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Hybrid Structures

Can a Capital On Call Funding Structure Fit the Hedge Fund Business Model?

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By Cara Griffith, *Hedge Fund Law Report*

For institutional investors in hedge funds, the most objectionable aspect of the recent crisis – even worse than the poor performance – was the evaporation of liquidity, the inability to get one's money back upon request. See, e.g., "How Can Hedge Fund of Funds Managers Manage a 'Liquidity Mismatch' Between Their Funds and Underlying Hedge Funds?," Hedge Fund Law Report, Vol. 2, No. 40 (Oct. 7, 2009); "Investors Demand More Specificity in Hedge Fund Governing Documents Regarding Circumstances in which Liquidity Management Tools may be Used," Hedge Fund Law Report, Vol. 2, No. 30 (Jul. 29, 2009). In the still-difficult fundraising environment following the crisis, hedge fund managers have been offering variations on the traditional hedge fund structure, all in the interest of accommodating investors' liquidity concerns and thereby growing or replenishing assets under management. See "Structuring Managed Accounts Key Focus of GlobeOp's 'Managed Accounts Insights for Investors' Event," Hedge Fund Law Report, Vol. 2, No. 39 (Oct. 1, 2009); "Steel Partners' Restructuring and Redemption Plan: Precedent or Anomaly?," Hedge Fund Law Report, Vol. 2, No. 34 (Aug. 27, 2009); "How Are Hedge Fund Managers with Funds Under their High Water Marks Renegotiating Performance Fees or Allocations?," Hedge Fund Law Report, Vol. 2, No. 33 (Aug. 19, 2009); "What Happens to High Water Marks When Managers Restructure Hedge Funds?," Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009).

One provocative alternative being explored by certain managers would involve importing the traditional "capital on call" funding approach of the private equity world into the hedge fund structure. According to sources polled by the Hedge Fund Law Report, this approach remains unprecedented. Nonetheless, in light of the heightened concern with liquidity on the part of hedge fund investors, any technique to enhance liquidity merits a serious look. Therefore, this article details the different funding mechanisms historically used by private equity and hedge funds, then explores the benefits and burdens to hedge funds of using a capital on call mechanism.

Private Equity versus Hedge Fund Funding Mechanisms

Private Equity Funding Mechanism

In a nutshell, private equity funds raise commitments of capital, then the managers of such funds "call" that committed capital on a deal-by-deal basis. So long as capital has not been called, it remains in the custody of the limited partners (though subject to a contractual obligation). Capital for investments generally is called during a private equity fund's "contribution period,"

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often the first three to five years of a private equity fund's life, while capital may be called for payment of management fees and operating expenses during the full term of the fund.

The manager of a private equity fund typically receives a management fee of 1.5 to 2.5 percent per year. During the commitment period, the management fee generally is calculated based on committed capital; after the commitment period, the management fee generally is calculated based on contributed capital (although there are many variations on this theme). See generally Stephanie Breslow & Phyllis Schwartz, *Private Equity Funds: Formation and Operation* (Practising Law Institute, 2009; First Edition)/

Private equity funds generally distribute investment proceeds (subject to a claw back) according to the terms of a "waterfall" provision that proceeds in steps. A typical waterfall provides for distributions in the following order, with respect to cash flows from a particular investment: (1) first, to the limited partners until they get a full return of all of their as yet unreturned called capital; (2) second, a preferred return to limited partners (often of six to eight percent); (3) third, a so-called "general partner catch-up," which could involve a full return to the general partner of its as yet unreturned called capital, or an 80-20 percent split between the general partner and the limited partners; and (4) fourth, a split of 80 percent to the limited partners and 20 percent to the general partner. See "Hedge Fund Managers Turn to Hybrid Fund Structures to Reconcile Fund Liquidity Terms and the Duration of Assets," Hedge Fund Law Report, Vol. 2, No. 5 (Feb. 4, 2009).

Hedge Fund Funding Mechanism

Jeffrey A. Saxton, Founder and Managing Member of Arsenal Investment Advisors LLC, noted that capital raised by hedge funds generally is handed over to the manager's custody on day one. Mechanically, the money may actually go to an administrator or prime broker, but practically, the hedge fund manager can invest the money as soon as the check clears.

These different funding mechanisms reflect the generally different investment techniques employed by hedge and private equity funds. Private equity funds generally take control positions in a relative small number of companies in any given fund. While it is difficult to generalize with respect to hedge fund investment strategies, on average, hedge funds make more investments than private equity funds, often in minority positions. (However, in many cases, the line between hedge and private equity funds is blurring. See "Financial Crisis to Slow Convergence of Hedge Funds and Private Equity Funds, But Not for Long," Hedge Fund Law Report, Vol. 2, No. 9 (Mar. 4, 2009); "Secondary Buyers of Private Equity Fund Interests are Looking at Assets in Hedge Fund Side Pockets," Hedge Fund Law Report, Vol. 2, No. 28 (Jul. 16, 2009).) Krassen Draganov, CEO of Netage Solutions, noted that hedge fund managers with strategies involving more frequent trades generally will deploy invested capital almost immediately, while managers that make fewer trades will often deposit invested capital with a prime broker or administrator pending its first use (and will treat proceeds of dispositions in like manner). For a while during the crisis, many prudent managers kept invested capital on the sidelines, which, combined with the real possibility of a prime broker insolvency, raised thorny questions about the safest way to store and manage cash. See "Why Do Hedge Funds Have So Much Dry Powder, and What Are They Doing to Keep It Safe?," Hedge Fund Law Report, Vol. 2, No. 20 (May 20, 2009).

Capital on Call for Hedge Funds?

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Given the different funding mechanisms and the rationales for the difference, can a private equity style capital on call mechanism viably be used by hedge funds? The idea has been mooted by lawyers, operations experts and others in the hedge and private equity fund worlds, but practitioners who spoke to the Hedge Fund Law Report could not identify a specific example in which a hedge fund has actually used a capital on call structure. Nonetheless, given the preeminence of liquidity on the issues list of most institutional investors, it is worth weighing the benefits and burdens of the approach.

Benefits to Hedge Funds of a Capital on Call Model

Investors Can Retain Capital

In theory, the capital on call model permits investors to retain capital for longer periods. According to Draganov, this could "reduce perceived risk in the eyes of the investor." In practice, that capital is encumbered because it can be called at any time and must remain in liquid form. It cannot, for example, be invested in another hedge fund.

Reduced Cash Management Burden and Improved Performance

In concept, a capital on call model can also reduce a hedge fund manager's cash management burden or its costs in connection with cash management. Similarly, it could improve performance by certain measures, at least in up markets, since the fund would only be in investments which presumably grow faster than cash. (However, in the recent down market, being largely cash saved many a portfolio from disastrously negative performance.)

The downside, though, is delayed access to cash. Most private equity funds give investors five to ten days from the date of notice to satisfy a capital call. Kevin Scanlan, a Partner with Dechert LLP, noted that for many hedge fund strategies, an opportunity would disappear well before five days elapsed.

Draganov noted that a manager might be able to work around this using a margin account, but conceded that a capital on call approach would not work for all types of hedge funds. In particular, those that use high frequency trading strategies would not be able to use a capital on call approach because of their need for immediate access to capital. See "Does Europe Offer a More Hospitable Regulatory Environment for High Frequency Trading Than Does the United States?," Hedge Fund Law Report, Vol. 2, No. 39 (Oct. 1, 2009); "What Are Flash Orders, and How Might Regulation Curtail the Ability of Hedge Funds Employing High-Frequency Trading Strategies to Profit from Such Orders?," Hedge Fund Law Report, Vol. 2, No. 32 (Aug. 12, 2009).

Burdens to Hedge Funds of a Capital on Call Model

Continuous Offering and Periodic Redemptions

Scanlan noted that while private equity funds have a ten to twelve year term, hedge funds generally have a perpetual term and continuously offer their interests. When an investor enters a private equity fund after the date of the initial closing, the investor generally is required to contribute its pro rata share of all prior capital calls, or to pay a specified interest rate on the amount of its initial capital contribution. The goal is to achieve fairness between first and

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subsequent close investors. With a hedge fund, this mechanism would be difficult to reconcile with the concept of a continuous offering and periodic redemption rights.

Capital Call Default

Steve Nadel, a Partner with Seward & Kissel LLP, said that another drawback is figuring out what to do if an investor defaults on a capital call. Private equity fund documents often empower the general partner or manager to impose onerous penalties on an investor that is unable to unwilling meet a capital call. For hedge funds that are using a capital on call feature to woo liquidity-conscious investors in difficult economic times, those remedies might be impracticable, Scanlan noted. They are present in fund documents, but managers would not viably be able to both use them and maintain relationships. (Of course, the same hesitancy afflicts private equity fund managers.)

Administrative Burden

Krassen also noted that operating with a capital on call system would increase the administrative burden on a hedge fund manager. It would require someone at the manager, for example, to keep track of commitments, capital call notices and investor responses to calls. It could also require the manager to spend time, legal and other resources on the delicate issue of how to respond to a default or threatened default. Additionally, the more moving parts exist within a hedge fund manager, the higher the cost and complexity. Complexity is out of fashion, Saxton noted, and adding a capital on call mechanism can add a level of complexity that can give investors pause.

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