Section: **Strategies/Analysis**

## Managers and Service Providers: Finding Happily Ever After (Corrected Story)

**By Maggie Shea, Financial Correspondent**
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*(Editor's Note: In an earlier version of this story some of the panelists were misidentified, and the nature of Caledonian's business was incorrect.)*

CHICAGO—The relationship between hedge fund managers and their service providers, as well as their respective roles in the hedge fund life cycle, are changing as the industry matures. And as with any relationship, attention, communication and honesty are key ingredients, though sometimes both sides learn that the hard way.

It's important to have a team of service providers that can work together, said David Morris, partner at Fox, Hefter, Swibel, Levin & Carroll LLP. He added that when assembling a team of service providers, he thinks managers often seek feedback from their existing service providers—lawyers or auditors, for example—since they have experience that can be helpful in the search process. "In practice the fund manager has certain relationships in place and … will bounce ideas off the attorney and certainly off other service providers," he said.

Mr. Morris spoke alongside seven other fund managers and service providers at a June 28 panel discussion at Chicago's Union League Club on managing hedge fund service providers.

"All the relationships with vendors become a partnership," said Mark Coe, president of Coe Capital Management LLC, which has launched six funds over the past 13 years. He also said that when looking for service providers, fund managers might want to begin the search somewhere other than with the service provider, as the vendor's representatives aren't always knowledgeable. "Maybe you're dealing with a front-facing person who doesn't have the knowledge. You need to seek out people with industry expertise, and I probably wouldn't start with a vendor. I'd start with someone else in the business who would recommend someone they've worked with."

He said word of mouth works well with attorneys, based on their reputations. "In Chicago, you may find that there's a few attorneys that created the documents for the majority of people's funds that are in the city."

While it is important to take the time to select the right team of reputable service providers, bigger isn't always better, said David Kavanaugh, president of Dearborn Capital Management LLC. "It's very important that you connect personally with your service providers, and I refer specifically to my experience with lawyers," Mr. Kavanaugh said. "I've been with a number of [law] firms that have very good reputations, and in those situations you end up being a very small fish in a big firm. And you don't get the attention you're looking for, and you're just not paying the bills as much as the larger clientele."

**What Do Offering Documents Really Offer?**

The life cycle of most funds usually begins on the legal side with the creation of the offering documents.

As a fund manager, Mr. Coe said it's a challenge for managers to set up a fund document that will make potential investors comfortable. "From the manager's side, you're trying to give the investors comfort, but you're also trying to create a situation where you're not being sued because of documentation," he said. "What we do with our documents is we say, 'OK, if we were investors, would we invest with this? What concerns would I have as an investor?'" Managers can benefit from looking at the documentation of other funds with a similar strategy.

But Mr. Coe warned new managers not to simply buy into cookie-cutter strategies and structures that attorneys may offer based on what they already have done. "When you start off you have no idea of the proper structure or all the proper covenants. You've got a great trading idea. And the discussion with the attorney often ends up being a factor of what's the last fund he's done, so you're in effect getting the structure that somebody's familiar with. But it may not end up being the best structure for you as you grow your business," he said.

However, oftentimes service providers come across managers with little idea of what's actually in their fund's offering memorandum, said David Shane, partner at McGladrey & Pullen LLP's Great Lakes practice. "The offering document serves as somewhat of a roadmap for us. From an accounting and tax perspective, we rely a great deal on the offering memorandum … for disclosure of strategy. And I can't tell you how many times people don't know what's in a document."

Fund administrators, who keep the books for the funds, have to ensure that the terms of the documents align with the fund's operation. "From an administrative standpoint the fund documents are an instruction manual," said Jim Gabriele, managing director of fund administrator Caledonian Fund Services (USA) LLC. He added that it's troubling when managers don't understand the documents, "so we have no choice but to … understand them ourselves—the mechanical parts, fee computations, investment thresholds—things we have to track on a monthly basis. The offering memorandum tells the investor what the managers can do. We have a responsibility to make sure the managers are operating in accordance with the documents."

Jim Harkness, chief operating officer of Wolverine Asset Management LLC, said he thinks the administrator works first and foremost for the investors. "I think we as managers hire [administrators] on behalf of our investors because they're targeted with making sure the practice of the fund is run as stated," he said. "The reality is that managers do daily [net asset value calculations] and internally keep our own books and records." Thus, he said, the administrator serves more as an "outside legion," representing the investors.

Additionally, Mr. Harkness said, as funds grow administrators have a responsibility to regularly re-test and re-certify products and structure. "[The administrators] understand the structure of your fund, they understand the products you create, and in those processes and in the structure of the fund there are certain conditions that take place that may bring about questions," he said. "There should be recertification of documentation … that happens on a regular basis so that the fund that grows from $10 million to $100 million to a zillion dollars is not the same fund."

But, according to Mr. Gabriele, while administrators are fund bookkeepers, they should serve both quantitative and qualitative functions. "The administrative landscape is changing…. You have to meet the requirements of moving around the data, and you have to have a quantitative function that does that. And you have to deliver the technology that allows you to do that," he said. "But at the same time you have to have a qualitative focus—you can't really be robotic."

**Lessons Learned**

Service providers and fund managers alike are being held more accountable when strategies fail or pricing issues arise, so the panelists agreed it's important to clearly determine the managers' and vendors' responsibilities early on. "There are plenty of cases out there right now where people are trying to hold various service providers culpable for a variety of things," said Jim Radecki, managing director of Goldman Sachs Group Inc. "You can't get caught into providing transparency to one investor without providing it to all because you'd be giving one the advantage over the other."

Mr. Morris added, "I think in general in the fund it's a good idea to have a roadmap of who handles what responsibilities. Engagement letters don't often address that. Legal counsel should review those documents and counsel the client accordingly, but I think internally the hedge fund manager has to understand who is really doing what."

Scott Schroeder, managing director of finance and a partner at Balyasny Asset Management, said it's imperative that service providers understand their responsibilities. "One thing [service providers are] all consistent in is they all slough off liabilities," he quipped. "You have to read [the documents]; you have to understand them because you will be accountable for them at the end of the day." He added that investors also look to service providers for liability in the event something goes wrong. "And if your answer is, ‘I thought the prime broker was looking at that,' it isn't going to suffice."

"If you do all your reporting with fairness and consistency you will probably be able to stay out of trouble," said Mr. Radecki. "I think other issues come into that. Like valuations—how you price more esoteric products like bank debt, trade claims and things of that nature—suddenly become a real issue, and that's when the scarecrow comes. Who's responsible for that pricing? The prime broker? The manager? The administrator?"

Mr. Gabriele said he thinks the industry will see more service level agreements in the future. "What the legal contracts do is they give us all our day in court," he said. "The concept of an SLA … drills it down to a lower level—who's going to do what by what time and date. To the extent that it was a letter of understanding of everyone's roles and responsibilities, I think that fills a gap that we're saying doesn't exist today."

**What's to Come**

Looking ahead, as the valuation world changes, fund managers will have to disclose more information, Mr. Shane said. "Come Jan. 1, 2008, when some of these fair value standards come out … as auditors we are going to have to go through a lot more robust documentation and understanding of procedures," he said. "In Europe, they are going toward independent valuation. That might be where we're headed."

"There is a gray area between independently pricing and providing valuation," Mr. Gabriele said. "I think as time goes by we're learning what the difference is. It's not so hard to independently verify prices on a portfolio. In many cases it's very difficult to provide valuation."

While managers and vendors can guard against some potential issues, sometimes the best way to avoid future mistakes is to learn from past ones. Mr. Kavanaugh said he learned the importance of interval fund auditing throughout the year to prevent the bottleneck at year-end. "Several years ago we were later than our investors would have liked to get our K-1 forms out," Mr. Kavanaugh said of his public fund. "We met up with … our auditors and our calculation agents and came up with a schedule. They come and audit us every quarter. As it gets to be the end of the year the audit procedure is much less onerous than if they walked in at the end of the year. We've had quite a bit of retail investors, and they feel they deserve their K-1 on Jan. 2."

*Financial Correspondent Jacob Bunge contributed to this story.*

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