OFFSHORE INVESTMENT STRUCTURES: ARE THEY RIGHT FOR YOU?
-AND-
SELECTED TOPICS

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a. U.S. Securities Act of 1933 (the "1933 Act") and U.S. Investment Company Act of 1940 (the "1940 Act"). (See also Section V.D. below)

(1) Regulation S of the 1933 Act affords the ability to make sales outside the U.S. to Non-U.S. investors who are not "accredited investors" under the 1933 Act.

i. However, as a practical matter, local "World Sky" restrictions may effectively impose the same sophistication requirements on Non-U.S. investors.

(2) The 1940 Act and various SEC No-Action Letters afford the ability to test only U.S. investors for purposes of private investment company exemptions (*i.e.*, 3(c)(1) and 3(c)(7))

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a. Use of an offshore corporate vehicle (including a pass-through vehicle that checks the box to be treated as a corporation for U.S. tax purposes) may block unrelated business taxable income ("UBTI") for U.S. tax-exempt investors and effectively connected income ("ECI") for Non-U.S. investors generated by underlying investment funds.

b. U.S. investors have the potential for more beneficial treatment under the U.S. tax rules related to Controlled Foreign Corporations ("CFCs") if a Non-U.S. flow through vehicle is used.

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A. Negotiability

1. Negotiability of fund governance documents may be more limited in certain Non-U.S. private equity funds.

a. Funds organized in jurisdictions requiring pre-approval of final offering documents and organizational papers (although "approvals" are often perfunctory, timing issues tend to make sponsors of funds in these jurisdictions reluctant to negotiate terms)

b. Tendency not to have a "U.S.-style" negotiated partnership agreement (*e.g.*, share-issuing vehicles offered pursuant to a "prospectus-type" offering document)

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c. No registration of the Fund as an investment company under the 1940 Act (to the extent interests in the fund are offered to U.S. investors)

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a. Portfolio-wide tax planning at the fund of funds level

b. Disclosures to U.S. tax exempts and Non-U.S. investors

c. Ability to give UBTI/ECI covenants to fund of funds investors

3. CFC, passive foreign investment company ("PFIC") and Foreign Personal Holding Company ("FPHC") issues should be analyzed in consultation with the fund of funds' tax advisors and counsel.

III. Choosing a Jurisdiction in which to Organize an Offshore Fund of Funds and Conduct its Administration

A. The relationship between the jurisdiction of fund formation and the jurisdiction of fund administration

1. In many popular jurisdictions, the sponsor is free to choose an administrator outside the jurisdiction.

2. Certain "corporate secretary" functions may, depending on the fund's structure, need be performed within the jurisdiction of formation, *e.g.*,

a. Limited partnerships often must have at least one local general partner.

b. Corporate structures are generally required to maintain a registered office locally which must maintain certain corporate records.

(1) Most third-party administrators and law firms operating in the more popular offshore jurisdictions are able to provide many of the "corporate secretary" functions locally.

c. Unit trusts must sometimes have a local trustee (and occasionally a management company).

3. In more regulated jurisdictions, as a practical matter it is often still possible to delegate administration services to an entity outside the jurisdiction.

4. As a practical matter, except in the most heavily regulated jurisdiction, sponsors of offshore funds of funds usually have a fair amount of latitude to choose a desired administrator located in or to conduct administration themselves from a jurisdiction outside of the jurisdiction of formation of the fund of funds.

B. Tax issues associated with choosing the jurisdiction of the fund

1. U.S. "check-the-box" rules give considerable flexibility in the choice of entities and jurisdiction.

2. Generally it is imperative that the offshore fund of funds be organized in a jurisdiction that does not impose incremental tax on the structure (*e.g.*, a tax haven).

a. Not all "tax-haven" jurisdictions are "no-tax" jurisdictions; so-called "low-tax" jurisdictions may, absent an available exemption, impose a small amount of tax.

b. Sponsors, in connection with accountants and counsel qualified to practice in a given jurisdiction, should diligence:

(1) The potential taxes that may be imposed in a given jurisdiction

(2) The availability of exemptions

(3) The need to receive undertakings and rulings from local tax regulators prior to the commencement of operations

i. Timing issues

c. Treaty benefits are not generally available for tax haven vehicles.

d. Potential "black list" problems may arise.

C. Tax issues associated with choosing the jurisdiction of fund administration

1. The jurisdiction should not subject the fund to tax (or at least to more than a *de minimis* amount of tax) in that jurisdiction.

2. Sponsors, in connection with accountants and counsel qualified to practice in a given jurisdiction, should conduct diligence to:

a. Confirm a favorable tax result

b. Understand any special conditions, procedures or limitations which are required to achieve that result (which should be incorporated into the administration/compliance manual).

3. Often, a jurisdiction has a specific tax exemption for offshore funds domiciled under its laws and, when problems arise, they tend to involve the administration of non-domiciled funds.

a. The exact tax analysis applicable to the administration of non-domiciled funds varies depending upon the jurisdiction, but is typically some variant of the formula that the administration of the non-resident fund must not result in the fund "carrying on business" or having a "permanent establishment", "principal place of business", "management and control" or "central management and control" in the jurisdiction of administration.

b. Potential problem areas include:

(1) Having Directors (or their equivalent under other structures) who are residents and holding meetings of the Board or equivalent governing body, investor meetings and similar types of actions in that jurisdiction

i. However, in an effort to move such functions outside of a particular jurisdiction, care should be given not to create a "permanent establishment" in an unrelated jurisdiction.

(2) In addition, in some jurisdictions, functions such as accepting subscriptions or entering into other contractual undertakings with third parties and authorizing expense

payments cannot be performed by the administrator on behalf of non-domiciled funds from that jurisdiction.

c. Knowing and following the rules is particularly important in jurisdictions that are <u>not</u> "no-tax" or "low tax" jurisdictions for business activities generally and can have very high tax rates applicable to a non-domiciled fund of funds if the fund accidentally were deemed to be subject to tax in that jurisdiction.

4. Fund sponsors should also ascertain whether VAT will be imposed on fees paid for administration, especially in EC domiciles, since the VAT cost will typically be passed on to the fund.

D. Practical drivers of jurisdictional selection

1. Preferences of fund counsel and accountants

2. Preferences of placement agents and other marketers

3. Quality of local counsel

4. Regulatory supervision in the jurisdiction

a. Less stringent regulatory oversight in certain jurisdictions may make it easier to organize, close and operate a fund in a particular jurisdiction.

(1) But note potential negative impact on marketing

b. Sponsors may desire to avoid cumbersome filing requirements and waiting periods which can delay a fund's closing or the passage of amendments to organizational documents or operating agreements.

E. Similarity of local law and regulation to that of the U.S.

1. Common law jurisdictions may have very different approaches to contract drafting and interpretation than civil law jurisdictions.

2. Flexibility of laws governing the structuring and contents of organizational documents may vary widely.

3. Certain jurisdictions claim to have based their partnership and corporate laws closely on U.S. (or, in many cases, U.K.) law—thereby allowing more flexibility in drafting, greater predictability of legal results and greater conformity to existing onshore funds.

IV. Selecting and Working with Fund Administrators and Custodians

A. Liability issues to consider in selecting fund administrators

1. The "buck stops with the sponsor": it is often not practical, for business reasons, to have the fund or the sponsor's clients bear the loss from mistakes and, in these situations, the loss will fall on the sponsor to the extent that the administrator does not bear the loss.

2. When mistakes in fund administration occur, responsibility for any resulting losses often, though not invariably, is determined with regard to the needs of the business relationships and reputations of the parties involved. While the legal parameters on the parties' responsibilities for losses (*e.g.*, contractual and fiduciary duties, exculpation and indemnification limitations on those duties and securities law liabilities) are certainly important in framing the parties' negotiating positions, they may not determine the result.

3. If a loss is clearly due to the administrator's mistake, that administrator may still be reluctant to claim that it is not liable because its mistake did not rise to the level of, for example, "gross negligence, willful misconduct, bad faith or willful disregard of its duties"--the business and reputational risks of such an attitude potentially overwhelming the legal considerations.

4. Steps a fund sponsor may take to protect itself

a. First and foremost, in recognition of the fact that, regardless of the legal niceties, "the buck stops with the sponsor" from its client's viewpoint, the fund sponsor must closely supervise the administrator's performance of its duties.

b. Deal with an administrator that has:

(1) A broader relationship with the sponsor so that the administrator will be less tempted to walk away from a relationship over a fund administration dispute

(2) A reputation for acknowledging its responsibilities and a strong commitment to the fund administration business that creates a vested interest in maintaining its reputation

(3) Adequate insurance coverage and the financial strength to back up its obligations (*e.g.*, should a sponsor feel comfortable contracting with thinly capitalized subsidiary without a parent guarantee?)

5. A fund sponsor should clearly disclose in the fund's offering documents that the liability of the administrator and other service providers to the fund for their actions is limited by exculpation and indemnification provisions and that the fund sponsor is not legally responsible for losses arising from the actions of the administrator and other service providers to the fund. A fund sponsor may ultimately decide for business reasons not to rely on these protections, but at least this disclosure will give it a choice.

6. There may be considerable practical obstacles to enforcing a party's rights against an administrator in the courts of its jurisdiction, and one may well be skeptical about the ability of the judicial systems in some locations popular with offshore fund administrators to fairly, impartially and effectively adjudicate disputes between administrators and their clients. Therefore, the administration contract should contain consent to jurisdiction and service of process clauses providing for the resolution of disputes in a mutually acceptable forum of recognized international standing.

B. Delegation of certain responsibilities to fund administrator

1. It is important to establish clear responsibilities for the various service providers, particularly during the fund-raising stage of a fund of funds.

2. Points of contact with investors should be well defined to avoid mixed signals or conflicting or incomplete advice, *e.g.*,

a. It is often more effective for fund counsel (and, where necessary tax counsel) to explain technical legal issues directly to investors or their counsel rather than the administrator, placement agent or the sponsor.

b. Review of investor subscription agreements and side letter negotiations should be overseen by fund counsel in order to ensure compliance with 1933 Act and 1940 Act exemptions, ERISA and other legal and regulatory matters and in order avoid unanticipated problems with counsel's ability to deliver legal opinions regarding such issues.

V. Setting up and Structuring an Offshore Fund of Funds

A. Key steps

1. Identification of market niche and precedents; target investors; target investments; fund size and basic terms

2. Selection of service providers and assignment of drafting responsibilities

a. Fund counsel

b. International accounting firm

c. Placement agents (if any)

d. Local counsel (and special local tax counsel, if needed)

e. Administrator

f. Printer

3. Selection of offshore jurisdiction and jurisdiction of administration (See III above)

4. Drafting of private placement memorandum

a. Confidentiality and disclosure issues associated with the inclusion of information regarding potential underlying investments (See "Part II--Selected Topics" Sections I.A. and I.B below)

5. U.S. "Blue Sky" survey and legends and Non-U.S. "World Sky" survey and legends

a. Significant lead-time issues

b. Use of multiple local counsel vs. international accounting firm or law firm

6. Structuring and documentation

7. Formation of local entities/local regulatory filings/initial board meetings and other corporate secretary functions

a. Consider lead-time issues

8. Fundraising period/negotiations with investors

9. Review of completed subscription agreements and follow-up diligence on investors (See Section IV.B. above)

10. Closing and post-closing filings in local jurisdictions

B. Selecting a form of entity

1. Types of entities available

a. Limited partnership

(1) Widely available in offshore jurisdictions and commonly used due to (i) flexibility and relative ease of establishment and operation, (ii) convenience of partnership accounting, (iii) wide recognition and acceptance among U.S. and Non-U.S. investors, and (iv) fund counsel's ability to draft and negotiate a U.S.-style partnership agreement that is then reviewed by local counsel and edited for local law requirements (which, in the more popular offshore jurisdictions, is usually not that invasive)

(2) May "check the box" to be treated as a corporation for U.S. tax purposes (thereby blocking UBTI and ECI (See Section V.E. below)

b. Corporate form entity

(1) Also widely used and accepted, but generally less flexible and involves more formalities and local counsel/corporate secretary involvement in setting up and operating due to,

inter alia, share capital requirements and other governance features

(2) More difficult for U.S. counsel to convert U.S.-style charter and by-laws into "memorandum" and "articles of association" under local law and more local counsel drafting is generally required

c. Trusts

(1) Increased involvement by the trustee in reviewing and negotiating the governance documents and operating the fund should be expected. When, for example, a bank serves as a fund's administrator it may have a more hands-off approach—relying more heavily on its ability to limit the scope of its liability and services through the administration contract. Conversely, the fiduciary duties and liabilities imposed by law on a fund's trustee may prompt the same bank to take a more proactive role.

d. Limited duration companies and other hybrid forms are available depending on local law. Although not as common in fund of funds structures, they may make sense in particular situations.

C. Investor-driven structuring

1. The particular tax and regulatory status of certain Non-U.S. investors or their desire to negotiate special terms often drives the selection of the form of entity to be used and its jurisdiction, *e.g.*,

a. German investors may prefer to invest in a German Partnership or in a partnership in which the general partner is itself a limited partnership with certain ownership characteristics; Dutch investors may wish to invest through a Dutch limited partnership.

2. Certain state pension plans will insist on obtaining customized terms such as a "simple" negligence standard of sponsor liability, subordination of sponsor capital, minimum levels of sponsor committed capital and reduced fees and carried interest.

a. Sponsors typically create single investor vehicles through which such persons invest to isolate the effect of more favorable investor-specific terms. See "Part II--Selected Topics" Section II.A.3. below for associated ERISA issues.

b. More of this is to be expected in "tighter" fund raising markets.

3. The desire to include investors who are not "qualified purchasers" may require that parallel funds be established, each relying on different 1940 Act exemptions (*e.g.*, 3(c)(1) vs. 3(c)(7)). See discussion below under Section V.D.1.

D. Key U.S. legal and regulatory issues

1. 1940 Act

a. As a practical matter, the typical private equity fund of funds will not operate as a registered investment company under the limitations of the 1940 Act and will require an exemption.

b. Section 3(c)(1) fund exemption

(1) Limits a fund to 100 or fewer beneficial owners of its securities (both debt and equity) other than holders of short-term paper and "knowledgeable employees" (see below).

i. There are complicated "look through" rules that in some circumstances require counting each investor in an entity which invests in the fund toward the 100 investor limit.

ii. To avoid application of these rules, among other things, no single underlying fund can represent more than 40% of the Fund's portfolio (based on capital commitments) and the Fund cannot hold more than 10% on the interests in any underlying fund.

(2) A 3(c)(1) fund also cannot engage in a public offering (see the 1933 Act discussion below to the effect that the fund must make a private placement of its securities to accredited investors without using any means of general solicitation or general advertising).

(3) 3(c)(1) funds which would not be regarded as being materially different to a reasonable investor will be "integrated" and their eligibility for the exemption will be determined with respect to their aggregate activities and number of investors.

c. Section 3(c)(7) fund exemption

(1) This exemption limits a fund to beneficial owners of its securities which are exclusively "qualified purchasers" (except for "knowledgeable employees" as discussed below).

i. "Qualified purchasers" are comprised of individuals and certain family investment vehicles with at least $5 million of "investments" (as defined to exclude, for example, real estate used for personal reasons) and entities with at least $25 million of investments.

(2) As with 3(c)(1) funds, a 3(c)(7) fund also cannot engage in a public offering.

(3) Even if the fund of funds is not itself a 3(c)(7) fund, so long as it has at least $25 million of capital commitments, it will constitute a "qualified purchaser" which is eligible to invest in other 3(c)(7) funds. This is important since some underlying funds are now offered exclusively to qualified purchasers.

d. Knowledgeable employees

(1) "Knowledgeable employees" of a fund or its investment manager are not taken into consideration when determining whether a fund qualifies for the 3(c)(1) or Section 3(c)(7) exemption.

(2) A "knowledgeable employee" is (a) any individual who is an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity of either a Section 3(c)(1) fund or a Section 3(c)(7) fund (the "Covered Fund") or its investment manager, or

(b) an employee of the Covered Fund or its investment manager (other than an employee performing solely clerical, secretarial or administrative functions) who, in connection with his or her regular functions or duties, participates in the investment activities of the Covered Fund, other Covered Funds, or investment companies the investment activities of which are managed by the investment manager, so long as such employee has been performing such function and duties for or on behalf of the Covered Fund or its investment manager, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

(3) The knowledgeable employee exception may be useful to a fund of funds sponsor in structuring employee participation in the fund. Alternatively, a sponsor should consider use of its "phantom equity" deferred compensation plan or seeking SEC relief to use an "employee securities company."

e. Offshore fund

(1) Under SEC no-action letters, the limitations on onshore private funds are applied to offshore funds so that an offshore fund must restrict itself to either (i) no more than 100 beneficial owners of its securities (other than holders of short-term paper and knowledgeable employees) who are U.S. investors (although it can have an unlimited number of non-U.S. investors) or (ii) only qualified purchasers (and knowledgeable employees) who are U.S. investors (again, it can have non-U.S. investors who are not qualified purchasers).

(2) A U.S. partnership for U.S. taxable investors only will not be integrated with a parallel offshore fund structured as a corporation for non-U.S. investors and U.S. tax-exempt investors only due to material differences in the tax treatment to the U.S. investors. This result effectively permits up to 100 U.S. taxable investors in the onshore fund and up to 100 U.S. tax-exempt investors in the offshore fund.

2. 1933 Act

a. In order to qualify for the exemption from registration under the 1933 Act, an offshore fund must be marketed in the U.S. only to "accredited investors" in a private placement in compliance with Regulation D (*i.e.*, there can be no use of any means of general solicitation or general advertising (including through web sites, interviews with trade journals, *etc*.)).

(1) Accredited investors include: a natural person with an individual net worth (or a joint net worth with a spouse) in excess of $1 million; a natural person with an individual income (without including any income of the investor's spouse) in excess of $200,000, or a joint income with a spouse in excess of $300,000, in each of the two most recent years and who reasonably expects to reach the same income level in the current year; a corporation, trust or partnership, not formed for the specific purpose of acquiring interests in the fund, with total assets in excess of $5 million; and various categories of institutional investors.

b. The offer and sale outside the U.S. of interests in the fund should be conducted as an offshore transaction under Regulation S. Generally speaking, only non-U.S. residents may be purchasers and the investor must be offshore when the solicitation is made.

3. ERISA

a. Generally, private funds of funds accepting investments from ERISA investors seek to avoid being subject to regulation under ERISA. If the assets of the Fund are deemed to be "plan assets" of any ERISA plan investing in the Fund (which will be the case absent availability of the exemptions described below), then this would result principally in (i) the application of the prudence and other fiduciary responsibility standards of ERISA to investments made by the fund, (ii) restrictions on the types of performance fees that may be charged by the fund manager and (iii) the possibility that certain transactions in which the fund might seek to engage could constitute "prohibited transactions" under ERISA and the Internal Revenue Code of 1986, as amended (the "Code"). If a prohibited transaction occurs for which no exemption is available, the fund manager and any other fiduciary that has engaged in the prohibited transaction could be required (i) to restore to the ERISA plan any profit realized on the transaction and (ii) to reimburse the ERISA plan for any losses suffered by the plan as a result of the investment. In addition, each party in interest (within the meaning of ERISA) involved could be subject to an excise tax equal to 15% of the amount involved in the prohibited transaction for each year the transaction continues and, unless the transaction is corrected within statutorily required periods, to an additional tax of 100%. Plan fiduciaries who decide to invest in the fund could, under certain circumstances, be liable for prohibited transactions or other violations as a result of their investment in the fund or as co-fiduciaries for actions taken by or on behalf of the fund or the fund manager.

b. Avoiding plan asset characterization

(1) Under Plan Asset Regulations issued by the U.S. Department of Labor (the "<u>DOL</u>"), the fund can avoid a "plan assets" problem by limiting participation by "benefit plan investors" in the fund to less than 25% of the value of any class of equity of the fund held by third parties (*i.e.*, excluding equity securities held by the investment manager and its affiliates) (the "<u>25% Exception</u>"). "Benefit plan investors" include all employee benefit plans, whether or not subject to ERISA or the Code, including governmental plans and foreign plans and any entity whose assets are deemed to include "plan assets" (*e.g.*, an entity of which more than 25% of the value of any class of equity interests is held by benefit plan investors and which does not satisfy another exception under the Plan Asset Regulations).

c. Managing the plan asset issues

(1) QPAM

i. If the fund's assets will constitute "plan assets" because the 25% Exception will not be satisfied, then qualifying the fund manager as a "qualified professional asset manager" ("<u>QPAM</u>") will significantly reduce, albeit not completely eliminate, the potential for non-exempt prohibited transactions as a result of investments made by the fund.

ii. In general terms, if a transaction with a plan is authorized by a QPAM and so long as the plan's assets managed by the QPAM do not represent more than 20% of the total assets managed by the QPAM, parties in interest with respect to the plan (other than the QPAM itself and its affiliates, the plan's sponsor and affiliates and any entity that has the authority to appoint or terminate the QPAM) are permitted to engage in other transactions involving the plan assets.

iii. The definition of QPAM includes, among other things, registered investment advisors with at least $50,000,000 of assets under management and shareholders' equity of at least $750,000 as of the last day of its preceding fiscal year and certain banks and insurance companies.

(2) Performance fees

i. Under ERISA, an ERISA fiduciary (like the fund manager) and/or party in interest with respect to a plan may generally provide services to the plan (including investment management services) if the compensation the fiduciary or party in interest receives is "reasonable" and the arrangement may be terminated by the plan on "reasonably short notice under the circumstances."

ii. The DOL has indicated in a number of advisory opinions that (subject to a number of detailed assumptions set forth in such opinions) a properly limited performance fee arrangement should not, in and of itself, be prohibited by ERISA. The apparent purpose of the limitations is to prevent investment managers from manipulating their own compensation.

(3) Self dealing

i. As a result of its ERISA-imposed fiduciary duties to the fund the sponsor must be careful to avoid any appearance of "self-dealing" with respect to the plan assets of the fund. ERISA § 406(b) forbids a fiduciary of a plan from dealing with plan assets for its own interest or its own account, acting on behalf of parties with interests adverse to a plan in a transaction involving the plan, or receiving consideration for its own account from a party dealing with the plan in connection with a transaction involving plan assets (*e.g.*, fiduciaries investing plan assets in companies in which they own a significant amount of equity). Where a sponsor acts as the fund manager of other investment funds, it should carefully examine and evaluate the merits of each investment opportunity of the fund solely with respect to the interests of the fund, to ensure that it is not acting in its own or other of its funds' interests when it makes decisions regarding the acquisition or disposition of investments.

4. Investment Advisers Act of 1940 (the "Advisers Act")

a. Sponsors seeking to qualify for the QPAM exemption described under "ERISA" above will be required to register as an investment adviser with the SEC pursuant to the Advisers Act if they want to be a "QPAM" as discussed above.

b. Even if a sponsor does not need to register with the SEC as an investment adviser, it will still be an "investment adviser" subject to certain antifraud and other requirements of the Advisers Act to which all investment advisers, both registered and unregistered, are subject.

c. Private adviser exemption from registration

(1) The private adviser exemption applies to advisers which (i) do not have more than 14 "clients" in any rolling 12 month period, (ii) do not have any registered investment

companies as clients and (iii) do not hold themselves out to the public as an investment adviser (*i.e.*, no advertising or solicitation of clients through impersonal means).

(2) Each investment fund vehicle will be treated as a single "client" rather than each investor in the fund being treated as a client so long as the adviser provides advice based on the investment objective of the fund as a whole (rather than based on the investment objectives of specific investors in the fund).

d. Section 206(3)

(1) Applies to registered *and* unregistered investment advisers.

(2) Requires consent of the client (*i.e.*, the fund of funds) where the investment adviser (*i.e.*, the sponsor) purchases securities from or sells securities to such client.

i. Typical situations in which consent may be required would include:

(i) Transfers of pre-closing "warehoused" investments from the sponsor to the fund of funds

(ii) The fund of fund's investment in an underlying fund that itself is one of the sponsor's other funds (*e.g.*, an investment bank's fund of funds investing in that bank's merchant banking fund)

(3) "Investor advisory committees" or "independent client representatives" may be used to give consent on behalf of the client for 206(3) purposes.

e. Performance fee prohibition

(1) The principal negative consequence of being a registered investment adviser is that registered advisers are prohibited, subject to the exceptions below, from receiving

performance fees or "carried interests" from funds they manage.

(2) As a result of legislation adopted in 1996, the performance fee restrictions do not apply to compensation arrangements with 3(c)(7) funds or with offshore funds.

(3) Rule 205-3 Exception — Performance fees can only be charged to investors which have $750,000 of assets under management with the adviser, have a net worth of $1.5 million or are any of an executive officer, director or employee of the investment advisor. If any of the investors in a 3(c)(1) fund is itself a 3(c)(1) fund, each investor in the investing 3(c)(1) fund must also meet the eligibility test.

E. Tax issues

1. UBTI and ECI

a. U.S. investors that are otherwise tax-exempt are nonetheless subject to tax on UBTI. U.S. tax-exempt investors often seek to avoid receiving any UBTI since, in addition to the economic impact of taxes, they must bear the administrative burden of filing tax returns and become subject to IRS audit. Similarly, Non-U.S. investors often seek to avoid tax return filing requirements in the U.S. with respect to ECI.

b. Some typical ways in which a private equity fund can generate UBTI are through "debt-financed income" (which is income from investments which are financed with indebtedness) or through receipt of trade or business income. Since almost all onshore private investment funds are structured as partnerships for tax purposes, if such fund incurs debt or receives trade or business income, then the character of that income will flow through to tax-exempt partners for whom the income will be UBTI as well as ECI (in the case of trade or business income) for Non-U.S. partners.

c. In order to avoid receipt of UBTI, U.S. tax-exempt investors in a flow-through entity will expect a prohibition on the incurrence of debt by the fund and a reasonable best efforts covenant in underlying funds to avoid the incurrence of UBTI. In addition, U.S. tax-exempt investors are increasingly investing in offshore funds which are structured as corporations for U.S. tax purposes. Because the debt-financed character of a corporation's income does not generally flow through for tax-purposes, a U.S. tax-exempt investor may avoid UBTI treatment. Such a vehicle would likewise block ECI for Non-U.S. investors (although it would be subject to U.S. tax on such ECI). If an offshore vehicle is being used already for non-U.S. investors, it may be advisable to put U.S. tax-exempt investors in this vehicle.

2. Potential Phantom Income on Carried Interest

a. If the carried interest to the fund's general partner is based on a "full payout" formula which requires that all of the fund's capital in an underlying fund or in the entire portfolio of underlying funds be returned before the carried interest becomes payable to the general partner, the general partner may receive phantom income for tax purposes on the carried interest which it earns but is not distributed to it.

F. Structuring of selected fund of funds terms

1. *Liability Standards* --The liability standard for a fund of funds sponsor should be "gross" negligence, as opposed to simple negligence. fund counsel should confirm the recognition of the gross negligence standard under the laws of the offshore jurisdiction. Even if a jurisdiction only recognizes "simple" negligence, a "gross" negligence standard should nonetheless be included on the grounds that courts will give plain meaning to the language of a contract. Sponsors may also consider making exculpation and indemnity standards governed by Delaware law.

2. *Drawdowns of Capital Commitments* -- In fund of funds targeted for institutional investors (an "<u>Institutional Fund</u>"), drawdowns are usually made on an "as needed" basis. In fund of funds targeted for high net worth investors (a "<u>HNWI Fund</u>"), a drawdown for an investment reserve is typically made at the initial closing (*e.g.*, 25%) and then renewed in increments (*e.g.*, 10%) thereafter. Where practicable in a HNWI Fund, consideration should be given to automatic debit arrangements of client accounts for drawdowns or other means to minimize credit risk.

3. *Multiple Closings* -- Typically, there would be a selling period that permits more than one closing with a "true-up" at subsequent closings on a cost plus interest at prime + 2% interest basis.

4. *Management Fee* -- Typically, it is based on a percentage of the overall size of the fund's capital commitments, with a reduction on the base on which the percentage is applied as capital is returned to investors. Generally, there are no management fee offsets since investments in the underlying funds do not directly generate other fee income.

5. *Placement Fee* -- Typically, a 1.5-2% load can be charged to investors in a HNWI Fund, with discounts potentially for large investors. In Institutional Funds, any load is typically borne by the investment manager, although sometimes this is not the case with foreign investors. Note that placement fees, even if borne by the fund's investment manager, are "syndication expenses" for tax purposes which must be capitalized rather than deducted or amortized.

6. *Carried Interest* -- Investment managers often charge up to a 5% carried interest, subject to meeting certain hurdle performance returns. Typically, the carried interest is charged on a fund-by-fund basis or a single netted pool, with investors receiving back all capital invested in a single fund or in the entire pool before any carried interest becomes payable to the general partner (with the phantom income consequence to the general partner discussed above). As a result of this tax consequence, there is some precedent now to trying to look through the underlying funds to calculating the carried interest on a cumulative realized underlying deal basis, but this can be very difficult to administer.

7. *Recalls of Capital by Underlying Funds* -- Given the ability of underlying funds to recycle capital for bridge financings and other reasons, the fund needs to provide for the ability to either retain capital or recall capital from fund investors to satisfy recalls by underlying funds. If any underlying funds have "limited partner givebacks", back-to-back rights may be needed for the fund with respect to its investors and/or a substantial right to take reserves against distributions.

8. *Length of Commitment Period* -- In addition to a traditional Commitment Period for the fund, a sponsor should analyze what the fund's obligations will be after each underlying fund's investment period expires. The amount and period of time that may be required thereafter for capital contributions to underlying funds for the purpose of follow-on investing

(committed or uncommitted), management fees, and expenses relating to the underlying funds should be assessed. See also "Length of Term" below.

9. *Size of Underlying Fund Commitments* -- In determining the size of commitments to underlying funds, adjustments should be made for: (i) underlying funds that charge management fees (and possibly organizational expenses) above the amount of the commitment to the underlying fund, (ii) management fees charged by the sponsor to the fund, (iii) the placement fee to the extent it is charged at the fund level and (iv) interest charges payable to the sponsor, if any, on transfers to the fund of existing commitments to underlying funds.

10. *Length of Term* -- The fund's term should be as long as the latest possible termination of an underlying fund rather than the standard 10-year term for underlying funds.

11. *Co-Investments* -- If the fund will have the ability to do co-investments the sponsor should consider the size of the "basket" allocated to co-investments by the fund and whether to reserve the right to take co-investments for its own account away from the fund.

12. *Diversification* -- The sponsor should consider what diversification restrictions to impose on the fund.

13. *In-Kind Distributions From Underlying Funds* -- Typically, a fund of funds would either automatically sell securities distributed in kind to it or require the general partner of the underlying fund to do so on its behalf, and would prohibit distributions in kind of non-marketable securities to it except upon liquidation of an underlying fund.

14. *Leverage* -- Subject to the UBTI considerations noted above, it would be typical to permit modest leverage at the fund level in case the fund needs to fund capital contributions to an underlying fund on a quick basis (underlying funds typically can require funds on 10 business days' notice) or for expenses of the fund.

15. *Scope of Underlying Funds* -- A sponsor should consider whether there will be venture capital funds, distressed funds, real estate funds or international funds in the fund.

16. *Reporting* -- In view of the delays in receiving financial reports and tax information from underlying funds, a sponsor should make sure to give itself sufficient time and flexibility in its reporting obligations to fund investors.

17. *Side Letters* – Sponsors should decide in advance how they will approach side letter requests and negotiations. Three basic approaches are (i) no side letters; (ii) allow only side letters that do not conflict with (and therefore do not purport to amend) the partnership agreement and (iii) authorize side letters in the partnership agreement which amend the agreement as between the fund and the particular investor with which the letter was entered into. The third approach gives the most flexibility to alter the terms of the agreement for a particular investor (*e.g.*, opt-outs, reduced fees, *etc*.), however there are limitations under local law on how and to what extent this may be accomplished (*e.g.*, benefits given to one investor may not prejudice another).

G. Local law and regulation

1. Confirm licensing, registration, filing, tax and other local law and regulatory matters with local counsel

a. Note lead-time issues

PART II -- SELECTED TOPICS

I. Fund of Funds Marketing Materials

A. Confidentiality restrictions

1. Sample private equity fund provision

a. "Unless otherwise agreed to in writing by the General Partner, each Limited Partner will maintain the confidentiality of information which is non-public information furnished by the General Partner regarding the General Partner and the Partnership (including information regarding any Person in which the Partnership holds, or contemplates acquiring, any Investments) received by such Limited Partner pursuant to this Agreement."

2. Sample carve-out

a. "Notwithstanding the confidentiality provisions above, the General Partner agrees that each Limited Partner that (i) itself is an investment partnership or other collective investment vehicle having reporting obligations to its limited partners or other investors and (ii) has prior to the closing of its subscription for Interests notified the General Partner in writing that it is electing the benefits of this provision may, in order to satisfy such Limited Partner's reporting obligations, provide the following information to such Persons regarding the Partnership and any Portfolio Companies: (i) the cost of the Partnership's investment in a Portfolio Company and the percentage interest of the Portfolio Company acquired by the Partnership, (ii) a description of the business of the Portfolio Company and information regarding the industry and geographic location of the Portfolio Company, (iii) the book value of a Portfolio Company on the last day of the quarter (as reported by the Partnership to such Limited Partners in the Partnership's financial statements under this Agreement) and (iv) a brief description of the investment strategy of the Partnership. Notwithstanding the foregoing, in no event may any such Limited Partner disclose any other confidential information regarding the Partnership, the General Partner, the Advisor or any of their Affiliates or any information regarding the Partnership's pending acquisition or pending disposition of a Portfolio

Company or proposed Portfolio Company without the prior written consent of the General Partner."

B. Disclosure issues

1. If the fund has identified specific underlying funds in which it plans to invest, disclosure will be needed about the underlying funds (*e.g.*, their terms, track record, management team, investment strategy, etc.). Liability issues over disclosure and use of the information will need to be resolved.

a. Sensitivities of private equity fund sponsor

(1) Liability for material misstatements or omissions

i. Inability of sponsor to adequately diligence performance/IRR presentations

(i) Comparisons to indices

(ii) Third-party compilations of market returns and comparisons

ii. Lack of indemnities

(2) Potential that the disclaimer is not respected by judicial body

b. Sample disclaimer of liability requested by underlying private equity fund sponsor

(1) "THE INFORMATION CONTAINED HEREIN RELATING TO XYZ PARTNERS, L.P. AND ITS AFFILIATES HAS BEEN DERIVED BY THE FUND OF FUNDS FROM MATERIALS FURNISHED BY THE SPONSOR OF XYZ PARTNERS, L.P. TO THE FUND OF FUNDS. THE SPONSOR OF XYZ PARTNERS, L.P. AND ITS AFFILIATES MAKE NO REPRESENTATION REGARDING, AND EXPRESSLY DISCLAIM ANY LIABILITY OR RESPONSIBILITY TO ANY INVESTOR IN THE FUND OF FUNDS FOR SUCH INFORMATION OR ANY OTHER INFORMATION SET FORTH HEREIN."

c. Fund of funds sponsor should have similar disclaimer of its responsibility for information provided by underlying fund sponsors

2. The section in the fund's offering memorandum on conflicts of interest will need to include exculpating disclosure allowing the fund of funds sponsor and its affiliates to have dealings with the underlying funds and their portfolio companies without restrictions.

II. ERISA Issues

A. Some noteworthy items in structuring for and administering the 25% Exemption

1. Taking $1 of ERISA money

a. Capital of U.S. and Non-U.S. investors that are "benefit plan investors" but are not subject to ERISA (*e.g.*, U.S. state pension plans, Non-U.S. public and private pension plans) is not relevant unless and until $1 of capital is accepted from benefit plans that are subject to ERISA (*e.g.*, private pension plans).

2. Integration

a. Parallel funds in a fund of funds structure that each rely on the "Under 25%" exemption risk integration for purposes of the test.

b. Risk can be reduced by having meaningful distinctions among the investment programs of the various parallel funds.

III. Reducing the Number of Parallel Entities Making Fund of Funds Investments

A. Use of holding companies

1. Not "formed for purpose"-- the 1940 Act and the 40% safe harbor

a. Each fund of funds would need to be a qualified purchaser.

2. Structuring each fund of funds as general partner/managing member of a single holding company

a. Note joint and several liability issues

3. Use of "nominee" company

4. See Exhibit 1

B. Potential drawback

1. Loss of flexibility to "opt-out" particular funds/investors in the fund of funds structure for tax or other reasons

IV. Listed, Non-U.S. Feeder Funds

A. Noteworthy features

1. Non-U.S. listed company that invests its capital as a limited partner of a fund of funds organized as an offshore limited partnership

a. Effective method of raising capital outside of the U.S. from a wider base of "private client"-type investors

b. Offers and sales by such listed company outside the United States to Non-U.S. Persons pursuant to Regulation S under the 1933 Act; restrictions on transfers to U.S. persons

(1) If structured properly:

i. No need to qualify company's shareholders as "accredited investors" under the 1933 Act

ii. No need to test company's shareholders for purposes of private investment company exemptions under the 1940 Act (*i.e.*, 3(c)(1) and 3(c)(7))

iii. Ability to avoid counting the company's capital commitment to the fund of funds for purposes of the "25% Exemption" from ERISA (*e.g.*, limit benefit plan participation to less than 25% of the third-party capital of the listed company)

Exhibit 1

HYPOTHETICAL FUND OF FUNDS STRUCTURE