LAUNCHING A HEDGE FUND IN 2012

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.

Fund Structure and Domicile

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

Domestic Hedge Funds

Most hedge funds offered to U.S based taxable investors are set up as general partnerships with a limited liability company acting as the general partner. This domestic fund structure provides the advantage of limited liability for the fund's investors and its manager along with the beneficial nature of pass-through taxation characteristic of the partnership structure (e.g. all income is passed through to the partners and members) thereby avoiding double taxation characteristic of the corporate structure. This structure also has the advantage of allowing certain categories of income, such as long term gains, to retain their character when distributed (as opposed to the corporate structure which does not distinguish between types of income). Generally, the LLC or manager is organized in the state

of the investment manager's domicile while the LP or fund itself is often organized as a Delaware entity because of the state's well developed and business friendly laws. An operating agreement is created 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.

Offshore Funds

If a U.S. domiciled manager intends to allow non-U.S. citizens or U.S. tax-exempt investors to invest in its fund an offshore vehicle is established. The vast majority 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 fund 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 structures used for establishing offshore funds:

Single fund structure – is primarily geared towards non-U.S. investors, and also potentially to U.S. based non-taxable investors (such as pensions and endowments). The sponsor and management company can be either U.S. based or offshore based, but most offshore stand alone fund structures are managed by offshore entity.

Side by Side structure – in this type of structure a U.S. based manager will run two completely separate funds, one domestic the other offshore, in an identical manner.

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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 U.S. and offshore investors to directly invest in the same "master" offshore fund through separate domestic and offshore based "feeder" entities.

Important Structural Considerations

In regard to the structural characteristics of the hedge funds I will now outline some of the common provisions regarding compensation and liquidity contained in the partnership agreement.

Provisions Regarding Manager Compensation

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. 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 current period performance allocation. 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

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certain minimum rate of return before a performance payment is allowed 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. 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.

Provisions Regarding Liquidity

Hedge funds typically 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 followed by many funds today. In all cases, exercise of 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. One such tool is the *lock-up* which 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 forty-five days notice. A second liquidity management tool is called a *gate*. A gate provides a manager with a means of limiting aggregate withdrawals on any given date, 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 such as occurred during the credit crisis several years ago. Therefore, if a fund provides for semi-annual redemption, subject to a fifteen percent gate, the manager may limit the aggregate redemption of all investors on any redemption date to fifteen percent of the fund's net asset value, reducing each investor's redemption on a pro-rata basis.

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. Fortunately, exemptions under these laws allow both the offering and fund to avoid the cost, administrative burden and disclosure requirements imposed by registration. And as will be discussed the manager to one or more private fund may avoid SEC registration if it advises private funds with less than $150 million under management. Additionally each state has its own laws relating to the offering of hedge fund interests and the registration of the manager.

Regulation of the Offering:

In order to avoid the difficult and costly process of registering a public offering of securities with the SEC, Regulation D of the 1933 Act provides a safe harbor 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.

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 value of such investor's 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; and

- The term also includes certain institutional, including banks, savings and loan associations, registered brokers, dealers and investment companies and ERISA plans among others provided they have with more than $5 million in assets.

To qualify for Rule 506, the fund may not be marketed or sold via a general solicitation or advertising. Generally this means that information regarding the offering may only be distributed to prospective investors who have a pre-existing relationship with the manager.

If non-accredited investors are eligible for purchase of fund interests, which generally is not the case for most hedge fund for a variety of reasons, such non-accredited investors 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.

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Additionally Rule 506 provides that all investors' purchase "restricted securities" in that they may not be sold for a year without being registered under the securities laws.

And while not requiring registration, the SEC must be provided notice of each offering under Rule 506 through the filing of a 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." However, given the various federal and state anti-fraud provisions, a fund is well advised to prepare a comprehensive offering 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 along with any the risks associated with investing in 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 also may 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.

Regulation of the Manager

Registration of investment advisers is governed by the Investment Advisers Act of 1940. Prior to 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 new rule 203(m) of the Advisers Act which 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 fund falling under the provisions of Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Advisers with between $25 and $150m 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 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 203(m) exemption imposes no cap on the number of funds a private fund 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 not 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 fund's have obtained exemption from registration under Section 3(c)(1) and 3(c)(7) of the Act as private funds. Section 3(c)(1) 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 interests jointly counted 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.

Section 3(c)(7) of the Company Act provides 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 Adviser's 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 that a safe harbor from this prohibition to registered investment advisers who advise private investment funds open only to investors meeting the so called *qualified client* standards. Dodd-Frank increased the requirements for *qualified clients.* 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

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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.

Alternatives to Full Hedge Fund Development: The Incubator Fund

Many fledgling 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 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 the relevant provisions under which the manager intends to run fund including performance and liquidity as have been 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.

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