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## Advantages for U.S. Tax-Exempt Investors via Onshoring Investment in Hedge Funds and Use of Swap Transactions

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### INTRODUCTION

The use of the Cayman master-feeder structure as a default fund structure for the hedge fund industry has created an exceptionally efficient means by which

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capital emanating from multiple geographies and with various tax sensitivities is pooled into a singular investing structure capable of deploying aggregate capital globally and across asset classes to produce attractive risk-adjusted returns for its investors. The structure has flourished because of its flexibility and adaptability or, perhaps more precisely, because of the work of industry service providers to adapt the structure to many varied and dynamic investor demands. Unsurprisingly then, and understandably, hedge fund managers (providers) and capital allocators (clients) alike have taken the broad strokes of fund structure as a given and have worked to customize structural details “within the lines” of the path which has been established.

At the operational level, hedge fund managers engage with prime brokers to provide many services to hedge funds. Chief among those value-added services are: (1) custodial services; (2) leverage and financing; and (3) stock borrowing facilities to allow funds to gain short exposure. These services are often considered existentially necessary to hedge funds, and the relationships among a fund and its prime brokers are core.

The capital-allocation community, specifically those allocators managing portfolios for U.S. tax-exempt entities (USTEs), has directed certain USTEs to invest in master-feeder structures through offshore Cayman feeder funds that serve as “blockers” to mitigate UBTI (unrelated business taxable income).<sup>1</sup> Most hedge fund strategies incorporate some modicum of leverage which generally constitutes “acquisition indebtedness” and may result in “unrelated debt-financed income” in the hands of USTEs if incurred directly or through a pass-through entity, triggering UBTI. Passive income (capital gains, dividends) is generally not UBTI; however, if the passive income is funded with acquisition indebtedness and is unrelated debt-financed income, then it is UBTI that is subject to unrelated business income tax (UBIT). As such, minimizing UBTI is a significant motivating factor in hedge fund investment decisions for USTEs. Within

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<sup>1</sup> Certain USTEs that are not subject to tax on their UBTI may already invest through domestic funds.

the industry, the adage goes that U.S. tax-exempt investors are “allergic” to UBTI.

A reconsideration of the way that USTEs invest in hedge funds may be appropriate now. This is due to the evolution of the swaps market and its converging (or perhaps, convergence) with the prime-brokerage construct, especially on financing, risk, and margining bases, being (or having been) accelerated by recent, higher-profile credit events within the swap market. We believe the outcomes of this reconsideration have the potential to augment returns for a potentially large subset of the hedge fund client base, namely USTEs, while providing the same portfolio-risk exposure that the fund currently provides USTEs in the current model. Of course, we recognize (and discuss within this article) that this new approach is not a panacea, and that consideration of its implementation must be idiosyncratically analyzed to ensure the specific circumstances of the fund and the investor are within the parameters needed for this new approach to benefit a given USTE fund investor.

In summary, USTEs that make use of offshore feeders when deploying capital into equity-weighted alternative investments to minimize UBTI may be unnecessarily subjecting themselves to U.S. withholding taxes on dividends on U.S. equities.<sup>2</sup> While avoidance of UBTI is advisable, an alternative structure for USTEs may simultaneously allow USTEs to avoid both UBTI and U.S. equity-dividend withholding, augmenting net returns to USTE investors. Specifically, in certain facts, we suggest that: (1) fund managers create a standalone onshore fund to stand side-by-side with the current master fund and be allocated investments on a *pro rata* exposure basis with the master fund; (2) the standalone onshore fund utilize a traditional custodian to the extent the fund maintains fully-paid-for securities and utilize total-return, delta-one swaps<sup>3</sup> in place of direct equity purchases which the traditional master fund would effect through its prime broker; and (3) USTE clients migrate from the Cayman feeder fund to the newly created onshore fund and thereby avoid the withholding tax on dividends with respect to U.S. equities while maintaining precisely the same leveraged exposure as they would

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<sup>2</sup> A USTE investor in a given fund that is subject to the tax on UBTI by virtue of the leverage utilized by the fund will generally invest in the offshore feeder to “block” the UBTI at the cost of tax leakage from withholding on dividends. Under the proposal advocated within this article, the USTE invests in the domestic fund, and swaps are used instead of margin/borrowing. UBTI is thereby avoided without the tax leakage.

<sup>3</sup> This article does not discuss the tax treatment of the swaps either as notional principal contracts, bullet swaps or otherwise, but assumes that any notional principal contract is appropriately structured and does not include any “embedded loan” feature that could give rise to UBTI.

have had in the Cayman feeder fund.<sup>4</sup> That is, a USTE may have its cake and eat it too.

## BACKGROUND

The Cayman master-feeder structure has been somewhat of a default hedge fund structure for decades. Hedge funds engage with prime brokers to solve their leverage requirements and to access stock to borrow (in addition to various other benefits to the fund and the manager).

Leverage created via the direct borrowing of capital by a hedge fund — as would occur in a prime-brokerage relationship — clearly creates UBTI and, therefore, UBTI concerns for USTEs. Income which would otherwise be tax-exempt in the hands of USTEs may become subject to tax in part and thereby reduce the after-tax returns of the fund to the USTE. As a solution, USTEs prefer to subscribe to offshore feeders to “block” UBTI, thus immunizing those USTEs from the potential for UBTI and the accompanying taxation and tax returns/compliance. Such an approach is generally accepted and commonplace.

By virtue of the Cayman feeder being treated as a foreign corporation for U.S. tax purposes, dividends on U.S. equities are subject to a 30% U.S. withholding tax payable at source (under §1442,<sup>5</sup> dividends are generally FDAP — fixed or determinable annual or periodical income). We note that this withholding occurs on common and preferred-stock dividends alike, but does not affect most coupon interest from fixed-income investments because of the portfolio interest exemption (§871(h) and §881(c)). We also note that withholding taxes, once incurred, are generally neither recoverable nor allowing of any deductions (to include netting against dividends owed via short-exposure positions).

## Prime Brokerage

The use of prime brokerage provides the fund with access to leverage, or financing, allowing the fund to purchase long positions in securities in an amount exceeding the fund’s equity capital and allows the fund to run short positions. The fund’s prime broker runs various risk models and algorithms to determine that amount of equity capital (margin) which the fund need post against its owned (or exposed) portfolio where the prime broker provides financing for the re-

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<sup>4</sup> The standalone onshore fund may, depending on its ownership (i.e., if it is more than 25% owned by ERISA plans), be subject to the requirements of ERISA.

<sup>5</sup> All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

sidual amount of capital (and charges a financing fee). The portfolio is viewed holistically such that, for example, offsetting short positions potentially lower the equity capital (margin) which the fund must post on any given day. As the value of the fund's portfolio ebbs and flows, the amount of equity capital required changes. To the extent the fund endures a loss, the net capital required for it to post to remain in good stead increases, reflecting not only the "buffer" (or margin) that the prime broker requires for the fund's continued exposure to the portfolio (i.e., security against the inherent movement or future volatility of the fund's exposures) but also the effect on the fund's net equity position (capital) for the movements of the securities since the fund gained exposure to the constituents of the portfolio. The requirements for capital by the prime broker are based on (1) the margin the prime broker requires in contemplation/expectation that the fund's assets will (continuously) change in value on a go-forward basis, and (2) the experienced mark-to-market move of securities to which the fund is exposed.

### **OTC Transactions/Trading Within the International Swaps and Derivatives Association (ISDA) Framework**

Over-the-counter (OTC) trading is a bilateral, contractual-based approach to trading in which credit lines are established between two counterparties such that they can trade derivative securities on a non-fully financed basis. That statement can be broken down into three parts: derivatives, non-fully financed, and credit. First, the transactions undertaken are derivatives in that they derive their value from the movement/prices of other securities. These derivatives may look and appear to be very similar to their underlying reference securities, such as an equity "delta 1" swap whereby the investor receives the performance for the referenced equity security (in a total return swap to include dividends and other payments), or they may be non-linear/asymmetric with characteristics of calls, puts, and other non-linear options and structures. Second, these transactions are not fully financed in that the purchaser of the risk exposure to the underlying security is not required to fully pay for the security upon initiation of the transaction. For example, were an OTC trading counterparty to desire exposure to stock XYZ, currently trading at \$100 per share, that counterparty could contract with one of its OTC counterparts for exposure to the return of XYZ without paying \$100 per share. Finally, these derivatives rely on credit. As per the immediately prior example, the OTC counterparty who grants its counterpart exposure to XYZ is either bearing the risk of providing the return of XYZ stock or is financing the synthetic exposure of the initial counterparty to XYZ.

The market for OTC trading has developed significantly over the past two decades, some of that evolution of its own accord, some motivated by regulators. Whereas decades ago, over-the-counter derivative transactions may have been undertaken via long-form confirmation (where a single document delineated all of the terms of each transaction in question), currently, virtually all OTC trading occurs under a set of documents which "govern" the bilateral trading relationship and reduce the documentation required on any given transaction considerably. These sets of documents, colloquially referred to as "ISDAs," normally include: (1) the ISDA Master Agreement itself which is the contractual framework comprised of a set of definitions and standard provisions as published by the ISDA; (2) the schedule to the ISDA encompassing those customizations which are definitively (agreed to be) needed in each bilateral relationship but which the ISDA left for counterparty-to-counterparty negotiation; (3) the CSA or credit support annex to the ISDA which generally defines how the counterparties will post and receive collateral from each other in support of OTC transactions to include eligible forms of collateral and their recognized value; (4) when applicable, the account control agreement (or ACA or tri-party agreement) which involves a neutral third party to service and maintain the collateral as outlined in the CSA (when one or both parties prefer to not post collateral directly to the other); and (5) when agreed, some sort of master confirmation agreement (MCA or otherwise named) which builds on the ISDA and schedule to further make static other potential variable terms typically found in a transaction-specific confirmation. The value of the MCA is that the per-transaction confirmation itself is reduced substantially, perhaps down to a set of numeric values and data elements, augmenting the efficiency of the post-trade, OTC trading process.

### **OTC Transactions as an Alternative to Borrowing Money**

In cases where the intent is to gain long or short exposure to the total return of an underlying equity, delta-one, total-return swaps (DTRSs) provide the same return as would be had in a financed setting. DTRSs provide the risk-asset holder with the performance of the risk asset, namely the underlying security, to include its price performance, regular dividends, extraordinary dividends, and other payments, either on a long or short basis. The counterparty which is providing the long/short return on the risk asset receives an interest rate on the notional exposure of the risk asset, normally expressed as the applicable London Interbank Offered Rate (LIBOR) plus some (financing) spread, when the risk-asset exposure is

long, and provides a rebate to the risk-asset holder (normally expressed as the applicable LIBOR less a rebate spread) when the risk-asset exposure is short. In this way, the performance of a risk asset is being “swapped” for a riskless rate return on a notional value plus some spread.<sup>6</sup>

From a collateral requirement perspective, where a prime-brokerage relationship will require a net amount of capital to be posted on an aggregate/portfolio basis, OTC transactions have historically been assessed on a transaction-by-transaction basis where, at initiation, an initial, static margin is required, and then, on a daily basis, a mark-to-market is exchanged between counterparties. The static and idiosyncratic nature of initial margin for OTC transactions is evolving, and several counterparties now maintain a dynamic initial margining requirement, creating a look and feel in the OTC transaction world which is exceptionally similar to the margin require-

ments within a prime-brokerage construct. As such, equivalent exposure can be had in a DTRS setup as can be had in a prime-brokerage context with identical (or near identical) financing and collateral requirements.

## RETHINKING OFFSHORE INVESTMENT TO SAVE WITHHOLDING TAX

Given the practical intersection of prime-brokerage accounts and OTC transactions (DTRSs), USTEs would be well served by considering the extent to which their hedge fund managers can provide exposure to each manager’s optimized portfolio via OTC transactions, onshore, instead of via the offshore fund structures. In bringing exposure onshore for the USTE, the USTE is avoiding U.S. withholding taxes which are 30% of the gross dividend paid.<sup>7</sup> This tax savings has significant implications in terms of both absolute dollars and compounded returns.

<sup>6</sup> While tangential to this discussion, we would note that the use of LIBOR is evolving to replacement reference rates.

<sup>7</sup> §1442.

### Example:<sup>8</sup>

Initial Capital	\$100,000,000				
Year	1	2	3	4	5
Hypothetical Annual Return	10%	10%	10%	10%	10%
Hypothetical Dividend Yield	3%	3%	3%	3%	3%
Year Ending Capital, post withholding	\$109,100,000	\$119,028,100	\$129,859,657	\$141,676,886	\$154,569,483
Year Ending Capital without withholding	\$110,000,000	\$121,000,000	\$133,100,000	\$146,410,000	\$161,051,000
				difference	\$6,481,517
				withheld IRR	9.1%
				non-withheld IRR	10.0%

<sup>8</sup> The provided example illustrates the gross differential in after-tax returns (both with and without withholding) using a hypothetical dividend rate. The actual differential will of course take into account fund-specific dividend yields (which may be less than the hypothetical rate) and any performance-based compensation.

The critical insight in this analysis is that leverage incurred within certain OTC derivative contracts is not leverage for UBTI purposes. Hence, USTEs are incurring an unnecessary drag on performance in dividend paying U.S. equity securities because an alternative exists via OTC transactions to replicate the portfolio in an onshore vehicle, currently served via an offshore (likely) prime-brokerage construct.

As a sidenote, we mention the effect that this model stands to have on manager incentive allocations. Because incentive allocations are generally determined net of withholding tax, the elimination of such withholding tax will increase performance and incentive allocations. This evolution is a win-win: clients re-

ceive higher net returns, and managers draw an incentive on an incrementally higher return.

## Implementation Considerations

At a practical level, implementation of the above-discussed idea requires introducing a sister (onshore) fund to the current master fund to trade “side by side” and replicate exposure undertaken within the master fund. The fund’s exposure/strategy occurs through long and short equity exposure which the DTRS can replicate. However, ancillary trading in other cash securities (e.g., debt) could be undertaken and housed at a custodian on a fully paid-for basis, and ancillary trading in other derivative securities

(e.g., credit default swaps, options, etc.) likely already requires an ISDA relationship and/or can be housed with another fund vendor (e.g., futures commission merchant, CMTA).

Aside from the typical requirements of fund initiation with which all active fund managers are familiar, managers undertaking this offering for their USTEs will have to implement the ISDA process outlined above. While some managers already maintain ISDA relationships within their traditional master-feeder structures, others will find it to be a new undertaking. For larger funds, the incremental requirements will be incidental and quickly mastered with help from fund partners such as fund counsel and derivatives counsel. For smaller funds, undertaking ISDA relationships may be cost prohibitive and/or may be prohibited because of a lack of interest in engagement by broker/dealer ISDA counterparties. To address access for smaller funds, a platform solution may be needed.

## Advantages and Disadvantages to Each Type of Structure

Economically, the difference between OTC transactions and prime-brokerage exposures is de minimis or zero. That said, there are a few more qualitative advantages and disadvantages to each of the structures. First, prime-brokerage exposure has the advantage of being direct ownership. Ownership allows for direct voting on shareholder votes and direct recognition as a shareholder (which could be relevant for access to management). These advantages would not exist if a DTRS (OTC transaction) were utilized. However, we are not recommending a migration away from the Cayman master-feeder structure *en masse*. We are recommending it in suitable cases for the benefit of USTEs, a subset of any current master-feeder investor roster. As such, the manager would continue to have the benefits of direct ownership through those assets which remain in the master-feeder structure, employ the prime-brokerage model, and create direct-stock ownership.

Conversely, OTC transactions offer their own set of advantages over the traditional prime-brokerage construct. Aside from the advantage we have highlighted here — that providing a vehicle through which USTEs, in an onshore fund, may avoid U.S. withholding tax on U.S. source dividends — there is also the credit augmentation of appropriately structured ISDA/OTC relationships. These enhancements include the relative benefits of segregation of initial margin at a tri-party, bilateral variance-margin collateralization, and greater asset protection and ease of counterparty credit remediation in case of a negative credit event involving a given broker/dealer (ISDA counterparty). While the creditworthiness of prime brokers certainly

has increased since the Great Financial Crisis and the last wave of broker/dealer credit failures, prime-brokerage relationships simply are not structured to provide the same surety as that found in appropriately structured ISDA relationships. To that end, ISDA counterparties may extend an equivalent financing and margin relationship “only to a point” relative to their prime-brokerage offerings, which are inherently more capital efficient for the broker/dealer. Hedge fund managers will need to assess any incremental costs of funding and margin requirements for the ISDA-based fund and communicate as much to potential USTE limited partners. The incremental cost of such an implementation will likely be outweighed by the benefit of avoiding withholding taxes.

Other potential benefits to the ISDA relationship, relative to prime brokerage, are generally for those funds which undertake global equity exposure and include the ISDA providing immediate broader access to global markets, amongst other inefficiencies.

## K-1 Receipt by USTEs

USTEs may have a natural reticence to receiving K-1s. Conversations with respective tax counsels may confirm that the K-1 need be examined by the USTE’s tax counsel/advisor only to confirm that the K-1 does not include UBTI — which, with appropriately structured DTRSs and other securities within the stand-alone fund, it will not. To the extent that it does not contain UBTI, the K-1 may have little to no significance to the USTE recipient (though it may be reported on the USTE’s IRS Form 990). A USTE may also simplify its U.S. tax compliance requirements by eliminating the need to file IRS Forms 5471 and 926.

## Suitability

As stated in the introduction, above, migration to an “all ISDA” model, even for USTEs, is not a panacea and should be considered only when and if suitable. The following is a list of considerations that funds and their investors should undertake in determining the extent to which our proposed structure would be additive:

- *Creating an Acceptable Swap.* Qualifying DTRSs must be structured correctly — we suggest a total-return, bullet swap — and cannot reference assets which are illiquid (a determination which relies not only upon the absolute liquidity of the instrument in question but also upon its liquidity relative to the size of the swap position). Further, the swaps must truly be passive investment instruments. Hallmarks which may call the passive nature of the swap into question would include any sort of “right

to receive” physical delivery of the underlying and/or any control over actions and rights typically ascribed to holders of the underlying securities, such as voting rights. Finally, the size of the position relative to the total number of shares outstanding is a factor. Swap counterparties typically require representations for positions over 5% of shares outstanding and an outright ceiling at 10%, though these metrics could easily be lowered based on facts and circumstances.

- *Reliance of Cash Broker Trading.* A subset of hedge fund managers relies on research and other services performed by brokers who are then compensated via the manager’s trading with the broker and paying an aggregate commission both for execution purposes and for compensation for the other services provided. This remuneration model is easily accomplished in a prime-brokerage construct because the manager may trade with the third-party broker in question, pay the commission, and direct settlement of the purchased or sold cash position to the prime broker for settlement. One would imagine an equivalent “give up” model would exist for DTRSs; however, while such a model does exist in other jurisdictions, such is not the case in the U.S. market. Practitioners have expected in multiple years — including 2021 — that the Securities and Exchange Commission would take up the idea of “executing away” within a swaps construct, but, as of yet, no determination/clearance has been given. Therefore, a manager desiring to utilize a domestic standalone fund would either execute the swaps solely with the ISDA counterparty or take on risk of swap recharacterization if the manager were to execute away from the swaps counterparty. There is a middle ground where the manager utilizes the research broker in question to execute that allocation of the transaction which will be settled into the master-feeder structure via a prime-brokerage relationship and utilizes the swaps counterparty for the DTRS. However, there is the potential for such a split execution strategy to be operationally onerous and/or to call into question execution quality. The manager may pursue an alternate avenue — perhaps via a soft-dollar arrangement — through which to compensate the research broker in question, should the relationship with the broker be critical.
- *Counterparty Balance Sheet Considerations.* As discussed earlier, swaps are potentially less balance-sheet efficient for DTRS swap counter-

parties than are prime-brokerage transactions. Swap counterparties attempt to create a “no-arbitrage” accommodation between swaps and prime brokerage for their valued client relationships, which is to say that the swap counterparties perhaps price swaps at a tighter/more attractive level than they would if the swaps were being priced in isolation as opposed to being priced in consideration of the holistic client relationship (which, to date, would rest heavily on prime-brokerage balances). Clients may need to have conversations with their swap counterparties to ensure that, were the counterparty-client relationship to evolve more heavily towards a swap weighting, the swap counterparty would be able to hold swaps pricing (and margining) at rates equivalent to that of prime brokerage, and, if not, to quantify the incremental cost of the swaps transactions for comparison to the benefit to the investor from “recovery” of the withholding tax heretofore incurred.

- *Section 4940.* For certain U.S. private foundations, §4940 imposes a 1.39% tax on net investment income. We note this in consideration of the redemptions that would occur, were a USTE to migrate from an offshore feeder fund within a current master-feeder construct to the standalone onshore fund we have proposed. In the case where the USTE has created an unrealized gain on its offshore holdings, the redemption would subject the private foundation to a 1.39% tax on its offshore redemption. Further, were the USTE to show a loss at offshore redemption, that loss would be claimable only in the redeeming tax year (i.e., could not be carried forward).

## A MODEL FOR IMPLEMENTATION

The authors have been part of a team that has assessed the suitability and feasibility of a model similar to the one described herein for a client that then successfully implemented it. Our experience leads us to suggest that the first step in assessing an opportunity like this is to appoint an internal or external lead with cross-functional and cross-departmental fluency to conduct a feasibility study on such a transition. Important questions at this stage would include:

- To what extent does the current fund’s strategy allow for the use of DTRS structures?
- What percentage of the fund’s historical trades could be expressed via DTRS?
- Does the manager have the (internal or external) resources to implement and execute ISDA

agreements and associated forms, to set up tri-party arrangements, and to conduct ongoing variance-margin and collateral operations?

- Does the manager have the requisite trading expertise to participate in the DTRS market and the appropriate compliance and legal resources for ongoing confirmation review and monitoring?
- What subset of clients are candidates for the migration to the standalone fund?
- What is the expected setup expense of the standalone fund relative to the candidate migration assets and relative to the projected annual savings to those clients?

Next, we would suggest bringing business partners (e.g., tax/audit, external fund counsel, etc.) into the consideration conversation to confirm their affirmation of the logic of such action and their assent to the tax and audit positions the new standalone fund would undertake. At this stage, it would be prudent to engage potential DTRS (ISDA) counterparties to understand the terms of new ISDA agreements and pricing and margining terms.

Last, surveying current clients which are candidates for a migration is appropriate, culminating in conversations with those clients' tax advisors to assure the new fund's merits are well understood by its candidate limited partners and that an "if you build it, they will come" mindset is likely for current USTE clients.

## **CONCLUSION: A BUSINESS CASE FROM THE PERSPECTIVE OF FIDUCIARY DUTY TO OPTIMIZE RETURNS**

We recognize the substantial degree to which our recommendation that USTEs undertake a new approach to hedge fund exposure may find resistance. Specifically: (1) hedge funds and their clients are accustomed to prime brokerage as the main structure through which funds are maintained; (2) USTEs have been trained to invest via offshore feeders, to be concerned with UBTI, and to resist receipt of a K-1; and (3) derivatives/OTC transactions have the potential to be considered "four letter words," even though the exposure profile relative to a prime-brokerage exposure is equivalent and, we would argue, the counterparty credit risk is lowered via an ISDA relationship. Finally, some hedge fund managers, USTE investors, and their consultants might not have familiarity with ISDAs, OTC transactions, and DTRSs.

Despite all these reasons, we feel it is incumbent on hedge fund managers and the capital allocators controlling USTE pools of capital to view this model from the perspective of fiduciary duty. For suitable USTE investors allocating to qualifying funds, the evolution to higher net returns to the USTE investor for undertaking identical portfolio exposure is clear and quantifiable. Provided USTEs and fund advisors and counsel can gain comfort with the new construct and view the structural risk as tolerable, we believe that it is in the best interest of all parties to consider this new fund model for a subset of fund investors.