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How to start a hedge fund

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Introduction

When setting up a hedge fund, you will need to consider the following matters:

- Jurisdiction
- Regulatory considerations
- Fund structure
- Eligible investors
- Authorisation and regulation
- Directors and other service providers
- Share classes
- Fees
- Equalisation or series accounting
- Lock up, redemption periods and gates
- Listing

In order to determine these issues, you will need to seek professional advice from your tax advisors and legal counsel.

Jurisdiction

A standard hedge fund will generally be based in an offshore jurisdiction, such as the Cayman Islands, the British Virgin Islands, Bermuda, Guernsey or Jersey, so that the investor, rather than the fund, pays tax on the increase in value of the fund's portfolio. For some investment managers, jurisdictions such as Luxembourg, Malta and Ireland are more attractive, due to perceived EU advantages, while others are deterred by the regulation which comes with an EU alternative investment fund ("AIF") as well as an EU alternative investment fund manager ("AIFM"). Which jurisdiction you choose will often depend upon the type of fund structure used, regulatory factors and the tax environment of the fund's potential investors.

Fund Structure

The types of hedge fund structure most commonly seen are: stand-alone, master/feeder and umbrella funds, segregated portfolio companies (SPCs) and side-by-side.

Stand-alone fund

A stand alone fund is a single fund in which investors invest by purchasing shares and the subscription monies are then traded by the fund directly in the markets. This is explained in the Appendix in diagrammatic form.

Master/feeder fund

A master/feeder structure is generally used if the fund is being promoted to two separate categories of investor: (i) US taxable investors; and (ii) US non-taxable and non-US investors. These two categories will, for US tax and compliance reasons, wish to invest in separate entities and this is generally achieved by setting up a master/feeder structure with two feeders, one for each category, which both feed into the master fund. Investors subscribe for shares in the relevant feeder and each feeder then subscribes for shares in the master fund, which then trades on behalf of the feeder funds. This is explained in the Appendix in diagrammatic form.

Umbrella fund

An umbrella fund is a single legal entity which has several distinct sub-funds, each of which are traded in effect as individual funds. This allows a fund to create different classes of shares, which generally trade different strategies by investing in underlying companies which conduct all trading. By this use of subsidiaries, the assets and liabilities of each share class are generally segregated from those of the other classes of shares. This type of structure is often used, for example, if the fund wants to apply leverage to some shares and not to others and the segregation means that any downside (or upside) as a result of a riskier strategy will, in most circumstances, only affect that share class and not those share classes pursuing a less risky strategy. The umbrella fund can also be the master fund in a master/feeder structure. This structure, without the master feeder element, is explained in the Appendix in diagrammatic form.

SPCs

An SPC, referred to as a protected cell company or similar in certain jurisdictions, is a fund which segregates the assets and liabilities of different portfolios, or cells, from each other and from the general assets of the SPC itself. The segregated portfolios (or cells) are each a separate legal entity with the effect that only the assets of each segregated portfolio are available to meet liabilities to creditors in respect of that segregated portfolio i.e. where there are liabilities arising from a matter attributable to a particular segregated portfolio, the creditor may only have recourse to the assets attributable to that segregated portfolio. A point to note, however, that although SPCs are found in a number of jurisdictions, in one form or another, the concept of segregation has not yet been tested in the courts and it is uncertain how it would be treated in an onshore bankruptcy, for example. An SPC can also be the master fund in a master/feeder structure. This structure, without the master feeder element, is explained in the Appendix in diagrammatic form.

NB. An SPC differs from the umbrella fund above in that, unlike the segregated portfolio, a sub-fund is not a separate legal entity and, despite the segregation of share classes and strategies within the umbrella fund itself, a creditor would have recourse to all the assets of the umbrella fund and not only to the assets in the relevant sub-fund.

Side-by-side fund

A side-by-side fund structure comprises two single funds, each of which takes a different category of investor but trades the same strategy. Again, investors invest by purchasing shares and the subscription monies are then traded by the fund directly in the markets. This is explained in the Appendix in diagrammatic form.

Eligible investors

The promotion of hedge funds is restricted by law and they may only be promoted to certain categories of investors as set out under relevant law; as a result they are generally directed at institutional investors, such as pension funds, and sophisticated high net worth individuals and, save with the exception of UCITS funds, are not available to the general public. The investment manager and/or any other distributor of a hedge fund is responsible for ensuring that shares in the fund are being offered only to eligible investors. UCITS may be offered to retail clients, but this is due to the fact that a UCITS fund incorporates certain investor protection mechanisms.

Authorisation and regulation

The fund

Unless the hedge fund is exempt from regulation in the relevant jurisdiction (due to its size or the number of its investors, for example), it will be necessary to register the fund with the relevant authority, such as the Cayman Islands Monetary Authority (CIMA), the Central Bank of Ireland or CSSF (the Luxembourg regulator), for example, and will be regulated by that authority accordingly. Depending on the type of fund, this regulation can range from paying a prescribed annual fee and submitting the fund's prospectus to obtaining approval of the service providers and any subsequent changes to those service providers.

The investment manager

In the EU and the USA, an investment manager is required to be authorised to carry out regulated activities and most investment managers will usually be based in these jurisdictions. In the UK, an investment manager must be authorised by the Financial Conduct Authority and it can take up to 6 months for an application to be approved. As part of the approval process, the investment manager has to demonstrate that it has adequate financial resources, has determined the systems and controls it will need to put in place and has appropriate staff carrying out controlled functions.

AIFM Directive

The Alternative Investment Fund Managers Directive (AIFMD) is a European Directive which was transposed in UK law by 22 July 2013. All alternative investment funds managers established in the EU, whether they manage EU or non-EU AIFs, are subject to the AIFMD. The AIFMD also governs the marketing in the EU of AIFs managed by non-EU AIFMs.

The scope of the AIFMD is broad and, with a few exceptions, covers the management, administration and marketing of AIFs. Its focus is on regulating the AIFM rather than the AIF. An AIF is a 'collective investment undertaking' that is not subject to the UCITS regime, and includes hedge funds, private equity funds, retail investment funds, investment companies and real estate funds, among others. The AIFMD establishes an EU-wide harmonised framework for monitoring and supervising risks posed by AIFMs and the AIFs they manage, and for strengthening the internal market in alternative funds. It also includes requirements for firms acting as a depositary for an AIF.

All investment managers established in the EU, whether they manage EU or non-EU funds, are subject to the AIFMD. In order to get permission to market their funds in the EU, an investment manager must be authorised by the regulator in the EU country in which it is established. Once the investment manager is authorised, it can then market its funds throughout the EU. Investment managers based outside the EU will be prohibited from marketing their funds in the

EU, unless they meet various fiscal and regulatory requirements. Investment managers based in the EU who run funds established outside the EU are also subject to additional restrictions. The Directive contains provisions on:

- Scope
- Organisational requirements
- Leverage
- Depositary
- Delegation
- Risk management
- Liquidity management
- Reporting/disclosure requirements
- Annual report

The impact of the AIFMD on AIFMs depends on the size of the assets under management of the AIFM, which determines whether the AIFM is a "full-scope" AIFM or a "sub-threshold" AIFM. Full-scope AIFMs are those AIFMs whose assets under management exceed €100 million, or €500 million where the portfolios of AIFs consist of AIFs that are unleveraged and where investors cannot redeem their interest in the first five years after investing. Full-scope AIFMs are required to comply with all aspects of the AIFMD. AIFMs whose assets under management fall below the full-scope threshold will fall into the category of small, or sub-threshold, AIFM and will be regulated as such (although a small AIFM may elect to be regulated as a full-scope AIFM). This can be described as falling under a "register and report" regime. (For further information on sub-threshold AIFMs, please see the Cummings Law note on our website entitled "AIFMD – Initial Guidance and Advice for the Sub-Threshold AIFM").

Regarding the passport regime, ESMA was required under the AIFMD to give an opinion as to whether the passport system should be extended to non-EU AIFMs and non-EU AIFs by July 2015. If adopted, the parallel passport regime would permit non-EU funds to be distributed by non-EU based managers on a pan-EU basis, provided certain criteria are met. These criteria have not yet been finally established, but are likely to include appropriate regulator cooperation agreements, appropriate AML and anti-terrorist financing laws and regulations and tax information exchange agreements with EU member states. There may also be a requirement for the local AIFM to fully comply with the AIFMD regime and have authorisation from a relevant member state for the purposes of supervision of EU focused activities. ESMA issued its initial advice in July 2015 on the extension of the AIFMD passport, and then issued its second set of advice on 19 July 2016. ESMA's advice on the extension of funds passport to 12 non-EU countries can be found at www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries. The extension of the AIFMD must be adopted by the EC via rules extending the passport to those third countries which have received a positive assessment from ESMA, and such legislation not being objected to by the European Parliament and Council. As of the date of this writing, this has not yet occurred. The parallel passport will be of particular interest to UK asset managers, since a possible implication of Brexit, if the UK is outside the EEA, is that UK AIFMs will lose their passport and be considered third party.

MiFID II

As of 3 January 2018, the MiFID II Directive and the Markets in Financial Instruments Regulation (MiFIR) repealed and recast MiFID. Together, the MiFID II Directive and MiFIR ("MiFID II") will form the legal framework governing the requirements applicable to investment firms, trading venues, data reporting service providers and third country firms providing investment services or activities in the EU. They are further developed by a series of regulatory technical standards, implementing technical standards and the EU Commission's delegated directive (the "Delegated Directive"). MiFID II does not only apply to MiFID II firms. On 3 July 2017, the FCA published its policy statement (17/14) which set out those parts of MiFID II which will impact non-MiFID firms, such as alternative investment fund managers ("AIFMs") and UCITS management companies. The impact of MiFID II on an investment manager will, of course, depend on the specific circumstances of such manager. However, the AIFM may wish to consider the following in light of MiFID II: (i) inducements and unbundling of research, (ii) taping and communications, (iii) conflicts of interest, (iv) product governance; and (v) client order handling.

GDPR

The General Data Protection Regulation ("GDPR") will come into effect on 25th May 2018. The GDPR aims to protect: (i) natural persons with regard to the processing of personal data and rules relating to the free movement of personal data and (ii) fundamental rights and freedoms of natural persons and in particular their right to the protection of personal data. "Controllers" and "processors" of personal data in the EU are regulated by the GDPR and have legal obligations to, among other things, provide guarantees of their ability to comply with GDPR requirements, maintain records of personal data and processing activities and implement safeguarding measures of personal data. The GDPR is quite broad in scope and the fines for breaching can be costly, therefore managers will want to ensure compliance with GDPR requirements.

Directors and other service providers

Directors

The fund will require at least two directors, who for a listed fund must be independent and this is often required for governance issues. For UK tax reasons they must be based offshore of the UK and if the fund has more than two, the majority must be based offshore of the UK. This is to ensure that central management and control is exercised, and is seen to be exercised, offshore of the UK for tax purposes and there is no danger of the fund being regarded as resident onshore or having inadvertently created a permanent establishment in the UK (and taxed accordingly). This must be adhered to strictly, as a tax authority, such as HMRC, will examine the position carefully and if they consider that acts of controlling power and authority are exercised to a substantial degree onshore, then despite the fund's jurisdiction, it will be taxed as resident wherever the person or persons exercising that control actually exercises it. This means that all meetings and conference calls should be held offshore and no decision taken without a majority of the board offshore and no UK based director may act or think in that role while in the UK. The directors are permitted to delegate certain duties, such as the discretionary investment management and administration, but must realise that they retain ultimate responsibility for management of the fund. The directors will commonly hold quarterly meetings, meetings at least once a year in person, and meetings may be required at other times; it is important to choose directors who will make themselves available and will execute documents promptly and efficiently and are fully suitable.

The Investment Manager Exemption

The Investment Manager Exemption (IME) allows a hedge fund to appoint a UK-based investment manager without creating a risk of UK taxation for itself. Through a series of qualifying tests, the IME ensures that overseas investors are not charged to UK tax in relation to investment transactions conducted on their behalf and that any fees received by a UK-based investment manager for services performed for the non-resident are fully chargeable to UK tax. The IME only applies to certain 'investment transactions' set out in government regulations. In addition to a transaction being an investment transaction, there are several conditions which must be met within a specific time limit for the IME to be satisfied. Broadly, these are as follows:

- the UK investment manager is in the business of providing investment management services;
- the transactions are carried out in the ordinary course of that business;
- the investment manager acts in relation to the transactions in an independent capacity;
- the requirements of a '20% test' (ie the investment manager and associates do not make up 20% or more of the fund investors) are met; and
- the investment manager receives remuneration for provision of the services at not less than the rate that is customary for such business.

Other Service Providers

In addition to an investment manager, a hedge fund requires an independent administrator, an independent auditor, and, depending on the investment strategy, a custodian and/or prime broker. Some funds appoint a manager as well as an investment manager and this is often done for tax reasons, as the manager is usually based offshore.

The fund will also require legal counsel, who will be responsible for establishing the fund and preparing and negotiating the various fund documents, including the prospectus, the material contracts between the fund and its service providers and incorporation documents. The fund will also need to consult tax advisors to enable the relevant parties to determine which structure is suitable in their own circumstances.

Share classes

It is common for a hedge fund to create management shares and investment shares. The management shares hold the voting rights, but do not participate in the profits of the fund, while the investment shares are non-voting, but do participate in the profits and are redeemable. The reason for this is to avoid having to seek the consent of the investors, who could be numerous, for decisions arising in the day to day management of the fund. For Cayman funds, the management shares are commonly held by a star trust.

Within the investment shares, the directors can choose to create any number of share classes. All the shares in the same class must be treated equally, thus it is necessary to create different share classes to accommodate varying rights, such as different redemption rights, different fees, the use or non-use of leverage or, most commonly, alternative currencies. A hedge fund will often offer a separate share class for investment solely for the officers and employees of the investment manager, which will not be subject to any management or performance fees so as to avoid the investment manager charging itself fees.

Funds may also consider establishing a class of share for UK taxable investors which could benefit from the reporting regime.

Fees

In addition to the fund start up costs (as to which see below), the investment manager will charge management and performance fees. These can range between 1% - 5% and 10% - 25% respectively, but a typical fee structure for a hedge fund is 1.5% to2% and 20% respectively. Other on-going fees for the fund include administration fees, regulatory fees, auditor fees, custody and brokerage costs, directors' fees and other professional costs.

Equalisation and series accounting

Equalisation or series accounting ensures that a performance fee is charged only to those investment shares which have appreciated in value and which equates precisely with each share's performance. Both methods are used by hedge funds and most administrators are able to offer both. Under the equalisation approach, there is one NAV per share for the entire fund and individual adjustments are made to each shareholder's account by issuing a small number of equalisation shares each month, if necessary. Series accounting uses multiple series of shares (one for each period of issue), each with a different NAV per share and each series has its own high water mark.

Lock up, redemption and gating

Traditionally, a hedge fund is relatively liquid and investors are able to redeem their shares upon a certain notice period, which could range between 30 and 180 days and in the event that insufficient notice is given, the investor could be charged a redemption fee (usually between 1% and 5% of the amount being redeemed).

However, some funds (increasingly so after the recent financial crisis) may choose to put an initial lock up in place, which means that no share can be redeemed within that lock up period, which could, for example, range from 6 months to 3 years. A hedge fund with a lock up is understandably less attractive to investors as its liquidity is compromised and its imposition will therefore depend on the strategy pursued and, in some cases, the agreement of the seed investor(s).

There has been a recent increase in the use of "investor gates" which impose a gate on redemptions at investor rather than fund level. This can be seen as a compromise to allow a fund to impose a gate but ensure that it does not adversely affect small investors who might be affected if a large investor were to seek to make a redemption which is over the fund's gate.

Side pockets

Where a hedge fund holds assets that are hard to value reliably or are relatively illiquid (in comparison to the redemption terms of the fund itself), the fund may employ a "side pocket". A side pocket is a mechanism whereby the fund segregates the illiquid assets from the main portfolio of the fund and issues investors with a new class of shares which participate only in the assets in the side pocket and which cannot be redeemed by the investor. Once the fund is able to sell the side pocket assets, the fund will generally redeem the side pocket shares and pay investors the proceeds. Side pockets therefore allow a fund to ensure that all investors in the fund at the time the relevant assets became illiquid will bear any loss on them equally and allow the fund to continue subscriptions and redemptions in the meantime in respect of the main portfolio. Side pockets are generally used as an emergency measure only.

Listing

Some hedge funds list their shares or certain share classes on smaller stock exchanges, such as the Irish Stock Exchange, as this provides a level of regulatory oversight required by some investors. In order to list, a hedge fund must fulfil certain notification requirements of the exchange and submit to certain investment restrictions and its prospectus will be subject to approval. The fund will need to appoint a listing sponsor, which liaises between the fund and the relative exchange, and will incur additional fees imposed by the exchange. At least two independent directors are required, counterparties must meet certain criteria, investment restrictions are imposed and certain changes must be reported to the exchange.

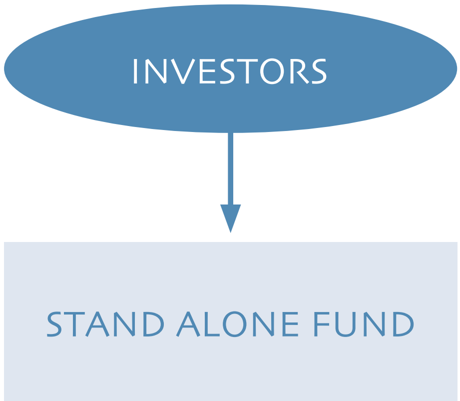
Timing

A hedge fund can take an average of approximately three months to set up, but this timing depends on a number of factors, not least the responsiveness and co-operation of the relevant parties and whether the investment manager is authorised or not.

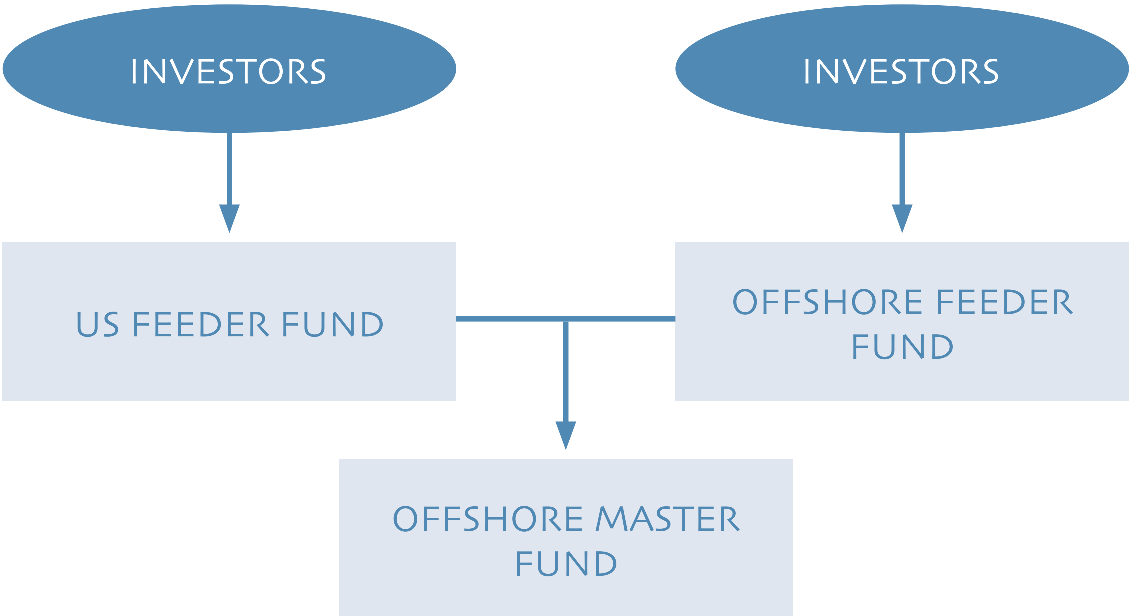
APPENDIX

Diagramatic examples of Fund Structures

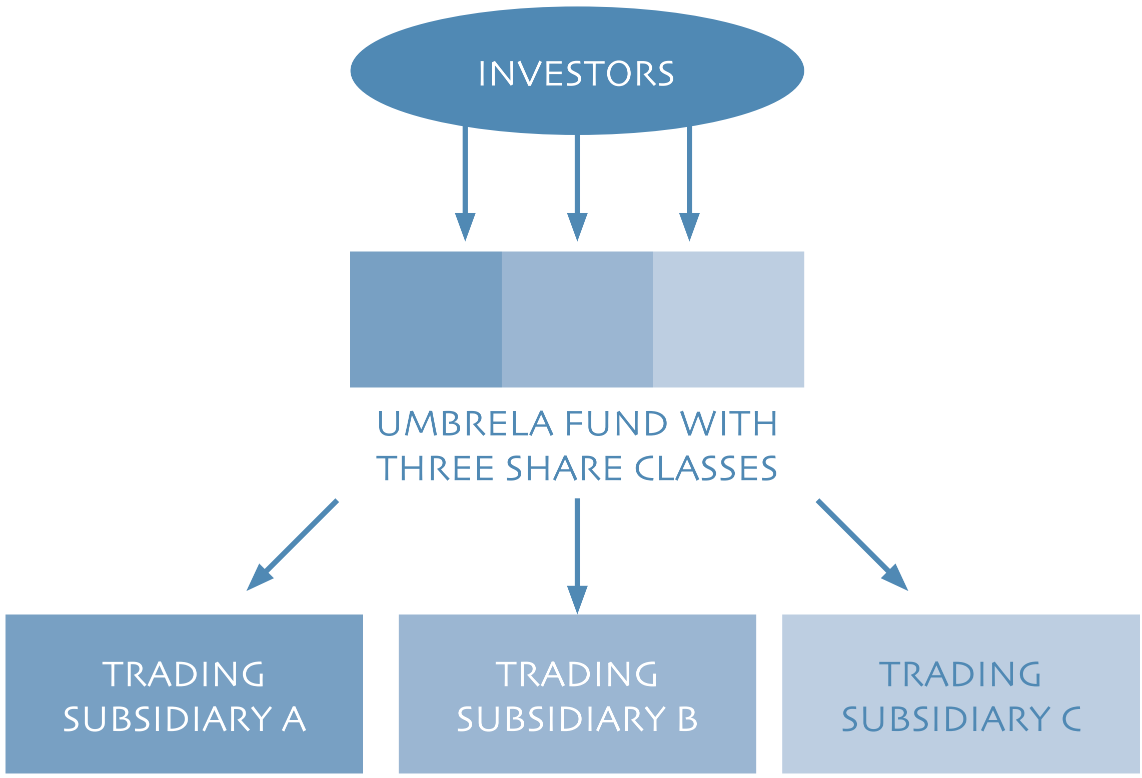
1. Stand alone fund:



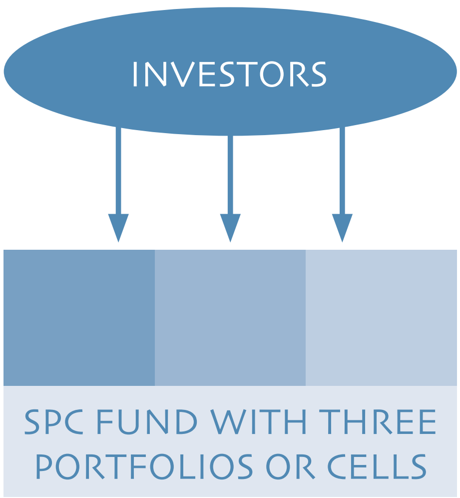
2. Master/feeder fund:



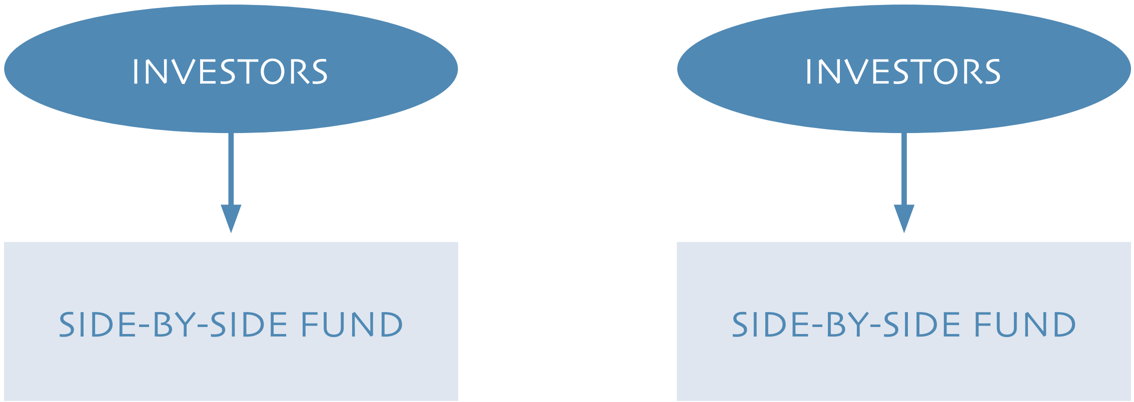
3. Umbrella fund:



4. SPC fund:



5. **Side-by-side fund:**



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