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Legal, Regulatory and Compliance Services

Forming a Hedge Fund or other Private Investment Fund: A Top 10 List for the Entrepreneurial Fund Manager

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If you are a money management or other financial services professional currently giving some serious thought to setting-out on your own as an entrepreneurial private investment fund manager, this publication is the right place to start. Our law firm specializes in the area of investment management, particularly with respect to providing comprehensive legal counsel to entrepreneurial asset managers of all types. We have prepared this publication as a go-to guide or roadmap for the entrepreneurial fund manager. In it you will find a top ten list of the major areas of consideration and concern for emerging fund managers. Starting a private investment fund—or "hedge fund"—is a daunting task and a potentially life-changing endeavor. In that regard, we aim to provide you with a departure point of concise information to assimilate as you begin your journey as an entrepreneurial fund manager. After reading this guide, we are certain that you will have additional questions and concerns. Accordingly, please do not hesitate to contact Tom Zagorsky at (404) 334-7212 for a free consultation.

Building Blocks—Basic Structure and Formation Considerations.

1 The majority of entrepreneurial private investment funds are formed as Delaware Limited Partnerships. Delaware partnership law—like Delaware corporate law—provides a level of comfort and familiarity to both potential fund investors being sought on a nationwide basis as well as to the various service providers that an entrepreneurial fund manager will need to rely on in order to operate his or her fund.

A limited partnership is a business entity solely controlled and managed by its General Partner which, in turn, permits multiple limited partners to invest capital into the partnership and take a share of its profits without becoming personally liable for the partnership's debts and obligations. In its most simple form, a typical private fund structured as a limited partnership consists of: (i) passive fund investors obtaining an equity stake in the fund as limited partners; and (ii) the fund's sponsor and investment manager who serves as General Partner. The General Partner is usually formed as a limited liability company in the state of its principal business office.

Compensation is typically provided to the General Partner in the form of both: (i) a periodic management fee (usually between 0.5% and 2.0%) assessed against the fund's net asset value; and (ii) a performance fee or incentive allocation, which allocates a percentage (usually between 10% and 20%) of the fund's total profits to the General Partner. The management fee, which is assessed whether or not the fund has profits, is designed to pay for the General Partner's operating expenses and overhead. The performance fee, on the other hand, is—as its name implies—meant to incentivize the General Partner to seek maximum profits in conformance with the fund's stated investment strategy or program.

While the actual "formation" of the fund and fund manager entities is a relatively simple clerical task—i.e., filing necessary paperwork with the Secretary of State or other corporate entity administrators in the applicable states—the creation of a private investment fund necessitates the careful drafting of a number of important legal documents (called "offering documents") to be provided to fund investors. This suite of documents—which must be prepared by a competent securities attorney—consists of: (i) a Private Placement Memorandum or "PPM", which serves as the master disclosure document for fund investors, setting forth all of the fund's material terms and risk factors; (ii) a Limited Partnership Agreement which acts as an operating contract between the General Partner and the limited partners; and (iii) a Subscription Agreement and Investor Questionnaire, which governs the sale of the partnership interests and assesses whether a particular person is qualified to invest in the fund.

Of course, as the fund's strategy and types of investors become more complex and sophisticated, a different more complex structure may be in order. For example, to the extent that a fund expects to receive significant investment from foreign investors or tax-exempt US investors, an offshore fund structure may be needed. Popular foreign fund formation jurisdictions include the British Virgin Islands and Cayman Islands to name a few. Additionally, where it is desirable to provide separate fund vehicles for domestic versus foreign investors, a common approach is to create a "master-feeder" fund structure where two or more feeder funds pool capital for investment into a master trading vehicle.

The Fund Management Team—Necessary Service Providers.

2 Setting up even the most basic private fund structure requires the entrepreneurial fund manager to engage a number of distinct professionals and service providers. Because the process of researching and interviewing potential providers and reviewing engagement contracts can be time consuming, the fund manager should allocate at least a full month to this endeavor well ahead of the fund's planned launch date.

As noted, the fund's attorney plays a crucial role in forming the necessary legal entities and drafting the fund's offering documents. Because these two tasks are building blocks in getting the fund off the ground, a fund attorney is typically the first professional to be engaged. However, the creation of a successful fund management platform requires the entrepreneurial fund manager to develop a number of key longstanding partnerships with the following additional providers:

- **Administrator.** The Administrator is the private fund's third-party accountant, primarily charged with maintaining the fund's financial statements, calculating the fund's net asset value, calculating the management and performance fees, and issuing periodic reports of account to the limited partners. While there is no legal mandate to have a fund administrator, not having one (a/k/a "self-administration") is a red flag for potential fraud which can both scare away investors and draw the attention of regulators. Additional services that can be provided by the administrator include the processing of investor subscription agreements, operation of the fund's bank accounts and general bill payment. Costs generally range from $1500 to several thousand dollars a month. Another rule of thumb is that as the volume, frequency and complexity of the fund's trading strategy increases, so too will the administration costs.

- **Broker/Prime Broker.** All private funds that hold or trade securities, commodity interests, or other financial instruments will need to have at minimum an introducing broker of record. As is the case with investment advisers and their managed accounts, the General Partner will have discretionary trading authority to buy/sell and otherwise dispose of all holdings in the brokerage account. "Prime Brokers" generally provide a bundled package of brokerage services including clearing, custody, leverage/securities lending and financing, back-office support, and technology management enabling complex reporting and analysis.

- **Banking.** Every private fund will need to have a bank account in the name of the fund into which subscribing investor checks or wire transfers are first deposited and from which redemptions of capital are issued. To the extent that a fund selects a prime broker that is part of a universal banking institution, the bank account will likely be provided as part of the bundled package of services.

- **Auditor.** In many instances—largely as a result of the General Partner being a registered investment adviser ("RIA") or a registered commodity pool operator ("CPO")—an annual fund audit is mandated. However, even where not mandated, the majority of fund managers choose to engage an auditor to perform GAAP-compliant annual audits of the fund's financial statements. Indeed, as with self-administered funds, an un-audited fund will be a significant red flag for potential fraud. At a minimum, it is fair to say that no institutional investor will invest in an un-audited or self-administered fund. Auditing costs can be expensive, ranging upwards from $10,000 per year.

Again, it's not an understatement to stress the importance of carefully filling-out the fund's "team." The fund's offering documents will generally list all of the fund's service providers, and this is an area that potential investors will likely have detailed questions about. Accordingly, it's important to be able to reach a decision on the identity of the fund's team as early as possible in the launch process.

One final point to note is that the ongoing costs of running the fund (i.e., the service provider costs) as well as the formation costs (the legal fees and other start-up costs) are all generally treated as expenses of the fund, deducted out of the capital pooled from the investing limited partners (although start-up costs are typically amortized over time). Note the distinction here between these expenses and the management fee, which represents compensation to the General Partner as well as a defrayment of the General Partner's overhead (staff salaries and benefits, office space rental, etc.).

The Regulatory Regime.

3 It is often incorrectly said that hedge funds and other private investment funds are "unregulated." However, in reality, private funds and their managers are subject to a host of laws and regulations that must be analyzed closely and carefully before a fund is offered for investment. The real key is to structure a fund in such a way as to exempt the fund from—or minimize the effects of—the various regulatory regimes applicable to a particular fund or fund manager. These potential regulatory obstacles include: (i) the federal Securities Act and state "blue sky" securities laws which require all offerings of securities to be registered prior to any offer/sale; (ii) the federal Investment

Company Act which applies a level of regulation akin to that of mutual funds on all investment funds not otherwise exempt; (iii) the federal Investment Advisers Act and state analogs which require fund managers to register as investment advisers and subject themselves to compliance examinations; (iv) the federal Securities Exchange Act which generally requires that persons selling securities and receiving transaction-based compensation register as a broker/dealer; and (v) the federal Commodity Exchange Act which requires that a manager of a fund trading futures, forex or other commodity interests register with the CFTC as a CPO.

- **The Securities Offering.** Because limited partnership interests—or any other type of equity interests—in a private fund are securities, the offer/sale of these interests by the fund sponsor is potentially subject to the need to file a registration statement and prospectus with the SEC and the states. However, the vast majority of private funds are structured as private placements under the SEC safe harbor Rule 506 of Regulation D. This is the same private offering exemption that most growth-stage companies use to sell shares of their company to accredited investors—primarily, individuals with either $1 million in net worth (not including a primary residence though) or an annual income in excess of $200,000 for the last two years. Other exemptions may also be appropriate, some of which require consideration of or compliance with state securities laws. There are no exemptions from the disclosure requirements of the federal and state securities laws, which is why a private placement memorandum drafted by a skilled securities lawyer is essential.

- **Company Act Exclusions.** Similarly, funds typically escape characterization as an "investment company" subject to Company Act regulation by fitting into one of two exclusions under section 3(c) of the Company Act. Notably, section 3(c)(1) provides an exclusion to the definition of "investment company" for funds that: (i) have no more than 100 beneficial owners; and (ii) are not making a public offering of its securities. Alternatively, section 3(c)(7) provides an exclusion for funds that: (i) restrict ownership of its securities to "qualified purchasers," which are natural persons holding in excess of $5 million in investments; and (ii) are not making a public offering of its securities. While section 3(c)(7) does not contain a limit on the number of beneficial owners, other applicable securities laws effectively cap a 3(c)(7) fund at 1999 owners.

- **Fund Manager Registration.** Avoiding fund manager registration as an entrepreneurial investment adviser is not so much a structuring issue as it is a matter of geography. First some basics—managing a fund that invests in securities is considered providing investment advice for purposes of assessing the need to register as an "investment adviser" under applicable advisory law. In such a case, the fund is the adviser's "client," not the individual fund investors (i.e., limited partners). While fund managers providing investment advice solely to private funds with total assets under management of less than $150 million are eligible for a blanket exemption from SEC registration pursuant to what is known as the "private fund adviser exemption," state law is less clear cut. Unfortunately, each state has different exemption thresholds and registration requirements. Accordingly, a detailed examination of the state advisory law in the various jurisdictions where fund management operations occur is in order. Some states provide for a *de minimis* exemption for advisers managing less than—say five—clients (again, note that one fund is one client). In such a state, a manager of two or three private funds would be fully exempt. However, other states see things differently—many require advisers to as little as one client (i.e., one fund) to register as an investment adviser. Of course fund advisers at the other end of the spectrum—managing assets in excess of $150 million—are fully required to register with the SEC and fall under all of the Advisers Act compliance rules.

- **Brokerage Concerns.** Selling interests in your fund is yet another regulatory minefield to carefully navigate. Generally speaking, fund sponsors (e.g., General Partners) may sell interests in their own fund without concerns as to registering as a broker/dealer pursuant to what is commonly known as the "issuer's exemption." The issuer's exemption generally allows principals and employees of a General Partner or other private fund sponsor to offer/sell interests in their fund so long as such persons: (i) receive no transaction-based compensation (i.e., commissions) for their sales activities; and (ii) primarily perform other substantial duties for the fund besides selling its securities. However, to the extent that you intend to engage third-parties to assist with capital raising, understand that, with rare exceptions, all such "finders" or "solicitors" must be duly licensed broker/dealers. A broker/dealer is a firm that is registered with the SEC to sell securities and is also a Member of the FINRA. You can easily check the current status of any FINRA Member by visiting the "Broker Check" web site at https://brokercheck.finra.org. Finally, keep in mind that in order to hire any third-party marketer, you will need to engage a FINRA Member firm directly. Simply signing an agreement with an individual registered representative is not sufficient as only that person's firm is authorized to contract as such and receive commissions for the individual's sales efforts.

- **CFTC/NFA Registration.** To the extent that your fund intends to trade in commodity interests, futures, swaps or forex, the fund's General Partner or other sponsor will need to register with the CFTC as a CPO and become an NFA Member firm—or invoke an applicable exemption. Registering as a CPO and complying with CFTC/NFA regulations is a time-consuming and costly process. One particularly onerous obligation of CPO regulation is that a commodity pool's offering documents (i.e., the PPM and partnership agreement) must be formatted as an NFA-compliant "disclosure document" and submitted to the NFA for approval prior to its usage with investors. This essentially means that your offering documents are subject to extensive editing by the NFA, which can add substantial time and cost to your fund project. There are two types of exemptions potentially available however—the first is a complete exemption from CPO registration, while the second is an exemption for registered CPOs from the disclosure document requirement. Bottom line—if your investment program includes the trading of any instruments that fall under CFTC/NFA jurisdiction, you should discuss this with your fund attorney early-on in the fund set-up process.

Who Can Invest in the Fund?

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Here we look at what types of investors are permitted to contribute capital to your fund. While the specific types of investors admissible into any particular fund will depend on how the fund is structured, regulatory jurisdiction, as well as prevailing exemptions, you should at the outset plan on selling your fund to a moderately high-net-worth class of investor known as "accredited investors." Additionally, to the extent that you plan on charging a performance fee in connection with a fund that invests in securities, you will likely also need to restrict admission to persons known as "qualified clients." Accredited investors, as defined in Regulation D of the SEC's rules, include natural persons with either $1 million in net worth (not including a primary residence) or an annual income in excess of $200,000 for the last two consecutive years. Satisfaction of the qualified client standard, on the other hand, requires that an investor have at least $2 million in net worth (again not including a primary residence) or be able to collectively invest at least $1 million with the manager of the fund.

Whether these particular qualification standards will be applicable to your fund is, as noted, a fact specific matter. For funds investing in securities, the qualified client standard will apply if the fund manager is registered with the SEC as an investment adviser—and may apply on a state by state basis if the fund manager is registered at the state level. However, note that if the fund manager is not registered at either the SEC or state level, then fund investors do not need to be qualified clients in order for the fund sponsor to receive a performance fee/allocation.

Escaping the accredited investor standard is a more difficult proposition. The Reg D private offering exemption that most private funds invoke allows for the admission of up to 35 non-accredited investors so long as those persons are still "sophisticated" investors—i.e., they have sufficient financial and business acumen to be capable of evaluating the merits and risks of a complex investment. However, if your fund must require its investors to be qualified clients (per above), then this "sophisticated investor exemption" will not be of any use. In other words, it will only be useful for funds that will not need to require their investors to also be qualified clients (since the qualified client standard is more stringent).

Another factor for funds investing in securities to consider is which of the two exclusions under section 3(c) of the Company Act your fund will be invoking to avoid Company Act regulation. Recall from above that so-called 3(c)(7) funds are restricted to "qualified purchasers," which are natural persons holding in excess of $5 million in investments—a high standard indeed. Alternatively, a 3(c)(1) fund need only ensure that its securities offering be done pursuant to the Reg D private offering exemption.

Finally, note that funds that do not invest in securities add yet additional wrinkles to the investor qualification issue. For example, pure real estate funds that exclusively invest in real property—which are effectively excluded from Company Act and Advisers Act regulation—do not need to screen investors for qualified client status at all, and may still charge a performance fee/allocation. On the other hand, funds trading commodity interests or other CFTC-regulated instruments may require even further restrictions—for example, such funds may need to limit investment to a special class of investors known as qualified eligible persons or "QEPs."

For these reasons, you need to very carefully discuss your investment program in detail with a competent fund attorney on the front end so that the fund's offering documents can be prepared in such a way as to properly screen fund investors without causing trouble for you down the road.

Marketing Your Fund.

5 Historically, private funds offered pursuant to the Reg D private offering exemption, were marketed on a purely private basis without any recourse to advertising, media, internet-based portals, or the like. However, following recent federal legislation known as the JOBS Act, fund sponsors now have two options in conducting a valid private offering: (i) using the traditional Rule 506(b), which requires that the offering be conducted without any form of "general solicitation" or public advertising/media; or (ii) the new Rule 506(c), which allows general solicitation but requires that the fund sponsor take reasonable steps to verify that all purchasers in the offering are in fact accredited investors.

While many fund sponsors are opting to utilize the new approach, a few words of caution are in order. First and foremost, with the added flexibility of being able to market your fund through general advertising and other media channels, comes considerably increased compliance obligations—most notably the need to scrupulously document your qualification of each and every investor's accredited investor status (as compared to the traditional approach of permitting investors to self-certify their status on the fund's subscription form). As detailed by the SEC in its formal implementation of the new Rule 506(c), this effectively means that fund sponsors must, as part of the subscription process, collect detailed net worth and/or income documentation such as tax returns, bank statements, brokerage statements, or the like. Needless to say, many investors—especially high-net-worth individuals and the self-employed—may balk at this when compared to the self-certification acceptable under the traditional approach. Additionally, also keep in mind that a fund utilizing the new Rule 506(c) will not be able to admit the up to 35 non-accredited "sophisticated" investors permitted under Rule 506(b). Finally, recognize that the eyes of regulators (at both the federal and state levels) are, and will be for some time, trained on the sub set of private offerings seeking to utilize the new approach—especially those using the more pervasive media avenues such as radio and television.

With the above caveats in mind, the new Rule 506(c) clearly offers fund sponsors tremendous marketing flexibility. The traditional "no general solicitation" restriction of Rule 506(b) not only rules out any form of advertising and media, but also effectively requires that the fund sponsor have a "substantive pre-existing relationship" with all potential fund investors prior to soliciting any such persons. By contrast, the new approach opens up a world of opportunities for marketing the fund, such as public seminars, internet portals, and/or targeted mailings. However, with all of these new marketing channels available, fund sponsors must be cautious as to not "over-market" their fund and thus end up with a pool of unqualified potential investors. Again, keep in mind that the new Rule 506(c) will require—at a minimum—that each and every fund investor be an accredited investor. And, to the extent that your fund's investors will also need to be "qualified clients," realize that your fund's net-worth threshold will be $2 million (not including primary residence). In this light, a mass marketing campaign that yields scores of interested but unqualified investors will be, in a word, counterproductive.

Offshore Funds?—Why and How.

6 Offshore funds are primarily formed as a means to facilitate investment by non-US persons—i.e., foreign citizens. For tax reasons, offshore funds are also a preferred investment vehicle for tax-exempt US investors such as pension plans, endowments and charities. To the extent that you plan on marketing to or receiving sizeable capital from foreign citizens and/or tax-exempt US persons, you will need to consider establishing an offshore fund. While non-US persons are free to invest in a US-based fund vehicle, many will refuse to do so as it exposes their identities to the IRS and other US regulators (and also note that US funds must withhold taxes on a foreign investor's share of certain types of US-sourced income, such as dividends and interest).

Offshore funds are typically formed in a small number of tax haven (i.e., low to zero corporate level tax rates) Caribbean and European jurisdictions with well-established banking and finance regulatory regimes and a complement of sophisticated fund-focused legal services and fund administration providers domiciled there. Attractive Caribbean jurisdictions include the Cayman Islands and the British Virgin Islands, as well as the Bahamas and Bermuda. Alternatively, the European jurisdictions of Ireland, Luxembourg, Guernsey and Jersey have traditionally been well-regarded by the fund management community.

Regardless of the jurisdiction, the formation process for an offshore fund is considerably more complex, time-consuming and expensive vis-à-vis the process involved in putting together a relatively simpler domestic fund formed as a Delaware limited partnership. The primary drivers behind these added complexities are that (i) you will need to establish a host of in-country relationships with service providers such as a law firm, administrator, auditor, registered agent, independent directors, and bank; and (ii) the fund and/or fund sponsors will likely need to register with the presiding financial regulatory authority in that jurisdiction. While the ongoing compliance responsibilities of this "registration" is minimal as compared to the ongoing responsibilities of an SEC-registered investment adviser or a security registered under the federal Securities Act, the timeframe for acquiring a registration with the BVI or Cayman regulators, for example, can stretch to several months. Additionally, the process of forming the offshore entity itself usually involves extensive "due diligence" on the fund sponsor principals in the form of submitting proof of identity and residence as well as professional references.

While a fund sponsor that expects to market exclusively to foreign citizens may decide to only form one fund (i.e., an offshore fund), it is more common that a structure implementing multiple funds will be utilized—either "side-by-side" or in a "master-feeder" arrangement. This is the case because fund sponsors will likely wish to simultaneously market their strategies to both domestic US investors (taxable as well as tax exempt) and foreign citizens. The side-by-side approach entails forming and running two separate but identical funds—one as a domestic limited partnership and the other as a foreign business company. However, for certain strategies such as those involving high-volume trading, the side-by-side approach can become unwieldy due to the need to duplicate all trade orders and consistently generate the same results across both funds. The alternative approach is the master-feeder fund structure, which requires the creation of two feeder funds, one foreign and the other domestic, which pool capital from their respective investor bases and then feed that capital into a master trading fund. While the detailed specifics of master-feeder structuring and accounting is beyond the scope of this discussion, suffice it to say that there are multiple approaches to designing the master-feeder arrangement in order to achieve a tax-optimal solution for both the fund sponsor and the various types of fund investors.

Because of the complexities involved in structuring an offshore fund, you should seek competent securities legal counsel early-on in the fund set-up process. Domestic law firms typically shepherd the process by helping the fund sponsor procure quality providers in the offshore jurisdiction. All legal documents, including those specific to the offshore jurisdiction, are generally drafted by domestic counsel who then, in turn, retain offshore counsel to review and approve those documents, as well as interface with the in-country regulators, to the extent necessary.

Hedge Funds, Private Equity Funds and Real Estate Funds.

7 Up to this point, we have talked generally about private investment funds. However, there are in fact a variety of different types of private funds, each with a distinct investment focus, usually in connection with a particular asset class. For example, some funds may be long-only, short-only or long/short; others may take their cue by focusing on distressed debt, particular sectors of the economy (like drug or tech companies) or particular regions of the world. At a higher level, funds are generally categorized as hedge funds, private equity funds, real estate funds, and commodity/futures funds. The term "hedge fund" is the most generic, encompassing all sorts of private fund trading strategies and investment programs. Historically, describing a fund as a hedge fund implied that the manager utilized some form of hedging against risk; however, today that distinction has withered away. Under the modern definition, a fund can engage in a host of strategies from the mundane to the esoteric and still be described as a hedge fund. Indeed, our discussion of "private funds" throughout this publication can be said to apply equally to hedge funds as defined here.

A private equity fund, on the other hand, describes a distinct investment program whereby the fund manager exclusively invests in the private securities of non-public growth-stage portfolio companies. Because of the illiquid potentially long-term nature of the investment program, private equity funds are uniquely structured as closed-end limited partnerships with very little to no redemption rights. Another defining characteristic of private equity funds is that the life cycle of the fund is usually split up into three distinct stages: (i) a Fundraising Period during which capital is raised; (ii) an Investment Period during which portfolio investments are made; and (iii) a Divestment Period during which portfolio investments are sold off. During the Fundraising Period (which usually lasts about a year), the limited partners in a private equity fund agree contractually to commit to contribute a fixed amount of capital to the fund on an as-needed basis as determined by the General Partner sponsoring and managing the fund. The General Partner in turn issues "capital calls" to each limited partner on a pro rata basis (according to each limited partner's commitments) as needed over the Investment Period in order to fund portfolio investments in targeted private companies. Finally, upon the occurrence of distinct liquidity events corresponding to each portfolio company investment, these investments are liquidated and the proceeds are distributed out to all of the partners during an extended Divestment Period which can last several years.

Fund sponsor economics under the private equity model also differ somewhat from the hedge fund model. Recall that private fund General Partners typically receive a two-part compensation stream consisting of: (i) an annual management fee of between 0.5% and 2.0% of the fund's assets; and (ii) a performance fee or incentive allocation of between 10% and 20% of the fund's total profits. Under the private equity model, the General Partner still receives a commensurate management fee, but is allocated its share of the fund's profits under a more complicated formula. Because private equity fund profits are sporadically realized in connection with a liquidity event (which can, for example, correspond to the sale of a portfolio company to a strategic investor), these profits are distributed out pursuant to a contractually arranged "distribution waterfall." While these waterfalls can vary, a typical scenario for allocating the proceeds of a liquidity event is as follows: (i) all the limited partners first receive a 100% return of all capital invested in that portfolio company; (ii) the limited partners then receive a preferred return of 5-8% on their invested capital; (iii) the General Partner is allocated all of the remaining profits until the allocation of profits is 20% to the General Partner and 80% to the limited partners; and (iv) any remaining profits are allocated 20% to the General Partner and the 80% to the limited partners. Note that the General Partner's profit allocation under this model—commonly known as "carried interest" or "carry"—has been set at 20% for illustrative purposes, but can range anywhere from 10-30%.

Real estate funds generally share many of the same structural characteristics as private equity funds as a result of the typically long-term and highly illiquid nature of real estate property investments. As with private equity funds, real estate funds seek firm capital commitments from investors during an extended Investment Period, then deploy that capital into various real property investments over time after having issued numerous capital calls to the committing investors. Similar to private equity funds, real estate fund profits are distributed pursuant to a pre-arranged priority waterfall, which accords the real estate fund sponsor with a typical carried interest in the range of 10-30%. Real estate funds differ from private equity funds somewhat to the extent that a real estate fund's strategy may oftentimes involve investing in income-producing (i.e., rent producing) properties. In such cases, a real estate fund may make periodic distributions of rental income to investors, even potentially offering a dividend feature to entice investors.

As noted above in the fourth section of this publication, pure (i.e., fully invested in real property) real estate funds also offer sponsors the added benefit of avoiding Company Act and Advisers Act jurisdiction altogether. However, one note of caution—real estate held through partnerships, holding companies or other special purpose vehicles, including REITs, as well as mortgages, notes or other debt instruments will generally involve the holding of a "security" and thus fall within both Company Act and Advisers Act jurisdiction. To the extent that your real estate fund will hold property through any of these intermediary interests, you are strongly encouraged to consult with competent legal counsel to ascertain the applicability of the various securities laws and regulations to your fund's activities.

Navigating RIA Registration.

8 Some private fund managers will be required to register as an investment adviser with either the SEC or one of the states, depending on their primary place of business, the fund's trading strategy, and the fund's assets under management. Likewise, for funds trading in commodity interests, futures, swaps or forex, registration of the fund manager as a CPO with the CFTC and NFA becomes necessary unless an applicable exemption is available. This registration process—whether it be as an RIA or a CPO—is a potentially time consuming undertaking which will likely add at least a month or more to your fund set up schedule. Keep in mind that if regulatory jurisdiction resides, you will likely be prevented from actively managing your fund until such time as all necessary registrations are in place. Additionally, both regulatory regimes require that registered persons set up and adhere to extensive compliance programs on an ongoing basis. Registrants need to be cognizant that regulators will monitor their adherence to these ongoing compliance requirements through virtual as well as on-site audits/examinations, and will enforce compliance with prevailing regulations through disciplinary proceedings if necessary.

RIA registration with either the SEC or a state entails the online completion of an application on Form ADV, which elicits extensive information about the fund management firm and its principals. Filing of a Form ADV, while done online, also involves creation of a substantive disclosure document known as a Form ADV Part 2 brochure which is uploaded along with the online filing. While federal RIA registration does not require the passage of any examination on the part of the individuals controlling and/or associated with the fund management firm, the states generally require all fund manager principals (and in some cases associated persons) to pass the Series 65 exam.

Once registered, SEC and state registered advisers must develop compliance programs covering issues as diverse as trading and portfolio management practices, proprietary trading by the advisory firm, personal trading by the firm's principals and employees, insider trading, safeguarding of client assets, marketing and advertising, asset valuation, privacy and disaster planning. Generally, these compliance programs must be memorialized in writing and reviewed annually. Federal rules and the rules of many of the states further require that a particular individual be designated as Chief Compliance Officer or "CCO" with responsibility for the firm's compliance program. Finally, both SEC and state advisory rules set forth extensive record-keeping provisions requiring the maintenance of voluminous records by the RIA, which are subject to inspection by regulators.

It's also important to note that both the SEC and the states have detailed rules applicable to RIAs in connection with the custody of client assets. General Partners or other entities controlling a private fund or other pooled investment vehicle are deemed by these rules to have custody over the assets of their private funds. This in turn subjects the RIA fund manager to a host of onerous provisions—such as arranging to have a "surprise examination" done annually whereby a CPA firm verifies the existence and safety of client assets. However, SEC and state rules generally provide various levels of relief to private fund managers so long as the financial statements of those managers' funds are prepared in accordance with GAAP, audited annually by a licensed CPA, and distributed to all fund investors within 120 days of the end of the year.

CPO Registration.

9 The CFTC and NFA similarly require that CPO registrants file a detailed online application, which is done on NFA Form 7-R. Individual registration of the fund manager's principals and associated persons is also required. Additionally, these persons must all take and pass the Series 3 exam. However, perhaps the most onerous hurdle to overcome for CPOs is the requirement that all funds must have a disclosure document (i.e., the fund's offering documents) pre-approved by the NFA before any such document can be provided to potential investors. In practice, this pre-approval process occurs in a series of steps whereby the document is submitted, the NFA staff responds with comments, and then the document is resubmitted, oftentimes receiving yet additional comments requiring a further resubmission. Accordingly, it is incumbent upon entrepreneurial CPOs to seek legal counsel familiar with this sometimes byzantine process.

Ongoing CPO compliance requirements are also substantial, perhaps even more so than is the case for an RIA. Like RIAs, the CPO firm must also designate an individual as the firm's CCO responsible for a multi-faceted compliance program covering many of the same areas such as trading, recordkeeping, advertising, business continuity planning and ethics. Additionally, however, CPOs are subject to a rigorous financial reporting scheme, requiring the submission of periodic reports to both the NFA as well as fund investors. Specifically, all CPOs must distribute account statements prepared in accordance with GAAP to all fund investors on at least a quarterly basis (or monthly if the fund's assets exceed $500k). Separate financial reports known as Pool Quarterly Reports or "PQRs" in turn must be provided to the NFA on a quarterly basis via the NFA's online filing portal. All CPOs must also distribute an annual GAAP-compliant audit to all fund investors within 90 days of the end of the year. Finally, CPOs will need to keep their disclosure documents up-to-date throughout the marketing period of their funds, submitting any documents containing material changes to the NFA for pre-approval.

With these factors in mind, emerging fund managers seeking to form funds that will trade instruments under the jurisdiction of the CFTC/NFA will not only need to seek competent legal counsel, but also retain both an administrator and an auditor who are well-versed in the preparation of CFTC/NFA-compliant financial statements.

How long will this take?—Let's get started.

10 Launching your hedge fund will be a major commitment on your part. However, with the right planning, preparation and assistance, it can be a painless and rewarding experience. The key is to start early and to absorb as much information as possible as soon as possible. Hopefully, this publication will help you in that effort.

To the extent that you are ready to begin moving the ball forward on your fund project, you should start by talking to a fund attorney to flesh out the details of your plans. A good attorney will be able to give you an idea as to the potential timeframes for your particular project. As should be evident from the discussions in this publication, different fund projects will pose different levels of added complexities. Your fund attorney should be able to quickly ascertain to what extent any regulatory registrations (such as RIA or CPO) are necessary. That, in conjunction with the complexity of the investment program that you will be offering, will be the primary determinant as to the length of time involved.

Generally speaking, a standard domestic fund set-up involving a simple Delaware limited partnership in tandem with a non-esoteric investment program can be completed in under a month. This allows time to form the fund entity and draft the basic fund offering documents—in this case a PPM, limited partnership agreement and subscription documentation. Keep in mind that as your investment program increases in complexity and sophistication, so too will the necessary disclosures and risk factors. Obviously, your ability to concisely define the trading strategy in writing will help the lawyer drafting the PPM disclosures immensely. As an aid to the lawyer drafting the offering documents, you should plan on preparing a 1-2 page summary of your trading program to help with this process. The lawyer will also need your biography as well as those of your co-principals, if any.

An RIA registration will add considerable time to the process—you should assume at least a month. Because the registration process involves dealing with the vagaries of government regulators, it is impossible to precisely determine the added amount of time involved here. This is especially so with respect to state registration as each state has its own unique processes and requirements.

CPO registration as noted earlier carries with it the added burden of getting your fund documents pre-approved by the NFA staff. Since we will need to submit final complete offering documents to the NFA, this part of the process cannot begin until we have finalized the documents as described above. Our experience in this area is that even the best written most straight-forward offering documents will still receive some level of comments from the NFA, with each "round" of comments running a week or two. Accordingly, at least a month should be budgeted for this NFA review process.

We've noted earlier that in some cases you and other members of your team will need to take and pass a qualifying examination. Both the Series 65 and Series 3 exams are substantive and potentially challenging exams. To the extent that passing these exams will be required, sufficient time should be set aside for study.

Finally, we note that creation of an offshore fund, especially in connection with a master-feeder structure, is an even more complex endeavor. Timelines involved with an offshore project will vary based on the jurisdiction selected as well as the need to obtain registrations in-country as well as domestically.

We hope that this information proves useful to you as you make plans to set up an entrepreneurial private investment fund.

If you'd like to discuss any of the information in this publication in greater detail, please feel free to contact Tom Zagorsky at (404) 334-7212 for a free consultation. We would welcome the opportunity to speak with you.

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Mr. Zagorsky recently served as Director/Assistant Commissioner of the Georgia Securities Division, the chief securities regulatory official in Georgia. Prior to his service with the Securities Division, Mr. Zagorsky practiced law at a boutique Atlanta firm focused exclusively on private investment fund formation, where he formed over 30 entrepreneurial investment funds (hedge funds, commodity pools, and private equity funds). Mr. Zagorsky was also Chief Counsel and Compliance Officer for an Atlanta-based hedge fund management company.

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