues” of securities; Investment 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. The fundraising process for any new investment manager is affected by “pay-to-play” regulations and by government regulations or internal investor policies either banning or requiring the disclosure of the use of placement agents. All private fund managers need to be familiar with the rules relating to the Employee Retirement Income Security Act of 1974, known as Erisa, and either structure each fund and its operations to qualify for exemptions from Erisa or understand the duties imposed on the manager by Erisa if the funds hold “plan assets.”

Naturally, any new manager will focus on management fees and incentive compensation. While some large institutional investors have put pressure on hedge and private equity fund
managers to reduce management fees, managers in many cases have been able to resist such demand (perhaps as a result of generally improving hedge fund performance during 2009). Incentive compensation structures for managers continue to evolve; those same institutional investors have made demands for multi-year measurement periods for incentive fees/allocations, holdback or escrow accounts, and netting arrangements to supplement the standard high-water mark as a tool for aligning investor and manager interests. Also, compensation arrangements between a fund manager’s principals and key employees must be carefully crafted with counsel to address tax and estate planning needs.

New managers should be meticulous in the creation of their fund documents. In most cases, a fund manager will put itself at risk by using fund offering and governing documents that are not “state of the art” and do not reflect recent regulatory and market developments. Off-the-shelf fund documents rarely work, and typically they do not adequately protect the fund, its investors and the investment manager in times of distress. 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 to address issues that have arisen in crisis situations over the past two years.

A new manager will need to structure and document carefully any investment by a seed investor or similar key investor. Tax planning, for example, is an essential element required for any seed investment to be fully effective. A manager may, faced with the potential for a significant cornerstone investor, agree with an early investor to terms that are less than ideal. It is important to take adequate time to work with counsel to structure an appropriate contractual arrangement with a seed capital provider based on market data and the latest drafting terminology. The terms of the arrangement should be flexible enough to accommodate the manager’s 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.

Like any business with employees, most hedge or private equity fund managers will need to address practical challenges that arise in connection with running a small business. 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 the market standards necessary to attract the right professional talent. Any new investment manager should work with experienced outside counsel to get familiar with the complicated regulatory landscape applicable to the manager and its funds.

Selecting the right third-party service providers like prime brokers, placement agents, auditors, administrators and law firms is crucial. Newer managers 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, withdrawal/redemption terms and other factors. Managers utilizing placement agents will need to be familiar with an evolving set of local, state and federal rules and regulations. A fund manager’s law firm must have significant experience counseling hedge and private equity funds regarding tax, Erisa, labor, litigation and government relations issues. Managers of new hedge funds or private equity funds during an era of great financial and regulatory change can take some comfort in knowing that they have access to experienced fund counsel that has seen the market at its worst and is prepared to guide new funds through the recovery period.

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