

## **Setting Up a Hedge Fund – Where Should it Be and What Should You Do**

The problem with writing about a topic such as starting up a hedge fund is that there are so many questions that have to be asked – for example, where do you want the fund to be established. The answer to these questions usually begs another question, so I am just warning you that this is going to be a long and, perhaps, convoluted paper, and indeed it will probably be spread over 2 months. This month will be more of a descriptive and discussion paper – next month will be more procedure and checklist orientated.

As mentioned above, this paper is meant to discuss and describe how to set up a hedge fund and not how to become a hedge fund manager (a "HFM"). However, you cannot do a credible job in the context of setting up a hedge fund without some reference to the HFM and its structure and organisation. Gone are the good (?) old days when a trader could leave the prop desk of a Goldman, a Morgan Stanley or Solomon and take a one-room office and start trading with one or two colleagues and spread the word that they were the new HFM on the block and "please send me your cheque".

The whole market has become much more sophisticated and investors have become much more demanding. The hedge fund industry started in the US and initially grew because of the involvement of enlightened high net worth investors, supporting a growing band of very smart traders. Today, it is the institutional investor who calls the shots and has taken over what was similar to the classic US "mom and pop" shop – albeit with extremely wealthy moms and pops.

It is, I think, fair to say that it has taken the institutional investors quite some time to become comfortable with these markets and to flex their muscles. This flexing of muscles has been increased following the 2007 – 2009 financial debacle and the institutional and professional investors have begun to make some quite draconian demands of the managers of funds they want to invest in.

The institutional investors were disappointed that hedge funds made losses in 2008, but they recognised that most hedge funds actually returned between 15% and 20% Alpha, despite net losses. Et ergo many institutional investors have maintained their interest in the sector, but they are looking more closely at the HFMs and target funds.

I can remember some fifteen or eighteen years ago speaking to a major European hedge fund investor – one of the first European bank fund of funds operators – who had five criteria that they considered when selecting a manager.

1. Obviously, they wanted good consistent performance, but, in addition, they wanted:
2. A unique or different trading strategy;
3. A high percentage of the HFM's own personal wealth invested in the fund;
4. Capacity to take continual level of investment (subscriptions) from the fund of funds investor; and, of course
5. A clean reputation.

At no time in my discussions with this particular fund of funds investor did he discuss reviewing their risk management programme or back office procedures. That has changed.

All this is a lead-in to stating that before you can consider establishing a hedge fund, the prospective HFM must take great care when establishing its management company or other corporate entity, about which more later.

### **Target Investors - Onshore or Offshore?**

When discussing establishing a hedge fund, the first thing one must do is clarify whether we are talking about setting up a hedge fund for US tax payers, in which case we are probably discussing a US Limited Partnership

("LP") or a US Limited Liability Company ("LLC") - (collectively for this paper a "US Fund", or an Offshore Fund ("OSF")), or both.

## **Tax Considerations**

The attraction of the different structures basically depends on both the residence and, often more importantly, the tax status of the investor. Certainly US tax payers will want a US Fund to enable them to 'look through' the investment activities of their fund so that they can complete their K1's and fulfil their tax reporting (and tax paying) obligations efficiently and with full clarity. Offshore Funds being incorporated open-ended investment vehicles, usually issuing shares, are not "look through" vehicles and as such the tax liability, if any, is usually limited to capital gains paid by the non-US or US tax-exempt investor, upon liquidation of the shares.

Firstly, most offshore funds are tax-exempt vehicles; the responsibility to pay tax lies with the institutional investor.

Offshore Funds attract non-US investors, many of whom are reluctant to invest in US Funds because they are, understandably, nervous about having their affairs scrutinised by the US authorities. They also appeal to US tax-exempt investors who wish to avoid Unrelated Business Income Tax ("UBIT"). UBIT can be created in a number of ways but in simple terms it is often a problem that is created by leverage. However, US tax-exempt investors abhor the US Fund structure, because the US tax authorities will consider that any profit made on the leveraged portion of the portfolio is Unrelated Business Taxable Income.

The US tax-exempt investor has, to date, been able to avoid this by investing in the shares of an Offshore Fund, because it is not a "look through" vehicle. The Offshore Fund may utilise leverage within its trading strategy but that is not deemed to be being utilised by each investor individually, which is the case in "look through" vehicles.

As a result, any potential taxable event, on the US tax-exempt investor will only occur when the investor liquidates its interest in the fund. However, any gain made by purchasing shares of a fund and reselling or redeeming them at a later date, does not realise any UBIT, even if the Offshore Fund's portfolio was hugely leveraged.

It can be seen that the choice of jurisdiction of a fund whether it is onshore in the US or offshore, is largely dependent upon the target market for that fund. Historically, most US HFMs have started their careers by targeting US investors and, for the most part, those have been US tax paying investors. Therefore, they have established a US Fund. Ultimately the successful HFM will almost certainly wish to target offshore (that is, offshore of the United States) and US tax-exempt investors. As such the HFM will require an Offshore Fund. As a result many HFMs have two stand alone funds that they manage – one a US Fund and the other an Offshore Fund, established in one of a variety of jurisdictions.

### **Master-Feeder Funds**

However, for administrative convenience, some HFMs establish a Master Feeder Fund so that they only have to manage one portfolio. The Master Feeder Fund structure is essentially very simple. There are several variations of structures, but the one I personally prefer is what I call the “Triangular Master Feeder Fund”. This means that a Master Fund is established, which can be just a simple trading company, into which the US Fund invests from onshore and the Offshore Fund also invests – both of these are deemed “Feeder Funds”. The Master Fund need only be a simple trading company, because it will only have two shareholders. The only specific requirement that will be imposed upon the Master Fund is that it maintains its books using partnership accounting so that it is able to provide reports to the US Fund, which will enable its investors to comply with tax reporting requirements and produce their K1’s efficiently.

There are several advantages to a Master-Feeder Fund structure' but, basically, they come down to efficiency, for the HFM, of managing just one portfolio and cost savings, in as much as the majority of the work, both administratively and from an accounting point of view, will be carried on with regard to the Master Fund. Furthermore, the cost of establishing and operating a Master Feeder structure with the Master Fund and two Feeder Funds is usually substantially less than the total cost incurred of establishing and running two stand alone funds with separate portfolios.

## **Advisors**

Having decided who your target market is - US tax-payers or non-US and/or US tax-exempt investors, the next important decision that has to be made by a promoter of a hedge fund is the selection of the jurisdiction and the appointment of various service providers including prime broker, payment bank, administrator, custodian, if required, auditor, and attorney. Of these, the first that you should select is the attorney. You need to select an attorney who is familiar with the fund industry and, as with all service providers, getting recommendations from people in the industry and references is extremely important. Your attorney will help you initially set up your management company and then set up your Fund.

Sometimes you may find your selected prime broker or administrator will be able to assist you in setting up the Fund, but even so they should only act as "Project Managers" because you need to have a "hands on" attorney who can help you avoid the pitfalls. This is even more important today, with the plethora of proposed legislation and regulation "coming down the Pike". Historically, a good attorney has helped fund promoters, not only with regard to tax efficiency and the structure and jurisdiction selected, but also by ensuring that the documentation avoids potential risk of litigation. Today, at the date of writing this paper, the legal situation, both in the US and externally, is unclear. What is known is that the new regulations that will come into place will produce a minefield in which competent attorneys will thrive with any US Fund.

## **Jurisdiction - Onshore**

The first choice is jurisdiction, in the case of your US Fund, tends to be either Delaware, which has much publicised tax advantages, or the jurisdiction where the HFM is based, such as Illinois. In this decision you will be guided by your professional advisors, both legal and tax. Similarly the choice as to whether your US Fund should be a US LP or US LLC is highly dependent upon the management. On the face of it, there is little practical difference between an LLC and an LP, but those differences can be quite crucial. Investors in a US Fund are either Limited Partners or Members and their liability is limited to the amount of money they invest. LP's have a General Partner, who is usually the HFM and/or promoter of the fund in question, but that General Partner usually has unlimited liability in the event of something going disastrously wrong with the LP. In an LLC the General Partner's position in an LLC is called "Managing Member". It is the General Partner or the Managing Member that represents the governing body of the "corporate entity" of a US Fund. Both LLP and LLCs maintain the books as if they were partnerships, which enable the investors to make their tax returns, as, discussed above.

## **Jurisdiction - Offshore**

The selection of a jurisdiction for an offshore fund is undoubtedly more complex than a US Fund because each jurisdiction has its own perceived advantages and disadvantages. Historically, the most popular jurisdiction for offshore funds established by US HFMs has been the Cayman Islands, closely followed by the British Virgin Islands and Bermuda -- and in the dim past the Bahamas. These, together with the British offshore centres in the Channel Islands and the Isle of Man, have been deemed to be lightly regulated and in the past that was largely their main attraction.

## **Attitude to Regulations**

However in the last fifteen years or so attitudes towards the attraction and/or the necessity of regulation have changed and today there is no doubt that investors seek out centres which have stronger regulations, as they deem that strong regulations will provide protection for their capital, which is arguable. Furthermore the introduction of the EU AIFM (Alternative Investment Fund Management) Directive, which, at the time of writing, is still subject to negotiation, has, nevertheless, led a lot of HFMs, to investigate the 'pros' and 'cons' of seeking to establish funds in Europe, many of which are 'UCITS' funds - see more about UCITS below

In the past couple of years there has been a noticeable shift from the Caymans to Europe, not only by new start-up funds, but also with a growing number of re-domiciliations of Cayman and BVI funds to European jurisdictions, such as Dublin, which recently introduced legislation to allow Irish companies, which hitherto had not been permitted to re-domicile, to do so, Malta has also benefited from this change, having had accommodating regulations to permit re-domiciliation for the past 10 years or more.

I believe this trend started as soon as the concentrated verbal attacks on the "Offshore Tax Havens" by Western Politicians, including, inter alia, President Obama, Gordon Brown, Ms Merkel and M. Sarkozy began. This was quite some time before those campaigns resulted in the raft of anti hedge fund legislation was proposed on both sides of the Atlantic. These laws and regulations have yet to be fully ratified in either US or EU. Nevertheless it is likely that there will be a sort of cross-border contagion effect, as both the US regulations will effect non-US investors and HFMs and the EU regulations, embodied in the AIFM Directive, will hurt not only non-EU and specifically US investors and HFMs, but also EU investors.

## EU AIFM Directive

Although, as I have indicated, we have yet to see exactly how the EU AIFM Directive will eventually 'pan-out', we have a pretty clear idea about some of the core points. Firstly, it is unlikely that the Directive will be implemented in Europe before the 3rd or 4th quarter of 2012. This is not as much time as it first seems, but it does give anyone currently contemplating setting up an Offshore Fund to forward plan. You may be asking yourself, "How can I do that without knowing what the Directive is going to say?" - a reasonable question, but I believe you can afford to make some assumptions and act accordingly. These assumptions concern some potential regulations that seem almost certain to be introduced and include:

- i) It is likely that a non-EU regulated fund will be permitted to be marketed to EU investors unless the HFM is based in and regulated by an EU regulator or is regulated by a regulator in another jurisdiction with equivalent regulations to the EU, This Equivalence Test will probably result in a very complex and lengthy series of negotiations;
- ii) It may be that if the Fund is established in an EU member state, the HFM will have been qualified by the regulator in that member state and therefore the Fund and the HFM are acceptable;
- iii) It is likely that investors resident in EU Member States will be prohibited from investing in non-qualifying fund – i.e. – a fund that does not meet the EU standards described.

Why have I spent so much time and ink on this topic? Because I think that, unless your non-US sales are going to be *limited* to the BRIC, MENA, SE Asian and other non-EU markets you must plan forward so you can meet the EU challenge and that probably entails setting up an EU registered fund and, perhaps, establishing an Investment Management Company in the EU.

## **UCITS**

UCITS is Euro speak for "Undertakings for Collective Investments in Transferable Securities and is an EU term describing a particular EU regulated fund product. Apart from only being available in the EU and further in EU member state that have implemented the relevant EU directives, the UCITS is a very much more regulated product than a Cayman fund or indeed any of the EU professional funds, such as the Dublin "QIF" (Qualifying Investor Fund), the Luxembourg "SIF" (Sophisticated Investor Fund), or the Maltese "PIF (Professional Investor Fund). For example UCITS have quite intrusive investment restrictions, which many hedge fund strategies cannot work with. These include restrictions on selling short and leverage as well as at least two valuation days per month - in fact, most UCITS are daily dealing. It is obvious that many hedge fund strategies cannot be used in a UCITS; nevertheless there has been a very strong demand for UCITS funds by HFMs and other fund promoters.

It is also a widely held belief that because it has a higher standard of regulation UCITS are safer, forgetting that at least two UCITS were decimated by Madoff. There are other considerations to be made before forming a UCITS, including the fact that \$100 million AUM is a necessary early stage target, because set-up cost will be much more than a QIF, PIF, or SIF, as will the annual operating costs and to compensate for that the promoter must introduce a very competent distribution plan to increase AUM and reduce the unit-cost of the higher overheads.

Having said all that, don't reject a UCITS fund without further consideration. For example some Institutional investors are prohibited from investing in any fund that is not a UCITS and that is very persuasive.

## **Non- UCITS Funds**

If you are not yet ready for a UCITS, that does not mean you should not consider establishing a presence in the EU either by setting up an EU

Investment Management Company or an EU QIF, SIF or PIF fund, or both. Just as you must retain a lawyer to set up your management entity (usually an LLC) in the US, so you must retain a lawyer to help you establish your EU management entity. Here your choice may be restricted as some EU Member States require that you set up both the Management company and the Fund in the same jurisdiction, but that is not the case (today) in Malta for example.

### **Master-Feeder Funds (revisited)**

I have already discussed the problems of running two stand-alone funds - one US Fund and one Offshore Fund - and have suggested a Master-Feeder fund as a solution. Subject to clarification of the AIFM regulations, it may be prudent to set up a EU-US Master-Feeder, with say a Maltese PIF as the Master, into which all non-US investors (and US Tax exempt, if allowed in the future) invest direct and US Tax payers invest via the US Fund as a feeder. The Maltese Master Fund would have to maintain its books using partnership type accounting, assuming there is no restrictive accounting regulation on the Horizon.

### **Structuring the Fund**

There are certain things that must be done and decisions that must be made before either the prospective HFM starts working on any of the above or the Fund can be set up. These include, inter alia:

- Firstly the HFM must prepare a detailed business plan so he/she can calculate what the initial establishment costs are for the Investment Manager, two years operating costs and repeat the exercise for the Fund. That will establish the minimum capital needed, before he can expect and revenue from investors.
- Secondly identify service providers and advisors, including an Attorney, Auditor, PB, Administrator and Payment Bank.
- Draft documentation, which MUST be complete and absolutely accurate and must cover all possible situations.

These documents, which will be drafted by the Attorney, will include the Offering Document, the Subscription Application form and the Investment Management Agreement as well as other Service Provider agreements. It will also be necessary to prepare a Pricing Policy Document with the Fund's Independent Administrator and, depending on the strategy, an Asset Verification Agreement, also with the Administrator.

The Offering Document should contain amongst other things a detailed description of the investment strategy and policies, including the markets and assets/instruments traded, the HFM and the individuals who run both the HFM and the Fund, as well as full risk disclosure, investment restrictions that will be followed and both subscription and redemption policies and procedures. And if it is an Offshore Fund the CVs of the members of the Board of Directors.

This is not an exhaustive list of what needs to be done or decisions that need to be made, for example;

- What is the fee structure?
- Do you want an Exchange Listing?
- Will you want sub-funds for different strategies?
- What currency will be the designated currency of the fund?
- Will you need to hedge currency exposure?
- Will you have sizeable cash balances? If so, how will they be managed?
- Will there be any sales fees/commissions charged?
- Who will be responsible for AML (Anti Money Laundering) issues?

That is only scratching the surface - I will expand on this detail next month.

Dermot S. L. Butler is Chairman of Custom House Global Fund Services Limited, a member of the Equity Trust group of companies, which offers a full 24/5, "round the world" and "round the clock" administration service out of fully integrated offices in Chicago, Dublin, Guernsey, Luxembourg, Malta, Singapore and The Netherlands.

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