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Legal Risk Management Tip
July 2008

CREATING AND MANAGING OFFSHORE FUNDS

The establishment and operation of hedge funds and other private funds outside the United States is becoming increasingly common. Offshore funds allow a manager to access investors located outside the United States as well as provide tax advantages to foreign and U.S. tax-exempt investors. Fund managers seeking to create and manage offshore funds should consider whether doing so is appropriate based on the fund's investment strategy and types of investors.

Generally, setting up an offshore fund and selecting the particular jurisdiction in which the fund will operate depends heavily on tax considerations, the fund's investment strategy, and the types of investors the fund intends to reach. For individuals and entities that manage money for foreign and/or U.S. tax-exempt individuals and businesses, setting up an offshore fund could be extremely beneficial. However, before making the decision to "go offshore," managers should understand the various implications of such a decision, as well as the basic organizational and regulatory considerations involved in the establishment and operation of offshore funds.

Most of the popular jurisdictions for establishing funds outside of the United States are chosen for their favorable tax environment, low cost of setting up funds, and relatively low degree of regulatory oversight. Some of the more popular jurisdictions include the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, the Republic of Ireland, and the Netherlands Antilles. Selecting a particular jurisdiction will depend on the type of investor the fund is designed for, where those investors are located and what tax or other benefits could be derived from the fund's jurisdictional location.

STRUCTURING OFFSHORE FUNDS

Correctly structuring an offshore fund is extremely important due to its complexity. Offshore funds are usually established in some type of corporate form, such as an international business company or an exempted company, and are governed by a Memorandum of Association and Articles of Association. Due to the global nature of the investment community, fund managers often want to have both offshore and domestic investment vehicles so that they attract a greater variety of investors. For managers that wish to operate both U.S. and non-U.S. based funds, offshore funds frequently are established as parallel funds to U.S. hedge funds, utilizing either a side-by-side or a master-feeder structure.

For those Fund managers who opt to utilize a "side-by-side" trading structure, the offshore fund will trade in *pari passu* with a domestic fund managed by the same manager. Consequently, offshore investors invest in an offshore fund that pursues identical trading strategies to a U.S. fund with U.S. investors. The manager then allocates trades and investments proportionally between the funds.

Other managers may use a "master-feeder" structure to simplify allocation issues and manage trading strategies more efficiently. This structure allows U.S. and offshore investors to indirectly invest in the same entity known as the master fund. U.S. investors directly invest in a limited partnership or limited liability company organized in the United States (referred to as the "domestic feeder") while the offshore investors directly invest in an offshore corporation (known as the "offshore feeder"). Each feeder fund then invests all of its assets in the master fund, thereby simplifying administrative issues for the manager and increasing the total asset level. This process makes it easier for the fund to obtain better financing terms and permits the fund to seek investments by investors that require certain minimum asset levels. However, such a structure is complex and may trigger additional regulatory considerations. Managers should weigh the various pros and cons of each structure before deciding which fund structure to utilize.

REGULATION OF OFFSHORE FUNDS

Managers of offshore funds should be aware of and adhere to all applicable regulations and requirements for the jurisdiction where the fund and its investors are located. Offshore funds generally are not subject to the U.S. securities laws or commodities regulations if shares are not sold or solicited in the United States or to U.S. citizens abroad. Therefore, most offshore funds are not registered with the Securities Exchange Commission ("SEC") nor are they subject to SEC regulations. Nonetheless, offshore funds should still consider U.S. laws and regulatory requirements if the fund is managed by a U.S. adviser, particularly if the adviser is registered with the SEC.

Setting up an offshore fund may be a beneficial decision for managers with foreign or tax exempt investors. Selecting the appropriate jurisdiction and properly structuring the offshore fund is critical to achieving positive compliance results. For more information, please contact us at (619) 298-2880.

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