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Alternative Mutual Funds

Risks Faced by Hedge Fund Managers That Access the Alternative Mutual Fund Market Via Turnkey Platforms

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A growing number of hedge fund managers are entering the alternative mutual fund market, attracted by the sizable amount of retail assets available for investment globally. See "Citi Prime Finance Report Describes the Competition among Traditional, Hedge and Private Equity Fund Managers for $1.3 Trillion in Liquid Alternative Assets (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 22 (May 30, 2013). There are multiple entry points for a hedge fund manager to access this space. See "How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital? (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 5 (Feb. 1, 2013). One option is for the manager to build its own operational and distribution infrastructure from scratch, but doing so involves considerable cost and execution risk. See "Kramer Levin Partner George Silfen Discusses Challenges Faced by Hedge Fund Managers in Operating and Distributing Alternative Mutual Funds," The Hedge Fund Law Report, Vol. 6, No. 16 (Apr. 18, 2013). An increasingly popular option is for hedge fund managers to join a so-called mutual fund "turnkey platform." This option is less costly than building original infrastructure, but it also leaves the manager with less control and other operating risks. This article examines some of those key risks and offers practical solutions for hedge fund managers seeking to mitigate them. See also "Deutsche Bank Survey Describes the Contours of the Nontraditional Hedge Fund Product Market: Investor Appetite, Performance, Marketing, Fees and More," The Hedge Fund Law Report, Vol. 7, No. 3 (Jan. 23, 2014).

The Mutual Fund Turnkey Platform: Structure and Costs

A mutual fund turnkey platform provides all of the necessary administrative and compliance support for running a mutual fund so that a manager interested in starting a fund can simply enter into an advisory contract with the platform and start operating the fund in relatively short order. A typical turnkey platform is structured as a series trust overseen by a board of trustees selected by the turnkey provider, with that same board also responsible for overseeing all of the trust's series (each series being a separate fund with a different manager). Cf. "Understanding the Benefits and Uses of Series LLCs for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012). The turnkey provider arranges for (or provides itself) all of the administrative, legal, compliance and other support needed for the trust and each of its funds to operate.

Turnkey platforms are relatively inexpensive for managers and funds because of the economies of scale that turnkey providers realize from operating such a large number of funds under the trust "umbrella." For instance, whereas a standalone fund may spend a significant amount on the audit, insurance and chief compliance officer, as well as other compliance costs, those expenses drop dramatically when they are spread over a number of funds on a turnkey platform. The same is true for organizational, legal and other expenses.

Primary Benefits and Shortcomings of Turnkey Platforms

The primary benefits of turnkey platforms are that they allow managers to enter the mutual fund space relatively quickly and with lower costs than if they were to launch a product on their own.

The primary shortcomings of turnkey platforms are: (1) lack of manager control; and (2) increased regulatory (and consequently reputational) risk. With respect to control, a manager who signs on to a turnkey platform is subject to the constant authority of that turnkey provider and its board, and the manager ceases to control its own brand and product. With respect to regulatory risk, recent SEC actions against turnkey provider Northern Lights are a clear example of the heightened SEC scrutiny on turnkey platforms – particularly, the ability of one board to effectively oversee dozens of funds, each with a separate manager.

Chief Risks of Turnkey Platforms

Business Control Risk

A manager in a turnkey platform is only connected to the fund it manages through its advisory agreement with the fund. That advisory agreement could be terminated by the turnkey board at any time with or without cause. While, as a legal matter, this is also true for a manager operating a standalone fund outside of a turnkey, that risk, from a practical standpoint, is more remote. After all, a standalone fund's board is assembled by the manager itself (which, unlike the board of a third-party turnkey provider, has a familiarity or history with the manager).

Other Ongoing Control Risks

A manager's day-to-day lack of control under a turnkey platform is often manifested through the turnkey provider's ongoing imposition of its own governance and operational processes and procedures on the manager, often without regard to the manager's practical needs. For example, in a turnkey platform, if a manager needs to alter its fund's principal investment strategy, it will likely have to wait until the turnkey provider's next scheduled quarterly board meeting. With a standalone fund, however, a manager often has the flexibility to assemble on short notice a majority of its (typically smaller) board for a telephonic meeting to act swiftly on the strategy change.

Another control issue unique to turnkey platforms is that they force a manager to adopt and implement the platform's numerous compliance policies and procedures, many of which are either not required to be adopted or are not relevant to the manager's business. In addition, any changes to a fund's pricing structure (e.g., fees, sales loads, etc.) that do not fit within the turnkey platform's model are difficult to implement.

Service Provider Control Issues

Turnkey platforms force managers to deal with the turnkey's auditor, legal counsel and chief compliance officer. Consequently, managers find themselves in a position where unfamiliar service providers are immersing themselves in sensitive aspects of the manager's business, and the manager is unable to leverage its longstanding relationships to help its mutual fund business grow.

Difficult Exit

A turnkey fund is forced to remain under its turnkey platform, regardless of how large the fund has grown, *unless* the board of the turnkey platform approves the fund's exit, which it has no obligation to do. If approved, such exits are typically accomplished through a merger into a standalone trust.

Reputational and Regulatory Risks

The reputational and regulatory risks inherent in turnkey platforms generally arise from one board being tasked with overseeing dozens of different funds, each with different managers. (While all major fund complexes have a single board overseeing dozens of funds, they, unlike turnkey platforms, have one investment adviser that has overall investment oversight responsibility.) As noted above, the SEC recently took action against a turnkey provider for its board's failure to properly oversee one of its funds. Moreover, because of a turnkey platform's structure, a board's failure to properly oversee any of its funds, or even an unaffiliated manager's bad behavior, could negatively affect the reputation of the entire turnkey platform, including the other managers operating under it.

Due to their structure – a single board responsible for overseeing numerous unaffiliated managers that are using different investment instruments and strategies – turnkey platforms attract a baseline level of heightened regulatory scrutiny. On top of that, turnkey platforms may attract additional scrutiny because of their cost structure, which typically involves especially low legal and compliance expenses, which puts significant cost pressures on those functions.

Best Practices

If a manager is going to join a traditional turnkey platform, it should be prepared to take on a more proactive role in ensuring the adequacy of its fund's regulatory compliance, even if it means additional legal costs. For instance, in the wake of the 2013 Northern Lights actions, a manager should review carefully its fund's 15(c) processes and disclosures. Further, managers should, at the outset of entering into a turnkey arrangement, aim to establish ground rules that allow the manager greater day-to-day control of its product and the ability to easily exit the turnkey platform should fund assets rise to a level that accommodates an independent, profitable product for the manager. As a practical matter, however, turnkey providers are unlikely to alter their business model and cede this level of control to any hedge fund manager.

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A Practical Alternative

In our view, managers looking for cost and operational efficiency need not be forced into a turnkey platform and cede control of their product. There are other platforms structures that could offer substantially the same services of a traditional turnkey platform (e.g., outsourced administrative, custody and accounting services, outsourced compliance and distribution, and outsourced legal) *plus* manager control. Manager control means the manager selects the fund's board and determines its launch schedule, policies and procedures and so on. This structure would reduce regulatory and reputational exposure because: (1) a single board is only responsible for one manager's funds; (2) a manager and its fund have dedicated (and customized) legal and compliance support; (3) a manager does not have to worry about unaffiliated managers and other funds tarnishing its brand; and (4) the heightened regulatory scrutiny of traditional turnkey providers is avoided.

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