

Launching a **HEDGE FUND** in 2017:  
KEY STRUCTURAL AND OPERATIONAL ISSUES



**INVESTMENT LAW GROUP**  
OF DAVIS GILLETT MOTTERN & SIMS LLC



# 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 can 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 emerging managers who frequently do not have extensive capital or 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 that administrators provide are the following: operating the fund's bank accounts; issuing payment instructions; determining the fund's net asset value; and, calculating management, performance, and other fees. Costs for administration services vary significantly depending on the scope of services provided and the reputation of the firm providing the services. We have seen fees range from \$1,000 to \$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 reputation of the firm providing the services. Accounting fees for an audit typically range from \$10,000 to \$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").

## 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 register, usually the manager will be required to take and pass the Series 65 exam.

### HOW DO I RAISE CAPITAL TO LAUNCH THE FUND?

Start-up funds 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 will usually require reduced fees, equity in the management company, or both, in return.

### 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?

The rules that govern marketing activities under private placements have changed as a result of the recent JOBS Act, and it is widely expected that hedge fund managers will have greater flexibility in marketing their funds than ever before. However, hedge fund managers must still comply with advertising requirements under the Investment Advisers Act of 1940 such that their advertisements are not misleading or otherwise deceptive.

### CAN I USE THIRD PARTIES TO HELP RAISE CAPITAL?

Yes, but individuals who sell interests in the fund and receive compensation must be licensed brokers and the fund manager must sign a selling agreement with the selling agent's broker-dealer. The traditional third-party marketing fee is 20% of fees earned on introduced capital. However, start-up funds will often need to provide an equity kicker, retainer, or higher fee-split, to entice an outside marketer to take on the project. In any case, a hedge fund manager should not enter into a selling agreement without advice of counsel.

### CAN A HEDGE FUND INVEST IN ILLIQUID ASSETS?

Yes, hedge funds are extremely flexible vehicles and are used by investment managers to pursue strategies across many different asset classes, from the highly liquid to the highly illiquid. Hedge funds that trade illiquid assets often utilize "side pockets," an accounting mechanism that segregates illiquid investments from each other and from the fund's liquid securities. Side pockets are designed to treat investors equitably, by allocating the side-pocketed investment to investors on a *pro rata* basis on the day the investment is made. This mechanism prevents later investors from receiving a stake in illiquid investments that are difficult to value.

Likewise, because withdrawals from side pockets are restricted, side pockets prevent withdrawing investors from depleting a fund's liquid assets to the detriment of the remaining investors. It should be noted that although side pockets serve a constructive purpose, side pockets create opportunities for improper use and have received some negative attention for this reason.

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

Yes, provided that any past performance and back-tested results are presented fairly and are properly disclaimed. Fund managers should ensure that performance figures in any offering documents are not misleading or deceptive and meet other legal requirements.

### CAN I TRADE FUTURES OR FOREX IN A HEDGE FUND?

If a hedge fund trades in futures contracts, options on futures, or foreign currencies ("forex"), the fund will generally be considered a "commodity pool" and the fund manager will be required to register with the Commodity Futures Trading Commission as a "commodity pool operator," unless there is an exemption available.

### 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, and will not implicate ERISA fiduciary responsibilities, but must be considered for the 25% calculation.

### SHOULD I ESTABLISH AN OFFSHORE FUND?

Offshore funds are typically created by investment managers that have an expectation of receiving significant capital contributions from investors located outside of the United States. Offshore funds are also attractive to U.S. tax-exempt investors as a way to avoid unrelated business taxable income (UBTI). Offshore funds are generally established in Caribbean jurisdictions, although a European offshore entity may be more appropriate if a substantial number of European investors are expected. 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 most desirable offshore jurisdiction (Cayman, BVI, Ireland, Luxembourg, etc.) based on your fund's unique characteristics.

### CAN NON-U.S. INVESTORS INVEST IN A U.S. FUND?

Yes, a U.S. hedge fund can accept non-U.S. persons as investors without additional U.S. regulatory issues. However, many non-U.S. investors will prefer to invest through an offshore fund to maintain anonymity.

### SHOULD MY FUND HAVE A LOCK-UP?

Lock-up provisions restrict an investor's ability to withdraw capital from the fund for some stated period of time. Traditionally, it was common for hedge funds to lock-up an investor's contribution for one or two years. In the wake of the recent financial crisis, lock-up provisions received considerable negative publicity as investors attempted to withdraw funds to meet liquidity needs, and were unable to do so. As such, many funds launched since have determined not to include a lock-up. These funds will generally restrict liquidity in other ways, by decreasing the frequency of periodic withdrawal dates and increasing notice periods to effect a withdrawal, for example. Despite the negative association of lock-up provisions, lock-ups are still relatively common and are often important for funds that trade illiquid assets.

### ARE THERE ANY RESTRICTIONS ON CHARGING PERFORMANCE FEES?

Many states and the SEC restrict a hedge fund manager's ability to charge performance fees that scale as a percentage of the capital appreciation earned for an investor. SEC registered investment advisers must follow Rule 205-3 under the Investment Advisers Act of 1940 which prohibits an adviser from charging a performance fee to any investor that is not a "qualified client." The "qualified client" standard was recently amended and now generally includes a person with greater than \$1 million under management with the adviser, or a net worth in excess of \$2 million. Many states follow the Federal rule on performance fees but state rules do vary widely and you should refer to the rules of your home state for greater clarity on your ability to charge performance fees.

### HOW DOES DODD-FRANK AFFECT HEDGE FUNDS MANAGERS?

Investment advisers, including hedge fund managers, are subject to new registration and reporting requirements as a result of changes implemented by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). In general, if an adviser has less than \$25 million in assets under management, the adviser is not eligible for SEC registration and must look to the laws of the adviser's home state to determine registration and licensing requirements.

Advisers registered in their home state can avoid SEC registration until they reach \$100 million in assets under management. Advisers that only manage hedge funds and other private funds can avoid registration until they reach \$150 million in assets under management. Dodd-Frank also increases reporting requirements for hedge fund managers with more advisers reporting on Form ADV and new Form PF.

### HOW ARE HEDGE FUNDS TAXED?

Hedge funds are typically structured as limited partnerships or limited liability companies. Both LPs and LLCs are taxed as partnerships by default, which means that they are pass-through vehicles for tax purposes. This means that there is typically no tax at the entity, or fund, level and investors will be distributed their proportionate share of the fund's gains and losses for tax purposes. Investors will report these gains and losses on their individual tax returns and will pay tax on items of income and gain according to the character of the income or gain reported on a K-1 form provided by the fund. For example, if the fund generates long-term capital gains, by holding an investment for more than one year, investors will pay taxes on such gains at the long-term capital gains rate. The fund's manager will generally pay tax on its management fee at ordinary income rates and structure the performance fee as a profit allocation, rather than as compensation for services, in order to receive more favorable tax treatment with respect to assets that are eligible for long-term capital gains.

### WHAT SHOULD I EXPECT FROM A LAW FIRM THAT IS ASSISTING WITH THE FORMATION OF A HEDGE FUND?

Interests in a hedge fund are securities and, as such, the manager of a hedge fund is undertaking a securities offering when offering and selling interests in the fund to outside investors. Undertaking a securities offering without competent counsel invites significant regulatory and litigation risk for the fund's manager and principals. You should expect a law firm that assists with the formation of a hedge fund to (1) advise you as to the applicable regulatory requirements and assist with important filings, (2) counsel you on key structural considerations in light of current market imperatives, (3) provide robust disclosure and governance documents (including an offering memorandum, limited partnership or operating agreement, and subscription documentation), (4) assist in developing marketing strategies and collateral materials, and (5) provide other documentation and advice as may be necessary to launch the fund in a compliant manner.

FOR ADDITIONAL INFORMATION REGARDING FUND FORMATION CONTACT BRENT GILLET DIRECTLY AT (404) 607-6940.



## ABOUT THE INVESTMENT LAW GROUP

We have substantial experience structuring and establishing a wide variety of investment funds and their management companies. We advise on all aspects of operations, registration, and regulatory and compliance matters for alternative investment funds (e.g., hedge funds, forex funds, commodity pools, funds of funds, private equity funds, venture capital funds, real estate funds, and energy funds), commodity pool operators, commodity trading advisors, and registered investment companies.

As a boutique law firm focused on the investment management industry, we are capable of handling sophisticated legal matters while providing our clients with an unsurpassed level of personal service. Clients choose our firm because of our expertise, experience, integrity, and desire to outperform in every aspect.

### FUND FORMATION SERVICES

- Hedge Funds
- Incubator Funds
- Offshore Structures
- Private Equity Funds
- Real Estate Funds
- Venture Capital Funds
- Registered Investment Companies
- Commodity Pools
- Forex Funds

### OUR ATTORNEYS UNDERSTAND

- Seed Investment Strategies
- Third-party Marketing Arrangements
- Affiliated Broker-dealers
- Side-letter Agreements
- Marketing & Advertising Restrictions
- Deferred Compensation Structures
- Joint Back-office Arrangements
- ERISA Restrictions
- Soft-dollar Arrangements

### REGISTRATION & COMPLIANCE

- Registered Investment Advisers
- Commodity Pool Operators
- Commodity Trading Advisors
- New Form ADV Rules
- Dodd-Frank Act Compliance
- Ongoing Compliance Requirements

### WE ROUTINELY INTERFACE WITH

- Securities & Exchange Commission
- Commodity Futures Trading Commission
- Financial Industry Regulatory Authority
- National Futures Association
- State Securities Divisions

### FOR MORE INFORMATION PLEASE CONTACT:

Brent S. Gillett, Esq.  
(404) 607-6940  
bgillett@investmentlawgroup.com