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Maintaining your hedge fund track record when launching a liquid alternative mutual fund

Kenneth Gerstein, a partner at law firm Schulte Roth & Zabel, explains the process of maintaining your hedge fund's track record when transitioning to a mutual fund

By Gillian Kemmerer

A hedge fund that converts to a mutual fund faces several challenges, including increased liquidity, limitations on leverage, and a lower fee structure. One challenge it can avoid, however, is hitting reset on its performance data.


Kenneth Gerstein

Kenneth Gerstein, a partner in the New York office of law firm Schulte Roth & Zabel and former special counsel in the U.S. Securities and Exchange Commission's Division of Investment Management, represents investment advisers, broker-dealers, and banks in regards to the organization and operation of investment funds, including hedge funds and mutual funds. In an interview with Absolute Return, Gerstein explained the nuances of maintaining a hedge fund's track record in situations when the firm either transitions some or all investors into a mutual fund vehicle.

In the event of a complete conversion of assets, in which the hedge fund is then closed, the SEC "allows [firms] to use related account performance in a mutual fund prospectus," according to Gerstein in instances when the mutual fund's investment objectives, policies and restrictions are the same "in all material respects."

Firms that do not convert all assets can also maintain their hedge fund track record in the mutual fund prospectus if they meet specific criteria. Most important is that "the mutual fund's investment program is substantially the same as that of the hedge fund and that both funds are managed by the same people," Gerstein said. (For further information on the SEC's governance on this issue, Gerstein recommends the SEC's 1995 no-action letter to MassMutual.)

The mutual fund's prospectus and its marketing materials are governed by different entities, and therefore subject to different restrictions. The Financial Industry Regulatory Authority (FINRA), which regulates broker-dealers and the marketing materials used in mutual fund offerings, does not permit use of the predecessor hedge fund's track record in advertising in any case. FINRA "solicited comments a number of years ago as to whether it should modify its rules to allow the use of this kind of performance information in advertising," Gerstein said. They have not yet adopted any rule changes. An interpretive letter from FINRA regarding the sale of hedge funds published in October 2003 and a 1997 regulation notice on presentation of related performance information further elucidate the policy.

Kenneth Gerstein is a member of the American Bar Association's Committee on the Federal Regulation of Securities, its Subcommittee on Investment Companies and Investment Advisers, and a member of the New York City Bar Association's Committee on Investment Management Regulation. He holds a J.D. from the James E. Beasley School of Law at Temple University, and an LL.M. from Georgetown University Law Center.