The following is a transcript of CES Part 3: IRA Custodian Money & Additional Ways to Raise Capital with Brad Janitz and Adam Sypniewski of Midland Capital.

Video link: https://youtu.be/ENRjDyBUxpw

Brad: Hello and thank you everyone for joining us today. We are here for the Capital Education Series presented by Richey May. I'm going to talk about some IRA considerations for hedge fund managers. My name is Brad Janitz of Midland Trust, joined today by my colleague Adam Sypniewski of Midland Trust and today we're going to have a 10 to 15 minute discussion on considerations that fund managers should be thinking about when onboarding IRA or 401K investors. And for those that have never heard from us before, we are with Midland Trust, which is in in alternative investment custodian, also known as a self-directed IR, a company that provides IRA accounts that make it an available option to invest in private assets such as private investment funds, hedge funds, venture capital, private equity, etc.

And through our roles, we are often talking to both individual investors as well as private investment fund managers of all different sizes and strategies, and we embark in a lot of discussions around the particulars of bringing in IRA money. We wanted to gather that information because there are lots of themes that that we go over often, and wanted to take that and provide it in a format for you to digest.

If you've maybe been thinking about IRA money but never really wanted to dig into it, or maybe you've never thought about it and are here to just find out and learn a little bit more... so now, Adam, to get you involved here. Why is this important? Why do fund managers need to think about you IRA and 401K money?

Adam: Yeah, thanks Brad. It's a subject that obviously is near and dear to us, where we spent the bulk of our careers and the conversations that we've had with fund managers, and in particular emerging fund managers, have always focused on ways to bring in... How can I raise AUM quickly and easily?

I think that's what IRA money presents to these fund managers, especially those that are just raising outside money for the first time from friends and family and the like. IRA money represents another channel of capital for you to unlock at the fund manager. It doubles the conversation that you're having with the person across the table from you.

Maybe you're doing an investor pitch and they have liquid investment accounts, but for those high net worth folks the bulk of their wealth might be tied up in, say, a retirement account, so there's another whole pool of capital that you might not have considered. I think that's what Brad and I have experienced over the course of our careers is that this tool for fund managers to help them raise AUM in a scalable fashion without having to go out and find new people that might be willing to invest with them.

So again, you know when you're having those investor meetings, you're not only talking to them, you're talking to the IRA as well. That's what I think we're here to talk about today and shed some light on. Brad and I have really boiled it down to about five items of discussion that we want to talk about today and have a conversation around. Because these are the five things that we feel come up most often that are going to be most effective for you to keep in mind when you are having these discussions with your investors. So that said, we're going to go through these items one by one, and I think I'll kind of open the discussion by posing this question: Brad, can I raise investment into Reg D and Reg CF offerings?

Brad: Good question, Adam. First off, Reg D, or Regulation D, basically means private placements or private investment funds and then Regulation CF, which speaks to crowd funding.

The answer to that is yes. To boil these both down, they're both private placements, generally, an LLC or limited partnership structure and that is what we at Midland do every day. Whether it's us or another custodian, we're providing the ability for individuals to invest in private placements. These boil into those two regulatory environments. What we see is hedge funds and private equity funds, venture capital funds again, lots of different strategies, lots of different sizes from emerging to big billion-dollar funds. You just need to understand the mechanics, and that is why we're here at Midland Trust, is to provide some simplicity around that concept. In short, what that really looks like is we have Midland provide IRA accounts just like anybody else does. You're setting up an IRA transferring money from another institution, effectively just changing the address of that money and then placing it into a private asset. So we work with both the client and the investment sponsor, ABC Hedge Fund, and work through all the paperwork items to get that money from point A to point B and do it in an efficient manner. So yes, you can invest IRA and 401K money in the private placements and that's what a lot investors want to do.

Adam: Yeah, that's a great response, Brad. I think it is important to point out that the IRS doesn't really restrict us in what we can invest using our IRA money. Yes, there are a few very limited asset classes that you can't hold, but any type of private placements for the paper trail with the subscription document. That's a great way to get involved, as long as your fund formation attorney has put IRA eligibility as an eligible investor in your sub tax, I think it's pretty standard nowadays that we see these boilerplate, PPMs and subscription documents that IRA is a common investor type for more of these hedge funds that we're working with.

So, moving on to the next question, Brad, why do I need a custodian if I'm going to bring in an IRA investor? Why should we even involve a third party? I just want to work with my investor if I'm a fund manager, so why is there a custodian involved?

Brad: Great question. We get it from both sides to the investors as well as the fund manager so we're here to tackle that one. Let's backtrack to when IRAs were created. IRAs were created to get people to save for retirement and they are given very good tax advantages to put money in and then to invest with them. So with all these great tax advantages surrounding retirement accounts, basically the government says they want a third party to oversee these accounts to make sure that not too much money is going in them and the proper reporting on the money, as well as making sure that money is going to where it's supposed to be going. Basically, just to make sure that there's a helping hand for the end investor when they are engaging with their retirement accounts.

For most people this idea of a custodian is really a little bit foreign because most people, myself included, have retirement accounts at the more "name brand" institutions that we're all familiar with (Fidelity, Schwab, etc.). They have created a process around being both the custodian and the investment sponsor and allowing you to buy mutual funds or ETF's, etc. So we're used to just having that one stop shop there.

But then, when you embark into private assets, private funds, startups, or venture capital groups, they don't have the capacity or to handle and administer retirement accounts. It's just not what they do. It's not their business, it's also from a regulatory perspective they're not able to do that. So we at Midland come in and provide that alternative solution to basically do the heavy lifting of the administration custodial work for the IRA account holders, so they still get all the tax forms that they need, their money is moved around in proper fashion and we are doing all the legwork on the cash management side and the subscription agreements to make sure that the rules are being followed. This brings up an item a lot of people kind of get themselves in trouble, and that's what happens when the investor just cuts a check out of their retirement account. They distribute, call it $100,000, then they just hand it directly to the fund manager. The problem with that is that's not an IRA transaction, you've just distributed $100,000 out of your account and given it to a fund manager to invest personally. It's a common mishap that we see and that's why you need a custodian like us in place to make sure that that doesn't happen and the proper steps are followed. The IRA stays an IRA and you still get all those great tax benefits of investing within a retirement account.

Adam: Yeah, we've all we have horror stories for sure. Brad, we talked about some “whoops” do-overs that we've seen from our from our clients. Self direction doesn't mean you just do it all yourself. That means that you got there picking and finding those investing opportunities yourself, but you still need to direct your custodian to make these investments for you. Again, we have the subject matter experts to be able to make sure that you're staying in accordance with IRS rules and regulations; ultimately you're trying to keep your tax shelter in place. That's why you need to have that custodian.

So great summary, Brad. Thanks for taking us through that. I think something that the audience might find beneficial is restrictions or limitations. In terms of the fund or the investor, what type of limitations are there when it comes to accepting IRA money into a private fund?

Brad: Yeah, great question. First off on the manager side, we always get a question often about this 25% rule and people say 30, 20, 15, nobody really seems to know.

But there is a 25% rule basically around ERISA assets, so then the next question what are ERISA assets? ERISA are qualified retirement accounts, and that's your 401Ks, your defined benefit plans or pensions. Basically, your employer sponsored plans. So there is a rule and, honestly, it's probably better to have this discussion with the attorney that that set up your fund, but, in short, there's a 25% hurdle that you don't want to get over of ERISA assets, because then you become what's called a plan asset manager, and it takes on some different registration and some different fiduciary responsibility that most managers don't really care to partake in. So moral of the story, you want to stay under that 25% of AUM when it comes to qualified retirement accounts like 401Ks, defined benefit plans, pensions and such like that.

Okay, progressing on to the investor, this is a total misconstrued thing that I get often where a lot of investors think that they can only invest a certain portion into private assets, which is so not true.

When the Department of Labor put in place retirement accounts they never really said what you're supposed to invest in. They put some rules around what you can't invest in, but there's really no kind of limitations on what you can invest in. If someone has a $1,000,000 Fidelity IRA account, they can invest that whole IRA into one particular hedge fund or a variety of hedge funds or venture capital, private equity and any really allocation model that they see fit.

So really, you have to just make sure that the money is being transferred correctly, rolled over correctly and again, that's the the job of the custodian to help make sure that those things are running its course, but from an investment standpoint, there's really no limitations to what investor you can really do or not do with their money.

Again, the IRS does not restrict us as taxpayers, investors with our retirement account on very much really. Life insurance and collectables are the only prohibited asset types in a retirement account, so you can invest really in anything you want. If you're getting advice otherwise it's probably because they're just reluctant to let go of your assets and in terms of a broker and advisor or if a tax attorney is telling you something like that, they are probably just unaware.

Adam: You know, this is something that's been in place since ERISA of 1974, so it's nothing new, it's just something that we're still struggling to raise awareness about each and every day. So, I think Brad, you hit it on the head again that this is just something that not everybody knows about, but you should feel comfortable when once you're working with the custodian that this is what you can be doing with your retirement account.

Again, it's your prerogative as an investor, as a taxpayer, as a retirement planner to do what's within your power to do.

Brad: Yeah, no, that's awesome. Great words and nice dates there with knowing the 1974, I always forget that. The memory bank of dates is just not in my wheelhouse.

So let's flip the script a little bit here and ask you the questions Adam, so you know one thing that we're always hearing, You know now they maybe they have chatted with us and now they have a little bit of an understanding on this whole IRA process and how to get Midland involved, So, what are some easy ways for fund managers to get IRA or 401K clients involved? Or how do you bring that up in discussion? You know, just what are some tidbits to get an IRA investor?

Adam: Right, yeah, because there's not just a stadium full of IRA investors sitting somewhere ready waiting to be pitched. How do we attract these IRA people? We've seen some creative ways, and there's no magic pill to attract these type of people or to bring their retirement assets into your fund.

At the top of the conversation, I talked about doubling the conversation, maximizing optimizing your one conversation with that specific high net worth person that might be across the table from you. Really, it's just something that you bring up each and every time, and it's a habitual thing that you're talking to John Doe, but you're also talking to his retirement account. It's just something you want to keep in mind. Maybe they have liquidity issues.

This is probably, Brad, the most common thing that we see, a fund is looking to bring on a new investor. They might have some liquidity issues. You know they don't have $100K to part with at that moment in time, but you know they can exit a position, their retirement account and transfer it into a self-directed account to get it in. I think that's probably what we see most often, folks are just looking to get involved with a particular manager. They love what you're pitching them. They want to get involved, but they just don't have that cash lying around you know? Maybe they're moving. Maybe they are looking to invest in something more direct, a piece of real estate, something like that, and they just don't have that liquidity.

So to hit your minimum, maybe they do it all through their IRA, maybe they partner with their IRA, maybe they still have that liquidity issue, but they can afford $50 or $75K out of pocket and you allow that. We've heard that referred to as a household minimum and so they meet the rest of that minimum making a difference with some retirement money, transferring $25K, $30K or any size chunk of money to make sure they hit your minimum. Again, you as a fund manager are empowered to do with that what you want to do to get your investor involved. This is just another tool for them to do that.

Brad, you know you have to obviously be cognizant of solicitation rules. Marketing rules are becoming a little bit more conducive to allowing you as fund managers to attract investors. IRA money is just a subject that you have to kind of keep in your repertoire. Keep it in the discussion when you're meeting with these new investors of yours.

Adam: Yeah, I don't know how many times I've heard when I'm on the phone with an investor and I asked them about their situation and they say, “I have this old 401K just sitting in a bunch of mutual funds. I don't care about and haven't really done anything for me and so now I want to give it to somebody that I like, I know and I trust,” and I think just the emotional component of being able to tap into your retirement account is so much easier than maybe, some money that you penciled away to go buy a boat and you might make the wife mad if you throw it in the hedge fund rather than by the boat. So go tap that retirement account instead.

So another question we get all the time, because the reality is as a fund manager they’re managing money for a living, why can't they just manage their own money? Maybe they want to manage their own IRA.

Brad: Yeah. I talked about what you can and can't invest in with your IRA. It's not a matter of “what” is matter of “who,” and the IRS has a list of what they called disqualified persons to your IRA, meaning there's certain people that your IRA can't transact directly with and, yourself being one of those people, you know one of those disqualified persons. So when you're operating your own private fund, can your IRA you know transact with your private fund?

Well, it is a little bit of a gray area and we're not here to provide legal advice, but it is something that we have seen done, but yes. There are redactions considerations. that you need to be aware of and we would strongly suggest that that you work with your attorney about this subject specifically because there are ownership and equity stakes to keep in mind from the role of the custodian.

So again, we've seen it done. But we're not the ones to tell you how to do it. We would strongly recommend that you seek out a legal opinion on how to do it to make sure that you don't find yourself in a situation where you’re unknowingly taking a large distribution from your IRA account so that you're getting the taxable income hit along with an early withdrawal penalty from the IRS, because that's not what you want to have happen!

Adam: We understand that fund managers they want to be out there raising capital and piecing together their initial seed money, but yeah, you gotta do it the right way, so we always recommend working with an attorney to do that.

Brad: Well, nice, well Adam, I am all out of questions, and so I will let you any additional thoughts you'd like to bring up here? I think we covered a lot of bases, Brad. I think I, or at least I hope, that the audience got a lot out of what we had to share with you today. I would just again reiterate to the audience that IRAs don't have to be scary thing.

It's probably a new thing for a lot of folks that have never taken it on before. It's something that you kind of wait and see it and deal with when it comes if you have never sought it out. I would encourage folks to get out of their comfort zone and actually bring it up in these conversations, when you're starting up a fund especially.

Adam: It kind of comes with the territory that IRA money has a longer investment horizon, right? It's what we're keeping for retirement, so maybe folks will be a little bit more open minded about investing with you, given the fact that they have more time for you to give them a return when they're using retirement money. Some of these direct investors want immediate returns, they want liquidity, they want cash flows right away. Maybe they're a little bit more understanding with their IRA money, and that gives you a little bit of breathing room as a fund manager to produce your returns.

So again, lean on the resources you have. Brad and I are those resources if you don't have one today, but again, don't be scared of it. I'd encourage you to seek it out. It's not all that scary once you've actually taken on that first IRA investor and we've seen great success through the fund managers that we've worked with to scale their AUM quickly, and a lot more easily without as many investor meetings. So I would, I would encourage the audience to seek it out rather than waiting for it to come to them.

Brad: Yeah, you nailed it there. Get out of your comfort zone. Ask the questions. Make it an option because people will want to do it. And on that note, if you couldn't tell Adam and I are both very passionate about this subject and we love talking to fund managers about this whole process and trying to create a system that makes it easy for you and your investors. So we encourage anyone to reach out to us for further discussion, maybe dig a little bit deeper on some of the other questions that you might have. Happy, happy to talk to anyone.

So with that said, contact information will be provided alongside this video. So again, Adam and I with Midland Trust and talk to you soon.

Adam: Thanks guys.

If you have any comments or questions about this content, please contact us at info@richeymay.com.