Launch or Grow your Private Fund Business

June 3, 2020

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Presenters

Ron S. Geffner

Daniel G. Viola

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During this Webinar, we will discuss:

- Launching a Hedge Fund - *Establishing the Right Structure for your Firm.*
- Regulatory Compliance Requirements for the Manager - *Overview of Investment Advisers Act and the Commodity Exchange Act.*
- Marketing the Hedge Fund - *Limitations in connection with raising assets for your fund and proven commercial practices*

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Hedge Funds

History

It is generally agreed that the first hedge fund was established in 1949 by A.W. Jones. Mr. Jones employed a hedge concept in which he used short selling as a way to protect his portfolio from misjudgments on the general trend of the market. He also leveraged his long positions in order to neutralize general market risks and to tie performance more clearly to his stock selecting ability.

Definition of a Hedge Fund

The term “hedge fund” is not defined or used in the federal securities laws and has no precise legal definition. Generally, the term is used to describe private investment vehicles that engage in active trading of various types of securities and commodities including equities, government securities, financial futures, options and foreign currencies. Hedge funds often employ sophisticated investment techniques such as arbitraging, leveraging and hedging.

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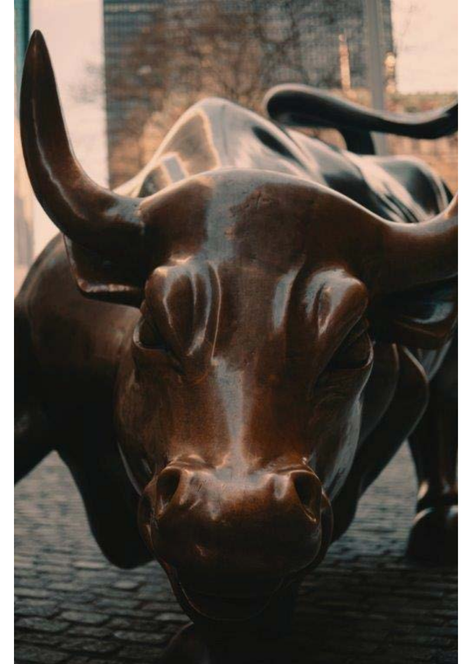
Definition of a Hedge Fund

- A “hedge fund” is a private investment vehicle organized for the purpose of pooling investors’ assets. The sponsor of the hedge fund, commonly referred to as the hedge fund manager, invests the hedge fund’s assets pursuant to a predetermined investment strategy. It is argued that in the absence of such a pooling vehicle, an investor, on its own, would not be able to diversify its assets or have the resources to monitor, evaluate and implement the investing and trading strategies to be engaged in by the manager of the fund. Although, historically, the defining characteristic of a hedge fund was to “hedge” against market risk and volatility, hedge funds today utilize a variety of investment techniques.
- Unlike mutual funds, which are highly regulated, hedge funds:
    - are not required to redeem investors’ assets within seven days from the date on which it receives a notice for redemption from an investor; and
    - may take illiquid positions without limitation and may engage in leveraged transactions with greater freedom.



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Questions Regarding Prospective Investors

- What do I anticipate assets under managements will be upon launch?
- What type of investors have you identified for investment?
  - Are they institutional investors or individual investors?
  - Are they domestic (US based) or offshore (foreign)?
    - If the investor resides offshore, in what countries do they reside?
  - If the investors are individuals, are they accredited, qualified clients, qualified eligible participants, or qualified purchasers?
  - If domestic, is the investor (a) US taxable or (b) US tax exempt?
  - If US tax exempt, is the investors governed by ERISA?

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Investment Company Act- Sections 3(c)(1) and 3(c)(7)

- Most commonly, hedge funds are not required to register as an investment company with the SEC, in reliance usually upon an exemption pursuant to either, Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the “Act”). Section 3(c)(1) of the Act, in part, provides an exemption from the Act’s registration requirement for an investment company whose securities are owned by not more than 100 “persons” at any given time. Hedge fund managers most commonly rely upon the exemption from registration as an investment company available under Section 3(c)(1) of the Act. Section 3(c)(7) of the Act, in part, exempts investment companies from the Act’s registration requirement without limitation as to the number of its beneficial owners as long as the securities are owned exclusively by “qualified purchasers” as defined in the Act. A hedge fund operating pursuant to an exemption under either Sections 3(c)(1) and 3(c)(7) of the Act, however, may not make any public offering of its securities under the Securities Act of 1933. There are numerous restrictions against advertising and general solicitation by hedge funds relying on either the Section 3(c)(1) or Section 3(c)(7) exemption, and managers should exercise proper caution in their selling efforts to ensure that the fund’s exempt status is never compromised.

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Qualification of Investors in a Section 3(c)(1) Hedge Fund

- Interests in a hedge fund are typically offered to prospective investors pursuant to an exemption from the public registration requirements for securities offerings under Rule 506 of Regulation D of the Securities Act of 1933. Securities offered under Rule 506 may be sold solely to “accredited investors” and, under certain circumstances, up to 35 “sophisticated investors”.

- The allowance of 35 sophisticated investors is not a realistic option for hedge funds.

- Rule 506(c) permits issuers to broadly solicit and advertise an offering, provided that, generally, all purchasers in the offering are accredited investors and that the issuer takes reasonable steps to verify purchasers are accredited investors.

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Key Considerations for Hedge Fund Formation

- Investor demographics (residency, type of investor, assets under management, cash burn)
- What is my strategy?
- Location of the Investment Manager and its Principal(s) and Employees
  - Regulatory Implications
  - Tax Implications
- The investor demographics and investment strategy effect the following:
  - Structure of Investment Vehicle (Domestic Fund, Offshore Fund)
  - Regulatory Implications on the Investment Manager (e.g. Commodity Pool Operator, Registered Investment Advisor)
  - Tax Effect on the Investors
- What is the sponsor's distribution model? How ill the fund be marketed and to whom?

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Hedge Fund Structures

- The structures available to a hedge fund managers are:
  - Stand Alone Domestic Fund
  - Stand Alone Offshore Fund
  - Master-Feeder
  - Mini-Master
  - Side-by-Side
- There are various tax, administrative and other issues that the manager should consider in determining whether to utilize a master-feeder, mini-master feeder, or a side-by-side structure. The choice will depend on the manager's strategy and goals.

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Qualification of Investors in a Section (c)(1) Hedge Fund- Accredited Investors

- Under the Securities Act of 1933, a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements. The Act provides companies with a number of exemptions. For some of the exemptions, such as rules 505 and 506 of Regulation D, a company may sell its securities to what are known as "accredited investors." The term accredited investor is defined in Rule 501 of Regulation D.

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Qualification of Investors in a Section 3(c)(1) Hedge Fund - Accredited Investors

- **An Accredited Investor Is Deemed To Include, In Part:**
    - A natural person with an individual net worth, or joint net worth with his or her spouse, at the time of purchase in excess of $1,000,000. Effective July 21, 2010, the value of a natural person's primary residence must be excluded from the $1,000,000 net worth calculation;
    - A natural person with an individual income in excess of $200,000, or in excess of $300,000 with his or her spouse, in each of the two most recent years and who has a reasonable expectation of an income in excess of $200,000 individually, or in excess of $300,000 with his or her spouse, in the current year;
    - An executive offer, director or general partner of the issuer of the securities offered;
    - An employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), (a) whose investment decisions are made by a plan fiduciary, as defined in Section 3 (21) of ERISA, which is either a bank, insurance company or registered investment advisor; or (b) having total assets in excess of $5,000,000; or (c) if self-directed, the investment decisions are made solely by person that are accredited investors;
    - A trust, with total assets in excess of $5,000,000 which was not formed for the specific purpose of acquiring an interest in the hedge fund, whose purchase is directed by a sophisticated investor; and
    - An entity in which each of the equity owners are accredited investors.

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SEC Accredited Investor Update

On December 18, 2019, the SEC proposed amendments to Rule 501(a) of Regulation D under the Securities Act of 1933, which would expand the definition of “accredited investor.” The amendments would add:

- “Spousal equivalent” to the accredited investor definition;
- New category to qualify a person as accredited based on certain professional certifications and designations, such as a Series 7, 65 or 82 license, or other credentials issued by an accredited educational institution;
- New category for any entity, including Indian tribes, owning “investments,” as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered;
- Family offices with at least $5 million in assets under management and their “family clients,” as each term is defined under the Investment Advisers Act.
- New category based on the person’s status as a “knowledgeable employee” of a private fund (similar to that for QPs);
- Limited liability companies that meet certain conditions, registered investment advisers and rural business investment companies (RBICs) to the current list of entities that may qualify as accredited investors; and
- A “catch-all” category that would permit the institutional accredited investors under Rule 501(a), of an entity type not already included in the qualified institutional buyer definition, to qualify as qualified institutional buyers when they satisfy the $100 million threshold.

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Investment Company Act - Section 3(c)(1) - Counting Investors

- For purposes of counting investors in connection with the 100-person limitation imposed by Section 3(c)(1) of the Investment Company Act of 1940, normally, each person is counted separately. The Act defines a "person" to mean a "natural person or a company." The SEC staff, however, will "look-through" a company that invests in a hedge fund and count each of the security holders of that company as a separate investor of the fund, if: (i) the company investing in the hedge fund is either a registered investment company or a private investment company organized pursuant to an exemption under either Section 3(c)(1) or Section 3(c)(7) of the Act; and (ii) the company beneficially owns 10% or more of the outstanding voting securities of the hedge fund. For offshore funds relying on Section 3(c)(1) that accept U.S. tax-exempt investors, only U.S. owners are counted towards the 100-person limitation.

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Qualification of Investors in a Section 3(c)(7) Hedge Fund

- Section 3(c)(7) exempts a hedge fund from having to register as an investment company without limitation as to the number of its beneficial owners as long as its securities are not publicly offered and its investors qualify as “qualified purchasers”. A person may not invest in a hedge fund relying on the Section 3(c)(7) exemption unless such person meets the definition of a “qualified purchaser.”
- The Act defines the term “qualified purchaser” to include, in part:
  - any natural person who owns at least $5 million in investments; or
  - any other person (e.g., an institutional investor) that owns and invests on a discretionary basis at least $25 million in investments.

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Hedge Fund Structures

Domestic Partnership

For purposes of managing the assets of taxable persons residing in the United States, a hedge fund is typically organized as a limited partnership. By purchasing an interest in the partnership, an investor becomes a limited partner of the partnership.

Management Entity Structure

In an attempt to limit personal liability, the manager of a domestic fund usually forms an entity to provide advisory services to the partnership. This entity serves as the general partner of the partnership. Depending upon the laws of the state in which the general partner will be domiciled, the hedge fund manager will organize the general partner as a limited liability company, corporation or limited partnership.

In certain cases, the manager will form two entities, one entity to serve as the general partner and the other entity to serve as a management company, commonly known as the investment manager. The use of two separate entities is very common for managers based in New York city, as well as certain other jurisdictions.

The use of an entity as the general partner or investment manager, however, will not shield an individual manager from personal liability for fraud and other claims under the federal securities laws.

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Hedge Fund Structures

Options for Structuring Offshore Funds

- If a manager elects to set the fund up “offshore” there are a variety of ways to structure the fund. The three most common structures are master-feeder, mini-master, and side-by-side.
- For the purpose of managing the assets of persons residing outside of the United States, an offshore fund is ordinarily structured as a corporation and organized in a tax haven jurisdiction. Examples of such jurisdictions include Bermuda, British Virgin Islands, Cayman Islands, Ireland and Luxembourg. The jurisdiction in which the fund is organized often depends on the countries in which investors reside and the type of entity the sponsor desires to form. Offshore funds are also attractive to United States tax-exempt organizations (e.g., individual retirement accounts, qualified pension and profit-sharing trusts) as a method for avoiding unrelated business taxable income.

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Master Feeder Structure

- This structure, also known as a “hub-and-spoke,” allows investors residing in the United States and investors residing offshore to invest, indirectly, in the same corporate entity commonly known as the “master fund” by providing two feeder funds, one domestic and one offshore, that each invest all assets directly into the fund.
- The master fund can be structured as a limited partnership or an offshore company, in either case treated as a partnership for U.S. federal income tax purposes. Ordinarily, U.S. taxable investors investing in a master-feeder structure directly invest in a limited partnership organized in the United States. This limited partnership is referred to as the “domestic feeder.” The offshore investors and U.S. tax-exempt organizations (e.g., IRAs) directly invest in an offshore corporation. This offshore corporation is referred to as the “offshore feeder.” The hedge fund manager then purchases and sells securities in an account held in the name of the master fund.

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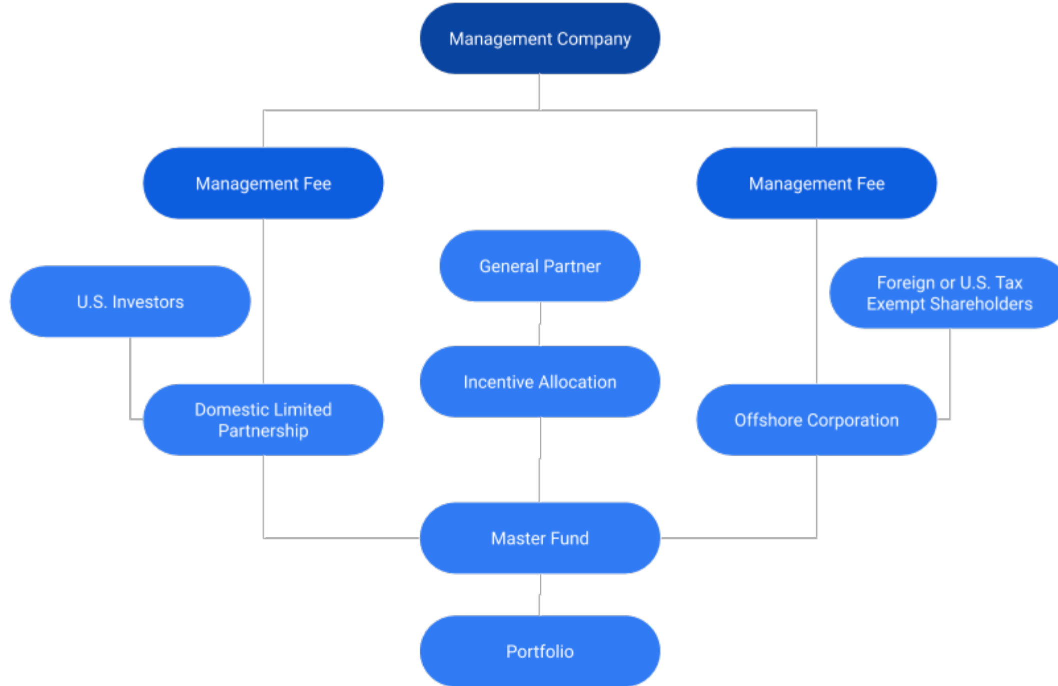
Master Feeder Structure



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Mini-Master Feeder Structure

- This structure, also known as a "hub-and-spoke," allows investors residing in the United States and investors residing offshore to invest, indirectly, in the same corporate entity commonly known as the "master fund" by providing two feeder funds, one domestic and one offshore, that each invest all assets directly into the fund.
- The master fund can be structured as a limited partnership or an offshore company, in either case treated as a partnership for U.S. federal income tax purposes. Ordinarily, U.S. taxable investors investing in a master-feeder structure directly invest in a limited partnership organized in the United States. This limited partnership is referred to as the "domestic feeder." The offshore investors and U.S. tax-exempt organizations (e.g., IRAs) directly invest in an offshore corporation. This offshore corporation is referred to as the "offshore feeder." The hedge fund manager then purchases and sells securities in an account held in the name of the master fund.

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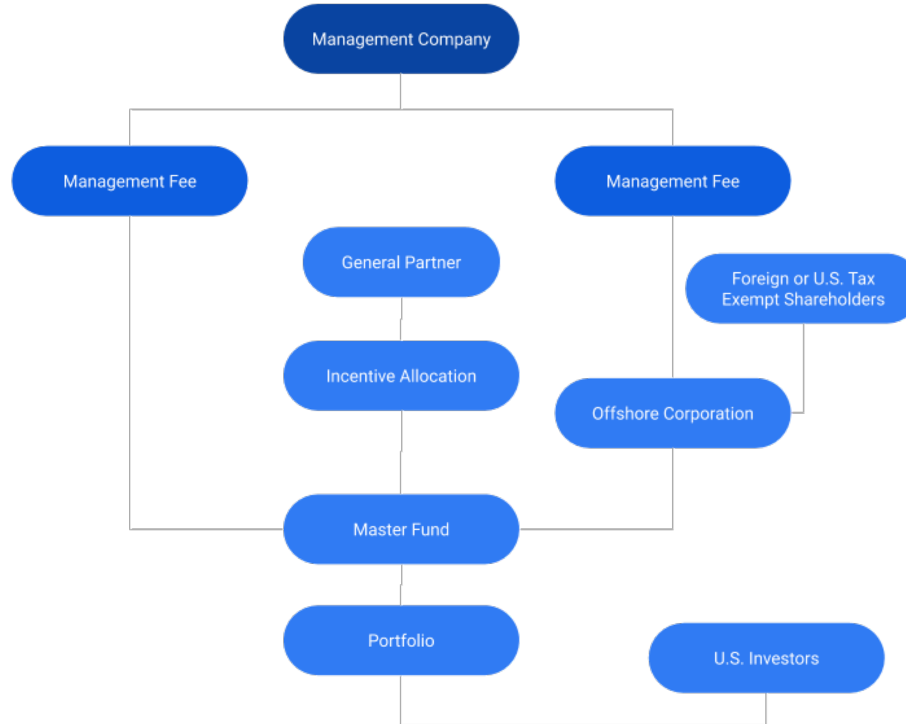
Mini-Master Feeder Structure



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Side by Side Structure

- In a side-by-side structure, U.S. investors typically invest in a limited partnership organized in the United States, and offshore investors invest in an offshore corporation. The prime broker typically allocates trade tickets between the domestic fund and the offshore fund.
- For hedge fund managers seeking to establish both a domestic and an offshore fund, there are various tax, administrative and other issues the manager should consider in determining whether to utilize a master-feeder or a side-by-side structure. The choice will depend on the manager's strategy and goals.

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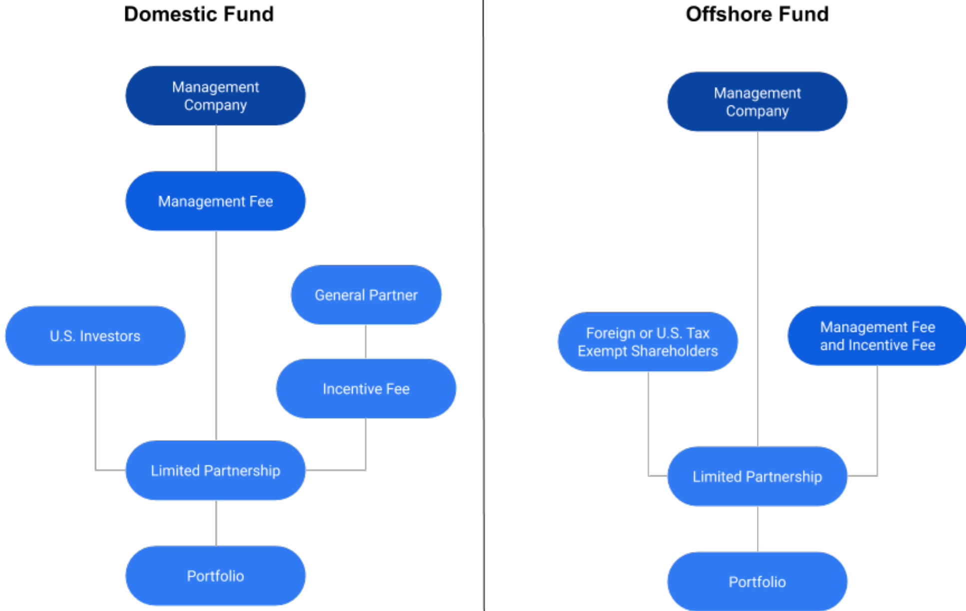
Side by Side Structure



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Service Providers

- Selecting service providers is crucial to the long-term success of your business. The selection process should be based on the providers' expertise in hedge funds, reputation and ability to grow business.
- The most common service providers are:
  - Prime Broker
  - Attorney
  - Compliance
  - Auditor
  - Fund Administrator
  - Information Technology

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Requirements to Register as Investment Advisor

Interplay of State and Federal Law for Private Fund Advisers

- Less than $25m AUM
  - Cannot register with SEC
  - Look to state law: may require registration
- $25m to $110m AUM
  - Generally, exempt from SEC registration as "mid-sized adviser" (except, e.g., New York)
  - Look to state law: may require registration—otherwise, file as an exempt reporting adviser ("ERA")
- Greater than $110m but less than $150m AUM
  - File as an ERA with SEC
- Private Funds Exemption Model Rule
  - Exemption from state registration for "private fund advisers"—file as an ERA with state
- Foreign Private Adviser Exemption
  - Has no place of business in the United States;
  - Does not hold itself out generally to the public in the United States as an investment adviser;
  - Has fewer than 15 clients/investors in the United States; AND
  - Has less than $25 million Regulatory AUM attributable to clients in the United States and US investors in private funds.

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Commodity Pool Operator Considerations

Hedge funds which invest in commodities or futures are deemed to be commodity pools under the Commodities Exchange Act. A manager of such funds will need to be registered as commodity pool operators ("CPOs") unless the manager fits within an eaxemption from registration.

The most common exemption is Rule 4.13(a)(3), which is a *de minimis* provision:

- The fund interests are exempt from registration under the Securities Act and privately placed;
- All investors are accredited investors or qualified eligible persons ("QEPs"); and
- Either of two tests (aggregate initial margin and premiums or aggregate net notional value) is met.

CPOs that wish to continue trading futures and swaps, and thus, are required to register, may be able to rely on exemptions from certain rules otherwise applicable to CFTC registrants.

The most common exemption is Rule 4.7, which provides relief from most of the disclosure and reporting requirements applicable to a CPO for a fund offered only to QEPs.

Qualified Clients

Limitation on Registered Advisers Charging Performance-Based Fees

- Generally, a hedge fund manager registered as an investment adviser may receive performance-based compensation from an investor only if such investors is a "qualified client."
- Under the Advisers Act, a person is deemed to be a qualified client if the hedge fund manager has a reasonable belief that the investor has a net worth in excess of $2,100,000 at the time of investment or the investor has at least $1,000,000 under the management with the manager. Certain states, however, use a lower standard, whereby an investor must have a net worth in excess of $1,000,000 or assets of $500,000 under management with the hedge fund manager. There are additional restrictions imposed on managers who are registered as an investment adviser by states utilizing the lower standard.
- Non-U.S. persons are not required to meet the requirements of a "Qualified Client".

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Compensation

- A hedge fund manager may receive several forms of compensation. The manager often receives a performance allocation equal to a percentage (usually 20%) of realized and unrealized appreciation of the hedge fund’s assets, allocable on a yearly basis. In addition, the manager typically receives a management fee equal to a percentage (e.g., 1% annually) of assets under management, which is payable quarterly or monthly. When two management entities are used, ordinarily the general partner receives the performance allocation and the investment manager receives the management fee. In such instances, the investment manager is responsible for managing the fund’s assets, and for paying the hedge fund manager’s overhead expenses (e.g., rent, furniture, equipment) and employing the manager’s personnel. The general partner, however, is more “passive”, and will not typically employ any direct personnel.

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Incentive Allocation vs. Incentive Fee

- Performance Fees/Incentive Allocation
- Allocation vs. Fee
  - Performance compensation is common and certain funds charge significantly greater fees.
  - Among U.S.-based managers, most charge a performance allocation from an entity treated as a partnership for U.S. federal income tax purposes.
  - Most funds have historically charged 20% on all profits.
  - Some funds also incorporate a “hurdle rate” which requires the fund to exceed a certain minimum rate of return before the performance compensation is assessed.
  - **THIS HOWEVER IS NOT THE INDUSTRY NORM AND IS MORE OFTEN SEEN IN VENTURE AND/OR PRIVATE EQUITY FIRMS OR FIRMS WITH EMERGING MANAGERS.**

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High Watermark

- Performance compensation calculations usually incorporate a high watermark concept, which requires the fund manager to make up any prior un-recouped losses before earning performance compensation on current profits.
- Some funds incorporate a “catch-up” which allows a manager to collect one half of its normal incentive compensation if the fund has gains from a lower position than the high watermark. Once the high watermark is exceeded the full performance compensation is reinstated. This partial payment of the performance compensation assists the manager in retaining talent and should deter the manager from taking unnecessary risks in order to achieve the high watermark.

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Management Fee

- The management fee, which is usually assessed on net present value of assets under management (NAV).
- The 2%/20% compensation schedule arose from the oil/gas industry and the wildcatters who borrowed money from people to explore for oil/gas. This compensation schedule has lasted for over 50 years.
- Over the last few years, there are a growing number of managers who forgo charging a management fee. In lieu of the management fee, they elect to receive higher incentive compensation.

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Common Mistakes

- Selecting the wrong service providers
- Cutting corners (operating agreements, employment agreements, agreements with third parties)
- Lack of routine communication with key service providers (making mistakes that cannot be undone or come at a high price)

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Cost and Timing

- Standalone funds either domestic or offshore
  - $35,000 plus out of pocket expenses
- Master feeder, mini master feeder, or side-by-side structures
  - $70,000 plus out of pocket expenses
- Staggering your structures
  - Creating a domestic and offshore structure in stages
- The majority of fund sponsors amortize start up costs over sixty months - so the costs are shared more fairly among investors over a period of time.
- While many of the operating costs associated with operating the fund, such as research, legal and third party administration are borne by the fund, certain expenses, such as compliance and legal costs relating to investment adviser registration will be paid by the Investment Manager.

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Questions?

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Thank you for attending this webinar. Please do not hesitate to the webinar presenters with questions.

Ron S. Geffner

rgeffner@sadis.com

Daniel G. Viola

dviola@sadis.com

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