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SECOND EDITION

THE FUNDAMENTALS OF HEDGE FUND MANAGEMENT

How to Successfully Launch and Operate a Hedge Fund

DANIEL A. STRACHMAN

The Fundamentals of Hedge Fund Management

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To Felice

"To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks."

—Benjamin Graham

* * *

"The day is short; the task is great."

—*Ethics of the Fathers*, Chapter II Verse 20

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Preface

Over the past five years since the first edition of this book came out, the hedge fund industry has grown enormously. Hedge funds, which were once thought of as a tool of the rich and privileged, are commonplace in investment portfolios around the world. No matter what you read, see, or hear in the popular press, the hedge fund industry is here to stay. Even in the wake of the collapse of many large funds, the industry is stronger than ever and has become a force to be reckoned with here and abroad.

Now is a wonderful time to be entering the hedge fund industry, for three reasons. First, the industry is primed for growth; second, the markets are volatile; and third, hedge funds have come into their own, nearly on someone else's nickel. This means a lot of the work you previously would have had to do to build your business has been done for you, and the road to hedge fund riches is going to be smoother than it was, say, three years ago. However, that being said, building a successful business is going to take a lot of hard work, there are going to be disappointing times, and it is going to be frustrating more often than not. Therefore, my advice is as follows: Be prepared for the worst, expect the best, and be satisfied on some level with your success.

I believe that the industry is primed for growth, and with this growth will be many questions. The intention of this book is to answer some, if not all, of the questions you or your colleagues may have and provide you with a foundation for your business and tools to enable you to find the answers.

Over the past 12 years, I have had the unique experience of working around the world with people who are creating, building, developing, and marketing hedge funds. Some are starting out and have less than $1 million in assets under management; some are well-heeled firms with billions in assets under management. Others fall somewhere in between. Though their situations are different and in some sense unique to them, they all have the same questions, they all need basically the same answers, and they don't have a place to turn to for advice. My job is to give them that advice, whether they want to hear it or not. My job is to tell it like it is and to help them get to where they need to be with their business. During this time, I have worked with clients around the globe; it has been quite a wild ride. The key for me has been to solve problems for those in the hedge business who fly without a net because they aren't part of some investment management behemoth.

This book provides you with some of what you need to be successful. It provides you with the tools you need to make good decisions, the tools you need to create good plans, the tools you need to set out a marketing strategy to help you raise assets, and the tools you need to create an infrastructure that will allow you to support your business.

Your goal in reading this book is to learn as much as you can about how to operate the business side of a hedge fund. This book is not about money management strategies. This book is not about buying low and selling high. It is about the infrastructure, the business side, of the hedge fund industry, and as you read the following pages, you will learn the fundamentals you need to run a successful business.

This book will not solve all problems or provide you with everything you need to succeed; instead, it will give you the fundamentals. One thing you should look for as you go out on your own is a mentor. To succeed, you need good, solid advice givers, and you need to be willing to take advice and look for it. Don't be embarrassed or too proud to ask for help. It is okay to have questions; the key is finding answers.

This book should be viewed as a great resource tool. It should be something you use repeatedly to help you understand, deal with, and operate your business more efficiently and successfully. I hope you will get as much joy from reading and rereading it as I have had from writing it. As I say more than once throughout these pages, if you have any questions about anything that you read in this book, or if you have issues you want to discuss, you can always send me an e-mail at das@hedgeanswers.com.

Thanks for purchasing this book. I hope you enjoy it.

Acknowledgments

The idea for the second edition of this book came about through a series of e-mails between my editor and me during the early part of 2011. Since that time, I have spent an enormous amount of time trying to update the original pages to provide you with new and informative information to help you launch and grow a fund. In the pages that follow, I have provided you with a road map that will allow you to avoid failure and to succeed. Your interest in hedge funds has made this book possible. I thank you very much for your interest in this fascinating subject.

I wrote the second edition of *Getting Started in Hedge Funds* because these unique investment products are here to stay. They are no longer considered an "alternative" investment vehicle but rather an important part of a diversified portfolio. Though hedge funds have not yet become "traditional," in the months and years ahead, the characteristics that separate traditional investments and hedge funds are going to become smaller and smaller. Hedge funds aren't going to disappear because people understand the value of creating a portfolio that is hedged against market volatility. Hedge funds are for investors of all shapes and sizes and play an important role in the future of the financial markets.

As in the past, to write this book I have called on many of the usual suspects who have helped me over the years look good in print. It has become more evident to me that there is nothing more important than to have good people at your side. These people are better than good, and without them I would not get my work done. They are, of course, Viki Goldman, the greatest librarian and researcher I have ever met, and Sam Graff, the only true newspaper man left in the tri-state area. Thank you for your hard work and for always making my work better. I appreciate everything you do for me. Special thanks to Christine Enners, who came through with the logistical support to make this book a reality.

The people at John Wiley & Sons have once again provided me a platform for my work. To all of them, I say thank you. I hope the book is all you intended it to be when you gave me the go-ahead to write it.

I want to thank all my family members for their support and guidance over the years. It is through your efforts that this book is possible.

And to my wife, Felice, all I can say is thank you for being a provider of inspiration and support to see this and all of the other projects through from start to finish.

Daniel Strachman
Fanwood, New Jersey
April 2012

CHAPTER 1

The Hedge Fund Industry

The last pure bastion of capitalism rests in two words: *hedge fund*. There is no other business, enterprise, occupation, or opportunity that exists to the best of my knowledge, that allows one to make so much so fast (legally). Hedge funds are not new. These types of investment vehicles have been around since 1949 when Alfred Winslow Jones launched the first fund known to Wall Street. However, in the more than 60-odd years since Mr. Jones's invention, the industry has grown larger, more diverse, and more powerful than one could have imagined. If you ask recent business school graduates where they want to work, they no longer say IBM, General Electric (GE), Intel, or the like but rather Bridgewater, SAC, Mariner, or Maverick. People rob banks because that's where the money is. Well, people want to work at hedge funds because that's really where the money is.

The growth of the hedge fund industry over the past few years in the wake of the credit crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the great recession has been amazing. Many industry observers believe that since those harrowing days in September of 2008, assets in these often-called secretive investment vehicles have continued to grow because people have realized that markets don't always rise and, as such, want some protection on the downside or better yet, a hedge. The industry continues to grow at a record pace even with the weak performance numbers in recent years.

As of the early spring of 2012, there are an estimated 12,000 hedge funds in operation globally, managing more than $1.6 trillion in assets.[1] The numbers are thought-provoking and compelling, especially if you are working at a service provider. Some in the industry equate the substantial growth in hedge funds over the past five years to what happened in the mutual fund industry in the late 1980s and early 1990s. That industry contracted in light of the bursting technology bubble and bear market. Many believe that as the hedge fund industry continues to grow, it is readying itself for a burst of sorts, and, as the new manager on the block, you need to be ready for what lies ahead. It is hard to build a successful business. That said, the strong will survive, and they will prosper. Your job as a new manager about to launch a fund is to ensure that you are ready, willing, and able to deal with everything the market and investors throw at you and you are prepared for the worst.

To understand where the industry is going, you will need to understand where it has been. The evolution of the hedge fund industry is easily seen when you come out of the Wall Street subway stop. When you exit the station, head northwest toward Broadway and make a left on Broad Street. In front of you will be the New York Stock Exchange (NYSE); behind you will be the former headquarters of J.P. Morgan, and to your left will be a statue of President George Washington.

If you make this trip around 9:00 A.M., you will see what Jones saw: traders and brokers hustling to get inside the building before the market opens. It was the action and excitement of this place that led Jones to create the first known *hedged fund*, an investment vehicle that went long and short the market and was able to protect and grow its investors' assets regardless of market conditions. Jones, a sociologist turned journalist, came up with the concept of this long/short fund based on a thesis he had written for an article in *Fortune* magazine.

In the late 1940s, Jones had held a number of positions in journalism, writing about finance and industry as well as social issues. During this time, he realized that the income he earned as a freelancer was not going to be enough to sustain him or his family in the life he wanted and expected. He looked to Wall Street for the answer. What he found was an idea he believed would work. In turn, he would earn enough money to support his family and fulfill his major passion: helping people. Though Jones developed his concept and his business for the money it earned him, his idea was to take the wealth and put it to work in the community. His idea was to use his hedged fund as a tool to allow others to help themselves. His son-in-law, Robert Burch, who currently runs A.W. Jones & Company with his son, said that Jones was more interested in the intellectual challenge of the business than the rewards that it provided.

"Jones was not a man who was interested in Wall Street," said Burch. "Although he made a lot of money over the years, he gave a lot of it away to create programs and organizations to help people here in the United States."

Jones was not interested in talking about the fund, how it worked, or what it did. He wanted to talk about how to make the country and the world a better place.

"When you had dinner with Jones, you always had four or five guys from various parts of the world," recalled Burch. "You didn't know if that night you were going to discuss some pending revolt in Albania or what language they speak in Iran. But what you did know was that you would definitely not be talking about money, Wall Street, or the firm. His mind was beyond that."

The foundation of the hedge fund industry lay not in the pursuit of money for conspicuous consumption but in the pursuit of money to help people.

It all began in a magazine. The article was not some how-to or get-rich-quick piece about making a fast buck but rather a thought-provoking look at how money is managed and the idea that going long some stocks and short others can earn great and stable rewards. In short, the Jones piece examined how you could go long a basket of stocks and short a basket of stocks yet protect and grow your assets.

The article that put his plan in motion was titled "Fashion in Forecasting," which ran in the March 1949 issue of *Fortune* magazine. It gave him the foundation for what today some people view as one of the most important tools used by money managers to make money. Following is an excerpt from the article:

> *The standard, old-fashioned method of predicting the course of the stock market is first to look at facts and figures external to the market itself, and then examine stock prices to see whether they are too high or too low. Freight-car loadings, commodity prices, bank clearings, the outlook for tax legislation, political prospects, the danger of war, and countless other factors determine corporations' earnings and dividends, and these, combined with money rates, are supposed to (and in the long run do) determine the prices to common stocks. But in the meantime awkward things get in the way (and in the long run, as Keynes said, we shall be dead).*
>
> *In the late summer of 1946, for instance, the Dow Jones industrial stock average dropped in five weeks from 205 to 163, part of the move to a minor panic. In spite of the stock market, business was good before the break, remained good through it, and has been good ever since.*
>
> *Nevertheless there are market analysts, whose concern is the internal character of the market, who could see the decline coming. To get these predictive powers they study the statistics that the stock market itself grinds out day after day. Refined, manipulated in various ways, and interpreted, these data are sold by probably as many as twenty stock market services and are used independently by hundreds, perhaps thousands, of individuals. They are increasingly used by brokerage firms, by some because the users believe in them and by others because their use brings in business.*[2]

The idea was simple: Some stocks go up and others go down and rarely do all stocks move in the same direction at the same time. If this makes sense to you, then the next thing you need to understand is that as some stocks move up and others move down, there is a way to make money when they go up, by being long a basket of stocks, and when they go down, by being short a basket of stocks. The key is to forecast which stocks go up and which go down and to position a portfolio accordingly.

The issue has remained the same over the years: How do you determine which stocks are going to go up and which are going to go down? Jones had a unique problem. He was not a stock picker. Fortunately, he learned this early on and was able to compensate for his inability to pick stocks by hiring those who could.

"My father was a good salesman. He knew people to raise money from and was a good organizer and administrator. But when it came to picking stocks, he had no particular talent," Tony Jones told me. "This meant that his job was to find people who did have the talent."

Jones was an executive, not a stock picker. He understood how to get things done and how to find people to execute his ideas. In the end, he created the first hedge fund and with it an entire industry.

Some 50-odd years later, in the fall of 2003, a report by the Securities and Exchange Commission (SEC) estimated that 6,000 to 7,000 hedge funds were managing between \$600 billion and \$650 billion in assets. The report noted that hedge fund assets were expected to grow to more than \$1 trillion between 2008 and 2010.[3] In mid-October 2011, according to BarclayHedge, at quarter end of 2011, total assets under management in the hedge fund industry stood at \$1,806.4 billion. Barclay tracks more than 21,000 funds in its database.[4]

Jones never saw this coming. He believed that his business did not have legs even though it was successful and even though his concept worked. In one of the few profiles of the founder of the hedge fund industry, Jones was quoted saying, "I don't believe that it [the hedge fund] is ever going to become as big a part of the investment scene as it was in the 1960s. The hedge fund does not have a terrific future."[5]

Jones seemed to have misunderstood the value of his invention because, as many people have realized, having a portfolio that is long and short is the only way to ensure, over a long period of time, that assets are protected and will grow—regardless of whether the market rises or falls.

Though a portfolio of longs and a portfolio of shorts make sense, the key to long-term success is to hit the ball out of the park with your stock picks and to put up singles and doubles every day. Move the runners around the bases and back to home plate while protecting your assets at all costs to ensure they go on to win another day. That, my friends, is the secret of successful hedge fund businesses, and it allows these organizations to maintain and create wealth in a safe and secure environment.

UNDERSTANDING HEDGE FUNDS

The concept of this book is not complex. It provides you with the tools you need to understand the functions that go into creating, launching, and running an investment vehicle that is a hedge fund. It provides you with information to make better decisions when choosing a lawyer, prime broker, accountant, administrator, and other service providers. These are the people who will help you grow and maintain your business. This book provides you with insight into the perceptions versus the realities of the hedge fund business, and most of all, it gives you a clear understanding of where the hedge fund industry came from, where it is now, and where it is going. In this way, you and your partners can create and run a successful business that allows you and your investors to build and preserve wealth.

This book is not about managing money or implementing trading strategies. That is covered in other, more thought-provoking books about money and markets. This book is a tool—a reference guide, if you will—that will be used by your front-, middle-, and back-office personnel. It will be used as a reference guide when you decide what sort of funds to launch, how the vehicles should be structured, and whom you should choose as a lawyer and prime broker, helping you create and implement a strategy for marketing your fund to raise money. If you want to learn about trading, stop reading right now and buy one of the countless get-rich-quick trading books.

With that said, we need to look at hedge fund basics to get started on developing and running a successful investment management business. The basics are, quite honestly, basic. One thing that needs to be said is that hedge funds, like most things on Wall Street, are thought to be intricate, confusing, and sophisticated. This is not the case. Hedge funds, like almost everything else on the Street, are simple when you break them down. These often-called secretive investment vehicles are easy to understand once you look at them closely and dissect them in an orderly and efficient manner.

Some aspects of the hedge fund industry are sophisticated, including structuring for tax efficiency and registration issues based on new legislation. For the most part, however, it is like riding a bike: After you have done it once (i.e., set up a hedge fund), you never forget how it works and what needs to be done. In addition, you'll be able to rely on a critical resource in the lawyers, accountants, and other service providers who will help you make the right decisions.

Although investors may initially assume that hedge funds and mutual funds operate in a similar fashion, the only similarity between the funds is that both operate as pooled investment vehicles. This means that a number of investors entrust their money to a manager for a specific fund that goes out and buys and sells securities to make a profit.

Hedge funds differ from mutual funds in that investors provide hedge fund managers with the ability to pursue absolute return strategies. Mutual funds generally offer only relative return strategies.

An *absolute return strategy* is the new name for the strategy that Jones invented in the late 1940s. It means that regardless of market conditions, a hedge fund manager should make money. This differs from what is called a *relative return strategy*, which is how one fund does against a benchmark. In recent years, a number of indices have been created to track and benchmark hedge funds. Even though these products are good, they are flawed. Therefore, it is best to think of hedge funds as vehicles that are measured on their specific performance, and not on how their performance is relative to the Standard & Poor's 500 Index (S&P 500), the Russell 2000 Index, or any other benchmark used to measure performance of traditional investments.

Mutual funds, due to their structure and the laws that govern how they operate, invest in a predefined style and strategies such as large-cap growth and mid-cap value or in a particular sector such as the utilities or biotechnology. The mutual fund defines its strategy and style in its prospectus, which is given to existing and prospective investors. Manager performance is measured on how a fund's return compares to that of a specific index or benchmark. For example, if you buy into a large-cap value fund, the managers of that fund try to outperform the S&P 500 Index or at least match the performance of the benchmark.

Most mutual fund managers construct portfolios by using their stock selection skills to create a portfolio they believe will perform well over time and provide them with an edge over the index. All they need to do is to outperform the index by a few basis points each month, and others deem them to be good at what they do. The problem with this is that it is good for the manager and bad for the investor. Mutual fund managers have one goal in mind when they manage their money: matching or beating their relative index. If the index is down 10 percent and the mutual fund is down 7 percent, the fund's performance would be called a success by those who rank mutual funds. The press would anoint these managers as heroes of the money management industry and they would be deemed to be expert stock pickers because they beat their relative benchmark. The problem is, as an investor, you can't eat relative returns. In the preceding scenario, you would have lost 7 percent of your investment, plus fees, to these heroes' expert ability to pick stocks.

Hedge funds are the opposite. Hedge funds are managed to seek positive absolute returns, regardless of the performance of an index or sector benchmark. Unlike mutual funds, which are long only (meaning they can only make money if stocks rise), a hedge fund can implement more aggressive strategies and put on positions that include short selling (i.e., profit when markets fall). Managers may employ derivatives instruments, such as options, and use leverage to enhance the portfolio to add to the fund's bottom line.

Due to their ability to short, many believe hedge funds are more popular in bear markets than in bull markets. However, in 2008, we saw many of these so-called hedge fund managers did not know how to hedge. Many of the industry's biggest and brightest stars failed during the credit crisis and continued to perform poorly as the economy continued to weaken. The BarclayHedge Hedge Fund Index was down 21.63 percent for the year. The industry came back in 2009 and 2010, up 23.74 percent and 10.88 percent respectively. However, through the first nine months of 2011, the index of managers was off 6.06 percent. Performance was horrible during this time.

Some funds were unable to take advantage of the volatility that markets experienced in the wake of the credit crisis. The poor performance left many investors scratching their heads wondering what was happening to the hedge fund industry. It seemed that people thought these so-called wizards of Wall Street could not fail, yet they failed miserably. Though assets continue to flow into the industry and new funds continue to launch, the credit crisis has made many investors step up their initial and on-going due diligence. Investors want to ensure the managers are doing what they say they're going to do with their assets.

Most investors believe that because hedge funds have the ability to go long and short and use any tool necessary to achieve their returns, they should do well regardless of whether the market is bullish or bearish.

Performance measurement is not the only difference between the two investment vehicles. Mutual funds are open-ended investment companies that sell their shares to the masses through multiple marketing channels, or they are closed-end, which trade on an exchange. Hedge funds do not operate this way. Hedge funds are limited to the number of investors they can have, either 100 or 500, depending on their structure, and are open only to accredited investors or qualified purchasers. For the most part, hedge funds in the United States are limited partnerships (LPs) or limited liability companies (LLCs) that are investment vehicles exempt from the Securities Act of 1933, herein referred to as the Thirty-Three Act. Later chapters will discuss specific structures and domiciles. For now, think of all hedge funds as LLCs. The manager is the general partner and the investors are the members or limited partners.

Hedge fund investors need to understand that these investment vehicles have different fee structures and liquidity provisions compared with those in mutual funds. The liquidity provisions vary, but for the most part, investors have trouble redeeming their investment at will. Most funds operate on quarterly redemptions and usually enforce a one-year lock-up. The lock-up if violated, meaning investors want to redeem before their one-year anniversary, often carries a hefty penalty or redemption fee, usually 1 percent of assets. Some funds have no lock-ups while others have lock-ups ranging from one, two or three years. It varies on a number of factors including strategy and how big the manager is in the industry.

Unlike mutual funds, hedge funds are not registered under the Thirty-Three Act, and thus they are prohibited from soliciting or advertising to the public. This prohibition tends to reinforce the popular press's notion that the hedge fund industry is secretive or mysterious. However, in the last few years, as hedge funds continue to gain traction on Wall Street, more managers are being quoted in the press, appearing on CNBC and Fox Business and sitting for interviews. The key thing to remember is that managers can't solicit. Therefore, they can appear on television or in an article but they can't discuss performance or the fund structure. Managers can discuss their views on the economy but nothing about their fund.

The press likes to call into question the fees associated with hedge fund investing, labeling these investment vehicles as expensive. Unlike mutual funds, which are governed by the Investment Company Act of 1940 (Forty Act), explicit rules about fees and how they are charged exist, but hedge funds are not subject to these restrictions and regulations.

For the most part, hedge funds typically charge a management fee equal to 1 or 2 percent of assets under management, along with an incentive fee—usually 20 percent—of the portfolio's profits. The management fee covers the operating expenses of the fund organization, and the incentive fee provides the bonus for performance. The idea is to make money for the investors as managers make money for themselves. If the managers don't make money for the investors, they don't make money for themselves. The interests of the investors and managers align.

As a side note, Jones did not charge a management fee; he charged an incentive, or a profit-participation fee. A number of hedge fund managers implemented the management fee in the late 1960s as a way to ensure business continuity.

You can find copies of the Thirty-Three Act and the Forty Act online by searching for the information. You don't need to read each act; however, you should become familiar with these documents as you build your business. The Forty Act governs the way all money management vehicles are marketed, sold, and operated in the United States. It stipulates who can and can't buy certain products and how those products need to be administered and operated by the individuals or corporations who own, sell, and market them. In certain cases, some money management firms market registered hedge funds that are similar in structure to mutual funds and are available to the public. However, for the purposes of this book, I will not be talking about such products. I will focus on funds that are not registered and, as such, are exempt from the Thirty-Three Act. Two specific characteristics provide for this exemption:

1. The number of investors that may be accepted into the fund.
2. The type of investor that is acceptable.

All funds are limited to 100 or 500 investors and are open to accredited or super-accredited investors, known as *qualified purchasers*. As of the spring of 2012, the definitions of an accredited investor and a super-accredited or qualified purchaser are as follows. An *accredited investor* must be a financial institution, an affiliate of the issuer, or an individual with a net worth or joint net worth of at least $1 million, excluding the value of the primary residence of such person or spouse or a natural person with income exceeding $200,000 in each of the last two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.[6] A qualified purchaser is any of the following four:

1. A natural person who owns not less than $5 million in investments.
2. Any person, acting for his or her own account or for the accounts of other qualified purchasers who, in the aggregate, owns and invests on a discretionary basis not less than $25,000,000 in net investments.
3. Any family-owned organization or entity that owns $5 million or more in net investments.
4. Any trust that was not formed for the specific purpose of acquiring the securities offered, as to which each trustee and person who contributed assets to the trust meets the previous requirements.[7]

However, Congress and the SEC made some changes to the definition of an accredited investor. Prior to this change, the definition has remained the same for many years; however, in the wake of the credit crisis and the great recession, Congress began to modify some aspects of the regulations. One of the biggest issues was the requirement for hedge funds to register. The registration requirement was set to go into effect at the end of March 2012.

Though these rules define who can and cannot invest in hedge funds, managers have the ability to accept non-accredited investors into their funds as long as they limit the number of this type of investor to fewer than 35 individuals.

SEC Regulation D stipulates that a maximum of 35 non-accredited investors are allowed to invest money into a private placement (i.e., a hedge fund). However, most managers do not allow for non-accredited investors because they are giving away investment slots that could go to other, more well-heeled investors who could provide more money to manage.

One hedge fund accountant who tracks the industry said that having non-accredited investors in the fund could become a regulatory issue, but it is a bad business decision because of the limited amount of money they can give a manager to manage.

"Managers are better off sticking with people who meet the investment requirement and who can afford to give them significant chunks of money to invest so that they can build their business," he said. "If they let all 35 non-accredited investors in the fund, they are really limiting their ability to grow their business."

Hedge funds have operated in relative obscurity for the better part of the past 50 years because they are not registered investment vehicles and because they are open to accredited and super-accredited investors. Unlike mutual funds, which are required to report their daily net asset values (NAVs), hedge funds are only required to report to investors. Over the past few years, the industry has come out of the shadows because many investors want products that zig when the markets zag. To understand how the industry came into the mainstream, we need to look at how Wall Street has evolved since the 1987 stock market crash.

HEDGE FUND HISTORY

Over the past 50 years, the hedge fund industry has grown at a significant but quiet pace. The industry grew steadily from the 1950s to the mid-1970s but hit a plateau of sorts for most of the 1980s. However, in the post-crash euphoria and as Wall Street kissed the 1980s goodbye, traders, brokers, and bankers realized the go-go days were over. They looked for an alternative to their traditional income streams, and what they found was the hedge fund industry.

In late 1987 and most of 1988, not much of a hedge fund industry existed. However, a number of smart and forward-thinking Wall Streeters saw the writing on the wall. This group of brokers, lawyers, and accountants collectively decided to begin pushing something called *prime brokerage*. Prime brokerage, which will be discussed in detail in Chapter 2, is a service that allows the trader to trade and the money manager to manage money, leaving pretty much all back-office functions of running a fund to a third party. Large, well-respected Wall Street brokerage firms had been providing prime brokerage services for years, which accounted for a small but significant part of their bottom line. Next to clearing, prime brokerage is one of the most profitable services that firms can offer because it makes money and is almost without risk, making its profits more attractive. For years, only the big firms offered their services to hedge funds. However, in the wake of the crash, a number of smaller, more aggressive firms decided that what they needed to do was to provide prime brokerage services to large, well-respected firms running successful hedge funds and to anyone who wanted to be in the hedge fund business.

"There was a consensus that prime brokerage could provide a steady stream of, for the most part, riskless income to the firm," said one former prime brokerage executive. "So, what we decided to do was to get the word out that starting a hedge fund was easy, not too expensive, and that we could help anyone who wanted to get into the business."

One interesting fact about the hedge fund business is that it is the great equalizer. Anyone can get into it as long as he or she has the money to pay the lawyers and can get some investors who will entrust their assets. That is why the industry has been and will remain so attractive to people from all walks of Wall Street and beyond. It is the only business that allows anyone to hang out a shingle regardless of experience or education. That said, every time a prolonged bear market continues, the hedge fund industry explodes. Getting into the game that is the hedge fund industry is easy. The question is, can you stay there?

Even though later chapters discuss how to survive, the name of the game is assets. If you can't raise assets and attract investors, then you are destined for death. If you can build a track record, attract investor interest, and draw in their assets, you are destined for hedge fund greatness and with this greatness come vast riches. That is why in the wake of the crash of 1987 brokerage firms pushed prime brokerage services and got people excited about the opportunities that existed in running, owning, and investing in a hedge fund.

To understand what happened in the hedge fund industry, think of the phenomenon that is Texas Hold 'em and how it has taken hold of the card-playing public around the world.

Poker was probably imported to the United States by French fur traders and explorers in the nineteenth century. Though no one seems to know for sure, it is expected that the origins of the game come from the Persian game called As Nas.[8] According to some poker historians, the first known direct reference to poker was made in New Orleans in the 1830s. It spread from there up and down the Mississippi and Ohio rivers and became a thing of lore among cowboys on the Western frontier.

Though people had been playing poker and various types of the games for years, Texas Hold 'em became popular among gamblers and card players in the early 1970s with the World Series of Poker at Binion's Hotel & Casino in Las Vegas. Over the years, the tournament grew and established itself around the world as the premier tournament for poker players. The game and the tournament grew in popularity throughout the 1980s and 1990s, but expanded more in the early part of the 21st century due to the confluence of television, the Internet, and some forward-thinking casino executives. For years, the tournament had been televised by a number of local outlets and on ESPN, but in 2003, it made its debut on the Travel Channel and picked up a huge following.[9] Like hedge funds, Texas Hold 'em has a low barrier to entry. It is open to anyone who has the money to get into the game. Furthermore, Texas Hold 'em offers great riches to those who are successful. The turning point for Texas Hold 'em came in 2003, when the winner of the World Series of Poker was Chris Moneymaker, a relative novice in the game who gained his entry to the tournament through his successful play on the Internet. The idea that a person playing the game on a computer could sit down with the best live players in the world and beat them set the game on a path to the moon. Sound familiar? Think novice hedge fund managers who pick great stocks! Today Texas Hold 'em is becoming the most popular casino game in gambling dens around the country and has become a mainstay on mainstream television stations like Fox, NBC, and ESPN, which broadcast tournaments all year.[10]

The parallels between the growth in the hedge fund industry and the growth in Texas Hold 'em are significant. Just as computer programmers, television executives, and casino operators pushed an old game to a new audience in an effort to bring more excitement to online and in-person gambling, brokerage firms, lawyers, and accountants made it easy to get into the hedge fund business and pushed the barrier of entry low enough to make it worth the financial risk. Unlike those who pushed Texas Hold 'em through the Internet and tournament play, those who pushed the hedge fund industry did it through seminars and cocktail parties. In the early 1990s, it was easy to find a Monday, Tuesday, or Wednesday afternoon in which a brokerage firm, along with lawyers and accountants, was offering a seminar and cocktail hour on how to get into the hedge fund business.

Going into the late 1980s and early 1990s, the hedge fund industry grew from being an afterthought for many to something that was front and center to most people on Wall Street. The growth was spurred by the uncertainty of the markets, the lack of perceived riches from the Wall Street firms, and a lack of good jobs for many. The large firms had scaled back their operations in light of the crash and let lots of people go. In addition, they scaled back compensation to those who remained employed. More people were out of work, which meant that more people became entrepreneurs. This, coupled with an expansion of lawyers, accountants, and prime brokers who saw an opportunity in offering services to hedge funds, combined to make the perfect storm that led to the industry's growth. The excitement surrounding the opportunity in the hedge fund industry was a direct result of the service providers realizing that most risk can be quantified when you are working with a hedge fund. Though the service providers could lose clients because individual funds perform poorly and the providers were unable to raise assets, it would be easy for them to keep their broader business as long as a constant flow of new managers cropped up. Therefore, service providers needed to get the word out and make it easy for managers to get up and running. The brokers realized that one hedge fund manager who blew up could not take down an entire firm like a rogue trader using firm capital could. They determined the business risk was and is limited to a hit to the bottom line in terms of fee income, but that a blowup couldn't destroy the business. In the worst-case scenario, the lawyer, accountant, prime broker, and administrator would need to find new clients to replace the lost income that the dead funds had provided.

Throughout the 1990s and into the new millennium, many service providers realized they needed to meet the needs of managers to continue to survive on Wall Street and to take advantage of the fee income generated by these financial vehicles, often thought of as mysterious and secretive. And like that scene in *The Godfather Part III* when Michael said, "Just when I thought I was out, they pull me back in," the hedge fund industry seemed to take a few hits during and after the credit crisis yet continued to thrive.

The reason is twofold. First, the entry barrier has been so low that the number of people getting into the business has increased. The entry fee is around 50,000 dollars or so to create and launch a fund, which means almost anyone can do it.[*] Second, because the great recession saw thousands of Wall Street jobs evaporate, many have decided to go at it alone. What better place to go it alone than in a hedge fund? Along with the low entry cost come huge financial rewards to managers and their team if they can build a successful business. Few areas of employment exist in which people can earn so much so fast for their efforts. The press makes us gasp every time a professional athlete signs a huge contract, but though

[*]This includes the legal work for the documents and all setup fees for the entities, but does not include infrastructure costs and/or investment assets.

their salaries and bonuses are large, this money pales in comparison to what hedge fund managers and their traders can earn in a single year. Some of the most respected and envied people on Wall Street—or any street, for that matter—are hedge fund managers who yearly earn hundreds of millions of dollars for their work in the markets. As the number of funds increases, so does the number of service providers offering tools to help the managers succeed. It has become a numbers game. Fees contract while the number of clients are expanding, meaning they need more people to provide services to hedge funds, and the industry keeps growing. Eventually, something will come along that will cause the pace of fund growth to slow. Until the fees generated by the industry subside, lots of people will be pushing other people to get into the hedge fund business.

Unlimited riches await the budding yet successful manager, and therein lies the main issue: Not everyone can or will succeed for two reasons. First, not everyone can really trade or invest successfully. Some hedge fund managers cannot earn the returns that investors have come to expect. Second, some managers are unable to raise enough money to keep their businesses afloat because they are unable to perform. The hardest part of being in the hedge fund business is raising capital. Few people can do it successfully. Many people say they can raise money and promise to help a fund start, but most of them fail to deliver. Marketing and raising capital are explored in Chapter 6. Make sure you read this information because it is the most important part of running a successful business.

WHAT'S NEW

Over the past five years, since the first edition, a lot has happened in the world, particularly the hedge fund industry. However, the real fun started in October 2004, when for one of the first times in SEC history, the commissioners split their votes, three to two, along party lines to change the regulation and require all hedge fund managers who meet specific requirements to register as *registered investment advisers* (RIAs). The vote was historic in that the commissioners almost always vote unanimously on rule changes.

The vote, thought of as controversial by some, required hedge fund advisers to register as RIAs by February 2006. In the wake of the ruling, a number of industry insiders and trade groups sought to challenge its legitimacy. One hedge fund manager challenged the ruling in court. In December 2005, a U.S. Court of Appeals for the District of Columbia heard arguments against the ruling. Its decision to strike down the SEC registration rule came down on June 23, 2006, vacating the rule and sending it back to the commission to reconsider its regulation. The action was brought by Phillip Goldstein, manager of the hedge fund Opportunity Partners LP. He argued that the SEC did not have authority to adopt the rule and that it misinterpreted a previous portion of the law that had exempted hedge funds from registration. The news of the decision by the D.C. Court of Appeals sent shock waves across both sides of the registration aisle. Those for and against the registration rule seemed to be in disbelief that it had been struck down.

The *Wall Street Journal* summed it best by calling Goldstein's efforts a David versus Goliath fight: "He took on the Commission on his own, no other managers joined him in the suit and he paid for it out of his own pocket, an expense of nearly $300,000."[11]

Prior to the court's ruling, many managers believed the SEC would not stop with the regulation but would ultimately require hedge funds themselves, and not just their advisers, to register with the SEC in a similar way that a mutual fund registers. Another smaller but important concern was the perceived additional administrative costs created by registration would raise the barrier to entry in the industry, stifling entrepreneurship. The latter was an objection raised by then-Federal Reserve (Fed) chairman Alan Greenspan in early 2004 when the SEC was accepting comments on the rule change and he was asked about the pending registration issue.

At the time, the SEC commissioners acknowledged the potential issue with entrepreneurship by exempting advisers of hedge funds with fewer than 15 clients or fewer than $25 million in assets from registering. This was their equitable solution to the little guy.

However, since the ruling, the hedge fund industry seems to believe it no longer has to deal with the registration issue. Although some believed the SEC would circumvent the court ruling, possibly turning to Congress or the states for relief or guidance on creating and implementing a registration requirement, by the midsummer of 2006, it looked like this effort was going nowhere.

From February 2006, when the rule went into effect, until late June 2006, the industry had been operating under the assumption that the regulation was in place. Managers who had not registered as RIAs went through the process to stay in the business. As RIAs, these hedge fund managers had to adopt basic compliance controls, improve their disclosures to investors, and open their doors to the SEC for periodic audits, the same as what is required of mutual fund managers. The regulation would allow the SEC to collect and make public basic information, including the assets and identities of U.S.-based hedge fund managers.

In the wake of the ruling, the debate continued. However, many believed the registration requirement would die a significant death, but that all changed on September 15, 2008, the day Lehman Brothers Holdings Inc. (Lehman) filed for bankruptcy and Bank of America bought Merrill Lynch.

With the collapse of Lehman, the fire sale of Bear Stearns to JPMorgan Chase, and the rushed merger of Merrill Lynch into Bank of America not to mention the Troubled Asset Relief Program (TARP), a great demand existed for more regulation on all aspects of U.S. finance. Most of the regulation was put together in the Dodd-Frank Wall Street Reform and Consumer Protection Act that on July 21, 2010, President Barack Obama signed into law. The Dodd-Frank act is considered to be the most sweeping change to financial regulation in U.S. history. The bill touches all of the federal financial regulatory agencies and almost every aspect of the nation's financial services industry.

Though many areas of the Dodd-Frank act affect Wall Street, hedge fund managers and investors have focused on Title IV, which puts in place rules and regulations on how hedge funds operate, particularly report on their activities. The biggest change is that fund complexes with under $150 million in assets under management are not required to register with the SEC as RIAs, and those with more than $150 million are required to register. Title IV calls for a number of studies to be made regarding other areas of the hedge fund industry including changing the accredited investor requirements, the establishment of a self-regulatory organization for hedge funds, and the study of short selling.

Some observers believe that the changes put in place by the Dodd-Frank registration requirement do not go far enough, while others believe that it goes too far. The Dodd-Frank act doesn't address marketing issues that have caused some investors to stay away from hedge funds. Many investors believe the regulation is a move in the right direction, but because hedge funds are illiquid, have a management-fee and incentive fee structure, and do not provide transparency, the registration does little to increase their interest in these investment vehicles.

Many industry observers believe that these types of rules will not deter fraud because the SEC and its staff are overextended and cannot complete the work they have. The SEC's response to this is that it will hire and put in place the resources needed to monitor and enforce the regulation. However, a study by the Government Accountability Office (GAO) found that, in 2003, the SEC was able to review just 23 percent of all corporate fillings.[12] In 2002, Congress passed a law requiring the SEC to review all public companies at least once every three years. Therefore, critics of the new regulation question how the SEC will deal with the added burden of monitoring thousands of hedge fund managers. When the Congress enacted the Dodd-Frank act, they knew how overworked and underfunded the SEC was but added the burden of these new tasks because of Bernard Madoff.

December 7, 1941, is a day that will live in infamy for the United States, but on Wall Street, December 10, 2008, is a day everyone will remember. On that day, Bernard Madoff surrendered to authorities admitting to orchestrating a massive Ponzi scheme. With the Madoff albatross around their necks, Congress and the SEC were forced to act and fix their reputations and make the American people believe they were going to protect them from the evil men do. In the end, the hedge fund industry will continue to thrive and flourish regardless of regulation; after all, it is the American Way.

One of the reasons that managers are not complaining so loudly about the new rules is because they believe the more regulations exist, the more likely hedge funds will become mainstream. As the industry becomes more mainstream, it can attract more assets. Often, these types of investors are institutions that make sizable allocations, and their assets are usually sticky. The money is lucrative and difficult to come by but is easy to keep. Once these institutions make an allocation to a fund, they rarely move the money. These types of investors use consultants, who for the most part operate within a check-the-box mentality. So, for a fund to qualify for the beauty contest that takes place prior to the allocation, it must meet all of the requirements the consultants and their clients have deemed necessary for their money. One of those requirements has been that the manager be an RIA. The reason for this is that the marketplace puts a high degree of significance on funds the RIAs operate, who are perceived to be more professional than those who are not RIAs.

The perception is different from reality. The reality is that almost anyone who meets certain requirements can—and, in most cases, is forced to—register. The registration process consists of filling out and filing a Form ADV and complying with the rules set forth by the SEC governing RIAs. Nevertheless, if a manager wanted money from an endowment, pension, or foundation, he or she would need to be registered, and because of the power of these assets, the manager would register willingly.

The funds that led the challenge to the registration requirement were organizations that believed the ruling would put undue pressure on them. With the rule's adoption, hedge fund managers needed to comply with and operate under strict guidelines that dictated how they operated their businesses. This has meant additional costs in human and nonhuman capital. For example, businesses have to put in place a compliance manual that details how the organization is run in the front, middle, and back offices. They have to install a chief compliance officer who must ensure the fund and its employees are operating appropriately in regard to accepting assets, putting assets to work, and tracking all communication between investors, potential investors, and their surrogates. In some cases, the regulation on the professional side of the organization will help the funds operate more efficiently, yet other aspects of the regulation are a real hindrance and could be a significant financial burden to the firm's operation.

The complaints notwithstanding, some believe the regulation will help the industry and bring it more into the mainstream. However, the registration requirement is expected to put investors more at ease with investing in hedge funds. In my opinion, this provides a false sense of security to investors with little or no experience with this product. Some believe that because a fund manager is registered, the investment is worthwhile. This is similar to saying that because you have a driver's license, you are qualified to drive in the Indianapolis 500. We know this is not the case in either scenario. Registration is not a seal of approval. It means the manager filled out paperwork, completed a compliance review, and is willing to be audited randomly by the SEC. It does not mean the fund is worthy of investor assets. Unfortunately, as funds become more mainstream and as they look more alike, investors are going to have to do stronger and more thorough due diligence. The question is, can and will they be willing to do it?

As a manager, your job is to run your business in the most efficient and cost-effective manner possible. Your job is to evaluate the costs associated with registering versus the fees that could be generated on assets raised because your fund was able to check the box. However, that will no longer be the case, and with the new rules comes a level playing field of sorts for managers of all strategies and sizes.

Hedge funds have caught the eye of regulators because of the growth the industry experienced in the new millennium. The SEC estimated nearly 8,500 funds were operating in 2008, with more than $1 trillion in assets under management.[13] According to an SEC spokesperson, the commission has not tracked funds since 2005 and was planning to do so when the new registration requirements came into place in March of 2012. Regardless of the SEC's tracking, the industry is no longer a private club for wealthy investors and their friends as it was in the first 30-odd years of the product's life. Hedge funds have become mainstream and part of almost every investor's vernacular. Large and small hedge funds have filled the role vacated by the large brokerage firms that shut down their propriety trading desks, and they provide liquidity and capital to the marketplace. Today, hedge fund managers are the people making markets and allowing the markets to move forward. They are the money managers who are looking for global opportunities to exploit while simultaneously providing liquidity.

With or without registration or regulation, the hedge fund industry is here to stay. Hedge fund managers and their investors will be around in one way, shape, or form for the rest of our lives. The question is how will the industry evolve as markets change and investor appetites become more and more refined? With this in mind, you, as a budding manager, need to address several issues before you decide to go out on your own.

First, you will need to have what it takes to be an entrepreneur. Second, you will need to ensure you have the financial backing to build and maintain a sustainable business and to ensure you can deliver on the promises you have made to investors in your offering documents. Third, you need to hire a genuinely qualified team of service providers to help you realize your dream.

MAKING IT ON YOUR OWN

Whether you have the skills to be an entrepreneur is difficult to know. Being an entrepreneur is harder when you have previously worked for a large company and have been long exposed to the corporate world. Some hedge fund managers don't like being the chief cook and the bottle washer in their new company. These managers want to be able to pick up the phone and get results from a network. Ultimately, such people don't make it in the hedge fund world. To make it, you need to be willing to roll up your sleeves and get involved in all aspects of your business and its operation. Taking an active role in all aspects of your business will make you more likely to succeed.

Nancy Havens, of Havens Partners, a New York City–based fund, told me during an interview for a profile in one of my other books, *Getting Started in Hedge Funds*, that the hardest thing about going out on her own was realizing that she didn't matter to anyone anymore. She could not pick up the phone and get her computer fixed or a new ink cartridge for the printer. As an entrepreneur heading her own company, she was no longer part of the machine that was Bear Stearns. She has to do during the day, tasks she does by herself.

"It was hard to get used to this," she said. "But after a while, I got a better understanding of how important infrastructure is and how to get things done on this side of the business."[14]

DELIVERING ON YOUR PROMISE TO INVESTORS

When you start a hedge fund, you will need to seed the fund with some assets—yours, your friends', and your family's—and you will need working capital to ensure you stay in business. As you will find out if you do not know, raising money is probably the hardest part of any business. Remember, those you think will give you money probably will not, and people whom you never in a million years believed would step up to plate will do so. In most entrepreneurs' experience, that is the way it works. To get investors and keep them, you will need to have a good, solid strategy clearly defined in your offering documents and marketing materials. Then you need to deliver on it. If you can't execute your strategy, don't start the fund. It does not matter if you are successful with positive numbers. You must do what you say you are going to do. Investors are willing to forgive you and stick with you if you make mistakes or the strategy does not work. Once you drift away from the stated strategy, you might as well look for a new job working for someone else. Investors have little or no tolerance for this kind of behavior.

"The markets don't allow managers to always be successful," said Richard Bookbinder, the manager of a New York City–based fund of funds. "The idea is to find a strategy that can work over time and a manager who does not stray from it simply in hopes of putting up better numbers. I would much rather have a manager tell me that the strategy did not work because of this, this, and this than have him or her tell me that they tried a new strategy midmonth and made a lot of money. I want to know that what I invest in is what I am getting."

Strategies and styles aside, one thing individual investors and institutional investors are looking at during the due diligence process is the service providers the fund uses to conduct its business.

You want to see that new and old funds use good, solid, and well-respected service provider partners as their lawyers, prime brokers, auditors, and administrators. The main reason investors like to see whom the fund is doing business with is that a number of cases of fraud have occurred at firms such as the Bayou Hedge Fund Group, KL Group, Lake Shore Asset Management, Drier L.L.P., Beacon Hill Asset Management, Lipper Investments, Tradewinds International, and Manhattan Investment Fund. Subsequently, a common belief is if respected firms are providing audit, administration, legal, and prime brokerage services to funds, they must have passed some level of due diligence. Unfortunately, you never know, and you should not take anything a manager says at face value.

A number of years ago, I was at a hedge fund conference in Boca Raton, Florida, and during the four-day hedge fund love fest, I was approached by the manager of a fund of funds who was looking for a strategic partnership with a large institution. The manager had gotten my name from a mutual friend, who told him about a number of projects that my firm had worked on similar to his. He needed to take his business to the next level and thought it made sense for us to meet.

My friend, the manager, and I decided to go to lunch to see if we could work together. During the meal, we talked about a number of things regarding the industry: how he perceived the partnership would work, what he wanted out of the deal, and whom he had talked with about partnering. All in all, the conversation went smoothly, and the lunch looked like it would turn out to be a profitable one for us.

The next step for me was to get a copy of the fund's documents, review its performance, and think about ideas on how to help the manager with his problem. A significant part of this research was to do some crude but significant due diligence on the manager, his fund, and the organization. The initial work would be based on a review of and contact with his lawyer, accountant, and administrator as well as some poking and prodding among industry contacts.

A few days after we had lunch, the documents arrived in my office, and I immediately scanned the name of the fund's service providers. As it turns out, the fund's lawyer was a firm I knew well. As an aside, most fund documents are the same, so it is easy to review a document quickly. A hedge fund document starts with a number of disclaimers, moves into the summary of the offering, and is followed by a detailed explanation of the summary. The summary of the offering always states the fund's auditor, administrator, lawyer, prime broker, and any other service providers of substance who may be working with or for the fund in its ongoing operation. (A thorough list of service providers can be found at www.hedgeanswers.com. Once you have the list, e-mail me at das@hedgeanswers.com for some names that may help you get started.)

After reading the document, reviewing the marketing material, and talking to my partner about the opportunity, I called the lawyer to find out what he knew about this fund he counseled. The lawyer said, "I know the fund and the manager. We wrote the documents about six or seven years ago, but I have not heard from him since. Is he still in business?"

He told me that since he had heard his name was in the document, he was going to call the manager to catch up and see how they could restore the relationship. This type of situation is normal. It is not a red flag but a fact of life; once a document is completed, there is not a lot of work that the fund and the lawyers do together unless a problem occurs or the business is expanding.

Maybe this manager had no questions or problems during the period of no contact. Maybe he found a different lawyer to work with and did not want the new lawyer to rewrite the documents. It was something my partner and I would question in one of our follow-up conversations.

During this particular due diligence, we found nothing that led us to believe that anything was wrong with the relationship. The fund and the lawyer had gone their separate ways. The manager had been minding his business, making investments, and gathering assets and had no need for this particular law firm or its counsel.

As a person who is looking to build a successful business, you need to be prepared and have answers for investors who pick up the phone and inquire about your firm. You need to ensure that you have all the answers before you are asked the questions, and that you never misrepresent anything to prospective investors. You must stay on top of your relationships with service providers and keep them aware you are using them for references. You don't want to be caught in a situation where the information offered by the service provider is different from the information you give your investor or be in a situation in which the service provider does not know how your two firms are working together. The key is to be prepared for all scenarios.

Unfortunately or fortunately, the service provider industry has grown substantially over the past five years. It seems everyone is getting into the business of providing products and services to hedge funds. Chapter 2 covers the role of the service provider and how you, as a start-up manager, should select and work with various service providers as you build your organization.

CHAPTER 2

The Service Providers

Hedge fund managers around the globe have a series of service providers to help them operate their business. Many different types of firms offer services to budding and existing hedge fund managers. Think of it this way: People believe all hedge fund managers are successful and have lots of money, therefore, many want to sell them something. Think about why people rob banks.

Today in the United States, most hedge funds have four different groups of service providers. Each fund manager has a prime broker, a lawyer, an audit firm, and an administrator. In some cases, hedge funds hire outside marketers, compliance consultants, and technology specialists.

By name, each of the providers is recognizable and probably needs no further explanation. However, in today's environment—with the new rules coming out of Washington and the potential for more regulation—you must realize the role each plays in a successful organization.

As a manager, you need to have top-notch firms that will provide exceptional, solid service to your fund, regardless of market conditions. You need to ensure you work with name-brand organizations. In today's competitive environment, many investors do business only with funds using service providers they have experience with from past investments.

This chapter explores the role of each of the service providers. The idea is to give you a basic but thorough understanding of the function each will play in your organization and how you can use them to your advantage as you grow and expand your business. In this chapter's final section, I discuss a fifth group of service providers, the marketers, exploring the role that outside or third-party marketers can play in building your business and presenting the pros and cons of using them in your organization.

TYPES OF PROVIDERS

Once you decide to get into the hedge fund business, you will need to assemble a business plan that outlines how the fund is going to be structured, how you are going to manage the assets, and how you are going to raise the assets. The first stop on the path to the hedge fund business that most people make is to a prime broker who refers them to a lawyer.

The prime broker usually serves as a good starting point for people who are new to going it alone and need help to get things going. The prime broker, along with providing you with execution services, will be a resource for information to contact and establish relationships with other service providers. Initially, finding a prime broker may be difficult. Many large firms will say they do not want to work with start-ups. Many smaller firms are start-ups themselves and have little or no track record to enable you to determine whether they can provide the service and executions your fund will need to launch and be successful. The choice is a difficult one requiring serious consideration as you continue to the fund's launch.

Because of weak hedge fund performance combined with the credit crisis and new registration requirements, the number of new fund start-ups in early 2011 seemed to be decreasing or leveling off. As a result, a number of prime brokers were seeing their new business decline. Existing businesses suffered significant declines as many large funds lost assets, funds went out of business, and the market volatility caused funds to sit on cash instead of trading. Prime brokerage has been a good business and many if not all of the large brokerage firms put a lot of resources into developing sophisticated execution and accounting systems to track trades and brokerage commissions. Today, the number of firms offering prime brokerage services has leveled off; however, all the usual Wall Street suspects are still in the game. Though many say they won't take small clients, many will. The key is to shop around and get the best deal for your fund. As a new hedge fund manager, you are entering a buyer's market.

The lawyer is usually the second stop on your path to hedge fund greatness. However, it is the first service provider discussed in detail in this chapter because the lawyer is the person you will spend the most time with in the early days of your business. The lawyer will provide you with a blueprint for what will become your fund and your management company, in short, your business.

Over the past few years, lawyers have changed the structure of choice for funds from a limited partnership (LP) to a limited liability company (LLC). Either structure will work and is acceptable. However, many lawyers believe an LLC offers a higher level of protection from investors in case something goes wrong and litigation comes from investors.

The accountant is your third stop on your path to building a hedge fund. An accountant will provide you with insight and guidance on how fees are calculated and paid, how you deal with taxes, and how to audit your performance and report performance to existing and potential investors.

The administrator is generally the last service provider you will talk to as you prepare to launch your fund. The administrator will keep your books and records, help you track investors, and prepare your performance reports on a monthly and quarterly basis.

The final service provider you might meet with is a marketer. I am not a big believer in marketers. I have met few over the years who can actually deliver in assets. However, some are good and are the ones who can raise money for your fund and attract investors. My suggestion is to hire an internal marketer. Make it your responsibility to raises assets and know your customers. It will help you in the beginning, middle, and end of your business.

LAWYERS

The lawyer's job is to guide you and your business partners through the process of drafting the offering and business documents of the fund and setting up the organization that will become the money management firm. The documents include, but are not limited to, an offering memorandum (the first document you draft), a subscription document, and an LLC agreement.

The offering memorandum describes the fund, how it trades, how it operates, and all of the organization's details. It discusses strategy and lockups and identifies the firm's partners, the charged fees, and the details of the business. This document is similar to a mutual fund prospectus. The subscription document is what investors fill out to invest in the fund. Its companion is the redemption document, the paperwork investors use to redeem their assets. The subscription document requires potential investors to answer many questions about who they are, their objectives, and their investing knowledge. In this document, investors make declarations about their financial health and state they have read all of the material provided in the other documents. The LLC agreement details how the company (i.e., the fund) is run, who is responsible for what functions, and the role of the investor in the company.

Each document serves a specific function in the operation and management of the company and details the relationship between the fund, its manager, and its investors. Examples of the documents can be found in my book *Getting Started In Hedge Funds*. The documents are long and detailed and seem boring and repetitive. The documents detail investment strategy, provide descriptions of the management team, and examine investment risks. You must read the documents cover to cover and ask questions if you don't understand something. You need to understand the documents and be able to answer questions and communicate with investors about the contents of the pages.

In the documents, disclosures are interesting to read. Without a doubt, the lawyer will include everything that could go wrong in this section of the document. Other areas to pay attention to during the review process are the way in which fees are calculated and paid to the management company, how the fund's style and strategy are described, and tax issues and considerations. The accountant will help you with the fee and tax areas. You and your partners will be the only ones who can determine whether the style and strategy sections are correct. Having an accountant go over the math sections of the documents—in particular, how fees are calculated—is important because they know numbers and putting their eyes on words ensures you can get paid.

Have a full understanding of all aspects of the documents. Each contains specific issues governing the business and its operation. You need to be familiar with the material so you can fulfill your fiduciary responsibilities to your investors and so you can communicate to potential investors clearly, concisely, and accurately.

With apologies to many of my hedge fund lawyer friends, as the hedge fund industry becomes more mainstream, the documents are becoming more boilerplate. Little new insight is being written into offering memorandums or subscription agreements besides what is required of the new regulation. That is because little has changed in partnership law and taxation regulations over the past five or six years. As new laws are passed and regulations come into force, the lawyers update the documents to reflect these changes. However, the bulk of the documents are relatively consistent.

Most new managers think they are getting something unique from their lawyers when all they are getting is a document updated with their pertinent information. Though some might not like this, it is good from a litigation standpoint. Should something go wrong, it is better for the manager to have a document similar to other offerings than something so unique that it stands out within the industry. This is true from a marketing standpoint. Sophisticated investors know what to look for in the document and seeing something familiar gives them great comfort. If it differs from what they have seen before, they might take longer to review it and to make an investment decision.

Today, a hedge fund can have its documents completed for as little as $15,000 to $25,000, or a new manager can spend close to 100,000 dollars.* It all depends on the law firm chosen to write the documents and

*This is just a ballpark figure on the legal fees. Other costs go into the set, and the fees range from lawyer to lawyer.

the amount of legal work required to complete the process. Off the record, some lawyers will say that less expensive firms provide flawed documents and pricier documents are flawless and as close to perfect as possible. I have worked with the expensive and the less expensive lawyers, and my comment is this: Work with the lawyer with whom you feel most comfortable and to whom you think you will matter most. In the end, paying a lot of money does not mean you are getting a better product than what you would get if you bought a less expensive one. Because the hedge fund industry has gotten so big so fast, you will find little difference in the product you get from the law firms that offer hedge fund services. Therefore, base your decision on what fits best with your needs, whom you feel most comfortable talking to about your business, and who you think will give you the best advice. You must take one caveat into consideration: No matter whom you choose, you must choose a lawyer with hedge fund experience. Make sure he or she knows what he or she is doing and check the references. E-mail me if you would like—I am always happy to comment on a service provider. No matter what firm you choose, make sure it has done fund work and is known in the industry. You do not want the firm to learn on your nickel.

Initially, you will spend an enormous amount of time working with lawyers on documents that will develop your idea into a viable hedge fund. The work will entail going over the strategy, the style, its function, and the instruments used to achieve the fund's performance goals. You will need to work on things like your biography and those of your partners. You must like the lawyers, respect them, and believe in their ability to get the job done. If the relationship is acrimonious, the process will take too long and will not yield the product you need to be successful. Most lawyers begin the process with a questionnaire, which you will fill out to detail all of the items discussed above and more.

You want a lawyer who provides insight and good answers to your questions. You want someone who is a reliable resource when you have a question about something in the business that may be legal in nature, even if unrelated to the document, and you want someone who can guide you smoothly through the process.

"The first lawyer we met with really seemed to not want to work with us," said one manager, who asked for anonymity. "He gave us a quote that we thought was completely unreasonable, and when we asked him why it was so high, he said, 'That is the price, take it or leave it.' We left it. We went with another firm that we had heard good things about and who was willing to work with us in a manner that made us feel extremely comfortable."

This particular manager met with three lawyers before deciding which firm met his needs. Choosing service providers can be a nerve-wracking and annoying process. However, the first rule in choosing a service provider is to remember that you are the customer, and the customer is always right.

Service providers need you as much as you need them. No one knows how successful or unsuccessful a new fund is going to be and, subsequently, how big a client your impending fund may become. Don't do business with those who do not believe in you and what you are about to do. They will not make good service providers. Remember you are the client: You are paying the bills, and they work for you.

The best way to choose a lawyer is to meet with many of them and get a feel for them. One lawyer I met with when I was starting a fund of funds was someone I had known for many years. He had a decent reputation, and I thought he was strong in this area. When I sat down with him to discuss the project, he seemed interested, listened intently, but took a number of phone calls and typed out messages on his BlackBerry. The meeting, which probably needed to be no longer than 40 minutes, lasted over an hour because we were interrupted so many times. Finally, after about 45 minutes of nonsense, I asked him if he wanted me to come back later because he was so busy and he replied, "No, this is how it always is." When my partner and I left, we looked at each other and said, "This guy is not for us." He is probably a great lawyer. He is a friend in the business, but he is someone who didn't make us feel comfortable as potential clients. The lawyer we chose for this specific project turned out to be a good, solid, though expensive choice. His work was exceptional, but it was mostly done by associates, one of whom left us in the middle of the project, which made things more difficult. However, in the end, we were happy with the result. Though the associate didn't stay through to the end, we appreciated the quality of her work.

What do lawyers do for all the money you pay them? They are going to create and put in place the structure that will become your business. The lawyer will establish the company and provide you with corporate documents to establish the infrastructure of your business. In some cases, the lawyer will secure your tax ID number, which allows you to set up banking and brokerage accounts. Think of lawyers as the architects who sketch out the plans for how your house will be built. This is what they do for you when you sit down with them and tell them about your fund's plans, the strategy, and the assets' origins. The lawyer will take your ideas and put them on paper so you can operate in a safe, legal environment and make money for you and your investors. The time it takes to complete the documents can range from a few weeks to a few months. It depends on how much work needs to be done and how busy the lawyer and the team are when you engage their services. Remember that your first fund is the hardest one to create. However, the more you do it, the easier it becomes. You are not reinventing the wheel.

During the drafting of the documents, you need to determine which other service providers you are going to use. In most cases, the lawyers will provide you with a good reference list of firms you can work with, and the prime broker will provide you with information on accountants and administrators. The lawyers will most likely have a preferred list of people they like dealing with for all of the functions you need. This list is usually a good place to start. Choosing the remaining service providers is important because all are mentioned in the documents, and they will want to review the material and provide comments. Go through this step because the remaining service providers can add valuable information to the material.

As a case in point, most fund managers think an accountant is unimportant with respect to the legal documents or an administrator has little to add because their main jobs are to keep the books and to maintain records of the fund, respectively. Both can ensure the lawyer spells out in the documents the proper and most efficient way for you to charge and collect your fees. The accountant and administrator can provide significant insight into the financial structure of the fund, which in turn determines how you are paid. Have your accountant and your administrator review the materials before they go to press because they will find an error or two in the final draft that could save you significant headaches in the future, which may include additional legal bills.

If your lawyer objects to having the accountant and administrator review the documents, then fire that person and find another lawyer. Several sets of eyes are important. However, once the documents have been completed, you probably will not talk to your lawyer more than a couple of times a year. You should keep your lawyer current on the number of investors, the amount of assets in the fund, the performance, and any other changes are occurring at the firm. Lawyers can provide good counsel and advice, so use them. You should have no problem asking your lawyer or any other service provider for leads on potential investors. Service providers can be a good resource in this area. These people can be helpful to your organization. Remember your success is only good for them. It means you will need them for additional services.

PRIME BROKERS

A single manager fund cannot exist without a prime broker. This fact cannot be overlooked. Without a prime broker, a fund cannot trade, make investments, or do anything to navigate the markets. That said, in the past 10 years, the prime brokerage business has led the charge in increasing the hedge fund industry size. One reason that prime brokers have been responsible for industry growth is because they see the unique opportunity that exists in providing execution services to money managers. Even as spreads have tightened and commissions decreased, prime brokers continue to push harder than ever because they have turned the business of executing orders into a numbers game. Essentially, the more funds they have, the more money they make. It is about quality and quantity. With the proliferation of trading technology, the costs of doing business have declined, meaning that prime brokers can offer good, cheap execution services to anyone who wants them. The days of the human broker expense for every account are over. In most cases, human brokers have been taken out of the execution process, replaced instead by trading screens piped through the Internet to fund managers on their desktop. Today, with a point and click of your mouse, you can buy, sell, or borrow shares in markets around the globe instantaneously. Prime brokers trade stocks, options, futures, and bonds. Have a screen and a keyboard and you can trade!

Ten years ago, the number of firms offering prime brokerage services to hedge funds was well under 50. Today, the number is closer to 100 in the United States. Since the credit crisis and the consolidation of a number of firms, Merrill, Bear and Lehman as well as some smaller players going out of business, the number of firms offering prime brokerage has decreased yet continues to grow nicely. Lately, it seems that with each new issue of a hedge fund newsletter or magazine, another story of a prime brokerage start-up firm with an exciting new take on execution services appears.

As a moniker, *prime broker* is a perfect description of what the firm does for the fund manager. The prime broker provides a number of services and functions to the fund that include, but are not limited to, start-up consulting, trading and execution, portfolio reporting, risk management, securities lending, office space, technology support, leverage, and capital introduction. Of course, the main business is providing a place for the manager to execute orders. The remaining services are used to entice the fund manager into working with the firm.

"Our role is to provide the fund managers with all the services that they need to operate their business and so that they can stick to picking stocks," said one prime brokerage salesperson. "We will provide them with office space, phone systems, a Bloomberg, and basically whatever they need so that they can stay focused and manage their portfolios."

A prime broker can't legally require funds to trade specific amounts of shares or positions of their portfolio through it. However, the unwritten rule is that if a fund does more than 50 percent of its orders away from its prime broker, it might not be treated as well as a fund that does.

"We cannot control how much or how little they do with us. But because we keep all of the records, we know how much money they are managing and get a feed at the end of the day of all the trades that were done with us and away from us [so] we know what is going on," said the prime brokerage salesperson. "If the numbers don't add up, the first thing we are going to do is ask why they are going away. And the second thing we are going to do is figure out how to get them to do more with us. If we don't get an uptick in the volume of trades, then we are going to raise their rates, which will in a nice way get them to move to another shop."

In all fairness, a prime broker should be compensated for all of the services it provides. Because of changes in soft dollar rules, the cost of doing business for hedge funds is going up. A few years ago, hedge funds could use *soft dollars*, or credits given to investment managers for paying higher commissions on their trades, for practically anything they needed. That is no longer the case. In the fall of 2005, the Securities and Exchange Commission (SEC) tightened the rules regarding what investment managers could and could not use soft dollars for in the normal course of their business.[1] As a result, fund managers are minimizing the costs of doing business because these costs come out of the fund and their coffers. Today, price does matter and is the bottom line.

Office space is one enticement for hedge fund managers that has helped a number of prime brokerage firms build successful practices.

Prime brokers who offer office space—through vehicles called hedge fund hotels—charge significantly for the space and the services that come with the real estate and provide a real service to managers who don't want to be bothered with building out their own offices.

Managers are not forced to take the space, but they often realize the cost of moving into a hedge fund hotel, even if only for a few years, is cheaper than going out and building their own offices.

One manager told me that she could not believe all of the headaches associated with setting up her own office. She said that if she had to do it again, she would move into her prime broker's office so if something went wrong in the office, she would have someone responsible to call who would most likely respond with a resolution.

In Manhattan, if you walk the blocks along Park Avenue from Grand Central Terminal to West 57th Street, you cannot throw a rock without hitting a hedge fund hotel or a stand-alone hedge fund. The city is littered with these operations.

However, because of the dramatic rise in the hedge fund industry, the business of offering these services has expanded to the point that Manhattan is one of many cities where a new manager can set up shop in space controlled by a prime broker or another service provider. Managers can choose where to set up shop because technology allows them to trade from nearly anywhere. Now that the option is available, many new managers are taking advantage of being outside of the major metropolitan areas.

To be clear, prime brokers do more than provide office space. This is something that smaller funds seem to take advantage of but that most funds of size do not. In short, they let the manager stay focused on picking stocks and implementing strategy instead of dealing with the logistical issues for the business. Prime brokers today offer online, real-time portfolio reporting, which includes position-level data and a real-time profit and loss statement. The information is a click away and is available 24 hours a day, 365 days a year, through secured web sites and networks. Offering this type of service is an amazing accomplishment for these firms, considering that a few years ago many prime brokers messengered daily reports on paper to managers a few hours after the market closed.

Most prime brokers offer some sort of portfolio accounting package that lets managers see a real and often live picture of their portfolio's status. This real-time profit and loss reporting has become an important part of managing money. It gives funds the inter-day score, and they can adjust portfolio positions accordingly. Along with profits and losses, managers can instantaneously get fee and expense details, along with risk reporting and leverage information.

"It is truly amazing what we can get with a click of the mouse," said Peter Cook, director of finance and administration at Dix Hills Partners, a New Jersey–based fixed income hedge fund. "Technology has leveled the playing field and now the data is readily available anytime I want it."

Some prime brokers pride themselves on the level of detail they provide clients through their reporting systems, and others focus on the type of execution provided to clients and their ability to offer "good borrows" on the short side. The landscape is cluttered with prime brokers, and the lines are blurred regarding who is better. In the end, it comes down to service and price.

Most managers believe that their prime broker's job is to provide the best execution possible. They believe that once that they are established, they can develop their own internal capabilities to deliver the same services that prime brokers offer as an incentive to do business with them.

"We don't want a firm that offers all sorts of bells and whistles and programs that are supposed to make our business better when in turn it costs us more money to do business," said one manager who was looking for a new prime broker at the time of this writing. "We want a firm that is going to make sure our trades are done quickly and efficiently and at the cheapest cost. Bells and whistles are great, but price is what is important."

One of the new selling points that prime brokers are using to attract customers is the promise of successful capital introduction (i.e., new client assets). Prime brokers are promising new and existing clients they will be able to help them raise assets. Capital introduction is the carrot that draws managers to the brokerage firm's stick. It seems that wherever I go, everyone seems to be talking about how firms are working harder than ever to help clients raise assets through their capital introduction departments. The selling point is that managers will be able to count on their primes to help them gain access to investors who will fill their funds with cash. Because of the regulations surrounding how money is raised and who can and cannot provide this function, the promise of assets from a prime broker is often empty. It is the one thing that the prime broker rarely, if ever, is able to deliver on successfully. You should not choose a prime broker because it is offering you capital introduction services.

"Our hands are tied. We can have events. We let managers make presentations. And we can try to get the right people in the room. But it is difficult to actually deliver in assets," said one prime brokerage employee who works in capital introduction. "Our compliance department is strict on what we can and cannot say about a fund. They are strict about who can and cannot come to our events. Our hands are truly tied when it comes to this area of the business. We try real hard, but we are not really successful because of the limitations placed on us by the firm and the regulators."

If you believe prime brokers will provide you with access to capital and help you bring investors to the table, I suggest you speak to other managers who use the firm for this service. In my experience, 9 times out of 10, I would expect you to find their prime brokers did offer them some help by letting them attend and make a presentation at capital introduction events, but the effort didn't lead to enormous capital inflows. Raising money is hard, and prime brokers offer little or no assistance besides the potential for an introduction. The introduction is important, but it is not a guarantee of new assets.

The way to raise money is covered later in this book. We need to look at accounting firms and the role they will play in your organization.

ACCOUNTANTS

In my opinion, no service provider is more important to the hedge fund than an audit firm or accountant. The role of the audit firm is to check the firm's books and records and to authenticate the fund's track record. The role of the accountant has become increasingly important over the past few years as investors look for more detailed portfolio and fund information.

Investors put a lot of weight on who the fund uses as an auditor during the due diligence process, and you must ensure you have a name brand.

"If the fund does not use an auditor that we recognize as being a firm that has experience in the hedge fund world, we will not even look twice at them," said Richard Bookbinder. "Audited financials provide a clear view into the fund and its manager, and it is a important part of our due diligence work."

Hedge fund accounting firms charge a range of fees based on the size of the fund's assets, the number of investors, and the strategy. Funds that are harder to price than others cost more than those that trade easy-to-price securities. Similarly, if a fund is relatively small—under $100 million in assets under management—it most likely will pay less than $50,000 for audit and tax work. Large funds often pay higher fees that sometimes reach multiples of what the smaller funds pay.

"It all depends on the scope of the work," said Peter Testaverde, a financial services audit partner at EisnerAmper LLP.

The credit crisis caused many funds to go out of business and as such has made it easier than ever to find a firm to be your fund accountant. In the first edition of this book, which came out in 2005, I wrote that as the hedge fund industry expanded, accounting firms were getting choosier. Six years later and a credit crisis have the accounting firms of all sizes fighting to maintain the funds they have and searching high and low to replace funds that are no longer clients. Today, most of the Big Four firms will happily take new clients. The question is do you want them. It is a buyers' market in the fall of 2011, and I expect it to be for year or so to come. Therefore, do your due diligence, be choosy, and demand a good rate.

"As hedge funds continue to grow, they look for talent that they can bring in-house that allows them to continue to grow and expand and use their outside service providers better," said Testaverde. "We see a lot of good people—not just from our firm but from around the industry—who have decided to go inside. It is a win-win for both the fund and the individual because the fund gets a good person on the inside who will work hard and the accountant gets a really unique opportunity to put their skills to work in a totally different environment and reap the benefits that come with working for a large hedge fund. The CPA firms are the only losers because a lot of good talent is walking out the door into the clients' offices."

The issue for the new fund manager is how to keep track of the books and records and track data accordingly. The answer is that when a new fund is launched, it must keep thorough records of all money flows and transactions. Most of these data can be compiled from customer records and brokerage statements. The fund's structure will determine how fees are calculated and paid and how expenses will be accrued and defined in the offering memorandum. The accountant will use the offering memorandum as the road map to determine how to allocate profits and losses to investors and fees to the manager.

When it comes to running the daily and monthly accounting functions of your business, you have two choices: You can do it internally or externally. Most of the back-office functions associated with the fund can be found on the prime brokerage reporting system, which makes the job of the in-house accountant easier. You can outsource this function of your business to a third party, who will keep track of the data and provide you with performance and accounting information, which is the role of the administrator. Keeping it inside has benefits, as does outsourcing the functions, but what are your company's abilities and resources? The benefits of having an internal person include the speed with which performance data are prepared and that he or she can sometimes help with risk management by providing financial insight into the portfolio. If the in-house accountant has a background in audit and tax, this can reduce the workload of the outside CPA firm. Regardless of which you choose, even if you have an in-house person with audit and tax experience, you will need to hire a third-party firm to prepare the audit. Sit down with your accounting people and learn how management and incentive fees are to be calculated and how they will deal with high-water marks, realized gains and losses, interest income, loss carry-forwards, and hot issues. You need to calculate and monitor these things on a monthly basis. You must know how these items are accounted for and calculated so you understand the fund's financial position at all times.

Choosing an audit firm is as difficult as choosing any other service provider. However, with an auditor, you have a lot less hullabaloo. In the end, the numbers never lie, and an auditor's work is completely objective. Like law firms, many CPA firms introduce you to the partner and hand off the work to an associate or junior-level staffer. It is mission critical that when you meet with your accountant, you find out who is going to work on your fund. You need to meet with that person to make sure you believe in his or her ability to get the job done. Once again, you are the client and have a right to ask questions and get answers.

Most CPA firms have a knowledgeable staff at all levels. However, you must understand how many people they have dedicated to the hedge fund practice, what sort of clients they have, and what services they can provide to make your operation run more efficiently. The fewer the people, the less of a commitment they may have to the hedge fund industry and, in turn, to your work. Check their references, but few people provide references unless they know how those references will respond to your questions. Most references offer little or no insight into the organization or its skills. The key is to ask clients about the services you are expecting to receive from the firm and get an understanding of how it performs the tasks you need for your fund. A firm may be good in one area and weak in another, and you need to understand this before signing on. Changing auditors is not something that investors or potential investors take lightly as it poses potential problems. Therefore, you must get it right the first time.

ADMINISTRATORS

Over the past few years, in the wake of some high-profile frauds and collapses, a trend has emerged for onshore funds to use third-party administrators to provide many of the daily and monthly functions that in-house accountants often do. This was not the norm four or five years ago. Just as auditors provide an objective accounting of the fund's finances through the yearly audit, the administrator can provide objective accounting services, such as net asset value (NAV) calculations and capital inflows and outflows, to allow for a more thorough and complete look at the fund and its finances on a monthly and daily basis.

Hedge fund administrators who operate onshore provide similar services to those of transfer agents and custodians in the mutual fund business. The reason most onshore, single-strategy managers use administrators is they can't afford to have an in-house team of accountants handle this function, and the use of an administrator is a cost-effective and reliable solution, Investors appreciate the "independent set of eyes" watching over the fund assets. Most administrators charge a declining basis point fee based on assets under management. Some will charge a flat monthly fee in the beginning and go to the sliding scale once the fund ramps up its operation and new assets come under management.

Due to the structure of offshore funds, it is an entity unto itself that employs the manager and has an independent board of directors and investors. It needs an administrator to keep track of asset flows, trading data, and client information. In the wake of the World Trade Center disaster, administrators provide anti-money laundering services to funds to ensure they are in compliance with the USA Patriot Act rules.

The use of an administrator is more prevalent among offshore single-fund managers than it is within the United States because administrator services are sometimes provided by onshore prime brokers. Chapter 3 covers the difference between onshore and offshore structures.

The use of administrators is most prevalent in the fund of funds industry. However, thanks to Bernie Madoff and other fraudsters and failures, the use of administrators among single manager funds is on the rise.

Fund of funds managers use administrators to keep their books and records and to track their positions in the underlying funds. Funds of funds usually do not have a prime broker and operate with a bank account that investor assets flow in and out of and a bank account that handles the operating expenses. Because they do not have a brokerage account to keep track of their positions, they use an administrator to fill this void. The administrator tracks the underlying fund positions and provides reports on how the fund and its funds are doing.

Over the next few years as the fund industry continues to grow, the administration side of the business will grow along with it. In some cases, having an administrator makes a fund seem more professional, and many funds need that to raise assets.

MARKETING AND MARKETERS

Ultimately, the hardest part of the money management business is raising money. The second hardest part is managing it. Don't let anyone fool you. There are plenty of people out there who say that picking the right stocks or choosing the right bonds is the hardest thing a manager faces. Raising money is harder than either of those tasks.

To understand how to manage money, you have to do the following: Read a book about value investing, study the principles of Graham and Dodd, follow the thoughts of Warren Buffett and Charlie Munger in any of the Berkshire Hathaway annual reports, and read articles about George Soros, Julian Robertson, and Michael Steinhardt. If you do this, you'll get an instant education on how to do it. This material will tell you the same thing, which is to find cheap things, load up your truck with them, and sell the investments when they are no longer cheap. You don't need to be a chartered financial analyst (CFA) or a Harvard MBA to be a good investor. You need to understand how to identify good companies at reasonable prices. It is not rocket science, and anyone who suggests otherwise is lying. The idea that only CFAs or MBAs are qualified to manage money is insane.

However, I believe that marketing or raising assets is a unique science. At any given moment, people somewhere are selling something to somebody. The problem is they may not know what they are doing, they may be speaking to the wrong person, or they may be poor at what they do and will fail. As the hedge fund industry has grown over the past few years, it has attracted people who specialize in marketing or asset raising who I would say have little or no business being in this business. You need to be careful of these people because they will hurt your business. The reason is that people think they can market, they think they know what to do, and they believe they will be successful. My friends, most of the time, they will fail and fall flat on their faces.

As a budding hedge fund manager, you will need to understand that raising money will be hard. Though the press writes about a fund that launched with $500 million or another fund that launched with a couple of billion dollars, this is not the daily reality. Few funds launch with substantial assets. You need to understand this because, without capital, you have no business. To avoid the pitfalls many new funds make, you need to know one rule: The only people who will be able to raise assets for you are people who are as committed to the business as you are. These individuals are difficult to find if they are acting as a traveling salesman for your firm.

For the most part, marketers or salespeople are thought of as the knuckle draggers on Wall Street. It is assumed that they don't understand how to put a trade or how to execute an order, so they are put into the asset-raising side of the business where the good times roll. This is total and utter nonsense. Marketers are the front line. They are your eyes and ears on Wall Street, and they are the first people most potential investors contact when they learn about your firm. You must realize how important these people are to you and your organization. They are the gasoline that makes the engine run.

Going out and asking for $1 million, $10 million, or $100 million is a lot harder than looking at a screen and deciding to buy $1 million, $10 million, or a $100 million in shares of stock. For many successful managers, little or no emotion is needed in actual trading, whereas an enormous amount of emotion is required when asking someone to invest in a fund. If you don't believe this, try it, and you will see firsthand I am telling the truth.

In building a successful hedge fund, you need to identify the roles that you and your partners are going to play. Someone needs to be responsible for managing the money. Someone needs to be responsible for the back office. A third person needs to be responsible for marketing and client relations. If only two of you are present in the beginning, divide the tasks according to your individual strengths. This is often the easiest part of the exercise because you need to ensure each of you follows through. Initially, when it comes to marketing you need to ensure you have the right message and your material puts forth what you want to say about the fund and your strategy.

Marketing 101 and 102 are covered in Chapter 6, but for now think of it this way: Every time you make your pitch, you should communicate a clear and concise message about your fund to the prospect. Provide ample time for your prospects to ask questions. Remember, if you don't have the answer, tell the prospect you don't know and will find out. Never fake it. Believe me, this will cost you. Whether you think investors are sophisticated or not, they will see right through you and it will cause you to lose the sale, and you need to make sales to raise money.

For the most part, the days of raising money by taking people out for dinner and drinks or a round of golf are over. Investors are demanding more information about the funds, the managers, and the people in the organization. People don't want to get caught with their pants down if the fund blows up. Therefore, investors are collecting more data on funds to do thorough due diligence. It is questionable how thorough this due diligence can be in light of Bayou and other fraudulent funds. Some well-respected and sophisticated investors found themselves caught in this web of deceit. Ultimately, this has forced legitimate marketers to work harder to provide potential investors with information for the due diligence process.

Marketers need to be smart, aggressive, forward-thinking people who understand that raising money is a numbers game. The more people you get in front of, the more people who potentially will invest. If you sit in the office and wait for investors to call, you will be sitting for a long time waiting for something that will never happen.

CHAPTER 3

Hedge Fund Structures

Launching a hedge fund is easy and difficult. It is easy because the process is simple: You hire a lawyer to write the documents, you open a prime brokerage account, you get some investors, and you're off. The whole process can take as little as 90 to 120 days. Yet launching a hedge fund is difficult because of all the nuances that need to be addressed with the lawyer, prime broker, auditor, administrator, and the investors.

Few funds launch on time and without a hitch. This is not something to worry about. Most new businesses suffer through fits and starts as they launch, so why should launching a hedge fund be any different? Many moving pieces go into a successful launch, and the key is to pay attention to all its aspects to ensure success and not waste time.

This chapter is dedicated to hedge fund structures. It explains the role of the lawyer, accountant, and administrator during the initial phase of your operation and details how hedge funds go from an idea in the manager's head to a reality of being an investment vehicle.

GETTING STARTED

When launching your fund, you need to determine where your investors will be based and what types of assets they will invest with you. The answers will put in place the foundation of the structure the lawyer will create. In the beginning, most start-ups get assets from friends and family and, consequently, create U.S.-domiciled entities that can accept taxable assets. However, if the manager has a commitment for assets from investors outside of the United States, tax-exempt U.S. investors, or both, launching an offshore fund and following with an onshore fund might make sense.

The structure and its domicile are dictated by the flow of investor assets. Most U.S.-based managers start with an onshore fund because it is where they can invest their money and where they can accept money from friends and family.

As discussed previously, the structure du jour is a Delaware-based limited liability company (LLC). Most lawyers believe this structure provides managers with the best vehicle to operate and run their business. As the regulatory environment evolves and continues to change, the structure of choice may change. From the late 1940s until a few years ago, the structure of choice was the limited partnership (LP). Whatever structure you choose, I can promise you this: Your lawyer will ensure that as long as you do not commit fraud or do anything illegal, your colleagues will most likely not be personally liable should something go wrong and the fund blow up. In an LP or a LLC structure, disgruntled investors will have trouble piercing the corporate veil. So, should all hell break loose, you should be protected on a personal level. However, if you commit fraud, all bets are off, and nothing will save you from your actions. In this case, all hell breaking loose means that a fund does not perform well. Most new managers and their lawyers like to talk about this because all who launch believe they are going to be the next George Soros, Julian Robertson, or John Paulson. However, this isn't the reality, and you and your partners must know this sort of protection exists. Things can and will go wrong, and you must ensure you're protected. This is one of the reasons I suggest you don't go to a local lawyer who has no experience in setting up funds. You need to go to someone who specializes in hedge funds, understands the issues, and knows what is important to include in the document to ensure your protection and that you and your investors are treated fairly.

"Doing documents is not that hard," said one hedge fund lawyer. "Most of the big firms in the city have some sort of hedge fund practice, and there are a number of firms that do only hedge fund work. The key is to have someone who knows about the industry so that the manager gets a document that is similar to others that their investors see and has all of the protections that are needed should something go wrong and an investor sues."

When it comes to setting up a hedge fund, you can go with an onshore vehicle, an offshore vehicle, or both. Many lawyers use structures called "master-feeder" or "side-by-side" when a client comes to them with the expectation of getting taxable and non-taxable investors. The domicile you choose will be a function of asset flows. Onshore funds are for the most part domiciled in Delaware because of that state's pro-business laws. Offshore funds are domiciled in tax-haven jurisdictions such as the Cayman Islands, Bermuda, and the British Virgin Islands (BVI). Along with the two types of funds, investors come in three types: domestic taxable investors, domestic tax-exempt investors, and non-taxable offshore investors. *Domestic taxable investors* are investors who have to pay tax on profits they make from their investments. For the most part, this group includes individuals and for-profit institutions based in the United States, and they pay tax on their worldwide income. *Domestic non-taxable investors* include, but are not limited to, pension plans, endowments, and charitable foundations and trusts that are the retirement accounts of domestic taxable investors. These investors are domiciled here in the United States but do not pay income tax because of their tax status. The third group of investors, *non-taxable offshore investors*, includes any individual or institution that is not based in the United States and, therefore, doesn't have to pay tax to the Internal Revenue Service (IRS).

The key to a successful launch is to understand what type of investors you will have and where the assets you will attract are coming from. By doing so, you will ensure you have the right vehicle for the money. The last thing you want to deal with are investors who wish to invest with you but cannot because you don't have the right vehicle for their assets. The key here is to know your customers and know your potential customers.

In some cases, particularly with offshore investors, location and not structure, is important, and this dictates whether they will invest in a fund. For example, if you are marketing to Japanese investors, you must have a Cayman-based unit trust. This group of investors rarely, if ever, invests in a hedge fund that is not set up as a unit trust. Therefore, if you discuss another corporation based in a different tax-haven jurisdiction, these investors will most likely decline because they don't approve of the fund's structure and domicile. It doesn't matter if they agree with the fund's strategy and like the fund's manager. They won't invest because of the structure and the domicile.

As a result of the credit crisis, the European Parliament approved regulation titled Undertakings for Collective Investment in Transferable Securities (UCITS) IV Directive, which was an update to the UCITS III Directive passed in 2001. The UCITS are rules that govern how collective investment vehicles operate throughout the European Union (EU). The rules allow for managers to operate throughout the EU, and they place regulations calling for a "simplified" prospectus. This allows for investors across country borders to have access to information in a neat little package. The most recent regulation additions included rules surrounding information on structure, investor communication, and manager operations. The EU, like Congress, believed that by implementing more structure and regulations around hedge fund and private equity managers, it may be able to avoid a future credit crisis.

If your investors are coming out of Europe, ensure your lawyers know this to make sure you have the right vehicle for them to invest in and you do everything you are supposed to in order to ensure you do not violate any regulation.

Similarly, you cannot take Delaware-based LLCs to Boston-based non-profits because they cannot invest in an onshore without a potential problem from the IRS.

The point is to know your market. Understand your investors' needs before you bring them a product. Make sure you can get over the simplest objections during the courting process.

Today, domestic hedge funds are usually set up as LLCs. Rarely, if ever, are S corporations or C corporations used for these types of investment vehicles. The structure outlined here includes an entity for the management of the fund and an entity in which the assets are managed.

The typical fund complex structure consists of two groups: the *members* (i.e., the investors in the fund) and the *managing member* (i.e., the management company or the manager). The managing member is the entity that provides investment management and runs the organization's daily administrative functions. The members are the investors who provide the capital that the managing member invests. The members, or investors, have "an economic interest" in the fund equal to their investment, and they share in the fund's profits and losses. Their liability is limited to the amount of their investment in the fund. In short, they can lose only as much as they have invested and nothing more than their profits and their initial investment.

The managing member, or manager, charges the members a management and an incentive, or performance, fee. The management fee, which currently ranges from 1 to 2 percent of assets under management, is calculated on the net assets of the fund and is usually paid to the managing member quarterly in advance.

The managing member charges an incentive fee, usually 20 percent of the profits earned on the portfolio's net new profits. This fee is usually calculated quarterly and paid annually to the management company. The incentive fee is calculated based on the profits of the fund and aligns the hedge fund manager's interests to the investors' interest. If the fund and the investors make money, the manager will make money. If the fund does not make money, the manager will not make money other than his or her management fee. This is where hedge funds and mutual funds differ. Mutual funds, for the most part, cannot charge an incentive fee. Some fund structures allow the managers to do so, but these are few and far between. As such, mutual fund managers tend to manage to their benchmark, with their goal being to meet or exceed it to attract new money from investors. Hedge fund managers can participate in the upside and have a greater incentive to perform. They don't focus solely on beating an index because though it may look good on a chart or a graph, it doesn't matter. Their job is to make money, and for that, they are compensated well.

Most hedge funds employ a *high-water mark*, which is used when calculating the manager's incentive fee. Should a fund lose money in any given period, the manager must earn back the losses that were incurred—back to the point of zero losses or the high-water mark—before charging an incentive fee. Most managers who have a high-water mark take their performance allocation yearly because they do not want to have to pay back any fees earned and received should they experience losses later in the year.

Your lawyer and accountant will explain this in your initial meetings with them. The fund's documents will explain how fees are paid and accounted for. The private placement memoranda, or offering documents, provide a thorough explanation of how the fund is to be operated, managed, and administered. It details all of the potential and real risks that investors are exposing themselves to by investing with the manager. It provides insight into the fund's legal structure, investment style and strategy, management and operation team, investment and redemption policies, and tax issues.

Most documents explain so many risks for potential for loss that if investors believed what they read, they would be considered crazy for investing in the fund. "The idea is cover all of the bases," said a hedge fund lawyer. "Our job is really to protect our clients from any and all litigation by putting in so many risks, explaining the risks thoroughly, and then having the investors sign off that they have read the documents in their subscription documents. We are providing a certain level of protection to the investment manager."

THE SETUP

From a mechanical perspective, setting up a hedge fund is the same as launching any new business. Your lawyer will file a certificate of formation with the domiciled state that creates the entity in which the fund operates. You will request a tax identification number from the IRS. You will need an office, computers, business cards, marketing material, e-mail addresses, phones, office supplies, and a series of bank and brokerage accounts. Some fund managers launch with web sites, I think this is unnecessary and is initially not critical to the success of the launch.

The banks, in light of the events of September 11, 2001, and the passage of the Patriot Act, have become diligent in checking that *i*'s are dotted and *t*'s are crossed before they open new checking accounts for hedge fund managers. Brokerage firms have become more diligent as well, but it seems banks have gone to an extreme.

"Before the Patriot Act, I could get a new fund's bank accounts opened in a day or two," said an administrator who works with new funds, "Now it takes at least a couple of weeks and an a mountain of paper as well as an enormous amount of due diligence on the bank's staff. Sometimes it can take month before the clients make their first deposit.

New fund managers usually need two bank accounts. One of the accounts will be used for the organization's daily operational expenses, and the other will be used as a conduit for investors in which to accept and redeem their investments. Keep these two accounts separate. You never want to be commingling client assets with operational monies. This could lead to a real nightmare, and avoiding nightmares is good.

To accept investors, you will need to provide them with three things: the private placement memorandum, the subscription documents, and the operating agreement of the LLC. In some cases, the subscription document and operating agreements are combined into one package, but they are two different documents. As I discuss in Chapter 6, the idea is to keep it simple. To do this, you must know all aspects of the documents so you can answer any question that arises or know where the question is addressed in the documents. You don't have to memorize the material. That would be a brutal exercise. However, you should become familiar with the contents and makeup of the material. I advise all of my clients to study the documents, question their lawyers about the contents, and understand them. Being prepared will allow you to succeed.

The process for investment is simple. Once investors are deemed qualified, they enter into an agreement with the hedge fund to have their money managed. The documents that detail this are called the *limited liability company operating agreement* for domestic funds (onshore investors) and the *articles of incorporation* for offshore funds (offshore investors). At the same time investors are completing the operating agreement, they fill out a subscription agreement.

The subscription agreement details the amount and type of investment they are making in the fund. Along with detailing the investor's investment, the subscription agreement is used by the manager to collect background information on the investor so the fund and/or its administrator can perform the required know-your-customer (KYC) and anti-money laundering (AML) functions. (In Chapter 6, I discuss KYC and AML issues, strategies, and practices.) Consequently, the subscription document is used to collect Social Security numbers (SSNs) or tax identification numbers, addresses, phone numbers, investment history, marital status, and employment status. The subscription document should be viewed as a tool to learn more about your investors and is their account application, if you will. The information is basic, but you must collect it. In light of the events of September 11, 2001, the U.S. government has focused on money laundering, in particular as related to terrorism activities. The government and its agencies require managers to ensure to the best of their ability their investors are not using the hedge fund as a tool to launder money. The government takes this issue seriously. When you discuss accepting investors with your lawyer, ask about

KYC and AML rules and the regulations you must fulfill to be compliant. Do not overlook this. Following is a brief story to prove my point and to open your eyes as to how serious an issue this is.

A few years ago, a Justice Department employee was speaking at a hedge fund conference about how the government was reacting to the money laundering problems uncovered in light of the September 11 attacks. After his speech, a hedge fund manager raised his hand and asked, "How serious is the government about money laundering?" Without missing a beat, the speaker replied, "How does 10 to 20 years sound?" The audience was in shock. Money laundering is a serious issue and something you as a hedge fund manager need to know regardless of how small or insular your investor base. AML rules and regulations are discussed later in this chapter.

As described, the management company or managing member is the entity responsible for all aspects of the fund's operation. In this capacity, it will manage and operate the fund and be paid a management fee for its services. The fund uses a management company to manage and operate the fund, rather than employing people directly, to avoid potential liabilities.

In theory, this structure shields the management team from liability should something go wrong with the fund. Of course, the strength of the shield has limits (e.g., if the manager commits fraud or breaks the law). In the most basic definition, *fraud* occurs when the manager steals the fund's money to buy a new car or pay off another investor in a Ponzi scheme; *law breaking* occurs when the manager trades on insider information or engages in front running a position. In front running, managers sell or buy a security for their own account before filling orders from the fund, thereby taking advantage of the upward price movement that the second order causes. In either case, the LLC will not shield managers and their employees from investors and regulator litigation. The LLC will shield managers and their employees should the strategy fail or the market crash and the fund's assets go to zero. Structures do not protect you from paying the piper in the event of fraud. In the past few years, many hedge fund frauds have been well-documented Ponzi schemes. Many prosecutions and convictions for insider trading have occurred. Both are despicable acts. I applaud the efforts of the regulators to rout these evils from the markets.

In today's litigious society, lawyers representing investors are working hard to pierce the corporate veil protecting managers and their teams from personal liability. A true test of this will be the outcome of the litigation surrounding the massive fraud that the world knows as the Madoff feeder funds frauds. The Madoff case and the ensuing feeder fund cases have been well documented and a number of cases are pending. One case that may set the example as to what extent the feeders are responsible for the underlying manager is the Bayou case.

The Bayou class action suit was filed in November 2005 by investors who believed that they were defrauded by the fund and its managers. The suit alleged that ever since the funds were launched in 1996, the managers operated a "financial sham and Ponzi scheme" in which defendants, two of Bayou's principals, and others fraudulently induced investors to invest approximately $450 million in the Bayou Hedge Funds.

The suit further alleged that the fund's principals spent the investors' money on luxury homes and cars instead of investing in the assets as per the fund documents.[1]

On September 29, 2005, Bayou's founder, Samuel Israel III, and its chief financial officer, Daniel E. Marino, pleaded guilty to charges that they stole more than $450 million from investors. Israel, 46, pleaded guilty to three counts of conspiracy, mail fraud, and investment advisory fraud. He was sentenced to 20 years in prison by U.S. District Judge Colleen McMahon of the United States District Court for the Southern District of New York in April of 2008. Marino, who pleaded guilty to one count of conspiracy and three counts of fraud, was sentenced to 20 years in prison.[2]

Along with Israel and Marino, the class action suit names Citibank, N.A., two of the Hennessee Group LLC's principals, and Sterling Stamos Capital Management LP as defendants. According to the suit, Citibank facilitated the fraud by permitting Israel to transfer at least $120 million of the investors' assets to his personal bank accounts. The suit further alleged that the Hennessee Group and Sterling Stamos Capital Management did not conduct appropriate due diligence on the Bayou funds before they recommended them to clients as sound investments.[3]

The suit alleged that the defendants failed to monitor the funds and provide timely reports on their activities. An interesting twist to the suit is that the plaintiffs' law firm, Berger & Montague PC, is trying to pierce the corporate veil of the Hennessee Group by naming the husband-and-wife team of Charles J. Gradante and E. Lee Hennessee as alter egos to the company.[4] If the lawsuit is successful, Gradante and Hennessee will be held personally liable for their actions along with their firm. According to a number of lawyers with whom I spoke regarding this specific aspect of the suit, it will be difficult for the plaintiffs' lawyer to prove the alter ego charges, but if they do it will most likely set a precedent in the hedge fund industry. The suit was dismissed by Judge McMahon.

Regardless of the outcome of this class action suit, hedge fund lawyers will continue to construct organizations that limit the manager's personal liability. Your lawyer will create a web of entities that should shield you, your colleagues, and your assets from litigation. Figure 3.1 is a diagram of the most commonly used onshore structure.

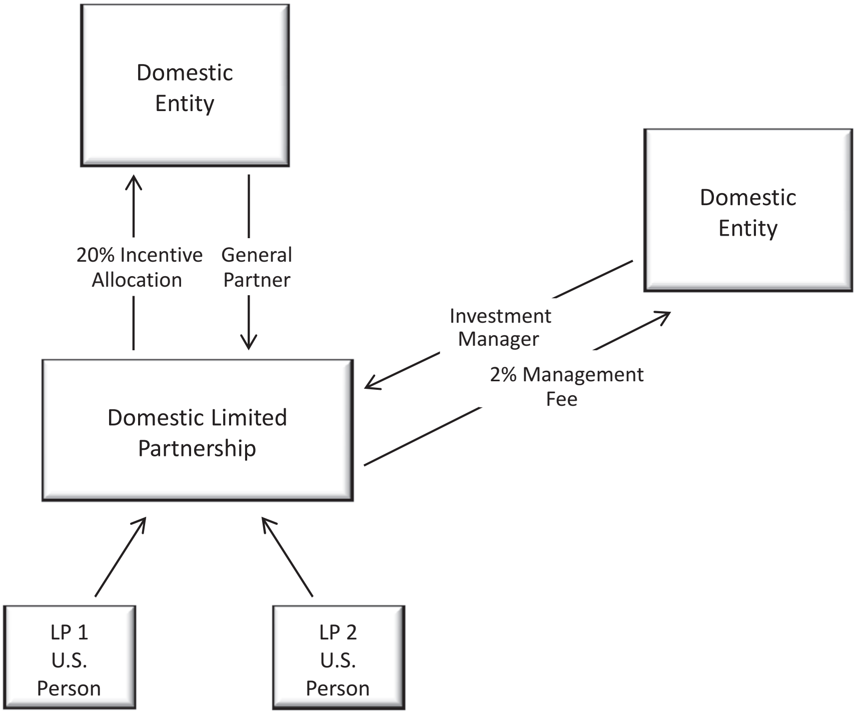

FIGURE 3.1 Simple Onshore Structure
The classic standalone fund structure is depicted here. The general partner receives only the incentive allocation, sometimes described as the performance allocation and commonly referred to as the carried interest. The management fee is paid to a separate entity serving as the investment manager. The general partner and the investment manager entities are typically formed as limited liability companies, but the investment manager is also often formed as a limited partnership to shield as much management fee income as possible from the self-employment tax. At this time, the incentive allocation would provide favorable income tax results for the general partner. The tax on unrealized gains would be deferred, the realized long-term capital gains would be subject to the more beneficial income tax rate of 15%, and qualified dividends would also be subject to the more beneficial income tax rate of 15%. Finally, all of the taxable income attributable to the incentive allocation would be exempt from the self-employment tax. However, the debate on the taxation of carried interests is ongoing in Congress, and the Obama administration had proposed to eliminate the income tax benefits of the carried interest.
Source: Created and reprinted by permission of Maury Cartine, JD, CPs.

Prior to the National Securities Markets Improvement Act of 1996, all hedge funds were limited to 100 investors. This meant that once the 100 investor slots were filled, the manager had to turn investors away. Prior to the changes in the law, there was little chance of maneuvering around this issue. Some managers cloned their funds to accept more investors, but this was deemed in violation of the Investment Company Act of 1940 (Forty Act). As a result, it forced fund managers to register the products as mutual funds if they exceeded the 100-investor limit. This was not an option. One way many managers sidestepped the issue was to create new funds that incorporated a variation of how the old fund operated or was managed. In some cases, the managers would create funds that had longer lock-ups, used more leverage, and used private equity investments to differentiate one fund from another. Tiger Management, led by Julian Robertson, was famous for coming up with new ways to skin this cat. Robertson and his team were instrumental in working with the people in Washington, D.C., to update the rules regarding investors.

The National Securities Markets Improvement Act of 1996 changed the rules of the game by implementing Section 3(c)(7), which allows managers to set up funds that can accept as many as 500 investors, as long as all of the investors are deemed to be qualified purchasers. A *qualified purchaser* is defined as an individual or family company having at least $5 million in investment assets or a company that owns or manages at least $25 million in investment assets.[5]

The 3(c)(7) fund, as it is called in the industry, provides managers with a significant amount of latitude in how to build their businesses. Prior to 1997, managers with 100 investors had to close their doors to new investors and were able to build their businesses organically only through their existing client base.

Today, a manager who can attract institutional assets, which may include funds of funds, can build a significant business through the use of a 3(c)(7) fund. However, there is one sticking point: Managers can't convert their 3(c)(1) funds, the traditional 100-investor vehicle, to a 3(c)(7) to let in more investors. Furthermore, a 3(c)(7) can't accept accredited investors; it is open only to qualified purchasers. Managers are not allowed to run a version of the 3(c)(1) fund as a 3(c)(7) in an attempt to be open to more investors. For everything to be acceptable to the regulators, two different funds must be managed distinctly.

"The funds can be similar, but they must be different," said a hedge fund attorney. "The regulators gave managers a little when they allowed for the new structure, but they did not make it easy for them. In some cases, managers are forced to make the decision to get rid of clients in order to grow or to not grow. Whichever structure the manager chooses, [he or she is] limited in some way to the number of investors and who is able to invest with them."

The sections of the Forty Act that exempt hedge fund managers from registering are Sections 3(c)(1) and 3(c)(7). To qualify for a 3(c)(1) exemption, the fund cannot accept more than 100 investors and it cannot make a public offering.[6] The fund is open to accredited investors and up to 35 non-accredited investors. Most fund managers don't accept non-accredited investors because by doing so, they limit the growth they can experience over the fund's lifetime. If they do accept these non-accredited investors, they are subject to additional disclosure requirements. However, it is sometimes necessary for funds to accept non-accredited investors specifically from a marketing point of view. The investment team must have some, if not all, of its net worth invested in the fund. In some cases, this poses a problem if some of team members have not yet reached the accredited investor level; they still need to invest. (In Chapter 4, I discuss the reason for this.) For now, know that the only non-accredited investors you should let into your fund are your employees. A full definition of an *accredited investor* can be found in the appendix.

When it comes to being exempt from the Forty Act, the Securities and Exchange Commission (SEC) is strict about how investors are counted. It uses a tool called a *look-through provision* to make sure a fund doesn't accept more than 100 investors and that no investors being counted are counted individually. If an entity is formed for the sole purpose of investing in a single hedge fund or fund of funds and is investing more than 10 percent of its assets in one manager, the SEC says that all of the individuals who form the entity must be counted as individual investors in the fund in which they are investing. This means that if 10 people get together and each invest $100,000 in a partnership, then take that $1 million and invest it into Fund FLJ, the manager of Fund FLJ needs to count the investment as coming from 10 individual investors. Since it takes 10 slots and is a relatively small amount of money, the manager's ability to grow will be stunted.

The SEC uses two tests to determine if the look-through position applies. The first test is if more than 10 percent of assets are invested in a single fund. The second test is if more than 10 percent of the fund's assets are invested in funds and that companies would have to register as investment companies if not for the 3(c)(1) and 3(c)(7) exemptions.

As part of adhering to federal regulations, fund managers are required to make a number of state filings when accepting investors from specific states. In some cases, hedge funds are required to file before accepting investor assets in a specific state; in other cases, they have to file after accepting investors from a specific state. Finally, filing may be unnecessary. In some cases, filing is required when setting up shop. Known as *blue-sky provisions*, the filings allow the manager to do business, meaning accept investors, and must be heeded. Initially, you should determine which states your investors are coming from and then have your lawyer ensure you are registered in these specific states prior to or after you make the offering to the potential investors. Keeping track of blue-sky laws is a necessary evil of being in the hedge fund business and something that you and your partners need to pay close attention to when you are launching and operating your fund.

Due to the structure and nature of offshore funds, managers do not have to worry about many of the issues that arise with onshore vehicles. However, they do need to pay attention to jurisdictional and tax issues specific to tax-exempt U.S. investors. One of the biggest concerns is anti-money laundering issues.

ANTI-MONEY LAUNDERING AND KNOW YOUR CUSTOMER ISSUES

The USA PATRIOT Act is intended to prevent and detect money laundering and the funding of terrorist activities. As a consequence, it creates significant compliance burdens for hedge fund managers. Title III of the Patriot Act includes two sections that need to be addressed by hedge fund managers and their employees: Section 352, which requires the establishment of an anti–money laundering program and Section 326, which mandates verification of account-holder identity.[7]

Section 352 of the Patriot Act requires unregistered investment companies, including hedge funds, venture capital funds, and private equity funds to establish anti-money laundering (AML) programs if the investment vehicle permits an investor to redeem any portion of the investor's interest within two years of purchase.[8] The idea is that Congress believes that illiquid investments are usually less useful to money launderers. Because a typical private equity or venture capital fund does not permit investors to redeem any portion of their interests within two years of purchase, these types of funds are not required to adopt an AML program under Section 352.[9]

Hedge funds without two-year lock-ups are deemed to be liquid investments and are required to adopt AML rules and practices. Consequently, managers who are subject to Section 352 are required, at minimum, to do the following to guard against money laundering:

- Develop internal policies, procedures, and controls.
- Designate a compliance officer.
- Offer an ongoing employee training program.
- Arrange for an independent audit function to test programs.[10]

In addition to these procedures and tasks, hedge fund managers must attend to Section 326 of the Act: Verification of Identification. Under this section, the secretary of the Treasury sets forth regulations that define the minimum standards that managers have to use when identifying their customer or investors. These include the following:

- Verifying the identity of any person seeking to invest in the fund.
- Maintaining records of the information used to verify the investor's identity including name, address, and other identifying information.
- Consulting lists of known or suspected terrorists or terrorist organizations provided to the hedge fund by any government agency to determine whether the investor is on the list.[11]

According to Robert Leonard, an attorney who specializes in hedge funds at Bingham law firm in New York, hedge funds that are subject to the Section 352 rule are required to develop and implement written anti-money laundering programs that are approved by the fund's general partner. Offshore managers are not exempt from the Patriot Act and are required to have AML policies and procedures in place that they follow and execute at all times. Due to the heightened awareness of money laundering and financial crimes, pay attention to AML and KYC issues and realize that Congress has the ability to change and amend the rules and regulations. Therefore, be in touch with your lawyer on this issue with some regularity. Read the e-mail missives that come from most lawyers every time a change or addition is made to the regulation; don't dismiss the correspondence as spam. Both onshore and offshore fund managers are required to pay attention to the AML issues as long as they are based in the United States. Knowing what and what not to pay attention to will be one of the keys to your success.

Your lawyer should be able to provide you with all the counsel you need in this area. However, you must take some initiative and learn the rules and regulations. For example, offshore funds are not subject to the regulations of the Forty Act or those of the Commodity Futures Trading Commission (CFTC). However, managers of offshore funds do need to pay attention to ensure they stay clear of any U.S. regulations and they observe the rules and regulations of the nation in which they are operating their fund.

Once again, the domicile of your fund will depend on whether you plan to market your fund abroad or are looking to attract tax-exempt, onshore U.S. investors. You need to address and pat attention to specific issues regarding tax-exempt onshore investors. (In Chapter 4, I address these issues.)

Most offshore investors don't care where the fund is domiciled as long as the location is deemed a tax-haven jurisdiction. If you want to grow your offshore operation, you will need to please U.S.-based investors who seek anonymity and who wish to avoid the U.S. government seeing their investments.

When you launch a fund, you need to keep this in mind to limit the objections that will arise during the investor-courting period. You never want to sit with potential investors and have them tell you they like your strategy but are unable to invest with you because you don't have the right structure in the right location.

The key to successful fund raising is to know your customer. Though I discuss marketing in Chapter 6, think about your marketing effort during the setup and initial stages of your organization. By doing so, you will avoid embarrassing moments with potential investors.

Due to potential tax implications, non-taxable U.S. investors, such as pension plans, endowments, and charitable trusts are required to invest mostly in offshore funds because these investors need to avoid unrelated business taxable income (UBTI).

If a hedge fund employs leverage to a U.S.-based tax-exempt investor, the investor would be subject to UBTI, because the IRS will deem it to be in "a trader business." Because the fund is a flow-through entity, any income is subject to UBTI, as per the Schedule K-1 tax form (K-1) that the fund issues at the end of the year. The firm's auditor sends a K-1 to all investors stating their profits and losses for the previous tax year as well as the investor's balance in the capital account at year's end.

"While the government does not come right out and say it, they do not want people who are not paying taxes to be in business, per se," said one accountant, who requested anonymity. "Therefore, if the IRS sees a tax-exempt investor investing in an onshore fund, they deem them to be in a business and not a not-for-profit entity. Therefore, the investor is now subject to UBTI, no different than a for-profit entity."

Most offshore funds are set up as corporations or non-flow-through entities to allow for U.S. investors who are concerned with UBTI. This means the fund doesn't issue a K-1 and the investors are not deemed to be in business. Rather, they have a passive investment in a company that is located in a tax-haven jurisdiction such as the Cayman Islands, Bermuda, or the BVI and are not subject to tax. The investment is viewed as the same as one in a publicly traded company here in the United States.

"By having an offshore fund, the fund manager provides the not-for-profit investor with an ability to make a passive investment in a company that happens to invest in the markets instead of making widgets," said the accountant.

The hedge fund industry in the United States and Europe is littered with service providers. The same can be said for tax-haven jurisdictions. Today, setting up offshore funds in these locales has few problems because it has become such an important piece of the corporate infrastructure in many of these countries.

"The hedge fund industry accounts are significant to the overall economy of the many places like Cayman, the BVI, and Bermuda," said Mark Lewis, a senior partner in charge of investment funds at Walkers, a Cayman-based law firm. "The governments of these jurisdictions are supportive of what we are doing and of the industry and have helped make it easier for us to grow and develop this area of our practice because of the vital role it plays in the community and the country's economy."

Despite setbacks caused by the credit crisis and the attempt by Congress to deter fund managers from developing offshore funds, the hedge fund industry in the Cayman Islands has grown. One reason is the perceived level of service the island nation offers fund managers. Another reason is that many onshore lawyers view regulations as more favorable to managers than in other tax-haven jurisdictions. Fund managers continue to use the Cayman Islands and other tax-haven jurisdictions to develop and run their business. The Cayman Islands seem to be the place of choice but Bermuda, the BVI, and others continue to be places that funds operate. The creation of new funds translates into significant amounts of fees and revenue for the government and its agencies and for the service providers that handle hedge fund operations in these locations. Many people and organizations are willing to guide you through offshore fund development and operation. As the customer, you should demand excellent service regardless of your operation's size. You are the client, and it is your money, so make sure you get what you pay for. If you don't like something about how the service providers are operating, then look elsewhere. Plenty of companies offer services to funds, and they all want your business.

Most new hedge fund managers rely too heavily on their onshore counsel to direct their offshore operations. I suggest you connect directly with offshore counsel. In most situations, hedge fund managers delegate the responsibility of finding offshore counsel to their onshore counsel. The appendix contains a listing of offshore lawyers. Contact them directly once you decide to go this route. It will save you money, time, and aggravation and will give you a direct connection to this aspect of your business.

Figure 3.2 illustrates a straight-line onshore fund. It outlines a master-feeder structure. Lawyers and accountants have debated the benefits of the master-feeder versus a structure called a side-by-side. However, most start-up managers use the master-feeder structure because it is easier to manage and allocate fund assets. Some accounting issues exist with the master-feeder structure that some consider an irritant; however, they are not so onerous that they make the structure unworthy. More important,

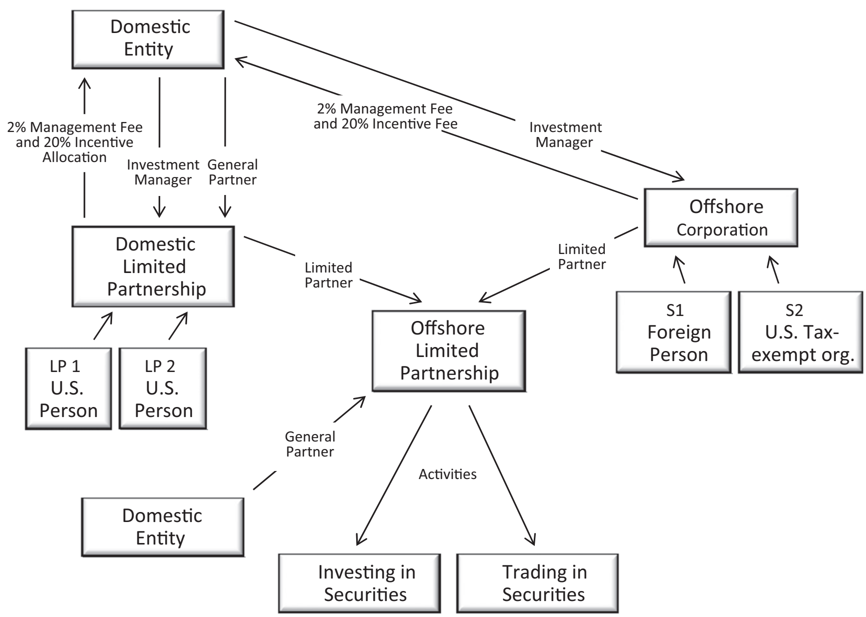

FIGURE 3.2 Classic Master-Feeder Structure
Typically, the shareholders of the offshore corporation that feeds capital to the offshore limited partnership are only foreign investors and U.S. tax-exempt investors. The offshore feeder corporation shields foreign investors from receiving partnership Schedule K-1s and perhaps, more important, shields U.S. tax-exempt investors from the U.S. unrelated business income tax that results from the use of margin indebtedness. All trading is done in the offshore limited partnership. This, in theory, provides assurance to both U.S. investors and foreign investors that they will be receiving the same returns on their investments. However, the same returns are assured only to the extent that capital from both U.S. and foreign investors was contributed at the same time. In earlier years, investment managers viewed the master-feeder as a more convenient way to trade since trades would not have to be segregated between a domestic fund and an offshore fund. However, advances in technology have reduced the significance of this advantage.
Source: Created and reprinted by permission of Maury Cartine, JD, CPA.

should you choose this structure, you will not be the first or the last manager to use it. Therefore, you should be able to get significant support for and resolution of any questions or issues that arise from the use of the master-feeder structure.

Many managers like the master-feeder structure because it allows them to accommodate onshore and offshore investors through a single entity. The master-feeder structure employs a simple concept, which allows managers to accept onshore and offshore assets from their respective investors, after which the assets are pooled into one account and managed as a single portfolio. The assets are traded in one vehicle, and the profits and losses are allocated pro rata based on where the money comes from. The master-feeder structure has a number of benefits. Cost is one of the most significant savings to managing the portfolio because the manager is trading out of a single investment vehicle. There is no need to split tickets or enter into rebalancing trades and this leads to lower commissions. Some believe a benefit exists from the perspective of risk management: It is easier for a manager to watch one portfolio than two.

Though the master-feeder structure is the most common structure used by hedge fund managers for onshore and offshore assets, some lawyers suggest managers create and use the side-by-side structure. To do this, a manager operates one domestic fund structure and one offshore fund structure. The manager keeps the businesses separate but allocates capital pari passu in accordance with asset flows. Many accountants believe that operating this way lets the manager manage for tax efficiency. However, this process requires more work. Lawyers may try to dictate which structure you create and use. You must ensure the vehicle you create makes sense for you from a cost and operational perspective.

When developing your offshore business model, regardless of your fund and management company's jurisdiction, as a U.S. citizen, you are subject to tax on your worldwide income. In October 2008, in the midst of the credit crisis, President Bush signed into law the Emergency Economic Stabilization Act. This law directly affected the alternative investment because it abolished the ability for managers to defer income from incentive fees that they were paid from their offshore funds. Prior to the act, managers of offshore funds were able to defer taxes on the compensation they received from incentive fees. The last thing you want to do is have a problem with the IRS over a simple issue. Remember, even though you are operating offshore, the IRS can reach you and your investors. Though specific tax and accounting issues are discussed in Chapter 4, the IRS loves making examples out of hedge fund managers and other Wall Street executives who use various schemes to avoid paying taxes. Do the right thing and you won't have to worry. Don't give the IRS agents an excuse because they are looking for these kinds of perpetrators to hold up to the light of day.

CHAPTER 4

Hedge Fund Accounting

Numbers never lie, and as we all know, numbers are important to the success of a hedge fund. Therefore, paying attention to the numbers in a hedge fund operation is the most important task. The numbers can include the investment price, the brokerage cost, the service provider fees, or the portfolio performance. All are key to the hedge fund's long-term success.

As a manager, you need to pay attention to the amount of assets under management, the profits and losses, the number of investors, the operating costs, and the fees you earn. Whether you like it or not, your job is to pay attention to the numbers because the buck stops with you.

In the beginning, you and your team will do the work. However, along with the work that is done internally, you will need to have work done externally. The accountant or auditor and the administrator provide these services.

This chapter is divided into two sections. The first section is on taxes and the audit functions of hedge fund operations; the second section is on the services an administrator provides. Regardless of the assets under management, you will need to hire an auditor for the fund. If you operate an offshore fund, you will need an administrator. However, the jury is still out on whether you need to have an administrator for an onshore fund immediately. The current industry trend is that onshore funds are using administrators. As discussed in Chapter 5, this is directly related to a change in the makeup of investors.

As stated, when you decide to get into the hedge fund business, you will need to find a lawyer, a prime broker, an accountant, and an administrator (if you choose). The roles are clear, and each is an important function for the operation.

Your accountant will be involved in every aspect of the business from its inception, through ongoing maintenance, and right up until you wind down the fund some 20-odd years from now. The accountant you choose will provide you with guidance on allocations of fees, capital and tax issues, and other financial non-trading issues that come up during the normal course of business. This person or organization will be important in keeping the numbers straight and giving you a clear picture of your financial status at all times.

As your business grows, you will come to trust and value your relationship with your accountant over the life of your organization. That person or firm will become a trusted business adviser and friend, someone you come to rely on as your business grows.

During the start-up phase, choose an accountant or auditor (the names are synonymous) who has a good reputation in the hedge fund industry and who is respected by investors. Just as choosing a lawyer with a good reputation in the industry helps from a marketing standpoint, so does choosing an accountant. I would even posit that an accountant is more important than a lawyer. After all, the accountant is the one who keeps track of the numbers, and numbers are everything to investors.

Therefore, pick an accountant who has a good background in hedge funds, has longevity, and will be able to grow with you and your business. This accountant and his or her firm are going to have inside information on your operation. Therefore, you must have a level of trust between your two firms. Remember, you will be opening up your doors for them to see the inner workings of your fund and the strategy you are using to make money. As a consequence, you want to like, trust, and respect each other.

Investors need to be able to trust your accountants. After all, these accountants will be keeping track of their money in your fund. So, choosing an accountant who has a good reputation in the hedge fund community is important. From a longevity standpoint, if investors see you switching accountants, they may think something is wrong with the way the fund is being managed or the portfolio is ailing. This will be a red flag, and you want to avoid red flags. Switching accountants could adversely affect your ability to maintain and obtain investors.

In the beginning, the accountant will review your documents to ensure the material specifies the fund's operation is using the correct accounting methods and allocations. The accountant will review the documents to ensure all relevant tax issues have been addressed. It sounds simple and straightforward, but having lived through a number of fund startups, I can attest that this process can add many gray hairs. For the most part, all private placement memorandums cover the same things: strategies, risk, management, and so on. For some reason, when it comes to accounting, a problem always seems to arise. The right thing to do is have the accountant review the documents before the material is finalized. This helps you avoid costly headaches in the future and saves you from going prematurely gray.

Along with reviewing your documents, your initial conversations with the accountant will include discussing how partnership accounting works, how you will run your internal accounting efforts, and what you can expect from your prime broker and administrator to run your business smoothly.

PRICING

Your strategy will determine how securities in your portfolio are priced and marked. Obviously, securities that trade in the over-the-counter (OTC) market or on an exchange are priced more easily than other types of investments that do not trade as frequently. In most cases, pricing is not an issue. However, hedge funds may be traded in esoteric securities or securities that are more difficult to price, such as non-exchange-traded securities, mortgages, trade claims, and illiquid securities. These could pose a potential problem when it comes time to value the portfolio. The pricing and valuation methods are easy to identify and use, and experienced accountants know the right way to price and value securities regardless of the liquidity. Most hedge fund accountants have experience in this area and will work with you to make sure items are priced appropriately. The problem will arise when they come up with one price and you come up with another.

Unfortunately, no good rule of thumb exists in this area, except that you are always better off to err on the side of caution regardless of how much money it may cost you. The worst thing that could happen to you as a new or existing manager is to have to restate performance results because something was priced incorrectly. Pricing should not be a problem. If it does become a problem, it most likely will have significant ramifications for your business. This will not be worth it. Many examples exist in which this specific issue has led to the demise of large organizations.

Pricing securities became a hot issue during the credit crisis as many fixed income securities seemed to have little or no market. As a result, it is at the forefront of the sophisticated due diligence process. The following story illustrates my point.

I was once tasked with looking at a fund that had nearly $800 million in assets under management, a strong management team, a solid infrastructure, and a good record. The initial impression was positive. The fund focused on distressed securities, which included trade claims, accounts receivable, corporate bank loans, private insurance notes, and corporate bonds. During the due diligence process, I learned how the business operated and how the fund put the money to work. In one of our meetings, we discussed the portfolio and especially the investments into trade claims. Trade claims are claims held by suppliers owed for goods or services by a company in bankruptcy. If an investor can buy the trade claim at the right price and can collect, investing in these can be profitable.

The fund had made a lot of money investing in trade claims, had built expertise in research in this area of the distressed marketplace, and has become an expert in the distressed area. However, there was one small problem: How does one value a trade claim? Getting a third party to come up with a valuation of a trade claim was nearly impossible. For the most part, accountants have been forced to take the word of the manager.

This was a problem because I could not get my head around how the fund priced this specific area of its portfolio. Although I didn't believe the manager was doing anything wrong, I was uncomfortable enough with the fund's process to pull the trigger and give it money. Some close friends of mine, people whom I have respect for in the hedge fund business, think I made a mistake. Needless to say, the fund has done well and has expanded its investments in this side of the distressed market. This was in 2005, fast-forward three years, and guess what? The fund got into deep trouble when the credit markets seized. The managers and their accountants could not agree on a pricing model, and the fund posted significant losses. In short, the fund got left holding the bag full of trade claims that could not be priced and were worthless because the underlying assets had fallen out of favor. I was not smarter than other investors by avoiding this nightmare—a few investors are still stuck in the fund waiting for the wind down to be completed—but it comes down to my own rules regarding understanding how money is managed and how portfolios are priced.

Had the fund's accountant provided me with a level of comfort on this issue, I might have decided differently. It all comes down to having enough information and being comfortable with the data.

Your investors must be comfortable with the methodology used to price the portfolio and with any potential issues that may come up due to the new issue rules and side pockets. (Side pockets are discussed later in this section.) You do not want pricing to be a reason for investors to decline your fund, which is why you should address it at the outset before the completing the documents. Doing so will avoid problems in the future.

Experienced accountants will help you ensure the documents are correct and the audit complete. They will help with all financial aspects of your business and allow you to operate more efficiently. In addition, accountants will help you with issues that arise, such as when investors withdraw their assets before you can divest from an illiquid investment. This has happened before, and it can be difficult to deal with.

One of the problems with trading or investing in illiquid securities is that a value can occasionally be realized only at the time of sale. This becomes an accounting problem if investors withdraw from the fund prior to your selling the position. Most funds deal with this issue through a *side-pocket account*. A side-pocket account allows the manager to segregate the specific investment from the rest of the portfolio and, based on an investor's capital, determine how much of it should be allocated to the capital account. Because the investment is side-pocketed, its illiquidity and value don't impact the fund's overall performance. Profits or losses from the side-pocketed investment are allocated to existing and former investors and aren't shared with new investors.

Over the past few years, hedge fund managers have discovered the value of investing in securities that aren't publicly traded. Such securities offer significant growth potential, which means an opportunity to create positive returns. Unfortunately, valuation, accounting, allocation, distribution, and other difficulties associated with illiquid securities present unique issues for hedge fund managers. Unlike private equity and venture capital funds that are designed for these investments, hedge fund managers and their investors aren't always equipped or ready for these investments. Therefore, hedge fund managers are using side pockets, referred to as *designated investments*, to take advantage of these opportunities and segregate them from other aspects of the portfolio. By using a side pocket, you are able to achieve what you need: the simplicity of a hedge fund structure with the effective management of issues associated with investments in illiquid securities. By comparison, a private equity fund structure has capital calls, no redemptions, preferred returns, and claw backs of the carried interest, among other things.

Side pockets are simple and flexible, and most lawyers have added this feature to funds. Side pockets enable a fund manager to invest in securities that are or are becoming illiquid by allowing the fund manager to classify the securities as "designated" or "special" investments (i.e., held in a side pocket).

Once designated, the manager can use valuation, allocation, withdrawal, and distribution provisions specific to side pockets without affecting the fund's general portfolio. Most documents written today carry side-pocket provisions that typically permit a fund manager—if it is deemed to be in the best interest of the fund and its investors—to mark any investment as a designated investment, which creates a side pocket. Investors are allocated an interest in a designated investment in proportion to their capital account. However, because these investments are difficult to value and trade, the manager treats this aspect of the portfolio as a private equity investment rather than as a hedge fund investment. This means profits and losses aren't distributed until the investment is monetized, and investors won't receive their interest in a designated investment immediately upon their withdrawal from the fund. They will have to wait until the fund exits the investment. As a fund manager, you aren't entitled to receive an incentive allocation or performance fee attributable to the net gain of designated investments until the profits are realized. However, in some cases, you can charge your management fee. This will be explained in your documents and is something you should discuss with your lawyer and accountant if you believe that these investments will be part of the portfolio. In the end, managers use side pockets because they offer flexibility to go after illiquid investments and to separate illiquid securities from the general portfolio.

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY RULES

Since March 2004, when the Financial Industry Regulatory Authority (FINRA) changed "the hot issue" rule to "the new issue" rule (Rule 2790), many managers have been able to avoid using side pockets for some portfolio transactions that not all investors could take part in. It was not because the trades were in illiquid securities but because the rule did not allow certain individuals to participate in these types of transactions.

Prior to the rule change, *hot issues* were defined as any security that traded in the aftermarket at a premium to its initial public offering (IPO) price, basically any IPO. The FINRA prohibited the allocation of gains or losses from these trades to restricted persons, such as employees, officers, or associates of broker/dealers, senior bank officers, investment advisers, and people who worked at financial companies.[1]

Before the rule changes, most funds that traded in the IPO market had to side-pocket profits and losses from these trades, and some investors were unable to reap the benefits from these transactions. The use of side pockets forced funds and their auditors to do a lot of work to track and allocate these trades among the right investors during the audit and performance reporting process.

However, with the rule change, the use of side pockets has decreased, along with a number of accounting headaches that accompanied these trades and allocations. The new rule redefined a hot issue, changed its name to a *new issue*, and changed the definition of a restricted person. The rule states that any new issue is defined as any IPO of an equity security. This means that regardless of whether it trades at a premium, it needs to be placed in a side pocket. The modification of the definition of a restricted person helps and managers and accountants can more easily track those who can and cannot participate in these trades.

The changes to Rule 2790 redefined *restricted person* as follows:

> *The definition of "restricted person" under the new rule includes FINRA members, other broker/dealers and any officer, director, general partner, associated person, or employee of a member or other broker/dealer (other than a limited business broker/dealer—a broker/dealer that only engages in the purchase and sale of investment company/variable contract securities and direct participation program securities), any agent of a member or any other broker/dealer (other than a limited business broker/dealer) that is engaged in the investment banking or securities business. It covers persons who own broker/dealers and are listed, or required to be listed, in Schedule A, Schedule B, and Schedule C of a Form BD (other than with respect to a limited business broker/dealer). Rule 2790 includes certain immediate family members of such specified persons.*

In addition, the new rule prohibits the sale of new issues to any senior officer of a bank, savings and loan institution, insurance company, investment company, investment advisory firm, or any other institutional type account. The new rule preserves the treatment of finders and fiduciaries of managing underwriters as restricted persons. However, in the case of a law firm or consulting firm, the restriction only applies to persons working on the particular offering.[2]

An additional change to the rule is something called the *de minimis exception*. As a hedge fund manager, you must pay attention to this. According to the de minimis exception, if your fund implements a procedure that ensures that a restricted person is not allocated more than 10 percent of the profit or loss from the trading of a new issue, then the fund does not have to side pocket the trades, thereby avoiding extra accounting and administrative work on the portfolio.

As the manager, you have to know who is and isn't a restricted person and operate accordingly. In all subscription documents, the investor is asked questions related to this issue. Your job is to track the information provided and share it with your service providers to ensure everything is done appropriately. Initially, this may seem like an overwhelming task; however, your administrator will help you with this. Your administrator is equipped to track this and other information to ensure you comply with all rules and regulations applicable to customer information.

Once the documents are set and the business is launched, you will have little if any interaction with your accountant until it is time to go through an audit. Your monthly accounting functions will be done internally by your chief financial officer or externally through an administrator. In either case, you will have limited interaction with your accountant until the audit begins.

THE AUDIT

The audit process is difficult and painful. It is the equivalent of going to the dentist and having your teeth pulled without Novocain or the use of the proper tools. You will need to collect significant amounts of data and material about your fund, your investors, your trades, your bank accounts, your standing with your lawyers and other service providers and provide all of this information to the accountant for review and audit. The most difficult aspect is that, in most cases, you have little control over the information flow. You will need to identify all of your service providers, including banks, brokers, the administrator, vendors, investors, and others and provide them with an information request. Once you have made the request, you have no control over how fast or how slow the service providers and investors respond. In some cases, the material will flow back to the accountant immediately; in others, it will be slow. Unfortunately for you, until all of the material is received, the audit cannot be completed. This means that you can't issue the documents you need to send to investors and potential investors. In short, someone else is controlling your destiny. It is painful and it stinks.

An example of a hedge fund audit, as well as other pertinent financial documents, can be found at www.hedgeanswers.com.

As discussed previously, most hedge funds are set up as limited partnerships (LPs) or limited liability companies (LLCs). Yet for accounting purposes, they are treated as LPs. This means that regardless of your structure, all funds are treated under limited partnership accounting rules. Unfortunately, partnership accounting is not easy and can be quite complex, regardless of strategy or assets under management. Each investor, or partner, is given a partner's capital account. This account tracks and values the partner or investor's interest in the fund throughout the entire life of the investment. The accountant provides a statement of account to the partner at year's end and, in some cases, when the fund has a break period. A *break period* is defined as anything that affects the partnership percentages (e.g., when a partner joins or leaves the fund). On the date of the break period, your accountant will tally all of the income and expenses, the portfolio holdings are marked to market, and the partnership has a set valuation. The partnership agreement typically will determine when the break period will end, usually on the last day of a given month. The accountant will value the partnership on that date, and the new capital activity and percentages will become effective on the following day, usually the first of the month.[3]

TAX ISSUES

You will need to address a number of tax concerns during the year that take into consideration the difference between economic income and taxable income. Generally accepted accounting principles (GAAP) require the use of accrual-based accounting when determining economic income and taxable income, and the fund must comply with Internal Revenue Service (IRS) regulations. Therefore, adjustments to economic income must be made prior to completing tax allocations. To do so, the accountant will review all of your financial records to determine your taxable loss or gain and create the fund's tax return. In most cases, the accounting firm will complete the audit annually. This will clarify the fund's financial status, performance, and stability. The audit can be a good tool for marketing purposes. Most investors will request an audited record, and in having one at the ready, you will move closer to getting more assets under management.

Over the next few pages, I outline tax and audit issues that will affect your fund or your investors. The idea is to provide you with a brief understanding of important issues and to give you an outline for discussion with your accountant and administrator. Hedge funds face many complex taxation issues. You would need to become a certified public accountant (CPA) to understand them all. The first thing to understand is that, because most U.S. hedge funds are organized as either LPs or LLCs, they are subject to state general partnership (GP) laws. These state GP laws permit some form of LP or LLC as structures that function as investment partnerships for the purposes of U.S. income tax.[4]

Following are some of the basic items that will help you as you discuss accounting and audit functions with your accountant and administrator:

- Investment partnership classifications
- Allocation of earnings and realized gains and losses
- After-tax performance results

As the general partner, you have the flexibility to structure your compensation as a fee or an income allocation. This will be determined during the document creation stage of your business. Because it is considered more advantageous to the general partner and the investors, most general partners take their compensation as an allocation of net income and profits. This way, each underlying allocated item is not considered an expense of the partnership; rather, it retains its character in the hands of the general partner.[5] Allocations of income, expenses, gains, and losses to partners must meet the following criteria to ensure "substantial economic effect":

- They must be consistent with the underlying economic arrangements of the partners.
- They must have substance.
- They cannot be done merely to shift the tax consequences of transactions among the partners.[6]

Hedge funds classified as investment partnerships use the *layering method* or the *aggregate method* to allocate realized profits or losses.

When the layering method is used, the fund allocates realized profits and losses to partners based on when the profits and losses occurred. The accountant takes into account each partner's respective portion of each security's unrealized gain or loss generated over time. This is individually recorded in an unrealized gain/loss account. When a particular security is sold, the resulting profit or loss is realized and is allocated to the investor's account.

In using the aggregate method, profits and losses realized are netted and allocated to partners. This differs from the layering method in that it does not specifically account for a partner's individual portion of the unrealized gain or loss for each security held by the fund. Rather, allocations are based on the unrealized appreciation or depreciation of the partnership's securities as a whole.[7] Most agree the aggregate method is easier to use than the layering method. Some experts believe that when used over time, the aggregate method generally provides for results that are not materially different from those produced using the layering method. Therefore, because it is easier to use, it should be used. However, the accountants you choose will tell you which method they believe is best for your specific fund, and you should heed their advice.

Even though I have discussed many of the differences between hedge funds and other investment vehicles in previous chapters, I have not discussed the fee structure that hedge funds imply. The popular press and many mutual fund companies like to say that hedge funds are expensive and the products are overpriced; however, the fees are something that hedge fund investors have come to expect with this investment vehicle.

Most people consider the payment of an incentive fee to be a defining characteristic of the hedge fund industry. The fee structure is simple: A performance fee is charged, usually equal to 20 percent of profits. A management fee is charged, equal to 1 percent of assets under management. Over the years, managers have used things like high-water marks and hurdle rates to level the playing field between the manager and the investor.

Most hedge fund managers use the *high-water mark*, which states managers will receive their performance fees only when the value of the portfolio is greater than its previous greatest value. If the portfolio drops below its previous greatest value, managers must bring the portfolio back to its previous greatest value before charging a performance fee. Here is an example of a high-water mark: A million-dollar investment in a fund goes to \$850,000 after one year. In this case, the manager would not be able to charge an incentive fee until he or she has brought the value of the investment back to its highest point, which in this case is \$1 million.[8]

Hedge funds use something called a *hurdle*, which is the minimum return the fund must achieve prior to the manager charging an incentive fee. In most cases, the hurdle rate is pegged to a relevant fixed income benchmark, such as the 10-year Treasury or the London Interbank Offered Rate (LIBOR) plus 100. Alternatively, the fund can use a fixed hurdle, such as 10 percent. If a fund has a hurdle rate of 10 percent but makes only 8 percent, the fund's manager won't collect his or her incentive fee. However, if the fund earns 15 percent, the manager will earn the incentive fee on the spread between the return and the hurdle, in this instance, 5 percent.[9] These two tools are used to confirm to investors that the manager's interests are aligned with the investors' interests.

Calculating performance fees is an easy exercise for an accountant when working with onshore funds. However, when a hedge fund is structured as a company that issues shares and publishes a net asset value (NAV), as done with most offshore funds, calculating a performance fee becomes more cumbersome. In this situation, a fund has several options for structuring its performance fee. According to Peter Testaverde of Eisner Amper LLC, many managers of offshore funds choose to apply the performance fee at the fund level, which can cause investors to be charged performance fees for performance that the managers didn't achieve in the fund. To deal with this potential problem, many funds turn to the *method of equalization*. By using equalization, managers ensure that performance charged to investors correlates to the performance earned by the fund. When speaking to accountants, you will find many ways to accomplish equalization exist. According to one discussion paper, the most common are the following:

- Equalization shares approach (also called the share-series or multiseries approach)
- Equalization/depreciation deposit approach
- Equalization adjustment approach[10]

Most hedge funds use the equalization shares approach, which requires the fund issue a separate series of shares with each opening. Each series is tracked individually, which results in the ability to calculate the appropriate performance fee for each of the series. Most believe this is a straightforward method of equalization. It does, however, become confusing to investors who make multiple investments in a fund, which results in multiple NAVs. The year-end change in a shareholder's outstanding share balances and ensuing NAVs sometimes adds to this confusion.[11]

To learn more about the other equalization methods and how they are used, consult with your accountant or administrator. Equalization is a complicated calculation, regardless of the approach, and it requires sophisticated record-keeping capabilities. Most administrators and accountants are capable of handling this for you, but be careful in determining which method you use because it will affect your ability to raise money.

ADMINISTRATORS

Today, in light of the increasing calls for regulation and the purported increase in due diligence efforts, many investors are demanding to see an audited record and audited financials before they invest in a fund. You will use the audit your accountant performs. Though the audit is done once a year, many onshore funds have started using fund administrators to track their performance and asset inflows and outflows. Prior to the calls for more due diligence and third-party verification, many onshore funds performed the daily fund accounting functions themselves using data provided by their banks and prime brokers. However, as investors have demanded more information, including information verified by third parties (objective sources), firms have begun to use administrators to provide these services and functions to their organizations. Using an administrator brings increased costs. However, the use of these service providers can help the marketing process. Consequently, the benefits outweigh the costs.

Hedge funds use an administrator to provide the following services on a monthly basis: bookkeeping, independent portfolio pricing and valuation, and asset inflows and outflows tracking. The administrator will help the fund track the management and incentive fee the manager earns.

Think of an administrator as your external accounting department. The administrator will keep a general ledger, maintain all books and records, be an objective source for portfolio pricing, and verify your track record. The service provider will help with compliance services including anti-money laundering needs, as required by the USA PATRIOT Act.

An administrator will service your investors and provide the administrative and operational services that are often difficult and time-consuming for managers, regardless of the organization's size. Your administrator will provide you with financial, tax, and compliance reporting, functions that will make your firm run more smoothly and efficiently.

Some fund managers believe they can provide the administration services themselves. However, those who do often become overwhelmed by the amount of work needed to ensure things are done properly. In the beginning, it can be quite expensive to hire in-house accountants and a chief financial officer, the people with the necessary skills and experience to complete the fund's administration in an efficient and timely manner.

By contracting a third party, you are hiring an expert to provide necessary staff, infrastructure, and supervision of the work performed. The administrator's only job will be to provide correct and timely performance of duties and to ensure your operation complies with all applicable rules, regulations, and laws. In doing so, you will be able to take advantage of the scale of the administrator's operation and experience and, most likely, will achieve the same ends in a cheaper and more efficient manner than if you performed all administrator responsibilities in-house.

Hedge fund administrators provide you with client servicing, administration, and accounting for your fund, typically billed on an asset-based fee basis subject to monthly minimums. Different types of administrators offering services to the hedge fund community are available. The biggest difference is that some administrators provide a "light NAV" service, and others provide "full NAV" service. The difference is in the number of tasks the company will perform for you. Most of the larger administrators offer only full NAV services because of potential liability issues.

In most cases, you will have some responsibility for client servicing, administration, and accounting, but the service provider will do the bulk of the work. One area where administrators can help is in compliance with the rules, regulations, and laws, especially regarding anti-money laundering and know-your-client (KYC) laws. Here they add significant value, and you will thank they are involved in your operation. They can help with new rules regarding registration.

Many reasons exist for using an administrator. Some believe that by outsourcing administration functions, a manager can reduce expenses and overhead for a fund and its investment adviser because it eliminates the need for a larger administrative and operational staff. Using a third party allows you to take advantage of skills, talents, and systems you may find too expensive to purchase through your investment adviser. In most cases, an administrator will give you access to people trained and often certified in accounting, finance, and operations. These people have significant experience and expertise you couldn't afford to hire nor would you want to carry them as overhead in your operation.

Though cost savings will be a direct benefit of using an administrator, the real advantage will come from the investors. Existing and potential investors will appreciate you use an independent third party to verify your fund's operating results. And marketing, my friend, is the main reason to use an administrator.

Over the past few years, one of the press's main topics about hedge funds has been the lack of information provided to investors. The media seems to be constantly questioning the industry's size, shape, and performance and is critical of the lack of standardized reporting requirements. One method for dealing with this is to provide investors with information verified by a third party. This can overcome certain objections raised by investors during the due diligence process.

Nothing forces you, as an onshore fund operator, to use a hedge fund administrator. However, offshore fund managers don't have a choice in the matter. Since fund managers cannot operate offshore funds, they are employed to manage the fund through a subadvisory agreement.

The offshore fund will have an independent board of directors that will dictate how the fund is operated and who is managing it. Just as mutual fund investors could potentially fire Fidelity as the manager of Magellan, offshore investors can potentially fire the manager of the hedge fund. This is something many managers find difficult to understand and hard to believe.

To understand this, consult your firm's counsel. Though you could be fired as the manager of the offshore fund you launched and paid for, this will not likely occur. Too much is riding on the hedge fund industry for this to happen. Nevertheless, because of this real but far-fetched possibility, the role of an offshore administrator is more important to the operation's continued success and a fund must have it.

As I discussed in Chapter 3, offshore hedge funds are typically organized as corporations in countries such as the Cayman Islands, the British Virgin Islands (BVI), and Bermuda. Investors in these products include non-U.S. residents and U.S. tax-exempt entities (e.g., pension funds, charitable trusts, foundations, and endowments). Due to unrelated business taxable income (UBTI) issues, U.S. tax-exempt investors use offshore hedge funds because they may be subject to taxation if they invest in domestic hedge funds.

Offshore funds use administrators to perform many of the same functions that onshore administrators provide, including portfolio pricing, NAV calculation, fund records maintenance, investor transactions processing, and fund accounting handling. The sponsor of an offshore hedge fund, the manager, appoints a board of directors to provide oversight activities for the fund. Though the manager/sponsor appoints these boards, they operate independently of the investment adviser and have the ultimate authority over who manages the fund and its assets. The board works closely with the administrator to ensure everything is being done in the fund according to the offering documents.

THE TEN COMMANDMENTS

The role of offshore fund administration changed dramatically in 1997 when the Clinton administration enacted its tax-relief program, which repealed items that most people in the investment world called the Ten Commandments. First enacted by the Foreign Investors Tax Act of 1966 (FITA), these regulations outlined 10 activities that limited the access of foreign investment in U.S. securities. The Ten Commandments required that any U.S.-managed fund have 10 functions performed at its offices outside the United States for the fund to be exempt from certain U.S. taxes on its U.S.-source income. These 10 functions were as follows:

1. Communicating with shareholders.
2. Communicating with the general public.
3. Soliciting sales of the company's stock.
4. Accepting subscriptions of new shareholders.
5. Maintaining the principal corporate records and books.
6. Auditing the company's accounts.
7. Disbursing payments of dividends, legal fees, accounting fees, and directors' fees.
8. Publishing or furnishing the offering and redemption price of the company's shares.
9. Conducting shareholders' and directors' meetings.
10. Making redemptions of the company's stock.[12]

In the wake of the repeal, managers no longer need to work with an offshore company but can use any of the onshore administrators to handle this aspect of their business.

Legislation enacted more than nine years ago allows you, as a fund manager, to get a better price for the services you need to administer your fund. The repeal of the Ten Commandments has caused the marketplace to grow by allowing new firms to change the competitive environment. This has resulted in a positive impact for hedge fund managers and investors on fees and service quality. Since the mid-2000s, competitive pressures have led to a consolidation among many in the fund administration industry, resulting in fewer players offering more services. However, most believe this consolidation has not negatively impacted price or the overall quality of service.

When it comes to selecting an administrator, you need to understand the services you need, what you want, and what you expect to receive from the service provider. To make this decision, you must go through a due diligence process on the service provider, and due diligence means more than getting a business quote.

The landscape is littered with hedge fund administrators. Even with the recent consolidation, many large and small firms offer administration services to the onshore and offshore community. A good starting place for names and contact information is the book's appendix. However, you can search through www.hedgeworld.com and www.albournevillage.com.

During the due diligence process, you will be able to weed out firms that are not right for you and your firm. The reasons will be obvious: price, service quality, and reputation will allow you to weed out those not worth talking to and you can bypass from the start. One way to get started is to develop a questionnaire you submit to firms that interest you to gather data on their operations. Ask your lawyer and accountant for ideas when crafting the questionnaire. You might find a prepackaged questionnaire on the web. However, most of these forms are not free, and you may need to join an organization to get them.

ADMINISTRATOR DUE DILIGENCE

I suggest you write your own questionnaire. Ask how NAVs are calculated, where the firm gets its pricing, and what business continuity programs are in place in case of a disaster. When you and your team are reviewing the responses, you must have a good understanding of the size and scope of the firm's business. More important, you must understand how you will fit into the organization. Likewise, because you have received information on a company does not mean you to decide. You need to use the material to understand the organization, meet with the team working on your fund, and talk to clients. Regarding the last point, I am not a firm believer in references because most rarely offer someone as a reference whose perspective and potential statements are not a foregone conclusion. Therefore, you need to do a lot of work, get a feel for the firm, and understand the level of respect it commands in the industry before you decide.

One thing you should do is talk to the firm's clients who use it for the same services you want to contract. For example, if you are trading long/short equity, you don't necessarily need to talk to a fixed income arbitrage fund manager. Your prime broker should be able to help you during this process. Most have a good feel for what is happening on Wall Street and will give you good, honest feedback about the people you are considering to service your fund.

As a money manager, you need to approach your choice of administrator the same way you would pick a stock or a bond. You need to obtain some market intelligence to determine if the person can add some value your organization. I recommend you do the following during the due diligence process:

- Do a site visit. Check out the firm's offices, particularly the office doing your work.
- Talk to the people who will be working on your fund. Get past the sales force.
- Ensure your technology and systems will plug into theirs, and vice versa.
- Ensure they have other clients who invest in the same instruments as you. Do not be a guinea pig for a new pricing system or service.
- Ensure you get the feeling that you matter.
- Ensure they understand what you are trading and have a comfort level for pricing the securities, regardless of how exotic the portfolio.
- Have your counsel review the administrator's standard agreement and get a detailed procedure manual—a term sheet, if you like—to explain what the administrator is going to do and who is responsible, in which office, for each specific task.[13]

You need to check more items. However, the preceding list will give you a good handle on the operation and the firm's ability to deliver. Other questions that will help you in the decision process include the following:

- Does the administrator have an independent electronic price feed? This is important because you don't want them to rely on you or your broker for pricing.
- What technology are they using and how current are their systems?

The idea is that you need to complete a thorough and meaningful due diligence exercise on the administrator before the firm is hired. When the selection process is complete, remember that because something costs more does not mean it is better, and because something is cheap does not mean it is bad. You need to pick the firm you and your team feel most comfortable with and you believe will deliver what you need.

A good administrator should add value to a fund and its operation. Unfortunately, even with significant advancements in technology, fund administration is still a labor-intensive business: The services will not be cheap. In the end, you need to ensure your administrator delivers. Only by doing much due diligence will you be confident you have found the right firm.

CHAPTER 5

ERISA, UBTI, and Offshore Funds

At cocktail parties, you will introduce yourself as a hedge fund manager. From here to eternity, you will do the same at any social event. It will become your moniker and your persona. It is your identity, and you will like it, be proud of it, and wear it on your sleeve like a red badge of courage.

A hedge fund manager is what you have become, and you will tell people with pride and vigor. You will be happy as long as you raise a lot of money and your fund performs well. If your fund raises no money and its performance is lousy, then you will be telling people you are looking for a job. Just because you launch a fund doesn't mean it will be immediately successful. It takes a lot of work, hard work in operations, portfolio management, and fundraising to make the machine tick.

To go out on your own is an accomplishment, and you should be proud you are making the leap into entrepreneurship. Be proud of this accomplishment. Being an entrepreneur is hard. To step out of the corporate world and solely rely on yourself and your own organization is difficult. Most people can't do this, so you should be proud of this accomplishment. Remember, however, that humility is a good thing. When push comes to shove, you are the same as any other entrepreneur, be it the guy who owns the shoe store or the gal who owns the dry cleaner. All of you have something in common: the hope and prayer your business will survive.

As I stated in previous chapters, most hedge funds fail because they cannot gather assets. They are unable to survive because they can't get people to invest in their products. Even though most managers know what to do with the money once they get it, they don't know how to go and get it into their fund.

In Chapter 9, you will read about funds that have succeeded and have failed. Your job is to learn from the negatives and positives and make something good happen for you and your partners. Before we get to that good stuff, it has been my experience that people like reading case studies. First, we need to examine a number of issues that surround raising the capital.

Specifically, you need to learn about the Employee Retirement Income Security Act of 1974 (ERISA), unrelated business taxable income (UBTI), and offshore funds.

Once the work is finished and your fund is operational, you will move into what I call your operation's business sustainability phase. You enter this phase at the point when you realize you no longer need to inject money into the company to cover your operating costs and your firm has become self-sufficient. This does not mean you are earning vast riches or taking a salary from the fund management company but that the business has a break-even cash flow and you and your partners have ceased depositing money into the operating account. This is a big day for most entrepreneurs and you should cherish and enjoy it.

When you hit this point—the critical mass, if you will—you will be able to focus all of your attention on growing and building the business and maintaining your ability to sustain the operation. Most hedge fund managers believe the key for long-term survival is to control as many assets as they can and ensure those assets are sticky, meaning that investors don't run for the door if performance takes a hit, thus the need for a lock-up. I believe this is true and it is the mantra we should live by. Remember that *sticky* means that regardless of performance, the assets will stay with you for the long haul. The assets come from more than your friends, family, or colleagues. These assets come from institutions with a well-defined and succinct mandate to invest in hedge funds, organizations that believe in and subscribe to your ability to manage money over a long time. The stickier, the better.

For most, gaining access to these institutional assets is hard. Most people aren't willing to put in the time, build the relationships, and do the dance with the powers that be to enable them to receive an allocation from these investors. Instead, they move away from this marketplace area and focus on the easy marks. This is a mistake. You need to construct and implement a plan to go after large asset pools you can control or maintain in your fund for a long time. Assets that fit this bill are those put to work by pensions, endowments, and other institutional investors, which is distinct from going after assets from fund of funds. Fund of funds can be a great asset source for you firm. However, the problem with fund of funds is you do not own the relationship. If you do well but other funds the fund of funds manager has allocated to do poorly, you are going to lose. You do not control the relationship and the underlying investor may not know about you and your strategy; you will not know them and that is a problem. You need to know your investors and need to have relationships with every one of them. This doesn't mean you should refuse fund of funds assets. On the contrary, if you can get it, take it, but develop relationships directly with your investors. In today's competitive environment, most investors chase returns.

They look for the hot manager and dive in when they should be running for the hills. You need to go after the smart money or the organizations that make smart investment decisions based on a manager's expectation for long-term performance. Saying no is hard, but sometimes saying no is the best thing you can do. When investors come to meet with you and discuss your strategy, ask them questions as well. Get an understanding of their needs, wants, desires, and expectations. Getting this information will help you manage the relationship better.

For as long as there have been hedge funds, smart money, endowments, and institutions have been investing in these products. These people are smart, good at what they do, and understand the value of going long and short the market, and they represent vast sums of money that need to be used in the markets. In the past 20 years, pension plans, retirement programs, and insurance companies have invested in hedge funds as a direct result of their inability to capture performance from long-only investment products. The people who run these programs understand they need something new to help them meet their needs during low-growth or no-growth periods. As a result, they have invested in hedge funds. Some organizations have been investing in these products awhile, and these people are well-covered by the industry. Other state and local organizations have started their foray into the land of hedge funds and are looking for a manager to help them with returns.

As a manager, you need to consider how to go after these asset pools and gain access to this capital. To do so, you need to understand the rules and regulations surrounding the plans investing in hedge funds.

EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA) with the intention to set up uniform federal standards to protect private employee pension plans from fraud and mismanagement. The legislation regulates the financing, vesting, and administration of pension plans for workers in private business and industry. It ensures that employees' plans will be there for them when they retire. ERISA is huge in the investment community. Most managers love to get ERISA money, but they hate the tasks and potential headaches that accompany having the assets in their portfolios. However, what saves most managers is that most of the responsibility is placed on those who decide to invest in a specific fund or pool. As long as the fund managers manage the money based on their assignment, they are protected if something goes wrong. Yet in today's litigious society, lawyers will sue all involved with a transaction should a fund blow up or post significant losses. As long as managers stick to their investment guidelines, they will generally not be held accountable for their mistakes. However, if they invest in illiquid securities when they were told to invest only in liquid securities, or if they trade futures when unauthorized to do so, they will have a problem. Needless to say, there can and will be headaches associated with these assets.

Two problems occur when going after these assets. First, significant rules and regulations accompany the acceptance of these monies that, if violated, can cause you problems. Second, you need to ensure the allocators of these monies deem you and your fund worthy of the assets.

As the new kid on the block, you are going to have to figure out a way to navigate this area of the investment world. You should do it only with people who work with you or for you. You don't need to hire an outside consultant to help you do this. Most people who hold themselves out as experts in raising assets from pension plans and endowments are worth little. Few successful third-party marketers exist, and you shouldn't hire one believing he will help you raise assets only to realize he does nothing but waste your time and ability to gain access to this marketplace.

You should go after a group of these investors and target them yourself. Getting the data points on their assets, their investments, and the contact information is easy and inexpensive. It might take longer than you like and may be frustrating, but you will understand the process and you will own the assets.

Unquestionably, some consider ERISA assets to be the most lucrative and most difficult assets to attain and manage. These pools are large and sticky, but they are often run by individuals, committees, and consultants who take a long time to decide to deliver assets into a fund.

The manager of ERISA money has a lot of responsibility. First, the 25 percent rule states that a fund won't accept more than 25 percent of its assets from ERISA plans. ERISA plans are defined as retirement accounts, such as pension, Keogh, and other plans that provide for people in their golden years. By limiting your ERISA assets to under 25 percent, you are neither required to do anything differently nor accept any additional responsibility for the assets, except to ensure you never have more than 25 percent of your assets from these investors. The calculation is simple. If you have $100 in total assets under management and $26 comes from ERISA plans, then you will be over the limit and in trouble. If you have $24, you are fine. You must watch the asset level and the percentage. The last thing you want to deal with is going over the limit and the headaches that come from this mistake.

However, if you do go over the 25 percent limit, your fund will be considered "a plan," and this distinction creates enormous responsibility.

As long as you do not violate the 25 percent rule, you are free to operate the same as you would with any other assets you manage. You should treat the investors the same and pay attention to the asset barrier.

In the summer of 2006, Congress passed, and President Bush signed into law, the Pension Protection Act of 2006, which changed how investment managers calculated the 25 percent test to determine if the fund holds plan assets. Under the new law, governmental plans, foreign plans, and certain religious plans no longer counted in the test. Under the old rule, if a fund that is considered to have plan assets invests in an entity, only the portion of assets of the investments attributed to plan investors counts in the test. The new rule makes it easier for funds to meet the 25 percent test because a number of large investors are no longer counted.

By not accepting more than 25 percent of your assets from ERISA plans, which means you forgo the extra responsibility that goes with becoming a plan, the responsibility for the investment rests with the people who made the investment in your fund. The burden, if you will, of ensuring the investment lives up to expectations is placed on those who are the plan's fiduciaries. The plan sponsor, plan director, and consultant, along with anyone else who shares in asset allocation duties, share in the liabilities of the assets placed with you. This means the due diligence process will likely be detailed and intense.

During the due diligence process, the plan allocators need to look at different factors and pieces of information to ensure they are making the right investment decisions for the plan participants. One of the first things they will look at is the investment's prudence. Allocators or fiduciaries must give appropriate consideration to the facts and circumstances relevant to the particular investment in your fund. This means they need to think about why they are making this investment, how they are making this investment, whether it makes sense for the plan, and whether the plan warrants these types of investments. They will question whether it is too risky or not risky enough, whether it does what it is supposed to do, and whether the managers meet the due diligence requirements.

To make these decisions, fiduciaries need to look at the portfolio composition, the fund's positions, and any relation to any other fund in which they invest. Diversification is important. They do not want to have all of their eggs in one basket. They need to look at things like liquidity and transparency, projected returns, where the returns will fall based on prior performance, and other market indices. They need to look at all of the things that make sense for making an investment in your fund. During the due diligence process, the fiduciaries and their agents constantly ask the same questions repeatedly in an attempt to uncover information about your fund. They need to be able to answer this question: Does an investment in the fund make sense for their plan?

Over the past few years, in direct correlation to the bursting of the technology bubble, diversification has emerged as one of the biggest issues during the due diligence process. Fiduciaries want to ensure enough diversification is in their pools of investments to minimize the risk of large losses with your fund and with yours in relation to all of their other investments.

Their job is to consider a number of different issues to make the most appropriate and sound investment decision for their plan. One thing that plan investors are looking to do is to ensure they have geographic dispersion of the investments.

For example, prior to 1998, many plans were investing in emerging market funds. These funds had, for the most part, a high concentration of assets in the debt of the former Soviet Union and other nations around the world. When the Russian debt crisis struck, many funds, specifically in the emerging market areas, were wiped out. Those funds, along with a number of global macro funds, saw their portfolios plunge to zero. This hurt investors of all shapes and sizes. In particular, it hurt investors who didn't foresee a global debt crisis could occur and wreak havoc on their investment portfolios.

Though a geographic dispersion of investments is a key factor in the investment decision process, investors are thinking about the dispersion of investments and distribution among industries. This becomes important if you are operating a sector fund. From a plan perspective, allocators who are doing due diligence on your fund may want to know portfolio positions because they want to ensure they understand all of the risks associated with an investment in your fund. If you say you are a technology fund, then it is understandable that you will have greater or more concentrated risks than a long/short fund that specializes in growth stocks.

They are expecting you to provide them with the most accurate and meaningful information. The last thing you want to have happen is for a plan to have to redeem because allocators have too many concentrated positions and are worried about the risks associated with the investment in your fund relative to others in their portfolio.

Plans look for position-level transparency. For example, they may want to ensure they don't have too much overlap between an investment in a technology fund and an investment in a large-cap fund. The plan wants to ensure that both are not overweighted in Google or Microsoft.

The plans should not be allowed to have too much concentration in one specific market sector or one specific company because of the fear that if the trade goes away from them, they could have potentially significant losses and not meet their obligations to their members.

During the due diligence process, you need to ask lots of questions so you understand the needs, expectations, and requirements of their investment portfolios. Since the bubble burst in the early part of this century and because the stock market has not met performance expectations, many ERISA plans are finding themselves underfunded and at risk of not meeting impending liabilities. In some cases, the people making investment decisions are relaxing requirements; in other cases, they are making them more stringent. It all comes to down to what shape the plan is in and how economic and market conditions are affecting its ability to meet its liabilities.

Investors need to look underneath the investments. They need to dig down into the portfolio and look at how your fund is structured and how your fund is invested. As the manager, you must do what is required during the due diligence process. Once you deliver what they need, they will deliver what you need: sticky money.

As a manager, you have some rights as well, and you can demand information from the potential investors. You should get as much information as possible about the plan, its directors, consultants, investments, needs, and expectations. During due diligence, investors are going to ask you all sorts of questions. Though you need to provide them with answers, you need to question as well. This is a two-way street and a partnership. They are providing you with capital, and you are providing them with returns to meet their obligations. Review the plan documents because you need to make sure that any investment they make with you is made in accordance with the plan's document.

You cannot accept the assets from the plan and then invest them. You need to do your homework. The right move is to understand the plan is going to make an investment. You must learn what they are going to do and determine what you are going to do for them. You must conduct this exercise and confirm with your lawyer that you are doing everything appropriately.

As I stated, the interesting thing about these investments is the fiduciaries are personally liable for plan losses resulting from any breach of fiduciary duties. So, if they act inappropriately, they are going to have to make up their losses if the fund loses money. The fiduciary may be liable for the difference between the earnings and the hypothetical return. As an example, if a fund benchmarks itself against the S&P 500, and that index is up 30 percent but the investments are up only 20 percent, the plan could come after the fiduciary and make that person pay.

However, before that plan can come after a fund, a real loss has to be incurred. The loss cannot just be hypothetical; it must be real. Obviously, a fiduciary may be removed for a breach in fiduciary duty even if the plan incurs no loss. Nonetheless, a fiduciary is subject to the 20 percent penalty or jail time for knowingly participating in a breach of fiduciary duty.

These plans are going to bring specific issues to you, and you need to know them. Before you start, you need to answer one question: Who is the fiduciary? The fiduciary is a person who exercises discretionary control with respect to management of such a plan. He or she exercises control regarding the management and disposition of assets. The fiduciary renders investment advice for a fee and other compensation. This is where many people sometimes get in trouble. Some fiduciaries act on behalf of a plan and a fund, yet they do not disclose that they or one of their affiliates is generating fee income from their work. Situations have occurred in which fund managers are compensating these people for bringing them assets. They often do not disclose this to the plans they are working for. In turn, they are paid on both sides of the transaction.

Over the past few years, this has been a big issue and most plans are paying attention to it. Major newspapers have published several articles on this, especially focusing on a number of large consulting groups that have gotten into trouble for entering into deals in which they are paid a fee for bringing assets to a fund even though they are supposed to be providing objective advice to that fund.

As a manager, avoid these conflicts. In the end, no matter how much money comes your way through this arrangement, it is not going to be worth it.

Understanding the issues surrounding ERISA investments is critical to the success of your business. You must understand unrelated business taxable income (UBTI). Although I briefly discussed UBTI in Chapter 4, the following pages provide insight and information in greater detail.

In the class I teach on hedge funds, we spend nearly a whole day talking about UBTI issues. Understanding the concept and regulations will make you a better a manager and help you reach a thorough understanding of the need for offshore funds.

UBTI came about not long after the adoption of the income tax in 1913. At that time, the government challenged the right of charitable organizations to use their exemptions to shield business profits from taxation. The government challenged the exempt status of a charitable organization that operated a business bearing no relation to its expressed charitable purpose.

The government, in enacting the new law, reasoned that if, for example, a church opened up a Burger King across the street from a McDonald's owned by the McDonald's Corporation, all of the proceeds from the Burger King should not be considered tax-exempt because it was owned by a tax-exempt charity, such as a 501(c)(3) tax-exempt organization, in this case the church. Because all of the profits from the McDonald's would be taxable, (i.e., the company that owned the restaurant was a taxable entity), the church that owned the Burger King had the upper hand: It didn't matter whether the burgers tasted better or whose fries the market preferred. Since the Burger King would not have to pay taxes, it can compete unfairly against McDonald's because its overall expenses and costs of doing business are lower.

It was assumed the organization operating in a tax-exempt environment had a leg up on the organization operating in a taxable one. Therefore, the government argued that if the church is running a business that is not part of, equal to, similar to, or considered to be part of its daily operations, it should pay tax on the revenue derived from that operation.

Consequently, the government successfully challenged the exempt status of the charitable organization operating businesses that bore no relationship to its organization, and the charity in question lost its tax-exempt status in relation to those businesses. However, the government was unsuccessful in its challenge when the organization in question used its business profits for the exempt purpose. For example, it probably would not have been successful if the Burger King had a church in it or if it had some relation to the church's daily activities.

The idea behind the government's challenge was twofold: (1) It was believed that it allowed people to compete unfairly, and (2) the government lost revenue from these operations. In the end, the government imposed a tax on business activities that were not substantially related to the exercise or performance of the organization's purpose or function.

This meant that the church could still get into the hamburger business but would have to pay tax on the business and its profits.

Even with the ruling and regulation, certain items of income were excluded from taxation and deemed to be fair competition. The government specifically said that dividends, interests, royalties, and rents from property were acceptable. However, dividend interest payments with respect to securities, royalties, and rents other than rent dependent on the net profits derived from the use of the property were to be specifically excluded from UBTI.

Certain items of income were specifically excluded from taxation. These included dividends, interest royalties, and rents from real property. The law included a provision that resulted in the taxation of a portion of rental income from real estate of indebtedness that was incurred to acquire or improve real estate debt-financed real estate.[1] The Tax Reform Act of 1969 stated that all exempt organizations would be subject to UBTI and the tax would be imposed on almost any type of debt-financed property. The tax is computed on unrelated business income tax (UBIT) on the exempt organization. This is not generally the net business income of the exempt organization. This income can result directly from the activities of an investment partnership engaged in nonsecuritized transactions (i.e., active management of trade claims, or distressed debt or can result indirectly from investment in other entities). Exempt organizations must make estimated tax payments. Underpayments are subject to estimated tax penalties. Compliance is almost impossible. Form 220 is used to compute the estimated tax penalty for exempt organizations subject to the corporate or trust rates. The prior year's tax exemption can be used to avoid estimated tax penalties.[2]

According to Maury Cartine, a partner in the Alternative Investments' practice at the accounting firm Marcum LLP in New York City, the problem with debt-financed property is that it needs to be defined. Is it property acquired or carried with debt? Prior to the expansion of the debt finance property rules, debt financing was frequently used in bootstrap transactions. For example, a charity would acquire stock on an installment basis from a seller. The seller would receive long-term capital gains treatment on the collections of the installment note. A charitable organization would liquidate the corporation and lease the business assets to the new corporation operated by the seller. The rental income would be exempt and the charitable organization would use the rent to pay the installment note. The seller would maintain control of the business, and the charitable organization would keep the rent from the installment note. "This was a problem because the government would lose the tax associated with this transaction," he said. "Expansion of the debt finance property rules did away with these types of situations."

In the world of hedge funds, the UBTI issue arises because of leverage in portfolios and the financing of funds with lines of credit. Initially, it was believed that exempt organizations should be able to invest idle assets to support exempt activities. However, the government questioned the use of the funds and margin and its relation to the exempt organization's activities. The government says that exempt organizations that invest in onshore (i.e., taxable) entities are no longer exempt and are forced to pay tax on their earnings. As a result, most of these investors have taken their investments offshore to mitigate UBTI's impact. The key for these investors is to avoid these issues by putting their assets in offshore fund investments. If you do not want to deal with UBTI issues and do not want your tax-exempt clients to have to deal with UBTI issues, do not give them access to your onshore fund. Tax-exempt investors who invest in onshore funds will be burdened with significant tax consequences because of the investment. These issues can be avoided by moving the money offshore.

Several recent rulings affecting UBTI are significant to you as a hedge fund manager. The first is the short-sale ruling. The government says that gains on short sales that are not debt-financed income do not result in UBIT. The ruling does not specifically address losses on short sales, but most accountants believe losses should be excluded from the complication of UBIT.

Another issue of interest is the ruling surrounding the sale of partnership interests. If a partnership interest is sold in a partnership that owned debt-financed property, the sale's gain is subject to UBIT. This rationale should extend to losses and exemptions of LP interests.

When it comes to commodities and futures contracts, gains from these transactions are not considered debt-financed income even though current cash deposits are required by the Commodities Futures Trading Commission (CFTC). Losses should be treated the same way.[3]

To avoid these issues, you need to have an offshore fund open to U.S.-tax-exempt investors. The advantage of offshore funds is no UBITs occur. Consequently, tax-exempt organizations do not risk running afoul of their exemption. There is no look-through provision for debt financing companies under offshore corporations' control. To learn more about the effects of UBTI on your business and your investors, you should talk to your accountant. He or she will be able to provide you the detail on how UBTI comes into play for your specific fund and organization.

OFFSHORE FUNDS

When you launch your business, you probably will not be thinking about onshore and offshore investors. You will be thinking about investors in general. However, the last few pages should have clarified why you need an offshore structure and why you need to know everything you can about who is investing in your fund. Knowing your customer is to ensure they aren't a terrorist or terrorist front group and to know they fit and they invest in the right bucket.

Most U.S.-based managers don't want to spend the money to launch a side by side or master-feeder fund right out of the gate. They want to keep costs down and creating this sort of structure can add to the launch price. It comes down to knowing the source of your assets and investors. You may or may not need a structure for non-taxable assets. However, you must ensure you have a product that is right for your market.

I have found that building a structure that can handle onshore and offshore assets is the right way to go even though it can add to the operation's cost. Having the right buckets for the money on day one is a lot easier. The key is to determine where your assets will be coming from and to ensure you have a home for them when they arrive.

An offshore fund provides tax benefits attractive to non-taxable U.S. investors and U.S. domestic managers. The first is the opportunity for foreign investors to invest without running the risk of owing U.S. taxes on their investments. In light of the repeal of the Ten Commandments, a foreign corporation—which is what the offshore hedge fund is—that trades securities for its own account is deemed not to be engaged in a trade or business within the United States even if the principal office of the foreign corporation is located within the United States. This means that it and its investors are not subject to any tax liability.

Using an offshore vehicle, offshore investors or non-taxable U.S. investors avoid connected income and capital gains. In an offshore fund, foreign partners of domestic partnerships trading securities for their own accounts are deemed not to be engaged in trade or business within the United States. Therefore, the foreign partner's share of partnership income will not be considered to be connected income. Furthermore, capital gains and most interest income are untaxed, and this rounds out the loop.

Still, the offshore fund is not the perfect solution to avoid U.S. taxation. The foreign corporation will still be subject to a withholding tax of 30 percent on dividends and certain interest. Interest on deposits with banks, savings and loan institutions, and insurance companies is exempted from withholding. As statutorily defined, portfolio interest is exempted from withholding. Separately, offshore funds should avoid using money market accounts that yield dividends for the investment of cash balances because the reduced 15 percent tax rate on qualified dividends is unavailable to foreign corporations or foreign persons subject to foreign income tax withholdings who choose not to file U.S. income tax returns.[4]

The offshore fund does provide an opportunity for U.S. tax-exempts to avoid unrelated business income taxes (UBITs) as it permits the use of leverage without triggering unrelated debt financial income. Unlike onshore funds, underlying items of income and deductions do not pass through from the foreign corporations to the investors.

As the manager, you and your team can enjoy the benefits from the offshore fund. In the first edition of this book, the last paragraphs of this chapter discussed, the substantial tax deferral opportunities that operating offshore funds provided to managers. However, in the wake of the credit crisis, the great recession, the powers that be in Washington have attacked tax deferrals by hedge fund and other investment managers. As part of the Emergency Economic Stabilization Act of 2008, the bailout of the banks by the federal government, Congress ended most of the deferral programs that hedge fund managers used with their offshore funds. To understand how this will affect your organization, you will need to review it with your onshore lawyer. Get a handle on it so you know the rules of the game. Another issue facing new and existing hedge fund managers in the United States is a call for the change in the tax treatment of carried interest. Currently, carried interest is treated as a capital gain. However, in the American Jobs Act of 2011, the president included a provision that would treat all carried interest as ordinary income. Carried interest is the share of the profits that the manager earns from the partnership for a job well done. The bill at the time of this writing was still up for debate and whether it will be passed is unclear. However, expect some change to the tax treatment of carried interest to take place in the next year or so.

CHAPTER 6

Marketing and Capital Raising

Before you launch your fund and create your strategy, you need to have a clear and concise marketing plan. Read that sentence 10 times before you go any further. Then read it again. Making a list is not enough. Check it twice and hope that assets come into the fund. You need to have a plan, a plan that includes a marketing pitch, a marketing strategy, and marketing ideas. Developing the plan can take time and it should be fluid. Paying attention to this area of the business is as important as any other area of the business. Remember, an engine can only operate with gasoline.

Once you have your plan in place, you will be set to begin talking about how you are going to raise money and develop your business from an idea to a reality.

The purpose of this chapter is to provide you with insight into how to create, develop, and implement a marketing plan for your organization. It will provide you with case studies that explore funds that are new or experienced in the marketplace, and will highlight a fund that faced a crisis of confidence in the marketplace. It will give you insight into how investors will view you before, during, and after the due diligence process.

The goal here is to provide you with enough information to demonstrate you need to be prepared to meet and work with investors.

The key to success in raising assets is a succinct and meaningful presentation, requiring perseverance. It comes down to one word: communication. You need to be a great communicator. It is through communication that you will find the success and perseverance necessary for the substantial growth of your assets. Marketing is the most important part of a successful hedge fund operation.

Some of you will gasp and ask, “How can that be?” While being able to manage your assets and execute your strategy is important to your success, without assets to manage, you cannot prove your strategy works. As I said, an engine can only operate with gasoline. Without gasoline, you have a nice hunk of metal that collects dust and takes up space in the garage. A fund is no different except, that without assets, you will have a nice ream or two of paper as kindling for a fire when you cannot pay your heating bill.

MARKETING 101

The key to your fund's short-term and long-term success will be management's marketing plan and its ability to implement it successfully. If you think that just because you built it, the assets will come, think again. The key is to create and implement a plan that will allow you to attract, maintain, and grow a solid asset base.

In Chapter 1, I explained that many people look upon marketing people in the hedge fund industry—and most of Wall Street, for that matter—as the knuckle draggers. The marketers are the people who did not go to business school or get CFA credentials, and for the most part, they are thought of as Wall Street's lowest common dominator. If they bring in a lot of money, it is because the fund's performance is so good the product sold itself. If they don't bring in money, they're worthless. It doesn't matter if the fund performed poorly for the past 6, 9, or 12 months or if the sector is in the toilet; they should be able to get some money or so says management. If you are going to be in charge of marketing at your firm, listen to the late, great Rodney Dangerfield.

My friend, whether you like it or not, you will get no respect no matter what you do. If you are going to hire marketers, I would suggest you treat them with the respect they deserve because without them you have nothing.

Most marketers I know love what they do. Hedge fund marketing can be a fun and rewarding, from an ego and a financial viewpoint. You get to travel to interesting places, eat at excellent restaurants, go to swanky bars, play lots of golf, and have a great time, all in the name of finding assets. In most cases, it pays to play this part even if you have to put up with a lot of nonsense from your partners. As long as you remember you are the gasoline that allows the engine to run, you will be all right and might have fun in the process.

To begin, you need to have a plan. It does not have to be 100 pages long, typed out single-spaced, but it should provide you with a road map to allow you to operate on a path to success. This is where most people fail because they believe in the Kevin Costner theory: If you build it, they will come. Generally, this does not happen, and you should not rely on it for your success. Of course, exceptions to this rule exist. Some funds launch with hundreds of millions of dollars. Often, these launches are the result of the manager leaving a large trading desk or hedge fund and getting seed capital from his or her former employer. However, this initial success is rare. The press tends to give these launches lots of ink and, therefore, a perception exists that all new managers launch with significant assets under management. This perception is not reality.

You need to subscribe to two rules or lessons when you are planning and implementing your marketing effort:

1. Those you think will give you money when you launch your fund will most likely not invest with you right out of the gate.
2. Those you think are out of reach and from whom you have no chance of getting an investment may be the first people to invest in your fund.

The hedge fund business is peculiar when it comes to gathering assets. It's hard to read investors and understand what they're thinking or what they're going to do until they tell you yes or no. Therefore, you need to be ready, willing, and able to market your product to everyone who is a qualified investor because you never know where the assets are going to come from until you get the subscription documents and the wired funds. Investors don't like change, which is why you see large hedge funds get bigger and small hedge funds remain small. Investors like to maintain the status quo even if that means picking a loser: Nobody ever got fired for buying IBM. The same applies to institutional investors who make allocations to hedge funds.

Understanding how the process works is going to help you succeed more. At the dawn of the new millennium, marketing consisted of playing golf, going to dinner, and having a good night out. If you could identify the investor, build a rapport, and your product was somewhat decent, you were likely to get assets. In most cases, wining and dining would lead to money. A lot of due diligence was done at the bar and on the phone between friends within the industry. However, as the industry has evolved, funds have failed, frauds have occurred, and the credit crisis sent volatility through the roof, playing golf and going to dinner was no longer enough to get an investor to say yes.

On the perception side, it would appear that investors have become more sophisticated as they search for alpha generators. Alpha is the excess return on investment over the index. However, people have stopped playing as much golf and going to dinner. Nevertheless, the due diligence process has become more thorough and important to the investment and marketing process.

"Five years ago, you could take a guy to the golf course, go to dinner and fill him with drinks, while telling him what you were doing, and you were pretty much assured that he would make an investment," said one hedge fund marketer.

Today, investors go out for dinner and drinks, but they appear to be taking due diligence more seriously. They work hard to develop a clear understanding of the strategy and style.

"When we meet with a potential investor, we spend a lot of time going over infrastructure, explaining policies and procedures and who we are as a firm as well as providing a thorough review of the fund and how it is managed," said a marketing executive at a hedge fund in midtown Manhattan. "Having the right policies and procedures in place to run the business is as important as the people making the investment decisions."

A few years ago, the hedge fund industry operated as a sort of old boy's network that relied heavily on relationships. I told you about a fund, you told me about a fund, and each of us would invest in the funds because we knew each other and trusted each other's judgment. The problem, however, was that you thought I did due diligence and I thought you did due diligence. In the end, we were relying on other friends' tips, no due diligence was done, and we did not know what we were getting ourselves into. Tips may get you there in the short term, but in the long term they hurt you. Period. End of story.

The turmoil in the economy and the poor performance of many hedge funds hasn't stunted the industry's growth over the past few years. Assets continue to flow into the industry, funds continue to launch, and things look healthy.

The landscape of investors has shifted in the past few years and has been divided into two distinct camps. The retail or high net worth set of investors and the institutional investors.

In the early part of the new millennium, many believed the marketplace for investors in hedge funds would remain strictly institutionalized as large groups of pensions, endowments, and foundations began to invest heavily in hedge funds to meet the needs of their pensioners and boards of directors. To some extent, this was true, but this new crop of investors is not all that new but rather has grown in the past 10 years. Sophisticated investors understand the value of investing in portfolios that profit, for instance, when markets rise. As such, they understand the need for investments that go long and short the market.

Though investors seem to favor hedge funds and other alternative investments, don't think for one minute that you have a shot at attracting assets from these large pools of investment dollars. The reason is as follows: Most institutional investors favor "checking the box." They invest in all the same funds that other institutional investors entrust their assets. If something goes wrong, they want to be able to blame someone else—usually a consultant—who recommended the fund and said it was right for the portfolio.

As a manager you should be aware of the inside baseball that occurs among the consulting and institutional investing community. Because of this, I suggest you forget about attracting institutional assets to get to a critical mass and focus on high net worth investors.

In my experience, managers don't mind going through the due diligence process with the institutions because they believe they may get money from these investors. Frankly, you will need a lot of time before anything comes in at all. Raising money is hard, raising money from investors who are not interested in you is harder. Go where the money is.[1]

Over the last few years, investors have changed. I see it when I meet with clients and talk about their portfolios and discuss their allocations and objectives. Many who market funds have experienced firsthand the change in the quality of questions and information requests.

"I don't know if they have gotten smarter or just seem to want to appear smarter, but now they are asking a lot more questions, and we are giving them a lot more information about our funds, our people, and our operation," said one hedge fund marketer. "I don't know if they know what to do with all the information that we give to them, but I do know that they are asking for it and that we are trying to give them whatever they want because we want their money."

THE LAZY INVESTOR

The key to your success is to remember that investors are mostly lazy. It does not matter whether they are so-called sophisticated investors or whether they are average Joes or Janes. Both groups are inherently lazy. Through this laziness, as a whole, Wall Street has made a lot of money and will continue to make a lot of money. People on Wall Street are able to exploit this laziness to their benefit. Peter Lynch, the money manager who earned great fame and fortune running Fidelity's Magellan Fund from 1977 to 1990, said that Americans spend more time choosing their refrigerators than they do their investment portfolios. My experience tells me that Mr. Lynch is on target with this comment. However, investors may request a lot of information but they might not know how to use it.[2]

As a manager, you need to be prepared. I suggest you go online or talk to your prime broker, lawyer, or administrator about procuring a due diligence questionnaire. You can find an example of one at www.hedgeanswers.com. The document is a series of questions about infrastructure, strategy, risk controls, people, and financial resources. The idea is that once investors get a completed questionnaire, they will have a good understanding on paper, at least of the size and scope of your organization. If you have one on file, you will be able to provide it to potential investors upon request. If potential investors give you a questionnaire to fill out, you will probably be able to cut and paste the answers you have into theirs. Either way, it will speed the process along. The due diligence questionnaire is something that seems to be used by most investors as a starting part in the research process and is a necessary evil most investors request and most managers produce to get the ball rolling. I would create one and make sure you have it available to provide regardless of whether you are asked for it or not. Include a due diligence questionnaire (DDQ) in your marketing material. The more material, the better; however, make sure everything is up to date and correct. Update the DDQ regularly as the business changes and evolves.

CHECKING THE BOX

Today, many aspects of hedge fund investing are about data points and checking boxes. The reason for this is that managers want institutional assets. Managers read stories about the California Public Employees' Retirement System (CalPERS), Massachusetts Pension Reserves Investment Management Board (MassPRIM), and every pension and foundation in between that is allocating assets to hedge funds. They want a piece of this pie. "Everyone is chasing the big-ticket investors because they believe that is where the money is really coming from," said a hedge fund marketing executive. "There is a lot of money coming out of these pools of assets, but in order to get it first you need to get through the consultants. And the only way to do that is to check the box."

As a hedge fund manager, the question becomes how you deal with this issue. On one hand, you don't want to do a lot of unnecessary work. On the other hand, you need to be able to provide data points that will allow potential investors to make an educated and thoughtful decision about your product.

The answer is simple. Present a clear and concise message, always be truthful, and listen to what the person sitting across the table is saying to you. If you put together thought-provoking, insightful material and provide good, solid answers to the questions asked of you, then consider it a job well done.

"Getting a potential investor to say yes is not easy, but as long as you feel you did everything they asked of you, then you can rest easy," said the marketing executive. "The issue is listening to their requests and providing them with the material they need. After you do that, it is out of your hands."

Listening is one of the most important skills a marketer needs to have to be successful in the hedge fund industry. Being a good listener means you are interested in what investors are asking for and you can provide them with the material they need to make a decision. You need to listen closely to everything the prospects are saying so you are completely aware of what is going on with them. Be aware that something that seems trivial to you may be important to them. If it is important to them, it should be important to you.

To prove my point, I want to share with you a story about listening that has forever impacted my view of its importance to the sales process.

Over the past 15 years or so, I have had the pleasure of speaking at hedge fund conferences and programs around the world. During this time, the world of hedge fund conferences has become a circuit that moves around the world. Generally, things kick off in Florida in January, make their way to Europe by early summer, and move on to Asia in the fall. Attending these events is fun and something most people enjoy. I have enjoyed participating in programs with some of the most interesting people in the hedge fund business, have learned a lot, and made some good friends along the way.

When I go to these events, the key for me is to learn something. I have probably been to more than 100 conferences, not including my own HEDGEAnswers programs in the 20 years. Even though all have unique attributes, one in particular sticks out. It's not because the venue was great or the program was fantastic but because of something I learned from someone I respect and admire.

Let me set the stage.

The conference was the annual winter gathering of managers, service providers, and investors at one of Florida's golf resorts. Because of the timing, the location, and a few of the speakers, the conference experienced a high turnout of hedge fund people from around the world. The program was relatively mediocre, but a number of highlights received significant interest from participants. One session that was packed to standing-room-only capacity was a discussion by the manager of a large well-respected endowment known for investing in existing well-established hedge fund managers and for his interest and investments in new fund firms. His topic was the asset allocation process.

It seemed at the time that this was one of only a few sessions that every hedge fund marketer and manager at the conference wanted to attend. His talk got people away from the bar, off the golf course, and into the meeting room on a lovely January afternoon. The managers and marketers were salivating to meet this speaker and to talk to him about their funds. They wanted to get to this guy and his assets.

The presentation lasted for about 45 minutes and consisted of the speaker discussing the investment process that he and his team employ when allocating to hedge fund managers. He detailed the five things he looked for in a manager and the one thing that immediately turned him off. The five things that he looked for were style, assets under management, the management team, communication skills, and infrastructure. If he liked what he saw in those areas, then he moved on to the fund's record.

He said he was happy to meet with managers and discuss their business to learn what they do and how they do it. To him, he had to understand the business of how the money was managed, and he liked to discuss this with them before the performance numbers. It turned him off immediately when the only thing a manager was selling was the fund's performance. "When the first words out of their mouths after hello were their fund's performance numbers, I politely excuse myself from the discussion and simply move on," he told the audience that day.

"If I am not an investor, I don't care about how a fund has done in the past. I care about how it is going to do when I do have my assets at risk," he said. "Telling me about the past does not help me understand the future, so therefore I have no interest. I want to know about style and strategy and the management team. Not how the fund did when I was not an investor."

People in the audience were taking furious notes. They were waiting with baited breath for him to finish so they could give him their pitch. The saliva was pouring out of their mouths. All the while, most of them forgot the most important thing. They forgot to listen to what he had been saying. They were so busy jockeying for position after the talk, they did not take to heart his words about his process. Had they done so, maybe they would have been happier with the outcome of their 15 seconds with the allocator. Instead of introducing themselves, they went with the numbers. They failed to listen and as a result failed to get a worthwhile meeting.

I know this because later that day, when we were by the pool sipping cocktails, the speaker told me that, "Nearly everyone who came up to him at the end of his talk began their conversations with the phrase, "My fund was up this much last year."

"The audience for the most part completely missed what I was saying, and yes, I probably will miss out on a few good managers because I immediately discounted them based on this initial encounter. But if they don't listen to what is important to me, how can I consider them?" he asked. "Listening is fundamental. And it is something we do and something we expect our managers to do."

Listening to potential and existing investors will be the key to your success. Listening will help you understand what they need and expect from you. Listening will allow you to learn what is important to them, and listening is what will help you ensure you can hold onto the assets regardless of market conditions and how the fund performs. Listening is important and something you never want to discount.

JUST DO IT

While listening and knowing your audience is important, another important aspect of marketing is to have the fund up and running. One problem that many new fund managers experience is their inability to get the fund up and running before they bring it to the market and talk to potential investors. These managers operate on what I call the “hope” or the “expect to” principle: when managers tell the potential investor they hope to get started by the end of the month or expect to be live on the first day of the month.

GETTING TO YES

A good marketing strategy begins when the fund starts operating, and this is the day after you decide to get into the hedge fund business. One of the most common mistakes budding hedge fund managers make is that they go around to their friends, family, and other potential investors and they tell them they are getting into the business. They tell them they are planning on starting or are working on getting the business started, but they don’t seem to have a plan to get the fund off the ground.

Potential investors don’t buy into this premarketing effort. They want to see, feel, and touch a fund before they put their money into it. Therefore, I counsel all of my clients and you the reader that you need to stop telling people that you expect to or hope to get started. You need to start. Don’t tell people you are going to launch a fund. Launch it. That’s my motto. Every day you are in business is one more day of record that you build. Every day you are not in business is one less day of record you have to market with. The key is to start.

This is hard for many people to understand. They feel they need a certain number of assets to get the ball rolling or a specific number of investors to launch. This is nonsense. If you are waiting for assets or investors, then you will never get off the ground. If you are worried about the costs of doing business, then you should stay at your job and wait until you have more money in the bank. You need to start. That is the only way you will ever get things going. As Nike says, “Just do it.”

The question is, How does one just do it?

In the previous chapters, I discussed how to get the entities up and running. Now we need to discuss how to create and implement a marketing strategy.

One of the first things you need to do is to get your story down. This should be an outline of sorts, something akin to what you did in the fifth grade. You know, no A without a B, and no number one without a two. Once completed, the outline will be the framework for your pitch book. It will have a beginning, a middle, and an end and will provide the potential investor with enough information about what you do and how you do it to make an educated decision about yourself and your product. The pitch book is not to be a selling tool that procures assets for you. That's your job. Instead, it's a tool used in the marketing process. Anyone who says a pitch book sells has sold nothing and will sell nothing. What a pitch book does is to tell the story of your fund and act as a placeholder during the sales process. It allows you to stay on track and focused during your presentation, and it allows you to leave something behind at the end of the meeting. When developing your outline and the rest of your marketing material, remember the two golden rules: Keep it simple (i.e., the KISS principle), and less is more.

Here is a quick story about why less is more. Six years ago, my colleague and I launched a program called HEDGEAnswers Launch Sessions. These at the time were half-day conferences where people interested in getting into the hedge business could come and learn about how to launch fund. The program consisted of a series of panel discussions along with question and answer sessions that allowed people to ask questions and get answers about how to launch. Over the years, the program has evolved into the HEDGEanswers.com, a community to exchange ideas about launching and growing a fund. Anyway, six years ago in Philadelphia, my colleague and I had finished up for the day and had been invited by one of the participants for dinner at the Palm Steakhouse in Philadelphia at the corner of South Broad and Walnut. The participant was a new manager who had been managing money in a long-only vehicle for some time and was interested in launching a hedge fund. He had been working with a lawyer and developed a pitch book. In short, he was getting ready to go live. As we looked through the pitch book, we found that this manager with $10 million in assets under management listed three different offices for the company. When I questioned this and asked how he could afford it, he replied he had people in these locations who work out of their apartments in Philadelphia, New York City, and West Conshohocken, PA—hence, his three "offices." I said this didn't make any sense. You're a new fund, with a small, albeit meaningful, amount of money under management. Investors are going to wonder what else is going on at the firm with this sort of structure. Remove all but one of the addresses and make the story clearer. Don't give the potential investors additional objections. He thought I was crazy. He thought it made the company look stronger and more solid.

A few weeks later, I was back in Philadelphia, this time with a dear friend who runs a fund of funds. The new manager asked to get together and we met again. This time, we settled into one of the high tables in the bar and began to discuss how his business was developing. He said that he was getting good feedback and he expected money to be coming in soon. I thought it was a good update and said he should go through his pitch with the fund of funds manager. As he started to go through the pitch book, the fund of funds manager asked him why three offices? The manager explained the firm was operating virtually out of the three partners' apartments and as such thought it should list the three locations as three offices. The fund of funds managers thought it was silly. He scolded him for this and said he should not be something that he is not. I sat there and laughed. I am not an "I told you so" kind of guy, but in this case, I was.

Get a story, stick to it, and make it your own. What you are doing is high finance. At the end of the day, your version of rocket science will be that you are trying to buy something cheap and sell something expensive. Of course, the method by which you reached the decision about what to buy and sell consisted of all sorts of research and math. But when it comes right down to it, all you are doing is presuming that something will go up in value and other things will go down in value, and you position the portfolio accordingly.

The simpler the strategy, the easier it will be for investors to understand. This is the key to successful marketing. You need to be able to explain your story to them and feel confident that they understand what you are telling them. Remember to use the KISS principle in all of your communications to investors. If you don't, you will have real problems. Investors will want to understand what you are doing, and if they do not, they will not want to invest. Gone are the days when an investor took a manager's word for it. Today, investors want to know how the money is being managed. They want to know what becomes of their capital. If they can't understand it from the pitch and the pitch book, then they are going to move on. You need to keep things on a level that is easy for everyone to understand. Trust me. This will help you be more successful and raise more assets.

THE KISS PRINCIPLE

One of the best clients my firm has ever had was a start-up fund run by two guys out of UBS. The pair spent several years at Paine Webber running money and building a lucrative business. When the firm was taken over by UBS, they decided to finish out their clients at the Swiss giant and go out on their own. Their plan for their newfound freedom—like most unemployed money managers and business development people—was to start a hedge fund. Over the years prior to the merger, the two had worked well together and had developed a successful strategy and business. They felt it was time to go out on their own.

The pair met regularly, developed a business plan, and worked with service providers to get things going. During one of these sessions, they realized they were going to need a partner with money, someone who could put up some working capital to cover the initial daily expenses and would provide seed money for the fund. They determined this person would allow them to get off the ground faster than doing it on their own. One of the partners believed he knew the right person, someone who would be willing to put up the working capital to get the business going and who would be willing to seed the fund with a few million dollars to get things moving. An added bonus was that this individual had recently retired from another wire house after nearly 40 years, and the partners believed he would be willing to use his contacts to help them raise additional assets once things were running.

"It made sense for us to find a partner who had the financial wherewithal to see us through the launching and running of the fund through at least one year of operation," said one of the founding partners of the new firm. "Our job was to get the fund up and running and his was to provide financial support for our day-to-day operation and help us raise assets from his list of contacts."

One of the problems with the business plan was the marketing strategy. Without revealing names or hurting anyone's feelings, all of the partners were weak in this area. They did not understand the hedge fund business and did not understand how to go about putting together a presentation that made sense to the investors they needed to target. The partners came from the institutional marketplace, where more is better. They did not understand the hedge fund marketplace, where less is more. It was a hurdle they had to overcome.

BEING AN ENTREPRENEUR

Being an entrepreneur is difficult. Most people who have spent a significant part, if not all, of their professional careers working at large, well-established organizations don't realize the blood, sweat, and tears that go into building a business from the ground up. This, my dear reader, is what separates those who succeed from those who fail. The people who fail are those who refuse to adapt to the entrepreneurial way of life. Those who succeed are the ones who realize they need to adapt and don't fight change. Thankfully, the guys in our example realized they needed to adapt and were willing to change.

"Being an entrepreneur is hard to do, no matter what industry you are getting started in," said this hedge fund manager. "It is really hard and a lot of work to make sure all of the bases are covered. You really have to be the chief cook and bottle washer, and for a lot of people that is hard to do."

This particular fund launch was stressful to the three partners because they didn't realize how much time and effort would go into building the firm's infrastructure. They worked for a long time to get the documents right and to select the prime broker and accounting firm. It was a long and tedious process.

"We knew it would be hard, but we did not know how hard it was going to be," one of the partners said. "It was a lot more than simply getting a brokerage account open, depositing money, putting on a trade, and working with lawyers to get the fund documents completed."

The partners realized they needed to raise capital. Though they had some names on a short list, it was difficult for them to get things going. One of the reasons for this was their inability to communicate what they were doing in print and oral presentations.

When my partner and I met with them for the first time, we spent nearly three hours listening to the strategy, learning about the infrastructure, and trying to understand what they were talking about. We found they had a real inability to communicate what they were doing. We listened intently, took notes, and were confused. Finally, I asked a question and found out they were forecasting interest rates. "Simple" was not the best way to describe the strategy because it was not simple at all. However, when it was broken to its barest components, it was easy to understand.

The fund uses a proprietary method of analyzing a number of economic indicators to determine which way interest rates will head over specific periods. It is simple to understand once you cut through the nonsense. However, sophisticated mathematical analysis and research go into the manager's investment decisions. The issue here was not whether the strategy would work because it did. We knew this because the partners had been using it for years at other firms. The problem was communicating the strategy to investors. Our job was to help them fix this. Regardless of their prior experience, we had to teach them less is more and keeping it simple are the keys to marketing success. It took us about six months, but they got it. The fund is doing well, has established a good record, and had under $1 billion in assets under management by the middle of 2011. This is up from nothing eight years ago.

"We needed to refine our pitch," the manager said. "Once we understood that, we were able to communicate more effectively with potential investors and started having more success."

In marketing, success comes down to one word: communication. It sounds silly to some, it sounds simple to others, but it is something most people who have done marketing believe is an absolute. Yet people lose sight of it when they're launching and running a successful business. They believe that because they get it, everyone else does, too.

Communication comes down to assembling a pitch that makes sense, is easy to understand, and leaves the prospect who is getting pitched with a good understanding of what is being done and how he can profit from it.

Again, keep it simple. You need to let people understand what you are doing, they need to believe they are operating on your level, and they need to believe you are worthy of their assets. They must understand what is happening in the fund and, most important, that they can talk to you about your fund, its strategy, and their investment without running the risk of being thought of as stupid or annoying.

"Investors like to be listened to," said one hedge fund marketing executive. "It is our job to listen to what they have to say and provide them with a platform to be heard. After all, they are our customers, and you know what they say about customers."

This may come as a shock to you, but many investors feel stupid because managers try to blind them with their investment philosophy. The idea that an investor is too dumb to understand what is going inside an investment portfolio is ridiculous. Whenever people tell me how smart they are, I cut them off and cross them off my list. This is what other investors will do as well. Keep things simple, and you will get better results than if you make yourself out as the smartest guy to trade the markets.

It took a lot of work, some of which is not complete, but the aforementioned manager has made great strides in keeping the presentation and fund materials simple and to the point. One of the partners was not used to this idea, so he has had to overcome many internal hurdles. He has problems realizing less is more. As the fund's assets have grown, he sees the value in communicating clearly and concisely, and he is making the switch from delivering too much information to delivering the right amount.

"It is a rude awakening for some people," said an institutional investor. "A lot of guys come out of a shop with a specific way of doing something, and they think that it is the way it is going to be in their new venture. That dog just won't hunt. You need to make sure potential investors feel like they are on your level, and the only way to do this is to adapt to your new environment."

THE OLD DAYS

Years ago, before the scandals and blowups of 2005 and 2006, the meltdown of 2008, and the frauds of 2009, marketing was more footloose and fancy-free. The due diligence process was not as thorough, and money flowed into funds like wine. Investors relied on the word of friends or fellow investors to tell them about funds. It was like a big game of telephone. The only difference between this game and the one we all played as kids was that at this end of the line, some investors lost a lot of money instead of getting the message wrong.

"A lot of investors have lost faith in the industry in the past few years as the blowups and scandals have gone from strategies that failed to out-and-out frauds," a hedge fund marketer said. "Prior to 2004, many people said that they did sophisticated due diligence but really did tertiary overviews. Now, however, because it seems that stakes are a bit higher, investors are looking for more and more information. What they are doing with it, I don't know, but I know that they are asking for it."

Collecting information and using it are two different things. Today, it seems that no matter whom you talk to, everyone wants all sorts of information on a fund, its managers, its trading partners, and even its milk-and-coffee providers. The call for business and position transparency remains as loud as ever. Everyone wants to know everything about what is going on with a fund's people and its positions. I have always asked, "What do they do with all this data?" Though that is not necessarily your problem, you need to be able to provide them with everything they want if you want them as investors.

Even the most sophisticated investors are unable to process and understand position-level transparency. The most unsophisticated investors are looking for these data before they make their investment decision. Unfortunately, providing position-level data is something you will have to deal with. It is a shame this is what the industry has become because, in some cases, a fund is judged by how much information it provides investors instead of the merits of its operation. Even though I have never been able to prove it, my belief is that the information provided to potential investors about positions and risk levels is put into a folder and becomes another box that is checked during the investor's due diligence process. Gathering the data allows these investors to feel good about their research efforts, and their potential investments, and, more important, it lets them feel like they have accomplished something. "Look, when we investigate a manager, we look at three things right out of the box: who is their lawyer, who is their accountant, and who is the prime broker. If they are names that we know and names that are respected in the industry, then we move forward and go further down the due diligence process," said Richard Bookbinder, manager of the Roebling fund, a New York City–based fund of funds. "If we don't recognize the names or don't have any respect for the organizations that they are working with, we just kick them out of the pile and move on. It may not be the most scientific way to do it, but it is a good place to start."

It is easy to understand the value of having good service providers in your documents for a fund of funds like Bookbinder's and for other high net worth and institutional investors. Regardless of size, many investors go through a check-the-box exercise when doing due diligence. This means that potential investors look for a few basic characteristics that they find in all funds. They continue with the due diligence process after verifying that the fund is operating and functioning with similar organizations as other funds in which they invest, meaning that the fund uses a recognizable prime broker, has a well known auditor and a law firm that has a respected hedge fund practice. As the manager being analyzed, you want to ensure investors can check off all of their boxes because it is silly to get hung up on items like your prime broker, lawyer, or accountant, when so many reputable organizations offer services to the industry.

As discussed in Chapter 1, you need to work with service providers who are experienced and respected in the hedge fund industry. Many people know lawyers who can probably write the documents for you. Let's face it, writing hedge fund documents is not rocket science, and all of us know a local CPA. However, when you are meeting with investors, they are going to look for names they recognize, the same names they have seen in other funds they have invested in or are performing due diligence on. If they don't see names they recognize, you could lose their assets.

This is probably the easiest hurdle you will face during the due diligence process. You do not want to be spending time with investors explaining why you chose one lawyer or one accountant over another. You want to show them whom you are working with and move on.

THE VALUE OF SERVICE PROVIDERS

One reason many investors put a lot of weight in the service providers is because they believe that if a respected law firm, accountant, or prime broker is willing do to business with the fund, the fund must have passed some level of due diligence. To these investors, this is an important first step in their investment process. Though having service providers who are recognizable is important, you must have a clear and concise explanation of your style, strategy, and how you got to where you are today.

In light of the frauds, blow-ups, and failures, investors continue to buy a lot of stock in who a fund does business with as they make their investment decision. As I wrote earlier in this book, when choosing a service provider, choose one with a good reputation and one who knows the business. Stay away from firms getting into the industry and those with questionable reputations. You have plenty of good firms to choose from. Make the right choice and avoid a problem in the future.

Along with good partners, you need to have a good story. The story is the story of the business, your background, the experiences that led you to go out on your own and start a hedge fund. The story is what you tell potential investors that details your background, your organization, and your strategy and style. Make sure it makes sense and is real.

A case in point follows.

A number of years ago, I went to a due diligence meeting with a manager based in Westchester, New York. I went to the manager's office and spent the afternoon learning about his fund, organization, and background in the securities and money management business.

One of the things I like to do when talking to new managers is to get a feel for where they came from. I don't mean prior jobs. I mean their childhood and their upbringing. I ask them questions about high school, the sports they played, and their activities, and I move on to college, and so forth.

This specific manager told me a lot about his family, his experience at a local high school, and his effort to get into a good college. He told me he went to an Ivy League college on a need-based scholarship. To me, this meant that he had the grades to get into the school but did not have the financial resources to pay for the education. I thought this was great. In my book, it meant a lot and told me he was probably smart and hungry, two characteristics I like in a potential manager. Check those boxes.

About a half hour later, after discussing his college days and the early part of his career on Wall Street, we started talking about the fund and how it got started. He told us the fund was seeded by his family, approximately \$10 million right out of the gate.

Something did not smell quite right. I asked him how this was possible. If the family had \$10 million to invest in his fund, why and how did he qualify for a need-based scholarship? To this question, he had no answer. He told us he preferred not to discuss it and he wanted to move on. I agreed and thanked him for his time. Needless to say, we did not invest with this manager.

To my chagrin, the manager has done well. He has more than \$500 million in assets under management and has built a successful business. Maybe I made a mistake by not investing with him, but I don't think so. Something did not and does not smell right with this guy. Plenty of good managers are out there, and the key is to find ones that you can be comfortable with. I was not comfortable with him or his story, so I passed.

As a new manager or as an existing manager looking for more assets, you need to avoid situations such as the preceding one. You need to be able to say, "This is my story, and I am sticking to it." It sounds funny, but as I wrote this, I kept thinking that the key is to be able to communicate in a clear, concise, and truthful manner. You need to be able to tell people who you are and what you do in a simple form. They need to believe they can get their arms around what you are doing and can have faith in you and your team's ability to manage money. If you have skeletons in your closet, you don't need to wear them on your sleeve. If someone asks you about them, tell the truth. Everybody makes mistakes, and everybody has issues. Those who know how to admit their mistakes and deal with their issues are the ones I want to do business with. Investors realize you are human. They are willing to work with you to help you succeed.

The search for investors is a difficult one. Many believe it is easy. I am here to tell you that it is difficult. You need to be focused. As a single-manager fund, you need to do the following exercise to ensure success.

First, you need to put together a list of everyone you know who you believe has the ability to invest in your fund. Second, you need to put together a list of all the potential outlets for your fund, such as institutions, endowments, and funds of funds that may have some interest. Third, you need to cast the widest net possible to reach people in all corners of the world. The idea is to get in front of as many people as possible to see whether they have an interest in what you are doing. The key to this exercise is numbers. The more people you hit, the greater the success you will have in finding assets. This is why marketers are the knuckle draggers. In its most basic form, raising money for a hedge fund is the same as selling magazine subscriptions door-to-door. The key is numbers. Get in front of enough people and you are bound to find someone who will have an interest in what you are doing. Once you find money, you will find it a lot easier to find more money. The hurdles become easier as your assets grow. Remember, you never know where the money is going to come from. It usually comes from the places you least expect. Therefore, cast a wide net and you most likely will come up with assets.

The issue comes down to what you are willing to do to be successful. Most people believe they are above aggressively marketing their products. Most people believe the money will come into their fund because they built it. Here is a harsh reality: Investors don't need you; you need them.

HUNGER IS KEY

You need to be focused. You need to be hungry. And you need to be aggressive. You also need to stick to the rules, which means no outward advertising and no soliciting anyone you don't know or who doesn't come to you first. To get a better understanding of the rules surrounding raising assets, talk to your lawyer. He or she should be able to provide you with a primer on what to do and not to do. They are experts in this area and will protect you from making mistakes. You must know the rules so you can play by them. Talk to your lawyer, get the rules, know the rules, and operate within them.

Marketing a new or existing fund is difficult; therefore, you need to be creative. You need to look for ways to meet and get exposed to as many potential investors as possible. Exploit the connections you have with friends, former colleagues, and acquaintances to gain access to investors. Asking people you know for introductions is fine; it is expected and acceptable. It is trench warfare. Man, does this sound hard. Well, guess what. It is. My only advice is be prepared for failure because failure will lead you to success. There is an old saying that things are at their darkest just before the dawn. In my experience of working with new and existing hedge funds, this has been proven true repeatedly. If you don't ask, you will not get. The worst someone can say is no. The best they can say is yes. Ask enough people, and you will get some yes answers.

Over the past few years, I have worked hard to help a number of managers get over certain problems they were experiencing with their marketing efforts. During this time, I have come up with strategies and ideas to help them better understand what they are doing wrong and to provide them with a knowledge base to be more successful in the marketplace. One of the first things I have told people is not to be too proud.

As the industry has grown during these past few years, it has faced a number of obstacles. Many managers have been unwilling to adapt or change according to investor demands. As I wrote earlier in this chapter, most investors are looking for, and sometimes requiring, position-level transparency, reduced fees, and specific liquidity provisions. Most existing fund managers are not willing to give an inch, but many new managers are willing to give it all.

I have seen resistance by some managers who question the need to provide special treatment to investors. I have been on the receiving end of e-mails that question why investors want this sort of treatment and whether they are worth it. My response is always the same: If it is not too much trouble, give in to their requests. If it is too much trouble, find a way to make it not too much trouble and give it to them. In the end, the customer is always right. Special treatment seems to be the request du jour of investors who want to enter funds that have had a problem or have experienced difficulty and are on their way back up the ladder.

I happen to be close to a fund that experienced some rough times over the past few years. There are many of them, and this is just one example. It posted poor performance, had significant employee turnover, and seemed to be on the wrong path. The owner of the company, who had done fabulously well by anyone's standards, decided that he was not finished and he wanted to bring the firm back to its glory days. He was willing to put the effort and finances into the firm to make this a reality, regardless of cost or effort.

Over the years, the firm had become lazy in its marketing efforts. It had taken a snobbish attitude toward raising capital. During its heyday, the fund's manager let things go. Part of the problem was the organization's size. Part of it was leadership, and part of it was the inability of its marketing people to deal with real marketing issues. The firm had adopted the attitude that it didn't care whether certain people invested money in it because, if they didn't, someone else would.

"We were bogged down in an environment that allowed us to take a guy out to dinner, play some golf with him, and buy him some drinks, and we were assured a nice investment because the guy did not want to get caught without us in his portfolio," said the firm's managing partner. "We literally were selling water in the desert, everybody wanted in, and we were willing to take them as long as we liked the size of the investment. We had a fund that everybody wanted."

However, as performance started to go south and people left, the marketplace developed jitters about the firm, and management realized that the investors they thought needed them had become the investors the fund needed.

"We did not cultivate or manage our relationships properly," the manager said. "Instead of selling water in the desert, we were trying to sell ice to Eskimos, and that was something that we were not prepared or quite qualified to do. It was something we did not have experience in."

This inability to manage the customer/investor relationship was the partial cause for massive withdrawals from the firm. Redemptions by a few caused a run on the bank, and the withdrawals had a deep effect on the funds, its managers, and its infrastructure.

"We were dumbfounded by what we saw happening," said one member of the firm's marketing team. "We could not believe how much money was being moved out of the funds and how fast the redemption notices were coming in."

To weather this storm, the firm began to operate with a bunker mentality. The managers met with investors to preempt their withdrawal notices. He resumed his position running the fund and got the word out about who was doing what at the firm. He hired a number of people to fill in some management gaps and began to right the ship. He was proving he was worthy of the client money they still had in their coffers and that new investors should take a look at what the firm had to offer.

"The idea was to get a story to them about what we were doing and how we were going to survive in order to ensure that the money would stay with the firm and not go out the door," the manager said. "In some cases it worked; in other cases we failed miserably."

In the end, the firm saw its assets drop by nearly 50 percent in one year, but the fund was up nearly 11 percent during this time. It proved to its investors and the world that its money management team was strong enough to make money regardless of the outflows and market conditions. This is something the firm has since used in its efforts to rebuild its asset base.

"We were involved in the perfect storm," said the manager. "We were hit on all sides, but I think what hurt us the most was when people on the inside turned against us and people on the outside started listening to what they were saying."

The firm has survived. One of the first things the manager did was to let go of a significant amount of deadweight in the marketing department. He cut off the arm to save the body. This caused some initial problems in the marketplace. In the long run, the marketplace seemed to understand it was necessary for the firm's survival.

"When your own marketing people refuse to talk to investors or prospects, it is a problem," said the manager. "It is even more of a problem when the Street finds out about it. The hedge fund industry is a small place, and the word gets out quickly. How can you expect outsiders to have confidence in you when insiders don't? These are the things we had to deal with and it was hard," he continued. "We had to make tough choices, but we are better for it. We are stronger now than before, and we will survive."

The firm made a number of adjustments to staff and overhead and worked hard to get the message out that it was here to stay, and it was committed to the business. It took the fund company about a year to turn things around. Now the tide has turned, and the business seems to be on track.

It comes down to self-confidence. If you have the financial wherewithal and the belief in your product and its sustainability, then you have a chance. If you don't believe in it, then it doesn't matter how much money you have. You should fold the tent and go home.

As a new fund starting out, it is critical that you have the financial wherewithal to get through the lean times. If you do not have in the bank at least three times the amount you earned in your best year working for someone else, then you are probably going to have a tough time making it through the first few years of being on your own.

Few funds start up and launch with hundreds of millions or billions of dollars. You may read in the popular press about those who do launch with hundreds of millions or more in assets, but these examples are few and far between. For the most part, new funds start with assets under $100 million. This means that you, as the manager, must cover the operating expenses of the fund and the organization out of your own pocket, and you will not be drawing a salary. Therefore, you need to be able to cover your living expenses. You will need to have significant amounts of cash in the bank. Questions about your rainy day fund are going to come up during the due diligence process. Most seasoned, institutional, high net worth investors know this and will ask you about it. If you are prepared, then they will know you are serious about your endeavor. If you appear not to have thought of or prepared for any eventuality, they will question your sustainability.

"I expect a manager to tell me that they are prepared to not take any salary or money out of the business for the first couple years," said one doctor who invests in hedge funds for his family office. "My experience is that for the most part, funds that succeed are those in which the manager and his team are prepared for the worst. If a manager gives a blank stare when I ask this question, it tells me that they are not prepared for the worst and it is probably a fund that I am not going to go with. I like managers who think of everything or at least try to cover all of their bases."

As I said at the beginning of this chapter, the goal of these 10,600-odd words is to provide you with enough information to attack your marketing effort with gusto. It is to make you understand that just because you have a bunch of rich friends, you may not succeed in getting them to invest in your fund. No matter how big you become, without investors you are nothing. I hope that has come across in these pages.

CHAPTER 7

Why the Back Office Matters

As you continue to build your business, one of the first things you will realize is you need to make your infrastructure good and solid. Your operation's infrastructure and how it appears will become a major part of the success of your business. Investors like to kick the tires. They do so by looking at your marketing and performance material and by viewing your office space, computers, and human resources. Many investors talk directly with service providers, perform background checks, and check references. Though it is important to put on a good show, you must ensure you have all the tools you need to succeed. The show is not something to take lightly since it is the infrastructure that runs the business. Technology is the great equalizer. Take advantage of available systems and services to create a professional well-oiled machine.

USING THE RIGHT TOOLS

Having the right tools at your disposal is important. Doing so will allow you not only to build your business but to also maintain an edge in the markets. With today's advances in technology, all of the information you need to make a decision about a potential investment is probably just a mouse click away. Though this is viewed as good by some, I believe it is actually bad and makes a manager's job harder. The Internet and its resources, combined with the development of Bloomberg and Thomson Reuters machines, not to mention the countless front-office, middle-office and back-office technology providers have leveled the playing field. The technological advances of a few short years have provided us with the ability to trade from anywhere we have access to the Internet. However, your competitors have access to everything you do. All of the same information, all at the same time, is available to everyone who wants it and is willing to pay for it. Remember, though you are using technology to make better, more efficient investment decisions, the funds you are competing against are doing the same.

Therefore, your job as a manager has and will become more difficult, sometimes before you have launched your fund. The days of picking off the low-hanging fruit are over. You can thank the Internet and the mayor of New York City for that. The question is this: How are you going to get and maintain your edge?

Right out of the gate—even before you make it to the gate—you need to think about developing and maintaining an edge. Let's face it: You would not be willing to put up the money and go through the motions of putting the business together if you did not think you had an edge. What you need to do is to define, massage, and master it. By the way, your edge is how you are going to make money.

Once you have defined and placed your edge, you need to determine how to maintain it. Undoubtedly, your strategy will rely on your ability to retrieve and process information. Some people do it with great speed; others do it with great volumes of material; and a third group does it using a combination of both and with a sprinkle of something else. You will figure out what works best for you and then determine how to implement infrastructure that will allow you to do it. When it comes to using technology for gathering and processing data, most people think of using sophisticated number-crunching algorithms. My belief is that this is generally unnecessary. I believe in making things simple. This means using commonly found tools to do uncommon things. Free news trackers on Yahoo! and Google are often a great first line of offense in finding potential new investment ideas. Using technology to help you with the heavy lifting is worth it. I am amazed at the number of stories in my inbox with an article on a subject I am interested in that I have missed through my conventional research methods. When this occurs, I realize the power of the Internet. Probably for the foreseeable future, content will remain king on the Internet. Tens of thousands of "journalists" are writing about every conceivable subject. This is good and bad. Good because it means that subjects are getting covered and bad because not all of the material can be good. By doing nothing, I receive the bulk of this material almost as fast as it happens. The key is setting up the parameters on your filters to ensure the trackers find what you need. This is important because it is free, and it takes little or no effort to retrieve this information that may have required you to review hundreds or thousands of articles to find.

As a start-up manager, you need to keep your costs in line with your business plan, and you need to maximize your ability to gather information efficiently. Many start-up firms I have talked to report they are big proponents of the free sites offered through Yahoo! Finance and Bloomberg.

These sites allow their people to gather data and do research without any cost. You do not need to reinvent the wheel, but you do need to figure out how to make that wheel most efficient for you.

As the hedge fund industry has grown over the past few years, so has the cost of technology for a start-up hedge fund. Buying services from multiple data providers can be difficult to justify. The cost of complete access to the Bloomberg terminals, a PerTrac license, and access to a Thomson Reuters machine can be more expensive than renting an office. As the manager, you need to determine your needs and build your infrastructure around them. Wants are important, but needs are usually critical to the success of the business.

When it comes to developing your infrastructure, your prime broker will tell you it is going to help you. In reality, the firm will not be able to do too much in the way of infrastructure advancement. Prime brokers are about making money, and though they have all of the tools and services you need, these things come at a price. Therefore, you must shop around to ensure your prime broker is giving you the best price on executions and on the technology offered as part of its service to your fund. It is not to your benefit to become accustomed to taking whatever the prime broker is giving. It will cost you more than necessary in additional fees and commissions.

THE BEGINNING

In the beginning, you need to sit down with your partners and look at how you trade, look at what markets you trade, and decide what tools you need to succeed. You need to look at where the information flow comes from and how that information is processed. Do that by determining which tools you are using at your current place of employment or at your house and then figure out what you plan to use when you are on your own. Most likely, the bulk of your work is being done through software found on standard issues of Microsoft Office. You may be gathering the data from a Bloomberg terminal, but you are probably crunching it through Excel and other tools in that suite of Microsoft products.

When it comes to Bloomberg, keep in mind that Bloomberg is not about doing any one thing well. It is about doing many things at an acceptable level. The beauty of the Bloomberg machine is that it can tell you the price of a vintage bottle of Château Mouton Rothschild or offer up the entire history of the 30-year Treasury bond. You may need both or neither. Nonetheless, the question is this: Do you need a Bloomberg? Only you and your partners can answer that question. Get what you need, not what you think you need.

Technology is good, but good research is better. The best research for hedge fund managers comes from the computer between their ears.

Your infrastructure should be built around making you the most efficient money manager possible. Obviously, you are going to need a couple of personal computers loaded with the basics and probably Microsoft Office or a similar suite of programs because you will need to be able to pump out documents and crunch numbers. You are going to need a data feed, which your prime broker will usually provide. This will be a desktop icon that gives you real-time market access. You can get this from other brokers you trade with as well. These services and systems will give you access to most of the analytics you need for basic quantitative analysis.

After the trade is made, you will need to rely on your prime broker, who will provide you with trade blotters and portfolio management software that will allow you to see your portfolio's full picture at all times. All of the prime brokers are able to deliver this information electronically to your desktop and to your administrator. In some cases, the information should be available in a real-time, online environment. The prime broker's platform is something you will become accustomed to using and something that will allow you to keep score and stay abreast of what is going on with all your portfolio positions. Many managers like the ability to have real-time profit and loss reporting because it gives them the ability see what is and what isn't working and what they need to do to fix what is not working. Many firms use a portfolio accounting system called Advent Geneva to provide real-time information needed to determine where they stand with their investments. Prime brokers and administrators use this software to integrate all orders and money flows. It provides performance data with a few clicks of the mouse. With this software, managers can see all positions at all times and understand the profits and losses from those transactions, margin balances, money in and money out, and historical performance data. Installing and using Advent Geneva, one of a number of similar software suites that perform these tasks, is expensive. The licensing fee can run into hundreds of thousands of dollars. Therefore, many managers rely on getting licenses from their service providers. Oftentimes, the service providers can provide the software as part of the overall fees associated with brokerage or administration. Going direct can be expensive, so avoid it in the beginning.

As the use of technology has evolved on Wall Street, most prime brokers have developed sophisticated web-based reporting functions and real-time execution systems. You need to determine the best way to execute your orders. Most likely, you will go through a screen from your prime broker. It can be done through instant messaging on your smartphone. Many brokers offer many of the same products and services. Shop around for the best price for what you need, and go with a firm that you are comfortable with.

Today, as prices come down and the industry moves away from soft dollars, many people are offering execution services to hedge fund managers. It pays to shop around for the best price and the service. Make sure you have multiple outlets to execute your orders because, at the end of the day, you want to get the orders done the way you want them. I always suggest that a new fund, regardless of size, open multiple accounts with prime brokers to ensure they are getting the best execution and the products and services they need to succeed. Some new managers often question this advice as they believe that by keeping everything in one place they will get a better price. This may be true in terms of execution costs; however, the cost of execution has come down so much in the last few years, that prices are relatively the same at all prime brokers. By using multiple primes, you can have access to additional research, conferences, potential capital introduction activities, and more. It makes sense to spread the trading around.

THE OFFICE

When it comes to setting up the office, you are going to need to buy computers, a fax machine, a copy machine, and other office equipment to make the office run smoothly. You can get around buying a fax machine if you get a copier that scans documents. However, if you are using an office within a hedge fund hotel, most of the equipment you need will be provided by the prime broker or the manager of the office complex. For a fee tacked onto your rent, you will be up and running and have all of the office accoutrements at your disposal. My experience in setting up an office is that less is more when it comes to technology, furniture, and other items found within the confines of the four walls that are your global world headquarters.

One of the problems our society has today is that we always want the latest and greatest technology. We believe that if we are not on the cutting edge, we will find ourselves on the bleeding edge.

A brief story will prove my point. In 1991, I had the pleasure of working for IBM as the on-campus representative at Clark University. My job was to educate staff and students about IBM personal computers and sell them to the community. It was difficult. IBM was selling the PS2, and its top competitor was Apple. For every IBM I sold, probably 10 Apples were being sold on campus. It was an incredibly uphill battle. Although it was something I thoroughly enjoyed, it proved to be frustrating. No one saw the value of the PS2 or the IBM Microsoft operating system. On the contrary, it seemed that everyone saw the beauty and ease of the Macintosh computer. During this process, however, I learned something interesting about technology and the way the market bought it. I learned that 90 percent of the time, people bought technology well above their real needs, because they wanted the latest and greatest machine. They didn't care if they were going to use it for outputting papers and going online. They wanted the power. Consequently, these people were willing to spend $3,000 to $4,000 for a machine that could process and deliver more data and run more programs than they needed. Unfortunately for me, I was on a fixed commission, so it did not matter whether they bought the expensive one or the cheap one. I got the same $40 commission, regardless of the size of the sale and the price of the computer. However, it did teach me a good lesson: When you are buying technology, write everything you are planning to do with it and figure out what you need before making the purchase. Less is more. Because something is new does not mean it is better; it just means it's new. When you are starting out you should pay attention to expenses. Buying the previous generation of technology will probably serve you as well as buying the latest version. Plenty of people are doing fine with the first generation of the iPad.

While purchasing technology is important, having someone who can service it is more important. When the machine fails, the last thing you want to do is dial a toll-free tech-support line and hope to get through to someone who can help you. You need to stay focused on your business and let someone else focus on the technology and its problems. You must have a reliable organization that can provide you with good services and support to make sure your needs are met before, during, and after problems occur.

As I wrote in Chapter 1, one of my favorite stories of the entrepreneurial side of being a hedge fund manager is Nancy Havens's comparison of her interaction with tech support at Bear Stearns and her experience after opening her own firm and realizing she had no one she could call. She became the head of tech support.

Today, we are so dependent on technology that you must commit resources, time, and energy to having good, solid technology resources at your disposal. This does not mean you need to hire your own on-site tech person, but it does mean you need to contract with a company that can provide you with the services you need in an efficient and timely manner.

Going through the process of setting up your fund and your firm can be a lot of fun as well as stressful and painful. One of the best parts of the exercise is coming up with a name for your company and its funds. There are great stories on Wall Street about how the names of funds came about and where they were chosen. Many are simple. For example, SAC Capital Partners comes from Steven A. Cohen, the company's founder and principal. Soros Management comes from its founder, George Soros. Tiger Management came from Julian Robertson's son, who told his father that he thought the name was easy to remember since Julian called people Tiger. Names come from all sources: trees, streets, squares, folk heroes, and characters out of a

Tom Clancy novel. A friend of mine named his fund of funds the Roebling Fund, after the engineer, designer, and builder of the Brooklyn Bridge, John A. Roebling. The key is finding a name that is not taken, that makes sense and is easy to use in marketing material, e-mail, and on the web.[1]

When it comes to building your web presence, you are on your own. I am not a firm believer in the web. I view it as little more than interactive television that shuts your mind off. However, my firm has a website, and I suggest yours should as well. Today, one of the first things sophisticated and institutional investors are going to do is to Google you. They will search for your name, your partners' names, and your company name to see what information comes up. You, too, should run this search occasionally to ensure you know what is being said about you on the Web. Again, I believe less is more, and this axiom will serve you well in the long run, too. Investors are not looking for sites with bells and whistles or the most current web design. They are looking for simple, concise sites that are easy to navigate. You should provide enough information to get them interested in learning more about you and your fund.

You must operate your own e-mail servers. Initially, you will think that this is a hassle and not worth it, especially if there are just two of you. However, e-mail is a critical function that cannot be left to someone else. You should run your own phones. However, this is a little more difficult if you are working in someone else's office or in a hedge fund hotel.

If something goes wrong, you know whom to blame and you can begin to fix it immediately. It is much easier for you to work with your own people to solve problems quickly than to wait in line for someone else's help. If you are using someone else's network or server, at the end of the day you are going to be at their whim. When something goes wrong, you will have to wait until they want to work with you to get things fixed. Remember, what is important to you may not be important to someone else. If they are on your payroll, it will be important to them. The key to success is communication, and you need to make sure your tools are always working.

INSURANCE

Another thing you need to think about is insurance. Insurance is a pain in the neck, but it is a necessary evil. You will need to get a health insurance plan, a property and casualty plan, a workers' compensation plan, and perhaps directors' and officers' insurance. It is a nightmare, a bloody nightmare. There is no other way to describe it. Why? First, insurance is a sunk cost with no potential revenue. Second, the application process is a hassle, and you and your colleagues probably know little about buying insurance, so it will be like flying blind in a snowstorm. Tread carefully when it comes to insurance. You need to make sure you are working with people you can trust, people who will give you good advice and offer the best solutions in products and costs for your needs.

Insurance is generally not something most start-up managers think about when they are discussing launching a business or working on the documents. Most people assume it will be there. Unfortunately, that is not the case. In fact, it is difficult to deal with, especially if you have a family. Health insurance can be an enormous expense for a start-up company, but it is one of those things that you have to have. If you can, a good option is to use Consolidated Omnibus Budget Reconciliation Act (COBRA) insurance because that program will last 18 months and can provide a good stopgap solution to going out and getting your own plan. The problem comes when you hire people for your firm. They are going to need some coverage and will expect you to pay for a portion of it. Get multiple bids when you are seeking a health insurance provider. You may find you can get similar coverage for substantially lower prices, depending on the carrier and whether the broker can tweak a plan. This is important, especially if you have multiple employees. I know from our own experience. Some employees have families, and some do not. As a result, our insurance bill is a significant portion of our monthly infrastructure expense and something we pay close attention to when it comes time for renewal.

Along with health insurance, you also must have a workers' compensation policy. Most states make it easy for you to get this coverage, and it becomes something you do not think about. However, if you do not get the coverage, be prepared to pay significant fines. A number of states, including New York, Connecticut, and New Jersey, look unfavorably upon companies that do not have plans in place. However, if it is just you and your partner, you will not need a policy. As soon as you hire an employee, you will need to have the coverage.

Payroll is something else you need to figure out. Initially, if it is you and your partner as members of the limited liability company (LLC), you are not allowed to draw a salary and will be compensated through distributions. However, if you have an analyst or administrator, you will need to be able to pay them. Thankfully, payroll services are a dime a dozen. The market is competitive, and as the consumer, you can play two against the middle to lower the price for the services you need. You cannot and should not do payroll yourself. You need to have a payroll company, another one of those things you need to figure out as the firm takes shape and operates.

The best thing to do is to make a checklist. We have a checklist available online at www.hedgeanswers.com. Using a checklist will help you stay focused, and will keep you on track, and allow you to be more efficient. You must take care of insurance in the beginning. Pay attention to it and make sure you are covered in the event of a medical, physical, or financial emergency. Better to do it today and sleep easy than have a problem and be up the creek without a paddle.

Under no circumstances should you lose focus of the fact that establishing good infrastructure is the first step to running a successful business. Infrastructure includes all of the stuff that allows you to run your business. It means the telephones, computers, fax machines, Internet connections, insurance, rent, lights, gas, electric, and water for your bathrooms. It means opening a cable television account because you are going to want to have a TV on in your office for the pictures, of course, not the sound.

You must stay focused on what is important. Get the infrastructure done and move on. That is what an entrepreneur does. Don't become bogged down in the minutiae.

To avoid hassles when setting up infrastructure, establish a budget for office expenses and stick to that budget. Sit down and say, "Okay, we are going to spend X dollars on furniture, X dollars on technology, X dollars on televisions, X dollars on this, and X dollars on that." Then you need to commit to the budget and stick with it, no matter what.

HIRING PEOPLE

Currently, many people are out of work and are looking for jobs at hedge funds. Unfortunately, there is a dearth of human capital willing to do whatever it takes to land a job at a fund or growing fund. Take your time, meet with people, learn about them, get an understanding of who they are before you hire them. Human capital mistakes can often be the most costly. Do not screw this up. Recently, a dear friend of mine told me the story about how his firm was interviewing people to fill the role of general counsel. He had met with a number of people and was unimpressed. After a couple of weeks, and a series of meetings that went badly, he put the hiring on hold. A month later, he got a call from someone who said they had the perfect person for the job. He was excited to meet the person. My friend and the candidate met and immediately hit it off. They agreed to another meeting a few days later and that meeting went well. Shortly thereafter, my friend completed a background check and decided to make an offer. The person accepted the offer, all set to start on October 3, 2011. The Friday before, the candidate called and said he decided to pass on the opportunity.

"He seemed like the right fit and then he went nuts," said my friend. "He called me late Friday to tell me he was not coming in and had accepted another position. I was angry that I had wasted time but relieved to not have to deal with such a flake."

On October 5, 2011, the candidate called my friend and asked for the job. It turns out the position he thought he was going to get did not come through and he was out of work.

My friend did not hire him. Though he still has no general counsel, he is happy to be without this candidate. One never knows. Often, it is important to trust your gut; however, this is not enough. One thing I suggest is walk before you run. With so many people out of work, you may be better off hiring a couple of part-time people to help with the business before making a full-time commitment. This way you can see how it is to work with people and decide if they are the right fit for you and your growing firm.

Plenty of people are looking for work. Take your time, be choosy, and do the best you can. My suggestion is to go slow and be steady.

As a new company, you do not need to hire a full-time chief financial officer (CFO) right out of the gate. You can get away with using a part-time bookkeeper and taking advantage of the services many consulting firms offer to outsource the CFO and chief compliance officer (CCO) function.

Unfortunately, too many qualified applicants exist for the positions. For the most part, that is good news for the start-up manager. You can take advantage of this because many people are looking for trading, marketing, and analyst positions, and the fruit is ripe for the picking. You should focus on hiring a good, solid office manager/administrator. This person can be someone who may not have a background in the hedge fund industry but should be someone who has good people and organizational skills and who is thorough. You need someone who is dedicated and focused, and who wants to work and seize the opportunity before them. You need to find competent people. In my experience, hiring people because of their background is a mistake. If they are coming from a big corporate environment, they will have problems adjusting to a small organization. They won't like it, and they won't thrive. You need to hire competent people who have an entrepreneurial spirit. It is a difficult task. There is no good way to hire people. Sometimes, you need to go with your gut.

Currently, there is a glut of high-priced people in the hedge fund market looking for jobs. You need to find people who are competent and who believe in what you are building.

People should hire people they know and have observed in the workplace and who can potentially lead to other good hires. For example, when I was launching our company, one of the first people I hired was someone who had been an administrator for us in a prior company. This person had a good background and was reliable and trustworthy. I knew the person's strengths and weaknesses, and her abilities matched what I needed. I knew she would be a great fit for us. My next hire was a graduate student. This person was fantastic. She was looking for part-time work while she was working on her master's degree, and she turned out to be an asset to the organization.

Over the past few years, I have learned that two of the most important things to stay focused on during the hiring process are your resources and how that person is going to use them once on board. You need to manage your resources. You do not want to spend your time educating people. You do not want to spend your time monitoring them to see whether they are making personal calls or handling things incorrectly.

When it comes to the person who is going to answer your phone, you have to remember he or she will be the voice of your company. If that person is unprofessional, unpleasant, unkind, or a poor speaker, then you are going to look like an idiot and be deemed unprofessional by the people who call your office. You cannot afford to have this happen. You get to make a first impression only once, so it has to be right. The person who answers the phone says a lot about your company and the firm's level of and commitment to professionalism.

Your first hire will probably be your office manager/administrator. This is an important hire because the person is going to take a lot of the pressure of the daily operation off of you. You need to hire someone you trust, someone who is reliable, and somebody who drinks the company's Kool-Aid. You are correct. It should remind these new employees of Jones. If you don't understand what I mean by this, e-mail me at das@hedgeanswers.com, and I will explain it to you.

In terms of headhunters, over the past few years, the number of people focused on finding jobs in the hedge fund industry for other people has grown. As you can imagine, headhunters have realized the hedge fund industry is shrinking. As it shrinks, many people need work and want to work. Therefore, the headhunters have built a business around people needing work. As with any industry, good and bad headhunters exist. My experience with headhunters is they generally look for the easy way out. They look for the person who seems to be the perfect candidate so they can minimize the amount of work they have to do with the client. They are uninterested in stories. They want to fit a round peg into a round hole and don't care about anything else. I have had little luck with headhunters over the years. For the most part, I think they don't get it.

Most of our hiring success has come from using the job boards at many of the hedge fund industry websites, including www.hedgeanswers.com. I have had great success with this web site and will continue to use it. The headhunters who focus on the hedge fund industry are unable to handle entry-level positions or are not looking for people who have little or no experience. They are trying to place a lot of accountants, administrators, and high-end jobs. Headhunters are perfect for a large organization looking for a head of marketing, head of product development, or head of prime broker sales. I have found that my needs are in an area of the market in which headhunters are not focused. The few hedge funds I know that use headhunters are looking for an in-house accountant, a CFO, or a COO.

Most hedge funds are not looking for people through headhunters. Those that do use headhunters are generally looking for a CFO or a chief operating officer (COO). If you are in need of someone for such a position, then I suggest you go to www.hedgeanswers.com, register free to the community, and put up your post. I believe you will succeed. You can, of course, e-mail me for ideas.

When it comes to setting up the business, you need to think about what I call "the way things are done."

"The way things are done" constitutes the processes you put in place that allow your business to function efficiently. You need to pay attention to a hundred little things when you are setting up and running a business.

Following is a list of things you and your employees are going to need to know. You will need to have policies and procedures in place for dealing with these as your business grows:

- Investors
- Potential investors
- Documents
- Performance results
- Brokers
- Administrators
- Banks/custodians
- Accountants
- Insurance
- Technology

These items are the front line and the rear and need to be looked after. I know it sounds silly and you might think it is unimportant, but trust me, by paying attention to the seven areas listed here, your firm will be stronger and more successful. You need to make sure you are focused on these items:

- Make sure you communicate properly to your investors.
- Make sure you communicate properly to potential investors.
- Keep a log of all the documents you send out.
- Keep all your data in one place for easy access, and ensure you have a point person who will traffic all material.

The reason you need to do this is twofold. First, you want to make sure you are doing everything you are required to do under current and future regulations. Second, you need to ensure all documents you send out are the right ones. As I stated earlier, you can make a first impression only once. Therefore, make sure you make the right impression the first time. To accomplish this, you need to have someone who traffics all your documents. This stuff may sound basic, right? I am here to tell you it is difficult. It is time-consuming and frustrating. It is the reason you need to appoint someone competent and qualified to get the job done right the first time.

A friend of mine runs a small fund of funds in midtown Manhattan. He has a great person working for him. She collects data and documents, processes documents, and does a super job. By doing her work well, she allows him to stay focused on his priorities, making investments for his investors and talking to investors and potential investors. The point of my story is this: You need to delegate some of your activities to make yourself more efficient. By being more efficient, you will be more successful.

This chapter is called "Why the Back Office Matters" because it is about the things that you need to do to build a successful business. You need to know that everything discussed in this chapter is part of the bigger picture, which is your ability to raise and manage assets. By having the right infrastructure and by focusing on the others, your life will be easier, your company will be more stable, and your organization will be stronger.

CHAPTER 8

The Launch

In life, few decisions are more difficult than deciding to become an entrepreneur. It takes guts, a strong belief in your abilities, and money. The first two are easier to come by than the third.

Wall Street, however, makes it easy for people to take the plunge. First, it provides you with the stories of those who did it before you and became successful and rich. Then it gives you all of the tools you need to build your business with the click of the mouse. In the end, what will allow you to go out on your own will be the desire and need to win. To win in the hedge fund business means you have built a fund complex that puts up good numbers, attracts significant assets, and is able to maintain both for a long time.

It may sound easy, but it is difficult. I am sure you can succeed. The real question is whether you believe you will be successful.

Only you can answer that question. If you hesitate and say you think so, my suggestion is to stop reading this book and go back to working for someone else. If you answer yes, you should read on. You know in your gut whether it is the right decision, and you have to be honest with yourself. Remember, the gut never lies.

Taking the plunge and going for it will be exhilarating, exciting, and difficult. In the end, it will be worth it.

Unlike opening a dry cleaner, pretzel stand, or bookstore, the hedge fund world is a complete enigma in the world of entrepreneurs. There is no other industry I know of in which two people in an apartment can be in business in a matter of weeks and be making money almost immediately. The barriers to entry are low, and that is a good thing. It does not, however, mean you will be successful; it means it does not cost a lot to launch a fund.

The reason most people are interested in going into the hedge fund business is not the glory that comes with picking winners but the financial rewards paid to those who pick the winners. I am a big opponent of the way the popular press writes about this industry, and most of the time, they get it wrong. However, they write about one thing correctly: the amount of money some of the best and brightest managers make on an annual basis. The press does a good job writing about fraud after it is uncovered.

Making money and becoming the next John Paulson or Julian Roberston is the reason you bought this book and are going to set up a meeting with a lawyer and accountant if you haven't done so already. This is why, deep down, you want to get into the hedge fund business. You want to make money and lots of it.

Don't get me wrong. I am in it for the money as well. Believe me when I tell you that nearly everyone you talk to will say that, in their heart of hearts, that is why they are hedge fund managers. The money and the fun that go along with a successful business make it all worthwhile.

Running a hedge fund will allow you to have a lot of fun managing your assets and your business. The best part of it all is that at the end of the day it is yours. You will reap what you sow. There is nothing wrong with thinking about the money and the rewards that come with the success of building a good business. It is the American Way. It is what should motivate you, drive you to do the research on potential investments, and raise capital. Through this work, you will succeed. Being a hedge fund manager is like having a license to print money legally. The only issues are figuring out how to get the ink and where to get the paper. If you can get these two things down, it is yours to mess up.

THE PLAN

Once you have decided to go out on your own, you need to put together a road map that details your plan for building your business, raising assets, and managing your portfolio. I am not a huge believer in extensive and thorough business plans, but I don't believe you can shoot from the hip and succeed.

My experience has been that the people who write thorough and thought-provoking business plans usually fail gracefully, and those who shoot from the hip crash like the Hindenburg. Therefore, you need to come up with what I call "the happy medium" of business plans. Your job is to put together a thorough yet flexible plan. It should allow you to adapt to situations that arise whenever you start a project and you don't know where it will finish. This is my advice to anyone who is leaving a job and going out on his or her own with a small amount of money: You will need a plan to succeed. Today, most fund managers launch with somewhere between zero and $25 million in assets under management. These aren't the funds you read about in the papers or hear about on CNBC. Nonetheless, they make up the bulk of new fund launches. Few funds launch with hundreds of millions or even billions of dollars. If you are a manager who is launching with anywhere north of $500 million, let me say thank you for buying my book, and let me tell you to stop reading. With this sort of asset base, you don't need this book to help you. You probably could have written parts of it. You need only to manage the money successfully. I would go with a value approach and short good stories, but that's just me. You should stick with what you know, and again, thanks for buying the book.

For those of you who will be operating in the real world, you need to be scrappy and be willing to get dirt under your fingernails because the opportunity is there. You need to be able to see it and seize it. The plan, like most good things, will start at home.

The first place to begin is to examine your personal financial situation and get a complete picture of it. You need to be prepared to go without a salary for some time. You should have enough money in the bank to cover the lifestyle you and your family have become accustomed to and to cover the immediate costs of launching the fund and managing the assets. One of the most important things you need to do on your road to success is to ensure all of your personal finances are in order so you do not create undue stress at home. Taking care of this in the beginning will allow you to be more successful going forward and relieve one source of pressure in your life that can be burdensome when no money is coming in. Being an entrepreneur is stressful enough, with all the nonsense and headaches that come from starting and running a business. The last thing you want to do is have stress at home. Make sure your family and friends realize what you are doing. They don't necessarily have to be behind you and your new work, but they should respect what you are doing. The frustration that comes from doing documents is enough to drive you crazy. The people around you know your life has hit stress factor nine, and you may need their support to deal with it.

If you are not used to working under self-imposed pressure or have a hard time dealing with the stress that comes with being an entrepreneur, I would suggest two things: (1) find a good business partner who will help you through the issues and problems as the organization is forming and growing; and (2) find an activity that will allow you to burn the stress and relieve some of the pressure that will undoubtedly arise.

You should realize that all of the trials and tribulations that occur in your business have occurred in one way, shape, or form to other entrepreneurs and hedge fund managers. You are not alone in this. Realize things do get better over time. If they don't, you will realize it and be smart enough to find a solution to make the situation better.

When it comes to making financial decisions, you need to have a sound mind. You need to have enough money in the bank to avoid any financial pressures or stresses that can occur when you are not drawing a salary and have little income. Most accountants and lawyers suggest having at least two years of living expenses in a money market or checking account that you can draw upon with ease as needed. You need money to pay for service providers and infrastructure, a figure that can rise to at least $150,000. You need to have at least $1 million in fund assets. It seems like a lot of money and it is, but by having these sorts of cushions, you will make your life easier and keep things relatively normal until the business is up and running and generating fee income.

PRESSURES FROM TWO SIDES

Along with financial pressures, people pressures go with launching a hedge fund. These pressures come from having to work closely with someone for the first time and learning how the person complements you and you complement him or her. Choosing a partner is difficult and something you should take seriously. Hedge fund managers seem to pick friends or colleagues they have some experience working with and with whom there is mutual admiration, trust, and respect. Finding a partner who is a friend is good, but find someone or a couple of people who complement each other. The key here is to identify strengths and weaknesses and find people whose strengths are your weaknesses and whose weaknesses are your strengths.

What makes my firm successful is the preceding sentence. My partner and I complement each other almost perfectly. There is little overlap, and that makes for an easy and successful working relationship.

All partnerships endure stressful periods. There are many frustrations in the beginning and throughout a business, regardless of its size or shape. You must be able to work through the difficult times without having irreconcilable difficulties. In your business, think of your partner as your spouse. The key to making the relationship work is to have open and thoughtful communication during good times and bad. Without good, solid communication between the partners, the company will fail no matter how much money you get under management and how solid your record becomes. Communication is the key to the partnership's success. If you communicate, you will get along. Getting along is important because you will be spending a lot of time together, and there is nothing worse than spending time with people you don't like. As your business grows, so will the number of people in the organization. You may grow apart from your partner. Even if this does happen, you still need to be able to talk and to have the lines of communication open.

There is a long/short equity hedge fund with well over a billion dollars in assets under management. From the outside, it seems to be a well-run, successful organization. And indeed it is. In public, the partners seem to get along famously. They are jovial and fun to be with. However, that's all a facade. When you go to their office and talk to them individually, you can see how much they detest each other and how difficult it is for them to work together each day. Their friendship has deteriorated, but their business partnership remains.

There have been times when I have spoken to one of the partners about something we are working on. Sometimes, two or three hours later or the next day, I will get a call from the other partner I did not talk to. He will ask me the same question and be looking for the same answers. At first, I thought this was funny. Now I find it sad. My initial thought was that the reason the two did not communicate was because they were so busy and did not have the time. However, I have come to find out that the reason they don't talk is because they can't stand being in the same room together. What makes the situation so interesting is that the partners have figured out how to make their lack of communication work and have built a successful business without liking each other. Even some of the employees don't realize the two don't get along. One is responsible for the front office—trading and marketing—and the other is in charge of the back office, dealing with operations and customer relations. They interact on a daily basis in a civil and professional manner.

"Look, you don't have to be best friends with your partners. You don't even need to see them outside of the office. All you have to do is be civil," said one of the partners, whom I will call Mike. "We don't get along anymore on a personal level, but I think that it is evident that the deterioration of our personal relationship has not affected our professional one, and investors do not need to worry because our performance is good and our operation runs smoothly."

The business has not suffered as a result of this strange, but probably somewhat normal, relationship. They are able to deal with issues that come up and work well under pressure to ensure the business does not suffer. They realize they need each other for the greater good of the business and for each other's livelihood.

"We simply don't like each other anymore, but what are we going to do? Split the business in two? That is just something we are not going to do because it won't work for us," said the other partner, whom I will call Pete. "We both realize that no matter how bad it gets between us, at the end of the day we like what we do and know that we are better together than we would be apart."

A number of successful hedge funds have been dissolved because the partners could not make it work anymore and believed that they would be better off on their own. In few of these situations, the separated entities were as successful on their own as they were when together. The lesson from these examples is to figure out a way to make it work because the rewards are well worth it. You don't need to reinvent the wheel. You need to make sure it keeps going.

This situation with the preceding hedge fund partners is an extreme one. In most partnerships, things do not get so bad that the partners can't stand each other. Nonetheless, you and your partner or partners should have clear definitions of each other's duties, understand each other's capabilities, and realize each other's strengths and weaknesses. This is how you will be successful even when things become difficult. In the beginning, it will help you get the firm up and running faster.

ROLE DEFINITION

You must pay attention to the definition of duties. More important is defining and agreeing on who will be the senior partner, the person who is responsible and who has the final say or vote over all decisions. This area of the start-up phase often proves difficult, yet you must check your ego at the door and work with your partner or partners to determine who will be the senior person. If you do not define this role, getting things done will be hard when times are tough, and decision making could become difficult when the business is under stress. In the end, somebody has to have the final say or vote, and that person needs to know the other partners will support his or her decision no matter what it is. You need to have a captain.

This person is not always the one with the most money invested in the fund or the business. It can be someone who has the best skill set and experience. It usually comes down to the partner with the most at risk. I have seen a number of organizations that ended up being run by someone who is a junior financial partner but definitely the senior business partner. The choice needs to be made. It will be a hard one but one you have to make to get things going.

The fund lawyers will give you some advice on how to structure your partnership and will provide documents for governing the management of the partnership. Your personal legal counsel, someone you trust and who works for you, should review these documents. You should advise your partners to do the same. The person who reviews the partnership documents should not be connected to the business. Most likely, the fund counsel will not provide advice on these documents for individuals since it would be a conflict of interest. Therefore, get a fresh set of eyes to review the documents, one that is biased in favor of your needs and your family's needs. This person will make sure that your best interests are protected.

The partnership documents should address a number of serious issues, including, but not limited to, the death or disability of a partner and the compensation to the family. Everyone should be aware of what would happen to the partner's interest in the firm and how his or her family would be compensated should something happen. It will give all of you peace of mind and prevent the stress that accompanies these issues. Frequently, in the beginning, people choose to avoid these issues because they feel their business is not up and running or not successful yet so the work is unnecessary. This is not true. Deal with it. Spell everything out. Everyone must know where everyone else stands. Remember that you have responsibilities, so you need to be responsible.

Before you deal with all the nitty-gritty of getting started, you need to sit down and determine how much capital you can commit to the fund for its operation and investment. You will put together a business plan that outlines the costs associated with launching and running the fund complex. You will assemble an estimate of expected revenue. The revenue projections are simple if you use a simple management fee and incentive fee structure. Put all of this together to ensure you understand what you are committing yourself to financially and how much you may make when the venture succeeds.

There are usually two or three ways to do things in life. When it comes to setting up a hedge fund, you have two: on your own and as part of an institution. Since I believe most people look to do it on their own, I will cover that first. If you are looking to build a fund within an existing platform of funds or through an institution, please skip the next few pages.

To go on your own, you need a timeline that details the various steps you must take to get your business off the ground. A number of prime brokers put out brochures and materials on how to start. Most of that material is good. All of the prime brokers say that one of the first things you need to do to start is to pick your lawyer, your accountant, and your prime broker. If you are immediately building an offshore fund, you will need to find an administrator. However, the law firm will provide you with advice on this, so you may be able to put it off for a few weeks.

The resource guide at the end of this book has a list of service providers to whom you will need to talk to get the business running. Most of the data in this chapter have been compiled from web sites and publications deemed to be accurate. In some cases, particularly those of administrators, there may be inaccuracies or outdated information due to industry consolidation. Therefore, if you run into any problems finding specific service providers, please send me an e-mail at das@hedgeanswers.com, and I will provide you with the most recent information I have. All of the service providers in this book will be happy to meet with you to discuss your situation and plans.

I would suggest you first meet with a number of lawyers. Three should be enough to start. The reason for this number is that you want to be assured of the best execution and you want to make sure you get a good price. Remember, the hedge fund industry is a commodity business, and you should treat it as one when you are buying goods and services. This means you should demand good service at reasonable prices. If that is not what the firm seems to be selling, move on to the next one.

GETTING GOING

As you start your process, I suggest meeting with three lawyers and three or four prime brokers. Make sure they do what you do, meaning that if you are going to trade equities, then they should trade equities. Going to a fixed income firm will waste your time and theirs. Meet with three accountants. You should complete all of these meetings within the first week of your effort. At the end of the week, you should determine whom you want to see again, whom you don't want to see, and who is in the running for your business. By the end of the second week, you should have this completed and be on your way.

When you meet with the lawyers, ask them who is going to do the work, what it will cost, and when it will be completed. Most hedge fund lawyers are so experienced in preparing the documents that unless you are doing something different, the paperwork will be ready in 8 to 10 weeks. In terms of fees, you should expect to pay between $25,000 and $35,000 for the onshore fund and another $12,000 to $15,000 for the offshore fund. Some law firms charge less and some charge more. The key is to find a firm you like, that you feel comfortable with, and that meets your budget requirements. You will need to have accountants signed up almost immediately. Though you probably will not work that closely with them in the beginning, you will need to have them review your documents prior to finalization. This should cost you less than $2,000. It is important and worth it.

As for the audit and tax fees, the current going rate for a big firm is about $35,000, yet some smaller firms charge anywhere from $7,500 to $12,500. Keep this in perspective because it is a significant cost, no matter what the size of the firm you choose. The audit in most cases is done at the completion of your first year in business. This means that if you start the fund in October 2012, it will be in January 2014 when you will do the audit. Most likely, it would not make sense to audit a three-month record. So, you wait until you had a full year's performance under your belt. That means you will not have to pay the accountant for more than a year. However, if you start in May 2012, in January 2013 is when you will do the audit.

This means you will have to pay the accountant within seven months of opening your doors. This may mean you have to use a significant portion of your start-up capital to cover the expense. In light of the new regulations regarding registration, new rules may pertain to when a fund is audited. Your fund counsel will give you the most current information on this issue.

Once you figure out who your lawyer, accountant, and prime broker are going to be, the next thing you need to do is to look for office space and start thinking about human and nonhuman infrastructure. Office space is important because it will provide a clear and defined base for your operation. You will need to determine how many people you will need to get the business up and running and whether you should hire people immediately or wait until assets and fees come through the door.

If you are starting with less than $100 million in assets under management, you and your partner or partners should do most of the work to keep costs low and in check. If you are going it alone, however, you should hire someone to help you. This person will become a solid member of your team and will make the process run a lot smoother.

Most of the things that you need to do to get set up are relatively easy but tedious. You should know how things work so if you have problems, you know how to deal with them. Use the guidelines in the back of this book to help you identify items you need to address. It will help you figure out the steps you need to complete the launch sequence and have all systems go.

If you have more than two partners, you likely won't need to hire anyone except to satisfy your egos. If you think any job in your operation is beneath you or are embarrassed to perform any task related to your business, you are destined to fail. Many people starting out come from organizations with a big infrastructure and huge resources and don't have to work so hard on the things that make the business run. As an entrepreneur, this is not the case. You need to be in charge at all times. If you are unprepared to do that, I suggest that you stay at your current position.

One of the first jobs to fill is that of facilities manager. In this capacity, you will be in charge of finding office space and outfitting it with all the tools you need to succeed. Two schools of thought exist in dealing with office space in the hedge fund world: The first is to take advantage of what the prime brokers offer in their hedge fund hotels, and the other is to go out and find your own space. Cost and time should not be the deciding factors. You should create an environment in which you will thrive. If you are used to working in a big space with lots of people to talk to and exchange ideas with, then it might make sense to work out of one of the hotels or perhaps sublet space from another fund or money management firm. If this does not appeal to you and you work better without distractions or other people around, then getting your own space is probably the best thing for you.

Ultimately, you should choose a place you believe will provide the most comfortable work environment for you and where you think you will thrive. You should not make a decision based solely on the setup cost.

Most likely, you will save money by working out of a hedge fund hotel because of the scale of these operations. The prime brokers are buying everything in bulk and generally pass the savings along to the managers in their space. But remember that everything comes with a price. If you are in a prime broker's hotel, then you are going to have to trade with those people, borrow securities from them for your shorts, and pay them rent. You may be free to trade with whomever you want, but you will be expected to put business through their desks.

The one thing about going with a hotel is it can save time and the frustration that goes along with outfitting any piece of real estate. This alone makes hotels look attractive. In the hotels, everything you need is at your fingertips. For the most part, the facilities are nice, clean, and up-to-date. They offer you the ability to be up and running in a day or two. If you do it yourself, setting up the infrastructure will take longer and be more work. It will be more expensive in the short run because you will have to lay out working capital to cover the costs of computers, furniture, and other things you need to complete the space.

Either way is fine. In the end, it will come down to weighing the benefits of going with space that your prime broker has available versus going out on your own. You will need to see which makes the most business and economic sense for your operation. Then choose one and go with it.

STUFF TO DO

The problem with being an entrepreneur is you need to make and execute many decisions related to the business. These decisions may not necessarily relate to the money management side of the business. You will need to figure out insurance, rent, lights, phone, technology, furniture, business cards, stationery, and even coffee. These can be daunting tasks for the most qualified executives.

As an employee, you are used to having someone else do all of this for you, which provides you with the freedom to go about your business. Now the business of the business is part of your job. It can be difficult to juggle both. One of the best decisions a new fund manager can make is to find a partner who is a good, solid office manager, someone who has experience working with you, who knows your style, and who will fit into the new culture you are developing. The key to this hire is that the person is going to be given a lot of responsibility immediately. You must have a firm grasp of his or her abilities. More important, you must have faith and trust your partner will execute appropriately on your behalf and make good decisions you do not have to check.

Over the years, a number of managers I have talked to about how they got started in the business have said the biggest mistake they made from the outset was doing everything themselves. They all agreed what they have been good at is making money in the markets and what they have not been good at is the logistics of running an office. This led them to realize they needed someone to step in and fill this gap. The solution was a good administrative assistant.

"Our fund started off pretty small, and so we thought the right thing was to stay small in terms of staff. What we did not realize was all the time it took to get the everyday aspects of the business up and running smoothly," said a fund manager. "We spent as much if not more time working on getting our business up and running smoothly than we did managing the little money we had and prospecting for new investors in the first six months. It was a mistake. We should have hired someone to handle all that stuff for us so we could focus on managing money."

A lot of hassles and distractions go along with setting up your physical plant. In the beginning, it will look as though the pros outnumber the cons, but you need to go with your gut on this.

Our firm has gone through both. Having our own office—even though it was an absolute nightmare to complete the renovations and get set up—ended up providing us with a nicer and more functional space than the one we had in a hotel complex. We decided to go with a hotel to save time and money, and we used it as a stopgap position.

Whatever you choose to do will be fine. You can always choose to move. Irrespective of your office arrangement, you must pay close attention to your service providers. In this case, I mean the phone company, Internet service provider (ISP), and computer support staff. You need to ensure they can provide you with everything you need to get your business operational in a reasonable time frame. Make them give you a schedule and force them to stick to it. Nothing is more frustrating than wanting to do something and not being able to do it because a service provider is not ready. You need to know whom to call if you have a problem and need to get something fixed. Remember, from Chapter 1, the Nancy Havens story.

As an entrepreneur, you will be on the bottom of the list in almost everything you do in the beginning because there will always be someone bigger than you who needs help at the same time. It will be humbling at first, but the rewards that come with running your own shop will make it worthwhile. You will get the service you need, but you will get it when the service provider wants to give it to you.

Most prime brokers offer help in this area to make the transition smoother, yet it will be difficult and will take some getting used to. Regarding service providers, make sure of two things: Pay your bills on time, and deal with them directly. Regardless of what they do, treat people with respect. The old adage that you catch more flies with honey than with vinegar is true.

If you treat service providers the way you want them to treat you, then you have a mutually beneficial relationship. Don't be demanding and overbearing. They won't like it and won't want to service you. This means you will be down for the count until you find someone else to fix the problem. The last thing in the world that you want to have happen is to lose a trade or go without needed research because you irritated the tech-support personnel in the office. This is not what you should be worrying about as you build your business.

All of these issues fade away if you decide that you want to build your hedge fund inside an existing organization. Fortunately for you, you have many ways to do this, and this area of the industry is gaining in popularity.

MANAGER PLATFORMS

One type of organization that is offering platforms for new managers is the multi-strategy hedge fund firm. These fund complexes usually consist of a slew of traders who trade various strategies and instruments under a single umbrella organization. In most cases, the firm uses a risk model to determine its tolerance for various strategies and increases or decreases its allocation to the traders based on the firm's overall risk appetite. If you work in this type of environment, you are being a prop trader for a hedge fund. Even though some fund groups allow traders to set up their own structures within the complex, most do not. It is a good way to go if you are starting out and don't want to be bothered with all the bells and whistles that go along with launching a stand-alone organization. By working within an organization, the manager can accept money from internal and external investors. Consequently, you are not going out on your own when you work within an organization; however, it can be rewarding.

Another opportunity that exists for hedge fund managers is to work within an organizational structure that I call a "proprietary" fund of funds. In this situation, you as the manager agree to trade for the firm. In turn, the firm goes out and raises assets for you and runs all of the administrative aspects of the operation. Together, you split the fees; in most cases, it is 70 percent for you and 30 percent for the firm. There are situations in which the fee split is more in your favor. I would try for an 80/20 split, but it never should be lower than a 70/30 split. Most firms like doing this because it keeps their costs lower and allows them to offer multiple products to potential investors with little or no additional effort. Fund complexes usually will market you in two ways: as a part of their fund of funds or multi-strategy fund or as a stand-alone fund within their organization. In either case, all you do is trade the money and collect your fees. It can be rewarding for both you and the fund you are working with. However, be careful since these situations may not work out and end up with both parties being frustrated. Relying on the manager's marketing team to raise money for you is a mistake. You have to be out there. Just because it is built does not mean they will come. One thing is for sure: If you have good numbers and a sound strategy, you are sure to be disappointed if the manager's marketing team doesn't deliver the assets.

Over the past few years, I have heard from a number of people about the frustration they have felt working in the situation described above. They don't understand why the money doesn't show up.

"We did our job," said one manager who was part of a large multi-strategy platform. "They did not do a thing except come up with one objection after another about why it was our fault that no money was coming in. It was a total disaster. After we burned through our operating capital, we decided to unwind the relationship because it was clear that they could not do anything to help us grow."

Be careful, cognizant, and alert at all times. It will save you lots of trouble in the long run.

The third option is to go to a trading house or investment company that offers trading platforms for hedge funds. Trading platforms took off after the technology bubble burst, when a number of former day trading shops reinvented themselves as firms offering this service to budding hedge fund managers. Institutional investors noted the success many of these firms had, and they began to offer similar platforms to get managers up and running. Many of these shops continue to exist; however, in late 2009 and early 2010, the seeding of new managers all but dried up. It seems that many of the seeders realized they should focus their efforts on existing managers and seeding new unproven managers was too risky an endeavor. In 2011, some of the seeders once again looked at new managers, but like those looking for jobs on Wall Street during this time, there were more managers look for assets than investors willing to invest. There is no set structure or deal associated with seeding. The deals can come in all shapes and sizes. A deal can be done where a seeder provides some seed capital and allows you to build a business using their trading platform. You will work out of their offices, share ideas with their proprietary traders, and use them for the bulk of your order executions. In some cases, managers are asked to manage firm capital along with their fund assets. This can provide for a nice additional income stream. Operating out of one of these trading houses is similar to working out of a hedge fund hotel. However, you do give up some autonomy.

Another option many people are using to get their businesses off the ground is to work with a seeding company. These have been around for awhile. They offer start-up funds access to pools of capital. In most cases, the seeder will take a piece of the equity in your firm and will need to be guaranteed a certain level of capacity in the fund as it grows. These companies work with funds across all strategies and provide capital ranging in size from $1 million to $50 million. Seeders range in size and shape and include insurance companies, large hedge funds, large money management firms. Even an endowment decided to get into the business. It is a growing industry trend and one that is probably a good solution for most new managers looking for capital to grow their businesses.

If you are interested in learning more about seeders or the other platforms discussed in this chapter, you are welcome to e-mail me with your questions at das@hedgeanswers.com. I will provide you with information on organizations willing to work with these types of transactions and structures and give you answers to any specific questions you have about this aspect of the industry.

This chapter should have provided you with the insight and guidelines you need to start on your journey in the hedge fund business. Unfortunately, a lot of questions will come up before, during, and after the process of getting you into the hedge fund business. You will need to find good resources to provide you with answers. The person who has given me the best answers from a business perspective has always been my firm's accountant. Regardless of the issue or question, he has always been able to give me good, solid, tactical advice and provided me with the resources to make the best decision. Unfortunately, most lawyers are not businesspeople and, thus, usually are not good at providing advice about the business side of your enterprise. However, they will always keep you out of trouble and tell you when you are doing something wrong. Use both relationships wisely and you will find most of your answers. The rest you can make up as you go along. It is the only way you are going to learn the business.

CHAPTER 9

Perception versus Reality

Today is the first day of the rest of your life. Now what?

That is what you will think as soon as you decide to get into the hedge fund business. It is frightening and exhilarating. This is it. You have broken free of the corporate bonds and are out on your own. It is a great time. You are about to embark on a wild and exciting ride, and you are going to rocket to the moon or crash in the desert. You are one of the few and the proud, a person who chases dreams, an entrepreneur. All that is left is to build a successful business. That is a lot, but it is doable. There will be ups and downs throughout the process but fear not—keep your head up—shake off the dirt and move forward.

As you step out of the corporate world, you need to make sure you have a positive attitude and stay focused on the tasks. Feel good about your decision and be proud you took the plunge, but feeling good and being proud are not going to pay the bills or build your business. You need to pay attention, get things moving, and begin putting in place a plan that will provide you with success and, more important, an answer to the question, "Now what?"

In the hedge fund business, every day is the first day of the rest of your life. Performance is bad? Don't worry. You can make it up tomorrow. Cannot raise any assets? You will find a way to do it tomorrow or the next. If you get that through your head, you will succeed. Don't get discouraged because being discouraged leads to a lack of enthusiasm. A lack of enthusiasm can lead to depression, and that can lead to failure.

However, don't repeat mistakes, learn from them, and adjust accordingly. If something is not working, try it a different way. Don't get stuck in the mud; get through it and past it.

DAY 1

The first thing you need to do is ensure you don't buy into the theory that if you build it, they will come. This works only in the movies. Read the sentence 25 more times, and don't forget it. When push comes to shove, the only way you will be successful in this business is by working hard and going after it. Waiting for people to come to you will lead to failure. Hoping and expecting is for fools. If you don't believe the previous sentence, stop reading this book and go directly to the classifieds. You need to find a job.

Hard work does not guarantee success. It doesn't necessarily mean failure either. It just means that you are a hard worker. The key to success is to work hard and to work smart. By working hard and working smart, you will succeed.

Frequently, when people enter the hedge fund business, they think about several things that cause them to lose sight of what is important. They think about how much money they will make, what kind of yacht they are going to sail, how big a house they will own, what kind of art collection they will acquire, how much money they can give to charity so others can see how successful they have become, and what kind of cars they will own. Thinking about these things will lead to failure. Instead, you need to focus on three issues: raising assets, managing assets, and operating the business successfully. You need to ensure you have the staff, systems, and infrastructure in place to make the machine run smoothly and efficiently. Forget about the luxuries. These will come with time. Instead, concentrate on building a successful business and what you need to do to make this a reality.

Hal Holbrook, who played Lou Mannheim in Oliver Stone's film *Wall Street*, said to young Bud Fox, played by Charlie Sheen, after receiving an inside tip: "Quick buck artists come and go with every bull market. The steady players make it through the bear market."[1]

This is what you want to do. You want to be a steady player who builds something that lasts. Don't waste time on things that don't matter. Instead, stay focused on the business at hand, which is building your firm. Most people who start off building a business do not set out thinking they are going to become rich from their endeavor. Most think they are good at this, they can do it successfully; and it will allow them to do what they want to do with their time.

If you were to ask Ray Kroc, Warren Buffett, or anyone else we equate with success, about their thoughts on being an entrepreneur, I believe they would say they didn't start out to revolutionize the way people go to restaurants or set the benchmark for investors all over the world. I believe they would say they had an idea, believed in themselves, and went forward with it. That is what you are going to have to do as a hedge fund manager.

My recipe for successful hedge fund management—besides assets, strong asset management skills, and a solid infrastructure—includes the following: stick with what you know, adapt to change, and listen to ideas. Do not check your ego at the door. You are the same as nearly 10,000 people selling basically the same product to the same people, except for one thing: You are better than all of them. You are faster, better, and smarter than everyone else, and you want the world to know it. In this business, being an egomaniac is a good thing.

EGOS MATTER

Hedge fund managers who do not check their egos at the door are the ones who are successful and the ones who come out on top. The ones who do check their egos at the door are the ones who fail and end up waiting for something to happen. Remember: A watched pot never boils. This is kill or be killed. The question is this: Are you ready for combat?

I know some people are sitting at home reading this saying this must be false and this is not the way it works. Let me tell you something: Ask any hedge fund managers you know whether they consider themselves the best around. The ones who say no are the ones you don't want to invest with or emulate. The ones who say yes are the ones you want to invest with and learn from.

It is counterintuitive to the way we were taught the world works. This is why some hedge fund managers fail and others succeed. If managers have egos or a chip on their shoulder, it is going to be hard for them to see the truth or see what is going on. To some, that may be a problem. In reality, you need to be this way when you are in the marketplace looking for assets and managing money.

- You need to believe you are the best money manager in the world.
- You need to believe you can pick the winners and losers before everybody else.
- You need to believe you understand the yield curve better than everyone else and you understand the value of buying something cheap and watching it become expensive to profit better than everyone else.
- You have to think in your heart of hearts you are the best and you should be in the hall of fame, along with all the other great managers.

If you do not believe you have built a better mousetrap or figured out a better way to skin a cat, you will fail. The whole idea of this book is to get you to understand the steps and tools you need to be successful in the hedge fund business. The last few chapters are about what I call the bricks-and-mortar side of the business. This chapter is about the mental side of it. It should help you understand how to succeed, where success comes from, and how it can be used to make you a winner.

In the hedge fund business, success comes down to one thing: your ability to communicate to investors and potential investors that you have an extraordinary ability to find opportunities in the market and make money from them. This is the crux of everything you will do from now on. It is the thesis of offering documents, the backbone of your marketing presentations, and the thread that runs through every conversation you will have from this day forward. It is all about exploiting the markets and your ability to create profits from these opportunities. The question you need to answer is this: Do you have it in you?

The answer must be yes. How do I come to this conclusion? If you didn't, you wouldn't be reading this book. By buying the book, you have demonstrated you have at least the fundamental requirement for successful entrepreneurship: curiosity. The road ahead is going to be tough, but you will be able to travel it. I have been writing books on hedge funds and investment management for the better part of the last 12 years. My books are widely read and well-respected and that means a lot. However, what gets me going and excited and causes me to pitch new book ideas year in and year out are the readers. I love readers' feedback. On average, I get a dozen inquires a month from readers who have questions about launching and running a fund. I always return their messages with the best answers I can or point them to a resource to find an answer. Even though I appreciate the kind words, what is most interesting is the excitement they all seem to have for hedge funds. Every one of them is passionate about how they manage money or what they plan to do with their lives. This passion breeds success. As a reader of this book, you have the passion; find, harness and use it for your success.

THE ACTION PLAN

The first thing you need is an action plan. This will provide you with a road map for your business. The map must not be written in stone. It should be a fluid, movable document that allows you to see where you are going and prepare you to get there. Completing the journey should take about 12 weeks, the time needed to get the fund up and running after your initial conversation with your lawyer. Set a reasonable time frame and stay on track. The map should keep you focused on the task and guide you through the process. As part of their welcome package, some lawyers and prime brokers provide timelines and guidance on getting started. These materials will prove useful and effective as you launch the fund.

The best place to start is to decide what your capital needs are and the fund's source. Unless you make a seeding deal right out of the box, you and your partners will have to front all of the money. This is a good way to ensure everyone is honest and motivated. However, this could put a serious financial drain on you and your partners, and you might want to assess all of your individual needs, expectations, and wants to make sure you don't get stuck before you've started. If you don't have the financial wherewithal to get the fund up and running, don't get started in the first place. You need to make sure you have enough money to launch the fund and you and your partners have money in the bank to cover living expenses for at least the first year or so.

Once you decide on capital, the next thing to do is to pick a lawyer, an accountant, and a prime broker. Each will provide you with insight on various aspects of the industry that will be mostly good and will give you the tools to get the infrastructure of the business running. During the interview stage, talk to everyone you know about the industry and running a fund. You need to stay focused on putting together investor lists with current contact details so when you launch the fund you have some assets to manage.

The key here is to stay focused, use the time to plan, and act according to your map. During the prelaunch and launch phases, many new managers lose sight of the investor. Nothing is more important than having a list of potential investors ready to go and in the queue. When you come out of the gate, you will have people to talk to and some money to manage. Put a lot of effort into investor lists and marketing from the beginning of the process. It is never too early to start working on this area of your business. You will not regret it.

The way for me to illustrate this and other points relating to the fund's start-up and launch is by providing three case studies on hedge funds, one that failed and two that succeeded. In each of the case studies, the principals started with the best of intentions. They knew how to trade markets. They knew how to make money. They believed they knew what to do to succeed. However, as we shall learn in the pages that follow, each of them attacked the problems of raising assets and building a business differently. One decided to build a business in his home with a childhood friend. One decided to build a business with a partner who acted as financial backer. The third took his own personal wealth, which he accumulated in a successful run on Wall Street, built a small fund on his own, and found a seed partner.

CASE STUDY 1: The Manager Who Did Not Make It

The first story begins in a small town about 30 miles south of Boston, with a manager who had been trading stocks for a number of large Wall Street brokerage firms. He built a fine reputation for himself on Wall Street. Over time, he developed a successful methodology for navigating the markets on a daily basis, using his capital and the firm's. Over time, he made a lot of money for his firm and himself. After a few years, he decided to take his experience and put it to work in a hedge fund.

The manager, whom I will call Tom, partnered with a friend of his from high school, whom I will call Charlie. Tom believed Charlie would be a good chief executive officer (CEO) or chief financial officer (CFO), someone who could help him build and run the business side of things. This would allow Tom to stay focused on trading stocks and managing the portfolio. Tom decided that instead of commuting every day into downtown Boston, he would take a spare room in his house and turn it into his office. The rationale was that it was cheaper, better, and more efficient to build the infrastructure in his house than it would be to rent space and start from scratch. After a while, he built an addition onto the side of the house by closing in a deck. The operation looked as good as that of other start-up managers in more traditional office locations. It had phones, faxes, computers, a Bloomberg. He had basically everything at his fingertips he needed to trade and manage money. It offered Tom the ability to roll out of bed and be in the office and at his desk in a matter of minutes.

Having the office in his house proved to be a blessing and a curse. It was a blessing because he was able to spend time with his family and live a simple, peaceful life. It was a curse because investors generally did not take him or his operation seriously. Working out of his home became a hindrance to raising capital.

Tom started with $1.5 million of his own money and attracted a few investors who were friends and family. Charlie put in about a million dollars of his money. By the time the fund launched, it had approximately $3 million in assets under management. From the outset, the partners used well-respected and well-regarded service providers, including Goldman Sachs as their prime broker, GGK as their auditor, and Bingham as their law firm. Regardless of market perception, the business was a serious concern and, as a reflection of this, used serious service providers.

During the first six months of operation, the fund did well. The portfolio weathered the various volatility storms that hit the market and finished its first year of operations with strong numbers. In the second year of operation, Tom managed the portfolio well and finished the year strong. Unfortunately, during this time when the performance was strong, he was unable to attract new capital. A number of funds of funds and other investors seemed to like what he was saying during his presentations, believed in what he was doing, and appreciated the performance, yet when the investors did due diligence, they could not overcome the hurdle of Tom working out of his home. They did not respect him or his operation. They felt he was not serious about building a business, so they always passed on investing in the fund.

Tom's initial reaction was that once people saw his record, they would get over the hurdle of the home office and be convinced. Unfortunately, this was not the case.

"I thought people would see the track record and see that the fund was growing, and one thing will lead to another and the money will come in based on our performance," he said. "This was not the case. I kept hoping that the perception would change and that people would forget about the office and focus on the track record."

After three years, he decided to call it quits. During this time, he was able to raise only an additional $2 or $3 million. This was not enough to support the business or his family. Today, Tom works as an institutional salesman at a prime broker in Boston.

The problem was that Tom wanted to have his cake and eat it, too. He enjoyed working out of his home. He enjoyed that he could see his children off to school and greet them when they came home at night. He enjoyed that he was able to go to his son's baseball games in the spring and summer and to another son's soccer practice and games in the fall. Tom enjoyed that he was able to participate in his children's lives. He enjoyed that he could have dinner with his family, help his kids with their homework, put them to bed, perhaps watch some television with his wife, and then go back into the home office for a few hours and have everything he needed at his fingertips. He enjoyed the operation he had built and he enjoyed the lifestyle he was leading. The problem was he couldn't raise money.

The other problem was that he put too much trust and responsibility in Charlie. Charlie had little experience running a business and building a money management operation. What he did have was experience as an order clerk, a position he had held at a large institutional brokerage firm. Charlie knew how to traffic trades, check out at the end of the day, and make sure that trades were being properly credited and correctly accounted for. However, what he did not know was how to deal with infrastructure issues, which are the heart and soul of the hedge fund business and the core that everything is built around. A business needs to find someone to deal with these things on a daily, minute-by-minute basis. Charlie was not this guy. Needless to say, Tom became frustrated with the operation and with his friend.

However, his frustration existed on three different levels. He was frustrated that he had traded the markets successfully during one of its most volatile periods, yet no one seemed to care. He was frustrated that he could not raise assets despite having contacts on and around Wall Street. Finally, he was frustrated because the person he expected to be able to create, deliver, and run the infrastructure and build a business was failing and incapable of doing what needed to be done.

After three years of frustration, he began to question what to do and how to deal with it. Unfortunately, his decision was that it was not worth it to run the business any longer, and that it was better that he quit. The problem was that he could not fold up the tent and go home. After coming to the conclusion that he needed to shut it down, he worked for about another year to wind down the business and close up shop.

When he gave back the assets he had received from investors, he was able to do so with pride. All of them had made money with him. During his tenure as a stand-alone manager, he put up good, solid numbers and made money for his partners. He built it, but no one came.

Looking back on his experience, Tom told me that his real problem was not that he had an office in his house, but rather that he did not have a seed investor to give him critical mass. "If I had gotten someone with $10 or $20 million, other investors would not have cared about where I was running the firm," he said. "They would have seen that I had real money and would have been interested in investing. The location of the office would not have been an issue."

Along with not finding a seed investor, another error that he made was that he hired a friend. In fact, he calls it the biggest mistake of his life. "In retrospect, hiring Charlie really made no sense at all. I should have seen that going in, and I just missed it completely," he said. "It would have been better to hire someone who I did not know very well and, more important, someone with the experience I needed, rather than relying on a person who I thought it would have been fun to work with."

In terms of running the fund from his house, he does not believe this was an error. He thinks it was great, and he believes it allowed him to maintain a quality of life that few Wall Street and hedge fund people enjoy.

He says he has few regrets about not being able to run his business or build it into the type of organization he wanted to. He maintains shutting it down was the right thing to do. He thought there was too much stress being put on him as an entrepreneur and it would eventually affect his performance.

"I did the right thing by my investors, and that is all that matters," he said. "Having learned from my mistakes will let me be more successful and help me get back on track when the time is right. Someday, I will be running a fund again. It will take some time, but this time it will last a lot longer."

CASE STUDY 2: Understanding Roles

This is the story of two individuals: a marketing guy and an investment guy. The marketing guy knows next to nothing about managing money, and the investment guy knows little about raising money. So, they make a great pair.

The two worked in a large institutional brokerage firm for a number of years, and in this capacity, they became friends. The marketing guy had previously worked at a number of the big brokerage firms and had developed deep and solid relationships with people at those firms at the organization's highest levels. The money manager was previously at a large endowment, managing assets for them after starting his career working at the Treasury Department. In his early days, he spent a lot of time doing economic research and learning about interest rates, money supply, and the markets. When he went to the large endowment, he was given its fixed income portfolio and managed that for a number of years. He took a position at the brokerage firm running company and client assets. Through one of Wall Street's twists of fate, the two gentlemen landed at the brokerage firm and became fast friends. A few years into their working together, the firm was sold to a large domestic bank, and they were forced to leave. They decided their next move was going to be one in which they could not get fired. They decided to set up a hedge fund.

They understood that they had not yet made it on Wall Street, meaning that they hadn't amassed millions of dollars to launch a fund, and they hadn't amassed the financial wherewithal they thought they needed to run a business. As a result, they needed a money partner. They decided to harness some of the relationships that the marketing guy had with people looking for the chance to be entrepreneurs. They wanted to turn those relationships into a seeding opportunity.

These two gentlemen put together a business plan that detailed the marketplace opportunity, the upside for investors, and the upside for them. The plan included hypothetical examples of the strategy and provided simulated performance data. They used the document to go into the market with a clear and concise message and objectives. Through their relationships, they found a small family office in the Los Angeles area that was willing to become a partner with them and provide them with financial backing. The team consisted of the marketing guy, the money manager, and the family office that was going to provide working capital and infrastructure support. Together, the team would develop a business, and within a few months, the three partners launched their hedge fund.

One of the first things they did when they launched the business was to get the strategy running immediately. They started with about $5 million, primarily from the three partners and some outsiders, and they began trading from the first day.

"We thought it was important to get things going," said the money manager. "We did not want to wait, so we opened an account and started trading from day one. If we had a dollar, we would have started. The assets didn't matter. What we wanted was to build a track record."

By having the family office involved, the marketer and the money manager could concentrate on their specific duties and let their other partner run the business operation. The working capital the family provided was used to pay the lawyers, the accountants, and other start-up costs associated with the fund's launch. More important, the family provided the team with ongoing working capital that maintained the firm and its infrastructure, as well as to provide salaries while the fund was establishing itself.

Together, the three operated in sync. Each paid attention to his specific duties and focused on the tasks to get things up and running.

In the beginning, raising money was difficult. A number of people, specifically institutional investors, believed the marketing person and the family office had little or no interest in the hedge fund business and they had too many outside interests distracting them from spending time with the fund.

"People questioned our commitment," said the marketer. "It was very frustrating. We would go to meetings, explain the strategy, show them the record and the hypotheticals. They would get excited, and then all of the sudden, they started questioning whether we were serious, and we would spend the next half hour trying to convince them that we were focused on the fund and that we put our other interests aside."

However, the track record grew, and in the second year, the fund started attracting assets. The numbers drove investors to the fund. The fund went from having about $5 million the first year to around $50 million by the end of the second. Since then, things have progressed quite nicely. Over the past two and a half years, the firm has grown to about $350 million in assets under management. The reason for the partners' success is threefold:

1. The daily responsibilities at the organization were defined.
2. They had the financial wherewithal to meet all of their financial commitments without placing any stress on the business or the individuals.
3. They were consistent with their investment strategy.

By staying focused, being consistent, and having the money to weather the storms, the partners have become successful entrepreneurs and hedge fund managers. "We have been able to create a business base by paying attention to these three things," said the money manager. "More important, we stuck with our plan and we did what we set out to do."

These people attacked the business the same as you would attack any other type of business. They did not wait for things to happen; they made things happen, and it worked for them.

"We defined our responsibilities. We put together a real budget that had real numbers and put a plan together that would allow us to truly be successful," the marketer said. "Not only did we do it when we first started out but continue to do it today. We have added staff, and in turn spread out some of the responsibilities. But in the end, we all know where we stand and what we are working for and truly have our eye on the prize."

I expect that by the end of the year, the fund will have more than $1 billion in assets under management. The fund's track record is good, the management is stable, the strategy is easy to understand, and the whole thing makes sense. Over the past few years, the partners have hired additional staff to help them manage and run the business more efficiently. They have added a chief operating officer (COO), who deals with all client relations and all operational aspects of the business. They have added an analyst, who helps the money manager with the investment strategy, and they have added an office assistant, who handles all of the firm's administrative functions. The team totals six. It is successful, and investors and potential investors appreciate and respect it. Hedge fund investors are looking for funds that have a strong, well-thought-out organization and that offer good, solid numbers regardless of market conditions. When investors look at this fund, that is what they see. Because of this, the fund is attracting assets at a fast pace and is able to expand quickly.

CASE STUDY 3: The Manager and the Seeder

This is the story of a well-respected, well-received, smart investor who spent the first 10 years of his career after graduating from Harvard Business School managing money for other people. He helped many money managers earn a lot of money and decided it was time to go out on his own. When he did, he hired a good lawyer. He engaged a good prime broker. He retained a well-known hedge fund accounting firm, and he hired a good administrator. He took these four service providers and opened a small office in midtown Manhattan, and presto, his fund was in business.

Unfortunately, throughout his first year of operation, he did not gather any assets or gain any traction. He was stuck in a rut. There was more to the story of the fund than one guy in a room in Manhattan. He could not find anyone interested in learning about what he was doing or how he was doing it. So, he decided to spend his time looking for a seed investor, someone who could provide him with assets to jumpstart his business. It had been depressing, unsettling, and frustrating being unable to raise money.

"It was quite apparent early on that I did not know the first thing about raising assets and how to actually run the business of a hedge fund," said the manager, whom I will call Mike. "After a while, I realized that I had committed to the business, made the investment in the fund, and decided to gather as much as I could from friends and family, and then spend the rest of the time building a track record, which I thought I would be able to market and use to gather assets."

The first thing Mike did was to hire an analyst, a former colleague with whom he had managed money before and who understood his investment philosophy and strategy. Instead of hiring the person as an employee, however, he decided to make him a junior partner. After meeting with Mike, the analyst/partner realized they needed to make sure the fund had good numbers. He realized he would be responsible for doing the research, finding new ideas, and paying attention to many of the daily details of running a fund. The key to Mike's strategy was good research and follow-through with the companies they targeted for the portfolio.

"We work very hard looking for nuggets of information that we can turn into ideas," said Eric, who is Mike's partner. "My job is to not only assist Mike with what he is working on but to also work independently to find ideas that we can put into the portfolio. In the beginning, I was also the chief cook and bottle washer, meaning that I was responsible for a lot of the daily things that make the business run."

Mike believed that if the numbers were strong, the assets would come. "The only way people care about you is if you are able to put up good numbers," he said. "So, we work really hard at putting up good numbers. It may sound silly, but I think a lot of people are happy with mediocre numbers. That doesn't work for us."

The two spend a lot of time developing a portfolio that has performed well, regardless of the way the market moves. They try to buy cheap businesses and to short fraudulent businesses. That is their story, and it's what they do to make the portfolio work for them. Throughout the first year of operation, the fund did well. The two put up good, solid numbers, and people began to take notice.

In the second year, they discovered that numbers were not driving assets and found it difficult to raise money. Mike decided to go after alumni from his days at Harvard Business School. He talked to as many people as he could and tried to find people to invest in the fund. He expanded his network to find a seeding partner.

"We talked to so many different people—famous money managers, not famous money managers, respected money managers, disrespected money managers—all around the country, all around the world, the conversations were really endless," he said. "We met with people looking to be seed partners, and finally we made a deal with a group that most people would never have thought would seed a start-up fund."

Mike found a well-respected, large hedge fund to put up $5 million, with an additional commitment of $15 million if he proved himself. The hedge fund was looking to expand its research and analytical tools and realized that by seeding this de novo hedge fund, it would have access to new money management talent and to Mike's ideas, which had the potential to become part of the firm's own portfolio.

"They bought into us because they believed that not only would we do good things with their money but that we would also provide them with ideas for their portfolio," Mike said. "It turned out to be a win-win for both of us. We get a well-heeled investor who made a substantial financial commitment to help us build the business, and they get an outlet for ideas that can help them with their portfolio."

Initially, this seeder came up with $5 million, and the fund jumped from about $1.5 million to $6.5 million. The initial $5 million was a test, and once Mike and Eric proved themselves, the seeder gave them an additional $15 million, and the fund's assets crossed the $25 million mark. At $25 million, the fund started sparking the interest of potential investors, who saw that the numbers were strong, and the fund was delivering on its strategy. Slowly, assets began to come in. Within five years, the fund went from $1 million to more than $100 million.

"All we have done is to deliver on what we said we were going to do, which was to employ a deep value, long/short strategy that shorts frauds (fraudulent companies)," said Mike. "Benjamin Graham, Warren Buffett, and Scott Black. We took all the things that these guys have proved to work, regardless of market conditions, and we do the same thing on a day-to-day basis."

Mike and Eric built a good business based on sticking to what they knew worked. They realized it was going to be difficult. They realized the only way they could build their business was to build it alongside someone else. Thankfully, they found a good seeding partner who was able to kick-start their organization and set it on the right track.

As a fund manager, your job is to determine what is going to allow you to build a successful business. The only way you can do that is through the development and implementation of a reasonable and solid business plan. The plan should allow you to build a business that will stand the test of time and the markets and will allow you to make money for your investors, you, your partners, and the people who work for you. That is your job.

I hope that in the last few chapters you have learned what you need to do to get started, launch your fund, and run your business. I set out to teach you what you need to do to build a fund, to identify markets that assets will come from, and to make decisions about how to build your business. That has been this book's goal. If you have any questions about what you have read, e-mail me at das@hedgeanswers.com. I would be happy to answer all of your questions.

The future is bright for the hedge fund industry because many smart people have realized the only way to make money in the market is to have tools available to investors as arrows in their quivers. The only way to do that is to be able to go long and short with the market. Hedge funds provide the managers with the necessary structure to perform regardless of market conditions. Investors need to have good numbers regardless of whether the market rises or falls. Hedge funds are the only way to achieve these goals. You have realized that the future is about being able to go long and short with the market. That is the journey you are embarking on, and it is the journey that will bring you success as you build a thoughtful and well-run organization.

APPENDIX A

Hedge Fund Litigation*

Scott M. Berman

Scott M. Berman is a partner at Friedman Kaplan Seiler & Adelman LLP in New York City and represents large investors in securities and fraud litigations involving hedge funds and their auditors, administrators, prime brokers, and other professionals (e.g., Madoff feeder funds, Lancer, Beacon Hill, Lipper, Livingston, Granite, Manhattan). He also represents hedge fund receivers and liquidators (e.g., Carlyle Capital Corporation Limited (in liquidation) and Beacon Hill), as well as hedge fund investors in bankruptcy and receivership proceedings (e.g., Bayou, Wood River) and other matters (e.g., Amaranth). In addition to his litigation practice, Mr. Berman counsels hedge funds, funds of funds, and investment managers. He is frequently quoted in the financial press on hedge fund–related issues.

INTRODUCTION

Hedge funds, like all industries, are involved in commercial and employment disputes. However, areas of disputes and litigation are more specific to hedge funds, their managers, investors, and service providers. When a hedge fund collapses, claims may be brought by investors, a receiver or a Chapter 11 bankruptcy trustee, the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the fund itself, or its investment manager. Claims may be brought against the fund, its investment manager, its auditor, its administrator, its prime broker, investors that redeemed their investments before a collapse, and trading counterparties.

* Mr. Berman gratefully acknowledges the assistance of Robert S. Landy, an associate at Friedman Kaplan Seiler & Adelman, in preparing this appendix.

Furthermore, claims may be brought in U.S. federal courts, state courts, foreign courts, or in arbitration.

Though hedge funds, their managers, investors, and service providers encounter myriad problems and disputes, few garner significant public attention. Hundreds (perhaps thousands) of funds close their doors each year. Most of them we hear nothing about because they have orderly liquidations or winding up processes, and investors' money is mostly returned.

However, within the past two decades, certain hedge funds and their managers have failed spectacularly enough to distinguish themselves in infamy, attracting the attention of the market, the financial press, the SEC, the CFTC, Congress, and, if they have lost enough money, the front page of the financial press. A number of common themes arise in litigation from these hedge fund failures. The litigations have many variations. However, hedge fund litigation tends to resemble one or more of three archetypes:

Manager Fraud Litigation: Litigation concerning fraud committed by a hedge fund manager usually involves some or all of three basic factual scenarios: (1) fraudulent reporting of a fund's value, or "Valuation Fraud"; (2) fund management that conflicts with strategies described to investors and potential investors in a fund's marketing materials (which I will refer to as "Strategy Fraud"),[*] or (3) pure Ponzi schemes.

1. *Valuation fraud* cases often involve funds that start with legitimate trading and valuation and become fraudulent when a manager seeks to hide losses. These cases can quickly evolve into Ponzi schemes as the manager is forced to pay off redeeming investors at inflated net asset values (NAVs) and must use other investors' invested capital to do so.[†] To report a fraudulent value to investors or potential investors, a manager must fabricate financial statements (which includes convincing auditors and administrators to rely on inflated values for positions

[*] Strategy fraud is the term I am using to describe a manager's intentional and significant deviation from a fund's advertised strategy. "Style drift," which may be unintentional, can give rise to negligence claims.

[†] Some managers who engage in this behavior may do so with the honest, but greatly misguided, intention they will cure their funds of fabricated gains by fabricating offsetting losses in better times. Some managers have almost done this and escaped detection. Well intentioned or not, this behavior is fraudulent and a violation of federal and state laws.

in the fund's portfolio) or must engage in manipulative trades to create inflated values based upon seemingly independent sources.

2. *Strategy fraud* cases occur when a manager is intentionally not following the investment strategy described in a fund's offering memorandum. The conflict between the advertised strategy and the strategy employed frequently involves a substantial and concentrated exposure to a particular risk where the fund's offering materials advertise diversification and limits on concentration or explicitly pledge to avoid exposure to the risk the manager bets the house on, such as interest rate fluctuation. In addition, strategy fraud often occurs in conjunction with valuation fraud, where a manager begins concealing losses incurred with the advertised strategy (thereby falsely suggesting to investors the strategy is succeeding) and then engages in strategy fraud, aggressively, in search of substantial and quick gains to "right the ship." When the manager's aggressive and undisclosed "plan B" fails, leading to further losses, more pervasive valuation fraud can occur as the fund heads into a downward spiral. If redemptions occur during this period, the problem is exacerbated because, to maintain the appearance of success, the redemptions must be paid out at the artificially high rates the manager is reporting while the fund is simultaneously incurring substantial losses.
3. *Pure Ponzi scheme* cases are the most sinister and receive the most publicity. In these cases, the fund is a sham, and the manager diverts investors' subscription money to the manager's own personal accounts or interests as opposed to investing it as advertised. Investor communications regarding purported performance of the fund are completely fabricated. Returns are fictitious. When investors redeem, they are paid in accordance with a fictional NAV with other investors' money. Managers work to discourage redemptions as much as possible, often by reporting unusually high or consistent gains.

   Unlike valuation fraud, which can theoretically escape detection if offsetting real gains saves the fund, Ponzi schemes all eventually collapse. The fraud is discovered and authorities intervene, or the scheme collapses when the manager doesn't have enough money to pay redeeming investors. Ponzi schemes, unlike valuation fraud and *ultra vires* trading, aren't particularly unique to the hedge fund and investment management industries.

Manager fraud cases are sometimes sensational and tend to receive more media attention than other types of hedge fund litigation. However, by the time litigation concerning manager fraud is initiated, the fund and its manager are often insolvent. Therefore, manager fraud cases are frequently asserted against hedge fund managers, solvent service providers, and other third parties based upon those entities' involvement with the manager's fraud.

Clawback Litigation: Clawback litigation is typically brought by the receiver or bankruptcy trustee of a fund against investors who redeemed before the fraud blew up. The goal of such litigation is to spread losses more evenly among all investors affected by a fraud by clawing back false profits and redistributing the estate assets more evenly among all affected investors, *pro rata*. Of course, where a fund collapses for legitimate reasons (i.e., losses on investments that are disclosed to the investors at the appropriate times), then clawback claims are inappropriate. Clawback litigation has changed in the past five years. The traditional theory of such cases is that when the redemption price that the redeeming investors received was artificially high due to a fraud, investors should be required to return that portion of their redemption payout that represents fictitious profits above the investors' principal investment. However, in the past, investors would not have to pay back withdrawn initial capital.

After the Bayou funds collapsed in 2005 (discussed further on), the receiver and the court took the position that initial investments as well as false profits could be clawed back unless the investor could show the funds were withdrawn in good faith. A similar position has been taken in a highly publicized battle between Irving Picard, who was the Securities Investor Protection Corporation (SIPC) receiver of the Madoff funds, and Fred Wilpon and Saul Katz (Madoff investors and owners of the New York Mets). Picard's argument is that Wilpon's and Katz's redemptions were not in good faith.

Margin Call Litigation: Margin call cases tend to pit the manager and/or the fund against the fund's prime broker. Many funds have leveraged portfolios and trade on margin as part of their strategy. Funds often enter into margin agreements with their prime broker to borrow against securities posted as collateral to further fund investment activities. Under these agreements, the prime broker is permitted, under certain circumstances, to make a margin call. If the prime broker properly makes a margin call, the fund is required to repay the borrowed funds or forfeit the collateral, which the broker sells to satisfy the debt.

Margin call litigations typically involve two types of accusations. In the first, the prime broker made an inappropriate margin call, thus harming or destroying the fund's business. In the second, when the prime broker seized the posted collateral, it sold the securities to itself or others at an unfairly low price. Margin call litigation can involve either or both of these theories.

OVERVIEW OF HEDGE FUND BLOW-UPS

In this section, I will survey the most spectacular hedge fund blow-ups that illustrate many common themes.

Year: 1994

Fund: Granite Partners, LP, Granite Corporation and Quartz Hedge

Fund Manager: David Askin

Litigation: Manager fraud litigation (valuation fraud and strategy fraud) and margin call litigation

The first serious hedge fund blow-up was the 1994 demise of the David Askin–managed Granite Funds. The funds purportedly invested in high-quality collateralized mortgage obligations (CMOs). The manager represented that the strategy would be "market neutral" (e.g., would make money whether interest rates rose or fell) with low leverage and that he used state-of-the-art analytics. Most important, there were representations that the portfolio would be marked (or valued) for NAV purposes by the manager in good faith, using dealer prices. (CMOs are not publicly traded and values can only be established through market makers and pricing services.)

Instead, the manager invested heavily in thinly traded CMO products that were sensitive to interest rates and mortgage prepayments. In addition, the Granite Funds were highly leveraged. The portfolio was volatile and, if properly marked, would have shown some months with gains and many with losses. Instead, the manager reported smooth positive returns of 1–1.5 percent per month.

Askin allegedly engaged in a pervasive valuation fraud by convincing certain broker/dealers to change their marks (thus enlisting their aid in concealing the Granite Fund's losses) to show a gain in the NAV instead of a loss. Some of these conversations were internally taped by certain dealers.

In addition to the pervasive valuation fraud, and misrepresentation of the fund's strategy, the manager had crude analytics. The bankruptcy trustee found no evidence of the complex models the manager claimed to have and use to predict the return that certain complex mortgage derived products could be expected to generate.

The funds collapsed when the counterparty dealers, which had extended leverage to the funds in the form of repurchase agreements, made margin calls which the funds could not meet. After the dealers seized and sold the collateral (much of it to themselves without an adequate auction), an involuntary bankruptcy proceeding was commenced by the dealers and a trustee was appointed.

The bankruptcy trustee did an investigation and a massive report. A litigation advisory board was created from the bankruptcy estate to pursue litigation claims on behalf of the funds (with proceeds ultimately to be distributed to investors).

The litigation fallout was substantial. Valuation fraud and strategy fraud claims were brought against the manager and the service providers. Investors made direct and derivative claims against the broker/dealers and the manager. Most of the investors sued as part of a large group. Several class actions were filed. Eventually, the various litigations were settled, with a substantial return to investors. The manager signed a consent decree with the SEC, enjoining him from future securities violations and left the securities business. The manager was never criminally prosecuted nor was any of the other participants in his fraud.

In addition, there was margin call litigation. The litigation advisory board brought an action against many of the fund dealers that provided margin for, among other things, improper margin calls and improper liquidation of the seized securities at below market prices. These claims were settled with substantial payments made by the dealers to the estate.

Year: 2000

Fund: Manhattan Investment Fund

Manager: Michael Berger

Litigation: Manager fraud litigation (valuation fraud and strategy fraud)

In 2000, the Manhattan Investment Fund, managed by 28-year-old Michael Berger, blew up. The manager's strategy was to short-sell technology stocks (a questionable strategy in 1999), and the fund lost money from inception. To conceal these losses, the manager fabricated account statements that misled investors to believe the fund had annual returns from 12 to 27 percent. By August 1999, Berger was reporting to investors that

Manhattan Investment Fund had a net market value of more than $426 million in assets when, in fact, it was worth less than $28 million.

Although Bear Stearns was the prime broker, Berger employed another small broker/dealer in Ohio and worked with its personnel allegedly to fabricate a set of account statements that differed tremendously from the account statements produced by Bear Stearns. These statements were given to the auditor and the administrator. The auditor and the administrator saw both sets of the conflicting statements but were allegedly persuaded by Berger to use the fabricated account statements to calculate and distribute NAV statements and to support the year-end audits. The scheme unraveled when Bear Stearns reported problems it was seeing to the SEC.

A Chapter 11 bankruptcy trustee was appointed. Because the fund was an offshore vehicle, offshore liquidators worked cooperatively with the trustee. The manager pleaded guilty to securities fraud in 2000 and tried to reverse his plea in 2002. He fled the United States in 2002 to avoid prison but was captured by Austrian authorities in 2007 (after being pulled over for speeding outside Vienna).

Again, the litigation fallout was substantial. Investors brought "manager claims" against the auditor, the parent of the auditor, the administrator and its affiliates, and the two broker/dealers. The manager was not sued because there was an injunction issued by the court against suing the manager and, as a practical matter, there was little utility is suing the insolvent manager.*

The auditor and administrator settled with the investors, and the claims against the Ohio broker/dealer were abandoned due to the entity's insolvency. Bear Stearns succeeded in having the aiding and abetting claims against it dismissed because its alleged failure to enforce the terms of margin agreements didn't constitute substantial assistance of the fraud,† and its conduct was not the cause of Berger's scheme.

The bankruptcy trustee pursued fraudulent conveyance claims against Bear Stearns in connection with margin trading. Bear Stearns ultimately

*The SEC commonly seeks, and federal courts to issue, injunctions that prevent investors from suing a fraud-committing investment manager while the SEC is pursuing an action based upon the same conduct. Such injunctions often direct that all federal litigation concerning a particular fraud be brought in the same court so one judge can oversee the big picture. These injunctions are referred to as "channeling injunctions."

†As discussed further on, the main theory whereby investors can sue a prime broker is aiding and abetting the manager's fraud. Substantial assistance is a required element of an aiding and abetting fraud claim. In this case, plaintiffs argued that were the margin agreements enforced, it could have halted the fraud.

succeeded in dismissing these claims by showing that it had acted in good faith.

Year: 2001

Fund: Lipper Convertibles, LP, Lipper Holdings, LLC and Lipper & Co., LP

Managers: Ken Lipper and Edward Strafaci

Litigation: Manager fraud litigation (valuation fraud) and clawback litigation

Ken Lipper was the owner of the management company of the funds. Edward Strafaci was the director of fixed income for the firm and its chief compliance officer (COO). The funds principally owned convertible securities on leverage, which they supposedly hedged in various ways. Though Lipper was the well-known name, the decisions that brought down the funds and the concealment of the funds' losses were Strafaci's work.

Lipper was well-known (as a former deputy mayor of New York City and the coauthor of the screenplay for the 1987 movie *Wall Street*, starring Michael Douglas and Charlie Sheen). Lipper's fund attracted investments from well-known Hollywood figures such as Julia Roberts. The world for Lipper abruptly changed in 2002 when Strafaci abruptly resigned and reported that the funds were worth 40 percent less than they had been the prior month. In 2004, Strafaci pleaded guilty to securities fraud and went to prison.

A 40 percent loss hadn't occurred between January and February 2002; instead, Strafaci had been inflating the value of the convertible bonds and preferred stock in the portfolio for years. Those artificially inflated performance figures were given to investors, prospective investors, and the SEC.

A special liquidating trustee (SLT) was appointed in New York State Court pursuant to the fund's LP agreement. Many litigations ensued on manager fraud and clawback theories: The SLT and individual investors sued the auditor and manager for negligence and malpractice (though many of these claims were removed to arbitration). The trustee brought claims against redeeming shareholders to claw back fictitious profits. An arbitration occurred between the SLT and Lipper for payments that the SLT allegedly failed to pay Lipper. Litigation occurred among investors concerning the plan by the trustee to make payments to investors and whether those payments should be based on NAV at a particular time. A key theory in all the claims against Lipper was that he failed to adequately supervise Strafaci and the funds' auditor. Investors' claims against the auditor were dismissed for insufficiently specific allegations of reliance on the auditor's statements. The SLT's claims against the auditor were settled.

Year: 2002

Funds: Beacon Hill Master, Bristol, Safe Harbor, and Milestone

Manager: Beacon Hill Asset Management LLC

Litigation: Manager fraud litigation (valuation fraud and strategy fraud)

Beacon Hill managed onshore and offshore funds that invested in CMOs. Its marketing materials advertised that the manager used a market-neutral hedging strategy to insulate the funds from interest rate variations and mortgage prepayments. The funds invested almost exclusively in inverse floaters. These securities are not market neutral and represented a directional bet that interest rates would fall, but that this drop wouldn't result in debtor refinancing (which destroys the income stream from the debt that is prepaid in the refinancing). Beacon Hill established a substantial short position in Treasury securities as a hedge against rising interest rates. This hedge didn't protect the fund from losses due to homeowner refinancing.

During 2002, interest rates fell, but there was a wave of refinancing and the portfolios lost 54 percent of their value. To conceal its losses, Beacon Hill manipulated its valuation procedures for Beacon Hill Master, Ltd., the parent fund that held and traded securities. This artificially inflated the prices of the securities in the Master Fund and the feeder funds, Bristol, Safe Harbor, and Milestone.

In October 2002, Bear Stearns, the funds' prime broker, determined that the funds were worth substantially less than what the funds had reported to investors and informed Beacon Hill. Within three weeks, Beacon Hill disclosed a 54 percent loss to its investors and the SEC.

Insolvency proceedings were brought in the Cayman Islands and liquidators were appointed. The SEC commenced an action against the manager and sought the appointment of a receiver for the onshore feeder funds. The Beacon Hill debacle led to various investor and receiver litigations. There, litigants alleged the manager's false valuations were aided by broker/dealers' collusion in providing pricing for the portfolio and that the manager gave these manipulated valuations to the administrators and auditors who allegedly accepted the marks without question. The actions were settled with the manager (and its principals and parent) and the broker/dealer. Claims against the auditor and administration were dismissed.

Year: 2003

Fund: Lancer Offshore, Inc., the Orbiter Fund, Ltd., the Viator Fund, Ltd. and the Omni Fund, Ltd.

Manager: Michael Lauer

Litigation: Manager fraud litigation (valuation fraud and strategy fraud) and clawback litigation

The strategy of the Lancer Funds was purportedly to invest in small-cap and mid-cap "fallen angels," which Lauer described as companies that had experienced negative events but whose share prices had fallen disproportionately low. This strategy may have begun as a legitimate strategy when the Lancer Offshore Fund opened for business in 1996. However, in the late 1990s, the manager began acquiring large quantities of unregistered stock and warrants of micro-cap companies for pennies per share in private transactions. He traded small quantities of registered securities of the same issuers through over-the-counter (OTC) exchanges at prices that vastly exceeded the average per-share purchase price of the funds' privately acquired positions. In more egregious cases, the Lancer Offshore Fund bought OTC shares of certain issuers for more than 500 times the average per-share price of the funds' position in privately acquired securities.

Lauer then marked the value of all the securities in the funds' portfolio at prices from the low volume OTC transactions, creating the appearance of incredible appreciation. Many of these "market" trades were allegedly made between the manager and "friendly" counterparties or between two "friendly" counterparties at Lauer's request.

The auditor and administrator allegedly ignored red flags including two conflicting position reports. The manager created one using a computer system provided by the prime broker for use by the manager. With the other conflicting report, the prime broker generated regular account statements. The administrator allegedly relied on the OTC trading prices as "independent values" for the publicly traded and privately placed securities as was the manager's intention.

In the spring of 2003, the manager put the Lancer onshore fund into a voluntary U.S. bankruptcy proceeding after rumors of a potential fraud began to circulate and a major investor redeemed. When it became apparent that misconduct had occurred, the SEC sued and a federal court in Florida appointed a receiver for the offshore (BVI) fund and petitioned the bankruptcy court to have the receiver put in charge of the onshore fund's bankruptcy. The British Virgin Islands (BVI) authorities deferred to the SEC.

Actions were commenced by a group of investors (originally in Florida and then moved to New York), by a class in Florida, and by the receiver in Florida. Claims were brought against the funds' New York–based prime broker and auditor and administrators located in the Netherlands Antilles and Ireland. The Florida federal court where these actions were commenced issued an injunction preventing any claims from being made against the manager. The SEC brought a civil action against the manager and the Department of Justice brought a criminal action several years later. The receiver brought clawback claims against people who received money from the fund as well as other litigations. The claims by the group investors resulted in settlements, and the other litigations were settled. The SEC succeeded in its civil action against Lauer for securities fraud, obtaining a judgment against Lauer personally for $62 million though Lauer may be effectively judgment proof. Lauer was acquitted in his criminal trial.

Parenthetically, the same year the Lancer Funds blew up, the Dobbins Fund blew up. The facts were similar to the Lancer case in that Robert Dobbins, the manager, was accused of valuation fraud by allegedly inflating the value of thinly traded and non-publicly traded stock. There were allegations that the administrator and the auditor recklessly and negligently failed to independently value the positions. Unlike the claims in the Lancer cases, Dobbins was accused of causing the Dobbins Fund to pay unnecessary commission payments to a broker, who then kicked back a significant portion of the commissions to Robert Dobbins. The SEC brought an action in Texas federal court and a U.S. receiver was appointed. Investors brought claims in the same court against the fund's BVI-based auditor and administrator. The investor claims against the auditor and administrator were dismissed for lack of jurisdiction. The receiver brought clawback claims against certain investors. The SEC obtained a preliminary injunction freezing all of Dobbins's assets. This injunction has been amended over the years but the SEC case has stalled as the receiver winds up the affairs of the estate.

Year: 2005

Fund: Wood River Partners, LP, and Wood River Partners Offshore, Ltd.

Manager: John H. Whittier

Litigation: Manager fraud litigation (valuation fraud and strategy fraud)

Between 2003 and 2005, investors placed tens of millions of dollars in the Wood River Funds based on statements in marketing materials that the investment strategy featured broad diversification and that an auditor would closely monitor the funds. The investment manager represented that the funds' maximum concentration in any one stock would be no more than 10 percent of total assets. However, the manager invested 65 percent of the funds' assets in one small-cap stock, EndWave Corporation, such that the funds amassed more than 45 percent interest in EndWave.

No audits were performed. The manager reported false valuations, stating the fund was increasing in value and outperforming the S&P 500 Index. Instead, the fund was principally invested in one small-cap stock and the value of that position had decreased. In late September 2005, the SEC commenced an investigation into allegations that the Wood River domestic fund had been unable to honor redemption requests. The SEC filed a fraud suit against the manager. A receiver was appointed. Several domestic investors sued the prime broker and the law firm that was involved in setting up the fund in New York State court. The claims were dismissed.

Year: 2005

Fund: Bayou Hedge Funds

Manager: Samuel Israel III

Litigation: Manager fraud litigation (valuation fraud, Ponzi scheme, and strategy fraud) and clawback litigation

Prior to Madoff, the scheme conducted by Sam Israel III under the guise of the Bayou Hedge Funds (Bayou Funds) was the most notorious hedge fund fraud. Shortly after the Bayou Funds were set up, they began to sustain large losses. The manager concealed these losses by knowingly misrepresenting the funds' performance in monthly statements. The manager created a fictitious accounting firm and fabricated audit reports to perpetuate the fraud. Although Spear Leeds (a Goldman Sachs affiliate) was the prime broker, the manager traded securities through Bayou Securities (which was owned by the manager) and made millions in commissions.

A U.S. bankruptcy was filed by creditors of Bayou. The bankruptcy trustee commenced a number of fraudulent conveyance actions against investors to claw back distributed monies. Most redeemed investors settled these actions. Seven large investors contested the clawback claims arguing they redeemed in good faith and could not have known of the fraud. The Bayou estate prevailed in bankruptcy court and in a subsequent federal jury trial (that was held due to an appeal of the bankruptcy court decision). In total, the trustee recovered $75 million in clawbacks to redistribute among the investors. These claims marked a turning point in clawback litigation as the large investors were required to return false profits and capital investments.

As part of the litigation fallout, claims were brought against the Hennessee Group LLC. The Hennessee Group had been hired by South Cherry Street, LLC, as an expert advisor in evaluating hedge funds and performing due diligence on South Cherry investments and potential investments. South Cherry Street sued the Hennessee Group for breach of contract and securities fraud on the theory that Hennessee could not have performed the diligence it promised to perform because it would have uncovered the more egregious Bayou problems, such as Bayou being unaudited. The breach of contract claim was dismissed because it was an oral contract and, thus, violated New York law that requires that long-term agreements (that cannot be performed within one year) are unenforceable if not in writing. The securities fraud claim was dismissed because the plaintiff could not allege facts that would support the conclusion that Hennessee knew of the Bayou fraud or recklessly disregarded facts. New York common law negligence was held to be preempted by New York's Martin Act.*

In addition, Bayou's unsecured creditors brought an arbitration against the fund's prime brokers, alleging that the defendants, as Bayou's prime broker, had a duty to investigate certain indicia that the fund was perpetrating a fraud and report the same to investors. The arbitrators ordered the prime broker to pay claimants the entirety of their claims, nearly $20.6 million. Interestingly, this action might have been dismissed if it had been tried before a judge.

The managers were criminally prosecuted and, in a well-known news story, Sam Israel III faked his own suicide.

Year: 2005

Fund: Philadelphia Alternative Asset Management

Manager: Paul M. Eustace

Litigation: Manager fraud litigation (valuation fraud) and clawback litigation

Another widely publicized fund blow-up in 2005 was the Philadelphia Alternative Asset Management managed funds. Unlike most hedge funds

*As noted further on, the judge-made rule that the Martin Act preempts certain actions relating to dishonest behavior in connection with securities transactions was later abolished by New York's highest court.

that trade in equities and structured debt products, the Philadelphia Alternative Asset Management managed funds were invested in commodities. The manager produced fictitious account statements purporting to show the funds were making money when they were suffering losses. He did this by maintaining two trading accounts, one of which was concealed. Eustace, the funds' manager, manipulated these accounts so only the profitable trades were visible. Man Group, a group affiliated with the manager that served as the prime broker for the fund, allegedly allowed the manager to hide the losing trades in an undisclosed account. Actions were commenced by the Department of Justice and the CFTC for commodities fraud. A U.S. receivership and offshore liquidators were appointed. The Man Group was sued by the receiver and investigated by the CFTC on suspicion of aiding the manager's creation and dissemination of fictitious account statements. In 2007, the receiver settled with Man Group and the CFTC.

Year: 2006

Fund: Durus Capital Management LLC

Manager: Scott Sacane

Litigation: Manager fraud litigation (valuation fraud)

The Durus funds story is peculiar. Like Lancer, a primary component of the manager's alleged fraud was to secretly acquire controlling stakes in portfolio companies to be in a position to manipulate their share prices. However, in the case of Durus, the portfolio companies were not mere shells. When the alleged scandal was exposed, the portfolio companies' stock fell by more than $300 million, causing huge losses to the fund. The manager failed to make required filings with the SEC, made false statements to prevent others from selling their stock in the companies, and made false statements to the companies to prevent them from implementing their poison pill provisions. The SEC uncovered the stock manipulation, but with help from an unlikely source, the Federal Trade Commission (FTC).

One of the interesting facets of the Durus story is that the manager, in amassing controlling stakes of three biotech companies at different times, effectively merged them with the fund. In a then-new interpretation of its regulatory authority, the FTC and the Antitrust Division of the Department of Justice investigated Durus for violation of the Hart-Scott-Rodino Act, which requires merging companies over a certain size to file for approval with the FTC's Pre-merger Notification Office. Durus violated the reporting requirements of Hart-Scott-Rodino Act with the acquisition of all three companies. The FTC enforcement action was related to the fund's failure to report the acquisitions but fortuitously exposed the market manipulation that landed Sacane, the manager, in prison for three years (he was fined $350,000 for the Hart-Scott-Rodino Act violations).

No receiver was appointed. Instead, the investors banded together and formed a committee to take over the board of the management company and to liquidate the positions.

Year: 2007

Fund: High Grade Structured Credit Strategies Fund, LP, and High Grade Structured Credit Strategies Enhanced Leverage Fund, LP

Manager: Bear Stearns Asset Management (Ralph R. Cioffi and Matthew M. Tannin)

Litigation: Manager fraud litigation (valuation fraud)

The spectacular and enormous collapse of Bear Stearns in 2007 is best known as the first big Wall Street event relating to the collapse of the U.S. housing bubble. Bear Stearns made huge bets on collateralized debt obligation (CDO) securities (CDOs), purchasing some for cash and others with leverage. Bear Stearns' strategy was to purchase CDOs that had an expected return that was higher than the cost of borrowing. Bear Stearns took the approach that the more it could borrow, the more CDOs it could buy and the more profit it would make. For the expected return to exceed the cost of borrowing, Bear Stearns heavily invested in subprime CDOs, which offered higher returns and greater risks. When the housing market began to crash and subprime borrowers began to default at higher rates, the CDOs that Bear Stearns owned followed suit. The beginning of the housing crash caused the returns from the subprime CDOs Bear Stearns owned to drop below Bear's ongoing borrowing costs. When this happened, due to the enormous amount of money that Bear Stearns borrowed to establish a giant position in leveraged subprime CDOs, Bear Stearns suffered huge and continuing losses. To cover the borrowing costs, Bear Stearns was forced to sell off portions of its position, which further depressed the value of what it still held. The largest investor in these hedge funds was Bear Stearns, and the funds' demise contributed to the entire bank's demise.

As we have seen with the other examples, to mask losses and prevent investors and institutional counterparties from running for the doors, the managers, Ralph R. Cioffi and Matthew M. Tannin, allegedly misrepresented the funds' deteriorating condition to bring in new money and keep existing investors and institutional counterparties from withdrawing money. In April 2007, Cioffi issued a monthly performance update with estimates that were allegedly based only on a subset of the funds' portfolios and did not contain sufficient disclosures to qualify the estimates. In addition, Cioffi and Tannin routinely told investors that the funds' exposure to subprime CDOs was from 6 to 8 percent when it was 60 percent. In November 2007, Bear Stearns' auditor issued a clean audit.*

Following the collapse of the funds' portfolios, Bear Stearns extended a line of credit to the funds so they could be quietly liquidated. In subsequent litigation, Bear Stearns' shareholders alleged this was done to mask the funds' collapse and to hide that the bank's substantial additional positions in CDOs were plummeting in value.

Actions were brought by Bear Stearns shareholders against Bear Stearns and its auditor (as a class action and as a derivative action). A large number of cases were filed and consolidated in federal court in New York. In January 2011, the court refused to dismiss the direct fraud claims against Bear Stearns and its auditor but dismissed derivative claims. In addition to the Bear Stearns shareholder litigation, some investors in the hedge funds commenced arbitrations against the manager and other Bear Stearns related entities. Since arbitration is private, the result of these arbitrations is not a matter of public record.

Year: 2008

Manager: Bernard L. Madoff Investment Securities

Litigation: Manager fraud litigation (valuation fraud and Ponzi scheme) and clawback litigation

December 2008 saw the unraveling of the mother of all hedge fund blow-ups: Bernie Madoff. Though Bernard L. Madoff Investment Securities was not a hedge fund but an investment manager, many of its investors were hedge funds. His fraud has been reported far and wide. Madoff supposedly had an investment strategy, called the split-strike conversion strategy, in which he would put money in and take money out of the market when he thought he could make money. Madoff never invested any money. He created false investment reports and paid off old investors with new investor money, stealing a cut. As the economy declined in 2008, more investors

*See *In re Bear Stearns Cos., Inc. Sec., Derivative, & ERISA Litig.*, 763 F. Supp. 2d 423, 510 (S.D.N.Y. 2011).

sought to redeem their investments and fewer investors put in new money. Therefore, the scheme collapsed. Madoff is serving 150 years in prison.

This blow-up has spawned many litigations. Of note are actions commenced by the SPIC receiver (who was appointed to take over the Madoff broker/dealer) to recover monies paid out to investors as fraudulent conveyances and under other legal theories. Some of the receiver's actions have generated substantial press coverage.

The Madoff debacle has spawned numerous litigations that more closely resemble typical hedge fund fraud litigations in which investors sue managers. Here, it has taken the form of actions against managers who invested in Madoff, so-called feeder funds, who invested some or all of their investors' money in Madoff. Claims have been made against the feeder funds, their parents, affiliates, auditors, administrators, and others. The common thread among these litigations is that the plaintiffs allege that the feeder funds should never have made the investments with Madoff. The litigations arising out of Madoff are too numerous to mention, but suffice it to say, Madoff litigation is almost a "full employment act" for lawyers.

Year: 2009

Entity: Stanford International Bank and Stanford Group Co.

Manager: R. Allen Stanford

Litigation: Manager fraud litigation (Ponzi scheme)

R. Allen Stanford, allegedly acting through a network of Stanford Group Co.'s financial advisers, sold approximately $8 billion fake certificates of deposit (CDs) to investors by promising high interest rates. Allegedly, Stanford and others misrepresented to CD purchasers that their deposits were safe, falsely claiming the bank reinvested client funds primarily in "liquid" financial instruments and maintained a careful regimen of monitoring the portfolio.

In February 2009, the SEC filed suit against Stanford and related entities based on an alleged Ponzi scheme and a receiver was appointed. The district court appointed a receiver and issued a channeling injunction. In June 2009, Stanford was indicted by a federal grand jury for mail fraud, wire fraud, conspiracy to commit securities fraud and money laundering, obstruction of justice and conspiracy to obstruct justice. The investors and the receiver have commenced numerous actions against banks and others alleging fraudulent conveyance and other theories, such as aiding and abetting. Stanford was scheduled to be tried in early 2012.

COMMON THEMES IN LITIGATION

Having surveyed the major frauds, I want to discuss some of the common themes that arise in the litigation that follows them. Claims are frequently made against managers for fraud, negligence, breach of fiduciary duty, securities fraud, and the like. However, often the managers cannot satisfy a potential judgment, are absent, or cannot be sued. In some cases, when the manager is the subject of an SEC action, a court will prohibit any private actions against them for the duration of the SEC action, which can last for many years.

Sometimes, service providers and others are willing participants in the manager's fraud; they participate in reckless or negligent disregard of the fraud; and they act in good faith but unknowingly assist nonetheless. As a result, hedge fund litigation has spawned claims against many other participants in the fraud as damaged plaintiffs search for a "deep pocket" or a solvent pocket to answer for the fraud and compensate the plaintiffs for their losses. Funds themselves are sued less often because they are protected from private actions by court order and/or are insolvent.

Targets

In addition to investment managers, lawsuits that arise from manager fraud are brought against auditors, administrators, prime brokers, the fund's trading counterparties, and parents and principals of the investment manager. While each may be a participant in the manager's fraud, and may have been party to the same underlying conduct, each has a different relationship with the fund's investors, and thus claims against each of these defendants can vary.

Auditors: Auditors have a responsibility under U.S. accounting or international accounting principles to ensure the financial statements of the fund are properly stated. They have access to information the investors do not. Investors rely on audit reports in making and retaining their investments. Although no direct privity (i.e., no contract) between the investors and the auditors exist, because the investors often receive audit reports and the auditors know that they are being sent to investors, their relationship with investors carries certain duties. When a hedge fund suffers a fraud-induced meltdown, investors have typically pursued actions against the auditor for negligence. The auditors are directly in privity with the fund and may be sued by those who step into the shoes of the fund, like liquidators or trustees. However, certain defenses can be asserted against those who step into the shoes of a wrongdoer, such as the *in pari delicto* defense.

Hedge fund administrators: Like the auditors, administrators of hedge funds have access to records of the fund that are usually kept away from investors. They are often targets of suits by investors and receivers/trustees. Administrators are responsible for maintaining a fund's books and records (with respect to cash, custody, trading, etc.) and calculating an NAV of the fund from those records on a daily, weekly, monthly, and/or yearly basis. These NAVs calculated by the administrator are disseminated to investors. Administrators are often found to owe a fiduciary duty to investors. When the NAV that is "struck" is fraudulent, the administrators can be culpable to varying degrees and have been held accountable. Administrators are often in direct communication with investors and can be held liable for intentional and negligent misrepresentation.

Prime brokers: Prime brokers often have access to fund manager records that others do not have and have been found to be culpable participants in a fraudulent scheme. Prime brokers are used by funds for, among other things, trading, custodying the fund's portfolio, providing financing in the form of margin loans, and providing managers with analytical reporting tools to review and analyze a fund's portfolio. For example, in the Lancer case, the prime broker was alleged to have aided and abetted in the fraud by creating a web site that allowed the manager to create false financial statements. Though the prime broker claimed this web site was a tool for the manager's convenience, the manager used it to create official-looking documents that resembled formal statements but which the manager manipulated. Since Lancer, prime brokers have programmed these analytical tools in such a way that they contain a conspicuous disclaimer that the report is not official and does not constitute any form of statement by the broker. This disclaimer is designed to prevent managers from using the tools to forge brokerage statements (and to avoid investor claims).

When a prime broker is not consciously aware of the fraud and is providing basic custodial and clearing services, the courts have often found that no aiding and abetting liability exists. Unlike auditors and administrators, prime brokers have no contact with investors, and thus, prime brokers' duties are more limited. Therefore, knowing assistance in a fraud is generally required for a prime broker to be liable to investors in connection with a manager fraud case.

Others: The principals of an investment manager (when the manager is an entity) and the owners or parents of an investment manager are often targets of lawsuits brought by investors. Issues of knowledge and piercing the corporate veil are paramount in deciding these claims. Others who are targets of investor lawsuits are lawyers who created the offering memorandum or other documentation for a fraudulent fund, back office providers, risk management providers (such as the Hennessee Group in the Bayou litigation), and introducing brokers. In claims that involve fraudulent trading activity, the funds' counterparties can be sued for aiding and abetting manager fraud among other theories.

COMMON CLAIMS BY INVESTORS

Among the claims that are often brought in hedge fund cases are federal securities fraud, common law fraud, breach of fiduciary duty, professional malpractice, negligence and negligence misrepresentation, aiding and abetting common law fraud, and aiding and abetting breach of fiduciary duty.

Federal securities fraud: Securities fraud claims can be alleged because hedge fund shares are securities. However, claims that investments were maintained or not redeemed typically can only be asserted under state law. That is because federal securities claims require that a fraud be committed in connection with the purchase or sale of a security. Federal securities claims are most often brought under SEC Rule 10b-5 (promulgated under Section 10 of the Securities and Exchange Act of 1934 (the Exchange Act), which establishes a private right of action for fraud in connection with the purchase or sale of a security. Claims are commonly brought under Section 20A of the Exchange Act, which establishes that controlling entities that commit securities fraud can be liable for fraud committed by the party they control. Sections 9 (manipulation of securities prices) and 18 (misleading statements in materials filed with the SEC) of the Exchange Act provide for private claims, but Rule 10b-5 is most common.

Securities fraud, as with all fraud, requires a plaintiff to prove scienter. Scienter means the plaintiff must show the defendant was deliberately or recklessly misrepresenting facts to cause the plaintiff to take the action that led to the plaintiff's loss.

In all fraud cases brought in federal court, including securities fraud, a plaintiff is required to make specific allegations concerning the exact misrepresentations that were made, and that the defendant was aware of the falsity of the statements when made. When a manager makes rosy predictions that do not come true, investors cannot bring a fraud claim by making a conclusory allegation that the manager knew the predictions were doomed.*

In addition to alleging scienter, a plaintiff must allege that he or she relied on that statement. In the context of securities fraud and certain related claims, this is often characterized as requiring the plaintiff to show transaction causation, meaning a plaintiff must show the defendant's misstatement caused the plaintiff to consummate the transaction that led to the loss. A plaintiff must show loss causation, which requires a showing that the loss (i.e., the investor's damages) was a foreseeable consequence of the defendant's bad acts.

Fraud claims (under federal and state law) are typically brought against the manager and its principals and are asserted against service providers who made knowing misrepresentations directly to investors.

Common law fraud: Common law fraud is a state law claim that investors may bring under the same circumstances as federal securities fraud. Federal securities fraud and common law fraud differ in three ways.

First, there is no purchase or sale requirement, so investors can bring claims on the basis that they were fraudulently induced to hold on to their positions. However, proving damages for a fraudulent maintenance claim can be complicated and difficult.

Second, because common law fraud is a creature of state law, plaintiffs need to be aware of the applicable state law. In addition, each state will have its own statute of limitations.

Third, in certain circumstances, reliance can be presumed for federal claims on the theory that the "market" was defrauded. There is no similar state law concept.

Breach of fiduciary duty: Managers, and under some circumstances, service providers, owe fiduciary duties to investors. The nature and the scope of those duties vary by defendant. A fiduciary duty claim can be brought where an investor can show that a special relationship

*This requirement of detail and specificity at the outset of a litigation stands in contrast to more ordinary claims like breach of contract, where a plaintiff may commence an action based on more conclusory allegations without risk of early dismissal.

of trust and confidence between the plaintiff and defendant existed, and that the defendant was aware that the plaintiff was relying on information the defendant provided. Depending on the circumstances, fiduciary duty claims can be brought against the manager, auditor, and administrator due to those entities' direct contact with investors. Prime brokers aren't ideal targets for breach of fiduciary duty claims because they do not have contact with investors as part of their routine activities.

Claims based upon a breach of fiduciary duty are premised on state law. As with any state law claim, the laws of the several states may have nuanced differences. Potential litigants must not assume their claims will be treated identically in every state.

Professional malpractice: Professional malpractice is only likely to be successful against an auditor in the context of an investor action. There are no professional standards under state law for administrators and prime brokers. While attorneys are potential targets of professional malpractice claims, investors are not usually in a position to bring them. However, bad advice or incompetent work from an attorney to the fund can lead to a claim brought by a receiver.

Negligence and negligent misrepresentation: Negligence and negligent misrepresentation are state law claims. In the case of negligent misrepresentation, it is a claim brought against any entity that makes a false statement to the plaintiff that the plaintiff relies on to its detriment. Negligent misrepresentation is fraud without scienter. A defendant needn't know its representation is false to be liable for negligent misrepresentation.

However, defendants aren't automatically liable for all the negative consequences of their unintentional false statements. The defendant can only be held liable for damages incurred by a plaintiff to whom the defendant owes a preexisting duty. Moreover, the harm that the misstatement causes the plaintiff must have been foreseeable.

In hedge fund cases, negligent misrepresentation claims have similar core issues. In claims against auditors, the issue is typically whether the auditor negligently issued a "clean audit" opinion for financial statements that were materially misstated. In claims against administrators, the issue is whether the administrator negligently determined the fund's NAV in statements sent to investors. In claims against managers, the issues often involve misrepresentations made to investors about performance and other material facts.

Managers, auditors, and administrators are the primary targets for negligent misrepresentation claims based upon their direct interaction with investors. In addition to negligence claims, plaintiffs will often plead claims for gross negligence. One key difference between negligence and gross negligence is the severity of the unreasonable behavior. Negligence requires a deviation from the range of actions that a reasonable person in the defendant's circumstances might engage in. Gross negligence requires a gross deviation. This distinction often arises in hedge fund litigation because investors frequently contractually agree to indemnify and hold the manager or the service providers harmless for negligence. Contractual arrangements are usually enforceable under state law, which can render managers, administrators, and auditors immune from suits for negligence. However, such provisions are generally unenforceable with respect to damage arising from grossly negligent behavior and from willful, reckless or intentional behavior. In any event, because negligence and contract are matters of state law, the viability of negligence and gross negligence claims in connection with similar behavior may vary by jurisdiction.

Aiding and abetting common law fraud: If a defendant intentionally aids another's fraud, he or she can be liable to the damaged plaintiff notwithstanding that the aider/abettor has no direct contract with investors. Were it not for aiding and abetting liability, prime brokers would probably be immune from hedge fund investor litigation. To make a claim for aiding and abetting fraud, a plaintiff must establish an underlying fraud. Then the plaintiff must show the defendant had knowledge of the fraud and substantially assisted it. However, there is no requirement that the plaintiff have had any interaction with, or even prior knowledge of, the aiding and abetting defendant.

Aiding and abetting claims are an important tool in a plaintiff's arsenal because the primary wrongdoer may be insolvent or off limits due to a bankruptcy stay or channeling injunction. Even though an underlying fraud is a prerequisite to a claim for aiding and abetting fraud, a plaintiff is under no obligation to pursue the underlying fraud claim. This means that a plaintiff can sue a service provider for aiding and abetting the manager's fraud but not sue the manager. Even though the plaintiff does not sue the manager, it must allege and prove that the manager committed the underlying fraud.

As with fraud claims, the allegations in a complaint asserting aiding and abetting fraud must be detailed and specific.

Aiding and abetting breach of fiduciary duty: As with fraud, if a defendant aids and abets another's breach of fiduciary duty, it can be held liable to the plaintiff. The requirements to make a claim for aiding and abetting breach of fiduciary duty are similar to breach of fiduciary duty. The plaintiff must establish the existence of a fiduciary duty and a breach of that duty. Then, the plaintiff must establish that the defendant was aware of the fiduciary duty and substantially assisted the third party in breaching that duty.

COMMON HURDLES TO COMMON CLAIMS BY INVESTORS

Even if a plaintiff can allege the elements of one of the claims above, additional hurdles exist, collateral to the substantive law that defines the claims, which can limit or prohibit a plaintiff's case. These hurdles fall into five categories: (1) preemption under federal law; (2) primary violator issues (i.e., whether a claim is for direct fraud or aiding and abetting); (3) statutes of limitation; (4) contractual indemnification and exculpation; and (5) heightened standards of proof.*

Preemption: Under federal law, the issue of preemption in connection with hedge fund litigation comes from the Securities Litigation Uniform Standards Act of 1998 (SLUSA). The purpose of the SLUSA was to force securities class and large group actions to be litigated under the U.S. securities laws. Among other reasons, the SLUSA was enacted to stop class action lawyers, and large groups of plaintiffs, from filing fraud claims in state court to avoid the Private Securities Litigation Reform Act of 1995 (PSLRA)† and assert fraudulent maintenance claims (or "holder" claims), which are prohibited under federal law. Under SLUSA, any action brought by a class‡ or a group of more than 50 parties that alleges actions for damages in connection with a "covered security" must be brought under federal law only.

*In addition to these, there may be jurisdiction hurdles. These are discussed later.

†The PSLRA was enacted to reduce what was perceived to be a signification amount of frivolous securities claims being filed in federal court. Among other things, the PSLRA heightened the pleading requirements for securities fraud claims and created an automatic stay of discovery once a defendant files a motion to dismiss the claim.

‡The SLUSA explicitly excludes shareholder derivative actions.

The SLUSA has two issues. The first is that it is a procedural rule. It doesn't preempt state law claims outright but only when they are asserted as a class or on behalf of a large group of plaintiffs. The second issue is that the claims must be in connection with a covered security. The act defines a "covered security" to mean any exchange-traded security. Because hedge fund shares are generally not listed on any exchange, they may avoid the application of the SLUSA. However, some courts more broadly defined the phrase "in connection with a security" to apply the SLUSA to certain large hedge fund and investment management fraud cases.*

Primary violator issues: Under federal securities law, there is no private right of action for aiding and abetting (i.e., actions against secondary violators). This was recently confirmed by the U.S. Supreme Court in the 2008 *Stoneridge Investment Partners, LLC v. Scientific Atlanta* decision. The Supreme Court recently decided another case regarding the definition of a "primary violator" who, unlike an aider or abettor, can be sued under federal law. In *Janus Capital Group v. First Derivative Traders*, the Supreme Court reversed the U.S. Court of Appeals for the Fourth Circuit's holding that service providers could "be held primarily liable in a private securities fraud action for 'helping' or 'participating' in another company's misstatements." In doing so, the Supreme Court further limited private securities actions under federal law.

In *Janus*, the Supreme Court held there was no private right of action against a mutual fund's investment advisor for misstatements in the fund's prospectus. The Court reasoned that because the fund and the investment advisor were legally separate entities, the advisor was not a primary violator with respect to misstatements in a communication from the fund itself. This decision means that plaintiffs must pay attention to the entity making a fraudulent statement. On a 10b-5 claim, courts aren't free to attribute statements from a fund to a manager and vice versa, even where the fund is under the manager's control. However, as the Court

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*New York law frequently applies to disputes involving hedge funds. Until recently, unlike any other state's securities' laws (known as blue-sky laws), New York's blue-sky law, the Martin Act, had been held by some federal courts to preempt certain private cases of action. However, in a December 2011 ruling in *Assured Guaranty (UK) Ltd. v. J.P. Morgan Inv. Mgt. Inc.*, New York's highest court, the Court of Appeals, held that that Martin Act does not preempt private cases of action.

noted, Section 20A of the Exchange Act provides for a private action against control persons, so investment managers won't get a free pass. Indeed, in a footnote, Justice Clarence Thomas suggested that had the plaintiff pleaded a claim under 20A, the claim might have survived.

Statutes of limitation: Under state and federal law, there is a time limit in which a plaintiff must commence private actions. These may be as short as one year or as long as six, depending on the state and the claim. For claims of fraud, an alternative period of limitations measures from the plaintiff's discovery of a fraud as opposed to the date it was committed. Plaintiffs must pay attention to these limits and investigate them as soon as they learn they have been the victim of fraud or another tort.

Contractual indemnification and exculpation: Offering memoranda, limited partnership (LP) agreements, and subscription agreements may contain broad waivers, indemnifications, and exculpations. These provisions may eliminate certain claims. Under U.S. and state law, waivers, indemnifications, and exculpations violate public policy and are unenforceable with respect to willful, reckless, or intentional conduct (and in some states, gross negligence). However, offering memoranda and subscription agreements may contain foreign choice of law clauses. It is unclear how any particular U.S. court would approach a contractual provision that exculpated a party for gross negligence where that provision was valid and enforceable by the law selected by the contract. It is unlikely that any court would enforce a prospective waiver of fraud claims under any circumstances.

In addition, some agreements include indemnification provisions for legal fees in connection with suits that may be brought against the funds' service providers. If service providers are indemnified by their client funds, plaintiff investors may end up paying for the lawyers on both sides of a case.

Heightened standards of proof: Most civil claims must be proven by a "preponderance of the evidence," which means that the plaintiffs must convince the court or jury that their version of events is "more likely than not." However, for certain claims, the standard is higher, requiring plaintiffs to establish their claims by "clear and convincing evidence." These standards will vary by jurisdiction, but for many of the common claims listed above (other than negligence), proof by "clear and convincing evidence" may be necessary.

LIABILITY AND COLLECTABILITY

In addition to liability, a major hurdle is the collectability of any potential claims. If the defendant is not domiciled in the United States, then enforcement of judgment issues may occur. More important, questions exist about how much money a defendant has. Many defendants can be judgment-proof, which is why auditors, prime brokers, and other deep pockets are sued. Many defendants have few executable assets, and a judgment may only be collected based on an insurance policy. However, often there is not an insurance policy or the insurance policy is small or has applicable carve-outs. If a policy exists, the insurance companies will often fight tooth and nail to avoid having to pay.

Offshore service providers are good at protecting assets. Even though they may, for example, bear the name of a "big four" accounting firm, the offshore entities may only be "eight guys on a rock" and those eight guys have found ways to shield their assets. Investors considering claims against service providers need to understand whether a service provider with a big name is the big name entity in the United States (or another jurisdiction with a well-capitalized firm) or whether it bears the name of a major service provider but is a separate and distinct entity.

In addition, if a foreign defendant is capable of paying a judgment but has no U.S. assets, the successful U.S. plaintiff will have to initiate a new action in the foreign jurisdiction to collect. Foreign courts may be hostile to foreign plaintiffs holding a foreign judgment against a domestic defendant. This is a particular concern with smaller jurisdictions, where the enforcement of a large judgment could have an impact on the local economy by bankrupting a significant employer.

INVESTOR CLAIMS VERSUS RECEIVER/TRUSTEE CLAIMS

Frequently, issues arise about who owns the claims (i.e., investors or a receiver/trustee). Fraud claims typically belong to investors. Claims for breach of an agreement between the fund and service providers are typically owned by the receiver/trustee. Claims for breach of fiduciary duty and negligence may, in many instances, be brought by the investor, the receiver/trustee, or both. The critical part of the analysis is to determine whether in a breach of fiduciary duty and negligence claim the service provider owes a duty to the investors in addition to the fund.

One particular concern in actions brought by trustees/receivers/liquidators is the *in pari delicto* defense. That defense prevents a wrongdoer from suing another wrongdoer. There is a lot of law on this subject, it is evolving, and various jurisdictions treat this issue differently. This is relevant because a receiver/trustee steps into the shoes of the fund and sues in the fund's name. If the fund were a wrongdoer, a receiver or trustee may be barred from asserting claims against service providers. Some courts treat receivers differently from trustees.

Another issue with receiverships is that they are expensive. Even though they are installed to maximize the estate's value and then wind it up by distributing assets to the investors, they are paid from the estate and lose their jobs once the estate is wound up. Once receivers are installed, their power is difficult to challenge because if investors bring an action to force the receiver's hand, investors end up paying every lawyer involved. This is why the self-management approach taken by the investors in the *Durus* matter is intriguing, as it may more closely align the investors' interest with the actions taken on behalf of the estate. This approach isn't frequently taken because the investors who volunteer to manage the fund take on fiduciary duties to the other investors and expose themselves to potential liability.

FORUM AND JURISDICTION

Suing in the United States: A critical consideration in hedge fund fraud litigation is where an action may be commenced. U.S. courts are typically preferable for investor claims because they are usually a more investor-friendly forum. Discovery rules are much broader than in foreign jurisdictions, and jury trials, which are considered to be more favorable for plaintiffs, are not commonly available for civil cases outside of the United States and Canada. Contracts, such as subscription agreements and LP agreements, may limit the jurisdictions where investors can bring claims. They may contain a provision that waives the investors' right to a jury trial.

Issues of extraterritoriality: The Supreme Court's 2010 decision in *Morrison v. Australia National Bank* will have a considerable effect on hedge fund litigation. Hedge funds are often domiciled outside the United States and use foreign-based service providers. Furthermore, investors in hedge funds are often from abroad. Sometimes, a fund's main anchor in the United States is the investment manager who controls the fund (e.g., from his or her Greenwich or Park Avenue office). Cases where the plaintiff and defendant were foreign and the security at issue traded on a non-U.S. exchange (know as "foreign cubed" cases), have been common in the past decade.

Prior to the *Morrison* decision, the question of whether investors could bring federal securities fraud claims in a U.S. court in connection with a foreign security or offshore fund was considered an issue of the court's jurisdiction. The *Morrison* decision changed that analysis. Justice Antonin Scalia's opinion held that whether a federal court can hear a federal securities claim involving foreign securities is not solely a question of the court's jurisdiction but rather a merits-based question of whether the facts alleged constitute a violation of U.S. securities laws. Under *Morrison*, there is no private right of action under the federal securities laws unless the purchase or sale is made in the United States, or the purchase or sale involves a security listed on a domestic exchange. Morrison has been interpreted to reject the idea that securities fraud cases involving foreign parties and foreign securities purchased outside the United States could be viable in federal court. The rule is new, and the jurisprudence is developing. For example, courts have not addressed if U.S. managers selling shares in offshore funds is a transaction that can be deemed to have occurred in the United States.

***Morrison* and the Government:** The *Morrison* decision was silent as to whether the Department of Justice or SEC could prosecute extraterritorial claims under the federal securities laws. In 2010, the SEC brought a widely publicized case against Goldman Sachs and Fabrice Tourre. Though Goldman Sachs promptly settled with the SEC for $550 million, Tourre did not. In June 2011, a federal district court in New York dismissed the SEC's 10b-5 action against Tourre under *Morrison* because no purchase or sale was made in the United States and the alleged fraud didn't involve a security listed on a domestic exchange.

The *Morrison* decision may have profound effects on federal securities actions brought in connection with offshore hedge funds. It shield certain defendants from private actions and may have removed certain funds from the purview of U.S. securities law and law enforcement entirely.

State and federal court: There are issues about whether claims should be prosecuted in state court or federal court in the United States. If they should be prosecuted in a state court, which state court; if in federal court, should it be in bankruptcy court or federal district court? Often defendants remove cases from state court to federal court or from bankruptcy court to federal district court if applicable jurisdictional requirements are met.

One consideration favoring federal court is that it is easier to secure personal jurisdiction there than in state court because, in securities claims, nationwide jurisdiction exists. However, the *Morrison* decision adds a new layer of complexity. Foreign-cubed cases that can no longer proceed under federal securities law may still be viable under state law. With foreign parties on either side of a case, and—thanks to *Morrison*—with no claims arising under federal law, federal courts lack subject matter jurisdiction to hear the dispute. Therefore, these claims can only be brought, if at all, in state court.

ARBITRATION

Some agreements that govern hedge fund investments have mandatory arbitration clauses. In addition, agreements between funds and service providers often have arbitration clauses. Even when not mandatory, if there is a "hook" to be in arbitration, circumstances occur where it may make more sense to litigate before an arbitration panel than in a court. Arbitration can be good if you have compelling facts but difficult law. Arbitrators are often not lawyers and may be more inclined to seek subjective concepts of justice and fairness and feel less compelled, as judges are, to adhere to the precedent of prior court decisions. Conversely, arbitrators may be unwilling to award the sums of money hedge fund litigants often seek. If given a choice, a prospective plaintiff should know that arbitrations differ. A panel of three FINRA-registered brokers presiding in a Financial Industry Regulatory Authority (FINRA) arbitration is likely to view a claim differently from a panel of three retired federal judges or of three prominent British barristers.

Other things to consider with arbitration are that discovery (where the parties demand and exchange documents and take depositions) is more limited in arbitration, and it may be difficult to obtain discovery from nonparties. In addition, arbitral decisions are, for the most part, unappealable. Furthermore, they don't always come with a reasoned analysis to explain the award.

GROUP VERSUS CLASS

Another continuing dynamic in hedge fund fraud cases is whether investor claims should be brought as class or group claims. A class action is a device in which an investor brings a case on behalf of all the investors who are similarly situated and have common claims. A group action is brought by a group of people with similar claims against wrongdoers. Class actions have the benefit of allowing claims to go forward on behalf of all aggrieved parties and are often brought on a contingency fee basis. Group claims are typically brought by more well-heeled investors with more at stake and are often brought on an hourly fee basis. Group claims are often a better economic model for investors than a class action because they end up costing less money as far as attorneys' fees unless the case is a difficult and losing one. Class actions allow investors who aren't the named plaintiff to remain anonymous.

In addition to the different fee model, group claims have the advantage of being able to assert fraudulent maintenance claims which can't be proven on a class-wide basis. The reason fraudulent maintenance claims can only be brought on a group basis is that reliance for such claims can't be proven on a class-wide basis but must be shown investor by investor.

Finally, due to the potential interplay between the SLUSA and *Morrison* decision, investors in offshore funds should use care before joining a group of more than 49 other investors (lest their state law claims be preempted in favor of a federal claim that doesn't exist).

CLAWBACK CLAIMS

In addition to hedge fund fraud cases in which investors and receivers/trustees sue the managers and service providers, many cases have occurred in which the receiver/trustee brings claims against investors to claw back money paid out before the fund blew up. These claims have been publicized in the Madoff case where the SIPC Trustee has brought claims for billions of dollars against people who received distributions from Madoff. These claims have been asserted in Bayou, Lipper, and other hedge fund fraud cases. Among the key issues is whether the fraud was a Ponzi scheme. This is discussed above in connection with the Bayou actions.

Hotly litigated issues include whether claims to claw back payouts can only be for fictitious profits or can include invested principal paid back to investors. The theory for only paying back fictitious profits is that everyone is entitled to the return of their invested capital and people should not be penalized for continuing due diligence. A theory for clawing back principal is that all investors should be treated equally and all the money should be put into one pot and redistributed. However, this seems inherently unfair.

MARGIN CALL LITIGATION

Since well before the financial crises and accelerating in 2008, hedge funds have been put out of business by broker/dealers who have extended leverage and then have made margin calls. This has been a fertile area of litigation involving various legal theories like breach of contract, breach of implied covenant of good faith and fair dealing, and various "lender liability" theories. These claims were discussed previously in connection with Granite.

TRENDS

Among the trends you see after hedge funds blow up is a liquidation or insolvency proceeding and then litigation, whether by the receiver/trustee, investors, or both. Sometimes, the proceedings are coordinated between the investors and the responsible fiduciary; other times, they are more fragmented. The relative roles of U.S. and offshore regulators and other authorities are evolving.

The SEC is getting more active in this area, notwithstanding (and perhaps, in part, because of) the public scrutiny it received for failing to prevent the Madoff fraud. Receiverships established by federal courts at the SEC's request have become more common. However, there is substantial concern about cost issues with receivers and trustees (i.e., whether the cost of employing them yields sufficient returns). The jury is still out on the Madoff trustees.

The politics of the relations between the responsible fiduciary and investors differ on a case-by-case basis. Sometimes, they are harmonious and cooperative; other times, a turf battle occurs over who should pursue claims. The claims process by the receiver and trustee can generate friction.

HOW NOT TO BECOME A VICTIM

Investors must perform in-depth quantitative and qualitative due diligence before and during the investment. A failure to perform proper due diligence can lead to investing in a fraud and can compromise an investor's claims against service providers due to the theory of comparative negligence. Under this theory, defendants can avoid a portion of their liability by showing that the investor-plaintiff's losses were, in part, the result of the investor's own negligence in making the investment.

The representations in the offering memorandum, marketing materials, audit reports, and other manager information must be checked in quantitative models. Of course, the testing of these representations is only as good as the veracity of the inputs. Accordingly, it is important to evaluate the manager's credibility and the information received before plugging in the numbers. Investors can use their own quantitative models or those of a third-party vendor. Of course, past results don't necessarily reflect future performance.

Qualitative due diligence is more important than quantitative due diligence. Every lie is important, and honesty is the key. If a manager lies about little things, he or she will likely lie about bigger things. For example, "puffing" education and experience in a prospectus is a red flag. A background check on the manager should be performed. There are many online resources as well as experienced due diligence providers.

Interviewing the manager is only the beginning of the due diligence process. Key members of the manager's staff, including people who are involved in investment decisions as well as back-office support, should be interviewed. Other questions should be asked: Does the manager have "skin in the game"? Does the fund have sufficient liquidity for redemptions? Where are assets custodied? (Read the earlier Madoff section, where securities were purportedly invested with a reputable firm but were then subcontracted back to Madoff.)

The quality of the service providers, such as accountants, administrators, and prime brokers, should be analyzed. Service providers should be interviewed and asked what they think of the fund and the manager. They should be asked what they are doing for the fund, the amount of their fee, and how valuations are done. For example, are valuations performed by a neutral source? What is the source of the valuations of positions? When manager mark their books, the temptation to fudge, if not outright lie, about returns may be overwhelming. When things need to be marked to market and there are no publicly available prices, there should be a neutral source doing the valuations. Furthermore, all subjective marks must be documented in a writing that identifies how the mark was determined and by whom.

However, service providers often will not speak to investors or will say little of value because of liability and confidentiality concerns. Of course, audit reports and NAV statements are typically addressed to investors, which would seem to give rise to an obligation to speak to investors to some extent. One way that service providers deal with potential liability is to put exculpation and indemnification provisions in their service contracts with the fund and the fund manager although this does not protect them from claims by investors. Investors need to be aware that service providers for offshore funds are often offshore entities with the exception of a U.S. prime broker. The absence of a U.S. domicile may create issues of jurisdiction and collectability of any judgment.

Another important step in the due diligence process is to interview other investors. Particular attention should be paid to people who didn't invest or who redeemed. The "herd" mentality needs to be avoided. For example, because John tells Pierre who tells Franz about some great fund, this doesn't mean that Franz should make that investment. Investors shouldn't invest in an instrument or strategy they don't understand; for example, many people invested in CDOs with no clue as to how they functioned. This rule is often violated by hedge fund investors who are looking to diversify and are chasing returns. Beware of representations of "market neutral" or similar terms that suggest a fund's strategy is immune from relevant risks but will be consistently, highly profitable.

Beware of the black box. Often, hedge fund frauds are concealed because the manager says, "The strategy's proprietary and complicated and you won't understand it, but believe me, you'll make money." Madoff is perhaps the leading example of this, but that conduct happens in many hedge fund frauds., Like Madoff, Granite, Beacon Hill, and others, if it looks too good to be true, it is. For example, in the Manhattan fraud, the manager's strategy was to short technology stocks during the period of a big tech stock run-up. How, in that circumstance, could he have had consistent double-digit returns? It makes no sense. No down months is usually a red flag. Smooth returns are usually a red flag.

Other things to look at are conflicts of interest, such as when a manager uses affiliates to execute trades (read the Bayou section, previously), overconcentration of positions (read the earlier Wood River and Lancer sections), and transparency of positions or lack thereof. One of the reasons Michael Lauer was allegedly able to perpetrate his fraud was that he would provide dated and often incorrect portfolio position reports to investors. So, have current transparent access to positions. If managers are afraid this proprietary information will be used against them, investors can offer to sign a confidentiality agreement.

AVOIDING BECOMING A DEFENDANT IN A HEDGE FUND FRAUD CASE

What can hedge fund managers, directors of hedge funds, and service providers do to avoid being the target of a lawsuit arising from allegations of hedge fund fraud?

Managers should use appropriate models. They need to be careful about allocations of trades between funds and with their personal accounts. Trade confirmations should be kept. Adequate internal accounting controls must be set up. Employees should be properly trained, and there should be a code of conduct. Obtaining and retaining proper investor documentation (e.g., subscription agreements and redemptions) is important. Focus on disclosures in legal and marketing documents and ensure they are accurate. Be careful of "puffing." When in doubt, come clean to investors. Communication is important (upfront, upright, and contrite).

Service providers must be carefully hired and oversight cannot be abdicated. The administrator and auditor who are hired must understand the fund's operation and strategy. Make sure an adequate back office is set up to reconcile trades or at least subcontract out to the appropriate back-office service providers. Of course, do not overleverage and be sure to diversify lenders. This cannot be emphasized enough. Often, this is the cause of the demise of the hedge fund and subsequent litigation.

As a broker/dealer acting as a counterparty and/or as a prime broker, you must "know your customer" and sell the hedge fund suitable investments. Execution must be done quickly and in a transparent way. Make sure that employees are properly supervised. If there are red flags that arise in connection with servicing the business of a hedge fund, including use of leverage, concentration, and performance, follow up on those red flags to avoid potential liability. Make sure proper documentation has been done, and comply with all margin rules and short-sale rules.

Many of the same tips for avoiding or mitigating investor litigation apply for auditors and administrators. Obviously, fraud should not be committed, and aiding and abetting fraud should not occur. Employees should be properly trained and supervised. The employees need to understand what functions they are performing and they need to understand the industry in which they are providing administrative or audit services. For example, the auditor must understand the differences between U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS), internal auditing standards. Check whether a Statement on Auditing Standards 70 (SAS 70) has been done, which would indicate whether the hedge fund has the appropriate internal controls and processes. Administrators need to understand whether the services they are providing are full NAV services or NAV lite. (NAV lite means that instead of doing independent work in striking the NAV, the administrator reports an NAV based upon prices received from the manager.)

Make sure sufficient resources are devoted to the engagement. Do not delegate to the most junior member of the team. I have often seen situations in which the auditors underbid a job and then delegated the work to a junior person, given them a manual with no training, and turned them loose. That is a prescription for disaster. Which brings me to the next point: Charge enough for the engagement to be sure the engagement will be performed properly. Make sure the client's business is understood by the engagement team. Properly identify and verify the existence of assets and valuation, including using third-party verification. Do not take the manager's word for anything, and obtain representation letters from the manager and the officers and directors.

Service providers need to understand who the other service providers are and what they have agreed to do and not do. Service providers need to have tight engagement letters with the fund manager and the fund. This helps in litigation against the managers and trustees/receivers. It is unclear how helpful it is against investors. The engagement letter should have provisions for exculpation, indemnification, favorable choice of law, favorable forum, waiver of jury trial, and mandatory arbitration.

A consideration for service providers is how much insurance should be in place to cover the costs of satisfying a judgment and paying legal fees for a lawsuit. Many service providers try to find ways to protect their assets.

Finally, notwithstanding all of these efforts, if a service provider still learns a fraud is occurring, the manager should immediately be confronted with a demand that the manager come clean to the fund's investors. If the manager refuses, resign. If a service provider discovers a fraud, never say anything to investors that suggests that everything is okay. If calming words buy the manager time to deepen the fraud, the service provider can face aiding and abetting liability.

CONCLUSION

It is hoped that this overview of hedge fund litigation, and ways to avoid an intangible litigation loss, has been interesting and enlightening. Fraudsters are creative, and potential litigation issues will continue to arise. If you follow the pointers in this appendix and learn from the history of prior failures, you may avoid becoming a plaintiff or a defendant in a costly hedge fund litigation.

APPENDIX B

Examples of Hedge Fund Structures

The purpose of this appendix is to provide you with examples of various structures used by hedge fund managers to operate their funds. The examples that follow include structures that are created by both onshore and offshore lawyers for managers around the world. The key element to the creation of a hedge fund structure is understanding where your investors are coming from. Once you understand this, your attorney can create a structure that meets the needs of your investors.

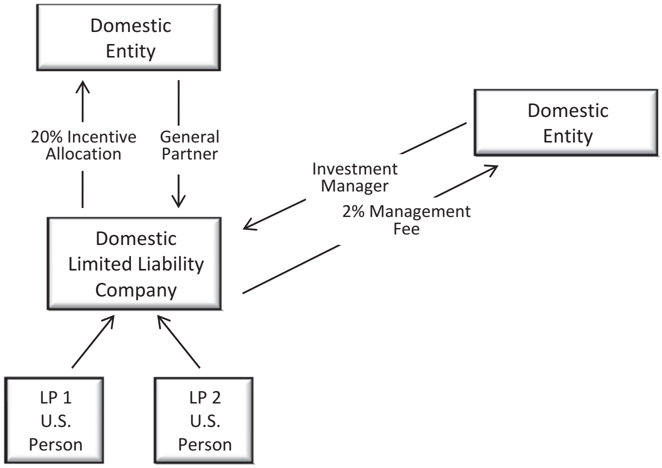

FIGURE B.1 Simple Onshore Structure
This figure illustrates a classic stand-alone fund structure that simply replaces the limited partnership with a limited liability company. For reasons best known to the drafters of the fund documents, they prefer the limited liability company. The general partner can, in certain situations, suffer more adverse income tax consequences from this structure.
Source: Created and reprinted by permission of Maury Cartine, JD, CPa.

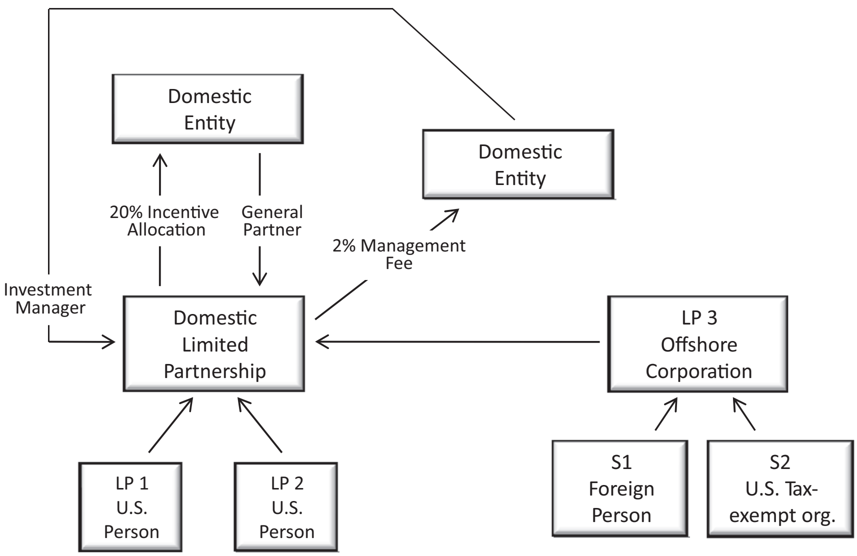

FIGURE B.2 Classic Master-Feeder Structure. In some cases, an investment manager may prefer a somewhat simpler version of the classic master-feeder structure illustrated in Figure 3.2. In this simpler version, the offshore partnership is eliminated and so is one audit. The auditors will only have to audit the domestic fund and the offshore feeder corporation. However, the general partner of the domestic fund will be required to collect and remit income tax withholding for dividends and other income subject to withholding that is reported on the Schedule K-1 provided to the offshore feeder corporation.
Source: Created and reprinted by permission of Maury Cartine, JD, CPa

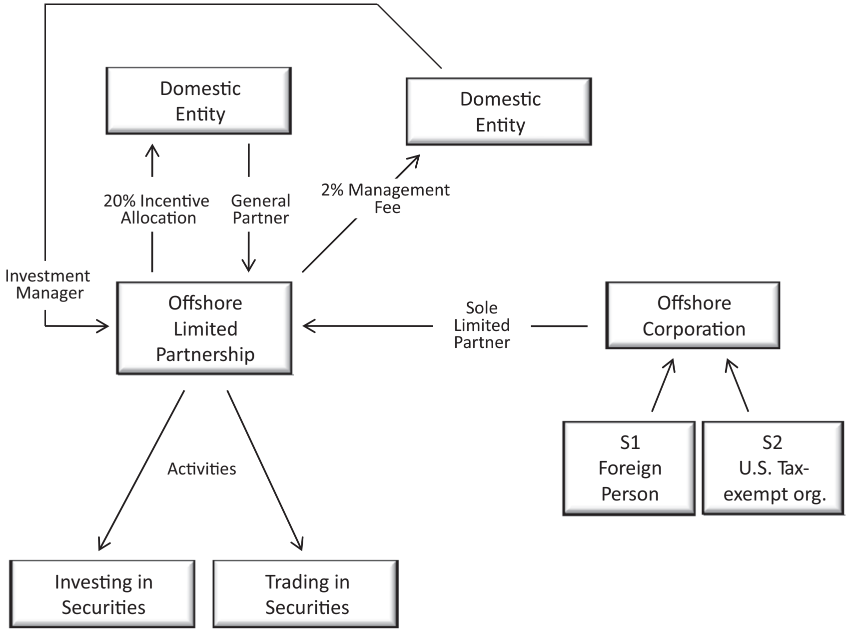

FIGURE B.3 Modified Master-Feeder Structure
This is the hedge fund industry's answer to the loss of the deferral opportunity that previously existed with respect to management fees and incentive fees paid by an offshore fund to the investment manager. Since investment managers could no longer defer the fees paid to them from offshore funds, they preferred to replace a totally fee-paying structure with a classic stand-alone fund structure. This new structure provides the general partner with the income tax benefits of an incentive allocation that is described in Figure 3.1. The only difference in the structures is the replacement of the domestic limited partnership with an offshore limited partnership. This simple extra step eliminates the investment manager's potential responsibilities with respect to income tax withholding described in Figure B.2.
Source: Created and reprinted by permission of Maury Cartine, JD, CPa.

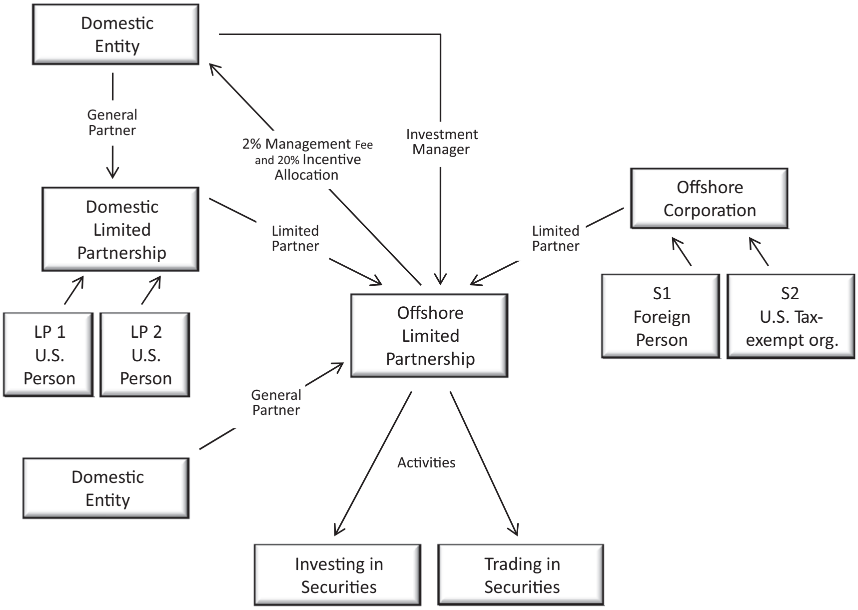

FIGURE B.4 Modified Alternative I Master-Feeder Structure
This figure demonstrates a variation to the payment of management fees, incentive allocation, and incentive fees in master-feeder structures. Instead of determining fees at the domestic and offshore feeder levels, the fees are determined at the master fund level. There is some potential U.S. income tax benefit to this structure for the limited partner of the domestic feeder. Several years ago, the Internal Revenue Service issued Revenue Ruling 2008-39 that denied limited partners a trade or business deduction for their share expenses incurred inside a fund of funds even if the fund of funds only invested in other partnerships that were in the business of trading securities for its own account (a "trader"). In effect, the trader status of the fund of funds' investments cannot be attributed to the fund of funds' own expenses. Consequently, these expenses can only be deducted by a limited partner as a portfolio deduction that is subject to a number of limitations including the 2 percent AGI limitation and the AMT add-back. There is a quiet concern among tax professionals that this same logic could be applied by the Internal Revenue Service to the expenses of the domestic feeder fund. Thus, the limited partners' benefits from the deduction for the management fee paid directly by a domestic feeder would similarly be limited even though the master fund is clearly a trader fund.
Source: Created and reprinted by permission of Maury Cartine, JD, CPa.

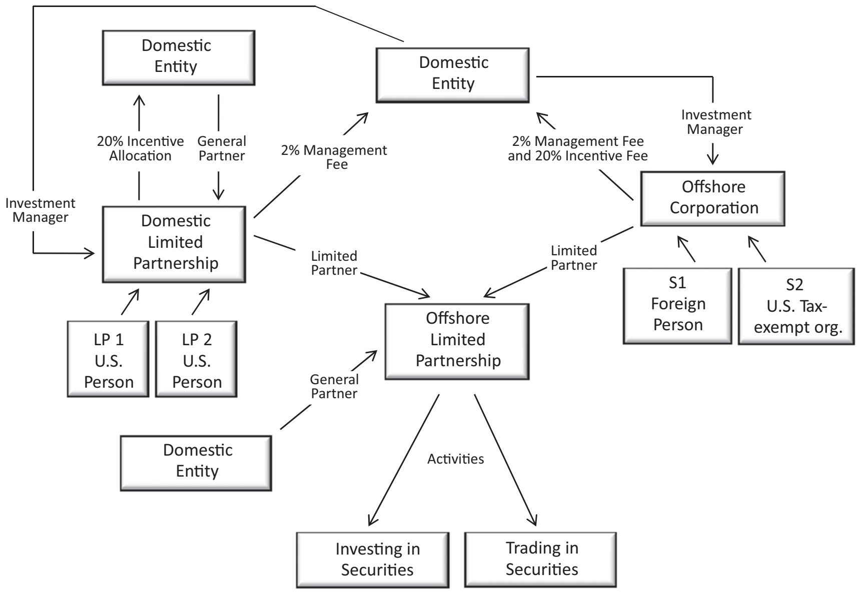

FIGURE B.5 Simple Master-Feeder Structure
This figure illustrates the classic master-feeder dressed with a belt and suspenders. Unlike Figure 3.2, the management fees paid by the domestic feeder and the offshore feeder are now paid to a separate entity, and the general partner only receives the incentive allocation. There are a number of reasons this structure is preferable to the structure illustrated in Figure 3.2 that any hedge fund lawyer or accountant should be able to provide. However, the extra entity does increase some administrative costs for the investment manager. There will be an extra book of accounts and extra tax returns. The segregation of management fees from the incentive allocation remains important for funds located in New York City and, therefore, are subject to the New York City unincorporated business tax.
Source: Created and reprinted by permission of Maury Cartine, JD, CPa.

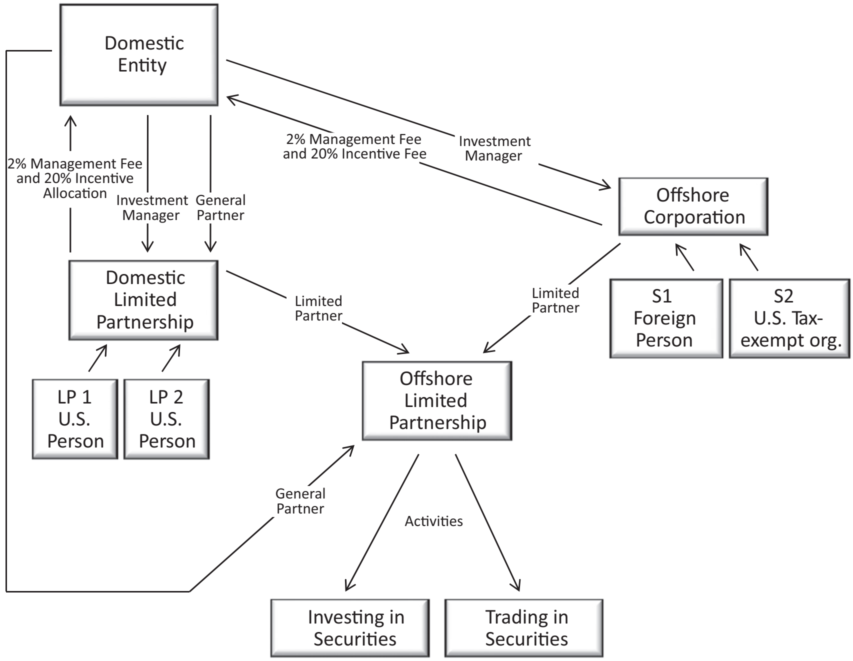

FIGURE B.6 Alternative I Master-Feeder Structure
This illustration depicts an investment manager's maniacal attempt to eliminate as many entities as possible from the master-feeder structure. Here, the belt and suspenders separate investment manager depicted in Figure B.5 has been eliminated as well as the separate general partner of the offshore limited partnership master fund. This is probably the best example of how not to create a master-feeder structure.
Source: Created and reprinted by permission of Maury Cartine, JD, CPa.

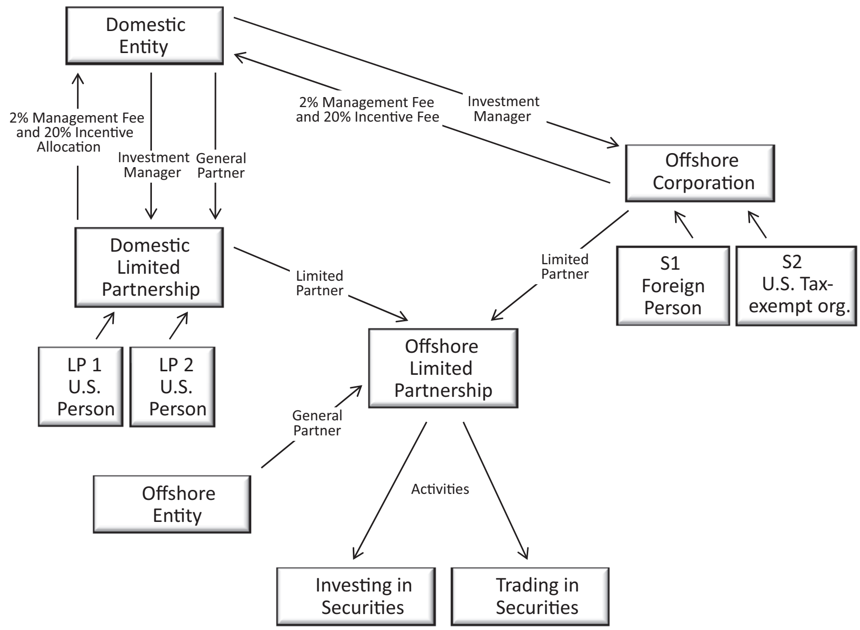

FIGURE B.7 Alternative II Master-Feeder Structure
This figure merely replaces the domestic general partner to the offshore limited partnership master fund with a foreign general partner. In certain foreign jurisdictions, this may be administratively more desirable or perhaps even required, depending on the laws of the jurisdiction.
Source: Created and reprinted by permission of Maury Cartine, JD, CPa.

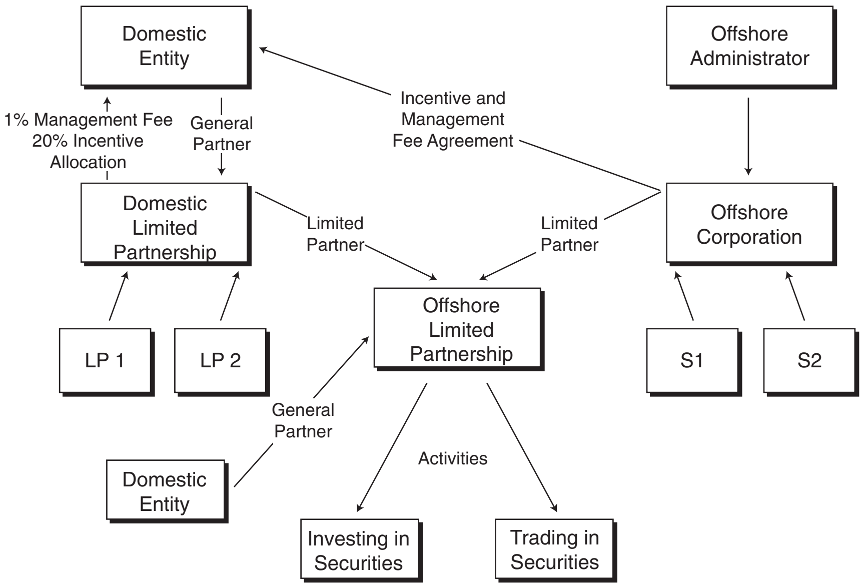

FIGURE B.8 Alternative III Master-Feeder Structure
Source: Created and reprinted by permission of Maury Cartine, JD, CPa.

Resource Guide

Following is a list of service providers that can help you with most aspects of your business. The list has been gathered from a number of industry web sites, publications, and personal contacts I have made over the years. Under no circumstances should you believe that since a firm is listed here I am endorsing it or its ability to provide you with the services you need. This list should be used solely as a guide to service providers who may prove useful to you in building your business.

PRIME BROKERS

BTIG LLC
825 Third Avenue, 7th Floor
New York, NY 10022
(212) 593-7558
Kira Bazile

Concept Capital Markets, LLC
527 Madison Avenue, 7th Floor
New York, NY 10022
(212) 419-3900
James Zurlo

Citigroup Global Prime Brokerage
390 Greenwich Street, 5th Floor
New York, NY 10013
(212) 723-4813
www.primebroker.citigroup.com

Goldman Sachs
1 New York Plaza, 44th Floor
New York, NY 10004
(212) 902-2938
www.gs.com

Grace Financial Group LLC
436 Willis Avenue, 2nd Floor
Williston Park, NY 11596
(516) 280-5773
Charlie Fisher

Jefferies
20 Madison Avenue, 11th Floor
New York, NY 10022
(212) 707-6492
Glen C. Dailey

LAWYERS

Akin, Gump, Strauss, Hauer & Feld
590 Madison Avenue, 20th Floor
New York, NY 10022
(212) 872-1030
www.akingump.com
Steven Vine

Arnold & Porter LLP
399 Park Avenue
New York, NY 10022-4690
(212) 715-1000
www.arnoldporter.com

Baker & Hostetler LLP
666 Fifth Avenue
New York, NY 10103
(212) 589-4200
www.bakerlaw.com
Steven H. Goldberg

Bingham McCutchen LLP
399 Park Avenue
New York, NY 10022-4689
(212) 705-7802
Robert Leonard

Cadwalader, Wickersham & Taft LLP
One World Financial Center
New York, NY 10281
(212) 504-6540
www.cwt.com
Drew G. L. Chapman

Davis Graham & Stubbs LLP
1550 Seventeenth Street, Suite 500
Denver, CO 80202
(303) 892-9400
www.dgslaw.com

Ronald R. Levine Dechert LLP
30 Rockefeller Plaza, 23rd Floor
New York, NY 10112-2200
(212) 698-3500
www.dechert.com
George J. Mazin

Foley & Lardner LLP
111 Huntington Avenue, Suite 2600
Boston, MA 02199-7610
(617) 342-4097
Thomas A. Hickey

Friedman Kaplan Seiler & Adelman LLP
7 Times Square, 27th Floor
New York, NY 10036-6516
(212) 833-1120
Scott Berman

Goodwin Procter LLP
Exchange Place
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Boston, MA 02109
(617) 570-1559
www.goodwinprocter.com
Elizabeth Shea-Fries

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200 South Orange Avenue, Suite 2600
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(407) 244-5239
www.hklaw.com
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Roseland, NJ 07068-1791
(973) 597-2424

www.lowenstein.com
Robert G. Minion

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Hearst Tower
214 North Tryon Street, Suite 3800
Charlotte, NC 28202
(704) 444-3500
www.mayerbrown.com
Kris Manzano

Sadis & Golberg
551 Fifth Avenue, 21st Floor
New York, NY 10176
(212) 573-6660
www.sglawyers.com
Ron Geffner

Schulte Roth & Zabel
919 Third Avenue
New York, NY 10022
(212) 756-2567
www.srz.com
Steve Fredman

Seward & Kissel
One Battery Park Plaza
New York, NY 10004
(212) 574-1231
www.sewkis.com
Steve Nadel

Tannenbaum, Helpern, Syracuse & Hirschtritt LLP
900 Third Avenue
New York, NY 10022
(212) 508-6700
www.thshlaw.com
Michael Tannebaum

Walkers
Walkers House
P.O. Box 265GT
Mary Street
George Town, Cayman Islands
(345) 914-4223
www.walkers.com.ky
Mark Lewis

ADMINISTRATORS

Alps Price Meadows
11747 NE First Street
Bellevue, WA 98005
(425) 454-3770
www.alpspricemeadows.com
Frank Duffy

Bank of Butterfield/Butterfield Fund Services
P.O. Box HM 195
Hamilton, Bermuda
HMAX (441) 299-3954
www.butterfieldbank.com

BNY Alternative Investment Services
One Wall Street, 42nd Floor
New York, NY 10286
(212) 495-1784
www.bankofny.com
Peter Mastriano

Maples Fund Services
250 Park Avenue, 7th Floor
New York, NY 10177
(212) 361-9513
Kim Waldman

Meridian Fund Services
370 Lexington Avenue, Suite 1806
New York, NY 10017
(646) 381-2645
Annabel H. Marisca

ACCOUNTANTS

Deloitte & Touche
Paramount Building
1633 Broadway
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www.deloitte.com

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New York, NY 10017-2703
(212) 891-4008
www.eisnerllp.com
Peter Testaverde

Ernst & Young
5 Times Square
New York, NY 10036
(212) 773-2252
www.ey.com
Arthur Tully

Grant Thornton LLP
60 Broad Street, 24th Floor
New York, NY 10004
(212) 422-1000
www.grantthornton.com
Cynthia Keveney

Halpern & Associates, LLC
218 Danbury Road
Wilton, CT 06897
(203) 210-7364
Barbara Halpern

J.H. Cohn LLP
1212 Avenue of the Americas
New York, NY 10036
(646) 254-7412
Jay D. Levy

KPMG LLP
345 Park Avenue
New York, NY 10154-0102
(212) 872-4490
www.kpmg.com
Jeffrey Millen

Marcum & Kliegman LLP
10 Melville Park Road
Melville, NY 11747
(631) 414-4230
Beth Wiener

Margolin, Winer & Evens LLP
330 Madison Avenue, 15th Floor
New York, NY 10017-5001
(516) 240-4408

Jeffrey Tunkel
PricewaterhouseCoopers
300 Madison Avenue, 24th Floor
New York, NY 10017
(646) 471-7830
www.pwc.com

INSURANCE

Brown & Brown of Lehigh Valley Inc.
268 Brodhead Road
Bethlehem, PA 18017
(610) 974-9490
Richard Knudson

Frank Crystal & Co., Inc.
1 Financial Square, 17th Floor
New York, NY 10005
(212) 504-1871
Ari Kleinman

Hub International Northeast
1065 Avenue of the Americas
New York, NY 10036
(212) 338-2252
Felice Strachman

OPERATIONS AND COMPLIANCE CONSULTANTS

Constellation Investments
305 Madison Avenue
Suite 2036
New York, NY 10165
(212) 300-6250
Boris Onefater

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Glossary

Absolute-return fund A fund that attempts to perform positively for investors regardless of market conditions. An absolute-return fund is not benchmarked against traditional long-only indices because it can go long and short to provide returns to investors.

Administrator A service provider hired by a hedge fund to calculate performance and net asset value (NAV) for the fund and to perform other record-keeping functions.

Alpha The return as measured by the fund's performance over the risk-free rate and other performance measurement tools, including but not limited to traditional and nontraditional indices.

Alternative assets Any investment vehicle that is not considered a traditional or long-only fund. Alternative assets include hedge funds, private equity funds, and commodities pools that are not regulated under the Securities Act of 1940.

Annual rate of return The compounded gain or loss in a fund's net asset value (NAV) during a calendar year.

Arbitrage An investment strategy that takes advantage of the mispricing of securities from one market to another.

Assets under management Includes all investments, leveraged and unleveraged, including cash that are overseen by a fund manager.

Average annual return (annualized rate of return) Cumulative compounded gains and losses divided by the number of years of a fund's existence.

Average monthly return Cumulative gains and losses divided by the number of months of the investment's life, with compounding taken into account.

Average rate of return The investment's performance or lack of performance over a specific period.

Back-test The use of historical data to prove or disprove a specific trading methodology.

Bear market Prolonged period of falling prices.

Bull market Prolonged period of rising prices.

Clearing The process of reconciling transactions between the manager and the broker once a trade is entered and executed.

Commodity trading advisor (CTA) A person or entity providing advice to others on investments in commodity futures, options, and foreign-exchange contracts.

Custodian A bank, trust company, or other financial institution that holds and protects a fund's assets and provides other services, including collecting money from investors, distributing redemption proceeds, and maintaining margin accounts.

Derivatives Securities that take their values from other securities.

Diversification The variety of investments in a fund's portfolio. In diversification, risk-averse fund managers combine investments that are unlikely to all move in the same direction at the same time.

Drawdown The amount of loss that an investment experiences from its highest value to its lowest value. The investment's maximum drawdown over a specific period is often used in a way to determine the risk associated with the investment.

Due diligence Questions by investors to the manager regarding investment style and strategy as well as the manager's background and track record.

Exposure The extent to which an investment has the potential to change based on changes in market conditions. In the hedge fund world, exposure is measured on a net basis. Net exposure takes into account the difference between the long positions versus the short positions. For example, if a fund is 150 percent long and 65 percent short, its net exposure would be 85 percent.

Fair value The price at which a single unit of a security would trade between parties that don't have interests in the issue.

Forward contract A private, over-the-counter (OTC) derivative instrument that requires one party to sell and another party to buy a specific security or commodity at a preset price on an agreed-upon date in the future.

Fund of funds An investment vehicle that invests in other hedge funds or other investment vehicles.

Futures contract An agreement to buy or sell a commodity or security at an agreed-upon date in the future.

General partner The individual or firm that operates, develops, and runs a limited partnership (LP).

High-water mark An agreement in the offering document that provides for the manager to earn an incentive fee on profits only after the fund's performance surpasses its highest net asset value (NAV) from the prior period.

Hurdle rate A set return rate the fund must achieve before fund managers collect their performance fee. The hurdle rate is usually a fixed rate such as the London Interbank Offered Rate (LIBOR) or the one-year Treasury bill rate plus a fixed amount of basis points.

Incentive fee (performance fee) The fee, usually 20 percent, that a fund manager is paid on the profits made in the portfolio.

Inception date The day on which a fund starts trading.

Limited liability company A legal structure that is the hedge fund investment vehicle.

Limited partnership A legal structure used as a hedge fund vehicle.

Liquidity The ease with which an investment can be sold without impacting its price in the market.

Lockup The term during which investors must maintain their investment in the fund (i.e., a period during which they aren't allowed to redeem assets).

Long position A transaction to purchase shares of stock resulting in a net positive position.

Management fee The charge that a fund manager assesses to investors, often used to cover operating expenses. The annual fee generally ranges from 0.5 to 2 percent of an investor's entire holdings in the fund and is usually collected on a quarterly basis.

Margin call Demand that an investor deposit enough money or securities to bring a margin account up to the minimum maintenance requirements.

Minimum investment The smallest amount that an investor is permitted to contribute to a hedge fund as an initial investment. Minimum investment requirements can range from $50,000 to $5 million, but most funds insist on $500,000 to $1 million.

Net asset value (NAV) The market value of a fund's total assets.

Offshore fund An investment vehicle set up outside of the United States.

Onshore fund An investment vehicle set up in the United States that is available to U.S. citizens.

Option A contract that gives parties the right to buy or sell a specific asset or security at a specified strike price by a preset date.

Performance fee Fee paid to manager based on how well the investment strategy performs.

Portfolio manager A company or individual that manages the firm's assets.

Poison pill Any number of legal defensive tactics written into a corporate charter to fend off the advances of an unwanted suitor.

Prime broker A securities firm that provides hedge funds with operational services, including trading, reporting, and financing.

Private equity fund A fund that makes investment in private companies.

Private placement memorandum The documents that set forth the hedge fund offering. These detail the fund's operation, management, risks, and reward potential.

Quantitative analysis Security analysis that uses objective statistical information to determine when to buy and sell securities.

Redemption The sale of all of an investor's interests in the fund.

Redemption fee A fee imposed by hedge fund managers at the time the investor redeems his or her investment.

Redemption notice period The notice that investors must provide to the hedge fund manager before withdrawing their investment from the fund.

Section 3(c)(1) A provision in the Investment Company Act of 1940 that allows certain hedge funds to be established without registering as investment advisers, provided their shares are owned by no more than 100 investors.

Section 3(c)(7) A provision in the Investment Company Act of 1940 that allows hedge funds to have more than 100 investors, provided all investors are considered to be qualified purchasers.

Sharpe ratio The ratio of return above the minimum acceptable return divided by the standard deviation. It provides information of the return per unit of dispersion risk.

Short position A transaction to sell shares of stock that the investor doesn't own.

Short sales The process of borrowing securities from a broker and "selling them into the market" with the belief that the security can be bought back at a later date at a lower price.

Spread The difference in price or yield between two securities.

Standard deviation A measure of the dispersion of a group of numerical values from the mean. It is calculated by taking the difference between each number in the group and the arithmetic average, squaring them to give the variance, summing them, and taking the square root.

Traditional investments Products whose performances are correlated with broad stock market or fixed-income market.

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