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Sound Advice For Emerging Hedge Fund Managers

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Structuring the Hedge Fund

Structuring a hedge fund involves both the creation of one or more entities through which investments will be made (domestic and offshore hedge funds), as well as the management entities through which the advisory services will be provided to the hedge funds (the general partner and/or the investment manager). The structure and domicile of the hedge fund is primarily dependent upon two variables: (i) the nature and demographics of the prospective investors, and (ii) the investment strategy employed by the investment manager. Investors can be divided into three classes: (i) U.S. taxable investors, (ii) U.S. tax exempt investors, and (iii) non-U.S. persons. In the majority of circumstances, if the investors are U.S. taxable investors, the fund will be formed as a U.S. limited partnership or limited liability company.

The U.S. fund is often referred to as a "domestic fund." Most domestic funds are organized in Delaware. If the investors are U.S. tax-exempt investors or non-U.S. persons, the fund generally will be formed in a jurisdiction outside of the U.S. as a corporation (or other analogous entity). The non-U.S. entity is often referred to as an "offshore fund." Most offshore hedge funds organized on behalf of U.S. based investment managers are organized in Bermuda, the British Virgin Islands and the Cayman Islands. U.S. tax-exempt investors typically prefer to invest in an offshore fund set up as a corporation because if the offshore fund purchases securities on margin (often referred to as leverage), an offshore fund which is set up as a corporation blocks the unrelated business taxable income ("UBTI") that would otherwise be taxable to the U.S. tax-exempt investor.

In determining whether to form both a domestic and an offshore hedge fund, it is advisable to anticipate the funds' asset size within a few months after launch. The anticipated aggregate investment at or shortly after the launch of the business may not justify the formation of both a domestic fund and an offshore fund and to create both may impair the investment manager's ability to survive due to the organizational expenses and the costs of maintaining both domestic and offshore hedge funds. With early stage managers, cash burn is often overlooked and can be critical to the survival. The manager must have an opportunity to establish a proven track record.

Types of Hedge Fund Structures

Side-by-side: In a side-by-side structure, the domestic fund and the offshore fund make direct investments pursuant to the investment strategy, and trade executions are allocated between the domestic fund and the offshore fund.

Master-feeder: In a master feeder structure, a third entity is created (the "master fund") and the domestic fund and the offshore fund, rather than making direct investments, invest substantially all of their assets into the master fund and in turn, the master fund makes the investments on behalf of the domestic fund and the offshore fund (often referred to as the domestic feeder and offshore feeder, respectively).

Mini-Master: The mini-master structure generally is comprised of two entities; an offshore feeder and a master entity. While the offshore feeder is taxed as a corporation to benefit U.S. tax exempt investors and block UBTI, the master entity may be structured for tax purposes as a partnership. Rather than the U.S. based manager receiving its incentive revenue as a fee from the offshore fund and being subject to ordinary income tax, the U.S. based manager may receive incentive revenue as an allocation from the master entity, in an attempt to benefit from capital gains tax treatment.

Several legal and commercial drivers determine the ideal hedge fund structure. For example, if the strategy calls for significant investment in illiquid or thinly-traded positions which are difficult to allocate among two brokerage accounts, a master feeder structure may be preferred. The investments will be allocated on a pro rata basis at the master fund yet only require the investment manager to purchase and sell the positions through one brokerage account. Also, in many transactions involving early stage or "seed" investments, if the seed investor is located offshore, it may prefer a master feeder structure so that all fees and allocations may be taken at the master fund and thus avoid the U.S. tax regime. Conversely, employing a tax efficient strategy for U.S. taxable investors may be of little benefit or detrimental to U.S. tax-exempt investors and non-U.S. persons. Thus, a side by side structure allows the investment manager the ability to employ tax efficiency with the domestic fund, while maximizing the entry and exit points of each securities position without regard to long term tax gains for the offshore fund.

Structuring & Domicile of the Investment Manager

The structure and domicile of the investment manager is primarily determined by the citizenship and tax considerations of its principals, as well as the regulatory regime of the jurisdiction. Empirical evidence suggests that the super majority of hedge funds are managed by U.S. domiciled entities structured as either limited liability companies or limited partnerships which are taxed as flow through vehicles (rather than as corporations). In circumstances involving non-U.S. persons, if the non-U.S. persons own the majority of equity in or receive the majority of the economics from the investment manager and their interests are controlling, the investment manager may be organized in an offshore jurisdiction to accommodate the tax needs of the non-U.S. persons.

Historically, federal and state regulation often impacted the location at which the investment manager maintained its office in the United States. Certain states have compulsory registration requirements which require an investment manager with an office in those states to register as an investment adviser prior to the launch of the hedge fund. Prior to The Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") certain managers chose to maintain offices in neighboring states which did not have compulsory registration requirements so as to avoid having to register as an investment adviser. Post Dodd Frank, managers have accepted registration as an investment adviser as inevitable.

Investor Due Diligence

A successful hedge fund launch is dependent upon providing prospective investors with comfort regarding non-investment considerations, such as the manager's operations, compliance, and risk management. In order to do so, having a standard due diligence questionnaire ("DDQ") is recommended.

It is also critical that managers be consistent in all of their disclosures to its investors. Consistency across documents is vital to the maintenance of a manager's credibility in the due diligence process. The same level of care and consideration should be invested in marketing material, DDQs and requests for proposals. Each of these documents should respond to each item in the same manner. A different sentence or even a single word can change the message or meaning and result in a different understanding to the investor.

Staffing

A key challenge faced by emerging hedge fund managers is weighing the need to build institutional-quality operational and accounting ("back office") and investment ("front office") functions versus the cost incurred in doing so. Smaller firms may consider assets under management ("AUM") in making headcount decisions, but must also adequately address the operational risk of running too lean an operation. A firm must also take into account the complexity of its funds' strategies in determining human capital requirements. Three key considerations in human capital management are (i) depth of the employee base, (ii) segregation of duties, and (iii) employee suitability.

Depth of Employee Base

Depth of staffing may be the most visible challenge faced by an emerging manager. Investors will have concerns if a firm's operations appear to be overly-reliant on one individual. What happens if a key employee goes on vacation, or is hit by the proverbial bus? Employees of emerging hedge fund managers may need to possess a broader skill set than peers at larger firms. Emerging hedge fund managers should also be aware that investors may pay particular attention to the employment history and work experience of the current staff, and the scope of reference checks conducted by managers prior to hiring new employees.

At smaller firms, key professionals may not have designated back-ups. For example, some firms may not employ a senior controller or other finance team members who are able to perform the accounting responsibilities of the Chief Financial Officer ("CFO"). Additionally, other firms may be too reliant on one individual to manage the back office operations. Thus, sufficient controls should be put in place that allow for staff redundancies and mitigate key man risk.

The same concerns are shared on the investment side of the business. At the smallest firms, the portfolio manager may be the sole authorized investment decision maker. Firms must establish procedures to enable investment activity to continue seamlessly when the portfolio manager is not available. Cross-training employees can help mitigate the risk of operating with a lean staff. Additionally, it is critical for firms to create operations manuals that detail the steps necessary to conduct the firm's trading, operational, and accounting functions on a daily basis. An operations manual can be referenced in the circumstance that a key employee is unable to perform his or her job. Creating redundancies of key responsibilities and cross-training employees are vital practices for mitigating operational risk at smaller firms because adding additional headcount may not be possible. Firms should also establish plans that delineate a clear road map for additional hires as the firm's assets under management increase.

Segregation of Duties

In order to mitigate conflicts of interest, segregation of duties is a key practice for hedge funds to follow. While complete segregation of duties can be difficult to achieve at hedge funds with a limited number of employees, there should be a clear distinction between front and back office functions. For example, investment professionals may collect a portion of a fund's incentive allocation. In order to increase their compensation, they are incentivized to ensure the portfolio is marked at the highest Net Asset Value ("NAV"). To prevent upward bias, the investment professionals should not have the final authority for the valuation of investments within the portfolio. Instead, hedge fund managers should establish valuation committees to provide oversight and processes for the valuation and NAV finalization. The valuation committee is responsible for overseeing, reviewing, and finalizing the valuations prepared for each of a fund's investments. While it may not be practical for the smallest firms (i.e. a two-person firm) to establish a valuation committee, the final approval of individual valuations and the NAV should be the responsibility of a back office professional, or a valuation committee comprised of a majority of back office professionals (this topic will be addressed further in Part 3 of this series). An additional risk mitigant against biases or conflicts of interest in the NAV finalization process is for funds to employ an independent administrator. An administrator provides accounting services, including maintaining the hedge fund's official books and records, and is charged with independently determining the fund's NAV.

Employee Suitability

SEC-registered managers are required to have a Chief Compliance Officer ("CCO"). As a consequence of this requirement, smaller firms may employ professionals in roles for which they have received no prior training of the role. Given their size, it is not uncommon for the CFO to also serve as CCO. Firms should consider enhancing their infrastructure by selecting third-party service providers to fill the functions which it is unable to optimally perform internally and promote the segregation of duties. For those funds that have this infrastructure in place, third parties can also be engaged to enhance a funds existing internal controls.

Counterparty Risk

Hedge funds custody their securities at one or more institutions, such as prime brokers, custodian banks, clearing agents or an execution and settlement broker acting as an ISDA counterparty. Collectively, institutions providing custodial services to hedge funds are known as "counterparties. " As we have witnessed with the collapse of Lehman Brothers, Bear Stearns and MF Global, it is important for hedge funds to maintain robust procedures for mitigating and monitoring counterparty risk, in order to safeguard customer assets.

In order to mitigate counterparty risk, firms should consider maintaining codified procedures for counterparty selection and monitoring. . Firms may assess the financial strength of their counterparties by evaluating metrics such as credit ratings, CDS spreads, and leverage. In their due diligence process for selecting prime brokers, firms may focus on the ability of a prime broker to provide services specific to their hedge fund's strategy and the financial instruments in which the fund transacts. The ability of counterparties to provide execution, custodial, and capital introduction services may be secondary considerations. Firms should carefully consider the entity with which their funds enter into agreements. Many of Lehman Brothers' customers' assets were custodied at its United Kingdom subsidiary, LBIE. The U.K. maintains no limits on rehypothecation and some customer assets have yet to be fully recovered. Assets custodied at U.S.-based entities are subject to legal limits on re-hypothecation and clear, delineated bankruptcy and liquidation procedures. International subsidiaries may be subject to less transparent liquidation procedures and may not be subject to rehypothecation limits.

In order to avoid disruptions in a fund's borrowing ability, firms should attempt to negotiate favorable financing terms. Favorable terms in prime brokerage agreements may include margin lock-ups, which prohibit the prime broker from changing the financing term within a certain period (usually between 30 days and 90 days). Favorable terms in ISDA agreements may include bilateral agreements, parental guarantees, higher NAV triggers, and NAV triggers which exclude the impact of redemptions.

In order to determine an appropriate allocation of assets amongst their funds' counterparties, firms may discuss the metrics noted above in regularly-scheduled committee meetings. Management and Risk Committees ("M&R Committees") should meet on a regular basis and under certain circumstances may require ad-hoc meetings, in order to formally review their funds' counterparty exposure. M&R Committees should be comprised of senior-level staff from the front and back offices. Establishing thresholds at which a fund will move assets away from its counterparty can provide a roadmap for action in the event of counterparty distress and serve to reduce counterparty risk.

Engaging a second prime broker (or custodian) may be a top priority for emerging hedge fund managers, in order to obtain flexibility in the custody of assets in the event of counterparty distress. Hedge funds engage custodian banks to hold unencumbered cash and fully-paid securities that are not actively traded. Maintaining cash-related instruments and securities at a custodian bank helps to mitigate counterparty risk, as a fund's securities held at a custodian are segregated from the entities' assets and may not be re-hypothecated. Hedge fund managers must understand the risks pertaining to the instruments in which unencumbered cash is invested. For example, during the 2008 credit crisis, some money market funds invested in commercial paper and debt securities issued by companies that later defaulted and / or deteriorated in credit quality.

Systems

A firm's systems, and the ability of its employees to effectively utilize those systems, are critical to maintaining efficient day-to-day operations and minimizing disruptions. Emerging managers face the dilemma that while robust systems are available, implementing them may not be cost-effective, or may be subordinate to other firm needs (such as adding headcount or engaging a second prime broker and/or custodian bank).

Accounting systems are critical to a manager's operations. A hedge fund manager should engage a third-party administrator whose duties include maintaining the official books and records of the fund. Ideally, a manager will use a dedicated accounting system that maintains parallel fund-level and investor-level accounting records to the administrator. However, because of cost or personnel constraints, emerging managers may employ less robust internal controls, such as maintaining only fund-level accounting records, or using Microsoft Excel, rather than an accounting system. In these cases, the manager will ultimately need to rely on the administrator's records. Given this reliance, managers should thoroughly review the administrator's records on at least a monthly basis, and investors should understand the manager's review process. Managers must understand the administrator's internal accounting and operating processes. Are the administrator's systems automated or is there manual intervention? Relying on an administrator's accounting records rather than maintaining complete parallel accounting records in-house can be risky for an emerging manager and is not recommended. Managers with lower AUM typically generate lower fees for an administrator. As a result, emerging managers may receive less responsive service and/or a less experienced support team at the administrator. These factors may pose problems in the event that the manager has questions regarding its accounting records. Overreliance on any service provider, including the administrator, creates operational risk.

Trading systems, including those pertaining to execution, order management, and reconciliation, can be the backbone of a firm's operations. Utilizing these systems, particularly, systems that are integrated with a manager's accounting system, can eliminate the need to enter the same information more than once, thereby reducing the potential for human error. In some cases, however, systems may not be cost-effective for emerging managers. Prior to launch, managers should create documents that address each stage of the trade flow process, including the systems employed. If the manager expects to employ additional systems as assets grow, managers may supplement their current documentation with additional diagrams and flow charts that clearly delineate the change in the operating environment.

Managers may also consider implementing systems to assist in risk reporting, investor reporting, and regulatory reporting as well as systems to help manage and automate margin and collateral processes.

Transparency & Valuation

One of the key concerns faced by investors is the fund's level of transparency. Over the past decade, investors have sought a higher degree of transparency. Transparency ensures that funds are making investments consistent with their investment mandate and helps monitor the performance of the fund and its respective holdings. Transparency needs have migrated from the investment / strategy side to all facets of the manager and hedge fund's infrastructure. The need for transparency can include addressing regulatory guidelines, notification provisions, staff changes, counterparty exposures and valuations.

Investors will typically raise questions about transparency well before they put money into the fund and more often than not, investors will continue to seek transparency throughout the life-cycle of their investment. Assessing the degree of transparency typically commences during the investors' diligence process. It is during this process that investors will begin to question the fund's valuation policy. During their diligence review, investors want to understand who will be performing the investment valuations, who will be involved in the valuation process for each asset, if valuations will be performed in-house or by a third party, and whether a third party will be hired to opine on the valuation process. Ultimately the investors will want to know what party and/or parties will determine the final booked value. Additionally, investors will also seek to understand what guidelines will be set forth in determining the valuations of the underlying asset/investment, and how often the fund will value its portfolio.

Valuation Policy

In meeting the needs of the investors and in an effort to increase transparency, regardless of the size of a fund, it is best-in-practice to establish a valuation policy. The valuation policy should be continuously monitored, evaluated and revised to encompass all asset classes in which the fund invests or plans to invest. The methodologies recommended by the policy should conform to industry standards and strive to abide by guidelines suggested by industry governing bodies.

In establishing a valuation policy, a fund should first consider the standards set forth by accounting and government bodies such as the Financial Accounting Standards Board ("FASB"), International Accounting Standards Board ("IASB"), the Securities and Exchange Commission ("SEC"), and International Private Equity and Venture Capital Valuation Guidelines ("IPEV Guidelines"). All firms should strive to meet the Valuation Principles set forth by the International Organization of Securities Commissions ("IOSCO"). Regardless of the size of one's fund, it is imperative that a fund maintain the integrity of the policies set forth by industry experts and regulatory agencies, as failure to do so could lead to the termination of one's fund or even punishment by law.

A component of the valuation policy should be for the fund to establish a valuation committee. As noted above, typically, the valuation committee oversees, reviews, and finalizes the valuations prepared for each of a fund's investments. The valuation committee also monitors the frequency of valuation review which is defined within the valuation policy. The frequency of valuation can range from daily, monthly and/or quarterly and will depend on the asset class/underlying investment type. Depending on the size of the fund, it may be difficult to develop a large committee. However, regardless of size, specific personnel in both the front and back office should be identified to perform the functions of a valuation committee. Additionally, there should be a clear and documented understanding for who has the final authority in concluding on a value of an underlying asset/investment. It is recommended that this authority be an unbiased individual. Ultimately, the methodology employed in one's concluded valuation should be consistent with the guidelines set forth in the valuation policy and in line with industry standards.

The valuation policy also describes the methodology and procedures by which the fund performs each of its valuations. The methodologies and procedures should have a consistent framework but typically vary depending on the type of investment/asset class. The policy states the valuation Fair Value hierarchy (i.e., defining Level I, Level II or Level III assets). The valuation policy should also identify and define the valuation approaches utilized in estimating a value for its investments (i.e. an Income Approach, a Market Comparable Company Approach, a Transaction Approach, and/or an Underlying Asset Approach). In employing such methodologies, it is recommended that funds seek the advice of a third-party consultant on hard-to-value and illiquid assets which are held by the fund.

Third-party valuation specialists have valuation expertise ensuring proper Fair Value guidelines are followed. Ultimately third party valuation specialists provide a level of assurance that the concluded asset values are reasonable.

Outsourcing

As emerging hedge fund managers attempt to build out their infrastructure, they are faced with the challenge of choosing which functions to perform in-house and which functions to outsource. Apart from auditors, administrators, legal counsel, and prime brokers/custodians, there exists a wide variety of service providers which perform functions such as valuation, regulatory compliance support and consulting, IT network support, trading, accounting, and other functions. Of these, it is most common to see a smaller firm outsource its IT function altogether, and it is also quite common to see a smaller firm engage a compliance consultant. Firms must weigh the costs incurred when outsourcing versus the challenges faced when certain key processes are performed by a third party service provider. For example, what happens if the service provider decides it will no longer provide a certain service level or platform? How will the manager address staff turnover or system inefficiencies at the service provider level?

Compliance budgets may be nominal for smaller advisory firms. Outsourcing compliance functions provides firms with full compliance services, including but not limited to, assisting with regulatory filings, creating compliance documentation (including compliance manuals), creating compliance calendars, conducting mock audits, monitoring employee personal trading activity, and monitoring employee gifts and political contributions. Compliance consultants may provide a manager with software to streamline these processes. Compliance consultants may be used as a supplement to the compliance duties performed by the firm itself and by its external legal counsel.

Given the complexity of certain assets, funds may outsource a portion of their valuation function. Funds often engage a third-party valuation specialist to price illiquid assets in order to ensure that a fund's NAV is calculated reasonably, independently, and without bias. Engaging a third-party valuation specialist is particularly important when illiquid assets represent a significant portion of a fund's assets. Given the lack of pricing on illiquid assets, subjectivity is often required in the valuation of such assets.

Dependent on the size of the firm other functions may be outsourced including but not limited to, IT network support providers, IT data warehousing services, accounting services, and key personnel such as traders and CFOs. Investment managers should try to maintain as many functions as possible in-house to ensure internal controls are met. Ultimately, investment managers should focus on providing investors with transparency and implementing the best-in-practice guidelines noted above. In doing so, managers will require a healthy, balanced approach to insourcing and outsourcing certain functions.

Thus, in order to successfully grow an asset management firm to manage a single hedge fund or a group of hedge funds, it is imperative that the investment manager entity and the funds be properly structured. From time to time, the structure of the firm and funds should also be reviewed in order to ensure that the firm and funds comply with material changes to tax laws or regulatory developments. Moreover, in an effort to reduce operational risk, as well as to provide comfort to existing investors and prospective investors, the investment management firm must hire and retain suitable employees. Key employees must be empowered to develop and implement policies and procedures specifically tailored to the firm's size and strategy including, in part, identifying and mitigating counterparty risk, ensuring that portfolios are properly valued, and maintaining a robust compliance program. A successful and sustainable fund will ensure that these essential characteristics are met and monitored.

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Contacts

Roy Gurny
Director
+1 212 871 0062
roy.gurny@duffandphelps.com

Brian Garfield
Vice President
+1 212 871 9940
brian.garfield@duffandphelps.com

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