Preparation of a Report on:

Hedge Fund Regulations, Structures and Strategies

Project Report submitted to Symbiosis Institute of Business Management, Bengaluru in partial fulfilment of the course "Summer Internship Program" for the award of the degree of

Master of Business Administration

Batch 2020-22

Submitted by

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Under the guidance of

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SYMBIOSIS INTERNATIONAL (DEEMED UNIVERSITY)

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Completion Certificate from Company

Morgan Stanley

July 23 2021

To Whom It May Concern

Dear Sir/Madam

Re: Ayush Gupta

This is to confirm that Mr. Ayush Gupta was employed by the Morgan Stanley group of companies from May 03 2021 to July 23 2021. Prior to his departure, he was working in the capacity of an Intern in the ISG Operations Division in India.

It is our policy only to provide references containing information as to the employee's title and dates of employment. This should not be seen as implying any comment about the employee or his suitability for future employment.

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Yours Sincerely,
Morgan Stanley Advantage Services Private Limited

Rajat Mathur
Authorised Signatory
Human Resources

Certificate

This is to certify that **Mr. Ayush Gupta** of MBA 2020-22 batch of Symbiosis Institute of Business Management, Bengaluru has completed the project entitled **“Hedge Fund Regulations, Structures and Strategies”** at **Morgan Stanley** under my guidance.

Signature of the faculty guide:

Name:

Designation:

Date:

Declaration

I hereby declare that the project submitted by me entitled **"Hedge Fund Regulations, Structures and Strategies"** at **Morgan Stanley** completed during my Summer Internship Program (SIP) is submitted as a partial fulfilment of the requirement of MBA Program at Symbiosis Institute of Business Management, Bengaluru

Project Details

Title: **Hedge Fund Regulations, Structures and Strategies**

Company: **Morgan Stanley**

Company Guide: Mr. Roydon Dsouza

Faculty Guide: Dr. Eliza Sharma

Ayush

Place: Noida

Name of the Student: **Ayush Gupta**

Date: 15/08/2021

PRN: **20020841054**

Acknowledgement

The Internship Opportunity I had with Morgan Stanley was a great chance for learning and development. Therefore, I consider myself lucky for the opportunity and to be a part of Morgan Stanley. I am also grateful for having the chance to meet so many professionals who led me through this internship period.

I would like to use this opportunity to express my deepest gratitude to Mr. Roydon Dsouza, who in spite of being busy with his duties, took time out to hear and guide me through the Internship Project.

I would also like to convey my heartiest thanks to Mr. Sathyaprakash G for providing valuable insights and direction on the subject.

Last but not the least, I would like to thank all the department heads and staff for the smooth on-boarding and functioning in the online mode and valuable training sessions conducted.

Ayush

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Executive Summary

Hedge Funds are a pooled investment vehicle targeted towards the High Net Worth Individuals (HNIs) and Institutional Investors only. They typically make use of various different strategies and financial products which makes them highly risky. The Fund Manager of the Hedge Fund tries to maximize the return and gets a separate fee known as the Incentive/Performance Fees if the fund performs above a certain pre-determined rate known as the Hurdle Rate.

Post the Global Financial Crisis, the Hedge Fund Industry is now heavily regulated by the SEC (Securities Exchange Commission) and CFTC (Commodity Futures Trading Commission). They are required to file reports such as Form 13-F, Form PF, Form CPO-PQR and follow OPERA Reporting Protocols.

Due to the Ponzi scheme created by Mr. Bernie Madoff, Hedge Funds hire the services of a Fund Administrator such as SS&C Globe Ops, Citco and Morgan Stanley to give credibility to their Investment Reports. In addition to the reporting service, the Fund Administrators help Hedge Funds by providing Reconciliation, Daily as well as Monthly GAV/NAV, Treasury, Risk Analytics, U.S. Tax Management Services and other supporting services.

In order to minimize the Tax liability of the Hedge Fund as well as of its investors, the Hedge Funds are structured strategically on the basis of factors such as the Domicile of the Investors and the potential Tax liability on them. The Hedge Fund also has to consider the strategy they will be undertaking since the use of a particular strategy such as Leverage may lead to higher incidence of taxes.

For providing returns to their investors, Hedge Fund undertake a lot risk and employ the below strategies:

a. *Long/Short Strategy*: The Hedge Fund in this strategy goes long on one Company of a particular industry and goes short on the other company of the same industry. The Hedge Fund gains if the Company it went long on performs better than the Company it went short on.
b. *Global Market Strategy*: This Strategy focuses on Major Global Macro Trends such as Interest Rates, Inflation, Currency, Economic Cycles, etc. and invests accordingly.

c. *Event-Driven Strategy*: This Strategy focuses on events related to a company or an Industry such as Mergers, Acquisitions, Bankruptcy, Liquidations, etc. These Events form the basis for Investments in Distressed Securities and Risk Arbitrage.
d. *Directional Strategy*: In this Strategy, the Fund Manager focuses on the directional movements and trends (Long/Short) which can then be applied to investments or investment vehicles.
e. *Relative Value Arbitrage Strategy*: These Strategies take advantage of relative price differences between different securities whose price the manager expects to converge or diverge over time.
f. *Dedicated Short Strategy*: In this strategy, the Hedge Fund shorts securities which are perceived to be over-priced however, in the near future they will be correctly priced.
g. *Emerging Market*: Hedge Funds specializing in this strategy seeks to trade in the Emerging Markets or the Developing Countries.
h. *Quantitative Strategy*: In this strategy, the Hedge Fund uses Quantitative Analysis which uses Mathematical and Statistical Models that relies on huge datasets. High Frequency Trading is an example of Quantitative Strategy.

Chapter 1

❖ Industry Analysis

A Fund Administrator is a company that primarily provides services to hedge funds. Its main role is to provide accounting and back-office services to hedge funds.

In general, the Fund Administrator assists the Hedge Fund Manager with a number of tasks. The central service is the accounting of investor contributions and withdrawals on a monthly or quarterly basis, as well as the computation of Profit and Loss for the Accounting Period. Other services, such as Transfer Agent Services, may be provided by the Administrator (handling the investor documents and ensuring wires and transfers are done properly).

Some Administrators additionally offer a "Second Signer" service, which is aimed to give investors more trust in the reporting and ensure that the Hedge Fund does not misappropriate their funds. When the Hedge Fund Manager wants to make a transfer or a withdrawal from the Fund's Account, he or she must also acquire the Administrator's approval under the Second Signer Agreement (Hedge Fund Administator - What is a HedgeFund Administrator? | Hedge Fund Law Blog, n.d.).

In addition to the aforementioned services, the Fund Administrator may also provide the following:

- Calculation of Management and Performance Fee
- Conduct Anti-Money Laundering Review
- Work with the Auditors for Reporting
- Serve as a Registered Agent and Registrar for Offshore Hedge Funds
- Price Verification and Maintenance of Books and Records

Firms such as SS&C GlobeOp, Citco, Morgan Stanley, State Street IFS, Northern Trust, US Bancorp are some of the biggest providers in the industry.

❖ Company Analysis

Morgan Stanley is an Investment Banking and Financial Services Company headquartered in New York City. It was established by Harold Stanley, Henry Morgan and Dean Witter as a response to the Glass-Steagall Act, which required the separation of Commercial Banking and Investment Banking. In 1986, Morgan Stanley went public and later on opens its offices in places such as Frankfurt, Hong Kong, Luxembourg, Melbourne, Milan, Sydney and Zurich.

The Company has the following three divisions:

- Institutional Securities Group (ISG)
- Investment Management (IM)
- Wealth Management (WM)

The Company earned a total of $ 48.2 Billion in Revenues providing a Return on Total Capital Employed (ROTCE) of 15.4%.

The Institutional Securities Group Division accounted for over 53% of the total Net Revenues to the firm in the FY 2020. The Division includes areas such as Investment Banking as well as Sales and Trading providing services such as Market Making Activities, Financial Advisory, and Prime Brokerage. The Fund Services forms a part of this division only.

The Investment Management Division accounted for about 8% of the total Net Revenues to the firm in the FY 2020. This Division provides traditional Asset Management services and Merchant Banking services.

The Wealth Management Division accounted for over 39% of the total Net Revenues to the firm in the FY 2020. The Division includes areas such as Loan and Fee based Clients and Flows providing services such as Advisory, Brokerage and other wealth management related services (Morgan Stanley).

The Morgan Stanley Fund Services is a subsidiary of Morgan Stanley. Its primary business is to provide fund administration services to Hedge Funds and Private Equity clients. The services provided to the clients may include the below:

- Daily and Monthly NAV Reporting;
- Intraday P&L reporting;
- Processing, Accounting and Reconciliation of Fund Security and Transactions;
- Processing of Cash wires related to Subscription and Redemption;

- Investor/Shareholder Accounting Reporting;
- Anti-Money Laundering (AML) due diligence of fund investors;
- Fund audit and support services; and
- Fund Regulations related services

❖ Introduction

Hedge Funds are pooled investment funds wherein the contribution to the pool is made only by High Net Worth Individuals (HNIs) and Institutional Investors. As per the SEC Rules, the individual should have a Net Worth of at least $ 1,000,000 or an Income of over $ 200,000 ($ 300,000 for married couple) for the last three years. Since Hedge Funds employ a variety of risky strategies such as Short Selling, Leverage, High Frequency Trading etc., they are not open for the general public to invest in. Once an Investor has invested in the Fund, he cannot withdraw from the fund till the lock-in period has expired. And once the lock-in period has expired, the investor needs to communicate to the fund concerning the redemption in advance and then only the funds are withdrawn. As such, the Redemption and Subscription to a Hedge Fund happens periodically based on the terms in the Contract. For Managing the Fund, the Hedge Fund Manager receives two different fees, namely, Management Fees and the Incentive/Performance Fees.

While Mutual Funds are also pooled investment funds, they are available to the general public unlike Hedge Funds. Another difference between the two stems from the fact that Mutual Funds are more regulated and cannot make high-risk investments. Mutual Funds are also highly liquid since they allow daily subscription/redemption but Hedge Funds typically allow subscription/redemption on a monthly/quarterly basis so that the Hedge Fund Strategy can be maintained and hence less liquid. In terms of fees, Mutual Fund also charges a management fee however, unlike Hedge Funds no Incentive/Performance Fee is charged.

In the Pre-GFC Era, Hedge Funds were not bound to much regulations however, post the GFC, Hedge Funds are now under the ambit of SEC, CFTC and OPERA Reporting Requirements. These Organisations require the filing of Form-PF, Form 13-F, Form CPO-PQR and Reporting as per OPERA Albourne Investor Transparency Standards. There are other tax filing related activities as well which the Hedge Fund needs to follow.

For Taxation purposes, it becomes important to know what type of a fund and structure a particular Hedge Fund follows.

There are two types of hedge funds based on domicile, namely, *Onshore* and *Offshore*. If a fund is based in the United States then it is an Onshore Fund however, if the fund is based in a country/territory other than that of the United States such as Cayman Islands and British Virgin Islands then it is known as an Offshore Fund.

With respect to the Structure of a Hedge Fund, there are five different types of structure as below:

a. *Master Feeder*: This structure requires the creation of a Master Fund which is then used as the fund for transactions and other hedge fund activities.
b. *Side-by-Side*: In this type of structure, the Hedge Fund Manager tries to execute the strategy on two different funds, i.e., Onshore and Offshore Fund simultaneously.
c. *Standalone*: In Standalone, there is either an Onshore Fund or an Offshore Fund which is used for the fund transactions.
d. *Mini-Master*: This Structure is similar to the Master Fund however, there is an absence of a separate domestic feeder and the investors invest directly into the Master Fund.
e. *Intermediate*: This Structure requires the creation of an Intermediate between the foreign feeder and the Master Feeder.

Hedge Funds also need to calculate the Month End (ME) Gross Asset Value (GAV) and based on that calculate the Net Asset Value (NAV) which is then used to determine an Investor's share of holdings for Subscription, Redemption and Positions.

❖ Objectives

- Understand how the Fund Administrators provide transparency to the Hedge Fund Investors and how their services help Hedge Funds in Middle Office Operations.
- Understand the various Regulations applicable on Hedge Funds and the filings of the same.
- Observe the different types of Hedge Funds and their respective Structures.
- Analysis of different Hedge Fund strategies employed and their implications for the Hedge Fund.
- Understand the Calculation of GAV and NAV by the Fund Administration Team.
- Understand the relevance of Daily and Monthly tasks and processes completed by the Fund Administration Team.

Chapter 2

❖ Research Methodology

The Research Methodology used in this Report is descriptive. It provides a detailed analysis of the various types of Hedge Funds and how they are structured keeping in mind the factors that determine or influence the same; the various Regulations applicable on Hedge Funds and the filing guidelines of these regulations; the different strategies used by Hedge Funds and their implications on Hedge Funds and lastly the accounting processes to determine the Gain/Loss, Hedge Fund Fees and the final computation of GAV/NAV which is shared with the Investors and Shareholders of the Hedge Fund.

To understand the various aspects of the Project, an in-depth analysis was done on different types of Hedge Funds to better understand their structure, strategies employed and regulatory filing completed by them. Furthermore, the accounting processes were observed to understand the working of the Accounting Team and relevance of each process in determining the GAV, Hedge Fund Fees and NAV under the guidance of professionals from respective departments. The Tools used by the Team also helped in getting a thorough understanding of the project and the suitability and usefulness of such tools in increasing efficiency for the team and the clients.

❖ Limitations of the Study

The following limitations were observed while undertaking the study:

- The Primary Limitation of the study is that the same is completed in online mode and no hands-on experience was acquired for the same. Additionally, no analytical study was done considering the confidentiality of the data.
- The Data for the Project has been acquired through various sources available in the Public domain and not of any client(s). As such, the analysis is also done on the same.
- The Study is focussed on US domiciled Hedge Funds as the country is home to many Hedge Funds and the availability of secondary data is also high for the same.

Chapter 3

❖ Analysis of Data

Since the Research is qualitative, no data-driven analysis has been done. However, certain graphs and comparisons have been made to better differentiate certain terms.

Following are the areas of Analysis done under the Project:

- Regulations
- Types of Hedge Funds
- Structures
- Strategies
- Working of the Accounting Team

❖ Regulations

Hedge Funds are required to file the below:

a. *Form-PF*: This form needs to be filed on a quarterly or annually basis by SEC Registered Investment Advisors who manage any number of private funds with at least $ 150 Million in AUM as of the most recent fiscal-year end. The Form's purpose is to submit data to the Financial Stability Oversight Council (FSOC) in order for it to identify systemic patterns in the industry and their influence on US financial markets.
   Large Private Advisors are hedge funds with Regulatory Assets Under Management of more than $ 1.5 billion and are obliged to file the Form within 60 days of the end of each fiscal quarter whereas Hedge Funds having Regulatory Assets UnderManagement of less than $ 1.5 Billion and more than $ 150 Million are known as Smaller Private Advisors and have to file the form within 120 days of fiscal year end annually.
b. *Form 13-F*: This form needs to be filed on a quarterly basis by all institutional investment managers with at least $ 100 Million in AUM. This form requires the disclosure of the fund's equity holdings.
   Form 13-F is required to be filed within 45 days of the end of a calendar quarter. The Form requires disclosure of the name of the institutional investment manager that files the report and with respect to each Section 13(f) security over which it exercises investment discretion, the name and class, the CUSIP number, the number of shares as of the end of the calendar quarter for which the report is filed and the total market value.
   Section 13(f) security: These Securities generally include equity securities that trade on an exchange, certain equity options and warrants, shares of closed-end investment companies and certain convertible debt securities. The Official list of securities is shared on the SEC Portal on a quarterly basis.
c. *Form CPO-PQR*: This form needs to be filed only by Commodity Pool Operators (CPOs) registered under National Futures Association (NFA) and Commodity Futures Trading Commission (CFTC) and was introduced in 2012. CPOs are investment structures that combine investor contributions to trade in the Futures and Commodity Markets. They are also known as Managed Future Funds (Form CPO-PQR | LSEG, n.d.).
   The filing defines CPOs within 3 classifications based on size:

- A Small-Sized CPO is classified as having less than $ 150 Million in pool AUM at the close of business during any day in the course of a quarter.
- A Mid-Sized CPO is classified as having more than $ 150 Million but less than $ 1.5 Billion in pool AUM at the close of business during any day in the course of a quarter.
- A Large CPO is classified as having more than $ 1.5 Billion in pool AUM at the close of business during any day in the course of a quarter.

There are three Schedules in total on the form: A, B, and C. All CPOs are required to file the Schedule A within 15 days after the end of the quarter. Schedule B must be filed by Mid-Sized CPOs within 90 days of the end of the fiscal year, whereas Schedule B must be filed by Large CPOs within 15 days of the end of each quarter. The Large CPOs also have to file the Schedule C within 15 days of the end each quarter.

The below sets out the information required in various Schedules:

Schedule A, Part 1 (for all CPOs):

- General Identifying questions around the firm's identification and key firm information.
- AUM and Net AUM

Schedule A, Part 2 (For each Pool):

- General Information
- 3rd Party Admins, Brokers, Custodians, Marketers, Auditors
- Monthly and Annual Performance
- Subscription and Redemption Information

Schedule B (For Mid and Large Sized CPOs):

- Pool Information (Including Strategies and Investment Techniques)
- Top 5 Counterparties by net counterparty credit exposure
- Trading and Clearing Practices
- Value of pools derivatives positions
- Detailed Schedule Investments by Type

Schedule C, Part 1 (For Large CPOs):

Aggregated Information for the commodity pools:

- List of Investments by Geography
- Portfolio Turnover

Schedule C, Part 2 (For Each Large Pool):

- Liquidity of Portfolio
- Pool Counterparty Credit Exposure
- Pool Risk Metrics
- Pool Borrowing Information
- Pool Derivative Position and Posted Collateral
- Pool Financing Liquidity
- Information on Pool Investors
- Duration of fixed income assets

d. *OPERA Albourne Investor Transparency Report*: The Open Protocol Enabling Risk Aggregation (OPERA) has set out certain standards for reporting to their investors. These standards, although are not mandatory for a Hedge Fund to follow however they are desirable and provides the investor reports with credibility.

Various 3rd Party firms and Fund Administrators provide Hedge Funds with the services to help them in filing these regulations.

❖ Types of Hedge Funds

There are two types of Funds which are discussed below-

Onshore Fund	Offshore Fund
Funds based in US	Funds based outside of US
Typically domiciled in Delaware, where the State Income Taxes and Personal Income Taxes are non-existent in certain conditions.	Typically based in Cayman Islands and British Virgin Islands as both the territories are tax neutral.
Funds are considered as Capital but Shares are not issued.	Shares are issued for the investment.
Investment Lots can be aggregated	Investment Lots can be aggregated yearly only
No Withholding Tax needs to be charged on Dividends	Withholding Tax needs to be charged on Dividends

Cayman Island Hedge Funds: Cayman Island is one of the most popular offshore jurisdiction. All the Hedge Funds in Cayman Islands can be categorised as either Registered with the CIMA (Cayman Islands Monetary Authority) or Unregistered (Offshore Hedge Funds Structure and Considerations, n.d.). Currently, it has over 10,000 Registered offshore hedge funds.

A Hedge Fund needs to be mandatorily registered with the CIM if it satisfies the below conditions:

a. The Fund is Open Ended has more than 15 Investors, or
b. The Fund has less than 15 or equal to 15 investors and those investors do not have the right to appoint or remove the Director.

If the Offshore Fund is registered then the Fund as to fulfil the below requirements:

a. Payment of Annual Fees of US$ 3048 to the CIMA,
b. At least 2 directors who must be individuals (not necessarily resident of Cayman Islands),
c. An Auditor who is situated in Cayman Islands and
d. A minimum initial investment of US$ 100,000 or higher.

❖ Structures

The Structure of a Fund depends on the need of the investors and the strategy adopted by the Fund Manager. Depending on the same, a Fund Manager may choose to follow one of the below structure:

a. *Commingled Fund*: A Commingled Fund is the most traditional fund structure. The Assets of the Investors are pooled into a single entity or account and then managed by the Fund Manager. This ensures that the strategy utilized by the Fund Manager is equally applicable for all investors and hence the operational efficiency is maintained.

b. *Managed Accounts*: Managed Accounts is a vehicle in which a single investor invests the money instead of pooling from a variety of investors. This Structure often requires a sizeable commitment from the investor due to operational difficulties of setting a fund however, the ownership lies with the investor only.
   The benefits of Managed Accounts include transparency for investor and customization of investments strategy as per the investor requirement; healthy liquidity due to limited subscription/redemption.

c. *Fund of One*: This structure is a combination of Commingled and Managed Accounts. A single investor invests a sizeable amount in a separate entity, most often an LLP for which the Manager is responsible and liable. This ensures some customization to the investor with governance and control in the hands of the manager (Hedge Fund Fees Types and Structures, n.d.).

d. *Side-Pockets*: A side-pocket is a mechanism within a fund whereby certain assets are compartmentalized due to illiquidity or the difficulty in valuing them. Assets in the Side-Pockets are valued separately from the main portfolio.
   At times, the Fund Manager may choose to value the assets in the side-pocket at the cost incurred to acquire them to calculate the Management Fee and NAV so as to avoid valuing them vaguely.

The Structure of a Hedge Fund depends on the following factors:

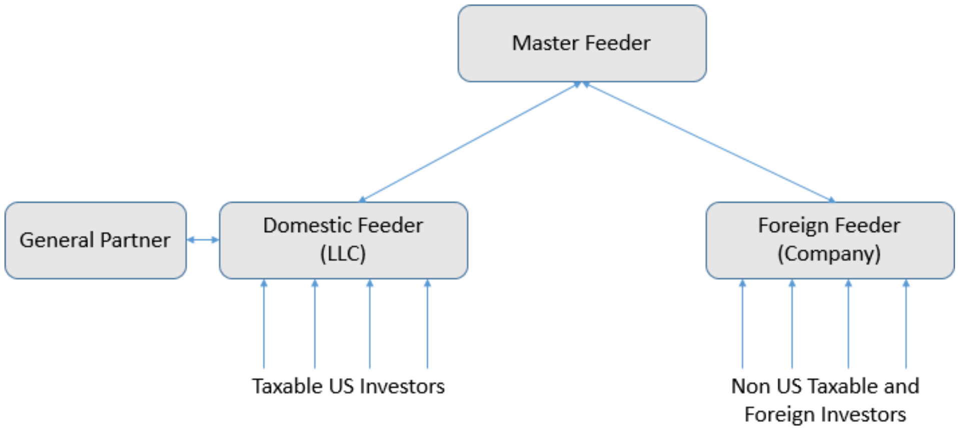
1. Fund Domicile
2. Investors Location
3. Tax Liability of Investors
4. Hedge Fund Strategy
5. Fund's Investment Criteria

Based on the above, a Hedge Fund can have the below Structures:

a. *Master Feeder*: This type of structure is the most common and requires the creation of a single main Feeder containing all the funds known as the Master Feeder which is used for all the transactions and securities. The Funds in the Master Feeder comes from two distinct Feeders, one known as the Domestic Feeder (containing funds provided by US Investors and incorporated as Limited Liability Corporation) and the other known as the Foreign Feeder (containing funds provided by Non-US Investors and US Tax Exempt Investors and incorporated as a Company). Typically, the Master Fund is incorporated as a LLC in the United States and predominantly in the State of Delaware due to Tax benefits to both the fund as well as the investors (John S. Lore, 2017).
   Advantages- It reduces trading costs as the Master Feeder is used as the main fund and the strategy does not need to be replicated in other feeders. It also eases the administrative burden of maintaining multiple portfolios.
   Disadvantages- If the Master Feeder is incorporated in the United States then it may be subject to UBTI if the Foreign Feeder is not incorporated as a Company however, if the Master Feeder is incorporated outside of the United States then Withholding Tax at the rate of 30% on Dividend may be charged. Secondly, the investment strategies available may not be advantageous to all investors at all times. For example, Long Term Capital Gains are preferable to US Taxable investors but not for Tax Exempt and Foreign Investors and hence the Hedge Fund may choose to hold an investment longer for favourable tax treatment.
   Suitability- This Structure is suitable for Funds with both US Taxable as well as US Tax Exempt and Foreign Investors.

UBTI (Unrelated Business Taxable Income): UBTI is a debt financed income derived by the Hedge Fund which does not relate to the activities of the tax-exempt investor such as Income earned from the use of Leverage. UBTI is generally taxed at the rate of 35%. To ensure the tax-exempt investors do not pay this tax, the Master Feeder structure with a Company as the Foreign Feeder helps to avoid the UBTI tax burden.

Figure 1: Master Feeder Structure



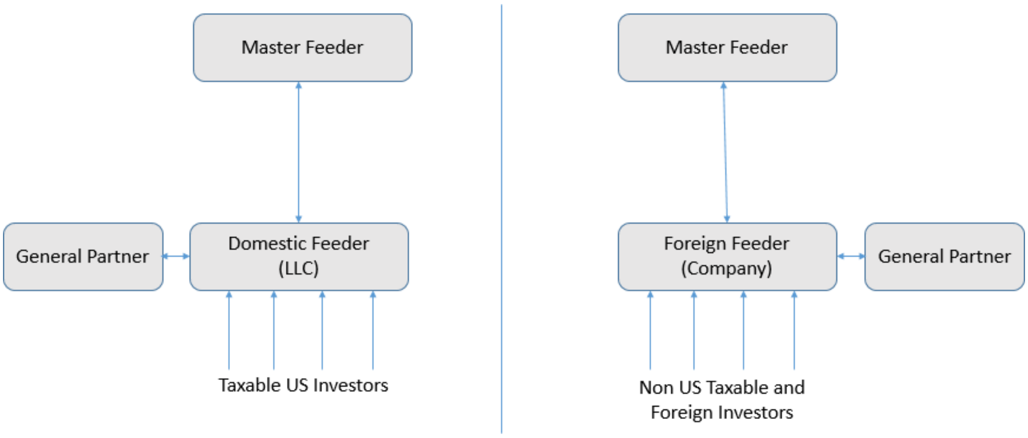
b. *Side-by-Side*: In a side by side structure, the domestic and foreign feeders are kept separate and the same strategies are applied individually.

Advantages- This type of structure provides tax benefits and clarity as the tax liability can be better managed and the fund manager may choose strategies keeping in mind the potential tax liability. This structure also helps in managing the UBTI liability.

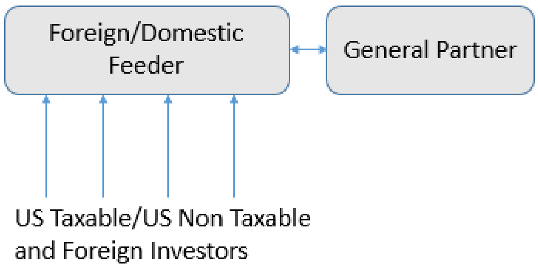
Disadvantages- This Structure brings inefficiency as the hedge fund manager has to execute the trades on both funds separately while trying to achieve similar performance. Hence, the trading costs and administrative costs also become higher. The Fund Manager also has to ensure that the strategies undertaken are not illiquid and can be replicated easily to both the feeders.

Suitability- The Structure is suitable where the Fund Manager wishes to segregate the Domestic and Foreign Feeder in order to follow a Strategy which require the same.

Figure 2: Side by Side Structure



c. *Standalone*: In a standalone structure, there is either a Domestic Feeder or a Foreign feeder which is used for all of the transactions. This kind of structure is suitable only for homogenous Investors. If the investors are US Taxable then the Domestic Feeder will be incorporated as an LLC however, if the investors are US Tax Exempt or Foreign Investors then the Foreign Feeder will be incorporated as a Company.
Advantages- Suitable for homogenous investors and provides clarity in tax liability and better management of the same. The Trading Costs and Administrative Costs are also low.
Disadvantages- Homogeneity in Investors is the main requirement of the structure and as such may not be possible for Hedge Funds to adopt the same.
Suitability- The Structure is suitable where the Investors of the Fund are homogenous, i.e., either they are US Taxable Investors or US Tax Exempt or Foreign Investors.
Figure 3: Standalone Structure



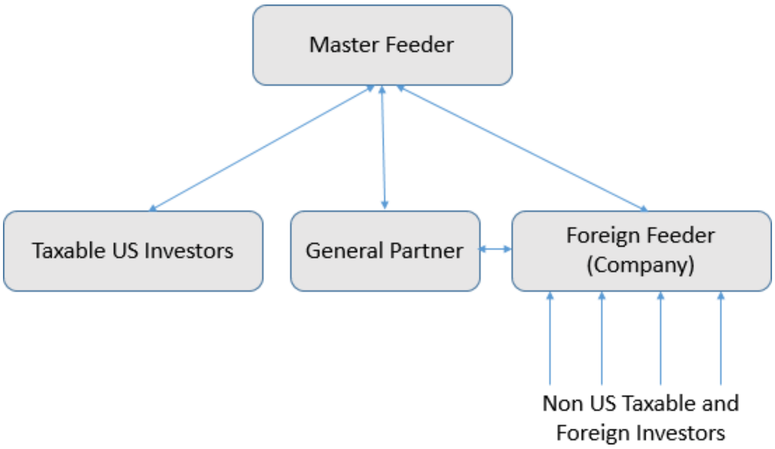
d. *Mini-Master*: Mini-Master Fund structure is similar to the Master Feeder structure. The point of distinction occurs due to the absence of the Domestic Feeder as the Domestic Investors directly invest into the Master Feeder. The Domicile of the Master Feeder is also in the US and incorporated as an LLC.

Advantages- The Structure blocks UBTI and provides other tax benefits to US Tax Exempt and Foreign Investors. It also saves administrative cost and the creation of a separate LLC for Domestic Feeder.

Disadvantages- The Structure has to be carefully set-up and maintained to ensure tax liability is kept to the minimum (Master Feeder Hedge Fund Information, n.d.).

Suitability- The Structure is suitable for lower costs with both US Taxable Investors and US Tax Exempt and Foreign Investors.

Figure 4: Mini-Master Structure



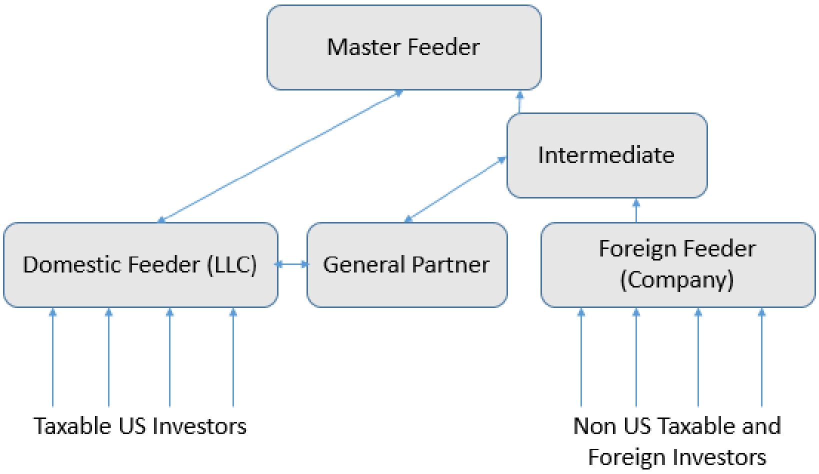
e. *Intermediate*: This a relatively new Structure which is closer to the Master Feed Structure. The Point of distinction occurs due to an intermediary vehicle between the Master Feeder and the Foreign Feeder which helps in grouping the investors. It also provides the General Partner the opportunity to invest or receive funds outside the US Territory.

Advantages- Provides General Partner opportunity to invest/receive fees outside US Territory.

Disadvantages- High Administrative Cost due to the inclusion of another vehicle.

Suitability- The Structure is suitable for Fund Managers having presence outside the US with both US Taxable Investors and US Tax Exempt and Foreign Investors.

Figure 5: Intermediate Structure



- If a Hedge Fund is set-up in the United States then it may lead to taxation for the Tax Exempt Investors if the Fund uses Leverage in its strategy as the same leads to Unrelated Business Taxable Income (UBTI). To block the same, the Tax Exempt investors are grouped in a Company which protects them from the same.
- The General Partners are the fund managers who have unlimited liability whereas the Limited Partners are the investors who have liability equal to the investment to be contributed.

Considering the above structures, Mini-Master Fund Structure is the most cost effective in terms of both the tax liability as well as the administrative costs for Hedge Funds with both US Taxable Investors and US Tax Exempt and Foreign Investors.

When it comes to the structure of fees, Hedge Funds usually follow a “2 and 20” agreement wherein the Hedge Fund charges a 2% fee on the Assets under Management (AUM) as Management Fee. To provide an incentive to the Hedge Fund Manager to achieve high returns, Hedge Funds charge a 20% Incentive/Performance Fee on the AUM which is applicable once the Fund achieves a return higher than a pre-agreed threshold.

Some of the alternative fee structures are mentioned below:

a. *Founder Shares*: In this structure, Start-up and Emerging Hedge Fund offer incentives to the investors during the early stages of their business. Such incentives are known as “Founder Shares” wherein the investors are entitled to lower fees such as a “1.5 and 10” instead of a “2 and 20” agreement. Alternatively, the Hedge Fund might offer a lower rate of fee agreement once the fund achieves a return over and above a specific threshold. For example, the fund may charge a fee of 2 and 20 till 20% and above that threshold 2 and 15.
b. *Discounts for Capital Lockup*: In this Agreement, the Hedge Fund offers a discount for locking up the capital with the Hedge Fund for a pre-determined period. Such kind of Agreements helps Hedge Fund Managers to pursue strategies requiring a long term investment for high ROI (2 and 20 - How the 2 and 20 Hedge Fund Structure Works, n.d.).
c. *First Loss*: In this structure, the Fund Manager also invests in the Fund and in case of losses, the loss is first allocated to the Fund Manager’s Capital and then to the investors. For Example, if a fund manager has invested $ 10 Million in the fund and the fund incurs a loss of $ 5 Million then the Capital provided by the Fund Manager is reduced by the amount of loss incurred to protect the investors capital. Such an arrangement is risky for the Fund Manager and hence they charge a higher fee on positive returns.
   As well as taking the losses, the Managers may also receive the gains first so as to make their capital whole again then profits are split determined by the performance fee. This is known as a first: first structure (Akingbehin, 2018).

❖ Strategies

Hedge Funds seek absolute return rather than relative return, that is, they look to make positive return whether the overall market is up or down in a variety of financial instruments through strategies which are as follows:

a. *Long/Short Equity*: In this strategy, the Hedge Fund takes long as well as short positions on two competing companies in the Industry based on relative valuation.

   For example, if Company A looks cheap as compared to Company B then a Fund might take a Long position in Company A and a Short position in Company B of equal value. If Company A outperforms Company B then the Fund gains no matter the situation in the market. In case Company B's stock price gains but does not outperforms the stock of Company A then too the Fund gains since the loss from Company B will be off set if there is no Short bias in the strategy. As such, the Fund may undertake to increase exposure to long or short and their payoff will shift accordingly.

b. *Global Macro Strategy*: In this strategy, the Hedge Fund analyses the macroeconomic trends such as Interest Rate, Inflation, Currencies, etc. and then invests in Asset Classes and securities which are most sensitive to their analysis.

   For example, if the Fund expects the Currency Exchange rate to change in favour of Company A, then the Fund will take a long position based on the same. Typically, the Fund will try to take positions which are most sensitive to the change so as to maximise its profits/gains. To maximise its gains, the Fund may also choose to invest in Derivatives which will help the fund in increasing its payoff however, the risk also increases accordingly.

c. *Event Driven Strategy*: The Fund Manager in this strategy tries to take advantage of the events such as Acquisitions, Mergers, Bankruptcy, Reorganizations, Liquidation, etc. These Events form the basis for Investments in Distressed Securities and Risk Arbitrage.

   For example, The Hedge Fund may buy senior secured debt of companies filing for bankruptcy in the hope of getting the par value or with small haircut in the reorganisation plan. In Risk Arbitrage, the fund intends to gain from the narrowing gap of the target stock's price and the acquirer's valuation of that stock in an intended takeover deal. For example, if the price of Company A's stock is currently at $ 10 and Company B offers a price of say, $ 15 then the fund will take position in Company A before the deal/acquisition is completed. The Margin for the fund gets lower as the stock price level reaches the offering price.

d. *Direction Driven Strategy*: In the Directional approach, managers bet on the directional moves of the market (long or short) as they expect a trend to continue or reverse over a period of time. A Manager analyses market movements, trends or inconsistencies, which can then be applied on investments or other investment vehicles such as Long or Short Equity Funds and Emerging Market Funds.

   For example, if the fund is of the opinion that the Market has entered a Bull phase, then the Fund will invest accordingly.

e. *Relative Value Arbitrage Strategy*: It is an investment strategy which seeks to take advantage of price differentials between related financial instruments such as stocks and bonds by simultaneously buying and selling the securities thereby allowing funds to potentially profit from the "relative value" of the two securities.

   This strategy is also referred to as 'pairs' trading since the fund will be investing in two related securities with high correlation. The strategy can be further sub-categorised as Fixed Income, Yield Alternatives and Volatility.

   Since the securities in this strategy are related, it is typically used in a side market, when the market is neither rising nor falling but trades within a specific range. However, it is difficult to gauge whether the market will stay in the range or not which increases the risks of the strategy.

f. *Dedicated Short Strategy*: In this strategy, the Hedge Fund takes a short position in securities which are perceived to be over-priced. The goal is to earn returns by maintaining a net short exposure in securities. Since the potential gain is limited but losses are unlimited, the strategy is considered very risky.

   For example, the Fund undertakes a short position in a Company whose stock price is at $ 100. The Fund's potential gain is equal to $ 100 however, the losses can amount to many times more than that.

g. *Emerging Market*: Hedge Funds specializing in this strategy seeks to trade in the Emerging Markets or the Developing Countries. They analyse the Emerging Markets and are exposed to high Currency Risk as well as the Operational, Liquidity and Credit Risk which they may hedge through the use of Derivatives. However, the Financial and Derivative Market in these countries are not developed and hence it becomes difficult for the Hedge Fund to hedge.

h. *Quantitative Strategy*: In this strategy, the Hedge Fund uses Quantitative Analysis (QA) which uses Mathematical and Statistical Models that relies on huge datasets.
High Frequency Trading is an example of Quantitative Strategy wherein the Fund may develop Algorithm and based on that the system trades by itself at a very fast pace to ensure the gains are made as fast as possible. In such cases, the Hedge Fund ensures the Trading Costs are less since the trading volume is very large (O'Hara, 2021).

❖ Working of the Accounting Team

The Accounting Team is tasked with preparing the daily reports for clients, calculating the GAV, Hedge Fund Fee and NAV. This ensures that the figures with the clients are accurate and also provides the investors of the Hedge Fund with confidence in the reporting.

GAV (Gross Asset Value) – The GAV is the total value of Assets Under Management of a particular fund. The same is calculated and shared with the Fund Manager on a Daily basis.

For Managing the Fund, the Hedge Fund Manager receives two different fees, namely, Management Fees and the Incentive/Performance Fees. The Management Fees is charged for the general management of the Fund which is typically 2% of the Assets Under Management (AUM). The other fee charged by the Hedge Fund Manager is the Incentive/Performance Fee which is charged only when the performance of the Fund is over and above a rate known as the Hurdle Rate for a period known as the catch-up period. In order to ensure the fund is being managed properly and is not recovering losses, the performance fee is chargeable above the highest level of the fund known as the High-Water Mark.

NAV (Net Asset Value) – The NAV is the total value of Assets under Management after deducting the performance fee (if any). As such, the difference between GAV and NAV is of the Performance Fee only.

Below is a summary of how the Accounting Team may compute the GAV on a daily basis:

- On a given day, the Hedge Fund transacts and provides the necessary details to the counterparty and records the same in its own books as well.
- Next day, the Team receives the trade details from both the counterparty/custodian as well as the Fund.
- The Team then Reconciles and creates a Report for Breaking Items which is then handed over to the Accounting Team for analysis. Such exceptional items can be related to Dividends, Price Mismatch on securities, etc.
- The Accounting Team then analyses individual transactions and reconciles the same based on the Individual Asset Class and Security.
- In some extra-ordinary scenarios, the Team will discuss with the Client issues related to the Reconciliation such as Pricing mismatch.
- Once the Reconciliation is done and the breaks are resolved, GAV is calculated by the Team by aggregating the value of all Assets and is then shared with the Fund Manager.

For Month End, the Accounting Team also calculates the Performance Fee (if any) as well which is necessary for the calculation of NAV. Depending on different Hedge Fund Structure, the Performance Fee is calculated differently. For example, Offshore Funds charge the Performance Fee at the Company level and hence the process of 'Equalisation' is followed to ensure there is a balance in Shareholder's liability (Understanding Master-Feeder Accounting).

Once the Performance Fee is calculated, it is deducted from GAV and divided by the Number of Shares outstanding to arrive at NAV. The below table highlights the same.

Table 1: Calculation of NAV

Particulars	Amount ($)
Assets:	
Investment in A	4,000,000.00
Investment in B	5,000,000.00
Total Investments	9,000,000.00
Profit and Loss from Investments	1,000,000.00
Total Assets	10,000,000.00
Fund Expenses:	
Trading Expenses	50,000.00
Non-Trading Expenses	50,000.00
Total Fund Expenses	100,000.00
Performance Fee	20%
Actual Profit and Loss	900,000.00
GAV	9,900,000.00
Performance Fee	(-) 180,000.00
NAV	9,720,000.00

	Investments in the beginning	Profit and Loss	Performance Fee	Investments in the end
Onshore Investors	4,500,000.00	450,000.00	90,000.00	4,860,000.00
Offshore Investors	4,500,000.00	450,000.00	90,000.00	4,860,000.00
Total	9,000,000.00	900,000.00	180,000.00	9,720,000.00

No. of Shares	4500
NAV per share at the beginning	1000.00
Total NAV (Offshore Investors)	4,500,000.00

No. of Shares	4500
NAV per share at the end	1,080.00
Total NAV (Offshore Investors)	4,860,000.00

Chapter 4

❖ Findings and Conclusions

The Project has helped in gaining an understanding of the Hedge Fund Industry and its requirements. It has also helped in gaining an understanding and importance of the Fund Administrator.

Below are some other findings and conclusions from the Project:

- Hedge Fund Managers are given incentive in the form of Performance Fee to give high returns to their Investors. It also means that the Fund Manager may take considerably high risk in order to provide high returns.
- Since Hedge Funds take a lot of risk, they are now regulated and need to compulsorily file reports to various regulators in order to ensure the Financial System does not take a hit due to an unforeseen event.
- Depending on various factors such as the taxability of investors and domicile, a Hedge Fund can incorporate different structures in order to ensure the taxability remains low to both the investors as well as the Hedge Fund.
- The Fund Services Team systematically helps Investors through Transparent Reporting and provides the Fund Manager with tools so that they are able to make sound decisions in an efficient manner.

❖ Suggestions and Recommendations

- Working of different departments and knowledge should be shared so that the understanding of related work and how it complements and provide value to the client can be understood. In certain cases, rotation of employees can be done between departments on a need to know basis.

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