Hedge Fund Law Report
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Managed Accounts

Structuring Managed Accounts Key Focus of GlobeOp's "Managed Accounts Insights for Investors" Event

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By Jennifer Banzaca, *Hedge Fund Law Report*

With the events of 2008 and early 2009 – faltering hedge fund performance, high profile frauds and prime broker and counterparty failures – hedge fund investors are showing increased interest in managed accounts. Managed accounts generally are investment portfolios owned by the investor and managed by the hedge fund manager side by side with a primary hedge fund. They can offer an efficient vehicle for investors looking to segregate their assets from the assets of a primary fund and to avoid the various problems (many having to do with the timing of redemptions) that can affect investors in a commingled vehicle. See, e.g., "Investors in Hedge Fund Strategies Increasingly Demanding Separate Accounts to Avoid Gates and Other Consequences of Commingled Investment Vehicles," Hedge Fund Law Report, Vol. 2, No. 8 (Feb. 26, 2009); "Hedge Fund Managers Using Special Purpose Vehicles to Minimize Adverse Effects of Redemptions on Long-Term Investors," Hedge Fund Law Report, Vol. 2, No. 15 (Apr. 16, 2009); "How Can Hedge Fund Managers Prevent or Mitigate Revocations of Redemption Requests?," Hedge Fund Law Report, Vol. 2, No. 21 (May 27, 2009). As a potentially attractive option for investors, managed accounts offer managers a method for attracting investor assets. But the various investor and marketing benefits of managed accounts have to be balanced against the significant administrative burdens posed by managing separate accounts – including but not limited to accounting and allocation issues.

On September 17, 2009, GlobeOp Financial Services hosted the *Managed Accounts Insights for Investors* event in New York City. During the one-day event, industry participants discussed such topics as structuring and negotiating managed account agreements, potential conflicts of interest and proper due diligence. This article highlights and discusses the key points discussed at the conference.

What is a Managed Account?

As noted, a managed account is an investment portfolio owned by the investor that often invests alongside a hedge fund investing in the same strategy. Each managed account has its own unique negotiated terms, meaning each one could have different terms and provisions depending on the investment goals and bargaining power of each managed account investor.

Since the managed account generally invests alongside a hedge fund, investments generally are allocated pro rata (usually based on net asset values) between the account and fund. The separate account, however, usually has different – often more advantageous – transparency, reporting and liquidity terms relative to the hedge fund. For more on managed accounts, see "Investors in Hedge Fund Strategies Increasingly Demanding Separate Accounts to Avoid Gates and Other Consequences of Commingled Investment Vehicles," Hedge Fund Law Report, Vol. 2, No. 8 (Feb. 26, 2009).

According to John Brunjes, a Partner at Bracewell & Giuliani LLP, because managed accounts are negotiated arrangements, the manager has to structure around the specific terms requested by the investor. Each account has its customized advisory fees, investor rights and investment management terms. The investment objectives are tailored to the needs of the individual account holder, Brunjes said.

Benefits of Managed Accounts

Key recurring advantages of managed accounts include greater transparency, direct asset ownership and improved liquidity terms. For hedge fund managers, managed accounts can offer opportunities to raise more assets, particularly in times when investor cash remains on the sidelines waiting for improved market conditions.

Transparency

Investors have often lamented the lack of transparency regarding portfolio securities and other positions in hedge funds. By contrast, managed accounts generally provide investors full disclosure of the managers' investment activities, including holdings, leverage levels and asset values.

Sean McGould, President and Chief Investment Officer of Lighthouse Investment Partners, noted during the GlobeOp event that managed accounts can offer daily position-level exposure and enhanced risk analysis. The enhanced transparency could lead to early detection of style drifts, he noted.

However, enhanced transparency is only a benefit if investors understand the information that they receive, explained Martin Kalish, COO and CFO at Waterstone Capital Management LP. "What investors do with the information they receive, that is a key part of a managed account," Kalish noted. "If you're going to do a managed account, make sure the investor understands what to do with that information. We don't necessarily want to offer 100 percent transparency where it's going to take more time for us to answer numerous questions because investors aren't able to decipher what the information means."

Asset Ownership

Asset ownership is another attractive benefit of managed accounts, Kalish noted. From an investor's standpoint, asset ownership allows the investor to manage and mitigate counterparty risk. Unlike investing directly in a hedge fund, investing in a managed account allows investors to require a third-party administrator or valuation agent to perform key accounting functions, such as portfolio valuations. On ownership of assets, see "How Will the Proposed Liquidation Audit Amendment to the Custody Rule Affect Hedge Funds?," Hedge Fund Law Report, Vol. 2, No. 35 (Sep. 2, 2009).

Kalish explained that in structuring a managed account agreement, the manager needs to understand the parameters of the specific mandate, particularly regarding risk controls. The manager may have specified reporting obligations for different risk metrics under each managed account agreement.

Liquidity

As the recent financial downturn has demonstrated, liquidity, or the lack thereof, can be a major problem for institutions investing directly in hedge funds.

Waterstone's Kalish explained each manager needs to determine what kind of liquidity it can offer to each managed account investor, depending on the underlying instruments. The liquidity of the account should not be greater than the liquidity of the underlying investments in the account. See "Hedge Fund Managers Turn to Hybrid Fund Structures to Reconcile Fund Liquidity Terms and the Duration of Assets," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009).

Drawbacks

While there are several potential benefits to investors, and to managers as well, there are also several drawbacks to offering managed accounts, not the least of which are the additional technology, legal, accounting and administrative costs incurred in setting up and maintaining such accounts.

"Not every manager is open to running a managed account. For some of them, it might not fit their business plan or it might be that they don't have the systems to handle it," Kalish said. "Also, there is a cost involved in setting up managed accounts and getting proper systems in place that may also be a hindrance to some managers."

Kalish also noted that a fund manager has to make sure it has the appropriate resources, including capital and personnel, to support the operations of such accounts.

"You need ample time to set up a managed account," Kalish added. "You need to make sure your systems are up and running and you have the proper resources in place. It takes two to three months to set up a managed account, and that's if everything is clearly defined. The biggest challenge is opening the various prime broker accounts and things of that nature."

Managed accounts also generally offer lower revenue prospects because fees associated with the accounts tend to be lower than those for direct investors in the hedge fund.

Also, managed accounts may require separate audits. Audit fees are often charged to the account, and reduce the returns on the account (but this is a negotiated point and to whom audit fees are charged should be specified in the account documents).

From an investor's perspective, the increased transparency of the underlying positions can be a benefit, but having this information requires active monitoring to be useful. Also, as the owner of the account, the investor must comply with regulations governing direct securities ownership, such as reporting requirements under Section 13 of the Securities Exchange Act of 1934, noted Bracewell & Giuliani's Brunjes. Section 13 generally requires any person acquiring "beneficial ownership" of more than five percent of a "subject security" to file a schedule with the SEC reporting the acquisition. See "SEC's Order in the Perry Case Effectively Creates a Presumption that Beneficial Ownership Acquired as Part of an Activist or Merger Arbitrage Strategy Is Not 'In the Ordinary Course,' and thus May Require the Filing of a Schedule 13D," Hedge Fund Law Report, Vol. 2, No. 30 (Jul. 29, 2009).

Investment Advisers Act Compliance

For an unregistered hedge fund manager, perhaps the biggest drawback of offering managed accounts is the potential to be subject to the provisions of the Investment Advisers Act of 1940 (Advisers Act).

Generally, under the Advisers Act, a hedge fund manager offering more than 14 separate accounts (or more than 14 separate accounts and hedge funds combined) would be required to register with the SEC as an investment adviser. Under the Advisers Act, the fund managed by the manager counts as one client, not each investor in the underlying fund, therefore a typical hedge fund counts as one client for Advisers Act registration purposes. However, separating investors into separate managed accounts would increase the number of the manager's advisory "clients," which could trigger a registration requirement that would subject the manager to additional disclosure requirements and fee limitations.

"One of the challenges is potential SEC registration," Brunjes explained. "Each account is a client for purposes of the 'private adviser exemption' in Section 203(b)(3) of the Advisers Act. If you're going down this road as a manager that is a decision you're going to have to confront."

Under the Advisers Act, there are additional disclosure and recordkeeping requirements. Alos, the SEC can conduct periodic examinations of the operations of a registered hedge fund adviser and review the firm's internal controls and compliance procedures.

This point may be moot, however, if proposed legislation passes significantly broadening the range of hedge fund managers that must register. See "U.S. Treasury Department Proposes Legislation Requiring Registration of Hedge Fund Advisers," Hedge Fund Law Report, Vol. 2, No. 29 (Jul. 23, 2009).

Conflicts of Interest

Another area of concern for hedge fund managers involves the potential conflicts of interest presented by offering managed accounts and hedge funds. Managers need to, to the best of their ability, align the terms and conditions of managed accounts with those of the associated hedge fund. In offering managed accounts, the manager does not want to create a privileged class of investors that has better liquidity, lower fees and lower access costs.

Waterstone's Kalish noted that liquidity is a heightened concern in the current environment. "If the managed account investor wants monthly or daily liquidity, I have to look at what I offer all my other investors and figure out if certain investors would get better treatment. It's something we try to manage and negotiate to the best of our ability to avoid any conflicts." See "For Hedge Fund Managers, How Would a Statutory Definition of 'Fiduciary Duty' Affect the Scope of the Duty and the Standard for Breach?," Hedge Fund Law Report, Vol. 2, No. 34 (Aug. 27, 2009).

Due Diligence

As with any investment in hedge funds, investors are advised to conduct thorough due diligence before committing capital to a managed account. Investors need to ensure that the manager has the technology and infrastructure to satisfy its fiduciary duty and to fulfill the responsibilities outlined in the investment management agreement, noted Nathanaël Benzaken, Managing Director at Lyxor Asset Management.

"An investor has to check the quality of the infrastructure, the quality of the teams, the quality of the counterparty. You should conduct a review of all the counterparties: the administrator, the prime brokers, the custodian and auditors. This must be done on an ongoing basis."

Also, the administrator can serve a vital role in a managed account – from reporting daily trade positions, daily P&L reports, portfolio valuations, risk reporting and collateral management. Therefore, Vernon Barback, President and COO of GlobeOp Financial Services, noted that due diligence on the administrator is very important.

Barback added that investors will want to research the personnel to ensure the administrator has people with the right qualifications and experience in place. It is also important to determine if the administrator has a proper control environment and real-time transparency so that the management within the administrator can monitor the various activities being performed.

"Investors will want to kick the tires on the technology and determine that the firm has the capability to handle the types of investments that are going to be processed in the various managed accounts," Barback explained. "Technology is key. The administrator needs to be accurate and timely in processing very large volumes of data and producing real time reporting. And, they need to have the right support staff to meet all the responsibilities to its clients."