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Private Equity, Hedge and all Core Structures

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Matthew Hudson

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1 Introduction to Funds

1.1 WHY THIS BOOK?

I have sought to write the manual I always wanted to find on the shelves. In my career as both an asset manager and a legal adviser to asset managers and investors, I have often been asked to recommend a guide that covers the broad ambit of fund and manager structures.

In the world of asset management, knowledge is often assumed, jargon is sometimes opaque and there can be a tendency towards mystification. Frequently, for example, I am asked 'What is market?', and certainly one possible answer to that question is that 'market' means whatever is investment worthy at that particular moment in time and given the particular investment: following the money has, after all, always been a plausible strategy. However, in these fast changing times where the industry is being required to adapt to survive, it is more crucial than ever to understand the logic behind the structures that have come to dominate this sector.

Broadly, these pages are intended to function as a guide to all things funds and fund managers. Although approached principally from a United Kingdom (UK), United States (US) and European Union (EU) perspective, this book also references other core fund establishment locations, as well as core economic or asset jurisdictions such as China and Japan. The book approaches its subject from a structural, legal, tax and regulatory perspective. It is, however, a guide and not an in-depth review. The latter would require a number of separate volumes. I hope it succeeds in pointing the reader in the right direction.

1.2 ALTERNATIVE ASSETS

I am going to focus principally on funds comprising what are known as alternative assets. 'Alternative' as opposed to the mainstream world that is largely composed of listed equities and bonds. The phrase derives from the pension fund term 'alternative allocation', which refers to the proportion of a fund's portfolio that is invested in alternative assets.

This type of fund comprises principally private equity, hedge, venture capital, real estate, energy, infrastructure, credit and related funds. The managers of these funds tend to fall into the category of '2 and 20' managers, where the '2' refers to the annual percentage fee received by management of the cost or value of assets under management and the '20' refers to the percentage of profit to be made by the manager as a percentage of profit for investors as a whole.

A fund is a fluid concept. It can refer to any pooling of capital or assets. Historically, the concept of alternative assets and funds perhaps finds its origins in the age of exploration. At the heart of Christopher Columbus's expedition to the Americas was an agreement that is an example of financial pooling. Columbus was backed in part by a 'fund' from Italian financiers and was able to convince the King of Spain to provide the top-up funding required for the trip. Columbus and his 'management team' had their overheads covered and were promised a generous share of performance profits, as well as real management power within any newly discovered lands, the 'portfolio assets'. Success would also mean prestigious titles and backing for the next 'fund'. The agreement was in fact quite detailed. Together with any treasure looted, Columbus would receive 10% of revenues reaped from newly discovered lands as well as having a right of first refusal to invest at a discount in any commercial venture deriving from the newly discovered territories – the King of Spain apparently believed that success or indeed Columbus's return were unlikely investment outcomes. Management and co-investment opportunities rarely come better!

1.3 WHAT IS A FUND?

A fund is a broad term, but as we have seen is used to describe any pooling of assets. These assets may be cash, shares, loans or tangible or intangible assets. A fund can even be a vehicle that holds a single asset (such as Vallar (now Bumi plc) and Vallares (now Genel Energy plc) – both originally special purpose cash shells established by the financier Nathaniel Rothschild to acquire specific companies), although, typically, a fund is established to hold more than one asset.

The term fund can of course be applied to other industries and concepts, for example:

- a fund or 'stable' of pop artists, managed by an expert pop promoter, manager or agent. The more stars under management, the greater the diversification
- a fund or 'library' of knowledge or
- a fund or 'team' of football stars (where the assets are footballers) that are bought and sold.

Almost any economic gathering or pooling may be regarded in terms of a fund. A fund could almost better be defined by describing what does not constitute a fund, such as a single purpose operating company with a small balance sheet, unlike Rothschild's cash shells referred to above. Typically, a fund would not otherwise include a large single purpose operating company, unless of courses it uses off (or near-off) balance sheet side vehicles underpinned by external capital, a fairly common feature of large energy, real estate and infrastructure companies.

A fund may have one owner, or many owners who subscribe, acquire and sell positions, shares or units. One of the defining features of a fund is that it often has a professional fund manager (usually regulated) that manages and advises the fund.

Funds can be operated for a variety of different purposes:

- to make a profit
- or to be run on a not-for-profit basis (e.g. a charity)
- to spread risk
- to obtain leverage (by debt financing) on assets
- to take advantage of a specialist manager to operate the fund
- to attract investors (a bank may create a fund to house certain assets and then seek other investors to generate management fees for the bank)
- to build an asset management group (although mere ‘asset gathering’ is sometimes criticized by investors)

1.4 CATEGORIES OF FUNDS

1.4.1 Ways to categorize

It is clear the term ‘fund’ is a broad one. However, in this book we are considering funds that occur in the investment management or financial services industries. But even within these sectors the range of different types of fund is wide. Investors and managers refer to a ‘hedge fund’ or ‘private equity fund’ or ‘mutual fund’, descriptions which embrace many investment strategies, structures and management arrangements. I would categorize funds within the alternative asset sector using the categories below.

Categorization by industry (by example):

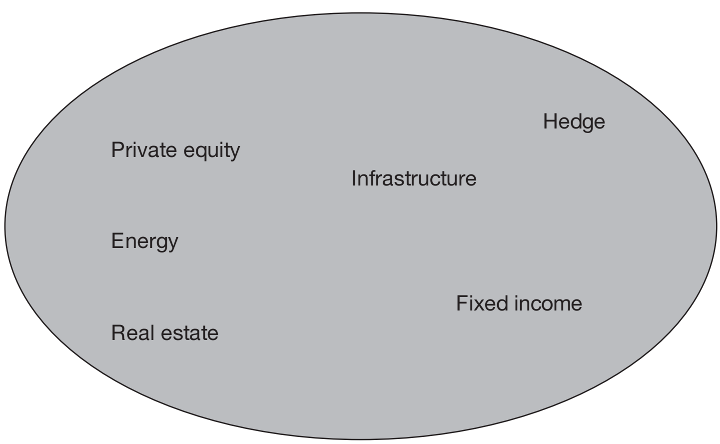
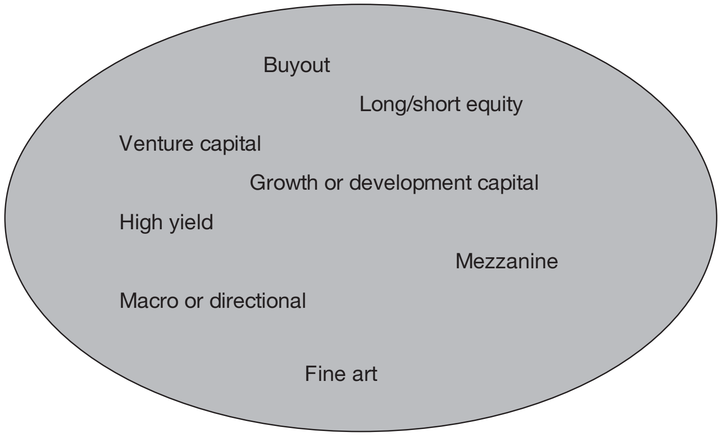


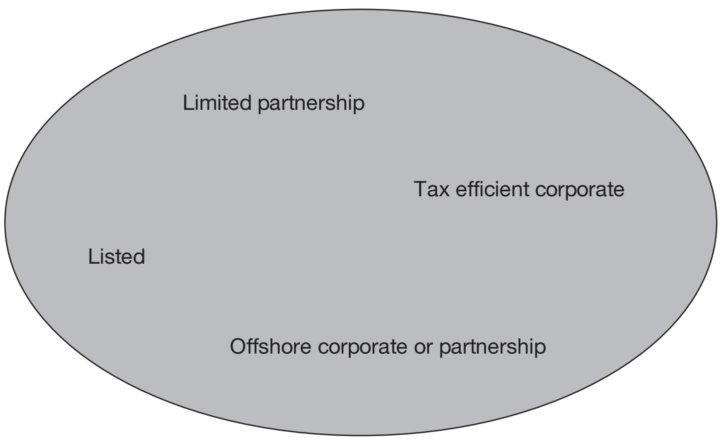
Table 1.1 Categorization by investor returns (or how they get their money back plus a profit)

Drawdown and distribution model	Tradable model	NAV or redemption model
Most private equity funds The fund 'draws down' money from investors when required for investment. Drawing down funds only when required as opposed to in their entirety in advance should have the effect of enhancing the fund's internal rate of return (IRR) when measured against the date of exit or realization of a particular investment. On exits, the original cost and the capital gain or profits relating to each asset are then 'distributed' to investors and are seldom re-invested. The fund usually has a fixed life, and the intention is to invest and then 'return' the entire capital and profits, before winding up the fund. A share of the fund profits ('carried interest' or 'carry') is distributed to the management team. In a drawdown and distribution model fund, assets remaining after distribution at the end of the life of a fund can be sold on the 'secondary market', as can an investor's position. Income generated from investments is usually distributed as it arises, for example, net yield from real estate, rental receipts or fixed-income gilts. The fund is usually 'closed' and not 'open' (meaning that the number of investors and amount invested are fixed and have a fixed life).	*Many retail or tax-driven funds* A tradable fund is one where the shares or units in the fund are traded, usually on a public market. The capital is not distributed to investors although regular and larger one-off dividends can be made. The funds may or may not have a fixed life and gains and profits made within the fund should cause the fund's share price to increase. However, tradable funds are subject to the ups and downs of trading and: • illiquidity • 'trading at a discount' to asset value • market, economy or investor sentiment. What this often leads to is a tradable fund trading at a premium to embedded value at moments of investor exhilaration, but at a discount the rest of the time. Sentiment or recognition can bear little correlation to actual asset value.	*Most hedge funds* This fund redeems or prepays units held by investors in the fund and on (or within a defined time of) redemption also pays investors any profit 'attaching' to those units. A share of the profits is paid as a performance fee to the fund's management team. Units are often redeemed at, or correlated to, the net asset value (NAV) of that unit. A unit's NAV is the total of the fund's gross assets, less leverage and liabilities, divided by the number of units in the fund. It is typically the manager or administrator and also third party valuers that calculate NAV. The fund is usually 'open' and not 'closed' (meaning the number of investors and amount invested fluctuate as investor commitments are made and redeemed) and can exist for an undetermined period of time, unless the fund is wound up.

Categorization by investment strategy (by example):



Categorization by vehicle:



1.5 CHOOSING A VEHICLE

Choosing the correct vehicle for a particular fund will depend on a number of factors. Some to consider are:

- the vehicle that is most tax efficient for the target investor base and for the fund's management team (taking into account the fund's likely assets and their location)
- the regulatory regime that is least onerous while still providing an appropriate degree of credibility to the fund (taking into account the likely views of potential investors)
- any limitation on the target investors (either internal or external) or their ability to invest in certain vehicles
- the previous experience of the potential investors and the manager with different fund vehicles.

1.6 OPEN-ENDED AND CLOSED-ENDED FUND STRUCTURES

1.6.1 Introduction

Alternative assets can also be divided into two other types of categories, those that are illiquid such as private equity, venture capital, real estate and infrastructure and those that are more liquid such as listed securities, commodities and derivatives. This has led to the development of, broadly, two types of fund structure: open-ended and closed-ended.

Table 1.2 Open-ended and closed-ended fund structures

Type	Liquidity/investment	Assets	Further reading
Open-ended	The vast majority of the fund's assets are realized over a relatively short period of time. The fund has an indefinite life. Investors may redeem their interest (wholly or in part) or increase their interest during the course of the fund's life.	Typically a large number of small assets (for example, listed shares) or assets whose size can be readily adjusted (for example, derivative positions). The fund can acquire new assets with additional proceeds invested. It funds withdrawals by investors through a partial realization of fund assets.	Common with hedge funds – Chapter 3.
Closed-ended	An illiquid structure. The identity of investors usually fixed by final closing. Not generally possible for investors to withdraw during the life of the fund as the fund is unable to liquidate assets in order to finance withdrawals. Only possible to invest during the first half or so of the fund's life to allow time to exit assets. The larger size of assets means that there are only, say, up to a dozen investments per fund. The fund operates for a finite period, terminating once all of the assets are disposed of.	Assets are held for a minimum period of time (for example, to restructure a portfolio company or refurbish a commercial property). Usually a smaller number of larger assets are held, e.g. private equity portfolio companies or specific real estate.	Closed-ended funds – Chapter 2. Growth of secondary trading of illiquid fund interests – Chapter 5, section 5.11.

1.6.2 Impact of the credit crisis

This book was written during a period often described as the ‘credit’ or ‘financial’ crisis. For our purposes, this period started in February 2007 with HSBC reporting record losses for US bad mortgage debt and was quickly followed by the collapse of the sub-prime industry in the US. The crisis spread in the US with the implosion of leveraged Bear Stearns hedge funds, the capitulation of structured investment vehicles (SIVs), the contagion of many US, UK and European banks (Northern Rock being a notable example) and arguably reached what in retrospect was its early peak with the collapse of Lehman Brothers. The US, UK and European markets (which were considered more sophisticated than the rest of the world) were among the most seriously affected during the crisis.

Some hedge funds were wiped out during the peak of the crisis due to over-leverage and also by ‘rehypothecation’. This was where the collateral pledged by funds with broker-dealers was called upon by those broker-dealers to satisfy their own liabilities. Lehman and Bear Stearns were market-dominant prime brokers at the time of their collapse. When the larger investment banks such as these two began defaulting, more hedge funds followed suit.

This ‘credit crisis’ usually refers to the period mid 2007 to late 2009 but was then eased by floods of central bank liquidity. Mid-to-late 2009 to the end of 2013 was a continuation of this period, known overall as the ‘financial crisis’. The later period is marked by a certain stability returning in the US credit markets, but overall by poor growth and the Eurozone crisis. The later period of the financial crisis was characterized by:

- restructuring and huge mark-downs (sometimes overdone in my view)
- continued bank weakness
- increased regulation – again in my view, often driven by headline-seeking politics and naïveté and leading to the disinclination of banks to lend on a scale that might otherwise have restimulated economies.

All manner of funds were impacted by the financial crisis. Despite negative publicity about the sector, funds themselves (whether private equity, hedge, or otherwise) were not a root cause of the crisis. Instead, funds were caught in the pre-crisis enthusiasm, over-leveraging and over-pricing funds and assets. The adverse effects on funds have since been keenly felt. During the crisis, funds found that fund-raising became more difficult as investment in general slowed, which was aggravated by the difficulty of borrowing.

Private equity funds are, by their nature, long-term investments. To an extent they have been able to ride out the financial storms. Some managers have been criticized for not continuing to invest during what might come to be viewed as vintage years for investment. Hedge funds adapted relatively quickly owing to their shorter-term investment horizons with rights to redeem (despite manager rights to ‘gate’, that is to say restrict withdrawals, or lock up investments), scaling down, reducing in size, investing differently, usually with much less leverage, as well as adapting their structure to managed accounts (see Chapter 4, section 4.7 for a full definition) and other more transparent investment programmes.

Alternative asset allocation is now starting to increase. The denominator effect has largely run its course (for the moment) as listed markets start to rebound. Funds are being sought out by investors:

- hedge funds as adjuncts to broader investment strategy
- private equity funds for growth
- credit funds for better than dismal bank interest and
- real estate, infrastructure and energy for the anticipated asset valuation rebound.

It is too easy to be a doom-monger, although some highly intelligent people believe we have entered a new low growth paradigm. However, I believe cycles will always exist, and that trends overshoot.

1.7 CONTENTS OF THIS BOOK

To help you find your way through this book, the main contents are set out below.

Table 1.3 Main contents of the book

Chapters	Contents
2 and 3	Dedicated to two types of funds that are significant in this book: private equity funds and hedge funds, although the structures for each are also used for other alternative asset strategies such as real estate, infrastructure, credit and energy. These chapters also cover the two principal structures of alternative investment funds, being closed-ended funds (Chapter 2) and open-ended funds (Chapter 3). The chapters dedicated to these types of funds go into detail about the most common structures, jurisdictions and the market terms
4	Analysis of other private fund structures
5	Investment strategies employed by different funds with an analysis of each
6	Key jurisdictions for funds to list on stock exchanges and the key types of listed funds and the regimes that apply to them
7	Principal 'offshore' fund locations and a summary of their regulatory and tax regimes and stock markets
8	Key global economies, the type of fund entities that exist there and the prospects for investors
9	Large investor players: sovereign wealth funds, state funds, pension funds and charities
10	Fund managers – the common investment manager structures and their commercial operations
11	Taxation of funds, investors and managers
12	Regulation of funds and managers
13	Conclusion – reviews the ground covered and remarks on future trends

2

Limited Partnerships – Use in Alternative Asset Funds

2.1 INTRODUCTION TO LIMITED PARTNERSHIPS

2.1.1 Suitability of limited partnerships for alternative asset funds

A limited partnership is the vehicle most commonly used for closed-ended funds investing in the less liquid alternative assets, including private equity, venture capital, real estate, infrastructure and energy.

2.1.2 Benefits of limited partnerships

A limited partnership offers a range of benefits in this context including:

- tax transparency (a limited partnership is effectively ignored for tax purposes and amounts received by the partnership (e.g. capital gains) retain their character when allocated to individual partners)
- the liability of investors can be limited to the amount which they agree to contribute to the partnership and
- a limited partnership is very flexible and subject to relatively few restrictions in terms of governance and profit sharing arrangements, which allows fund managers greater freedom than may be the case for other types of vehicle.

2.1.3 Types of limited partnerships

Limited partnerships are available across a range of different jurisdictions. The two most commonly used onshore jurisdictions are the UK and the US (typically Delaware). Commonly used offshore jurisdictions include the Cayman Islands and the Channel Islands (Guernsey and Jersey). Other jurisdictions such as Luxembourg are also available.

There are many similarities between limited partnership structures across jurisdictions. The fact that many offshore jurisdictions (including the Channel Islands and the Cayman Islands) have legal systems closely related to English law assists in this regard.

2.2 STRUCTURE OF LIMITED PARTNERSHIP FUNDS

2.2.1 Role of general and limited partners

Participants in a limited partnership are called partners and fall into two categories.

(a) Limited partners (LPs)

The limited partners are the partners whose liability is, broadly, limited to the amount of their investment, provided that they do not take part in the management of the partnership. Therefore, the investors in a fund participate as limited partners. Limited partners are typically required to make a capital contribution to the partnership. The carry vehicle (as described below) is also often a limited partner.

(b) General partners (GPs)

The general partner has unlimited liability for the debts and liabilities of the partnership (i.e. the fund) but is able to undertake the management of the partnership. There must be at least one general partner although in practice, in the context of alternative assets funds, there will only be a single general partner which will normally be an entity with minimal assets (as those assets will be at risk in the event that the fund becomes insolvent).

Typically, each partnership will have its own general partner which will not carry out any activities unrelated to the fund of which it is the general partner. The use of a separate general partner for each fund reduces the risk of cross-contamination, which is the risk that the insolvency of one partnership leads to the insolvency of its general partner which could, in turn, adversely affect other partnerships of which it is also the general partner.

2.2.2 Management and operation of the partnership

In a limited partnership structure, it is the general partner that is responsible for and is permitted to undertake the management and operation of the partnership. However, it is common either for a separate manager to be appointed or, where the general partner does manage the partnership, for it to be advised by a separate investment adviser or even a combination of both a separate manager and an investment adviser.

There are a number of reasons for adopting these more complex structures:

- separate management or investment advisory entities in turn allow the management/advisory functions for multiple funds to be contained in a single holding entity which facilitates building up value in the fund management/advisory business
- the general partner may need to be located offshore and may be reliant on an onshore investment adviser to provide it with advice on the acquisitions, management and disposal of investments
- there may be regulatory or tax reasons for having a separate manager/investment adviser and
- it can protect the management vehicle from the unlimited liability nature of the general partner.

In the rest of this chapter (and book) references to ‘manager’ are, depending on the structure of an individual fund, to the general partner/manager in conjunction with any investment adviser. The management structure adopted in US and UK limited partnership structures is discussed in more detail in sections 2.2.4 and 2.2.5 below.

2.2.3 Remuneration

There are broadly three forms of remuneration that are generated by a fund structured as a limited partnership for the benefit of the fund manager (or its principals):

- management fees
- carried interest and
- transaction or monitoring fees.

These are discussed in more detail under section 2.6 of this chapter (Economics) below.

In terms of a UK fund's structure, it is worth noting that management fees are typically structured as a share of the fund's profits (if there are no profits, the amounts can be drawn down from the investors, so while technically a profit share it still operates much like a fee), which is paid to the general partner and by the general partner to the manager in the form of a fee. For limited partnerships established in the UK, this means that no value added tax (VAT) should be payable on the 'management fee' as no VAT is payable for a share of profits paid to a partner and VAT is also not payable in respect of the subsequent payment of that amount from the general partner to the manager provided that they are grouped for VAT purposes.

For offshore funds in jurisdictions where there may be no VAT payable, the management fee may be paid by the fund directly to the manager as a fee for its services and not via a profit share to the general partner.

The carried interest is the performance-based remuneration received by the management team. It is a share of the profits paid to a partner in the partnership, which is called the founder partner, carry partner or carry vehicle. This entity is often a Scottish limited partnership – as either a limited partner in an English limited partnership or an offshore limited partnership. For the distinction between English and Scottish limited partnerships, see below in section 2.2.4(a) of this chapter. Each member of the fund manager's management team who is entitled to receive a share of the carried interest is then a limited partner in the carry vehicle. As it is another limited partnership, the carry vehicle also requires its own general partner, called the carry general partner, which is usually a limited company in the same jurisdiction.

Transaction or monitoring fees are received by the manager or its affiliates from entities in which the fund has made an investment or third parties and may be shared between the fund and the manager.

2.2.4 UK limited partnerships

(a) Legal background

In the UK, partnerships originated under common law (that is, legal practice developed by the courts) rather than being established by legislation (as is the case for companies). For example, unlike a company, a partnership in the UK can be established by an agreement between the relevant partners without the need to apply to a government authority or register the existence of the partnership. Such a partnership is a general partnership, that is, one in which all the partners are general partners and have unlimited liability for the debts and obligations of the partnership.

However, all UK partnerships are now subject to the Partnership Act 1890. While fundamental to the law on partnerships in the UK generally, this Act has little day to day impact on the use of partnerships as a vehicle for alternative asset funds.

More relevant to alternative asset funds is the Limited Partnerships Act 1907. This Act allows a general partnership to be registered with Companies House in the UK as a limited partnership. This allows some (in practice all the partners who are investors) to be registered as limited partners with the consequence that their liability is limited as described in section 2.2.1 of this chapter. The Limited Partnerships Act 1907 imposes relatively few requirements on limited partnerships. Those that are most relevant relate to registering the fund with Companies House and notifying certain changes in the partnership such as the addition of new limited partners.

Technically, limited partnerships established in the UK can be divided between those that are English (or Welsh) and those that are Scottish. The principal difference is that English limited partnerships do not have separate legal personality (that is, no legal entity distinct from its partners) while a Scottish limited partnership is such a distinct legal entity. While largely a legal technicality, the effect of this is to make Scottish limited partnerships more appropriate for partnerships that will invest into other partnerships (for example, carry vehicles (described below) and fund of funds) or partnerships that invest in registerable assets (as property funds for example).

Therefore, while it is necessary to distinguish between English and Scottish limited partnerships, this chapter uses the term ‘UK limited partnership’ to refer to them generically.

In Figure 2.1, the fund uses special purpose vehicles (SPVs) to act as liability blockers, or vehicles into which different levels of investment are made.

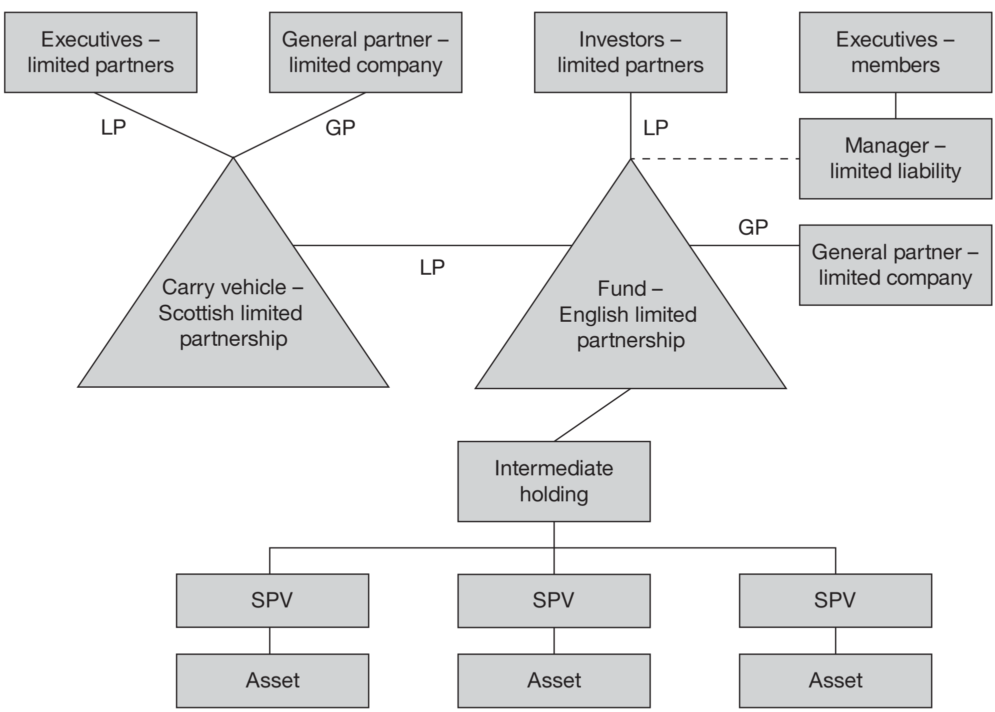


Figure 2.1 Typical English limited partnership structure with a separate manager and Scottish carry vehicle.

(b) Management

An alternative asset fund structured as a UK limited partnership will normally have a separate manager that is appointed by the partnership (see Chapter 10, section 10.2 for more information). The reason for this is that acting as a manager and operator of an alternative asset fund is an activity which if carried on in the UK requires authorization by the Financial Conduct Authority (FCA) (see Chapter 12 for more detail).

(c) Loan/capital split

An investment in a limited partnership fund is normally structured as a commitment that is drawn down over time (see section 2.5.1 below). The amounts actually contributed to the fund are usually referred to as capital contributions. However, one unusual feature of UK limited partnerships is that the commitment made by an investor is split between a capital contribution and a loan.

The reason for this is that under the Limited Partnerships Act 1907, while a limited partner is required to make a capital contribution to the partnership, that capital contribution can only be repaid to the investor on the liquidation of the partnership or, if it is repaid early, the investor remains liable to re-contribute it if required in order to meet the partnership's liabilities. So, if part or all of an investor's capital contribution is repaid prior to the liquidation of the fund, that investor has no certainty that they will not be required to pay it back to the fund if a liability arises (for example, litigation against the fund from a purchaser of one of its investments). This is clearly an undesirable consequence of using a UK limited partnership as a fund vehicle.

In order to avoid this problem, in a UK limited partnership, an investor's commitment is divided into a capital contribution and a loan. The capital contribution is nominal (either say 0.01% or 0.001% of their commitment) and is subject to the restrictions set out above. However, as the amount of the capital contribution is so small this restriction is of no practical importance. The rest of an investor's commitment is then a loan to the fund. The loan can then be repaid together with any profits during the life of the fund as it disposes of assets or receives income from them without being recalled (unless the fund's terms specifically allow such recall). However, as the loan is repayable only to the extent that there are such proceeds available to do so, the loan/capital split has very little economic significance on the operation of the fund.

2.2.5 US limited partnerships

As discussed above, the most common vehicle for an onshore closed-ended fund in the United States is a limited partnership organized under the laws of the State of Delaware. Delaware is commonly used in large part because the Delaware Revised Uniform Limited Partnership Act (DRULPA) includes some management-friendly provisions, and Delaware has a well-established body of partnership law and a focused and specialized court (the Delaware Court of Chancery) that is widely thought of as the forum of choice for litigation of corporate and partnership issues, including the scope of duties and liability of executives. A Delaware limited partnership is a separate legal entity, unlike an English limited partnership.

Management-friendly provisions include the following.

(a) Exculpation

DRULPA provides that the duties, including fiduciary duties, of the general partner or any other person may be limited or even eliminated if so provided in the limited partnership agreement, provided that the limited partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(b) Indemnification

A limited partnership has broad power to indemnify the general partner or any other person and advance costs and expenses to any indemnified person.

(c) Access to information

DRULPA permits a limited partnership to restrict the access of a limited partner to information, to a reasonable extent. Additionally, a limited partner's request or demand for information must be reasonable and for a purpose reasonably related to the limited partner's interest as a limited partner.

(d) Certain flexibilities

The limited partnership agreement may provide specified penalties or specified consequences that arise from or are related to a breach of the limited partnership agreement and for different classes of interests that have different rights, benefits, obligations, restrictions or limitations. This gives the sponsor the ability to 'pre-game' the results of certain events, such as a failure to contribute capital and the statutory authority to assert a penalty, although courts in some states will not enforce penalty or forfeiture provisions.

Typically, the sponsors will control the limited partnership through a general partner that is organized as a Delaware entity – typically an entity with limited liability. The general partner or an affiliate will also act as the carry vehicle.

The typical structure for a US private equity fund is illustrated by Figure 2.2. The fund is a limited partnership. The general partner of the fund is a limited liability company (LLC). An affiliate of the general partner will hold the carried interest and makes the investment in the fund on behalf of the sponsor. This figure illustrates a structure in which there is not a separate investment adviser and the assets or operating companies are held through separate special purpose companies.

Structures often include holding companies so that the sponsor or certain parts of the management team form an entity, typically a limited liability company, which holds all of the interests in the general partner, the special limited partner and the investment manager. The primary reasons to include a holding company structure are to provide greater flexibility in management, compensation and other specified relationships among the management team. A holding company structure may also be used to implement tax efficient structures that consider state and local (e.g. New York City) tax regimes.

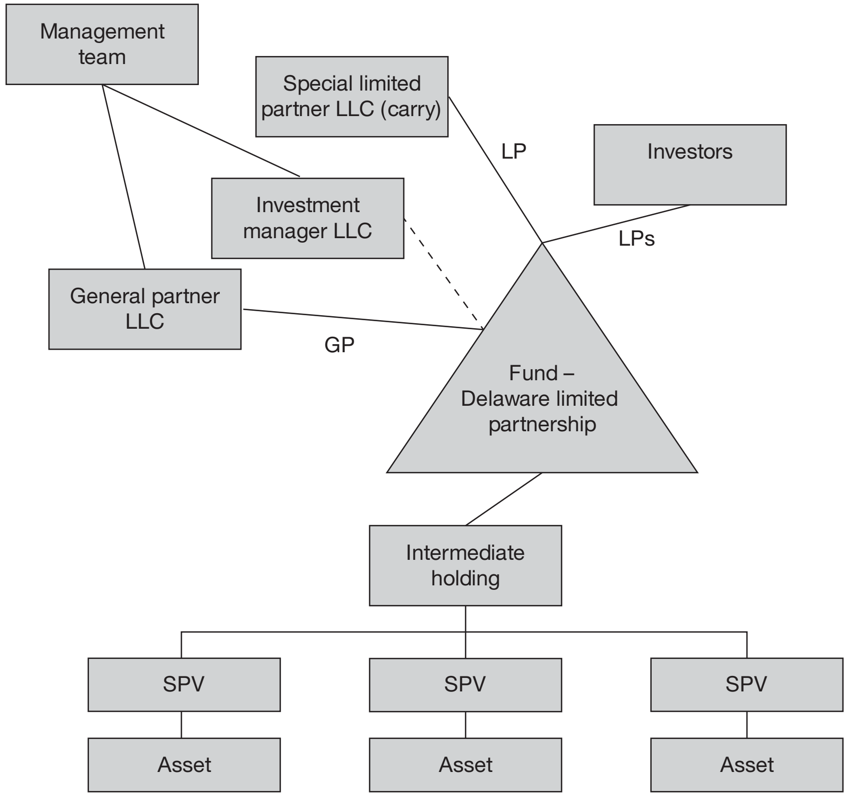


Figure 2.2 Typical US Delaware limited partnership structure with a separate manager, a special partner that receives carried interest and a general partner.

2.2.6 Parallel funds

While an investment fund structure often employs a single limited partnership (the discussion below refers to limited partnerships but the same principle is equally applicable to other types of entities such as limited liability companies or indeed a combination of different types of entities), investment funds that accommodate tax and certain regulatory or investment policy concerns of the investors often employ more than one limited partnership (or other entities) which invest alongside each other in parallel (see Figure 2.3).

There are a number of different situations that give rise to the need for a parallel structure. One of the common situations is where taxpaying and tax exempt US investors require the partnership in which they participate to make different elections for US tax purposes (US tax exempt investors that do not want to have unrelated business taxable income (or UBTI) will generally want their partnership to elect to be treated as a corporation or hold investments through a corporation, while US taxpaying investors will generally want their partnership to be treated as a partnership). An organization that is recognized as a tax exempt entity under the US Internal Revenue Code (IRC) may be liable for tax on its unrelated business taxable income and be required to file certain returns or forms with the US Internal Revenue Service (IRS). This area of US taxation is subject to complex rules and regulations that are beyond the scope of this book. The concern for sponsors of investment funds is to determine whether

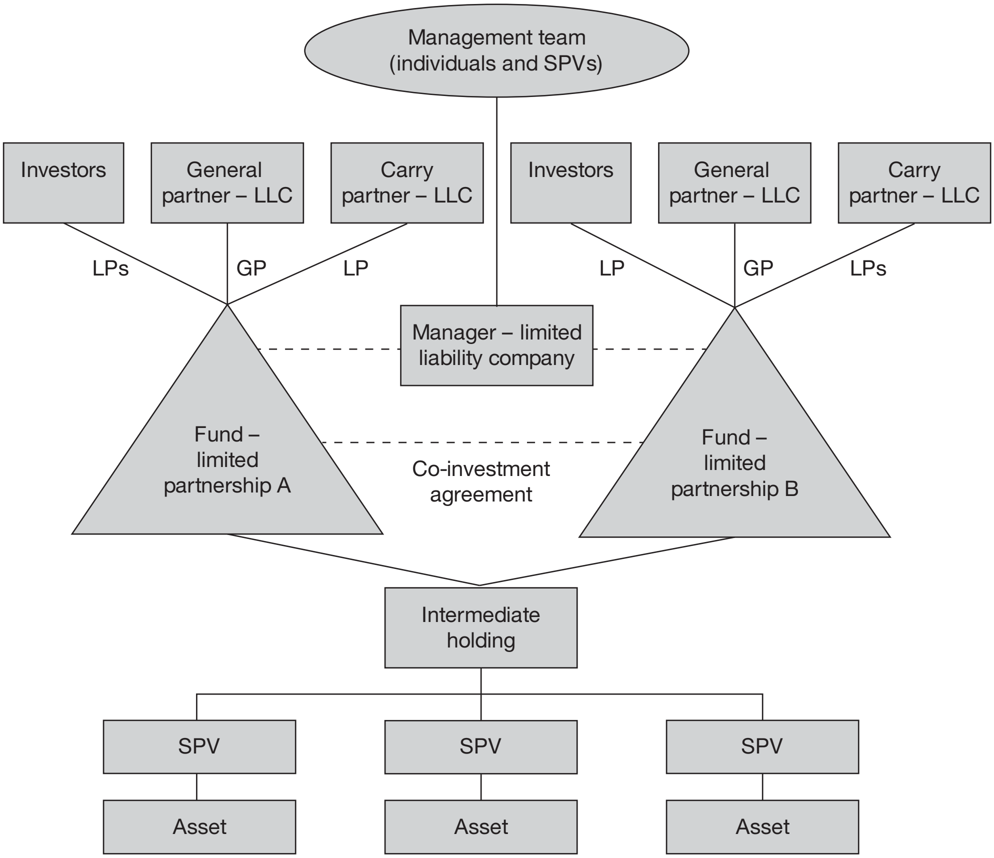


Figure 2.3 Parallel partnership structure.

investment will be solicited from such investors, including charities, pension funds and state funds, and then to use corporations in the investment fund structure to block or shield such investors from unrelated business taxable income to the extent so desired by the investors. Similarly, non-US investors often have US tax and tax withholding issues and will employ parallel funds or other tax-sensitive structures to reduce their overall income tax and/or avoid the requirement to file a tax return with the IRS.

In a parallel fund structure, each limited partnership or fund provides similar terms to their respective investors (other than any differences necessary to overcome the relevant regulatory or tax issues that have led to the parallel structure in the first place). One of the significant differences between the terms is that the calculation of the carry interest payable to the special limited partner or general partner is grossed up (increased) by the corporate income tax payable within the structure, so that the carry is not reduced by the investment fund structure accommodating the investor tax issues.

The separate affiliated limited partnerships enter into a co-investment agreement, which requires each limited partnership to acquire and dispose of investments at the same time and on the same terms pro rata to their investment commitments that may be drawn and deployed to the investment. The investment allocation between the separate limited partnerships is