MARHEDGE

EDITORIAL
Editor-in-Chief
Randall S. Devere
rdevere@marhedge.com

Managing Editor
Michael Fischer
mfischer@marhedge.com

Conference Editorial Director
Mindy Rosenthal
mrosenthal@marhedge.com

Associate Editors
M. Corey Goldman
cgoldman@marhedge.com

Liam Tarry (Europe)
ltarry@marhedge.com

Hung Tran
htran@marhedge.com

Phyllis Feinberg
pfeinberg@marhedge.com

Database Manager
Indira Peters-DiDio
ipeters@marhedge.com

Contributors
Fred Gehm (Chicago)
Rupert Lee (Sydney)
Ben Warwick (Denver)

GLOBAL HEADQUARTERS
President & Publisher
Gary Lynch
glynch@marhedge.com

Senior Vice President, Sales
Mark Salameh
msalameh@marhedge.com

Director of Marketing
Lisa McErlane Yao
lmcerlane@marhedge.com

Account Manager
Alana Ezderman
aezderman@marhedge.com

Account Manager, Subscriptions
Richard Robinson
rrobinson@marhedge.com

Junior Account Manager
Corinne Termini
ctermini@marhedge.com

Subscription Manager - Customer Service, Reprints
Keisha Morgan
kmorgan@marhedge.com

Production Manager
Brooke Abrams
babrams@marhedge.com

Manager, Conference Operations
Jill Hoffman
jhoffman@marhedge.com

Associate, Conference Operations
Patrick Brady
pbrady@marhedge.com

Conference Officer
Jeannie Lee
jlee@marhedge.com

MANAGED ACCOUNT REPORTS LLC
Founded in 1979
1250 Broadway, 26th Floor
New York, NY 10001
Tel: 212-213-6202
Fax: 212-213-1870
www.marhedge.com

EUROPEAN OPERATIONS
111 Westminister Bridge Road
London SE1 7UL
United Kingdom
Tel: +44-(0)20-7827-9977
Fax: +44-(0)20-7827-6413

Founders
Leon & Joy Rose
Publisher Emeritus
Greg Newton

SUBSCRIPTION RATES
One Year - $1195 US/Canada*
One Year - $1295 ROW
*(in Canada, please add GST tax)
Call +1-646-274-6224

Self-Destructive Managers

Avoiding the gambling addict

By Fred Gehm

One of the fund-of-funds manager's jobs is to identify and avoid self-destructive hedge fund managers. One of the worst of this species is the gambling addict.

The first fund manager I realized was a gambling addict was Ian S., and I didn't realize that he was addicted until after he was dead. Ian was a talented trader with real insight into the market. Unfortunately, he wasted much of his potential by overtrading, trading too often and trading too large.

Ian's wife told me that while he was dying, she kept saying to him, "Gold is rallying, Ian! Gold is rallying!" She knew her husband. Ian wasn't particularly greedy as fund managers go. He wouldn't have gotten off of his deathbed just to make money. But I could almost see him getting up for the action.

Some authorities on gambling estimate that 1–2% of the general population is addicted. Considering the cost of gambling addiction in terms of ruined marriages and lost property, that estimate seems high to me. But perhaps I don't get out enough.

On the other hand, if that estimate is correct, or, at least, reasonable, then the percentage of hedge fund managers who are addicted to the action might be, say, 10–20%. And if these estimates are even vaguely correct, the fund-of-funds manager who can identify the gambling addict could have a real and important advantage over those who cannot.

Or perhaps not. Gambling addiction is almost certainly a medical problem as opposed to, say, a lack of understanding of probability theory. (A recent article in the *American Journal of Psychiatry* showed preliminary evidence that the drug nalmefene can help control pathological gambling. Nalmefene is an impulse control drug used to treat alcoholism.)

Unfortunately, lacking a cerebral dipstick or, at least, a safe and polite way of getting a hedge fund manager's bodily fluids, there is no obvious way to use this insight. Worse, the difference between an addicted and a nonaddicted hedge fund manager is almost certainly only a matter of degree. Worse still, it is not at all clear that a need for action, a need to take big risks, is a bad thing. After all, nearly everyone in this industry is a risk-taker.

Consider, as a noninvestment example, Catholic priests. As I understand the issues (I am not Catholic), there is nothing to prevent a strongly sexed heterosexual man from becoming a priest. He is expected, however, to behave himself, to remain celibate.

> A mechanical trading system won't stop a gambling addict from losing your money.

A similar argument can be made for gambling addicted hedge fund managers. The only difference being that faith is a liability in our line of work. This means that the fund-of-funds manager must determine the extent to which the hedge fund manager needs action, how aware the manager is of his needs and to what extent he can control himself.

In vino veritas

In my experience, people who seek risk rarely seek only one kind of risk. A gambling addict might take sports, marriage and health risks, for instance. Some of this information is available on the Internet, some of it is available only by employing a private detective, but some of it is available for the asking.

Asking a hedge fund manager how he got into this line of work, what he did before and what he does with his time off is often enough. On the other hand, the only time some hedge fund managers tell the truth is at two in the morning after the sixth or seventh drink.

If a fund-of-funds manager's interviews and research indicate that the hedge fund manager has a need for action, he needs to look at the manager's trading approach and see where this need can compromise that approach. For obvious reasons, nonsystematic approaches are the most vulnerable.

But for many reasons, a mechanical trading system won't stop a gambling addict from losing your money. Usually, this just means that overtrading is built into the system. Managers who have a need for action, for example, typically do not have the patience necessary to do research right. Or they may have money management systems that are far too aggressive for their trading methods.

If the fund-of-funds manager's research indicates the hedge fund manager needs action but he finds no weaknesses in the manager's technique, it may be that there are no weaknesses in the manager's technique. Much more likely, the fund-of-funds manager screwed up.

If a hedge fund manager has a destructive need for action, there are only two things he can do. He can try to manage his psychological needs, and he can set up systems to manage his work in a rational manner.

Unfortunately, unless the fund-of-funds manager is willing to place a relatively large amount of money, he will rarely be able to enforce rules or delve deeply into the hedge fund manager's psychology. This is a serious problem because it is part of fund-of-funds manager's job to ensure that the hedge fund manager controls himself.

If the fund-of-funds manager thinks this is necessary and does not think he can do it, he must place his money with someone else. Gambling addiction leads to overtrading and overtrading turns a game that is at best difficult to win into a game that is almost impossible to win.

Fred Gehm is a hedge fund industry consultant. He can be contacted at fredgehm@dls.net.

Planning Ahead

When setting up a fund, principals should address estate planning opportunities

By Michael Ben-Jacob and Peter Bilfield

In the early stages of fund formation, hedge fund and private equity fund principals must focus on a host of issues, among them the type of entity to be used at each level of the structure, the jurisdictions of formation, tax and allocation provisions, deferred compensation arrangements and myriad other details.

One important aspect of fund formation often overlooked, however, is the significant estate planning opportunities attendant on forming hedge funds or private equity funds and which, if not addressed at the early stages of fund formation, are generally lost to the principal.

Some estate planning background

Typically, when considering estate planning options for high-net-worth clients, estate planners will seek to isolate a client's assets that are currently of comparatively low value and suggest strategies for transferring those assets to trusts or other estate planning vehicles on a transfer tax advantaged basis, thereby removing the asset—and its future appreciation—from the individual's taxable estate.

From a transfer tax valuation perspective, a carried interest derived from a hedge fund or private equity fund is the ideal asset candidate for this type of tax planning. Prior to the initial closing of the fund, and even for a short time thereafter, the carried interest would generally be valued at only a small fraction of its actual future value.

The reason for such a low valuation, in most circumstances, is that the carried interest is paid only if certain profit hurdles are met by the fund (i.e., the high-water mark), and at the earliest stages of the fund, it would be mere speculation to assume that the fund would be successful enough to result in carried interest payments.

Thus, the carried interest with its 10 ▶

◄ 9 Planning Ahead low current value and expected significant appreciation serves as an excellent asset for estate planning purposes. If a fund principal could simply transfer a portion of his or her carried interest to a trust, the valuation problems would be solved—but nothing is ever quite that simple.

Estate freezes, IRC Section 2701

Prior to 1996, estate planners often employed the following strategy to move significant value from the estate of the senior generation to the junior generation at a reduced transfer tax cost: The senior generation would fund a family corporation or partnership with an asset expected to appreciate significantly in the future. In exchange for his or her capital contribution, the senior family member would retain preferred return shares with future appreciation allocated to the common shares.

Since at the time of formation the value of the preferred return shares encompassed most, and possibly all, of the value of the entity, the common shares could be given away to junior family members or trusts for their benefit at little or no transfer tax cost. This technique became known as an "estate freeze," as it froze the value of the assets in the estate of the senior family member.

Enter section 2701 of the Internal Revenue Code, which was enacted in 1996 to address this perceived abusive tax planning strategy.

At its core, Section 2701 is a valuation rule that provides that if one makes a transfer of an interest in a corporation, partnership or limited liability company and the transferor or related family member keeps an "applicable retained interest," the value of the rights retained is treated as being zero.

An interest is an "applicable retained interest" if the transferor retains an equity interest that is either a distribution right (except for certain qualified payments), or a liquidation, put, call or conversion right. Thus, if in assessing a transfer what the transferor has retained is valued at zero, all of his or her interest in the entity is deemed to have been given away and gift tax, currently at a maximum federal rate of 46%, will be imposed accordingly.

In the context of hedge funds and private equity funds, carried interest distributable to a fund principal would be deemed a "distribution" right that seems to fall squarely within the definition of an "applicable retained interest." Accordingly, a transfer of a portion of a principal's carried interest would implicate this section and result in gift tax being imposed. Unfortunately for the fund principal, the resultant gift tax will be significant and will not be limited solely to the portion of the carried interest transferred.

Because of the manner in which the value of the gift is calculated in this context, once Section 2701 is found to apply, gift tax will be imposed on the value of the principal's entire interest in the fund enterprise, i.e., the entire value of the capital contributed to the general partner, all of the principal's carried interest and the value of any investment made directly by such principal in the underlying fund.

Needless to say, if Section 2701 is found to apply to the transfer of a carried interest, the gift tax burden on the principal would be untenable.

But whether Section 2701 applies to transfers of a carried interest in a hedge fund or private equity fund is technically still an open question, and there are reasonable arguments in favor of the position that it should not apply.

For example, in the case of a distribution right (such as the right to receive carried interest payments), Section 2701 applies only if the transferor, immediately before the transfer, controlled the entity. In the classic two-tiered fund structure (i.e., a limited liability company acting as general partner of a fund that is formed as a limited partnership) where the entities are treated as limited partnerships for federal income tax purposes, the principals who hold a portion of the carried interest will generally hold the carried interest by virtue of their investment in the general partner.

The regulations under Section 2701, however, state that control of a limited partnership means "holding any interest as a general partner." One might distinguish the circumstance where fund principals hold their interests in the general partner, but where no principal functions as the general partner. Thus, if the principal does not hold a liquidation, put, call or conversion right, Section 2701 may not apply.

Despite this and other possible arguments that favor the nonapplication of Section 2701, given the overwhelming gift tax burden on the principal if Section 2701 is found to apply, and the lack of authority on point, prudent practitioners will advise their clients to formulate any estate planning strategy involving gifting of a carried interest to fall within a clear exception to Section 2701.

Exceptions

Several exceptions to Section 2701 exist, but the one most often employed in the context of hedge and private equity fund planning is the "proportionate transfer" exception. This exception states that Section 2701 does not apply to the extent that the transfer results in a proportionate reduction of each class of equity interest held by the individual and all of his or her applicable family members in the aggregate immediately before the transfer.

Thus, if the principal transfers, say, 20% of his carried interest and capital interest in the general partner of the fund, and 20% of his direct investment in the underlying fund (keeping in mind that Section 2701 applies to the entire fund enterprise), and these proportions are kept constant throughout the lifetime of the fund, the proportionate transfer exception to Section 2701 should be met and the value of the carried interest should be determined in accordance with standard valuation practices, resulting in significant estate planning benefits.

Sheep Mentality

HedgeWorks recently increased its client base by over 30%.

Find Out What the Flocking is All About.

www.hedgeworks.com

HedgeWorks

San Diego ■ Cayman ■ Boston

Section 2701 is extremely complex, and the foregoing should not be construed as a full and complete overview of this often overlooked valuation rule.

Timing is everything

As mentioned, and setting aside the possible application of Section 2701, the value of the carried interest is most likely lowest before the fund's initial closing, since at that point in time the possibility of payment is most speculative. Therefore, for maximum benefit such estate planning should be implemented prior to the fund's launch or as early in the fund's life as possible.

But addressing estate planning concerns prior to the fund's initial closing is important for other reasons as well. When estate planning is not considered during the preparation of the fund's operative documents, it is later difficult—if not impossible—to incorporate the necessary estate planning provisions.

For example, while it is becoming more commonplace to see fund documentation that permits the transfer of a principal's interest to an estate planning vehicle, it is still rare to see default language that deals with the implications of Section 2701 described above.

Specifically, the operative documents should include language that keeps the proportionality of interest between fund principal and the estate planning vehicle constant, and ensures that capital contributions and all distributions are made in accordance with the proportionality rules.

In addition, it is important that these provisions be incorporated into *each* entity in the fund enterprise in which the principal has an equity interest. Finally, it often occurs that some technical point of the fund structure or the business deal makes it impossible to comply with Section 2701, but only because the issue was not considered from inception.

More often than not, if addressed early enough the overall fund structure and business deal can be achieved while at the same time permitting highly tax efficient and beneficial estate planning to be implemented.

Michael Ben-Jacob is a partner at Withers Bergman LLP in New York, who works extensively with fund principals to develop estate planning and lifetime transfer strategies, estate and trust design, tax planning and analysis, asset-protection planning, and tax efficient investment strategies. He can be reached at +1.212.848.9801. He was assisted in the preparation of this commentary by Peter Bilfield, an associate in the firm's New York and Greenwich, Connecticut offices, and a member of the FIT Group, which provides US, UK and cross-border structuring, tax and regulatory advice to hedge funds, private equity funds and funds of funds. He can be reached at +1.212.848.9859 or +1.203.302.4100.

The authors intend this commentary for information purposes only and not as legal advice. The foregoing should not be used or relied on in regard to any particular facts or circumstances without first consulting with legal counsel.

COMPANY INDEX

ABN Amro 1
AIS Futures Management 3
ALTIN 1
Amaranth 1
Bassini Playfair Wright LLC 12
Bridgewater Capital 1
Campbell & Co 14
Cedar Partners 1
Cliffwater 16
CSFB 12
Custom House Group 1
DE Shaw 1
Dexion Capital 1
DUNN Capital Management 14
Eton Rock Capital Management ... 13
Freeman Associates 1
GAIM Advisors 1
Glopar 13
Grupo Elektra 13
HSBC 1
John W Henry & Co 14
Kenmar 16
Laurus Capital Management LLC ... 4
Lotsoff Capital Management 1
Mount Lucas Management 16
Net Servicos de Comunicacao SA . 13
Numeric 1
Penthouse International 13
RMF Investment Management 1
Rocaton Investment Advisors 16
Rockefeller Treasury Services 3
Salus Capital 1
Strategic Investments 14
WG Trading 1

"I have to cut my transaction costs. But first I have to measure them."

ITG's Transaction Cost Analysis does more than quantify results—it reveals ways to improve them. PMs can analyze performance from any angle. Uncover the "why" behind results. And do it within hours. TCA delivers the numbers, and the insights. For information, contact ITG at (212) 444-6300 or visit www.itg.com.

ITG