

## Q&A

With Paul N. Roth, Schulte Roth & Zabel LLP

BILL McINTOSH

**P**aul Roth is a founding partner of Schulte Roth & Zabel LLP, a full-service law firm with 450 attorneys and offices in New York, Washington, D.C., and London. In the alternative investment sector, SRZ has a long and distinguished record in advising hedge fund managers. It is the leading law firm by market share in servicing US hedge funds in the US and it has had an office in London for seven years.

Roth has been a leading innovator in servicing hedge fund clients and their very specific needs in fund formation, manager regulation, tax advice and business development planning. With over 40 years experience in the hedge fund sector, Roth has a wealth of knowledge and experience in handling the complex legal issues that can impact alternative management firms. He was in London recently to co-chair the International Bar Association/American Bar Association conference on private investment funds where he spoke with Bill McIntosh, editor of *The Hedge Fund Journal*.

### **Q: How did you get involved with the nascent hedge fund industry in the late 1960s and what was the opportunity you spotted to build a business?**

A: I'd like to say it was a very planned and strategic decision. But the truth of the matter is that in 1967 my brother-in-law Howard Berkowitz decided to join with Michael Steinhardt and Jerry Fine to form Steinhardt Fine Berkowitz & Co. It was one of the earliest hedge funds. They asked me to advise them so I became knowledgeable about hedge funds at an early stage in my career. Hedge funds were just starting to develop. Because of that, anyone starting a hedge fund would call Michael or Howard or Jerry. Since they were friends as well as clients, they recommended me and I became a so-called expert on hedge funds. It exposed me to incredibly interesting and intelligent people and it became something I wanted to continue to develop. As the hedge fund community grew, our practice grew with it.

### **Q: Back in the late '60s and early '70s what type of things did you do to get managers on their way?**

Steinhardt Fine Berkowitz started in 1967 and was a US domestic partnership. In 1968, we did their offshore fund. So we developed prototypes for hedge fund documentation. At that time, hedge funds were by and large long/short equity investors. Hence the name hedge funds where they were hedging their portfolios against downside market risk by having some portion of their assets allocated to short positions. They always had stock selection risk because if you were short the stocks that went

up and long the stocks that went down you hadn't created a very good hedge! The markets suffered significantly in the early 1970s so there weren't a lot of new hedge funds set up in that period. It started to pick up in the late 1970s and in the 1980s. The explosion in the market in terms of AUM really didn't happen until the mid-1990s when institutional investors started to come into the alternative asset space. Only when the Investment Company Act of 1940 was amended in 1996 to add Section 3(c)(7) (following a recommendation by the SEC to Congress) did you get away from the 100 investor limitation for US managers. That really opened the door for the dramatic growth in hedge fund AUM from the mid-1990s to 2007.

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### **Q: After long-short equity what was the next strategy that developed?**

A: There was a drift towards a global macro approach. Some of the funds that were set up as long/short equity funds started to get engaged in the bond market when they saw long-term secular trends. For example, in the early 1990s there was a whole collection of US hedge fund managers who were long European bonds. In the '70s some managers were making interest rate plays with respect to secular trends where they thought they would see very high interest rates come down and bond prices go way up. So global macro developed as a strategy. Other trading strategies also developed, such as different arbitrage strategies – merger arb, risk arb and convertible arb – as more people were able to raise money for strategies with which they had experience from proprietary trading at Wall Street firms. Capital structure arbitrage similarly developed as proprietary traders in that strategy left Wall Street to start hedge funds.

### **Q: How did regulation develop in the hedge fund sector and how might this evolve in the next couple of years?**

A: Let's start with the US. In the US there was an exemption under the Investment Advisers Act – if you were an investment adviser and you had 14 or fewer clients, didn't advise any registered investment companies and didn't hold yourself out as an investment adviser, you did not have to register as an investment adviser with the SEC. So, the issue early on for hedge funds was whether their client was the fund or the investors in the fund. There was a series of no action letters that indicated the fund was the client of the investment adviser. So it wasn't necessary to register with the SEC as an investment adviser if a manager was advising fewer than 15 funds. It meant the industry developed without a lot of regulatory oversight of managers under the Investment Advisers Act. Of course, hedge funds were subject to all the regulations relating to market regulation and the anti-fraud rules. In the early '70s a study raised the question whether hedge funds should be required to register as broker dealers. From a regulatory perspective, the decision was that hedge funds were not broker dealers because they weren't holding themselves out as making a market as dealers would do; and because they didn't have customers they were simply trading for their own account. It pretty much stayed that way until 2004 when the SEC adopted a rule under the Investment Advisers Act requiring that, for purposes of counting “clients” to determine whether a manager was required to register as an investment adviser, a manager would be required to “look through” the fund and count the number of investors. Essentially, the SEC said the exemption from registration for hedge fund managers was no longer appropriate when the industry had grown to more than \$1 trillion in AUM. It was a departure from past practice and the DC Circuit Court overruled the SEC (in the Goldstein case) and said the SEC didn't have the authority to change the established understanding that the fund was the client (rather than the investors) under the language of the statute. Now we have legislation that is pending in Congress that most assuredly when it passes will require advisers to hedge funds to register based on an AUM test rather than on the number of “clients”. In today's climate that makes a good deal of sense as well.

There is a bill that has passed the House and there is a draft of a bill that has been proposed in the Senate. These bills (there is a long way to go before they become law) raise the AUM threshold for registration of hedge fund managers to \$100 million or more. But there may be a lot of hedge fund managers that have small funds who would not be permitted to register with the SEC and would be required to register with

individual states. It's probable that a manager will only have to register as an investment adviser in the state in which its main office is located, and comply with rules in no more than five states. Even so, that could cause us a great deal of difficulty because each state has its own statutory and regulatory framework that is different from the SEC's and different from the other states. I would prefer to see the SEC have jurisdiction over these managers because then we have one single national body of law regulating hedge fund managers with more than \$25 million in AUM, which is the registration threshold at this time. That to me would make more sense.

There is also a new way of looking at things. To the extent hedge fund managers have been looked at in terms of regulation, they've been looked at only in terms of investor protection. Since the financial crisis of 2008, systemic risk has become a major issue with respect to all financial institutions and hedge fund managers haven't escaped that prism. The legislation that is proposed also talks about collecting information regarding systemic risk, such as AUM, counterparty risk exposure, leverage, portfolio positions and trading practices, as well as such other information that SEC determines is relevant. In addition, there are provisions giving the SEC authority to require disclosure with respect to, and even develop regulations regarding the appropriateness of, incentive fee compensation and whether or not it is adequately framed to deal with the risks of the investment and inappropriately promotes risky behaviour by hedge fund managers. That is a long way from what one would normally think that the SEC would be doing with respect to regulating hedge fund managers. Although everybody (except, perhaps, some European governments) agrees that the hedge funds were not responsible for the financial crisis and the lack of stability in the financial system, they are getting swept up in some of these issues, even though I think one would be hard pressed to demonstrate that compensatory practices in the hedge fund industry are related to systemic risk. I think, actually, it's to the contrary because the manager's compensation is directly tied to the performance of the fund.

**Q: Would it be prudent advice to US firms to concentrate on the global market outside the US and avoid Europe given the issues raised by the AIFM Directive?**

A: People tend to go where they have relationships and where they can raise money. They don't ask the lawyers about that. They ask the lawyers what they need to do to be able to compete in those jurisdictions. It's premature to say what may happen. If you look at the Dutch pension funds, and

some others as well, they are saying we don't wish to be circumscribed with whom we can invest. The real issue is: why would the EU adopt a Directive which would put it in conflict with the wishes of some of the largest and most sophisticated investors in the EU? I think it is too early to say what exactly is going to happen and how it is going to impact US and UK managers although at the IBA/ABA conference it has been a huge topic of conversation. A big issue is whether it will become relatively impossible for US managers to raise money in Europe. I don't believe that is a desirable result.

**Q: Do you think hedge fund firms will continue to develop into multi-purpose asset managers with many different businesses?**

A: We don't know exactly what is going to happen with regulation. Before the financial crisis and during the "liquidity bubble" we saw alternative asset managers developing streams of income from management fees and incentive fees from multiple different hedge fund strategies, as well as developing private equity and venture capital products. Managers who were able to diversify their income streams had a valuation advantage if they wished to go public or position their firms for sale. Since then we've seen the large scale traditional investment bank either go bankrupt, be merged into a bank in a Treasury sponsored take-over, or in the case of Goldman Sachs and Morgan Stanley, become bank holding companies which gave them access to the FED window. The landscape of financial institutions has changed significantly and the bills making their way through Congress will definitely impact the future shape of financial institutions. For example, will the Volker Rule be part of the legislation and restrict proprietary trading by banks?

What that means in terms of how hedge funds will develop in the future is a good question. Markets have also changed. The SEC recently issued a concept release to consider the correct way for markets to be regulated when more than 50% of the volume in NYSE listed securities is done by high frequency traders using computer driven systems. When substantial trading volume is being done though "dark pools" it means that only executions, but not quotes, are being exposed to the national market system. So, we are dealing with new developments affecting markets, as well as the institutions (such as the investment banks) that historically have been the major participants in those markets. Will we see certain hedge funds develop broker dealer affiliates? We've seen some start to do that already. Will they become market makers? That's also potentially possible. Will they be seeking to raise their own capital rather than going through intermediaries? That's also possible.

Will they also seek to develop affiliates which are boutique investment bankers? We've seen considerable talent moving to those boutiques, and they appear to be flourishing in developing advisory M&A businesses. There is a lot of potential for hedge fund managers to expand their businesses, and I cannot predict how this will happen, or whether it will. Too many things are in flux right now. What I do foresee is continued concentration of AUM with a limited number of hedge fund managers. My guess is that less than 400 managers represent at least 75% of AUM in the hedge fund world. That is an enormous concentration of AUM. With institutional investors coming in, they want to see an institutional type of infrastructure in a manager's business - and the cost of that infrastructure requires a lot of AUM. So you are seeing a migration from the entrepreneurial beginnings of hedge funds (the so-called image of two guys and a dog in a garage trading equity long/short) to a more institutional model. What that means is that the high concentration of AUM creates a certain natural market barrier to entry, and regulation also tends to raise that barrier, although it is likely to be less a factor than market forces. I expect what we will see develop is a two tier market: very large managers in which institutions will continue to invest and smaller entrepreneurial managers. It's not likely that a lot of institutional money will go to the smaller managers because the institutions don't want to be too large a proportion of money in any fund. And the smaller manager isn't going to have the fees to build out the infrastructure that the institutional investor wants to see. While I do see this concentration of AUM continuing, we have to be careful about predictions because this is an industry that has developed over a relatively short period of time, and just as the model has undergone a lot of change, there is no reason to believe it will suddenly become static. It will continue to change, but exactly in which direction is still up in the air.

**Q: Typically hedge funds started with prop desk people from an investment bank setting up a business and raising assets as they went. It almost sounds like you are sounding the death knell for that traditional hedge fund business formation model. Do you have sense of what might replace it?**

A: I don't think it is a death knell. What's happening is that people who have developed reputations doing prop trading or doing investment banking in areas such as distressed and things of that nature are able - if they have built a reputation and if they decide they want to go into business on their own - to do it. Frequently it means they will have to have made a fair amount of money before they can start their hedge fund. It's not going to be

the young guy who just decides he wants to trade on his own account. They will need to be able to bankroll to some degree the development of their fund, or gain sponsorship from an institution. Given market conditions today - with a few exceptions - most aren't going to raise \$500 million out of the box. They are going to start smaller and as they gain credibility with a track record - generally institutions require a three year track record - and they build up their infrastructure and compliance operations they will be able to attract institutional money.

**Q: How would you characterise some of the key changes that have occurred with prime brokers in the last couple of years?**

A: If you go back to 1998, the issue with Long Term Capital was the extent to which hedge funds were a risk to the prime brokers. If you go back to Bear Stearns and Lehman in 2008 the issue was to what extent were the prime brokers a risk to the hedge funds. I think the relationship has changed dramatically in the sense that hedge funds are much more careful these days in terms of evaluating the creditworthiness of their prime brokers, and diversifying their exposure. The prime brokerage model some years ago was to have a single prime broker. Now the model is to have multiple prime brokers. There is much more careful negotiation of prime brokerage agreements and what prime brokers can do with respect to excess assets, meaning those not needed to secure loans. In this respect, the relationship has become more mature.

**Q: Obviously legal advice is a key factor in how a hedge fund relates to its investors as well as registration, tax planning, business models and more. What's SRZ's approach to this?**

A: I don't think that advising hedge fund managers is conceptually different than advising other businesses that are starting out. What we try and do with our managers is ask them to think about what their business plan is three and five years out. What we are looking to do is structure a business model for them that is compatible with their business plans. You might, for example, structure a fund one way if you are just going to be a long/short equity business. But if you are going to have a second fund that is, say, global macro and expect next year to open an office in London and the following year in Hong Kong, you'd structure something differently for that manager than one that is going to be just in New York City. I think what we have tried to do is build a bespoke type of organisation for our clients so it is consistent with what their long-term goals are from a tax, regulatory and business standpoint. That approach has served us and our clients well.

**Q: The early '70s saw a pronounced bear market and about half of the 200 hedge funds in business close. Do you see any parallels between that period and now?**

A: Not really. The stress in the hedge fund market in 2007-08 wasn't primarily in the long/short equity space. Long/short equity funds suffered declines in value because the market fell substantially. But they didn't suffer illiquidity. The equity markets worked pretty well. The real distress in the industry was in the fixed income markets where you simply couldn't trade. Therefore some managers had to impose gates or suspend redemptions and that created an enormous tension between the continuing investors and the investors that wanted to withdraw. It was a question of how managers navigated uncharted waters of frozen credit markets to deal fairly with both redeeming and continuing investors. The rebound in the market in 2009, both in terms of valuations and liquidity, helped managers who had to suspend redemptions because they were able to liquidate assets more quickly and at better prices than redeeming investors had originally thought.

Contrast this to the early '70s when hedge funds were basically long-short equity. It was a young industry. Investors were almost entirely high net worth individuals and they withdrew money because the market was doing badly. There wasn't an illiquidity problem. And hedge funds were such a small part of the market that they were almost irrelevant. What did occur in the early 70s was there were some hedge funds that were doing private placements, that is buying securities directly from an issuer that weren't publicly tradable because they were subject to registration requirements before they could be traded. There were some valuation issues with respect to how they valued those securities. Similarly there were valuation issues with respect to hedge funds in the liquidity crisis for credit investments. The question is: how do you value something that temporarily cannot be traded because there is no market for it. Valuation may be a common theme but I think that the two issues are very different. Systemically there was no issue with respect to the markets of the 1970s. However, in 2007-08, the regulated financial institutions were so over extended that they stopped being buyers. So hedge funds couldn't sell to their natural buyers - the financial institutions. At the same time those institutions were unloading their assets into the market, driving down prices and calling in the credit they had extended to the hedge funds, putting funds in a three way bind. That is a very different situation from the 1970s.

**Q: Is SRZ's pipeline showing growth in new business?**

A: 2009 was the year of the restructure. So we were restructuring funds to put the liquidity of a portfolio

and the liquidity to investors on a more even footing. We are seeing new funds being formed now but we are not seeing them being formed with the same rapidity or, with some exceptions, raising as much money as a start-up as they did pre-2007. When that will come back remains to be seen but I don't think it is there yet. On the other hand, our existing managers are successfully launching new products.

**Q: Tell us a bit more about your thoughts on a uniform approach with respect to how regulators in different parts of the world approach systemic risk.**

A: It's a goal. Obviously it becomes very important. The SEC and the FSA have been working with IOSCO to focus together on what is relevant systemic risk information. On 25th February, The Technical Committee of the International Organisation of Securities Commission (IOSCO) came out with a template on what kind of information should be collected in terms of systemic risk. Hedge fund managers and others would go crazy if every regulator they have to deal with starts asking for different systemic risk information, and if they ask for it in a different form and use different definitions, for example, of leverage or counterparty exposure. Key to intelligent regulation going forward is international coordination in defining a common template for collecting information for systemic risk purposes. That's why the IOSCO initiative is so important, and why it is so discouraging to see the European Council dealing with the AIFM Directive in a way that is so contrary to the manner in which the industry is regulated in the US and UK. It appears not to be a cooperative effort but instead an EU centric effort with respect to regulation. If we have learned anything it is that systemic issues are global and we need a cooperative regime with which to deal with them. One of the areas that clearly must be dealt with - Lehman taught us this - is that there needs to be some kind of global understanding of how an institution that carries accounts of customers is going to be wound down. We have such a regime in the US but as people trade throughout the world more global cooperation is going to be required. The IOSCO format for defining systemic risk data requirements from hedge fund managers is a good first step and it provides an intelligent approach for dealing with systemic risk regulation on a multi-national basis. **THFJ**

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