

How to Set Up Your Own Hedge Fund

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By and large there seem to be two groups of people in circulation these days: those who want to run a hedge fund and those that want to invest in them. For many, the dream of running a hedge fund is realized once they move beyond the bounds of cocktail party chatter and investigate for themselves what is required to set up a hedge fund. Luckily for Main Street, the answers from Wall Street are amazingly simple. Today, pretty much anyone with \$15k or thereabouts can start a hedge fund. What money cannot buy is talent, courage and entrepreneurial drive.

Traders and money managers often dream about one day running their own hedge fund, managing large sums of money, and competing toe-to-toe with the world's top traders. For the uninitiated, the first step toward setting up a hedge fund is getting a better grasp on what exactly a hedge fund is and what it is not.

Not a Mutual Fund. Unlike a mutual fund, a hedge fund is not open to any and all investors and it cannot advertise for investors. Unlike a mutual fund, a hedge fund can use any means necessary to make money. The SEC does not allow a mutual fund manager to use derivatives or employ shorting strategies to make money. As a mutual fund manager is limited to taking long positions in stocks and in bonds, there is more risk to investing in the typical mutual fund than investing in the typical hedge fund. Unlike a mutual fund manager, a hedge fund manager can use long and short positions and is better positioned to make money in good and bad markets.

A mutual fund manager is paid on the basis of the amount of assets under management and makes money even when he or she loses money for investors. Unlike a mutual fund manager, a hedge fund manager is paid primarily for results. Unlike a mutual fund manager, a hedge fund manager often invests significant amounts of his or her own money into the funds that they manage.

Unlike a mutual fund manager, a hedge fund manager must aggressively preserve capital and make money for investors. Hedge fund managers cannot afford to be “gunslingers” and take uncalculated risks since, as the old adage states, “it takes money to make money.” For these reasons, hedge funds are far more attractive to investors than mutual funds. It is widely agreed that the best minds in the money management business have moved from mutual funds and brokerages to the world of hedge funds.

Hedge or Hedged Fund? The term “hedge fund” was reportedly coined by Alfred Winslow Jones in the 1940s. Hedge funds are private investment pools of money. Originally, a hedge fund invested in equities, used leverage, and actually had to “hedge” and protect itself against market swings by taking long and short positions. Only a hedging fund was actually called a “hedged fund.”

A hedge fund is structured as a limited partnership structured to give the general partner (*e.g.*, the fund manager) a share of the profits earned on the limited partner's (*e.g.*, the investors) money. The profit sharing (*e.g.* called a "performance fee" if referring to an offshore fund or an "incentive allocation" if referring to an onshore fund) is typically 20 percent of the fund's profits. It is believed that probably about the time when the powers that be on Wall Street changed the term from "hedged fund" to "hedge fund," it added on management fees. Management fees – typically 1 to 2 percent of assets under management -- are paid to support the cost of day-to-day fund operations. From an investor's standpoint, management fees are unfortunate in that they cause fund managers to focus on asset gathering rather than fund performance. The best hedge funds are those that actually engage in arbitrage and employ hedging strategies and duck or minimize management fees.

As noted, a genuine hedge fund has a manager that engages in arbitrage and employs hedging strategies.

So-called "hedge fund managers" that use traditional, long-only equity strategies and do not hedge in fact operate a type of mutual fund, and an expensive one at that. A hedge fund manager that uses large amounts of leverage to take long positions but fails to use short positions to protect against market bottoms will most likely fail.

Though they represent a very small portion of the U.S. financial markets, hedge funds are (reportedly) rapidly increasing in number and pose a threat to world financial markets (allegedly). Whatever growth in the industry exists, it is fueled by increased interest from both the top and bottom levels of the investing public. At the top level, hedge funds attract a mix of institutional investors, pension plans, funds of hedge funds, endowments, and foundations seeking to diversify their portfolios. At the bottom level (under \$200 million in assets), hedge funds attract the working wealthy and their IRAs, high net worth investors, family offices, and small businesses looking for superior returns. This growth has not escaped the notice of the SEC, which has expressed concerns about the retailization of hedge funds and its potential impact on the securities markets.

Getting Started

It is very easy for people to join the hedge fund industry. Setting up a hedge fund gets easier every year. By networking, some of the best legal and financial services talent in the business is either a click or a phone call away. Brokerages, lawyers and accountants team up in order to provide a one-stop shop approach to developing and launching a hedge fund. Much of the consultation work (if not all of it) is conducted over the phone or Internet.

Key items needed to start a hedge fund are the following: money, a lawyer, a prime (or introducing) broker, office space (or a home office), and eventually, an accountant.

Money. The first people hedge fund managers tap for seed capital money are friends and family members. It is hard to attract institutional investors to a new fund. The first investors in a new fund are usually the fund manager's close associates and family members who know and trust the fund manager. As noted, all hedge funds have some if not most of their manager's wealth invested in them.

Legal Services. The legal development process normally begins with a planning consultation. This is when important issues (*e.g.*, investment adviser registration, location of the hedge fund and its management, reliance on safe harbors and exemptions, etc.) are addressed and resolved. A good legal consultation will expose areas (outside the legal process) that need further planning. Once the course is charted, the legal development process begins. The fund and management company entities are first formed in their appropriate jurisdictions. This enables the fund manager to begin the process of opening bank and brokerage accounts and preparing for the administrative needs of the hedge fund. After the entities are formed, the legal team gathers the necessary information to form the operating agreements for the entities and then the offering documents, first in draft stage and then finalized for distribution to prospective investors.

Prime Broker Services. Once the lawyer is engaged, the hedge fund is organized, and the offering documents are drafted, the next thing needed is a relationship with a prime (or introducing) broker. An introducing broker is a registered broker/dealer that has an agreement with a prime broker to use that firm's custody and clearing services. A good prime broker or introducing broker will provide marketing and capital introduction services. Conventional advertising and marketing of hedge funds is not allowed but workarounds have been developed by brokers so that good fund managers get the right kind of investor attention. When setting up a hedge fund, it is best to stay away from the retail brokerage firms since they are not geared toward hedge funds and the needs of hedge fund managers.

Office Space. Advances in technology and the proliferation of information have made investment research and trading convenient as well as efficient. One can work from any location where there is high-speed Internet service. As everyone knows someone starting a hedge fund these days, the industry cannot not keep track of all the hedge fund managers and their business operations, whether based at home or at a hedge fund hotel. There is no stigma to running a hedge fund from home. Hedge fund managers — the best in the business — can and do work from home. Enough said.

Hedge Fund Mechanics. To start a hedge fund, the aspiring hedge fund manager needs to set up the hedge fund entity and the management company. In the United States, the hedge fund is typically established as a limited partnership and in some cases as a limited liability company. With hedge fund start ups, the management company will also function as the hedge fund's general partner and is set up as a limited liability company or, in some special cases, as a corporation.

The lawyer is responsible for drafting the offering documents. Some fund organizers try to draft their own set of documents or use a family member who is a lawyer with experience in a specialty other than securities law. In most cases, it will be obvious to the potential investor that proper legal counsel was lacking. A poor set of offering documents is a mark against the hedge fund manager.

One document that is of particular importance is the private placement memorandum (PPM), since potential investors generally rely heavily on the information that the PPM provides. The PPM is an extensive document individually created for each hedge fund. Although there are no specific disclosure requirements for the PPM (provided the offering is made solely to accredited investors) and a lot of boilerplate language is used, basic information about the hedge fund's manager and the hedge fund itself is disclosed. The information provided is general in nature, and it normally presents in broad terms the fund's investment strategies and practices. For example, disclosures generally include the fact that the hedge fund's manager may invest fund assets in illiquid, difficult-to-value securities, and that the hedge fund manager reserves the discretion to value such securities as he believes appropriate under the circumstances. Also often included is a disclosure about the hedge fund manager having discretion to invest fund assets outside the stated strategies. PPMs tend to be very protective of the hedge fund manager. As a fallback measure, the PPM will list every type of security, commodity, or futures contract in the financial market to provide the hedge fund manager with freedom and latitude to make money.

The PPM usually provides information about the qualifications and procedures for a prospective investor to become a limited partner. It also provides information on fund operations, such as fund expenses, allocations of gains and losses, and tax aspects of investing in the fund. Disclosure of lock-up periods, redemption rights and procedures, fund service providers, potential conflicts of interests to investors, conflicts of interest due to fund valuation procedures, "side-by-side management" of multiple accounts, 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 that introduce investors to the fund, and further disclosure of how soft dollars are used. Copies of financial statements may be provided with the PPM.

Fiduciary Audits. In theory, the investment policy and strategy sections of the PPM exist to help investors evaluate the hedge fund as an investment opportunity. Therefore, PPMs should be written with accountability in mind. Consider the PPM that states that "the goal of the fund is capital preservation." Unless capital preservation is clearly defined in terms of asset allocation, one might expect that all of the fund's assets consist of principal protected investments with specific maturity dates as such investment would most likely preserve capital. Given this, PPMs should not state capital preservation as a goal unless the fund invests in items that return the principal investment. When used in a PPM, the terms "capital preservation," "liquidity and marketability," "risk aversion" need to be defined (and adhered to by the hedge fund manager) with a future audit in mind.

In the future, there may be a trend toward investment policy audits (at the top levels of the hedge fund industry). An investment policy audit evaluates whether the hedge fund manager is in compliance with the statements made in the investment policy and investment strategy section of the PPM. An asset allocation audit examines whether the fund's portfolio is within the range of a PPMs stated asset allocations percentages.

Time Line. The legal process of setting up a hedge fund usually can be completed within 60-90 days, though registration as an investment adviser, specialized circumstances, or delays in providing information can lengthen the fund launch process.

“Accredited Investors” and Due Diligence. Offerings made to “accredited investors” exclusively are exempt from disclosure requirements under Rule 506. If the offering is made to accredited investors only, issuers are not required to provide any specific information to prospective investors. The term “accredited investors” is currently (see below) defined to include:

- Individuals who have a net worth, or joint net worth with their spouse, above \$1,000,000, or who have income above \$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, or who are directors, officers, or general partners of the hedge fund or its general partner; and
- Certain institutional investors, including banks, savings and loan associations, registered brokers, dealers and investment companies, licensed small business investment companies, corporations, partnerships, limited liability companies, and business trusts with more than \$5,000,000 in assets; and
- Many, if not most, employee benefit plans and trusts with more than \$5,000,000 in assets.

Of course, the hedge fund may wish to allow non-accredited investors into the fund, in which case it will not be exempt from disclosure requirements. Moreover, even if the fund will only open to “accredited investors,” those investors will want information about the fund before buying into it. Indeed, prospective investors will often subject the fund and its managers to an extensive process of due diligence. Investors often spend significant resources, frequently hiring a consultant or a private investigation firm, to discover or verify information about the background and reputation of a hedge fund adviser. Prospective investors may gain access to brokers, administrators, and other service providers during the initial due diligence process, verifying most information contained in the PPM (including the adviser's history). Since the PPM usually is the starting point for those conducting due diligence, it remains a crucial document, even for offerings made exclusively to “accredited investors.”

Proposed Change to Accredited Investor Standard. In mid-December of 2006, the SEC voted to propose several new rules that are intended to provide additional protections to investors in hedge funds. One of the proposals would define a new category of accredited investor that would be used for offers and sales of securities issued by hedge funds and other private investment pools to natural persons (e.g., individuals). The proposed definition would include any natural person who (a) meets either the net worth test or income test specified in rule 501(a) or rule 215, as applicable, and (b) owns at least \$2.5 million in investments, as defined in the proposed rules. The SEC states that rule proposal to increase accredited client standards reflects its concerns over the retailization of the hedge fund industry and desire to protect unsophisticated investors.

The foregoing SEC proposed rule change, if adopted, would not affect hedge fund managers with less than \$30 million under management, unless the state in which the hedge fund manager is based in adopts some form of the proposed the SEC rule (not a likely event outside of California).

Another rule proposal would create an anti-fraud rule that would have the effect of looking through a hedge fund to its investors. The proposal would make it a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser for a pooled investment vehicle to make false or misleading statements or to otherwise defraud investors or prospective investors in that pool. The rule as proposed would apply to all investment advisers for pooled investment vehicles, regardless of whether the investment adviser is registered with the SEC.

Investment Adviser Registration. In some cases (subject to a state-by-state determination), a hedge fund manager will have to register with his or her state as an investment adviser if he or she has less than \$25 million under management. If the fund manager has more than \$30 million under management, he would need to register with the SEC as an investment adviser once he has 15 clients.

In August of 2006, the U.S. Court of Appeals vacated the SEC's rule that required more fund managers to register as investment advisers via an expanded definition of a "client" under the Investment Advisers Act of 1940. The expanded definition of a "client" imposed a look through rule counting every investor in a hedge fund as a client of the fund manager. The SEC did not appeal the decision of the court to nix this expanded definition of a client.

As a result, for purposes of SEC (not state) investment adviser registration, any hedge fund manager with \$30 million or more under management that has had fewer than 15 clients in the past 12 months and does not hold himself out as an investment adviser can avoid registration. For investment advisers based outside the United States, only U.S. clients are counted.

As a practical matter, "holding out" would seem to be a moot question in the case of the hedge fund manager that acts to increase funds under management by seeking additional investors, and registration should be considered seriously on those grounds

alone once the fund manager has more than 15 investors in the fund he or she manages. If the fund manager is actively adding investors to its hedge fund, it is hard to believe that the fund manager is not “holding out” his services as an investment adviser (despite the view of some that hedge fund investors are spontaneously generated without any effort at all).

For those hedge fund managers with less than \$30 million under management, state investment adviser registration issues are relevant. It is impossible to make a blanket statement pertaining to registration requirements and exemption options, except to say that they vary by state and fund structure. In general, the strictest states are located on the West Coast, with the state of Utah and Colorado being the most hostile toward hedge funds and hedge fund managers. Texas and Arizona are strict states, but very fair in their approach to regulating hedge fund managers. California is one of the slowest states to process investment adviser registration. On the East Coast the toughest states in which to base hedge fund management, due to strict approach to regulating of investment advisers, are New Hampshire, Connecticut and Massachusetts.

In those states where the fund manager must register as an investment adviser, the Series 65 (or its equivalent) is required, unless the state is satisfied with some other credential, such as that of a Certified Financial Planner. No sponsor is needed to take the Series 65 exam.

Side Letters. Investments in a hedge fund are subject to the fund’s offering documents (PPM, limited partnership agreement, etc.). A hedge fund manager may enter into a separate agreement (*e.g.*, side letter) with an investor in the hedge fund. Typically, seed capital investors and large institutional investors seek preferential terms from a hedge fund’s manager in a side letter. A side letter provides preferential treatment to the investor that obtains the side letter. Other investors in the fund do not benefit from the terms of the side letter. Side letters cover a range of topics. They may provide the investor with reduced fees or impose limits on the expenses that can be charged to the hedge fund. Side letters may grant the investor special redemption rights (*e.g.*, no “claw back,” a percentage of the amount redeemed that is held back from the investor for a specified period of time) and modify the lock-up period (*e.g.*, a time period during which an investor cannot redeem money from the hedge fund) or notice period for withdrawals from the hedge fund. Some side letters provide the investor with daily or weekly net asset values for the fund and information on levels of leverage and risk. They may also grant to an investor “most favored nation” status. This status automatically provides an investor the most favorable terms or conditions granted to other investors through side letters.

The problem with side letters is that they may create a new share class in the fund and/or cause a breach in the hedge fund manager’s fiduciary duty to the hedge fund. Fiduciaries of a hedge fund owe an identical obligation to each investor in the fund. Should a side letter favor one investor at the expense of another, legal complications could arise. In some cases, the terms of a side letter may be so unique that the investor is

arguably, in legal and economic senses, a separate client of the fund manager rather than just another investor in the fund.

Incubator Hedge Funds

There is an alternative approach for hedge fund managers who want to test the waters before spending \$15k or more to set up a hedge fund. Setting up an incubator hedge fund allows a hedge fund manager to develop a track record which will assist in attracting investors later in time.

An “incubator” can be created by breaking down the hedge fund development process into two stages and isolating the first.

Stage One. The first stage sets up the hedge fund and management company, and creates the required operating documents and resolutions. Completion of the first stage allows the hedge fund to begin trading and developing an auditable performance record. The incubator fund, in nearly all cases, is seeded with the fund manager’s money. By trading under this structure, the hedge fund manager develops a track record, which, once audited by an accountant, can be marketed legally to potential investors through the offering documents which are developed in the second stage.

Stage Two. In the second stage, the offering documents are developed and an audit of the fund is completed by an accountant. The offering documents, with the financial statement of the hedge fund, is circulated to prospective investors.

Starting out with an incubator method affords the opportunity for those with a skill for trading (often in their personal accounts) to break down the hedge fund development process into a cost manageable undertaking. One of the caveats of the incubator approach to launching a hedge fund is that the aspiring fund manager is not paid for trading his own money. The acceptance of third party money (and whether this is permitted depends on the state or country where hedge fund management is based), creates a fiduciary obligation and risk for which the hedge fund manager is not paid. Acceptance of third party money into an incubator fund, in the rare case when allowable, is not recommended, given the legal exposure it creates for the hedge fund manager.

Offshore

Hedge funds are set up as offshore or onshore funds to allow for different groups of investors. U.S. based hedge fund managers who have significant potential investors outside the United States and/or U.S. tax-exempt investors typically create offshore funds. Many hedge fund managers use offshore hedge funds to provide privacy to investors. In those cases where complete investor confidentiality and privacy are necessary, an offshore fund should not accept U.S. investors and the fund manager should not be based in the United States.

Confusing to some is the use of onshore and offshore funds in a master/feeder structure. The master/feeder structure allows a hedge fund manager to manage money for a broad spectrum of investors. The master fund, structured as an offshore corporation (but treated as a partnership for U.S. tax purposes via a “check-the-box” election), engages in all trading activity. A hedge fund manager will pool money and “feed” it in to a master fund and allocate trading gains and losses back to the onshore and offshore feeder funds based on the percentage assets under management in each feeder fund. A master/feeder structure typically includes (in addition to the master fund company) a U.S. limited partnership or limited liability company as the feeder fund for U.S. taxable investors and a foreign corporation as the offshore feeder for foreign investors and U.S. tax-exempt investors.

If U.S. taxable investors invest in or effectively control an offshore hedge fund, some complex U.S. tax rules applicable to controlled foreign corporations, foreign personal holding companies, or passive foreign investment companies (PFIC) need to be addressed. However, these rules are manageable when knowledgeable tax advisors are on board.

An offshore fund is set up outside of the United States in offshore financial centers (“OFC”) and is usually managed from a low or zero tax jurisdiction. OFCs are countries that cater to the establishment and administration of mutual and hedge funds. Offshore funds generally attract the investment of U.S. tax-exempt entities, such as pension funds, charitable trusts, foundations, retirement plans and accounts, and endowments, as well as non-U.S. residents.

U.S. tax-exempt investors favor investments in offshore hedge funds because they may have exposure to U.S. taxation if they invest in U.S. based hedge funds. Under U.S. tax laws, a tax-exempt investor (such as an IRA, an ERISA-type retirement plan, a foundation, or an endowment) is liable for income tax on “unrelated business taxable income” (“UBTI”), notwithstanding its tax-exempt status. UBTI exposure exists when a U.S. tax-exempt investor invests in a hedge fund that uses leverage (e.g., trades on margin). The UBTI tax is avoided by investing in an offshore hedge fund. A U.S. based hedge fund manager should consider setting up an offshore fund if he or she manages money for foreign and/or U.S. tax-exempt investors.

For a new hedge fund manager who is a small operator and for whom the extra costs are a major burden, the best location to launch an offshore hedge fund or a master feeder fund is the Cayman Islands or the Bahamas. Both countries have tiered statutory regimes for hedge funds, allowing hedge funds to start out as unregistered funds and then later upgrading to registered fund status if necessary. Hedge fund attorneys in both countries are familiar with hedge fund start ups and will work with a new hedge fund manager. Related service providers (accountants, administrators, etc.) in both countries are good, with the Cayman Islands offering a greater number of service providers.

Good News

Despite some bad press, hedge funds are here to stay and remain an intriguing topic du jour. Hedge funds are no longer for the elite. Hedge funds will grow in good and bad times because they have complete market freedom. The hedge fund industry has years of success ahead of it. With respect to traditional mutual funds, it is safe to say that the market is self correcting and that investors will continue to gravitate away from them toward hedge funds. In a capitalist country, talented money managers will find profitable outlets for the skills, regardless of government regulation. Hedge funds are about making money and running a hedge fund is a great way to do so. Starting a hedge fund is probably one of the most efficient ways to make money today.