FREQUENTLY ASKED QUESTIONS CONCERNING INVESTMENT LIMITED PARTNERSHIPS (HEDGE FUNDS)
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Q: WHAT SORT OF LEGAL STRUCTURE SHOULD BE USED FOR THE FUND?

A: The typical investment fund structure for a U.S. domestic private investment fund (“Hedge Fund”) is a limited partnership, with the investment manager serving as the general partner. Investors will contribute capital to the limited partnership and receive partnership interests and a capital account in the partnership in return. The gains and losses attributable to the Hedge Fund’s performance are passed through to the investor’s capital accounts on a pro rata basis. The use of limited liability companies for Hedge Funds is on the rise, but certain managers (such as Texas-based managers) will not use limited liability companies because of the franchise tax consequences in certain jurisdictions.

Q: WHAT SORT OF LEGAL STRUCTURE SHOULD BE USED FOR THE INVESTMENT MANAGEMENT ENTITY?

A: The simplest, least expensive and least complicated form for the management of a Hedge Fund is for an individual to serve as the general partner and investment manager of the Hedge Fund partnership. Most investment managers do not like this form because it does not offer the “appearance” of limited liability. Instead, most Hedge Funds are formed as limited partnerships with a limited liability company acting as the general partner. Often, for tax and other structural reasons, the general partner may be a limited partnership with its general partner being a limited liability company.

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 that 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 strategic investors or to create certain incentive compensation arrangements for employees. For tax reasons in some jurisdictions, managers frequently use two separate entities at the management level, one serving as the general partner of the Hedge Fund partnership and one serving under a contract as the investment manager to the Hedge Fund partnership.
Q: WHAT IS THE TYPICAL COMPENSATION TO THE GENERAL PARTNER?

A: The general partner typically is entitled to an incentive 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 and is made on a partner by partner basis. It is important to note that managers that are registered as investment advisers are generally prohibited from collecting incentive allocations except from investors with a net worth over $1,500,000, or people who invest more than $750,000 in the Hedge Fund (“Qualified Clients”), Qualified Purchasers (as described below) and certain “knowledgeable employees” of the investment manager. The general partner or an affiliate also typically receives a management fee which is typically 1 - 2% of the net asset value of the Hedge Fund and paid quarterly in advance.

Q: ARE THERE TYPICALLY ANY LIMITATIONS ON THE COMPENSATION OF THE GENERAL PARTNER?

A: For incentive allocations, there is usually a loss carryforward provision which carries forward any losses previously allocated to a partner either for one year, 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 incentive allocation is conditioned upon the limited partners getting a minimum specified return. Usually the general partner gets a 20% incentive allocation with respect to all net profits 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. We are seeing the increased use of a “rolling high water mark” where the incentive allocation is reduced (but not eliminated) if there have been losses until the losses (plus, typically, some additional amount) have been recouped.

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. In the past, 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. However, under current law, 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 (and in most cases do) (1) require “blue sky” notice filings which are similar to the Form D that is filed with the Securities and Exchange Commission (the “SEC”) pursuant to Regulation D and (2) collect filing fees. Current 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: Historically, most Hedge Fund managers or general partners choose not to register under the federal Investment Advisers Act of 1940 (the “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. However, the SEC has adopted a new rule changing this exemption so that an investment adviser would have to count the underlying investors in the Hedge Fund as clients unless all investments made on or after February 2006 are subject to a two year lock-up. An exemption from federal registration does not exempt a fund or fund manager from the anti-fraud provisions of the Advisers Act or from any state registration requirements. Hedge Fund managers based in Texas must register as investment advisors under Texas law unless all investors in the fund are subject to a two year lock-up. In the interest of best practices and due to pending changes being considered by the SEC, we encourage Hedge Fund managers which are currently exempt from registration to operate their businesses as if they were registered.

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 allocation as most Hedge Fund managers do) potential investors to “accredited investors” that are also Qualified Clients or Qualified Purchasers 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 restrictions on incentive fees. Certain institutional investors will only place funds with registered investment advisers.

Should a manager choose to register under Federal law, it can only do so after the Hedge Fund (or other assets under management) exceeds $25,000,000 in size. Many individual states regulate investment advisors who have $25,000,000 or less under management that are not registered federally.

Q: HOW CAN I SELL INTERESTS IN MY FUNDS?

A: Very carefully. The private placement rules severely limit what you can do to sell interests 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. One should be even more careful if one is soliciting unaccredited investors.

To remain exempt from registration as an investment advisor (if so exempt) a manager cannot hold itself out “publicly” as an investment advisor. The SEC has taken the position that, unless considerable care is taken, 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.
Q: SHOULD I LIMIT MY OFFERING OF LIMITED PARTNERSHIP INTEREST TO ACCREDITED INVESTORS ONLY?

A: In general, yes. The private placement exemption under Regulation D of the Securities Act is only available if you limit offerings to 35 persons who are non-accredited. In addition, 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. Furthermore, as noted above, incentive compensation can only be charged if the investor is a Qualified Client.

Q: CAN I TAKE PENSION PLAN MONEY?

A: Yes. However, most Hedge Funds limit participation by pension plans to no more than 25% of the value of the fund that 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 in order to avoid being subject to ERISA. Those that wish to take more than the 25% threshold may qualify as “qualified professional asset manager” under a Department of Labor exemption if they, among other things, are federally registered, have client assets under management in excess of $50 million and have equity in excess of $750,000. A proposed amendment to this exemption may raise the above mentioned thresholds to $85 million under management and $1 million in equity. If so qualified, the adviser is exempt from compliance with certain “prohibited transaction rules” under ERISA, which, without the exemption, make the operation of a Hedge Fund not practical.

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 private placement memorandum (“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. 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 and other required information 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, in most cases anyone who sells your units must be licensed as a broker/dealer. Solicitation service agreements with broker/dealers must comply with certain disclosure requirements under the Advisers Act.
Q: IS THERE A DIFFERENCE BETWEEN A “FINDER” AND A BROKER/DEALER IN SELLING MY INTERESTS?

A: Under both federal and many state laws both must be registered as a broker-dealer, except in very limited circumstances. If a Hedge Fund uses an unregistered broker/dealer to sell its interests, it will have violated applicable law and may have an obligation to refund investors’ money.

Q: WHAT IS A “3(C)(1) FUND”?

A: The reference to “3(c)(1)” is to an exclusion from registration as an investment company pursuant to Section 3(c)(1) of the Investment Company Act (a law which mainly regulates mutual funds) (the “3c1 Fund Exclusion”). Under this exemption, a Hedge Fund will not have to register under the Investment Company Act if its outstanding securities are not owned by more than 100 persons (a “3c1 Fund”).

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. Sometimes the rules force a fund to “look through” an entity investor and count each of the underlying beneficial owners of the entity based on certain percentage tests which may increase the number of investors which count against the 100 investor limit. Also, certain “knowledgeable employees,” spouses of jointly held interests, or interests held by one beneficial owner through multiple entities may not count (or only count as one investor) 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 strategies employed by the funds are not sufficiently distinct.

Q: WHAT IS A “3(C)(7)” FUND?

A: The reference to “3(c)(7)” is to an exclusion from registration as an investment company pursuant to Section 3(c)(7) of the Investment Company Act (the “3c7 Fund Exclusion”). This exclusion is available for a Hedge Fund which limits its limited partners to individual investors (“Qualified Purchasers”) who own not less than $5,000,000 in investments, and to entities which own not less than $25,000,000 in investments, as defined by the SEC (a “3c7 Fund”). An entity that has less than $25,000,000, but which is beneficially owned by persons who are Qualified Purchasers may also be considered a Qualified Purchaser. For a number of tax and regulatory reasons, 3c7 Funds still must limit the number of investors to fewer than 500.

Q: CAN A FUND MANAGER SIMULTANEOUSLY OPERATE BOTH A 3C1 FUND AND A 3C7 FUND WHICH ARE SUBSTANTIALLY SIMILAR TO EACH OTHER?

A: Yes. Legislation passed in 1996 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 3c1 Funds. 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 3c1 Exclusion is available. While the new rule exempts properly constituted 3c1 Funds and 3c7 Funds from the integration principle, the principle still applies in most other cases.
Q: CAN THE 3C7 FUND EXCLUSION AND THE 3C1 FUND 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 satisfies certain additional requirements.

Q: DOES THE 3C7 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. SECURITYHOLDERS?

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 3c1 Fund 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, which the SEC concurred with in a subsequent no-action letter.

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 National Futures Association as a commodity pool operator (and if a separate entity acts as investment adviser, it too may need to register as a commodity pool operator and/or commodity trading adviser). Current CFTC regulations offer an exemption to registration to investment managers of Hedge Funds that limit a Hedge Fund’s commodities positions to (i) (in the aggregate) initial margin and premiums of less than five percent of the net assets of the Hedge Fund or (ii) a net notional value of less than one hundred percent of the Hedge Fund’s liquidation value. Another exemption from registration as a commodity pool operator is available to investment managers whose Hedge Funds are limited to Qualified Purchasers.

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 an 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 to investors the possibility of execution of trades by an affiliate.

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 documented. In addition, while managers are allowed to take soft dollar offers into consideration when selecting brokers, managers must select those brokers that offer best execution for investors and soft dollars are only one factor that may be
considered. Additional regulations concerning the use of soft dollars are currently being considered.

Q: ARE THERE ANY RESTRICTIONS ON MY PARTICIPATING IN “NEW ISSUES”?

A: Yes, the fund must have a profit allocating procedure in place to deny or limit participation in profits from securities sold in IPOs (“new issues”) to certain categories of investors who are specified in NASD regulations. Without such a provision, the fund can either not participate in new issues or not take NASD restricted persons as investors. Recent amendments to the NASD rules permit restricted persons to have an aggregate of up to 10 percent participation in new issues.

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 those jurisdictions that require a manager to register as an investment adviser, managers generally need to have taken a general securities law exam (usually Series 7 and Series 66) or the exam on state law (usually the Series 65 exam). CFAs are exempt from exam requirements in some states.

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 hold long positions in certain U.S. publicly traded equity securities valued at more than $100,000,000, you are required to file a Schedule 13F listing your portfolio holdings on a quarterly basis. Although the 13F regulations permit confidential filings, in practice confidential treatment requests are often rejected by the SEC absent compelling reasons.

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 SEC (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 provides information with respect to the acquirer’s reusable, the purpose of acquiring the securities. Amendments to a Schedule 13D must be filed if there is a material change in investment intention or if the percentage of outstanding securities of the issuer held by the filer
changes by more than 1%. 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 that
has securities registered with the SEC. 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 only 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: 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: If the Hedge Fund is classified as a trader and not an investor, 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
finance one-half of the purchase price with debt and then sell 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. Therefore, they will generally avoid Hedge Funds which generate 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 typically 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: 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.

An offshore fund generally makes sense only if a money manager has significant clients or prospects who reside outside the United States or who are U.S. tax exempt entities. 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 and Bermuda have developed comprehensive schemes for the organization and administration of investment funds that provide additional security to potential investors, but the costs of establishing and maintaining a fund in the Cayman Islands or Bermuda 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. The Organization of Economic Cooperation and Development (“OECD”) has developed a list of jurisdictions with “harmful tax practices,” that could have a significant impact on the choice of offshore jurisdiction.

**Q:** WHAT IS A “MASTER/FEEDER” STRUCTURE AND SHOULD I CREATE ONE?

**A:** A “master/feeder” structure is one in which assets from domestic and offshore “feeder” funds are dropped into a “master” fund which serves as the investment entity the feeders. A diagram of a typical master/feeder structure follows:

![Diagram of a typical master/feeder structure]

Master/feeder structures provide significant benefits for active traders (i.e., having one investment entity instead of two), but may also raise issues under U.S. securities laws and limit the ability to differentiate strategies. The desirability of a master/feeder structure will depend on the strategy and goals of the individual manager as well as the overall fund structure.

**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 (“PFIC”) for U.S. tax purposes, which may have adverse tax consequences for taxable U.S. investors.
Q: **WHAT ARE MY OBLIGATIONS WITH RESPECT TO ANTI-MONEY LAUNDERING?**

A: The USA PATRIOT Act (the “Patriot Act”), adopted in the wake of the events of September 11, 2001, requires that all financial institutions, including private investment funds such as Hedge Funds, implement policies and procedures designed to guard against and identify money laundering activities. Under the Patriot Act, a Hedge Fund is required to confirm (prior to acceptance of any subscription) the identity of each investor to the extent reasonable and practicable, including the principal beneficial owners of an investor, if applicable. The Hedge Fund is required to undertake enhanced due diligence procedures prior to accepting investors the manager believes present high risk factors with respect to money laundering activities. In addition, the Hedge Fund should prohibit accepting subscriptions from or on behalf of certain specifically identified persons set forth on lists specified by the Patriot Act. The Hedge Fund may be required to undertake additional actions to guard against and identify money laundering activities when final regulations under the Patriot Act are adopted by the Department of the Treasury. Offshore jurisdictions also typically have anti-money laundering laws and regulations that will apply for offshore investment funds.

Q: **WHAT CUSTODY RULES APPLY?**

A: SEC rules require that all client assets must be held by a qualified custodian, which is typically a bank or other financial institution. The custody rules also require that the manager inform its clients of the identity of the custodian and that either the custodian or the manager deliver quarterly account statements to the clients. An exemption to the rule allows pooled investment vehicles like limited partnerships to deliver audited annual financial statements in lieu of the quarterly statements.

Q: **WHAT POLICIES MUST I DEVELOP AND MAINTAIN?**

A: The SEC requires investment advisers to adopt written policies and procedures designed to prevent violations by it and its supervised persons of the Advisers Act and rules. Such policies and procedures and their effectiveness must be internally reviewed at least annually. An adviser is also required to designate an individual responsible for administering the adopted policies and procedures.

Q: **WHAT OBLIGATIONS DO I HAVE TO PROTECT INVESTOR INFORMATION?**

A: The general partner or manager of a Hedge Fund is subject to federal rules designed to protect the privacy of information it obtains concerning its investors. These federal rules (the “Privacy Rules”) require the general partner or manager to (1) adopt policies and procedures to safeguard certain personal information about prospective and existing investors and (2) give initial and annual notices to prospective and existing investors about these policies and procedures.

The Privacy Rules apply to you even if you are not registered with the SEC or any other financial services industry regulator. If you are registered with the SEC, you are subject to the SEC’s privacy rules. If you are registered with the CFTC, you are subject to the CFTC’s privacy rules. If you are not registered with the SEC or the CFTC (and you are not regulated...
by any other financial services industry regulator), you are subject to the Privacy Rules of the Federal Trade Commission (described above).

Q: WHAT DO I HAVE TO TELL MY HEDGE FUND INVESTORS ABOUT VOTING PROXIES?

A: In the course of managing accounts or funds, an investment adviser may be required to exercise its proxy voting authority on behalf of clients. Rule 206(4)-6 of the Investment Advisors Act prohibits an investment adviser from exercising proxy voting authority with respect to client securities, unless the investment adviser: (1) adopts and implements written policies and procedures that are reasonably designed to ensure that the advisor votes proxies in the clients’ best interests; (2) describes its proxy voting procedures to its clients and provides copies upon request; and (3) discloses to clients how they may obtain information on how the investment adviser voted their proxies.

Q: WHAT ARE MY RECORD-KEEPING REQUIREMENTS?

A: The SEC imposes extensive recordkeeping requirements on registered investment advisers and the SEC attaches considerable importance to these provisions. Generally speaking, Rule 204-2 of the Investment Advisers Act requires an adviser to maintain two types of records: (1) typical business accounting records and (2) certain records the SEC believes an adviser should keep in light of the special fiduciary nature of its business, including copies of all written communications relating to any advice or recommendations given or proposed to be given; any receipt; the disbursement or delivery of funds or securities; or the placing or execution of any order to purchase or sell any security. The SEC believes that this policy encompasses all forms of written communication, including e-mails. We recommend that all registered investment advisers develop a comprehensive record-keeping policy, including provisions for e-mail retention. A copy of the adviser’s policies and procedures must also be maintained.

CONTACT INFORMATION

If you have any questions or would like to learn more about Hedge Funds, please contact any of the lawyers listed below:

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