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

If you have any questions regarding the matters covered in this memo, please contact any of the partners and counsel listed below or your primary attorney in Seward & Kissel's Investment Management Group.

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