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HOW TO START A HEDGE FUND IN THE US 2011

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FUND COUNSEL: WHAT YOU NEED TO KNOW

GEORGE MAZIN OF DECHERT LLP'S FINANCIAL SERVICES GROUP OUTLINES THE QUESTIONS HEDGE FUND MANAGERS MUST ASK WHEN SELECTING WHICH LAW FIRM TO WORK WITH



George Mazin

is a partner in Dechert LLP's financial services group. He advises clients on the structuring and restructuring of domestic and offshore private funds, private placements of securities, structured products, private equity investing, and broker-dealer and investment adviser compliance.

One of the early decisions that hedge fund managers must make when they decide to launch a fund is to select a law firm to prepare the fund's offering documents. Despite the importance of this decision, many managers are inexperienced in selecting counsel. Here are some of the factors that should be considered when making a decision:

- Experience – how extensive is the firm's experience in organising private funds? How deep is the bench and which lawyers will be doing the work?
- Market intelligence – does the firm know what current terms are for competitive funds?
- Compliance expertise – in an industry that is increasingly becoming subject to greater regulation, does the firm have the requisite experience in compliance matters?
- Geographic coverage – many funds invest globally and seek to raise capital from investors around the world. Does the law firm have the necessary geographic footprint to address these needs?
- Ancillary services – in addition to fund formation and compliance expertise, managers will require advice in a broad array of areas, including tax, ERISA, derivatives, intellectual property and employment law. Does the law firm have expertise in each of the areas required by the manager?

While it is relatively easy to diligence these areas, there are several other considerations that are at least as important, but are perhaps more difficult to assess. These include the following:

- Is the proposed attorney an effective business adviser, or merely a legal technician? Is the attorney able to establish a good rapport with you?
- How responsive will the firm be in meeting deadlines and answering questions?
- Will services be provided in a timely and efficient manner? Higher hourly rates need not mean that the cost of delivering services will be higher than lower cost by less experienced firms. Experienced

firms can often do the work more efficiently than a firm that is learning 'on your nickel'.

While fees are important, managers should take a longer view and select a firm that will provide value and be an effective partner with the manager in building a business. Also, in comparing fee quotes from competing firms, make sure you are comparing 'apples to apples'. Do both quotes cover the same scope of work?

WHAT DO LAWYERS DO?

Often the perception of the manager, as a prospective client, is that offering documents are simply boiler plate, and preparing a set of documents requires little more than filling in the blanks.

While the need to deliver legal services as efficiently as possible requires attorneys to strive to create more standardised documents, one size does not fit all. Fund documents must be carefully tailored to fit the investment strategy that will be employed by the manager. Liquidity terms must match the duration

of the assets in the portfolio and risk factors must be drafted in a manner which highlights the most relevant risks and eliminates those that are of limited relevance to the strategy.

Before the drafting begins, time must be spent developing the optimal fund structure. Many factors should be taken into account in doing so, including the desire to achieve the greatest tax efficiency, considering the proposed investment strategy and its impact on fund structure, regulatory considerations and the needs and requirements of investors.

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DEVELOPING FUND TERMS

Once the basic fund structure has been developed, the remaining fund terms must be established. Space does not permit an exhaustive description of all issues which must be evaluated. However, the following are some of the more important considerations:

- Parallel vs master/feeder structure: there are advantages and disadvantages to each approach.

A master/feeder structure is often favoured to simplify trade allocation and to be able to publish consistent returns for both the domestic and offshore feeders.

- Offshore fund: is there a need for an offshore fund and in which jurisdiction should the offshore fund be formed? Non-US investors and US tax exempt investors still prefer offshore vehicles. While Cayman is still the jurisdiction of choice for most US managers, it is not the only option and the European Alternative Investment Fund Managers Directive is causing many managers to consider other jurisdictions, including Ireland and Luxembourg.
- Regulatory exemptions: consideration must be given to navigating the exemptions available under the Investment Company Act, Securities Act and Commodity Exchange Act.
- Management fees: the rate at which fees will be charged must be determined as well as the frequency of payment.
- Incentive fees: will a standard 20% incentive fee arrangement be used, or will the incentive fees reflect some new terms emerging in the market?



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IN COMPARING FEE QUOTES FROM COMPETING FIRMS, MAKE SURE YOU ARE COMPARING 'APPLES TO APPLES'

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EMERGING TERMS

- Use of hurdle rate.
- Multi-year performance period with clawback.
- Modified high-water mark.
- Reduced fee for longer term lock-up.
- Expenses. Certain expenses (such as legal fees, fees payable to the administrator, audit fees and trading expenses) are almost always charged to the fund. Other types of expenses are up for grabs. How aggressive does the manager wish to be in shifting expenses to the fund. Possible categories of expenses that might be charged to the fund (if properly disclosed) include risk management and order management software, insurance premiums, travel and marketing expenses and compliance expenses.
- Liquidity – decisions concerning the restrictions that will be imposed on investors who wish to withdraw their investment from the fund have become the most contentious part of negotiating offering documents with investors.

Consideration must be given to the following:

- How frequently will investors be able to withdraw their capital?
- Will there be a lock-up period during which withdrawals are prohibited?
- Will withdrawals be permitted during the lock-up period upon the payment of a fee ('soft lock up')?
- Should the amount of capital that may be withdrawn on any withdrawal date be limited by the im-

position of a gate. If so, should the gate be a fund gate or an investor level gate?

- Should the manager have the ability to fund withdrawals through distributions of securities?
- If securities cannot be readily distributed, should the manager have the ability to create an SPV or liquidating share class?
- Should the manager have the ability to suspend withdrawals, and if so, under what circumstances?
- Investment limitations; purchase of illiquid assets. While fund managers seek maximum flexibility to modify their investment strategy to take advantage of market opportunities, investors are increasingly seeking to constrain this flexibility. Similarly, investors are reluctant to give the manager carte blanche to purchase private or illiquid securities, and have a strong negative reaction to the use of side-pockets to manage the fund's exposure to illiquid securities.
- Transparency; reporting. With investors demanding a high level of transparency, managers must determine the policies they will employ in providing portfolio information and disclosing those policies to investors.

The advice provided by counsel to managers is critical in helping them make sound decisions in developing the terms for their fund. Counsel will explain legal requirements, liability issues and market practice. The goal should be to create a set of documents for a fund that will be viewed favourably by investors, while still appropriately protecting the manager. ■