

Considerations for Hedge Fund Managers and Investors Contemplating a Fund-of-One Vehicle (Part Two of Two)

As hedge funds have faced performance and capital raising hurdles over the last two years, more institutional investors have sought customized solutions for their investment objectives and operational priorities. In response, and as the overall hedge fund market trends toward customization, managers have embraced the need to address institutional investors' priorities by offering separately managed accounts and funds-of-one. For institutional investors that would otherwise invest capital in commingled funds, the fund-of-one (or captive fund) structure can be the optimal vehicle to provide the limited liability shield, protection from co-investor risk, administrative efficiency and transparency they seek, among other benefits.

This second part of a guest article by Morgan Lewis partner Jedd Wider and associate Joseph Zargari examines certain advantages that funds-of-one offer to investors, including increased control and transparency, heightened standards of care, flexibility and tax benefits, among others. It also considers the expense and ownership-related disadvantages of the vehicle. The first article reviewed fund-of-one legal structures, and explored the fine points of preferential terms such as oversight of portfolio composition and leverage guidelines, tailored investment restrictions, accelerated liquidity and reduced fees.

Advantages of Funds-of-One

Preferential Terms

Greater Transparency and Oversight

Funds-of-one can be structured to provide investors with greater transparency and oversight than commingled funds, and

investors that may be accustomed to these enhanced rights with separately managed accounts can build them into the operative documents of the fund-of-one. Specifically, investors may be able to obtain position-level information, information on leverage and short positions, valuation reports, and more frequent and more detailed reporting. Investors may also be able to have greater inspection and audit rights, including with respect to valuations and the calculation of fees and performance allocations. Furthermore, an investor in a fund-of-one may require that the manager appoint a custodian that is selected by the investor, so that the investor can have real-time access to the fund-of-one's performance and holdings. Finally, investors may be able to obtain notification of certain material events—which may or may not give rise to accelerated liquidity rights—such as indemnification claims, change of service providers, side pocketed investments, breaches of the operative documents, pending or threatened litigation, non-routine government investigations, changes to the strategy of the fund, felony convictions, change in control and key person events.

Heightened Standard of Care

Institutional investors (especially pension plans) may require heightened standards of care apply to the managers of funds-of-one, so that the managers are subject to the same standards as those applicable to the investors themselves vis-à-vis their pension plan participants or beneficiaries. For example, an institutional investor subject to ERISA may require a manager to act in accordance with ERISA's heightened standard of care, which requires the manager to exercise and discharge its duties and investment responsibilities with the care,

skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of a similar enterprise of like character and objectives. By delegating investment authority to a manager subject to the same standard of care, the investor may be able to discharge its own fiduciary duties and liabilities to its own beneficiaries. Furthermore, since institutional investors frequently seek to limit the generally broad exculpation and indemnification rights managers insert into the governing documents of commingled hedge funds, the heightened standard of care obviates the need for investors to negotiate individual carve-outs for various misdeeds like fraud, bad faith, willful misconduct, gross negligence, breaches of fiduciary duties, material breaches of the operative documents or for actions between principals of the manager.

Flexibility

A fund-of-one can be structured to provide investors with varying degrees of operational and investment control. Although separately managed accounts can be structured in various manners—including with respect to the manager’s discretion over the account—the level of involvement and participation they require may deter some investors. Alternatively, these investors may appreciate that funds-of-one can provide them with certain preferential rights, but also allow them to maintain a passive role in other matters, like administrative duties involving service providers or regulatory report filings, which can be delegated to managers.

At the same time, however, other investors may want to have a heightened degree of control, and a fund-of-one can also be structured to provide them with more active roles with respect to the operations of the fund-of-one and its portfolio construction, the appointment of service providers, valuation policies and oversight of the manager.

Leveraging the Manager’s Infrastructure

A fund-of-one can leverage the existing infrastructure a manager has developed with respect to its commingled fund and managed account program. For instance, the manager may already have pre-existing relationships with administrators, prime brokers, custodians and other service providers, which can be utilized for the fund-of-one as well.

Furthermore, the manager’s existing operational, reporting, management, and administrative systems and platforms likely already conform to the requirements and systems of its service providers, so a fund-of-one could also benefit from operational efficiencies that reduce additional set-up time and the costs associated with establishing the fund-of-one.

Confidentiality

Unlike a separately managed account, where an investor holds title to an asset in its own name, the fund-of-one can shield the investor’s identity from other persons, which can be an attractive feature for an investor that values confidentiality. Nevertheless, while such information may not be disclosed to counterparties, disclosure of the investor’s identity may still be required by regulators or courts to the extent required by tax, anti-money laundering, and other applicable laws and regulations.

Tax Structuring

Certain investors may prefer funds-of-one because they can elect to be taxed as corporations for U.S. federal income tax purposes, and therefore block “effectively connected income”—which may be important to non-U.S. investors—as well as “unrelated business taxable income”—which may be important to certain U.S. tax exempt investors. Furthermore, a manager may prefer establishing a fund-of-one instead of a separately managed account because the fund-of-one can structure the performance allocation in a similar way to a commingled fund, so that it is treated as an allocation of profits, taxable at a lower capital gains rate for U.S. federal income tax purposes. By comparison, for separately managed accounts, the manager’s receipt of a performance fee may be taxable at the greater ordinary income tax rate for U.S. federal income tax purposes.

Certain Disadvantages of Funds-of-One

No Ownership of the Assets

A fund-of-one can be structured to provide an investor preferential terms, control and oversight, advantages which in many ways may mirror the rights an investor would have with a

separately managed account. However, a disadvantage to the fund-of-one that cannot be structured around is that the assets of the fund are owned by the fund itself and not by the investor, as is the case with a separately managed account. The impact of this lack of ownership is most acute for an investor when it desires to transition the portfolio, whether because of poor returns, termination of the fund-of-one or fraud or other bad acts by the manager. Therefore, the tradeoff for investors determining whether to invest in a fund-of-one or a separately managed account is often whether the investor desires the limited liability protection afforded by the fund-of-one more than the ownership and degree of control afforded by the separately managed account.

More Capital Required to Invest

Managers may require investors to commit a substantial amount of capital to a fund-of-one—more than the minimum requirements for an investment in a commingled fund—for various reasons. First, when a manager is already operating a commingled fund, a fund-of-one may add further costs and operational issues. It also likely provides less favorable terms to the manager, and, depending on the investment objectives and fees of the fund-of-one, the manager may not be able to consolidate the

track record of the commingled fund with the track record of the fund-of-one. Therefore, to make a fund-of-one economically feasible for managers, many managers require investors to invest a significant amount of capital in order to launch a fund-of-one, typically at least \$100 million for large institutional fund managers.

Increased Expenses and Costs

An investor will typically bear more costs and expenses with respect to an investment in a fund-of-one than with respect to an investment in a commingled fund. For instance, the costs associated with the organization of the fund-of-one, drafting and negotiating the operative documents for the fund-of-one, establishing new arrangements with service providers, the costs associated with greater reporting and compliance obligations, and other administrative costs may be borne solely by the investor of a fund-of-one rather than being shared by all investors in a commingled fund.

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