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Are hedge funds registered in Delaware different?☆

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ABSTRACT

Delaware hedge funds exhibit significant differences in contractual structure in terms of higher management and incentive fees. Delaware funds are more likely to use high watermark provisions and less likely to invest their personal capital. Both the redemption notice periods and lock up periods are significantly longer for Delaware hedge funds. While Delaware hedge funds do not outperform or underperform funds registered elsewhere, fund flows are more sensitive to Delaware funds' prior performance and Delaware funds are more likely to be liquidated due to poor performance. Further, Delaware funds are more likely to increase risk after poor absolute performance.

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1. Introduction

Hedge funds are essentially pools of capital that are typically sourced from institutional investors and high net worth individuals (Boyson, 2010; Boyson et al., 2010; Clifford, 2008; Dimmock and Gerken, 2012; Hodder and Jackwerth, 2007; Teo, 2009). Hedge funds may select any jurisdiction to be registered, although inevitably the jurisdiction chosen will be determined by more practical, operational factors. For example, the scope of investors that may invest in a hedge fund depends on the regulatory landscape in which the fund is registered (Cumming et al., 2012, 2013), therefore fundraising will be a factor in jurisdiction choice. While prior work has compared offshore and onshore fund choices (Aragon et al., 2014; Endelman et al., 2013), prior work has not studied legal registration choice within the U.S. This question is important due to the legal implications associated with Delaware limited partnerships and Delaware limited liability companies identified in practice (Schwartz, 2012), and the practical reality that over 60% of U.S. hedge funds are registered in Delaware despite the fact that 95% of these funds are physically located and managed elsewhere, as documented herein. This paper represents a first law and finance analysis of registering in Delaware for hedge funds.

While the focus of most Delaware related research has centered on the question of whether state competition has been good or bad for shareholders (e.g., Romano, 1985; Ryngaert, and Scholten, 2010; Bebchuk et al., 2014; Boone and Mulherin, 2014;

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Macias and Pirinsky, 2015; Dimmock et al., 2015), in this paper we seek to ask whether state competition has been good or bad for *fund investors*, more specifically hedge fund investors. We address the question of whether or not there are differences in the structure and performance of hedge funds that incorporate in Delaware and how these differences may exacerbate or reduce agency behaviors of hedge fund managers.

What makes an analysis of hedge fund incorporation choices unique and important? First, investors into hedge funds are among the most sophisticated in the financial world. To this end, we would not expect hedge funds in Delaware to earn superior returns (even though Delaware companies are valued higher on average; Daines, 2001, 2002), because if there is a premium associated with Delaware law, it will be well-known to hedge fund investors, thereby increasing their price and lowering their return. By examining hedge fund performance among Delaware funds versus other funds, we provide a measure of the degree to which sophisticated investors into hedge funds are familiar with Delaware law.

Second, because Delaware investors face less legal uncertainty with the legal and governance structure of Delaware funds, we conjecture that such investors will be more willing to provide Delaware managers with higher fixed and performance fees. Relatedly, investors will be less inclined to require Delaware managers to invest their own capital into the fund that they are managing. Delaware law provides greater certainty with respect to governing agency problems between fund managers and their investors, and hence there is less of a need for the fund managers to have "skin in the game" to mitigate potential agency problems. Also, Delaware hedge fund investors will be more likely to accept longer redemption notice periods and lock-in periods relative to non-Delaware funds given the greater and more transparent legal environment among Delaware funds.

Third, and more importantly, the familiarity with Delaware Law means that investors from a diverse set of states and even countries will be on more equal footing and have a more common understanding about the structure and governance of Delaware hedge funds relative to other hedge funds. Together with the more managerial discretion in a typical agreement between Delaware fund managers and investors, we expect that Delaware hedge funds are more likely to have a more pronounced flow–performance relationship. Investors will be more inclined to invest in the future when a Delaware fund does well, and conversely more inclined to withdraw funds in the event of poor performance, because there are more investors that are better aware and more fully informed of the causes and consequences of investing in a Delaware fund relative to non-Delaware funds. At the extreme end of the spectrum, we expect Delaware hedge funds are more likely to be liquidated or liquidated more quickly in the event of very poor performance.

Fourth, the stronger flow–performance relationship and the more manager-friendly contract (as discussed above) for the Delaware hedge funds give both incentives and opportunities for risk taking (e.g., Brown et al., 2001; Basak, Pavlova, and Shapiro, 2007; Hodder and Jackwerth, 2007; Panageas and Westerfield, 2009; Aragon and Nanda, 2012).[1] For instance, incentives to take risk can arise from the strong flow–performance sensitivity as investors direct more money into hedge funds that outperform. The higher incentive fee and the more frequent usage of the high watermark provision among Delaware funds would further manifest the probability of increasing risk in the event of poor performance. Furthermore, longer lockup periods and redemption notice periods give Delaware hedge fund managers more discretion in managing their risk level.

We test these propositions with the Lipper/TASS database over the period 1994–2010. We provide empirical evidences that are highly consistent with these propositions. Our evidences are robust to a number of controls, including but not limited to the endogenous selection of Delaware as the choice of jurisdiction. We use the Heckman (1976, 1979) treatment regression framework to address the endogeneity concern. In modeling the choice of jurisdiction, we control for a number of things that potentially explain the dominance of Delaware as a domicile location as documented in many law literature (Daines, 2002; Klausner, 1995; Kahan and Klausner, 1997). Specifically, we control for the organizational form of the hedge fund, the type of investors the fund is designed to attract, the network effect measured by the percentage of new hedge funds choosing to domicile in Delaware in the previous year, and the physical location of the fund, as discussed herein.[2]

This paper is organized as follows. A discussion of why Delaware law matters for hedge funds is provided in Section 2. Section 3 introduces the Lipper/TASS dataset and provides summary statistics. Multivariate tests and various robustness checks are presented in Section 4. Section 5 provides a summary, concluding remarks and suggestions for future research.

2. Why do hedge funds prefer Delaware as a domicile location

In this section we first review the literature on why Delaware is attractive to the U.S. corporations in general in subsection 2.1. Thereafter in subsection 2.2 we explain why the U.S. hedge funds prefer Delaware as their domicile location and hypothesize how being a Delaware hedge fund would be different in contracting, flow–performance relationship, and risk-taking.

[1] Our analyses likewise builds on a large and growing literature on hedge fund structure and performance (Ackermann, McEnally, and Ravenscraft, 1999; Amin and Kat, 2003; Baquero, Horst, and Verbeek, 2005; Brown et al., 1999; Brown and Goetzmann, 2003; Brunnermeier and Nagel, 2004; Cremers et al., 2005; Edwards and Caglayan, 2001; Getmansky, 2005; Getmansky, Lo, and Makarov, 2004; Gupta and Liang, 2005, Teo, 2009), as well as hedge fund activism (Brav et al., 2008a,b; Klein and Zur, 2009; Thomas and Partnoy, 2007) and the structure of hedge funds and strategies (Fung and Hsieh, 1997, 2000, 2001; Goetzmann, Ingersoll, and Ross, 2003; Jorion, 2000). Our analyses are also related to analyses of hedge fund share restrictions (Aragon, 2007) and hedge fund registration (Brown et al., 2008). Our analyses are further related to recent work on international cross-country law and finance analyses of hedge fund regulation in relation to fund structure and performance (Cumming and Dai, 2009; Cumming and Dai, 2010a, 2010b; Cumming and Johan, 2008 Cumming et al., 2013) in the spirit of La Porta et al. (1998, 2002, 2006).

[2] As a further robustness check, we alsoapply management firm fixed effect regressions using a subset of sample whether the same management firm has managed both funds domiciled in Delaware and funds domiciled elsewhere. The fixed effect model enables us to eliminate potential bias due to the unobserved variations across different hedge fund management firms.