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Fund Structures

Pepper Hamilton Attorney Discusses Fundamental Structuring Issues for Investment Advisers: Taxation, Organizational Expenses, Redemptions, Publicly Traded Partnerships, Performance Fees and Alternative Structures (Part Two of Two)

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By Charlie Marlow, *Hedge Fund Law Report*

Pepper Hamilton partner Gregory J. Nowak recently examined in a presentation the key regulatory issues an investment adviser faces when developing its advisory business. This article, the second in a two-part series, summarizes the portions of the program that covered taxation issues, organizational expenses, redemptions, publicly traded partnership rules, performance fees and alternative fund structures. The first article covered separately managed accounts, adviser registration and the applicable federal securities laws.

For further commentary from Nowak, see our two-part series on how hedge funds can protect their intellectual property: "Trademarks and Copyrights" (Feb. 23, 2017); and "Trade Secrets and Patents" (Mar. 9, 2017).

Taxation

Asset managers often use U.S. partnerships and limited liability companies to avoid entity-level tax, according to Nowak. They may also establish funds in tax havens like the British Virgin Islands, which has no entity-level tax. For example, a U.S. mutual fund, which cannot own commodities, can own the securities of an offshore company that trades commodities and pays dividends. In that event, the controlled foreign corporation (CFC) rules will apply, and the CFC must pay dividends to the mutual fund, which the fund can reinvest in the CFC.

See "New Tax Law Carries Implications for Private Funds" (Feb. 1, 2018); and "Tax Practitioners Discuss Taxation of Foreign Investments and Distressed Debt Investments at FRA/HFBOA Seminar (Part Three of Four)" (Jan. 30, 2014).

Organizational Expenses

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Separately managed accounts (SMAs) generally do not have organizational costs, Nowak observed. Accounting treatment of organizational expenses by hedge funds that have custody of client assets can be difficult. For tax purposes, they must be amortized ratably over 180 months.

For accounting purposes, contrary to common belief, hedge fund organizational expenses usually cannot be expensed over 60 months. Under generally accepted accounting principles (GAAP), they must be expensed on the date operations commence, unless amortization would be immaterial (*i.e.*, it would not change the fund's per-share net asset value [NAV] by more than $0.005). Therefore, amortization is essentially impossible for a startup fund and probably only realistic when a fund is "gargantuan," Nowak said.

This is important because, in order to avoid a surprise custody examination called for by Rule 206(4)-2 under the Investment Advisers Act of 1940 – which can double a manager's accounting costs – a manager must provide GAAP-compliant audited financial statements within 120 days after the end of a fund's fiscal year. An audit exception on the amortization issue would render the financial statements non-compliant. To get around this, managers typically pay the expenses themselves, place an expense cap on the fund and seek reimbursement of the expenses from the fund over time.

See our two-part series "How Can Hedge Fund Managers Structure, Negotiate and Implement Expense Caps to Amplify Capital Raising Efforts?": Part One (Jun. 20, 2013); and Part Two (Jun. 27, 2013).

Managers should ensure that their calculations of accounting and investor NAVs match, Nowak added. A mismatch may lead to claims of fraud. The SEC expects organizational costs to be expensed up front to avoid the risk that last-to-redeem investors get stuck with a fund's unamortized organizational expenses.

See also "How Should Hedge Fund Managers Account for Organizational Expenses and Fund Loans, and What Role Should Such Accounting and Manager Solvency Play in Operational Due Diligence?" (Aug. 25, 2011).

Redemptions

In an SMA, there is no concept of redemptions because the investor owns the entire account. Hedge funds, which are offered continuously, calculate NAV on a regular basis and permit investors to redeem based on the fund's liquidity terms. They have a number of mechanisms to manage liquidity and redemption requests including gates, suspensions of calculation of NAV and mandatory redemptions. In a private equity fund, investor money is usually locked in until the underlying assets are sold.

See "Lock-Ups and Investor-Level Gates Prevalent in New Hedge Funds" (Mar. 23, 2017); and our two-part series "Schulte Partner Stephanie Breslow Addresses Gates, Side Pockets, Secondaries, Co-Investments, Redemption Suspensions, Funds of One and Fiduciary Duty": Part One (Dec. 4, 2014); and Part Two (Dec. 11, 2014).

Publicly Traded Partnership Rules

A fund whose interests are readily tradeable on a secondary market or a functional equivalent may be deemed to be a publicly traded partnership that is subject to entity-level tax under Internal Revenue Service rules. A fund that offers liquidity more frequently than quarterly risks

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being subject to entity-level tax, Nowak warned. An exemption exists for funds with 100 or fewer investors, under which a manager is safe offering more frequent liquidity.

If the fund has more than 100 investors, the manager must look at the facts and circumstances to determine whether the fund is the substantial equivalent of an exchange or secondary market, he continued. A Section 3(c)(7) fund that has more than 1,000 investors may have to restrict liquidity to quarterly or less frequently to avoid being deemed a publicly traded partnership. Monthly liquidity is becoming common in private funds, and investors are starting to look for even more frequent liquidity. Therefore, funds with more than 100 investors that offer such frequent liquidity should probably register and risk triggering the publicly traded partnership rules.

See "Accounting for Uncertain Income Tax Positions for Investment Funds" (Jan. 14, 2011); and "What Effect Will the Carried Interest Provision in the Tax Extenders Act Have on Hedge Fund Managers That Are or May Become Publicly Traded Partnerships?" (Jan. 27, 2010).

Performance Fees

The Pennsylvania Attorney General is pursuing fund managers, claiming that performance fees are a "rip-off." The industry is pushing back, arguing that a performance "fee'" is simply an allocation that is granted at the time a fund is created, has no value and is something that the investor never owns. In addition, some argue that the attempt to recoup a performance allocation for investors is a taking of property rights without due process.

See "How Are Your Peers Responding to Investor Demand for Alternative Fee Structures?" (Oct. 12, 2017); and "Investor Pressure Drives New Performance Compensation Models and Increased Disclosure Obligations for Managers" (Jun. 29, 2017).

Alternative Structures

Decentralized Fundless Model

A "decentralized fundless model" is, in effect, "a series of separately managed accounts that are being managed coterminously in accordance with a strategy," Nowak explained. The manager offers a particular strategy, and investors retain the manager to apply that strategy to their separate accounts.

This model works best when all investors come in at the same time, Nowak continued. Problems arise when investors join the manager after the strategy is already in operation. Managers may try to find a way for the new investor to "catch up," or may require the investor to start fresh without any of the historical assets and performance of the original accounts.

See "RCA Session Spotlights Risks With Investment Allocation, Trade Execution, Soft Dollars, Client Solicitation and Valuation" (Apr. 14, 2016); and "How Can Hedge Fund Managers Avoid Criminal Securities Fraud Charges When Allocating Trades Among Multiple Funds and Accounts?" (Jun. 8, 2011).

Some managers address this issue by creating a Global Investment Performance Standards verified composite for their separately managed institutional accounts, Nowak added. They then sell the composite with robust disclosures. Of course, future returns never match the composite because later investors buy in at a later time. The manager must make clear to later investors

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that the advertised returns have been built in for some period of time. This is only an issue when past returns have been positive. In funds, high water marks give managers an opportunity to raise new money after a drop in fund value because new money comes in at the new, lower mark, allowing the manager to potentially earn performance fees on that new money.

See "The Ins and Outs of GIPS Compliance: What Hedge Fund Managers Need to Know About the Voluntary Standards and Pending Revisions" (Aug. 30, 2018).

The model "raises huge compliance issues," especially if one of the separate accounts is a registered fund, in which case "compliance issues go off the charts," Nowak cautioned. In that event, the savings from not having a fund structure are offset by additional compliance costs. Allocation is very straightforward when investors establish all of their accounts at the same time. On the other hand, deploying assets among separate accounts that are established over time, especially when those assets are unique, creates an "allocation nightmare." This is not an issue in a fund, however, because all investors enter at a NAV that reflects historical performance.

In a fund structure, compliance costs are shared by all investors through the fund. In contrast, in a fundless structure, those costs are borne by the manager. A manager can deal with the additional compliance issues in two ways. First, it can establish and impose strict compliance rules on traders. Second, it can establish separate investment teams – walled off from one another – for public products and private funds. The latter approach, however, is duplicative and costly. Managers cite the additional compliance costs to justify charging higher fees for separate accounts.

See our three-part series on the simultaneous management of hedge funds and alternative mutual funds following the same strategy: "Investment Allocation Conflicts" (Apr. 2, 2015); "Operational Conflicts" (Apr. 9, 2015); and "How to Mitigate Conflicts" (Apr. 16, 2015).

Series Structures

A structure consisting of a series of separate closed-end funds solves many compliance problems, Nowak said. If service providers treat each series as a separate fund, however, operational, administrative and accounting costs may be prohibitive. "Family pricing" across all series can minimize administrative costs. Series structures are particularly good for marketplace lending. Some hedge fund managers have tried to adopt private equity models for their debt funds.

Registered Investment Companies

Registered investment companies (RICs) are "wonderful vehicles," according to Nowak, because they do not have investor qualification requirements and do not require subscription agreements. To be eligible for registration, however, an investment company must invest in "securities." Consequently, the SEC rejected a proposed bitcoin exchange-traded fund because it does not consider bitcoin to be a security.

See "SEC Halts Registration of Cryptocurrency Mutual Funds, Calling for Dialogue Regarding Valuation, Liquidity, Custody, Arbitrage and Manipulation Risk" (Feb. 15, 2018).

For many years, small managers leveraged RICs to build their assets under management. Once they reached a critical mass, they would sell the RIC and focus on private funds and SMAs.

Open-end RICs, or mutual funds, are not exchange listed. They provide liquidity through redemptions, which is why they must be able to liquidate their entire portfolios within seven

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days, Nowak explained. Open-end funds cannot issue senior securities. Closed-end RICs can be listed on an exchange, which is very expensive, or may conduct tender offers to give investors a chance to exit the fund. They can issue senior securities as long as they maintain 300-percent asset coverage.

Open-end RICs – but not closed-end RICs – must register under the Securities Act of 1933. If a fund is unregistered, it must use the traditional private fund subscription process and may only be sold to accredited investors. Some mutual funds and funds of funds choose this model because they have closed distribution networks.

See "PLI 'Hot Topics' Panel Addresses Operational Due Diligence and Registered Alternative Funds" (Dec. 10, 2015).

A business development company (BDC) is a type of closed-end RIC that can charge a performance fee. A BDC must invest at least 70 percent of its assets in certain eligible securities. A private equity fund that is running into distribution limitations can use the BDC model to reach a broader audience, Nowak noted.

See "How Hedge Fund Managers and Others May Address Logistical Considerations When Acquiring or Consolidating BDCs" (Nov. 5, 2015); and "Dechert Global Alternative Funds Symposium Evaluates Liquid Alternative Funds and Fund Governance Trends" (Jun. 25, 2015).

Collective Investment Trusts

Collective investment trusts are regulated by the Office of the Comptroller of the Currency and include Revenue Ruling 81-100 collective trusts, which are "super pension plans" and are only eligible for investment by other pension plans and individual retirement accounts, and common trust funds, which are used by banks to pool funds into a common account that is managed by a third party.

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