**Basic Hedge Fund Model:**

**Starting / Running a Private Fund – Avoiding Pitfalls**

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* **Objectives Statements**
	+ **For Panel [NFH]**
		- Legal, Financial and Business Issues in Forming a Fund:
			* Corporate Law, and Entity Structure
			* Intellectual Property
			* Tax & ERISA
			* Securities Laws
			* Futures Laws
			* Audits
			* Anti-Money Laundering Laws
			* Fund Manager Income
			* Investor Issues & Running the Business
	+ **For Fund [DMM]**
* Minimum regulation
* Maximum flexibility
* Simple structure
* Tax efficient
* Revenue-producing, with modest risk of personal capital
* **Definition of Hedge Fund [DMM]**
	+ **History -**
	+ **Includes futures**
* **Legal Structure for Fund & Manager [LTW] [comm. NFH & DMM]**
* **Legal protection for Fund Managers** in the entity – don’t leave home without one **[NFH]**
* **LP or LLC for Fund. LLC or S Corp Fund Manager [LTW**]
* Two entities: One for fund, one for Manager
* Salary & distribution issues **[LTW covering tax]**
* Compare Investment partnership vs. Trade or Business **[LTW][**Comments by DMM]
* Master Feeder Offshore Funds –
* Only reason to go offshore is if you have a tax exempt investor (trust or 501(c)(3)
* Save complex structures, such as master feeder trusts, for your second fund, or for an offshore fund; Complex structures can built on these early entities. [DMM and NFH]
* **Delaware vs. Illinois**:
* Legal - **DMM**
* Tax: **[LTW]** - Illinois replacement tax
* Corporate qualifications required in more than one state, Corporate Franchise Tax – [**NFH**]
* **UBTI [LTW]**
* **ERISA Investors [LTW]**
	+ - Plan asset rule; 25%
			* **Manager's money counts in the numerator but not in the denominator. It is a double whammy (that's a technical term).**
			* **If Mgr money is non-ERISA and non-IRA, you leave it out of the calc. The denominator is 200 and the number is how ever much of the 200 is ERISA or IRA.**
			* **If the fund is "plan assets", the Manager has to be careful about charging management and incentive fees to his own IRA. It could look like a premature distribution of IRA assets to its beneficiary.**
		- Not suitable for all investors
* **Creating Additional Funds [DMM]**
* Material differences
* Issues with using multiple strategies or single strategies
* **Operational Documents Needed**: **[NFH]**
* Founders Agreement;
* Offering Memo;
* LLC or LP Agreement;
* Subscription Agreement Brokerage Agreement.
* **Relationship Between Founding Fund Managers [DMM]:**
* Multiple Owners of Management Company **[DMM]**
* Cash invested vs. sweat equity
* Valuation for new partners buying in and old principals exiting
* Who will provide additional capital ?
	+ - Address best case and worst case
		- VC fund incubators want large equity for investment in Fund Manager entity
* The “Pre-Nup” agreement **[NFH]**
	+ - Issue spotting for Founders’ Agreement, discussion items among your founding business partners **[NFH];**
		- **Death, Disability Divorce, Departure, Side Action**
		- ½ of startups, after operating first 12 months, have one person gone [Defensive or offensive approach?]
* **Ownership of Trading Strategy – IP Rights [NFH]**
	+ **Trading Strategy** Belongs to Whom?
	+ **Track Record ?**
	+ **Developed** Where? While employed somewhere else? Might former company have a claim to it?
	+ **Co-developed** with another individual? If so, legal rights assigned to you?
	+ **Protection of Your Intellectual Property**
		- Is protection of your Trading Strategy Possible? Business Process Patent option? See Gardner Carton & Douglas
		- NDAs for Employees and Partners to prevent them from leaving and starting a competing business
		- Balance how much to disclose in O. Memo vs. Proprietary Info
* **Non-Compete Agreement** with Current Employer? **[NFH]**
	+ Does your current, or former, employer’s Non-Compete Agreement or Employment Agreement **impede your starting your business?** To what degree? Applicable after you leave?
	+ Employer perhaps **negotiable** on a supplement to the agreement that would allow you to start your business, compete in their space, but not steal their customers or employees?
* **Name Check [NFH]** Critical before business formation, importance of national, if not global, name check, given the global use (and surveillance) of business names through Internet. Allow sufficient time, because your first choice, or several choices, of name will be taken,

*[Hand out – Incorporation / LLC Formation Checklist, including search vehicles & techniques for “knock out” name search]*

*[Hand out - Filing Fees For Business Formation]*

*[Hand out - Corporate Maintenance Checklist – “Legal Ducks in a Row”*

* **Adhere to Corporate formalities**
	+ Sophisticated Investors want to see papered transactions (prior transactions) before they invest agreements (employment agreements, outside party agreements), Expensive to retroactively paper agreements.
* **Due Diligence - Clean Background is Key [NFH]**
	+ Due Diligence - Investors will conduct on Fund Managers, Background check, criminal, regulatory, tax liens, bankruptcy
	+ Expectations By Investors or Asset Allocators (As to Fund Manger Principals, the entity itself, and prior business and legal history) – All of above, plus business reputation

*[Hand out – Due Diligence Questionnaire for Private Placements]*

* **Regulatory Compliance Issues For Exempt Funds [DMM]**
	+ Unregistered is not unregulated **[DMM]**
	+ Interests being offered are securities
	+ Multiple layers of regulation apply – 4 securities acts, 1 commodities act, and the US Patriot act apply.
	+ Risk of non-compliance is:
		- Regulatory action or
		- Investor lawsuits
		- Rescission means give all the money back, ***at the value the investor invested, not at current value.*** (Plus interests and attorney’s fees.) [State laws all different]

*[Handout – “Securities and Futures Regulation Applicable to Private Funds”]*

*[Handout – Private Offering Exemption Q & A Chart]*

* **1940 Act and Exemptions [DMM]**
* Avoiding Regulation as a Mutual Fund
* Investment Company Act of 1940
* Section 3(c)(1) – fewer than 100 beneficial owners and privately sold
* Section 3(c)(7) – if all investors are "qualified clients," can privately sell up to 499 investors, subject to Regulation D
* No Blue sky for 40 Act.
* **Securities Law Issues for Private Funds [NFH]**
	+ 1933 Act - NFH
	+ Investor gives you money with intention of making a profit = Security;
		- Even sales to your Mom
		- Even 1 investor
		- Even equity interests to consultants, employees, board members, for services, are securities
		- LLC and LP interests are securities
		- Key: Find exemptions from registration.
	+ Exemptions are from registration, and not from disclosure or notice filings.
		- Disclosure can be curtailed in a few instances
		- Notice filings most always required
		- **Blue Sky Law- State** Filings are required in each state where investors reside.
	+ Seed Capital – exempt from more complex disclosure
		- 4(2) – perhaps no offering memo, very small group, close friends
		- “trader friends” exemption
		- Folks who would never sue you exemption
		- Highly sophisticated investor – may ask for book
	+ Or Reg D 506 with Offering Memo
* **SEC Reg D 506 Offering Exemption [NFH]**
	+ Reg D 506 most preferable –
		- Blue Sky uniform –
		- But disclosure book required
	+ Investor Qualifications –
		- Accredited Investor?
	+ Limits on # of non-accredited investors 35, 99 Accrediteds
		- Why Limit sales to nonaccrediteds? – Sophistication
		- What about family who are not accredited?
	+ Audited Financials requirement for nonaccrediteds
	+ **Manner of Offering – No general Solicitation**
		- Private vs. Public Fund – Don’t want to be a public fund
		- Illegal to Offer Your Fund on the Internet,
			* IPO.Net and Lamp Technologies apply to brokered funds only
		- No Cold Calls, No Advertising
			* Plant an article about your fund in a news publication, then it’s an illegal general solicitation.
			* If they contact you for interview, perhaps not. Careful not to say any thing about fund or the offering, only about fund manager and trading track record
		- Pre-exiting relationship or private introduction
		- Cold calls to Institutional Investors / Professional VCs are probably OK, but gray area without a pre-existing relationship, Truly Institutional required.
		- **Blue Sky Law – Notice** Filings required with the SEC and in each state in which investors reside; general costs, notice filings only if Reg D. *Hand out summarizing 50-state notice filing requirements.*
* **Disclosure Document / Offering Memo [NFH]**
	+ **10b-5 requires full and fair disclosure of all info material to investment decision**
		- **Regardless of whether investors are Accredited**
	+ **Rely on the YOU the Fund Manager to provide info**
	+ The **“CYA” Document** – Disclosure Document
		- * Not promising to make money, nor even that its a fair deal, “we are taking your money and losing it all”
			* Just true facts of people, fund, strategy, industry
			* If you are **uncomfortable disclosing** it, its material
			* Protect, not insulate, from liability
			* Business Tool - Saves time – Can Cover much of your presentation first in writing
				+ Investors like to see electronic first
			* Providing **consistent information** to **each** investor
			* Must also **update disclosure** for facts or occurrences that render the previously disclosed facts inaccurate

*[Hand Out – Why Offering Memo Required]*

* **When securities disclosure document requirements apply to friends, family, traders:**
	+ - When You Can Get By Without a Disclosure Doc:
			* Very close family, 1st degree relative
			* Very, very, very close friends
				+ Money changes things
			* Highly sophisticated institutional investors
				+ But they will ask for a disclosure document
			* Only a few – 5? Perhaps 10 too many?
		- Other methods of accomplishing disclosure under 10b-5
			* **(**“stack of docs”, no book, if all accredited.)
		- Not the number, but the relationships
* Disclosure **Doc Highlights [DMM]**
	+ - Risks
		- Conflicts
		- Fees
		- Financials,
		- “your” doc, customized, no boiler plate,
		- Material info,
		- Litigation,
		- Prior performance
		- Bios,
		- Strategy,
		- Corporate and Personal Due Diligence,
		- Industry Description,
		- Possible Tax Section,
		- Summary of all material agreements.
	+ **Audited Financial Statements if investors not accredited [NFH]**
* **Audited Financial Statements [LTW]**
	+ Audit opening balance sheet if non-accrediteds – investors expect audit
	+ Audits customary for fund managers, even if not required
	+ Use of Margin/Leverage
	+ Disclosure of Positions greater than 5% of asset – positions disclosed – no audited exceptions allowed – disclosure - or opening to do the special report
	+ Other Audit Issues
* **Futures Law [DMM]**
	+ When futures laws apply single managed account is not- individual separate accounts
	+ NFA Exams
	+ CFTC filings and the Rule 4.7 Fund, super accredited investors
	+ Using Futures to Hedge
	+ Options in indexes are futures, while options on securities are not.
	+ No Blue sky for commodities Acts.
	+ 4.13 a 3 and a4
* **Futures Trading Funds – "Pools" [DMM]**
* Even small amount of futures can trigger CFTC registration and disclosures; even if futures trading is dominant, still can avoid much of regulation if investors all are "qualified eligible participants"
* Definition of QEPs
* new relief from CFTC for certain futures funds
* All one disclosure doc for Securities / Reg D, and Futures
* If formerly CTA with, D-Doc, can use that as basis to start

* **Investment Adviser Registration [NFH]**
	+ Whoever renders investment advice must be registered or exempt
	+ 15 client exemption
	+ Fund counts as 1 client.
		- If no managed accounts and one fund, then no IA registration
		- SEC leaning toward looking through the fund and counting all fund investors individually.
	+ **State versus Federal registration - <25 million**
	+ **Managed Accounts = IA, versus trading a Pool**
	+ **Managers who run Multiple Funds, help investor decisions**
	+ Exemption allows profit-based compensation without regard to financial condition of investor
	+ Fund Manager May Need to Be an IA anyway
	+ **Recent hedge fund scandals, SEC may require investment adviser registration of all hedge fund managers, or may adopt some other regulation of funds [DMM]**
	+ **Comment Wilmer Cutler Pickering – SEC has exceeded its authority in proposing Rule change, need to go back to Congress [DMM]**
	+ **2/3 of the largest fund managers are registered IAs**
* **Anti-Money Laundering Requirements** [DMM]
	+ Know your customer. “Don’t ask, don’t tell” is Dead.
	+ Certifications required “This is not terrorist funding money”.
	+ Take only Money you know, or bank you know, foreign source, or foreign bank, compliance manual procedures.
	+ Who covered? Driver’s licenses.
	+ Regs not out yet.
	+ Exemptions for smaller funds may apply.
	+ **In all docs anyway, even thought does not apply to US fund managers.**
* **Money finders** – Generally using them to sell your fund is illegal, if they are not registered securities brokers under 1934 Act.) **[NFH]**
* **Prime brokers cap intro – disclosure item, not formal, may intro you, but creates a conflict of interest**
* **How Fund Managers Make Money - Fee Structure [LTW, comments by DMM]**
* Management Fees vs Incentive Fees – treatment
* Quarterly Accounting
* asset-based fee
* profit-based fee (or "profit allocation" to enhance tax benefit)
* special or discount fees for early or larger investors
* operating expenses, employee salaries
* need for competitive features/structure
* selection of broker
* hurdle rates
* Business success versus attractiveness to investors
* Operating expense and employee salaries, rent managers' salaries, drags down performance,
* Wisdom of negotiating fees with certain investors
* **Redemption or Withdrawal by Investors [DMM, comments by LTW]**
* Tied to liquidity of fund's investments
* Frequency
* Lock-up period for hedge funds, and not applicable to future funds
* **Conflicts of Interest Trading or Investing by Fund [DMM]**
* Valuation - "Marking" or valuing portfolio
* Single or multiple strategies – differences must be material
* Proprietary trading
* Capacity
* Allocation of Trades
* Employee personal trading
* Front Running
* Illiquid securities?
* Futures
* Watch the trades
* Disclosed and Managed Internally
* Transparency of trades and NAVs
* **Tax & Financial Regulations [LTW]**
* Wash Sales
* Performance reporting and financial statement disclosure and the importance of proper reporting to individual partners.
* Partner allocations
* **Effect of new 60/40 rule: 1256 contracts are split 60% long term, 40% short term. The participant wanted to know if that applies to section 1256 contacts in the fund, which it does.**
* Responsibilities fund managers undertake to investors, on start-up and through operations on above
* Illinois Replacement tax if not covered above
* State Tax Return Filings where investors reside
* **Business Issues [ALL]**
* This is a business, you are no longer a trader.
	+ Do you want to own and run your own business?
	+ Marketing, Schmoozing
	+ Timely compliance,
	+ Work you don’t want to do,
	+ Manage people, back office – IT, accounting, hiring service providers
* Make sure you can make a living at it, or don’ quit day job yet.
* Implementing structure and strategies to maximize profits for managers and investors
* Establishing Track Record; time frame for doing so
	+ Family and Friends
	+ How does one establish track record? Is institutional money required ? How far back?
	+ All your track record counts
* Reasonable expectations as to cost and timing –
	+ Funding the fund with your own money or find seed funder
* Time line for seeking help from professional service providers and out-sourced functions: Lawyers, accountants, Prime brokers, back office, technology / server / network professionals, Website
	+ Ask your service providers for referrals to other services providers
* Reasonable expectations as to cost and timing –
	+ Funding the fund with your own money or find seed funder
* Need for quality administrator/accountant/lawyer/prime broker/back office - interviews - No
* Importance of having technology and accounting systems in place, either internally or outsourced – USE THEM!
* Run the business like a business, keep records
* Importance of communication with Investor partners
* Understanding the Capital formation –
	+ Winning an allocation or an investor
	+ Surviving the Due Diligence process of investors
	+ Meeting With Sophisticated Investors
	+ Due Diligence Preparation and Reponses
* How do you do an AIMR audit, how do you contact them, and how much does it cost ?
* How Will SEC Come down on hedge funds – custody rule, 10-5 -4
* Compliance officer requirements – not adopted yet.