Katten

Financial Markets Litigation and Enforcement

From A(lgorithm)–Q(uantitative): What You Need to Know About Creating a Quantitative Asset Manager

Webinar Series Episode 1: Formation of the Manager

May 14, 2021

Introduction

For new quant managers, information about how to set up your fund is fairly easy to find. What is less readily available is information on how to set up, organize, fund, and manage your business. “From A(lgorithm)–Q(uantitative): What You Need to Know About Creating a Quantitative Asset Manager,” offers straightforward, actionable guidance for those seeking to launch their own quant manager. In part one of our four-part series, “Formation of the Manager,” we explored practical considerations for setting up your business.

The session was moderated by **Lance Zinman**, Partner and Global Chair of Katten’s Financial Markets and Funds Department, and **Tim Kertland**, Associate in Katten’s Financial Markets and Funds group. Lance and Tim were joined by **Niraj Patel**, General Counsel and Chief Compliance Officer at Aquatic Capital Management, and **Jessica Sohl**, President of HC Technologies.

Corporate structure

The webinar began with a discussion on corporate structure. You will want to work closely with legal counsel on setting up the right structure for your firm and your needs, but you’ll want to carefully consider a few key areas.

- **Location**
  You’ll want to take state laws into consideration as you form your corporate structures. You will most likely want to form in Delaware, but there may be reasons to consider other states. Your legal counsel will be able to help you weigh this important decision.
- **Taxes**
  The structures you create can have significant tax implications, and you’ll want to ensure that the corporate structures you set up are individually tax-efficient but also work together to create tax-efficient whole.
- **Ownership**
  The structure you build will also have significant ownership implications for partners in the firm, especially around self-employment taxes.
- **Subsidiaries**
  Subsidiary units will be critical in housing key assets, such as IP, employee benefits, and hardware and infrastructure. You will also want to consider separate units from which to conduct test trading and strategy development.

Agreements

Locking in the agreements is about more than just percentages. Consult with experienced legal counsel on how these terms will help you build the firm (and firm culture) you want, but here are a few terms to consider:

- **Management and funding of the company:** Single founder vs. board? What role does each board member play?
- **Funding:** Where is the capital coming from? Pass-throughs? Seed investor?
- **Economics split:** What is the waterfall for allocations and distributions? What about the issuance of discretionary allocation?
- **Duties:** What duties will each partner owe to the others? How do you ensure everyone is contributing?
- **Separation terms:** What are the buy/sell terms? Book value payout vs. sunsetting or equity drop-down? What about noncompete agreements and tax implications?

Equity and incentive compensation arrangements

Equity and compensation arrangements allow you to attract and retain the talent you need while also building longevity and a sustainable culture.

- **Deferred compensation.** This is one of your best tools for incentivizing results and long-term commitment from employees. A portion of discretionary bonuses are deferred for 3 to 5 years. How those discretionary bonuses are allocated can reinforce firm culture ("One team, one dream" or "Eat what you kill"?). Deferring some of that cash encourages employees to stay on and incentivizes positive separations. Many firms, depending on the employee, will deploy a hybrid model that combines deferred compensation with a points system.
- **Phantom Equity Plans.** This model allows you to attach employee compensation to the health of the fund. It can help more closely align your employees and your investors, which can encourage performance. But it has limitations (ERISA, etc.) after separation. Some firms use this specifically with junior employees as a way to build loyalty.
- **Partnership.** Some firms will create a new class of equity for junior partners as a way to encourage high performers. This offers no voting rights or control and would come with certain duties. Typically, these are fully vested over a period of three to seven years and are valued based on the value of the company at the time (this can have important tax and separation implications). Tax implications can be a barrier to accepting partnership for some (self-employment taxes and the cost of benefits can go up), but deferred comp and phantom equity plans can help make up this loss for new partners.

Intellectual property and hiring

Employment documentation is one of the most important tools you have to protect your IP. For most employees, many firms rely on a combination of restricted covenant agreements (often non-negotiable) and offer letters (tailored to the specific hire/position). These will include standard IP protective language that our panelists cautioned against negotiating.

Unsurprisingly, employees who create IP will require more extensive IP documentation. You may choose to carve out exemptions for previously owned IP (though be sure to secure royalty-free licensing even after the employee's departure). You may also carve out for things the employee does on his or her own time that are unrelated to work. The biggest question you'll likely have to resolve with these employees is "What is considered IP?"

Regulatory considerations

Quant fund managers will need to register as investment advisors and as CPOs and CTAs. The SEC, CFTC, and NFA will be your chief regulators, but be prepared to navigate more questions as a quant manager than you might in another space. Regulators will be especially concerned about:

- Checks and balances re: code and software
- Security and access re: hardware, servers, and cages
- Risk management and cybersecurity (a new hot topic among quant regulators)
- Restrictions on personal accounts

Our panelists encouraged CME memberships, especially for the pricing benefits. But they did remind attendees to pay attention to the responsibilities involved with membership.

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