The Growth of the Hedge Fund Industry

Q&A with Dan Shapiro, founding partner, Schulte Roth & Zabel

INTERVIEWED BY HAMLIN LOVELL

Hamlin Lovell: We are delighted to speak to Schulte Roth & Zabel's Dan Shapiro, a recipient of a special award for an outstanding contribution to the hedge fund industry from *The Hedge Fund Journal*. Shapiro is a founding partner of SRZ, which was formed in New York in 1969. Today, Dan is a partner in the Investment Management and Tax Groups and he is based in the London office, which opened in 2002. What inspired you to co-found Schulte Roth & Zabel?

Dan Shapiro: I was working at what I thought then was a very big firm called Cleary Gottlieb Steen & Hamilton – a major New York-based international law firm. Four of us from Cleary got together with two from another firm and two others, and decided to create our own boutique law firm, thinking, "Well, we're leaving firms that are much too big" (e.g., about 150 lawyers). Law firms have grown just as the whole investment banking and financial world has grown. So our "boutique" firm now has about 400 lawyers, and Cleary and the other firms our founders left are more than twice that size.

When we set out to create a boutique law firm, we did that with the knowledge that we were starting with very few clients. But one of our major areas of legal work had been, even before we started the firm, representing hedge funds. In particular, our first iconic hedge fund manager client was Michael Steinhardt, who ran a firm which was then called Steinhardt, Fine & Berkowitz. They continued using us at our new firm, and that led us to start representing many of the ever-growing number of hedge funds.

HL: I see. 13 years ago you decided to set up shop in London as well as New York. What was behind that?

DS: Around 2002 we noticed that a number of our clients were opening offices in London. And at that time there seemed to be an interest on the part of certain London investment managers in creating new hedge funds. So we decided, partly to protect our franchise since we were the biggest in terms of hedge fund legal representation in the US, it would be important to have an office in London. I think there were only two or three hedge funds in existence in London then. There must be a few hundred or more hedge fund managers today in and around London.

After a search we found an experienced hedge fund lawyer, Christopher Hilditch, who had been at Simmons & Simmons for a while and was then a partner in the London office of the Cayman Islands firm Maples and Calder. Chris said, "Look, I think you guys will do well here – you've been in this business for more than 30 years – but you need to send someone from New York to integrate your 60 to 70 hedge fund lawyers, with what we set up in London, which will be a much smaller office". For a variety of reasons, I volunteered to come to London for what I thought would be two or three years. Now in our 13th year(!), we have more than 20 lawyers concentrating on hedge and private equity funds.

HL: What do you think is driving the growth of the hedge fund industry? Is it institutionalisation?

DS: I think if you had to pick one word to describe what has happened to the hedge fund business, it is institutionalisation, broadly defined. In the days of Michael Steinhardt, George Soros, and Julian Robertson's Tiger funds (which we did a lot of work for), followed by the "Tiger Cubs" (who were the next generation who spun out of Julian Robertson's firm), most of the investors in hedge funds were high-net-worth individuals, occasionally family offices. Institutions at that time didn't pay much attention to hedge funds and indeed were nervous about hedge fund investing. But the institutions (and here I'm talking about pension funds, charitable foundations and large endowments – in the United States there must be 200 endowments of size that invest in hedge funds) were also looking for professional money management. And hedge fund managers tend to be among the most talented investors. Also, hedge funds are designed to protect against downside movements in the market, as well as capturing alpha on the upside. A lot of the institutions who have hired professional outside consultants have stayed with the hedge funds as a part of their investment portfolio. Some of them have been disappointed that in the last few years the long-only managers, whether a mutual fund or a unit trust in the UK, have done better by not hedging, by not having any short sales, because the market recently has been relatively strong.

There has been a whole discussion recently in the news, including *The Hedge Fund Journal* and others, about whether institutions will continue to be invested in some large percentage in hedge funds. CalPERS, which is probably the biggest single pension plan, announced that they were getting rid of what was a pretty small allocation to hedge funds – 4% I think – and a Dutch pension plan also said that. But many other institutions, pension funds included, have stayed with their hedge fund investments.

Their reasoning, I think, is in part that they remember that in 2008 and 2009, hedge funds generally did not perform very well, but they did a lot better than long-only managers. Although the hedge funds might have been down 15% to 20% in that period, long-only managers, on average, generally suffered losses of 35% to 40%. Today, most professionals who run institutional money recognise that it's important to have some hedged investments as part of their portfolio.

HL: So how does all this institutionalisation of the industry impact the seeding market for new funds?

DS: The providers of seed money are really critically important for people starting up new hedge funds. Organisers of hedge funds range from investment professionals leaving other hedge funds, to those leaving proprietary trading desks of banks, who recognise that there is

significant money to be made running a hedge fund and that there is a lot of flexibility that comes from being a hedge fund manager. But start-up hedge funds need to have significant up-front money to be able to get into business.

The estimates are that one needs anywhere from $75 million to $100 million, or maybe more, to just enter into the hedge fund business today, taking into account all of the regulatory and business requirements. Who are the seeders? Well, there have been some smart bankers and investment groups that put together funds that would provide the seed money. The biggest seeder probably today is Blackstone, the US public company that engages in a lot of hedge fund and hedge fund of funds activity.

There has been a reduction in some of the seeding activity by specialised funds. That slack has been taken up to some extent by a combination of investors, which could include some institutions and family offices (who I think of as the "new" institutions) that see the opportunity to make an early investment with a great manager as a way of not only making money on their investment, but by participating in the fee revenues payable by the fund to the manager. Very often managers will start by raising $10 million to $20 million from "friends and family" to get into business, and then going out to seeders to raise the additional money. It's a very difficult task for managers starting up today, because there are only a few institutions still providing seed capital. Some of the prime brokers, however, have started to provide seed capital.

HL: What are the most popular types of seeding deals, such as gross revenue shares or equity stakes, for instance?

DS: That's a hotly debated topic. Every time you have a seeding transaction, usually the seeder provides a term sheet – indicating all the terms they want – and then there's a negotiation. As lawyers, we help the new hedge funds negotiate those deals. A big issue is, should a hedge fund manager take money from a seed provider who wants to have a share of all the "net profits" of the management company? The problem is that while a "net profits" share may be seen by the seeder as the fairest way to do the deal, that means sometimes the seeder may insist on some kind of say about who gets paid bonuses, and how much are the bonuses, and who (and how much) gets paid for administrative activity. They really may try to interfere in the operation of the business, because expenses directly affect their share of the "net profits".

A deal which involves sharing in gross revenues by definition doesn't involve any impact of the seeder saying, "You have too many expenses", because they're getting a share of the gross revenue, and they don't care what the expenses are, because those expenses are being paid for by the hedge fund manager. I think you could say it's almost a 50/50 division as to whether a seed deal will be a gross deal or a net deal, and it depends a lot on the inclinations of the seeder and how much leverage the hedge fund manager has. We try to move our hedge fund managers in the seeding deals towards the gross deal. We do that primarily because we think it's better not to have the seeder involved in decision-making in terms of expenses.

HL: There are so many different types of fund structures now, ways to access hedge fund strategies. You can do UCITS, '40 Act, Cayman, Delaware, single managed account, managed account platforms, etc. Which of these structures are going to see the fastest growth?

DS: Traditionally, the structures have been very much to use Cayman offshore funds for US investors and US tax-exempt investors (for specific tax reasons they have), coupled with a separate US partnership (typically Delaware). That bifurcation is because US taxpayers have to pay their taxes every year, and so you need to have a fund structure that will be a "pass-through" vehicle, or partnership, so that the actual taxable income of the year can be passed through and reported by the US taxpayers. Offshore investors typically, and the US tax-exempt investors, don't pay taxes currently, but only (in the case of offshore investors) when they redeem out of the fund. US tax-exempt investors will also avoid taxation under the US "Unrelated Business Taxable Income" ("UBTI") rules if they are not invested in partnerships which use "leverage", income from which is subject to tax under the "UBTI" rules, but in a corporate fund which "blocks" any leverage which would pass through to them if they were partners.

So you are marrying one fund that is a partnership fund (where there has to be a reporting of current income) and an offshore fund where it's not really relevant how much current taxable income there is. The way that's done is through a master entity: the two "feeder" funds come together as investors in the master. It is not efficient to have parallel funds that invest at the same time, because that means you have to split every investment ticket and make decisions and balance each portfolio every time you have new money coming into (or leaving) one fund rather than another. That happens automatically if one master fund is used.

Some investors have felt that Cayman is somewhat tainted, and so they want to be in Luxembourg or Irish funds, which involve more regulatory oversight. So I can't say that Cayman is always the choice (or the British Virgin Islands, which some people have a preference for), but there still is a significant amount of Cayman offshore investment. You mentioned single-manager funds: when institutions invest, very often they say, "We don't want to be coupled with all the other investors who are in an offshore fund, so we would like to have our own fund with you". It's called a "fund of one", and so if an institution comes to a manager and says, "We have $100 million and we would like to invest, but we would like to have a more bespoke kind of investment and talk to you about what you invest in", very often the manager will set up a separate fund. That separate fund often makes co-investments alongside of the master fund.

The UCITS structure is typically used for retail investors. Part of the problem for hedge fund managers is the UCITS requirement of significantly greater liquidity for investors – the same with US mutual funds. In the US there is a huge mutual fund industry; it dwarfs the hedge fund industry. Some of the mutual fund managers have adopted some of the techniques of hedge fund managers, so you have liquid alternative mutual funds that use short selling and other techniques that hedge funds use, but they also have to be able to allow redemptions daily for their investors, so they are subject to significant liquidity constraints.

Some very good hedge fund managers have stayed away from creating alternative mutual fund or UCITS structures. Others have concluded that, "That's another whole source of money for us; why don't we tap into that by running a mutual fund or a UCITS fund?"

HL: Right. Moving to the other end of the liquidity spectrum from liquid alternatives, do you see some hedge funds setting up a private equity-style structure where they get the performance fee only after the capital is returned to investors?

DS: We have seen a trend of some of the smarter hedge fund managers saying that they want to try managing private equity funds. The big difference is that a hedge fund manager marks to market the total hedge fund portfolio and takes an allocation or a fee of 20% of the calculated profit (based on realised and unrealised gains). There has been some pressure recently for managers to reduce that fee and/or its typical 2% fixed management fee.

So some hedge funds have set up private equity funds. The big difference is those private equity funds are illiquid. It is advantageous for a hedge fund manager to manage a private equity fund, if they have an expertise in longer-term investing. There is a hybrid kind of activity where a hedge fund will set up a portion, maybe 5% to 20% at the most of the assets in a fund being available to be invested in longer-term investments, often called "side pockets", which are sort of mini-private equity funds. Here, the manager takes, let us say, 10% of the assets of the hedge fund and puts them into a special situation account or a "side pocket" that is run like a private equity fund. The manager doesn't take a fee by marking these "side pocket" positions to market, because they are illiquid. Rather, the manager only takes a fee if there is a realised profit in that investment, like a private equity fund.

We've seen some diminishment in the use of the "side pocket" or the "special situation" account, because some investors really just want to be in a fund that is 100% liquid. In terms of private equity, there are funds that are invested into distressed debt positions and other illiquid kinds of positions which can be traded, but which don't have full liquidity. Sometimes a hedge fund manager will have a hedge fund for that kind of investment standing side by side with a separate parallel private equity fund investing in similar securities, but giving the hedge fund manager and the investor greater flexibility to allow those positions not to be marked to market, but just to have fees paid on any profits when the positions are sold.

HL: Right, so would high-water marks on hedge funds normally be impacted by the side pocket?

DS: When I came over to London I was used to the typical calculation for side pocket results in the US. Where the side pocket was calculated (let us say there were two positions, X and Y, in side pockets) if X was a profitable side pocket and it was sold and Y was a loss transaction on sale, the loss and the profit were offset against each other, so no fee was taken if there were more losses, but a smaller fee would be taken if there was a smaller profit, because Y's losses are allocated against the X profits). Typically, in the US structures, whatever happened in the side pocket is then reflected by moving the profit or loss into the overall fund accounting, so that if the fund was up 100 and there was a realised loss in the side pocket of 10, the incentive fee, i.e., the carry for the manager, would be 90, because the realised side pocket results would be integrated.

The European style for accounting for side pocket results was often different from that: the side pockets tended to be judged each on their own without offsets. We have seen some movement towards the European managers following the lead of US managers by integrating the side pocket calculation with the overall calculation in the hedge fund.

Now to come to your question, the high-water mark is a measurement of losses that have to be made up before the manager can take a "carry" in the future. I think the fairest thing, and the thing that would be done following on my description of the US structure, is to have the high-water mark affected by profits or losses that take place in the side pocket. That happens automatically if the realised losses and profits in the side pocket are actually integrated with the operations in the fund.

HL: Yes, so that's the fairest way to structure things in that regard. Moving onto taxes, that are one of your specialist areas, do you think that more hedge fund companies are re-shoring or bringing management companies back onshore?

DS: I think that there are built-in tax requirements that apply to hedge funds managed in the US and in the UK. Most jurisdictions like the UK and US have very strict transfer pricing rules. So with respect to a hedge fund, let us say one managed in the UK, setting up an offshore management entity which it claims is entitled to 20% or 30% of the overall fees that would be earned by the UK manager for marketing activity done "offshore", but where there really wasn't much marketing activity actually going on offshore, HMRC have said, "We're going to look very carefully at what's actually happening. What are the real facts which would potentially justify some of the fee income not coming back to the UK?"

The UK is very zealous in getting all the fees that it thinks it's entitled to from hedge fund management. What the UK "Investment Manager Exemption" rules say is, "In order to be sure that non-UK organised funds managed from the UK are not taxed in the UK, even though discretion is given to a UK manager to manage the money, we insist that all of the "customary rate of remuneration", which essentially is interpreted by HMRC as all of the fees, come back to the UK". Now can some part of that – 5%, 10% or 20% – be left in Jersey or Guernsey or the Cayman Islands? UK managers have done that, but in order to justify that, there needs to be some serious and robust activity going on there.

The UK tax authorities are now saying, "Well, if you want to leave 10% or 20% of your fees outside of the UK tax "net", for administrative activity or marketing, show us who is doing that activity and where, because we think it's all going on in the UK". Some very major funds have been subject to audit on that issue. The answer to your question is, it's a very special set of rules which is being implemented in the context of much more focus on all of the tax planning that big companies are doing to try and leave some of their profits in non-tax or low-tax jurisdictions. The rules for hedge funds are very much more precise, and on the US side, there are also transfer pricing rules. US taxpayers generally have to pay taxes on all of their income currently, making it very hard to justify leaving money offshore, unless there is some real factual justification for this.

HL: AIMA, the Alterative Investment Management Association, recently announced that UK hedge funds had paid record tax of about £4 billion (over $6 billion) last year. Do you think that tax receipts from UK hedge funds will continue to go up?

DS: Well, the reason why tax receipts have gone up is related to what I referred to before: the "Investment Manager Exemption" says that if a UK manager is managing money of "offshore funds", in order to be sure those offshore funds are not taxed because discretion is being exercised over them in the UK, the UK manager must bring back to the UK the "customary rate of remuneration", which is

pretty much interpreted as the full amount of fees that are generated by that activity. As UK hedge funds have grown and developed (and even though some of them have moved some of their operations to places like Switzerland, Guernsey and Jersey) inevitably the taxes that are derived from the activity that actually goes on in the UK will increase. So your question really implies the question, "Do I think there are going to be even more hedge funds set up in the UK than have been set up before?" The revenues that are generated and taxed in the UK will depend on how much profit is earned by the manager as the result of the incentive fees and fixed management fees that they get from the offshore funds. So there are really two parts to the answer: firstly, how well will the UK managers do? The second thing is, how many new funds will be set up to be managed in the UK?

HL: Right, and a related area is the domicile and structuring of funds: is that important to take advantage of double taxation treaties and to minimise or possibly avoid withholding taxes on dividends and coupons?

DS: There are some legitimate structures that are used for certain kinds of investments: for instance, funds that are being organised in the Cayman Islands to acquire debt instruments, distressed debt or debt that is paying interest but has diminished in value. A number of the US as well as the UK managers are now investing in distressed debt in Europe. So one of the things we and the accounting firms that we work with discuss with the manager is, "Okay, you buy debt in Germany, Switzerland or France, but the interest on that is subject to significant withholding taxes. So if a Cayman fund, which is where your fund(s) are organised, owns that debt, there is no treaty that would reduce the withholding tax, which could be as high as 30%". So some of the Cayman funds have used a structure where they interpose a subsidiary, a Luxembourg company, for instance, which has tax treaties with Germany and the other countries where these debt instruments may be issued from. So the argument that the Luxembourg subsidiary's parent makes, is, "This interest is legitimately coming to a company that has treaties with all these other jurisdictions which reduce the withholding tax or eliminate it".

The area of controversy around the use of, e.g., Luxembourg or the Netherlands to hold positions in European debt instruments, and even equity investments also to reduce the withholding tax on dividends, is how substantial is the activity actually carried out in Luxembourg or the Netherlands or wherever these intermediary companies have been set up? So we advise our clients, if you're just going to open an entity in one of these "treaty" jurisdictions, and you're not going to have located in that jurisdiction a process for reviewing and deciding on what investments to make, and you don't have directors and an administrative apparatus in those countries, you're going to have a hard time convincing the tax authorities that there should not be withholding tax. A lot of this is going to depend on whether the hedge funds are willing to spend the money to have a robust structure apparatus in place, so that they can legitimately justify using the treaties to reduce withholding taxes.

A lot of the jurisdictions are focusing very hard on whether they can attack treaty shopping, because it's reducing their revenues. Every government in Europe, just like everybody in the rest of the world, is looking for new revenues and don't want those revenues to be diminished by a treaty that is, in their view, being misapplied.

HL: So the debate over taxation of carried interest has probably been rolling on for as long as you've been a lawyer, which is over 50 years. Do you think that that debate will ever be resolved and result in carried interest being taxed at high rates or rates close to those applying on income?

DS: You only have favourably taxed long-term gains in the United States if you hold a position for more than a year, so many of the hedge funds who rarely hold a position for more than a year don't generate long-term capital gain. There are certain kinds of transactions which would generate long-term capital gain at a lower tax rate, so what happens is that when the fund realises long-term capital gains and allocates, say, 20% of those gains to the General Partner of the US feeder fund, the General Partner pays the much lower US capital gains tax on its "incentive allocation" from the US feeder fund. President Obama keeps talking about getting rid of this "hedge fund loophole". It's really not a hedge fund loophole: it is a set of rules that allow, by virtue of the General Partner being a partner, it to get the same treatment on income that's realised as if that income were realised directly by the General Partner. Instead, this is income that is being allocated from the partnership and it is, under present rules, correct that that allocated income can be taxed favourably.

You have a similar kind of trend in the UK, where the UK is trying to prevent especially private equity managers from converting management fees to favourably taxed capital gains that can be left offshore by non-domiciled UK participants in the General Partner of a private equity fund.

So that's just a very brief summary of a lot of debate. The answer to your question is, yes, there's going to continue to be a tussle between the tax authorities and even administrations like the Obama administration, about what is a fair way of taxing people who manage either hedge funds or private equity funds. Should they be paying just ordinary income tax as if they were getting salary or a guaranteed payment from a partnership? Or should they have favourable tax treatment on capital gains that are realised by the funds to the extent they receive a percentage of those gains as "carry" income?

HL: In Europe, a few countries have introduced financial transaction of taxes on securities trading, which may increase transaction costs. Are you seeing that having much impact on any hedge fund strategies?

DS: Well, I think the countries so far that have adopted it and others that are thinking about it are France and Italy. Most UK and US managers don't trade on exchanges or markets where there are financial transactions taxes. The UK will never, I believe, adopt a financial transaction tax. So I don't think UK hedge fund managers are particularly focused at all on potential financial transaction taxes.

HL: Dan Shapiro, partner of Schulte Roth & Zabel, London office, thanks very much for your time and insight today.

DS: I enjoyed talking with you, thank you.

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