How do you start a hedge fund?
The new era of hedge fund creation and operational management

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Stonegate Capital Partners
Hedge Fund In A Box™ and PrimeOne™
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How not to start a hedge fund with a long and expensive journey

Until recently, starting or launching a hedge fund was a very expensive and overwhelming task requiring six months or longer to complete, while startup, infrastructure and operational costs ran well into the six-figure range.

The hedge fund manager, who is typically the portfolio manager and/or the head trader, has the core responsibility of managing and trading the fund’s proprietary strategy, which prior to the creation of the hedge fund is typically traded in the manager’s personal account.

The traditional market approach to creating and launching a hedge fund would require the future hedge fund manager not only to run the strategy, but also to oversee many other elements simultaneously. The hedge fund manager must recruit an executive team and support staff, locate office space and negotiate a lease, and select various service providers to be key players in assisting with the operational management of the new hedge fund.

These service providers include fund formation consultants, attorneys, prime brokers, administrators, auditors, tax and advisory firms, compliance firms, media and marketing companies, Web design firms, and software companies. (Certain software applications can help the fund manage its portfolio and perform risk management activities.) Additionally, myriad questions must be answered regarding the detailed structural components of the hedge fund.

Until recently, starting or launching a hedge fund was a very expensive and overwhelming task requiring six months or longer to complete, while startup, infrastructure and operational costs ran well into the six-figure range.
A hedge fund product can be constructed as a single U.S. domestic hedge fund, as a single offshore fund, or as a combined domestic and offshore fund. The decision regarding whether to use a domestic versus an offshore structure will be based primarily on the tax considerations and implications for potential investors.

**Domestic hedge funds: Single funds**

Domestic hedge funds are typically structured as limited partnerships (LPs), with the investment manager serving as the general partner (GP) of the fund. Investors in the fund contribute capital to the partnership and receive partnership interests, and the fund’s gains and losses are passed on pro rata to investors.

Domestic hedge funds are also typically structured as either 3(c)(1) or 3(c)(7) funds, depending on the type of investors that the manager intends to serve. The references to 3(c)(1) and 3(c)(7) indicate that these funds are excluded from registration as investment companies pursuant to Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, which primarily regulates mutual funds. The 3(c)(1) fund is geared mostly toward managers who will cater to high-net-worth or accredited investors, small family offices, foundations, or funds of funds. A 3(c)(1) fund is required to keep the total number of investors at 100 or less.

A 3(c)(7) fund structure is used when a manager’s clients are primarily large institutional investors that the SEC considers to be qualified purchasers under the Investment Company Act. In general, a qualified purchaser is defined as an individual investor with at least $5 million in net investments or an entity with at least $25 million in net investments. The maximum number of investors in a 3(c)(7) fund is 500.

It’s also important to note that a manager may operate both a 3(c)(1) fund and a 3(c)(7) fund, which are quite similar to each other.
**Incubation funds**
In certain situations, structuring an incubation fund is the most appropriate means by which a manager can begin building an investment management business. An incubation fund is a lean, efficient, cost-effective structure that is suitable when a manager is looking to manage his or her own capital for a relatively short period of time (e.g., six to 12 months) before seeking outside capital from investors. This allows the manager to build a performance track record for his or her investment strategy, which can then be marketed to prospective investors.

**Offshore hedge funds: Single funds**
Offshore hedge funds can be domiciled in jurisdictions such as the Cayman Islands, Bermuda, the British Virgin Islands (BVI), Dubai, Guernsey, Jersey, Gibraltar, Hong Kong, the Isle of Man, Switzerland, Luxembourg, Liechtenstein and Nevis, among others. These low-tax or tax-free jurisdictions do not impose corporate-level taxes on offshore hedge funds. The investors are generally taxed in their country of residence. The manager typically selects the fund domicile based on investor sentiment regarding the regulatory regime of the jurisdiction.

Among offshore jurisdictions that are favored by investors, the Cayman Islands, Bermuda and the BVI have historically been the most sought-after because of their strong regulatory structures. When a jurisdiction’s regulatory bodies, such as the Cayman Islands Monetary Authority (CIMA) and the Bermuda Monetary Authority (BMA), maintain strict policies and guidelines, investors view this as a form of risk management and therefore demand that managers select those jurisdictions. Other jurisdictions have also built strong regulatory bodies and have become popular among investors of late.
Domestic and offshore hedge funds: Combined structures

Depending on the type and domicile of prospective investors, the manager may choose to establish onshore and offshore hedge funds that are entirely separate from each other. However, hedge funds can also be created using combined structures such as a master-feeder structure, a side-by-side structure, or a reverse master-feeder structure.

**Master-feeder hedge funds and reverse master-feeders**
The master-feeder structure is a combined hedge fund structure in which the domestic and offshore funds feed into a single offshore master fund. The master-feeder structure allows U.S. investors to contribute to the domestic fund, while foreign investors and tax-exempt U.S. investors can participate in the offshore fund. This structure provides an efficient way to raise capital across international borders.

**Side-by-side hedge funds**
As the name suggests, a side-by-side domestic and offshore structure is just that: a structure whereby the domestic fund and the offshore fund are created to manage the fund strategy pari passu in both funds without a master fund. A side-by-side structure is used more often for hedge fund of funds, as there is a significant amount of work involved to effect a trading strategy under this structure, as well as the duplication of administration for the two funds.
As one might imagine, hedge funds can be structured in a myriad of combinations, resulting in very complex structures by creating cells, separate portfolios, portfolio combinations and reporting conventions. Although extremely complex to create, manage and administer, some of the more exotic hedge fund structures include offshore segregated portfolio companies, master-feeder segregated portfolio companies, and domestic series limited liability companies, and they are typically structured for the purpose of operating as hybrid funds.

Hybrid fund structures typically incorporate investments in other asset classes such as private equity or real estate. These funds are called hybrid funds because of the cross-pollination of certain elements of hedge fund and private equity fund structures. Although significantly more expensive and complex to create and manage, hybrid funds are used when the investment manager allocates to multiple asset classes as a part of his or her core investment thesis and investment strategy.
Other hedge fund features:
Side pockets and multiple share classes

Side pockets are an element of a fund (not a fund structure), and they can be an effective tool for the hedge fund manager and a source of potential returns for the fund’s investors. Side pockets are used as a component of a more traditional hedge fund structure (in lieu of a more expensive hybrid fund structure) in cases in which the manager invests in these illiquid opportunities infrequently. Regardless of the fund structure or domicile, side pockets may also be included in order for the hedge fund to take advantage of illiquid investment opportunities that fall outside the scope of the fund’s core investment objectives.

In addition to side pockets, some managers employ separate share classes for deviations in their trading strategy. For example, a hedge fund manager may have two classes of shares (e.g., Class A and Class B), whereby Class A may only trade equities with no leverage and Class B may trade in equities and options with leverage. Investors would have the option of participating in either share class or a combination of the two share classes.
The GP and legal liabilities

While an individual can act as the GP for a hedge fund, in most cases the manager establishes a limited liability company (LLC) to serve as the fund’s GP. It’s important to note that although structuring the GP as an LLC may afford the manager some level of reduced liability, he or she should have a strong understanding of securities laws. Regardless of the structure or entity used, there are substantial liabilities under the securities laws for which the manager could be held personally responsible, and the manager should seek legal counsel regarding these liabilities.
Historical costs and timelines for starting a hedge fund

The traditional market approach to hedge fund creation, launch and operational management requires significant time investment — and a tremendous upfront capital investment — by the hedge fund manager.

If a potential manager interviews three to five service providers in each category, the manager and his or her team will spend a few hundred hours evaluating all of them. Additionally, the costs associated with this approach are significant. Legal fees can run between $20,000 and $150,000 for domestic and offshore fund formation and attorney representation (depending on the complexity of the fund structure). The manager can spend $15,000 to $25,000 for corporate branding, marketing and website development. Annual audit and tax fees range from $20,000 for small, emerging funds to more than $100,000 for large, complex funds. Annual fund administration fees average $24,000 for emerging hedge funds and more than $100,000 for large, complex funds.

With respect to establishing a U.S. hedge fund, average hedge fund startup costs range from $50,000 to $100,000, and first-year operational costs usually total $75,000 to $150,000. For a manager seeking to launch an offshore hedge fund, startup costs typically average $75,000 to $125,000, with ongoing operational costs ranging from $100,000 to $175,000 per year, depending on the complexity of the fund. In general, a manager that is looking to start either a domestic or offshore hedge fund is faced with budgeting approximately $75,000 in hedge fund startup costs, as well as annual costs averaging $100,000.

**Fund formation services**

One of the first things that a hedge fund manager needs to do in order to start a hedge fund is to retain a firm that is experienced in hedge fund structuring and hedge fund formation. The process includes evaluating and advising on fund structure, formulating the appropriate hedge fund offering documents, structuring the hedge fund company and the management company, as well as drafting the limited partnership agreement (LPA) and operating agreements. The offering documents should include a private placement memorandum (PPM), or offering memorandum, which contains the terms and conditions of the investment offering, along with a discussion of risks and other important factors. The PPM is typically provided to prospective investors.

**Legal services**

Although there is no requirement — legal or otherwise — for a manager to retain an attorney to write the fund’s formation documents, legal counsel should review them to confirm that the fund is compliant with relevant securities laws and not exposed to undue risks.
Prime brokerage and custodial services
The manager also needs to establish a prime brokerage account. Prime brokers are either major investment banks or smaller mini-prime brokers that typically cater to hedge fund managers with assets of $250 million or less. Prime brokers offer traditional institutional brokerage services and a centralized securities clearing facility to hedge funds, which allow the hedge fund’s collateral requirements to be netted across all deals handled by the prime broker. Prime brokerage services include global custody; securities lending/stock loans; trade execution; trade clearing and settlement; trade-aways; portfolio financing and margining; electronic trading systems; order management systems; risk management; portfolio management; and reporting. In addition, some prime brokers provide capital introduction and office space leasing. A few mini-prime brokers self-clear their trading business and act as the custodian for their hedge fund clients. However, most mini-primes maintain a fully disclosed custody and clearing relationship with one or more of the larger global custodians, thereby offering their hedge fund clients a choice of custodians.

Fund administration
Fund administrators provide monthly and annual accounting services to hedge funds. Most of these services are offered monthly and encompass:
- portfolio accounting and reporting;
- partnership accounting and reporting, which includes the calculation of the fund’s net asset value (NAV) and the statement of change in partners’ net capital and partnership interests in each fund class;
- entry, reconciliation and recording of all transactions in the accounting records;
- subscription and redemption account services, including the calculation and processing of management and performance fees; and
- invoicing, cash management, bookkeeping and bank reconciliation.

Marketing and media services
Just as they would with any other business, managers will need to build a corporate brand identity for their hedge fund. This identity should be supported by a logo and accompanying graphics, a website, business cards and stationery, and printed marketing materials (typically a pitch book and a one-page summary).
Audit and tax services
Selecting an audit and tax provider is one of the most important decisions that a manager will make. Although there is no legal requirement for the hedge fund to have an auditor, investors consider the work of the auditor to be a critical factor in due diligence, for obvious reasons. Audit work for hedge funds involves specialized expertise, and the manager should ensure that the fund retains a competent and reputable auditor with considerable brand recognition in the hedge fund industry. In some cases, a startup manager may not need an auditor in the fund’s first year of operation, instead choosing to wait until the second year after launch before retaining an auditor.

Regulatory compliance
A manager may require assistance with regulatory compliance, which involves filing SEC and state investment adviser registrations as appropriate; coordinating the registration process at all stages; submitting account entitlement forms, gaining access to the Investment Adviser Registration Depository (IARD); preparing and filing Parts 1 and 2 of Form ADV; and building the fund’s compliance infrastructure, as well as keeping up to date with ongoing regulatory and compliance matters. Depending on each manager’s particular situation, compliance services may not be needed until the second or third year after launch.

Additional services
Other services that managers may want to consider, depending on the particular needs of their strategy and business, are risk management systems and services; third-party marketing; outsourced chief operating officer (COO) services; and outsourced trading, as well as key man, directors and officers liability (D&O), and other insurance services.
Hedge Fund In A Box\textsuperscript{SM} and the Hedge Fund Wrap Account\textsuperscript{SM}: More streamlined, less costly

A significantly more efficient and cost-effective approach to starting a hedge fund is to take advantage of a comprehensive service offering such as our Stonegate Capital’s Hedge Fund In A Box\textsuperscript{SM} solution, which can be deployed through a Hedge Fund Wrap Account\textsuperscript{SM}. This type of account wraps all the services required to launch and manage a hedge fund into a single service offering.

Under this model, the processes and costs of review, cost analysis and procurement are streamlined, and the primary services, such as fund formation, prime brokerage, fund administration, marketing and media, compliance, and capital introduction, can be provided through one firm. Through the Hedge Fund In A Box\textsuperscript{SM} solution and the Hedge Fund Wrap Account\textsuperscript{SM} structure, the upfront and ongoing costs are reduced by as much as 50–90 percent when compared with the costs that would be incurred under the traditional market approach, while the timeline for launching a hedge fund can be as short as couple of weeks.
Five things that startup hedge funds need to know

1. Raising enough capital (seed money)
   It is important that a new hedge fund be appropriately capitalized. The dollar amount of assets a fund will need to manage to become profitable will usually depend on three things:
   
   • Team size and expectations
   • Investment partners
   • Unique cost structure

   Some hedge fund managers claim profitability with less than $10 million AUM, while others believe that a fund must manage $70 million–$100 million in assets to be considered a serious business venture that has some long-term prospects for survival. The actual number is probably somewhere in the middle, especially considering current market conditions, but everyone’s business is unique, and if performance fees are high, you can sometimes see large profits with relatively low asset amounts.

2. Selecting the right internal team
   A competent team will make the manager’s job easier and contribute to the fund’s success. The most important people to hire are traders who are capable of implementing the fund’s strategy. Funds should look for traders who have managed accounts on their own or traded for another fund. There is no room for compromise as far as a trader’s knowledge and expertise are concerned. Fund managers should make sure they review traders’ performance (as audited by a reputable accounting firm) before hiring them.

   Depending on the dollar amount of assets managed, funds might also need an internal administrative group, but even if they do not need internal assistance, they will need external assistance. The skills that internal administrative personnel need to have will differ depending on how much a fund relies on its external administrator. A good way to determine a candidate’s competence for an internal administrative role is to have the external administrator participate in the interview process. The manager may even hire someone who has been referred by the fund’s external administrator.
3. Choosing the most appropriate service providers
Selecting the wrong service providers is an easy mistake for funds to make. Most funds need a prime broker, an administrator, a placement agent, an attorney and an auditor. Avoiding errors in this area is critical because the fund needs these services in order to operate successfully; further, they are part of the image the fund presents to investors in the marketplace. Hiring service providers that are inexperienced or have a poor reputation could affect the fund’s image in a negative way. In contrast, selecting respected professionals with industry experience and solid reputations provides prospective investors with confidence and sets the fund up for success.

For example, during the process of selecting auditors, it can be tempting for a fund to hire low-cost service providers because audits are perceived as a compliance process rather than a beneficial service. However, funds should bear in mind that auditors opine on their performance and track record. This can come in very handy from a marketing standpoint, especially when dealing with institutional investors. (Also, the cost of a service provider may be less than a fund would normally expect to pay; certain service providers are very accommodating to new funds that don’t have significant external investors — and these providers sometimes offer deep discounts in the initial years of the fund’s life.) Good service providers can also assist with the fund’s documentation process.

In this respect, having knowledgeable counsel is critical, but errors often occur because an independent review is not completed by the fund’s service providers. Whatever a fund decides to include in its documentation, it should make sure that its auditor and tax accountants as well as its attorneys review it before it is finalized. This can help funds avoid issues over the long term.

As they do when selecting the internal team, funds should look for proven experience when choosing service providers. It is very important to hire providers that are reputable and experienced. Funds should ask to see a list of similar clients as well as references and should spend the time necessary to contact the references.
4. Using an optimal cost structure
Funds should choose a cost structure that is not only cost-effective but also most beneficial to existing or prospective investors. By understanding the fund manager’s investment strategy, including the nature of its targeted investors, your service providers can help select the right structure. For example, if you expect to target a large percentage of offshore investors, you might be well-advised to set up an offshore feeder fund that would house all the contributions from tax-exempt and foreign investors. This would help avoid issues your offshore investors might encounter with unrelated business taxable income (UBTI) and manage dividend withholding issues for the fund and its investors. But there are costs associated with establishing an offshore fund; therefore, careful consideration is needed. Deciding which cost structure is right for your fund will depend on the needs of your investors and will always require thought and planning beforehand.

5. Keeping tax considerations in mind
When setting up a hedge fund, there are many factors to consider from a tax standpoint. One of the first items that needs to be addressed is the tax structure of the fund. Most U.S. hedge funds are typically structured as fund limited partnerships, or fund LPs, domiciled in Delaware (that state has a favorable legal environment for business and as such has historically been the preferred locale for U.S. companies). As a partnership, a hedge fund is not a taxable entity; rather, it is treated as a flow-through entity for U.S. tax purposes. This means that the tax effects of the fund’s income and expenses flow to the owners and must be reflected in each partner’s tax returns, regardless of actual cash distributions. Generally speaking, each fund LP will have its own management company and GP. The fund LP will typically be engaged in the hedge fund’s trading activities.

Many hedge fund managers inquire about choosing onshore versus offshore entities. The answer is usually driven by the mix of investors that a hedge fund plans to pursue. Tax-exempt U.S. investors (e.g., pension funds, charitable entities) and foreign investors are generally leery of investing in a U.S. fund for fear that the IRS may try to declare the income unrelated to their tax-exempt purpose (in the case of tax-exempt U.S. entities) or effectively connected to a U.S. trade or business (in the case of foreign investors); either ruling could expose investors to U.S. income tax. For this reason, an offshore structure is generally chosen when the mix of investors includes foreign investors or tax-exempt U.S. entities.
One of the most commonly used structures is called the master-feeder. This structure employs a Cayman master fund, a U.S. feeder fund and a Cayman feeder fund. The master fund is a Cayman corporation that elects to be treated as a partnership for U.S. tax purposes (giving it the flow-through treatment previously discussed). The master fund will trade on behalf of the hedge fund. The U.S. feeder will be a regular U.S. partnership (similar to a fund LP) to which U.S. investors will contribute. The Cayman feeder will be a Cayman corporation and will not have a U.S. presence for U.S. tax purposes. Foreign investors and tax-exempt U.S. entities will invest in the Cayman feeder. Because the feeder fund is a corporation, any tax effects of its income will be blocked at the corporate level and will not flow to the tax-exempt or foreign owners. The gains and losses from the trading that occurs at the master fund level will flow to the U.S. feeder and the Cayman feeder in proportion to the capital that each holds in the master fund. There are other structures that use offshore funds, but this one is the most common.

As mentioned earlier, each hedge fund will generally set up a management company and a GP entity, each of which will file its own tax returns. These entities are typically formed as U.S. LLCs for tax purposes. The principals of the hedge fund are usually the members of the GP and the management company. Each entity serves a distinct purpose. The management company usually receives the management fee income from the hedge fund (one to two percent) as revenues. The expenses of operating the fund (e.g., research, rent, salaries) are deductible from the management company’s income. Again, because the management company is a flow-through entity, the income of the management company is taxable to the principals. The GP typically holds a profits interest in the fund. This entity is where the performance fee, or carried interest, is allocated. For tax purposes, the carry is not a fee in the traditional sense. The 10-20 percent carry is generally calculated as a reallocation of the income and expense items taken out of the fund (that is, away from the LPs) and allocated to the GP such that all the character of the income items (e.g., long-term gain, short-term gain, interest, dividends) is maintained with respect to the GP. There has been much discussion in Congress over the past several years about changing the way that this carry is taxed (i.e., by effectively removing the ability to maintain the character of this income and thereby treating the carry as a fee or ordinary income to the GP), but thus far no legislation has been passed that would alter the character of that income.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) stipulates that advisers of hedge funds and other private funds of a certain size must register with the SEC by March 30, 2012, but makes clear that venture capital managers and certain hedge fund advisers are exempt from the requirement. The SEC’s proposal on hedge fund registration could subject fund managers with less than the $150 million in assets threshold to the regulation as early as 2012. A fund with $75 million in net assets needs to be registered if it is two-times leveraged. The more leverage a smaller fund uses, the more susceptible it is to registration.
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How do you start a hedge fund? The new era of hedge fund creation and operational management

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About Stonegate Capital Partners

Stonegate Capital Partners is an offshore and domestic hedge fund consulting firm which specializes in the creation and operational management elements of offshore and domestic hedge fund products. With offices in New York and Atlanta, the organization provides unparalleled service to startup and emerging hedge fund managers. Leveraging its industry-leading and patent-pending Hedge Fund In A Box™ and PrimeOne™ solutions and its Hedge Fund Wrap Account™ structure, the firm deploys a range of hedge fund services to its clients, including domestic and offshore hedge fund formation, fund administration, fund compliance, prime services, marketing/media, website development, and capital introduction.

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• Compensation and benefits consulting
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