

## Hedge Fund Regulation (2nd Edition)

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## Chapter 2

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# Form Over Substance: Hedge Fund Structures

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## § 2:1 **Hedge Fund Design—The Jones Blueprint**

Although it is convenient to use terms such as “absolute return” and “alpha” to identify certain investment vehicles as hedge funds, the diversity of strategies pursued by hedge funds, as well as the erosion of the distinctions that have historically separated hedge funds from more traditional money management, renders unsatisfactory any attempt to define hedge funds solely by investment style. Hedge funds are, in fact, more readily defined by their form of organization and manner of operation, rather than by the substance of their activities in the financial markets.

Indeed, while many modern hedge funds bear very limited resemblance to the original Jones hedge fund, if one compares their portfolios and means of generating returns, many of the structural and operational traits of today’s hedge funds can trace their lineage directly back to Jones. As reported by Carol Loomis in 1966, the Jones hedge fund was organized as a privately placed, unregistered fund and was originally structured as a general partnership.<sup>1</sup> It was subsequently converted into a limited partnership in 1952 to accommodate outside investors. The partnership afforded its investors only limited liquidity, as it permitted capital contributions into and withdrawals from the fund at the end of each fiscal year. In addition, the general partners of the fund received as compensation 20% of any realized profits (after deduction of realized losses) generated on the fund’s capital. Also of note was the fact that the general partners had agreed to keep all of their investment funds in the partnership. Loomis also described a fairly centralized and streamlined decision-making process on the part of the fund’s portfolio managers when it came to implementing investment decisions.

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1. Loomis, *The Jones Nobody Keeps Up With*, FORTUNE, Apr. 1966, at 237.

## **§ 2:2 Common Characteristics**

The structural approach taken by Jones has largely been followed by hedge fund managers to the present day. In surveying today's hedge funds, one finds four traits that characterized the Jones fund that are commonly found in most current funds and the firms that manage them.

### **§ 2:2.1 Centralized Management**

Hedge funds are managed by a hedge fund advisory firm. That firm may be run by an individual portfolio manager or a team of managers, but the firm makes all decisions regarding the hedge fund's investment activities. The hedge fund itself is organized as a limited liability entity whose partners, members, or shareholders are passive investors with little or no voting rights.

### **§ 2:2.2 Co-Investment**

Hedge fund managers usually invest a significant portion of their own liquid net worth in their hedge funds alongside of the fund's other investors. This is often a major distinction from mutual fund managers, and provides investors some measure of comfort in that the manager is "eating his own cooking," thereby helping to align the interest of the manager with that of the investor. Indeed, most sophisticated investors in hedge funds will insist upon such co-investment as a prerequisite to investing their own money with the manager.

### **§ 2:2.3 Performance-Based Compensation**

Perhaps the trait most often focused upon is that of performance-based compensation. While hedge fund managers generally receive a periodic asset-based management fee of 1% or 2% per annum, and may also pass through to investors certain other costs, it is the assessment of performance-based fees or profit allocations, pursuant to which the manager receives a percentage (often but not exclusively 20%) of the annual profits generated for the hedge fund, that has been a significant distinguishing characteristic from traditional money management. This is a major factor behind the ability of hedge funds to attract a steady stream of talented traders and portfolio managers.

### **§ 2:2.4 Limited Liquidity**

The fourth defining characteristic is the limited liquidity of hedge funds. This does not mean that the underlying investment portfolios of hedge funds are necessarily illiquid. Most hedge funds pursue their strategies in securities that are traded in broad liquid markets. The limited liquidity in question relates instead to the ability of investors to either add to or withdraw from the hedge funds in which they

invest. Hedge funds often accept capital only at the beginning of calendar months and, if they determine that they may be reaching levels of assets under management that exceed their ability to effectively deploy such capital, may temporarily close themselves to new investor contributions. Conversely, hedge funds typically limit the ability of investors to withdraw capital or redeem from a fund, so that investors may only be able to exit annually, semi-annually, quarterly or monthly, upon tendering a certain amount of advance notice to the fund. This differs markedly from mutual funds, which offer daily liquidity to their investors.

In forming a hedge fund, the legal form of the fund entity, its jurisdiction of organization, and the terms by which it will operate must be selected. Generally, a significant driver in making these determinations is the nature of the investors who will capitalize the fund. In the broadest sense, hedge funds can be divided between those organized in the United States and those organized offshore. The structure of both domestic and offshore hedge funds, as well as of the firms that manage them, is driven largely by two overriding factors: the desire to limit liability and to operate in a tax-efficient manner.

### **§ 2:3 Domestic Hedge Funds**

Domestically, a hedge fund operation, in its most basic format, consists of the fund itself and the investment advisory firm that manages the fund. Most domestic hedge funds are organized as limited partnerships under state law, as this legal structure affords flexibility and enables the fund to meet both objectives of limited liability and tax efficiency. An alternative structure, which is of more recent vintage and was not available at the time that Jones launched his fund, but which also achieves these ends, is the limited liability company. While the various states have statutes pursuant to which limited partnerships and limited liability companies are organized and operated, the most popular jurisdiction for organization is Delaware, as its statutes are considered among the most flexible and its case law the most developed, affording both relative administrative ease and a high degree of legal certainty with respect to the manner in which these entities are operated. Corporate entities also limit liability by limiting their shareholders' liability to their investment in the corporation's shares; however, as is discussed below, they are not as attractive from a tax perspective in the domestic context.

#### **§ 2:3.1 Limited Liability**

A limited partnership consists of at least one general partner and one or more limited partners. The hedge fund management firm serves as the general partner of the partnership while the fund's investors comprise its limited partners. A limited partnership limits

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