MOVING INTO THE ROLE OF HEDGE FUND MANAGER – DID YOU THINK OF EVERYTHING?

MAURY CARTINE, PARTNER AT MARCUM LLP, IDENTIFIES THE MOST COMMONLY MADE MISTAKES MADE BY NEW HEDGE FUND MANAGERS

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Recently, my spouse and I decided to move to a new home – a relatively new experience, since we had lived in the same home for 23 years. We thought everything was under control as we had done this before. We hired the best moving company, and we hired the best home inspector to examine our new home. Nonetheless, it was absolutely astounding how many things we had to do and how many things we forgot to do. Did we inform the utility companies we were taking over? Did we notify the post office, the banks, the credit card companies and the insurance companies of our new address? Did we arrange for internet service and cable TV? Did we purchase insurance coverage for the new home? Some of the mistakes seem silly now, but it was not so silly at the time!

This moving experience reminded me of the countless money managers I have met over the past 25 years who were moving on to start their own funds. Like me, they thought they knew enough to get by. After all, they were leaving well-respected investment banking firms and had little left to learn. Big mistake! Whenever a money manager goes out on his own, the choices and decisions along the way can be endless. After all these years, I have identified some of the most common mistakes. Some are just silly, but some are silly and hazardous! It might be helpful to the next crop of would-be hedge fund managers to consider some of these potential mistakes before they happen.

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1. **Contributions of appreciated securities as capital to the fund.**
2. **Admission of ERISA plans to the fund.**
3. **Admission of foreign individuals to a domestic fund.**
4. **Admitting tax-exempt investors to a domestic fund utilising margin account financing.**
5. **Choosing a fee structure that is below the industry standards to attract capital.**
6. **Failure to make a timely mark-to-market election.**

My personal favourite mistake is the manager who chooses to contribute highly appreciated securities as the initial capital to the fund. The manager has heard the gain on the appreciated securities is immediately taxable to him if he winds up with a diversified portfolio of securities. This would occur, for example, if other investors simultaneously contribute other securities and/or cash. The money manager may have also heard that the gain could be avoided as long as the contribution of appreciated securities is substantially identical to the securities in the fund, both with respect to the issuers and the shares. The money manager reasons to himself: "My securities must be substantially identical because I am the initial investor and there are no other securities in the fund." Unfortunately, the tax rules take into account subsequent contributions, and if other investors contribute cash and/or non-identical securities, the manager is doomed to immediate taxation on his gains without benefit of any losses on depreciated securities! The way out may be simple. The manager can avoid this harsh result if he contributes an already diversified portfolio of securities. An already diversified portfolio is a portfolio where the securities of no one issuer is more than 25% of the portfolio and no five or fewer positions in any one issuer is more than 50% of the portfolio. So, before the first contribution

is received by outside investors, the manager should rearrange his portfolio of contributed securities to be already diversified.

If the manager accepts ERISA plans to the fund and the ERISA plans combined with other employee benefit plans (e.g. IRA accounts) represent 25% or more of the fund's capital, exclusive of the manager's own non-employee benefit plan capital, the fund will become a plan asset to the ERISA plans and the manager will become a fiduciary to the ERISA plans, bringing the potential for prohibited transaction sanctions including excise taxes under the Internal Revenue Code and similar penalties under ERISA. The remedy is simple – kick the investor out!

The desire to raise capital knows no boundaries, and the manager may be quick to accept capital in the start-up stage from a foreign individual. US dividends and certain other US sourced income will generally be subject to US income tax withholding, and this can be a nuisance to monitor. However, what may be of greater concern is the foreign individual's exposure to US estate tax if the individual dies while owning the partnership interest and, assuming there is no named executor, the custodian of the property becomes the executor for estate tax purpose. And who is that executor? You guessed it – the manager! In time, this investor will be headed to the successful manager's new offshore fund (organised as a foreign corporation), and the estate tax problem is solved.

The manager's ability to utilise margin borrowing can enhance performance significantly, but it can be a nightmare for tax-exempt investors. Dividends, interest and capital gains earned by a tax-exempt investor are, as expected, generally exempt from regular US income tax. However, this exemption does not extend to the portion of dividends, interest and capital gains derived from securities that have been purchased with margin borrowing. This income tax is called the "unrelated business income tax". No tax-exempt investor likes to pay income tax. Again, the answer can be as simple as moving the tax-exempt investors to the manager's new offshore fund (again, organised as a corporation), which will block the investors from the unrelated business income tax.

Less confident managers often seek to attract capital by reducing the management fees and/or performance allocation. Instead of the usual 2% management fee and 20% performance allocation, they may charge a management fee of only 1% and a performance allocation of 15%. The most neurotic managers may add a hurdle rate to the performance allocation. Experience has taught me that this lack of confidence often is followed by failure in what can only be described as a self-fulfilling prophesy. Finally, if the manager is successful, he will be stuck with the lesser fee arrangement in much the same way a home buyer is stuck with the house he bought that was smaller than he could really afford, simply because he lacked confidence in his financial wherewithal.

Some managers trade so rapidly they can only be described as being traders in securities engaged in the trade or business of trading securities. While the benefits of business tax deductions are often well known to a manager, he may be less aware of the benefits of making a mark-to-market election as a trader in securities. This election causes all positions to be marked-to-market at the end of the year, with gains and losses treated as ordinary gain or loss. Since the fund is likely to only realise short-term capital gains and losses from the trading activity, there is no benefit lost by having the gains and losses treated as ordinary, and if there are losses, the individual capital loss limitation of $3,000 does not apply! However, making a mark-to-market election in anticipation of harvesting ordinary losses is another unfortunate self-fulfilling prophesy. The real benefits of the mark-to-market election for the successful fund involve the elimination of adverse tax adjustments for wash sale losses and straddle losses. How does a new fund make this election? The new fund merely includes a statement in its books and records within two months and 15 days after the first day of the election year that the election is being made, the first taxable year the election is effective and the trade or business for which the election is made.

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What mistakes did I forget to mention? Probably as many as I made when we moved to our new home!

On a more serious note, this article only scratches the surface of mistakes that a new hedge fund manager can make. However, you can avoid most mistakes if you think ahead and start out by hiring the best professionals servicing hedge funds. You would not want a plumber inspecting your fire alarm system, and you would not want an accountant servicing the manufacturing industry advising you on hedge funds. Good luck on your move into the role of hedge fund manager. There will be a bottle of champagne waiting for you in the office refrigerator. ■