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Co-Investments

Seward & Kissel Private Funds Forum Highlights Key Trends in Fund Structures (Part Two of Two)

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As hedge fund managers adapt to changes in the marketplace, they are employing special fund vehicles, such as pledge funds, activist funds and alternative mutual funds, in order to take advantage of special opportunities. During the recent Seward & Kissel Private Funds Forum, panelists discussed these and other hedge fund industry trends with respect to fund structuring and capital raising. This article, the second of a two-part series, explores how hedge fund managers are employing such fund structures and strategies. The first article highlighted current trends in seeding arrangements and fee terms, and examined the impact of ERISA and tax considerations on hedge fund structuring.

For additional insight from the firm, see "The First Steps to Take When Joining the Rush to Offer Registered Liquid Alternative Funds," Hedge Fund Law Report, Vol. 7, No. 42 (Nov. 6, 2014); and "Private Investment Funds Investing in CLO Equity and CLO Warehouse Facilities," Hedge Fund Law Report, Vol. 7, No. 18 (May 8, 2014).

Pledge Funds

Pledge funds (or co-investment funds) are used by managers to raise money for a specific investment opportunity, and can be thought of as "deal-by-deal funds," explained Seward & Kissel partner Christopher Riccardi. "The manager will present an opportunity to the investor and set up a fund just for that investment. The investors can do their own due diligence on the opportunity itself," said Riccardi.

"From the manager's perspective, it's another way to get additional capital, but they're also able to structure the fee and liquidity terms so that they are better correlated to the opportunity that exists," Riccardi continued. These structures are particularly attractive to certain institutional investors who may not be comfortable giving a large allocation to a co-mingled fund for a manager to invest on a blind pool basis.

However, all parties are forced to act rapidly when a compelling opportunity presents itself, noted Riccardi. "The manager has to quickly come up with the documents to send to investors, and investors will also have to act fast. Otherwise, the opportunity will pass." Despite this risk, Riccardi said that the establishment of pledge funds by managers has been increasing, along with investor requests for such funds.

Managers must also consider certain compliance issues before creating this type of structure. The greater the number of existing vehicles already under management, the more complexities may arise. For example, Riccardi pointed out that most favored nation (MFN) provisions may be impacted by these arrangements, and any investment allocation issues should also be taken into account. "You really need to consider how you're going to integrate these funds into your platform and how they will invest in relation to your other funds."

Tax Implications for Pledge Funds

Additionally, the chosen structure can have tax implications. "Hedge fund managers need to understand that pledge funds are structured much more like private equity funds," noted James Cofer, a partner at Seward & Kissel. "Instead of taking 20% of profits every year, the performance fee is usually structured as a waterfall. This means investors get their capital back first, and then the manager gets paid."

Cofer explained that the tax allocations work differently under a waterfall than with a traditional profit allocation structure. "They don't exactly follow the cash that's coming out of the vehicle but work on a target capital cap basis. What this means is that, if there is taxable income coming in every year, it has to be allocated to someone. Thus, 20% gets allocated to the manager, even though the manager isn't entitled to anything immediately because the initial cash is returned to the investors."

Cofer clarified that hedge fund managers used to structures where the cash flow roughly follows the tax may be thrown off by the tax treatment of pledge funds. "The way to ameliorate the tax consequences is to mandate that the manager will get a tax distribution every year to pay their taxes. There also may be a clawback if the manager is paid too much."

ERISA Consequences for Pledge Funds

The fund manager's fee structure in a pledge fund can also create issues with ERISA compliance. "The ERISA analysis is counter-intuitive," said Seward & Kissel partner John Ryan. "ERISA provides that if a manager can set the timing of its fee, it constitutes a prohibited transaction. In these types of arrangements, when the fee is paid on a realized only basis, the manager controls the timing of the sale and therefore controls the timing of the fee."

According to Ryan, however, there is a way to alleviate this problem. "If the fund is over the 25% ERISA threshold and subject to ERISA, we ensure that payment to the manager occurs on a fixed date, which is usually at the end of the partnership's term or upon its termination."

Activist Funds

In recent years, managers have expanded their investment practices to cover a greater range of activist strategies and sectors. "We have seen increasing interest from managers and allocators in more specialized strategies," observed Spiros Maliagros, president of Tiedemann Investment Group. David Mulle, a partner at Seward & Kissel, agreed. "The trend we're seeing with activism is simply 'up.' There are a greater number of activist campaigns, and they also tend to be bigger than a few years ago."

Activist funds may allow managers to pursue investment opportunities outside the scope of their other hedge funds, whether because of liquidity concerns, duration or specific restrictions in the investment mandate. According to Maliagros, activist funds can also provide managers with a longer-term capital base.

Activist funds similarly offer attractions for investors, particularly those with holdings in a manager's other funds. "From the allocators' perspective, these specialized strategies allow an investor to have a differentiated portfolio of investment opportunities. They also allow allocators to signal support for particular investment strategies and to have a broader, perhaps stronger, relationship with the manager," said Maliagros.

Mulle agreed that activist strategies are often viewed positively by allocators, citing investor demand as a key factor behind the rise in this type of fund. "One of the reasons for the trend is that investors are willing to put a lot more capital to work with managers who have plans for activist campaigns. Not surprisingly, we're seeing an increase in the broad range of activist strategies from M&A targeted strategies to campaigns focused on corporate governance," he observed. "One area where we've seen a particular increase is cash utilization."

"Post-2008, companies have been shoring up their balance sheets, and with corporate cash balances at all-time highs, you would expect investment managers to be focused on cash utilization," Maliagros agreed. "Companies are looking to either increase dividends, conduct share repurchases or participate in M&A opportunities. All of these options are company specific, based on a particular company's financial position, the state of its balance sheet, the willingness of the board to be creative and the opportunity that offers the best rate of return for shareholders. Investment managers can look to replace board members who are reluctant to listen to new ideas. Alternatively, they can employ 'silent activism' and work with the board, offering positive suggestions." Maliagros noted that managers are increasingly employing the silent activism strategy.

Hedge fund managers considering activist investing first need to consider their form of approach, noted Mulle. "One thing to think about when contemplating an activist campaign is whether you can get things done cooperatively with the company. It's expensive and time-consuming to carry out a proxy fight, and it's a huge drain on the company's resources. So, more managers are looking at working in the background with the company to implement changes," observed Mulle. "Although not particularly high profile, we've found that managers have had a lot of success working with company management in this way."

For managers wishing to develop an effective "soft" approach, "one of the most important things is thinking about the tone that you use with management early on, both in your private communications and any public statements you may make," advised Mulle. "You're trying to direct management toward the outcome you'd like them to achieve, but you want to at least give them the appearance of having different options available to them so they don't feel backed into a corner." He suggested that managers choosing to take a cooperative route should, however, ensure they leave other paths open in case a more adversarial approach is required in the future.

Maliagros provided additional insight with respect to factors that managers should consider when determining an activist approach. "When deciding what path to take for a successful activist campaign, you have to consider whether you have the internal corporate apparatus to manage the process, whether you can actually manage the operating company and what will resonate in the marketplace to effectuate the result you're looking for," he stated. "Sometimes publicly suggesting a path for a company to take is enough to effectuate that result." For more on activist investing, see "Structures and Characteristics of Activist Alternative Investment Funds," Hedge Fund Law Report, Vol. 8, No. 10 (Mar. 12, 2015).

Alternative Mutual Funds

Alternative mutual funds employ investment features traditionally only found in hedge funds, including the use of leverage, derivatives and short selling. In the U.S., such funds are governed by the Investment Company Act of 1940 and, as such, must meet a broad array of regulatory and compliance requirements. See "The First Steps to Take When Joining the Rush to Offer Registered Liquid Alternative Funds," Hedge Fund Law Report, Vol. 7, No. 42 (Nov. 6, 2014). For a general discussion of ways that hedge fund managers can enter the retail alternatives space, see "How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital (Part Two of Two)," Hedge Fund Law Report, Vol. 6, No. 6 (Feb. 7, 2013).

The launch of an alternative mutual fund can allow a hedge fund manager to expand and diversify its product offering and investor base. "Alternative mutual funds have really exploded in the last two or three years," noted Seward & Kissel partner Paul Miller.

"Before launching an alternative mutual fund, a manager needs to consider the investment restrictions and liquidity restrictions of these structures, to make sure their strategy is able to be ported into the mutual fund structure," he cautioned. "That said, the liquid alternatives space has grown dramatically and offers a new product and distribution platform for managers. If you can utilize the strategy, it gives you more diversification."

An alternative mutual fund's investments in illiquid assets are limited to 15% of its portfolio. Under SEC rules, a "liquid" asset is one that can be liquidated in the ordinary course within seven days. Similarly, the fund must be able to make any requested redemption payment within seven days. As Miller noted, "If your strategy is focused on holding 90% of the fund's assets in illiquid securities, that's not going to work in the liquid alternative context."

"Another consideration is the valuation component around your portfolio holdings," continued Miller, who noted that holdings in alternative mutual funds are required to be valued daily. Valuation can be a significant concern for funds that invest in "hard to value" assets, where prices are not readily available. Hedge funds managers are often given valuation discretion in such circumstances. With mutual funds, the board typically has the power to value investments for which market prices are not readily available. "You have to look to market quotations that are readily available for valuing the securities or holdings. If they're not available, you have to follow fair valuation strategies," said Miller.

An additional concern for managers launching alternative mutual funds is the risk of cannibalization of existing hedge fund products. To the extent a manager offers the same strategy through a mutual fund and a hedge fund, the fear is that that investors in the hedge fund may redeem their holdings and move over to the mutual fund, to avoid paying the hedge fund's higher fees. There are, however, various means to combat this risk. "Some managers are offering different versions of their strategies or taking the multi-manager approach, whereby investors can't get pure exposure to the manager because they are commingled with other managers," revealed Maliagros.

"Another option is a subset approach, where investors don't get exposure to the full portfolio and strategy. However, this adds to the portfolio management complexity," Maliagros continued. "It's difficult enough to run one portfolio, but when you add individual portfolio management decisions on sizing, exposure management and hedging of a separate portfolio, it's even more complicated," he cautioned.

Managers considering the launch of an alternative mutual fund product should also understand the distribution options, which differ from those used for the hedge fund model. With an alternative mutual fund, options include distribution by the manager itself and the use of distribution partners. Alternatively, managers may utilize a subadvisory model, subadvising either an entire fund or a sleeve of a multi-strategy fund.

For more on alternative mutual funds, see "FRA Liquid Alts 2015 Conference Highlights Due Diligence Concerns with Alternative Mutual Funds (Part Three of Three)," Hedge Fund Law Report, Vol. 8, No. 19 (May 14, 2015); and "Five Key Compliance Challenges for Alternative Mutual Funds: Valuation, Liquidity, Leverage, Disclosure and Director Oversight," Hedge Fund Law Report, Vol. 7, No. 28 (Jul. 24, 2014). See also our series on the Conflicts Arising Out of Simultaneous Management of Hedge Funds and Alternative Mutual Funds Following the Same Strategy: "Investment Allocation Conflicts," Vol. 8, No. 13 (Apr. 2, 2015); "Operational Conflicts," Vol. 8, No. 14 (Apr. 9, 2015); and "How to Mitigate Conflicts," Vol. 8, No. 15 (Apr. 16, 2015).

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