FOCUS ON: US investors in Latam


As momentum continues in Latam and the region becomes more established on the world fund stage, **Joseph Suh** and **Daniel Hunter** of **Schulte Roth & Zabel** discuss the opportunities for US investors in the region

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By most economists' estimates, much, if not most, of the global growth in gross domestic product over the next 10 years will come from emerging market countries.

Brazil, with recent annual GDP growth projections of 5% to 7%, will account for a significant portion of that growth. Institutional investors in the United States have taken notice of the opportunities in Brazil and have been investing in, or conducting diligence on, Brazilian companies and investment managers over the past several years. Despite significant interest by US institutional investors in Brazil, most Brazilian managers have not taken significant steps to reach out to US institutional investors and offer them compelling investment products.

This article explores the opportunities for Brazilian managers in offering a hedge fund product to US institutional investors and highlights certain key issues for Brazilian managers to consider in launching a hedge fund for US institutional investors.

Why US institutional investors?

US institutional investors include US corporations, US corporate pension plans, state government pension plans, universities and charitable foundations. There are two main reasons why Brazilian managers should consider offering an investment product that is attractive to US institutional investors.

First, US institutional investors control an extremely large investment pool. For example, the US pension fund industry alone controlled more than $15trn as of December 2010, several times larger than the size of the global hedge fund industry.

Second, Brazilian managers may wish to diversify their investor base. Many successful Brazilian managers have focused almost exclusively on Brazilian investors. However, the Brazilian experience with hyper-inflation, unstable local currency and the availability of relatively safe, high-yielding Brazilian government bonds to Brazilian investors have created an extremely demanding local investor base. It is not unusual for a Brazilian fund investor to redeem from a fund even if the fund returns 12% or more per year if that return merely matches the return of Brazilian government bonds over the same performance period.

By contrast, most US institutional investors tend to be long term or 'sticky money,' more concerned about high, risk-adjusted returns over a longer period and less likely to redeem at the first sign of volatility.

Why hedge funds?

In Brazil, all Brazilian managers must be registered and all investment funds offered by Brazilian managers to Brazilian investors are registered with Comissão de Valores Mobiliários (CVM). By contrast, in the US, many funds are not required to be registered with the US Securities and Exchange Commission (SEC) and many managers are not required to register as US registered investment advisers.

Typically, mutual funds are retail investment funds that are registered with the SEC and are available to both institutional and US retail investors whereas hedge funds, private equity funds and venture capital funds are private funds that are not registered with the SEC and are only offered to certain eligible US investors (including institutional investors and high net worth individual investors) and non-US investors.

When presented with the opportunity to invest in an investment fund, a US institutional investor will typically attempt to determine the type of fund that is being offered: a mutual fund, a hedge fund, a private equity fund, or a venture capital fund. For the reasons outlined below, a hedge fund gives a typical Brazilian manager the most cost-efficient and flexible investment vehicle to offer to US institutional investors.

- US laws governing mutual funds are complex and make it difficult for a Brazilian manager to offer a mutual fund product to US investors, unless the manager is already a US-registered investment advisor and has a thorough understanding of the US securities laws and compliance infrastructure.
- US institutional investors' investment in alternative investments such as hedge funds, private equity funds and venture capital funds have more than doubled over the past five years. In particular, pension funds with underfunded liabilities are turning to alternative investments to generate higher risk-adjusted returns than traditional investments can generate. For instance, the number of public pension systems investing in hedge funds has grown by approximately 50% over the past four years.
- Unlike mutual funds, a hedge fund manager typically earns both a base management fee between 1% and 2% per year and a performance fee between 10% and 20% per year.
- Unlike typical private equity funds or Brazilian multi-mercado funds, a hedge fund manager is often entitled to receive performance fees starting with the first dollar of return to investors instead of receiving performance fees only on the portion of returns that exceed a particular hurdle rate (such as the Brazilian government bond rate).
- In the US, a private fund can be considered to be a hedge fund if it offers its investors periodic redemption rights and a strategy that promises sufficiently high returns to justify a performance fee. A hedge fund does not need to use leverage or shorting as a strategy.
- Neither private equity funds nor venture capital funds are appropriate investment vehicles for the typical Brazilian manager investing in relatively liquid securities issued by Brazilian public companies.
- The cost of structuring a private equity fund and negotiating the terms for investments of its investors could be several times higher than the cost of launching a hedge fund.

Typical hedge fund structure

A typical hedge fund investing in Brazilian securities that is offered to US investors will involve a limited liability company or a limited partnership organised in Delaware or other state in the US (the 'US fund') and an offshore limited partnership or company (the 'offshore feeder') organised outside the US (such as Cayman Islands, BVI or Ireland). The US fund will either invest directly in Brazilian securities or in a Brazilian fund that invests in Brazilian securities. The offshore feeder will invest indirectly in Brazilian securities or a Brazilian fund by making investments into the US fund. US taxable investors (such as US corporations) will invest directly in the US fund and US tax-exempt investors (such as pension plans and charitable foundations) and non-US, non-Brazilian investors will invest in the offshore feeder.

Reaching US institutional investors

Since investments made by a US institutional investor tend to be fairly large, the due diligence process used by a US institutional investor is more thorough and far more time consuming than those used by a retail investor. It is not unusual for this process to last several weeks or even months. Below are some issues that should be considered when structuring and

marketing a hedge fund for US institutional investors.

- Established managers with good track records. US institutional investors prefer large established managers with good reputations, stability of investors and investment teams, good operational controls, established track records and less volatility of returns.
- Well understood fund structures. It is important to US institutional investors that a hedge fund look and feel like a typical hedge fund. Base management fees, performance fees, liquidity terms and other important investment terms should be similar to comparable hedge funds in the market. The greater the differences in investment terms, the more time US institutional investors will spend negotiating those terms rather than completing the due diligence of the manager.

São Paulo, the largest city in Brazil, has much to offer US investors

- Equivalent liquidity rights. It is important to many US institutional investors that a hedge fund offered by a Brazilian manager has similar liquidity terms as a fund investing in substantially the same securities that is offered by the manager to Brazilian investors.
- Independent directors. Although a hedge fund is not required to have a board of directors or independent directors overseeing the affairs of the fund, a board of directors with one or more reputable, professional and independent directors should be considered since US institutional investors prefer to invest in funds that have investor-friendly safeguards.
- Placement agents. Brazilian managers may need to hire a placement agent firm that can help introduce them to US institutional investors. Placement agents prefer to work with managers on an exclusive basis and charge a percentage (typically 15-20%) of both the base management fees and the performance fees earned by the manager from investors introduced by the placement agent. Some placement agents may also require an upfront retainer or periodic fixed fees.

Issues related to securities offerings

In the US, issuers of securities, which include any fund that issues an interest in the fund, must either register such securities under the United States Securities Act of 1933 (the '1933 Act') or offer such securities in reliance on one or more exemption from the registration requirements under the 1933 Act. In addition, an investment fund must register as a registered investment fund (i.e. a mutual fund) under the United States Investment Company Act of 1940 (the '1940 Act') unless an exemption from registration under the 1940 Act is available to the fund.

Managers do not want or need to comply with the registration requirements under the 1933 Act or the 1940 Act. The securities of a hedge fund are readily marketed to US institutional investor on a 'private placement' basis. Therefore, it is important for a Brazilian manager to consult with US counsel and limit its marketing activities in a way that complies with both the 1933 Act and the 1940 Act. For instance, the manager must avoid publicising the fund offering in professional conferences, newspapers, journals or websites or otherwise engaging in any activity that constitutes a general solicitation.

Advisor registration issues

Generally, a manager that has a substantial US investor base will be required to register as a registered investment adviser under the US Investment Advisers Act of 1940 (the 'Advisers Act') unless an exemption applies. Although the registration process under the Advisers Act is not difficult, it is time consuming and the compliance structure that is required once the adviser is registered involves significant costs, both in terms of cash and time of the key officers of the manager. For instance, a registered adviser is required to have a compliance officer with knowledge of the Advisers Act and other relevant US laws (such as fiduciary duty rules, insider trading rules, advertising restrictions, custody of assets, use of solicitors, fee restrictions and political contributions). Finding and hiring such compliance officers in Brazil may be challenging. In addition, registered advisers are subject to periodic or cause-based examinations by the SEC.

In light of the significant costs and other issues related to registering as an advisor under the Advisers Act, a Brazilian manager that wants to have more than $25m of investment by US investors in a hedge fund may wish to become an exempt reporting adviser by using the Private Fund Adviser Exemption. Under this limited exemption, although the manager is required to report certain information to the SEC, it is not required to register with the SEC and is not subject to some of the more costly requirements, such as the requirement for a compliance officer. A Brazilian manager should consult with US counsel regarding the applicability of this exemption given the facts and circumstances of the manager's US business.

In general, a Brazilian manager that (i) does not have a principal office or place of business in the US and (ii) does not advise any US person other than a qualified private fund (i.e. no managed accounts involving US investors) may rely on this exemption even if the private funds have hundreds of millions (or even billions) of US dollars of US investors' capital.

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