

Alternative Investment Watch

The newsletter of developments in finance for alternative investment providers

Fourth Quarter 2009

Considering a Master-Feeder Structure? Be Sure to Consider These Tax Issues First

By Moshe Metzger, CPA

Prior to passage of the Emergency Economic Stabilization Act of 2008, it was common for investment managers to defer receipt of earned incentive fees from managing offshore hedge funds. This deferral meant that the fee was not subject to current taxation and, when combined with an interest charge equivalent to the rate of return of the offshore fund, the investment manager was able to keep the pre-tax dollars invested in the fund. The change in law effectively imposed immediate income recognition for nonqualified deferred compensation from tax-indifferent parties, thereby removing the ability to defer taxes on this income.

Hedge fund managers reacted to the law change by restructuring their agreements to allow for payment of their offshore incentive fee in the form of an allocation of income in a partnership structure. This afforded them the ability to potentially receive some of the incentive fee in the form of tax-favored, long-term capital gains and qualified dividends, and also to defer immediate taxation of the entire fee, as the incentive allocation would typically include an element of unrealized gain.

This restructuring took the form of what is known as either a mini-master or a master-feeder structure. A year later, it is now much more common for start-up domestic funds that have an offshore equivalent to utilize a master-feeder structure. In this structure a master fund (typically foreign), is formed and elects to be treated as a partnership for tax purposes. A stand-alone domestic fund and a stand-alone offshore fund invest their capital into the master, wherein all trading occurs. The general partner of the master fund is another partnership which receives the allocation of incentive fee as it is calculated with respect to the domestic and offshore fund's investments. The use of the master also affords for more efficient trading.

Certain tax and accounting issues arise in the master-feeder structure which do not normally occur in the side-by-side structure. Some of these issues are examined in more detail below:

Incentive fee/allocation calculation – The documents that outline the calculation of the incentive fee earned from the domestic and offshore fund feeders need to be explicit in the computation of the incentive fee. At the master

level, there are only two investing entities which will periodically contribute and withdraw funds. In order to capture the appropriate incentive fee for each investor at the feeder levels, the calculation at the master level will necessarily refer to class shares or sub-class share of the feeder entities. This way, a new investor in the offshore fund who has experienced gains on his investment for the period he was in the fund will be charged an incentive fee despite the possibility that the other existing share classes are currently in a loss carryforward situation. Similarly, an investor in the offshore fund that is withdrawing funds will be subjected to a crystallization of his incentive fee. The incentive fee calculation as it relates to the domestic feeder would likewise refer to accounts or sub-accounts at the domestic feeder level.

U.S. stock dividends, and other items of income, subject to U.S. withholding

– As a foreign pass-through entity, the master would be required to provide Form W-8IMY ("Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding"), to the paying agents (along with Form W-8BEN for the offshore feeder and a W-9 from the domestic feeder), which informs the paying agent how much of the underlying ownership of the master is foreign. The paying agent would then take the appropriate percentage withholding on U.S. dividends allocable to the offshore feeder. Since the offshore ownership of the master varies as withdrawals and contributions take place at the master level from both the domestic and offshore feeders, it is critical that Form W-8IMY be updated at every break period. The mechanism for correcting both over- and under-withholding after year end is onerous.

Security contributions at formation – When existing stand-alone domestic and offshore funds restructure as a master-feeder, they will contribute their existing portfolios into the master. Tax law requires that any unrealized gain or loss in the existing portfolio at the date of contribution be allocated to the contributing partner upon realization. Thus, the unrealized gain or loss of the combined portfolios must be tracked post-combination to allocate this

unrealized gain or loss properly to the domestic and offshore feeders. In addition, in order to avoid immediate gain recognition on the contribution of the portfolio to the master, the portfolio must be "diversified" as defined in the tax regulations.

Informational filings – The Internal Revenue Service has designated Form 8865, "Return of U.S. Persons with Respect to Certain Foreign Partnerships," as the mechanism for reporting contributions and certain levels of ownership, or changes in ownership, of foreign partnerships. Depending on the level of ownership and other criteria, the reporting party may have to provide detailed balance sheet, income statements and other information regarding related party transactions. The domestic feeder would likely be required to file this informational form. In addition, recent formal and informal guidance from the IRS has expanded the class of U.S. persons that are required to file Form 90-22.1, "Report of Foreign Bank and Financial Accounts." The current thinking is that the offshore master is considered a financial account, thereby requiring the domestic feeder to file for its ownership interest therein.

Potential conflicts – With trading for both the domestic and offshore funds contained in the master, conflicts may arise with respect to the interests of these two parties. A potential for conflict could arise in the area of tax efficiency. For example, aging a position to long term yields a favorable tax result to the domestic fund but the offshore fund would be indifferent.

There are other issues that may arise in the master-feeder structure that should be considered before proceeding. Some of these issues deal with the methodology for allocating taxable income or loss at the domestic feeder level based on its share of income or loss from the master, the utilization of special allocations for departing partners and the potential for the distribution of securities. Careful planning will reduce any unwelcome surprises later. [AIW](#)



Moshe Metzger is a managing director in the New York office of RSM McGladrey, Inc. He can be reached at 212.372.1316, or via e-mail, at moshe.metzger@rsmi.com.

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Contact one of our Financial Services-focused experts in an office near you.

EDITOR-IN-CHIEF

Sal (Kislay) Shah (New York) 212.372.1201
kislay.shah@rsmi.com

TECHNICAL EDITORS

John Hague (Chicago) 312.634.3354
john.hague@rsmi.com

Martin Lax (New York) 212.372.1208
martin.lax@rsmi.com

CAYMAN ISLANDS

Alex Bodden 345.743.3011
alex.bodden@rsmi.com

CHICAGO

Steven Johnson 312.634.3347
steven.johnson@rsmi.com

Simon Lesser 312.634.4604
simon.lesser@rsmi.com

Paul Nockels 312.634.4623
paul.nockels@rsmi.com

DALLAS

John Wilson 410.308.5927
john.f.wilson@rsmi.com

DENVER

Jason Sibley 303.298.6446
jason.sibley@rsmi.com

NEW YORK

Alan Alzfan 212.372.1380
alan.alzfan@rsmi.com

Richard Nichols 212.372.1135
richard.nichols@rsmi.com

Jeffrey Yager 212.372.1269
jeffrey.yager@rsmi.com

RICHMOND, VA.

Lisa Brock 804.281.6808
lisa.brock@rsmi.com

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RIAs Await Final Changes from SEC as Madoff, Other Frauds Trigger Custody Rule Changes

By Colin Sanderson & Reggie Uduhiri

As rapid regulatory changes are proposed for the financial services industry, investment advisers stand to be significantly impacted. Current proposals aim to bring advisers to private investment funds, such as hedge funds, private equity funds and venture capital funds, under the umbrella of the Securities and Exchange Commission, through registration under the Investment Advisers Act of 1940 (the advisers act)¹.

The SEC is also proposing amendments to Rule 206 (4)-2 (the custody rule) under the advisers act in response to recent enforcement actions (most notably, the Ponzi scheme orchestrated by Bernie Madoff). According to the SEC, these measures are intended to provide additional safeguards when a registered investment adviser (RIA) has custody of client funds or securities.

The SEC announced the proposed changes for public comment on May 20, 2009, and advisers and other interested parties were allowed to comment on the proposals by July 28, 2009. (See sidebar, "RIAs, Public Accountants Make Voice Heard to SEC.")

The proposed amendments would impact RIAs in three major areas, including:

- ▶ Annual surprise examinations
- ▶ A change in the delivery of custodial account statements, and
- ▶ Internal control reviews.

Requirement of annual surprise examinations

The SEC proposal would require all RIAs with custody² of client assets to maintain those assets with a qualified custodian³ and to enter into a written agreement with an independent public accountant (who is registered with the Public Company Accounting Oversight Board), to conduct annual surprise examinations to verify those assets exist. The RIA must identify the accountant performing the audit, the type of engagement and whether the accountant's report is qualified on Schedule D of Form ADV, which investment advisers file with the SEC.

Under the current rule, annual surprise examinations are not required if:

- ▶ The qualified custodian sends quarterly account statements to clients detailing the position and type of transactions, or
- ▶ The RIA is a general partner of a pooled investment vehicle and can satisfy the requirement to issue U.S. GAAP audited financial statements within 120 days of the fund's fiscal year end (180 days for fund of funds).

According to the SEC, the proposed compliance requirement is intended to provide another set of eyes on client assets, providing additional protection against misuse. During surprise examinations, the independent accountant should, at a minimum:

- ▶ Confirm with the custodian all cash and securities held by the custodian, including a physical examination of securities; and, if applicable, reconciliation of all such cash and securities to the books and records of client accounts maintained by the adviser.
- ▶ Verify the books and records of clients' accounts maintained by the adviser by examining the security records and transactions since the last examination and confirming with all clients, all funds and securities in client accounts.
- ▶ Confirm with clients, on a test basis, closed accounts or securities or funds that have been returned since the last examination.

The proposed amendments to the custody rule would also require the adviser and accountant to meet a number of heightened reporting requirements in connection with annual surprise examinations. Among the new disclosures, the independent accountant would be required to electronically file with the SEC a Form ADV-E and an examination certificate within 120 days of the date selected for the surprise exam. Additionally, the accountant would have an additional filing with the SEC upon resignation, dismissal or removal from the engagement. On Form ADV, advisers will also have to state the dollar amount they oversee, the number of clients for which the adviser or a related person has custody, and whether the adviser or related person acts as the qualified custodian.

1 See this edition's "Treasury's Registration Act Could Mean Big Oversight Changes for Private Fund Investment Advisers in the U.S. and Beyond," by Sal (Kislay) Shah and Rudi Ialamov.

2 For the purposes of this rule, an adviser has custody when the adviser or a related person holds client assets directly. An adviser is also deemed to have custody if it has the authority to obtain client assets by deducting advisory fees from client accounts, writing checks or withdrawing funds on behalf of a client or by acting in a capacity, such as a general partner of a limited partnership, that gives the adviser or its supervised person the authority to withdraw funds or securities from the limited partnership account.

3 A "qualified custodian" under the Rule 206(4)-2(c)(3) includes: (i) a bank as defined in Section 202(a)(2) of the Advisers Act or a savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act; (ii) a broker-dealer registered under Section 15(b)(1) of the Securities Exchange Act of 1934 holding client assets in customer accounts; (iii) a futures commission merchant registered under Section 4(a) of the Commodity Exchange Act holding client assets in customer accounts, but only with respect to clients' funds and security futures or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; or (iv) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

Change in the delivery of custodial account statements

Amendments to Rule 206(4)-2 are also expected to provide additional safeguards regarding the integrity of account statements. The proposed amendments would eliminate the option for an adviser to satisfy the delivery of account statements by directly mailing statements and relying on surprise examinations. The custodian holding client assets would now be required to directly deliver custodial statements to advisory clients rather than through the investment adviser and registered advisers with custody of client assets will be required to have a reasonable basis for believing that the qualified custodian sends at least a quarterly account statement. The new amendment would require advisers to provide their clients with information regarding the custody arrangements they have established with a qualified custodian (including the name and address of the custodian and the manner in which client assets are maintained) and would require advisers to instruct clients to compare account statements they received from the custodian with those they received from the adviser.

This proposed amendment would maintain the current exception for advisers to pooled investment vehicles if the pool is audited by an independent public accountant and the audited financial statements are distributed to the pool's investors within 120 days of the pool's fiscal year end (180 days for a partnership operating as a fund of funds). For pooled investment vehicles that liquidate and make a final distribution, the SEC is proposing an amendment that will clarify the availability of the annual audit exception to such pools. This aims to ensure that the proceeds of the liquidation are appropriately accounted for and allow investors to take timely steps to protect their rights.

Internal control review mandate

The proposed amendments also include a requirement for an internal control review if the qualified custodian is not independent of the RIA (such as if the adviser itself or related person serves as the qualified custodian for client funds or securities). Under the proposed rule, the qualified custodian would be required to obtain an annual written SAS 70 Type II Internal Control Report by an independent public accountant registered with the PCAOB.

Among other requirements, the accountant will provide a description of the controls in place for safeguarding assets, test the operating effectiveness of those controls and report the test results. The SEC proposed the internal control review in addition to annual surprise examinations

for advisers because of concerns that during surprise examinations, the independent accountant may have to rely on custodial reports issued by the advisers or its related person when verifying client assets. According to the SEC, maintaining client assets with the advisers or a related person (instead of with an independent custodian), presents higher risk to advisory clients. In the Madoff Ponzi scheme, the Madoff firm held custody of its own assets (reported at \$17 billion). Advisers would be required to maintain the internal control report in its records for a minimum of five years from the end of the fiscal year in which the report is finalized and make it available to the SEC upon request.

Conclusion

McGladrey & Pullen published its views on the proposed changes to the custody rule in a letter to the SEC in late July. In light of the recent financial crisis and the fraudulent activity among certain RIAs, it appears that additional regulation is inevitable. A key consideration is to make sure the regulation does not present an unnecessary financial burden, while still failing to achieve investor protection.

Advisers have been closely monitoring the actions of the SEC and have voiced concerns on these proposals, especially around the cost effectiveness of requiring confirmation of 100 percent of assets, and the requirement for a surprise audit for advisers who are deemed to have custody by the mere fact that they debit management advisory fees directly from client accounts. These two proposed amendments, in particular, will present an undue burden if implemented, especially for small advisers. There is a great likelihood that many of these proposed amendments will pass, giving the SEC greater authority over investment advisers.

In light of the proposed amendments to Rule 206(4)-2 of the Advisers Act, investment advisers would do well to commence discussions with their auditors to ensure accounts and pooled investment vehicles under management are in compliance with the requirements of the proposed regulations. McGladrey & Pullen will continue to monitor and report on these and related proposals as the amendments and regulations evolve. [AIW](#)



Colin Sanderson is a partner in the New York office of McGladrey & Pullen LLP. He can be reached at 212.372.1216, or via e-mail, at colin.sanderson@rsmi.com.



Reggie Uduhiri is a manager in the New York office of McGladrey & Pullen LLP. He can be reached at 212.372.1088, or via e-mail, at reggie.uduhiri@rsmi.com.

RIAs, Public Accountants Make Voice Heard to SEC

There was an overwhelming response of written comments from the public regarding the proposed changes to Rule 206(4)-2, coming from registered investment advisers as well as public accountants (including McGladrey & Pullen). A summary of the most pressing issues identified by the public follows; these are areas where the SEC may consider amendments to its proposal:

- ▶ The increased scope of the amendments to the custody rule will inevitably pose a financial burden to small RIAs. While the SEC identifies the average cost of a surprise audit to be \$8,000, many RIA commentators said that figure is likely to be much higher.
- ▶ Many RIAs expressed concern that there is redundancy in conducting annual surprise examinations, particularly when the investment adviser is deemed to have custody of client assets due only to its authority to withdraw advisory fees. To avoid this burden, RIAs would have to restructure their billing arrangements and systems – all overhead costs though would most likely be passed on to clients.
- ▶ RIAs also questioned the viability of conducting a truly surprise audit. Most RIAs or pooled investment vehicles do not close their books on a daily basis (as opposed to a quarterly basis), particularly those invested in highly illiquid private equity and venture capital securities.
- ▶ A consistent recommendation from public accountants was for the use of statistical samples in reviewing assets and client account balances, rather than confirming 100 percent. Also, limiting the definition of assets to cash and securities would clarify the scope of the auditor's testing in accordance with the spirit of the rule.
- ▶ Public accountants asked the SEC to provide further guidance on the specific scope and nature of procedures and alternative procedures to be performed by an independent auditor regarding privately offered securities in surprise examinations; what constitutes a material discrepancy; timing of the procedures; and finally, the control objectives of the SAS 70 Type II Internal Control Report to be issued by the auditor.

Treasury's Registration Act Could Mean Big Oversight Changes

By Sal (Kislay) Shah and Radi Ialamov

The Private Fund Investment Advisers Registration Act of 2009, recently proposed by the U.S. Treasury Department, is the fourth piece of legislation delivered to Congress this year intended to regulate the activities of the private investment industry. Other legislation yet to make its way to a vote this year include the Hedge Fund Adviser Registration Act of 2009, the Private Fund Transparency Act of 2009 and the Hedge Fund Transparency Act of 2009.¹

With the Private Fund Investment Advisers Registration Act, the Treasury Department is proposing regulations that would provide more transparency in the activities and business conduct of private advisers. The Treasury believes that a lack of transparency in the activities of private advisers poses a high systemic risk to the capital markets. In the current environment, regulators believe that there is an increasing need for additional regulation of private investment funds and investment advisers.

Private Fund Investment Advisers Registration Act of 2009

Delivered to Congress on July 15, the proposed legislation would require investment advisers to any "private fund" to register with the Securities and Exchange Commission as part of the Investment Advisers Act of 1940. The proposed legislation defines a "private fund" as a pooled investment vehicle that would be an investment company, but for exceptions in sections 3(c)(1) or 3(c)(7) of the Advisers Act and is either located in the United States, or U.S. persons hold an ownership stake greater than 10 percent. As a result, investment advisers to funds which rely on sections 3(c)(1) or 3(c)(7), as an exemption to registering with the SEC, will now be required to register under the proposed legislation. The current intra-state adviser exemption, the private adviser exemption, the registration exemption for certain commodity trading advisors and non-U.S. investment advisers exemptions would also be eliminated. Each of these is examined in more detail below.

Intra-state advisers

Under Section 203(b)(1) of the existing Advisers Act, if the investment adviser maintains his principal office and place of business in the same state as his clients, the adviser is exempt from registering with the SEC. Under the proposed legislation, this exemption would no longer be available to advisers of private funds.

Private advisers

Currently, the "private adviser" exemption under Section 203(b)(3) exempts investment advisers from registering with the SEC if they have had less than 15 clients in the past 12 months, and neither presents themselves to the public as an investment adviser, nor acts as an investment adviser to a registered investment company. The proposed legislation will require investment managers with assets under management of at least \$30 million to register

with the SEC, regardless of whether the investment adviser manages private investment funds (e.g. general partners of private equity funds, managers of hedge funds and family offices).

Commodity-trading advisers

As written, Section 203(b)(6) of the Advisers Act provides an exemption for an investment adviser that is a commodity trading advisor (CTA) registered with the Commodity Futures Trading Commission and whose business does not consist of primarily acting as an investment adviser to a registered investment company. Under the proposed legislation, this exemption will be eliminated for certain registered CTAs who act as an investment adviser to a private fund.

Non-U.S. investment advisers

The most significant impact of the proposed legislation could be on non-U.S. investment advisers (foreign private advisers). Under the current Advisers Act, non-U.S. investment advisers having a principal place of business outside the United States and with less than 15 U.S. clients, are exempt from registration. The proposed legislation expands the definition of foreign private advisers, to be any adviser that:

- ▶ Has no place of business in the United States
- ▶ Has had less than 15 U.S. clients and less than \$25 million in assets under management attributable to clients in the United States during the preceding 12 months
- ▶ Neither holds themselves out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to a registered investment company, or a company that has elected to be a business development company

This, in combination with the elimination of the private adviser exemption, could potentially bring a high number of non-U.S. investment advisers within the scope of the SEC, even though they may only have a few investors. Some have expressed concerns that this could potentially result in a negative impact, with non-U.S. advisers turning away from U.S.-based funds and investors.

Client definition

The proposal would also give the SEC the ability to redefine terms in the Advisers Act. One such term receiving attention is the definition of "clients" in the Advisers Act. This is a throwback to the Goldstein vs. SEC case in 2006, whereby the SEC tried to include the shareholders, limited partners and members of a fund in its definition of clients through the Hedge Fund Rule.

Under the current Advisers Act, investment advisers are exempted from registering with the SEC if, within the last 12 months, they had fewer than 15 clients and do not hold themselves out to be an

investment adviser. The Hedge Fund Rule would have had the added effect of increasing the number of investors to be counted as "clients," thereby requiring the investment adviser to register with the SEC. The Hedge Fund Rule was overturned by the U.S. Appeals Court after the court determined that:

"An investor in a private fund may benefit from the adviser's advice (or he may suffer from it) but he does not receive the advice directly. He invests a portion of his assets in the fund. The fund manager – the adviser – controls the disposition of the pool of capital in the fund. The adviser does not tell the investor how to spend his money; the investor made that decision when he invested in the fund. Having bought into the fund, the investor fades into the background; his role is completely passive. If the person or entity controlling the fund is not an 'investment adviser' to each individual investor, then a fortiori each investor cannot be a 'client' of that person or entity."

Conclusion

If the proposed legislation passes, investment advisers would be required to make certain reports and records available to the SEC, which would include assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices.

Although the proposed legislation provides that the SEC cannot be compelled to disclose the information filed with the SEC, it could be required to disclose the information if requested by Congress or any other regulatory authority. Additionally, the proposed legislation would require registered investment advisers to provide such records as reports, and other documents to investors, prospective investors, counterparties, and creditors for the protection of investors or for the assessment of systemic risk by the SEC.

The proposed legislation is still in the early stages of review by Congress, but it is becoming clear that investment advisers to private funds will likely be required to register with the SEC. Current investment advisers not registered with the SEC should begin to review their systems, operations and business practices to determine the requirements for registering and compliance with the SEC. McGladrey & Pullen LLP will continue to monitor the progress of the proposed legislation in Congress. [AIW](#)



Sal (Kislay) Shah is a partner in the New York office of McGladrey & Pullen LLP. He can be reached at 212.372.1201, or via e-mail, at kislay.shah@rsmi.com.



Radi Ialamov is a supervisor in the New York office of McGladrey & Pullen LLP. He can be reached at 212.372.1085, or via e-mail, at radi.ialamov@rsmi.com.

¹ See *Alternative Investment Watch's* June 2009 edition, "Crisis Gives New Life to Legislators Hedge Fund Transparency Act," by Steve Jugan.