

Steps to starting your own hedge fund for the experienced manager

By Peter Greene

Experienced hedge fund managers looking to set up on their own should take note – running a book and launching a fund are two very different things. So says Peter Greene, a partner at law firm Lowenstein Sandler in New York, who outlines four vital steps on the road to a successful launch...

If you're a well-pedigreed hedge fund manager – one who has worked at a blue-chip firm and managed a large book with a successful track record – you might have a desire to launch your own hedge fund. It's hard to say how many think about taking this step, but several funds get started this way each month.

But there's one thing you should know, no matter how many years of experience you have: running a book and launching a fund are two very different propositions. For starters, it is much more than just launching a fund, it is building a firm.

Before you can begin to think about managing your own fund, you must consider the ins and outs of running an organisation from an operational perspective – you need a back office, a middle office and service providers. That's not easy, and it's likely one of the reasons that the failure rate amongst start-up funds is high. In the fourth quarter of 2018, more hedge funds liquidated than launched.

Although it might be harder to launch new funds now than it was a decade ago, because (x) it's harder to find the capital and (y) it costs more to build an operational and compliance infrastructure, for well-pedigreed managers, there's usually a path.

Here are vital steps to consider as you prepare to launch your business and then, later, your fund:



Peter Greene, partner at Lowenstein Sandler

Steps before launch

1 Extraction

As a well-pedigreed manager, you (of course) will be leaving an established fund when you decide to start a new one. It is crucial that you approach your then-current CIO constructively, and, if at all possible, garner support for your new venture. As part of this "extraction," you will need to analyse any restrictive covenants (non-compete, non-solicitation of investors, non-solicitation of employees) you may have signed to ensure that you are abiding by your agreements. The odds are that you cannot take investors or colleagues from your current shop over to your new shop.

2 The operational face of the firm

Building your team is crucial. You should seek insight from key advisers (prime brokers, lawyer, trusted advisers) when looking for talent. Ask yourself and your colleagues: Who will be hired? How many should be hired? What will their pay look like – base salary, AUM step-ups, actual or phantom equity, deferred compensation?

Most importantly, it is nearly impossible to enjoy a successful launch without hiring a C-level executive to be the operational face of firm. This person will need to run your business (so that you can run your book) day to day, along with facing investors, prime brokers, lawyers, auditors, accountants, administrators, regulators, just to name a few. This person likely will be your Chief Operating Officer and Chief Compliance Officer.

3 Formation and structuring

Once you have a team in place, it will be time to brainstorm with your lawyer and



confidants as to the potential terms for your fund. You will need to structure your various classes (founders, regular) management fees, incentive compensation, capacity rights, liquidity and transparency in light of your track record, the constitution of your book and the market for your fund. This structure will be iterative as you socialise your potential terms with prospective day-one investors. After likely much back and forth with your prospective investors, you will settle on terms, and your lawyers will convert a slide or two from your marketing deck summarising the fund's terms to hundreds of pages of PPMs, partnership agreements and subscription agreements – the legal guts of your partnership with your investors.

4 Compliance program

While you are putting your investment and

operational teams in place, developing your fund's terms and marketing to investors, your Chief Compliance Officer will be developing a compliance program, which will include a compliance manual, a code of ethics and a personal trading policy. Your buy-in to this aspect of your business will be critical to both investors and regulators.

Looking forward

Though it's hard to launch a new hedge fund, the work doesn't stop once you place your first trade. Looking forward, you need to constantly think about how to scale the fund and who you'll need to hire to handle that growth.

And given the slow rate at which funds were launched last year, this advice is probably more important – and potentially differentiating for those funds that do launch – than ever. ■