

Separate Accounts

Hedge fund managers are occasionally presented with the opportunity to accept investment capital in the form of an account separate from their funds. This can happen for one or more of several reasons:

- Many institutions have a desire to monitor and track the individual security positions, rather than just a fund NAV.
- A separate account is usually easier to terminate.
- There is a perception⁽¹⁾ that separate accounts may be safer than funds.
- Some institutions might want to invest in a fund, but the fund is too small for its investment guidelines.
- Some funds have their own restrictions – such as a limit of 10% of capital from any one investor.

The investment underperformance of the last year, plus the many discovered frauds, suggests that managers should expect more inquiries about separate accounts in the future.

As we are all aware, individually managed accounts are not uncommon, and are, in fact, the norm among investment advisors in general. So, what are the special challenges for a hedge fund manager to offer separate accounts? This Element discusses the pluses and minuses from both the perspective of the manager and the investor.

The Challenges

One perceived advantage of a separate account is that the assets are held in the investor's name, at a broker or custodian chosen by the investor, and the investor therefore has complete transparency to view the activity in the account. So, if a properly structured separate account is theoretically more secure, why don't we see more of them in hedge fund shops? There are a number of reasons – some of which are obviously felt in common by "ordinary" investment managers – and a number which are industry-specific to hedge fund managers:

- Separate accounts add significant operational complexity. One reason to form a hedge fund is the simplicity of aggregating investors into just one portfolio. If each investor had its own account, perhaps with many different brokers involved, it's a much bigger management and staffing challenge: getting multiple trade tickets entered and executed; keeping accounts with differing cash flows in alignment; arranging for the "borrow" for short sales in multiple accounts and firms; billing; plus addressing investor inquiries when full transparency permits every trade to be second-guessed.
- There is a higher risk of unauthorized disclosure of positions. While a managed account agreement normally includes confidentiality terms, it is really a matter of trust that the investor will control the dissemination of trading and position information in its offices. In a hedge fund, transparency, while often available upon request, is usually measured and any details are not typically real-time. Most managers believe there is some proprietary value in security selection and trading (including the identification of short positions), so it requires some forethought before providing full transparency.
- A separate account may result in the manager taking a significant after-tax pay cut. Incentive fees on separate accounts are taxed as ordinary fee income. Incentive allocations in a typical hedge fund structure are usually⁽²⁾ treated as a share of portfolio income. For a manager who produces some level of long-term capital gains or qualified dividends – and who would receive the incentive allocation as a share of that portfolio income (some of which may be unrealized) – an incentive fee, versus a performance share, can mean a significant reduction in after-tax compensation.

The Challenges (continued)

- One significant limit to the attractiveness of separate accounts is the likely adverse tax consequences to taxable investors. If the beneficial owners of the separate account include taxable natural persons, either directly or indirectly, such as via a fund-of-funds, the payment of an incentive fee in the separate account can be much more expensive, after tax, than paying a share of portfolio income in a normal hedge fund. If a hedge fund gains 15% gross and pays the manager 20% of profits – 3% – in the hedge fund, the investor simply sees (and reports) a 12% net return. If that 3% is a fee, the investor will generally report a 15% return, with a 3% investment expense that may be difficult to deduct.
- Separate accounts may be viewed critically by the other investors in the manager's hedge fund(s). Other than the contribution their revenue makes to a larger research budget, there is little advantage to other investors. Additional capital in a fund will help pay the fund's fixed expenses; however, that is not the case with an investment outside the fund. Moreover, there may be concerns that the full position transparency given the separate account holder may be detrimental to fund performance.
- Lastly, where strategies utilize leverage, investors may benefit from the limited partnership structure in the event of a severe loss.

Practical Considerations

While separate accounts aren't for everybody, they may be requirements for some institutional investors. If asked to manage a separate account, the following suggestions may be helpful:

Account Domicile

If it is possible, it is usually easier administratively if the separate account is housed at the same broker that acts as prime for the manager's hedge fund(s). This

would permit bulk trades and may also reduce the potential for the problems that can occur when significant orders for the same security are sent to two or more separate brokers simultaneously.

Trade Practices

Managers who currently supervise only one fund account in a strategy should establish procedures for fair trade allocation among funds and separate accounts.

Administration

It is becoming more common to have an administrator involved in separate accounts. Administrators will typically have a specially tailored report package and, among other advantages, their presence inserts a neutral and skilled party to determine valuations and fees. Because separate accounts usually do not require audit or tax support or financial statements and have limited cash flows, administration fees can be expected to be somewhat lower. Typically, the administration agreement is executed with the separate account holder, since it is the primary beneficiary of the reporting.

The Investment Management Agreement (the "IMA")

An IMA is typically much simpler than the legal documents associated with a hedge fund; however, it should be carefully reviewed by the manager's legal counsel and the administrator. Since the initial draft of the IMA may come from the investor, it may have been written by a non-hedge-fund attorney. Accordingly, in addition to the normal legal review of any contract, special care must be taken in reviewing the incentive fee language. In our experience, as often as not, proposed IMAs contain improper or missing fee language. Some things to look out for:

- The asset-based part of the fees should be clearly based on month-end or quarter-end values, not some form of “average” assets. If quarterly, adjustments for intra-period additions or withdrawals need to be addressed.
- The high-water mark needs to adjust for withdrawals, just as it does in a hedge fund.
- If there is a hurdle or threshold, it similarly needs to adjust for withdrawals, plus needs specific definitions for period-by-period or cumulative application.

It is common that IMAs also articulate the funding intentions and may include conditional lock-ups on capital.

Disclosure / PR

Legal counsel should be consulted regarding the advisability of disclosing the existence of the separate account to fund investors. In any case, the conflicts of interest should be clearly understood so that the separate account can be presented as favorably as possible to the fund investors when and if disclosure is made.

Negotiating Fees

As noted earlier, in many cases, separate accounts may result in less net after-tax income for the manager, versus the same rates in a hedge fund. While we are unaware of any managers offsetting this effect by charging a premium for a managed account, the reverse is often discussed. It may be that a manager can offer a discount to invest in the hedge fund and still be ahead on an after tax basis.

Summary

While separate accounts have their complexities, they are manageable if the challenges are fully explored and suitable processes installed. Please feel free to contact your ALPS Price Meadows fund administrator if you are considering a managed account and we will be happy to assist in whatever way you think appropriate.

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⁽¹⁾ We use the word “perception,” of course, because the largest fraud yet – Madoff – involved managed accounts. While his name is associated with hedge funds, it’s because he swindled a number of them. Madoff never offered a fund – he provided separate accounts to others who formed funds around those accounts. The fraud was apparently possible only because he required the separate accounts to be domiciled at his broker-dealer.

⁽²⁾ There have been a number of legislative proposals that would re-characterize these allocations as ordinary income. As with any legislation, there is no way to predict “if or when.”