# HEDGE FUND FORMATION AND SECURITIES LAW COMPLIANCE

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I. Defining “Hedge Fund”

A “hedge fund” is a private investment vehicle organized for the purposes of pooling investors’ assets and of applying a centralized investment strategy and management style. The sponsor of the hedge fund is commonly referred to as the “asset manager” or “investment advisor.” Although historically the defining characteristic of a hedge fund was to “hedge” against market risk and volatility, hedge funds today apply a variety of investment techniques. Instruments used and markets traded also vary and, because financial engineers constantly develop new mechanisms and strategies to access investment opportunities and increase investment returns, it has become difficult to define hedge funds solely by investment style. Hedge funds are, in fact, more readily defined by their form of organization and manner of operation, rather than by the substance of their activities in the financial markets. Hedge funds have the common characteristics of (a) centralized management, (b) co-investment, (c) performance-based compensation, and (d) limited liquidity.

II. Legal Structure

The legal structure of a hedge fund largely depends upon the characteristics of its targeted investors. For example, a private investment vehicle formed to manage assets of U.S. taxable investors will be different from a private investment vehicle formed to manage assets of U.S. tax-exempt investors (such as charitable foundations and pension funds) and non-U.S. investors.

A. Domestic Fund

For the purpose of managing the assets of U.S. taxable investors (U.S. persons other than endowments, charitable foundations, pensions and other tax-exempt investors), a hedge fund is typically organized as a limited liability company (LLC) or limited partnership under state law, as this legal structure affords flexibility and enables the fund to meet both objectives of limited liability and tax efficiency. The most popular jurisdiction is Delaware, as its statutes and case laws provide the greatest flexibility. By purchasing an ownership interest in the LLC or the partnership, an investor becomes a non-managing member (in the case of an LLC) or a limited partner (in the case of a partnership) while the asset manager becomes a managing member (in the case of an LLC) or a general partner (in the case of a partnership).

See Chart I below for a typical domestic fund structure.
As shown above, in an attempt to limit personal liability, the sponsor-asset manager of a domestic fund usually forms another entity to provide advisory services to the domestic fund. Instead of the sponsor-manager firm, it is this new entity that will serve as the managing member (in the case of an LLC) or general partner (in the case of a partnership) of the fund. Depending on the laws of the state in which this advisory firm will be domiciled, the hedge fund manager (i.e., the sponsor-manager) will organize the advisory firm as a limited liability company, corporation or limited partnership. In certain cases, the sponsor-manager will form two entities, one entity to serve as the managing member (or general partner, in the case of a partnership) who will receive performance-based compensation from the fund, and the other entity to serve as the asset manager/advisory firm who will receive 1-2% of asset management fee.

The use of an entity as the general partner or investment adviser, however, will not shield an individual manager from personal liability for fraud and other claims under the federal securities laws.

B. Offshore Fund

For the purpose of managing the assets of non-U.S. investors and U.S. tax-exempt investors (such as endowments, pensions and charitable foundations), an offshore fund is predominantly structured as a corporation and organized in a tax haven jurisdiction. Under tax regimes of many countries, an offshore corporation organized in a tax haven will often enable
non-U.S. investors to defer taxes in their home countries on earnings from the fund until they dispose of their shares. An offshore partnership doesn’t afford such a deferral. In addition, an offshore corporation (that is not engaged in U.S. trade or business and that withholds dividend and interest income) will not be required to file a U.S. tax return; an offshore partnership is required to file a U.S. tax return. Offshore funds are attractive to U.S. tax-exempt investors (e.g., individual retirement accounts, charitable foundations, pensions, endowments and profit sharing trusts) as a method for avoiding tax liabilities related to “unrelated business taxable income.”

As shown in Chart II below, the sponsor-manager of an offshore fund often forms a corporate entity to provide advisory services to the fund. If the sponsor-manager already manages the assets of a domestic fund through a single corporate entity, the managing member or the general partner of such domestic fund may be used to serve as the asset manager of the offshore fund. If the sponsor is managing a domestic fund through two corporate entities, the entity serving as the asset manager of the domestic fund will ordinarily serve as the asset manager to the offshore fund.

**Chart II: Offshore Fund Structure**

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**Sponsor-Manager**
(Limited Liability Company or Limited Partnership)

**Asset Manager**
(Limited Liability Company or Limited Partnership)

**US Tax-Exempt Investors**

**Non-US Investors**

Capital Contribution/Asset Management Services

1-2% Management Fee/Performance Fee

**OFFSHORE FUND**
C. Other Structural Options

Fund managers with both U.S. taxable investors and non-U.S. investors (as well as U.S. tax-exempt investors) would need to establish both a domestic and an offshore fund. In such a situation, either a parallel fund structure or a master-feeder fund structure is utilized. There is various tax, administrative and other issues that the manager should consider in determining whether to utilize a master-feeder fund structure or a parallel fund structure.

1. Parallel Fund Structure

In a parallel fund structure, U.S. investors typically invest in an LLC or a limited partnership organized in the United States and offshore investors and U.S. tax-exempt investors invest in an offshore corporation. The prime broker typically allocates trade tickets between the domestic fund and the offshore fund.

Chart III: Parallel Fund Structure

2. Master-Feeder Fund Structure

This structure allows U.S. investors and non-U.S. investors to invest, indirectly, in the same offshore corporate entity commonly known as the “master fund” by providing two feeder funds, one domestic and one offshore. Mainly for tax reasons, U.S. taxable investors directly invest in a fund organized in the United States. This fund is referred to as the “domestic feeder.” The offshore investors and U.S. tax-exempt investors directly
invest in an offshore corporation. This offshore corporation is referred to as the “offshore feeder.” Each feeder fund, then, invests all assets into the master fund. The fund manager then purchases and sells securities in an account held in the name of the master fund. The master fund can be structured as a limited partnership or an offshore company.

Chart IV: Master-Feeder Structure
3. Mini-Master Fund

U.S. fund managers of offshore funds generally receive their incentive compensation from offshore funds in the form of an incentive fee, as opposed to an incentive allocation from a partnership (note the difference between a fee and an allocation). For many years, fund managers deferred receipt of performance fees generated from their offshore funds in order to avoid taxation and permitted these pre-tax fees to be invested in the offshore funds. In 2008, however, section 475A of the Internal Revenue Code was enacted, which effectively eliminated this tax deferral benefits. With the benefits of tax deferral and the potential for pre-tax appreciation of offshore fees gone, fund managers restructured their fund structure to enable the manager to receive an incentive allocation from the co-investment entity in lieu of a fee. These co-investment structures are commonly referred to as “mini-master fund structure.”

Under a mini-master fund structure, the offshore corporation invests in an entity (the “mini-master fund”) that is treated as a partnership for U.S. federal income tax purposes. The other partner of the mini-master fund is the manager, which itself is organized as an entity treated as a partnership for tax purposes. This way, the manager receives an incentive allocation rather than an incentive fee from the offshore fund. When the underlying trading generates long-term capital gains, non-corporate managers may benefit from a lower tax rate. A mini-master structure can also prevent the application of Section 457A of the IRC to any designated investment or side pocket. Section 457A does not apply to partnership allocations.

The mini-master structure has two types: (a) mini-master parallel structure and (b) mini-master master-feeder structure. Please see Chart V and Chart VI below.
Chart VI: Mini-Master Master-Feeder Structure

**DOMESTIC FEEDER FUND**
(U.S. Limited Liability Company or Limited Partnership)

Sponsor-Manager
(U.S. Limited Liability Company or Limited Partnership)

Management Fee & Performance Allocation

**MINI-MASTER FUND**
(Non-U.S. Entity)
Partnership for U.S. Tax Purposes

**MASTER FUND**
(Non-U.S. Company)
Check the Box

**OFFSHORE FEEDER FUND**
(Non-U.S. Corporation)

U.S. Tax-Exempt Investors
Non-U.S. Investors

**BROKERAGE ACCOUNT**
III. U.S. Securities Law Compliance

A. Fund Regulation: Avoiding Investment Company Status

The Investment Company Act of 1940 (the “Investment Company Act”) defines an “investment company” as any issuer of securities which is engaged primarily in the business of investing, reinvesting or trading securities, and it prohibits any investment company from engaging in the business of buying and selling securities unless it has registered with the SEC or has a valid exemption from registration. Hedge funds fall within the definition of an “investment company” and therefore are required to register as an investment company unless they are qualified for an exemption.

Offshore funds seeking to market their securities (fund products) to U.S. investors or in the United States must also be sensitive to the Investment Company Act. The Investment Company Act prohibits offshore funds from making a public offering in the U.S. through U.S. jurisdictional means unless the SEC issues an order permitting it to register under the Investment Company Act. As a practical matter, the standard imposed by the Investment Company Act requires offshore funds to organize and operate themselves as registered investment companies, which has prevented most offshore funds from obtaining the necessary SEC order.

Registration exemption for both domestic and offshore funds is provided under two provisions of the Investment Company Act: Section 3(c)(1) and Section 3(c)(7).

Section 3(c)(1) of the Investment Company Act, in part, provides an exemption from its registration requirement for a fund whose securities is owned by not more than 100 “persons” at any given time. Hedge fund managers most commonly rely upon Section 3(c)(1) to obtain registration exemption.

Section 3(c)(7) of the Investment Company Act, in part, exempts funds from its registration requirement without limitation as to the number of its beneficial owners as long as the securities are owned exclusively by “qualified purchasers.” A hedge fund with 500 or more investors, however, is required to register its securities with the SEC. A hedge fund operating pursuant to an exemption under either Sections 3(c)(1) or 3(c)(7) of the Investment Company Act may not make any public offering of its securities under the Securities Act of 1933. There are also restrictions on advertising and general solicitation by hedge funds relying on either the Section 3(c)(1) or Section 3(c)(7) exemption.
1. The 100-Beneficial Owner Requirement

For purposes of counting investors in connection with the 100-person limitation imposed by Section 3(c)(1) of the Investment Company Act, normally, each person is counted separately and joint ownership by spouses is considered held by one beneficial owner. “Person” is defined to mean a “natural person or a company.” The SEC will “look-through” a company that invests in a hedge fund and count each of the security holders of that company as a separate investor of the fund, if: (i) the company investing in the hedge fund is either a registered investment company or a private investment company organized pursuant to an exemption under either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act; and (ii) the company beneficially owns 10% or more of the outstanding voting securities of the hedge fund. For offshore funds relying on Section 3(c)(1) that accept U.S. tax-exempt investors, only U.S. investors are counted towards the 100-person limitation.

The Integration Doctrine

When a hedge fund begins to approach the limitation on the number of investors (e.g. 100 persons), the manager cannot avoid the limitation by forming another hedge fund identical to the prior fund.

To prevent managers from creating identical hedge funds each time they approach the 100-person limitation, the SEC applies the “integration” doctrine. In the event that two or more hedge funds, which are managed by the same sponsor, are substantially similar, the SEC will “integrate” such funds so that they will be deemed to constitute one issuer. If the SEC integrates two or more hedge funds, it combines the number of each fund’s investors to determine whether the funds, in the aggregate, are owned by more than 100 persons.

The SEC will not integrate two hedge funds if one is a Section 3(c)(1) fund and the other fund is a Section 3(c)(7) fund. Additionally, the SEC normally does not integrate domestic funds and offshore funds.

2. Qualification Of Investors In A Section 3(c)(1) Fund

For a hedge fund relying on the Section 3(c)(1) exemption, ownership interests in the fund are typically offered to investors pursuant to Rule 506 of Regulation D of the
Securities Act of 1933. Securities offered under Rule 506 of Regulation D may be sold solely to “accredited investors” and, under certain circumstances, up to 35 “sophisticated investors.”

Regulation D provides eight categories of “accredited investor,” which include:

☐ An individual whose net worth, or joint net worth with his or her spouse, at the time of purchase exceeds $1,000,000 (excluding the net value of the investors’ personal residence under the Dodd-Frank Act);

☐ An individual whose individual annual gross income exceeded $200,000, or whose combined annual gross income with his/her spouse exceeded $300,000, in each of the two most recent years, and who has a reasonable expectation of an income in excess of $200,000 individually, or in excess of $300,000 with his or her spouse, in the current year;

☐ Any executive officer, director, managing member or general partner of the issuer of the securities offered;

☐ An employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), (a) whose investment decisions are made by a plan fiduciary, as defined in Section 3(21) of ERISA, which is either a bank, insurance company or registered investment adviser; or (b) having total assets in excess of $5,000,000; or (c) if self-directed, the investment decisions are made solely by persons that are accredited investors;

☐ A trust (and other vehicles), with total assets in excess of $5,000,000 which was not formed for the specific purpose of acquiring an interest in the hedge fund, whose purchase is directed by a sophisticated investor; and

☐ An entity in which each of the equity owners are accredited investors.

A “sophisticated investor” means an investor, either alone or with the investor’s purchaser representative(s), who has such knowledge and experience in financial and
business matters that the investor is capable of evaluating the merits and risks of an investment in the hedge fund.

3. Qualification Of Investors In A Section 3(c)(7) Fund

A person may not invest in a Section 3(c)(7) fund unless such person meets the definition of a “qualified purchaser. The term “qualified purchaser” includes:

- Any natural person who owns not less than $5 million in investments;

- Any “family owned company” that owns at least $5 million in investments and is directly or indirectly owned by or for two or more natural persons who are related as siblings or spouses (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estate of such persons or foundations/charitable organizations/trusts established by or for the benefit of such persons;

- Any other trust that was not formed for specific purpose of acquiring the securities of the Section 3(c)(7) fund and as to which the trustee and each settlor or other person contributing assets to the trust are qualified purchasers;

- Any other person (e.g., an institutional investor) acting for his/her/its own account or the accounts of other qualified purchasers, who in aggregate owns and invests on a discretionary basis not less than $25 million in investments.

B. Fund Manager Regulation: Investment Advisers Act

The Investment Advisers Act of 1940 (the “Advisers Act”) defines an “investment adviser” generally to include a natural person or entity who, for compensation, engages in the business of providing advice to others regarding securities. Investors’ ownership interests in an LLC or a limited partnership is considered as securities under U.S. securities laws. The meaning of “compensation” under this definition may include any form of direct or indirect economic benefit. All hedge fund managers, therefore, fall within the definition of an “investment adviser.” However, they may not be required to register as an investment adviser with the SEC pursuant to various exemptions (they may still be required to register with state securities authorities). The
SEC and each state impose different registration requirements and exemptions from registration for investment advisers.

A hedge fund manager is exempt from registering as an investment adviser under the Advisers Act, if such person or entity (under the Dodd-Frank Act):

- If it’s a U.S. person or entity (i.e., is not a foreign manager):
  - Has had less than $150 million in asset under management; and
  - Manages only pooled investment vehicles (among other things).

- If it’s a foreign manager:
  - Has had less than $25 million of U.S. investors’ assets under management; and
  - Manages only pooled investment vehicles (among other things).

An exempt investment adviser may still be required to comply with the Advisers Act’s other rules, including investor disclosure rules, record keeping and reporting requirements and rules on capital raising. For details of various registration exemptions as well as compliance requirements under the Advisers Act, please referred to our other client memoranda on these subjects.

**Limitation on Registered Advisers Charging Performance Based Fees**

Generally, a hedge fund manager receives performance-based compensation in addition to management fees. However, Section 205(a)(1) of the Advisers Act prohibits investment advisers who are registered or required to be registered with the SEC from receiving performance-based compensation, unless (a) the advisory contract is entered into with funds that are exempted from the definition of “investment company” in the Investment Company Act by section 3(c)(7), (b) the advisory contract is entered into with persons who are not residents of the United States, or (c) each of the investors is a “Qualified Client.” A Qualified Client must be either:

- An investor that the manager reasonably believes that, immediately prior to entering into the performance-based management contract, has a net worth of more than $2,000,000 or is a “qualified purchaser” as defined in the Investment Company Act at the time they enter into the contract;

- An investor that, immediately after entering into the performance-based management contract, has at least $1,000,000 under management with the manager; or
An investor who falls within certain categories of the management or employees of the manager.

Most hedge funds are either section 3(c)(1) funds or section 3(c)(7) funds under the Investment Company Act. In the case of section 3(c)(1) funds, the individual investors of the fund, rather than the fund itself, are considered for purposes of determining “Qualified Client.” In the case of section 3(c)(7) funds, as long as the fund itself meets the Qualified Client requirements, the manager can charge performance-based compensation.

Most states also have similar rules. The legislative intent of this rule is to prevent managers from taking undue risk with investors’ assets in order to receive performance-based compensation. Some states provide relief from this prohibition on performance-based compensation by following the exceptions provided under federal regulatory regime. Other states provide an exception that tracks an older version of the federal rule and impose contract and disclosure obligations on investment advisers.

C. Commodity Exchange Act

A fund manager must register as a commodity pool operator (CPO) under the Commodity Exchange Act, if the fund trades any commodity futures contracts or options thereon. As a CPO, the manager is subject to various record-keeping, reporting and disclosure requirements under the Commodity Exchange Act and related rules adopted by the Commodity Futures Trading Commission.

In addition to the registration requirement, the fund’s offering document must be approved by the National Futures Association prior to its use. If, among other things, the fund’s aggregate initial margin and option premiums for commodity transactions do not exceed 10% of the fund’s assets, or if investors in the fund are limited to “qualified eligible participants,” the fund may request an exemption from many of the regulatory requirements otherwise applicable to it.

In general, a “qualified eligible participant” includes any person who the fund manager reasonably believes at the time that person invests in the fund:

- Owns securities (including pool participations) of issuers not affiliated with such participant and other investments with an aggregate market value of at least $2,000,000; or
Has had on deposit with a futures commission merchant, for its own account at any time during the six-month period preceding the date of sale to that person of an interest in the fund, at least $200,000 in exchange-specified initial margin and option premiums for commodity interest transactions.


Employee retirement or other benefit plans, individual retirement accounts and Keogh accounts are normally considered as “benefit plan investors” when these plans/accounts invest their assets into a fund managed by a fund manager. If the aggregate investment amount from these “benefit plan investors” equals or exceeds, at any time, twenty-five-percent (25%) of the aggregate equity of a fund managed by a fund manager, the fund manager will be deemed to be managing “plan assets” and thus, it will become a “plan fiduciary” under ERISA. As a plan fiduciary, the hedge fund manager would be prohibited from participating in or entering into any transaction that may result in a conflict of interest with the benefit plan investors, among other restrictions.

For this reason, in order to avoid the possibility of becoming a “plan fiduciary,” each time there is an investment or withdrawal in a fund, the fund manager is required to calculate the percentage of assets invested by benefit plan investors in the aggregate. The reporting on this issue is commonly handled by the fund’s administrator.

To discuss these issues further, please consult our attorneys.

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