CHAPTER 1

The Hedge Fund Industry

The growth of the hedge fund industry over the past five years is truly amazing. Many industry observers believe that since the dawn of the new millennium, assets in these often-called secretive investment vehicles has grown fourfold. If you factor in the number of funds of funds, the growth factor is probably closer to fivefold. The industry continues to grow at a record pace, even with the weak performance numbers in 2005 and the decrease in asset inflows in the first quarter of 2006.

According to one published report, 2,073 hedge funds were launched in 2005, up from 1,435 in 2004.[1] As of spring 2006, there are an estimated 12,000 hedge funds in operation globally.[2] The numbers are shocking and quite 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. The result was an industry that 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 bursting, of sorts. Therefore, as the new manager on the block, you need to be ready for what lies ahead, because, quite frankly, it does not look so pretty. That being said, the strong will survive, and they will prosper. Your job as a new manager about to launch a fund is to make sure that you are ready, willing, and able to deal with everything that the market and investors throw at you and that you are prepared for the worst.

To understand where the industry is going, you need to first understand where it has been. The evolution of the hedge fund industry is best seen by coming out of the Wall Street subway stop. When you exit the station, head northwest toward Broadway and make a quick left on Broad Street: In front of you will be the New York Stock Exchange, 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 exactly what Alfred Winslow 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 that he expected and wanted. He looked to Wall Street for the answer. What he found was an idea that he believed would work. In turn, he would earn enough money to support his family and to fulfill his major passion—helping people. While Jones clearly 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 for 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 that was very interested in Wall Street," said Burch. "Although he made a lot of money over the years, he gave quite a lot of it away in order 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," recalls 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 looked at how you could go long a basket of stocks and short a basket of stocks and still 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 actually 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 though 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.*[3]

The idea was simple: Some stocks go up while others go down, and very 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 both 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 then was no different than the issue today: 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," said Tony Jones. "This meant that his job was to find people who did have the talent."

Alfred Winslow 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 estimated that there were 6,000 to 7,000 hedge funds managing between $600 billion to $650 billion in assets. The report noted that hedge fund assets were expected to grow to more than $1 trillion between 2008 and 2010.[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 is quoted as 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 realize, having a portfolio that is both long and short is the only way over a long period of time to ensure that their assets are protected and grow regardless of whether the market rises or falls.

While a portfolio of longs and a portfolio of shorts make sense, the key to long-term success is not just to hit the ball out of the park with your stock picks but to put up singles and doubles each and every day. Move the runners around the bases and back to home plate while protecting your assets at all costs to make sure you live to fight 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 idea of this book is simple. 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—the people who will help you grow and maintain your business. It 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 when you decide what sort of funds to launch, how they should be structured, who you should choose as a lawyer and prime broker, among others, and most important, who your funds can be marketed to. If you want to learn about trading, stop reading right now.

With that said, we now need to look at hedge fund basics in order to figure how to get started on developing and running a successful business. The basics are, quite honestly, very basic. One thing that needs to be said up front is that hedge funds, like most things on Wall Street, are thought to be very intricate, confusing, and sophisticated. This is just not the case. Hedge funds, like most everything else on the Street, are quite simple when you break them down and quite easy to understand once you look at them closely and dissect them in an orderly and efficient manner.

Some aspects of the industry are sophisticated, including structuring for tax efficiency and legal issues, but for the most part, once you have done it the first time (i.e., set up a hedge fund), it is like riding a bike: You never forget how it works and what needs to be done.

Although investors may initially assume that hedge funds and mutual funds operate in a similar fashion, in reality 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 in order 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 will make money. This differs from what is called a *relative return strategy,* which is how one fund does against a benchmark. In recent years there have been a number of indices created to track and benchmark hedge funds. While these products are good, they are not flawless. Therefore, it is best to think of hedge funds as vehicles that are measured on their specific performance, not on how their performance is relative to the S&P 500 Index or the Lipper Small Cap 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 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.

Most mutual fund managers construct portfolios by using their stock-picking skills to create a portfolio that they believe will perform well over time and in turn provide them with an edge over the index. All they need to do is to outperform the index by a few basis points and they are deemed to be good at what they do. That being said, mutual fund managers have one goal in mind when they manage their money: beating their relative index. If the index is down 10 percent while the mutual fund is down only 7 percent, the fund's performance would be called a success. 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 completely 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 are able to make only a buy or sell decision), a hedge fund is able to implement more aggressive strategies and put on positions that include short selling. Managers may also employ derivatives instruments, such as options, and use leverage to enhance the portfolio and add to the positive performance of the bottom line.

Due to their ability to short, many believe that hedge funds are more popular in bear markets than in bull markets. However, in 2005 this was not the case. For the most part, hedge funds performed quite poorly for the 11 months ending November 30, 2005, and eked out only single-digit positive numbers for the month of December. This meant that numbers for the year were not good. Some funds were unable to take advantage of the volatility that markets experienced in the wake of the increase in oil and other commodity prices and the geopolitical uncertainty that stemmed from U.S. military operations in Afghanistan and Iraq. Consequently, 2005 proved to be a very difficult year for hedge funds. The year was disappointing for almost everyone who invested in these products. Many fund managers looked forward to 2006 and to the idea of being able to fight another day. However, in the wake of the continued volatility that the markets experienced in the first six months of 2006, managers and investors were disappointed with the performance results of most funds. Most investors believe that because hedge funds have the ability to go long and short and really 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 either open-ended investment companies that sell their shares to the masses through multiple marketing channels or 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 either limited partnerships or limited liability companies 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, just think of all hedge funds as limited liability companies, or LLCs.

Hedge fund investors need to understand that these investment vehicles have significantly different fee structures and liquidity provisions than mutual funds. The liquidity provisions vary, but for the most part it is difficult for an investor to redeem his or her investment at will. Most funds operate on quarterly redemptions and usually enforce a one-year lockup. If violated, this carries a hefty penalty or redemption fee—usually 1 percent of assets. Unlike mutual funds, hedge funds are not registered under the Thirty-three Act, and thus they are prohibited from soliciting or advertising to the general public. This prohibition tends to reinforce the popular press's notion that the hedge fund industry is secretive or mysterious. The press also 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 according to explicit rules about fees and how they are charged, 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 1.5 percent of assets under management, along with an incentive fee—usually 20 percent—of the profits of the portfolio. As a side note, Jones did not charge a management fee; he charged only 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.

Copies of both the Thirty-three Act and the Forty Act can be found online by simply Googling the information. You should read and become familiar with both of 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 cannot 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, including right now, for example, it should be made clear that some money management firms market registered hedge funds that are similar in structure to mutual funds and are available for the masses. However, for the purposes of this book, I will not be talking about such products. I focus solely 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 either 100 or 500 investors and are open to either accredited or superaccredited investors, also known as *qualified purchasers*. As of early 2006, the definitions of an accredited investor and a superaccredited or qualified purchaser are as follows. An *accredited investor* must be one of the following: (1) a financial institution, (2) an affiliate of the issuer, or (3) an individual with a net worth of at least $1 million or an annual income of at least $200,000, and the investment must not account for more than 20 percent of the investor's worth.[6] A *qualified purchaser* is any of the following: (1) a natural person who owns $5 million or more in net investments, (2) any person, acting for his or her own account or for the accounts of other qualified purchasers who, in the aggregate, own and invest 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, and (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, as of the summer of 2006, in the wake of the Goldstein decision (which I discuss in detail later in this chapter), the SEC was considering changing the rules that define accredited investors and was in the process of proposing new definitions for these investors.

The definition has remained the same for quite some time. However, there has been some talk among industry observers that once the hedge fund registration requirement put in place in February 2006 is fully digested, the SEC will look at changing the definition of an accredited investor to further limit who can invest in hedge funds.

While these rules define who can and cannot invest in hedge funds, it needs to be made clear that managers have the ability to accept nonaccredited investors into their funds as long as they limit their number to fewer than 35 individuals.

SEC Regulation D stipulates that a maximum of 35 nonaccredited investors are allowed to invest money into a private placement (i.e., a hedge fund). However, most managers do not allow for nonaccredited investors, because in doing so 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 nonaccredited investors in the fund could become a regulatory issue, but it is also 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 nonaccredited 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 only to accredited and superaccredited investors. However, to understand how hedge funds have come into the mainstream, we need to look at how Wall Street has evolved since the stock market crash of 1987.

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 and then 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 began to realize that the go-go days were truly over. They looked for an alternative to their traditional income streams, and what they found was the hedge fund industry.

In late 1987 and for most of 1988, there was not much of a hedge fund industry. However, a number of very 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 basically 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. Not only is it quite profitable, it is also nearly risk free, making its profits that much 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 not only to large, well-respected firms that were already running successful hedge funds, but also to basically 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. Literally anyone can get into it as long as they have the money to pay the lawyers and can get some investors who are willing to entrust them with 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 truly the only business that allows anyone to literally hang out a shingle regardless of experience or education. That being said, every time there is a prolonged bear market, the hedge fund industry explodes. It is truly easy to get into the game that is now the hedge fund industry. The question is, can you stay there? While later chapters discuss at length how to survive, remember that the name of the game is assets. If you cannot raise assets and attract investors, then you are destined for death. But if you can build a track record, attract investor interest, and in turn draw in their assets, you are destined for hedge fund greatness—and with this greatness comes vast riches. That is why in the wake of the crash of 1987 there was movement by brokerage firms to push prime brokerage services and get 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.

It is believed that poker was imported to the United States by French fur traders and explorers in the nineteenth century. While no one seems to know for sure, it is expected that the origins of the game come from the Persian game 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.

While 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 Binions 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 continued to grow in popularity throughout the 1980s and 1990s, but exploded in the early part of the twenty-first century. This was due to the confluence of a number of events, primarily 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 literally open to anyone who has the money to get into the game. Furthermore, Texas Hold'em offers great riches to those who are successful at it. 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 fast 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 year-round.[10]

The parallels between the growth in the hedge fund industry and the growth in Texas Hold'em are significant. Just as a few computer programmers, television executives, and casino operators decided to push an old game to a new audience in an effort to bring a new level of excitement to online and in-person gambling, a number of brokerage firms, lawyers, and accountants decided to make it very easy to get into the hedge fund business and pushed the barrier of entry low enough to make it worth the financial risk associated with the transaction. But 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 next to impossible to find a Monday, Tuesday, or Wednesday afternoon in which a brokerage firm, along with lawyers and accountants, was not 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 a relative afterthought for many to something that was front and center to most people on the 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 significantly 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 explosion 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 explosive growth. The excitement surrounding the opportunity in the hedge fund industry was a direct result of the service providers' realization that there was, and still is, very little risk that cannot be quantified when you are working with a hedge fund. This means that while they could lose clients because individual funds did not perform and in turn were unable to raise assets, it would be very hard for them to lose 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 quickly 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 that the business risk was and is limited to a hit to the bottom line in terms of fee income, but that a blowup cannot truly destroy the business. In the worst-case scenario, the lawyer, accountant, prime broker, and administrator would simply 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 came to realize that they needed to be able to meet the needs of managers, not only to continue to survive on Wall Street, but also to take advantage of the significant fee income that is generated by these financial vehicles that are often thought of as mysterious and secretive. The barrier to entry is so low that there has been an explosion in the number of people getting into the business—it costs around $50,000[11] or so to create and launch a fund, which means almost anyone can do it. Along with the low cost to enter come huge financial rewards for the manager and his or her team if they can build a successful business. There are few areas of employment 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 in truth, while their salaries and bonuses are undoubtedly large, this money pales in comparison to what a hedge fund manager and his or her 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 earn hundreds of millions of dollars for their work in the markets in a single year. As the number of funds increases, so does the number of service providers offering tools to help the managers be successful. And it becomes a numbers game. Fees contract while the number of clients expands—

meaning they need more and more people to provide services to hedge funds, which means the industry keeps growing and growing. Eventually something will come along that will cause the pace of fund growth to slow. But for now, until the fees generated by the industry subside, lots of people will be pushing other people to get into the hedge fund business.

It is clear that unlimited riches await the budding yet successful manager. And therein lies the main issue: Not everyone can or will be successful. There are two reasons for this. First, not everyone can really trade or invest successfully. Simply put, some hedge fund managers cannot earn the returns that investors have come to expect. Second, some managers are simply 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. Very few people can do it successfully. Many people say they can raise money and promise to be able to help a fund get started, but most of them fail to deliver. Marketing and raising capital are explored later in the book. It is Chapter 6 that should not be missed because it is the most important part of running a successful business.

WHAT'S NEW

In October 2004, for one of the first times in the history of the Securities and Exchange Commission, 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 it is rare for the commissioners not to vote unanimously on rule changes.

The vote, thought of as controversial by some, required hedge fund advisers to register as investment advisers 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. Both camps—those for the registration rule and those against it—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."[12]

Prior to the court's ruling, many managers believed that 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, similar to the way that a mutual fund is registered. Another smaller but still important concern is that 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 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 less 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 that it no longer has to deal with the registration issue. Although some believed that the SEC would try to circumvent the court ruling, possibly turning to Congress or the states for relief or guidance on how to create and implement a registration requirement, by the midsummer of 2006, it looked like this effort would go nowhere.

From February 2006, when the rule went into effect, until late June, the industry had been operating under the assumption that the regulation was fixed in place. Managers who had not already registered as investment advisers went through the process in order to stay in the business. As registered investment advisers, 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—no different than what is required of mutual fund managers. The regulation would also allow the SEC to be able 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 goes on. Some observers believe that the registration requirement needs to be resurrected, that it does not go far enough, and that it does not address marketing issues that have caused some investors to stay away from hedge funds. Other investors believe that the regulation is a move in the right direction, but that because hedge funds are illiquid, have a management- and incentive-fee structure, and do not provide transparency, the registration does little if anything to increase their interest in these investment vehicles. Many industry observers believe, however, that these types of rules will not deter fraud because the SEC and its staff are overextended and cannot complete the work that they already 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 found that the SEC was able to review just 23 percent of all corporate fillings in 2003.[13] 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 be able to deal with the added burden of monitoring thousands of hedge fund managers. However, when the SEC made the ruling, it was estimated that nearly 40 percent of hedge fund advisers were already registered with the SEC. Funds that had preregistered with the SEC were institutions that targeted pension, endowment, and foundation money.

The reason for this is that managers believe the assets that these institutions put to work are some of the best that are out there. Often, these types of institutions make sizable allocations, and their assets are usually quite sticky. It is money that is very lucrative and very difficult to come by but also easy to keep. Once these institutions make an allocation to a fund, they very rarely move the money. These types of investors use consultants who, for the most part, operate within a check-the-box mentality. This means that in order for a fund to qualify for the beauty contest that takes place prior to the allocation, it needs to 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 that are run by RIAs, who are perceived to be more professional than those who are not RIAs.

The perception is quite different from the 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 registered investment advisers. In the past, hedge fund managers generally registered with the SEC when they had $25 million or more in client assets. In some cases, an adviser with less than $25 million was forced to register with state securities regulators based on the location of the principal place of business. This aspect of the registration requirement varies from state to state. Nevertheless, if a manager wanted money from an endowment, pension, or foundation, he or she needed to be registered, and, because of the power of these assets, the manager registered 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 adoption of the rule, hedge fund managers needed to comply with and operate under strict guidelines that truly dictate how they operate their businesses. This means additional costs in both human and nonhuman capital. For example, businesses now 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 whose job it is to ensure that 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, while 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 that the regulation will actually help the industry and bring it more into the mainstream. However, the registration requirement is also 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 type of product. Some believe that just because a fund manager is registered, the investment is worthwhile. This is similar to saying that just because you have a driver's license you are qualified to drive in the Indianapolis 500. We all know that this is just not the case in either scenario. Registration is not a seal of approval. It simply means that the manager filled out some 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 and more mainstream and as they start to look more and 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 now 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 explosive growth the industry experienced in the new millennium. The SEC estimated that there were nearly 8,500 funds operating in 2005, with more than $1 trillion in assets under management.[14] This clearly means the industry is no longer just a private club for wealthy investors and their friends, as it was in the first 30 years of the product's life. Now hedge funds are mainstream and part of almost every investor's vernacular. Hedge funds both large and small have filled the role vacated by the large brokerage firms that shut down their propriety trading desks, and they now 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, there are a number of issues that you, as a budding manager, need to address before you decide to go out on your own.

First, you need to have what it takes to be an entrepreneur. Second, you need to make sure you have the financial backing to build and maintain a sustainable business and to ensure that you can actually deliver on the promises that you are making 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 even 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 the fact that in their new company they will have to be the chief cook *and* the bottle washer. These managers just 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. In order 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 $500 million fund in New York, told me while I was interviewing her 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 did not matter to anyone anymore. She could not simply pick up the phone and get her computer fixed or a new cartridge for the printer. As an entrepreneur heading her own company, she was no longer part of the machine that is Bear Stearns. She now does the day-to-day tasks 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."[15]

DELIVERING ON YOUR PROMISE TO INVESTORS

When you start a hedge fund, you need to be able to seed the fund with some assets—yours, your friends', and your family's—and you need working capital to ensure that you stay in business. Raising money (as you will find out soon enough if you do not already know) is probably the hardest part of any business. Remember, those you think will give you money most likely 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 just the way it works. In order to get investors and, more important, keep them, you need to first have a good, solid strategy that is 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 (i.e., put up positive numbers); it is more important that you 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. But 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," says Richard Bookbinder, the manager of a New York–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 both individual and institutional investors alike are looking at during the due diligence process is the service providers the fund uses to conduct its business.

You want to see that both 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 who the fund is doing business with is that there have been a number of cases of fraud at firms such as Bayou, KL, and Beacon Hill over the past few years. Subsequently, there is a common belief that if respected firms are providing audit, administration, legal, and prime brokerage services to funds, they must have passed some level of due diligence. Unfortunately, the reality is that you never know, and therefore you should not take anything a manager says at face value.

About a year ago, I was at a hedge fund conference in Boca Raton, Florida, and during the four-day hedge fund lovefest, 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 that were similar to his. Similarly, 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 there was something we could do 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 who he had already talked with about partnering. All in all, the conversation went very smoothly, and the lunch looked like it would turn out to be a profitable one for both of us.

The next step for me was to get a copy of the funds' documents, review their 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 and administrator.

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 my firm's fund counsel—small world. As an aside, for the most part, all fund documents are the same, so it is very easy to review a document rather quickly. A hedge fund document starts with a number of disclaimers, then moves into the summary of the offering, 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 on the Internet. You can also 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 our 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 also told me that now that he had heard his name was still 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 quite normal. It is not a red flag but rather a fact of life; once a document is completed, there is little, if any, work that the fund and the lawyers do together unless there is a problem or the business is expanding.

Maybe this manager had no questions and, more important, no problems during their lack of contact, or 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 simply 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.

The point of this story is that 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 make inquiries to you about your firm. You need to make sure that you have all the answers to the questions before you are asked them, and, furthermore, you should make sure that you never misrepresent anything to prospective investors. It is important that you are on top of your relationships with service providers and that they are aware that you are using them for references. You don't ever want to be caught in a situation where the information offered by the service provider is different from the information that you give to your investor, or one 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 quite 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.