Launching a Hedge Fund: An Overview

After years of hard work, you finally have the strategy, experience and resources to establish and manage a hedge fund. Now it's time to evaluate the options available to you in structuring your fund, navigating the regulatory landscape and choosing the right partners to ensure that your fund and management company has the proper foundation in place for growth. Launching a hedge fund is a major undertaking that requires a systematic approach and experienced partners in a variety of industries and areas of expertise. Brokerage, legal, tax and technological considerations are essential to the development of a successful fund. Creating a legal and structural framework at the outset that is in tune with the fund's investment objectives and investor base is the foundation for a successful fund. The following is an outline of legal, structural and practical considerations to be evaluated in establishing your hedge fund.

I. Fund Structure:

The structure and domicile of a hedge fund is primarily dependant on two variables: (i) the tax status and residency of its prospective investors; and (ii) the investment strategy employed by the manager.

A. Domestic Hedge Funds:

When dealing with U.S. citizens or U.S. taxable investors, a hedge fund can be constructed as a single U.S. domestic hedge fund. Typically the hedge fund is set up as a General Partnership, with a limited liability company acting as the funds General Partner. This provides the advantage of limited liability for the investors and its managers (through the LLC), along with the benefit of "pass-through taxation" (all income is passed through to the partners and members) inherent in the structure of a partnership, thereby avoiding the double-taxation characteristic of the corporate structure.

Generally, the general partner or LLC is organized in the state of the investment manager's domicile, while the LP or Fund is often organized as a Delaware entity because of the state's well-developed and business friendly laws. An *operating agreement* is prepared for the LLC and a *limited partnership agreement* for the investment vehicle. The limited partnership agreement provides wide latitude in defining all relevant control, operation and fee structures of the fund.

B. Offshore Funds

If a US domiciled manager intends to allow non-US citizens or US tax-exempt investors to invest in its fund, an offshore vehicle is established. The vast majority of offshore funds are established in low or zero tax jurisdictions so that there is little or no corporate level tax for the fund (although the offshore investor will still be liable for taxes on gains and income from the und in their country of residence). The Cayman Islands and the British Virgin Islands are the two most frequently used jurisdictions for offshore funds, with Bermuda, Ireland and the Netherlands Antilles less frequently utilized. In both the Caymans and BVI, there are strong regulatory structures in place in order to assure investors that the funds in which they invest are legitimate. There are three primary structure used for establishing offshore funds:

Single Fund Structure: This structure is primarily geared towards non-US investors, and also potentially to US based non-taxable investors (such as pension and endowments). The sponsor and management company can be either US based or offshore based, but most offshore stand-alone fund structures are managed by an offshore entity.

Side by Side Structure: In this type of structure, a US based manager will run two completely separate funds, one domestic and the other offshore, in an identical manner. This structure is often useful for certain strategies, such as a fund of funds strategy, but less advantageous for trading intensive strategies because of the administrative burden of splitting trade tickets between both funds.

Master-Feeder Structure: This is a common structure, which allows both US and offshore investors to directly invest in the same “master” offshore fund through separate domestic-based and offshore-based “feeder” entities.

II. Manager Compensation and Expenses:

Management Fee: Along with a performance-based allocation, virtually all funds impose an asset-based management fee (often 1-2% of the fund’s net asset value) to cover the General Partner’s on-going expenses in running the fund, such as rent, salaries and computer equipment.

Performance Allocation: As mentioned, the performance-based element of a manager’s compensation is probably the defining characteristic of the hedge fund structure. It is intended to reward and incentivize the manager for generating positive returns. Today, the industry standard for performance-based compensation is 20% of any realized or unrealized profits over realized or unrealized losses. Typically the performance fee is structured as an allocation of the fund’s income to the General Partner (calculated on an investor-by-investor basis) rather than a fee on the entire fund. Generally the incentive allocation is calculated in a quarterly, semi-annual or annual basis.

High Water Mark/Hurdles: Performance-based allocations are generally subject to a *high water mark*, which requires the manager to make up for previous losses before being entitled to a performance allocation for the current period. The performance allocation may take place on a monthly, quarterly or yearly basis. Some funds include an additional requirement before the manager may receive a performance allocation. These are known as "*hurdles*" and typically require the fund's performance to exceed a certain minimum rate of return before a performance payment is to be made. Some hurdles are calculated on an annual basis with each year's return measured against the hurdle applicable to that particular year. Others are calculated on a cumulative basis.

Expenses

Organizational Expenses: While the manager must cover the legal and other costs of establishing the Fund, most managers choose to structure the fund documents so that these organizational expenses will be repaid to the manager over the course of one to five years.

Ongoing Expenses: Virtually all funds provide that the fund itself is responsible for its on-going expenses, including legal, administrative, audit and trading commission costs and fee.

Third Party Capital Raising: Generally, the management company absorbs the cost of compensating third party marketers, solicitors or finder for their capital raising activities, most often by sharing 20% of the management and performance fee attributable to investors they introduce to the fund.

Manager Discretion to Waive LPA Provisions**:**

Side Letters: Under certain circumstances a manager will want to provide herself the authority to take on investors on terms more favorable to the investor than provided for under the offering documents. Many times side letters are used in the early stages of a fund to entice seed investors with preferable terms. Common side letter arrangements include reduced management or performance fees and/or greater rights to fund information. Side letter are general confidential in nature.

III. Contributions, Withdrawals and Dissolution:

Redemption Rights: Hedge funds provide less liquidity to their investors than regulated investment vehicles. The nature of the fund's investments will generally determine how often the fund will allow investors to withdraw their assets. Funds investing in highly liquid securities, such as domestically traded large cap stocks, generally allow their investors to withdraw on a monthly or quarterly basis. In contrast, funds investing in less liquid assets will allow withdrawal only semi-annually or annually. The original Jones fund permitted investors the ability to exit only on an annual basis. This level of liquidity is used by many funds today. In all cases, exercise of such *redemption rights* requires the investor to provide advance notice of intent to withdraw in order to allow the manager to liquidate positions and free up cash. Typically, 30 to 90 day written notice is required. In order to provide the manager with some control over redemptions, certain liquidity management tools are used.

Lock-Up: A lock-up subjects an investor's initial and/or future investments to a minimum holding period. For example, a hedge fund may have an initial two-year lock-up and then provide semi-annual redemption on 45 days notice.

Gate: A gate provides a manager with a means of limiting aggregate withdrawals on any given date, which is typically tied to some specified percentage of the fund's net asset value, in order to minimize the potential damage caused by mass simultaneous withdrawals. Therefore, if a fun provides for a semi-annual redemption, subject to a 15% gate, the manager may limit the aggregate redemption of all investors on any redemption date to 15% of the fund's net asset value, reducing each investor's redemption on a pro-rata basis.

Key Man: One concern for investors is that while their investments are locked up, key hedge fund personnel might leave or become incapacitated. To address this, funds sometimes insert a key man clause, which gives investors the option to redeem their funds if a key manager suddenly leaves the firm, or worse is incapacitated for some reason.

IV. Regulation of the Offering, the Manager and the Fund under Federal and State Securities Laws:

Hedge funds and the investment advisers managing them are governed by a variety of securities laws and a number of regulators. The marketing of interests in a hedge fund is regarded as a securities offering under the Securities Act of 1933 (the "1933 Act"). The manager of the fund, as an investment adviser, is governed by the Investment Advisers Act of 1940. And the Fund itself is subject to the Investment Company Act of 1940 (the "Company Act"). Absent exemptions under these securities laws, the offering, manager and fund would have to be registered with the SEC - a costly and time consuming process. Fortunately, exemptions under these laws allow both the offering and the fund to avoid the cost, administrative burden and disclosure requirements imposed by registration.

Additionally, the manager to one or more private funds may avoid SEC registration if it advises private funds with less than $150 million under management. Each state also has its own laws relating to the offering of hedge fund interests and the registration of the manager, which will also need to be navigated.

A. Regulation of the Offering:

Rule 506 Offering: Regulation D of the 1933 Act provides a safe harbor from registration for the private placement of securities under section 4(2). Many, if not most, hedge funds offer interests under Rule 506 of Regulation D. Rule 506 imposes no dollar limit on the size of the offering and permits sales to an unlimited number of “accredited investors” and up to thirty-five non-accredited investors.

General Solicitation: Prior to September 2013, a fund could not be marketed or sold via a general solicitation or advertising. Generally, this meant that information regarding the offering could only be distributed to prospective investors with whom the manager had a pre-existing relationship, such as family, friends or other members of y personal network. However, as of September 23 2013, the SEC adopted amendments to Rule 506 of Regulation D (“Rule 506(c)”), implementing changes mandated by the JOBS Act of 2012. Now a manager is able to generally solicit or generally advertise its private fund, provided the manager reasonably believes and takes “reasonable steps” to verify that all investors in such offering are accredited. The SEC has adopted a “principles based approach” to determine whether reasonable steps were taken to verify an investor’s accreditation, with the method of verification depending on several factors including the nature of the purchaser and of the offering. Examples of non-exclusive methods of verification specified by the SEC include, amongst others, obtaining copies of IRS income tax returns or statements of the net worth of investors verified by independent third parties. A manager now has the option of running his fund under the pre-2013 solicitation regime or taking on the additional compliance requirements demanded of funds that generally solicit under Rule 506(c).

Amount and Qualifications of Investors: The fund can be offered to an unlimited number of "accredited investors" and up to 35 other purchases. If non-accredited investors are eligible for purchase of fund interests, which generally is not the case for a variety of reasons, they would nevertheless need to be, either alone or with a purchaser representative, deemed to be *sophisticated investors*, such that they have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment. The term "*Accredited Investor*" is currently defined to include:

- An individual who has a net worth, or net worth jointly with their spouse, of more than $1 million (*excluding the value of their primary residence*), or who has an income over $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment; <u>and</u>
- The term also includes certain institutional investors, including banks, savings and loan associations, registered brokers, dealers and investment companies and ERISA plans among others, provided they have more than $5 million in assets.

Restricted Securities: The interests that investors receive in the fund are considered "restricted," meaning that they may not be sold for one year without being registered under the securities laws.

Form D Notice Filing with SEC: While not requiring registration, the SEC must be provided notice of each offering under Rule 506 through the filing of Form D, which provides basic information about the Fund and manager.

Full and Fair Disclosure – Antifraud Provisions: Given their high net worth and assumed sophistication, the 33 Act does not require that accredited investors be furnished specific information under a private placement of securities. Non-accredited investors must, however, receive a level of disclosure regarding the fund akin to that required in a registered offering "to the extent material to an understanding of the issuer, its business and securities being offered." Given the various federal and state antifraud provisions, a fund is nevertheless well advised to prepare a comprehensive offering memorandum ("Private Placement Memorandum" or "PPM") for both accredited and non-accredited investors. The information provided in a PPM varies from adviser to adviser but typically discusses the fund's investment strategies and practices, the manager's professional background and its principal owners, the fund's structure and business practices, and any risks associated with investing the fund. Additionally, the PPM outlines pertinent provisions of the limited partnership agreement including the fund's withdrawal and transfer restrictions, valuation procedures and profit and loss allocations, as well as information about investor qualification and suitability standards and subscription procedures.

Disclosure of lock-up periods, redemption rights and procedures, the fund's service providers, potential conflicts of interests and allocation of certain investment opportunities among clients may be discussed briefly or in greater detail, depending on the fund. The PPM may also include disclosures concerning soft dollar arrangements, redirection of business to brokerages, proxy voting standards and guidelines for record keeping. Copies of financial statements may also be provided with the PPM.

B. Regulation of the Manager:

The Investment Advisers Act of 1940 governs registration of investment advisers. Prior to the passage of the Dodd Frank regulatory reform act in July 2010, all hedge funds could avoid registration with the SEC under what was known as the private adviser exemption, which created a safe harbor from registration for an adviser to private funds with fewer than 15 "clients" over the previous twelve months who did not hold itself out to the public as an investment adviser. For purposes of the exemption, each fund was considered one client. Dodd Frank eliminated the private adviser exemption, but enacted a narrower exemption under Rule 230(m) of the Advisers Act.

Rule 230(m) provides a safe harbor from SEC registration to any adviser who solely advises private funds and has assets under management of *less than $150 million*. As will be discussed, a private fund is a one falling under the provisions of Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Advisers with between $25 and $150 million in assets under management are known as exempt reporting advisers. To determine eligibility, an exempt reporting adviser must annually aggregate the value of its "regulatory assets under management." These regulatory assets under management include securities portfolios over which the adviser provides continuous and regular supervision or management services. The value of the assets should be calculated on a gross basis such that the managers' utilizing leverage in one or more fund must include assets bought on margin into their calculation. Despite exemption from registration, exempt reporting advisers will nevertheless be subject to certain reporting requirements under a subset of Form ADV and may be required to register in the states where they are located.

Unlike the Repealed Private Adviser Exemption, the new 230(m) exemption imposes no cap on the number of private funds that a private manager may advise. While counting the number of clients advised is no longer necessary, assessing the type of clients advised is of paramount importance. An investment adviser will no qualify for the new exemption if the adviser accepts a single client that is not a "qualifying private fund." For example, advising a managed account would make an adviser ineligible for the exemption. It is important to note that a private fund adviser that accepts a client that is not a qualifying private fund would immediately lose the exemption. Therefore, the adviser should apply for and obtain SEC registration before it accepts a client that is not a qualifying private fund.

Regulation of the Fund: The fund itself is regulated under the Investment Company Act of 1940, which requires the registration of any "investment company." Hedge funds have obtained exemption from registration under Section 3(c)(1) and 3(c)(7) of the Act as private funds.

<u>Section 3(c)(1)</u> provides an exemption to a fund with no more than 100 beneficial owners that does not make an offering of its securities to the public (namely makes a Reg. D offering). As a general proposition, each individual investor is counted as a beneficial owner (with spouses owning interest jointly also counted as one beneficial owner). Any entity (*e.g.*, corporation, trust or partnership) investing in the fund is considered a single beneficial owner unless such entity is another 3(c)(1) fund and such subscribing 3(c)(1) fund will own more than a 10% investment. If more than a 10% investment is made, the SEC has taken the position that it will "look through" the subscribing 3(c)(1) fund and count each of its investors as a beneficial owner. This rule is meant to prevent pyramiding of 3(c)(1) funds to avoid mutual fund registration rules.

<u>Section 3(c)(7)</u> of the Company Act provides an exemption to a fund owned by no more than 499 investors, all of whom qualify as "*qualified purchasers*" at the time of their investment. A qualified purchaser is any person with not less than $5 million in investments or any institutional investor with not less than $25 million in investments.

Regulation of Performance Fees: The imposition of hedge fund performance fees are regulated at the federal and state level. As a general matter, investment advisers registered at the SEC and advisers registered in many states who have adopted provisions of the Advisers Act are prohibited from collecting any performance based compensation or assessing any performance based fee or allocation. Rule 205-3 of the Advisers Act provides a safe harbor from this provision to registered investment advisers who advise private investment funds open only to investors meeting the "qualified client" standards. Today, a qualified client under Rule 205-3 includes (i) a natural person, or a company, that the investment adviser reasonably believes has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million (excluding the value of such investor's primary residence), or (ii) a natural person, or a company, that has at least $1 million under the management with the investment adviser immediately after entering into an advisory contract, or (iii) an officer, general partner, or employee participating in the investment activities of the investment adviser.

V. Service Providers

While performance will be the ultimate arbiter of whether a manager can attract capital, to be credible to investors a manager will want to engage the following service providers.

Legal Counsel: Of paramount importance to ensuring the long term viability and marketability of the fund and its manager is to ensure the fund is structured properly from the outset; that the fund's operating and offering documents are properly drafted and to ensure that manager has complied with all regulatory requirements. Therefore choosing an attorney specialized in this area of securities law is critical.

Prime Brokerage Firm: The manager should establish a prime brokerage account. These firms offer typical brokerage services, including custody of assets, trade execution, trade clearing/settling, portfolio financing and management, risk management, and reporting.

Fund Administrator: Fund administrators provide monthly and annual accounting services to hedge funds. These services generally include portfolio accounting and reporting, recording of all transactions in the accounting records, subscription and redemption accounting services, performance fee and soft dollar accounting, invoicing and bookkeeping.

Audit and Tax Services: Although having a yearly fund audit prepared is not required by law (unless the manager is a registered investment adviser), investors generally consider auditing services to be paramount to due diligence. For start-up managers an audit may be delayed until the end of the fund's first fiscal year of operations.

VI. Alternative to Full Hedge Fund Development: The Incubator Fund.

Many hedge fund managers abandon their goal of starting a fund because of the extensive cost and time associated with establishing a fully structured fund. The so called "incubator fund" is an alternative for hedge fund startups who do not yet have the track record necessary to attract investors.

An incubator fund can be created by breaking down the hedge fund development process into two stages. The first stage sets up the fund and management company entities, as well as pertinent operating agreements outlining all of the relevant provisions under which the manager intends to run the fund, including performance and liquidity as previously discussed. This is enough to allow the hedge fund to begin trading, usually with the manager's own funds. By trading under this structure, the manager can develop a track record separate from his personal account, which can be marketed to generate indications of interest from investors. In the second stage, generally six to twelve months after establishment, the PPM is circulated and investors can be brought into the fund. The incubator method affords the opportunity for skilled traders to break down the hedge fund development process into a manageable undertaking.