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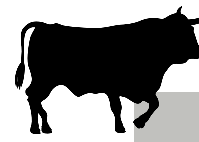

Deciding between a Master-Feeder and a Side-by-Side Structure

One of the fundamental decisions in structuring private investment funds for U.S. and non-U.S. investors is whether to use a master-feeder or a side-by-side structure. In a typical master-feeder structure, a U.S. limited partnership (open to U.S. taxable investors) and an offshore corporation (open to U.S. tax-exempt and non-U.S. investors) invest all of their assets in an offshore "master" entity taxable as a partnership. All of the trading is conducted in the master fund and the feeder vehicles participate pro rata in such trades. In a side-by-side structure, the U.S. limited partnership and the offshore corporation are separate, stand-alone entities that trade alongside each other. While both structures are designed to allow for investment by U.S. taxable and tax-exempt investors, as well as non-U.S. investors, each structure has distinct advantages that should be considered.

The main advantages of a master-feeder structure are as follows:

- A single trading vehicle eliminates the need to split tickets or engage in "rebalancing" trades
- A single trading vehicle eliminates the need to enter into duplicative documentation with counterparties
- A single portfolio may lend itself to easier application of risk management and other analytics
- A master-feeder structure will smooth out performance differences
- A single pool of assets will be available as collateral for credit lines or to otherwise satisfy the concerns of counterparties
- A single pool of assets may make it easier to meet "qualified institutional buyer" or other asset-based requirements
- In certain circumstances, a master fund may have better

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Exceeding ERISA's 25% Threshold

While most private investment funds limit benefit plan investor ownership to less than 25% of each class of equity interest in the fund (the 25% Threshold) (for a discussion of this calculation, see Summer 2001 edition of The Private Funds Report), certain funds may, by design or because of changes in their investor base, desire to exceed the 25% Threshold. Exceeding the 25% Threshold will subject the fund's assets to the Employee Retirement Income Security Act of 1974 (ERISA) and the manager will be subject to ERISA's fiduciary requirements. As a practical matter, exceeding the 25% Threshold is an option only for registered investment advisers, since unregistered advisers are not "investment managers" under ERISA. There are four primary areas of concern for funds that exceed the 25% Threshold:

(i) Prohibited Transactions. There are essentially two types of prohibited transactions (PTs), namely transactional PTs and fiduciary PTs. A transactional PT occurs if there is a transaction between the fund and any party-in-interest to any ERISA investor in the fund. A party-in-interest includes the fund's manager, the fund's service providers, a fiduciary of any ERISA investor or service provider to any ERISA investor. While transactional PTs are often highly restrictive, there are numerous statutory and administrative exemptions available. For example, there are exemptions for the payment of reasonable fees, for executing securities transactions, and for "qualified professional asset managers" (essentially, registered investment advisers with at least $50 million under management and $750,000 in ownership equity). A fiduciary PT is generally a transaction in which the manager (or its affiliate) benefits from its management of the

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Deciding between a Master-Feeder

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opportunities for leverage than a stand-alone U.S. fund (generally, if U.S. investors represent less than 50% of the assets of the master fund)

The main advantages of a side-by-side structure are as follows:

- The manager can manage for tax efficiency in the U.S. fund without disadvantaging the other categories of investors (e.g., 12-month holding period of securities is preferable for U.S. taxable investors, but irrelevant to U.S. tax-exempt or non-U.S. investors)
- If the funds are relying on Investment Company Act Section 3(c)(1), a total of 100 U.S. investors is permitted in a master-feeder structure, whereas in a side-by-side structure, a total of 200 U.S. investors is generally permitted (i.e., 100 U.S. taxable investors in the U.S. fund and 100 U.S. tax-exempt investors in the offshore fund)
- U.S. taxable investors in a stand-alone U.S. fund would not be subjected to an administration fee, as generally would be the case in a master-feeder structure where the fee would typically be based on the total assets held at the master level
- Under current law and SEC interpretations, a 3(c)(1) fund and a 3(c)(7) fund may not be combined in a single master-feeder structure, while a side-by-side structure will permit the use of both a 3(c)(1) and 3(c)(7) fund pursuing identical strategies
- The offshore fund can choose a fiscal year end other than December 31, thereby allowing the manager to stagger the timing of its receipt of the incentive fees/allocations from each fund, whereas a master-feeder structure as a practical matter requires a December 31 fiscal year end for all entities
- A stand-alone U.S. fund may be eligible for certain tax treaties, whereas a master fund itself is generally not eligible
- In the case of a fund-of-funds, a side-by-side structure avoids disadvantageous tax issues for U.S. taxable investors (as would be the case with an offshore master fund) and 3(c)(1) counting issues (as would be the case with a U.S. master fund)

Ultimately, when making this decision, the manager will have to decide which structure best suits its strategy, target investor goals and other relevant factors. It has been our general experience that a master-feeder structure may be appropriate when a significant portion of the investments are other than publicly-traded securities and/or the portfolio turnover is very active, while a side-by-side structure generally is more appropriate in most other instances.

ERISA's 25% Threshold

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fund, other than through its reasonable and fully disclosed compensation arrangements. If a performance fee is charged, the Department of Labor's long-standing position has been that it must be based on the NAV obtained from independent pricing sources (e.g., market quotes for publicly-traded securities). The 8th Circuit Court of Appeals recently held, in *Harley v. Minnesota Mining and Manufacturing Company,* March 26, 2002, that a reasonable performance fee based on a NAV determined by the fund manager was not a prohibited transaction. Other examples of a fiduciary PT would include the receipt of brokerage commissions or soft dollars (other than to pay for research items within the SEC safe harbor), or the retention of rebates of fees, commissions or interest. Unlike transactional PTs, ERISA provides only a limited number of exemptions for fiduciary PTs.

(ii) ERISA Compliance. The manager of a fund exceeding the 25% Threshold will also be subject to compliance obligations, including: (a) a requirement to be covered by an ERISA "fidelity bond", (b) having the capability to provide year-end transaction, asset and expense information so that such information can be included in each ERISA investor's (or the fund's, in some cases) Form 5500 filed with the U.S. Department of Labor, and (c) maintaining custody of fund assets in the U.S. or, if the fund invests in foreign securities and holds them offshore, complying with certain ERISA regulations.

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ERISA's 25% Threshold

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(iii) Liability. The manager of a fund exceeding the 25% Threshold will also be subject to the "prudent expert" standard of care imposed by ERISA on fiduciaries (so that a gross negligence standard may not be used). The principals of the manager will also be personally liable for any breaches of the fiduciary duties to an ERISA investor and will not be able to claim indemnification from the fund for such a breach.

(iv) Disclosure. If the fund was not initially structured to exceed the 25% Threshold, the offering documents may need to be amended to accurately describe the current situation. A short letter to the fund's investors may also be appropriate, especially to the fund's ERISA investors, as ERISA has formal procedures for appointing fiduciaries.

While the foregoing is an attempt to summarize the relevant issues for a fund exceeding the 25% Threshold, there are often specific facts that require a more detailed analysis of the fund's structure and investment program to determine the optimal approach.

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Legislative and Regulatory Snapshots

Deferred Effective Date for the Patriot Act. On October 26, 2001, the USA Patriot Act was passed in an attempt to combat terrorist financing and money laundering. Section 352 of the Act provided that, effective April 24, 2002, all "financial institutions" were to have established an anti-money laundering program that included the: (i) development of internal policies, procedures and controls, (ii) designation of a compliance officer, (iii) establishment of an employee training program, and (iv) arrangement of an independent audit function. *On April 23, 2002, the U.S. Treasury issued a press release and accompanying rules stating that it was exercising its authority to temporarily defer, for a period of not longer than six months, the application of Section 352 to various financial institutions, including private investment funds, commodity pool operators (CPOs) and commodity trading advisors (CTAs) to allow more time to study these institutions and develop applicable regulations.*

Although the application of Section 352 to private investment funds, CPOs and CTAs has been deferred, *we believe that these financial institutions should consider the adoption of certain of the AML procedures set forth in our April 15, 2002 communication to clients, including a procedure to check the names of all existing and prospective investors against the OFAC List (found at www.treas.gov/ofac), and to obtain appropriate representations from all new investors. At this stage, however, we do not necessarily recommend that existing investors be asked to sign any specific representations, until further guidance is provided by the Treasury or other regulatory agency.* We will be following this matter closely.

Unconstitutionality of New York's Publication Requirement. On December 3, 2001, in the case of *Barklee Realty Co. v. Pataki,* the New York County Supreme Court ruled that the New York State requirement of having to publish the initial existence of limited liability companies for six consecutive weeks in two newspapers (which, for New York City companies, can cost approximately $1,500) violated the plaintiff's State Constitutional due process rights. There is a similar law for limited partnerships, which would also likely be affected by this case. As of this writing, the New York law had not yet been repealed or amended in response to the case, however, if that does occur, the New York publication costs applicable to limited partnerships and limited liability companies will likely be eliminated.

Amendments Passed to the California Investment Adviser Registration Rules. On March 27, 2002, the California Commissioner of Corporations adopted a rule that exempts a California-based adviser from registering as an investment adviser with the State, provided that the adviser (i) does not hold itself out generally to the public as

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an investment adviser, (ii) has fewer than 15 clients, (iii) is exempt from SEC registration by virtue of (i) and (ii) above, and (iv) either has at least $25 million under management or provides advice only to venture capital companies.

CFTC Ethics Requirement Changes. On October 23, 2001, Commodity Exchange Act Rule 3.34, regarding Mandatory Ethics Training for Commodity Futures Trading Commission (CFTC) registrants, was eliminated and the CFTC has now issued, instead, a Statement of Acceptable Practices (SAP). The CFTC will no longer maintain a list of training providers and will not send reminders when training is due, as there are no longer any mandated due dates. The CFTC is now allowing registrants to develop their own ethics training programs and to determine how often personnel are required to take ethics training. The SAP (found at www.nfa.futures.org) discusses "appropriate training" upon which registrants may rely as a safe harbor concerning acceptable ethics procedures.

Online CFTC Registration. The National Futures Association (NFA) has designed a mandatory Online Registration System (ORS) for CFTC registrants to make new filings, and amend existing ones, electronically. NFA anticipates that the password-accessible ORS will be ready to accept filings on June 3, 2002. There will be a "quiet period" of approximately 2 weeks, beginning May 17, 2002, during which time the NFA will not accept registration applications or grant any new registrations while they transition the existing paper applications onto the mainframe database. Any incomplete applications which have been submitted will be withdrawn on May 17th and the applicant will have to refile electronically once the system is operational.

Security Futures Trading Coming Soon. The Commodity Futures Modernization Act of 2000 lifted the ban on single stock futures and narrow-based security indices (security futures). The NFA is still working with the CFTC, the SEC and other organizations on various issues — including best execution, suitability, supervision, disclosure, margin rules and testing/proficiency — that must first be resolved before retail trading of such products can commence. While the start date depends on resolution of the above issues, current estimates are that the earliest that these products could begin trading is June 2002. Note that CFTC registration will be required to trade these instruments.

Soft Dollars on Certain Riskless Principal Transactions. On December 27, 2001, the SEC provided new guidance on soft dollars that narrowly expands the types of transactions for which money managers may receive soft dollars. The SEC had previously limited the "safe harbor" (set forth in Section 28(e) of the Securities Exchange Act of 1934) relating to the value of brokerage and research services provided by a broker-dealer to commissions paid to a broker-dealer acting in an agency capacity. Under the SEC's new interpretation, soft dollars will be permitted with respect to certain types of riskless principal transactions involving Nasdaq National Market securities reported under NASD Rule 4632, Nasdaq SmallCap Market securities reported under NASD Rule 4642 and "eligible securities" reported under NASD Rule 6420, if the (i) commission and the transaction price are separately disclosed on a confirmation, and (ii) transaction is subject to trade reporting rules of a self-regulatory organization such as the NASD. Note that if soft dollars are to be received for the foregoing transactions, we recommend that changes be made to, as applicable, the firm's policies, offering materials and Form ADV.

Cayman Islands Enacts Segregated Portfolio Companies Law. On March 12, 2002, the Cayman Islands enacted new legislation entitled the "Segregated Portfolio Companies Law." The new law allows for the creation of a new exempted company (e.g., an offshore private investment fund) that can have multiple portfolios (i.e., with different strategies), while protecting the assets of the investors in one portfolio from the liabilities of another portfolio within the same company. Exempted companies formed after March 12, 2002 may be converted as well. Note that Bermuda is expected to pass similar legislation shortly and that Delaware has a segregated portfolio law already in effect for limited liability companies and limited partnerships.

Practical Considerations

Drafting the Management Company's Operating Agreement. The management company of a private investment fund (i.e., the general partner of a U.S. fund or the investment manager of an offshore fund) will often take the form of a limited liability company (LLC). LLCs afford their owners (called members) limited liability like a corporation, flow-through tax treatment like a partnership and tremendous overall structuring flexibility. While some private investment fund managers start out with only one key principal and thus do not require a detailed operating agreement, when multiple members are involved (e.g., key persons are to be given some form of ownership in the business), an operating agreement addressing a number of issues should be adopted.

Such an operating agreement should address issues relating to governance and management, allocation of profits and losses, and withdrawals. With regard to governance and management, the agreement should cover the responsibilities of each person, how decisions are to be made, and how disputes are to be resolved. A common arrangement will vest one person, known as the managing member, with final authority. With regard to the allocation of profits and losses, the agreement may provide both for vesting provisions and for the assignment to a member of a different participating percentage for its share of each of the management fee, incentive fee/allocation and the proceeds from the sale or disposition of the business, irrespective of such member's actual pro rata capital account ownership. Finally, with regard to withdrawals, the agreement should specify what constitutes a withdrawal (e.g., termination with or without cause, voluntary retirement or resignation, death or disability), to what degree and under what circumstances, if any, does a withdrawing member continue to participate in the profits, and whether such member will be subject to any restrictive covenants concerning non-solicitation of clients and/or employees, non-competition, and confidentiality of information.

Transactions Beyond Long/Short Equities. While many private investment funds primarily focus on investments in publicly-traded long/short equities, a growing number of funds make investments in private or restricted securities, distressed/special situations and/or derivatives. These somewhat less traditional investments raise the following important issues that may need to be considered:

- the fund's offering documents should authorize the particular type of investment, may require that certain mechanisms (e.g., side pockets) be in place to make such investments, and should disclose the particular associated risks,
- the instruments being purchased may have unusual valuation issues that should be addressed,
- frequently, the investments will be purchased in privately negotiated transactions, which will generally require an understanding of the private placement rules and how they affect the transaction, the negotiation of investors' rights and specific exit strategies,
- many of the investments will require extensive due diligence of the issuer and the industry, as well as a knowledge of related regulatory issues (e.g., laws affecting bankruptcies/reorganizations, mergers and acquisitions, capital markets and/or derivatives), in which case outside experts will have to be consulted, and
- the relevant transaction documents should be reviewed by someone who is able to ensure that they legally and accurately reflect the business terms that the manager has agreed to, as well as the latest industry standards and practices concerning the transaction.

Investment Management Group News

John E. Tavss was a recipient of the Open Your Heart for Caring Award at the Hedge Fund Cares benefit on February 4, 2002 at the Grand Hyatt in New York.

John J. Cleary will be speaking at the Goldman Sachs Fifth Annual Hedge Fund Conference on May 21, 2002 at The Breakers in Palm Beach, Florida.

Peter Pront, a partner in the Tax Group, will be speaking on the special tax considerations relating to seed capital funding of new investment managers at IIR's July 2002 conference on Mastering Effective Tax & Audit Practices for Hedge Funds.

Important Reminder

Private investment fund managers are reminded that they are required to provide their clients with an annual privacy notice describing their policies regarding disclosure of clients' nonpublic personal information. The annual notice may be provided at any time during the year and can be included in a periodic mailing to clients.

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Prior editions of this newsletter may be found on the web at www.sewkis.com under News & Publications.

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If you have any questions or comments about this newsletter, please feel free to contact any of the attorneys in our Investment Management Group specializing in private investment funds via telephone at (212) 574-1200 or e-mail by typing in the attorney's last name ***@sewkis.com***

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