Multi-Strat Funds: Structuring Considerations

In a typical multi-strategy fund ("Multi-Strat"), a fund structure is established by an investment manager (the "Investment Manager") that runs multiple investment strategy portfolios within it, oftentimes with different portfolio managers (the "PMs") responsible for each strategy under the Investment Manager's overall supervision. While Multi-Strats have grown significantly in size and popularity in recent years, they present unique structuring challenges that need to be considered when they are being established, as set forth below.

I. Fund Entity Structure

Since Multi-Strats often invest in multiple asset classes and seek to attract a wide investor audience, the Investment Manager must create a product sensitive to the issues that these goals present:

a. **Cross-Portfolio Liability.** If the fund is trading in multiple portfolios within different (or even the same) asset classes, an adverse "blowup" event in one portfolio can compromise the rest of the fund, as the counterparty will seek restitution against the fund's entire asset base. The most common mitigation technique taken by Multi-Strats is the adoption of extremely comprehensive risk management guidelines that are overseen by an omnipresent risk oversight team. Among other things, this would include:

   - PM limits on various exposures (especially leverage and volatility)
   - Diversification guidelines
   - Cross-portfolio correlation restrictions
   - Extensive portfolio stress testing
   - Monitoring of counterparty risk
   - Implementation of sophisticated risk measurement techniques
   - Liquidity management, and
   - Complete portfolio transparency and related reporting.

   In addition, one or more strategies may be traded through a subsidiary of the fund, including a segregated cell or series of a subsidiary. Creating trading subsidiaries adds additional operational work and complexity and is not a replacement for overall risk management, but it will limit cross-class liability in scenarios where counterparties do not require a guarantee from the parent fund or other subsidiaries.

b. **Tax Considerations.** If the Multi-Strat seeks to invest in strategies that may create adverse tax consequences to certain pockets of investors, that will significantly complicate fund structuring. For example, if the Investment Manager seeks to establish a credit portfolio that includes lending activity, this could create "effectively connected income" for non-U.S. investors. Similarly, engaging in U.S. real property investments would have a negative impact on such investors.

c. **Location of Personnel.** If the fund will offer strategies that are to be run by PMs in different jurisdictions, besides creating complications at the Investment Manager level (see discussion below), this could result in taxes being imposed on the fund in certain jurisdictions as well as the imposition of local trading regulations.

d. **Fund and Investment Manager Expenses.** In many Multi-Strats, in part due to the complexities associated with operating such a structure, the Investment Manager will seek to adopt a "pass-through" expense structure where the fund not only pays the traditional fund level expenses such as legal, audit and trading, but also pays some or all of the Investment Manager's overhead costs. For a complete discussion of the pass-through expense model, please refer to our memo entitled "The Rise of the Pass-Through Expense Model."

e. **Fund Redemption Rights.** Depending on the strategies traded, the Investment Manager will need to implement a redemption mechanism for investors within the fund that takes into account the liquidity of the various underlying portfolios. Accordingly, the Investment Manager may consider clauses such as gates, lock-ups and, if needed, some form of sidepocket mechanism.

II. Attraction and Retention of PMs

The success of a Multi-Strat is highly correlated to the performance of its PMs. As such, careful thought must be given to what PMs are offered, including the following components:

a. **Types of Compensation.** Buckets of compensation will often include base salary (or draw), a percentage of the management fees and/or incentive allocations (usually in the form of an annual bonus or distribution), additional bonuses (signing, discretionary or guaranteed), and benefits.

With respect to the percentage of fees and incentive allocations, the Multi-Strat must consider whether the percentage is on the PM's portfolio only or the whole fund, and whether the percentage share is in the form of phantom equity (W-2 income) or actual equity in the firm (K-1 income). Additional bonuses could be fixed, discretionary or some combination thereof. Moreover, if equity is granted in the Investment Manager, consideration would need to be given as to whether this includes a share of any revenue derived from a sale of the business.

Lastly, for PMs who seek to onboard a team, a major point of discussion will involve the extent to which the Investment Manager (as opposed to the PM) is responsible for personnel costs and other costs associated with the PM's portfolio.

b. **Vesting, Deferred Compensation and Clawbacks.** In some instances, significant portions of PM compensation will be deferred, meaning it will vest over time based on length of service. A PM's compensation (or the ability to claw back compensation) may be contingent in part on the nature of their departure. These items could have a major impact on negotiations and the tax impacts attendant to this will need to be studied thoroughly.

c. **Severance.** PMs also sometimes negotiate protections for certain termination events. For example, a PM may negotiate a provision whereby if the Investment Manager terminates them without "Cause," the PM will be eligible for continuation of base salary for a period of time and/or a pro-rated incentive payment for the year of termination, often as consideration for a release of claims. There are a number of ways to structure these provisions.

d. **Netting of Compensation.** Because Multi-Strats involve one fund with many different underlying portfolios managed by numerous PMs, the Investment Manager is generally paid an aggregated incentive allocation based on the total net performance of the entire fund. This would seem quite fair to fund investors. However, if a high performing PM is paid based on the net performance of the whole fund and the other PMs underperform, the outperforming PM would view themself as being underpaid. Here are a number of approaches that may be taken by the Investment Manager to reduce or eliminate netting risk with respect to the incentive allocation:

   i. Paying off any incentive allocation shortfall out of the management fee and the pass-through expenses borne by the fund.

   ii. The outperforming PM receives a supplemental guaranteed bonus up to a certain pre-set dollar amount and any shortfall is carried over into the following year.

   iii. The outperforming PM receives a higher percentage of the management fee and any shortfall is carried over into the following year.

e. **Track Record Ownership.** The PM may seek to negotiate a right to the ownership and portability of their track record upon their departure. In light of the recently passed Marketing Rule, the Investment Manager would need to provide the PM with all of the backup documentation attributable to such track record in order for the PM to use it down the road. Investment Managers who permit PMs to utilize their track record often style it as a license subject to continued compliance with the PM's obligations to the Investment Manager and its affiliates.

f. **Restrictive Covenants.** The Investment Manager may seek to impose on the PM post-departure restrictions on competition and solicitation of Investment Manager personnel and clients. The length and breadth of these clauses will need to be discussed, and their enforceability and permissible scope may depend on applicable law.

g. **Tail and Capacity Rights.** It is becoming much more common for Investment Managers to ask for rights in the future businesses of PMs after their departure, including capacity rights with special fee terms, and, most significantly, a share of the revenues of the future business.

III. Investment Manager Concerns

Establishing a Multi-Strat is a very complex undertaking that will create numerous issues for the Investment Manager itself, including:

a. **Deep Pocket Exposure of the Fund's Incentive Allocation Recipient.** In Multi-Strats, typically there will be one general partner receiving the aggregate incentive allocation across all of the strategies, whereas in non-Multi-Strats you would often have a different general partner for each new fund strategy. Until such time as the incentive allocation is withdrawn from the fund, which may be delayed to the extent it consists of unrealized gains, such amounts are at risk under the general partner liability rules within limited partnerships. Moreover, even if the fund is set up as a limited liability company, claimants would be quick to name the recipient of an incentive allocation as a defendant in all sorts of lawsuits.

b. **Significant Overhead Burden.** In light of the numerous PMs, strategies and jurisdictions that could be present in a Multi-Strat, the Investment Manager will need to expend significant resources towards areas such as technology and infrastructure; offices and utilities; insurance; accounting, risk management, operations, marketing, investor relations, legal/compliance and trading personnel; recordkeeping, accounting and reporting; travel and entertainment; and research.

c. **Trading Complexities.** With multiple PMs trading in the same asset classes, extensive trading controls must be put in place in order to meet all applicable trading and reporting requirements/restrictions, including wash trades, position limits and order marking. This compliance becomes even more difficult, if PMs do not use a consolidated trading desk.

d. **Regulatory and Tax Coordination.** Trading a wide variety of assets potentially across multiple offices and jurisdictions will raise a host of issues, including those relating to adviser registration and licensing, immigration law implications, and multi-jurisdictional tax exposure.

e. **Firm Oversight.** In a wide-reaching structure such as a Multi-Strat, the chain of command is a critical decision point, as multiple layers of management spread across different geographies in various time zones could significantly hamper the decision-making process and adversely impact alpha generation.

A Multi-Strat fund has the potential to create a diversified portfolio that provides positive returns across all market cycles. To achieve such potential, an Investment Manager must address the unique structuring, employment, tax, operational and other considerations discussed above.

If you have additional input that you would like to share with us, or have any questions, please contact your primary attorney in Seward & Kissel's Investment Management Group.

Recognitions:

The Investment Management practice and partners have been widely recognized by industry organizations for our representation of investment managers, including but not limited to recognition by the following organizations:

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