How Hedge Funds Are Structured

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HEDGEfundamentals.org

How Hedge Funds Are Structured

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Executive Summary

Most U.S. hedge funds are established as limited partnerships between the fund manager and investors. While the specific structure can vary from fund to fund, there are a few characteristics that are applicable across the industry.

This presentation provides a brief overview of some of the most common fund structures.

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Hedge Funds’ Unique Structure

Unique to the investment community, hedge funds are partnerships formed between fund managers and investors.

Typically hedge fund managers invest a significant amount of personal capital - in some cases in excess of 50 percent of the total assets in the fund - aligning their interests with that of their investors.

Source: Nocera, Joe, May 2009.

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Most Hedge Funds Are Established As Limited Partnerships

Investors share the partnership's income, expenses, gains and losses. Each partner is taxed according to their respective share of the partnership.

Key Players:

Investment Manager

Determines strategy and makes investing decisions and allocations, as well as manages portfolio risk. The investment manager is also invested in the fund and is compensated via a management fee, as well as a performance fee based on the fund's annual performance. Managers only get a performance fee if the fund makes money above a certain benchmark.

Prime Broker

Funds must secure their loans with collateral to gain margin and execute trades. In turn, each broker (usually a large securities firm) uses its own risk matrix to determine how much to lend to each of its clients. Brokers are also subject to federal regulations, which act as indirect regulations on the hedge funds doing business with them.

Auditors

Verify financial statements as required by federal law.

*Note: All hedge funds and managed futures firms are required by law to be registered with the SEC/CFTC or local and state regulators depending on level of assets.

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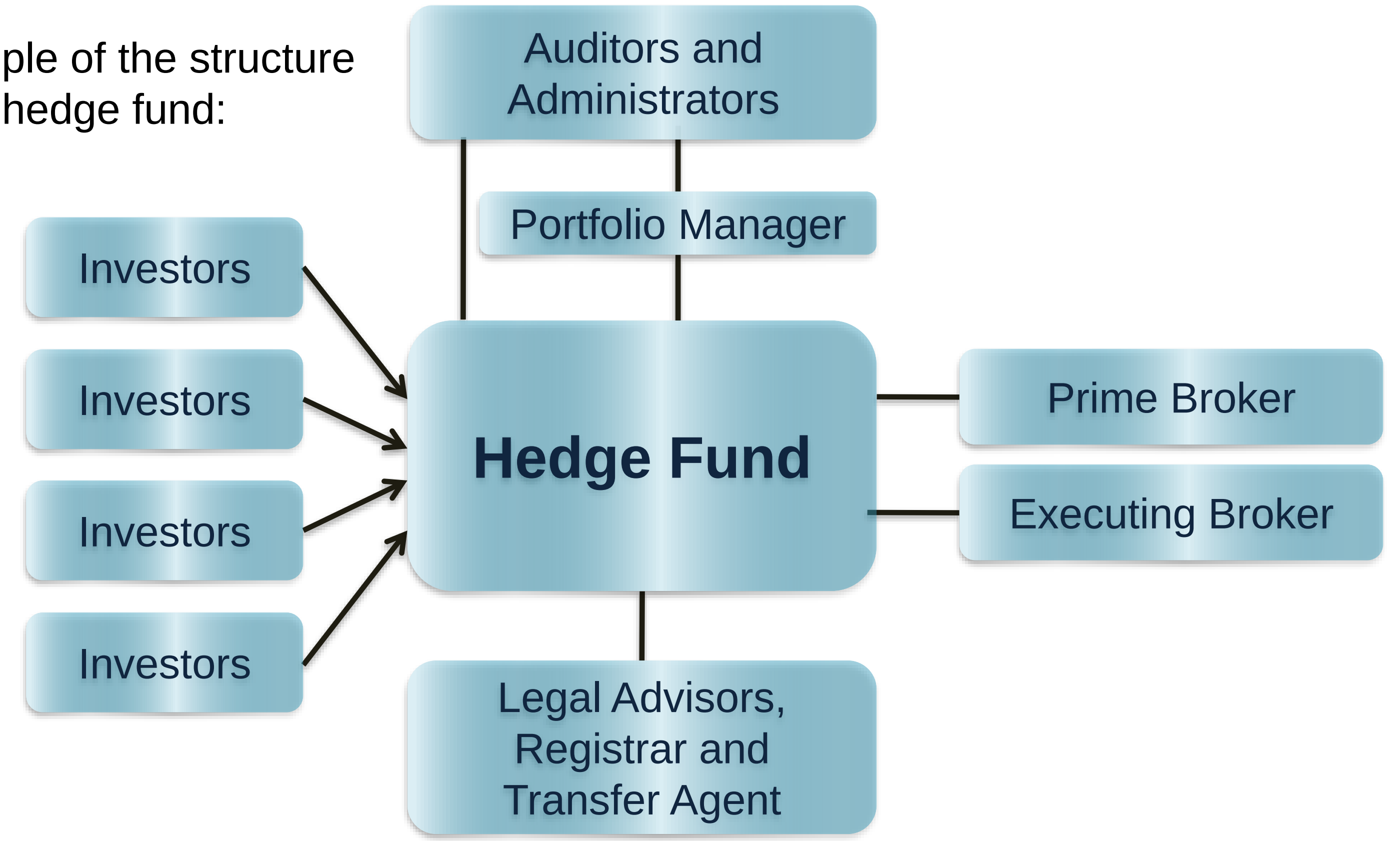
Typical U.S. Hedge Fund Structure

Here is an example of the structure of a typical U.S. hedge fund:



Source: “Hedge Funds and Other Private Funds: Regulation and Compliance” Thomson West, 2010

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Investors

In the U.S., hedge fund managers are regulated by the SEC and CFTC and manage investment capital from accredited investors or qualified purchasers, including:

1. Public employee retirement plans;
2. Corporate employee retirement plans;
3. University endowments;
4. Foundations and non-profit organizations; and
5. Family offices and high net-worth individuals.

To qualify as an accredited investor, a high net-worth individual must have:

- A net worth, or joint net worth with their spouse, that exceeds $1 million at the time of the purchase. The net worth calculation excludes the value of their primary residence.
- A yearly income of $200,000 or higher in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.

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Investment Managers

What is the role of a Investment Manager?

- The investment manager makes daily investment decisions for the fund, choosing where and when to allocate investment capital. The manager also manages portfolio risk.

- Investment managers may be either direct employees of the hedge fund management firm or employees of another firm hired by the management firm to provide investment advice, pursuant to a sub-advisory agreement.

Prime Broker

A brokerage firm provides multiple services to a hedge fund that are beyond the scope of those offered by a traditional broker, such as:

- Clearing and Settlement of Securities Transactions;
- Financing;
- Custodial Services (holding of assets); and,
- Research Capabilities.

Below are examples of Prime Brokers:

Credit Suisse, Morgan Stanley, UBS, Bank of America Merrill Lynch, Barclays Capital, Citi, JPMorganChase

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Executing Broker

An executing broker is a type of financial dealer or broker that is accountable and responsible for the completion and processing of an order requested by a client.

As part of the process, executing brokers will evaluate the order to make sure it is in line with all current policies and procedures.

Below are examples of Executing Brokers:

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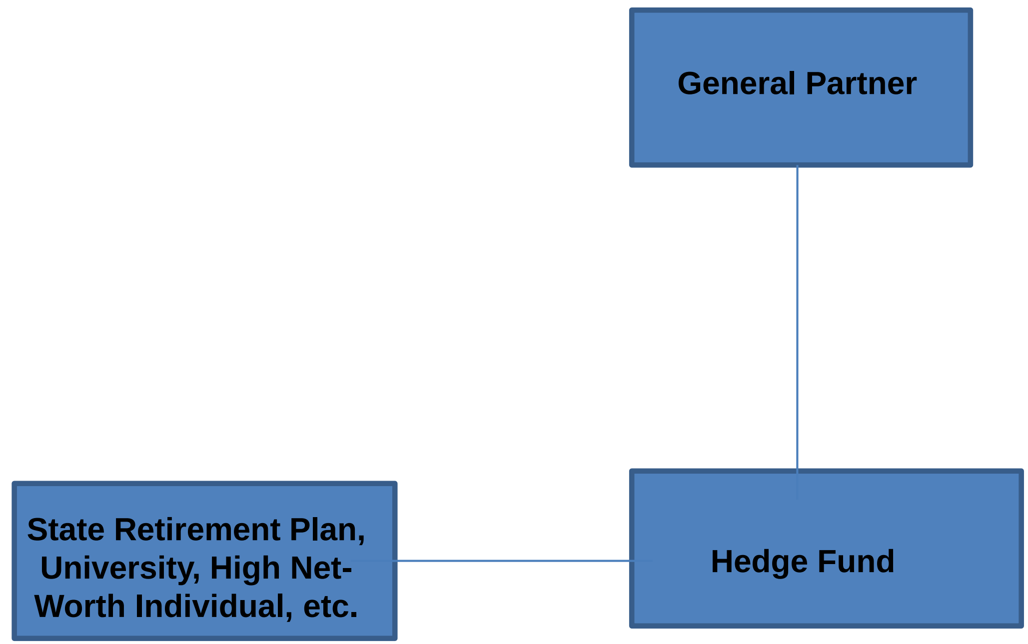
Organizational Structure

The range of investment strategies available to hedge funds and the types of positions they can take are quite broad.

The typical hedge fund structure is really a two-tiered organization.

The limited partnership model is the most common structure for the pool of investment funds that make up a U.S. hedge fund.



Limited Partnership Model

In the limited partnership model, the general partner is responsible for selecting the service providers that perform the operations of the fund.

General Partner — **Operational**

Limited partners can make investments into the partnership and are liable only for that amount.

Limited Partner — **Investors**

The second element of the two-tiered structure is the arrangement of the general partnership. General partners typical use a limited liability company structure. The general partner's responsibility is to select service providers to market and manage the fund as well as perform any functions necessary in the normal course of business.

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Fee Structure

Fee structures at hedge funds differ from other types of investment vehicles. Hedge funds typically charge investors a management fee, usually a percentage of the assets managed.

Most hedge funds also charge a performance fee of anywhere between 10-20 percent of fund profits. Managers only collect this fee when the fund is profitable, exceeding the fund's previous high-water mark. This means that if a fund loses 5 percent from its previous high, the manager will not collect an incentive fee until he or she has first made up the 5 percent loss.

Fees are negotiated by individual investors and can vary from investor to investor.

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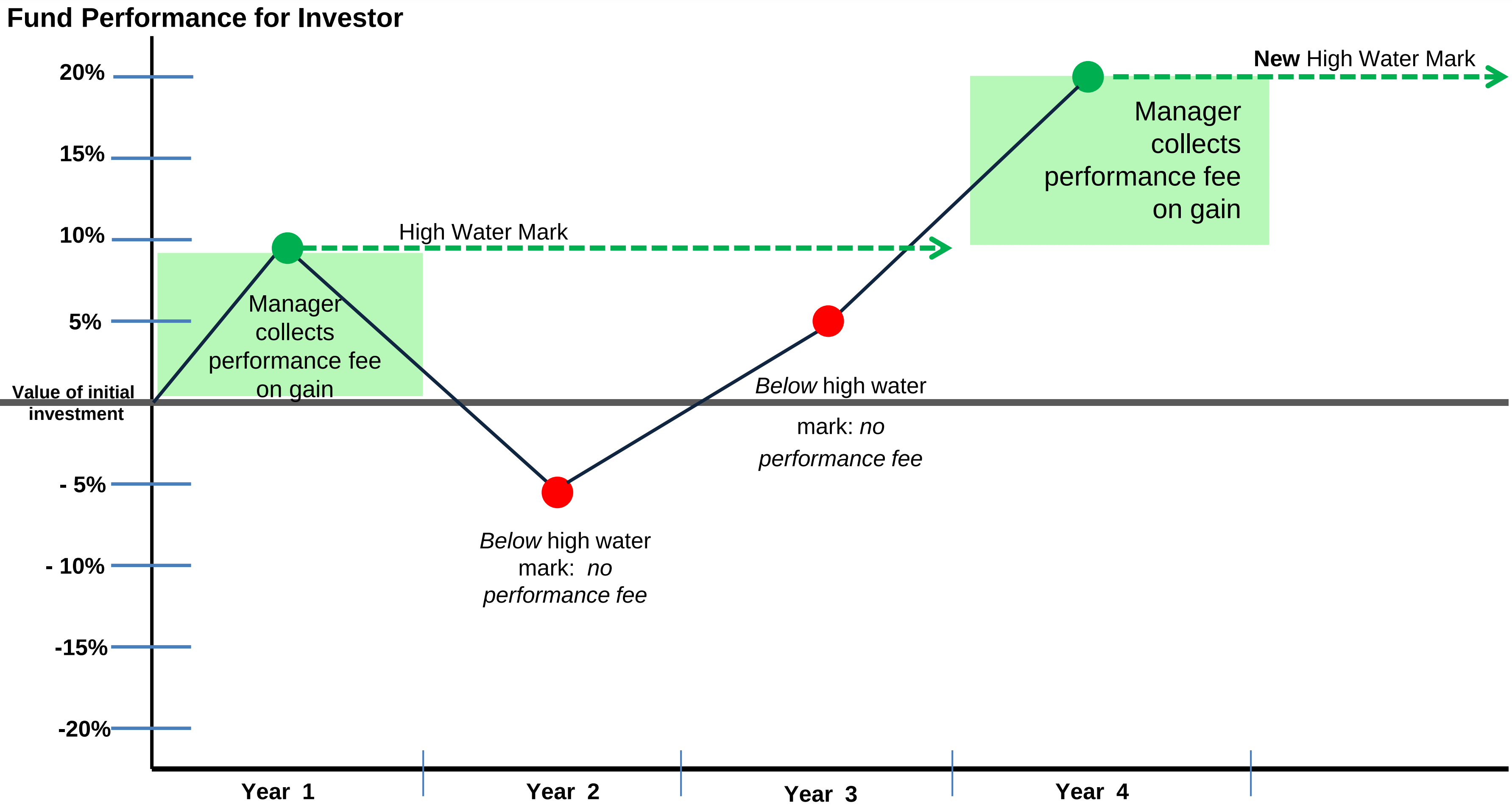
Graphic Illustrating Typical Fee Structure



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Term Structure

The actual terms of partnership vary according to the fund, however they are usually based on a few factors.

Subscriptions and Redemptions:

- A subscription is when the investor applies to join a particular fund. Subscription minimums vary from fund to fund.
- A redemption is when the investor withdraws part or all of their investment from a fund.
- Unlike registered investment companies, hedge funds are not required to have daily liquidity. Some hedge funds offer subscriptions and redemptions monthly, while others accept them only quarterly or annually.

Lock-Ups:

- A lock-up is the time period that an initial investment cannot be redeemed from the fund. The length of time varies based on the fund.
- The average lock-up period for a U.S. hedge fund is eight months*. In certain cases, it could be a "hard lock", which prevents the investor from withdrawing funds for the full time period, while in other cases, an investor can pay a penalty and withdraw funds early.

*Source: 2016 Preqin Global Hedge Fund Report

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Summary

Hedge funds offer qualified investors a range of unique investment strategies.

Hedge funds' investor base has evolved significantly over the years, with 64 percent of U.S. industry assets currently held by institutional investors like pensions, endowments and foundations.

Most U.S. hedge funds are created as limited partnerships between the fund manager and investors.