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DEFINITION OF A HEDGE FUND

A "hedge fund" is a private investment vehicle organized for the purpose of pooling investors' assets. The sponsor of the hedge fund, commonly referred to as the investment manager, invests the hedge fund's assets pursuant to a predetermined investment strategy. It is argued that in the absence of such a pooling vehicle, an investor, on its own, would not be able to diversify its assets or have the resources to monitor, evaluate and implement the investing and trading strategies to be engaged in by the manager. Although historically the defining characteristic of a hedge fund was to "hedge" against market risk and volatility, hedge funds today apply a variety of investment techniques which may not involve hedging. Unlike mutual funds, which are highly regulated, hedge funds: (i) are not required to redeem investors' assets within a statutorily defined period of time; and (ii) may invest in illiquid positions and may engage in leveraged transactions with greater freedom.

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LEGAL STRUCTURE

The legal structure of a hedge fund largely depends upon the characteristics of its targeted investors, and the investment strategy that will be employed by the investment manager.

I. Investments

The type and domicile of investors should be taken into consideration in connection with the structuring of the investment vehicle for tax and regulatory analysis.

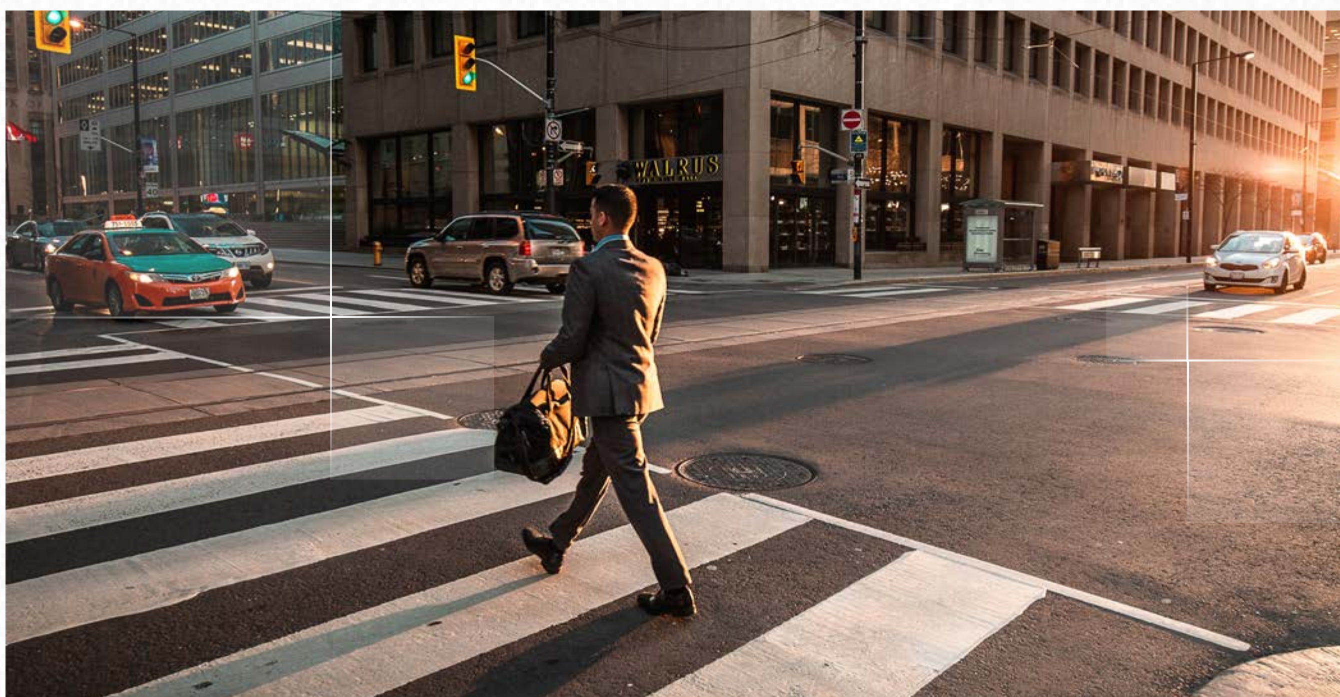
For those investors residing in the United States, it is beneficial to ascertain what percentage of early stage investments will be made by the U.S. taxable investors versus U.S. tax-exempt investors. Further, the domicile of any investor which is a non-U.S. person should also be determined. For example, an investment by an investor residing in the European Union requires analysis under the Alternative Investment Fund Managers Directive. Conversely, an investment by a person residing in Canada requires a different analysis.

II. Investment Strategy

The investment strategy may have an impact on the structure of the investment vehicle(s). Commonly asked questions are: (1) What percentage of the portfolio will be illiquid? (2) Will the assets that are purchased or sold be traded on an exchange in the United States or elsewhere? (3) Will the investment vehicle(s) employ leverage?

DOMESTIC PARTNERSHIP

For the purpose of managing the assets of persons residing in the United States who are investing U.S. taxable assets, a hedge fund is ordinarily organized as a limited partnership in the United States. By purchasing an interest in the partnership, an investor becomes a limited partner of the partnership.



In an attempt to limit personal liability and maximize tax efficiency, the manager of a domestic fund usually forms one or more entities to provide advisory and/or administrative services to the partnership. An entity should be formed to serve as the general partner of the partnership. Depending on the laws of the state in which the general partner will be domiciled, the hedge fund manager will organize the general partner as a limited liability company, corporation or limited partnership. In certain cases, the manager will form two entities, one entity to serve as the general partner and another entity to serve as the investment manager.

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

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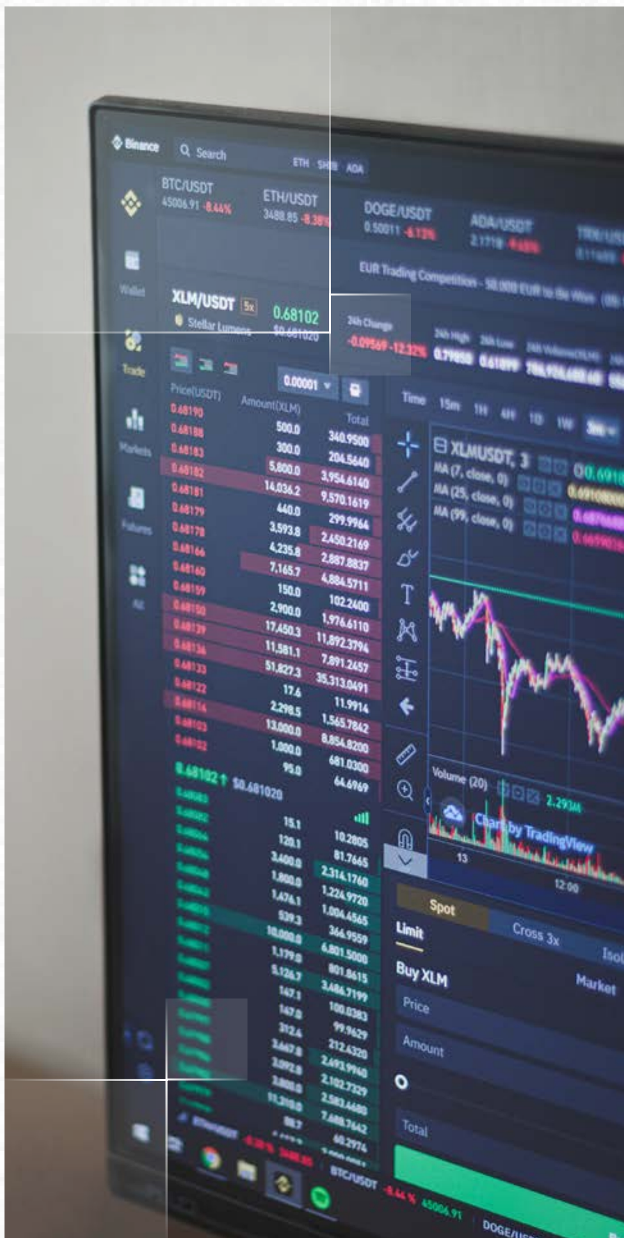
OFFSHORE FUND

For the purpose of managing the assets of persons residing outside of the United States, an offshore fund is ordinarily structured as a corporation and organized in a tax haven jurisdiction. Examples of such jurisdictions include Bermuda, British Virgin Islands, Cayman Islands, Ireland and Luxembourg. The jurisdiction in which the fund is organized often depends on the countries in which investors reside, the investment strategy employed, and the type of entity the sponsor desires to form. Offshore funds are also attractive to United States tax-exempt organizations (e.g., individual retirement accounts, qualified pension and profit sharing trusts) as a method for avoiding unrelated business taxable income.

Often, the manager of an offshore fund forms a corporate entity to provide advisory services to the fund. This entity serves as the investment manager of the fund. If the hedge fund manager already manages the assets of a U.S. domiciled partnership through a single corporate entity, the general partner of the partnership may also serve as the investment manager of the offshore fund. If the sponsor is managing the assets of a partnership through two corporate entities, the entity serving as the investment manager of the domestic partnership will ordinarily serve as the investment manager to the fund while the general partner serves as the management company of the offshore fund. For various reasons, Sadis strongly advises its clients to have management fees paid to one entity and the incentive allocated or paid to a different entity.

OPTIONS FOR STRUCTURING DOMESTIC AND OFFSHORE FUNDS

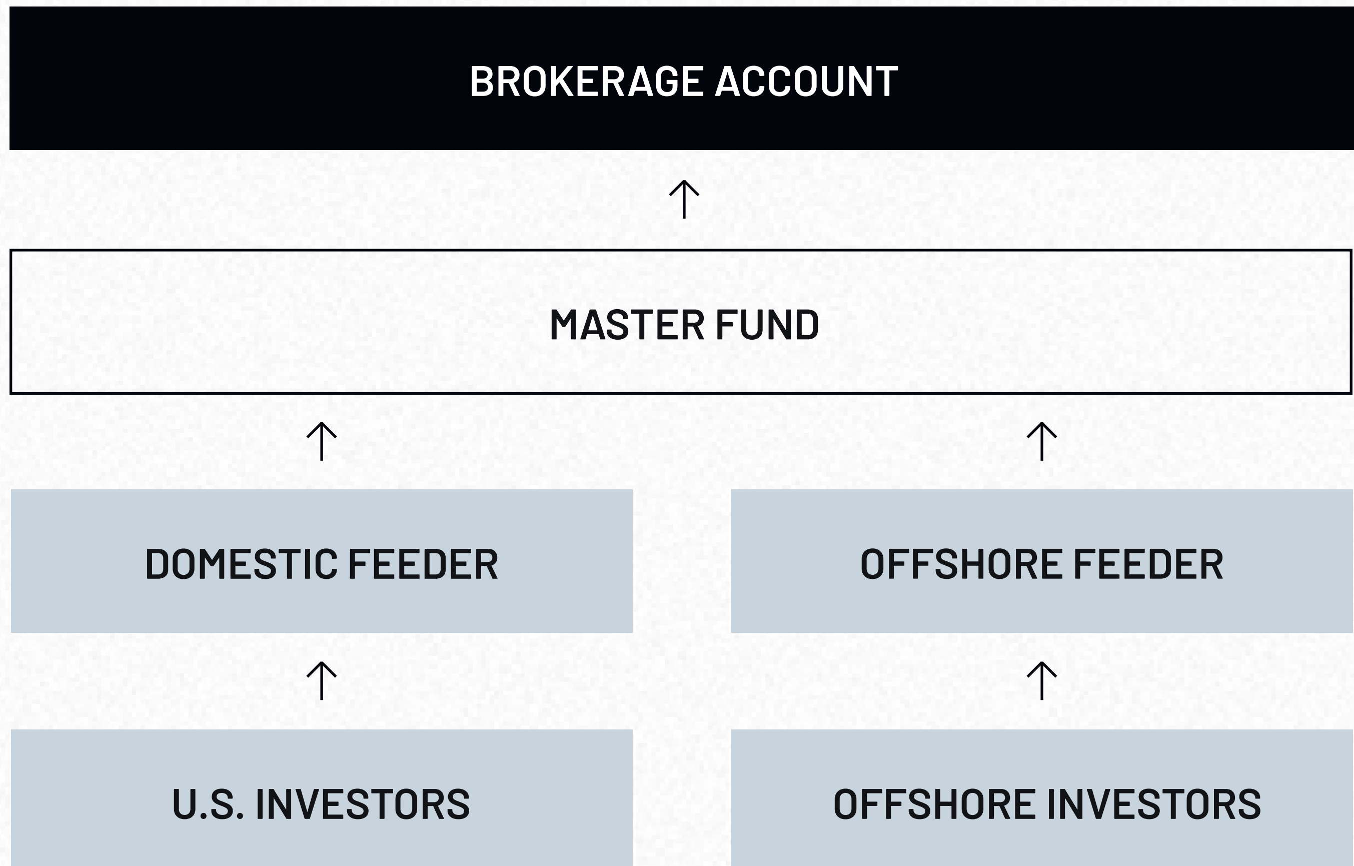
Hedge fund managers seeking to establish both a domestic and an offshore fund generally utilize either a master-feeder or a side-by-side structure. There are various tax, administrative and other issues the manager should consider in determining whether to utilize a master-feeder or a side-by-side structure. The choice will depend on the investment manager's investment strategy and goals.



MASTER-FEEDER STRUCTURE

This structure, also known as a "hub and spoke," allows residents in the United States and investors residing outside of the United States to invest, indirectly, in the same offshore corporate entity commonly known as the "master fund" by providing two feeder funds, one domiciled in the United States and one domiciled outside of the United States, that each invest all assets directly into the master feeder. The master fund can be structured as either a limited partnership or an offshore corporation.

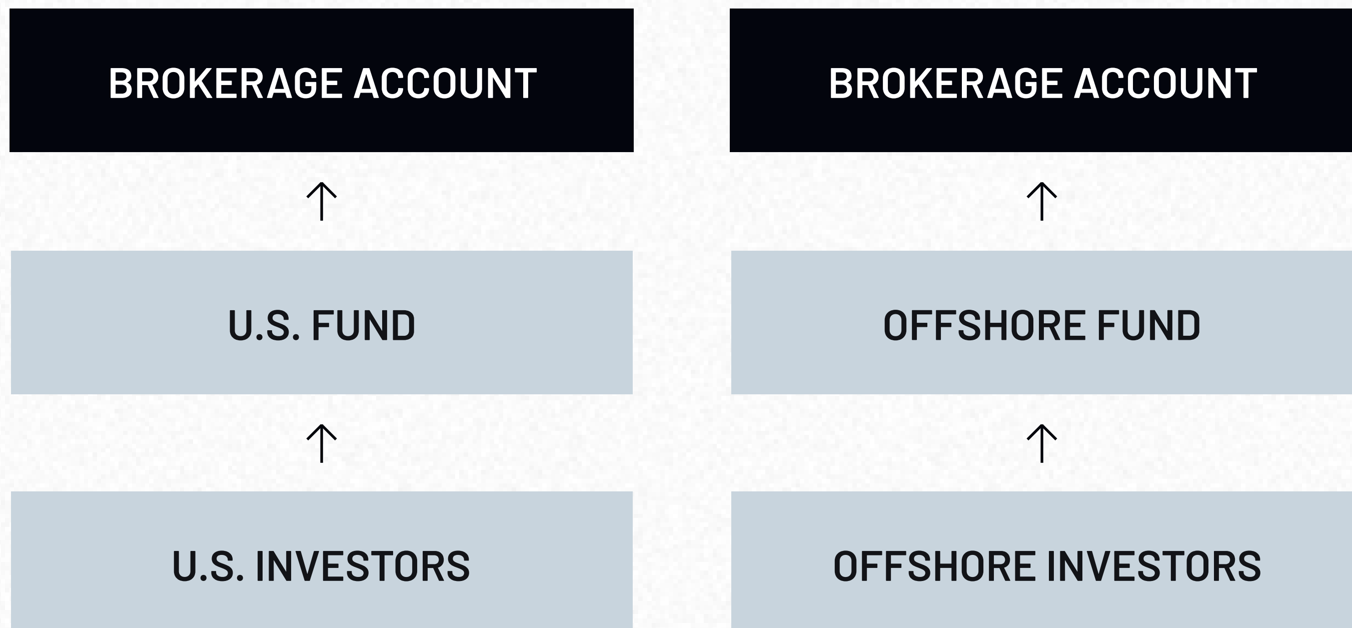
Ordinarily, U.S. taxable investors investing in a master-feeder structure directly invest in a limited partnership organized in the United States. This limited partnership is referred to as the "domestic feeder." The offshore investors and U.S. tax-exempt investors (e.g. IRAs) directly invest in an offshore corporation. This offshore corporation is referred to as the "offshore feeder." The hedge fund manager then purchases and sells securities in an account held in the name of the master fund.



SIDE-BY-SIDE STRUCTURE

In a side-by-side structure, U.S. taxable investors typically invest in a limited partnership organized in the United States and offshore investors, as well as U.S. tax exempt investors, invest in an offshore corporation. The prime broker typically allocates trade tickets between the domestic fund and the offshore fund.

For hedge fund managers seeking to establish both a domestic and an offshore fund, there are various tax, administrative and other issues the manager should consider in determining whether to utilize a master feeder or a side-by-side structure. The choice will depend on the manager's strategy and goals.



COMPENSATION TO HEDGE FUND MANAGER

A hedge fund manager may receive several forms of compensation. The manager often receives a performance allocation equal to a percentage (usually 20%) of realized and unrealized appreciation of the hedge fund's assets payable on a yearly basis. In addition, the manager typically receives a management fee equal to a percentage (e.g., 1.5% annually) of assets under management, which is commonly payable quarterly or monthly in advance. When two management entities are used, ordinarily the general partner receives the performance allocation and the investment manager receives the management fee. In such instances, the investment manager is responsible for managing the Master Fund's assets, and for paying the hedge fund manager's overhead expenses (e.g., rent, furniture, equipment) and employing the manager's personnel. The general partner, however, is more "passive", and will not typically employ any personnel.

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EXEMPTION FROM REGISTRATION AS AN INVESTMENT COMPANY

Hedge funds are not required to register as an investment company with the United States Securities & Exchange Commission ("SEC"), usually in reliance upon an exemption pursuant to either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "Act"). Section 3(c)(1) of the Act, in part, provides an exemption from the Act's registration requirement for an investment company whose securities are owned by not more than 100 "persons" at any given time. Emerging hedge fund managers most commonly rely upon the exemption from registration as an investment company available under Section 3(c)(1) of the Act. Section 3(c)(7) of the Act, in part, exempts investment companies from the Act's registration requirement without limitation as to the number of its beneficial owners as long as the securities are owned exclusively by "qualified purchasers" as defined in the Act. A hedge fund with more than 1,999 record holders, however, is required to register its securities with the SEC pursuant to Section 12(g) of the Securities Exchange Act of 1934. A hedge fund operating pursuant to an exemption under either Sections 3(c)(1) and 3(c)(7) of the Act, however, may not make any public offering of its securities under the Securities Act of 1933, unless an offering is made under Rule 506(c) of Regulation D under the Securities Act of 1933. There are numerous restrictions against advertising and general solicitation by hedge funds relying on either the Section 3(c)(1) or Section 3(c)(7) exemption, and managers should exercise proper caution in their selling efforts to ensure that the fund's exempt status is never compromised.

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DETERMINING THE NUMBER OF INVESTORS IN A HEDGE FUND

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

THE INTEGRATION DOCTRINE

When a hedge fund begins to approach the limitation on the number of investors (e.g. 100 persons), the manager cannot avoid the limitation by forming another hedge fund identical to the prior fund.

To prevent managers from creating identical hedge funds each time they approach the 100-person limitation, the SEC applies the "integration" doctrine. In the event that two or more hedge funds, which are managed by the same sponsor, are substantially similar, the SEC will "integrate" such funds so that they will be deemed to constitute one issuer. If the SEC integrates two or more hedge funds, it combines the number of each fund's investors to determine whether the funds, in the aggregate, are owned by more than 100 persons.

The staff of the SEC will not integrate two hedge funds if one was formed pursuant to an exemption under Section 3(c)(1) of the Investment Company Act of 1940 and the other fund was formed under Section 3(c)(7) of the Act. Additionally, the SEC staff normally does not integrate domestic hedge funds and their offshore counterparts.

QUALIFICATION OF INVESTORS IN A SECTION 3(C)(1) HEDGE FUND

Section 3(c)(1) of the Investment Company Act of 1940 provides an exemption from having to register as an investment company under the Act for a hedge fund whose securities are not publicly offered and are owned by not more than 100 persons. Set forth below are the qualification requirements for investors in hedge funds relying on the exemption from registration under Section 3(c)(1) of the Act.

For a hedge fund relying on the Section 3(c)(1) exemption, interests in the fund are typically offered to prospective investors pursuant to an exemption from the public registration requirements for securities offerings under Rule 506 of Regulation D of the Securities Act of 1933. Securities offered under Rule 506 may be sold solely to "accredited investors" and, under certain circumstances, up to 35 "sophisticated investors".

An "accredited investor" is deemed to include, in part:

- A natural person with an individual net worth, or joint net worth with his or her spouse, at the time of purchase in excess of $1,000,000 (the new definition under the Dodd-Frank Act excludes the net value of the investor's personal residence);
- A natural person with an individual income in excess of $200,000, or in excess of $300,000 with his or her spouse, in each of the two most recent years and who has a reasonable expectation of an income in excess of $200,000 individually, or in excess of $300,000 with his or her spouse, in the current year;
- Any executive officer, director or general partner of the issuer of the securities offered;
- An employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), (a) whose investment decisions are made by a plan fiduciary, as defined in Section 3(21) of ERISA, which is either a bank, insurance company or registered investment adviser; or (b) having total assets in excess of $5,000,000; or (c) if self-directed, the investment decisions are made solely by persons that are accredited investors;
- A trust (and other vehicles), with total assets in excess of $5,000,000 which was not formed for the specific purpose of acquiring an interest in the hedge fund, whose purchase is directed by a sophisticated investor;

- An entity in which each of the equity owners are accredited investors.

A person is a "sophisticated investor," if the investor either alone or with the investor's purchaser representative(s) has such knowledge and experience in financial and business matters that the investor is capable of evaluating the merits and risks of an investment in the hedge fund.

QUALIFICATION OF INVESTORS IN A SECTION 3(C)(7) HEDGE FUND

Section 3(c)(7) of the Investment Company Act exempts a hedge fund from having to register as an investment company without limitation as to the number of its beneficial owners as long as its securities are not publicly offered and its investors qualify as "qualified purchasers". A Section 3(c)(7) fund with 500 or more investors, however, is required to register its securities with the SEC. A person may not invest in a hedge fund relying on the Section 3(c)(7) exemption unless such person meets the definition of a "qualified purchaser."

The Act defines the term "qualified purchaser" to include, in part:

- Any natural person who owns at least $5 million in investments;
- Any other person (e.g., an institutional investor) that owns and invests on a discretionary basis at least $25 million in investments.

REGISTRATION AS AN INVESTMENT ADVISER

The Investment Advisers Act of 1940 defines an "investment adviser" generally to include a natural person or entity who for compensation engages in the business of providing advice to others regarding securities. Compensation may include any form of direct or indirect economic benefit (e.g. compensation paid directly from the person receiving advice or compensation paid by a third party).

Whether a person is "in the business" of providing investment advice depends on the frequency and regularity with which a person or entity provides advice with regard to securities. Although all hedge fund managers fall within the definition of an "investment adviser," they may not be required to register as an investment adviser pursuant to various exemptions. The SEC and each state impose different registration requirements and exemptions from registration for investment advisers.

A hedge fund manager is exempt from registering as an investment adviser under the Advisers Act which is enforced by the SEC, if such person or entity (under the Dodd-Frank rules):

Has had less than $150 million in AUM;
and Manages only pooled investment vehicles.

The regulations surrounding this area have been interpreted in a wide range of manners and the area is changing every day.

LIMITATION ON REGISTERED ADVISERS CHARGING PERFORMANCE BASED FEES

Generally, a hedge fund manager registered as an investment adviser may receive performance-based compensation from its investors, if each of the investors is a "qualified client."

Under the Investment Advisers Act of 1940, a person is deemed to be a qualified client if the hedge fund manager has a reasonable belief that the investor has a net worth in excess of $1,500,000 at the time of investment or the investor has at least $750,000 under the management with the manager. Certain states, however, use a lower standard, whereby an investor must have a net worth in excess of $1,000,000 or assets of $500,000 under management with the hedge fund manager. There are additional restrictions imposed on managers who are registered as an investment adviser by states utilizing the lower standard.

Non-U.S. persons are not required to meet the requirements of a "Qualified Client".

REGISTRATION UNDER THE COMMODITY EXCHANGE ACT

A hedge fund manager must register as a commodity pool operator, commonly referred to as a CPO, under the Commodity Exchange Act if the fund trades any commodity futures contracts or options thereon. As a CPO, the manager is subject to various record-keeping, reporting and disclosure requirements under the Commodity Exchange Act and the regulations there under adopted by the Commodity Futures Trading Commission.

In addition to the registration requirement, the hedge fund's offering document must, ordinarily, be approved by the National Futures Association prior to its use. If, among other things, the hedge fund's aggregate initial margin and option premiums for commodity transactions do not exceed 10% of the fund's assets, or if investors in the fund are limited to "qualified eligible participants," the fund may request an exemption from many of the regulatory requirements otherwise applicable to it as a CPO.

In general, a "qualified eligible participant" includes any person who the hedge fund manager reasonably believes; at the time that person invests in the fund:

- Owns securities (including pool participations) of issuers not affiliated with such participant and other investments with an aggregate market value of at least $2,000,000;

- Has had on deposit with a futures commission merchant, for its own account at any time during the six-month period preceding the date of sale to that person of an interest in the fund, at least $200,000 in exchange-specified initial margin and option premiums for commodity interest transactions.

THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 ("ERISA")

In the event that the investment assets of "benefit plan investors," in the aggregate equal or exceed, at any time, twenty-five-percent (25%) of the aggregate equity of a hedge fund, the hedge fund manager will be deemed to be managing "plan assets" and thus, become a "plan fiduciary" under ERISA. As a fiduciary under ERISA, the hedge fund manager, in part, would be prohibited from participating in or entering into any transaction that would result in a conflict of interest with the benefit plan investors. Employee benefit plans, individual retirement accounts and Keogh accounts are some of the types of investors considered to be "benefit plan investors."

Each time there is an investment or withdrawal in a hedge fund, the hedge fund manager or an agent of the manager is required to calculate the percentage of assets held by benefit plan investors in the aggregate. The value of the manager's account(s) is not included in the calculation to determine the percentage of assets held by benefit plan investors in the aggregate. The reporting on this issue is commonly handled by the fund's administrator.

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Ron S. Geffner is a member of the firm's Executive Committee and also oversees the Financial Services Group. He regularly structures, organizes and counsels private investment vehicles, investment advisory organizations, broker-dealers, commodity pool operators and other investment fiduciaries. Mr. Geffner also routinely counsels clients in connection with regulatory investigations and actions. His broad background with federal and state securities laws and the rules, regulations and customary practices of the SEC, Financial Industry Regulatory Authority, Commodities Futures Trading Commission and various other regulatory bodies enables him to provide strategic guidance to a diverse clientele. He provides legal services to hundreds of hedge funds, private equity funds and venture capital funds organized in the United States and offshore.

Mr. Geffner began his legal career with the SEC, where he investigated and prosecuted violations of the federal securities laws with an emphasis on enforcement in connection with violations of the Investment Advisers Act of 1940 and the Investment Company Act of 1940. He also assisted federal and state criminal agencies, such as the Federal Bureau of Investigation, U.S. Attorney's Office and the Attorney General's Office, in their investigations of possible criminal violations of federal and state securities laws.

Prior to joining Sadis & Goldberg, Mr. Geffner was associated with two other New York City-based law firms, where he represented domestic and offshore private investment vehicles, as well as broker-dealers, registered investment advisers and registered investment companies.

He began his corporate legal career as in-house counsel to the Investment Management Industry Services Group of PricewaterhouseCoopers LLP. He provided legal advice regarding investment advisers, registered investment companies and broker-dealers.

Mr. Geffner is often interviewed as a legal expert in the securities industry. He has been interviewed on Fox News, CBS Morning Show, CBS Evening News with Dan Rather, Squawk Box, Power Lunch and Closing Bell on CNBC, British Broadcasting Channel and Bloomberg Radio. He is regularly quoted in The New York Times, The Wall Street Journal, Bloomberg News, Barron's, Barron's Online, Reuters, Dow Jones, Financial Times, New York Newsday, London Daily News, TheStreet.com, Private Equity Week and other national and international publications.

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