Internet Appendix

IA.1. Regulation D of the Securities Act of 1933

The Securities Act of 1933 ('33 Act) requires any offer to sell securities to U.S. investors be registered with the SEC. Regulation D of the '33 Act contains exemptions from the registration requirements, allowing companies to offer and sell their securities without having to register with the SEC. Of these exemptions, hedge funds typically rely on Rule 506, which regulates solicitation or advertising of the securities and requires the securities be offered to accredited investors.[1] In doing so, funds are able to offer an unlimited amount of securities to investors by filing a Form D indicating the sale. In filing the Form D, funds must disclose their exemptions that enable them to avoid being defined as an "investment company" under the Investment Company Act of 1940 ('40 Act). Hedge funds primarily rely on two exemptions: Section 3(c)(1) and Section 3(c)(7). Under Section 3(c)(1), the issuer must not have more than 100 investors and must only sell securities to accredited investors.[2] Funds with more than 100 investors must rely on the Section 3(c)(7) exemption which limits the fund to no more than 500 investors and requires the more rigorous qualified purchaser standard.

In March of 2009, the SEC implemented amendments to Reg D, requiring an electronic filing of the form.[3]

[1]For a more complete description of Rule 506, see:`http://www.sec.gov/answers/rule506.htm`.

[2]The accredited investor standard requires natural persons to have a liquid net worth of more than $1 million or income of $200,000 or more in each of the two most recent years or joint income with a spouse of $300,000 over each of the previous two years. The qualified purchaser standard requires a natural person to have more than $5 million in investments or an investment manager to have more than $25 million in assets under management.

[3]More complete analysis of the amended Reg D filing can be found at: `http://www.sec.gov/rules/final/2008/33-8891fr.pdf`) The fund is required to file the notice within 15 days after the first sale of securities, is required to amend the filing when a material change has occurred, and annually thereafter.

IA.2. Offshore jurisdictions and boards of directors

Hedge funds routinely create offshore vehicles for privacy and tax purposes.[4] Managers looking to attract U.S.-based investors will often choose to use a master/feeder structure. A typical structure will consist of three entities: an onshore limited partnership feeder fund through which U.S. taxable investors can enter the fund; an offshore feeder fund, typically set up as an exempted corporation, through which non-U.S. and U.S. tax-exempt investors can enter the fund; and an offshore corporate master fund through which all trading activity is carried out.

For U.S. tax-exempt investors, the advantage of this approach is avoidance of Unrelated Business Taxable Income (UBTI). Under U.S. tax law, a tax-exempt organization (such as an ERISA-type retirement plan or endowment) that adopts an investment strategy where leverage is used is liable for UBTI. In offshore locales, however, the fund is set up as an exempted corporation rather than pass-through entity, such as a limited partnership. As such, the tax does not pass through to the investor, thus removing the burden on U.S. tax-exempt investors. For non-U.S. based investors, benefits include both possible tax-advantages from the home country, as well as privacy from disclosure laws in the U.S. For example, if offshore investors make any investments in U.S. securities, then U.S. withholding tax rules will apply and U.S. forms will have to be filled out to claim exemption from U.S. withholding taxes. The investors will have to submit these forms, which declares their participation, to U.S. tax authorities. Alternatively, if the offshore fund is structured as a corporation, then only the corporate entity will have to submit the paperwork, thus allowing its individual non-U.S. investors to remain anonymous to U.S. tax authorities.

Among the hedge funds in our sample, the most common domicile for offshore hedge funds is the Cayman Islands, which accounts for 79.6% of the sample. The next two largest

[4] Aragon, Liang, and Park (2014) study the differences in regulatory environment and investor clienteles between onshore and offshore funds.

domiciles are the British Virgin Islands and Bermuda, respectively. Collectively, these three locales account for 91.4% of the offshore funds in our sample.

In the Cayman Islands, a fund typically creates a registered mutual fund and is subject to the requirements of the Cayman Islands Mutual Fund Law.[5] These requirements include that the fund appoint at least two directors (in the Cayman Islands the two directors must be natural persons i.e. not a corporate entity) that the Cayman Islands Monetary Authority (CIMA) deems are fit and proper to be directors. Managers or officers of the fund are not precluded from serving as a director. Upon review of CIMA, any director not believed capable of fulfilling her duties may be forced to be replaced or the fund's registration with CIMA may be canceled. Non-CIMA registered funds in the Cayman Islands require only a single director.

Other jurisdictions have similar but not identical regulations regarding directors. In the British Virgin Islands, funds are only required to have one director, and the director does not have to be a natural person. In Bermuda, one director must be a resident of Bermuda.

[5]Note that the term mutual fund is generic and is distinct from the typical U.S.-based interpretation of a mutual fund. Further, while funds can avoid registration with CIMA by maintaining 15 or fewer accounts, the majority of whom are capable of appointing or removing the fund's operator, most funds fail to meet this requirement and choose to register. See the 2012 Mutual Fund Law: `http://www.cimoney.com.ky/WorkArea/DownloadAsset.aspx?id=2147483702`