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Manager Investments

Investments by Hedge Fund Managers in Their Own Funds: Rationale, Amounts, Terms, Disclosure, Duty to Update and Verification

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Corporate and investment management law are replete with doctrines intended to put the interests of investors (principals) ahead of those of managers (agents). Such doctrines include fiduciary duty, the duty of care, the duty of loyalty and anti-fraud rules. However, such doctrines routinely run up against human nature. While generosity, especially in the form of tax-deductible charitable giving, is a noteworthy and laudable trait among the managerial class, selflessness in zero-sum situations – where my loss is your gain – generally is not a defining characteristic of corporate or investment managers. That's not why people get into this business. Yet selflessness among managers is precisely the ideal to which the foregoing doctrines aspire. The tension between this aspiration and reality is the stuff of daily business news. In its most tame variety, this tension plays out in the ongoing debates about compensation of executives of public companies. And in its most extreme incarnation, the tension manifests itself in lurid investment adviser frauds and Ponzi schemes.

Economists call this tension the principal-agent problem. The problem is that corporate or investment managers have the legal right to decide what to do with assets they do not own, and therefore may take actions that benefit themselves (the managers) but that are not in the best interests of the owners. The separation of ownership and control is a common feature of public companies, where the equity owned by management is small relative to the equity over which management exercises day-to-day control. Even in many mutual funds, the management company or individual portfolio manager often only owns a small investment.

By contrast, a distinguishing feature of the hedge fund business model is substantial investment by the hedge fund manager – the individual portfolio manager as well as partners and employees of the management company – in its own funds. While such investments are not legally required, they are a tradition and an expectation among institutional investors. Indeed, in its 2009 annual report, the Yale endowment (a pioneer among institutional investors in hedge funds) noted: "An important attribute of Yale's investment strategy concerns the alignment of interests between investors and investment managers. . . . [M]anagers invest significant sums alongside Yale, enabling the University to avoid many of the pitfalls of the principal-agent relationship." See "Lessons for Hedge Fund Managers on Liquidity, Allocations, Marketing and More from Yale's 2009 Endowment Report," Hedge Fund Law Report, Vol. 3, No. 14 (Apr. 9, 2010).

This article analyzes various aspects of investments by hedge fund managers in their own funds, including: the rationales for such investments from both the investor and manager perspectives; the "market" for the amounts of such investments (as a percentage of the individual manager's

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liquid net worth); the concern among investors where the manager has invested too little or too much in its own funds; reinvestment of bonuses in managed funds; the terms of manager investments; when, where and in what level of detail to disclose manager investments and redemptions; whether and in what circumstances managers have a duty to update representations regarding their fund investments; and how investors can verify managers' representations with respect to their investments.

Rationale for Manager Investments

Investor Perspective

Like Yale, other institutional investors and other types of hedge fund investors consider it important for the manager to have a material investment in its own funds for two related reasons: alignment of incentives and mitigation of the principal-agent problem.

On the first point, Allison Gill, a Consultant at Kinetic Partners US LLP, suggested that "having the manager invested in his fund shows prospective investors that their interests are aligned. It adds a little bit of faith on the investors' part that the manager will be fully involved in portfolio management and will do his best to get returns for investors."

Similarly, Richard Bookbinder, founder of Bookbinder Capital Management LLC, noted "I want to make sure the manager is going to feel the pain if the fund doesn't perform well and also to be able to participate in the upside." And Douglas Saksa, Portfolio Manager and General Partner of hedge fund management firm Pegasus Investment Management LLC, added that "it's very helpful to be in the same boat with your investors. I'm going to be dedicated because my money is as much on the line as there's is. At least they know there aren't divergent interests."

The second point – mitigating the principal-agent problem – is closely related to the idea of aligning incentives, but in the hedge fund context focuses more on monitoring and ongoing due diligence. That is, the "problem" in the principal-agent problem is that based on the divergence of incentives, the principal has to invest resources in monitoring the actions of the agent, where those actions can be monitored. (There are circumstances in which the actions of the agent cannot be monitored, e.g., where a hedge fund investor has no legal or contractual right to transparency, or can only be monitored at prohibitive cost.) Material manager investment can mitigate the monitoring cost problem based on a presumption of manager self-interest. If the manager has a material investment in the fund and is self-interested, the manager can be relied upon take actions that increase the value of the fund. Absent a material manager investment, the investor would have to invest more resources in monitoring the manager to ensure that the manager was taking appropriate actions to maximize the value of the fund.

Manager Perspective

Managers have two related motivations for investing in their own funds: investment considerations and marketing.

On the investment side, managers frequently invest in their funds for the same investments-related reasons as other high net worth individuals: the potential for gain and absolute return, diversification, uncorrelated exposure, access to unique assets and access to star talent (investment and other) and top service providers.

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On the marketing side, given the importance that investors attach to investments by managers in their own funds, making and maintaining such investments can signal aligned incentives and can credibly demonstrate a manager's confidence in its own strategy. Saksa, of Pegasus, noted that pointing to his own investment in his hedge funds offers a marketing advantage. Similarly, Bookbinder added that "making sure the manager has skin in the game certainly is one of the first tenets of hedge fund investing. One of the reasons people invest in hedge funds is because they know they can invest alongside superior managers with superior strategies."

Amount of Manager Investments

The Hedge Fund Law Report looked diligently for, but did not find, reliable and comprehensive statistics on levels of manager investments in their own funds. However, we did uncover anecdotal evidence on this point, and perhaps more importantly, principles to guide the appropriate level of manager investment. The key ideas here are that the precise level of manager investment that is appropriate in a given circumstance depends on the level of assets under management, the strategy and the liquid net worth of the manager. Too little manager investment is bad because it signals a lack of commitment, but too much manager investment also gives investors pause, as explained in more detail below. Finally, as a rule of thumb, an investment of something around 70 percent of the lead portfolio manager's liquid net worth appears to be the "market" for investors' expectations with respect to manager investments.

Context-Specific

Bookbinder emphasized that ascertaining the appropriate level of manager investment in a hedge fund depends largely on the circumstances. "When investors look at managers they want to invest with, one of the key principles of the due diligence process is to determine the amount of dollars the manager has at risk in the fund, what the percentage is of his liquidity, and how much of this represents his net worth in the fund. How much is going to be invested is going to vary from manager to manager. It's going to vary based on fund size and strategy. Obviously, a smaller manager is probably going to have a larger percentage of his net worth invested than a larger manager."

Neither Too Little nor Too Much

Bookbinder continued by noting that "regardless of the size of the fund, you want to make sure there is a considerable financial commitment on the part of the manager." Similarly, Neil Morris, a Partner at Kinetic Partners US LLP, noted that the absence of an investment by the manager in its own fund could offer an independently sufficient reason for an investor not to invest in the fund. This is a stronger version of a somewhat intuitive point: that no manager investment is a bad sign.

The somewhat counterintuitive point raised by sources interviewed by the Hedge Fund Law Report is that too much investment by the manager in its own funds can also be a source of concern among investors. Chris Kundro, Co-Chief Executive Officer of LaCrosse Global Fund Services, noted "there is a concern" in circumstances where the manager has invested too great a proportion of its own assets in its own funds "that eventually the manager could start to manage the fund according to its own risk preferences as opposed to those of the investors and what's outlined in the fund documents, like the offering memorandum."

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Brad Balter, Founder of hedge fund advisory firm Balter Capital Management, agreed that there can be cases where the manager has overinvested in its own funds. Balter said he does not want to see a manager with 100 percent of his liquid net worth in the fund because it signals that the manager is not appropriately diversified, which can adversely affect his investment decisions with respect to the fund. "If I hear they have 20% of their investable net worth in the fund, I'm not excited about that. If they have 70%, I'm fine with that. If you move to 100%, what can happen is that their behavior may become erratic because they basically have all their eggs riding on this one investment. It would be foolish not to have some money farmed out elsewhere." Balter said that he likes to see an individual manager invest somewhere between 60 and 90 percent of his liquid net worth in his fund, with 70 percent as the ideal amount. However, in cases where "the manager has adequate liquidity for day-to-day living needs and isn't drawing off the fund," it may be acceptable for a manager to have all his liquid net worth invested in his fund.

Along similar lines, Morris, of Kinetic Partners, suggested that a manager who is overweight his own fund may be unduly conservative in management of the fund. "If a manager has all of his liquid net worth in a fund, there could also be a concern that the manager would manage the fund too conservatively and not take enough calculated risk," Morris said.

Bonuses

LaCrosse's Kundro noted that investors are increasingly demanding that principals and, to the extent they are permitted, employees of the management company reinvest a material portion of their bonuses in the funds. Kinetic's Morris agree with this observation, stating that "investors want to see more than just the principals of the firm invested in the fund, so there is demand that the manager and some of the employees have some of their bonus deferred in the fund."

Such investor demands are making their way into manager policies. For example, fund of funds manager K2 Advisors recently told its portfolio managers and other key staffers that they must reinvest 50 percent of their bonuses in one of the firm's investment vehicles. For more on the law relating to which employees of a hedge fund manager are allowed to invest in that manager's funds, see "Conflicts and Opportunities Offered by Concurrent Management of Employee-Owned Hedge Funds and Outside-Investor Hedge Funds," Hedge Fund Law Report, Vol. 2, No. 32 (Aug. 12, 2009) (section on "Knowledgeable Employees ").

Parity of Terms

According to sources interviewed by the Hedge Fund Law Report, managers and management company employees that invest in their own hedge funds must do so on terms that are no more advantageous than the terms granted to outside investors, and in cases where interests conflict (as they may, for example, in certain redemption scenarios), managers may be required by their fiduciary duties to privilege investor interests over their own interests.

Such parity of terms is particularly important with respect to redemption rights and timing. Balter counseled investors to be wary of a situation in which the manager has more advantageous liquidity terms than those granted to investors, "particularly if a manager had foresight and knowledge that some things were not working out in the portfolio that could result in a suspension of redemptions or gates, and the manager put his money in front of the investors."

Similarly, Saksa noted that in cases of liquidity conflicts between managers and investors, investor interests should be privileged. "You have a fiduciary duty to put your investors first.
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There's no way a manager giving himself preferential liquidity terms would fly with investors or regulators. The fund documents should state the liquidity terms of the fund and a general partner cannot change those rules for his own benefit."

On related conflicts arising out of manager investments in its own funds, see "Conflicts and Opportunities Offered by Concurrent Management of Employee-Owned Hedge Funds and Outside-Investor Hedge Funds," Hedge Fund Law Report, Vol. 2, No. 32 (Aug. 12, 2009).

Disclosure of Manager Investments and Redemptions

Where

Representations with respect to the level of current manager investment, and covenants with respect to ongoing manager investment and notification of any changes in manager investment generally are made in three places: orally at marketing meetings, in written marketing materials and in fund documents.

Pegasus' Saksa noted that his firm generally discusses manager investment with potential investors as part of the fund marketing and due diligence process, "to get investors interested by letting them know you'd be right there with them." Saksa also noted that manager investment information is included in his funds' private placement memoranda.

Scope

The key question is the level of depth in which to disclose current manager investment, and more importantly, the level of specificity regarding promises of ongoing investment and notification to investors of changes of investments (especially via redemptions).

According to Kinetic's Gill, hedge funds more commonly include general disclosure in the PPM, to the effect that the manager's current investment is, and that its ongoing investment will remain, "significant." That is, most fund documents do not specify a percentage or dollar value for current or ongoing investments, or as a trigger of notification to investors of redemptions. Gill also noted that any special terms granted to the manager would have to be disclosed in the PPM, but as indicated above, such special terms granted to the manager may conflict with the manager's fiduciary duty.

Duty to Update?

The frequency with which a manager is obligated to update investors with respect to its investment in its funds depends on two factors: what is promised to investors (in marketing meetings or materials or fund documents) and the materiality of any change in the manager's investment, based either on the size of the investment or the events preceding or following it.

If a manager promises investors updates with respect to its investment in its own funds, it of course has to stick to that schedule (or risk a breach of contract action). And indeed, some managers take this route. Potential triggers for updates include updates to fund documents, periodic accountings or simple passage of time.

Saksa suggested that "any changes in a manager's investment in the fund should be noted when the manager's documents are updated. In addition, every time there is a monthly or quarterly

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accounting may be another time to disclose a manager's personal interest. That information should be completely transparent and available every time there is a fund accounting." And Kundro suggested that investors should inquire about changes to manager investments "at least quarterly," presumably in reliance on the previously-negotiated right to such information.

The harder questions arise where the manager has not undertaken specific obligations with respect to notifying investors of redemptions on a certain schedule. In those cases, any duty to notify may arise based on general contractual undertakings with respect to notification or the materiality of the size or circumstances of any redemption.

Regarding general undertakings, Rory Cohen, a Partner a Venable LLP, suggested that a manager generally is not required to disclose redemptions "unless the manager has separately represented (in pitch books, due diligence questionnaires, etc.) that it would make a minimum capital commitment or has made other representations regarding the level of its investments (i.e., percentage of net worth), and a withdrawal were to result in commitments below its prior assertions." That is, a manager can undertake an obligation to disclose redemptions even below the threshold of materiality, and failing to make such disclosures could be a violation of contract, even if not of securities and related laws.

However, even where the relevant fund documents are silent or very general with respect to a manager's obligation to update investors regarding any changes to its fund investments, the manager still may have a duty to disclose or update where the size of a redemption is significant or the redemption precedes an event that materially impacts the value of the fund.

For example, Gill suggested that if a manager were to redeem its entire investment, it generally would have a extra-contractual duty to disclose that redemption, and in any case, some fund documents specifically call for disclosure of full redemptions. "If something like that were to happen," Gill said, "it is very important to let the limited partners know and I think that is why some fund documents specifically require it."

Balter also indicated that investors generally would take issue with "a manager who made a significant redemption for unknown reasons prior to what, in hindsight, became a significant event in the fund." Likewise, Venable's Cohen suggested that "a manager should not base its decision to redeem on material, non-public information about the fund's performance, or place its own interests ahead of investors. As a result," Cohen concluded, where a manager wishes to redeem based on its access to information that is not available to investors, the manager "should either process investor redemptions first or redeem pro rata."

Verification

Investors can obtain an added level of comfort, beyond representations and covenants from the manager, by independently verifying the manager's investments in its funds. Investors can do this in three ways: via the fund's administrator, by review of the fund's audited financial statements and by background checks.

On the first method, Kundro noted that his firm (LaCrosse Global Fund Services) has been asked to put together reports on manager investments for investors. Such reports generally require the administrator to obtain consent from the manager to provide such data to investors.

Morris also noted the potential utility of direct reporting of manager investments by administrators, but also emphasized the requirement of manager consent. The second approach, review of audited financial statements, may not require manager consent, but likely

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would require more work on the part of investors, and frequently would be more delayed than direct reporting from an administrator.

Bookbinder spoke to the third verification approach, background checks. "At the end of the day, the most important thing that we have always used as a tool is an outsourced, independent background check. That background check will help uncover the truth of a manager's claims and the integrity of the manager. If the manager in a prior life may have had some blemishes related to missed filings or giving incorrect information, an investor might be a little suspect as to the assets claimed to be in the fund or pertinent financial reports. The background check provides an additional tool to check and verify claims and facts that the investor has learned through the due diligence process." See also "In Conducting Background Checks of Hedge Fund Managers, What Specific Categories of Information Should Investors Check, and How Frequently Should Checks be Performed?," Hedge Fund Law Report, Vol. 2, No. 36 (Sep. 9, 2009).

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