

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 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 subsidize, 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 filings.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 proprietary 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 in to 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.

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