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

As hedge funds have faced performance and capital raising hurdles over the last two years, more institutional investors—including pension plans, endowments and sovereign wealth funds—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 customization, preferential terms, limited liability shield and other benefits they seek.

In a two-part guest article, Morgan Lewis partner Jedd Wider and associate Joseph Zargari, examine the advantages and disadvantages of funds-of-one for both managers and investors. The first article reviews fund-of-one legal structures, and explores the fine points of advantages to investors such as oversight of portfolio composition and leverage guidelines, tailored investment restrictions, accelerated liquidity and reduced fees. The second article examines additional preferential terms like increased control and transparency, and heightened standards of care, and also considers certain expense and ownership-related disadvantages of funds-of-one.

## Fund-of-One Legal Structures

A fund-of-one can be structured in various ways, but the most common structures are a limited partnership with one limited partner, a limited liability company with one non-managing member or an offshore exempted company with one shareholder. The fund-of-one is typically managed by its general partner (in the case of a limited partnership) or managing member (in the case of a limited liability company), who is responsible for the operations and investments of the fund. Similar to a commingled fund, but unlike a separately managed account, the fund-of-one itself is the owner of all of the investments and is usually structured to provide limited liability protection for the underlying investor.

## Advantages of Funds-of-One

### Customized Portfolio

One of the most attractive features of a fund-of-one is that it can be customized to suit the specific investment and risk management objectives of the underlying client. A manager of a commingled fund may be unwilling to tailor its entire investment strategy for that fund to the requirements of one particular investor. However, a fund-of-one can more easily be structured to satisfy an investor's demands for certain investment guidelines and restrictions, including with respect to leverage, concentration limits, sector and geography limits, derivative exposure and asset types. In particular, certain institutional investors have strict investment restrictions that prohibit them from investing in certain assets or industries, such as weapons, alcohol, pornography, gambling, or pork; or jurisdictions, such as Sudan or Iran. These investors may otherwise be unable to invest in commingled hedge funds whose managers may have wide discretion to invest in any and all assets and/or jurisdictions. Since a fund-of-one is customizable, an investor's requested investment parameters can be incorporated directly into the governing terms of the fund-of-one, and an investor that otherwise may not be able to invest in a manager's commingled hedge fund may be able to allocate capital to that manager through a fund-of-one with a suitably tailored investment strategy.

### Limited Liability

A customized portfolio is not necessarily unique to funds-of-one, because an investor may be able to achieve similar objectives by investing with a manager through a separately managed account. Separately managed accounts, however, expose an investor to liability to third parties because, although a manager acts on behalf of an investor, the investor holds title to the assets directly and not through an intervening entity. A fund-of-one, on the other hand, can provide liability protection to an investor and protect its assets from third party claims. In addition, the governing documents of a fund-of-one can limit an investor's potential liabilities to a certain pre-defined amount, such as the amount of its capital invested in the fund-of-one. Finally, by delegating investment authority and control over the fund-of-one to the manager, and by virtue of the fund-of-one (rather than the investor) holding title to the underlying assets, an institutional investor may be able to limit the fiduciary duties it otherwise would owe to its plan participants or beneficial owners.

### Preferential Terms

In addition to flexibility to tailor investment portfolios to specific objectives and limit liability exposure, funds-of-one generally provide preferential terms to their investors, including with respect to liquidity, fees, transparency and standards of care.

*Redemption Rights*

Investors in funds-of-one may be able to negotiate more favorable redemption rights and may not be subject to the same restrictions on withdrawal as investors in a manager's corresponding commingled hedge fund. Funds-of-one may also provide for accelerated liquidity rights upon the occurrence of certain events, including, for example, a 'key person event,' such as the departure of certain key persons or the failure of such key persons to devote the requisite time and commitment to the fund, the bankruptcy of the key person, or the death or permanent incapacity of the key person; a change in control or ownership of the manager; pending or threatened litigation or non-routine governmental investigations; the manager's breach of fiduciary duty or material breach of the operative documents; or a felony conviction of, or plea of no contest by, the manager. Generally, if one of these triggering events occurs, an investor may be able to withdraw all or a certain portion of its investment from the fund-of-one at the next available withdrawal date and without regard to any lock-up period, suspension, withdrawal fee or gate. Some funds-of-one also prohibit the manager from exercising any discretionary trading authority after an accelerated liquidity event.

In contrast to a commingled hedge fund, fund-of-one investors aren't subject to the risk of a "run on the bank," a scenario in which substantial redemptions by other investors can result in the manager imposing redemption restrictions (such as gates or suspensions), exiting investments prematurely or selling the most liquid investments (thereby affecting the liquidity profile of the fund). On the other hand, unlike a separately managed account, an investor of a fund-of-one does not directly own the assets managed, so transitioning the management of the portfolio upon a redemption event, termination of the fund-of-one, subpar performance or disputes with the manager can be more difficult.

However, a manager that agrees to form a fund-of-one for a client may require that the client is initially locked up, and cannot redeem absent an accelerated liquidity event, for a longer period of time than would be the case for an investment in its commingled fund so that the manager can gain the benefit of forming the fund-of-one over the long term, despite the lower fees typically negotiated. This lock-up may take the form of a "hard lock-up," whereby an investor is prevented from redeeming for a pre-defined set of time after its initial investment—which could be several years for a fund-of-one—or a "soft lock-up," whereby an investor may be able to exit the investment prior to the expiration of the lock-up period, subject to payment of a higher carried interest or a penalty rate.

*Reduced Fees*

Performance allocations for traditional hedge funds are usually payable on an annual basis if both realized and unrealized net gains exceed previously unrecouped losses, a 'high water mark' or 'loss carryforward'. In recent years, though, investors in funds-of-one have had concerns with the conventional model for several reasons: (i) first, as a result of performance allocations being based on both realized and unrealized gains, investors may bear the cost of performance allocations on assets that may never be realized; (ii) second, while the high water mark provisions generally restrict payments of future performance allocations unless prior losses are recouped, there is no clawback of any previously paid performance allocations to the manager in the event of subsequent losses; (iii) third, managers may be paid performance allocations even if the fund underperforms relevant benchmarks or the market; and (iv) fourth, as a result of the foregoing, the manager's incentives may be misaligned with the investor's interests. Because investors in funds-of-one invest more capital with a manager, and therefore, in general have more negotiating leverage than investors in commingled funds, the performance allocation in funds-of-one may be structured in the following ways to address the foregoing concerns of the traditional model:

- *Reduction in Fees.* Fees for funds-of-one are usually lower than the standard '2% and 20%' model for commingled hedge funds. While the rates vary depending on the amount of capital invested, the negotiating leverage of each party, the structure of the fund-of-one and the particular investment strategy of the fund-of-one, typically they can range from between 0.50% to 2.0% for management fees and 7.5% to 20% for performance allocations.

- *Performance Allocation Determined over Multiple Years.* Rather than calculating the performance allocation on an annual basis, some funds-of-one determine performance allocation based on a multi-year period (typically, a two-, three-, or four-year period). In these situations, the performance allocation would only be payable if, at the end of pre-specified multi-year period, net realized and unrealized gains for such period exceed prior unrecouped losses. By measuring performance over a multi-year period, a manager's incentives are more closely aligned with the investor's long term commitment to the strategy, and the manager is not unjustly rewarded if the fund performs well early on, but underperforms in subsequent years. For the manager's benefit, though, a withdrawal of capital during the multi-year period may also trigger the early payment of a performance allocation as of the date of such withdrawal. Furthermore, because a manager may be allocated income each year, even though it is not entitled to a performance allocation until the end of the multi-year period, the fund-of-one may be structured to enable the manager to receive annual tax distributions as advances against later payments of the performance allocation.

- *Escrows and Clawbacks*. In lieu of determining the performance allocation over a multi-year period, some funds-of-one determine and pay the performance allocation on an annual basis, but require the manager to either (i) place a portion of the performance allocation in an escrow account to offset future losses, which would be released in subsequent years if there are no future losses; or (ii) agree to a clawback mechanism to return that portion of the performance allocation, if any, that the manager would not have been entitled to receive had the performance allocation been calculated on a multi-year, rather than annual, basis.

- *Hurdle Rates.* To address the concern that the manager may be entitled to receive a performance allocation even when the fund-of-one underperforms the market or a relevant index, investors of funds-of-one may require that the performance allocation can only be paid if performance exceeds a relevant benchmark, market, index or other applicable threshold. Subject to the high water mark, some funds-of-one permit the manager to be paid a performance allocation on all profits in excess of the hurdle, whereas others permit the performance allocation to be paid on all profits so long as the payment of the performance allocation does not reduce the fund-of-one's net performance below the applicable hurdle.

- *Oversight Over Valuation*. Investors concerned with performance allocations being calculated on unrealized gains may seek greater oversight over the valuation process to ensure that the values assigned to assets are not inflated. This is particularly important with respect to assets that are illiquid or for which valuations are not readily available.

As a tradeoff for lower fee rates and calculating performance allocations in the foregoing manners, managers often require investors in funds-of-one to be locked up for a period of time after their initial investments (as noted above).

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