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Incubator Funds: A Cost Effective Way to Develop a Track Record

Many emerging hedge fund managers have recently launched incubator funds as an intermediate step before creating full-fledged hedge funds. This structure allows the entrepreneurial manager to develop a track record that is very important in this difficult fund-raising environment. In addition, an incubator fund provides the manager with a cost-effective option before incurring all of the expenses associated with creating a traditional hedge fund. Finally, this structure allows the manager to concentrate on implementing his or her investment strategy and achieving performance before marketing interests in the fund to outside investors.

In the incubator fund structure, two entities are generally formed: (1) a limited partnership or limited liability company that serves as the incubator fund; and (2) a general partner or managing member that serves as the manager of the incubator fund. The general partner/managing member then contributes capital to the fund and manages those assets for a certain period of time to develop a performance record. If prospective future investors will be primarily non-U.S. or tax-exempt investors, it may be more advantageous to create an offshore incubator fund.

The incubator fund structure also provides favorable tax treatment and efficiency. If the general partner/managing member is owned only by one person, such person can use his or her social security number as the entity's tax identification number and avoid having to file a separate tax return. In addition, if the fund is solely owned by the general partner/managing member, the fund can avoid more complicated tax filings as well. Furthermore, it is not necessary to retain an administrator to launch an incubator fund.

It is important to recognize that the general partner/managing member cannot market interests in the fund or accept capital from outside investors during the incubation period. However, the general partner/managing member can begin collecting indications of interest from potential investors with whom it has a pre-existing relationship.

In terms of costs for launching a U.S. incubator fund, Armor Law Group can handle all of the legal work to develop this structure for a fixed fee of \$2,500, plus any state filing fees to form the fund and the general partner/managing member. Please contact Douglas F. MacLean at 617.350.5250 if you would like more information or want to discuss this popular structure.

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