MoneyScience

Site News, Notes, Links and Resources for the Quantitative Finance Community

Strategic Hedge Fund Planning

Tue, 20 Mar 2012 11:32:00 GMT

By Attorney Hannah M. Terhune, JD, LLM (Taxation)

2012 © Email: hterhune@capitalmanagementservicesgroup.com Telephone: (307) 213-4732

Creating a hedge fund to protect and manage your assets or the assets of others for a fee is a practical way to earn a living. Successful hedge funds continue to attract the wealthy, the working not-so-wealthy, businesses, and pension funds looking for better investment options. Despite recent law changes, the United States still offers a favorable environment for smaller hedge fund startups. The purpose of this article is to highlight key U.S. hedge fund development and planning issues of interest to hedge fund sponsors worldwide.

Why the United States?

Even if you are based in another country, consider forming a U.S. hedge fund. The United States offers easy low cost access to the legal, tax, accounting, retail and institutional brokerage, and the regulatory services needed by a hedge fund sponsor to organize a hedge fund. Despite what some investors think about the purported negativity surrounding the United States, many more investors continue to establish U.S. based hedge funds because of the minimal expenses associated with starting a U.S. hedge fund. Hedge fund sponsors (i.e., the organizer(s) of the hedge fund) based outside the United States are usually surprised and delighted to learn about the "light touch" of U.S. regulation and low costs associated with forming a U.S. hedge fund.

More Articles from Hannah Terhune

- How to Start a Hedge Fund
- Hedge Fund Performance Fees
- Partnership Tax Issues of Offshore Hedge Funds
- Starting an Offshore Fund
- Must Hedge Funds Register as Commodity Pool Operators?
- Starting a Forex Fund
- Managing Offshore Funds - A View from the Beach
- Hedge Funds - Raising Capital and Internet Offers
- Investment Advisor Registration and Regulation
- Hedge Funds and Introducing Brokers
- Mixing Investment Adviser and Brokerage Services
- Forex Trader-to-Forex Fund Manager - Starting a Forex Fund
- Drafting Hedge Fund Performance Allocations
- Due Diligence, Disclosure and Fund Managers

How long does it take to start a hedge fund?

It really depends on the particular circumstances because no two funds (including the people who want to start them) are completely alike. In the United States, companies can be formed in a matter of just a few minutes. For example, in the State of Florida, a company can be formed over the Internet in less than ten minutes for about $120 USD. In the United States, no minimal capital is needed to form a company. Even a U.S. tax identification number (i.e., EIN or "employer identification number") can be obtained quickly from the U.S. Internal Revenue Service over the Internet.

In general, and assuming no registration is required, the average U.S. hedge fund takes about four (4) weeks to organize and launch, including the time needed to prepare offering documents and arrange for the hedge fund's bank and brokerage accounts.

Minimal Legal Infrastructure Needed

To start a U.S. hedge fund, you generally need to form two business entities: the hedge fund, and its investment manager. The hedge fund is typically set up as either a Delaware Limited Partnership (LP) or Limited Liability Company (LLC). For tax reasons, hedge fund sponsors based in New York or Texas should consider setting up three companies: the hedge fund, the investment manager and a management company. The investment adviser can be set up as an LLC, or as some other type of business entity in your home state or country.

Hedge fund sponsors based offshore can set up both a hedge fund and its management company in the United States.

Why a Delaware Hedge Fund?

In the United States, hedge funds are found chiefly in Delaware. U.S. hedge funds are established primarily in Delaware because Delaware offers the most advanced business friendly law in the United States. In fact, Delaware's business friendly environment is attractive to companies across the globe, not just hedge funds. Governing law matters. Delaware corporate law affords directors and officers a great deal of discretion in managing the business free from the undue interference of shareholders and regulators.

Delaware's highly regarded reputation stems from the Court of Chancery that focuses solely on company law. The Court of Chancery has earned a reputation for fairness and decisiveness when hearing disputes between investors and hedge fund managers. Indeed, the Delaware "brand" of company law has been "exported" to several other countries. Moreover, Delaware is one of the most protective jurisdictions in the world of proprietary information.

The issue of privacy extends beyond Delaware's borders to other U.S. states. A 2006 Government Accountability Office report, found that most other states do not require ownership information when businesses are formed or don't have to submit periodic reports. Read the GAO 2006 Report of U.S. Company Formations In addition to Delaware, Nevada and Wyoming are considered advantageous places to set up a company. In any event, given the depth, privacy, predictability and pro-business cast of Delaware's company law, it makes good business sense to set up a hedge fund in Delaware.

How many investors can invest in a U.S. hedge fund?

If you set up a U.S. hedge fund you have two choices. If all of your investors, without exception, are "qualified purchasers," your U.S. hedge fund can accept up to 500 investors. This type of hedge fund is referred to as a "3(c)(7) fund." Qualified purchasers" are generally those that have $5 million in net investment assets. Once a 3(c)(7) fund reaches 500 investors, it may be required to register under the Securities Exchange Act of 1934.

If you are not able to satisfy the qualified purchasers only requirement, your U.S. hedge fund will have to operate on a smaller scale; one thatcan accept up to 100 investors. This type of hedge fund is referred to as a "3(c)(1) fund." Of the 100 investors it can accept, only 35 can be non-accredited investors.

The Investment Company Act of 1940 provides for certain exemptions from registration under the Investment Company Act (i.e., 3(c)(1). However, operating under one of these exemptions does not negate the need to file a Form D with the SEC on behalf of the hedge fund, and to file related state "blue sky" filings. Additionally, operating under one of the Investment Company Act exemptions does not negate the need of the hedge fund's manager to register as an investment adviser.

Equity Funds

If the hedge fund trades securities, ETFs, etc., and has U.S. investors, the hedge fund manager must register either with the SEC or its "home" state (or country) as an investment adviser, unless an exemption from investment adviser registration is available to it

Spot Forex, Commodities and Managed Futures Funds

If the hedge fund trades in one or more of the following: spot forex, futures contracts, commodity options (including options on futures contracts), leverage contracts involving certain precious metals, futures contracts, commodity options traded on a board of trade, foreign futures or foreign options, and has U.S. investors; then the hedge fund manager must register with the U.S. National Futures Association (NFA), unless an exemption from registration is available.

Recently, the NFA eliminated the exemption contained in Rule 4.13(a)(4)--a rule relied upon by a substantial portion of the hedge fund industry. Hedge fund managers operating commodity pools under Rule 4.13(a)(4) have until December 31, 2012 to register as commodity pool operators, unless they can avail themselves of some other exemption.

Use of Offshore Hedge Fund Manager to Avoid Home Country Hurdles

A U.S. hedge fund's investment manager can be set up in your home country, offshore, or in the United States. Unfortunately, many potential managers live in countries where the capital formation, tax and regulatory hurdles to become a hedge fund manager are insurmountable. Many countries require a working background in finance, substantial education, and other credentials to be licensed as a hedge fund manager. Even if you have the necessary background and experience, you may not be able to obtain licensing in your home country simply because the regulators do not favor smaller one-man operations. If you are based in a country like that, consider setting yourself up as an investment manager either in the United States or elsewhere.

Set Up a U.S. Hedge Fund Manager

As stated previously, in the United States, companies can be formed in minutes and a U.S. visit is not required. When setting up a hedge fund manager outside of your home country (or state), arrange for a "virtual office" so that you have both a working and physical address outside of your home country (or state). These arrangements allow you have to a hedge fund manager based in another part of the world with few, if any, regulatory barriers to hedge fund management. Note that you can use the hedge fund management company not only to serve as the fund's investment manager, but also to operate a managed account business (i.e., unlike a hedge fund, managed account customer money is not pooled).

Use of Investment Adviser Sub-Contracts

Many hedge fund sponsors opt to set up a hedge fund management company outside of their home country, whether for tax, commercial, or regulatory reasons. If you (as the hedge fund sponsor) set up the hedge fund management company outside of your home country, you should have a sub-agreement for "advisory" services between yourself and the offshore hedge fund management company.

In the United States, an investment adviser is an investment manager. However, there is legal distinction between "investment manager" and "investment adviser" in most other countries. If you live in a country where such a distinction exists, and you set up the hedge fund's manager in such a country, you should position yourself through contracts as an investment adviser to the offshore investment manager. Such "advisory" services (i.e., an independent research analyst) are not usually a regulated business activity. To do this, you need an agreement between the offshore investment manager and the hedge fund, and a sub-agreement between the investment manager and the investment adviser. The goal of the agreements, considered together, is to allow you to offer research services to the offshore investment manager for a fee.

When the agreements are drafted properly and timely executed, you will be able to control the timing, tax character and amount of taxable income reportable in your home country (i.e., income tax deferral). A hedge fund manager seeking to defer substantial amounts of management and performance fees should use third-party (i.e., "outside") directors to ensure that the deferral mechanisms are respected for home country tax purposes.

U.S. Investment Adviser Registration

Many hedge fund sponsors choose to set up a U.S. investment manager to avoid home country licensing issues, and to make the hedge fund more attractive to U.S. investors. Another reason for considering U.S. investment adviser registration is to satisfy a brokerage and/or bank's requirement that a hedge fund's manager be licensed somewhere before it is willing to supply bank and/or brokerages services. If your home country's licensing requirements put investment manager registration out of reach, consider getting licensed in the United States.

Fortunately, a foreign based investment manager is eligible to register with the U.S. Securities and Exchange Commission (SEC) without regard to the amount of assets under management. The SEC registration process is very simple and relatively streamlined. On balance, the SEC is a very light regulator of foreign-based hedge fund managers.

Exemptions for U.S. Based Investment Mangers

If you opt to set up a U.S. based investment manager, you may not be eligible for SEC registration. U.S. based investment advisers must register with the SEC or their "home" state. Any U.S. based investment adviser with less than $150 million assets under management generally must register with its "home" state; you are not eligible to register with the SEC.

The good news is that most U.S. states have generous exemptions from registration as an investment manager. A hedge fund manager with less $150 million assets under management based in state that exempts it from state-level investment adviser registration, does not have to register at all with any regulatory authority; provided, that the hedge fund does not trade spot forex, futures and or commodities. The net effect of this is that a U.S. investment manager can be formed and ready for operation relatively soon after initiating the process.

U.S. Regulatory Filings--Blue Sky

The sale of any hedge fund interest to any U.S. investor triggers U.S. Securities and Exchange Commission (SEC) and state-level reporting requirements for the hedge fund. A timely Form D must be filed with the (SEC). This is the case even if the hedge fund is formed outside the United States. Both the SEC and state-level filings for the hedge fund are referred to as "blue sky" filings. The blue sky filing requirements can be confusing. Blue sky filings have nothing to do with whether the hedge fund's manager is required to be registered as an investment adviser.

The most important thing to understand is that the requirement to file blue sky filings is triggered by the hedge fund's sale of an interest to a U.S. investor. Many hedge fund managers wrongly believe (or are wrongly advised by brokers) that simply because they are exempt from registration as an investment manager, the hedge fund they operate is not required to file blue sky. That simply is not the case. Again, blue sky filings have to do with an investor's subscription to a hedge fund interest. Blue sky filings have nothing to do with whether the hedge fund's manager is required to be registered as an investment adviser.

Many U.S. states require that a copy of the SEC-filed Form D be provided to the state along with the state's filing fee. The blue sky filing requirement and filing fees vary from state to state. Moreover, some states require that the hedge fund file blue sky documents on an annual basis (e.g., Alaska).

Many U.S. states require that a copy of the SEC filed Form D be provided to the state along with the states' filing fee. The blue sky filing requirements and filing fees vary from state to state. In some states, the hedge fund blue sky filing must be renewed annually (i.e., Alaska). The SEC and state blue sky filings apply to any hedge fund that accepts U.S. investors even if the hedge fund trades spot forex, managed futures or commodities and without respect to whether the hedge fund manager is required to be registered with the U.S. National Futures Association (NFA).

U.S. "Qualified Client" and "Accredited Investor," and Charging Hedge Fund Fees

In the United States, much is made about the terms "qualified client" and "accredited investor" for good reason. The reason is that when a hedge fund has a SEC-registered fund manager, the hedge fund performance fee can be charged only to qualified clients. This is also the case in many U.S. states when a hedge fund's manager is a state-registered investment adviser (i.e., California follows the SEC rules).

Recently, the SEC changed the definition of a qualified client and accredited investor. SEC rules permit certain private offerings to be made without registration and without requiring specified disclosures, if sales are made only to "accredited investors." Generally, accredited investors include individuals with a minimum annual income or $1 million in net worth, excluding the value of the primary residence, and most entities and institutions with $5 million in assets. A non-accredited investor is simply one that does not meet the definition of an accredited investor. A U.S. hedge fund can accept up to 35 non-accredited investors.

As stated above, SEC-registered (and many state registered hedge fund managers) U.S. hedge fund managers can charge a performance fee (also referred to as an incentive allocation or performance allocation) only to qualified clients. The performance fee cannot be charged to either accredited or non-accredited investors. Generally, qualified clients include individuals with a net worth of $2 million, excluding the value of the primary residence, or investors with $1 million of assets under management with the hedge fund manager.

Be certain that your expectations about charging performance fees are correct. On the other hand, management fees can be charged to all investors. If the investors in your hedge fund are not qualified clients, avoid U.S. SEC registration or base the investment manager in a U.S. state or foreign country that does not require investment adviser registration.

Hedge Fund Offering Documents

Offering documents are the key to hedge fund sales. While there is no requirement that prospective investors in a U.S. hedge fund be provided with offering documents, it is good (and common industry practice) to do so. Most hedge funds provide written information to their investors in the form of a private offering memorandum (Memorandum). Offering documents-- referring to both the prospectus and subscription agreement--go by several names and/or acronyms including: Private Placement Memorandum, PPM, Offering Memorandum, OMM, or Prospectus. Whatever it is called, offering documents are extensive documents individually created for each hedge fund.

In the United States, offering documents include a private placement memorandum (PPM, OM or prospectus), a limited partner (or limited liability company) agreement, and a subscription agreement. If the hedge fund's manager is registered with a U.S. federal or state regulator, the offering document "package" will included a Form ADV Part 2, which describes the investment manager in detail.

Offering documents for an offshore hedge fund include the private placement memorandum and the subscription agreement.

Incubator Hedge Funds

If you delay drafting your hedge fund's offering documents and are willing to defer collection of management and performance fees, you can operate an incubator hedge fund. In the United States, the incubator hedge fund is established with two companies—the hedge fund and its investment manager. In many other countries, a hedge fund incubator can be established with one company and the investment manager can be established at a later date.

Until the time you have the offering documents ready for use with customers, you can deposit your own money as "seed capital," and/or money from friends and family into the hedge fund, and begin developing a track record. While you can accept money from friends and family, you cannot charge them performance and management fees.

One of the biggest advantages of the incubator hedge fund approach is that it allows you to start and fine-tune your investment strategy while generating a record of trading performance that can be used to transition to a full-fledged hedge fund when you are ready. The key difference between a full-fledged hedge fund and an incubator hedge fund is the ability to charge performance and management fees and the availability of offering documents.

Hedge Fund Banking and Brokerage Services

You cannot use your personal account as the hedge fund's account. The hedge fund needs its own bank and brokerage account. The hedge fund does not need to have a prime broker or an introducing broker. In fact, you should consider using the broker with which you are already familiar and presumably have a good trading record. Nearly all small hedge funds start out with retail online brokers.

Many hedge fund sponsors of offshore hedge funds want to use a U.S. broker. While it may take longer than expected to open a U.S. brokerage account, the process is speeded up considerably when the offshore hedge fund has a bank account.

In the United States, bank accounts can be opened over the Internet with minimal documentation and very modest initial deposits. In addition, operating costs such as monthly bank maintenance fees - are relatively low in the United States when compared to most other countries. Banking in the United States presents a lesser burden to a hedge fund sponsor than banking in most other parts of the world. U.S. banks and brokers generally do not require a hedge fund's investment manager to be licensed by a regulator in order to open accounts. For these reasons, the United States presents an extremely attractive option for banking and brokerage services for sponsors of smaller hedge funds.

Conclusion

The purpose of this article was to highlight recent U.S. hedge fund development and planning issues of interest to hedge fund sponsors worldwide. If you are considering starting a hedge fund, consider all of the advantages offered by forming your fund in the United States. The U.S. remains one of the best countries on earth in which to start a hedge fund and, within the United States; Delaware is considered one of the top states for establishing a hedge fund due to its business friendly environment. The U.S. hedge fund industry promises to offer great potential in the years ahead to those based in the United States and in other countries.

About Hannah Terhune, Attorney

A veteran hedge fund attorney in private practice for two decades, Ms. Terhune and her staff of professionals through Capital Services Group provide advice and services to a wide range of investment management clients, including active investors, active traders, day traders, investment advisers and hedge funds on six continents. Ms. Hannah M. Terhune has served with KPMG Peat Marwick LLP (Palo Alto), Deloitte &Touche LLP, (San Jose) and the United States Tax Court, Washington, D.C. Ms. Terhune has written over 100 articles and white papers on hedge funds and tax matters. Ms. Terhune holds two law degrees. She attended in law from New York University's School of Law in New York City and received a Master of Law in Taxation in 1991. She also attended George Mason University School of Law in Arlington, Virginia and received a Juris Doctor in 1989. She attended the American University in Washington, D.C. and received a Bachelor of Arts in Public Relations. For many years, she shared her wisdom and wealth of knowledge as a tax law columnist for WorldTrade Executive, Inc. At times, she has served as an adjunct professor, lecturing in taxation, business, and accounting at George Mason University's Graduate School of Management and at the Columbus School of Law at Catholic University, Washington, D.C. Hannah served as military lawyer (Judge Advocate General or "JAG") with the United States Army, Special Operations Command. Her prior military service includes serving as the JAG at the 426 th Foreign Internal Defense/Unconventional Warfare Battalion (component of U.S.A. Special Operations Command) located in Upland, California. She also served as the Aide-de-Camp to Brigadier General Robert Lucas while attached to the 351 st Civil Affairs Command, located in Mountain View, California. She also served with the 221 st Military Policy Brigade located in San Jose, California.

About Capital Management Services Group, Inc .

Capital Management Services Group is a law firm catering to active investors, active traders, investment advisers and hedge funds worldwide. Thanks to our hundreds of highly satisfied clients around the world and our leading role as a contributor to the alternative investment media, we have built up one of the most trusted brands in the hedge fund development business. Capital Management Services Group offers direct client access to comprehensive hedge fund development and launch services, hedge fund back office services, small business planning, wealth preservation and asset protection advice and services to customers on six continents. We offer great value, low fees, and superior service and advice. We are wealth services professionals with the goal of providing exceptional care to a select few.

For more information about Miss Terhune and Capital Management Services Group, visit capitalmanagementservicesgroup.com .

Hannah Terhune, Esquire (United States)

Telephone: (307) 213-4732 | Facsimile: (866) 748-3939 | Skype: CapitalManagementServicesGroup

regulation hedge funds, deloitte &touche llp, hedge fund banking, capital management services group inc . capital management services, hedge fund, introducing brokers, launch services, advice and services, corporate law, commodity pool operators, active traders, finance, regulatory services, brokerages services, company law, business friendly law, hannah m. terhune, finance, financial economics, financial services, investment, hedge funds, funds, prime brokerage, management fee, due diligence, performance fee, hedge fund startup, ms_hedgefunds, ms_guestpost

Related content

News: New 'Corzine Rule' For Hedge Funds Sets Tongues Wagging - http://t.co/e5DHfDWo
4 hours ago - MoneyScience Twitter Stream
moneyscience: New 'Corzine Rule' For Hedge Funds Sets Tongues Wagging - http://t.co/e5DHfDWo

Blog: Forex Trader-to-Forex Fund Manager - Starting a Forex Fund
Capital Management Services Group yesterday

Blog: Mixing Investment Advisor and Brokerage Services
Capital Management Services Group yesterday

News: Weekly Announcements – January 16, 2012
61 days ago - The SSRN Blog
Here are the latest announcements from SSRN: A Short Tribute to Larry Ribstein I am personally and professionally saddened at the sudden passing of my friend,...

News: eToro OpenBook Winner of the 2011 Superior Trading and Resource (STAR) Award
12 hours ago - PR Newswire: Banking & Financial Services
NEW YORK and LONDON, March 21, 2012 /PRNewswire/ -- eToro, the world's largest investment network announced today that http://www.TraderPlanet.com, the financial social-networ...

Blog: Will business repay the chancellor's generosity?
Robert Peston Blog 3 hours ago