CHAPTER 1

The Arcane World of Hedge Funds and Investment Partnerships

What Is a "Hedge Fund"?

So, what is a hedge fund really? A "hedge fund" is an entity that offers "alternative" investments to investors, distinct from "traditional" investments in bonds and equities. A general counsel to the Securities and Exchange Commission (SEC) aptly simplified this as "The term *hedge fund* is not really descriptive, but just refers to a private pool of institutional capital."[1] One would have expected that in the freewheeling world of the Internet, wiki volunteers would have arrived at a concise definition, in place of a confusing opening attempt at definition: "A hedge fund is an investment fund open to a limited range of investors that is permitted by regulators to undertake a wider range of investment and trading activities than other investment funds, and that, in general, pays a performance fee to its investment manager."[2] In order to identify and decode the nature and character of hedge funds and their secretive "alternative" investment or trading strategies, we shall follow the U.S. SEC's attempt to corral and codify this popular object of perpetual regulatory concern.

[1] "The Future of Securities Regulation," Brian G. Cartwright, in a speech by SEC staff, University of Pennsylvania Law School Institute for Law and Economics, October 24, 2007.

[2] Wikipedia entry of "hedge fund" accessed on October 13, 2009, at http://en.wikipedia.org/wiki/Hedge_fund. Note that Wikipedia entries are dynamic.

In 2004, the U.S. SEC proposed hedge fund regulatory rules to bring most hedge funds into its regulatory net. These were published in the U.S. Federal Register in December 2004 and made effective February 2005, in 46 pages of fine print. The new rules lack both specificity and brevity, stating:

> There is no statutory or regulatory definition of hedge fund, although many have several characteristics in common. Hedge funds are organized by professional investment managers who frequently have a significant stake in the funds they manage and receive a management fee that includes a substantial share of the performance of the fund. Advisers organize and operate hedge funds in a manner that avoids regulation as mutual funds under the Investment Company Act of 1940, and they do not make public offerings of their securities. Hedge funds were originally designed to invest in equity securities and use leverage and short selling to "hedge" the portfolio's exposure to movements of the equity markets. Today, however, advisers to hedge funds utilize a wide variety of investment strategies and techniques designed to maximize the returns for investors in the hedge funds they sponsor. Many are very active traders of securities.

The 2005 SEC rules remained in force for barely one year. In June 2006, the U.S. Federal Court of Appeals in the District of Columbia struck down these 2005 SEC Hedge Fund regulatory rules.[4] During the remainder of the administration of George W. Bush's term through 2008, there was no further attempt to pass new legislation to regulate hedge funds.

The Federal Court of Appeals ruling that reversed and cancelled the SEC's hedge fund regulation provides interesting counterperspectives in its official court opinion. The very first line of the court opinion is "Hedge funds are notoriously difficult to define." The court then provided an interesting alternative definition by negation as "Hedge funds may be defined more precisely by reference to what they are *not*." In light of this federal appeals court reversal, new rules of the type that the SEC sought to enact under its own authority require higher legislative approval from U.S. lawmakers.

[3]The SEC rules entered into the Federal Register on December 10, 2004, are available to view in their entirety as a pdf file at the SEC Web page www.sec.gov/rules/final/ia-2333.pdf.

[4]The U.S. Court of Appeals for the District of Columbia has tabled it so opinion for the viewing public is in the form of a pdf file at http://pacer.cadc.uscourts.gov/docs/common/opinions/200606/04-1434a.pdf.

During the brief period when the new SEC rules were in force (before they were struck down in court), many large hedge fund managers registered with the SEC, even though they could have avoided such a registration by remaining exclusively offshore entities. This was because U.S. institutional investors indicated their preference to invest with hedge fund managers who registered with the SEC. Thus, SEC compliance was seen by U.S. institutional investors as a seal of good housekeeping, with the advantage of recourse to the U.S. legal system should disputes arise. Those hedge fund managers who operated as exclusively offshore entities risked losing the significant volume of their assets under management from U.S. institutional investors desirous of pursuing alternative investments.

At the time the proposed SEC rules were being actively debated, many neutral economists and policymakers warned that such SEC regulation of hedge funds would likely drive hedge funds to offshore locations without making any meaningful dent in their overall assets under management. Indeed, large European banks and offshore financial hubs might become beneficiaries of tightened U.S. regulation of hedge funds. The SEC regulations imposed meaningful reporting and compliance burdens on hedge fund managers that might have put small hedge fund managers at a cost disadvantage relative to large hedge funds.

U.S. Venture Partnerships

Although hedge funds have obtained media limelight in the past two decades, their plain older cousins, venture-capital partnerships, also organized as U.S. limited partnerships with almost the same exact structure as hedge funds, including the structure of management and performance fees, but they have received less media attention. Contrary to hedge funds, typical Silicon Valley venture partnerships have been objects of admiration for achieving multibillion-dollar companies in a reasonably short time based on entrepreneurial seeds, mostly located in college dormitories and neglected academic university laboratories, mostly in their local geography vicinity, with Stanford University serving as an anchor showcase. The creation of Genentech out of a single molecular biology researcher's lab at the University of California at San Francisco based on an investment of less than $100,000 by Kleiner, Perkins, Caufield & Byers (Kleiner Perkins), and the more recent rapid growth of Google out of a personal project of Stanford University graduate students, also associated with early investment by Kleiner Perkins, would remain showcases.

Chapter 11 elaborates upon to the nuances and differences between hedge funds and venture funds, as well as primary aspects of pass-through taxation to taxable U.S. Investors, and concerns regarding Unrelated

Business Tax on Income (UBTI) for tax-exempt U.S. investors. Until then, much of the subsequent discussion on hedge funds almost exactly applies to U.S. Venture Funds (or, more appropriately, Silicon Valley venture funds).

We have not separately reviewed U.S. oil and gas partnerships, which were extremely popular in the 1980s. Their popularity was largely fueled by then-prevailing tax credits and deductions from intangible drilling costs and accelerated depreciation. Many investors believed that the tax benefits outweighed their investment cost, even if oil and gas were never found.

Types of U.S. Hedge Fund Entities and the U.S. Tax Code

At origination, a U.S. investment fund makes a primeval choice by typecasting itself into one of the various molds of U.S. federal taxation: It is obliged to seek a U.S. taxpayer ID number as a subchapter C corporation, a subchapter S corporation, a SEC-regulated investment company, or partnership, following the creation of such an entity in a corporate entity-friendly state such as Delaware. Its physical place of business would most likely be a hedge-fund-friendly state, in terms of state securities laws, such as Connecticut.

A subchapter S entity is almost never chosen to structure an investment fund due to the limited number of investors that it can have (at most 100). Its investors/shareholders should be natural persons who are citizens or residents of the United States, which precludes the inclusion of institutional investors and foreigners. Similarly, a subchapter C entity is almost immediately banished from consideration due to its flat 35 percent U.S. corporate tax on all future profits (with the exception for reduced taxation on U.S. source dividends, called the "dividends reduced deduction").

Further, dividends and distributions to shareholders from such a subchapter C entity are double taxed (i.e., taxed once again) in the hands of the shareholders when remitted. The Bush administration softened the blow of double taxation by taxing dividends on holdings of more than 60 days at a reduced tax rate of 15 percent in the hands of the shareholders, under new rules that define such "qualified dividends." It is rare but not unusual to find a maverick fund manager operating what is largely an investment fund in the form of a subchapter C corporation. For instance, Warren Buffett's Berkshire Hathaway Corporation is only nominally an industrial company and is considered by many investors to be a grand mutual fund. Its subchapter C standing attracts double taxation. It remains a puzzle that this brilliantly managed pseudo industrial de facto financial and portfolio investment entity stands out alone as a subchapter C corporation, when

every other fund manager is seeking to typecast their entity under the lowest possible tax regime with the lightest regime of regulation.

The SEC regulated investment company, more commonly called a mutual fund,[5] is also a tax pass-through entity. There is no U.S. corporate or state tax at entity level that applies to such a company. However, the constraints of operating a regulated mutual fund under the U.S. Investment Company Act limit the range of feasible and permissible investment strategies. The world of venture capital funds, private equity funds, illiquid-securities funds, and hedge funds is disjoint from the world of SEC-regulated mutual funds. The latter is organized mainly for the benefit of small investors.

The overwhelming majority of U.S. venture capital funds, private equity funds, illiquid securities funds, and hedge funds are formed as pass-through partnerships under the U.S. tax code. Most lawyers would use the expression "investment partnership" as formal representation for a hedge fund as well as its close cousin of Silicon Valley, a venture fund. The latter have become more colloquial terms.

The source income from U.S. investment partnerships is not subjected to paying two layers of tax, as is the case with a U.S. subchapter C entity, by organizing themselves as pass-through partnership entities for the purpose of taxation under U.S. tax law. A U.S. limited partnership or a U.S. limited liability company is permitted to file its tax returns as a partnership, paying no direct corporate tax as would a subchapter C corporation, passing through its taxable income to its partners, who in turn are taxed as individuals. Thus, the income and earnings of the hedge fund or investment partnership are taxed only once, at the relevant marginal tax rate of each partner. Tax-exempt U.S. partners would not be paying any tax. However, the investment partnership must avoid being classified as a U.S. "publicly traded partnership."[6] If such classification were to occur, the partnership would be treated as if it were a subchapter C corporation for federal tax purposes, and would have to pay corporate tax. Further, investment partners who receive cash flows that are considered to be dividends would be taxed once again on such cash flows. Nearly all U.S. investment partnerships, both hedge funds and venture funds, qualify not to be deemed publicly traded partnership due to not having an active secondary

[5] A mutual fund is a regulated investment company that is governed by the Investment Company Act of 1940, described in 15 U.S.C. Sections 80a-1 to 80a-64, available at www.law.cornell.edu/uscode/html/uscode15/usc_sup_01_15_10_2D_20_I.html.

[6] Section 7704 of the Internal Revenue Code defines a publicly traded partnership and provides exceptions to the definition: a partnership with 90 percent or more of its gross income consists of dividends, interest, rents, and capital gains, and its interests should not be readily tradable in a secondary market.

market in its partnership interests, and due to producing nearly all of its income comes from "qualifying" sources, that is, dividends, interest, rents, and capital gains.

Hedge funds that pursue computerized high-frequency trading strategies and decide to count the trading profits as operating income, as opposed to capital gains, would be trading partnerships. This is not a preferred form of structuring, except for trading partnerships that incur significant expenses and desire to offset these expenses directly with trading income.

Organizing a Typical U.S. Hedge Fund

The hedge fund manager, formally the general partner to the hedge fund, a U.S. limited partnership (LP), is typically a U.S. limited liability company (LLC), which for U.S. tax purposes may elect to be taxed as a partnership. The most popular U.S. state for formation of the hedge fund general partner LLC and LP pass-through partnership entities is Delaware. This is primarily because the relatively small state of Delaware has positioned itself among the 50 states as a friendly regime for corporate domicile, with well-developed corporate laws and longstanding corporate case history in the state court system.

Delaware itself is a taxable state and imposes corporate tax on Delaware entities having a physical business presence in the state. For this reason, nearly all U.S. general partner entities establish a principal place of business in a U.S. state other than Delaware, which does not impose corporate taxes on LLC entities that are pass-through partnerships for U.S. federal tax purposes. Connecticut is one such popular state for Delaware entities setting up their principal place of business for hedge fund management and operations. Thus, such a general partner LLC pass-through entity does not pay either federal or state corporate tax on its income. All of the general partner entity's items of income are taxed only once, when passed through to its partners.

The hedge fund manager, that is, the general partner, charges fund management fees to its limited partners. The details of such fees, contractual provisions, as well as tax consequences both to the limited partners and the general partner are described later. The general partner is responsible for the day-to-day operations, administration, and overall management of the fund, and incurs management expenses.

Thus, a typical U.S. hedge fund structure is a *pair*. The hedge fund sponsor organizer sets up two entities, usually in the state of Delaware. The first is typically a Delaware LLC (limited liability company) that becomes the general partner of the second entity, a Delaware LP (limited partnership). The general partner entity is governed by a private operating agree-

ment of the LLC signed by its members, who are its partners. LLC members are granted limited liability by the State of Delaware. At a minimum, the LLC agreement establishes the voting powers of members, designation of a manager (who could be a member), power of attorney and authority delegated to the manager, and profit sharing among members. The limited partnership entity is governed by its agreement of partnership. Delaware and other states do not require the operating agreement of the LLC or the partnership agreement of the LP to be filed, so they remain private documents in private domain. For a limited partnership, Delaware requires a sparse one-page formation document, "Certificate of Limited Partnership," provided on its Web site signed by an authorized representative of its general partner LLC entity, such as its manager or member. Similarly, the general partner entity, the LLC, files a sparse one-page formation document provided on the Delaware state Web site, "Limited Liability Company Certificate of Formation," signed by an authorized person who is either a member or simply an appointed or employed manager.

The GP/LP pair immediately obtain taxpayer identification numbers from the Internal Revenue Service (IRS) by filing the appropriate IRS Form SS-4, which requires clear identification of the type of entity in a check box. The LLC can elect to be either a subchapter C corporation or a partnership for the purposes of U.S. taxation. The LLC entity (which is general partner to the LP) wisely elects to be taxed as a pass-through U.S. partnership to avoid double taxation that a U.S. subchapter C corporation would face. The pair of entities is required to have nominal registered offices in the state of Delaware, which is really the physical address of its Delaware-registered agent named on the certificate of formation. The pair of entities appoints such a state agent prior to seeking entity formation, for which the agent charges a modest annual fee. The state of Delaware charges a modest initial filing fee, which at this time is $200 for an LP and $90 for an LLC. Subsequently, the LP and LLC that are formed in the State of Delaware are not required to file an annual report but are required to pay an annual flat tax of $250.

The pair subsequently establish a common physical place of business, which is typically in the state of Connecticut for hedge funds. For Silicon Valley venture partnerships, the physical place of business is in the state of California. (Silicon Valley venture partnerships have no particular affinity for Delaware and might elect to form their LP and LLC pair in Nevada or California.) They are required to make Delaware-like filings in their state of domicile and business presence, as a "foreign" out-of-state entity that is doing business in the state.

Delaware courts have well-established precedents that firmly protect the limited liability of partners in a limited partnership, as well as members in a limited liability company. The managers and members of the Delaware

LLC are shielded from personal liability that might arise from their actions conducted for the benefit of their LLC or LP. The manager of an LLC is presumed to be acting in the best interests of partners and shareholders. The general partner entity that runs the LP is an LLC, so it is automatically shielded from liability in excess of its assets. The manager and members of the general partner entity, which is an LLC, are similarly shielded from claims of personal liability. While this kind of protection from external liability claims upon individual managers and members of the LLC is offered practically in all other states, Delaware has the best established record of case law that demonstrates its seriousness as a business domicile. Large publicly traded subchapter C corporations particularly prefer Delaware, whose case law has favored companies and their directors in shareholder litigation relating to corporate takeovers.

Connecticut is a popular location for hedge fund operations. The most important reason is that its securities laws generally exempt those entities from state registration as an investment adviser as long as they are exempt from such SEC registration. Generally, a hedge fund that trades for its own account, with investors sharing common objectives in a limited partnership agreement, and all look-through investors being either U.S. "qualified purchasers" or suitable foreign purchasers, is exempt from registration as an investment adviser with the SEC and consequently from registration as an investment adviser with the state of Connecticut. A similar exemption is offered by the state of New York, which is why a large number of hedge funds maintain their operations in New York City.

The second important reason in favor of Connecticut as a business location for U.S. hedge fund is that, like many states, neither only state-resident partners of the general partner LLC entity nor the LP entity are subject to pass-through state income tax on investment income. Only resident partners of an LLC or LP in a particular state are required to pay that state's income taxes on taxable pass-through partnership income. Neither of the entities is subject to direct state taxation on income or assets. Similarly, a branch of an offshore hedge fund is not considered to be producing business income in the state and is not subjected to state tax on income or assets.

The general partner, which is the LLC entity, has no place of business in its state of formation (Delaware) and is not taxed (in Delaware) on any of its operating income as general partner. Likewise, the state of Connecticut where the LLC/LP pair maintains its physical place of business does not impose a blanket corporate tax on U.S. partnership entities. Only partners who are resident of the state of Connecticut have to pay personal tax on pass-through income arising from the LLC or LP.

The pair of entities is now ready for business. The fund organizers set up bank accounts for the LLC and LP, and securities brokerage accounts

for the LP. This step requires passing the compliance standards and requirements of the banks and brokerage firms, whose compliance departments review both the LLC operating agreement and the LP agreement to determine the powers of attorney granted in the agreements and identify the relevant individuals who are the authorized signatories and traders.

The United States presents a simple procedural environment for forming pass-through limited liability entity-structures with no direct taxation. The hedge fund LLC/LP pair can be formed in Delaware and its IRS taxpayer ID obtained instantly, within one day. It may take a week or two to obtain a bank and securities brokerage account and begin trading, allowing time for review by compliance departments. That is the easy part. The thorny parts follow, of accounting, audit, tax filing, partner reporting, regulatory compliance, and, the most important challenge, of marketing the hedge fund to seek new fee-paying limited partners. A hedge fund appoints its legal counsel, organizes its accounting, seeks the engagement of an independent outside auditor, and prepares an information memorandum containing all pertinent information, including a description of the fund strategy, the people and investment decision makers in the fund, and its organization and governance. As the years go by, the information memorandum is updated with presentation of historical performance and risk measures, which is described in detail in Chapter 10.

The U.S. states under whose laws the LLC or LP were formed generally do not impose direct corporate income taxes on items of pass-through investment income. Their focus is on state corporate taxation of ordinary income from in-state business operations. Nearly all states charge an annual fee to their domiciled LLCs and LPs. This is usually a flat fee that is only nominally called an annual tax; yet there are some states that charge franchise fees that are linked to assets and income and are really state corporate taxes in disguise. Some states impose a de facto income tax on any partnership in the state, only it's not called an income tax but something else. The state of Illinois imposes a 1.5 percent "replacement tax" on taxable pass-through income of an Illinois partnership, to be paid by the LLC or LP entity. The state of Pennsylvania imposes "corporate capital stock tax" as a percentage of assets on LLCs (but not LPs) that are formed in that state or do business in that state, along with a complex formula that attempts to capitalize income according to a hypothetical statutory assets-to-earnings ratio. At the time of forming the core *pair* of entities (the LLC and LP) that constitute a U.S. hedge fund, the hedge fund organizers look carefully to selecting the state of formation so as to avoid or minimize fees and indirect taxes that are linked to income and assets. Conversely, states that are popular domiciles for partnerships that are LLCs and LPs tend to be states that have low flat annual fees and no direct or indirect taxes on assets and income. Delaware is one such state, which comes with the added

advantage of a state court system with well-established legal precedents on entities formed in the state that clearly favor the entities.

Limited partner investors should recognize that the limited partnership agreement assigns power of attorney for banking and securities trading to the general partner entity, which in turn assigns its power of attorney for banking and securities trading to one or more individuals who are managers, members, or manager-members of the general partner LLC entity. Implicitly, a high-trust relationship is formed between the limited partner investors and the authorized signatories of the general partner entity.

In summary, a U.S. hedge fund is organized as a limited partnership by its organizer, who is also its fund manager as its general partner. Limited partners have limited liability and do not expect to lose any more than the amount of their capital investment. The general partner makes the legal appearance of absorbing all the residual liabilities of the hedge fund, in the unlikely event when liabilities exceed the value of the partnership. However, by simple legal construction, the general partner is organized as a limited liability entity and effectively bears negligible economic liability. The investment, trading, and administrative decision-makers for the hedge fund act in the capacity of managers to the general partner, and thus they do not personally absorb residual liabilities of the general partner entity under well-tested laws in states such as Delaware.

The general partner entity may itself contribute a portion of the capital of the hedge fund (i.e., into the limited partnership entity). However, instances of large holding by the general partner in the LP are rare. The general partner in a hedge fund typically contributes only a token amount of capital to the fund. The general partner usually does not pay any fees. The primary objective of the general partner is to earn fees on a larger base of capital that is raised from fee-paying limited partners. The fees are a source of cost to the limited partners that detract from their investment returns, and the sole source of revenue and profit to the general partner.

Investor Clienteles in Hedge Funds

A hedge fund has to be careful in its choice of admitting appropriate limited partners. These clienteles of fee-paying investors whose inclusion and admittance would not trigger the regulation of the hedge fund by the SEC are described next.

Accredited Investors. These SEC limits appear to segment the income profile of typical professionals: It encompasses those individuals with at least $1

million in assets and $300,000 of family income.[7] This segment of investors is unlikely to raise the desired billions of dollars of capital for a mega hedge fund. Accredited investors are typically folded into hedge funds through "wrap accounts" offered by nearly all full-service brokerage firms, which in turn invest in a target hedge fund.

Qualified Purchasers. U.S. hedge funds typecast in the format of a U.S. investment partnership are typically targeted at limited partners who are considered "qualified purchasers" by the SEC, following their definition in the U.S. Investment Company Act, as a natural person who owns not less than $5 million dollars in investments, or an entity that invests at least $25 million.[8]

The hedge fund market largely draws from qualified purchasers, since a very small number of them might easily add up to orders of $100 million. Pre-existing SEC rules clearly exempt an investment adviser from registration with the SEC if all investors fall within this category. A large consortium of accredited investors joining a hedge fund through a brokerage firm wrap account would likely be considered by the SEC to have a surrogate single qualified purchaser. If the hedge fund organizers do not want to take chances of incurring the wrath of the SEC by admitting accredited investors into a large hedge fund, the recommended clean approach to keep the SEC at bay is to admit only qualified investors into a hedge fund. Note that all U.S. funds are *regulated* by the SEC, even those that are *exempt* from the SEC due to admitting qualified investors only. There is an immense benefit to hedge funds that are exempted from registration that the SEC, due to not having to comply with the ongoing burden of SEC registration and perpetual filings.

Foreign Investors. All of the SEC definitions of accredited and qualified investors apply only to U.S. persons or U.S. entities. The regulations are silent about financial wealth and standards for foreign investors admitted to a U.S. investment partnerships or hedge fund. A foreign investor to

[7]The SEC provides a clear definition of "accredited investors" at www.sec.gov/answers/accred.htm. The SEC is relaying a regulation that governs it, at 17 CFR part 230, section 501. The source is at http://edocket.access.gpo.gov/cfr_2006/aprqtr/17cfr230.501.htm. There is also a user-friendly Wikipedia entry at http://en.wikipedia.org/wiki/Accredited_investor.

[8]A complete formal and official definition of "Qualified Purchaser" is in Title 15 U.S.C. Chapter 2D, Subchapter I, Section 80a-2(a)(51). "U.S.C." stands for U.S. Code, which is published to the Internet in its entirety by the U.S. Government at www.gpoaccess.gov/uscode/browse.html.

whom adequate disclosure of the investment strategy and risks has been provided in an information memorandum, who appears to have sufficient wealth, and who demonstrates understanding and experience with risky investments could be viewed as a "suitable" investor and be duly admitted into a U.S.-domiciled hedge fund without reference to the formal accredited investor and qualified purchaser standards of the SEC that apply to U.S. investors. Many U.S. master hedge funds are based on admitting a foreign partner/investor who is actually an arm's-length-affiliated offshore feeder fund that is created by the hedge fund organizers.

U.S. Investors, Tax-exempt and Taxable. In recent years, large numbers of U.S. institutional investors have sought participation in limited partners in hedge funds. These institutions, typically pension plans and nonprofit endowments or charities, are typically exempt from U.S. taxation. As a result, these large institutional tax-exempt investors in hedge funds mostly care about economic returns on their investment without regard to tax, except for perpetual fear of Unrelated Business Tax on Income (UBTI, also sometimes written as UBIT).[9] There are clear, legal precedents that establish borrowing or debt financing by tax-exempt entities, either directly or as a pass-through partner in an investment partnership, that would invite UBTI on all income flows attributable to the borrowing. Thus, hedge funds and venture funds that are U.S. entities and admit large institutional tax-exempt limited partners are effectively restricted from investment strategies that involve any direct form of debt. On the other hand, there are clear precedents that permit the same nonprofit entities to engage in forms of indirect borrowing such as forwards and futures contracts or other derivatives such as options. Many hedge funds seek to establish private party swaps and notional principal contracts that contain embedded forward contracts and derivatives. After 2008, institutional investors are painfully aware that private swaps and notional principal contracts are subject to serious counterparty risk. The Lehman Brothers bankruptcy of 2008 was a grim reminder that private party swaps are not exactly safe from counterparty default, and that a new economic cost has been introduced, of insuring against default of private swap counterparty. Such default insurance is further subject to default by the insurer, as was highlighted by the recent collapse of AIG in September 2008.

A significant set of U.S. investors are taxable individuals and entities that are keenly sensitive to tax considerations surrounding cash flows from their investment in a hedge fund or venture fund. While taxable investors

[9]UBTI is described in the Internal Revenue Code Section 512(a)(3), which is available at www.law.cornell.edu/uscode/26/usc_sec_26_00006033----000-.html.

indeed primarily seek decent economic returns without regard to taxes, they also look at tax consequences and after-tax returns. Taxable investors often are obliged to make partial redemptions from a hedge fund to pay out tax obligations, some of which may be arising from their participation in the hedge fund. Most hedge funds and venture funds have strict clauses in their agreements to permit partners to make cash redemptions of all or some part of their partnership interest whenever there is any significant taxable cash flow or tax allocation. This is to ensure that the taxable partners have funds to pay tax liabilities arising from the present year tax allocations, which could be significant.

Foreign investors in U.S. hedge funds are usually domiciled in tax-free countries or regimes. The only relevant tax imposed on foreign investors by the U.S. government on foreign investors is a flat 30 percent withholding tax on U.S. source dividends. Generally, all other pass-through sources of partnership investment income and their tax allocations to foreign limited partners are not subject to U.S. withholding tax. Any ordinary income earned from business operations by a U.S. partnership is not considered "portfolio income" and is subject to 30 percent withholding tax to foreign limited partners.[10] The U.S. hedge fund becomes the withholding agent for the withholding tax on dividends and ordinary income. Typically, the amount of dividend tax payment by the foreign limited partner is funded by redemption of the tax amount from their partnership interest.

We should not ignore foreign investors in both U.S. and offshore hedge funds who are domiciled taxpayers in tax paying regimes, such as mature market countries in Europe and Asia. Nearly all countries that impose a personal tax have inter-country tax treaties. Thus, any withholding tax on U.S. source dividends held back for such a taxable foreign investor in either the U.S. entity or an offshore entity could be applied as credit toward their domestic home country taxes.

It should be noted that some hedge funds might report pass-through operating business income that arises from holdings in other operating businesses and partnerships, such as real estate operations and securities or commodities trading operations that report their income as ordinary operating income. A foreign partner's pass-through allocation share of such operating active net income would be considered as active U.S. source income that is subject to 30 percent withholding tax and not as passive U.S. "portfolio income" that is exempt from U.S. withholding tax.

[10]Rules for withholding tax of U.S. income of foreigners are stated in the Internal Revenue Code Sections 871 and 881. They are available at www.law.cornell.edu/uscode/26/usc_sec_26_00000871----000-.html, and www.law.cornell.edu/uscode/26/usc_sec_26_00000881----000-.html.

Foreign Investors in a U.S. Hedge Fund

Offshore Affiliate Feeder Fund. A typical structure adopted by U.S. hedge funds for admitting foreign limited partners is to create an offshore affiliate that acts as a feeder fund. Such an offshore affiliate is organized in popular Caribbean colonies of the United Kingdom, such as the Cayman Islands, British Virgin Islands, and Bermuda, the Dutch colony of Netherlands Antilles, and so on. These regimes offer credible legal protection to investors by a court system and laws of their mother countries, the United Kingdom and the Netherlands, while at the same time offering the benefit of complete exemption from taxation as well as the benefit of participation in tax treaties between the U.S. and their mother countries. It is unlikely that independent sovereign countries that merely offer tax-free regimes would offer credible legal protection to investors. In the coming years, we may witness the rise of similar offshore locations in the Middle East (like Dubai) and in the Pacific (like Singapore), but these are unlikely to be viewed as regimes with the same legal protection to investors offered by the crown colony laws of the United Kingdom and the Netherlands.

The advantage of such a structure is that in its tax reporting, the U.S. hedge fund is required to report only the name of the feeder fund as the offshore entity to the IRS, and not the names of the individual foreign investors and shareholders of the offshore entity, in order to preserve their anonymity. If the same individual foreign investors are admitted as limited partners in the U.S. limited partnership, their names are reported to the U.S. IRS in the tax filing of the U.S. limited partnership.

Offshore Funds

The expression "offshore fund" is a catchphrase that denotes a hedge fund located outside taxing jurisdictions and high-tax regimes, conveniently formed under the laws of a tax-free political regime that is friendly to nonresident shareholders and investors, but also belongs to the legal sovereign jurisdiction of solvent European countries with well-established legal systems to deter and punish fraud and protect investors.

A large number of foreign investors are alarmed by the fear of falling into the U.S. regulatory and tax enforcement net as direct foreign limited partners in a U.S. hedge fund. The last thing they want to receive is an IRS notice, however innocuous it might be. Their fears are often mitigated through participating in an offshore feeder fund that in turn purchases a partnership interest in a U.S. investment partnership. These investors usually seek comfort through investing in an entirely offshore fund with no tax enforcement connection with the U.S. government. Such an offshore fund

might also directly invest in U.S. securities through a U.S. brokerage firm, which in turn acts as the U.S. dividend tax withholding agent. However, from the perspective of U.S. tax enforcement, there is a big difference to a non-U.S. investor between participating as a partner in a U.S. hedge fund versus participating in an offshore fund that in turn operates a brokerage account to trade U.S. securities. In the former case, the names of the foreign limited partners in the U.S. investment partnership are provided to the IRS. In the latter case, only the name of the foreign offshore feeder fund is provided to the IRS, not the names of its pass-through shareholders. Thus, for foreign investors desirous of investing in U.S. securities, participating in a U.S. domiciled hedge fund either directly into a U.S. master fund or indirectly by participating in an independent offshore fund, is a tradeoff. Direct participation in the U.S. partnership reveals their names to the IRS, while offering the benefit of the long arm of U.S. anti-fraud enforcement and the right to U.S. litigation. Indirect participation in a U.S. partnership (or, in general, in U.S. securities) through investment in an offshore fund or entity shields their names from the IRS but only offers light anti-fraud legal protection under the legal system in the offshore location.

What exactly is meant by a "U.S. security"? Generally, any security issued by a U.S. entity, particularly a publicly traded security in a stock exchange, securities exchange, or futures exchange, or a U.S. treasury bond, requires the issuer to record the name of the holder and pass on information about payments of dividends, interest, and security sales to the U.S. government. In a limited concession to the brokerage industry, brokerage firms retain the names of the foreign holders of U.S. securities on their own records and collect U.S. withholding taxes but do not have to submit the names of the foreign holders to the IRS. However, foreign investors do not take their chances. If they wish to invest in U.S. dollar denominated fixed income securities, they participate in the London Interbank Offered Rate (LIBOR) market rather than engage in direct holding of U.S. treasury bonds.

There is a large segment of independent offshore hedge funds that invest in non-U.S. securities. In the past several decades, when the United States housed the world's largest markets for bonds, equities, currencies, commodities, options and futures, credit derivatives, swaps, and other exotic forms of securities such as collateralized debt obligations, foreign investors needed access to these sophisticated U.S. markets. In future decades, with the rapid emergence of London, Paris, and Frankfurt as financial centers, followed by Dubai, Mumbai, Hong Kong, Singapore, Shanghai, and Tokyo, and the rapid economic growth in the developing countries, participation by non-U.S. investors in U.S. capital markets and hence in U.S. securities may not be as important as it might have been in the past. Similarly, the U.S. investors would likely increase their holding of non-U.S. securities in their portfolios.

Organization of an Offshore Fund. Each offshore regime has different formats, definitions, and language for organizing tax-exempt hedge funds under their laws. In most of the popular offshore locations, such as the British crown colonies in the Caribbean, there are three forms of organization offered: as a company, a mutual fund, or a partnership. Companies and partnerships are loosely regulated, while mutual funds tend to have more controls and rules, though none as onerous as the enforcement and regulatory net of the U.S. government. The choice of organization primarily rests with the hedge fund managers and their clientele of investors. An offshore mutual fund or partnership best allows for contractual clauses for shareholders to pay management fees to the fund manager. A simple company is intended for distributing profits as dividends to shareholders according to their shareholding interest. Thus, it would be necessary to create corporate charters that are filed with the offshore government that permit two classes of shareholders, in which one class pays a management fee to another class. Generally, the simple company form of organization is best suited for small entities with a few investors intending to divide profits according to their shareholding. An offshore hedge fund is typically organized either as a limited partnership or as a mutual fund under the laws of the offshore government. The offshore governments usually do not require simple, small companies or partnerships to file annual audit reports of corporate financial statements. However, to offer a semblance of regulating an offering protection to investors, the offshore government usually requires an annual audit to be conducted by chartered accounting and audit firms in that country to sign an annual audit letter. The friendly tax and regulatory offshore regime collects annual filing fees, while local law and chartered accounting firms benefit from a nice stream of professional fees.

Thus, an independent offshore master fund that directly trades for itself, without having to affiliate itself with a U.S. hedge fund, offers some advantages. To the extent that the independent offshore fund trades in U.S. securities, a U.S. brokerage firm becomes the tax withholding agent. Since there is no direct filing to the U.S. tax and regulatory regime, the names of its shareholders are not filed with the U.S. authorities. The U.S. brokerage firm acts as a buffer between the offshore fund and the U.S. tax regime. From the perspective of the hedge fund manager, there is a great benefit of simplicity in administering such an offshore fund.

There are indeed some disadvantages to independent offshore hedge funds. Shareholders and limited partners of such funds are wary of the lack of strong protection from fraud that exists in the United States. Indeed, financial fraudsters in the United States and Europe are known to seek refuge in similar and ambivalent offshore political jurisdictions that might offer them some hope of not being extradited due to lack of extradition treaties. Offshore fund investors might find themselves only lightly pro-

tected from financial fraud. Indeed, the best protection for an investor against the risk of losses from financial fraud in an offshore fund, despite coming under the jurisdiction of the crown colony laws of the United Kingdom and the Netherlands, is to become a direct foreign limited partner in a U.S. hedge fund. Of course, such foreign investors must be willing to have their names reported to the IRS every year by the master U.S. hedge fund.

Tax-Exempt U.S. Investors, UBTI, and Offshore "Blocker" Corporations. As briefly mentioned before, a significant investment in a U.S. partnership by a tax-exempt institutional investor restricts on the investment strategy of the hedge fund or venture partnership by denying that the ability to borrow, issue debt, take on margin loans or any other form of collateralized loans, since such activity would trigger UBTI for these investors. A common fix is that the general partners or organizers of a U.S. investment partnership also organize an offshore feeder fund, which takes in the investment capital from tax-exempt U.S. investors. The objective is to block UBTI. Cash flows received from the offshore feeder fund by the tax-exempt U.S. investor are treated as dividends, which did not attract UBTI. The offshore feeder fund in turn purchases a limited partnership interest in the U.S. hedge fund or venture fund. The offshore feeder fund itself would be subject to 30 percent withholding taxes on dividends, ordinary income, or income that is not deemed to be portfolio income. As long as a U.S. partnership conducts its trading and investment activity and does not produce dividends and ordinary income, this may be a good arrangement.

Such an offshore blocker corporation structure would work for investment in trading strategies that are based on direct borrowing or taking any other form of collateralized loans. The tax-exempt U.S. institutional investor assumes a small risk that any dispute or impropriety conduct by the organizers relating to their investment in the offshore blocker corporation that is acting as the feeder fund would have to be resolved under the lighter and lesser tested justice systems in the offshore British and Dutch crown colony regimes. It is only logical that a U.S. tax-exempt investor of any meaningful size should establish captive offshore "blocker" corporations. However, most U.S. tax-exempt investors, whose financial statements and tax returns are public record, are hesitant to display direct nexus to captive offshore corporations due to fear of public censure.

U.S. Investors in Offshore Funds

The U.S. tax code places serious burdens both on U.S. investors in foreign hedge funds and on offshore hedge funds that admit too many U.S.

shareholders or partners. If a foreign entity has majority ownership (i.e., more than 50 percent) by U.S. shareholders or investors, it may trigger the U.S. IRS rules that apply for "Controlled Foreign Corporations" (CFC).[11] It may be a stretch to consider a limited partnership interest or nonvoting shareholder interest in a foreign entity by U.S. investors as any kind of controlling interest. However, neither U.S. investors nor offshore hedge funds wish to get entangled with U.S. CFC classification, which effectively makes the foreign entity into a defacto U.S. entity. The more restrictive set of U.S. IRS regulations that apply to U.S. investors in foreign hedge funds that might be deemed as "foreign corporations" under U.S. tax law are the U.S. Passive Foreign Investment Corporation rules.[12] Broadly speaking, a foreign entity whose primary sources[13] of income and profit are dividends, interest, and capital gains could be deemed a PFIC. A U.S. investor in a PFIC is required to provide annual reporting of income from a PFIC, which could include accrued unrealized income, and pay a U.S. tax on it at the ordinary income rate of that investor. Furthermore, an offshore entity that is deemed to be a PFIC might be asked by the U.S. IRS to report PFIC income of U.S. investors. Most offshore hedge funds generally do not encourage the admittance of U.S. investors due to IRS compliance complexities associated with admitting them.

Most hedge funds are organized under a master-feeder structure that benefits from obtaining IRS classification of the offshore fund as a partnership or association for U.S. taxation purposes,[14] and thus *not be deemed a*

[11]The formal IRS definition for a Controlled Foreign Corporation (CFC) appears at several IRS publication locations routinely, for example, in IRS Form 5471 Instructions at www.irs.gov/pub/irs-pdf/i5471.pdf. Section 956 of the Internal Revenue Code defines Controlled Foreign Corporations. This is available at www.law.cornell.edu/uscode/26/usc_sec_26_00000956----000-.html.

[12]The formal IRS definition for a Passive Foreign Investment Company is in Title 26, Section 1297 of the U.S. Internal Revenue Code (mirrored at the Cornell law library at www.law.cornell.edu/uscode/uscode26/usc_sec_26_00001297----000-.html), which further points to formal definition at Section 954 (mirrored at the Cornell law library at www.law.cornell.edu/uscode/uscode26/usc_sec_26_00000954----000-.html). This definition is routinely relayed in several IRS forms, such as the instructions to Form 8621 at www.irs.gov/instructions/i8621/ch01.html and www.irs.gov/pub/irs-pdf/i8621.pdf.

[13]Section 1297 regards a PFIC as a foreign entity with 75 percent of its income being "passive income" or 50 percent of its assets being "passive assets." Section 954 broadly defines passive income or assets as dividends, interest, capital gains, royalties, annuities, commodity trades, foreign currency gains, swaps (i.e., notional principal contracts), dividends claimed on short sales, etc.

[14]U.S. Code of Federal Regulations, Title 26, Part 301–Procedure and Administration, § 301.7701-3(b)(2) classification of certain business entities, foreign eligible entities.

PFIC. A U.S. investor in such a foreign fund that elects the IRS "check box" provision of its classification[15] is not subject to PFIC rules. Similarly, a tax-exempt U.S. investor in such a foreign fund is not subject to UBTI on cash flows received from such a fund. Several master offshore funds set up captive feeder entities solely for U.S. investors, which in turn own an interest in a master offshore hedge fund. Such a captive feeder entity, which is the U.S. entity, performs all the necessary compliance and paperwork that might be required for U.S. investors. The U.S. investors benefit from not having a difficult and draconian PFIC classification apply on their nexus to an offshore investment fund. Should the offshore fund the master fund and the U.S. fund be the feeder, or vice versa? A lot depends on the nature of the cash flows and investor clientele preferences. Note that it is possible for hedge fund organizers to set up multiple feeders into a single master according to client in preferences. In general, hedge fund organizers overwhelmingly prefer establishing the offshore fund as the master, and the U.S. fund as a feeder. The only thing holding them back are a limited number of large institutional investors who may be concerned during the process of their due diligence, that they bear risk of dispute and litigation of their potential future claims as investors and shareholders in an untested offshore non-U.S. jurisdiction.

Just as the U.S. has a vibrant supply of SEC regulated mutual funds, there is an equally healthy supply of foreign mutual funds that are similarly government registered or regulated. Would PFIC classification apply to investment in an offshore mutual fund by a U.S. person or entity? PFIC rules apply only to offshore entities that are corporations in the first place, which primarily produce income from interest, dividends and capital gain. An offshore mutual fund that that seeks classification as an association or partnership under U.S. tax regulations for the purposes of admitting U.S. investors is not a PFIC-rule triggering entity.

U.S. Investors in Swiss Bank Accounts

For comprehensiveness, we discuss the issue of U.S. taxable individual investors who maintain accounts in the secretive Swiss banks. The banking

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This is accessible at the U.S. government's eCFR Web site at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=e02fe9b246c7f12f475bc874b923069c&rgn=div8&view=text&node=26:18.0.1.1.2.20.69.4&idno=26.

[15]A foreign entity elects to be classified as an association or partnership for U.S. tax purposes by electing the appropriate checkbox in IRS Form 8832 Entity Classification Election. Once such an election is made, it cannot be changed for five years.

secrecy policy of the Swiss government and Swiss banks was partially penetrated by the IRS, which publicly announced its settlement with the Union Bank of Switzerland (UBS) on November 17, 2009, that UBS had agreed to turn over the names of 4,450 U.S. taxpayers whom the IRS suspected of evasion of U.S. taxes by using the bank's offshore services.[16] At one point, the 4,450 accounts held $18 billion, according to the IRS. The IRS had offered an amnesty, officially called a "voluntary disclosure program," to U.S. taxpayers, ending on October 22, 2009, to disclose their offshore accounts to mitigate stiff penalties. Subsequently, the IRS announced that more than 14,700 U.S. taxpayers disclosed their secret foreign bank accounts, including accounts held at foreign banks other than UBS, under its amnesty program. The IRS gave widespread publicity about its agreement of February 2007 with UBS to pay $780 million in fines and admit to criminal wrongdoing in facilitating offshore banking services to U.S. taxpayers that enabled the invasion of U.S. taxes. This may have motivated U.S. taxpayers holding secret Swiss banking accounts to participate in the IRS amnesty program.

A renewed challenge to the IRS-UBS settlement appeared in 2010. The Swiss federal administrative court ruled on January 22, 2010, that the account details of a U.S. depository client of UBS may not be disclosed. Earlier, on January 8, 2010, the Swiss federal administrative court ruled that the Swiss financial regulator broke the national banking secrecy law when it ordered UBS to provide client data to the U.S. government authorities. The Swiss government announced on March 30, 2010, that it did not support the court rulings and their reversal now available by vote in the Swiss parliament.[17]

The global hedge fund industry is indeed linked to European banking secrecy sector, since a good part of the asset base of offshore hedge funds is from these institutions. While a large number of U.S. taxable investors elect to keep their hidden assets in the form of nearly riskless interest-bearing bank deposits, a significant proportion diverts their Swiss bank holdings into hedge funds. Some of the Swiss banks invest in offshore hedge funds in the bank's beneficial name, while maintaining a record of

[16]This was widely reported in the global media. One such detailed media report is that of the *New York Times* on November 17, 2009, at www.nytimes.com/2009/11/18/business/global/18irs.html.

[17]These Swiss federal administrative court rulings were reported in the *New York Times* on January 9, 2010, at www.nytimes.com/2010/01/09/business/global/09ubs.html, and on February 23, 2010, at www.nytimes.com/2010/01/23/business/23tax.html. The reversal of the court rulings by the Swiss Federal Council and their pending approval by vote in the Swiss Parliament are reported at www.nytimes.com/2010/04/01/business/global/01ubs.html.

the underlying investors deeply guarded and hidden under Swiss banking secrecy laws. Thus, a considerable proportion of assets held in offshore hedge funds are indirect holdings by taxable U.S. investors who hitherto believed that, under Swiss banking secrecy, their names would not be known to the IRS. Another significant part of offshore hedge fund investment is indirect holdings of investors from countries other than United States, who wish to hide their assets from their respective governments and from the public eye.

We can appreciate why corrupt foreign officials or drug lords might want to hide their assets, which are acquired in violation of the laws of their own countries as well as the laws of other countries and international laws. Why would U.S. taxable investors want to hide assets from the U.S. government and the IRS? This could be partly because the United States taxes the global income of a U.S. citizen without regard to country of residency. Many other developed countries, like Canada and the United Kingdom, have a tradition of exempting their nonresident citizens from tax on income earned outside the home country. Income acquired by U.S. persons outside the United States might be part of hidden and underhanded deals, not visible as taxable income in any taxing regime, and eminently suitable for concealment in secret Swiss bank accounts. Further, there are U.S. persons who succeed in siphoning assets out of legitimate U.S. businesses through outright fraudulent means, and who seek a vehicle not just for hiding these assets under the shroud of offshore banking secrecy but also to earn tax-free investment income from such assets.

An interesting U.S. case is that of U.S. grocery store owner Stewart Leonard,[18] who was convicted in 1993 for skimming cash from his own grocery stores in Connecticut and smuggling it to the Caribbean, packed in suitcases or stuffed in baby gifts. Such U.S. tax evaders directly save at least 35 percent U.S. federal corporate tax and subsequent 36 percent on personal taxes for every pre-tax corporate dollar of their controlled corporation that is diverted for personal use. In addition to the incentive of reducing their U.S. corporate and personal income taxes, there is another serious incentive for wealthy U.S. persons to hide their assets from the IRS and the U.S. courts. Disclosed assets become part of hotly contested community property in lower court cases relating to divorce, paternity, and personal liability. If a divorce or liability settlement is viewed as a tax, though not imposed by the U.S. government but facilitated by the U.S.

[18]There is a Wiki on Stewart Leonard at http://en.wikipedia.org/wiki/Stew_Leonard, in addition to a large number of archived media reports on the case, such as that of the *New York Times* at www.nytimes.com/1993/07/23/nyregion/store-founder-pleads-guilty-in-fraud-case.html.

legal system, there is a significant saving, of as much as 50 percent of the assets, by hiding assets in an offshore bank account that is protected by banking secrecy.

Prior to the Bush administration, the U.S. gift and estate tax rate was 55 percent. The recent Bush administration reduced it according to a gradual schedule, from 55 percent in 2001 to 45 percent in 2009, and repealed it for only one calendar year, 2010. This repeal lasts only for one year! The estate tax rate reverts back to the top rate 55 percent in 2011. The Obama administration and U.S. Congress would have to vote in 2010 on whether to repeal the estate tax in 2011 and beyond. At this time, it seems unlikely that the repeal of estate taxes will prevail. The Obama administration is looking to all possible sources of tax revenue to fund its health care reform agenda and also to finance the deficits resulting from bailing out banks and brokerage firms in 2008. The Bush administration either did not have sufficient votes in the Senate and the Congress to enact a permanent repeal, and it may have acted to provide an incentive to wealthy U.S. taxpayers to support their party in the 2008 election. The one-year repeal, for calendar year 2010 only, at the tail of the Bush presidential term ending in 2008, does not appear to be serious tax reform policy. Without any new legislation, the estate tax automatically is reset to the top rate of 55 percent in 2011. United States legislators and the Obama administration would have to introduce new legislation to change U.S. estate tax policy.

By hiding assets in an offshore banking account that is protected by banking secrecy, a taxable super-wealthy U.S. person evades the looming 55 percent estate tax that would apply to hidden offshore assets passed on to successors. It might be a puzzle to a U.S. beneficiary of secret offshore assets: What to do with the secret inheritance? A beneficiary is not the perpetrator of estate tax evasion. Upon investigation of the source of such inheritance by the IRS, an estate might be further investigated and imposed an estate tax.

Thus, the combination of divorce and liability settlements being perceived as garnishment at a 50 percent rate, the hefty 55 percent U.S. gift and estate tax, layered on top of a U.S. personal tax rate of at least 35 percent on global income without regard to residency, and a corporate tax rate of 35 percent with double-taxation provides a strong incentive to U.S. taxpayers to hide their income and assets in offshore banking accounts. By these standards of direct taxes, estate taxes, and court enforcement of settlements, a super-wealthy U.S. citizen is perhaps the most taxed person on earth. It is not surprising that the wealthiest U.S. persons, Bill Gates and Warren Buffett, have pledged most of their wealth to charity, which is not only exempted from U.S. gift and estate tax but also is tax deductible from personal and corporate taxes.

U.S. Investors in Madoff-Like Managed U.S. Trading Accounts

The recent scandal resulting in the conviction of Bernard Madoff,[19] on June 29, 2009, to 150 years in prison brought to light the colossal scale of onshore U.S. investment advisory schemes residing in securities trading accounts bearing trading authority delegated to an investment adviser. There were varying reports of amounts missing from clients' accounts, and the court-appointed trustee estimated actual losses at $18 billion. Prosecutors said that Madoff perpetuated the largest Ponzi scheme ever, exceeding $50 billion and involving 13,000 investors.

It is important to recognize that the Madoff scheme was not a hedge fund or investment partnership. On the contrary, it appealed to U.S. taxpayers who were uninterested in the evasion of U.S. taxes and therefore uninterested in offshore banking services that offer banking secrecy protection. Each investor would remit investment funds to a securities brokerage account at Madoff's SEC-regulated brokerage firm. All U.S. securities brokerage accounts have investor protection from the Securities Investor Protection Corporation (SIPC) to the extent of $0.5 million. Most U.S. securities brokerage firms offer excess-over-SIPC coverage from an independent insurance company, usually to the full extent of the assets. It is unclear whether investors paid attention to excess-over-SIPC coverage in a Madoff securities brokerage account, and Madoff probably did not buy such coverage. The subsequent Madoff litigation and SEC enforcement lacked the mention of claims upon an insurance underwriter for excess-over-SIPC coverage. Even if such an insurance policy existed, it may have had clear language clauses for denial of coverage in the event of fraud. In any case, the wealthy investors in the Madoff securities accounts ought to have conducted reviews with due diligence to examine the terms of excess-over-SIPC coverage, if any, and sought such insurance coverage (inclusive of securities firm fraud coverage) privately if the Madoff securities account would not provide it.

Subsequently, each account holder in a Madoff securities account delegated trading authority to the Madoff brokerage firm for conducting securities trades in their account, making them into managed securities accounts. Each account holder would get a typical securities brokerage statement every month, which turned out to be pure fiction[20] created

[19]The Madoff pyramid scheme provided huge media fodder. A good summary is in the Madoff Wiki, at http://en.wikipedia.org/wiki/Bernard_Madoff.

[20]A sample Madoff securities account statement presents a popular Web destination at www.scribd.com/doc/8976754/Madoff-Trading-Statement-November-2008.

by Madoff's computer programmers[21] who were arrested by the FBI on November 13, 2009.

The IRS made a special exception[22] to allow Madoff investors to claim theft loss equal to 95 percent of their net investment. Unfortunately, theft losses are itemized deductions on Schedule A of individual tax returns and are excluded from the calculation of alternative minimum tax, which is usually the binding tax structure that applies to high-income U.S. taxpayers. It is not surprising that the IRS was generous in making a special one-time exception to theft loss deductibility. The IRS stopped short of including this theft loss as a one-time deduction from alternative minimum taxable income, thus ensuring that the U.S. Treasury will not be subsidizing the theft losses.

In the meantime, Madoff investors are debating with the SEC and SIPC, while pressing lawsuits against the Madoff trustee. The SIPC has taken the view that investor losses should be the tax basis of their investment, that is, their initial cash investment, adjusted for any cash withdrawals. The SEC has suggested that the tax basis be adjusted for inflation. Most investors argue that their losses are to be derived from the final account statements that were delivered to them by the Madoff-managed brokerage account before the fraud was revealed. In either case, the SIPC compensation is limited to $0.5 million and would not offer any meaningful restitution to large investors in the Madoff-managed brokerage accounts.

What Madoff offered to U.S. investors were individualized managed securities brokerage accounts, with the appearance of an umbrella of strict U.S. regulations and enforcement tightly governed by the U.S. securities industry and securities brokerage firms within the industry. There was no hedge fund or limited partnership that kept the actual trades hidden from partners. All trades in holdings were reported monthly to each brokerage account holder. It appeared to be transparent, clean, and regulated outright by the U.S. government under strict securities laws in which investors placed their trust, as well as the self-regulatory compliance departments of the stock exchanges. Every U.S. securities brokerage firm is required to file IRS Form 1099 annually for each brokerage account, reporting on the gross proceeds of the sale of securities, interest, and dividends. A copy of this IRS Form 1099 is provided to the securities account holders, who are required to reconcile their schedule of realized capital gains,

[21]The Madoff computer programmers were reportedly given 25 percent pay increases and bonuses of about $60,000 to maintain their silence: www.nytimes.com/2009/11/14/business/14madoff.html.

[22]The IRS special rule for deductibility of Madoff theft losses is described at www.nytimes.com/2009/03/18/business/18madoff.html.

dividends, and interest on their personal tax return with the Form 1099 received from the brokerage firm. Madoff seems to have been a pioneer in providing fictional brokerage account statements and committing outright fraud under the much-feared watchful eyes of U.S. government regulatory agencies and self-regulatory compliance departments of the U.S. securities exchanges.

While the media and investors were focused on Madoff as the perpetrator of financial fiction and fraud, less attention has been paid to the weaknesses and lacunae in implementation and enforcement of securities law by regulatory agencies of the U.S. government. Although regulatory enforcement and court outcomes in British crown colony regimes such as the Cayman Islands are perceived as uncertain, Madoff pushed the envelope to establish the vulnerability of U.S. securities regulation and enforcement. At a minimum, the U.S. government ought to implement the same degree of regulatory enforcement and surveillance as it has for homeland security. The FBI and U.S. Treasury surveillance system was perhaps enhanced to watch for terrorist cash flows. It is now necessary to extend the same to SEC-regulated brokerage firms, to implement simple algorithms to test for implausibility, such as aggregating all Form 1099s submitted to the IRS across all capital accounts, and to check reported trading volumes at the regulated securities exchanges against aggregate trading volumes of customers reported by regulated securities firms. Until then, the U.S. regulatory and enforcement net is revealed to have gaping holes that can be exploited by scam artists, and investors are protected largely by the integrity and honesty of securities firms.

Size of the Global Hedge Fund Industry

There are several hedge fund data-tracking services and companies that admit various hedge funds into their database universe to track returns and assets under management that are self-reported by the included hedge funds themselves. Notable hedge fund databases are Lipper-TASS, Hedge Fund Research (HFR), Barclay Hedge, and Morningstar-Altvest. For the last decade, the number of hedge funds in each of these database tracking and hedge fund reporting companies is of the order of 7,000 to 10,000 hedge funds. Compare this with 9,870 funds reported as having registered with the Cayman Islands Monetary Authority in 2008.[23] This exceeds the number of mutual funds in the U.S. There were 8,022 U.S. mutual funds in 2008.

[23]The Cayman Islands Monetary Authority provides statistics of Investment Funds regularly at its Web site, www.cimoney.com.ky/.

The number of U.S. mutual funds held steady at around 8,000 funds during the same decade of 2000–2009, as reported by the U.S. mutual fund industry organization the Investment Company Institute.[24] The latter also reports that assets of the U.S. mutual fund industry varied in the range of $7 and $12 trillion during the last decade. Considering that the Federal Reserve reported the aggregate financial assets (including bank deposits) of all U.S. households and nonprofit organizations combined as $42 trillion at the end of 2008,[25] the U.S. mutual fund industry's garnering of 20 to 25 percent of this aggregate is a significant achievement. This estimate is a reliable indicator of true wealth, or net asset savings, of mostly U.S. investors in U.S. mutual funds. This is because mutual funds do not take on leverage and do not take on short positions, which net out against long positions when aggregated across mutual funds.

Why are there so many hedge funds? In 1994, the Fidelity mutual fund manager Peter Lynch wrote:

> We've lately reached an important milestone in (mutual) fund making history: the number of funds now exceeds the number of individual stocks traded on the New York and American stock exchanges combined. This is even more remarkable when you consider that 328 of these individual stocks are actually funds in disguise.[26]

A similar situation has been reached with hedge funds. One distinction between the mutual fund and the hedge fund industry is that the survival rate of hedge funds is much lower than that of mutual funds. Hedge funds are constantly closing down due to poor performance and rapid investor redemptions, and at the same time, new hedge funds are constantly being formed. On aggregate, there appears to be a steady rise in the number of worldwide hedge funds every decade. Another important difference is that hedge funds do not have to disclose their portfolio holdings to their investors except voluntarily, and hence are able to apply a shroud of secrecy over their investment strategy. Mutual funds have to disclose their portfolio holdings, at a minimum in their annual reports, which has its own perverse consequence of year-end portfolio restructuring by active mutual funds for

[24] "2009 Investment Company Fact Book," Section 1: U.S. mutual fund totals, table 1. Investment Company Institute, 2009. This is accessible at www.icifactbook.org/fb_data.html#section1.

[25] Table B.100, Z.1, "Flow of Funds Accounts of the United States," Federal Reserve statistical release, Board of Governors of the Federal Reserve System, September 2009. The Table B.100 releases can be accessed at www.federalreserve.gov/releases/z1/current/accessible/b100e.htm.

[26] Peter Lynch, *Beating the Street* (New York: Simon & Schuster, 1994).

the purposes of window dressing and appearing good. The large universe of hedge funds has created business and career opportunities for hedge fund consultants and managers of "fund-of-funds" (FoF).

The corresponding net assets under management, or net investment or net liquidation value of partners by the hedge fund industry, is an elusive order of magnitude, indicated as about $2.8 trillion at its peak in 2008 by one of the hedge fund industry's professional association, the Alternative Investment Management Institute.[27] One reason is a bookkeeping consideration: that the hedge fund industry numbers are not accurately checked for double counting under master-feeder structures, as well as fund-of-funds, which in turn invest in hedge funds. Another is that the secretive nature of this industry does not lend itself to reliable reporting, since all size and return numbers are self-reported voluntarily to database aggregator companies. Finally, unlike mutual funds, which are unleveraged and contain negligible short positions, if the holdings of hedge funds were aggregated, long and short positions would mostly cancel out. If combined with the books of swaps and derivatives traders, the grand aggregate position would be be zero, since *on an aggregate, forwards, futures, swaps, and options are in net zero supply*. For every long position in any kind of derivative, its supply is created by short sellers of the same position. Some of the short sellers might be natural hedgers, such as airlines wanting to hedge their fuel cost or farmers wanting to lock in prices from the next harvest.

Even though we might encounter reports stating that the gross assets of hedge funds are of the order of tens, or even hundreds, of trillions of dollars, gross of leverage, we should recognize that such aggregation of the absolute values of notional amounts present the hedge fund industry as being much larger than life. For every hedge fund that takes long positions in leveraged crude oil futures contracts, there is some hedge fund or futures trader out there who has exact corresponding short positions that net out to zero.

During the global financial meltdown of 2008, hedge funds are rounded up by the media and legislators as the usual suspects that might be responsible for intense market volatility arising from excessive leverage and hyper speculation. Indeed, several hedge funds collapsed or were seized by their banks as collateral against loans made out to them. It later became clear that that the financial meltdown was better attributable to banks who are

[27] "AIMA's Roadmap to Hedge Funds," commissioned by AIMA's investors steering committee, November 2008. The acronym AIMA stands for "Alternative Investment Management Association," which is one of the primary associations representing the hedge fund industry. Available at www.aima.org/en/knowledge_centre/education/aimas-roadmap-to-hedge-funds.cfm.

attempting to create net positive supply of complex asset backed securities, and not hedge funds. These complex securities were later termed "toxic assets" by the media and euphemistically labeled as "troubled assets" by Congress. Many hedge funds indeed became victims to these toxic assets that were manufactured in net positive supply by banks, which were not only internally leveraged but also further leveraged by collateralized borrowing. The hedge funds seem to have been a small force, perhaps a minor player, and perhaps even a target victim of the toxic assets that were originated by the banks.

At the time of this writing, Congress is debating measures to regulate hedge funds to find legal means to have them register with the SEC so as to facilitate better disclosure, and also considering measures to increase taxes on fees and profits that are earned by the organizers of the general partners of hedge funds and venture funds. Many of these fears of regulators seem to be overblown. Whatever may be the new legislative outcome that engulfs U.S. hedge funds and venture funds, most of the industry is already offshore, well outside U.S. jurisdiction. Further, from an economic perspective, hedge funds are broadly leveraged investors or short sellers. When combined with other derivatives traders, the net positions of forwards, futures, swaps, and other notional principal contracts aggregate of zero. The collapse of AIG and subsequent financial meltdown was triggered by the imprudent sale of credit default swaps by AIG at low prices. The tidal wave of the recent financial instability came from a source of net positive supply, of toxic assets with housing as collateral. Warren Buffett's popular saying that "derivatives are financial weapons of mass destruction"[28] needs modification to include complex asset-backed securities in net positive supply. Panic arising from financial failures of derivative counterparties may indeed amplify financial market volatility. The true source of underlying financial market volatility is the underlying assets, and their originators and issuers.

Fund-of-Funds

The rise of fund-of-funds (FoF) within hedge fund industry is partly explained by a rarely mentioned but exceedingly common practice in the hedge fund industry, that the general partner entity is willing to pay 25 to 33 percent of its fees to an introducing broker or facilitator who brings limited partners into a hedge fund. Thus, as much as one-third of the 2

[28] "Buffett warns on investment time bomb," BBC News, March 4, 2003, available at http://news.bbc.co.uk/2/hi/business/2817995.stm.

percent fixed fee and 20 percent performance fee is shared with and introducing blocker or facilitator. An FoF organizer is usually successfully able to seek the same sharing of fees with each of the underlying hedge funds. Thus, without imposing a second layer of fees, they are able to offer their limited partner investors the same gross fee structure that they would face if they were to directly invest in a hedge fund. Many FoF investors also see value in obtaining a diversified exposure to 20 to 40 hedge funds, as against concentrated exposure in a limited number of hedge funds. Thus, through diversification, an FoF hedge fund indeed presents economic value to an investor.

The sharing of fees paid by limited partners to the general partners with introducing brokers and facilitators is the dark underbelly to the hedge fund industry. Indeed, many hedge funds jump-start themselves by finding their limited partner investors through paid fee-sharing intermediaries. When conducting due-diligence, limited partners ought to examine this issue. Are the general partners willing to disclose in writing that their general partner entity does not pay fees and commissions to outside brokers? If they do pay such fees, limited partner investors ought to seek a discount to the stated fee structure in the limited partnership agreement, representing a commission that would otherwise be paid to an introducing broker. Even though partners in a hedge fund share common objectives, the fees that each one pays to the general partner, and the proportion of their fees that are shared with introducing brokers, could be vastly different. The hedge fund manager's dark hour presents itself when an intermediary calls, saying, "I shall introduce this $100M investor client to you. What is in it for me?" It takes a determined hedge fund general partner sponsor to reply, "We have a policy not to share limited partner fees with third parties, and we do not pay commissions to agents for bringing clients to us."

In general, venture funds and private equity organizers in Silicon Valley, who typically invest in technologically driven venture projects, are not known to part with a share of limited partners' fees with commission agents. These funds have a long tradition of directly obtaining investments from limited partners, and would tend to be large U.S. nonprofit institutions. The venture fund organizers have multiple decade-long relationships with their limited partner investors. If they ever need to raise capital to finance a flurry of venture projects, they directly approach their long-standing limited partners.

In sharp contrast, the world of hedge funds is always in flux. New funds are constantly arriving to the market and searching for limited partner investors. A significant number of funds are imploding and falling apart due to sharp losses and investor redemptions. A substantial number of them start small and grow rapidly in size from internally generated profits attributable to stellar returns, which becomes a signal that attracts new investors. One

fund's sharp losses becomes another fund's buying opportunity, due to an abundance of distressed securities that temporarily flood the capital markets.

Incentives of the Hedge Fund Manager and Investors

Incentives of Hedge Fund Investors. The rapid evolution and steady growth of the global hedge fund market reveals the benefits and incentives to investors from investment strategies and investment vehicles that regulators do not ordinarily permit in standard mutual funds. Typically, hedge funds greatly benefit from obtaining a high degree of leverage; conducting short sales to benefit from overvalued securities; extracting returns from undervalued nonexchange traded securities; in liquid or lumpy securities; initiating leveraged speculative positions using both exchange traded and privately traded options, forwards, futures, swaps, and complex collateralized directives; or conducting high-frequency trading on exchanges to extract profits from becoming liquidity providers. Virtually none of these strategies or financial instruments are permitted in regulated U.S. mutual funds that are in turn governed by the Investment Companies Act. Net of the cost of management fees paid to the fund manager, hedge fund investors expect to earn superior risk-adjusted returns on their capital.

Many hedge funds are popular with investors due to that track record of earning steady investment returns with low volatility. Such hedge funds proudly present their superior "Sharpe ratio" (named after its inventor, William Sharpe, who shared the 1990 Nobel Prize in economics), which is the ratio of the hedge fund's excess return over the riskless rate to its volatility. The numerator of this ratio represents excess returns over the riskless rate, and the denominator seeks to quantify risk. There are a number of other risk-adjusted performance measures,[29] which are not described here but are detailed in later chapters. In summary, hedge investors seek superior risk-adjusted returns (net of management fees) through participation in innovative investment strategies that are not available through participation in standard regulated mutual funds.

Incentives of The Hedge Fund Manager. The hedge fund manager profits from collecting two types of management fees from the participating hedge fund

[29]The Treynor ratio is the excess return over riskless rate divided by the fund's beta relative to a benchmark index. The Sortino ratio is the excess return over riskless rate divided by variance of only those return observations with negative returns, sometimes called the "semi-variance."

investors. The first component is the fixed fee, much like with mutual funds, levied as a small percentage of the market value of the investor's capital balance in the hedge fund. The fixed fee ranges between 1 and 2 percent of assets and is very similar in order of magnitude to the fee structure of standard regulated mutual funds. Typically, the hedge fund manager makes only very marginal profit after deducting actual management expenses, including salaries, legal/accounting professional fees, and overheads. Just like with standard mutual funds, fixed fees can be a source of decent profit to the hedge fund manager when the fund manages large volumes with relatively lower costs. This is a benefit of scale economies.

The more important component is the performance fee paid to the hedge fund manager by the hedge fund investors according to preset contractual provisions in the partnership agreement. This performance fee in a typical hedge fund is about 20 percent of net new profits earned for investors in excess of a preset hurdle rate. The hurdle rate is typically set to the riskless Treasury bill rate within a return calculation period. In order to be fair to the investors, the hedge fund manager calculates new profits, so that previously achieved "high-water marks" on which performance fees have already been paid are not levied as a repeat performance fee. There could be situations where hedge fund investors who paid performance fees and subsequently are subjected to capital value drawdown due to market volatility. These investors are not levied any additional performance fees until the capital value recovers to the level, called a "high-water mark," at which they had paid performance fees. Investors entering and exiting the same hedge fund at different points in time are likely to have differing high-water marks.

Valuation of a Hedge Fund Management Company

The publicly traded shares of investment management companies offer unusual insights into the world of hedge funds, also called "alternative" investment funds. While the shares of conventional investment managers trade at 0.4 percent to 0.5 percent of assets under management, those of "alternative" investment managers such as Blackstone Group, Och-Ziff Capital Management, and Fortress Investment Group trade at about 20 percent of assets under management in normal equity market conditions.

This glaring difference in the market valuation of investment management companies (as a percentage of assets under management) is directly attributable to the performance fee that exists in hedge funds, but that is absent in SEC-regulated mutual funds. The SEC attempt at defining hedge funds cited earlier stated, "(Hedge funds) receive a management fee that includes a substantial share of the performance of the fund." The SEC did

not provide a quantitative estimate of the performance fee here. It is widely known that the performance fee of hedge funds is roughly 20 percent of profits, and some hedge funds are known to charge up to 25 percent of profits. Usually, "excess" profits are calculated in excess of a hurdle rate, equal to the U.S. Treasury bill rate, and in excess of a high-water mark. Thus, performance fees apply at a 20 percent rate on new profits generated during the calendar year (in excess of previously achieved profits engraved into a "high-water mark," and further, in excess of the hurdle rate for that year).

From an economic perspective, the performance fee is a call option granted by investors to the hedge fund manager, much like executive stock options. A performance fee can never be negative. Asymptotically, if the hedge fund consistently sustains positive excess returns over the hurdle rate, it is simply 20 percent, or one-fifth, of this excess return. Thus, if a hedge fund consistently earns 10 percent per year in excess of the Treasury bill hurdle rate, the performance fees would amount to 2 percent per year of hedge fund investors' capital (20 percent, or one-fifth, of 10 percent excess return is 2 percent). When such a hedge fund is scaled to a size of the order of $1 billion, cash flow from performance fees to the hedge fund manager is on the order of $20 million per year. This is nearly all pure profit, since the fixed fees paid to the hedge fund manager by the investors cover the operating costs and expenses of the hedge fund manager.

Despite the seemingly large absolute amounts of performance fees in this example of superior returns that are paid to the hedge fund manager, investors examine their net returns after all fees and evaluate associated risk. The enormous growth of the hedge fund market reveals the presence of a large number of hedge fund managers who deliver superior risk-adjusted returns. The mavericks among these hedge fund managers and their innovative strategies are keenly pursued by investors.

The valuation of alternative investment and hedge fund management companies at about 20 percent of assets under management almost directly reflects the markets' valuation of this upside call option granted to the fund management company by the limited partner investors, also combined with an expectation of the growth in assets under management. This stock market valuation also establishes the willingness of investors in limited partners to grant a call option on the upside of the hedge fund, as much as 20 percent of their initial investment, to the hedge fund management company. In an efficient market of rational institutional investors, this would suggest that investors expect superior risk-adjusted returns net of these enormous performance fees, and that the hedge fund management companies are privy to a secret sauce that would produce high returns from alternative investments that still remain attractive to investors after these high performance fees.

Economies of Scale in Hedge Funds

Perhaps the most compelling feature of the hedge fund industry is the remarkable economies of scale. A relatively small fixed-cost operation is able to manage many billions of dollars. Typically, a single talented and experienced financial market trader with a few assistants and the support of a competent back-office that manages paperwork and IT (information technology) infrastructure can comfortably manage $2 billion to $5 billion. This could be considered the most profitable cottage industry to date. It is not surprising that various surveys estimate that there are 7,000 to 10,000 hedge funds today, which supposedly exert exposure to a significant portion of the global capital markets, amounting to several trillion dollars. Indeed, the tracking and reporting of performance of all these hedge funds has become a significant mini industry. In the United States, during the past decades, traditional institutional investors, such as pension plans, endowments, and insurance companies, dominated the U.S. capital markets. Today, U.S. and global hedge funds are at least as significant as traditional institutional investors in participating in the U.S. capital markets.