

General Hedge Fund Structure & Regulation

A hedge fund is an entity that holds capital contributed by investors to be allocated among one or more investment opportunities pursuant to a management or advisory agreement with another entity, which may or may not be an affiliate¹ of the hedge fund itself. Hedge funds traditionally invest in or against publicly held entities, but their investment activity continues to broaden.

A. The Hedge Fund Itself

1. The Hedge Fund Structure

Generally, a hedge fund is structured as a limited liability entity, such as a limited partnership or limited liability company (an “LLC”), whose assets are used to make various types of investments. A limited partnership fund typically has

¹ Under securities laws, an “affiliate” is “a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.” 17 C.F.R. § 230.405; 17 C.F.R. § 230.501(b). “Control” means “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” 17 C.F.R. § 230.405. Thus, affiliates can include partners, members, shareholders, directors, officers, or contract parties, and affiliates can be entities that are subsidiaries of the same parent entity.

“general partner(s)” responsible for certain business decisions and “limited partner” investors with varying rights and activities. *See* Brown & Max, RAISING CAPITAL: PRIVATE PLACEMENT FORMS & TECHNIQUES § 4(A) (Mar. 2015). An LLC fund typically has “manager(s)” responsible for certain business decisions for the fund and “member” investors with varying rights and activities.

General partners and managers may, but need not, own an interest in the partnership or LLC. Each person involved in the fund—whether a general partner, limited partner, manager, or member—can be another limited liability entity or an individual. However, due to securities law restrictions, limited partners and members are typically funds-of-funds, institutions, family offices, and high net-worth individuals.

a. Master Feeder Structures

One particular hedge fund structure pertinent to the present Petition is the “master feeder” structure. Master feeder structures have tax and administrative advantages. The most common master feeder structure is one in which affiliates set up a “master fund” in an offshore jurisdiction—often the Cayman Islands—and at least two “feeder funds”, one a U.S. entity and one a non-U.S. entity. The feeder funds are each separate legal entities that raise two pools of money from investors. The U.S. entity raises capital from U.S.-domiciled investors, and the non-U.S. entity raises capital from non-U.S.-domiciled investors. This assures that the tax

status of the U.S. investors will have limited impact on the tax situations of the non-U.S. investors and that the ultimate hedge fund sponsors can avoid the costs of setting up and running two completely separate hedge funds. The feeder funds become limited partners in the master fund, contributing the capital they raise for the master fund to allocate among its investments.

2. Registration/Exemption under Securities Laws

a. The Registration Statement and Prospectus

Generally, the Securities Act of 1933 (“the ’33 Act”) regulates hedge funds’ offerings because hedge funds are “issuers” of “securities” as defined in the ’33 Act. *See* 15 U.S.C. §§ 77b, 77e. The ’33 Act prohibits the offer or sale of a security unless the issuer of the security either (i) files a “registration statement” with the U.S. Securities and Exchange Commission (“SEC”) or (ii) is exempt due to the nature of the security, the nature of the transaction, or the nature of the issuer. 15 U.S.C. §§ 77c-e.

The registration statement will include information about the manner in which the offering is made, the securities to be issued, investment risks, and information about the issuer and its business. 15 U.S.C. §§ 77f-g; 17 C.F.R. §§ 230.404, 230.408; Brown § 19.01(A). Unlike the Form D filings discussed below, the registration statement “is not a ‘check the boxes’ exercise”; rather, its “objective is to achieve a full and fair disclosure that will enable an investor to

make an intelligent investment decision.” Johnson, McLaughlin & Haueter, CORPORATE FINANCE AND THE SECURITIES LAWS § 1.06(C)(2)(a) (Dec. 2014).

A “prospectus” is also filed by the issuer. 17 C.F.R. § 230.404. This document contains similar information to the registration statement but in narrative form. 17 C.F.R. § 230.421.

The registration statement and prospectus are documents that most individuals unfamiliar with securities investments turn to when confronted with investment questions.

b. Exemptions and Hedge Funds

The bulk of U.S. filings are not by a registration statement and prospectus. Rather, most filings are accomplished through exemptions in the '33 Act and associated regulations. Johnson, *et al.*, § 7.04. Hedge fund offerings are conducted through these exemptions.

Regulation D of the '33 Act (“Reg D”) provides three exemptions from filing a registration statement under the '33 Act. 17 C.F.R. § 230.500 *et seq.* The exemption used most often is 17 C.F.R. § 230.506 (“Rule 506”), which is estimated to account for 90% to 95% of all Reg D offerings and an overwhelming majority of capital raised in accompanying transactions. Johnson, *et al.*, § 7.04. Other Reg D exemptions impose limits on the amount of capital that may be raised in an offering (namely \$1 million or \$5 million raised, depending upon the

exemption). *See* 17 C.F.R. §§ 230.504-05. However, Rule 506 does not impose a capital limit when the offering is made to “accredited investors,” as defined in the ’33 Act and discussed in the next section. *See* Rule 506. Rule 506 offerings may also be made to unaccredited investors, but unaccredited investors are less likely to be involved in hedge funds. *See* 17 C.F.R. § 230.501(e); Rule 506. Year to year, Rule 506 exempted offerings raise almost as much capital as all public offerings. Brown, § 19.04(C)(1).

When an issuer offers securities under the Rule 506 exemption, the issuer must still file a Form D with the SEC, which becomes publicly available on the SEC’s Electronic Data Gathering, Analysis, and Retrieval system (“EDGAR”) at <http://www.sec.gov/edgar/searchedgar/companysearch.html>. *See* 17 C.F.R. § 230.503(a).

A Form D requires disclosure of, *inter alia*: (i) “related persons” of the issuer, which are directors, executive officers, or persons who perform similar functions, and promoters of the issuer; (ii) whether the filing is for an offer of equity securities; (iii) the minimum investment that will be accepted; (iv) the amounts of the offering and resulting sales of securities; and (v) the number of investors. *See, e.g.* Ex. 2011. Form D is a check-the-box exercise, with brief, less-descriptive information. Johnson, § 1.06(C)(2)(a). Form D disclosures are not

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