

Hedge funds - A guide



Updated edition

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Practical guide on setting up a hedge fund

This guide is aimed principally at the new hedge fund manager setting up in business, although Part II will be of equal interest to established fund managers or other regulated entities setting up new funds. Those funds need not be hedge funds since much of the guide is also relevant to funds with other investment policies such as securities funds, emerging markets funds, currency funds or derivatives funds.

For the purposes of the guide, we have assumed that the prospective hedge fund manager will wish to operate out of London. This is not essential but it is fair to say that London is the accepted European centre for hedge fund managers. London benefits from a state-of-the-art regulatory environment and, while this imposes ongoing costs for the hedge fund manager, it in turn provides comfort to prospective investors. London also boasts an unparalleled infrastructure, and the UK tax environment is relatively benign in comparison with some other jurisdictions, particularly for persons who have their tax domiciles overseas.

A budding hedge fund manager will need to obtain a regulatory licence (authorisation) from the Financial Services Authority (FSA) and this guide includes practical information as to how to go about this.

Choices must be made as to the offshore jurisdiction in which the hedge fund is to be established, its legal form and structure, whether or not to list its shares and how, where and to whom it will be marketed. The guide provides some pointers on these issues.

We also look at the service providers involved, the roles they play and the documentation that is needed. Finally, we demystify equalisation in performance fee calculation. Taylor Wessing LLP can assist you at all stages of the process. We recommend that you come to see us at the earliest opportunity to ensure that you get off on the right foot. There will be no charge for this initial interview.



Part I - The UK adviser/manager FSA application

Before you can begin to advise or manage a fund from the UK, you will need to obtain authorisation from the FSA, unless you already have the necessary regulatory licence or are able to associate yourself with an appropriately authorised firm and take advantage of its regulatory umbrella. The FSA has up to six months to determine an application from the date it becomes complete.

Assuming that the applicant deals with all matters expeditiously, a straightforward application should take 12 to 14 weeks from commencement to approval. Usefully, the entire pack can be downloaded from the FSA website.



Regulatory business plan

Preparation of this plan is the first step in getting the application under way. You should not delay in getting started on this important element of the process - it will focus the mind and ensure that you are giving consideration to all the key areas of setting up a successful hedge fund management business. The FSA application pack provides guidance on the information that needs to be covered in the plan, including the background and competitive advantages of the proposed business, as well as how the risks will be monitored and controlled. The plan will need to provide details of the individual(s) behind the business and the proposed structure of the fund - for example, the firm might be formed as a limited company, limited partnership or limited liability partnership (see "Legal status of the firm" below). It should include a discussion of the proposed investment policy to be followed by the fund.

The regulator is not only concerned with seeing that the persons it authorises have in place the necessary culture, systems and procedures to ensure that the business is operated in accordance with its rules. It will also be looking for comfort that the firm will have a viable future and that it will be sufficiently funded during its initial period of operation to continuously satisfy the FSA's financial resources requirements. Taylor Wessing is happy to assist you at whatever level is required in the preparation of this document and can, if required, provide you with an initial template to get the process under way.

Core details form

This form is designed to provide the FSA with essential information regarding the firm, including the following:

■ Contact details

■ **Legal status of the firm:** a limited company has traditionally been used to provide limited liability for the manager although since 2001 a more popular route has been to form a limited liability partnership (LLP). Another possibility is a limited partnership but this option appears largely to have been superseded by the LLP option. LLPs offer several possible advantages:

- limited liability for all members of the LLP (roughly equivalent to partners in a general partnership);
- LLPs are not subject to tax on their income or capital gains - instead the tax authorities 'look through' to members who pay tax on their share of the profits and gains of the LLP as though they received them personally;
- early trading losses can be set off against members' other income;
- no employers' National Insurance contributions for members;
- a more informal, flexible structure which facilitates the introduction of new members, changes in ownership and focused arrangements for rewarding individuals;

- the creation of a services company (which can itself be a member of the LLP) to provide services to the LLP can provide added flexibility and additional ring fencing for long-term liabilities;

As with companies, an LLP's audited accounts and members' details must all be registered at Companies House together with annual returns.

- **Group structure chart**
- **Details of all senior management, controllers, investment managers, directors or partners, etc**
- **Details of key service providers to the fund:** see page 12.
- **Business profile and limitations:** this specifies the type of regulated activity the firm will conduct (investment management), any particular limitations that will apply to the firm's regulated activity and any restriction on the type of client. Typically, the firm's initial clients will be the hedge fund or other fund vehicles whose accounts it will manage. Offshore funds are classified as "intermediate" (i.e. non-private) customers. Also acting for private customers will increase the level of regulation.
- **Prudential categories:** the manager will come within the category of an investment management firm.
- **Requirements:** these are limits on the firm's regulated activities and affect the level of regulation. For example, hedge fund managers will generally not hold client money as the fund's prime broker/custodian will do this. Holding

client monies or assets implies a higher level of regulation and an increased financial resources requirement. If the firm proceeds on the basis of not holding client monies or assets, it should apply in the application for a requirement to be imposed that it does not do so.

- **Supporting documents:** this list includes the documents necessary to support the application. As the applicant for authorisation, the firm must, at a minimum, have been established even if it is not yet fully capitalised. The FSA will want to see a draft of the proposed offering document of the fund as well as drafts of the prime brokerage, management (if the fund's structure includes a separate offshore manager), investment management and administration agreements.

Compliance form

This form requires the firm to set out its compliance arrangements, including:

- Compliance officer's reporting line
- Any compliance outsourcing arrangements
- Personal account dealing procedures
- Customer classification procedures and draft terms of business
- Complaints handling procedures
- Anti-money-laundering procedures, including identity verification procedures, disciplinary measures and record-keeping arrangements
- Procedures to ensure initial and ongoing

competence of staff; supervision arrangements for trainees.

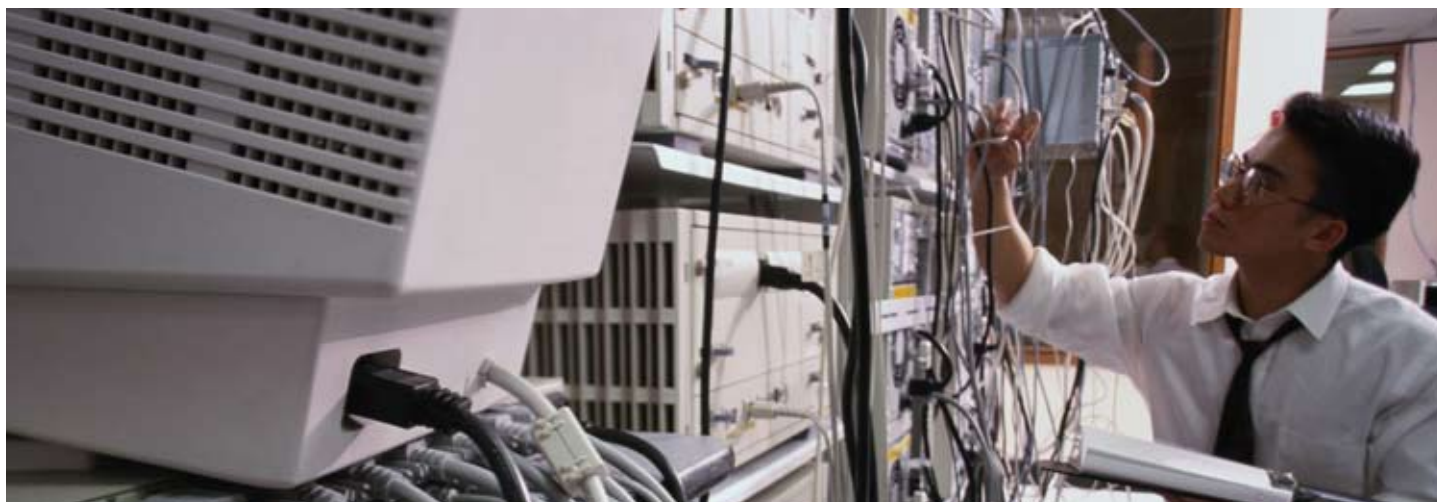
The FSA will also require a compliance manual, procedures manual and monitoring programme for use by the firm's staff to be prepared in draft and enclosed with the application.

Systems form

The systems form provides information regarding the key systems that the firm will require. For example, details must be provided of transaction reporting, recording and settlement systems as well as of the firm's accounting systems and testing procedures. It is likely that the systems required by a hedge fund manager will be relatively simple and that considerable reliance will be placed on the prime broker.

If the firm proposes to use particularly complex IT systems, or will be highly dependent on its own or outsourced IT systems, then considerable detail of those systems must be provided, such as their implementation, testing, relevant consultants, contingency plans, disaster recovery, security and IT governance and infrastructure arrangements.

The systems form, and supporting documents, must then be signed off by an auditor or independent accountant.



Financial resources form

This form allows the FSA to examine whether the hedge fund manager has sufficient financial resources to carry on the proposed regulated activities. The form requires details of share capital and external funding obtained, together with any charges and guarantees. Detailed financial information must also be given, including a balance sheet as at the start-up date and a forecast profit and loss account for the first year end.

Typically, and very broadly, the hedge fund manager will need to be capitalised at a minimum of €50,000 (or €125,000 if it is to hold client monies or assets) and will need at all times to maintain its liquid funds at a level in excess of one quarter of annual projected expenditure. Once again, supporting documentation will be required and you will need to have the form signed off by an auditor or independent accountant.

Additional forms

The main application must be accompanied by applications for approval of all individuals in the firm who will undertake one of the controlled functions listed in the FSA's supervision manual. These include governing functions such as being a director (executive or non-executive), chief executive or partner; required functions such as those covering apportionment of responsibilities, compliance oversight and money laundering reporting; other functions involving significant influence on the firm's management; and functions involving dealing with customers or their assets. The individuals responsible for managing or advising the hedge fund's account will need to have qualifications recognised by the FSA.

Finally, the application form must be accompanied by controller forms covering all persons who are 'controllers' of the investment manager through ownership or participation or voting power. This includes any person exercising direct or (subject to certain criteria) indirect control over 10 per cent or more of the firm.

Taylor Wessing's role

Our recommendation is that prior to putting pen to paper, you have a meeting with us to discuss the application. This will enable us to give you pointers as to how each element of the project should be reflected in the regulatory business plan and how to go about putting together a coherent and well-structured application.

We are happy to pitch the level of our input to satisfy your particular needs. This might range from leading the application process to simply reviewing the initial regulatory business plan, providing ad hoc advice on what the FSA will expect to see in each of the forms and by way of supporting documents, as well as conducting a final review of the application before submission.

We would normally expect to draft the hedge fund's offering memorandum as well as the investment management and (if appropriate) management agreements. We would also need to review the draft administration and prime brokerage agreements (which will be prepared by these service providers). First drafts of these documents will either need to accompany the application or be submitted to the FSA within a few weeks. In addition, we can help at whatever level is required in relation to the preparation of the compliance manual, procedures manual and monitoring procedures including providing first drafts.

We can, of course, deal with or assist in the incorporation of the firm and provide draft memorandum, articles of association and shareholders' agreement (for a company) or partnership agreement (for an LLP).



Part II - The fund

Fund planning

There are many issues to be taken into account when setting up a hedge fund. Who are your target investors? How should the fund be structured? Where should it be established? Should the fund be listed? What are the tax implications? How can the fund be marketed?

Here we take a quick glance at these and some of the other key questions you will need to consider. Of course, we would be happy to answer any questions these may raise and discuss and advise you on them in greater depth.

Structure

The principal vehicles used for hedge funds set up by managers based in the UK are a corporate entity or a limited partnership, or a combination of both. Although corporate vehicles are more common and often the more familiar to European investors, limited partnerships are worth considering - particularly if your fund is to be aimed at US taxable or Japanese investors because of the taxation and regulatory treatment applicable in those countries.

For example, where target investors include US taxable and non-taxable investors as well as non-US investors, a frequently-used structure is an offshore master fund/feeder fund. The feeder fund is incorporated as a limited liability company in, say, the Cayman Islands or Bermuda, and is generally the vehicle into which non-US investors and US non-taxable investors invest. This arrangement needs to be monitored to ensure that the level of subscription by 'benefit plan investors' is not significant for the purposes of US ERISA legislation. US non-taxable investors need to invest in a non-transparent entity to avoid becoming liable to tax on unrelated business taxable income (UBTI). The master fund is likely to be set up as a limited liability company or a limited partnership in the same jurisdiction as the feeder fund. The structure

frequently includes a US limited partnership to facilitate investments by US taxable investors. Occasionally, the corporate feeder fund for the US non-taxables will feed into the US limited partnership.

Advantages of the master feeder structure include:

- Operating efficiency such as in relation to monitoring of risk
- Trading is carried out through one investment vehicle only (which avoids the need for split allocations and engaging in equalising trades)
- Critical mass within a single pool of assets (for example, for obtaining better credit lines)
- Only one set of documents is required
- Provided US investors represent less than 50 per cent of the assets in the master fund, higher leverage may be possible than with a standalone US fund (such as with a parallel fund structure)
- The master feeder structure lends itself to flexibility in that feeder funds can be customised for specific groups of investors with, for example, different fee structures.

Some advisers are now veering towards a 'parallel' or 'side-by-side' solution. The advantages of this approach include:

- Exemptions under the Investment Company Act of 1940 can be used

for each of the parallel funds, thereby doubling up on the 100 US persons limit under section 3(c)(1) of the Investment Company Act of 1940 or using that exemption for one vehicle and the section 3(c)(7) exemption (only "qualified purchasers") for the other (not possible in a master feeder structure).

- Different trading strategies can be adopted for each of the funds (for example, the US fund might adopt strategies with a view to tax efficiency and potential tax treaty benefits which might not otherwise be available).
- Selecting a different financial year for each of the parallel funds will enable the receipt of incentive fees or allocations to be staggered.

An alternative is a single limited liability offshore company. This could potentially meet the requirements of the different types of investor, but a number of issues have to be covered. Firstly, the fund would be a passive foreign investment company, or PFIC, for US tax purposes. To avoid the adverse tax consequences of this, US taxable investors would have to elect to have the fund treated as a "qualifying electing fund". As a result, the fund would need to agree to provide them with certain required tax and accounting information. This information is not readily collated and therefore imposes an additional cost on the fund. Secondly, some administrators and auditors are not willing or do not have the systems to meet this information requirement. Thirdly, non-US investors will be unhappy to learn that their identities will become known to the US Internal Revenue Service - as 'partners' of the US taxable investors. And, fourthly, there is a general antipathy on the part of US taxable investors towards the PFIC regime, and they will be less likely to invest as a consequence.

Of course, it may be that non-US fund managers will wish in future to consider keeping US and non-US investors completely separate to protect their non-US investors from the increasingly invasive regulations coming out of the US. This can be achieved by use of parallel fund structures, although

this brings with it other problems - for example, the need for two pools of assets.

Ultimately, the structure of the fund will be driven by the needs of the target investor base. If the US is not being targeted, at least in the initial stages, it is possible to start with a single corporate entity and to convert later on if the need arises. This is likely to be a little more expensive than setting up a master/feeder structure on day one, but would enable you to get going with the simplest structure, leaving the extra cost of a master/feeder structure until the need for it arises. The offering memorandum should in this case include wording to cover the possible conversion. A halfway house is to start out with a one-legged master/feeder structure, leaving the US leg to be set up as and when US taxable investors express interest or are to be targeted.

You will also need to consider whether an offshore management company should be set up. For UK tax reasons (see below), the UK manager would only be responsible for trading or investing the hedge fund's account and would not be responsible for operating the fund vehicle itself. This role could be played by the fund (via its board of directors with the assistance of the administrator) or might be delegated to an offshore manager. The offshore manager, in turn, would delegate the trading/investment management function to the onshore regulated investment manager. It is not possible to attribute investment management income to the offshore manager in this structure if it is, in effect, a brass plate entity with no real presence, as we discuss in the next section. However, an offshore manager can be useful for holding management shares and it can be appointed to market the fund, so that when individuals with the UK fund manager go abroad to promote the fund they can do so on behalf of and in the name of the offshore manager, thereby justifying a commission.

Tax

The need to provide a tax-efficient structure will generally have a significant impact on

the fund structure and domicile ultimately chosen.

Use of the double tax treaty network is limited as offshore centres are not usually party to such treaties, and treaties of onshore centres frequently exclude open-ended funds. The frequent movement by hedge funds in and out of markets also limits their application. Therefore corporate hedge funds are normally set up in a jurisdiction that imposes no, or minimal, taxation, but care will need to be taken to ensure that the fund does not become resident, and therefore potentially subject to tax, in other jurisdictions. For UK tax purposes this includes ensuring that the control and management of the fund takes place outside the UK. Regular board meetings (we would recommend quarterly as a minimum) at which management and control issues are decided will need to be held overseas. It is essential that all management and control decisions are dealt with at such meetings and that there is proper, fully informed discussion prior to the resolution being passed. A fund whose board simply rubber stamps decisions already made onshore will simply not pass muster. A majority of directors should be non-UK resident. Taylor Wessing can provide further guidance in this regard and a 'dos and don'ts' checklist.

The use of a UK-based fund manager of a hedge fund has the potential of causing the fund's activities to be taxed as a trade in the UK. To prevent this, and to take advantage of what is colloquially known as the 'investment manager exemption', care will need to be taken to ensure that, among other things, the onshore investment manager carries out its function in an "independent capacity". For this purpose, the fund should not constitute more than 70 per cent of the manager's investment management business. Note that this requirement will be deemed to have been met if it can be demonstrated that there was a clear intention to achieve it or if it is achieved within 18 months. Alternatively, the fund manager's independent status

can be established by demonstrating that the fund is "widely held" or by listing the fund on a recognised stock exchange - a fund which is quoted on a recognised stock exchange will be accepted as meeting the independence test. Whether a listing on its own can be taken to come within the meaning of "quoted" on exchange is not entirely certain and might be challenged by the Inland Revenue in the absence of other indications of independence. Listing has the added advantage that some institutional investors are only permitted to invest in listed funds. A second condition is that the fund manager must receive the "customary" rate for the job of acting as fund manager. It will also be necessary to ensure that the investment manager and persons connected with it are not beneficially entitled to more than 20 per cent of the income (excluding fees) generated for the fund by the efforts of the investment manager. There are arrangements to permit this limit to be breached in the initial stages.

Thought should also be given to the taxation implications for target investors of investing in the fund (although of course these will inevitably differ from investor to investor) since it may be possible to tailor the fund's structure to minimise any unwanted effects. For example, UK "offshore fund" tax legislation may have the effect of treating capital gains from the redemption of shares or units of the fund as income, with the result that taper relief and annual capital gains exemptions cannot be applied to the gain. Classification as a "distributing fund", through the adoption of an appropriate distribution policy (85 per cent income distribution), would enable gains to be treated as such. However, the rules are opaque and easily breached: for hedge funds it may be difficult to derive an appropriate measure of income on the basis that profits may well be considered to be trading income, and the tax treatment will only apply if the "distributing fund" classification is maintained throughout the period of the investor's share ownership.

If the fund is targeted at US investors, a Delaware limited partnership or LLC will be familiar to US taxable investors, while US tax exempt investors will generally require an offshore corporate structure.

If the UK-based promoters of the fund include persons who are not UK domiciled for tax purposes, the inclusion of an offshore manager in the structure can have tax advantages. However, the offshore manager must have a real presence offshore and fees received by the offshore manager must be justifiable on an arm's length basis. That said, where individuals who are resident but not domiciled in the UK for tax purposes go abroad in order to promote the fund on behalf of and in the name of the offshore manager, they may be able to avoid UK tax on their overseas income from this source, provided it is not brought onshore in the UK.

Management shares

In addition to the potential tax advantages, management shares are often used to provide the manager with a level of control over the fund. This is done by retaining the sole voting rights on key issues for the management shares, such as board appointments, addition of another class of shares, amendments to the company's articles of association, removal of a director (whether proposing or blocking) or a decision to wind up the fund. In addition, the existence of an offshore manager will enable the board to delegate some of the functions for which it would otherwise have day-to-day responsibility.

Care is needed to prevent the management shares held by a UK manager resulting in the fund being brought onshore and subject to UK tax. Management shares may be participating or non-participating. It is also possible to provide for them to receive an ongoing, small "founder share entitlement" linked to the performance of the fund, provided it can be demonstrated that the fund manager receives the "customary" rate for the job of acting as such.

Investment objectives and policy

You will need to give careful thought to the fund's investment objective and policy.

These will be described in the fund's information memorandum. This is a key section of the document and it is where you, as hedge fund manager, set out your wares on the basis of which you are seeking investment from potential investors. It will be important to retain flexibility while accurately describing the criteria according to which the fund's assets will be traded. While the objective is generally a basic statement of the focus of the fund, the investment policy extends this to provide a detailed statement of the strategy to be adopted. This would typically include the securities, instruments and markets in which investments will be made, your investment philosophy, methodology and selection process, relevant investment restrictions and the fund's risk control policies. In addition to any investment restrictions you may wish to include, it will also be necessary to take account of any requirements under the local law where the fund is based and, if it is to be listed, of the listing authority.

Investors

Who are your target investors and what are their requirements and preferences? In addition to the impact of taxation on investors, your target investors are likely to have their own needs/preferences/views on the investment policy, the base currency of the fund, the manner of calculation of the performance fee, the level of fees, whether the fund should be listed or not and the redemption policy (in particular, the time delay for a redemption to become effective and any redemption charge). Funds frequently provide for share classes of different currencies to meet investor preferences. The investment policy of the classes may be the same, the only differences between the classes being the base currency of the particular class and an element of currency hedging. The location and type of investors will also determine the marketing methods that may be used - in

general the more sophisticated the investor, the fewer regulatory hurdles you will have to overcome. Nevertheless, the national rules of the investor usually apply so advice will generally be needed for each jurisdiction into which you intend to market.

Listing

Listing a hedge fund on a UK exchange is currently not a realistic option except in respect of a fund of funds. While the FSA is continuing to keep options under review, it has recently said that it does not believe it appropriate to provide for listing of individual hedge funds at present. However, several other exchanges, in particular Dublin and Luxembourg, do offer this possibility. The Channel Islands, Bermuda and the Cayman Islands also operate exchanges on which a hedge fund can obtain a listing of its shares.

A listing may widen the range of potential investors by opening the fund to institutions whose policies or local regulatory environment require investment in listed securities only, although lesser-used exchanges may not qualify for this. It may also convey a certain level of security to investors, since the listing process involves scrutiny of the fund's offering memorandum (which doubles up as the listing particulars) and requires both initial and ongoing compliance with an independent body's regulations. Of course, the downside is the extra time and cost that achieving and maintaining a listing involves and you will need to weigh this against the advantages.

Taylor Wessing is experienced in managing the listing of the shares (in conjunction with listing sponsors) to ensure that this part of the transaction is dealt with within the agreed timetable for launch of the fund.

Taylor Wessing's role

The possibilities in terms of structures, achieving the most beneficial tax treatment and whether and where to list are endless. Taylor Wessing can advise and assist you in dealing with all of these issues to ensure that together we achieve the best combination of options to meet your needs.

Location

The choice of location in which to establish the hedge fund will be largely dependent on the needs of its potential investors. Here we take a quick look at the upsides and downsides of a few of the key jurisdictions. Taylor Wessing has experience of setting up funds in these and a number of other locations and is able to advise on the pros and cons and suitability of each.

Europe

EC member states, given their high level of regulation and investment restrictions, are not seen as hedge fund-friendly locations. Nevertheless, funds can be incorporated in Dublin (where they benefit from being exempt from income and capital gains tax), and Luxembourg may become more popular following recent changes in its rules, although funds are subject to a subscription tax, generally at an annual rate of 0.6 per cent of their net asset value. Italy has also recently established an onshore regime for hedge funds. On the back of this, regulators in other European jurisdictions - such as Switzerland, France, Germany and Italy - are increasingly looking at domestic hedge funds or funds of hedge funds. In tandem with this, the European parliament has been looking at proposals for a Europe-wide, lightly regulated regime for sophisticated alternative investment vehicles (including hedge funds).

Offshore

The offshore European jurisdictions (such as Jersey, Guernsey and the Isle of Man) have fewer restrictions than EEA jurisdictions, but are still perceived (in many respects somewhat unfairly in recent times) to have cumbersome approval regimes and may require a local custodian or administrator and, in some cases, a local manager. For these reasons, the three most popular offshore jurisdictions for the establishment of hedge funds are the Cayman Islands, Bermuda and the BVI. All three enjoy a low level of regulation and virtually no restrictions on investment policies, can offer

a good local infrastructure and allow the fund to be set up relatively quickly (up to eight weeks) while keeping the costs at a reasonable level. It may be that with a lightening of the regulatory burden in the offshore European jurisdictions, the time has come to give more consideration to any of them as a suitable home for your hedge fund. This would certainly make it easier to hold regular board meetings in the place where the fund is established, but investors will need to become familiar with the idea.

Bermuda

Historically, Bermuda has been perceived as the least user-friendly and most costly of the three. However, our view is that this perception is now misplaced and Bermuda has come to satisfy the needs of most budding hedge fund managers. It is also more conveniently placed for visits and enjoys a better reputation. The fund may be classified as either a standard scheme or an institutional scheme. Approval from the Bermuda Monetary Authority is required for all schemes. The institutional scheme is subject to very few regulatory requirements and there are no restrictions on investments for either scheme. All service providers must be approved but need not be licensed or based in Bermuda. To qualify as an institutional scheme, either the minimum subscription for investors must be no less than US\$100,000 or the fund can only be marketed to sophisticated investors. Most hedge funds will not find either of these conditions onerous. If the fund is classified as a standard scheme, the normal requirements of the Bermuda

Monetary Authority will apply: the nature and content of the constitutional documents and the prospectus must be compliant; all service providers must be licensed, either in Bermuda or elsewhere, but only the administrator or custodian needs to be based in Bermuda (although there are exemptions available to allow a prime broker to be appointed in lieu of a custodian and for the prime broker to be based outside Bermuda). For all funds established in Bermuda certain administrative activities must be carried out in Bermuda and the Bermuda Monetary Authority will need to be satisfied as to the investment management, expertise and good standing of the fund's promoters. In addition, Bermuda-established hedge funds must appoint a registered representative in Bermuda. Normally, none of this proves onerous. The initial and annual registration fees start at around US\$1,800.

Cayman Islands

Historically, Cayman has been the location most favoured by hedge fund managers for their fund vehicle, principally on grounds of cost and the low level of regulation. Both have increased in recent times so that our view is that there is little to choose between Cayman and Bermuda on these grounds, and it is possible that setting up and running a Cayman fund may now be marginally the more expensive. Hedge funds should fall within the definition of "mutual fund". The principal obligations imposed on the fund will be to:

- Register the fund with the Cayman Island Monetary Authority.
- File with the Authority the prescribed details of the prospectus and offering documents.
- File audited accounts annually with the Authority (these must be signed off locally for which the international audit firms charge an additional fee).
- Pay a prescribed registration fee (currently approximately US\$2,500). In addition, you must use a local administrator unless the fund falls into an exemption, including where it is separately licensed, has a minimum subscription and holding for

each investor of no less than US\$50,000 or where it is a listed fund. No local manager or custodian is required, and there are no investment restrictions. An annual fee equal to the registration fee is payable.

British Virgin Islands

The low level of regulation in the BVI used to be an attraction to weigh against the less sophisticated infrastructure and the loss of communications every time a hurricane hit the islands. Since the implementation of the Mutual Fund Act in the BVI, there has been much less to choose between it and Cayman or Bermuda.

There are two relevant categories of funds: private and professional (it is also possible to constitute a public fund, subject however to more onerous registration and filing requirements but with the advantage that investments in them are not restricted). All private and professional funds established in the BVI must be recognised by the Registrar of Mutual Funds for which the initial and annual fee is US\$350. Recognition is granted on the submission of proof of lawful constitution and of falling within the relevant category. A private fund may either not have more than 50 investors or be offered on a private basis only (although the Registrar would still expect to see a summary of the offering proposals). A professional fund may be offered to high net worth (US\$1 million+) and professional investors only, the majority of whom must each invest at least US\$100,000 in the fund. A fast-track launch procedure is available for professional funds. In addition, BVI-established hedge funds must appoint a registered agent in the BVI, at an annual cost of US\$400. There are no restrictions on investments, and no local manager or custodian is required. An annual fee of US\$500 is payable for a manager's licence.

Which to choose

When comparing possible locations for the establishment of the fund, you should consider these key issues:

- Investor preferences
- Reputation

- Investment and marketing restrictions
- Length and complexity of the local incorporation, licensing and approval (including regulatory approval) processes
- Necessity or ability to obtain a listing
- Tax transparency/neutrality for the fund and its investors
- Local infrastructure
- Convenient time zone
- Accessibility and language
- Cost.

Taylor Wessing's role

Taylor Wessing can assist and advise on which is the right location for you. We have close relationships with legal counsel in all of these, and other, jurisdictions and will manage the transaction to ensure that all local corporate and regulatory requirements are dealt with on a timely basis.



Marketing hedge funds

Successfully marketing your hedge fund will involve compliance with the regulatory requirements and restrictions in the jurisdiction where your target investors live. Early consideration should be given to the types of investor to be targeted and their location as this is likely to have implications for the structure of your fund. Taylor Wessing has offices in Germany, France and Belgium as well as being part of the Interlex Group, a worldwide association of leading law firms serving international clients. We are able to quickly access local advice on all of these issues.

In the EU, marketing of funds to the public is generally restricted to funds that comply with strict requirements under national and EU legislation. Funds that meet the requirements of the EU's UCITS directives can market to the general public in the country in which the fund is established and to the public in other EU member states using passporting provisions. However, although the rules have recently been updated to enable authorised retail funds to invest in a broader mix of assets than was previously the case (including derivatives, deposits and other funds), they still do not suit the investment policies typical to hedge funds. Marketing to the public therefore remains restricted in accordance with local laws, and advice will be needed for each country in which the hedge fund will be marketed. Recent e-commerce developments are an exception, provided that the promotion is made from an EEA country (i.e. the EU countries plus Norway, Iceland and Liechtenstein) to another EEA country by electronic means (e.g. by email). In these circumstances, subject to any exceptions imposed in the local jurisdiction, it is the marketing rules of the country from which the promotion is sent that apply.

As a general rule the more sophisticated the investors targeted, the fewer the regulatory hurdles that will need to be overcome. Indeed most countries have useful private

placement exemptions applicable to hedge funds sold privately to institutional investors and, in some cases, to high net worth individuals. Where such an exemption is available, regulatory filings and consent will not generally be necessary. As examples, we consider the position in four key jurisdictions - the UK, Germany, Switzerland and the US.

UK

Hedge funds are almost always classified as unregulated collective investment schemes and as such face greater restrictions when being marketed to UK investors than vehicles authorised by the Financial Services Authority. Currently this applies to UK authorised unit trusts, UK open-ended investment companies, UCITS funds and other recognised offshore funds based in the Channel Islands, the Isle of Man or Bermuda (but hedge funds are not currently eligible for recognition because of the investment restrictions which apply). UK-authorized firms such as a UK-based investment manager can market the fund themselves to market counterparties, intermediate (non-private) customers (e.g. listed companies, high net worth firms or trusts and other funds) and even to certain sophisticated/experienced private customers provided suitability and other criteria are met. Authorised persons may also approve certain promotions so that



this target investor base can be accessed by non-authorized persons. Without such approval, non-authorized persons are, in the case of hedge funds, effectively limited to marketing to investment professionals, high net worth companies and (within certain limits) sophisticated investors who have been certified by an authorised firm as being sufficiently knowledgeable to understand the risks and who have signed a statement to that effect.

Germany

Although registration can be obtained that will permit public marketing, the restrictions imposed on borrowing and investment policies mean that hedge funds are generally sold by private placement. This means that you can only approach specific investors, in particular existing clients, clients introduced to you through a local financial adviser, and potential clients who

have sought information from you about the fund. Provided that such a relationship exists, no restrictions are imposed as to the sophistication of the investor concerned or the number of investors that may be approached. Changes made in January 2004 to the German tax law governing the taxation of investor funds mean that non-institutional investors will no longer be disadvantaged where investing in foreign investment companies.

Switzerland

You will need to obtain a licence from the Swiss Banking Commission to promote and market a foreign fund in a professional capacity or on a systematic basis. A private placement exemption may be available if the fund is sold to a limited number (possibly up to 20) of institutional investors with a professional treasury department (such as banks, insurance companies and pension funds). The fund can also be sold to investors who make unsolicited applications. Swiss law in respect of collective investment schemes (including hedge funds) is currently under review and changes may be made in 2007, including the introduction of a 'qualified investor' concept.

US

The regulatory imperialism of the US means that it is essential to analyse the impact of any US regulations on your fund, given that the presence of just one US person as an investor could have serious US regulatory implications, including a jail sentence. For this reason it is common for investors to be required to warrant that they are not US citizens, with a separate application form provided for US investors.

Registration of the hedge fund

An exemption will need to be found to avoid having to register the hedge fund vehicle under the Investment Companies Act of 1940. Funds may be sold without requiring registration if the only sales are private offerings to "qualified purchasers", i.e. institutions with investments of at least US\$25 million, or individuals with investments of at least US\$5 million (section 3(c)(7)). Alternatively, you may sell the fund

to up to 100 beneficial owner investors, whether or not they are qualified purchasers (section 3(c)(1)). You may not, however, rely on both the 100 investor rule and the qualified purchaser rule for a single fund, although separate funds could be established to rely on each of these rules.

A word of caution: the rules for calculating the number of investors are complex and uncertain, including a requirement to 'look through' to underlying investors where another fund takes more than a 10 per cent interest in your fund.

Registration of interests in the hedge fund

In addition, non-US funds cannot be sold to the US general public without first preparing and filing a prospectus and registering it with the SEC. Funds sold by private placement are exempt from registration (under Rule 506 of Regulation D), as are those sold to up to 35 "accredited investors" including banks, registered investment companies and certain high net worth companies, trusts and individuals provided that you do not undertake general advertising or solicitation and you carry out inquiries to ensure that the investments are not bought for resale.

State law

The requirements described above are under US federal law. In addition, individual US states have their own securities laws and, in some cases, registration requirements. However, in many states exemptions that mirror the federal exemptions are available for non-public offerings.

Commodity pools

Given the nature of hedge funds and the likely need to engage in derivatives trading, you will probably need to register with the National Futures Association (NFA) as a commodity pool operator (CPO). There is also a requirement to register as a commodity trading adviser (CTA), but registration is not required where the fund manager limits the number of persons to whom it provides investment advice to 15 (the fund is one customer for this purpose).

The registration process for both CPOs and CTAs can be dealt with online but should be started well in advance of when it is intended to approach US investors, as it may be necessary to complete a top-up US examination and fingerprint cards must be provided.

Registration as a CPO and/or CTA requires you to comply with detailed and regular disclosure requirements. To avoid this, many fund managers take advantage of exemptions under CFTC Regulations. In particular, exemptions for both requirements are available if investors are limited, broadly, to persons who are both "qualified purchasers" and "accredited investors". Generally, an individual investor with \$5 million or an entity investor with \$25 million in investments which it owns and invests on a discretionary basis will qualify under both categories.

Summary

You will note that accessing US investors, while at the same time avoiding the filing of a prospectus, the registration of the fund and the detailed CFTC disclosure requirements, can only be achieved in limited circumstances. Note also that the regulatory environment in relation to hedge funds and their managers has been undergoing significant scrutiny in the United States, particularly by the SEC. This is likely to increase the regulatory burden on them over time.

ERISA (Employment Retirement Income Security Act 1974)

To avoid becoming subject to fiduciary and other duties under ERISA, it is important that the assets of the fund are not treated as "plan assets". To ensure this, the percentage of the fund represented by employee benefit plans (whether or not US plans) should never be more than 25 per cent. If investments are accepted from employee benefit plans, you will need to monitor this on an ongoing basis on behalf of the fund in conjunction with the administrator and auditor.

Institutions/documentation

Aside from the fund vehicle itself and its manager(s), several other people play a role in setting up and operating hedge funds, in particular the sponsor, prime broker, custodian, administrator and auditor. Here we set out the role each of these key participants plays.

Sponsor

The sponsor is likely to be a significant investor in the fund. In many cases, the sponsor will be you. As well as demonstrating confidence in your abilities and avoiding conflicts by investing your own funds as opposed to trading them separately, there may also be significant tax-planning opportunities, depending on the tax position in your country of domicile and/or residence.

Prime broker

The hedge fund manager's key appointment is the prime broker and this should be one of your first ports of call. The prime broker's main roles are the provision of centralised clearing and settlement facilities for all of the hedge fund's transactions, trade financing, securities lending and custody services. The use of one or more prime brokers enables the fund manager to maximise its leverage. Aside from the basic clearing and settlement services, the prime broker typically:

- Provides credit lines and margin trading facilities to permit leverage and short sales
- Holds long positions as collateral for short positions and stock borrowing
- Tracks market movements and prices of the hedge fund's investments, and supplies this information to the administrator
- Operates online reporting facilities;
- Provides access to risk management systems
- Provides the fund manager with access to its research
- Acts as the fund's custodian. We have listed a number of the principal prime broker services available in London in the Appendix.

Custodian

The role of an independent custodian is restricted by the fact that the prime broker will probably hold all of the fund's assets as security for the credit granted/borrowings permitted to the fund. If that is the case, the practical function of the custodian will be reduced to that of the initial receiver of the funds from the administrator and the



dispenser of money from the fund's account to cover redemptions and fees. As a result, it is increasingly common for the prime broker to assume the custody role.

Where you need an independent custodian for regulatory purposes, the practice is for the custodian to accept responsibility only for those assets in its possession from time to time with the prime broker also appointed as custodian and therefore directly responsible to the fund vehicle for assets held by it.

Administrator

The administrator is responsible for all NAV calculations, dealing with subscriptions and redemptions and shareholder enquiries, providing corporate and secretarial functions, calculating and paying fees (including equalisation calculations), generating reports and interfacing with the prime broker and the fund manager to ensure that all necessary information regarding trades, positions and valuations are made available on a timely and accurate basis. Your choice of administrator will be driven by issues such as location, competence and cost but also, critically, the administrator's ability to interface with the prime broker and the fund manager. We have worked with a variety of administrators, custodians and prime brokers in a number of jurisdictions and are happy to advise on suitable institutions as well as to negotiate the agreements involved, there being no such thing as a standard agreement.

Auditor

In deciding on the auditor, you will need to take account of the location of the fund (for example, Cayman Islands funds require audited accounts to be signed off locally), the location of the administrator and the ability of the audit firm to work with the administrator. If PFIC reporting is required for US investors, you will need to establish that the auditor is able and willing to provide this service (in conjunction with the administrator).

Key documents

Fund documents

- Fund vehicle constitutional documents - e.g. memorandum and articles of association, byelaws or limited partnership agreement.
- Offering memorandum and listing particulars.
- Share application and redemption forms.
- US supplement and subscription agreement.
- Necessary shareholder and board resolutions.

Investment management/advisory agreement

- Defines the relationship between the hedge fund, the onshore investment manager and, if there is one, the offshore manager.

Management agreement

- Defines the role and responsibilities of the offshore manager, if any.

Prime broker agreements

The prime broker will typically have a suite of documents covering the following areas:

- Prime Broker Agreement - the prime broker agrees to act as a central clearer on all transactions entered into by the fund and to arrange settlement of all such transactions.
- Margin Trading or Prime Brokerage Facility Agreement - details the terms on which the fund is allowed credit in relation to its positions and the security and other rights granted to the prime broker.
- Stock lending, repo and short sale agreements.
- General Terms of Business.
- OTC Master Agreements - for non-exchange transactions such as swaps and contracts for differences.
- Electronic Access Agreements - grants access to the prime broker's computer system in order for a direct feed and analysis of positions, trades, margin requirements, valuations, etc.

Custody agreement

- Describes the role and responsibilities of the custodian. If the prime broker performs this role, the prime brokerage agreement will provide for custody services.

Administration agreement

- Describes the role and responsibilities of the administrator.

Registrar and Transfer Agent Agreements

- Terms agreed with the body responsible for registering and transferring shares in the hedge fund, frequently part of the administrator's role and therefore included as part of the administration agreement.

Other agreements

There may also be executing broker agreements (where executing brokers separate from the prime broker are to be used) and marketing, introducer and intermediary agreements.

Performance fee equalisation

Hedge funds generally remunerate their investment manager, at least partly, on the basis of performance. In the past, this generally took the form of a simple percentage of any capital appreciation during any calculation period increase in the net asset value over a high water mark.

This method is simple and clear, and effective for partnership structures using partnership accounting with no common net asset values per share (NAVs). However, for corporate structures, distortions can occur when investment and performance cycles do not coincide. For example, if subscriptions are made when no performance fee is payable (because the fund has under performed), those subscribers get a free ride until the high watermark is passed. This is unfair to other investors and to the fund manager. This resulted in the development of the alternative calculation methods considered on this page. However, each method has its advantages and disadvantages. Funds that we have set up recently have used both of the principal alternative methods described here, and which you opt for will ultimately be down to personal and investor preference.

Issue of shares in Series

This method eliminates the problem of investment and performance cycles not coinciding by creating a new series of shares each time new subscriptions are received. The performance fee is then calculated separately for each series by taking a percentage of the net increase (if any) in profits attributable to the series since the series' previous high watermark. If a performance fee is payable then the high watermark for that series is reset. Since this method results in separate NAVs for each series, it is common to minimise the number of NAVs wherever possible by collapsing series on which a performance fee is payable into one series each year.

Advantages: It gives a true indication of

the performance of the fund manager, the performance fee reflects the actual performance achieved by the investor and it is relatively simple to understand.

Disadvantages: It can result in multiple NAVs per share class which can cause confusion.

Equalisation accounting

Equalisation accounting is the most complex system. It relies on clever software to square the circle of maintaining the same NAV for all shares in the same class while effectively tracking the performance attributable to each subscriber even where subscriptions have come in at different times during the performance cycle. This ensures fair treatment for both investors and for you, the fund manager.

The method involves the use of an equalisation credit. If an investor subscribes at a time when the gross asset value (GAV)¹ per share is higher than the existing high water mark then the investor effectively purchases each share at its current NAV, and in addition pays an equalisation credit per share equal to the difference between the NAV per share and the GAV per share. At the end of the performance cycle, further shares are purchased using the equalisation credit at the new NAV per share. If the NAV per share has fallen since subscription then only such proportion of the credit equal to the value of the performance fee charged on the NAV per share will be used, but the remainder of the credit will still be available to be used at the next performance fee calculation, or will be credited to the investor on redemption of his shares.



If an investor subscribes at a time when the GAV per share is below the class's high water mark, he would potentially enjoy a free ride in relation to performance fees until the NAV got back up to this level. The equalisation method prevents this by the compulsory redemption of a sufficient number of shares (or fractions of shares) belonging to the investor to correct the position.

This is a very quick explanation of the basic premise behind the equalisation credit method. While the method appears complex, the results are fair to all investors and wider use of the method means that investors are increasingly familiar and comfortable with it.

Advantages: The performance fee reflects the actual performance achieved by the investor, each investor has the same amount of capital per share at risk and there is a single NAV per share class.

Disadvantages: The method is complex to understand and administer (but increasingly common) and it results in an understatement of the fund manager's performance when the performances of different funds using other methods are compared.

1. i.e. the NAV before accrual of the performance fee

Our services

Based in the UK, France, Germany, Brussels and Dubai, as well as representative offices in Alicante, Beijing and Shanghai - Taylor Wessing LLP provides the full range of legal services to major corporations, financial institutions and growing enterprises, capitalising on our reputation in disciplines such as intellectual property, corporate finance, financial services, projects, real estate finance and inward investment.

As to our investment funds practice, we act for both authorised and unregulated funds (established in the UK and overseas in all the main offshore locations: BVI, Bermuda, Cayman Islands, Jersey, Guernsey, Isle of Man, Ireland and Luxembourg) and for their managers/investment managers and investment and financial advisers. Our highly regarded corporate and financial services and tax expertise means that we are ideally placed to advise on hedge fund transactions, in addition to more traditional securities fund vehicles.

We combine both regulatory and corporate and tax expertise within our investment funds practice group, which means we provide a holistic approach to prospective and established hedge fund managers. This enables us to ensure that documentation conforms to market norms and regulatory requirements. We are able to assist in or lead the authorisation application process for investment managers/advisers setting up in the UK. We are also able to lead and co-ordinate the process of establishment of the fund and to anticipate and advise on the regulatory, transactional and financing aspects that may affect the fund during its lifetime.

We have a strong corporate taxation department whose input is invaluable in putting in place tax-efficient corporate structures and a thriving private client department able to provide personal taxation advice with a view to ensuring that the most tax-efficient arrangements are put in place for the individual fund manager and key members of the team.

Taylor Wessing is used to working closely with the other service providers in the sector such as prime brokers, brokers, sponsoring brokers, administrators and custodians as well as with our network of contacts in overseas law firms, and thus is able both to include regulatory, marketing and taxation advice in all relevant jurisdictions and to lead the transaction, thereby providing clients with a single port of call.

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Berlin Brussels Cambridge Dubai Düsseldorf
Frankfurt Hamburg London Munich Paris
Representative offices: Alicante Beijing Shanghai
www.taylorwessing.com

London

5 New Street Square
London EC4A 3TW
United Kingdom

Tel +44 (0)20 7300 7000
Fax +44 (0)20 7300 7100

london@taylorwessing.com

Cambridge

24 Hills Road
Cambridge CB2 1JP
United Kingdom

Tel +44 (0)1223 446400
Fax +44 (0)1223 446401

cambridge@taylorwessing.com

For further information please

contact:

Clive Cunningham

Email c.cunningham@taylorwessing.com

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