



Master-feeder Structures

Master-feeders are commonly used as a mechanism for simplifying portfolio management when multiple funds are managed in an identical style. A single investment portfolio can eliminate performance differences between funds plus reduce the management challenges associated with alignment of positions.

At its simplest, a master-feeder is a structural separation of the investment portfolio from the investors. A single portfolio is maintained in a master fund and its participants are feeder funds – funds that hold the investors and “feed” capital to the master. Feeders are defined by their investors, most often with a US limited partnership feeder for taxable domestic investors, plus the offshore corporation feeder for non-US and perhaps non-taxable US investors.

This material discusses general considerations regarding master-feeder structures, especially as they apply to offshore funds. It is divided into 2 sections:

- ✓ A discussion of the considerations involved when choosing a structure
- ✓ Structural details for each type

Choosing a structure

Choosing Parallel or Master-feeder

Of course, parallel funds – two separate funds managed identically – despite the portfolio challenges, are sometimes preferable. Due to the different tax concerns of offshore and domestic investors, some managers embrace the opportunity to manage the domestic fund with taxes in mind while ignoring taxes on the offshore fund. For example, in a domestic fund filled with taxable investors, there is good reason to hold an enormous gain about to go long-term, even if it has become less attractive on a technical or fundamental basis. In an offshore fund filled with non-taxable and non-US taxpayers, that consideration doesn't exist.

The conundrum is that portfolio alignment won't exist when one fund is managed for taxes. On the one hand, investors generally like to see identical performance from identically-managed funds. On the other, when only one portfolio is managed for tax considerations, results will differ.

The decision to structure parallel or master feeder is based primarily on the level of difficulty associated with alignment of two portfolios when there are varying cash flows, plus trying to gauge investor expectations. The decision to structure as parallel funds or in a master-feeder structure is one that should be discussed with counsel, taking into consideration portfolio characteristics and expected investor composition.

Master-feeder types

Master-feeders that include offshore funds generally fall into two types:

- “Conventional” master-feeder. This structure contains at least 2 feeders, one of which is an offshore entity (often a corporation) and one that is a domestic entity (often a limited partnership). The master fund is simply a portfolio with a minimal number of common expenses; all fees and incentive compensation plus most of the expenses are accounted for at the feeder level. The offshore fund, as a corporation, uses classes of shares plus series within each class issued over time to divide up capital and performance among the investors.
- “Memorandum” master-feeder. Again, 2 feeders; however, there is a tracking process at the master level – the memorandum accounts – for feeder participants. The purpose is to charge incentives as allocations at the master level versus fees at the offshore feeder level. Note that some memo



master feeders may simply have a single offshore corporation feeder. This is a memorandum structure aimed solely at converting the fees of a stand-alone offshore fund into incentive allocations. Such a structure is sometimes called a “mini-master-feeder.”

A Digression on Tax Deferral

One historical benefit of having an offshore fund has been the manager’s option to defer receiving fees: leaving fees in the fund to compound at the fund’s pre-tax rate of return until withdrawal at a later time. The downside is that fees, whether taken now or later, are received as ordinary income. Plus, deferred fees remain at risk to creditors of the fund during the deferral period and aren’t available for personal use.

In a domestic fund having a portfolio with long-term capital gains, qualified dividends and occasional unrealized gain deferrals, the after-tax return can be higher than the deferred fees in the offshore fund. Depending on the fund – and the assumptions – it may be better to pay taxes now at lower rates than to defer.

The variables in this calculus are, of course, the proportion of return that is tax-advantaged plus the projected return of the fund. The bottom line is that some portfolios and managers are better suited to conventional fee deferral and some to incentive allocations in a “memorandum” structure. For further exploration, PMI has a deferral calculator in Excel that is available upon request.

A master-feeder decision matrix

The following are intended as prompts when contemplating fund structure. The primary considerations are three: the level of difficulty in the portfolio; expected US tax characteristics; and offshore investor expectations. The prompts below are ones that should be carefully considered with the assistance of counsel, keeping in mind that there may be additional considerations. The assumption is that two funds are to be formed; one domestic; one offshore.

Is portfolio alignment between two funds both difficult and important?

Yes – Are long-term gains and/or qualifying dividends significant?

Yes – Consider a **memorandum master-feeder**.

No – Consider a **conventional master-feeder** (also, consider a 475(f) election¹).

No – Are long-term gains and/or qualifying dividends significant?

Yes – Do offshore investors prefer that US tax considerations be ignored in trading decisions?

Yes – Consider **parallel**.

No – Consider a **memorandum master-feeder**.

No – Consider a **conventional master-feeder** (also, consider a 475(f) election¹).

Note that if a 475(f) election is warranted, the structure should likely be a conventional master-feeder. In a 475(f) fund, there would be no tax advantage for a memorandum master-feeder, offshore fees can be deferred in the conventional structure, plus the implied level of portfolio activity would best be managed in a single master account.

Because of the recent popularity of memorandum structures, this discussion will address them first.

¹ A 475(f) election marks the portfolio to market at year-end, with all income being considered “ordinary” in character. Its principal advantage is that it eliminates wash sale issues, which can be troublesome in high turnover funds.



Memorandum master-feeders

While the master fund in a “conventional” master-feeder has just two participants to track – the two feeders, a “memo-master” has multiple accounts used for tracking underlying investments at the feeders. This may be in the form of (a) “memorandum accounts” at the master level reflecting each feeder participant or (b) separate capital accounts at the master for each feeder series. The feeder, in turn, links each of these accounts at the master to an individual investor or to one of its series. Since manager compensation (and hopefully expenses – more on that below) are accounted for at the master level, the master’s net “memorandum accounts” become the feeder’s net values for the relevant participants or series.

Since the master entity is a partnership, incentive compensation occurs as an allocation of portfolio income.

A special sub-set of memo-master-feeders is the “*mini-master-feeder*,” which has only a single feeder. While this structure may be used as a structural precursor to multiple feeders, it is often an objective in itself: simply a way of earning incentive *allocations* rather than incentive *fees*. The discussion in “Structural Details” below applies equally to multiple and single feeder arrangements.

Conventional master-feeders

The master fund in a conventional structure simply has each feeder as a participant, with the P&L and portfolio effects flowing through to those feeders.

The offshore fund is typically a corporation having shares. Because of the “unitization” implicit in share accounting, classes of shares and series within each class are necessary. In general, a class defines a subset of the fund having a set portfolio interest and/or fee structure. A series defines a subset of a class with a separate high-water mark for incentive fee purposes.

A fund usually has multiple classes, including one for investors who are not NASD “New Issues” restricted and one or more for those who are. There will also be classes for each fee variation, plus classes reflecting portfolio divisions such as side-pockets.

A new series in a class is normally issued each time a new subscription is received (sometimes referred to as a “calendar series” because its designation reflects the effective calendar subscription date for that series). A separate high-water mark for each series ensures that incentive fees, when charged, reflect actual gains on that series.

At annual intervals, there is usually a process to convert superfluous series to a single series within a class. All series that pay an incentive fee have capital equal to high-water mark at that point in time, so they are arithmetically equivalent for incentive fee purposes. Accordingly, they are “rolled-up” into the earliest-issued series that is in that condition.

For reporting purposes, an administrator will typically report the series NAV per share as well as the various subscriber account values.

A second method of dealing with shares and high water marks is to have only one series and add and subtract “equalization” shares monthly to make the account valuations work. Since the number of shares held by an investor can change each month, it makes NAV-per-share reporting meaningless. This method is not commonly used.

Expenses in a conventional master-feeder can either be applied all at the master level to achieve a pro-rata apportionment among investors or divided fund by fund according to some other equitable method. Manager compensation will normally occur at each feeder level.

Other considerations

Note that this discussion is limited to administration issues and investor perceptions. There may be other considerations relevant to the structure of any fund, such as the existence of other manager-affiliated funds



plus the legal implications of commingling of assets in the master fund. These are issues beyond the scope of this material and should be discussed with counsel.

Structural details

Note that the structural differences in “memorandum” or “conventional” master feeders focus on the master fund and the offshore fund component.

Memorandum master-feeders

There are two important structural elements for a memorandum master-feeder: expense mechanics and whether the master fund tracks participants or calendar series.

Expenses

- **Location.** One added promise of a memorandum master-feeder is simplicity. When all the expenses and allocations occur at the master level, then two important things occur:
 - The incentive calculation will be on true net gains. (Conversely, any expenses occurring at the feeder level would be post-incentive.)
 - The master “memorandum” or series capital accounts are directly convertible into participant or series capital in the feeder.

Conversely, if expenses were paid or reserved at the feeder level, the feeder would have its own accrued payables plus possible cash balances to facilitate payment, which would mean that the master memorandum accounts won’t directly translate into feeder valuations. Accordingly, documentation should provide that feeder expenses be handled in one or more of the following ways:

- At the master fund as an obligation of the master fund;
 - Nominally at the feeder level, but administered by agreement at the master level, so as to provide for proper incentive computation and eliminate separate feeder assets and liabilities;
 - For management fees, mechanically at feeder level for offshore deferral purposes, but taken into account via a memorandum adjustment at the master level, so as to provide for proper incentive computation.
- **Allocation.** Expenses may be shared pro rata at the master fund level or allocated differentially among the feeder funds.
 - Pro rata. While some expenses may relate more to one feeder than another, both feeders can be considered inseparable parts of a common business enterprise. Increased capital, regardless of source, generally helps to reduce the performance effect of third-party expenses and can make operations more efficient. Pro rata sharing is simpler administratively and will usually decrease accounting costs.
 - Allocated by feeder association. If some expenses are to be attributed to one feeder and not the other, such an allocation can be made at the master fund level to the memorandum accounts associated with the relevant feeder.

These allocation decisions may differ depending on the type of expense (formation costs, audit, administration, RTA if separate, offshore directors, and ongoing legal).

PMI Observation: The simplest and least expensive structure is for expenses to be shared pro rata at the master fund level.



The Tracking Choice

The master fund can track the offshore feeder's individual participants or its calendar series. Note that the master fund always tracks participants in the domestic feeder.

The advantages of tracking participants are:

- ✓ Each participant has its own aggregate high-water mark. In a "conventional" offshore fund, the series shares, not the investor, have the high water marks, so one series may pay an incentive while other series held by that investor are below high-water. The investor's realization that "If I add money, I may pay an incentive even if I haven't made money overall" can stall added contributions during bad patches. Conversely, an aggregate high-water mark can encourage capital additions – which also help the manager by reducing the percentage gains needed to get back to incentive territory.
- ✓ Series roll-ups and the associated paperwork and potential confusion are eliminated.
- ✓ Investor reporting is less confusing. Instead of multiple calendar series accounts for multiple capital additions, investors see just one aggregate account.

PMI Observation: The simplest and least expensive structure is for the master fund to track offshore feeder participants rather than calendar series.

Memorandum Master Feeder Parameter Table

Fund:

A. Tracking Choice

Offshore: Memo accounts track offshore participants calendar series²

Domestic: Memo accounts track domestic participants.

B. Expense Treatment²

Location: At the master fund as defined obligations of the master fund
 Nominally at the feeder level, but administered by agreement at the master, for proper incentive computation and to eliminate separate feeder assets and liabilities

Allocation choices:

Formation costs	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Audit	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Administration	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
RTA (if separate)	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Offshore Directors	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA
Ongoing legal	<input type="checkbox"/> Master pro rata	<input type="checkbox"/> Special allocation among relevant feeders	<input type="checkbox"/> NA

C. Management

Fees:

- At master level
- Nominally at offshore feeder level for deferral purposes, but administered by agreement at the master level, so as to provide for proper incentive computation.
- Mechanically at offshore feeder level for deferral purposes, but taken into account via a memorandum adjustment at the master level, so as to provide for proper incentive computation.

² If the master fund tracks subscribers and limits expense allocation complexity, due to the reduction in the administrative burden, PMI may waive the customary \$250/month administrative charge at the master level.



An offshore fund in a conventional master-feeder

Note that the feeder funds in a “conventional” master feeder are usually structured much like any stand-alone fund. Accordingly, this discussion addresses the share structures that would apply to offshore funds that are stand-alone, part of a parallel fund family, or part of a conventional master-feeder.

It is best to understand the basics of classes and series prior to launching an offshore fund. Because of the formalities, future classes that aren’t contemplated at the outset will have to be established via directors’ resolutions, so it’s a good idea – not to mention, cheaper – to get things laid out in advance. The following is how PMI suggests class and series hierarchy in a “conventional” offshore fund:

➤ **Share classes can be thought of as having 4 dimensions:**

- ✓ **Fee differences.** Each variation in management or incentive compensation requires a separate class.
- ✓ **New Issues participation.** There are 3 basic types: (1) unrestricted persons; (2) restricted persons who elect to participate under the de minimis exemption; and (3) persons who do not want New Issues at all (this type is usually limited to employees of brokerage firms having internal New Issues policies more restrictive than the NASD Rule, plus some funds-of-funds.) Note that “partially restricted” status that is common in domestic partnerships is problematic for a share structure, since each partially restricted investor might require a separate share class. For more information, see the PMI publication on New Issues.
- ✓ **Portfolio divisions other than new issues.** This usually would apply to side-pocketed investments not shared by all investors.

Note: Side-pocket accounting in a conventional master-feeder is challenging, to say the least. Non-pro-rata allocation of side-pocket income and expense is quite convoluted in a unitized class, series and share system. See the PMI publication “Side Pocket Checklist” for further explanation.

- ✓ **Voting rights.** While voting rights ordinarily don’t affect accounting, there may be classes segregated by voting rights: management versus investor, plus limited voting shares related to the nature of the investor (bank holding companies, for example). Note that investor shares may be voting or non-voting, depending on advice of counsel.

PMI suggests that an initial share structure include the following:

CLASS	DESCRIPTION
A	New Issue Unrestricted (with Fees)
B	New Issue Restricted - may participate via de minimis exemption (with Fees)
C	Zero New Issues Participation (with Fees)
D	New Issue Unrestricted (No Fees)
E-L	Different Fee and/or Term Variations
M	Management

- **Shares should be issued at \$1,000 per share (\$10,000 is also acceptable).** Smaller share issue prices can lead to unnecessary inquiries by investors regarding accuracy. For example, with an issue price of \$100 per share, a million dollar investment will have 10,000 shares. If NAV/Unit is reported as, say, \$101.52, that million dollar account will figure its value at \$1,015,200, when in actuality, the administrator knows the account value down to pennies. Some investors, realizing this, will call for more accurate numbers. An alternative to larger denominations would be more



decimals, but we've found that some investors' accounting systems truncate decimals at two or three places. Our recommendation is higher issue prices.

- **Consider a Management Share class.** One non-participating share class is usually necessary during a fund's wind-down stage. A domestic fund will always have a general partner even after the limited partners have withdrawn; however, a corporation must have an established shareholder who will be able to act to close the fund after the investors have been redeemed. Discuss this issue with counsel.
- **Define the series nomenclature.** Each incentive-paying class is divided into series. The initial series for each class would be series 1 and others will progress numerically (e.g., Class A Series 1, Class A Series 2, Class A Series 3 and so on). Periodically, each series of shares (2 through x) that has paid an incentive fee may be "rolled up" into the lowest numbered series that has similarly paid an incentive fee.
- **If stated, the issue price of each series should be identical, e.g., \$1,000 or \$10,000.**
- **The documents should provide for other classes as required:**

The Board of Directors reserves the right, without the approval of the Shareholders, to create and issue additional classes of Common Shares in the future which may differ in terms of investment program, suitability requirements, functional currency, fees charged, redemption and subscription rights and other aspects. All Shares, when duly issued against receipt of the Offering Price per Share, will be fully paid and non-assessable

Note that counsel may choose to avoid nomenclature specifics in the offering documents and instead rely on the administrator to establish some of these structural details. In that case, some of these details may be set forth in launch resolutions or other directives to the administrator.

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