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CONSIDERATIONS IN SELECTING AN INVESTMENT VEHICLE: A GUIDE FOR U.S. TAX-EXEMPT INVESTORS

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Considerations in Selecting an Investment Vehicle: A Guide for U.S. Tax-Exempt Investors

While most investors justifiably devote the majority of their time to asset allocation and manager selection decisions, the choice of investment vehicle is frequently an afterthought, based primarily on precedent, fees, or access. In practice, however, the choice of investment vehicle can have unexpected but meaningful implications for the business of managing a portfolio, affecting audit and accounting processes, financing decisions, taxes, liquidity, and even investment performance.

A clear illustration of these "unexpected implications" occurred during the market turmoil of 2008, when the liquidity of collateral used in securities lending programs rapidly deteriorated. Many institutional investors and their trustees—including some who had never even *heard* of securities lending—were surprised to learn that their pooled investment vehicles were participating in securities lending programs, and that the liquidity and returns of their portfolios had been impaired as a result. For most investors, the resulting impact of these events proved to be temporary, but these problems clearly illuminated an unintended exposure within many portfolios.

The intent of this paper is not to argue the merits of some investment vehicles over others. Different institutions will have different considerations, and each will have its own decisions to make regarding the trade-offs among access, transparency, liquidity, and return. Rather, this paper is intended as a resource for investors so that they are better prepared to ask the right questions, avoid unexpected outcomes, and ultimately reach more profitable decisions.[1]

[1] This paper is not intended to constitute legal advice; as ever, investors should seek professional legal counsel to determine the appropriate legal structure for each investment.

To that end, this paper has been organized into the following sections:

- An overview of the basic U.S. laws and regulations governing investment advisers and investment funds;
- A survey of investment vehicles available to U.S. institutional investors; and
- Considerations in selecting an investment vehicle by asset class, including:
  - Traditional Assets
    - Public Equity (U.S. and Global ex U.S.)
    - Fixed Income (U.S. and Global ex U.S.)
  - Alternative Assets
    - Hedge Funds
    - Private Investments (Private Equity, Venture Capital, Real Estate, Oil & Gas).

At the end of this report, we have provided a sample list of questions investors should ask before selecting an investment vehicle, followed by summary matrices that compare the various vehicle options along a variety of factors. These matrices sum up many of the considerations outlined in this report and the accompanying tables.

An Overview of the Laws Governing Investment Advisers and Investment Funds

In the wake of the market turmoil of 2007–08, institutional investors have come under increasing pressure from regulators, auditors, and their own stakeholders to demonstrate a prudent degree of oversight over their portfolios. Among the questions being asked of institutions—particularly during annual audits—is whether their investment advisers and fund managers are "registered with the Securities and Exchange Commission (SEC)."

Unfortunately, the answer is not as straightforward as some auditors or their clients might think: being registered with the SEC means different things for different entities, and implies different degrees of oversight. Before elaborating, however, a distinction must be made between investment *advisers* and the investment *funds* they manage.

The Adviser Entity and the Investment Advisers Act of 1940

The *investment adviser* is the entity that actually makes the investment decisions implemented in the fund—what we typically think of as the "investment manager." Nearly all investment advisers to U.S.-domiciled funds are required to register with the SEC under the *Investment Advisers Act of 1940* (the "Advisers Act").[2]

The Advisers Act requires that all Registered Investment Advisers (RIAs) must, among other requirements:

- Keep a written compliance manual and code of ethics and appoint a chief compliance officer.
- Establish and maintain books and records relating to:
  - Management of client accounts;
  - Fees, personal trading by employees, proxy voting, and compliance procedures; and
  - Financial and corporate records.
- Submit for public record Forms ADV 1 & 2.
  - Form ADV 1 provides the RIA's name and the number of employees, as well as a description of the form of organization and nature of the business. It may also include information on the adviser's auditor, administrator, and prime brokerage relationships.
  - Form ADV 2 discloses to clients of the firm a description of services provided, risk factors, conflicts of interest, fees charged, and whether the RIA acts also as a broker-dealer.
- File with the SEC reports that describe:
  - Assets under management,
  - Trading practices,
  - Type of assets held,
  - Valuation procedures,
  - Counterparty exposure,
  - Side letters,
  - Use of leverage, and
  - Trading and investment positions.

The Fund Entity and the Investment Company Act of 1940

The *investment fund* (or "vehicle") is simply a legal structure that provides a framework for an investment portfolio. A fund's structure and its intended investor base determine whether it must be registered with the SEC, the Office of the Comptroller of the Currency (OCC), another state or federal regulatory body, or not at all. As discussed later in this paper, the types of investments to be made in the portfolio also impact the adviser's choice of investment vehicle.

The principal piece of legislation that determines whether certain vehicles are required to register with the SEC—and which governs the investment activities of those that are—is the *Investment Company Act of 1940* (the "Company Act"). Under the provisions of the Company Act, a Registered Investment Company (RIC) must:

- Register with the SEC, and submit to SEC inspection;
- Keep a written compliance manual and code of ethics and appoint a chief compliance officer;

[2] Two acts were passed in 1940 that attempted to bring some degree of regulation to the asset management industry: the *Investment Advisers Act of 1940* and the *Investment Company Act of 1940*. Among investment managers and others in the industry, the standard terminology for reference to the Investment Company Act is the "40 Act." However, to distinguish between the Investment Company Act and the Investment Advisers Act (both passed in 1940), for the purposes of this paper we will refer to these acts as the Company Act and the Advisers Act, respectively.

- Appoint a Board of Directors/Trustees, 40% of whom must be independent from fund management;
- Make available to the public a prospectus describing the company's strategy, liquidity terms, fees, and other expenses;
- File semi-annual reports detailing company holdings, transactions for the period, and gains or losses;
- Provide an audited annual report;
- Follow certain restrictions on borrowing (which is interpreted as restricting leverage for investment purposes); and
- Observe certain restrictions on short sales.

These provisions are somewhat more restrictive and costly to implement than those of the Advisers Act. What makes this all worthwhile from the standpoint of the fund manager is that, in return for closer regulation and scrutiny, a RIC structure allows for access to an unlimited number of investors, and, by extension, an unlimited amount of capital.

It is important to note that there are differences between these two statutes and the corresponding degree of regulatory oversight imposed by each. While the Advisers Act mandates a certain level of transparency about the processes of investment firms, it imposes few restrictions on the investment strategies they employ or the type of securities their funds hold. In contrast, the Company Act and related regulations have a wider scope, creating standards for governance and investment transparency, and to some extent imposing risk controls on investment strategies employed. Moreover, the Company Act and other related statutes restrict the marketing of non-compliant vehicles to qualified purchasers or accredited investors (depending on the vehicle), whereas RICs may market themselves to the general public if their securities are registered under the Securities Act of 1933. Thus, institutional investors (and their auditors and stakeholders), may perceive an additional degree of safety in vehicles that comply with the Company Act.

At the same time, however, it is important not to overstate the protections of registration with the SEC under the Company Act. For example, it is a widely held misconception that the Act *prohibits* leverage and short sales, and thus makes RICs less risky than non-compliant vehicles. In reality, it is the Act's restrictions on the issuance of senior securities that limits RICs from selling securities short, buying on margin, or using certain derivatives, since any of these tactics may be interpreted as creating senior securities. In fact, a RIC *may* sell a security short if it owns an equivalent long position in that stock or segregates on its custodian's books liquid securities equal in value to the short position. Moreover, while the use of leverage is limited, RICs may in fact borrow as long as the coverage ratio of total net fund assets to borrowed funds is 300%. The result is that RICs may employ small amounts of leverage and short sales as long as they fall within well-defined ranges. These tactics are often employed by 130/30 funds and similar products, which may be structured as RICs.

Nonetheless, while all regulatory oversight is imperfect and there is no such thing as a risk-free vehicle, there remain important differences in transparency and oversight between a vehicle registered under the Company Act and one that is not. Understanding these differences can help investors focus their due diligence when evaluating an investment.

Other legislation that impacts the investment management industry at the security level—but not always at the Adviser or Fund level—includes the Securities Act of 1933 and the Securities Exchange Act of 1934. The Securities Act requires that all publicly offered investments be registered with the SEC and that they provide investors with a prospectus that describes investment strategy and risks associated with the investment. The Securities Exchange Act requires that issuers of securities registered under that Act report regularly to their investors. Because they are sold to the general public, mutual funds and exchange-traded products (exchange-traded funds [ETFs], exchange-traded notes [ETNs], etc.) must register under these two Acts in addition to registering under the Company Act. Separate accounts and most other commingled vehicles do not have to.

Summary Comparison of 1940 Acts

	Investment Advisers Act of 1940	Investment Company Act of 1940
External Oversight	SEC	SEC
Internal Oversight	None	Internal Board of Directors or Trustees
Compliance	Must maintain a written compliance statement and code of ethics and appoint a Chief Compliance Officer	Must maintain a written compliance statement and code of ethics and appoint a Chief Compliance Officer
Reporting Detail	• Form ADV 1: Details adviser's business, ownership, clients, employees, practices, affiliations, and any disciplinary actions against adviser or its employees • Form ADV 2: Must provide brochure describing in "plain English" advisory services offered, fee schedule, conflicts of interest, disciplinary information, and educational and business experience of management and key investment personnel • Must provide periodic summary changes to the brochure • A brochure supplement must be offered that provides details on employees actually providing investment advice, including contact information for that employee's supervisor	• Shareholder Report: Must provide semi-annual report detailing holdings, transactions, gains and losses, as well as an audited annual report • Prospectus: Must maintain a Summary Prospectus available to the public detailing strategy, risk factors, fees and other expenses, and performance as well as a Statutory Prospectus describing the investment adviser, portfolio managers, and how to purchase and redeem shares • Statement of Additional Information: RICs (excluding UITs) must provide on request a Statement of Additional Information including policies on concentration and securities lending, detail on directors and trustees, brokerage commissions and financial statements
Reporting Frequency	• Forms ADV 1 & 2: Available from SEC at www.adviserinfo.sec.gov • Summary changes: Annual • Brochure supplement: At or before new employee begins to provide investment advice to clients, or in the event of disciplinary action	• Shareholder Report: Annual and semi-annual 60 days after year- and mid-year end • Prospectus: Ongoing, available online or upon request • Statement of Additional Information: Upon request
Offering Restrictions	The Advisers Act does not explicitly address investment offerings, but applies to all advisers managing funds that may be offered to the public and those that must limit offerings to certain qualified investors (with the exception of venture capital funds)	RICs may offer their shares to the general public (and must also be registered under Securities Act of 1933, with a few exceptions)
Investment Constraints	No explicit constraints	• RICs may not issue senior securities, which effectively prohibits extensive short sales or use of derivatives • Borrowing is restricted to asset coverage of 300%

A Survey of Investment Vehicle Structures Used by U.S. Institutional Investors

In the broadest sense—and particularly from the standpoint of regulatory oversight—investment vehicles can be divided into two groups: those that comply with the Company Act and those that do not.

Structures That Comply with the Company Act: RICs

The Company Act broadly defines an investment company as one that issues securities *and* whose primary business is investing in securities. Under this definition there are three types of investment companies required to register under the Company Act:

- **Mutual Funds.** Mutual funds are legally known as "open-end companies" because new shares in a given fund are created when money flows into it. Unlike public equities, mutual fund shares do not trade on the secondary market. Rather, shares are purchased by investors directly from the fund, are redeemed by the fund when investors want to sell, and are priced daily. As a result, there is no discrepancy between the price of a mutual fund's shares and its net asset value (NAV) per share.

- **Closed-End Funds.** A closed-end fund is "closed" in the sense that the number of shares issued is fixed at the inception of the fund. Like a public company, closed-end funds raise capital through an initial public offering, after which shares trade on the secondary market. Also, like shares of a public company, closed-end fund shares will trade at a premium or discount to NAV depending on demand for the shares.

- **Unit Investment Trusts (UITs).** A UIT is something of a hybrid of the two forms above. Like a mutual fund, it issues redeemable shares; like a closed-end fund, the number of shares is fixed and they trade on the secondary market. However, unlike either of the above vehicles, a UIT has an expiration date established at the time of its creation, and will typically have a fairly static investment portfolio, such as a specific group of bonds held until maturity. Some ETFs are structured as UITs.

Structures Exempt from the Company Act: Everything Else

While RICs—and mutual funds in particular—are probably the most familiar and most widely used investment structures in the retail market, the majority of institutional investments are made through vehicles that in some way or another are exempt from registration under the Company Act. Unregistered investment vehicles typically achieve exemption by limiting the amount of capital raised, the number of shares issued, or the number or type of investor. Reasons for seeking exemption include wanting to use tactics restricted by the Company Act (e.g., greater use of leverage and short sales), or a desire to avoid the costly registration process and ongoing scrutiny of the SEC.

While these vehicles may escape registration with the SEC, most of them must submit to some other form of regulatory oversight, whether at the state or federal level.

Common Trust Funds (CTFs) and Collective Investment Trusts (CITs). Typically referred to as "commingled funds," CTFs are maintained by banks or trust companies for pooling and investing assets of their customers. They are exempt from the Company Act under section 3(c)(3), which allows for pooling of funds by a bank's trust department to be managed by the bank as fiduciary. Similar to CTFs, CITs are pooled accounts maintained by banks, but are restricted to retirement assets. They are exempt from the Company Act under section 3(c)(11), which allows for exemption of a fund that contains exclusively money derived from contributions to retirement accounts.

While both CTFs and CITs are exempt from registration under the Company Act, they do fall under the supervision of the OCC. The OCC imposes similar restrictions on leverage, requires an annual report on holdings and transactions, and mandates that banks operating commingled vehicles provide a "written plan" (similar to a mutual fund's prospectus) outlining the fund's investment strategy, fees, and other terms. Also, while CTFs and CITs do not have the same legal prohibition on short sales as investment companies, tax implications effectively restrict short selling.

Separate Accounts. A separate account, as the name implies, is simply an account maintained by one investor separate from others. As such, it is exempt from registration with the SEC under any of the Acts described above (though usually the adviser managing the assets will be registered under the Advisers Act). While the portfolio is managed by an investment adviser, the assets are custodied separately (typically with the investor's custodian bank), offering an additional layer of protection from manager fraud.

Limited Partnerships. Limited partnerships are the most common investment vehicle for alternative investments, both marketable (hedge funds) and non-marketable (private equity and venture capital). Limited partnerships typically avoid registration under the Company Act through sections 3(c)(1) or 3(c)(7), which limit both the number and the type of investors in the fund (described in greater detail later in this paper). This structure also allows for the use of leverage and short selling, and has almost no restrictions on the type of assets held. However, despite being free from the provisions of the Company Act, limited partnerships and their advisers must still comply with anti-fraud statutes.

Historically, hedge funds, private equity funds, and venture capital funds have managed to escape registration with the SEC at the adviser level as well as the fund level, typically taking advantage of a rule that limits the number of clients an exempt investment adviser may have (for the purposes of this rule, the "clients" of hedge funds and private equity advisers are the funds they advise, not the limited partners). However, with passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, managers of private partnerships with more than $150 million in assets under management will be required to register as investment advisers under the Advisers Act by March 30, 2012.[3] This includes most hedge fund and private equity managers, though for now venture capital firms will remain exempt.[4]

Requiring hedge fund managers to register under the Advisers Act will provide greater transparency into the strategy and *types* of holdings in their portfolios, but actual security-level detail will still not be provided. Perhaps the greatest benefit to investors from hedge fund registration will be the detail provided in Form ADV on the fund's auditor, prime brokers, directors, administrator, marketers, and custodians. These details—along with an additional requirement that hedge funds use accredited custodians or broker-dealers—should help to make outright fraud along the lines of a Bayou or a Madoff much more difficult. Despite these enhancements, however, it would still be unwise to assume that registration with the SEC will make hedge funds "safe" or alleviate in any way the burden of due diligence required to vet these managers.

[3] Funds above $100 million must register if they manage separate accounts.
[4] Most venture capital funds relying on exemption from the Advisers Act must nonetheless file Form ADV 1, described earlier.

Considerations in Selecting an Investment Vehicle: Traditional Assets

U.S. investors have a number of ways to access equity markets. In the United States, the menu ranges from mutual funds and ETFs to commingled funds and separate accounts. Globally, the types of equity vehicles are even larger in number, though in practice U.S. investors are more limited in their actual options for investing.

U.S. Public Equity (Long Only)

Given their long history as the dominant asset class exposure for many institutional portfolios—and the fact that developed equity markets are liquid, transparent, and widely regulated—public equities are often considered the most straightforward part of an institutional investor's portfolio. However, depending on the vehicle used to access those markets, implementing publicly traded equity investments can prove nearly as complex as some of their "alternative" counterparts.

Mutual Funds (Open- and Closed-End Funds). As institutional investors have increasingly diversified away from long-only public equities over the past 15 years toward other asset classes such as hedge funds and private equity, smaller and mid-sized institutional investors have increasingly been pushed toward using commingled or pooled vehicles. Among the primary beneficiaries of this shift have been mutual funds.

Mutual funds are able to aggregate assets across a broad pool of investors, which allows for a smaller minimum investment than other vehicles like separate accounts or even commingled trusts. Mutual funds are therefore a great way for small institutions—or large institutions wanting to make a small allocation—to gain exposure to a given manager or strategy they might not otherwise be able to access.

Mutual funds are also convenient from an administrative standpoint. Accounting, valuation, reporting, and custody services are all aggregated in one place by the fund sponsor, and in most cases shares can easily be traded through a basic brokerage account, making rebalancing fairly simple. Liquidity is usually excellent, with the majority of mutual funds providing cash next day.[5] From the standpoint of headline risk, mutual funds are considered a safe option due to their double-regulated nature at both the fund and adviser levels.

However, the pooled structure that makes mutual funds so attractive also comes with certain drawbacks. The most obvious is that investors in a pooled vehicle are equally bound by the terms described in the fund's prospectus, which means, among other things, that individual investors have no say over investment strategy or the type of securities held in the portfolio, how proxies are voted, or securities lending practices. For most investors, this not a deal-breaker—in fact, outsourcing those decisions is precisely why many investors use active management in the first place. However, for institutions with social restrictions or that are required by their own bylaws to avoid certain stocks or sectors, a pooled vehicle of any kind may not be an option.

Another drawback is that although institutional share classes typically offer a lower expense ratio, institutional investors will pay that expense ratio regardless of how large their investment grows. In contrast, most commingled trusts and separate account structures offer a laddered fee schedule as assets rise or larger commitments are made.[6]

[5] Mutual funds are prohibited from suspending redemption of their shares (subject to extreme exceptions), may not delay disbursement of redemption proceeds for more than seven days, and are required to maintain at least 85% of assets in liquid securities.

[6] Typically, a mutual fund pays a laddered fee schedule to its adviser. As a result, as assets under management in the mutual fund grow, the expense ratio will come down.

More important from a risk control perspective is investors' lack of control over securities lending practices within a given share class. As noted earlier, many institutional investors regretted ceding that authority to their managers during the liquidity crisis of 2008, when problems with lending collateral caused some funds to suspend redemptions, denying clients access to their investments.[7] Of course, not all mutual funds engage in securities lending. In fact, in recognition of the concerns raised by the recent liquidity crisis, many firms have launched new vehicles or share classes for existing strategies that forbid securities lending. It is therefore important to understand which funds or share classes do and do not engage in securities lending before investing. A mutual fund's securities lending policy is normally found in the Statement of Additional Information (SAI).

From an audit and accounting standpoint, mutual funds are typically considered highly liquid and transparent. By law, mutual funds are required to provide detail on the holdings and transaction history of the portfolio at least semi-annually. In the past, some funds were also willing to provide a certain level of detail on an ad hoc basis, but in the wake of the mutual fund trading scandal in the last decade, funds may be less likely to oblige such requests. For most investors, this will probably not be an issue, but for those that must report a certain level of detail with some specified frequency (e.g., institutions that must report realized and unrealized gains and losses quarterly), mutual funds may not provide sufficient detail with sufficient frequency.

Finally, from a performance standpoint, the structure of open-end mutual funds may create a number of obstacles to performance that other pooled vehicles do not face. First, due to their status as RICs, mutual funds incur costs that other investment structures do not. Second, because they are open-ended, they are more likely to make additional advertising expenditures in an effort to attract new investors. Mutual funds also tend to have smaller average account balances, and, all else being equal, managing more accounts per dollar invested raises costs. Of course, in the vast majority of cases, these costs are passed on to the investor in the form of higher fees. Funds may also impose exit and entry fees that can further hamper returns.

In addition, because cash flows can be more frequent and less predictable than for other structures, open-end mutual funds must maintain a structural cash position in order to manage redemptions. While most managers employ strategies designed to reduce cash drag, there remains the potential for this cash position to create a headwind for returns during periods of strong market performance.

Closed-end funds face a different issue. While closed-end funds do not have to redeem or issue new shares—and thus, do not have to maintain structural cash balances like their open-end counterparts—they can trade at a substantial premium or discount to NAV. Consequently, their returns can be influenced positively or negatively by something other than the performance of the underlying assets and outside the control of the investment adviser.

Of course, mutual funds still provide better transparency than many other structures, excellent liquidity, daily valuation, and peace of mind from a regulatory oversight standpoint. For most institutions, they remain a convenient and even cost-effective option.

ETFs. The popularity of ETFs has grown exponentially over the last 20 years, going from $1 billion in invested assets in 1993 to over $1 *trillion* in 2011. This explosive growth is due primarily to

[7] For a more detailed discussion of the risks of securities lending, see our primer *Securities Lending: An Introduction*.

the perceived convenience, low cost, and relative safety of ETF investing. For the most part, those perceptions are accurate, although ETFs can still have risks and hidden costs. In addition, the growth of ETFs over the past two decades has been accompanied by a proliferation of securities that trade on secondary markets like ETFs, but whose investment objectives and attendant risks may be very different in reality.

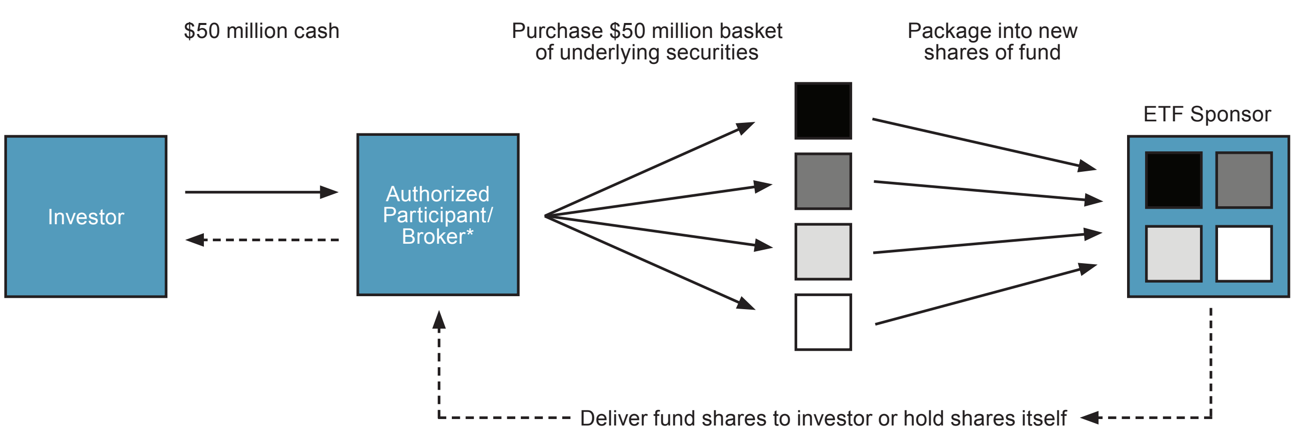
Traditional ETFs. The vast majority of ETFs are structured as either managed investment companies or UITs, both of which are RICs and regulated by the SEC under the Company Act. UITs are fairly rigid in structure, may hold only securities (no cash or derivatives), and must fully replicate a reference index by holding all its constituent securities in the correct proportion. A UIT will not re-invest dividends and may not engage in securities lending. Examples of ETFs structured as UITs are S&P Depository Receipts (SPDRs), Dow Jones Industrial Average Diamonds (DIA), and Nasdaq "Qubes" (QQQ). By contrast, a managed investment company is a bit more flexible, with the freedom to hold cash or employ enhanced strategies, re-invest dividends, and engage in securities lending. Examples of managed investment companies include iShares and various sector- or style-specific funds.

Before elaborating, it may be helpful to describe the creation process for traditional ETFs. ETFs are not created by the sponsoring bank or investment adviser, but by a go-between called an authorized participant (AP). APs are typically market makers or large institutions, and their role in this process is to purchase the individual securities that will be represented by an ETF and deliver them to the sponsor in large quantities called "creation units." The sponsor then delivers to the AP newly created shares of the ETF, which the AP either keeps or sells on the secondary market. APs can also sell large blocks of ETF shares back to the sponsor in exchange for the underlying securities (which other ETF investors *cannot* do).

This unusual setup has a number of implications for the ETFs' end consumer, most of them positive. For example, because of how transactions between the AP and sponsor are treated, this arrangement lowers taxes paid by the fund and thus reduces the expense ratio.

Another implication is that because they trade separately from their underlying securities, ETFs can trade at a discount or premium to NAV. The AP minimizes this valuation discrepancy by taking advantage of its unique position to

Creation of New Shares in an ETF



* Some but not all brokers are authorized participants. Brokers that are not authorized participants serve as a conduit between the investor and the authorized participant.

arbitrage between ETF shares and the underlying stocks or bonds. This arbitrage also helps alleviate downward pressure from short sales of an ETF, which are not subject to the "uptick rule."

However, during periods of extreme market stress, APs may choose to sit on the sidelines and inadvertently allow the gap to grow wider until the dust clears; this happened briefly during the "flash crash" of 2010. Investors forced to sell during these periods could therefore suffer from a temporary discount to NAV of their ETF shares on top of any decline in the value of underlying securities.

From a cost standpoint, ETFs may or may not offer an advantage over other vehicles. Most ETFs quote a lower expense ratio than a comparable commingled index fund, but since they trade on the secondary market, there are additional costs associated with buying and selling ETFs that have to be taken into account, including wider bid-ask spreads and higher commission costs. However, the relative cost/benefit will depend on the time horizon of the investment and other factors, and must be weighed on a case-by-case basis. For example, investors wanting to make a short-term tactical allocation will have to weigh the higher initial trading costs of using an ETF against any entry or exit fees charged by a commingled index fund provider, or against the cost of simply holding a basket of stocks. Moreover, higher commissions on ETFs may make dollar-cost averaging into a position cost prohibitive, as it becomes more expensive to transact frequently or in small amounts. For institutions willing to engage in securities lending, income from lending out ETFs can also offset any cost discrepancy between ETFs and other vehicles. ETFs in general have become a popular means for hedge funds to express short positions, and some ETFs in particular command a healthy lending premium.[8]

From an audit and accounting standpoint, because ETFs are publicly traded and their valuations are easily verified, they will likely fall into the Level 1 category for Topic 820 purposes. However, it is worth noting that some auditors still seem unsure of how to treat ETFs, and as ETFs continue to gain in popularity with institutional investors, auditors may feel compelled to look more closely at how they are valued in relation to their underlying securities.

Because most ETFs are structured as passive index funds, their underlying holdings will be well known. In addition, as of 2008 there are now some actively managed ETFs, and if anything, their transparency is superior to their passive counterparts. For active ETFs to receive an exemption from the Company Act of 1940 (which would otherwise prohibit their issuing shares under this structure), they must post all portfolio holdings to their website daily, as well as transaction details on a one-day lag.

While this is wonderful for investors that need such frequent reporting (e.g., hospitals), it also makes active ETFs vulnerable to front-running by competitors. Most active ETFs deal with this issue by trading infrequently, although this may constrain the manager's ability to add value through "active" management.

Grantor Trust ETFs. A third structure ETFs can employ is the grantor trust, although this form differs so much from managed investment companies and UITs that many authorities, including the Investment Company Institute, do not consider them ETFs. For one thing, grantor trusts are not RICs as defined by the Company

[8] Note that this is a separate issue from whether the ETF sponsor allows securities lending at the underlying security level, which is out of the investor's control.

Act. In addition, they hold a changeless basket of stocks or other securities—often of a type forbidden by the Company Act, such as gold or other commodities. Indeed, grantor trusts are often designed to offer investors access to illiquid or difficult to access markets, or to securities proscribed by the Company Act. Since the portfolio composition is static, expense ratios for grantor trusts tend to be lower than for other ETFs.

Leveraged ETFs. Perhaps a more critical distinction is the difference between the plain vanilla ETFs described above and the relatively recent development of leveraged and inverse-leveraged ETFs. These ETFs are designed to deliver a multiple of the long or short return of a given index. Beyond the obvious hazards of introducing leverage into the mix, leveraged ETFs introduce additional risks not posed by traditional ETFs, including counterparty risk due to the swaps and futures they use to affect the levered return of the target index.

An even greater risk is that leveraged ETFs are still somewhat poorly understood and may be misused as a result. It is dangerous to think of a 2 times levered ETF as offering twice the return of a given index over long periods of time; in reality, levered ETFs are designed for short-term investors, and thus most settle daily. This means that the daily compound return of a double-levered ETF over one year may be dramatically different from simply doubling the target index's return over the same period. In fact, in volatile markets it is not unlikely that a double-levered ETF can post a *loss* even if the underlying index posts a modest gain over several weeks. For example, over 2011 the S&P 500 Index posted a modest return of 2.1%. A 3 times levered ETF based on the S&P returned -14.9%, rather than the +6.3% return that the product's name would imply. Long-term investors need to understand these limitations and should probably seek to express secular market views in their portfolios through other means.

Other Exchange-Traded Products. Also important to note is the difference between ETFs and other exchange-traded "products," including ETNs and exchange-traded vehicles (ETVs). These are newer products that are often lumped into the same category as ETFs, but which may have very different risks associated with them.[9] Both ETNs and ETVs are debt securities issued either by an index provider or bank (in the case of an ETN), or by a special purpose vehicle (in the case of an ETV). Like other debt securities, they often have a specific maturity date, but unlike most debt securities, they do not provide current yield and typically offer no principal protection.

More critically, the return of an ETN or ETV is not designed to mimic a loan in the traditional sense; instead, it is more often tied to the performance of a particular index or class of securities. Indeed, ETNs and ETVs typically offer investors access to sectors or assets that would otherwise be too illiquid or impractical to achieve. This synthetic exposure is accomplished through swaps and other derivatives, which again introduces counterparty risk.

Commingled Funds (CTFs and CITs). Like their pooled cousins described above, commingled accounts offer many of the same benefits and pose some of the same problems as mutual funds. They gather assets from multiple investors, allowing for smaller investment minimums than separate accounts (though often higher than for mutual funds), and they aggregate accounting, custody, and other services in one place. Also, because of their pooled nature, they do not allow for individual investors to dictate strategy, the type of securities held, or whether the fund may engage in securities lending.

[9] The landscape for ETF investing is somewhat different in Europe, where the use of derivatives and leverage is more widespread. As this paper covers only U.S.-domiciled ETFs, investors should seek expert advice before investing in European-domiciled ETFs.

However, because they are *not* required to register under the Company Act at the fund level, and are not obligated by the OCC to incur the same advertising, compliance, and other costs, commingled accounts typically are able to offer lower fees than mutual funds. In addition, they do not have the same structural cash drag that open-end mutual funds have since they do not have to redeem shares as frequently. As a result, commingled accounts have fewer initial obstacles to performance relative to mutual funds.

That said, from the standpoint of performance, the decisions of fellow investors are more likely to impact investors in commingled funds than investors in mutual funds. The size of inflows to and outflows from commingled accounts can be substantially larger than for mutual funds relative to overall assets in the fund, and because commingled accounts do not maintain a structural cash balance to deal with redemptions, a few skittish investors trying to liquidate their investments in a period of high volatility could impact valuations in the fund.

From an accounting and audit standpoint, commingled funds may prove a little trickier than mutual funds. Shares in a commingled vehicle do not trade on a public market and are much more difficult to value at the fund level, so they are more likely to be classified as Level 2 assets for Topic 820 purposes, no matter how liquid or easy to value the underlying securities may be. In fact, because some commingled accounts have more restrictive redemption requirements than a comparable mutual fund, they *could* be classified as Level 3—which may be rare, but bears noting since a Level 3 (and even a Level 2) categorization carries with it not only greater scrutiny but a requirement for additional disclosures that, if nothing else, will certainly increase the administrative burden on investors.

Finally, for all the reasons stated above, some auditors have categorized commingled vehicles as "alternatives" regardless of the publicly traded, long-only nature of their holdings. None of these issues is likely to result in a qualified opinion or impact actual liquidity[10]; however, for those institutions without significant liquidity elsewhere in their portfolios or that rely on audit opinions to support bond ratings, it is imperative to understand how these holdings may be viewed by an auditor and how that may impact the institution as a whole.

Another important distinction between mutual funds and commingled accounts is that while mutual funds are priced daily and are required by the Company Act to report fund holdings and transactions semi-annually, many commingled accounts are priced only quarterly and are only required to provide a similar level of detail once a year. Again, for institutions that require a greater level of detail on realized or unrealized gains and losses, this frequency of reporting may create more difficulties than with mutual fund investments. However, in trying to remain competitive with mutual funds, many commingled account sponsors will provide that level of detail more frequently than required—and, since they have more flexibility, potentially more frequently than some mutual funds. Moreover, because commingled account sponsors have substantially fewer and usually much larger clients than most mutual funds, they may be more willing to provide that information—at least on an informal basis—to the relatively few clients that require it more frequently. However, these are questions that must be settled before an investment is made.

Separate Accounts. Investing in a separate account can eliminate many of the potential performance and reporting problems described

[10] For more information on how different vehicles might be treated under Topic 820, see our 2008 report *"Mark to Market" Accounting: An Endowment's Guide to the New Valuation (FAS 157).*

above, as well as offer a greater degree of control to investors. As the sole investor in a separate account, an institution can dictate the types of securities held, vote proxies directly, apply social or other screens, and decide whether to engage in securities lending. A separate account is also the only vehicle that affords investors the option of engaging in commission recapture or "soft dollar" arrangements, which can reduce the expenses associated with managing the account.[11]

In addition, because the investor's custodian or broker holds the individual stocks or bonds directly in the separate account, it is possible to transfer securities "in kind" into and out of the account without having to liquidate them or incur additional transaction costs. Since all transfers, purchases, and sales are tracked by the investor's custodian—as opposed to a fund administrator or the investment adviser—the custodian should be able to provide any level of transactional detail for any time period on demand. Moreover, because the securities are owned directly by the investor (as opposed to being held by a fund on behalf of the investor), most separate accounts will qualify as Level 1 assets under Topic 820, assuming the underlying securities are not thinly traded or in any other way difficult to value. Liquidity is excellent, with proceeds typically available three days after trade date.

However, it is important to note that in some instances, separate accounts may place a greater burden of fiduciary oversight on the investor. First, the investor must decide who will custody the securities in the account. Those investors that already have a relationship with a custody bank will often use their existing custodian for this purpose, but some managers may recommend using a particular broker or custody bank with which *they* have a relationship. We would typically advise against this, since part of the attraction of a separate account is that it keeps the management and custody functions separate, making fraud on the part of the manager more difficult.

Holding securities at a custody bank rather than a broker-dealer may also strengthen protection against fraud or failure. A custody bank segregates separate account assets from its own balance sheet, shielding client assets from the bank's creditors if the bank should fail. In contrast, a broker-dealer typically aggregates client assets under the broker's "street name," though in some instances a broker may be willing to segregate assets under the client's name. Both broker-dealers and custody banks offer some protection against outright fraud. Brokerage accounts are insured by the Securities Investor Protection Corporation (SIPC), which will replace lost securities up to $500,000 and up to $100,000 in cash, while both broker-dealers and custody banks will usually offer additional insurance covering up to $150 million in assets. Again, in the case of separate accounts, it falls to the investor to "read the fine print" to understand what protections of its assets any particular custodian offers.

Custody banks may offer more transparency than broker-dealers as well. While brokers tend to aggregate expenses—making it difficult to separate transaction costs and manager fees—a custody bank should be able to provide detailed transaction history as well as a breakdown of fees and expenses. Moreover, a custody bank usually allows investors to use a broker of their own choosing for all trades, whereas a broker-dealer may be hesitant to use third-party services.

Perhaps more critically from the standpoint of fiduciary oversight, separate accounts are typically not audited, which means that responsibility for valuation of the underlying securities may fall to the investor. Commingled vehicles, in contrast,

[11] See our 1998 report *Soft Dollars, Directed Brokerage and Related Trading Practices.*

are audited at the fund level, providing third-party assessment of valuation, custody, fees, and controls. "Observability" of valuations is important not only for categorizing assets as Level 1, 2, or 3 for fair value and reporting purposes, but also because it impacts performance and consequently the fees charged by the manager. A separate account investor must rely on data provided by its custodian to verify transaction costs and other expenses.

Nonetheless, separate accounts still offer several benefits over commingled vehicles. The trade-off, of course, is that the minimum investment for a separate account can be prohibitively high for smaller investors. Separate account minimums can range from $100,000 to $500 million, though most range between $5 million and $50 million, depending on the strategy.[12] Moreover, some investment strategies do not work well as separate accounts. Strategies centered on inefficient markets such as small-cap equities are much more cost effective to manage in pooled vehicles with larger absolute dollar amounts. When comparing the cost of a separate account to a similar commingled account or mutual fund, it is critical to include the cost of custody and any additional expenses not captured in the investment adviser's management fee for a fair comparison.

Limited Partnerships. Perhaps the *least* common investment vehicle for traditional, long-only equity and fixed income strategies is the limited partnership. Limited partnerships are typically employed by alternative investment managers as a way to avoid restrictions on leverage or short sales and, until recently, the requirement to register with the SEC. In the long-only world, though, a manager may decide to use the cheaper limited partnership structure as a way to get its business off the ground quickly. By comparison, starting a mutual fund from scratch would require meaningful capital investment in accounting, compliance, personnel, and other infrastructure—not to mention the critical mass of assets required to achieve a reasonable expense ratio. To offer a CTF or other commingled fund, a manager must be affiliated with a trust bank; in contrast, all a manager needs to get an investment strategy off the ground with a limited partnership is a legal structure, the bare minimum of personnel, and enough money to finance initial business expenses.

Among the potential disadvantages of a limited partnership structure from an investor's perspective are limited liquidity, less favorable accounting treatment, and little or no regulatory oversight at the fund level. Exit provisions from most limited partnerships are typically monthly, as opposed to daily or weekly for separate accounts or pooled vehicles. As a result, limited partnerships are almost certain to be classified as Level 2 or even Level 3 assets.

Despite these considerations, there may be good reasons to invest with a long-only manager through a limited partnership; however, the potential for headaches is greater than with most other investment structures. The level of conviction that the investment will add alpha to the portfolio should be accordingly higher.

Global ex U.S. Equity (Long Only)

Whereas the range of vehicles for U.S. equity investments is fairly narrow, the universe of global equity vehicles is a seemingly bottomless alphabet soup of SICAVs, OEICs, CCFs, and FCPs.[13] In theory, U.S. tax-exempt investors may invest in most of these offshore vehicles, but

[12] Minimums as low as $100,000 are occasionally offered by start-up firms that are willing to subsidize the cost of managing a separate account to attract new business.

[13] Because individual regions—and some individual countries—have their own forms of incorporation for investment funds, with variations for type and domicile of investor, the number of potential global equity vehicles quickly skyrockets. The vehicles listed here are a sample of various forms of pooled vehicles offered in Europe and the United Kingdom.

in practice, the costs will usually outweigh the few potential benefits. Indeed, practically the only reason a U.S. tax-exempt might consider investing in one of these vehicles would be to avoid unrelated business income tax (UBIT).[14] However, since most equity strategies employ little to no leverage—with the exception of REITs—UBIT is not normally a concern for long-only global equity investors. Moreover, investing in these offshore vehicles can subject tax-exempt investors to steep withholding taxes and other administrative costs.

In light of the above, we will focus our attention here on U.S.-domiciled global equity vehicles, which comprise essentially the same cast of characters as domestic equity vehicles: mutual funds, ETFs, commingled vehicles, separate accounts, and limited partnerships. Not surprisingly, most of the considerations outlined for the vehicles above apply to both domestic and international investors alike. There are, however, some important differences.

The first involves potential tax issues that may arise from investing in global ex U.S. equities via any pooled vehicle, regardless of the investor's tax status. Certain jurisdictions impose a capital gains tax on non-resident funds, the most notable of these being Australia and Spain in the developed world and Brazil and China in the emerging world. To the extent that a fund is composed solely of tax-exempt investors, it may be able to reclaim much of these taxes, but it is up to the manager to ensure this happens—which involves, among other things, gathering all the proper tax documentation from each of the fund's investors. Not all managers do this, however, so it is critical to understand how a manager handles these tax issues and how they may impact returns.

The structure of the vehicle may also influence the amount of tax a manager is able to reclaim. For example, a Delaware business trust may be taxed as a partnership in some jurisdictions and as a corporation in others, whereas a corporation may be taxed at the entity level across the board—with different implications for each.

A second, related difference is how recent tax and accounting rules—specifically, ASC 740—may impact performance in U.S.-domiciled funds investing in global equities. Among other things, ASC 740 requires funds to accrue tax liabilities to account for certain capital gains and dividend taxes. These accruals may or may not be paid out, and depending on the size of the accrual could impact NAV positively or negatively. Particularly if a fund has frequent entries and exits, there is the potential for some exiting investors to bear an accrued burden that is not paid and for some entering investors to get the benefit of a future reversal of the liability. Again, managers may have some tools at their disposal to limit these fluctuations, so it is important to understand how the manager handles these issues.

Another difference between domestic and global equity investing is the relative attractiveness of using separate accounts. As they do for domestic equity investors, separate accounts can offer global investors greater control and alleviate many of the potential challenges associated with pooled vehicles. Indeed, a separate account could eliminate the potential impact from tax accruals not incurred by the investor under ASC 740.
In addition, a separate account allows global equity investors to monitor and even exercise some control over certain costs, most importantly those associated with foreign exchange (FX) trades. In theory, a custodian should be able to provide separate account investors transparency

[14] UBIT is a tax designed to prevent nonprofit institutions from taking advantage of their tax-exempt status to compete with taxable businesses. Among the triggers of UBIT is the use of leverage, which is why most hedge funds will employ an offshore vehicle for tax-exempt investors. See our primer *Unrelated Business Income Tax (UBIT): An Introduction*.

into the cost of all FX trades, including a time stamp showing when the trade was executed, which allows the investor to assess whether the trade was executed at a fair price. In practice, not all custodians provide this level of detail, though transparency is improving. In contrast, investors in commingled trusts and mutual funds are reliant on the adviser to monitor the prices charged by the fund's custodian with little if any transparency. This issue has come to the fore recently as several large institutional investors have come under fire for lax monitoring of FX costs.

However, in global equity markets, a separate account has the potential to create additional challenges as well. To create a separate account for ex U.S. equities, an investor's custodian must set up individual custody accounts in each of the countries in which it intends to trade. Since each jurisdiction has separate tax treaties, laws, and regulatory systems, this can quickly become onerous from an administrative and cost standpoint, particularly when attempting to set up accounts in dozens of individual emerging markets.

Vehicles for U.S. and Global Long-Only Investments

Vehicle Type	Oversight	
	Manager Level	Fund Level
Mutual Fund	SEC - Investment Advisers Act of 1940	• SEC - Company Act, 1933 and 1934 Acts • Internal Board of Directors/Trustees • FINRA
ETF (Traditional)	SEC - Investment Advisers Act of 1940	• SEC - Company Act, 1933 and 1934 Acts • Internal Board of Directors/Trustees (except UITs) • FINRA
ETF (Grantor Trust)	May be none; may be required to register as a Commodity Trading Adviser	• SEC - 1933 and 1934 Acts • May also be required to register with CFTC • FINRA
ETF (Levered)	SEC - Investment Advisers Act of 1940	• SEC - Company Act, 1933 and 1934 Acts • FINRA has required broker-dealers to increase margin requirement for levered ETF investors
ETNs	May be none; may be required to register as a Commodity Trading Adviser	• SEC - 1933 and 1934 Acts • Regulated by CFTC (if using commodity futures) • FINRA
CTF - Common Trust Fund "Commingled Fund"	SEC - Investment Advisers Act of 1940	• OCC and/or other state or federal regulatory body • Exempt from SEC registration, typically by claiming 3(c)(3) exemption under the Company Act
CIT - Collective Investment Trust "Commingled Fund"	SEC - Investment Advisers Act of 1940	• OCC and/or other state or federal regulatory body • Exempt from SEC registration, typically by claiming 3(c)(11) exemption under the Company Act
Separate Account	SEC - Investment Advisers Act of 1940	Not applicable
Limited Partnership	SEC - Investment Advisers Act of 1940	• None • Exempt from SEC registration by claiming the 3(c)(1) or 3(c)(7) exemptions under the Company Act

Note: 1933 Act = Securities Act of 1933 • 1934 Act = Securities Exchange Act of 1934 • CFTC = Commodity Futures Trading Commission • Company Act = Investment Company Act of 1940 • FINRA = Financial Industry Regulatory Authority • OCC = Office of the Comptroller of the Currency

Because of the varying degree of liquidity and efficiency of various foreign markets, the most cost effective and simplest route is often to invest in global equities via some form of commingled vehicle. Of course, despite these challenges, separate accounts still offer improved transparency and control for global equity investors. For investors with sufficient scale or whose governance structure mandates a certain degree of control, the additional cost and effort may be well worth it.

Fixed Income

Many of the investment vehicle considerations described above apply as much to fixed income investors as to public equity investors. As with global equity investors, however, fixed income investors may find that a separate account creates as many problems as it solves.

The majority of fixed income strategies are either passive or attempt to closely track a particular benchmark, such as the Barclays Capital Aggregate Index. However, because most bond indices contain a vast number of securities, some

Vehicles for U.S. and Global Long-Only Investments

Vehicle Type	Typical Liquidity Characteristics and Auditing/Reporting Considerations	
	Liquidity	Auditing & Reporting Considerations
Mutual Fund	• Always daily • Cash typically available one day after settlement date; fund may not delay proceeds beyond seven days	Level 1
ETF (Traditional)	• Always intra-day • Trades like a stock with similar liquidity	Level 1
ETF (Grantor Trust)	• Always intra-day • Trades like a stock with similar liquidity	Level 1
ETF (Levered)	• Always intra-day • Trades like a stock with similar liquidity	Level 1
ETNs	• Institutional-size redemptions may be weekly	Most likely Level 1
CTF - Common Trust Fund "Commingled Fund"	• Varies considerably by manager and strategy • Most common: daily, weekly, semi-monthly • Sometimes: monthly	Typically Level 2, potentially Level 3
CIT - Collective Investment Trust "Commingled Fund"	• Varies considerably by manager and strategy • Most common: daily, weekly, semi-monthly • Sometimes: monthly	Typically Level 2, potentially Level 3
Separate Account	• Cash availability dependent on Investment Management Agreement • Commonly available within three days of settlement date • Some managers may require up to ten days' prior notice	• Commonly Level 1, may be Level 2 or Level 3 depending on liquidity or complexity of securities held • Investor may have responsibility for verifying valuation and monitoring of fees and expenses
Limited Partnership	• Most common: monthly • Sometimes: quarterly, semi-annually • Some funds may impose an initial lock-up, but this is less common than with hedge funds	Level 2 or Level 3

of which are not widely traded, it is essentially impossible for an investment manager to hold every bond in the index. The transaction costs of doing so would be prohibitively high.[15] Instead, most managers create a representative "sample" of the index, which needs to have a reasonable number of the component securities to decrease tracking error against the index. This means larger funds are generally more efficient, and a separate account for such a strategy would have to be disproportionately large—much larger than for most equity strategies. In fixed income, a pooled vehicle managing hundreds of millions or even billions of dollars is much more efficient.

Another potential drawback to separate accounts for passive fixed income investors is that the investment adviser will likely have to allocate odd lots to an individual account. Bonds are typically bought and sold in large blocks of $1 million or more. Unfortunately, most separate

[15] This applies principally to passive fixed income strategies, as active managers are much less concerned about replicating an index.

Vehicles for U.S. and Global Long-Only Investments

Vehicle Type and Eligibility	Important Considerations / Differentiating Factors Among Vehicles
Eligibility: Retail and Institutional Investors	
Mutual Fund	• Structural cash position may pose headwind to returns if not equitized • Reporting frequency/detail may be insufficient for some investors • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
ETF (Traditional)	• Dividends might not be reinvested • May have higher trading costs • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
ETF (Grantor Trust)	• Invests in a static basket of securities • Will not reinvest dividends (required to disburse them immediately) • May own commodities • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Certain expenses, including foreign exchange costs, will be less transparent • Unlike traditional ETFs, investors have voting rights in underlying companies
ETF (Levered)	• May not be appropriate for investors intending to hold for longer than one trading session • Will use swaps and futures, incurring counterparty risk • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Certain expenses, including foreign exchange costs, will be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
ETNs	• Not an "evergreen" investment; will have a maturity date • Will not provide current yield or offer principal protection • Lack of arbitrage mechanism means price may differ substantially from NAV • May use swaps and futures, incurring counterparty risk • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Concerns over proxy voting, securities lending, and social screens do not apply

accounts are too small for each issue in the portfolio to fit into nice, round blocks. Instead, the investment adviser often has to allocate blocks across separate accounts in odd lots ($460,000 here, $540,000 there). The problem is that when an investor decides to liquidate a passive bond portfolio, the adviser will likely have to offer the bonds at a discount to attract buyers that also usually like nice round lots, which may negatively impact performance.

Of course, separate accounts still offer the ability to dictate the type and quality of securities held, which for bond investors may be even more important than for equity investors. Unfortunately, most bond indices—and thus, most bond portfolios—have some exposure to callable, low-quality, or otherwise undesirable bonds that will do little to protect against an economic contraction or market volatility. Market-weighted indices by definition are biased toward the largest and most persistent debt issuers. Since bonds are often meant to play a

Vehicles for U.S. and Global Long-Only Investments

Vehicle Type and Eligibility	Important Considerations / Differentiating Factors Among Vehicles
Eligibility: Institutional Investors (see notes)	
CTF - Common Trust Fund[1] "Commingled Fund"	• Reporting frequency/detail may be insufficient for certain investors, but may be negotiable • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
CIT - Collective Investment Trust[2] "Commingled Fund"	• Reporting frequency/detail may be insufficient for certain investors, but may be negotiable • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
Separate Account[3]	• For some markets, including emerging and other global markets, separate accounts may be less efficient than a commingled vehicle in terms of trading volume, costs • If investing in non-U.S. securities, separate custody accounts may need to be established in each jurisdiction where securities are traded • May be less efficient for fixed income investors than pooled vehicle • To make a fair comparison to commingled vehicle fees, include account custody and other costs • Separate accounts may ameliorate problem of recapturing capital gains taxes imposed by certain foreign jurisdictions; pooled vehicles will differ in their ability to recover those taxes for tax-exempt investors • Should offer complete transparency into breakout of fees and expenses (via custodian) • Only vehicle that allows control over types of securities held, social screens, proxy voting, securities lending, commission recapture, currency hedging, and other elements
Limited Partnership[4]	• Reporting frequency/detail may be insufficient for certain investors, but may be negotiable • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending

[1] Typically held by personal trust accounts exempt from tax under Section 584 of the Internal Revenue Code.
[2] Available exclusively to ERISA investors and other qualified retirement plans exempt from tax under IRS Revenue Ruling 81-100.
[3] Minimum account sizes may be prohibitively high for some institutions.
[4] Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.

defensive role in the portfolio, being able to place restrictions on the quality, callability, and duration of the bond portfolio may be invaluable to institutions that rely on their fixed income portfolios to sustain spending when equities and other higher-risk markets are falling.

As is the case for global equity investors, investors that wish to establish a separate account for global bonds must take into consideration the additional costs of establishing sub-custody arrangements in each of the countries in which they are issued. The investor's domestic custodian should be able to assist with this. As with domestic bond investors, a commingled vehicle that already has these arrangements in place and that can allocate expenses across a larger pool of assets may be a more efficient path.

Unlike domestic bond and equity investors, however, U.S. investors in global fixed income may find offshore vehicles to be an attractive option. This is because some global bond managers may employ a sufficient amount of leverage to trigger UBIT. While the amount of UBIT generated may be minimal, investors must weigh the trade-offs between using an offshore vehicle (and whatever additional reporting or other hassles that may entail) and paying UBIT (including the additional filing cost).

Considerations in Selecting an Investment Vehicle: Alternative Assets

The phrase "alternative investment" is as broad as it is vague, encompassing not only all manner of hedge funds but also illiquid investments in private equity, venture capital, real estate, and oil & gas. However, despite the material differences between these strategies, vehicles for accessing alternative investments are generally structured in one of two ways—either as U.S. limited partnerships for onshore investors or as offshore corporations for non-U.S. and tax-exempt U.S. investors.

As a result, investors in alternative assets have fewer vehicle options and consequently fewer decisions than investors in traditional assets like equity and fixed income. Also, since most vehicles share the same structure, many of the same considerations apply across the board: with the exception of separate accounts, all will be relatively illiquid, all will be classified as Level 2 or even Level 3 for reporting purposes, all will have limited transparency, and, from an administrative point of view, all will require much more front-end due diligence and ongoing monitoring than other types of investments. We assume that most of these issues are familiar to investors that have made the decision to invest in alternative assets, so we will not elaborate on them in detail here.

Despite the relative uniformity of vehicles for alternative investments and the various issues that accompany them, there is still a small handful of choices to be made by investors—not least of which is whether to invest offshore or onshore—that can have a material impact on the eventual success of the investment, and are certainly worth understanding.

Hedge Funds

Investors in the hedge fund space typically use one of the following vehicles: limited partnerships, offshore vehicles, or separate accounts.

Limited Partnerships. The majority of hedge funds domiciled in the United States are structured as limited partnerships. In this limited liability structure, the liability of the limited partners (LPs) is "limited" to the amount they invest in the partnership, whereas the general partner (GP) (typically the manager or management company) has unlimited liability. From the standpoint of taxable investors at least—

including the GPs managing the fund—the limited partnership structure is preferable to that of a corporation in a high-tax environment like the United States because all tax considerations flow through to the individual partners rather than impacting the entity level, thus avoiding multiple layers of taxation.

Most limited partnerships are able to avoid registration under the Company Act by structuring the partnership as a private offering and limiting the number and type of investor. There are two exemptions in the Company Act that allow them to do this, and almost all limited partnerships are structured to take advantage of one of these:

- **3(c)(1) Limited Partnership.** Section 3(c)(1) of the Company Act allows a hedge fund to offer its services to 100 or fewer investors, who must typically be "accredited investors" as defined by that section. For institutional investors, an accredited investor is one with $5 million or more in total assets.
- **3(c)(7) Limited Partnership.** In 1997, Congress added section 3(c)(7) to the Company Act, expanding the number of potential LPs to 499,[16] all of whom must be "qualified purchasers." For institutional investors, a qualified purchaser is one with more than $25 million in investable assets.

From the LP's perspective, the primary difference between these structures is obviously the size threshold required to qualify for one or the other. Of course, a qualified purchaser may invest in either a 3(c)(1) or a 3(c)(7) fund, while an accredited investor may only use a 3(c)(1) fund. In theory, if a *qualified purchaser* faced "slotting" issues in accessing a given fund—if all 499 slots have already been filled—it could take a slot in an equivalent 3(c)(1) fund offered by the same manager. In reality, however, 3(c)(1) funds are becoming an endangered species as most managers would prefer to have five times as many clients with five times as much money. Some firms have closed or converted their existing 3(c)(1) funds, though many have simply opened parallel 3(c)(7) funds.

Offshore Vehicles. For tax-exempt U.S. investors, the primary objective of investing offshore is to avoid filing UBIT returns. Offshore vehicles are typically organized as corporations, which, because tax implications do *not* flow through to individual investors, serves to block UBIT from the standpoint of the individual investors. For that reason, it is usually taken for granted that tax-exempt investors should go into an offshore vehicle when investing in a strategy that might employ leverage.

Nonetheless, there are costs associated with offshore investing that may outweigh the benefits of avoiding UBIT. First, the amount of UBIT triggered by most strategies may not be enough to meaningfully impact returns. It is usually the administrative burden of *filing* UBIT returns—not the amount paid—that has historically led tax-exempt investors offshore. Second, because it can be more costly for managers to set up and run these vehicles, offshore funds may have higher expenses than their onshore counterparts.

Third, going offshore may create tax implications for nonprofit investors regardless of their tax-exempt status. Because offshore corporations are taxed at the entity level, they must pay a 30% withholding tax on dividends received from U.S. companies.[17] Offshore vehicles may also

[16] Section 3(c)(7) theoretically allows for an unlimited number of investors; the restriction to fewer than 500 investors is imposed to avoid registration under the Securities Exchange Act of 1934.

[17] Dividend withholding tax may vary depending on the tax treaty with each jurisdiction. For example, withholding on dividends for an offshore vehicle domiciled in Ireland and structured as a section 110 company would be only 15%. Depending on the amount received

be subject to additional corporate net profits tax and, if doing business in the United States, a branch profits tax. To avoid these latter, most hedge funds take advantage of a "safe harbor" rule allowing an investor to trade marketable securities in its own account. It is important to understand in advance what taxes an offshore strategy may be subject to and what impact that may have on returns.

Fourth, investors in offshore vehicles could also be subject to a whole host of filing requirements—although to date, tax-exempt investors have been excused from many of those requirements.[18] However, lawmakers and others are closely watching the trend of institutional investments in offshore vehicles, and it is not out of the realm of possibility that in the future, reporting requirements will be much stricter for all types of investors—particularly if we see another wave of Madoff-like fraud. It should also be noted that since administrators are often domiciled in other countries, additional documentation may have to be provided for anti-money laundering laws—a minor inconvenience, but nonprofit investors should be prepared. Also, if a fund does change administrators, each investor may have to provide the documentation all over again.

Finally, Senator Chuck Grassley has introduced legislation that could make it illegal for tax-exempt institutions receiving certain federal funds to invest offshore. For the time being, this restriction would be limited to institutions receiving funds under the Second Chance Act (a prison rehabilitation program), but Senator Grassley has made it clear that he would prefer any institution receiving public money of any kind to be barred from offshore investing.

While it is possible that future legislation may prohibit offshore investing (or make it more burdensome), it is also possible that it may make offshore investing irrelevant altogether. Michigan Representative Sander Levin has more than once introduced legislation that would exempt nonprofits from paying UBIT. While nothing has come of these efforts yet, such legislation would obviate the need for U.S. tax-exempt institutions to invest offshore. Whatever the future holds, institu-

in dividends, however, this tax may be minor and must be weighed against the potential savings from avoiding UBIT.

[18] Among the reports that offshore hedge fund investors are not currently required to file is the Foreign Bank Account Report (FBAR). However, tax-exempts are still subject to the 10% ownership of a foreign corporation rule: if an investor's commitment to an offshore hedge fund represents more than 10% of the offshore vehicle's total assets, then it must file a report to that effect with the SEC.

Vehicles for Hedge Funds

Vehicle Type	Oversight	
	Manager Level	Fund Level
Separate Account	SEC - Investment Advisers Act of 1940	Not applicable
Limited Partnership	SEC - Investment Advisers Act of 1940	• None • Exempt from SEC registration by claiming the 3(c)(1) or 3(c)(7) federal exemptions afforded under the Investment Company Act of 1940
Offshore Corporation	SEC - Investment Advisers Act of 1940	• None • Exempt from SEC registration by claiming the 3(c)(1) or 3(c)(7) federal exemptions afforded under the Investment Company Act of 1940

tions should consider the potential uncertainty surrounding future legal, tax, and compliance requirements of investing offshore when choosing between onshore and offshore vehicles. Investing in offshore vehicles is often the only way for tax-exempt institutions to gain access to hedge fund strategies without having to pay UBIT. Nonetheless, it is critical for those investors to understand that there are alternatives to offshore vehicles, and to weigh the choice between offshore and onshore carefully. For those institutions already set up to handle filing UBIT—or those willing to take on the burden—staying in the onshore vehicle could be a more attractive option.

Separate Accounts. Like separate accounts for equity or fixed income investments, separate hedge fund accounts can eliminate many of the fundamental drawbacks of investing in pooled vehicles—and given the lower transparency, reduced liquidity, and greater complexity of hedge fund strategies generally, those benefits may be even more critical than for equity or fixed income investments. A separate hedge fund account offers complete transparency and much better liquidity, and the fact that the assets are custodied separately in the investor's name reduces the potential for outright fraud and should provide investors and their auditors some additional measure of comfort.[19]

Unfortunately, the hurdle for commanding a separate account can be substantially greater for hedge funds than for traditional investments. First, the size of the minimum commitment required to make running a separately managed account worth the manager's time and effort can be substantially larger, typically around $50 million. Second, not all hedge fund managers will be willing to bother with a separate account for any investor at any size. This will often include the most desirable managers, which have no difficulty attracting capital.

Finally, even if an investor has the scale required for a separate account, the internal administra-

[19] It should be noted that part of the Dodd-Frank Act passed in 2010 requires that all hedge funds use accredited custodians or broker-dealers, which should also help alleviate fears of fraud to some degree.

Vehicles for Hedge Funds

Vehicle Type	Typical Liquidity Characteristics and Auditing/Reporting Considerations	
	Liquidity	Auditing & Reporting Considerations
Separate Account	• Cash availability dependent on Investment Management Agreement • Commonly available within three days of settlement date • Some managers may require ten or more days' prior notice	• Level 1, potentially Level 2 depending on observability of valuations for securities held • Investor may have responsibility for valuation verification and monitoring of fees and expenses
Limited Partnership	• Most common: monthly or quarterly after initial lock-up • Sometimes: semi-annually or annually • Many funds impose an initial lock-up period, typically ranging from one to three years	Level 2 or Level 3
Offshore Corporation	• Most common: monthly or quarterly after initial lock-up • Sometimes: semi-annually or annually • Many funds impose an initial lock-up period, typically ranging from one to three years	Level 2 or Level 3

tive requirements can be so burdensome that the benefits of added control may not be worth the effort—especially when multiplied across a presumed ten to 15 hedge fund managers in a diversified direct investment program. Investors that set up a separate hedge fund account must be willing in effect to insource many of the operational functions—if not investment functions—typically provided by the hedge fund manager, including establishing prime brokerage relationships, setting up ISDA agreements for swaps or other over-the-counter derivatives, managing collateral, and perhaps even setting up a separate accounting system. Using a separate account may also have some impact on performance if the manager is unable to aggregate trades.

As it is with global equity or fixed income investments, the appeal of a separate account for hedge fund investments may be limited to those institutions with vast scale and deep internal resources, or those whose governance restrictions would otherwise prohibit them from investing in hedge funds at all.

Private Investments

As noted above, vehicle structures for private investments—including real estate, private equity, oil & gas, and venture capital—are similar to those for hedge funds. For the most part, onshore vehicles will be structured as either 3(c)(1) or 3(c)(7) limited partnerships, and will be subject to all the considerations described above—except that funds are typically locked up for substantially longer than hedge fund investments. The principal difference among private investment strategies and the vehicles they

Vehicles for Hedge Funds

Vehicle Type and Eligibility	Important Considerations / Differentiating Factors Among Vehicles
Eligibility: Institutional Investors (see notes)	
Separate Account[1]	• Only vehicle that allows for some control over liquidity, leverage, social screens, securities lending, proxy voting, commission recapture, and other elements • Investment minimum may be prohibitively high for most investors • Can reduce or eliminate liquidity lock-ups • Creates large administrative burden for investor • Investor must negotiate ISDA, establish prime brokerage relationships, manage collateral, and potentially set up separate accounting system
Limited Partnership[2]	• Breakout of expenses may not be transparent • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • May face "slotting" issues (particularly 3(c)(1) structures) given limits on the number of investors allowed to qualify for exemption • Amount of investment from ERISA plans restricted to 25%
Offshore Corporation[3]	• Breakout of expenses may not be transparent • Investors may incur additional filing requirements • Uncertain regulatory future for tax-exempt investors • May be subject to higher taxes on U.S. dividends

[1] Available to institutional and large individual investors. Minimum account sizes may be prohibitively high for many institutions.
[2] Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.
[3] Typically restricted to non-U.S. and tax-exempt U.S. institutional investors only. Investors receiving federal funds may be prohibited from investing. Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.

employ is how they use different structures to avoid UBIT.

As in the hedge fund world, most private investment strategies rely on an offshore corporation to block UBIT—although, depending on the strategy, there may be additional options. Unfortunately, in contrast to the hedge fund world, the drawbacks of offshore investing may be higher in the private world. For instance, because private equity strategies do not invest in publicly traded securities, they cannot take advantage of the same safe harbor rule described earlier for hedge funds, which means they are more likely to be subject to branch profits tax if conducting business in the United States. Moreover, depending on how distributions are structured—i.e., whether they are outright sales of, or dividends from, portfolio companies—they may be subject to the same 30% withholding tax as offshore hedge fund vehicles, though given the relative size of these distributions, the impact may be even greater.

Private real estate investments face even greater hurdles for offshore investing.[20] Fortunately, however, real estate investors have an onshore option—the private REIT structure—that effectively blocks UBIT without the additional tax, reporting, or other obstacles associated with an offshore vehicle. Because a REIT is taxed at the entity level—similar to the corporate structure for

[20] For the purposes of the branch profits tax, private real estate investments will almost always use criteria for "doing business in the United States." Also, because of the substantial current yield from rents, the 30% withholding tax on dividends may have a greater impact than for marketable strategies.

Vehicles for Private Investments

Vehicle Type	Oversight	
	Manager Level	Fund Level
Limited Partnership (Private Equity)	SEC - Investment Advisers Act of 1940	None
Limited Partnership (Venture Capital)	None	None
Offshore Corporation	SEC - Investment Advisers Act of 1940	None

Vehicles for Private Investments

Vehicle Type	Typical Liquidity Characteristics and Auditing/Reporting Considerations	
	Liquidity	Auditing & Reporting Considerations
Limited Partnership (Private Equity)	Most common: ~ten years (excluding trades on secondary market)	Most common: Level 3
Limited Partnership (Venture Capital)	Most common: ~ten years (excluding trades on secondary market)	Most common: Level 3
Offshore Corporation	Most common: ~ten years (excluding trades on secondary market)	Most common: Level 3

most offshore vehicles—the implications of using leverage do not flow through to individual investors.

Most private investments will employ a substantial amount of leverage, so avoiding UBIT is an important consideration for nonprofit investors—especially because some tax-exempt investors can lose their tax-exempt status by generating any unrelated business taxable income.[21] Investors need to understand how these issues may impact performance, and carefully weigh the differences between investing offshore and remaining in a domestic vehicle.

[21] 501(c)(2) organizations can lose tax-exempt status if any amount of unrelated business taxable income is generated, while 501(c)(3) organizations may lose tax-exempt status if unrelated business taxable income constitutes a significant portion of its total revenue.

A Final Word on Fees: All Vehicles

Whatever vehicle is selected in the end, it is important for investors to understand exactly *what* is included in the fees they pay their managers. Too often, investors assume that the check they cut their manager includes all custody, accounting, and transaction costs, as well as compensation for active management. Instead, most managers charge a separate fee for active management, with all other costs taken out of the fund. Obviously, this creates a headwind to fund performance—particularly for high-turnover strategies—but because investors do not cut a separate check for these expenses, they tend not to think too much about them or include them in any assessment of the overall costs.

Vehicles for Private Investments

Vehicle Type and Eligibility	Important Considerations / Differentiating Factors Among Vehicles
Eligibility: Institutional Investors (see notes)	
Limited Partnership (Private Equity) [1]	• May face "slotting" issues, particularly 3(c)(1) structures, given limits on the number of investors allowed to qualify for exemption (though funds generally reach fund-raising targets before facing slot constraints) • May generate UBIT unless a "blocker structure" is put in place (i.e., private REIT structure for real estate investments) • Amount of investment from ERISA plans restricted to 25%
Limited Partnership (Venture Capital) [1]	• May face "slotting" issues, particularly 3(c)(1) structures, given limits on the number of investors allowed to qualify for exemption (though funds generally reach fund-raising targets before facing slot constraints)
Offshore Corporation [2]	• Investors may incur additional filing requirements • Uncertain regulatory future for tax-exempt investors • As private investment managers are unable to take advantage of safe harbor rules used by hedge funds, may be more likely to incur branch profits taxes if doing business in the United States • May be subject to 30% withholding tax on distributions

[1] Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.
[2] Typically restricted to non-U.S. and tax-exempt U.S. institutional investors only. Investors receiving federal funds may be prohibited from investing.

Other managers charge one inclusive fee out of which *they* pay all fund expenses and are compensated for their active management skill. Not surprisingly, these all-inclusive fees will often be higher than the stated management-only fees quoted by other managers, but can actually represent a significant cost savings in the end. This is because all-inclusive fees tend to align the manager's interests with the investor's by providing the manager with an incentive to seek best execution and keep costs low.

Nonetheless, all-inclusive fees can also create a misalignment of interests between manager and investor—especially in the case of securities lending. For managers that pay all costs out of their own pockets, there may be the temptation to defray some of those costs by engaging in securities lending and applying the revenue toward the cost of custody. This was the case in 2008, when some investors discovered that they had borne much of the risk of the securities lending program while the manager reaped most of the benefit.

Obviously, the apparent discrepancy between management-only and all-inclusive fees can lead to an unfair comparison between a manager with a seemingly low management fee but high operating costs that are passed on to the investor, and one with an apparently high fee but which effectively caps the investor's expenses. Particularly for high-turnover strategies in less efficient markets,[22] the all-inclusive fee arrangement can help keep costs down and make a meaningful impact on return. It is therefore well worth the effort for investors to understand the fee structure for all managers under consideration to make an apples-to-apples comparison on overall costs.

Finally, it is worth noting that some managers of commingled vehicles may subsidize administrative or custody expenses for a smaller fund in the hope that as the fund grows, those costs will come down closer to the level of the subsidy. It may be good to note when these temporary arrangements are in place, and monitor whether these costs should fall once the fund reaches a certain size.

Conclusion

The selection of an investment vehicle has historically played a secondary role to the more critical issues of asset allocation and manager selection. Yet this choice has the potential to influence all elements of an investment program, from liquidity to audit and accounting issues, and even investment performance. In the future, as markets become increasingly complex, fiduciaries come under greater pressure to demonstrate adequate oversight of their portfolios, and excess returns potentially become harder to achieve, the selection of an investment vehicle may become increasingly important.

As the investment landscape continues to shift, so too will the list of potential challenges posed by the choice of investment vehicle. Fiduciaries of endowed institutions—their trustees, their investment staff, and their consultants—must maintain a strong grasp of the potential impact of those decisions. They should be willing and prepared to explain the reasons for their choice of vehicle, and to ask the appropriate questions to avoid unwanted outcomes and ensure the success of the overall investment program. ■

[22] Some emerging markets in particular have high transaction costs, most notably India and Thailand.

List of Acronyms

AP	Authorized Participant
CIT	Collective Investment Trust
CTF	Common Trust Fund
DIA	Dow Jones Industrial Average Diamonds
ETF	Exchange-Traded Fund
ETN	Exchange-Traded Note
ETV	Exchange-Traded Vehicle
FBAR	Foreign Bank Account Report
FX	Foreign Exchange
GP	General Partner
LP	Limited Partner
NAV	Net Asset Value
OCC	Office of the Comptroller of the Currency
QQQ	Nasdaq "Qubes"
RIA	Registered Investment Adviser
RIC	Registered Investment Company
SAI	Statement of Additional Information
SEC	Securities and Exchange Commission
SIPC	Securities Investor Protection Corporation
SPDR	S&P Depository Receipt
UBIT	Unrelated Business Income Tax
UIT	Unit Investment Trust

Sample Questions to Ask Before Selecting an Investment Vehicle

All Vehicles

1. Does this vehicle engage in securities lending? Is there a non–securities lending vehicle or share class available in the same strategy?
2. Are dividends reinvested or distributed?
3. What are the valuation practices?
4. How will this vehicle be treated for reporting purposes (Topic 820)?
5. How often is detail provided on transactions, valuations, fees charged, realized and unrealized gains? Can more frequent reporting at a certain level of detail be negotiated?
6. Are expenses taken out of the fund, or from the management fee? Is it possible to receive a regular break out of fees and expenses?
7. Will this strategy trigger UBIT, and if so, is there a vehicle that will block it?
8. What kind of additional reporting or filing will this vehicle require on the investor's part (tax, compliance, financial disclosures)?
9. What are the entry and exit provisions of this fund? How soon will proceeds be distributed? Is there a holdback for audit purposes, and if so, how much?
10. Is it more efficient to invest in the commingled vehicle or a separate account? What are the trade-offs in cost?
11. Is the fund or adviser audited? By which firm?

Exchange-Traded Products

12. What is the bid-ask spread? Broker's commissions? Additional costs associated with this exchange-traded product?
13. What is the legal structure of this exchange-traded product, and how will it be perceived by auditors and other stakeholders?

Vehicles for Investing in Global ex U.S. Assets

14. What local taxes are incurred by this strategy? Is the manager able to reclaim taxes in this vehicle, and if so, how much?
15. Is it more efficient to invest in the commingled vehicle or a separate account? Does the efficiency offered by the commingled vehicle's economies of scale outweigh the greater flexibility of a separate account, or vice versa?
16. For separate accounts, what level of detail can the custodian or broker provide on trading costs, foreign exchange costs, fees, and other expenses?

Vehicles for Investing in Alternative Assets

17. What are the trade-offs between price and liquidity for different share classes? Are there any inefficiencies or additional cost considerations between share classes? Are any performance differences expected?
18. Is the amount of UBIT generated (and avoiding the administrative burden of filing a UBIT return) worth going offshore, or is the onshore vehicle more practical?
19. To what extent do any additional withholding or branch profits taxes impact returns?

Vehicles for U.S. and Global Long-Only Investments

Vehicle Type	Manager Level: Oversight	Fund Level: Oversight	Liquidity	Auditing & Reporting	Important Considerations / Differentiating Factors Among Vehicles
Eligibility: Retail and Institutional Investors					
Mutual Fund	SEC - Investment Advisers Act of 1940	• SEC - Company Act, 1933 and 1934 Acts • Internal Board of Directors/Trustees • FINRA	• Always daily • Cash typically available one day after settlement date; fund may not delay proceeds beyond seven days	Level 1	• Structural cash position may pose headwind to returns if not equitized • Reporting frequency/detail may be insufficient for some investors • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
ETF (Traditional)	SEC - Investment Advisers Act of 1940	• SEC - Company Act, 1933 and 1934 Acts • Internal Board of Directors/Trustees (except UITs) • FINRA	• Always intra-day • Trades like a stock with similar liquidity	Level 1	• Dividends might not be reinvested • May have higher trading costs • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
ETF (Grantor Trust)	May be none; may be required to register as a Commodity Trading Adviser	• SEC - 1933 and 1934 Acts • May also be required to register with CFTC • FINRA	• Always intra-day • Trades like a stock with similar liquidity	Level 1	• Invests in a static basket of securities • Will not reinvest dividends (required to disburse them immediately) • May own commodities • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Certain expenses, including foreign exchange costs, will be less transparent • Unlike traditional ETFs, investors have voting rights in underlying companies
ETF (Levered)	SEC - Investment Advisers Act of 1940	• SEC - Company Act, 1933 and 1934 Acts • FINRA has required broker-dealers to increase margin requirement for levered ETF investors	• Always intra-day • Trades like a stock with similar liquidity	Level 1	• May not be appropriate for investors intending to hold for longer than one trading session • Will use futures and swaps, incurring counterparty risk • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Certain expenses, including foreign exchange costs, will be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
ETNs	May be none; may be required to register as a Commodity Trading Adviser	• SEC - 1933 and 1934 Acts • Regulated by CFTC (if using commodity futures) • FINRA	• Institutional-size redemptions may be weekly	Most likely Level 1	• Not an "evergreen" investment; will have a maturity date • Will not provide current yield or offer principal protection • Lack of arbitrage mechanism means price may differ substantially from NAV • May use swaps and futures, incurring counterparty risk • To make a fair comparison to commingled vehicle fees, include account commissions and trading costs • Concerns over securities lending, social screens, and proxy voting do not apply

Note: 1933 Act = Securities Act of 1933, 1934 Act = Securities Exchange Act of 1934, CFTC = Commodity Futures Trading Commission, Company Act = Investment Company Act of 1940, FINRA = Financial Industry Regulatory Authority, and OCC = Office of the Comptroller of the Currency.

Vehicles for U.S. and Global Long-Only Investments (continued)

Eligibility: Institutional Investors (see notes)					
CTF - Common Trust Fund[1] "Commingled Fund"	SEC - Investment Advisers Act of 1940	• OCC and/or other state or federal regulatory body • Exempt from SEC registration, typically by claiming 3(c)(3) exemption under the Company Act	• Varies considerably by manager and strategy • Most common: daily, weekly, semi-monthly • Sometimes: monthly	Typically Level 2, potentially Level 3	• Reporting frequency/detail may be insufficient for certain investors, but may be negotiable • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
CIT - Collective Investment Trust [2] "Commingled Fund"	SEC - Investment Advisers Act of 1940	• OCC and/or other state or federal regulatory body • Exempt from SEC registration, typically by claiming 3(c)(11) exemption under the Company Act	• Varies considerably by manager and strategy • Most common: daily, weekly, semi-monthly • Sometimes: monthly	Typically Level 2, potentially Level 3	• Reporting frequency/detail may be insufficient for certain investors, but may be negotiable • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending
Separate Account[3]	SEC - Investment Advisers Act of 1940	Not applicable	• Cash availability dependent on Investment Management Agreement • Commonly available within three days of settlement date • Some managers may require up to ten days' prior notice	• Commonly Level 1, may be Level 2 or Level 3 depending on liquidity or complexity of securities held • Investor may have responsibility for verifying valuation and monitoring of fees and expenses	• For some markets, including emerging and other global markets, SA may be less efficient than a commingled vehicle in terms of trading volume, costs • If investing in non-U.S. securities, separate custody accounts may need to be established in each jurisdiction where securities are traded • May be less efficient for fixed income investors than pooled vehicle • To make a fair comparison to commingled vehicle fees, include account custody and other costs • SA may ameliorate problem of recapturing capital gains taxes imposed by certain foreign jurisdictions; pooled vehicles will differ in their ability to recover those taxes for tax-exempt investors • Should offer complete transparency into breakout of fees and expenses (via custodian) • Only vehicle that allows control over types of securities held, social screens, proxy voting, securities lending, commission recapture, currency hedging, and other elements
Limited Partnership[4]	SEC - Investment Advisers Act of 1940	• None • Exempt from SEC registration by claiming the 3(c)(1) or 3(c)(7) exemptions under the Company Act	• Most common: monthly • Sometimes: quarterly, semi-annually • Some funds may impose an initial lock-up, but this is less common than with hedge funds	Level 2 or Level 3	• Reporting frequency/detail may be insufficient for certain investors, but may be negotiable • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • Certain expenses, including foreign exchange costs, may be less transparent • Investor has no control over strategy, security restrictions, proxy voting, or securities lending

[1] Typically held by personal trust accounts exempt from tax under Section 584 of the Internal Revenue Code. [2] Available exclusively to ERISA investors and other qualified retirement plans exempt from tax under IRS Revenue Ruling 81-100. [3] Minimum account sizes may be prohibitively high for some institutions. [4] Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.

Vehicles for Hedge Funds

Vehicle Type	Eligibility	Manager Level: Oversight	Fund Level: Oversight	Liquidity	Auditing & Reporting	Important Considerations / Differentiating Factors Among Vehicles
Separate Account	Available to institutional and large individual investors. Minimum account sizes may be prohibitively high for many institutions.	SEC - Investment Advisers Act of 1940	Not applicable	• Cash availability dependent on Investment Management Agreement • Commonly available within three days of settlement date • Some managers may require up to ten days' prior notice	• Level 1, potentially Level 2 depending on observability of valuations for securities held • Investor may have responsibility for valuation verification and monitoring of fees & expenses	• Only vehicle that allows for some control over liquidity, leverage, social screens, securities lending, proxy voting, commission recapture, and other elements • Investment minimum may be prohibitively high for most investors • Can reduce or eliminate liquidity lock-ups • Creates large administrative burden for investor • Investor must negotiate ISDA, establish prime brokerage relationships, manage collateral, and potentially set up separate accounting system
Limited Partnership	Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.	SEC - Investment Advisers Act of 1940	• None • Exempt from SEC registration by claiming the 3(c)(1) or 3(c)(7) federal exemptions afforded under the Investment Company Act of 1940	• Most common: monthly or quarterly after initial lock-up • Sometimes: semi-annually or annually • Many funds impose an initial lock-up period, typically ranging from one to three years	Level 2 or Level 3	• Breakout of expenses may not be transparent • Not all managers reclaim taxes not owed by tax-exempt investors from various jurisdictions • May face "slotting" issues (particularly 3(c)(1) structures) given limits on the number of investors allowed to qualify for exemption • Amount of investment from ERISA plans restricted to 25%
Offshore Corporation	Typically restricted to non-U.S. and tax-exempt U.S. institutional investors only. Investors receiving federal funds may be prohibited from investing. Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.	SEC - Investment Advisers Act of 1940	• None • Exempt from SEC registration by claiming the 3(c)(1) or 3(c)(7) federal exemptions afforded under the Investment Company Act of 1940	• Most common: monthly or quarterly after initial lock-up • Sometimes: semi-annually or annually • Many funds impose an initial lock-up period, typically ranging from one to three years	Level 2 or Level 3	• Breakout of expenses may not be transparent • Investors may incur additional filing requirements • Uncertain regulatory future for tax-exempt investors • May be subject to higher taxes on U.S. dividends

Vehicles for Private Investments

Vehicle Type	Eligibility	Manager Level: Oversight	Fund Level: Oversight	Liquidity	Auditing & Reporting	Important Considerations / Differentiating Factors Among Vehicles
Limited Partnership (Private Equity)	Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.	SEC - Investment Advisers Act of 1940	None	Most common: ~ten years (excluding trades on secondary market)	Most common: Level 3	• May face "slotting" issues, particularly 3(c)(1) structures, given limits on the number of investors allowed to qualify for exemption (though funds generally reach fund-raising targets before facing slot constraints) • May generate UBIT unless a "blocker structure" is put in place (i.e., private REIT structure for real estate investments) • Amount of investment from ERISA plans restricted to 25%
Limited Partnership (Venture Capital)	Funds claiming a 3(c)(1) exemption are limited to 100 or fewer investors, who must typically be "Accredited Investors," with at least $5 million in assets. Funds claiming a 3(c)(7) exemption are limited to 499 or fewer investors (to be unlimited in assets), all of whom must be "Qualified Purchasers," with at least $25 million in assets.	None	None	Most common: ~ten years (excluding trades on secondary market)	Most common: Level 3	• May face "slotting" issues, particularly 3(c)(1) structures, given limits on the number of investors allowed to qualify for exemption (though funds generally reach fund-raising targets before facing slot constraints)
Offshore Corporation	Typically restricted to non-U.S. and tax-exempt U.S. institutional investors only. Investors receiving federal funds may be prohibited from investing.	SEC - Investment Advisers Act of 1940	None	Most common: ~10 years (excluding trades on secondary market)	Most common: Level 3	• Investors may incur additional filing requirements • Uncertain regulatory future for tax-exempt investors • As private investment managers are unable to take advantage of safe harbor rules used by hedge funds, may be more likely to incur branch profits taxes if doing business in the United States • May be subject to 30% withholding tax on distributions