Launching an Incubator Hedge Fund

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- An incubator fund provides an emerging manager without a prior track record a cost-effective method to generate a marketable track record by trading or investing the manager’s personal capital before incurring the considerable expense of launching a full-fledged hedge fund open to outside investors.
- The establishment of an incubator hedge fund involves the organization of a typical GP/LP structure characteristic of a full-fledged hedge fund without preparation of the legal documents needed to accept outside investors (such as a private placement memorandum and subscription documents).
- As the viability of the fund’s strategy is proven during the incubator phase, the marketability of the fund and the manager’s credibility are enhanced.
- Building a track record with personal capital in the fund entity helps to avoid many of the pitfalls of marketing a track record generated at a former fund, as an adviser to separately managed accounts or through trading in a personal account.

How is an incubator fund structured?

- The structure of a fund is typically no different whether first launched as an incubator and later converted to a full-fledged fund or initially as a full-fledged fund with outside investors accepted at launch.
- A fund is typically established under a GP/LP structure with a limited liability company domiciled in the state where the manager’s primary operations are located serving as the general partner to the fund and the fund organized as a limited partnership under the laws of Delaware.

Can friends and family invest in an incubator fund?

- No. The state and federal securities laws require that all outside investors (whether friends and family or institutional investors) receive full and fair disclosure regarding all material terms of and risks involved in the purchase of an interest in a pooled investment vehicle (e.g. interests in a fund are "securities").
- These comprehensive disclosures are generally provided in the Fund's private offering memorandum otherwise known as a private placement memorandum.

Does a manager need to be licensed or engage a fund administrator during incubation?

- Generally, no. Since a manager is only trading personal capital during the incubator phase, the investment advisory laws of the state in which the manager is located generally do not apply and the manager will therefore not need to have passed any industry exams nor be registered as an investment advisor or an exempt reporting adviser with the state's securities regulatory authorities.
- Additionally, when there is no outside capital in the Fund, most of the work a fund administrator is tasked with providing is not necessary, including valuing the assets of the fund to allow for subscriptions and redemptions, calculating fees and expenses attributable to each investor's capital account and preparing periodic reports for investors.

Are there negative tax consequences to a manager to trading personal capital in an incubator fund?

- A U.S. fund is generally organized as a limited partnership (or less frequently an LLC) and treated as a pass-through entity (a partnership) for tax purposes. As a consequence, all gains and losses are passed taxable at the investor level and not at the entity level and reported on the personal income tax return . As an investor in the incubator fund a manager therefore faces identical tax payment obligations whether their capital is invested in a personal account or in the incubator fund.

Is there a minimum capital contribution needed to seed an incubator?

- Legally speaking, no. Practically, however, a manager is advised to fund the incubator with sufficient capital to adequately implement the strategy they intend to pursue. If underfunded, returns in the incubator may not be representative of returns likely to be achieved in the full-fledged fund.

When would launching the incubator fund as an offshore entity make sense?

- If a manager anticipates that the fund will initially be composed primarily of non-US investors or tax-exempt US investors, rather than taxable U.S. investors, an offshore fund incorporated in an offshore jurisdiction such as the Cayman Islands, for example, may be the right choice.
- When launched as a full-fledged fund, an offshore fund will allow non-US investors to avoid the need to obtain a U.S. tax ID and report annually to the IRS and would ensure that tax exempt US investors avoid any Unrelated Business Taxable Income (UBTI) issues associated with a domestic fund borrowing capital (being leveraged).

How much does it cost to launch an incubator?

- Generally, all work involved in forming, structuring and launching an incubator fund and its management company can be done for approximately $4,000 including state entity formation fees). The cost of launching the incubator fund is then applied to the overall cost of launching the full-fledged fund, if and when the manager determines to accept outside capital such that the total cost to launch the full fund is the same whether an incubator fund is launched first or not.
- Since an incubator fund does not require an outside administrator or auditor (unless the manager has his track record verified or audited by an independent third party (which is certainly best practice), the ongoing operational costs associated with running a full-fledged fund with outside investors is avoided. As such, other than the initial legal costs to establish the incubator fund and any year end tax preparation expenses, the ongoing costs to operate an incubator fund are minimal.

We provide comprehensive advice and legal services to incubator funds, including:

- Reviewing our fund formation questionnaire in depth with the manager as if a full-fledged fund were being launched and providing guidance as to the fund's economic terms (management and performance fee), liquidity provisions (such as lock up, frequency of withdrawals, notice provisions) hurdle rates, investor qualification requirements, etc.;
- Advise the manager regarding the regulations applicable to their fund, if any, whether as an exempt reporting adviser, investment adviser or commodity pool operator, or otherwise;
- Review the Fund's marketing materials for legal disclosures;
- Introduce the manager to appropriate fund service providers including administrator, auditor and brokerage firms.

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