Morgan Lewis

ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives

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Expanding Your Fund Platform

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Overview

- Managed accounts and funds-of-one
- Migration to private equity
- Multiple fund offerings
- Hybrid funds
- Hedge fund co-investment vehicles
- Liquidity concerns with illiquid structures
- Global capital raising: EU feeder funds
- Global capital raising: deferred variable annuities

Managed Accounts and Funds-of-One

Investor perspectives

Greater investment size

Customized investment programs – ease of modification; customized leverage, concentration, sector and geography limits, derivative exposure, and asset types

Lower or different fee structures (e.g., multiyear crystallization period for incentive allocations)

Greater setup costs for LPs, although possibility of budget/oversight on operating expenses

Generally, more LP-favorable indemnification and standard-of-care terms

Greater control, transparency, and governance terms (e.g., position-level transparency, customized reporting, notice of bad acts, approval of service providers, removal/termination rights, directed trading/suspension of trading)

Managed Accounts and Funds-of-One

Investor perspectives

Negotiable/preferential withdrawal terms (fewer gates, suspensions, and lockups; fee tails for early termination; practical consideration includes transfer of illiquid assets to investors)

Additional rights that may be inapplicable to other investors (e.g., representations or closing opinions; governing law and/or jurisdiction of choice)

Long-term relationships

Leveraging the manager's infrastructure (e.g., access to sponsor knowledge; may include required training for investor)

One governing agreement—side letters less prevalent

Managed Accounts and Funds-of-One

Fig. 9.2: Terms and conditions of managed accounts vs. single-manager hedge funds

Structure	Mean minimum investment ($mn)	Mean management fee (%)	Mean performance fee (%)	Mean lock-up (months)	Median redemption frequency (days)	Median redemption notice (days)
Managed accounts	19.7	1.3	17.8	6.2	30.0	30.0
Hedge funds	4.5	1.4	18.4	11.8	90.0	45.0

Source: Preqin Pro. Data as of September 2022

Source: Preqin Global Report 2023: Hedge Funds

Managed Accounts and Funds-of-One: Manager Perspectives

Managers with existing commingled funds may desire the operational efficiencies afforded by all investors participating through a single entity.

The terms governing the commingled fund are more likely to be favorable to a manager than the customized terms prevalent in funds-of-one and separate accounts.

While these structures are often less favorable to investment managers than traditional commingled funds, they are often used for strategic investors, early investors, or investors willing to commit enough capital to justify their costs (e.g., $50-$100 million).

A manager may not be able to present a consolidated track record among its commingled funds, funds-of-one, and separately managed accounts, especially if there are differing investment restrictions, strategies, objectives, and fees.

The fund may be prone to tracking errors, and its performance may not correlate with the commingled fund that it is intended to track (as a result of different fees/costs, setup delays, different investment program, different valuation procedures, etc.).

Managed Accounts and Funds-of-One

Additional Manager Issues

Disclosure Issues

Conflicts of Interest: allocation of expenses between commingled funds and funds-of-one/managed accounts; allocation of investment opportunities between commingled funds and funds-of-one/managed accounts

Deal Structuring: are SPVs used/permitted to aggregate investments?

Regulatory Issues: manager that has managed accounts would not be able to rely on the "private fund exemption" to be exempt from the Advisers Act

Migration to Private Equity

In recent years, we have seen increasing activity by hedge fund managers investing in traditional private equity/debt. This trend is a result, in part, of the public markets and investor demand.

Traditional private equity/debt investing is generally a less liquid strategy, and therefore many current hedge fund structures and terms are not well equipped to accommodate such private equity-style investment strategies.

Hedge fund managers are attempting to modify their fund terms (or set up new funds with different terms) to address reduced liquidity of these investments by imposing gates, longer lockups, or increase of side-pocket capacity.

Hedge funds, however, have certain advantages over private equity funds: hedge funds have no restrictions on when a private equity-style investment can be made, can more easily reinvest capital, and can raise or draw in additional capital for its private equity investments.

Multiple Fund Offerings

Compliance with disclosure in existing funds	Time and attention/exclusivity standards (in offering documents and seed agreements)	Sharing revenue among the principals	Expense allocations
Trade allocations	Co-investment rights	Cannibalization risk of flagship product	Business complexities

Hybrid Funds

- A hybrid fund combines attributes of a hedge fund and a private equity fund.
- Hybrid funds – various forms:
  - Traditional hedge funds with side pockets (still common)
  - Private equity–styled fund with a large portion of its portfolio in public securities and a long hold period, with no incentive fee on unrealized appreciation and limited or no redemption rights (limited rights may include rolling long lockup periods)
  - Side-by-side fund (hedge fund for liquids and private equity fund for illiquids)
- Hybrid funds are bespoke.

Hedge Fund Co-Investment Vehicles

Hedge fund managers are offering co-investment vehicles for the following reasons:

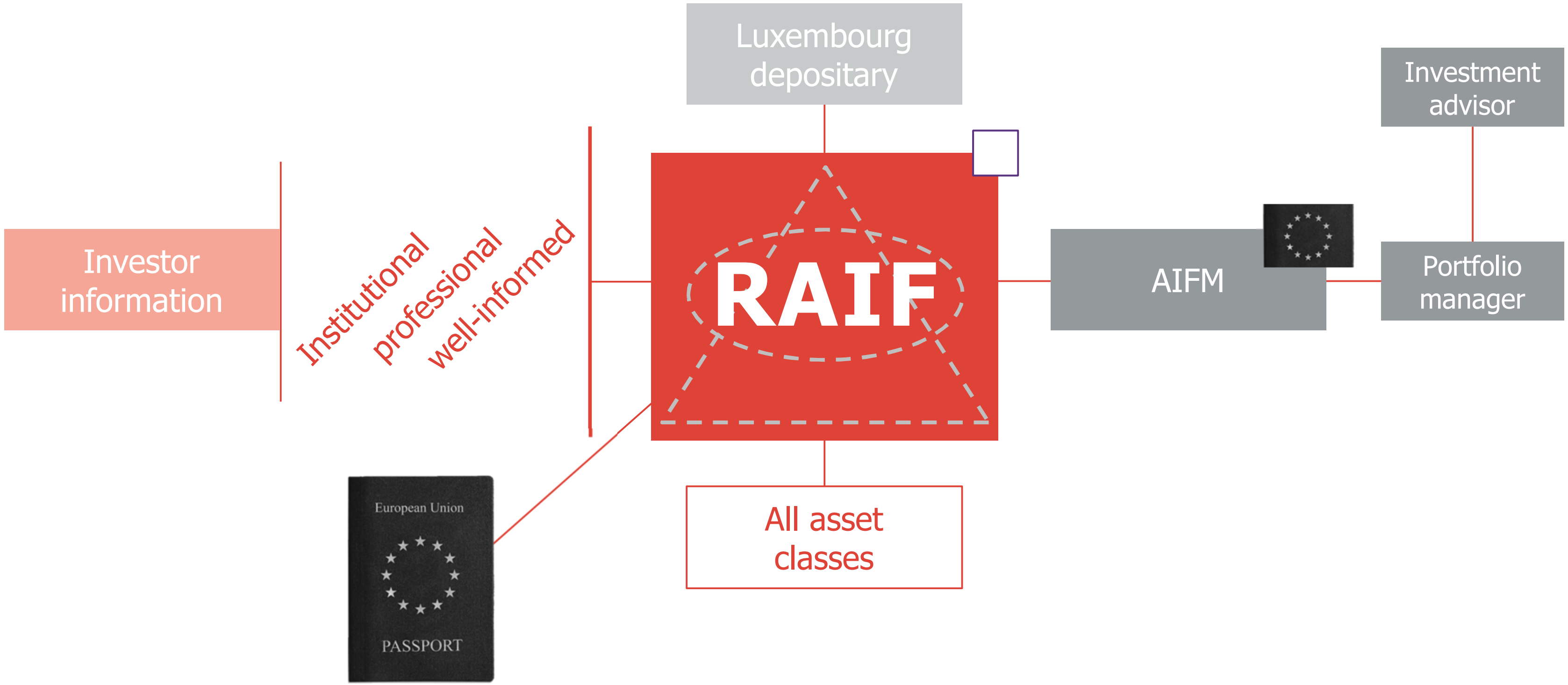
- Negative perception of "side pockets"
- Concentration and capacity limitations
- Opportunities in illiquid investments
- To showcase expertise and distinguish oneself from "the pack"
- Creation of goodwill; raising of additional capital
- Dedicated fund for a manager's "best ideas" or to co-invest alongside the flagship fund

Liquidity Concerns with Illiquid Structures

- Adequacy of valuation
- Risk management
- Inability to redeem
- Increase in secondary transactions for hedge fund side pockets
- Spinouts and reorganizations of illiquid assets

Global Capital Raising – EU Feeder Funds

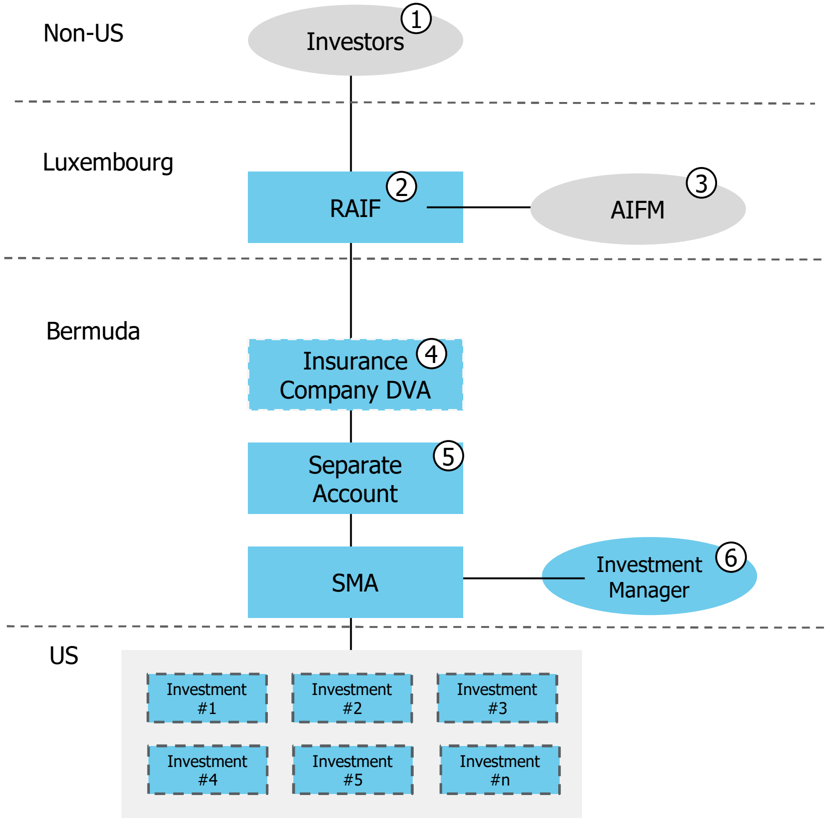
The Reserved Alternative Investment Fund (RAIF)



Global Capital Raising – EU Feeder Funds

- Legal structuring flexibility: Similar to the SIF and to the SICAR, all Luxembourg corporate, partnership and contractual legal forms are available to set up a RAIF.
- Eligible investors: RAIFs are available to "well-informed" investors, a category that includes institutional investors, professional investors, and natural persons investing a minimum amount of EUR 125,000 (self-certification).
- Investment strategy: The RAIF can invest in all types of assets either directly or via controlled intermediate companies subject to minimum risk-spreading requirements.
- Governance: Each Luxembourg AIF that elects to be treated as a RAIF must appoint an authorised AIFM, whether established in Luxembourg, in another EU Member State or a third-country authorized AIFM.
- Delegation: The AIFM can delegate portfolio management or risk management functions to delegates and/or rely on investment advisors based in the EU or outside the EU, in compliance with the requirements of the AIFM Directive. A Luxembourg-based depositary bank or professional of the financial services sector providing depositary services needs to be appointed.
- Investors' information and transparency: Being managed by authorized AIFMs, RAIFs will be required to comply with AIFM Directive transparency requirements, notably in relation to disclosures to investors (initial and ongoing) and annual reports.
- Passport: As an EU-based fund managed by an authorised AIFM, the Luxembourg RAIF avails of the AIFM Directive passport for cross-border marketing to professional investors across the EU.
- Tax efficient features: The RAIF is either subject to an annual subscription tax (*taxe d'abonnement*) at a rate of 0.01%, with various exemptions, or subject to the tax regime applicable to SICARs, in which case it would fully benefit from tax exemptions for qualifying risk capital income and gains.

Global Capital Raising: Deferred Variable Annuity (DVA)



1. Non-US investors purchase an interest in the RAIF.
2. Reserved Alternative Investment Fund
Established in 2016,the RAIF has characteristics and features of a Luxembourg regulated specialized investment fund (SIF).
3. RAIF is managed by a regulated Alterative Investment Fund Manager ("AIFM").
4. A non-US insurance company issues a single DVA contract to the RAIF.
5. All policy assets are held in the segregated separate account of the non-US insurance company .
6. Independent investment manager(s) contract with the non-US insurance company via an investment management agreement.
7. Investments are subject to the diversification requirements in IRC § 817(h) and Treas. Reg. § 1.817-5, as well as the investor control doctrine.

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*There are numerous important aspects of the proper structuring of US-compliant annuity structures that are not discussed herein and beyond the scope of this article, and which may have material impacts on the ultimate structuring of an investment arrangement intending to be US-compliant.

Global Capital Raising: Deferred Variable Annuities

- Eliminates US tax leakage otherwise associated with ECI, FIRPTA and BPT
- Eliminates need to file US income tax return
  - Insurance carrier assumes sole/complete responsibility for US tax compliance
  - Tax reporting streamlined and less costly—no Schedule K-1s, etc.
- Strong tax foundation
  - US tax regime governing life insurance companies and policyholders is extensive/specialized
  - Based on continuing evolution of Code/Treasury regulations, other rules/guidance, and judicial decisions, since enactment of the US income tax
  - Framework premised availability of tax-deferred inside buildup of insurance/annuity policy
  - Since 1977 a specialized test—the "investor control doctrine"—has been used to determine the limited facts/circumstances where tax deferral should be denied by treating policyholder (instead of insurance company) as "tax owner" of the investments supporting a policy
  - Eliminates need to rely on sometimes difficult to interpret US income tax treaties

Global Capital Raising: Deferred Variable Annuities

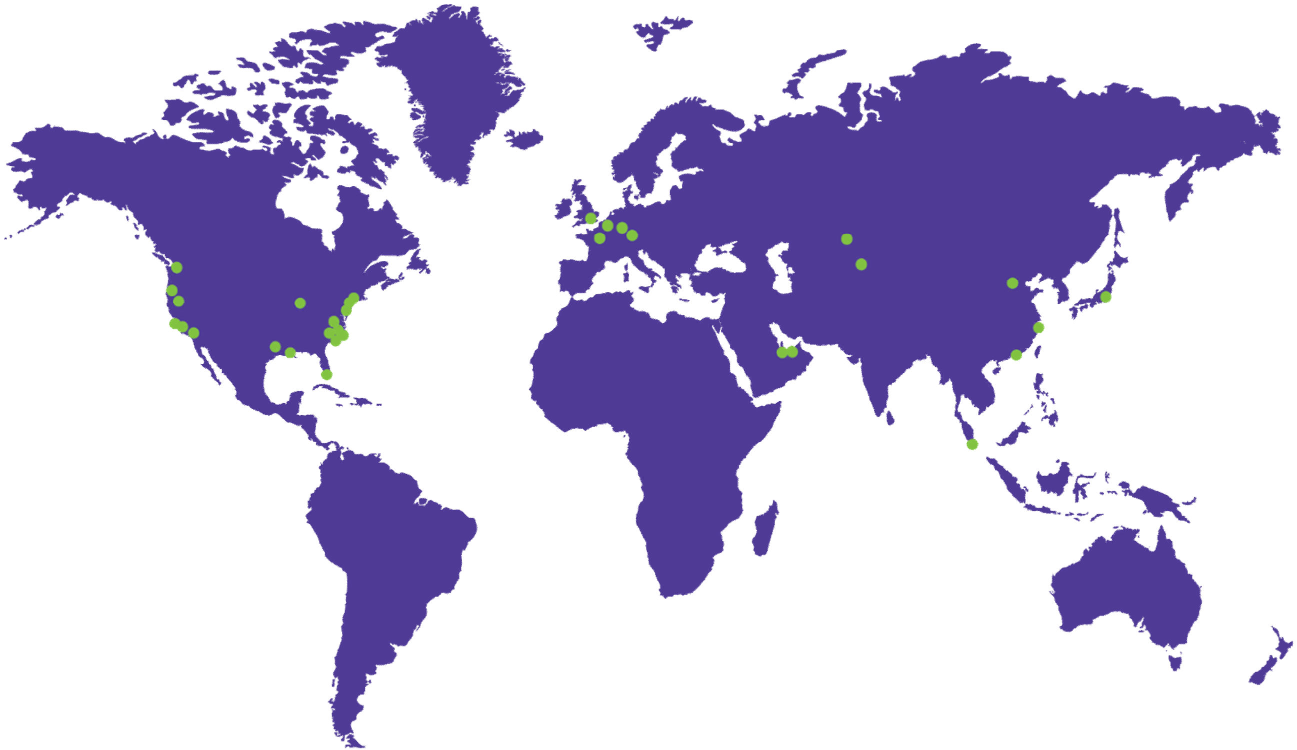
- Eliminates counterparty risk
  - Segregated asset account protection from creditors of the insurance company and other unrelated investors
  - Creditor/asset protection perceived stronger in BM than US
- Enhances confidentiality and privacy
- Streamlines administrative costs

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Astana
Beijing
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong
Houston
London
Los Angeles
Miami
Munich
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Seattle
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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