Opportunistic Investment Structures: Issues to Consider

Alternative investment managers are increasingly being approached by investors seeking access to a structure that provides a modified, more bespoke version of the manager's overall portfolio strategy. Investors' reasons for this may include: ESG allocation guidelines, an interest in different beta or volatility levels, a desire to capitalize on a market dislocation, or an appetite for a specific market sector or exposure. Often these investor requests are accompanied by a need to implement the modified portfolio for the investor quickly.

Investment managers have various options that may work to satisfy these investors, but should be mindful of the following considerations:

1. Establishing a Separate Share Class in an Existing Fund

- **Timing:** Can be accomplished relatively quickly
- **Documentation:**
  - Requires amendments to fund disclosure materials
  - May create issues with the fund's existing counterparty documents
  - Requires the adoption of policies designed to ensure the proper allocations of fees and expenses within the fund
- **Customization & Structure:** Likely less tailoring available to the investor as compared to the other alternatives outlined below, since the investor is joining an existing structure with investors already in place
- **ERISA:** May create ERISA issues with respect to the "25% test"
- **Additional Considerations:**
  - Typically, will give rise to cross-class liability exposure with the existing classes in the fund, unless the fund has been structured as a segregated cell company (which could require both existing investor and creditor consent, if being considered post-launch)
  - Allows for multiple investors
  - No additional infrastructure required

2. Establishing a Separately Managed Account Arrangement

- **Timing:** Can be established very quickly, if there's not extensive client negotiations
- **Documentation:** Does not require any offering documents (just an investment management agreement)
- **Customization & Structure:**
  - Most flexible of all options in terms of individual investor tailoring
  - Aside from the trading authority which is vested with the manager, the account is fully controlled by and in the name of the client, with corresponding portfolio transparency
  - Sometimes set up as a "fund-of-one"
- **ERISA:** May subject the manager to onerous ERISA requirements, if it's an ERISA client

- **Registration & Compliance:**
  - An unregistered manager may have to register as an adviser with the SEC or at the state level, and may no longer be able to rely on certain registration exemptions
  - May raise compliance issues under Sections 13 and 16 in terms of who is the responsible filing party
- **Fees & Tax Treatment:**
  - Since the manager usually receives a performance fee as opposed to a performance allocation, generally there is no carried interest tax treatment
  - Fees paid by the client to the manager are not deductible
- **Additional Considerations:**
  - Can only accommodate one client
  - Typically, no audit is required, unless requested by the client
  - Manager will need an infrastructure to allocate trades and expenses, as applicable, among the separately managed account and other client accounts
  - May expose the client to greater counterparty risk than a fund which has limited liability
  - May raise most favored nation issues with other manager products

3. Establishing a Traditional Hedge, PE or Similar Fund for the New Strategy

- **Timing:** Typically requires more time to establish and the costs will likely be higher than the other options
- **Documentation:**
  - Requires a complete suite of offering documents
  - Use of the flagship fund's offering documents as a starting point may mitigate drafting issues somewhat
  - May be able to leverage the existing fund's counterparty documents when setting up the new fund
- **Customization & Structure:**
  - Can be somewhat customized, if the investor's investment is contingent upon having a say in the key fund terms to be included at launch
  - May require the establishment of both a US and an offshore fund (depending on the strategy and type of investors)
- **Registration & Compliance:** Fund will be disclosed on the Form ADV, if the manager is SEC-registered
- **Fees & Tax Treatment:**
  - Carried interest tax flow-through on an incentive allocation is possible
  - Better tax treatment for US taxable investors with respect to manager compensation, especially as compared to a separately managed account
  - Management fees paid by US investors are deductible, if the fund is a "trader"
- **Additional Considerations:**
  - Will allow multiple investors to access the opportunity
  - Audit is required

4. Establishing a Special Purpose Vehicle ("SPV")

- **Timing:**
  - Quicker and less expensive to establish than a traditional fund described in 3 above
  - Timing, however, may be delayed, if there is the need for an offshore SPV counterpart
- **Documentation:** Offering documents tend to be shorter than for a traditional hedge, PE or similar fund
- **Customization & Structure:**
  - Usually more closed-end in nature with a limited offering and investment period, even when the investment assets are publicly-traded
  - Capital is sometimes raised via a drawdown mechanism
  - Generally, only holds one or a small number of investments within a theme (e.g., a subset of the main fund's portfolio)
  - Investors are normally given limited, if any, withdrawal rights
  - Since SPVs tend to be set up very quickly, they offer limited customization opportunities to investors
- **Fees & Tax Treatment:**
  - Typically, the manager receives a performance allocation or carried interest only upon a realization event
  - Management fee is usually lower than any affiliated traditional fund
- **Additional Considerations:**
  - Usually an audit is required and the manager (if registered) will have to include the SPV as a private fund on its Form ADV
  - May give rise to allocation issues with the flagship fund, if similar positions are held in both vehicles
  - Usually only meant for a small number of investors who can rapidly deploy their capital