At Risk: Managing for the Future

Hedge fund partners may be less prepared than they know for sudden changes in the management teams of their firms. If unaddressed, this state of affairs has the potential to jeopardize both their wealth and controlling stakes in the business.

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When Rothstein Kass decided in 2007 to conduct empirical research, we did so with the knowledge that our standing as a trusted adviser to the alternative investment community afforded us a unique perspective on the trends and challenges shaping the industry. Our initial report, “Capturing the Opportunity in Hedge Funds” (July 2007), revealed that the industry continued to experience dramatic growth even amid a shifting competitive environment, due in part to growing institutional interest. Equally important, this initiative established the framework for subsequent surveys designed to offer quantifiable survey data surrounding industry trends.

Since that time, Rothstein Kass has polled hedge fund industry professionals on their views on topics including fundraising targets, market volatility, regulatory issues, and compensation. In each instance, we partnered with renowned wealth managers Russ Alan Prince and Hannah Shaw Grove to develop probing lines of questioning that offer an inside peek at industry attitudes and practices. The response from clients and associates has been exceedingly and consistently positive and shapes future surveys and research. We also rely heavily on the expertise of Rothstein Kass principals and our extensive client base to provide additional insight into the findings.

For our latest report, “At Risk: Managing for the Future,” we surveyed 349 hedge fund partners to assess whether the industry as a whole is prepared to handle management changes arising from a variety of scenarios, including partner death, disability, attrition or termination. We then turned to Rick Flynn and Alan Kufeld, principals in the Rothstein Kass Family Office Group, to provide insight surrounding data points. This group’s established record of providing comprehensive financial and wealth planning services to family offices and high-net-worth individuals enabled our firm to examine more closely the potential impact of a lack of contingency planning on both alternative investment entities and their owners.

Our findings suggest that regardless of firm size, most participants have not taken all of the necessary steps to ensure a smooth transition in the event of a change in the senior management team. We also learned that a large percentage of firms do not know if they are equipped for such events, suggesting that the problem might be more pervasive than we had originally speculated. Even among firms that had developed formal contingency plans, a surprisingly large percentage—nearly 60 percent—indicated that these plans have not been updated in three years or more.

Given the outlook for ongoing industry consolidation and the fact that many senior partners are nearing retirement age, the need for cohesive succession planning has been heightened. Still, the prioritization of asset-generating components of the business plan has left this important component largely ignored. Fortunately, with minimal intervention and oversight by senior management, shortcomings can be relatively simple to correct. The key is for senior partners of hedge funds to recognize that succession planning and related initiatives are not solely the function of human resources. The involvement of those in leadership roles is required, since these individuals are well-versed in all aspects of the business and have the clearest understanding of how changes to the management team would impact firm operations. Once a plan is in place, regular review is imperative. These processes require only limited resources but can profoundly affect a firm’s ability to avoid serious disruptions to investment management and fundraising capacity in the event of unexpected executive changes.

On behalf of Rothstein Kass, we hope that you find the following pages incisive and interesting. We look forward to sharing the results of additional research and thank you for your support.

Howard Altman
Co-Managing Principal
Rothstein Kass

At Risk

Hedge fund senior partners must focus on the eventuality of death, disability and changes in the management team of their firms, a state of affairs that jeopardizes both their controlling stakes in the business and the wealth they have accumulated.

Key Observations

- On the whole, partners at established hedge fund companies have not done sufficient succession planning to ensure that their firms will operate as desired after a change in ownership or control.

- This lack of preparedness poses a threat to both the role and personal wealth of the principal and will almost certainly affect the other owners of the management company as well as investors in the firm's funds.

- In particular, very few hedge fund partners have planned for the death, disability or departure of another owner and the associated consequences for the firm and its operations.

- Roughly one-third of partners do not know if they are prepared for an ownership change, indicating either a lack of familiarity with the elements of their succession plans, limited consideration for the adverse effects of such an incident, or both.

- The large majority of partners assume the operating agreements of their management companies will address ownership and control issues caused by events triggering questions or changes related to succession and have not taken the steps to confirm the document's provisions or to put additional structures in place to protect senior management control of the business.

Succession plans are an important part of any business, but critical for businesses that are as closely held, profitable and reliant on the intellectual capital of its senior partners as the typical hedge fund firm.

Our ongoing research with highly successful business owners has revealed that planning for future events, especially unpleasant ones such as disability, death and potential litigation, is a top priority for most. However, these issues are rarely addressed to the degree necessary to sufficiently protect business owners and their assets. Hedge fund partners also expressed a desire to protect their wealth to the greatest extent possible and structure their estates in the most tax-efficient way. And like other accomplished individuals, the majority of hedge fund senior partners have yet to address these matters with the appropriate planning efforts.

The harsh reality is that without a solid succession plan that clearly addresses key financial issues, fortunes and legacies built largely through the skills and efforts of the partners can erode significantly and rapidly in response to an unexpected change in the status quo.

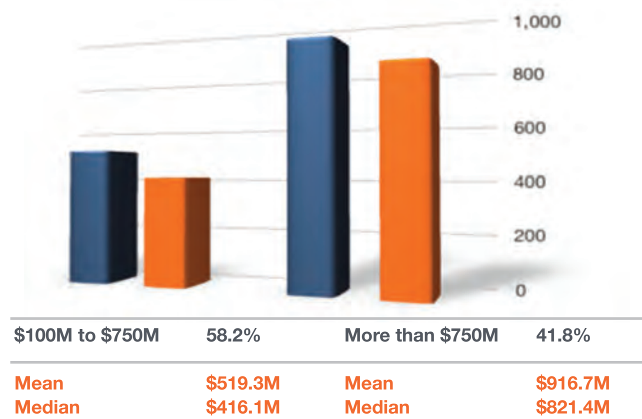
Hedge fund senior partners need to take the time to identify potential threats and work with the requisite legal, accounting and financial planning experts to protect their hard-earned assets. Those who have taken the steps to prepare for succession issues hold a competitive advantage but need to revisit their plans regularly to test their efficacy relative to current legislative, professional and personal circumstances.

The Research

In April and May of 2008 we interviewed 349 senior partners of hedge fund management companies. All of the companies represented had been operating for at least five years and had multiple owners. With a goal of understanding how well hedge fund owners are prepared for succession-related events, we excluded firms controlled by entities such as trusts, corporations or estates.

Almost 60 percent of those firms had between $100 million and $750 million in assets under management. The balance managed more than $750 million in assets. (Exhibit 1)

Exhibit 1: AUM



What If…

Any number of events can affect the composition of a management company, but not all of them demand the same intense level of preparation. Changes to the leadership structure can have a ripple effect on the firm's core revenue-generating competency, and must be anticipated with thoughtful and meticulous planning to avoid organizational instability and maintain strategic focus.

We posed the following four hypothetical scenarios—the death, disability, voluntary termination and involuntary termination of an owner—to 349 senior partners at hedge fund firms to gauge their level of preparedness.

Death

Only 30 percent of all the partners surveyed were ready to deal with the death of a managing partner, 22 percent claimed they were not ready and almost 50 percent said they were uncertain. Partners at the larger hedge fund firms were more likely than those at smaller firms to have taken steps to accommodate the loss of a partner, which is understandable, since they are often more cognizant of the need to protect the enterprise value of the venture. (Exhibit 2)

"While you'd be hard-pressed to find a hedge fund senior partner who wasn't well-versed on the tax issues impacting operations, we were somewhat surprised to learn that nearly 25 percent of respondents admitted that they were unprepared to handle the death of an owner in the management company," said Rick Flynn, principal-in-charge of the Family Office Group at Rothstein Kass. "Moreover, nearly half indicated that they just do not know if the firm is prepared for this eventuality. While these results could be viewed as a wake-up call, the good news is that, with the focus and commitment of senior partners, these issues can easily be resolved."

"Again we found that regardless of firm size, many alternative asset firms are not well-prepared to handle issues arising from partner disability. Nearly 70 percent of the senior partners acknowledged their lack of preparation," said Mr. Flynn.

Disability

Even fewer principals said they were prepared to handle an extended absence of a partner due to disability. Just one in 10 partners had planned for such an event, nearly 70 percent admitted that they were not prepared and about one-quarter were unsure. There wasn't a meaningful difference in how prepared the partners were when segmented by the company's assets under management, although larger firms were more likely to acknowledge their lack of planning. (Exhibit 3)

An owner in the management company dies

Exhibit 2:	$100M to $750M	More than $750M	Weighted Average
Prepared	23.6%	38.4%	29.8%
Unprepared	16.3%	30.1%	22.1%
Do not know	60.1%	31.5%	48.1%

An owner in the management company is disabled for 6 months or longer

Exhibit 3:	$100M to $750M	More than $750M	Weighted Average
Prepared	8.4%	12.3%	10.1%
Unprepared	61.1%	76.7%	67.6%
Do not know	30.5%	11.0%	22.3%

Termination

More firms were ready to address the departure of an owner, whether voluntary or involuntary, than the death or disability of an owner. However, the majority of partners said they are unprepared or uncertain about their ability to deal with this kind of situation. As seen previously, partners of larger firms were more likely to have planned for the termination of an owner.

(Exhibits 4 and 5)

"Most professional organizations must deal with employee termination issues at some point, though the challenges can be magnified when handling the departure of an owner. Considering the importance of properly managing the termination of an owner—whether voluntary or involuntary—we expected that most firms would be prepared. While nearly 40 percent indicated that they are adequately prepared, we were surprised to see that an almost identical percentage are not," said Mr. Flynn. "In assessing their readiness, firms need to consider both how the event is managed logistically and the potential impact to the brand, particularly at smaller firms where firm identity is often closely linked to the reputation and experience of a single owner."

Protective Measures

We then asked the hedge fund partners about the steps they have taken to prepare for the succession of a business owner or events that can impact the current structure and operation of the company. Our survey explored three aspects of succession planning, which are discussed in detail in the following sections:

- The use of various succession planning strategies and products
- The specific terms of existing plans and agreements
- The status of the preparatory initiatives that were implemented

An owner in the management company voluntarily terminates employment

Exhibit 4:	$100M to $750M	More than $750M	Weighted Average
Prepared	31.5%	43.2%	36.4%
Unprepared	29.6%	26.7%	28.4%
Do not know	38.9%	30.1%	35.2%

An owner in the management company is involuntarily terminated

Exhibit 5:	$100M to $750M	More than $750M	Weighted Average
Prepared	30.1%	41.1%	34.7%
Unprepared	30.5%	30.1%	30.3%
Do not know	39.4%	28.8%	35.0%

Succession Plans and Agreements

Formal Plans

Just one-quarter of partners said they have a formal succession plan that provides for ownership and control of their management company when a change occurs. (Exhibit 6) As is often the case, more than half of those plans have not been updated in three or more years and may no longer effectively address the structure of the company or the desires of the owners. (Exhibit 7) The large majority of firms that did have plans, however, made an effort to share the plans with critical members of their management teams. (Exhibit 8)

Operating Agreements

Eight in 10 partners said the operating agreements of their management companies provide for ownership and control issues stemming from the succession of an owner. (Exhibit 9)

"When you consider that fewer than one-third of firms polled claimed to have a sufficient succession plan in place, it becomes easier to understand the lack of planning for specific scenarios such as death, disability, or owner termination. The firms that address these challenges head-on have a clear advantage during periods of transition. Firms must also realize that these contingency documents can quickly become outdated and, therefore, must be reevaluated and amended on an annual basis," said Alan Kufeld, tax principal with the Rothstein Kass Family Office Group. "Because of this, there may still be cause for concern, even among the roughly 25 percent of respondents who do have a formal succession plan in place. Nearly 60 percent also acknowledged that the existing succession plan has not been reviewed in three years or more."

Have a formal succession plan for ownership and control of the management company

Exhibit 6:	$100M to $750M	More than $750M	Weighted Average
Yes	20.7%	29.5%	24.4%
No	79.3%	70.5%	75.6%

The last time the formal succession plan was reviewed

Exhibit 7:	$100M to $750M	More than $750M	Weighted Average
Within last year	7.1%	20.9%	14.1%
1 to 3 years	26.2%	30.2%	28.2%
3 years or more	66.7%	48.8%	57.6%

N = 85 partners

The succession plan has been adequately communicated to key employees

Exhibit 8:	$100M to $750M	More than $750M	Weighted Average
Yes	85.7%	90.7%	88.2%
No	14.3%	9.3%	11.8%

N = 85 partners

The entity's operating agreements address the ownership and control issues

Exhibit 9:	$100M to $750M	More than $750M	Weighted Average
Yes	77.8%	81.5%	79.4%
No	7.9%	7.5%	7.7%
Do not know	14.3%	11.0%	12.9%

Buy/Sell Agreements

Slightly more than 33 percent of all partners have a buy/sell agreement, in addition to the provisions of the management company's operating agreement, to specify (and potentially fund) the transfer of controlling shares when one partner withdraws from the business. Curiously, an even larger percentage of partners did not know if such an agreement exists. When the responses are segmented by firm assets, we find that the owners of larger firms are far more likely to have a buy/sell agreement than their counterparts at smaller firms. (Exhibit 10)

As with many business succession efforts, more than half of these agreements have gone unreviewed in more than three years. However, the owners of firms with more than $750 million in assets have done a better job keeping their planning documents current; two-thirds of plans had been updated within the past three years and almost one-quarter were reviewed within the last 12 months. (Exhibit 11)

"Hedge fund partners at larger firms have generally kept buy/sell agreements current, though over 50 percent revealed that this material was last reviewed three or more years ago. These larger firms seem to be more inclined toward regular review, as roughly 35 percent had let three or more years elapse since the last review, compared with over 75 percent of smaller firms," said Mr. Kufeld. "Larger firms often have more partners than their smaller counterparts and recognize the need for smooth transfer of controlling shares in the event of a partner withdrawal. At smaller firms, there tend to be fewer partners working closely together in a more collaborative environment, obscuring the need for contingency planning and making owner departure a difficult topic to broach."

Terms and Provisions

Slightly more than 50 percent of all partners know what person or entity will obtain control or voting rights of their management companies in the case of an owner's death. When viewed by assets under management, we find that the senior partners at larger firms are more likely to understand the terms and stipulations of existing agreements than those at smaller firms. Regrettably, the large number of partners without knowledge of these ownership provisions increases the probability that day-to-day fund management will be disrupted when a succession event occurs—and the time and attention needed to sort out the control issues, often a complicated and protracted process, can further undermine the viability of their businesses. (Exhibit 12)

Have a buy/sell agreement outside the operating agreement

Exhibit 10:	$100M to $750M	More than $750M	Weighted Average
Yes	30.5%	43.8%	36.1%
No	21.7%	17.8%	20.1%
Do not know	47.8%	38.4%	43.8%

The last time the buy/sell agreement was reviewed

Exhibit 11:	$100M to $750M	More than $750M	Weighted Average
Within last year	3.2%	21.9%	12.7%
1 to 3 years	21.0%	43.8%	32.5%
3 years or more	75.8%	34.3%	54.8%

N = 126 partners

Obtains control/voting rights of the management company if an owner dies

Exhibit 12:	$100M to $750M	More than $750M	Weighted Average
Other Owners	36.6%	45.2%	40.1%
Beneficiaries of the deceased owner	5.4%	9.6%	7.2%
Non-owner employees	4.4%	5.5%	4.9%
Another management company or entity	3.4%	2.7%	3.1%
Do not know	50.2%	37.0%	44.7%

"There's no more obvious argument that the hedge fund industry should reevaluate its approach to ownership issues than our findings on voting rights transfer. While just over 40 percent of respondents suggested that other owners would obtain control, an even larger subset—nearly 45 percent—indicated that they just do not know. The underlying assumption that voting rights will be transferred to other owners leaves far too much to chance and increases the probability that fund operations will be disrupted by such a scenario should it occur," said Mr. Kufeld. "Such circumstances can be mitigated by conducting regular diagnostic reviews involving senior management."

"In an industry often mischaracterized by its high-profile implosions and evolving regulatory environment, the potential for litigation always lurks. As wealthy individuals, hedge fund partners need to have a firm grasp on their own liability issues within the ownership structure. Our findings show only 15 percent of respondents believed that the management company is sufficiently protected if an owner is sued or divorces. Over 40 percent were in the dark about such plans, showing that awareness of the threat significantly lags the potential for litigation," said Mr. Kufeld.

About one-third of all senior partners believed that intellectual property plays a meaningful role in the management of their hedge funds, and a similar percentage said intellectual property ownership has been explicitly addressed in the event of a partner's death. (Exhibit 13) Again, a much larger group admitted no knowledge of how intellectual property will be treated should an owner die. (Exhibit 14)

Intellectual property is a critical element in managing the funds

Exhibit 13:	$100M to $750M	More than $750M	Weighted Average
Yes	29.1%	39.0%	33.2%
No	70.9%	61.0%	66.8%

The ownership of the intellectual property is clearly specified if an owner dies

Exhibit 14:	$100M to $750M	More than $750M	Weighted Average
Yes	28.8%	35.1%	31.9%
No	22.0%	24.6%	23.3%
Do not know	49.2%	40.3%	44.8%

N = 116 partners

The integrity of the management company is assured if the owner is sued or divorces

Exhibit 15:	$100M to $750M	More than $750M	Weighted Average
Yes	10.9%	22.6%	15.8%
No	38.4%	46.6%	41.8%
Do not know	50.7%	30.8%	42.4%

N = 116 partners

Relatively few, just 16 percent, of all hedge fund senior partners have taken steps to preserve the integrity of their firms' ownership structure if the owner's assets are at risk due to lawsuits or divorce proceedings. While twice as many partners at large firms say they have planned for these possibilities as compared to partners at smaller firms, they represent less than 25 percent of the segment. More than 30 percent of respondents from firms with assets exceeding $750 million and half of those at smaller firms were unaware of any such preparations. (Exhibit 15)

"Fewer than 35 percent of respondents indicated that intellectual property is an important component in the management of their firms. Given this fact, it's not surprising that issues arising from the ownership of intellectual property seem to be a low priority. Nearly 25 percent said that new ownership is specified in the event of owner death, and almost half reported that they did not know. We feel that both of these figures are low and reflect an incomplete understanding of what constitutes IP assets. In many cases, business practices, marketing methods and, most importantly, proprietary investment management and operations technology can be classified as proprietary and protected. Firms that have not done so would be wise to work to establish the true value of their IP portfolios and take measured steps to plan for their disposition in the event of a management change," said Mr. Kufeld.

Life and Disability Insurance

Key Person Life Insurance

Three-quarters of all hedge fund firms have key person life insurance to cover any expenses, such as consulting and recruiting fees, incurred to ensure the continuity of operations and replace the deceased individuals' expertise. (Exhibit 16) Unfortunately, many policies are outdated and should be revisited to determine if the death benefit will meet the firm's needs. (Exhibit 17)

Disability Insurance

Far fewer firms have disability insurance on the owners—just 38 percent of firms managing more than $750 million in assets and only 23 percent of firms managing less than $750 million in assets. (Exhibit 18) The survey also disclosed that the majority of those policies are in need of review, although smaller firms are more likely to have outdated policies than are bigger companies.

"The fact that over 75 percent of those polled have key person life insurance in place shows that the industry understands the importance of such policies. Yet again, there seems to be a sense of complacency toward maintenance. Nearly 60 percent of respondents claimed that the key person life insurance policies have not been reviewed in three years or more. The good news here is that since so many firms have taken steps to address this need in the past, reviewing and updating policies can be a very straightforward procedure," said Mr. Kufeld.

Has key person life insurance on the partners

Exhibit 16:	$100M to $750M	More than $750M	Weighted Average
Yes	69.5%	84.9%	75.9%
No	30.5%	15.1%	24.1%

The last time the key person life insurance was reviewed

Exhibit 17:	$100M to $750M	More than $750M	Weighted Average
Within the last year	9.9%	21.8%	15.5%
1 to 3 years	23.4%	30.6%	26.8%
3 years or more	66.7%	47.6%	57.7%
N = 265 partners			

Has disability insurance on the partners

Exhibit 18:	$100M to $750M	More than $750M	Weighted Average
Yes	22.7%	37.7%	28.9%
No	77.3%	62.3%	71.1%

About The Contributors

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About Rothstein Kass

Rothstein Kass provides audit, tax, accounting and consulting services to hedge funds, funds of funds, private equity, broker-dealers and registered investment advisers. The firm is recognized nationally as a top service provider to the industry through its Financial Services Group. The Financial Services Group consults on a wide range of organizational, tax, operational and regulatory issues. The firm also advises on fund structure both inside and outside the U.S., compliance and financial reporting, as well as tax issues from a federal, state, local and international perspective.

The Rothstein Kass Family Office Group offers a wide range of financial, wealth planning and lifestyle management services to management companies, family offices and high-net-worth individuals, including family members, business owners and members of the financial services, entertainment and sports industries. Comprising seasoned financial professionals and Certified Public Accountants, the Family Office Group applies proven expertise with the utmost discretion and attention.

Rothstein Kass has offices in New York, New Jersey, California, Colorado, Texas and the Cayman Islands.
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Publications

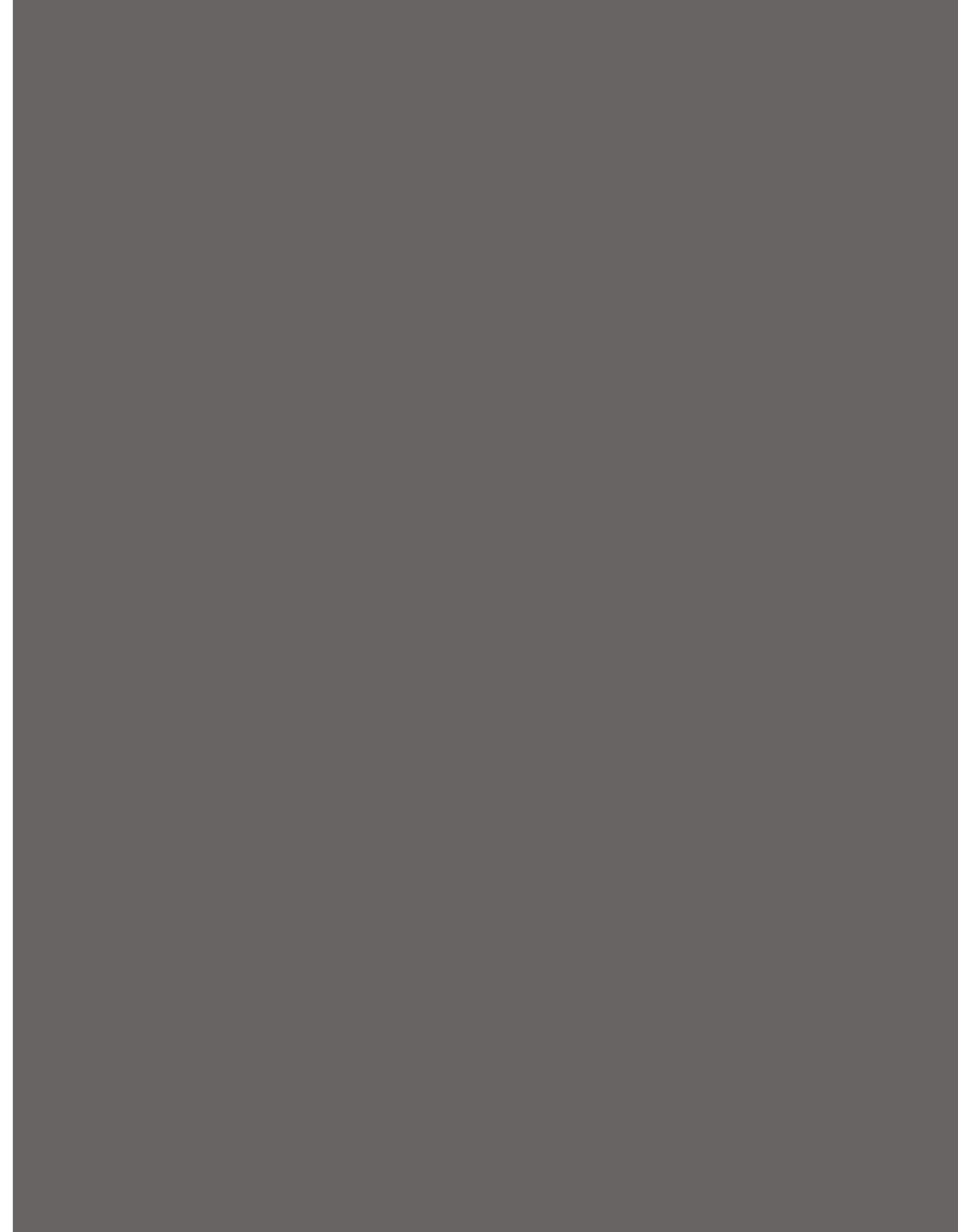
Beyond Performance: How Hedge Funds Can Strengthen and Build Their Affluent Client Base

As competition in the hedge fund sector intensifies, it will be more important than ever for hedge fund professionals to complement strong investment results with a thorough recognition of the priorities and expectations of their client base. Authors Russ Alan Prince and Hannah Shaw Grove share the research they have conducted with wealthy individuals and families that invest regularly, and significantly, in hedge funds and funds of funds. Their findings will help hedge fund firms understand the most effective ways to reach, cultivate and retain high-net-worth investors.

Fame & Fortune: Maximizing Celebrity Wealth

Wealthy celebrities have the world at their feet – but the unique circumstances of their professions often present financial and legal challenges that require special handling. The leading authorities on affluence and celebrity wealth management—Russ Alan Prince, Hannah Shaw Grove, and Richard J. Flynn—deliver the first data-based insights on the world of high-profile wealth in this invaluable resource for celebrities and their closest advisers on how to enhance, protect and pass along their hard-earned assets.

Copies of both publications are available upon request.



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