# Fund or Managed Account?

## Before Launching A Hedge Fund, Managers May Consider A Managed Account Program Instead

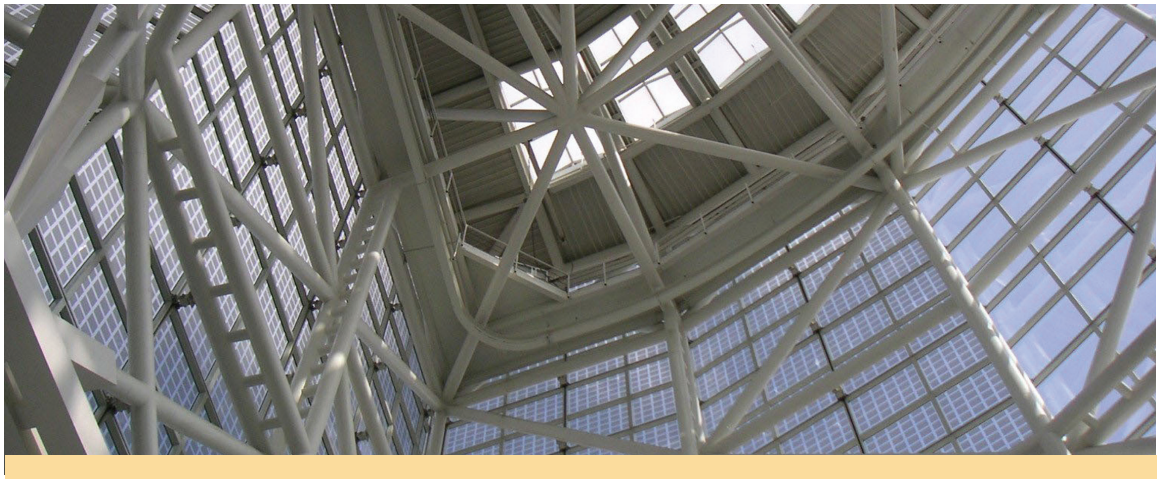
**One of the first decisions a prospective money manager** should make is whether it would be better, given their particular circumstances, to form a fund or trade individually managed accounts. The outcome of this single decision will result in markedly different outcomes from a legal, accounting, tax, business, cost and revenue perspective.

Fund Marketing 101

Practical considerations for marketing an **alternative investment** fund in the evolving legal and regulatory environment

**This white paper** will provide a brief synopsis of the structural differences between a fund versus individually managed accounts. It will also discuss the comparative pros and cons with respect to each structure.

***The following discussion is not intended to be all-inclusive and does not constitute legal advice.***



## Structural Considerations

Whether a money manager's chosen trading strategy will be in securities, futures, forex or in other alternative trading products, a prospective money manager will first need to decide whether it wants to use a fund or managed accounts to trade the assets of others. The first task therefore is to become acquainted with the structure of both funds and managed accounts, as described briefly below.

# Structure

### *Fund*

A fund seeks to combine the investments of more than one investor to trade pursuant to a particular trading strategy. A fund is often structured as a limited partnership, wherein investors become limited partners in the fund. The money manager, often times the general partner of the fund, receives a management fee and incentive fee in return for the management of fund assets. The general partner is often set up as a separate management company, whose purpose is to advise the fund on its trading decisions.

or

### *Managed Account*

For managed accounts, the money manager trades the accounts of separate investors and does not pool their investments together. In each case, the investor is required to establish a trading account with a third party brokerage firm, and the money manager is granted discretion to trade the account only. The money manager cannot withdraw any funds from the account to cover its management fees or incentive fees. Rather, a third party trading agreement is entered into with the brokerage firm to authorize the money manager to be able to trade the account and to receive payments accordingly. The money manager may choose to trade many managed accounts pursuant to the same general trading program, or choose to trade the managed accounts differently from one another.

## Legal Considerations

There are numerous legal considerations applicable when deciding whether to trade a fund or managed accounts. As a result, only a few of the key legal considerations are being provided below.

# Registration

Depending on whether the money manager intends to trade securities, futures, forex or other alternative trading products, there are many registration related considerations that should factor into the money manager's analysis. A brief synopsis of general registration guidelines is provided below.

### *Fund*

In general, a money manager seeking to raise money to trade securities for a fund will be required to register as an investment adviser either with the state where its business is to be conducted or with the U.S. Securities and Exchange Commission (SEC), depending primarily on the money manager's assets under management (AUM). In general, a money manager seeking to raise money to trade futures or forex for a fund will be required to register as a commodity pool operator (CPO) with the Commodity Futures Trading Commission (CFTC) and to become a member of the National Futures Association (NFA).

or

### *Managed Account*

In general, a money manager seeking to trade securities for managed accounts will be required to register as an investment adviser either with the state where its business is to be conducted or with the SEC, depending primarily on the money manager's AUM. In general, a money manager seeking to trade futures or forex for managed accounts will be required to register as a commodity trading advisor (CTA) with the CFTC and to become a member of NFA.

## Accredited Investors

### Fund

A fund generally seeks to raise its investment funds by use of a private placement under Regulation D ("Reg D"). A Reg D offering requires that the fund offer ownership interests in the fund to not more than 35 unaccredited investors, wherein all other investors must meet the accredited investor standard. In essence, only very high net worth individuals and companies can satisfy the accredited investor test. As a result, it may be difficult to locate and attract accredited investors to invest in a particular fund. Moreover, if a fund wishes to use the new Reg D provision allowing for general solicitations, all of its investors must be accredited investors. Under the new Reg D provision, Rule 506 (c), a money manager would be able to use the Internet and other news media outlets to solicit accredited investors for the fund.

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### Managed Account

For managed accounts, the money manager is not restricted to only, or mostly, accredited investors. Rather, the money manager can trade accounts for investors of any net worth. There is also no private placement restriction in terms of the types of solicitation that can be used to attract managed account investors. As a result, it would likely be far easier to find investors under the managed account scenario. (A greater investment might be required from each investor, however, since the money manager is not able to pool investors' money together in order to pursue a particular trading strategy.)

## Transparency & Control

### Fund

A fund is generally less transparent than a managed account, as highlighted by the illegal conduct of Bernard Madoff. Investors to a fund must rely on the money manager to make all decisions relating to the trading of the fund's assets. Investors must also wait for the money manager to periodically report on performance. Investors are not entitled to make any investment decisions concerning the fund, nor are they entitled to receive any additional information concerning the performance and trading of the fund beyond what is provided for in the fund's subscription and disclosure materials. Investors are also generally restricted in terms of how and when they can withdraw their money from the fund.

or

### Managed Account

For managed accounts, the investor can maintain full control of the trading account if they so choose. The investor can make trading decisions for the account, liquidate portions of the account, and fire the money manager at their own discretion. The investor can also maintain full transparency of the account's performance and trading since the investor can view their account's trading records in real time by accessing the brokerage firm's account records.

# Loss Limitations

## Fund

When an investment is made in a fund, the losses that can be incurred by an individual investor are generally limited to the amount invested. This is because the loss is generally limited to the amount contained in the investor's capital account, as a limited partner of the fund.

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## Managed Account

For a managed account, particularly in the case of futures, forex and naked options, the losses incurred by an individual investor can potentially exceed the amount initially invested if the account falls into a debit balance. A managed account may also be subject to margin calls, which must be satisfied by the investor to the account often within a very short amount of time. If a margin call is not satisfied within a time deemed appropriate by the brokerage firm, open positions in an account might be liquidated resulting in a loss for the investor.

# Prime Brokerage

The prime broker will usually offer some variety of capital introduction to aid in the solicitation of investments. A prime broker may also provide prospective money managers with introductions to key industry service providers, such as lawyers, accountants, tax and other compliance professionals. Some prime brokers also offer consulting and management related services to their money manager clientele.

## *Fund*

With a fund comes the ease of managing one pooled account and not enduring the burden of opening and managing new separate accounts for each additional investor. Allocating can become an issue with smaller managed accounts when rounding becomes more pronounced (for instance, a managed account cannot hold a fraction of a contract or share); in a pool, a client may have a fractional interest (proportional to net investment) in a position. In addition, although some (smaller) managed accounts may not be permitted to establish a give-up/take-in arrangement individually, a fund may be allowed to do so if the assets are pooled into a single larger account. Some custodians may also impose ticket charges, which would have a greater impact on small managed accounts than on a pool. It is a benefit to a fund manager to know what he or she is going to be trading each day, due to restrictions on client redemptions. Most prime brokers charge lower commissions for funds than they do for managed accounts and offer enhanced trading technology to fund managers. Reporting is also easier for one pooled account, because if managed account results are to be audited, then all accounts must be considered. By employing the use of a trust company (for a cost), an IRA client may participate in a fund that shorts and uses leverage (prohibited actions directly in an IRA).

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## *Managed Account*

In a managed account, clients maintain a direct, portable ownership interest in the position(s) and with that, greater transparency, greater liquidity, and they do not have to wait on a K-1 tax form from the limited partnership. In a managed account, the client may retain the ability to vote and make corporate action decisions whereas in a fund, the fund manager will exercise these rights. If a client is not accredited or otherwise qualified or eligible to invest in a fund, they must invest via a managed account (or not at all). An IRA account may be managed with rather minimal expenses. Finally, some custodians offer the technology to execute one block-trade and allocate across all client accounts, even for options, making the process as comfortable as trading a single account.

# Tax Implications

When selecting whether to use a fund structure or separately managed account, the tax implications need to be viewed from two different perspectives: (1) the impact on the **advisor**, and (2), the impact on the **investor**.

Advisors that utilize the **fund structure** can take advantage of tax benefits associated with how the incentive fee is characterized. For the advisor that manages separate accounts, any income that they receive is treated as ordinary fee income. While incentive allocations in a typical fund structure often times are allocated as a share of portfolio income. For managers that generate long-term gains, and qualified dividends, this could mean a substantial difference in their after-tax income.

The investor has a completely different perspective. Before we discuss this, it might be helpful to point out that the tax implications related to mutual funds are different than those commonly associated with investing in the majority of investment partnerships. Mutual fund investors are subject to allocations of gains and losses annually, and can be impacted by transactions that occurred prior to their investment (i.e. unearned capital gain distributions). The investors in these funds also may lose some of the tax benefits associated with the different types of income or loss that is generated by the investments.

Since the majority of hedge funds are structured as LPs and LLCs, and all income and losses are passed through on K-1's, most tax benefits as well as income and gains are directly distributed. This limits the possibility of unearned capital gains being distributed, as well as ensuring that favorable tax benefits are able to be utilized by the investor.

While the tax benefits of hedge funds are preferable to that of mutual funds for investors, the benefits of privately **managed accounts** are even better. The fact that all the assets are owned directly by the investor ensures that the investor will only pay tax on income that they have received. Additionally, investors can request that securities are sold at specific times to ensure that losses are able to be utilized.

# Asset Custody

An independent qualified custodian can be a valuable and, sometimes, necessary service provider to portfolio managers no matter which option – fund or managed account – the portfolio manager chooses. An advisor who must register under the Dodd-Frank Act must also use a qualified custodian. The role of the independent qualified custodian differs according to the direction the portfolio manager chooses.

## *Fund*

As a fund manager, one of the most crucial steps in the process is attracting qualified investors. That is obvious. But what is not so obvious to many portfolio managers is that funds residing inside an individual's retirement account are eligible to be invested in a fund. Of course, the investor must be accredited, but self-directing an IRA to invest in a fund is a rather simple process which opens up opportunities for the fund manager. An independent qualified custodian is needed to set up a new IRA for the investor, direct money into the fund and provide custody of the asset for the duration of the investment. On a final note, it is important for hedge fund managers to be familiar with the so called "25% Limit" or the Plan Asset Rule. Fund managers should consult an ERISA attorney to ensure compliance with this rule.

or

## *Managed Account*

In this situation, a custodian's role becomes much broader as it not only can provide custody of the IRA, but the custodian can also provide reporting options which can benefit both the manager and his or her clients. First and foremost a custodian can provide account values to both the manager and client on one statement. Managers and clients may also access the custodian's online platform. A custodian's role has increased in recent years due to the passage of Dodd-Frank, which requires qualifying advisors to comply with new regulations. Primarily, investment advisers are subject to expensive surprise audits by PCAOB auditors unless they employ a qualified independent custodian.

## Transparency & Access

Hedge funds and managed accounts are compared in two ways: transparency and trader's access to investor's funds.

# Transparency

### *Fund*

Hedge funds are managed by a separate party (i.e. the trader/manager). All trades, transactions and positions are completely confidential. This also means that the traders have full authority to allocate the fund's assets into other opportunities such as multi-asset, multi-strategies (provided that it is properly disclosed in the offering documents). Hedge funds typically have an external administrator/firm whose function is to properly calculate NAVs, profit/loss allocations, perform KYC/due diligence on potential investors and other important accounting functions. Investors tend to feel more comfortable with an outside third party overseeing the trading operations and properly reporting only the "financial" aspects of the fund.

or

### *Managed Account*

In a managed account structure, the investor has more transparency and direct access to his account. This is provided by the brokerage firm the investor opens the account with. Every trade that the trader makes is seen by the investor including the positions and transactions in the account or the profit (and loss) from each transaction. A managed account may not work well if traders are not comfortable with disclosing their proprietary trading styles.

# Trader's Access

## Fund

Hedge fund assets are controlled by the trader/manager not the investor. This gives enormous flexibility to the trader to manage his or her positions and cash flow. Once an investor subscribes to the fund, the investment capital is wired directly to the fund's administrator who in turns conducts due diligence on the investor. Once cleared, the funds are sent, per instructions to the fund's prime broker or wherever the trading account is located.

Investors do not have direct access to their own funds. Most hedge funds have an initial lock up period of 1 year before an investor can redeem their shares in the fund. This means that traders can take advantage of a long period of time trading and recouping and drawdowns without relinquishing any capital back to the investors.

Recently, as a best practice, more hedge funds are using administrators as a "second signer" when it comes to paying out expenses. This simply means that the trader/manager needs to get a "sign off" from the administrator before making a withdrawal or transfer from the hedge fund's account. Investors have the peace of mind that the trader/manager will not run off with their money.

or

## Managed Account

In a managed account structure, investors open their own accounts with a regulated brokerage firm. All funds are wired directly from the investor into their own account at the brokerage firm. The trader does not receive deposits/withdrawals and only has limited authority to make trading decisions in the investor accounts. A managed account provides a higher level of safety of funds for the investor but a limited amount of trading control for the trader.

# Fund Marketing 101

**Fund Marketing 101** is a collection of service providers formed in the summer of 2013 to promote practical considerations for marketinig an alternative investment fund in the evolving legal and regulatory environment. Firms participating in the initiative are listed below:

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