

Factors Behind Different Structures Used for Hedge Fund Investments and Potential Reforms

European institutional investors have begun to focus on improving the governance of the hedge funds in which they invest. In Europe, institutional investors typically access hedge funds through the purchase of shares in the fund company, much like U.S. investors buy shares in mutual funds. Conversely, U.S. institutional investors generally invest in hedge funds by contributing capital as limited partners of a partnership vehicle.

The difference in hedge fund investment approaches used by European and U.S. institutional investors has raised questions as to whether U.S. institutional investors could acquire hedge fund shares, rather than limited partnership interests, and obtain enhanced rights as to the governance of the fund. This e-alert discusses some of the factors behind the different structures used for hedge fund investments and identifies potential reforms in the hedge fund investment process that could be explored by U.S. institutional investors.

Hedge Fund Investments by U.S. Investors

Investments into Cayman and other non-U.S. hedge funds by U.S. domestic investors are generally structured as a direct investment in a U.S. limited partnership feeder vehicle (a Feeder Fund), which in turn invests directly or indirectly into a Cayman or other non-U.S. underlying fund (a Master Fund). Fund sponsors often cite tax and regulatory reasons for choosing a limited partnership Feeder Fund vehicle, but the use of a limited partnership structure also provides greater control to the investment manager at the expense of investor control.

A Feeder Fund is largely controlled by its general partner, which is typically a new entity formed and controlled by the investment manager. The general partner maintains primary control of the feeder vehicle, with minimal input from investors (other than perhaps through an advisory committee and other limited voting rights or powers enumerated in the vehicle's partnership agreement). There is no Feeder Fund board of directors or other independent management oversight entity (*i.e.*, no equivalent to a board with independent directors used at corporate entities).

Master Funds are generally organized as corporations in the Cayman Islands or

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other tax havens. Such Master Funds have a board of directors; however, those boards often do not reflect important corporate governance best practices. For example, Cayman law does not require that any corporate directors be independent, and many hedge fund boards do not have any external directors. In addition, external directors are often professional directors who sit on dozens or hundreds of hedge funds' boards and do not have a close working relationship with the Master Fund.

Even where a Master Fund's board includes external directors that provide an appropriate level of time and attention to the Master Fund's activities, U.S. investor interests are held through a Feeder Fund—which is at least one step removed from the Master Fund. As a result, U.S. investors have very limited (if any) ability to ensure there is independent oversight of the management at the Master Fund or to provide input on governance matters.

Tax, Structuring and Regulatory Issues

Investment managers and fund counsel generally control decisions with respect to the structuring of Master Funds and Feeder Funds. While the Master Fund and Feeder Fund structure used for U.S. investors minimizes tax and regulatory burdens, it usually comes with inferior corporate governance practices.

Offshore Master Funds are generally domiciled in a low-tax or no-tax jurisdiction (such as the Cayman Islands). Feeder Funds are generally organized as U.S. limited partnerships or limited liability companies, so they avoid taxation at the Feeder Fund level and provide flow-through tax treatment to U.S. investors. This serves to minimize tax losses.

In addition, hedge funds and the securities they issue are generally not registered with the Securities and Exchange Commission (the SEC) or other U.S. regulators. Under the Investment Company Act of 1940, as amended, registered investment companies are required to comply with certain corporate governance requirements related to conflicts of interest, limits on debt, calculation of fair value of assets, shareholder voting, reasonable management fees, regular disclosure to investors, and reports to the SEC. Hedge funds generally qualify for exemptions from registration and regulation as an investment company. In most cases, the securities offered by hedge funds are also exempt from registration under the Securities Act of 1933, as amended. Because neither hedge funds nor the securities they offer are registered, investors in hedge funds do not receive the disclosure, accounting and oversight protections that registration provides.

Master Funds may be registered with Cayman or other non-U.S. regulators, but typically such regulators impose less rigorous requirements than U.S. registration would require. Furthermore, corporate or other applicable law is generally less well developed in non-U.S. jurisdictions where hedge funds are located and courts or other dispute resolution proceedings may be less transparent and accessible for U.S. investors than their equivalents in the United States. Non-U.S. jurisdictions may also not require hedge funds to comply with the same accounting, auditing and financial reporting standards as found in the United States.

In general, without these regulatory protections, hedge fund disclosure requirements are minimal. This can make it more difficult for investors to gather critical information, including details on board composition, names of directors, their qualifications and number of directorships held.

Potential Reforms

To address these concerns and improve hedge fund governance, U.S. investors could consider pursuing one or more of the following reforms:

- Restructure hedge fund Feeder Funds as limited liability companies or other domestic vehicles that provide the same limited liability and tax benefits, while also allowing investors to exercise greater rights on corporate governance matters.
- Encourage U.S. and non-U.S. regulators to increase oversight and disclosure for hedge funds, investment managers and their affiliates.
- Negotiate with hedge fund sponsors to obtain structural and contractual protections to provide investors with additional input on partnership corporate governance matters. (However, it should be noted that partnership law limits the extent to which limited partners can be given control rights over management without losing their protection from liability to third parties, which would restrict the robustness of this as a single reform option.)

Governance best practices that could be considered for application to hedge funds might include:

- Investor election of directors.
- Requirements for independent directors, an independent board chair and/or other independent governance professionals (for example, to serve on the Feeder Fund general partner's board.)



- Rights for investors to put forth board candidates.
- Regular reporting on risks, executive compensation, conflicts of interest and other key matters.
- Rights to call special board meetings by written consent.
- The ability to remove and replace directors.
- Approval of independent auditors.
- Rights for investors to vote on the manager's contract.

In summary, there are options open to U.S. institutional investors that are interested in obtaining enhanced governance and oversight rights at the hedge funds in which they invest. Consideration of the structures used by European institutional investors for hedge fund investing could provide guidance on this side of the Atlantic.

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