

Forming a Private Fund FAQ (2007)

Why Would a “Normal” Registered Investment Adviser Form a Private Fund?

“Normal” investment advisers (“IAs”) – those who operate by offering separately managed accounts – often also choose to create private funds. We see three basic objectives being met: simplification, the launch of a new investment strategy, and management diversification.

- Many IAs form private funds simply to aggregate many accounts into one with the objective of managing only one portfolio, eliminating dispersion of results, and simplifying billing. Some are aggregating their business into 2 or 3 funds matching their existing levels of aggressiveness and risk control. Others are aggregating only the smaller “courtesy” accounts.
- Many IAs have developed separate specialized strategies that do not lend themselves to managed accounts. These can include strategies which involve smaller cap stocks, derivatives, short selling, complex trading positions, leverage, non-marketable securities, etc. In addition, some of these styles may fit into an incentive compensation model.
- Some IAs seek to diversify their business risks by forming funds-of-funds to allocate capital to strategies which are specialties of other managers. Having a product that includes “alternative” investment strategies may help capture or retain assets that might otherwise go elsewhere.

What Advantages Exist for the Private Fund Structure?

As opposed to a mutual fund, private partnerships and limited liability companies enjoy the advantages of pass-through taxation. Basically, this means that taxable income can be allocated to the persons who made the economic gains, not just arbitrarily assigned to whoever happened to be invested in the fund at the end of the year. In addition, in years that the fund realizes taxable losses, those losses are allocated to the participants. And, funds that have sufficient turnover may qualify for trader status, so that management fees and expenses can be deducted as business expenses, thereby increasing deductibility. Incentive compensation of the fund manager, in a properly structured fund, is also netted against fund gross gains, so there should be no issue of deductibility. Plus, incentive compensation under current practice typically

retains the tax character of the fund’s gains (perhaps long-term, perhaps unrealized). Although we note that the IRS and some members of the U.S. Congress continue to give this tax attribute particular scrutiny.

So, from the point of view of both the investor and the IA, a private fund is more efficient than a mutual fund. While partnership accounting is somewhat more complex than mutual fund accounting, firms like APM are available to minimize the general partner’s administrative burden and to provide the benefits of third-party administration, performance reporting, and capital account valuations to the investors.

What’s the Difference Between a Partnership and an LLC?

From an accounting perspective, both structures permit fee flexibility and the pass-through of taxable income to participants. Most private funds are formed as limited partnerships, with a corporation or LLC as the general partner. LLC funds have a slight disadvantage by being a newer structure. For example, limited partnerships were exempted from the Florida intangibles tax, while LLCs were not; also, older trust agreements may not list LLCs as permissible investments. In addition, as small as it may seem, because the person controlling the LLC is the “Manager” or “Managing Member,” the semantics can be a nuisance (a lot of sentences where “the Manager manages...”). Picayune but true.

Regulatory Issues

What are the Regulatory Differences Between Operating Managed Accounts and Operating a Private Fund?

Most investment advisers are registered with the SEC or their home state and are governed by the Investment Advisers Act of 1940 and the state counterparts. When an IA forms a fund and offers it to clients, the IA is now also engaged in the offer and sale of a security – the interest in the fund. Securities sales are governed by the Securities Act of 1933 (the “1933 Act”). The interests of nearly all private funds are offered and sold under Regulation D, which provides for exemptions from registration under the 1933 Act for privately offered funds, provided that certain requirements are met.

Regulatory Issues continued

Among these are the restrictions on "general solicitation and general advertising." In addition, in order to avoid registration as a mutual fund, the fund must abide by the 100 beneficial owner limitation set forth in Section 3(c)(1) of the Investment Company Act of 1940, or else limit its investors to "qualified purchasers" under Section 3(c)(7). Under this second – sometimes called "super accredited" – category, a fund comprised solely of "qualified purchasers" (e.g., individuals with at least \$5 million, and entities with at least \$25 million, in investment assets) are exempted from registration. These "3(c)(7)" funds are limited to 499 investors, under other rules.

For a 3(c)(1) fund – limited to 100 beneficial owners – an investor can often have several accounts (such as a personal account plus an IRA) without taking up more than one "slot" in the fund.

How Does One Avoid a "General Solicitation?"

The language in Regulation D goes as follows:

"...neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

1. Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
2. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising;"

These 72 words have spawned a sheaf of staff interpretations as to what general solicitation or general advertising means. These letter rulings show that the SEC's overriding concern is whether the issuer of the security has a reasonable basis to know that the investment is suitable for a particular investor. The key factor here is the existence of a pre-existing relationship with the potential investor. The fund manager will therefore want to show that it has "pre-qualified" the potential investor through such means as having the prospect fill out and sign an investor qualification questionnaire.

The interpretations as to general advertising and solicitation we have seen range from "you can't have a business card" (we're not making this up) to permitting unsolicited articles as long as the purpose of the article was to discuss some topic of general investment interest and not specifically aimed at introducing a fund. Key to this latter interpretation is that the IA had other business (e.g., managed accounts) besides the private fund. We had one recent case where a client – whose sole business was a hedge fund – was interviewed in Barron's and his attorney advised that anyone who called in as a result of that article was permanently blacklisted.

A key take away is that: (1) federal and state regulators are paying closer attention to how hedge fund managers market their funds, (2) the regulations that apply to hedge fund marketing involve several federal statutes that are not always intuitive, and (3) never market interests in the fund without first consulting with experienced hedge fund counsel.

How About the Internet?

One apparent exception to the general broadcast restriction is that two private letter rulings exist that permit the posting of information on multiple funds on a web site, provided that access is restricted via password protection to pre-qualified accredited investors. While there are many single-manager sites that appear to abide by that private letter ruling, it is not clear that such arrangements are permitted according to the private letter rulings. *This is definitely a "consult your attorney" subject.*

What Constraints Exist for Performance-Based Compensation?

There are restrictions on performance-based compensation, whether in a managed account or in a fund. Under the Investment Advisers Act of 1940, a registered IA may charge a performance-based fee to any investor with a minimum net worth of \$1.5 million, or one who has a minimum of \$750,000 under the management of the adviser. Such a person is called a "qualified client." Accordingly, any federally-registered IA (and this is true for nearly all the states who have adopted similar rules) cannot earn an incentive allocation from an investor who is not a "qualified client."

Regulatory Issues continued

How Does One Become an “Accredited Investor?”

Under the Securities Act of 1933, the principal test currently is individual net worth of \$1 million or more. This is a true net worth test, including assets held jointly with a spouse. In addition, one can be accredited through income by having an individual income of over \$200,000 or joint income of \$300,000 over the 2 most recent years, and the expectation of such income continuing. We note that the SEC has introduced changes to the definition of accredited investor for purposes of hedge funds and certain other private investment funds.

What are the Rules Regarding Entities?

A corporation, trust or partnership, if not formed for the specific purpose of investing in the fund, is generally considered accredited if it has total assets in excess of \$5,000,000. In addition, smaller entities may become accredited by a “look through” to underlying individual beneficiaries who are accredited – for example, a small retirement plan trust might be considered an accredited investor entity, if each and every beneficiary of the trust meets the individual test as an accredited investor.

What’s the Practical Bottom Line on Investor Eligibility in a “3(c)(1)” Fund?

A. No incentive compensation:

35 unaccredited investors, plus accredited investors (accredited by either income or net worth) up to 100 total.

B. With incentive compensation:

Up to 100 accredited investors, each having a net worth of \$1.5 million or more (making them a “qualified client” as well). It is possible for a person with less than a \$1.5 million net worth to place \$750,000 under one person’s management, but it is rare. It is possible to accept unaccredited persons and accredited persons who are not “qualified,” with the substitution of an increased asset-based fee in lieu of an incentive.

Do Most Funds Accept Unaccredited Investors?

Most true hedge funds do not. When a fund accepts unaccredited persons, the offering materials are held to a higher standard of disclosure. Accordingly, one’s legal risk may be more limited if only accredited individuals

are accepted. On the other hand, funds formed to aggregate an IA’s smaller accounts in an established strategy often accept unaccredited persons.

Must I be Registered to Operate a Hedge Fund?

Since the successful challenge of the SEC registration rules that went into effect in February 2006, there is no Federal requirement. Stay tuned, as there will likely be more news on this subject. Note that a manager with less than \$25 million in assets may not register federally – so, if assets are expected to fluctuate, it would be prudent to exceed that amount by a comfortable margin before registering.

Note that state registration requirements exist even if Federal registration is not required. So, if in a state that requires registration (and most states do), must a manager register with the state if initial assets are less than \$25 million and then shift registration several months later when assets grow? The SEC provides relief from this chicken-and-egg problem by permitting registration if the applicant reasonably believes that it will exceed \$25 million in assets within 120 days.

If you are not currently registered, you should consult counsel to determine requirements in your state and develop a strategy for dealing with any registration requirements.

Service Providers and Start Up

Where Does the Prime Broker Fit in?

It is useful to think about service providers in term of time frames. Over the course of weeks and months, your administrator will collect trade information, account for the participants and provide the valuations necessary for monthly capital flows. Over the course of a year, the auditor is engaged by the fund to review and attest to the accuracy of the accounting (done by the administrator) and the operations of the fund. What is left is the day-to-day trading and management of a portfolio. So it is essential to select a brokerage firm that can provide clear and accurate daily (or minute-by-minute) views of your portfolio and a trade entry mechanism that fits your style. If you intend to trade with multiple brokers, a prime broker is essential to act as your custodian to receive and report to you “away” trades done at other firms.

Service Providers and Start Up continued

So How Does the Administrator Get Information from the Prime Broker?

The common "snapshot" information that nearly all brokerages make available on web sites is not enough for an administrator to determine how a portfolio got from point A to point B. In order to create financial reports, we must know the character of the income that results in the change, e.g., realized gains for the period, dividend income etc. Many of the major prime brokers now have sophisticated software overlaying their accounts that we can use to run special reports on the portfolio. For other brokers, we require a data feed of transactions that are re-posted on portfolio software we run in-house.

Should I Use More than One Broker or Custodian?

The use of a prime broker will allow a fund to execute trades at a variety of firms while maintaining assets in one place, so most new funds will not need more than one prime broker or custodian. Also, keep in mind that a single broker/custodian greatly simplifies the fund's financial controls. Larger funds (those of several hundred million to billions of dollars) may find it useful to have the extended financing and trading flexibilities offered by multiple prime brokers.

What Assurances Exist for the Investor Switching from a Managed Account to a Private Fund?

One proper concern of an investor is the financial controls and safeguards that exist when he or she sends money to a private fund. Usually, the initial financial control is that all cash contributions are made directly into the fund account at the prime broker or another designated custodian. Money is not sent via the general partner or the administrator. Secondly, investors should be certain that someone independent of the general partner is calculating the numbers. Thirdly, many funds have certain controls installed so that the general partner cannot pay or send money to itself without the involvement of, or notice to, the administrator. Lastly, investors should look for audit reports on an annual basis.

How Long Does it Take to Get a Fund Formed and Going?

Our rule of thumb is that if you have a clearly articulated description of your investment approach and management

policies, and have vetted your structural choices with ALPS Price MeadowsSM, you can be up and running in 45 - 60 days. Note that this assumes that you are already registered as an investment adviser (or are properly exempted from registration) either in your state or federally. If not, keep in mind that state registration processes sometimes involve idiosyncrasies that can consume several months of time.

What Happens During the Start-Up Period?

The primary task is the creation and editing of the offering memorandum – similar to a prospectus – and the limited partnership agreement, which is the legal document that structures the fund. Nowadays, this all occurs with emailed electronic documents between your attorney, your administrator and auditor, and you. ALPS Price MeadowsSM will generally be actively involved with the documents as we are the ones who have to abide by their accounting provisions.

Secondly, the attorney will undertake a number of legal filings to claim the fund name, form the fund entity at the state level, and qualify the fund for exemptions from registration with the SEC and the states in which the fund will initially be offered.

What State Should the Fund be Formed in?

We see the majority of funds being formed in Delaware (due to its "corporate friendly" regulations) or the home state of the general partner. In some cases, it may make sense to create the general partner entity in a state other than your state of residence. This might be done in an effort to insulate investors from state taxation in those few states which try to impose a tax on funds within their state. This is a subject to take up with your legal advisor.

Is an Auditor Required by Law?

Nearly. While not legally required, hedge funds managed by SEC-registered IAs will most likely choose to audit in order to avoid complications related to rules on the custody of client assets. In a nutshell, if an audit is delivered to fund participants within 120 days (180 days for a fund-of-funds), life is a lot easier for the manager.

Also note that, for practical purposes, an audit is a good idea. Investors would be ill-advised to invest in a fund that was not audited, nor will ALPS Price MeadowsSM administer a fund that is not also audited.

Offshore Funds

Why Start an Offshore Fund?

An offshore fund is usually necessary only if you have significant marketing plans directed towards foreign investors or non-taxable U.S. investors (such as tax-exempt organizations and benefit plan investors). Since the repeal of the "Ten Commandments" in 1997, more foreign investors are investing directly into US funds. The remaining principal concerns for foreigners have been a desire for anonymity – now all but impossible after the Patriot Act – and a theoretical risk of exposure to US estate taxes. This latter concern seems moot, as most foreign investors in our experience are formed as entities anyway. However, it seems that most offshore marketers want to be able to offer the simplicity of an offshore fund, rather than go through the explanations about investing domestically, and the reality is that offshore funds comprise a significant industry.

One other reason to form an offshore fund is to provide a way for tax-exempt entities to avoid unrelated business taxable income due to margin leverage. If the entity invests in an offshore fund formed as a corporation, currently there is no pass-through. However, this is a complex area, subject to differing legal opinions about the amount of capital that can be from ERISA plans and from US-based investors. This is definitely another "consult your attorney" subject.

Lastly, offshore funds may be used as a means of deferring compensation to the manager. Deferral is especially relevant for offshore funds because the incentive compensation is nearly always "fee" income, taxed at ordinary rates. A deferral agreement may be used to delay the payment of taxes while reinvesting the fees in the fund. However, the terms of the deferral agreement must meet a number of technical requirements and lock up the fees for a significant length of time. Note that for managers expecting significant long-term gains tax treatment on their portfolios, it may be preferable to have foreigners invest in a domestic fund as the incentive compensation could be received with favorable capital gains treatment.

What are the Advantages of a Master-Feeder?

A master-feeder can be used to simplify the portfolio management of what would otherwise be two funds that the manager would attempt to manage in an identical manner. Typically, the two funds involved are a domestic hedge fund and its offshore clone, each holding an interest in a common portfolio. The master

fund is a partnership that holds the portfolio and the two feeders feed capital into the master. While there are three legal entities to set up and administer, the portfolio management is much easier.

The best candidates for a master-feeder structure are funds having high turnover and low chance of any tax-advantaged trades. Managers who would ordinarily attempt to enhance after-tax returns for their US fund may decide to keep their two funds separate – as so-called "sister funds." Since holding periods are irrelevant to offshore investors, there can be a significant conflict of interest between the offshore and domestic feeder participants. A manager would likely make two different decisions on a stock with a gain that is acting poorly but is about to go long-term. Sell for the tax-exempt and foreign fund; hold for the taxable fund.

What About the New "Memorandum" Master-Feeder Structures?

In the last couple years, we have started to see and administer a number of Master-Feeder structures where there is a tracking process at the Master level for Feeder participants. The purpose is to charge incentives as allocations at the Master level versus fees at the offshore Feeder level. The benefit to the manager is the conversion of what was normally fee income from incentives to a combination of possible long-term capital gains treatment, qualified dividends and unrealized gain deferrals. While many offshore fund managers elect to defer fees, deferred comp will still eventually be received as ordinary income, plus it remains at risk to creditors during the deferral period. Depending on the fund – and the assumptions – it may be better to pay taxes now at lower rates than to defer.

In order for the incentive allocations at the Master to properly track the performance of the Feeder participants, a look-through to the underlying Series or participant is needed. This may be in the form of (a) "memorandum accounts" at the Master level reflecting each participant or (b) separate capital accounts at the Master for each Feeder Series. After the incentives are charged at the Master level, the net "memorandum account" becomes the Feeder's net value for the relevant participant.

Offshore Funds continued

How Does One Choose a Jurisdiction for an Offshore Fund?

This is usually a subject for your attorney, but we can say that the vast majority of Funds we see are forming in the Cayman Islands. This is due in part to critical mass – the large number of funds in the Caymans means that many service providers are available, and in part due to a friendly, but respected, regulatory environment. The Cayman Islands Monetary Authority, for example, has very strict anti-money laundering regulations rivaling the requirements of the Patriot Act.

May a US Firm Administer Offshore Funds?

Yes. ALPS Price MeadowsSM, for example, administers stand-alone and master feeder arrangements in both the Cayman Islands and the British Virgin Islands. Since the repeal of the Ten Commandments, there is no US requirement that administration occur outside the States. Moreover, most offshore jurisdictions do not require more than a registered office (usually arranged by the attorney) for a hedge fund in their jurisdiction. One objection to using a US administrator on an offshore fund has been a hypothetical reluctance of foreigners to have their names recorded in records maintained on US soil. However, with the advent of the Patriot Act and other international anti-money laundering efforts, the era of anonymity for the offshore investor is over. Some of the largest offshore administrators now have operations in the US, and scores of investors, including banks, trusts, individuals, and offshore funds-of-funds invest in offshore funds administered by ALPS Price MeadowsSM.

Structural Choices

Most Hedge Funds Seem to Charge 1% on Assets, Plus 20% of the Profits. Is that the Best Arrangement?

How many people can name 10 managers who returned 16% gross over the last twenty years? That's what it would have taken to achieve the S&P 500 return after the standard hedge fund fees. That is not to say that "one and twenty" is not fair, but suffice it to say that investors expect something else in addition to the returns: such as consistency, superior risk control or diminished correlation.

However, even if one were to argue that "1 & 20" is not fair, it is the standard, and we occasionally see the

law of unintended consequences working with lower rates. We hear stories of institutions or funds-of-funds wondering "why you're not worth 1 & 20" when a manager has a lower rate.

May Performance Compensation be Calculated More Often Than Annually?

Prior to 1998, one-year measurement periods were required by the SEC for all managers who were registered investment advisers. Soon after the rule change, ALPS Price MeadowsSM saw a rush to incorporate quarterly incentives; however, now we see less of that. Clearly, the client would like the incentive to be calculated over as long a period as possible. In a quarterly incentive arrangement, it's quite easy to visualize a situation where the investment manager receives a healthy incentive while the client loses money over a 12-month period. A volatile fund might be up 30% mid-year and give it all back by year-end, leaving the investor underwater, solely because of a 6% incentive charged mid-year. Occurrences exactly like this in the last several years have caused some funds-of-funds to refuse investment with managers not having an annual calculation.

Occasionally, someone asks why incentives aren't calculated over multi-year periods. It is mathematically possible of course, but there are complications for tax allocations. If the manager isn't allocated the gains, he can't be allocated the taxable income. Accordingly, a client under that arrangement would be getting tax allocations on income that will sooner or later be transferred to the manager. Tax allocations will be artificially higher for the investor, plus down the road, when the manager is paid the incentive, there is the worry about having the right kind of sufficient taxable income and loss to reallocate those earlier gains back to the manager.

Are High-Water Marks Universal?

Nearly. Fairness requires that if you charge on profits, that those profits are real new profits. We have seen variants of the high-water concept, such as a partial claw-back of previous period incentives in lieu of a high-water, but such arrangements have not been used widely.

Should a Hedge Fund have a Hurdle?

Hurdles, which would seem to make a lot of sense in an incentive arrangement, are not as common as one

Structural Choices continued

might expect. In our experience, less than 10% of funds contain one of the two structures that are commonly called hurdles. In APM parlance, a true “hurdle” means that the return in excess of a defined benchmark is charged an incentive allocation. A “threshold,” on the other hand, means that the incentive allocation is calculated on the entire gain; provided that it cannot reduce the investor’s return below the benchmark. Most benchmarks are simple rates of return such as 5%, although some use T-bill or equity indexes. A hedge fund should choose its benchmark carefully, keeping in mind that a fund with a short component is not really part of the “equity” asset class. Also note that having equity benchmarks – which can decline – require careful drafting in order to avoid unintended outcomes.

What Asset-Based Fee Variations Exist?

Most “flat fees” are fixed, however, ALPS Price MeadowsSM has several funds that diminish the rate based on overall fund assets, plus some that reduce the rate investor-by-investor based on their capital accounts. These type of arrangements require careful drafting in order to create the desired effect.

What do Funds-of-Funds Charge?

Typical fund-of-funds fees range from an asset-based fee between 0.50% and 2.00% and may include an incentive rate of 5% to 10%. The “fees on fees” of a fund-of-funds is a key issue for investors and it is important to relate the fees to the added value of the fund-of-funds manager. ALPS Price MeadowsSM has had a number of prospective fund-of-funds managers proposing an incentive at their level of 20%; however, we haven’t yet seen an investment plan that would justify the compounded effect of two 20% incentives – which would mean that 36% of the gains – plus asset based fees – would be eaten up prior to the net return. Due to the low odds of such a fund being successful, investors (and service providers) may pass on such a fund.

What are the Industry Standards for Investor Liquidity?

Most funds permit additions monthly and withdrawals quarterly. A principal exception is for “aggregation” type funds which often permit withdrawals monthly. Some hedge funds also employ “lock-ups” which require the investor to be in the fund for a year prior to exiting. The ALPS Price MeadowsSM opinion is that the only certain effect of a lock-up is that investors will tend to contribute less money. Our experience

is that if a fund has reasonable liquidity and good communication – not to mention some control over volatility – investors will stick with the program for at least a year anyway.

However, for funds whose investment media are less liquid, stability of capital is still a concern. But since stability of capital is a concern in every year – not just the first one – the lock-up does not really address the problem. One option is to consider the use of a longer notice period. Typically, quarterly withdrawals are associated with 30 day notices. However, a distressed bond portfolio might be better structured with a 60 or 90 day notice (or perhaps semi-annual withdrawal periods) and dismissing the notion that a 12 month lock-up on new capital can help.

What are the Industry Standards for Reporting?

While there are still a few of the quarterly-results-only funds out there, the standard is now monthly. This is largely due to the greater role of funds-of-funds and other institutional investors who need monthly numbers for their own internal purposes. Secondly, we have observed that regular communication decreases the chances of surprises and builds trust with investors.

For a tale of excess, a recent trend has been for managers to provide weekly and daily information – some of which include full trading and position “transparency.” The difficulty here is twofold. One, if a manager actually does research that is proprietary and valuable, it would seem a bad idea to broadcast positions on a daily basis. Secondly, giving investors information that they cannot use (since withdrawals are likely permitted only quarterly) flies in the face of the lessons of behavioral finance. Those lessons are that the more volatility an investor views, the more unhappy he or she will be. The style, frequency, and content of a fund’s reports will have a significant effect on the expectations of investors and the quality of life of the manager. The bottom line is that reporting is important and merits a plan.

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