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Fund Structures

Annual Walkers Fundamentals Seminar Highlights Trends in Investor Sentiment, Governance, Side Letters, Fund Structures, Investment Vehicles and Restructurings

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While the hedge fund industry has generally rebounded from a dismal 2016 with improved performance and net inflows, not all hedge funds have benefitted equally. Investors continue to apply pressure on and shape how hedge fund managers structure their funds and negotiate with investors. A panel at the recent 10th annual Walkers Fundamentals Hedge Fund Seminar hosted by Walkers Global in New York City addressed, among other things, investor sentiment; developments and trends in the use of independent directors, side letters, fund structures and investment vehicles; and fund restructurings. Walkers partner Ashley Gunning introduced the panel, which featured partners Tim Buckley and Rolf Lindsay. This article summarizes the key points presented by the panelists.

For coverage of the Walkers Fundamentals Hedge Fund Seminar from prior years, see: 2016 Seminar; 2015 Seminar; 2014 Seminar; 2013 Seminar; 2012 Seminar; 2011 Seminar; and 2009 Seminar.

Investor Sentiment

In 2016, only one-third of hedge fund investors felt that hedge funds met or exceeded their expectations, Buckley said. Just one year later, about two-thirds of investors said they planned to maintain or increase their hedge fund allocations. As of the end of the third quarter of 2017, hedge funds recorded net inflows of $43.9 billion. In contrast, hedge funds experienced net outflows of over $100 billion in 2016.

Investor sentiment in the private equity space remains strong, Lindsay observed. In 2016, 95% of investors said they were satisfied with their private equity investments, and 97% said they were maintaining or increasing allocations. Private equity fund managers raised $580 billion in the first three quarters of 2017.

For other recent studies of investor sentiment, see "Survey Reveals Substantial Disconnect Between Actual and Desired Hedge Fund Fee Structures" (Aug. 3, 2017); and "Credit Suisse Investor Survey Finds Steady Demand for Hedge Funds and Growing Demand for Less-Liquid Products" (Apr. 13, 2017).

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Key Developments and Trends

Governance

Start-up managers remain "very much in favor" of including independent directors on their boards, Buckley said. In contrast, the use of independent directors in larger managers has stabilized and even dropped off this past year. Investors in large credit funds that started with three or four big investors, for example, have become comfortable with those managers and are less inclined to insist on having independent directors.

For further insights on hedge fund governance, see "CIMA Regulator Discusses Key Issues for Advisers That Manage Cayman Funds: AML, Fund Governance and the Cayman LLC (Part One of Two)" (Sep. 7, 2017); "Former General Counsel and Current Independent Director Discusses the Importance of Robust Fund Governance" (Dec. 8, 2016); and "Former Law Firm Partner and Current Independent Director Provides Perspective on Hedge Fund Governance Issues, Regulatory Matters and Allocator Concerns" (Oct. 27, 2016).

Side Letters

Side letters are ubiquitous in private equity, Lindsay said. Although hedge fund managers started to include a variety of fee and liquidity provisions in original fund documents, some are moving these provisions back into side letters.

Side letters typically include fee provisions; most favored nations provisions; and layers of additional reporting and transaction management requirements, Lindsay continued. Managers are faced with the challenge of negotiating, managing and applying complex side letters provisions over the life of a fund.

Both investors and the SEC are interested in how fund managers handle side letters, Buckley added. To assist with this, Walkers is developing tools that will facilitate the negotiation and management of side letters.

For more on side letters, see coverage of the recent HFLR and Seward & Kissel webinar:

"Key Side Letter Terms" (Nov. 16, 2017); and "Side Letter Trends" (Nov. 30, 2017). See also "Seward & Kissel Study Finds Reduced Fees and MFN Clauses Remain Most Prevalent Side Letter Terms" (Oct. 5, 2017).

Convergence

Hedge and private equity fund terms have begun to converge, Buckley explained. Previously, convergence was typically limited to either fee or liquidity provisions. Hedge funds and private equity funds, Lindsay observed, are increasingly borrowing each other's strategies.

See "Beyond the Master-Feeder: Managing Liquidity Demands in More Flexible Fund Structures" (May 25, 2017); and "How Can Liquid Hedge Funds Be Structured to Accommodate Investments in Illiquid Assets?" (Feb. 3, 2011).

Venture Capital Hedge Fund Platforms

Traditionally, venture capital has not been suitable for offshore fund platforms, Buckley noted, and was more commonly conducted through joint ventures and series financing. In 2017,

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however, Walkers established a number of offshore venture capital funds that incorporated both hedge fund and private equity fund concepts. See "Anatomy of a Private Equity Fund Startup" (Jun. 22, 2017).

These funds accept investors "in perpetuity," frequently on a monthly basis, Buckley continued. Investors commit capital, which is often paid up front but is sometimes drawn down as in a traditional private equity fund. New investors are not exposed to the fund's prior investments. Instead, their commitments are allocated among anywhere from 10 to 20 underlying venture capital investments.

Return of capital is done on a deal-by-deal basis, Buckley said. There is no need for private equity-style catchup provisions. As deals are exited, capital is returned to investors using hedge fund-like fee provisions. Once an investor's capital is fully allocated, the investor is not exposed to any other investment that the fund may make.

The same approach is being used for investments in certain stand-alone real assets, such as oil tankers or individual buildings, Lindsay added. Once this type of fund is set up and the investor base is identified, the manager allows the investors to decide whether to participate on a deal-by-deal basis. Thus, investors come and go depending on how long the manager holds the assets in which those investors chose to invest.

SPACs

"SPACs [special purpose acquisition companies] are back," proclaimed Lindsay, with a remarkable number of these companies formed in the last year. In his experience, over the past few years, investors have been "very keen" to negotiate co-investment rights, but they are often unwilling to participate in deals that go beyond a fund's typical capacity.

SPACs solve this problem by giving a fund moderate exposure to a project (*i.e.*, typically a 20-25% interest), with the rest of the necessary capital raised in the marketplace. As a result, managers are able to participate in large deals that they would not otherwise be able to manage. Managers can attract investors who may otherwise be unlikely to invest in, or receive exposure to, hedge funds.

In the 1990s, SPAC managers were more specific about what their investments would be, identifying specific strategies or industry sectors, Buckley added. Recent SPACs, however, are much more open-ended, similar to buyout funds.

Despite their re-emergence, there have not been significant inflows to SPACs. Nevertheless, because SPACs typically have two-year terms, the model may still become attractive and lead to substantial acquisitions. This is one area where market participants may think about innovative remuneration mechanisms.

See "Permanent Capital Structures Offer Managers Funding Stability and Access to Capital While Granting Investors Liquidity and Access to Managers" (Apr. 9, 2015).

Restructurings

There have been many recent hedge fund and private equity fund restructurings, Buckley observed. These are different from the restructurings in 2007-2009 that were brought about by economic crises. Recent restructurings have been driven by managers that wish to take advantage of positive market sentiment.

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See our two-part series on winding down funds: "How Managers Make the Decision and Communicate It to Investors and Service Providers" (Mar. 2, 2017); and "Navigating Illiquid Assets, Unanticipated Windfalls and Fees and Expenses During Liquidation" (Mar. 16, 2017).

Since the 2008 financial crisis, the Cayman Islands has introduced a merger statute that allows hedge fund managers to merge existing businesses into new fund structures, Lindsay explained. "The underlying assets simply move by operation of law into the new structure," and investors may choose either a cash buyout or shares in the restructured fund. See "Recent Cayman Islands Developments Impacting Fund Governance, Master Fund Registration and the Insolvency Regime: An Interview with Neal Lomax, Simon Dickson and Simon Thomas of Mourant Ozannes" (Jun. 8, 2012).

Some private equity fund managers who raised funds between 2003 and 2007 have been asking their limited partners to extend the duration of those funds, Buckley continued. A recovery in asset values and a strong secondary market has allowed managers to present their limited partners with a variety of options and deals. Those deals have "infinite levels of complexity and differentiation," Lindsay added. While many funds are similar at inception, there are dramatic variations among them after a decade.

A significant concern in a fund restructuring or extension is fulfilling the general partner's fiduciary duties, Buckley said, noting a fund's general partner might be both a buyer and a seller. It may have a fiduciary duty to the existing or exiting limited partners, but it must also satisfy its duties to incoming investors. These potential conflicts can be managed through appropriate disclosures and independent valuations. See "Barbash, Breslow and Rozenblit Discuss Hedge Fund Allocations, Restructurings and Advisory Boards" (Apr. 7, 2016); and "SEC Charges Hedge Fund Manager and Its Principals with Defrauding Investors in Connection With an Undisclosed Restructuring of Feeder Funds to Favor Largest Investor" (Mar. 7, 2013).

Pending legislation in the Cayman Islands will make partnerships more flexible and restructuring transactions "even easier than they currently are," Lindsay noted.

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