HEDGE FUND STRUCTURAL CONSIDERATIONS

KEY DECISIONS WHEN SETTING UP A DOMESTIC OR OFFSHORE FUND

By John S. Lore, Esq.

CAPITAL FUND
LAW GROUP

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Emerging hedge fund managers face a labyrinth of regulatory and tax considerations, investor reporting requirements, and business operation issues. Managers must also balance investor relationships, capital raising, developing their investment strategies, and a myriad of other roles. Operating a hedge fund entails significant legal exposure, with substantial liability for improper disclosure. Even inadvertent mistakes can lead to substantial personal liability.

The SEC, the CFTC, the NFA and state securities commissions have developed a network of complex regulations with which a fund sponsor must comply to avoid liability. In recent years SEC regulations have undergone and continue to undergo major shifts, largely in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank 2010) and the Jumpstart Our Business Startups Act (JOBS Act 2012). Failure to properly navigate the complex and continually changing regulations carries significant liability, including personal civil liability and criminal penalties in some cases.

The structure of a hedge fund is dependent on a number of tax, regulatory, and financial considerations. Fund structure is also driven in large part by the fund’s strategy, such as the degree of liquidity of the portfolio investments. The fund structure should be developed based on careful and thorough analysis with assistance of an experienced fund attorney.

OPEN OR CLOSED-SOURCE FUND?

A closed-end fund is an investment fund intended to last for a fixed term, usually between five and ten years. Investors in a closed-end fund are generally not permitted to make withdrawals or additional capital contributions during the life of the fund. Most real estate funds, private equity funds, venture capital funds, and other funds investing in illiquid assets are structured as closed-end funds. Most hedge funds, on the other hand, invest primarily in liquid assets, and are structured as open-end funds, allowing investors to make periodic redemptions and contributions (subject to limitations in the fund's offering documents).

3(c)(1) Funds or 3(c)(7) Funds?

The Investment Company Act of 1940 generally requires investment companies to register with the SEC. The Investment Company Act is the regulatory structure under which mutual funds are regulated. Hedge funds and private equity funds are typically structured to be exempt from the Investment Company Act under one of two exemptions: Section 3(c)(1) or Section 3(c)(7).

3(c)(1) Funds

A 3(c)(1) fund is limited to 100 investors, all of which should be "accredited investors" pursuant to Regulation D (although there are certain exceptions). An accredited investor (if an individual) must have either (i) a minimum of $1 million net worth or (ii) $200,000 annual income/ $300,000 if combined with spouse, or (if an entity or trust) a minimum of $5 million net worth. As a general rule, most startup funds are structured as 3(c)(1) funds because of the lower investor suitability requirements.

> "Because of the high barrier to investment, the 3(c)(7) is typically used only by established funds backed by institutional investors"

3(c)(7) Funds

A 3(c)(7) fund must be owned by "qualified purchasers." A qualified purchaser (if an individual) must have a minimum of $5 million in net investments, or (if an entity or trust) a minimum of $25 million in investments. Section 3(c)(7) funds may technically have unlimited investors but typically limit the number of investors to 2,000 to avoid registration under the Securities Exchange Act of 1934 as a publicly traded partnership. Because of the high barrier to investment, the 3(c)(7) exemption is typically used only by established funds backed by institutional investors.

> "If a fund sponsor expects to have only U.S. investors, a domestic fund structure is sufficient."

DOMESTIC OR OFFSHORE FUND?

Another initial consideration when structuring a fund is whether to form the fund domestically, offshore or both. If a fund sponsor expects to have only U.S. investors, a domestic fund structure is sufficient. However, if a sponsor anticipates significant participation by offshore investors an appropriate offshore fund in a tax neutral jurisdiction will be needed to shield such investors from US tax liability.

Unrelated Business Taxable Income (UBTI)

Even if foreign investors are not anticipated, a fund manager should consider setting up an offshore fund if the fund anticipates that its investors will include US tax-exempt investors (IRAs, pension plans, endowments, etc.) and if the fund plans to use leverage (technically known as acquisition indebtedness) in its investment. Otherwise tax-exempt entities may be subject to UBTI to the extent of the acquisition indebtedness used by the fund.

DOMESTIC FUND STRUTURE

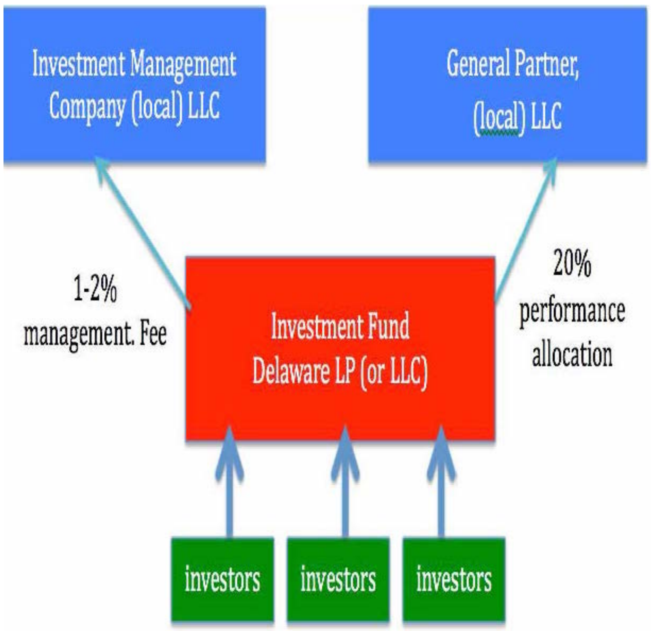
A domestic-only investment fund structure is typically comprised of the following entities:

• A limited partnership to act as the fund entity (although LLCs are becoming increasingly popular). The fund entity is formed in the state of Delaware.

• An LLC to act as the investment manager and general partner (GP) of the fund (managing member in the case of an LLC).

The investment manager/GP entity is typically formed in the jurisdiction of the fund sponsor. For hedge fund sponsors that anticipate creating multiple funds, the general partner and the investment manager are formed as two distinct entities. This is done to allow subsequent funds to maintain separate general partners for liability purposes.

In New York City (for local tax reasons), even hedge funds that do not anticipate subsequent funds should form a separate GP and investment manager for tax purposes. With the two-entity structure, management fees are paid to the investment manager, while performance allocation (carried interest) is allocated to the general partners.

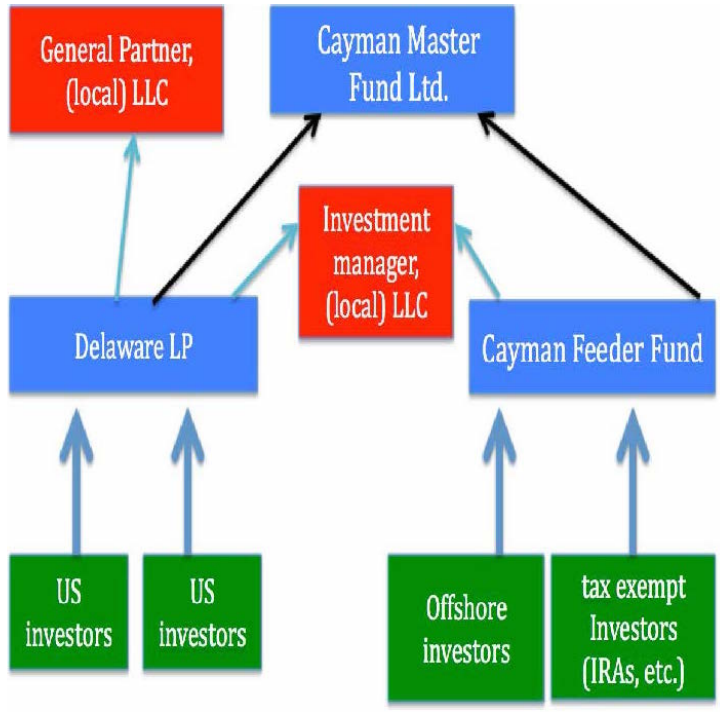


OFFSHORE FUND STRUCTURES

When properly set up, an offshore fund structure blocks offshore and tax-exempt US investors from direct US tax liability. The most common offshore fund structures are the master-feeder structure and the side-by-side structure.

Master-Feeder Fund

A master feeder structure consists of a domestic feeder fund and an offshore feeder fund (in a tax-free jurisdiction) that feed into a single offshore master fund, where all the trading activity of the fund takes place.



Parallel Fund Structure

A side-by-side structure has a U.S. fund and domestic fund that parallel each other in trading and have the same investment manager, but maintain separate investment portfolios.

Offshore Jurisdictions

Once the structure of the offshore fund has been determined, the next step is choosing an offshore jurisdiction. While hedge funds can be formed in a number of reputable jurisdictions, the most common jurisdictions are the Cayman Islands and the British Virgin Islands (BVI).

Cayman Islands

The Cayman Islands has historically been the top choice for offshore funds because of its business friendly structure, stable government and well-developed investment laws. Cayman Islands is a tax-exempt jurisdiction, allowing offshore investors and US tax-exempt investors (that would otherwise be subject to UBTI taxes) to avoid paying US taxes on hedge fund gains. The Cayman Islands is the world leader as a jurisdiction for hedge fund domicile.

British Virgin Islands (BVI)

BVI is a popular jurisdiction for offshore hedge funds and other private funds. BVI has recently gained the reputation as being a cost-effective and convenient jurisdiction. BVI's regulatory structure has sought to create a flexible jurisdiction with streamlined processes and strong legal certainty. BVI's regulatory filing fees are considerably lower than those of the Cayman Islands.

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John S. Lore, Esq. is the managing partner of Capital Fund Law Group, a boutique law firm providing expertise focused on the alternative investment industry. Call 801.456.3620 or email us to schedule a consultation to discuss your fund.