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High-Class Problems: Issues Successful Start-Up Managers Face - Part I

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In recent years, a number of fund managers have launched funds primarily with friends and family money, hoping to develop a track record before targeting larger, institutional investors down the road. It's not the old days when someone with a Bloomberg terminal in their apartment could be successful in scaling the business, so what does a manager need to do after the fund has launched and is putting up impressive performance? In this series, we'll address some of the questions and issues managers face when attempting to grow their fund and make it more attractive to institutional investors.

The first big picture topic many managers should consider is structure. *Does my current structure make sense? What happens if I get close to my investor limit? Do I need an offshore vehicle?* These are all important questions which need to be thought about as a manager contemplates growth of their firm.

For managers who have started their funds on a smaller scale, most have used a simple stand-alone domestic fund structure. In these cases, the fund is typically a 3(c)(1) fund which limits the number of U.S. investors to no more than 100 investors and permits only "accredited investors" to invest in the fund.

As the fund approaches the 100 investor limit, a fund manager has a few options to address this issue. One is for the manager to convert the 3(c)(1) fund to a 3(c)(7) fund, which can accept up to 2,499 investors. Problem solved, right? Not exactly. In order to invest in a 3(c)(7) fund, the investors must all be "qualified purchasers," which is a significantly more onerous standard for investors to meet. Many friends and family do not meet this standard, so they would have to be removed from the fund. Most managers don't want to force their friends and family to withdraw from the fund, especially when they were the initial investors that supported the manager at launch.

The second option is for the manager to launch a new 3(c)(7) fund alongside the existing 3(c)(1) fund and move any investors who are "qualified purchasers" into the new fund. The benefit of this is that friends and family can stay in the existing fund, new slots are opened up in the existing fund, and the new 3(c)(7) fund can take all new investors that meet the qualification standards, allowing the manager to greatly increase the number of investors while not kicking out friends and family.

After a manager has performed well and started to build a track record, one of the other major considerations is the addition of an offshore component to the current fund structure. Setting up an offshore arm allows the fund to accept investments from U.S. tax-exempt investors (pensions, endowments, ERISA investors, etc.) as well as offshore investors. These investors are not technically prohibited from investing in a U.S.-based fund, but there are tax and other reasons why many of those investors will not typically invest in a domestic fund. For example, if a fund utilizes leverage, tax-exempt investors will be subject to UBTI (unrelated business taxable income), which will negatively impact performance. In addition, many non-U.S. investors do not want to receive a K-1 and show up on the IRS radar.

Once a manager establishes that there is interest in an offshore vehicle, the process is straightforward, but does have several steps that must be taken. The manager will work with their fund lawyer to engage offshore counsel to form an offshore feeder fund as well as a master fund (typically domiciled in the Cayman Islands). The existing fund would then become the domestic feeder in a master-feeder structure, and as an administrative matter, the existing domestic fund documents would need to be revised to reflect that restructuring.

There are also several things to address from an operational perspective before the new structure can be finalized. First, the manager will need to update all of its trading documentation (PB agreements, ISDAs, repos, etc.) as those contracts were drafted when the existing fund was the trading vehicle. With the change in structure, the master fund would now become the trading vehicle, so the agreements must be amended to reflect that. The Administration Agreement will also require updating to add the offshore feeder fund as well as the master fund as parties to that agreement. In addition, the master fund will have to open a new brokerage account, and the existing domestic fund would then need to contribute the positions in its portfolio to the master fund, as all investments will now be held at the master fund level. Once these steps are accomplished, the restructuring is complete and the new structure is ready to launch and accept capital.

While these changes may sound daunting, this is the next step in your evolution as a fund manager, and if you have surrounded yourself with the right partners, it will not be as overwhelming as you might think. Dealing with these issues just means that you have been successful in growing your business and you are ready for the new challenges ahead.

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