Starting a Forex Fund

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Market conditions have never been better for setting up a forex fund. The number of forex funds and corresponding investors has grown as a result of expanding customer markets. Therefore, traders interested in starting a forex fund (or managing customer accounts) should familiarize themselves with the legal landscape as they consider earning a living in this profitable retail industry. An experienced and disciplined forex fund manager can earn a substantial income. Most forex funds to which we provide services are small. We often encounter people who have been trading accounts for others "under the table" and now want to formalize their arrangements.

One key advantage to starting a forex fund is that the fund manager can legally accept compensation for his or her trading and advisory services. In many cases, the fund manager can legally advertise their services as well. This compensation can provide an excellent supplement to an existing income or it may allow trader to work as a paid forex adviser on a full-time basis. In our experience, many forex new fund managers also keep their "day jobs" for a while until they are certain this is the business they want to be in. Market conditions have never been better for setting up a forex fund.

Whether you want to set up a fund or just invest in one, it is a good idea to understand the basics.

Is Running a Fund Profitable? Forex fund managers typically demand management fees of 1% to 2% of assets under management (AUM) as well as performance fees of 20% of net gains a year. This income can be substantial. If you had a mere $2 million AUM and a 1% management fee and a 20% performance fee, you would have management fee income of $140,000 ($2 million x 1%) and (assuming fund performance of 30%) performance fee income of $120,000 ($2 million AUM x 30% performance = $600,000 x 20%). If you had $5 million under management, you would have combined fee income of $350,000. If you had $1 billion AUM, you would have $60 million in combined fees (assuming fund performance of 20%).

Forex Fund Risks. Funds are not for the thin skinned; there are many real risks. In this era of global mood swings, all bets are off. Money invested in a forex fund must truly be discretionary. A fund is only as good as its advisers, so the human risk is significant. Greed and ego often trump integrity and ethics.

Due Diligence. In 2008, there is also a noticeable trend toward increased review of funds by investors and counterparties (e.g., prime brokers, fund administrators, and auditors). Fiduciaries have a duty to perform due diligence to ensure that a fund's investment decisions are sound and compatible with their client's risk profiles. Prospects may submit a due diligence checklist to management, requesting extensive information covering every major aspect of the fund's organization, operation and management. Prospects may seek meetings with the officers of the fund and other persons significantly involved in the fund's business.

How does a forex fund work? A forex fund requires infrastructure in the form of corporate entities. In the United Sates, we use a limited partnership as the fund and use an S corporation (or LLC) as the general partner (and forex adviser to) of the limited partnership. When set up outside the United States, both the forex fund and its advisor are set up as corporations in a low or zero tax country or other jurisdiction.

Managed Accounts. A CTA (commodity trading adviser) manages individual accounts, while a CPO (commodity pool operator) manages a fund (also called a "pool"). In our experience, many people lose interest in a managed account business when they experience the administrative hassles of managing separate accounts. However, some choose to be both.

Advertising and Attracting Investors. Unless listed on a recognized securities exchange, a forex fund cannot advertise to solicit new investors in the fund. A forex trader managing accounts, however, can advertise his or her managed account services. A few countries have rules similar to those of the United States in this regard. Prospective investors in the fund like to see that you have invested your own capital in the fund. It is also a good idea to show prospects that you take fees subject to a hurdle rate, which means that you earn fees only when trading profits exceed a minimum percentage.

An investor in a forex fund should be sophisticated enough to understand the risks associated with forex trading. Many investors would be interested in forex funds if they had the opportunity. Because advertising of the fund and any other non-personal communications are prohibited, and the media has touted the risks over the benefits, investors must be sought in more direct and creative ways. A trader may find that in addition to family and close friends, many colleagues and casual acquaintances may be potential investors. If you are interested in getting investors for your fund, your selling efforts must be personally directed toward investors who are known to you. Advertising and any other non-personal communications are prohibited. For the forex trader who wants to trade for his family and friends, this is obviously no problem at all. Since the forex fund is an ideal vehicle to pool the resources of a small group of investors, forex funds can be especially appealing.

How do I set up a forex fund? In 2008, forex traders remain positioned to launch a forex fund quickly without much red tape. In short, starting a forex fund means hiring a legal adviser with the proper expertise to prepare the required documents and provide you with tax and regulatory advice. You will have to work closely with your lawyer to prepare the private placement memorandum (PPM), fund's limited partnership agreement, and subscription agreement. A forex fund can be developed and launched within 2 weeks (on an expedited basis) but the normal development time is about 4 weeks. Offshore funds, while they can be incorporated quickly, take a little longer to establish due to the time required to open a bank and brokerage account for the fund.

Favorable Tax Treatment. There are two ways to trade foreign currencies and they have different tax rates. “Foreign currency contracts" are taxed by Internal Revenue Code Section 988. Currency futures, otherwise known as “regulated futures contracts” are taxed under Section 1256. Forward contracts and over-the-counter options in other traded currencies for which there is also trading in regulated futures qualify as "Section 1256 contracts." Gains from futures trading are taxed at a blended rate of 60% long-term gains and 40% short-term gains (regardless of how long a position is held). This 60/40 split gives futures traders an advantage over forex traders. While the long-term rate is capped at 15%, the short-term (or “ordinary”) rate can go as high as 35%. The maximum blended 60/40 rate is 23%.

Forex gains are taxed at the short-term (“ordinary”) rates. Forex traders do not necessarily have to live with the higher "ordinary income" tax rates as they can “elect out” of ordinary income tax rates. Traders who do this will have their currency positions treated as Section 1256 contracts, and their gains will be taxed at the blended 60/40 rate. In addition, the fund will most likely qualify as a "trader in commodities" so that investors are able to deduct the fund's expenses.

Securities Act of 1933. Forex funds are private and are not required to report returns, unlike mutual funds that are publicly traded and post their net asset values daily. In the United States, private (hedge) funds are unregistered securities offered as a private placement under the Securities Act of 1933. Also, in the United States, a forex fund is a Regulation D (Rule 506) offering in that it is an unregistered security offered as a private placement. Regulation D provides a safe harbor that exempts the private offering from compliance with the registration and prospectus delivery requirements of U.S. securities laws. However, Regulation D does not exempt an offering from compliance with the anti-fraud provisions of the law. You must supply all investors in your fund with offering documents (also called "disclosure documents") disclosing comprehensive information about the fund.

Commodity Exchange Act. The Commodity Exchange Act (CEA) gives the Commodity Futures Trading Commission (CFTC) limited anti-fraud and anti-manipulation jurisdiction over off-exchange (also called over-the-counter or OTC) foreign currency futures and options transactions. "Forex transactions" are leveraged off-exchange foreign currency transactions where one party is a customer. The term does not include transactions that result in actual delivery within two days or that create an enforceable obligation to deliver between parties who are capable of making and taking delivery for business purposes.

Must I register with the CFTC? If you plan to trade currency futures contracts, currency futures options, or forward contracts, your fund must be approved by the CFTC. In addition, you must register with the National Futures Association (NFA) and become a CPO. The CEA defines a commodity pool as an "investment trust, syndicate or similar form of enterprise operated for the purpose of trading commodity interests."

CFTC Exempt. A person who operates a commodity pool must register as a CPO unless an exemption applies. If you operate a pool that limits its trading solely to forex and only trades with authorized counterparties, it is not required to register as a CPO, but may do so voluntarily. Forex managed account managers are generally not required to register with the CFTC or become Members of NFA. Understand that any NFA Member forex dealer that services your customer accounts, or you introduce accounts to, is subject to NFA enforcement action for your conduct should your conduct violate NFA requirements. Violations can mean disciplinary action against your dealer even if it acts diligently and has no knowledge of your conduct. As a result, there is a trend among forex dealers to require NFA registration of forex traders managing customer accounts (including a fund). NFA compliance rules address the general issues of following just and equitable principles of trade and avoiding fraudulent behaviors.

Commodity Pools. If your forex fund trades in commodity futures or interests, it is also a commodity pool and you are a CPO. Any person who is involved with the commodity pool must register as an associate of the CPO. A registered CPO is required to provide a detailed disclosure statement (the prospectus) to prospective participants in the pool. Your Disclosure Document must also be filed with the NFA at least 21 days prior to the delivery of the documents to a prospective participant and updated often. There are exemptions from the CPO registration requirements.

Investment Adviser Registration. If you plan to execute more than an occasional equity trade in your forex fund, you might also have to register as an investment adviser. If you manage less than $30 million, you are not eligible to register with the SEC (unless you are based outside the United States or you are based in Wyoming) but are subject to applicable state law. Each state has its own registration requirements.

Offering Documents. Investors in your fund must receive all material information about the offering and the offering documents should be provided to all investors. Any investor who is not an accredited investor must have sufficient knowledge and experience in financial and business matters to be able to evaluate the merits and risks of your hedge fund. Since the PPM usually is the starting point for those conducting due diligence, it remains a crucial document.

Accredited Investors. Regulation D limits the number of non-accredited investors to 35. Generally, accredited investors includes persons whose net worth (or joint net worth with that person's spouse) exceeds $1,000,000, or whose income was in excess of $200,000 in each of the two preceding years (or, together with that person's spouse, in excess of $300,000 in each of the two preceding years) and who reasonably expect to reach the same level of income in the current year. There are numerous other categories of accredited investors.

Performance-based Compensation. Performance-based compensation for fund advisers are paid as an allocation of profits, typically 20%, associated with the growth of the fund. There are state regulations regarding performance based fees and these regulations vary considerably. In some instances, the compensation agreement specifies that funds be only paid when the profits of the fund exceed a hurdle rate.

Blue Sky. Within 15 days of the first sale of your offering, an SEC Form D Notice of Sale must be filed with the SEC. Your fund must also comply with state blue-sky laws. In most states, Form U-2 must be filed.

Conclusion. Forex funds are about making money and running a forex fund is a great way to do so. The desire to pool assets in a way that is proper, both from a business and a legal standpoint, has led many forex traders to start their own forex funds. For a successful forex trader, a forex fund is an efficient, legal, and professional way to trade your own money along with the money of those who want to benefit from your expertise. No longer just for the elite, forex funds will continue to grow in varying financial conditions because of their complete market freedom. The private investment fund industry has years of success ahead of it. Talented forex traders will find profitable outlets for their skills, regardless of government regulation. Forex funds are about making money and running a forex fund is a great way to do so.