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Fund Structuring Options: Using Parallel Funds to Improve Capital Formation

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US fund managers that seek to meet the diverse needs of investors often find themselves considering the launch of more than one legal vehicle that will meet unique investor requirements, and yet function as a single investment strategy or "fund." This is the essence of one or more parallel funds.

Side-by-Side Funds for Retail

When it comes to retail funds for individual investors, fund formation choices are limited by local regulations and customs. The Investment Company Act of 1940 introduced the proposition from its inception that only funds domiciled in a state of the United States could be marketed to the public in the United States.[1]

The rest of the world has taken note, and has (except within the European Union[2]) essentially adopted similar regulatory propositions excluding marketing of extra-territorial retail funds. For example, the European Union excludes, in principle, marketing of retail funds that are not organized in a member state.[3] Coupled with tax policy that favors domestic "regulated investment companies" in the United States and European Union "undertakings for collective investment in transferable securities" (UCITS) domiciled in individual member states of the European Union, as prominent examples, US fund managers of retail funds are compelled to adopt "side-by-side" funds when marketing their strategies globally. For European strategies, an entire industry stands ready in Luxembourg to host US fund managers' retail investment strategies on UCITS platforms.[4] That said, this article will focus on some structures allowing US managers to target professional investors globally.

Parallel Funds vs. Co-Invest Vehicles or Alternative Investment Vehicles (AIVs)

Parallel funds usually co-invest and divest alongside the main fund of the structure at the same time and on the same terms, pro rata based on their respective committed capital. Unlike parallel funds, co-investing consists in one or more investment transactions made alongside the main fund, usually offered by the manager on a discretionary basis to strategic partners external to the main fund, or existing fund investors. The distinction should be made as the latter have a purpose of obtaining additional resources and bridging fund gaps, but concern individual underlying investments, not a participation in the entire portfolio. AIVs may also be formed as alternative vehicles aggregating a portion of the existing investors' commitments. They usually enter into play when the main fund to which they relate is not the optimal vehicle to make a specific investment for tax, regulatory or other reasons.

Institutional Investors Resist One Size Fits All Solutions

In contrast to retail funds, funds for professional investors typically qualify for regulatory exclusions or exemptions from the requirement to be domiciled in the investor's nation-state and can be designed (and sometimes are designed) with the objective of "one size fits all."[5] The question for US institutional fund managers is *when are parallel funds the better option*? We would submit that having considered the factors set out below, US fund managers will have a path to unique markets that can be superior to a "one fund" solution.

The Seed Money Investor Conundrum

When US managers commence raising a fund, choice of domicile leads to consideration of marketing restrictions and permissions: Discussions with counsel often turn to what fund type would travel the farthest and have the greatest reach. After all, a single fund might offer economies of scale, particularly as fund service providers will inevitably have fees for fund set up and minimum fees for their services. One fund might mean lower running costs than parallel funds.

When Simplicity Is Perfection

In competition with this objective for economies of scale in fund administration, considerations of the unique tax, regulatory and cultural expectations of seed money investors take precedence, as selling to those most inclined to close first must have primacy of place. Moreover, for US fund managers a glance at Prequin or a similar database shows where US institutional investors are putting their money, routinely: Delaware and Cayman. The answers to this are simple: for investment strategies in stocks, securities, commodity interests (whether liquid market strategies or private equity) for US super tax-exempt investors (such as pension plans that are "instrumentalities" of governmental bodies) and US high net worth individuals, a simple Delaware fund (coupled with partnership tax reporting for US high net worth individuals) does the trick, is fast to market and will meet the expectations of US platform gatekeepers and consultants. For these investors and their consultants, Delaware partnerships work like a charm for venture capital, private equity and private debt alike. Because most US fund managers have offered US domiciled funds to their core constituency of repeat investors, the case for a Delaware fund is made.

When Leverage Compels a Parallel Solution

In contrast, similar investors that are US tax-exempt and that keep an eye on the tax bill generated by "unrelated business taxable income" (UBTI) or "unrelated debt financed income" (UDFI) occasioned by leveraged investment strategies are unlikely to prefer a Delaware limited partnership. US tax exempts must pay tax at corporate rates on UBTI and UDFI. Accordingly, US tax-exempt investors typically prefer investing in the leveraged strategies through an offshore corporate vehicle (including a foreign partnership that elects to be treated as a corporation for US income tax purposes) that is not subject to corporate income tax in its country of domicile. The rationale for this choice is well understood: Dividends paid to a US tax-exempt shareholder by a foreign corporation are not subject to UBTI or UDFI taxation, as these characteristics do not pass-through corporations. So for decades, Cayman funds (sometimes as corporate parallel funds, sometimes as corporate feeders into a partnership master fund) have been the order of the day for US tax-exempt investors that are sensitive to UBTI/UDFI when the investment strategy includes investment leverage.[6] Non-US corporate funds (such as Cayman corporate parallel funds) also are well received from a tax perspective by non-residents of the United States. It is easy enough to either launch the Cayman fund as a parallel fund, or to combine the Cayman point of investor "entry" for tax exempts with a Delaware point of entry for our US high net worth individuals and super tax

exempts. This solution is fast to market, and will get the strategy up and running the quickest of all options. Many US fund managers set up these structures without the need for outside counsel. This approach often sets the table for parallel funds for non-US investors.

We tend to forget, however, that the Internal Revenue Code treats investing in stocks, securities and commodity interests uniquely by excluding investments of this type made by foreign persons from the definition of a "US trade or business". Effectively connected income (ECI) with a US trade or business is subject to US income tax or, if income tax is not being paid, then US withholding tax, and ECI from a partnership can give rise to the branch profits tax. Not so for most hedge funds and some private equity strategies because of the ECI exclusion. The unique tax treatment afforded to investing in "marketable securities" is the prerequisite for using Cayman corporate funds to "block" UBTI and UDFI for hedge, venture capital, and private equity strategies.

When the Nature of the Asset Compels Parallel Funds

Using one or more parallel funds allows the US fund sponsor to design a fund structure that is tailored to each community of investors' specific needs. For example, investments in certain alternative asset categories do not benefit from the ECI exemption that hedge, venture capital and private equity funds enjoy. These alternative assets could cause a non-resident alien to receive ECI; for example, both private debt and real estate investments, will likely present these considerations.[7] Again, investments that are potentially subject to ECI for non-residents (and by US tax-exempts looking to block UBTI by investing in an offshore corporate fund) often lead to the use of a parallel fund tailored to address tax considerations not relevant to US taxable and super tax-exempt investors.

The solutions to the considerations of US tax-exempt and non-resident investors will involve structuring. By building a parallel fund that "blocks" ECI/Foreign Investment in Real Property Tax (FIRPTA) and UBTI for offshore investors (perhaps by making use of a private real estate investment trust for leveraged real estate strategies or by taking advantage of a favorable US double tax treaty), the costs of the additional complication and delay in getting to market can be focused on the recipients of the benefit. Not all parallel funds are truly parallel. Some have (of necessity) different investment returns. For example, in private debt, a parallel structure (in the sense of a fund that invests at the same time as the other funds in the structure) simply may not be possible for US tax exempts and non-residents. However, a similar offshore fund (perhaps in Cayman or in Luxembourg) that purchases a portion of some of the seasoned loans from the US manager's onshore fund on an arm's length basis can be organized in a manner beneficial to investors in the selling fund (that earn origination fees) and for the buying fund (that have the opportunity to invest in seasoned loans without being subject to ECI).

When Regulatory Considerations Encourage a Parallel Fund

US managers are well aware that the European Union offers a market of institutional investors that are receptive to investing in US alternative assets. US managers can access institutional investors via either their Delaware or Cayman funds, by means of country specific national private placements, provided that (1) no marketing takes place prior to authorization by the local regulator, and (2) the investors in the fund (from that country) are "professional investors"[8] (although this universe can be further limited by local regulations).

Permission to "market" is granted by the local regulator. The concept of what constitutes marketing is quite broad, and is beyond the scope of this article. Suffice it to say, that limited activities are permitted on a country-specific basis prior to marketing permissions being granted, and are now also subject to a new European Union regulatory framework

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that defines the maximum scope of pre-marketing.[9] Certainly, no investment commitments can be solicited prior to receipt of a marketing permission from the local regulator. The typical process is to engage local counsel to prepare a filing that will be reviewed by the regulator in the relevant country. The road map for national private placements is found in the Alternative Investment Fund Managers Directive (AIFMD),[10] which lays out minimum requirements for investor disclosures and reporting, but each member state is free to set its own contours with respect to its national private placement process.[11] Post sale filing requirements with the local regulator are also required.[12] Each member state of the European Union is authorized under the AIFMD to introduce some country-specific requirements to national private placements that are unique to that member state. Some have done so.[13] The local regulator may (depending on the country) have no obligation to grant the requested marketing permission, and for managers of closed-end funds that have established a "marketing period" for their fund launch, precious time can be lost, waiting for the regulator's review. Moreover, once obtained, marketing authorization would apply only to one country. Accordingly, the process of commencing marketing within the European Union would be country specific, unless the US manager opts for the pan-EU marketing passport route.

In contrast to marketing a Delaware or Cayman fund in the European Union, a parallel fund can be established in the European Union, perhaps in Luxembourg, and tailored more broadly for EU investors. With EUR 5.5 trillion in assets under management and with US originators representing the largest share of the market, it is clear that the Luxembourg structuring toolbox offers a variety of choice sufficient for structuring across various investment strategies. Under the AIFMD, a European domiciled alternative investment fund (AIF) can have access to the EU-wide marketing passport on a pre-determined timeline of not more than 20 business days. It is the best way to market a fund throughout Europe. Indeed, the marketing passport circumvents the need to file and receive regulatory approval on a country-specific basis prior to commencing marketing. This puts the fund sponsor in control over the timing of marketing. The passport also brings normalcy to the process of negotiating and closing with institutional investors, once the passport issues on (or before) a date certain.

In terms of structuring, it is worth mentioning the Luxembourg special limited partnership (*société en commandite spéciale,* SCSp) which is similar to US limited partnerships. Its design was inspired by common law vehicles, such as Delaware or Cayman partnerships, and provides US managers with a tool that they are accustomed to from an operational standpoint (primarily through the flexibility offered by the limited partnership agreement).

Luxembourg further offers a well-established AIF product label, the Reserved Alternative Investment Fund (RAIF) which is subject to the RAIF Law.[14] The RAIF, despite not being itself subject to the prudential supervision by the Luxembourg Financial Sector Supervisory Authority (the CSSF), adds a widely known product label to an AIF providing for minimum diversification requirements (reference is made here to the so-called SIF regime RAIF[15]) and the mandatory appointment of a range of external service providers. The RAIF has become a product of choice for many institutional investors. The quid pro quo for a marketing passport and also a mandatory requirement under the RAIF Law, however, is the appointment of an external EU based Alternative Investment Fund Manager (AIFM). The AIFM can delegate to the US manager portfolio management, allowing the US manager to pursue a consistent investment strategy. However, compliance with the AIFMD regime comes with costs that might best be allocated to the parallel fund that benefits from the marketing passport and the regulatory protections afforded by AIFMD.

Further, US managers will take note of the fact that passported funds are subject to the terms of the AIFMD, which has within it a statutory standard of

care that varies from the "gross negligence" standard common for Delaware funds. Luxembourg RAIFs also require a depositary, an administration agent and an auditor in Luxembourg.[16] These requirements are "market" for institutional investors in the European Union and the United Kingdom, but are not typical for US institutional investors. A parallel fund for European investors can afford EU based investors a product that is "market" to them, without imposing terms on US investors that are not "market" in the United States, and that come with additional cost.

Passported funds that operate on the basis of delegation of portfolio management to the US fund manager bring with them considerations that may give US managers pause. One of these considerations is the application of AIFMD's remuneration guidelines.[17] Typically, the more burdensome component of the remuneration guidelines is the payout process rules, that would (generally) delay and potentially limit the payment of performance based compensation (in favor of base salaries). These rules may be disapplied when they are "disproportionate." Small firms have a potential "out." But for larger firms, the issue is one that has to be faced.

Alternatively, some US managers will decline to operate their passported parallel fund as a delegate, and will instead operate as an advisor to the appointed authorized AIFM.

Key Operational Factors to Consider when Using Parallel Funds

Having considered the benefits of parallel funds in light of the unique regulatory and tax requirements of a diverse universe of institutional investors, a US fund sponsor has options on how to manage the parallel funds in relation to one another.

Fund Size and Parallel Funds

Closed-end funds typically operate on the basis of capital commitments to be drawn as investments are identified, with a cap on the size of the "fund." It is typical that the size of a fund offering will aggregate the capital commitments to all parallel funds. If this is not the case, fund managers will want to disclose how their size cap will work. A similar theme applies to successor funds, as the concept of when the fund manager will be free to launch the marketing of or the operation of a successor fund will need to address the manager's policies in respect of parallel funds.

Organizational Costs

It is market to assure that organizational costs would be paid by parallel funds separately, including the costs of forming the general partner of each vehicle.[18] While it is common for parallel funds to pay their own organizational costs, fund sponsors should anticipate that institutional investors may expect a cap on organizational costs for their fund. Parallel funds offer the opportunity to have multiple organizational caps, and to tailor cost caps such that investors in different markets see "normal" organizational costs for their marketplace.

Timing of Investments and Dispositions

Investments and dispositions of portfolio assets by parallel funds typically should be made at the same time as one another. Typically, investment expenses and fee income related to the investment should be shared in proportion to capital committed to that transaction. As not every transaction closes, the fund sponsor will need to establish a policy on "broken deals." This is subtle as "participation" in a broken deal can be controversial.[19] The fund sponsor will want to disclose its policies on the allocation of deal expenses, including its definition of participation in a broken deal, and how it intends to share broken deal expenses and break-up fees across parallel funds and other clients of the fund sponsor (particularly if the fund sponsor is investing side-by-side with its funds), and whether the fund sponsor will pay a predetermined portion of the broken-deal costs.

Typically, parallel funds might be expected to sell their interests in a portfolio company at the same time and on the same terms as one another.

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However, it is "market" to accept that legal, tax, regulatory or other considerations might intervene to cause one of the parallel funds to exit on different terms or at a different time leading to so-called near parallel funds. Fund sponsors will want to give consideration to disclosing their policies in this regard.

The rules governing the decision making by parallel funds can be detailed in each of the fund's constitutional documents but are often subject to co-investment agreements as well.

Allocation of Co-Investment Opportunities

Typically, the allocation of co-investment opportunities is of interest to investors in the various parallel funds established by the fund sponsor. Investors will anticipate that they will not be at a disadvantage to one another by reasons of which parallel fund they invest in, that best suits their regulatory and tax position. Accordingly, the fund sponsor will want to consider and disclose its policy on allocating co-investment opportunities across investors in parallel funds, as well as its policy for allocating costs and expenses of the co-investment.

Investment Period Suspension: Key Persons and Cause Events

Typically, defining the universe of key persons within the context of parallel funds is straight forward—they are the same across each of the funds. Similarly, parallel funds will normally have a common standard for what constitutes a "cause event," which in turn may give rise to replacement of the investment manager (or general partner, or both). Again, it is typical that either or both of key person or cause "events" may trigger a suspension of the investment period. What is open for consideration, is the application and resolution of a trigger event. It is not unusual (but not always the case) for parallel fund investors, either directly or through a committee of parallel fund investors collectively to vote to waive the event. Of course, replacement of the investment manager or general partner(s) is also a matter to be considered as to whether replacement will be determined by all parallel fund investors voting together. For some structures, tax considerations intervene in setting this policy. In addition, a particular attention should be paid to these clauses in parallel structures having a European sleeve appointing a third party AIFM.

Governance

Investor Advisory Committees typically are authorized to resolve key person and cause events, and often have broad authority to resolve matters giving rise to conflicts of interest. Indeed, investors may well prefer to have a broad remit in the advisory committee to address conflicts of interest rather than to have pre-approved policies on a disclosed basis.[20] Consideration should be given as to having a common advisory committee for each of the parallel funds because transaction related matters (such as waiver of an investment period suspension) would affect each of the parallel funds.

Further, the question of how representational diversity is to be achieved needs to be considered, and whether investors that do not have the tax or regulatory needs of investors in a parallel fund might take decisions adverse to the very purposes for which the parallel fund was established. For example, consideration should be given as to whether each parallel fund will have a representative, or at least an observer, and how the rules for penalizing advisory committee members (including revocation and replacement) will apply if individual parallel funds will have a right to have a representative. The definition of quorum needs to be considered in this context as well. When constructing an advisory committee of parallel funds, attention also should be paid to the status of members of the committee as fiduciaries, and whether applicable law will allow for waiver of that status by the other investors in that structure.

Given that parallel funds typically will have a diverse choice of laws, the obligation of members of the advisory committee to disclose their conflicts of interest to other members of the advisory committee

also should be considered. The decision to have, or not to have a common advisory committee will dictate whether the parallel funds have uniformity of valuation methodology, term extensions, waiver of investment restrictions, increasing permitted leverage, transactions with affiliates of the investment manager, and/or remedies for capital call defaults ("uniformity" to comply with applicable laws and regulations of each jurisdiction).

Capital Call Procedures and Defaults

It is common that in the event that a fund operates on the basis of capital commitments followed by capital calls, an investor's capital contribution might be delayed or might not be made. Typically, other investors make good on the defaulted investor's failure on a pro rata basis. In a fund structure with parallel funds, consideration needs to be given to determining whether the default remedies will be pro rata across all parallel funds, and if so, how such structure will work in the context of different governing laws and time zones.

Rebalancing and Subsequent Closing Investors

Assuming that parallel funds will hold closings at different times during the fund's marketing period, interest charges on late closing investors are likely to be imposed within each parallel fund. Similarly, exposure to investments already made will presumably be rebalanced within each parallel fund. Typically, subsequent closing investors will be subject to organizational expense costs as if they invested at the first close, within each parallel fund. Each of these factors should be considered as to whether they will be treated as if the parallel funds were one fund, or as separate funds. While it is not uncommon to treat parallel funds as if they were one fund for one or more of these purposes, in some instances, regulatory and tax considerations will preclude treating the parallel funds as a single entity. For the same reasons it is key to have a clear view on whether or not parallel funds will be launched and initial closings will be held at the same time to avoid any mismatch as regards the term or investment period of each parallel fund.

Conflicts of Interest

The timing of distributions, performance fee calculations, determination of highwater marks or preferred returns, clawbacks, and give backs each merit consideration when drafting the terms of the parallel funds.

Aggregation of Voting Rights

Another key subject to be considered by the investment manager is the organization of the voting mechanism (besides within committees) across parallel funds. While it may make sense to aggregate voting rights for certain decisions based on proportionate capital commitment in each parallel fund, the applicable fund documents might need to take a more nuanced approach. It might be appropriate to allocate certain decisions to one parallel fund only, particularly when the issue arises in a context related to the legal, tax, organizational or regulatory requirements unique to that parallel fund.

Conclusion

Parallel funds offer the opportunity to tailor just how parallel the funds will be, and can offer the opportunity to precisely address the needs of distinct investor groups. At the same time, they can be operated as a single fund, as a practical matter, if that approach best suits the needs of investors. This being said, a parallel structure faces operational and organizational challenges. It needs *inter alia* to have a robust conflicts of interest policy and to ensure equal treatment of investors, adequate allocation of costs and a fair balance in voting rights. It is therefore a structuring option for a sizeable "investment strategy" or fund.

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NOTES

1 Investment Company Act of 1940, as amended, Section 7(d). See, Protecting Investors: A Half Century of Investment Company Legislation, Division of Investment Management, United States Securities and Exchange Commission, 1992 at footnote 17. Upon enactment, concerns focused on the distribution of Canadian funds.

2 Directive 2009/65/EC of the European Parliament and the Council of 13 July 2009 on the coordination of laws and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS Directive).

3 It should be noted that individual member states of the EU may authorize the marketing in their jurisdiction of retail funds organized in a jurisdiction other than a member state of the EU. In practice, this option is rarely used and an example is the possibility for Swiss securities funds (Effektenfonds/fonds en valeurs mobilières) to be offered in Germany.

4 As at 31 May 2021, US fund initiators represent 20.4 percent of all UCITS initiators for a combined AUM of over 1trn EUR. Luxembourg based UCITS represent in aggregate nearly 4.5trn EUR in AUM (source: CSSF). Irish based UCITS represent in aggregate nearly 2.6trn EUR in AUM (source: EFAMA).

5 The authors collaborate on establishing unitary institutional closed-end private credit master funds that are marketed through investor specific feeder funds to US high net worth investors, US super tax-exempt investors, US tax-exempt investors, professional investors in the EU and UK, institutional investors in Canada, Switzerland, Japan, and otherwise—on a virtually global basis. That being said, based on our experience with successful fund launches of this type, we offer here the case for parallel funds.

6 Many readers will be familiar with the concept of a "mini-master" fund structure in which the Cayman fund invests in a Delaware master fund. This structure is well accepted by US institutional investors.

7 Private credit and real estate are on different footings from a tax perspective, the details of which are beyond the scope of this article. In summary, real estate is subject to a statutory tax regime called the Foreign Investment in Real Property Tax Act (FIRPTA). The authors understand that loan origination in the United States is a trade or business.

8 The notion of "professional investor" is defined in Annex II of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

9 Directive (EU) 2019/1160 of the European Parliament and of the Council of 20 June 2019 amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings.

10 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on alternative investment fund managers (AIFMD).

11 Articles 22 and 23 of the AIFMD.

12 Article 24 AIFMD and Annex IV AIFMD.

13 In Germany, for example, the national private placement regime is an approval process. When seeking authorization to market to professional investors in Germany, investment managers should anticipate two to four months from the date of a complete submission, preceded by the appointment of a depositary in Germany.

14 A RAIF (reserved alternative investment fund) is a Luxembourg based fund subject to the Luxembourg law of 23 July 2016 on reserved alternative investment funds but that is not subject to the supervision of the Luxembourg regulator, the Commission de Surveillance du Secteur Financier (CSSF).

15 RAIFs can qualify as Specialized Investment Fund (SIF) RAIFs or as Investment Company in Risk

Capital (SICAR) RAIFs. SICAR-RAIFs are not subject to any diversification requirements.

[16] These requirements are not specific to RAIFs but also apply to any Luxembourg based Fund that qualifies as an alternative investment fund (AIF) within the meaning of AIFMD and to Luxembourg funds that, in addition to qualifying as AIFs, are set up under a specific "product law" (such as a SIF or a so-called Part II fund).

[17] "Guidelines on sound remuneration policies under the AIFMD", European Securities Market Authority, March 7, 2013 at paragraph 25 and Annex II.

[18] ILPA Guidelines 3.0.

[19] KKR enforcement broken deal expense.

[20] *See*, "ILP Principles 3.0", Institutional Limited Partners Association, June 2019: "Governance" at page 9: "GPs should neither undertake nor seek to "pre-clear" actions through overly broad disclosures that constitute or could potentially constitute a conflict of interest between the fund, a portfolio investment, and/or a portfolio manager on one hand and the GP, key persons, affiliates, etc. on the other without the approval of the LPAC."

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