

Launching a **HEDGE FUND** in 2011:
KEY STRUCTURAL AND OPERATIONAL ISSUES

FREQUENTLY ASKED QUESTIONS

WHAT SORT OF LEGAL STRUCTURE SHOULD BE USED?

Most domestic hedge funds are organized as limited partnerships with the management company organized as a limited liability company. Additional entities may be needed for certain tax purposes.

HOW DO I INCUBATE A HEDGE FUND?

Managers will incubate a fund by managing their own money for 6–12 months within a limited partnership to establish a marketable track record.

DO I NEED A PRIME BROKER?

Prime brokerage arrangements are common in the hedge fund industry and are particularly attractive to start-up or smaller managers who frequently do not have extensive capital and other resources. Prime brokers generally provide custody, back office support and other services, while the manager concentrates on managing the fund's portfolio.

DO I NEED AN ADMINISTRATOR?

Most funds hire a third party to provide administrative services to the fund. Among the services administrators may provide are the following: operating the fund's bank account; issuing payment instructions; providing net asset calculations; and, calculating management, performance, and other fees. Costs for administration services vary significantly depending on the scope of services provided and the notoriety of the firm providing services. We have seen a range between \$500 and \$3,000+ per month.

DO I NEED AN AUDIT?

Although generally not required by law, most domestic and offshore funds provide investors with annual financial statements audited by an independent accounting firm. Investors generally are reluctant to invest in a fund that does not undergo an annual audit and provide these financial statements. Costs for audit services vary significantly depending on the complexity of the fund's investment program and the notoriety of the firm providing services. Accounting fees for an audit typically range between \$5,000 and \$30,000+ per year.

WHAT IS THE TYPICAL FEE STRUCTURE FOR A HEDGE FUND?

Typically investors in a hedge fund will pay the manager a management fee and a performance fee. The management fee, paid either quarterly or monthly, will range from 1–2% of AUM. The performance fee is generally assessed annually (although some managers will assess the fee quarterly) and typically is 20% of the fund's profits (subject to a "high water mark").

HOW DO I RAISE CAPITAL TO LAUNCH THE FUND?

Start-ups are typically marketed initially through the manager's personal network and often through friends and family. It is also possible to raise capital from seed investors who usually require reduced fees, equity in the management company or both in consideration of the seed investment.

CAN I OFFER INTERESTS IN THE FUND TO NON-ACCREDITED INVESTORS?

A hedge fund may have up to 35 non-accredited investors and still remain within the SEC's "safe harbor" under regulation D which governs private placements.

WHAT ARE THE RULES REGARDING MARKETING THE FUND TO POTENTIAL INVESTORS?

Interests in a hedge fund are generally sold pursuant to a private placement exemption and should be marketed very carefully without using any general advertising or solicitation. Generally speaking, the manager should have a pre-existing relationship with everyone who is offered interests in the fund. Furthermore, to remain exempt from registration as an investment advisor at the state or federal level, a manager cannot hold himself out "publicly" as an investment advisor. Promotional activities involving the use of websites and providing information to organizations that track hedge funds should not be engaged in without the advice of counsel.

CAN I USE THIRD PARTIES TO HELP ME RAISE CAPITAL FOR THE FUND?

Yes, but anyone who sells interest in the fund and receives a commission (or any kind of compensation) must generally be licensed as a registered representative (Series 7) of a broker-dealer. There are many third party marketers who specialize in raising capital for hedge funds who are licensed with broker-dealers. The traditional third party marketing fee is 20% of the fund's management and performance fee. Start-up funds, however, often need to provide an equity kicker or much higher compensation to entice a third party marketer to take on the project. A manager should not enter into an agreement with a third party marketer without advice from counsel.

CAN I USE PAST PERFORMANCE OF ANOTHER ACCOUNT OR BACK TESTED RESULTS TO MARKET THE FUND?

Yes, provided that the past performance and back tested results are presented fairly and properly disclaimed. Fund

managers should ensure that performance figures in all offering documents meet the legal requirements for such presentations.

CAN I ACCEPT PENSIONS AND IRAs INTO THE FUND?

Yes, but generally speaking no more than 25% of the value of the fund can be held by employee benefit plan investors of any description including ERISA plans, IRAs, 401(k) plans, state funds, or other employee benefit plans unless the fund goes to great effort (usually at great expense) to comply with ERISA. IRAs themselves do not constitute ERISA assets but must be considered for the 25% calculation.

DO I NEED ANY REGISTRATIONS OR LICENSES TO OPERATE A FUND?

Possibly. Each state has different registration requirements and exemptions. If a state does require a manager to be registered, usually the manager will be required to have passed the Series 65 exam.

CAN I TRADE COMMODITIES IN THE FUND?

If a hedge fund trades in futures contracts or options thereon, the fund would likely be considered a commodity pool under the Commodity Exchange Act and the manager of the fund would have to register with the Commodity Futures Trading Commission as a commodity pool operator. Such manager would have to pass the Series 3 exam administered by the National Futures Association.

SHOULD I ESTABLISH AN OFFSHORE FUND?

Offshore funds are typically created by investment managers with significant prospective investors located outside the United States. They are also attractive to U.S. tax exempt investors as a way to avoid certain taxes. Offshore funds are usually established in Caribbean jurisdictions, although a European offshore entity may be more appropriate if a significant number of European investors are involved. We can help you determine whether an offshore fund is necessary based on your fund's needs. Additionally, we can help you determine the proper structure (parallel or master-feeder fund) and the proper offshore jurisdiction (Cayman, BVI, Ireland) based on your fund's unique characteristics.



INVESTMENT LAW GROUP
OF GILLETT MOTTERN & WALKER, LLP

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Fund of Funds
Distressed Securities
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FOREX / Currency Trading
PIPE Investments
Quant Strategies
Market Neutral
Managed Futures
Sector Specific
Arbitrage Strategies

WE HAVE REPRESENTED CLIENTS BEFORE VARIOUS REGULATORY AGENCIES AND ORGANIZATIONS:

National Association of Securities Dealers (NASD)
Securities and Exchange Commissions (SEC)
National Futures Association (NFA)
Commodities and Futures Trading Commission (CFTC)
State Securities Divisions

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