

Why is it so hard to launch a hedge fund today?

| BY MARIE T. DEFALCO

Not very long ago, launching a hedge fund presented an attractive and potentially lucrative opportunity for a significant number of smart and successful traders, some spinning out of large and established funds, many striking out on their own with training and experience earned at the big banks. Like all entrepreneurs, they were happy, or at least willing, to give up security for a chance at independence and real economic success.

Like early tech start-ups, they often needed little more than a computer and a little space in the garage to start trading their own or their friends' money in order to establish the all-important 'track record' that would allow the business to expand. They had to heed the securities laws, of course, but if they had contacts with a significant number of sophisticated investors, they had a real chance to prove themselves without the massive amounts of capital, experience, and infrastructure needed to launch and run a highly regulated retail fund. Some succeeded and grew from such humble beginnings, adding infrastructure, employees, formality, and institutionalisation as they grew; many more failed to make a go of it, and their founders went to work for someone else again, without much lost except perhaps a little confidence.

Many assumed that the implementation of the Volcker Rule, restricting certain proprietary trading by banks, would accelerate start-up launches, as traders on those prop desks spun out on their own, but that really has not happened. Several opposing trends have made it nearly impossible for even some very promising managers to launch or grow.

The most difficult challenge facing new managers has not been, as it was in the past, posting positive performance. It has been attracting a critical mass of investors and enough assets under management to fund the ever-increasing costs of running the business. Some still start with miniscule 'friends and family' funds and hope that a few years of positive performance will attract the big money. More often than not, it has not. Many others now engage third-party marketers, increasing current costs and decreasing current and future profits, in an attempt to attract enough capital to get started. But the marketers cannot sell a fund that does not have a stellar record going back at least a few years, so there is a bit of a chicken-and-egg problem.

Some turn to seed investors, who are more willing to take a chance based on their own skill in selecting 'winners', but the seeders can afford to be choosier in recent years also, since so many managers are looking for funding.

Allocators for family offices and institutional investors are still spooked by the Madoff debacle and the redemption suspensions, gates, and liquidations of funds associated with the economic downturn that began in 2008. Prompted by caution or protective of their own jobs, the allocators are relying much more on consultants to select their fund investments. The consultants, perhaps also protective of their own reputations and livelihood, tend to steer their clients toward large and established funds with impeccable records. If an investment in one of those funds did not work out, it would be hard to critique the consultant for recommending it – at the least, the consultant would be in very good company. On the other hand, if a recommended investment in a smaller or less well known fund were to go badly, the consultant's reputation would, at the least, suffer. As a result, the big funds keep getting bigger, while many of the smaller ones stagnate and cannot get the traction to grow. The fear and caution that the allocators and consultants feel have overshadowed two potential advantages associated with investing with newer managers: certain research has shown that investors have the most to gain by investing with managers in their first five years of operation, and newer managers are often willing to cut their fees and offer other sweeteners for early allocators.

A second impediment to new managers launching funds is the barrier to entry posed by new regulation. This is happening worldwide, and in the United States is happening at the state and federal and, in some cases, on the local level. Dodd-Frank is the most obvious example. Managers with very small funds (under \$150m) generally will not have to register with the SEC, but \$150m is still quite a small fund. The prospect of registering within a short time, with the costs attendant to hiring a chief compliance officer, implementing compliance policies, engaging professional advisers to help with the registration, conducting simulated audits, recordkeeping, filing periodic reports with the SEC (some, such as the new Form PF, quite onerous), and undergoing SEC audits, dissuades many from even getting started. The management fees from such a small fund just could not cover the costs involved. Engaging third-party marketers to solicit certain investors now requires registration as a 'lobbyist' in several jurisdictions. 'Pay-to-play' rules now govern solicitation of government entities and pension plans. Privacy regulations have gotten increasingly complex and burdensome. Hedge fund managers used to engage attorneys to draft their offering documents, update them on an annual or biannual basis, and advise them ►►



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as needed on compliance issues. Now, most need in-house counsel and constant contact with their outside attorneys just to keep up with the constantly evolving regulations and legal issues. To be compliant, it is virtually a requirement to hire employees and establish a complex infrastructure from the very beginning. Some managers look at what will be required and decide that it is not feasible to go forward. For those who do, the added costs are an impediment to growth and a drain on profit.

The purpose of most financial services regulation is to protect investors, but the surge of 'protection' lately has smothered new launches, which ultimately reduces investor choices and returns.

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