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Side-by-Side Management

# Operational Conflicts Arising Out of Simultaneous Management of Hedge Funds and Private Equity Funds (Part Two of Three)

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The simultaneous management of hedge funds and private equity funds is rife with potential conflicts of interest, including issues relating to allocation of investment opportunities between the funds, possession of material nonpublic information, valuation and allocation of expenses. Conflicts of interest – and whether advisers have appropriately discharged their fiduciary duties to identify and eliminate or mitigate and disclose them – remain top enforcement priorities for the SEC and its Asset Management Unit. See “Regulators from the SEC, CFTC and New York Attorney General’s Office Reveal Top Hedge Fund Enforcement Priorities (Part One of Four),” Hedge Fund Law Report, Vol. 7, No. 45 (Dec. 4, 2014). Accordingly, especially in today’s regulatory environment, managers must be aware of and mitigate such conflicts of interest.

This article, the second in a three-part series, discusses operational conflicts arising out of simultaneous management of hedge funds and private equity funds, including conflicts involving the possession of material nonpublic information, valuation, allocation of expenses, personal trading and investors. The first article explored the structural considerations that give rise to potential conflicts; conflicts involving the investments held by each fund; and conflicts with the allocation of investment and disposition opportunities between affiliated hedge funds and private equity funds. The third article will address offshore concerns and ways to mitigate conflicts of interest. See also “Operational Conflicts Arising Out of Simultaneous Management of Hedge Funds and Alternative Mutual Funds Following the Same Strategy (Part Two of Three),” Hedge Fund Law Report, Vol. 8, No. 14 (Apr. 9, 2015).

## Operational Conflicts

### Possession of Material Nonpublic Information

Concerns over the possession of material nonpublic information (MNPI) and insider trading are very real. Managers need to try to envisage instances where one fund that has MNPI could share that information – even unintentionally – with the investment professionals of the other fund. For example, hedge funds and private equity funds may invest in different levels of the capital structure of the same company. The manager, through the investment in one level of the capital structure (such as the debt or loan) may receive MNPI which could lead to a conflict with respect to investments in the other level.

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"I think there is the potential here for a big concern," explained Terrance Reilly, of counsel at Montgomery McCracken Walker & Rhoads. "If one fund has board seats and gets information about things that are going on that aren't known to the general public, you would need to have walls and procedures in place at the investment advisory level to make sure that the inside company information does not get out. Technically, an investment adviser always has the duty not to trade on insider information, but it becomes more real when you're in a situation like this. It's important to keep the two sides separate and take the actions that are only in the best interest of each fund and its investors. Sharing information or trying to influence another fund to act in a certain way can lead to so much legal trouble."

"If you have private equity professionals that are entering into nondisclosure agreements and getting nonpublic information," Drew Chapman, a partner at King & Spalding, added, "there is clearly a compliance issue in terms of making sure that the information the private equity professionals receive doesn't get translated into information that goes into the hedge fund investment side of the business. That's a big concern that needs to be addressed. You can have walls or informational barriers designed to prevent this. Given insider trading topics, it's a major issue."

Jennifer Klass, a partner at Morgan, Lewis & Bockius, agreed, "MNPI is a serious concern, particularly where you have funds investing at different levels of the capital structure of a company." Klass then identified the following two approaches for dealing with potential MNPI issues:

- *Team Segregation:* Under this approach, the firm must "identify the different teams managing the different strategies and where they might come into possession of MNPI; wall off those people internally to ensure there is no sharing of MNPI that can taint the management; and then monitor and control that segregation very carefully."
- *Firm-Wide Restricted Lists*: "Rather than having internal walls between each team or strategy, the firm institutes a process where there are restricted trading lists of companies whenever a team receives MNPI of any kind. The entire firm would be restricted from trading in a certain issuer, including at different levels of the capital structure."

Klass clarified that the above two approaches are not mutually-exclusive. "Depending on the size of the firm and the control environment, the firm may take one approach or the other or a combination of the two."

## Valuation

According to Elizabeth Fries, a partner at Goodwin Proctor, "Valuation can be a conflict, particularly where the two funds invest in the same company, because your hedge fund is trying to value assets with a different valuation methodology and a different performance payment scheme. That creates the potential for conflicts."

## Allocation of Expenses

The allocation of expenses, such as investment expenses or due diligence costs, may also lead to potential conflicts where both funds are invested in the same company. Although it is vital for the manager to fairly allocate the expenses between the two funds, the actual allocation of expenses may be rather complicated in practice. For example, while a manager may simply prefer to allocate expenses pro rata between the two funds, the manager must consider if that is

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the proper methodology if a member of the manager's team travels to a portfolio company to conduct due diligence on a possible private equity target but ultimately only invests in that company from the manager's hedge fund.

"Expense allocations can create conflicts," noted Fries, "especially when you start dealing with questions of allocation of investment opportunities. For example, if the hedge fund side pocket co-invests with the private equity fund you have to worry about what happens with busted deal expenses. Does the hedge fund bear those costs up front, even if it's a busted deal?"

As Chapman noted, "Typically, both of those entities have their own people who do their own research and analysis. But, you have to also look at what goes into it. A private equity fund will have a different strategy and analysis than what a hedge fund does and tries to achieve. I think it will generally be separate, but where it's not, you have to look at what was done and by whom and make your decision based on that."

"The funds are generally coming from two different worlds in the due diligence and research they do on companies and investment opportunities," Chapman continued. "Stick to what your governing documents say you will be doing when it comes to allocating expenses. You don't want to get away from what you have told investors you'll be doing. That's something the SEC has really been focusing on – managers not following their own policies and procedures." See "Enforcement Action against Private Equity Fund Manager Highlights Five Aspects of the SEC's Thinking on Allocation of Expenses," Hedge Fund Law Report, Vol. 7, No. 36 (Sep. 25, 2014).

## Personal Trading

Typically, private equity funds have few restrictions on personal trading. However, hedge funds that are registered as investment advisers with the SEC are required by Rule 204A-1 under the Investment Advisers Act of 1940 to establish, maintain and enforce codes of ethics that include personal trading policies designed to detect and prevent fraud in connection with personal trading. For more on hedge fund personal trading policies, see "Key Legal and Operational Considerations for Hedge Fund Managers in Establishing, Maintaining and Enforcing Effective Personal Trading Policies and Procedures (Part One of Three)," Hedge Fund Law Report, Vol. 5, No. 3 (Jan. 19, 2012).

"You have regular conflicts around personal trading, gifts and entertainment," explained Fries. "Those don't really play out differently when you have the two different funds, but the policies may get altered a bit to deal with the differences in the two businesses. In a private equity firm, you might have a fair amount of personal trading; because the firm makes a limited number of private equity investments, the principals need to do something with the rest of their personal capital." Fries contrasted this with a hedge fund, where the principals' personal capital is more likely to be tied up in the fund.

"Hedge funds are less likely to permit a lot of personal trading," continued Fries, "whereas private equity more often permits it. When you bring the two businesses together in an 'all in' or integrated model, you have to figure out how personal trading can work, if at all. It's not a conflict between the two businesses, but it is a conflict in bringing the two businesses together. It really comes down to whether you have an information barrier and how it works."

## Investor Conflicts

Managers who manage private equity investments and hedge funds may use the hedge funds as a place to "park" client assets during periods when those assets are not deployed in private equity

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investments. Thus, the manager may have two potential conflicts in light of that practice: (1) managing the assets of the hedge fund in such a way to ensure that those client assets remain liquid and available to be deployed as soon as a suitable private equity investment is available; and (2) withdrawing those assets from the hedge fund when such a private equity investment opportunity arises.

Jedd Wider, a partner at Morgan, Lewis & Bockius, added, "There are terms and conditions that are unique to each type of fund product. For example, for investors, there are fairly unique terms and conditions that apply to hedge fund investors and to private equity fund investors." Noting that investments into private equity funds are fairly well-negotiated, Wider said, "It's certainly standard protocol for a private equity fund manager to be issuing side letter arrangements to their underlying investors or embedding those underlying provisions into the fund documents themselves so all investors have the benefits of those provisions. There are circumstances where certain investors do have the right to withdraw or be removed from an underlying fund vehicle or from particular investments for any number of reasons, for example due to specific investor restrictions, ERISA limitations or other regulatory concerns. Those investor-related considerations or conflicts need to be disclosed."

"On the hedge fund side," Wider continued, "liquidity can create inherent conflicts. To the extent that an underlying investor needs liquidity and seeks to redeem; an investor in a fund class has preferential liquidity rights and decides to redeem; or a fund requires liquidity that would necessitate the underlying sale of its investments or assets, an earlier partial disposition of a fund's holdings in a particular position could affect the rest of the fund's holdings in that position and the other investors indirectly. That's a real issue. Those conflicts and risks need to be disclosed in the offering documents."

Another potential conflict can arise with respect to the receipt of information about an underlying investment by the investors in one fund but not the other. However, the existence of such a conflict comes down to the business model chosen by the manager, argued Fries. "If you choose a segregated model – where there are walls to prevent the sharing of information – you really don't have investor issues, because they have a separate deal with the two sides of the house." Noting that the issue arises where a manager has an integrated business model or co-investment, Fries stated, "Where an investor in a side pocket or a hybrid fund receives information about a private equity-type investment and the private equity investors themselves may not necessarily get that information, you have to worry about the conflict there. It's typically not actionable. However, it's very complicated, since private equity funds consider investment information as highly confidential and sensitive. So, determining who will get what information up front is part of the consideration. It's manageable but it's definitely something you have to be ahead of."

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