Hedge Funds (April 2006)

The term “hedge fund” dates from the early 1950s. Initially, it described collective investment vehicles, often organized as private partnerships, that specialized in combining two investment techniques, short sales (borrowing a security and selling it in the hope of being able to repurchase it more cheaply before repaying the lender) and leverage (buying securities with borrowed money) in a way that reduced risk. By shorting a basket of stocks to protect against a general drop in equity prices, and then borrowing money to buy particular shares they deemed undervalued, these funds “hedged” their positions so as to prosper whichever way the market moved. Hence the name of hedge funds.

Modern hedge funds are a far more eclectic group. They share only one important characteristic: compensation strategies. Typically, hedge fund managers are paid a modest management fee, but receive a hefty 15-20% or so of any profits the fund makes. Some critics argue that this structure creates incentives to take inordinate risks, because managers share the upside if the risks pay off but not the downside should the risky strategies fail. However, the fact that many hedge-fund managers put their own capital into their funds may mitigate this risk.

By accepting money from limited numbers of high networth individuals or institutional investors, and by basing themselves in places where regulation is lax, hedge funds escape the standard reporting requirements faced by mutual funds. As private investment vehicles, hedge funds are exempt from many basic regulatory requirements, giving their managers broad discretion. Most hedge funds are local, niche players, yet all carry their own marketing and support structures. Hedge funds are extremely flexible in their investment options because they use financial instruments generally beyond the reach of mutual funds, which have sophisticated regulations and disclosure requirements that largely prevent them from using short selling, leverage, concentrated investments, and derivatives. This flexibility, which includes use of hedging strategies to protect downside risk, gives hedge funds the ability to best manage investment risks. The strong results can be linked to performance incentives in addition to investment flexibility.

The huge rise in Gulf stock markets the past years, high oil revenues and strong liquidity as a result of the diversion of funds from the western capital markets to the maturing markets in the GCC after the September 11 events, has left investors with a problem, albeit a nice one, where to invest their money. These investors are becoming more sophisticated and thus increasingly willing

to put money into "alternative investments" such as hedge funds in their search for market-beating returns.

Because hedge funds can sell short, use leverage and take concentrated positions, they can produce those superior returns, although admittedly, they bear higher risks. These factors will definitely fuel growth in popularity of hedge fund assets in the Gulf region.

The offshore funds market is growing rapidly and the Cayman Islands (“Cayman”), the British Virgin Islands (“BVI”) and Bermuda have become the pre-eminent jurisdictions for the establishment of investment funds.

The similarities of the key features in each jurisdiction are i) **Trustworthy and reliable legal systems**. The laws of all three jurisdictions ensure that funds in these jurisdictions can be structured as internationally accepted vehicles; ii) **Flexibility in fund structure.** Funds in any of the jurisdictions may be formed as companies, partnerships or unit trusts according to investor requirements; iii) **No direct taxes.** There are no capital gains, income, profit, corporation or withholding taxes or any legal restrictions on the investment policies and strategies of funds in any of the jurisdictions.

But which is the best jurisdiction? There is no definite answer to this question. Funds vary widely, and therefore, the best way to approach this question is to examine the differences between these jurisdictions and what each jurisdiction has to offer and see how this compares to what the client needs.

For example, the Cayman offers an exemption for funds with less than 15 investors, as long as the majority in number are capable of appointing or removing the operators of the fund. If the client has this type of fund structure in mind then Cayman may be the better option, as it will completely avoid registration with a regulatory authority. Such a structure in the BVI will fall under the Private Fund category requiring an application for recognition to the BVI regulatory authority.

For some promoters, the location of certain service providers, such as investment managers or administrators, is very important. In Cayman, with the exception of Administered Funds, which require a local administrator, there are no specific requirements with regard to the location of investment managers, advisers, administrators and custodians. In the BVI, fund managers, advisers, administrators and custodians of all BVI funds must be domiciled in the BVI or in a recognized jurisdiction.

So, in the event that a fund is to have, for example, an investment manager domiciled in China (or in any other country not regarded as a recognized jurisdiction by the BVI), Cayman may be the more suitable jurisdiction.

Industry perception may also be a factor for the client in deciding where to domicile a fund. Cayman is currently the most popular jurisdiction for offshore funds and sophisticated investors may be more comfortable with Cayman rather than the BVI.

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