

## FREQUENTLY ASKED QUESTIONS CONCERNING INVESTMENT LIMITED PARTNERSHIPS (HEDGE FUNDS)

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**Q: What sort of legal structure should be used?**

**A:** The simplest, least expensive, least complicated form for an investment limited partnership ("Hedge Fund") is a limited partnership with an individual general partner. Many investment managers do not like this form because it does not offer the "appearance" of limited liability. Many prefer a limited partnership with a limited liability company as the general partner or even a limited partnership with a limited liability company as its general partner serving as the general partner of the Hedge Fund. The use of a limited liability company as a general partner of the Hedge Fund or as the general partner of the general partner of the Hedge Fund gives the "appearance" of limited personal liability. We use the word "appearance" in quotation marks because many of the unexpected liabilities which a general partner might have in running a Hedge Fund are liabilities under the securities laws for which he or she can be held to be personally liable irrespective of the legal form of the entity which serves as the general partner. One advantage of a limited liability company or limited partnership as a general partner is the opportunity it offers for estate planning provided one wishes to take advantage of such opportunities. These entity general partners also provide the opportunity to offer equity interests to employees or to create certain incentive compensation arrangements for employees.

**Q: What securities laws are applicable?**

**A:** Historically, the offer and sale of securities within the United States has been subject to concurrent federal and state regulation under the Securities Act of 1933 (the "Securities Act") and state blue sky laws. In order to avoid the registration and prospectus delivery requirements of the Securities Act, securities of hedge funds and offshore funds are typically offered in private placement transactions which rely on the private placement "safe harbor" provisions of Regulation D or the safe harbor for offerings outside the United States contained in Regulation S. Until the passage of a recent law, however, a separate exemption from state registration or qualification requirements needed to be perfected under the blue sky law of each state where the securities were offered. Pursuant to recent legislation, states are prohibited from imposing their blue sky laws relating to registration or qualification of securities with respect to securities offered in a private placement pursuant to Rule 506 of Regulation D. States are still permitted to require notice filings which are similar to

the Form D that is filed with the SEC pursuant to Regulation D, and to collect filing fees. The new law prohibits states from regulating the content of offering documents or the terms of securities being offered. Certain states may regulate general partners and their employees (if applicable) as brokers and require certain filings under their broker-dealer regulatory schemes prior to the offer of any securities in their jurisdictions. These filings can be burdensome and time consuming.

**Q: Should I register under the Investment Advisers Act?**

**A:** Most hedge fund managers or general partners choose not to register under the federal Investment Advisers Act as a result of an exemption from registration because they have fewer than 15 clients (because the Hedge Fund is deemed, under certain circumstances, to be one client) and do not hold themselves out to the public as investment advisors. Under current interpretations of Texas law, all Hedge Fund managers based in Texas must register as investment advisors under Texas law. An exemption from federal registration, however, does not exempt a fund or fund manager from the anti-fraud provisions of the federal Investment Advisers Act. Some managers feel it is easier to get investors to invest in the Hedge Fund if they register, but doing so limits (if the manager charges an incentive fee [and most Hedge Fund managers do]) potential investors to people with a net worth over \$1,500,000, or people who invest more than \$750,000, Qualified Purchasers (as described below) and certain “knowledgeable employees” of the investment manager. (Registered investment advisors who act as advisors to offshore funds and “Qualified Purchaser Funds” described below are not subject to these restrictions on incentive fees.) Certain institutional investors will only place funds with registered investment advisors. Should one choose to register under Federal law, one can only do so after the Hedge Fund (or other assets under management) exceeds \$25,000,000 in size. Individual states regulate investment advisors who have \$25,000,000 or less under management.

**Q: How can I sell interests in my funds?**

**A:** Very carefully. The private placement rules severely limit what you can do to sell units in the fund. Generally speaking, you should have a pre-existing relationship with every offeree. You may send private placement memoranda to as many people as you have pre-existing relationships with provided they meet the sophisticated investor requirements of an accredited investor. Furthermore, to sell securities in a private placement to accredited investors requires a very low key selling effort which is subject to numerous restrictions. To remain exempt from registration as an investment advisor one cannot hold oneself out “publicly” as an investment advisor. The SEC has taken the position, except in certain special circumstances, that providing information to organizations that track hedge funds constitutes “holding oneself out to the public” as an investment advisor and, accordingly, requires

registration under the advisers act. One should be even more careful if one is soliciting unaccredited investors.

**Q: Should I limit my offering of limited partnership interests to accredited investors only?**

**A:** The traditional wisdom is that accredited investors are less likely to sue than non-accredited investors and that juries are less sympathetic to accredited investors than they are to non-accredited investors. The traditional wisdom is probably right.

**Q: Can I take pension plan money?**

**A:** Yes, but generally speaking no more than 25% of the value of the fund can be held by employee benefit plan investors of any description including ERISA plans, IRA's, 401(k) plans, state funds, or other employee benefit plans unless the Hedge Fund goes to great effort (usually at great expense) to comply with ERISA.

**Q: Do I have to wait until I have a PPM prepared before I can talk with people about the fund?**

**A:** Although there is no *per se* requirement that a PPM ever be prepared in a private placement, as a matter of practice the whole point of having a PPM is to minimize one's liability under the securities laws and to make an offer (and it is hard to imagine that "talking to someone" who later buys would not be making an offer) without delivering a PPM to some degree acts to defeat that purpose. The most that can be said for making an offer before a PPM has been prepared to a person one reasonably believes to be an accredited investor is that the subsequent delivery of a PPM should cure any liability resulting from the premature offer. No attempt should be made to "pre-sell" a fund prior to the delivery of a PPM. Non-accredited investors should not be contacted prior to delivery of a PPM. Furthermore, Rule 506 of Regulation D requires the delivery of a PPM to non-accredited investors and compliance with Rule 506 is required in order to be exempt from certain state blue sky law restrictions.

**Q: Can I use third parties to sell the fund?**

**A:** Yes, you can use third parties to sell the fund, but typically substantial investors will not consent to the use of their own money to pay commissions. Furthermore, anyone who sells your units must be licensed as a broker/dealer.

**Q: Is there a difference between a finder and a broker/dealer in selling my units?**

**A:** Under Texas law both must be registered as a broker-dealer. If not, you will have violated Texas law and may have a refund obligation.

**Q: What is the "Counting to 100 Rule"?**

**A:** The counting to 100 rule relates to an exclusion (the "Private Investment Company Exclusion") from the Investment Company Act (a law which mainly regulates mutual funds) providing that the outstanding securities of your fund cannot be owned by more than 100 persons without compliance with the Investment Company Act. Compliance with the Investment Company Act would be difficult, if not impossible, for most hedge fund managers. Counting to 100 is not as straightforward as it might seem, however, because sometimes one name can mean more than one owner. Furthermore, there are certain percentage tests that might increase the number of names which count against the 100 investor limit. In addition, separate hedge funds that are managed by a single fund manager may be integrated for purposes of the 100 investor limit if the funds are not sufficiently distinct. There is an additional exclusion from the Investment Company Act (the "Qualified Purchaser Fund Exclusion") for Hedge Funds ("Qualified Purchaser Funds") which limit their limited partners to individual investors who own not less than \$5,000,000 in investments, and to institutional investors which own not less than \$25,000,000 in investments, as defined by the SEC ("Qualified Purchasers").

**Q: Can a fund manager simultaneously operate both a Private Investment Company and a Qualified Purchaser Fund which are substantially similar to each other?**

**A:** Yes. The 1996 Act eliminates the application of the "integration" doctrine in this context. (The "integration" doctrine was developed by the SEC staff to police the 100 securityholder restriction on Private Investment Companies. In broad terms, this doctrine requires two substantially identical funds to be treated as if they were a single fund for purposes of testing whether the Private Investment Company Exclusion is available.)

**Q: Can the Qualified Purchaser Fund Exclusion and the Private Investment Company Exclusion be combined in a single fund in which the investors consist of Qualified Purchasers plus up to 100 others?**

**A:** No, except in the case of a fund that was in existence on September 1, 1996 and that satisfies certain additional requirements. The principal requirements are:

- each non-Qualified Purchaser acquired securities of the fund on or before September 1, 1996;
- the fund discloses that future investors must be Qualified Purchasers and that the fund will not be limited to 100 holders; and
- the fund gives each beneficial owner the opportunity to redeem his interest in the fund in cash at net asset value or in kind for a proportionate share of the fund's assets.

**Q: Does the Qualified Purchaser Fund Exclusion apply to an offshore fund that restricts ownership of its shares by United States persons exclusively to Qualified Purchasers but does not impose similar restrictions on its non-U.S. security holders?**

**A:** Yes. Pursuant to the so-called Touche Remnant doctrine, the SEC staff for a number of years has permitted offshore funds to sell their shares privately to up to 100 U.S. beneficial owners, without regard to the number of non-U.S. owners, by analogy to the Private Investment Company Exclusion. The same policy reasons would support extending this doctrine to permit offshore funds to place their shares with an unlimited number of U.S. Qualified Purchasers and the SEC, in a recent no-action letter, concurred with this analysis.

**Q: What about trading commodities?**

**A:** If a Hedge Fund trades in futures contracts or options thereon, the fund would likely be considered a commodity pool under the Commodity Exchange Act and the general partner of the fund would have to register with the Commodity Futures Trading Commission as a commodity pool operator and would have to take a test administered by the CFTC.

**Q: Can I take soft dollars from brokers?**

**A:** Yes, but general partners should make certain that soft dollars are not used to circumvent the expense sharing arrangements set forth in the partnership agreement and that their use is properly disclosed and properly documented.

**Q: Are there any restrictions on my participating in "hot issues"?**

**A:** Yes, the fund must have a profit allocating procedure in place to deny participation in hot issue profits to certain categories of investors who are specified in NASD regulations relating to free riding. Without that provision, the fund can either not participate in hot issues or not take as investors NASD restricted persons.

**Q: What is the typical compensation to the general partner?**

**A:** The general partner typically gets a special allocation equal to 20% of the net profits allocated at the end of the year to each partner. This allocation is based on realized and unrealized gains and losses. It is made on a partner by partner basis. The general partner or an affiliate also receives a management fee which is typically 1% of the net asset value and the fee is paid quarterly in advance.

**Q: Are there any limitations on the compensation of the general partner?**

**A:** There is usually a loss carryforward provision which carries forward any losses previously allocated to a partner either for one year or some other period or without time limitation until the loss has been completely absorbed. If the loss carryforward is without time limitation, it is usually called a high water mark. Additionally, sometimes general partners are subjected to a "hurdle rate" wherein their fee is conditioned upon the limited partners first getting a minimum specified rate which might be the yield on one year or five year treasuries. Usually the general partner gets a full 20% profit allocation as long as the limited partners receive the hurdle rate. In the event the hurdle rate is not earned, the general partner receives no incentive allocation.

**Q: Do I need to take a test to be a general partner of a fund?**

**A:** The answer varies depending upon the state in which an investment manager is domiciled. In Texas, managers generally need to have taken a general securities law exam (usually Series 7) and the exam on state law (usually the Series 65 exam).

**Q: Can a partner satisfy its capital contribution requirements by contributing marketable securities to the Hedge Fund?**

**A:** Yes, but under certain circumstances the contribution may be taxable to the contributing partner if the contribution results in a diversification of the partner's interest. Generally speaking, if the partner contributes an already diversified portfolio of securities wherein not more than 25% of the value of the contributed portfolio is invested in the securities of one issuer and not more than 50% of the value of the contributed portfolio is invested in the securities of five or fewer issuers, then there should be no current tax to pay. This issue can result in a series of calculations of some complexity.

**Q: Will I have to file a 13f report?**

**A:** Yes, if you have over \$100,000,000 in publicly traded equity securities under management; otherwise, no.

**Q: When will a Hedge Fund have 13D or 13G filing obligations?**

**A:** Hedge Funds may be required to make a filing on Schedule 13D or Schedule 13G with the United States Securities and Exchange Commission (and send copies of the filing to the principal exchange on which the securities are registered and to the issuer of the securities) if the Hedge Fund acquires 5% or more of the outstanding securities of any class of a publicly traded company. The Schedule 13D or 13G provide information with respect to the acquiring entity and the purpose of acquiring the securities. Amendments must be filed to a Schedule 13D if there is a material change in investment intention or if there is a change of 1% or more in the outstanding securities of the issuer held by the Schedule 13D filer. Registered investment advisors and other investment advisors that hold less than 20% of the securities of an issuer on a strictly passive basis are exempt from 13D filing obligations and, instead, are generally required to file a short-form Schedule 13G. These filings must be made electronically.

**Q: Will the short swing profits rules of the Federal Securities laws ever be applicable to my Hedge Fund?**

**A:** The short swing profits rules of the Federal Securities laws will be applicable to any Hedge Fund to the extent that it acquires 10% or more of the outstanding securities of an issuer. The short swing profits rules essentially provide that profits obtained through the purchase and sale or sale and purchase of an equity security within a six-month period must be repaid to the issuer. The short swing profits rules apply to officers, directors and 10% shareholders of publicly traded companies. The short swing profit rules will also be applicable to a Hedge Fund if the General Partner of the Hedge Fund is an officer or director of a publicly traded company in which the Hedge Fund owns any securities. Registered investment advisors are generally exempt from the short swing profit rules.

**Q: Can I use my affiliated broker/dealer to execute trades on behalf of the Hedge Fund?**

**A:** A Hedge Fund manager may generally use his affiliated broker/dealer to execute trades on behalf of the hedge fund, but in all cases the general partner of the Hedge Fund will be obligated to seek best execution on behalf of the fund and should disclose the possibility of execution of trades by an affiliate.

**Q: Will my Hedge Fund be subject to the 2% floor and 3% limitation on the deductibility for Federal income tax purposes of business expenses?**

**A:** Hedge Funds are normally classified as traders and not investors and thus they are not subject to the restrictions on deductibility of expenses.

**Q. What is UBTI and why should a Hedge Fund manager care?**

**A:** Tax-exempt organizations, including qualified pension and profit sharing trusts and individual retirement accounts, are generally exempt from federal income taxation. However, such organizations are subject to taxation on their “unrelated business taxable income” (“UBTI”). UBTI includes income from most business operations; however, it generally does not include interest, dividends, and gains from the sale or exchange of capital assets. Because hedge funds trade for their own accounts in debt and equity securities, their income will consist almost exclusively of interest, dividends, and gains from the sale of capital assets. Consequently, a tax-exempt investor’s distributive share of such income of a hedge fund will not be UBTI and will not be subject to federal income tax. Tax-exempt investors will be subject, however, to federal income tax on a portion of any income and gains derived through a hedge fund from property with respect to which there is acquisition indebtedness. Hedge fund borrowings would give rise to UBTI if the related investment were to give rise to any income during the taxable year or years in which such borrowing was outstanding or if the related investment were disposed of at a gain within 12 months after such borrowing was repaid. Further, an investment by a hedge fund will result in acquisition indebtedness (i) if indebtedness incurred before the investment would not have been incurred but for the investment, (ii) if the investment is actually made with the use of borrowed funds, or (iii) if the investment necessitates future borrowings and this eventuality was foreseeable at the time the investment was made. For example, if a Hedge Fund were to purchase stock in a company and financed one-half of the purchase price with debt and then sold the stock for a gain, the Hedge Fund would have UBTI equal to one-half of the gain offset by one-half of the net interest cost. A tax-exempt organization will be subject to a tax return filing requirement if it takes into account \$1,000 or more of gross income in computing UBTI. The receipt of UBTI by a tax-exempt organization (other than charitable remainder trusts) generally will not affect its tax-exempt status if the investment is not otherwise inconsistent with the nature of its tax exemption. Short sales transactions involving publicly traded securities do not generally give rise to UBTI, but, as in all matters relating to taxes, it is wise to check with your tax adviser.

As a general proposition tax exempt investors do not like to receive UBTI principally because it requires them to prepare and file a tax return on Form 990T which they would not otherwise have to file and pay taxes on that income at the corporate rate and, therefore, they will generally avoid Hedge Funds which generate UBTI.

**Q: Should I create an offshore fund?**

**A:** Offshore funds are typically created by investment managers who have significant potential investors outside the United States. The advantage of an offshore fund is that the investors in the fund would generally not be subject to United States taxation as long as the fund complied with certain rules established by the Internal Revenue Service. U.S. fund managers typically create offshore funds in Caribbean jurisdictions, although a European offshore entity may be more appropriate if a significant number of European investors are involved. Offshore funds are also attractive to U.S. tax exempt investors as a way to avoid UBTI.

**Q: What is an offshore fund?**

**A:** Offshore funds are investment companies, organized outside the United States, which offer their securities primarily to non-U.S. investors (and, as noted above, to U.S. tax exempt investors in some instances). These funds do have contacts with the United States, however. First, the fund's portfolios consist of securities of American issuers which are usually traded in United States securities markets. Secondly, the managers of these funds are generally American money managers.

**Q: When is it worth while to establish an offshore fund?**

**A:** An offshore fund generally makes sense only if a money manager has significant clients or prospects who reside outside the United States. When initially breaking into non-U.S. markets, many U.S. money managers will utilize their contacts who have significant experience and resources in the investment community outside the U.S. Money managers often permit these "sponsors" to invest in their offshore funds on favorable terms or pay them a finder's fee for investors that are brought to the table.

**Q: Where should I establish my offshore fund?**

**A:** The answer to this question for most money managers is one of the Caribbean tax haven jurisdictions. Which of these jurisdictions is chosen will often depend on the type of entity that is desired and the cost structure of the fund. For example, the Cayman Islands has developed a comprehensive scheme for the organization and administration of investment funds that provides additional security to potential investors, but the costs of establishing and maintaining a fund in the Cayman Islands are generally higher than many of the other Caribbean jurisdictions. The British Virgin Islands, on the other hand, does not have as extensive a regulatory scheme, but the costs of establishing and maintaining a fund in the BVI are generally lower.

Although some money managers with significant European investor interest establish funds in European offshore jurisdictions such as the Isle of Man, we have found that the time difference creates administrative difficulties for U.S. managers.

**Q: What happens if a Hedge Fund offers interests in an offshore fund to U.S. investors?**

**A:** To the extent that U.S. investors are solicited, many of the legal considerations applicable to domestic funds (such as the Investment Advisors Act, the Investment Company Act and federal and state securities laws) will need to be analyzed. Also, the fund will likely be considered a passive foreign investment company or "PFIC" for U.S. tax purposes, which may have adverse tax consequences for taxable U.S. investors.

**Q: How much will it cost?**

**A:** We tell our clients that the legal fee for the partnership agreement, the private placement memorandum and the subscription documents and the formation of the general partner if an "entity" general partner is prepared will approximate \$15,000 to \$20,000. Expenses generally are limited to filing fees which principally will depend upon how many states are filed in for blue sky purposes. Other expenses are strictly a function of how much time and money you wish to spend organizing the fund. An offshore fund will usually cost \$30,000 to \$40,000.