Building a Scalable Hedge Fund Business

As new portfolio managers enter the hedge fund space with dreams of running billions of dollars in a traditional US/offshore master-feeder structure, many of these managers are encountering the asset raising headwinds that have permeated the industry recently. Accordingly, many of these managers have tamped down their longer-term ambitions in order to build an interim product in the short-term that will allow them to: (1) build a track record, (2) keep costs down, and (3) expand when the markets improve.

It's very important to be strategic in these efforts, as building an alternative investment management business in a haphazard fashion will make it more challenging to evolve to a fuller scale model. The following sets forth a number of approaches[1] that are available that may help achieve these goals, along with recommendations worth implementing in order to avoid the common mistakes often seen in these scenarios:

1. *Start with a US Standalone Fund Only.* Managers may wish to consider keeping organizational costs down by launching just a US standalone fund at first, with language built into the governing documents allowing for unilateral conversion to a master-feeder structure at a later date (thereby eliminating the need to seek investor consent at conversion). A US standalone fund can accept capital from all types of investors, although it is often not the most efficient or desired structure for non-US and US tax-exempt investors. The fund structure can then be expanded once capital commitments from these non-US and US tax-exempt investors are significant enough to warrant an offshore fund.

    a. What happens when a manager converts to a master-feeder from a domestic standalone? At the time of conversion to the master-feeder structure, the assets in the US fund would be novated down into the master as the new trading entity – while this involves some additional counterparty papering, usually it's not a heavy lift. Note that in some cases where the novation aspect is expected to be particularly cumbersome or where a non-US trading vehicle is necessary to reach the desired markets, the master fund may be set up at inception along with the US feeder fund. An offshore feeder fund could be established at a later date.

[1] Even before undertaking one of the suggested approaches, many managers will set up a personal trading account to test their strategy and build an auditable track record. In addition, they may create a PowerPoint outlining their proposed plans. These items will then often be used to test the waters with potential investors, which will help them make their future growth decisions.

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b. Rather than transitioning to a full master-feeder structure, an offshore feeder fund could be created to invest into the existing US fund, creating a "mini-master" structure. This may, however, raise concerns for non-US investors in terms of their exposure to the US jurisdiction of the US master fund.

Pros of launching just a US fund at inception
- Cost-effective
- Speed
- Fewer service providers

Cons of launching just a US fund at inception
- Limited fundraising capabilities
- May need to convert structure at a later date

Offering document drafting tips:

i. **Use investor-friendly terms:** A first-time manager can seek to secure an anchor investor and/or may consider founder-type classes to attract day-one investors; this may include offering discounted economics for early investors (sometimes with the requirement of a lock-up). Obtaining early capital/anchor investors will make it easier for the manager to scale the business without worrying about paying its overhead.

ii. **Add in both 3(c)(7) and 3(c)(1) Representations into the Subscription Agreements.** For those managers who are unsure where their capital is coming from and who do not wish to foreclose a large number of potential investors, the fund can start off as a 3(c)(1) (i.e., 100 beneficial owners) fund, but with the 3(c)(7) (i.e., qualified purchaser) representations built in too for future reference, should the manager decide to convert to a 3(c)(7) structure (which allows for 2,000 investors, but requires a higher level of investor qualification) at a later date. While the representations will need to be refreshed at the time of the actual 3(c)(7) conversion, having the preliminary information in advance will help inform the manager's future decision making process.

2. *Establish a Fund of One.* Large investors may be willing to give the manager capital, but may require a bespoke fund structured solely for the investor's benefit. This structure is requested for reasons including: safety of capital, different risk parameters and/or greater use of leverage, among other reasons. Often, given the sophistication of larger investors, the documentation associated with setting up such a structure is simpler than a commingled fund for multiple investors. However, the manager will need to be mindful of whether the fund of one triggers additional compliance requirements, such as SEC registration, and how it will impact its future business operations, once the manager sets up a traditional alternative investment fund. In some cases, managers have been able to add a clause stating that the fund of one will be folded into the main fund, once the main fund has met certain AUM triggers. It is not uncommon for these funds to have a "most favored nations" (MFN) provision – note that given that the strategy may be different than the manager's future flagship fund, the MFN clause should have a carveout to limit its application to other products with substantially similar strategies to the fund of one.

Pros of establishing a Fund of One
- Ability to raise capital from a large institutional investor
- Simpler legal documents

Cons of establishing a Fund of One
- There may be additional SEC/compliance requirements for the manager
- Potential challenge moving the investor's assets into the future flagship fund

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3. *Enter into a Separately Managed Account (SMA) Agreement*. Somewhat similar to a fund of one, in a separately managed account, there is just one accountholder and, depending on the accountholder, it can be quite easy to establish in a short period of time. The SMA will be in the client's name, which provides the client a number of benefits, such as the ability to pull their capital from the account at any time as well as complete portfolio transparency. There may also be some tax inefficiencies in a separately managed account, as performance-based compensation will always be treated as ordinary income. Moreover, running a separately managed account may cause the manager to have to register sooner with the SEC as an investment adviser than if it were just running a fund. Finally, in light of the recently enacted SEC Marketing Rule, the manager must ensure that it will be provided all documentation needed to substantiate its track record in the future.

Pros of an SMA
- Simple legal structure/set up
- Faster launch timeline than a fund

Cons of an SMA
- Additional compliance requirements
- No lock-up/notice period for withdrawal of capital
- Tax inefficiency

4. *Join a Platform*. Some managers who wish to avoid the operational challenges associated with starting their own firm in a difficult fundraising and/or economic environment may instead opt to work (at least in the short run) at one of the large alternative investment management platforms investing a pool of allocated capital. If the manager is contemplating such an approach, they should try to ensure that the agreement is not overly restrictive in terms of the ability to spin out at a later date without overly harsh non-compete and non-solicit obligations and, in light of the Marketing Rule, that their track record is portable and will be supported with all documents necessary to substantiate it under applicable law.

Pros of joining a platform
- Minimal cost
- Operational support from platform

Cons of joining a platform
- Potential non-compete and spinout challenges
- Potential track record portability challenges

If you have any questions regarding the matters covered in this memo, please contact any of the partners and counsel listed below or your primary attorney in Seward & Kissel's Investment Management Group.

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