

Launching an Incubator Hedge Fund

What is an incubator fund?

For managers without committed investors ready to seed their start-up hedge fund, an incubator fund is a cost-effective way for to generate a track record with which to attract outside investors before going to the time and expense of establishing a full-fledged hedge fund. Generally a manager will contribute their own capital to the investment vehicle and manage its assets for 6 to 12 months in order to test investment strategies and create a track record. Once successful, the manager can reach out to prospective investors to obtain indications of interest. If such indications are positive, the time and expense of establishing a full-fledged fund will be worthwhile.

How is it structured?

Typically an incubator fund is structured by forming two separate entities: a limited partnership (LP) or a limited liability company (LLC) to serve as the fund along with an LLC to serve as the investment manager of the fund and the general partner of the LP. This structure provides the foundation and allows for an easy transition to the full-fledged fund. If the fund will eventually be marketed to non-U.S. citizens and/or tax exempt persons the manager should consider establishing offshore entities instead, although a domestic structure can also be used before investors are taken on.

Incubator fund provides flexibility

Since there are no investors during the incubator phase there are no complex investor level accounting issues. It's much easier to prepare accounting and NAV reports. Annual tax preparation is also a breeze; almost as easy as preparing tax returns for any trader entity. This saves money and reduces time with tax and legal professionals. Since most complications arise when investors come into the fund, an incubator fund can save you many headaches while you get the fund's business operations in order. The incubator phase also gives you the time to fine tune your business plan. When your incubator fund is successful and you're ready to meet with prospective investors, it's time to complete your hedge fund business plan and incorporate it into your offering documents. With the time afforded during this two-step process, you can benefit from hindsight and experience. Maybe you want to change systems, your management team, brokers, or take soft dollars. Since you can tweak your hedge fund business plan before preparing your offering documents, those documents will be more representative of your revised operations than if you created them on day one. Since these offering documents are the way you

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fulfill your disclosure obligations, the incubator approach provides added legal and compliance protection.

How is an incubator fund taxed?

As a partnership, the incubator fund is a pass-through entity for U.S. tax purposes, meaning that the fund's realized income and gains are taxed on the investor level only (i.e. not at the company level). Gains, losses, income and deductions are reported on Schedule K-1 of the investors 1040 unless the manager is trading through a single member LLC in which case the LLC will be disregarded and tax items will be reported on Schedule C of the managers 1040.

What is the cost to establish an incubator fund?

A domestic incubator fund can be established for between \$2,000 - \$3,000 (plus state filing fees) depending on whether the LLC and/or LP will have more than one member/partner. A British Virgin Islands based incubator hedge fund will range anywhere from \$4,000 to \$6,000 and a Cayman Islands based incubator fund will range from \$6,000 to \$8,500.

Can I accept outside investors during the incubator phase?

Because an incubator fund does not have the traditional “full” offering documents outside investors should generally not participate in the fund during the incubator stage. Managers who would like to incubate a track record with outside money should create a full set of offering documents - namely establish a full-fledged fund. In certain circumstances an incubator may be permitted to accept limited investments from friends and family *for no compensation* but legal counsel should be consulted to discuss the relevant legal issues prior to accepting such investments.

Can I begin to gather indications of interest from potential investors during the incubation phase? If so, what kind of information should I send out?

Yes. Although you cannot market interests in the fund or accept capital from outside investors during the incubation period, you can begin gathering indications of interest through your personal network, friends and family (i.e., those with who you have a pre-existing relationship). And you may market your term sheet to potential investors during this phase as well. But keep in mind that advertising or solicitation to the general public is prohibited. In addition, holding yourself out publicly as an investment adviser is also generally prohibited, depending on your state of residence.

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Can I use a track record prior to the incubator to gather indications of interest and eventually when marketing the fund?

While a trader may have lots of experience, securities laws make it difficult and expensive to use prior performance to promote a new venture. However, showing past and prior performance may be allowable under certain restrictive circumstances by using appropriate disclaimers and disclosures. If prior performance is used, these figures must be audited for accuracy in accordance with the GAAP and verified in accordance to the standards established by the CFA. This is expensive but if you have a stellar prior record and plan on using the same trading strategy and environment in your new fund, it may be worth the cost and effort to go this route.

How do I transition an incubator fund to a full-fledged hedge fund?

With the existing entities already in place and a marketable track record to show potential investors, transitioning your incubator fund to a full-fledged fund is usually a straight forward process. Once you are ready to launch the fund, you should consult legal counsel regarding the preparation of formal offering documents for the fund, which will include a private offering memorandum, partnership agreement, and subscription documents. You may also need to engage additional service providers, such as a third-party administrator, prior to launching a full-fledged hedge fund.