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Investment Management Hot Topics

Long-Only and Other Tailored Private Funds

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1. About the Speakers

2. PowerPoint Presentation

3. Outline

1. About the Speakers

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Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including the acquisition of Prisma Capital Partners by global investment firm KKR & Co. Philippe's other recent representations include advising Credit Suisse on the sale of Strategic Partners to Blackstone Group LP; representing the Related/Oxford joint venture developing Hudson Yards in closing nearly $1.4 billion in equity investments and debt financing for the center's first tower; advising ABS Investment Management LLC in Evercore Partners Inc.'s purchase of a non-controlling stake in ABS; representing Gresham Investment Management LLC in its sale of a 60 percent stake to Nuveen Investments; advising Secor Asset Management LP in regard to an investment by Babson Capital Management, a subsidiary of MassMutual; and advising the asset management division of Credit Suisse Group AG in its acquisition of an interest in York Capital Management LP. Philippe has also advised multiple alternative asset managers on the formation and structuring of many funds during the past year.

A frequent speaker at prominent industry events, Philippe recently spoke at the Bank of America Merrill Lynch COO and CFO Hedge Fund Symposium. He also presented "FATCA — Issues for Private Fund Managers" at an SRZ webinar, as well as "Current Developments in the Secondary Market for Fund Interests" and "Manager Acquisitions and Spinoffs" at SRZ's 22nd Annual Private Investment Funds Seminar.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship and served on the staff of the *Journal of International Law and Politics*. He obtained his B.S., *summa cum laude*, from Adelphi University.

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Brian advises hedge and private equity fund managers and commodity pool operators on regulatory, compliance and operational matters, including registration and disclosure obligations, trading issues, advertising and marketing, and the establishment of compliance programs. Having spent nearly a decade serving in-house as general counsel and chief compliance officer at several prominent hedge fund management firms, Brian is well versed in a wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisors and has extensive experience designing and improving compliance processes and organizational systems. Brian has represented clients in proceedings and interactions with regulators in the U.S., the U.K. and Asia.

Brian is well-known for his thought leadership in the regulatory and compliance area as it affects alternative investment funds. In addition to participating in SRZ-sponsored seminars and workshops and authoring SRZ client alerts, he co-authored "FSA Conflicts of Interest Safeguards: Action To Be Taken by All UK-Authorised Hedge Fund Managers" which was published in *The Hedge Fund Journal*, presented "Marketing and Working with Investors in the Current Environment" at Ambrose Connects 2013, discussed "Trading Compliance and Regulations" at ACA Compliance Group's Spring 2013 Compliance Conference, and spoke on the "US Regulatory Update" and "40 Act Developments" panels at the Bank of America Merrill Lynch COO and CFO 2013 Hedge Fund Symposium.

Brian also teaches legal ethics at Yale Law School, focusing on the challenges faced by in-house counsel, and formerly served as co-chair of the Managed Funds Association's General Counsel Forum and as a steering committee member of its Investment Advisory Committee.

Brian received his B.A., *magna cum laude*, from Catholic University of America, his M.A. from the University of Hawaii and his J.D., with distinction, from Stanford Law School.

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David practices in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and structures seed capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and has been recognized by *The Legal 500 United States* as "an extraordinarily capable attorney. He has a mastery of the pertinent matters, but he also brings a pragmatic approach." A published author on subjects relating to investment management, David also is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law and business schools. Some of his recent presentations include "Trends in Fund Governance and Investor Scrutiny" for the UBS Premier Hedge Fund Client Conference, "Operational Issues" for SRZ's London Investment Management Hot Topics and "Capital Raising in 2013" for the SRZ 22nd Annual Private Investment Funds Seminar.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law and his B.A. from Vassar College.

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Jason concentrates on investment management and regulatory & compliance matters, and advises on general corporate, securities and compliance issues for investment advisers and investment funds. Jason's practice focuses on advising managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structuring and negotiating seed and strategic investments and relationships; and advising investment managers with respect to regulatory and compliance issues.

Jason's writing and speaking engagements include co-authoring "Dodd-Frank Becomes Law: Key Issues for Private Fund Managers," published in *The Hedge Fund Journal*, and presenting "Form PF" at a recent Goldman Sachs Prime Brokerage Form PF Workshop.

Jason earned his J.D. from Fordham University School of Law, where he was a member of the *Fordham Law Review*, and his B.S. from the University of Michigan.

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Investment Management Hot Topics

2. PowerPoint Presentation

Overview

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Investment Management Hot Topics

Notes:

"Long-Only" Defined

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Investment Management Hot Topics

Notes:

Long-Only Market Terms

Fees and Liquidity

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Investment Management Hot Topics

Notes:

Other Tailored Funds

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Investment Management Hot Topics

Notes:

Fund Structure

Side-by-Side, Mini Master and Master Feeder

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Investment Management Hot Topics

Notes:

Conflicts of Interest

Trade and Expense Allocations

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Investment Management Hot Topics

Notes:

Other Conflict Issues

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Investment Management Hot Topics

Notes:

Marketing Issues

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Investment Management Hot Topics

Notes:

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Investment Management Hot Topics

3. Outline

Long-Only and Other Tailored Private Funds

I. Introduction

A. Long-only products have historically been offered by traditional asset managers. However, within the last few years, a number of alternative asset managers have moved into the long-only space and have offered long-only funds and managed accounts alongside the manager's "flagship" hedge fund. The popularity of long-only products has grown alongside the stock market gains in the post-recession recovery.

B. In addition to long-only funds, many alternative asset managers have offered other tailored funds and products designed to meet specific investor interest. These custom products may draw on a particular investment strategy or invest in securities based, in part, on the "flagship" fund's investment program or securities portfolio.

II. Current Market Terms (Based on SRZ Internal Survey and External Surveys of Long-Only Funds)

A. Investment Program

1. Long-only programs may provide flexibility for a manager to hedge (including through derivatives and short positions) under extraordinary market circumstances or as otherwise deemed warranted by the manager.
2. Long-only programs may also employ varying degrees of leverage. This could be as simple as utilizing "Regulation T" margin in an equities account to more complex portfolio margining using assets in various classes.
   (a) If total return swaps are utilized to obtain leverage (or for other reasons), managers need to be sensitive as to whether those swaps are CFTC-regulated "swaps" or SEC-regulated "securities based swaps."
   (b) Depending on the classification and the volumes utilized, a manager's ability to claim exemptions from CFTC or SEC registration could be affected.
3. Long-only funds may seek to replicate the entire long portfolio of a manager's "flagship" fund or focus on a concentrated strategy or subset of strategies, opportunities or best ideas from the "flagship" fund.
4. Long-only programs can focus on different types of assets and geographical scope. Managers sometimes seek long "exposure" to a particular asset class, geographical area or other element of risk.

B. Liquidity

1. Long-only programs offered by alternative asset managers are generally liquid, although long-only private funds are generally not as liquid as long-only products offered by traditional asset managers through mutual funds which offer daily redemption rights.
2. Most long-only products offered by alternative asset managers provide for monthly or quarterly redemption rights with short notice periods.
3. A minority of long-only funds offer classes with hard lock-ups or soft lock-ups varying from six months to three years with post-lock-up liquidity ranging from quarterly to annual liquidity. Redemption fees generally range from one percent to five percent for funds with soft lock-ups.
4. Long-only funds with lock-ups generally provide for variable pricing, e.g., lower management fee rates and/or incentive fee rates in exchange for longer lock-up periods.

C. Compensation

1. The surveys indicate that fees for long-only products generally are not dramatically lower than other products offered by alternative asset managers.

2. Management Fees

   (a) The majority of long-only products offer classes with management fee rates of 1.5 percent or higher.

   (b) 1.5 percent management fee rate is standard.

3. Incentive Compensation

   (a) Incentive fee rates generally range from 15 percent to 20 percent, although some outliers charge from zero percent to 10 percent.

   (b) Unlike standard hedge fund incentive fee terms, the most common incentive fee structure for long-only funds is to base such fees on the outperformance of a particular index (e.g., S&P 500 Index or MSCI Index). As such, an incentive fee may become due as long as the fund outperforms the index even though an investor experiences a loss in its capital account for the applicable period. If the fund underperforms the index, the underperformance amount is carried forward to future periods which must be recovered before an incentive fee is charged.

   (c) When incentive compensation is structured as an allocation of profits (as is the case in most domestic funds and offshore mini-master funds), the timing and manner in which the compensation is allocated needs to be considered in the event that there is negative performance that is nevertheless outperformance over the benchmark. Recharacterization of an incentive allocation as an incentive fee may have negative tax consequences both to noncorporate taxable U.S. investors (deductibility) and fund managers (e.g., entity-level taxes if based in NYC).

   (d) Some long-only funds use standard hedge fund incentive fee terms, including a cumulative loss carryforward. Some also utilize hard or soft hurdles in the incentive fee calculation.

4. Cannibalization. A key hurdle for managers to overcome is the cannibalization issue. Simply put, how can a long-only or tailored product be marketed and operated in a way that does not undercut the flagship products.

   (a) This is a particular concern when there is a lower fee and incentive structure.

   (b) It can be a delicate balance for managers, in promoting a new, more narrowly-focused fund with a lower fee structure, to send a message that the new vehicle will get enough of the manager's expertise while also disclosing that the new fund is — in essence — a narrower and simpler product (and not the same product at a discount).

III. Structure and Tax Considerations for Long-Only Funds

A. Long-only funds are usually commingled, and the factors for determining the structure of long-only funds are similar to the structuring decisions for other types of funds.

B. Long-only funds typically produce more dividend income and long-term capital gains than a typical fund. While taxable U.S. investors may benefit from such tax treatment, non-U.S. investors are subject to a 30 percent U.S. withholding tax on U.S.-source dividends unless an applicable treaty reduces or eliminates such tax. Accordingly, a fund for non-U.S. investors may dispose of securities prior to dividends being declared or may invest in derivative instruments referencing the underlying security, while a fund for U.S. investors may prefer to invest directly in the security and hold it through the dividend payment.

IV. Other Tailored Funds and Products

A. Types of Tailored Funds

1. *Socially Responsible*. Funds that incorporate environmental, social and corporate governance criteria in making investment decisions (often referred to as “socially responsible” investment criteria).
2. *Concentration/Best Ideas*. Funds which focus on a small subset of a flagship fund’s program or on a specific set of “best” ideas from a flagship fund.
3. *Tailored Funds*. (Often funds of one or traditional managed accounts) that follow very specific, tailored investment guidelines and have limited investment strategies (e.g., single-deal funds).

B. Structure and Tax Considerations

1. These types of funds may be structured as comingled or funds of one depending on the investment program and the circumstances.
2. FATCA requires reporting and possible withholding on certain U.S. persons or non-U.S. persons who do not provide sufficient beneficial ownership information. Compliance with FATCA may be simpler with a U.S. fund (which itself does not have to register with the IRS), especially where the fund has a majority direct or indirect corporate owner.
3. When the target is a non-U.S. corporation, a non-U.S. commingled fund may be preferable for sizeable acquisitions so as to reduce the possibility of the target becoming a controlled foreign corporation, where gain on disposition becomes ordinary income instead of long-term capital gain.

V. Regulatory/Fiduciary Considerations

A. Allocation Issues and Conflicts of Interest

1. Trading Considerations

(a) Allocations are almost always more difficult in practice than they appear at first blush.

(i) Investment ideas for a long-only or tailored product may be predominantly drawn from the universe of positions in which a flagship fund invests, although the manager may determine that certain investments not contained in the flagship fund’s portfolio are appropriate for the long-only fund/tailored fund and vice versa. If a long-only fund or tailored fund invests in a subset of securities in which a flagship fund invests, managers need to be attuned to potential conflicts in allocations of trades and opportunities.

(ii) When setting up an allocation structure, a manager needs to understand what it is allocating. Is it shares or dollars of principal in a given name or strategy? Or is it exposure to a conceptual risk factor (which could be expressed as a basket of risks)?

(iii) In setting allocations, managers often have to determine if there are substitutes.

(iv) Allocating investment opportunities between a long-only or tailored fund and a flagship fund based on percentage guidelines (e.g., 70/30) may still result in material differences in the actual exposure of each fund when hedging and shorting are factored in.

(b) Dealing with funds that trade on different schedules can be challenging, especially when the instruments are less liquid. For example, if a more opportunistic flagship fund strategy can trade ahead of a slower-moving long-only fund, a manager needs to analyze whether one fund is front running the other or, conversely, if the earlier fund is capturing the entire opportunity and leaving the later fund to trade on prices in the new market.

(c) Similarly, later transactions in less liquid instruments in one fund can move the valuations for the other fund in a disproportionate manner.

(d) *"Cherry picking."* If an idea is promoted (even colloquially) as a "best ideas" fund, there are clear fiduciary considerations to consider: If the long-only or tailored fund has the "best" ideas, what does that say about the other portfolios? How will the manager seek to ensure that its best efforts are fairly allocated among all of its clients (or, if that is not the case, is the manager comfortable that its disclosure is sufficient and understandable).

2. Expense Allocations. Managers running long-only or tailored funds alongside a flagship strategy have a number of expense allocation issues to consider.

(a) Expenses need to be examined in light of each fund and its mandate to determine applicability; is the underlying product or service something that is applicable to the long-only or tailored fund at all? Conversely, is it something that was purchased as a result of the higher concentration in the long-only fund, and is of questionable value to the flagship fund?

(b) Allocations of expenses will need to be thought through. "Pro rata" may or may not work, but is the correct test pro rata by capital or by position size and how are those numbers computed?

(c) How should a manager handle a situation where the expense allocation provision of the long-only or tailored fund (or a managed account) is more restrictive than that of the flagship fund?

B. Other Conflicts

1. If a flagship fund has higher fees, or if principals have more of their own money invested in a flagship fund, managers must be careful to avoid favoring the flagship fund when allocating investment opportunities or making other trade decisions. For example, buying securities for a long-only account which are already held by a flagship fund to drive up the price for the flagship fund, using a long-only fund's purchasing power to enable a flagship fund to access otherwise unavailable investments (because of investment minimums) or permitting a flagship fund to dispose of a position or short a position right before a long-only fund sells the same position could be problematic.

2. If principals invest their own money in the firm's products, are there guidelines for how these amounts should be allocated among products (i.e., how much money they will invest in each product)? If principals have more "skin in the game" with respect to particular products, they should not unfairly favor such products. In addition, permitting principals to take their money out of a flagship fund and put it into a new tailored fund could lead to conflicts and raise investor concerns.

3. If a manager has "incubated" an investment program for a long-only product with principals' money, "prohibited transaction" issues may also arise.

C. Disclosures.

1. As fiduciaries, managers must be sensitive to conflicts of interest and their presentation to clients. Effective disclosure of actual, anticipated, and certain potential conflicts may be

required under the Advisers Act or under general fiduciary principles. There are also consent requirements that apply in certain cases under the Advisers Act.

2. In structuring disclosure documents for long-only and tailored funds, tailored and understandable disclosure of conflicts that the manager faces or may face in managing the different products is necessary. In addition to inserting disclosures into the long-only and tailored funds offering documents, consideration should be given on inserting corresponding disclosures into the offering documents of the "flagship fund."

3. Conflicts of interest disclosures should be periodically reviewed and updated, including when there are material changes in the investment program or changes in asset size.

VI. Marketing Considerations

A. Managers seeking to utilize the track records of existing unconstrained portfolios (or extracted portions thereof) for a new long-only product face a series of significant challenges. It is always difficult — and is often impossible — to reconcile the differences between the strategies (even after inserting extensive disclosure) with existing SEC guidance on marketing materials.

B. Long-only programs and other tailored products are often tested or "incubated" using proprietary money before a fund is launched. Once a manager determines that the program is viable and decides to launch a fund, the manager must be careful when using the previous track record to market to investors. Clear and thorough disclosure on the limitations of reliance on the earlier track record (including, if applicable, the lack of formal oversight and possible disproportionate returns due to the relatively small capital base) will be needed, at a minimum.

C. Managers marketing long-only and tailored funds under other regulatory regimes obviously need to consider the impact of additional guidance, requirements and prohibitions. For example:

1. FINRA rules often create challenges for marketing new funds through broker-dealers due to restrictions in FINRA's rules on the use of pro forma presentations and projections.

2. Managers subject to Commodity Futures Trading Commission regulations and National Futures Association rules also need to address constraints on the use of hypothetical and pro forma performance presentations.

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