



# Forex hedge fund management

The number of hedge funds and hedge fund investors has soared. Forex traders looking to start a fund need to understand the rules and regulations before they quit their day jobs.

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It's understandable why hedge funds have become so popular in recent years — from a trader's perspective. A talented hedge-fund manager can accrue substantial income, and while starting a hedge-fund obviously isn't for the novice forex trader, it's not as complicated as it seems.

Let's assume a trader has a modest \$3 million under management and his forex hedge fund has a 1-percent management fee and a 20-percent performance allocation fee (i.e., a share of the profits). Assume the fund was started on the first day of the year and returned 15 percent.

In this case, the trader would have gross income of \$120,000, consisting of a \$30,000 management fee ( $\$3 \text{ million} * 1\% = \$30,000$ ) and a \$90,000 performance allocation ( $\$3 \text{ million} * 15\% \text{ return} = \$450,000 * 20\% = \$90,000$ ). Using all the same assumptions, a hedge-fund manager with \$10 million under management would make \$400,000.

Also, because prospective investors like to see fund managers' risk their personal capital, assume the fund manager has a significant portion of his own money invested in the fund. Because there are no fees assessed (it would just increase taxes), the trader earns an additional 30 percent on his own investment in the fund.

However, before a trader can potentially enjoy these rewards, he or she must structure a proper business. The good news is forex traders are now positioned to quickly launch a forex

fund with minimal regulatory oversight.

## Forex fund basics

Regulation D, Rule 506, of the Securities Act of 1933 defines a forex fund as an unregistered security offered as a private placement. Regulation D provides "safe harbor" provisions which, if complied with, exempt the private offering from compliance with the registration and prospectus delivery requirements of federal securities laws. However, Regulation D does not exempt the offering from compliance with the fraud provisions of the federal and various state securities laws.

Most foreign currency trading is eligible for favorable federal income tax treatment.

Forex funds must supply all investors with comprehensive information about the offering in "disclosure documents." The purpose of these documents is to limit the hedge fund's potential risk by providing full disclosure to investors.

A typical set of disclosure documents includes a private placement memorandum, an investor questionnaire and subscription agreement, and an operating agreement for the fund.

Most foreign currency trading is eligible for favorable federal income tax treatment. Regulated futures contracts, regulated commodity option contracts,

forward contracts, and over-the-counter options in currencies for which there is also trading in regulated futures, all qualify as "Section 1256 contracts." Gains in these instruments are taxed at a maximum federal rate of 23 percent (60 percent of the gains and losses are long-term and 40 percent is short-term). In addition, the fund usually qualifies as a "trader in commodities," so the investors are able to deduct the fund's expenses more favorably than expenses in an investment partnership.

Performance-based compensation for fund advisers is usually structured as an allocation of profits, but it is sometimes structured as fees — in

either event typically between 10 and 20 percent of trading profits. In some instances, the compensation agreement specifies that funds be only paid when the profits of the fund exceed a minimum rate, or "hurdle rate."

## Exempt forex funds

To be exempt from registration under the Securities Act of 1933, a fund must have no more than 100 beneficial owners (also known as the "100 investor test") and must not publicly offer its interests.

Under the Section 3(c)(7) exemption, a fund must offer its securities to

“qualified purchasers.” There are no limitations on the number of qualified purchasers under the Investment Company Act of 1940.

However, when there are more than 500 investors in the limited partnership, the entity may be subject to classification as a “publicly traded entity.” If that occurs, the entity could lose its flow-through tax treatment (i.e., a partnership) which is one of the primary benefits of the hedge fund’s structure.

### **Accredited vs. non-accredited investors**

Generally, “accredited” investors includes persons whose net worth (or joint net worth with spouse) exceeds \$1,000,000, or whose income was in excess of \$200,000 in both the two preceding years (or, with a spouse, in excess of \$300,000 in both the two preceding years), and who reasonably expect to reach the same level of income in the current year.

If you plan to have “non-accredited investors” in your fund, you will not only need a detailed set of disclosure documents, but also audited documentation of the source of initial capital invested in the fund. This initial audit is referred to as a “launch audit” or as a “seed-capital audit.” Regulation D limits the number of non-accredited investors to 35.

Taking on non-accredited investors is risky because if there are ever any problems with the fund’s performance and investors seek relief in the courts, a judge would probably take the side of the non-accredited investor.

### **How do I attract investors?**

Rule 502(C) of Regulation D prohibits any form of a general solicitation or general advertising. Generally, interests in your hedge fund may be sold by registered broker dealers, registered investment advisors or officers of the fund’s management to those persons with whom they have existing relationships.

Your marketing efforts must be per-  
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## **Steps to launch a forex hedge fund**

1. If you need to register as a Commodity Pool Operator (CPO), start the process, which you will continue while executing the rest of these steps. See [www.iard.com](http://www.iard.com) to get started.
2. Determine what will make your hedge fund unique. Finalize the fund’s investment objective and investment strategies, prepare biographical data on yourself for the offering documents, and make decisions that will affect how often you accept investors, how you will be compensated, what expenses your fund (as opposed to the management company) will bear, how you will be set up regarding trader tax status, etc.
3. If you are forming a commodity hedge fund, start the process of becoming a member of the NFA. See this page: [http://www.nfa.futures.org/registration/nfa\\_membership.asp](http://www.nfa.futures.org/registration/nfa_membership.asp). You will need to register as a Commodity Pool Operator with the NFA. See <http://www.nfa.futures.org/registration/cpo.asp>.
4. Obtain a first draft of your offering documents (Private Placement Memorandum, LLC Agreement, and Subscription Materials) from your provider (the firm advising you on setting up your hedge fund). Form your business entities, get tax ID numbers, make the appropriate IRS elections, and prepare resolutions so you can open bank and brokerage accounts.
5. Your provider’s attorney should be actively involved in the review of your documents. This is an important part of the preparation of your fund.
6. If you are registered as an Investment Adviser or registered with the NFA as a Commodity Pool Operator, make sure the regulators have approved any such applications.
7. Your provider should give you the SEC Form D and the blue sky filings for the initial states where you expect to distribute your offering documents. Make sure your provider gives you instructions on how and where to file the various documents, and general instructions regarding the distribution of your offering documents. You should now have a final set of offering documents.
8. Have your offering documents printed and bound. Consider the image you wish your fund to project when choosing the printing materials and binding method. Remember that you can have no marketing materials other than your offering documents.
9. Mail your SEC Form D. You can check here to see that it was processed by the SEC: <http://www.sec.gov/edgar/searchedgar/companysearch.html>. File your blue sky filings within the appropriate time – either before distribution or within 15 days of the first sale in that state, depending on the state’s rules.
10. Start distributing your offering documents and attracting investors. Keep a log of all individuals to whom you distribute your documents. Deposit your seed capital and start the initial trading of the fund.



sonally directed toward investors who are known to you. The SEC views non-personal communications as "general solicitations," even when the targeted recipients of the communications could reasonably be expected to be qualified investors.

However, it is possible to comply with the prohibitions against general solicitation or advertising by using a secure Web page for which access is limited to accredited investors.

### **Blue sky**

Within 15 days of the first sale of your offering, you will have to file your Form D (Notice of Sale) with the SEC as well as comply with filing requirements of the states in which each of your investors are located. Then you need to be sure that your securities are sold without violating the prohibition on general advertising.

### **NFA registration**

If your forex fund invests in currency futures contracts, currency futures options, or forward contracts, it must be approved as a commodity pool by the Commodity Futures Trading Commission (CFTC). In addition, you must register with the National Futures Association (NFA) and become a Commodity Pool Operator (CPO).

This raises the differences between registration as a CPO and a commodity-trading advisor (CTA). A CTA manages individual accounts, while a CPO manages only the hedge fund, or pool. Many people lose interest in the CTA option when they realize the administrative hassles associated with managing separate accounts.

Spot forex trading is not regulated by the CFTC and does not require CPO registration if the fund trades spot currencies exclusively. Legally, "spot currency" refers to contracts that settle by the second business day after the date the trade is entered.

While CFTC registration is not required for spot forex traders, it is important for fund managers to trade with firms that are NFA registered, as NFA registered members are subject to

arbitration, capital requirement rules, and customer account regulations.

No sponsor is needed to take the Series 3 exam, also known as the National Commodity Futures Examination, which is administered under the auspices of the NASD's testing program. You can find the nearest testing location at [www.nasdaq.com/NASDW\\_010803](http://www.nasdaq.com/NASDW_010803).

The CFTC has allowed the NFA to become the primary regulator of futures and commodity products (as a self-regulatory organization, similar to the NASD's status with the SEC).

The item that will typically take the most time for processing of a CPO application is the fingerprint card, which is supplied by the NFA. A CPO will take it to their local police station and have their fingerprints taken. The card is then mailed to the NFA, which sends it to the FBI for processing. This takes six to eight weeks, and there is no rush service available, so take care of this very early in the application process.

The NFA must approve all disclosure documents before they can be used to solicit clients. If the NFA has comments, it will usually give them to the CPO candidate verbally, and in writing if the CPO candidate requests.

The guide for CPOs and CTAs (see "[Web resources](#)") is an invaluable tool for creating disclosure documents. The NFA essentially uses that document as a checklist, and every item must be addressed to their satisfaction before they will approve disclosure documents.

The disclosure document must include information about the CPO and its principals (including performance record), commodity trading advisors, futures commission merchants, brokers, details of the commodity interests, expenses associated with the pool, conflicts of interest, minimum investment amounts, transferability issues, and any litigation (material, administrative, civil, or criminal) against anyone involved in the management of the fund. Additionally, any person who is involved in the commodity pool must register as an associ-

ate of the CPO.

The disclosure document must be filed with the NFA at least 21 days prior to the delivery of the documents to a prospective participant, and updated periodically. The CPO must receive a written confirmation from each participant in the pool that they received the Disclosure Document prior to accepting the participant's funds.

### **CPO registration exemptions**

The CFTC provides for several exemptions from CPO regulations. A person is not required to register as a CPO if the person did not receive any compensation or payment directly or indirectly, operated only one commodity pool at a time, or was not otherwise required to register with the CFTC. This is referred to as the "closely held pool exemption."

Registration as a CPO is also not necessary from registration when total gross capital contributions for participation units in all pools that are operated (or intended to be operated) do not in the aggregate exceed \$400,000 and there are less than 15 participants in the pool.

Also exempt from registration as a CPO with respect to the pool, where the interests have been sold exclusively to participants that the CPO reasonably believes at the time of their investments were QEPs, and the pool trades commodities in *de minimis* amounts. The *de minimis* limitations are: 1) the pool limits its commodity interests positions such that the aggregate notional value of such positions does not exceed the liquidation value of the pools portfolio, or 2) the total amount the pool commits as initial margin and premiums to establish commodity positions does not exceed 5 percent of the liquidation value of the pool's portfolio. Another requirement is the interests in the relevant pool are not marketed as participants in a vehicle for trading in commodity interests.

CFTC Rule 4.13(a)(4) establishes a CPO registration exemption for a CPO with respect to a pool where interests

are offered and sold without marketing to the public in the United States, and are sold exclusively to participants that the CPO reasonably believes are QEPs.

### **Are you going to trade stocks, too?**

If you plan to execute more than an occasional stock trade, you might also have to register as an investment adviser. Beginning in February 2006, hedge fund managers will be required to register with the SEC as investment advisers when a fund has assets of \$25 million or more and has 15 or more investors in the hedge fund.

Until then, the hedge fund itself is considered the "client" of the adviser, which affords the adviser an exemption from registration if there are less than 15 clients and the adviser does not hold itself out to the public as an investment adviser.

Funds with less than \$25 million will not be permitted to register and will be subject to applicable state law.

### **State investment adviser registration**

Each state has its own registration requirements which are also interpreted in conjunction with the National Securities Market Improvement Act of 1996.

In some instances, where the investment adviser has a particular kind of client, has fewer than a certain number of clients within a 12-month consecutive period, and does not hold itself out to the public as an "investment adviser," it may be exempt from that states' registration requirement. In each instance, it is important that the law of the state in question be reviewed for compliance.

### **More rules and regs**

In addition to the registration and solicitation guidelines summarized above, there are also federal and state laws governing the operation of the fund. These laws govern marketing and advertising, the compensation of fund advisers, fund management, personal trading, the use of soft dollars,

## **Web resources**

<http://www.nfa.futures.org/>

The home page for the National Futures Association (NFA).

[http://www.nfa.futures.org/compliance/issues\\_cpo\\_cta.asp](http://www.nfa.futures.org/compliance/issues_cpo_cta.asp) and  
<http://www.nfa.futures.org/compliance/publications/dd2001/DD2004.pdf>

The web pages are related to the NFA's Guidance to Commodity Pool Operators (CPOs) and Commodity Trading Advisers (CTAs). The second link is particularly valuable. It essentially defines the sections that need to be included with a CPO document that is submitted to the NFA. It also discusses some of the various exemptions from registration that are available. Some of these exemptions (particularly the Qualified Eligible Person [QEP] – only pools) are very powerful and should be strongly considered. The QEP exemption allows you to not have to take the Series 3, not have to become a member of the NFA, and not have the NFA or the CFTC as a regulator. Other exemptions, such as those related to small pools, may be of more benefit to certain clients.

<http://www.nfa.futures.org/registration/cpo.asp>.

The NFA's guidance related to who has to register as a CPO, and how it is accomplished. It includes a link to a page for an "Easy Reference Guide" to exemptions from registration here: <http://www.nfa.futures.org/registration/easyReferenceGuidePart4.pdf>.

<http://www.nfa.futures.org/registration/cta.asp>

The equivalent to #3, above, except that it is for CTAs.

[http://www.nfa.futures.org/registration/nfa\\_membership.asp](http://www.nfa.futures.org/registration/nfa_membership.asp)

Data related to becoming a member of the NFA. All CPOs and CTAs must be members of the NFA, unless they achieve an exemption. Note the reduced fee schedule that became effective on July 1, 2004.

<http://www.nfa.futures.org/basicnet/>

This is the equivalent of the NASDR's website, except that it is for the NFA. Through this page, you can access a summary of the status of all NFA members, including regulatory status and sanctions.

<http://www.cftc.gov/cftc/cftclawreg.htm#cea>

This is an invaluable site to review the underlying federal law related to CFTC issues. Note the various links in the body of the page as well as on the left navigation buttons.

**Securities Law:** <http://www.law.uc.edu/CCL/sldtoc.html>

State Securities Administrators: [http://nasaa.org/members\\_only/CFTC](http://nasaa.org/members_only/CFTC) Law and Regulation links: <http://www.cftc.gov/cftc/cftclawreg.htm#cea>  
Investment Adviser application (for most states): [www.iard.com](http://www.iard.com)

Our website (tons of additional data):

<http://www.greencompany.com/HedgeFunds/index.shtml>

reporting requirements, and record keeping.

Although the process is involved, experienced forex traders who wish to expand into professional money management can save themselves a great

deal of trouble later by learning now about the forex hedge fund registration process and regulations they will have to abide by in the future. ☎

*For information on the author see p. 8.*