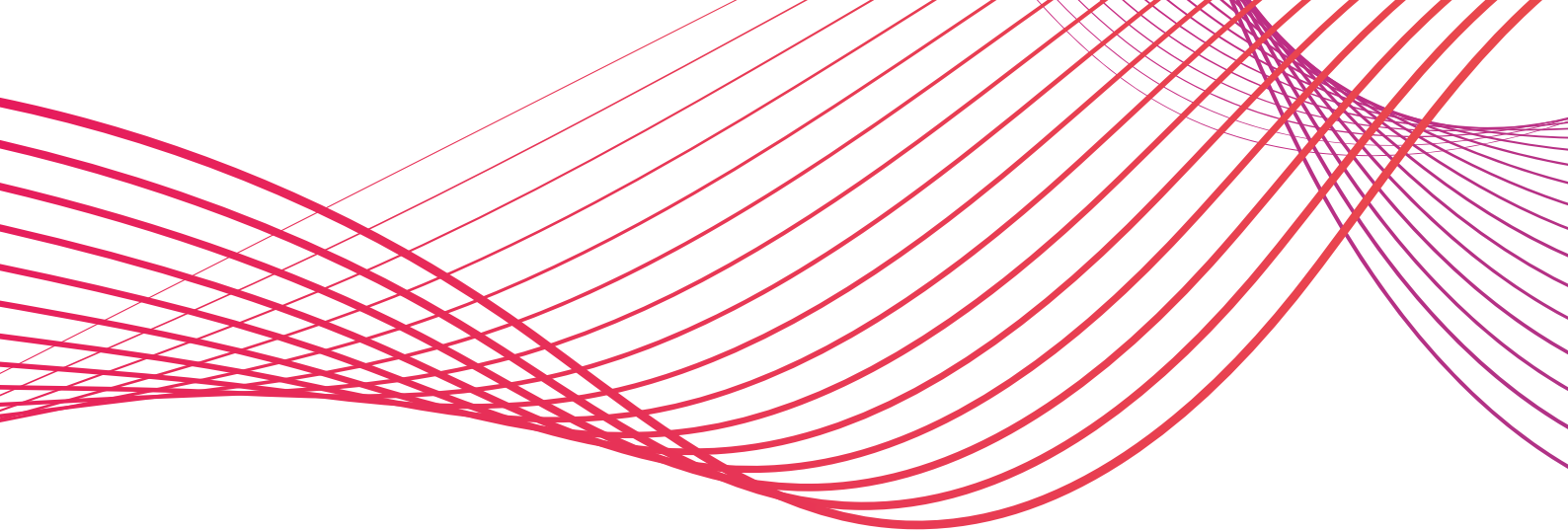




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HOW TO START A HEDGE FUND

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Introduction

The landscape of alternative investment management continues to evolve at a rapid pace. Regulatory changes, technological advancement and shifting investor expectations all have to be understood and taken account of. For fund managers navigating this complex environment, having access to clear, practical guidance has never been more critical.

How to Start a Hedge Fund brings together insights across the spectrum of hedge fund structuring, establishment and operation.

It introduced you to the initial structuring decisions that will shape a fund's future, through the intricacies of prime brokerage relationships and regulatory compliance, to the on-going challenges of marketing and investor relations. Each chapter looks at the key areas of consideration encountered by fund managers.

What sets *How to Start a Hedge Fund* apart is its practical focus. Rather than offering theoretical frameworks, it provides guidance on the decisions that matter most: choosing the right jurisdiction, structuring fee arrangements, navigating regulatory requirements, and building sustainable investor relationships. It is a working document that managers can return to throughout their fund's lifecycle.

For start-up managers, it provides a roadmap through what can seem like an overwhelming array of considerations. For established managers, it serves as a comprehensive reference for ensuring best practices across all aspects of fund operations.

So here is our practical, comprehensive guide to help you build a successful, compliant, and sustainable investment business.

How to set up a hedge fund

Introduction

When setting up a hedge fund, you will need to consider the following matters:

- Jurisdiction
- Regulatory considerations
- Fund structure
- Eligible investors
- Authorisation and regulation
- Directors and other service providers
- Share classes
- Fees
- Equalisation or series accounting
- Lock up, redemption periods and gates
- Listing

In order to determine these issues, you will need to seek professional advice from your tax advisors and legal counsel. You may also find our new funds questionnaire useful in helping distil your thoughts:

Jurisdiction

A standard hedge fund will generally be based in an offshore jurisdiction, such as the Cayman Islands, the British Virgin Islands, Bermuda, Guernsey or Jersey,

so that the investor, rather than the fund, pays tax on the increase in value of the fund's portfolio. For some investment managers, jurisdictions such as Luxembourg, Malta and Ireland are more attractive, due to perceived EU advantages, while others are deterred by the regulation which comes with an EU alternative investment fund ("AIF") as well as an EU alternative investment fund manager ("AIFM") and some prefer the UK. Which jurisdiction you choose will often depend upon the type of fund structure used, regulatory factors and the tax environment of the fund's potential investors.

Fund Structure

The types of hedge fund structure most commonly seen are: stand-alone, master/feeder and umbrella funds, segregated portfolio companies (SPCs) and side-by-side.

Stand-alone fund

A stand alone fund is a single fund in which investors invest by purchasing shares and the subscription monies are then traded by the fund directly in the markets.

Master/feeder fund

A master/feeder structure is generally used if the fund is being promoted to two separate categories of investor: (i) US taxable investors and (ii) US non-taxable and non-US investors. These two categories will, for US tax and compliance reasons, wish to invest in separate entities and this is generally achieved by setting up a master/feeder structure with two feeders, one for each category, which both feed into the master fund. Investors subscribe for shares in the relevant feeder and each feeder then subscribes for shares in the master fund, which then trades on behalf of the feeder funds.

Umbrella fund

An umbrella fund is a single legal entity which has several distinct sub-funds, each of which are traded in effect as individual funds. This allows a fund to create different classes of shares, which generally trade different strategies by investing in underlying companies which conduct all trading. By this use of subsidiaries, the assets and liabilities of each share class are generally segregated from those of the other classes of shares. This type of structure is often used, for example, if the fund wants to apply leverage to some shares and not to others and the segregation means that any downside (or upside) as a result of a riskier strategy will, in most circumstances, only affect that share class and not those share classes pursuing a less risky strategy. The umbrella fund can also be the master fund in a master/feeder structure.

SPCs

An SPC, referred to as a protected cell company or similar in certain jurisdictions, is a fund which segregates the assets and liabilities of different portfolios, or cells, from each other and from the general assets of the SPC itself. The segregated portfolios (or cells) are each a separate legal entity with the intention being that only the assets of each segregated portfolio are available to meet liabilities to creditors in respect of that segregated portfolio. A point to note, however, that although SPCs are found

in a number of jurisdictions, in one form or another, the concept of segregation has not been fully tested in the courts. An SPC can also be the master fund in a master/feeder structure.

Side-by-side fund

A side-by-side fund structure comprises two single funds, each of which takes a different category of investor but trades the same strategy. Again, investors invest by purchasing shares and the subscription monies are then traded by the fund directly in the markets.

Eligible investors

The promotion of hedge funds is restricted by law and they may only be promoted to certain categories of investors as set out under relevant law; as a result they are generally directed at institutional investors, such as pension funds and sophisticated high net worth individuals and, save with the exception of UCITS funds, are not available to the general public. The investment manager and/or any other distributor of a hedge fund is responsible for ensuring that shares in the fund are being offered only to eligible investors. UCITS may be offered to retail clients, but this is due to the fact that a UCITS fund incorporates certain investor protection and investment arena mechanisms.

Authorisation and regulation

The fund

Unless the hedge fund is exempt from regulation in the relevant jurisdiction (due to its size or the number of its investors, for example), it will be necessary to register the fund with the relevant authority, such as the Cayman Islands Monetary Authority (CIMA), the Central Bank of Ireland or CSSF (the Luxembourg regulator), for example, and will be regulated by that authority accordingly. Depending on the type of fund, this regulation can range from paying a prescribed annual fee and submitting the fund's prospectus to

obtaining approval of the service providers and any subsequent changes to those service providers.

The investment manager

In the UK, an investment manager must be authorised by the Financial Conduct Authority (the FCA). As part of the approval process, the investment manager has to demonstrate that it has adequate financial resources, has determined the systems and controls it will need to put in place and has appropriate staff carrying out controlled functions.

The investment manager will also need to be properly constituted from a legal perspective. It may be a limited liability company which requires a shareholders agreement, or a limited liability partnership which requires a partnership agreement.

AIFM Directive

The Alternative Investment Fund Managers Directive (AIFMD) is a European Directive which was transposed in UK law by 22 July 2013 and onshored into the UK post-Brexit. All alternative investment funds managers established in the UK, whether they manage UK or non-UK AIFs, are subject to the AIFMD. The AIFMD also governs the marketing of AIFs in the UK.

The scope of the AIFMD is broad and, with a few exceptions, covers the management, administration and marketing of AIFs. Its focus is on regulating the AIFM rather than the AIF. An AIF is a 'collective investment undertaking' that is not subject to the UCITS regime, and includes hedge funds, private equity funds, retail investment funds, investment companies and real estate funds, among others.

All investment managers established in the UK, whether they manage UK or non-UK funds, are subject to the AIFMD. Investment managers based outside the UK who wish to market their fund in the UK must meet certain conditions.

The Directive contains provisions on:

- Scope
- Organisational requirements
- Leverage
- Depositary
- Delegation
- Risk management
- Liquidity management
- Reporting/disclosure requirements
- Annual report

The impact of the AIFMD on AIFMs depends on the size of the assets under management of the AIFM, which determines whether the AIFM is a "full-scope" AIFM or a "sub-threshold" AIFM. Full-scope AIFMs are those AIFMs whose assets under management exceed €100 million, or €500 million where the portfolios of AIFs consist of AIFs that are unleveraged and where investors cannot redeem their interest in the first five years after investing. Full-scope AIFMs are required to comply with all aspects of the AIFMD. AIFMs whose assets under management fall below the full-scope threshold will fall into the category of small, or sub-threshold, AIFM and will be regulated as such (although a small AIFM may elect to be regulated as a full-scope AIFM). This can be described as falling under a "register and report" regime. The AIFMD was onshored after Brexit and continues to apply to UK investment managers.

MiFID II

The MiFID II Directive and MiFIR (MiFID II) form the legal framework governing the requirements applicable to investment firms outside the AIFMD, trading venues, data reporting service providers and third country firms providing investment services or activities in the UK, having been onshored post-Brexit.

The impact of MiFID II on an investment manager will depend on the specific circumstances of such manager. However, the AIFM may wish to consider

the following in light of MiFID II: (i) inducements and unbundling of research, (ii) taping and communications, (iii) conflicts of interest, (iv) product governance; and (v) client order handling.

GDPR

The General Data Protection Regulation (GDPR) aims to protect: (i) natural persons with regard to the processing of personal data and rules relating to the free movement of personal data and (ii) fundamental rights and freedoms of natural persons and in particular their right to the protection of personal data. “Controllers” and “processors” of personal data are regulated by the GDPR and have legal obligations to, among other things, provide guarantees of their ability to comply with GDPR requirements, maintain records of personal data and processing activities and implement safeguarding measures of personal data. The GDPR is quite broad in scope and the fines for breaching can be costly, therefore managers will want to ensure compliance with GDPR requirements.

Directors and other service providers

Directors

The fund will require at least two directors, who for a listed fund must be independent and this is often required for governance issues. For UK tax reasons they must be based offshore of the UK and if the fund has more than two, the majority must be based offshore of the UK. This is to ensure that central management and control is exercised, and is seen to be exercised, offshore of the UK for tax purposes and there is no danger of the fund being regarded as resident onshore or having inadvertently created a permanent establishment in the UK (and taxed accordingly). This is also an economic substance consideration. This must be adhered to strictly, as a tax authority, such as HMRC, will examine the position carefully and if they consider that acts of controlling power and authority are exercised to a

substantial degree onshore, then despite the fund's jurisdiction, it will be taxed as resident wherever the person or persons exercising that control actually exercises it. The directors are permitted to delegate certain duties but must realise that they retain ultimate responsibility for management of the fund. The directors will commonly hold quarterly meetings and may be required at other times; it is important to choose directors who will make themselves available and will execute documents promptly and efficiently and are fully suitable.

Other service providers

In addition to an investment manager, a fund requires an independent administrator, an independent auditor and, depending on the details of the investment strategy, a custodian and/or prime broker. Some funds appoint a manager as well as an investment manager and this is often done for tax reasons, as the manager is usually based offshore.

The fund will also require legal counsel, who will be responsible for establishing the fund and preparing and negotiating the various fund documents, including the prospectus, the material contracts between the fund and its service providers and incorporation documents. The fund will also need to consult tax advisors to enable the relevant parties to determine which structure is suitable in their own circumstances.

Share classes

It is common for a hedge fund to create management shares and investment shares. The management shares hold the voting rights, but do not participate in the profits of the fund, while the investment shares are non-voting, but do participate in the profits and are redeemable. The reason for this is to avoid having to seek the consent of the investors, who could be numerous, for decisions arising in the day to day management of the fund.

Within the investment shares, the directors can choose to create any number of share classes. All

the shares in the same class must be treated equally, thus it is necessary to create different share classes to accommodate varying rights, such as different redemption rights, different fees, the use or non-use of leverage or, most commonly, alternative currencies. UK taxable investors may wish to invest in reporting regime share class, if possible. A hedge fund will often offer a separate share class for investment solely for the officers and employees of the investment manager, which will not be subject to any management or performance fees so as to avoid the investment manager charging itself fees.

Funds may also consider establishing a class of share for UK taxable investors which could benefit from the reporting regime.

Fees

In addition to the fund startup costs (as to which see below), the investment manager will charge management and performance fees. These can range between 1% - 5% and 10% - 25% respectively, but a typical fee structure for a hedge fund is 1.5% to 2% and 20% respectively. Other on-going fees for the fund include administration fees, regulatory fees, auditor fees, custody and brokerage costs, directors' fees and other professional costs.

Equalisation and series accounting

Equalisation or series accounting ensures that a performance fee is charged only to those investment shares which have appreciated in value and which equates precisely with each share's performance. Both methods are used by hedge funds and most administrators are able to offer both. Under the equalisation approach, there is one NAV per share for the entire fund and individual adjustments are made to each shareholder's account by issuing a small number of equalisation shares each month, if necessary. Series accounting uses multiple series of shares (one for each period of issue), each with a

different NAV per share and each series has its own high water mark.

Lock up, redemption and gating

Traditionally, a hedge fund is relatively liquid and investors are able to redeem their shares upon a certain notice period, which could range between 30 and 180 days and in the event that insufficient notice is given, the investor could be charged a redemption fee (usually between 1% and 5% of the amount being redeemed). However, some funds (increasingly so after the recent financial crisis) may choose to put an initial lock up in place, which means that no share can be redeemed within that lock up period, which could, for example, range from 6 months to 3 years. A hedge fund with a lock up is understandably less attractive to investors as its liquidity is compromised and its imposition will therefore depend on the strategy pursued and, in some cases, the agreement of the seed investor(s).

There has been an increase in the use of "investor gates" which impose a gate on redemptions at investor rather than fund level. This can be seen as a compromise to allow a fund to impose a gate but ensure that it does not adversely affect small investors who might be affected if a large investor were to seek to make a redemption which is over the fund's gate.

Side pockets

Where a hedge fund holds assets that are hard to value reliably or are relatively illiquid (in comparison to the redemption terms of the fund itself), the fund may employ a "side pocket". A side pocket is a mechanism whereby the fund segregates the illiquid assets from the main portfolio of the fund and issues investors with a new class of shares which participate only in the assets in the side pocket and which cannot be redeemed by the investor. Once the

fund is able to sell the side pocket assets, the fund will generally redeem the side pocket shares and pay investors the proceeds. Side pockets therefore allow a fund to ensure that all investors in the fund at the time the relevant assets became illiquid will bear any loss on them equally and allow the fund to continue subscriptions and redemptions in the meantime in respect of the main portfolio. Side pockets are generally used as an emergency measure only.

Timing

A hedge fund can take an average of approximately three months to set up, but this timing depends on a number of factors, not least the responsiveness and co-operation of the relevant parties and whether the investment manager is authorised or not.

New funds - key structuring questions

Introduction

This questionnaire is designed to consider the main issues to be considered when structuring a fund and thus which will need to be set out in the offering memorandum. It is important that the information given in the offering memorandum is correct. The fund's directors will be responsible for ensuring that that they have taken all reasonable care to ensure that, to the best of their knowledge and belief, the information it contains is not only in accordance with

the facts, but also that it does not omit anything likely to affect the import of that information.

Not all the issues referred to below will be relevant in all circumstances. However, this questionnaire will help identify issues and prompt consideration with the aim of drafting the offering memorandum specifically to suit the specific circumstances.

Main points to consider:

2.1 Fund structure

Name of fund	
Size of fund	
Currency of the fund	
Structure (M/F, Exempt, SPC etc)	
Jurisdiction of fund	
Open-ended or closed-ended fund (if closed-ended, what is the duration?)	
Will the fund be listed?	
Preferred timescale	

2.2 Shares and investor details

Proposed share classes	
Investment share details	
Management share details	
UK taxable investors hence reporting regime share class considerations	
Type of investor: US taxable; US non-taxable; non-US?	

2.3 Functionaries

AIFM – small or full. Note that it must be appointed by or on behalf of the AIF under the AIFMD	
Any regulatory hosting platform	
Investment advisor and/or distributor	
Third party distributor	
Offshore manager, entity holding IP or similar	
Directors of the fund	
Auditors	
Custodian/prime broker/clearing broker	
Administrator	
Bank	
Depository (consider AIFMD)	

2.4 Assets and investment strategy

Investment strategy	
Investment objective	
Nature of assets and investment types	

Investment process and risk management details	
Investment restrictions	
Article 23 requirements (AIFMD)	
Borrowing/leverage policy	

2.5 Subscriptions, redemptions and NAV calculations

Minimum initial subscription	
Minimum subsequent subscription	
Subscription price per share after launch	
Amount to be paid up on subscription	
Frequency of dealing for subscriptions	
Frequency of dealing for redemptions	
Amount to be paid on redemption	
Redemption notice period	
Frequency of NAV calculations	
Seed investor details	

2.6 Fees

Management fee per share class	
Performance fee per share class	
Hurdle rate	
High water mark or Series	
Set-up and on-going costs	

Prime brokerage and ISDA agreements

Introduction

Brokerage and trading agreements are some of the most important that a fund enters into. Custody, pricing which can drag down otherwise solid performance and margining are key to all trading.

What do prime brokerage and ISDA agreements do?

How does the relationship they create keep your assets safe?

What are the key terms and the key risks?

Below we look at some of the points to consider and perhaps negotiate when you appoint brokers and custodians under these agreements.

The points about prime brokerage also apply in the main to clearing brokers.

Prime brokerage and custody agreements

The basic services offered by a prime broker enable a fund manager to trade with multiple brokers whilst

maintaining, in a central account with the prime broker, all of the fund's cash and securities.

These services therefore include global custody, securities lending and financing for leverage purposes as well as adjacent services such as operational support, cash management services, portfolio reporting and capital introduction.

The prime broker is generally appointed by the fund, with the fund manager acting as agent of the fund, under the terms of a prime brokerage agreement. Each bank has its own version that covers terms relating to such matters as custody, client money, transaction settlement, margin, securities lending, rehypothecation and fees.

While prime brokerage agreements are traditionally designed to protect the prime broker from the insolvency of the fund, it is important for a fund to be protected from the insolvency of the prime broker. For this reason, the following matters need to be looked at carefully:

- FCA client money rules and the segregation of assets;

- custody, not forgetting how these terms apply to sub-custodians;
- rehypothecation, or the use of the fund's assets; and
- reciprocal terms in relation to events of default and termination events, including on insolvency.

We look at these in more detail below.

Client money and segregation of assets

The Client Assets Sourcebook (CASS) sets out the FCA's regulatory framework for firms which hold money on behalf of clients. The assets remain the property of the fund and the prime broker puts in place the protections needed to prevent it from using these use client assets for its own account or misuse.

Key to the current rules are the events of Lehman's collapse and the litigation which followed.

In this litigation, the court considered the position of clients whose money was intended to be segregated, but was not. It was held that segregation takes effect on receipt of the money, rather than at the time of actual segregation, meaning that a claimant's right to its share in the client money pool upon insolvency is by reference to the amount of client money which should have been segregated upon its receipt by the prime broker. The result is that money which is held in accordance with the client money rules offers a higher level of protection to that to which the client money rules do not apply.

The FCA has since proposed and initiated a number of changes to the CASS Rules and attaches priority to an extremely high level of compliance in this area.

Custody

The holding of assets other than cash is subject to the custody rules and these are also set out in the FCA's CASS Rules.

Similar to the rules on client money, the custody rules require the fund's assets to be segregated

unless full ownership has been transferred to the prime broker (see Rehypothecation below).

As many prime brokers use sub-custodians, it is important to consider how the terms of the prime brokerage agreement apply here. It is common for the prime broker to be responsible and liable for sub-custodians and this is one reason why a prime broker may only use its own affiliates. But be careful. Liability for third party custodians can be limited. For example, the prime broker may only be subject to a duty of reasonable care in respect of the selection and on-going suitability of such sub-custodian.

Rehypothecation

The right of a prime broker to re-use client assets for its own purposes is key to prime brokerage and how banks make money.

When a fund's assets are rehypothecated, the title to those assets transfers to the prime broker and the prime broker's only obligation is to return 'equivalent assets'. This sounds sensible but insolvency has to be considered as, if the prime broker becomes insolvent at this point, the fund may only be a general, unsecured creditor in respect of those equivalent assets.

To protect itself, it is wise to include terms which set a rehypothecation limit or even forbid the use of client assets.

Termination and close out rights

Of increasing importance is to ensure that the prime brokerage agreement has adequate termination rights and close-out rights in the event of the prime broker's insolvency as the fund's assets need to be protected.

It can be difficult to negotiate protection in a prime

brokerage agreement and as a consequence, many funds spread counterparty risk by using multiple prime brokers.

ISDAs and CSAs

ISDA documentation is used for OTC transactions and is negotiated separately from the prime brokerage agreement. They cover specific trading terms and, unlike prime brokerage agreements, they follow an industry standard set by ISDA.

ISDA has developed a standard suite of documents, all of which together form a single agreement, which include:

- a Master Agreement;
- a Schedule to the Master Agreement;
- Forms of Confirmation;
- Credit Support documents; and
- ISDA Definitions.

We look at each of these below.

The Master Agreement

The Master Agreement is the main document and is not amended within itself (see The Schedule below).

It sets out the terms of each individual derivative transaction and while older versions exist, most parties use the 2002 version which includes clauses on:

- set-off;
- a single Close-Out Amount valuation;
- wider categories of transactions, such as repos and credit derivatives, included in the definition of Specified Transaction;
- grace periods for certain Events of Default reduced; and
- disclaimer or repudiation and Event of Default.

The Schedule

The Schedule is the document which takes most time and attention.

It is in the Schedule that the parties amend the terms of the Master Agreement to meet needs of the fund's particular trading strategy. As such, this is the document that the parties negotiate. Some of the clauses on which the parties concentrate are:

- key person event i.e. death, departure or incompetency and change in investment manager;
- NAV decline over certain time periods and failure to report NAV;
- failure to deliver financial statements;
- change in investment strategy;
- breach of investment restrictions; and
- prohibited transaction under ERISA.

Confirmation

The confirmation is often used in letter format and is the trumping document in a dispute. This means that any fund trading and using a confirmation must be sure that its terms, both economic and commercial, are correct. The confirmation includes:

- key dates
- payment obligations;
- payment mechanisms;
- administrative details;
- if a short form confirmation, the incorporation of the relevant ISDA definitions; and
- if a long form confirmation, the specific economic and commercial terms and conditions.

Credit Support Annex

A credit support annex (CSA) regulates collateral under the ISDA, by defining the terms and conditions under which collateral is posted to mitigate counterparty credit risk. While CSAs can be either unilateral (i.e. only the weaker counterparty is required to post collateral) they are commonly bilateral (i.e. either party may be required to post collateral). They may incorporate variation and initial margin terms if the parties choose not to use a separate document.

As with the Schedule, the terms of the CSA are negotiated, for example around:

- collateral eligibility;
- currency eligibility;
- threshold amounts;
- interest on posted collateral; and
- initial margin requirements.

The function and selection of administrators

What administrators do

Key to setting up a fund, running it smoothly and attracting investors is selecting the right administrator.

The role of a fund administrator is extensive. In some ways, it acts as the operational backbone. It conducts anti-money laundering, helps value investments and the fund's value, liaises with investors, administers the bank account and completes other activities that keep investment funds compliant, transparent, and functioning.

These can be split into the four areas set out below.

Compliance

In this role the administrator ensures that the fund adheres to complex, evolving regulatory frameworks across multiple jurisdictions. This includes maintaining current knowledge of all relevant regulatory

requirements (for example the FCA and the SEC), implementing necessary controls, and managing regulatory reporting obligations.

Financial reporting and accounting

Every fund needs accurate financial statements and this falls into the administrator's function. It will calculate net asset values, process investor transactions, maintain comprehensive transaction records and liaise directly with the investment manager, the fund's board and the prime broker. Clear, accurate and timely actions in this sphere directly impact investor confidence and the fund's regulatory standing.

Investor services

All investors need to be vetted before investment and on redemptions. As well as this, they will want to communicate with the fund during their investment period.

The administrator is responsible for managing communications, processing subscriptions

and redemptions, distributing reports, and maintaining investor records. The quality of these services directly affects investor retention and fund reputation.

Operational efficiency and independence

The administrator will, quite simply, administer the fund. It will streamline processes to minimize errors, reduce delays, and ensure timely execution of administrative tasks. If these are not conducted fully and with efficiency, problems can cascade throughout the fund's operations.

It is important to remember that the administrator serves as an independent third party to each of the investment manager and the fund. In this role it provides the governance oversight that institutional investors require as a condition of investment. This independence is intended to minimize conflicts of interest, particularly around fee calculations and asset valuations.

How to choose an administrator

Choosing the right fund administrator requires systematic evaluation across several areas, including those set out below as a checklist.

Operational competence

- ☐ Track record of accurate, timely reporting
- ☐ Robust compliance systems and processes
- ☐ Technology infrastructure capable of supporting your fund's complexity
- ☐ Demonstrated ability to scale with fund growth

Risk management

- ☐ Internal controls and oversight mechanisms
- ☐ Compliance history and regulatory standing
- ☐ Business continuity and disaster recovery capabilities
- ☐ Professional indemnity insurance coverage

Service quality

- ☐ Responsiveness to inquiries and issues
- ☐ Quality of investor communications
- ☐ Flexibility in accommodating fund-specific requirements
- ☐ Senior management accessibility

Financial considerations

- ☐ Fee structure transparency and competitiveness
- ☐ Hidden cost potential
- ☐ Service level agreements and performance metrics
- ☐ Cost relative to value provided

Red flags

- ☐ Delayed or inaccurate reporting
- ☐ Poor responsiveness
- ☐ Compliance oversights
- ☐ High staff turnover
- ☐ Outdated technology

Conclusion

Fund administration is the point at which critical infrastructure meets compliance, investor relations, and operational efficiency. The key lies in selecting an administrator whose capabilities, culture, and cost structure align with fund requirements and growth trajectory.

This should help the administrator become part of your team to help build a stable foundation that supports fund growth and investor confidence.

Marketing your fund

Introduction

Your fund is being set up and you are now ready to go and see potential investors, with the serious intention of getting them to invest with you.

But you want to make sure that you do this, in the United Kingdom, in compliance with the relevant rules.

While there is leeway during the pre-marketing stage and when there is no fund documentation, at some point you will go over the line from unregulated pre-marketing to regulated marketing. It's at this stage that you need to be sure that you always act in line with the legal and regulatory framework in the United Kingdom.

Below, we set out some of the issues you need to consider, looking at FCA permissions, financial promotion rules and the AIFMD.

FCA Permissions

Generally speaking, marketing a fund means carrying out two FCA regulated activities, each of which needs FCA permission.

These regulated activities are giving investment advice on why to invest in the fund and making arrangements for that investment, or making arrangements with a view to the investment happening.

The legal definitions of these activities allow for some flexibility in terms of giving investment advice, but where a fund is being sold it is more than likely than not that investment advice will be being given.

Similarly, while there are exclusions to the activities which make up arranging and/or making arrangements, these are difficult to fit into where a fund is being sold for investment.

The wisest course of action is always to be correctly authorised by the FCA. Indeed, most investors will only deal with regulated firms.

While many distributors have these permissions alone, most fund managers will have these permissions as part of their wider permissions to act as an investment manager. If in doubt, the FCA Register lists all regulated firms and sets out what they are allowed to do.

Some exclusions apply for overseas persons though they do not apply in all situations and being able to

fit into the precise wording of the exclusions is not always easy.

Financial Promotions

The definition of a financial promotion is wide-ranging and will cover your offering memorandum and marketing documents.

This means that you have to go through an approval process with each document and put the correct regulatory wording on each one, or find an exemption to the rules on financial promotion. Again, there is wording to add to each document where this is the case.

Regardless of which route you take, the contents of all fund marketing documents need to be clear, fair, not misleading and there should be no omission of relevant information.

The rules on financial promotions also apply to overseas persons. While fund managers who are regulated are able to approve their own financial promotions, unauthorised firms (which is likely to include overseas persons), will need to have theirs approved by an FCA regulated firm which has permission for this specific action.

One other word of warning is to make sure that social media campaigns stay within FCA rules and legislation. The FCA is clamping down on financial promotions as a whole and the misuse of social media is in its sights.

The AIFMD

Fund managers will generally be authorised by the FCA under the AIFMD as it applies post-Brexit.

How the AIFMD applies will depend on a number of factors including the jurisdiction of the fund and whether the fund manager is a sub-threshold or full-scope AIFM.

Though regulated by the FCA if you are a UK fund manager, you will still need to consider the exact AIFMD rules which apply to you and are likely to need to comply with the national private placement regime, the NPPR.

NPPR compliance generally means that a fund manager, being the AIFM, will need to notify the FCA of its intention to market each fund. This is done by completing one or more of the forms found on the FCA's website. Secondly, the fund manager may also need to include information in the offering memorandum (meaning that potential investors have this information before investing) which is set out in and prescribed by the AIFMD.

Even if this is not required, many fund managers consider it good practice to include this information as it gives sensible disclosures to investors on matters such as the fund's investment objective and strategy (and how changes to it can be made), the limits, use and risks of leverage, asset types, investment restrictions, risk management and the roles of prime brokers and administrators.

Marketing into EU was a case of understanding how the AIFMD was interpreted and imposed in each member state before Brexit and the same applies now so local advice should be taken for each jurisdiction. The same applies to Switzerland which has its own strict laws on fund marketing.

Reverse solicitation under the AIFMD

This is a route to marketing outside the AIFMD which we always warn is difficult to comply with in a legally sound fashion.

At first glance it would seem that passive marketing, or reverse solicitation, is not considered 'marketing' under the AIFMD. For example, if an investor approaches the manager about investing in a fund entirely without any prior solicitation.

In reality, this does not happen frequently as relationships exist and conversations are had in advance of a new fund being set up.

The other difficulty is that the AIFMD explicitly states that no one can use reverse solicitation as a means of circumventing it and this can be tricky.

The Investment Manager's Exemption

Executive Summary

The Investment Manager's Exemption (IME) is a crucial tax relief that allows UK-based investment managers to manage offshore funds without creating a UK tax liability for those funds.

Without IME: Offshore funds managed from the UK would be subject to UK corporation tax on their profits

With IME: Funds remain tax-transparent in the UK, preserving their offshore tax status

Understanding and complying with the IME is absolutely critical for all UK AIFMs of offshore funds.

1. The fundamentals

The IME is a statutory relief that prevents UK investment managers from being treated as a "UK representative" of the offshore funds they manage.

Without this exemption, managing an offshore fund from London would make that fund liable to pay UK corporation tax on its profits, which would defeat the

purpose of the fund being offshore.

2. Step 1: Is this "trading"?

The Trading Test

The IME only applies if the UK manager's activities constitute "trading." Here's what counts:

Usually trading:

- Active portfolio management with frequent transactions
- Managing hedge funds, private equity, or active strategies
- Any financial trade carried on by an offshore fund

Usually not trading:

- Pure investment holding (buy and hold forever)
- Passive index tracking with minimal rebalancing

3. Step 2: Are these “Investment transactions”?

Approved Investment Transactions

The law provides a specific list of qualifying transactions:

Qualifying Transactions:

- Stocks and shares
- Options, futures, and contracts for differences
- Loan relationships (bonds, credit facilities)
- Collective investment schemes (fund-of-funds)
- Other securities
- Foreign exchange transactions
- Certain cryptocurrency transactions

Non-Qualifying Examples:

- Direct property purchases
- Operating business activities
- Non-financial trading

4. Step 3: The five conditions checklist

To qualify for IME, you must satisfy ALL FIVE conditions:

Condition A: Investment Management Business:

Test: Was the AIFM carrying on investment management business at the time of the transaction?

Practical Check:

- Firm has proper FCA authorization
- Investment management is core business activity

- Transaction occurred while business was active

Condition B: Ordinary Course of Business:

Test: Was the transaction part of normal business operations?

Practical Check:

- Transaction fits within fund's investment mandate
- Consistent with firm's usual services
- Not a one-off or unusual arrangement

Condition C: Arm's Length Relationship:

Test: Are the AIFM and offshore fund dealing independently at market terms?

Widely Held Funds:

- Fund is widely held within 18 months of launch, OR
- Being actively marketed to become widely held, OR
- Being wound up or dissolved.

Diversified Business:

- Services to this fund represent $\leq 70\%$ of manager's total business (by fees)
- New managers get 18-month grace period
- Can exceed 70% if outside manager's control and reasonable steps taken to remedy

Red Flags (likely fail test):

- Fund owned by manager's shareholders
- Preferential fee arrangements
- Lack of proper fund documentation
-

Condition D: The 20% Rule:

Test: At least 80% of fund's income must benefit parties unconnected to the manager.

How It Works:

- Look at 5-year average (or fund lifetime if shorter)
- Connected persons = manager + related entities
- Must have <20% beneficial interest in fund's income

The test is satisfied if the AIFM intended to meet condition and took reasonable steps, but failed due to circumstances outside their control.

Practical Tips:

- Critical for fund launches and small funds
- Document efforts to raise third-party capital
- Consider seeding arrangements carefully

Condition E: Customary Remuneration:

Test: Is the management fee at market rates?

Practical Check:

- Fees comparable to similar managers
- Standard industry terms (e.g., 2% management + 20% performance)
- No unusual discounts or premiums
- Proper benchmarking documentation

5. Common pitfalls and solutions

Start-Up Funds

Problem: New funds often fail Condition C (arm's length)

and Condition D (20% rule) initially.

Solutions:

- Document active marketing efforts
- Use 18-month grace periods
- Implement proper governance structures
- Keep records of third-party outreach

Concentrated Investor Base

Problem: Fund dominated by few large investors may struggle with Condition D.

Solutions:

- Plan investor diversification strategy
- Consider seed capital arrangements
- Document efforts to broaden investor base

Related Party Issues

Problem: Manager-related entities investing in fund.

Solutions:

- Ensure arm's length terms for all investors
- Limit manager's economic interest
- Proper disclosure and documentation

6. Upcoming changes (2026)

On 28 April 2025, the government published draft legislation to amend the IME.

Action Items:

- Review current arrangements against proposed changes
- Plan transition strategy for 2026 implementation

7. Critical actions

Check your documentation for each fund arrangement to make sure that you have, and maintain:

- Well-drafted investment management agreement
- Well-drafted fund documentation
- Fee benchmarking analysis
- Investor base analysis and marketing records
- Connected party analysis
- Transaction records and investment mandate
- HMRC condition compliance monitoring

8. What do you need to do now?

Our specialist team works exclusively in fund management and financial services. This means that we can give you advice which is tailored to your needs and your business.

For example:

IME Compliance Reviews

- Comprehensive condition testing and documentation
- Risk assessment for existing fund structures

- Ongoing monitoring and compliance systems

New Fund Structuring

- Optimal offshore fund design for IME qualification
- Regulatory strategy and documentation
- Cross-border tax planning

2026 Transition Planning

- Impact assessment of upcoming legislative changes
- Restructuring advice to maximize benefits
- Strategic positioning for new rules

Get in Touch

With the significant IME reforms taking effect from January 2026, now is the time to review your fund structures and ensure continued compliance..

The UK's Reporting Regime

Introduction

For fund managers seeking to attract UK investors, understanding the UK's reporting regime represents a critical strategic advantage.

The UK's reporting regime allows UK investors to achieve favourable tax treatment across a range of investment strategies.

What is the reporting regime?

The reporting regime allows UK investors to benefit from capital gains tax treatment when disposing of their fund interests, rather than facing the onerous income tax rates that would otherwise apply.

The regime operates on a principle of transparency and annual reporting and funds need to meet specific reporting requirements each year to maintain their status.

This beneficial tax approach reflects the UK's broader policy objective of maintaining tax neutrality between domestic and offshore investments, provided that offshore structures meet comparable transparency standards.

The UK investor advantage

The distinction between reporting and non-reporting fund status creates a significant tax differential for UK investors.

Under the reporting regime, UK investors benefit from capital gains tax rates on disposal of their holdings, which typically represent a lower burden than income tax rates.

Without this status, the entire gain on disposal becomes subject to taxation as offshore income gains at full income tax rates. This difference can be substantial, particularly for higher-rate taxpayers who face substantial rate differentials between capital gains and income tax treatment. Its tax efficiency extends beyond rate differentials to include access to various capital gains tax reliefs and allowances that may not be available for income-based taxation.

The reporting regime therefore gives funds that qualify a comprehensive advantage, making their fund particularly attractive for long-term investors and those with substantial holdings.

Investment strategy flexibility

One of the most compelling aspects of the reporting fund regime is that it is strategy-neutral.

There are no restrictions on underlying investment strategies, accommodating equity, fixed income, credit, alternatives, and hybrid approaches within the same regulatory structure.

Instead, the critical requirement is based on the structure of the fund rather than its investment approach. Funds must qualify as “non-UK offshore funds” within UK tax law definitions. Fortunately, this encompasses both open-ended and closed-ended structures that meet the relevant criteria.

This flexibility allows fund managers to pursue their investment strategies while simultaneously providing UK tax efficiency to their investor base.

So what the reporting regime does is support innovation and specialisation in fund management while maintaining sensible and efficient tax oversight which allows managers to attract more UK investors

Reporting requirements

The annual reporting obligation is relatively straightforward to manage with the appropriate systems and support in place.

Fund managers need to calculate and report the reportable income per share or unit, providing detailed breakdowns by share class where multiple classes exist.

The reporting must be in GBP which requires coordination between fund administrators and tax advisors.

Timing requirements are strict but not frequent. Reports must be made to both HMRC and UK investors within six months of the fund’s accounting year-end. This needs coordination however with

the right advice and implementation, fund managers can embed the reporting processes with minimal disruption to their core operations.

Implementation

Fund managers interested in the reporting fund regime must begin with an application to HMRC. Ideally this should be done before the end of the fund’s first accounting period as it will allow for the benefits of reporting status from inception. This proactive approach maximizes the tax benefits available to early investors.

Operational infrastructure is crucial yet has a logistic simplicity for ongoing compliance. Fund managers need to put in place reliable systems for calculating reportable income annually, between service providers including administrators, tax advisors, and distributors. This means having administrators and tax advisors who have the appropriate expertise across relevant jurisdictions while also being able to focus on UK reporting requirements.

Strategic value and investor relations

For fund managers with UK investor bases, or those seeking to expand into UK markets, reporting fund status represents a competitive differentiator.

Its tax efficiency can be quantified and communicated directly to prospective investors, providing tangible value in marketing and investor relations efforts.

The regime also supports broader capital raising strategies by removing a potential tax barrier that might otherwise limit UK institutional and individual investor participation. This expanded investor base can contribute to fund growth and diversification objectives.

Regular communication with UK investors about their annual reportable income obligations helps

maintain strong investor relations while ensuring compliance with the regime's transparency requirements. This ongoing dialogue reinforces the value provided through the reporting fund structure.

Conclusion

The UK reporting fund regime offers a well-established pathway for fund managers to provide material tax benefits to their UK investors while maintaining operational flexibility across investment strategies and fund structures.

Success requires early planning, robust operational processes, and ongoing coordination with experienced service providers, but the competitive advantages for UK-focused fundraising make this investment in compliance infrastructure increasingly valuable for internationally focused fund managers.

Distribution agreements - key issues

Introduction

While most fund managers will also act as the distributor of the funds they manage, some will appoint third parties to help as well.

The starting point for entering into any such arrangement will be full due diligence on the third party. Once satisfied that the legal and personal relationship will work, the next step is to negotiate a distribution agreement.

In this note we look at the key questions to ask before beginning negotiations. These questions will help guide your thinking and make the negotiation process more streamlined.

Who appoints the distributor?

This could be either of the parties involved, for example the fund or the fund manager. If it is the fund manager, you need to be sure that the fund documents allow this and do not preclude it.

Documentation

It's not just the distribution agreement that needs to be considered.

It is common for the distribution agreement to contain a clause that the appointing party must supply accurate and up-to-date documents and information. The appointing party needs to be sure that is able to meet this requirement. It is also common to include a clause that the distributor cannot accept subscriptions or bind the fund/fund manager and this needs to tally with fund documentation.

Regulation

The distributor will need to be regulated by the relevant authority. In the UK, this is the FCA. The distribution agreement should make it an express term that each party will comply with all relevant rules, regulation and legislation which are relevant to it. It's important to

remember that different rules apply in different jurisdictions, for example AIFMD marketing rules. The appointing party needs to consider this as part of its due diligence and may restrict the jurisdictions in which the distributor can act. Where the AIFMD is relevant, both the offering materials and notification requirements must be met within the correct time scale. In some cases, it may be the MiFID rules need to be followed as well, for example those relating to manufacturers and distributors.

Investor universe

Hedge funds are not suitable for retail investors and the fund documentation should make this clear, and deal with this point in the marketing legends set out in the offering memorandum.

This means that the distributor must ensure that all the recipients of marketing information will be correctly identified and categorised at the right time, and in accordance with the relevant regulations.

It is also important to be clear on which potential clients the distributor may approach. No one wants to pay away distribution fees for an investor who they know, or get into arguments where there are multiple distributors.

What product is being sold?

While this may seem blindingly obvious, some agreements fail to explicitly state which fund or product is being distributed.

Capacity

An important question is whether any capacity constraints will be placed on the distributor. If so, what will these constraints be? There could be a set amount and/or a time limit.

Where a set amount is used, the distribution agreement should be clear about the potential re-use of this amount if an investor redeems and whether it, and the fees related to it, can extend beyond termination. This may be granted with a tapering.

Fees

Distribution fees are generally linked to success. The terms need to be very clear here and deal with a variety of circumstances. For example will they be paid after termination and, if so, on which investments and will they be tapered over a certain time period?

Another question is whether fees can be made on an investment which is made, redeemed, then made again. This may be subject to a time limit.

The timing of payments is important and should be synchronised with the fund's NAV calculation any relevant fee payments it makes.

Liability

One form of liability centres around identity. The distribution should only approach suitable potential investors and the fund should not accept certain investors.

Also important is that the information provided about the fund is correct, as explained above. Giving out incorrect information can lead to unfortunate situations and potential litigation.

Confidentiality

The parties to the distribution agreement will need to exchange information that allows each of them to complete their duties and should not be used for any other purpose.

As information on the investment strategy may become known to the distributor in detail, the fund manager's intellectual property needs to be protected.

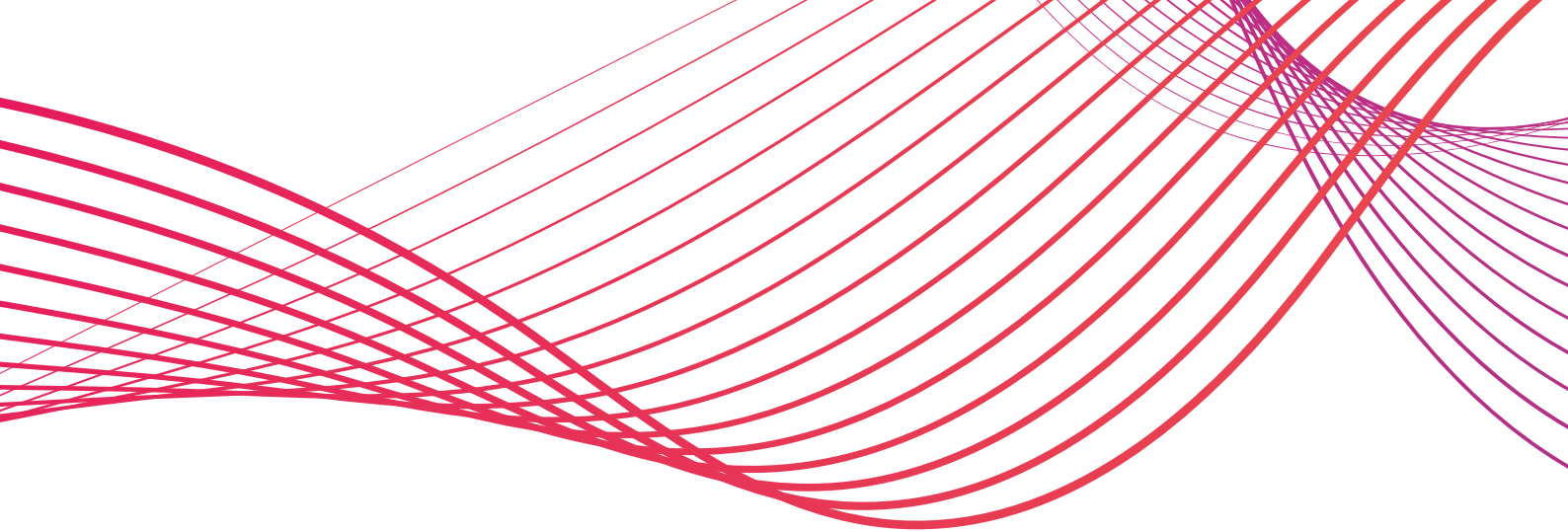
Protection also needs to be afforded to client information and data protection rules will apply. Some matters should remain confidential after termination.

Side letters and favourable terms

These terms may be granted by either the fund or the fund manager and different laws and rules will apply in each situation.

Whichever party grants these terms, they must first have the power to grant them and the fund structure must meet its legal obligations. For example, shareholders in the same class of share may need to be treated equally under the laws of the fund's jurisdiction leading to the creation of new share classes.

The FCA has rules on side letters which may apply and these are linked with AIFMD considerations. They can usually be balanced with the potential need for confidentiality.



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Afterword

Building success

The landscape of alternative investment management continues to evolve at an extraordinary pace. As we've explored throughout this guide, establishing and operating a successful hedge fund requires navigating an intricate web of regulatory requirements, tax considerations, operational complexities and investor relations challenges.

The foundations

What emerges clearly from these pages is that successful fund management needs managers who have in place robust legal and regulatory compliance, operational excellence and strategic investor engagement. Regulatory missteps can undermine investor confidence, operational inefficiencies can erode performance, and poor investor relations can limit growth.

Fund managers who comply with the AIFMD, the Investment Manager's Exemption, the UK's Reporting Regime have a strategic advantage and differentiate their fund from others.

Similarly, well-structured prime brokerage relationships provide the operational foundation for performance and clearly negotiated distribution agreements allow for increased investment.

Looking forward

The regulatory environment will continue to evolve.

The fund managers who will be successful will be those who view these developments as opportunities to enhance their legal, regulatory and operational frameworks and investor value propositions.

The funds that thrive will be those that embed best practices from inception rather than retrofitting compliance as an afterthought.

Final thoughts

The frameworks and considerations outlined in How to Start a Hedge Fund provide a roadmap for navigating the complexities of the world of investment management.

Successful fund management is rarely a solitary endeavour. The complexity of modern alternative investment management demands partnerships with experienced legal counsel and other specialist service providers.

The cost of getting these relationships right from the outset is nothing compared to the expense and disruption of remedying problems later.

We look forward to supporting you in your growth.

info@cummingspepperdine.com
+44 2030 623 340
www.cummingspepperdine.com

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This guide represents general guidance and does not constitute specific advice. The specific circumstances of each fund require tailored professional guidance.

Notes

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