Hedge Fund Law Report
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Fund Structures

Interest in Bespoke Fund Structures Surges As Markets Adjust to New Administration and Regulatory Regime

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A little more than a year into the Trump administration, the private funds market displays growing levels of innovation and experimentation. Fund managers are increasingly opting to employ bespoke fund structures, such as first loss capital arrangements, each of which has its own unique set of advantages as well as potentially catastrophic liabilities. Lawyers advising fund managers must command more varied and granular knowledge of different fund structures than ever before if they hope to remain competitive.

Recent changes at the regulatory level – including the newly effective revisions to Form ADV; a heightened regulatory focus on blockchain and the fiduciary responsibilities of legal professionals providing related advice; and a growing emphasis on individual liability, particularly with respect to chief compliance officers (CCOs) – add to the environment's complexity and may sometimes appear contrary to the administration's pro-business rhetoric. These factors and trends make the 2018 private funds environment drastically different from that under the previous administration, raising exhilarating and daunting possibilities for fund managers.

To help readers understand the unique benefits and potential drawbacks of some of the more popular bespoke fund structures, the Hedge Fund Law Report recently interviewed Peter Bilfield, partner at Day Pitney with experience in this area. This article presents his thoughts.

For further commentary from Bilfield, see "What Do the Investor Advisory Committee's Recommendations Mean for the Future of Marketing of Hedge Funds to Natural Persons?" (Oct. 24, 2014); and "Investments by Family Offices in Hedge Funds Through Variable Insurance Policies: Tax-Advantaged Structures, Diversification and Investor Control Rules and Restructuring Strategies (Part One of Two)" (Apr. 1, 2011).

HFLR: What level of interest are you seeing in bespoke fund structures and vehicles?

Bilfield: We are seeing a lot of interest in funds of one, separately managed accounts, seed capital deals, first loss capital deals and founder class-type provisions.

[For more on seeding, see "Primary Legal and Business Considerations in Hedge Fund Seeding Arrangements" (Sep. 24, 2009). For more on founder classes, see "How Can Hedge Fund Managers Use Founder Share Classes to Raise and Retain Capital?" (Jul. 19, 2012).]

HFLR: Can you go into a bit more detail about first loss capital deals and how they are typically structured?

Bilfield: An investment adviser that is looking to build a track record will go to a first loss provider to raise capital. The deal is typically structured as a managed account arrangement. The adviser, who usually serves as a sub-adviser to the first loss provider's fund, will manage the account and make a capital contribution as an investor (*i.e.*, as a special limited partner) in the first loss provider's fund. If the assets managed by the adviser depreciate in value, the first loss provider can debit the capital account of the adviser until it has recouped the loss.

Some argue that this provision is draconian. Conversely, the clients we have talked to who are considering these types of structures – who can be either new or previously existing managers – believe that they are useful in building a track record.

For those clients, we carefully review the termination provisions. The first loss capital structure may be viewed as a stepping stone for some advisers, not necessarily as an arrangement that those clients want to maintain in perpetuity. We also review the separately managed account agreement, the partnership agreement for the first loss provider and the subscription agreement (given that the adviser would be investing as a special limited partner in the first loss provider's fund).

[See "First Loss Capital Arrangements for Hedge Fund Managers: Structures, Risks and the Market for Key Terms" (Sep. 27, 2012).]

HFLR: What types of clients are most interested in these deals?

Bilfield: We often see interest from both U.S. and non-U.S. managers that are seeking capital from first loss providers in the U.S. These tend to be managers that are seeking to either reestablish a prior successful strategy or, alternatively, are seeking to enhance their existing strategies with additional assets.

HFLR: What are the potential pitfalls associated with first loss capital deals?

Bilfield: I think the glaring pitfall is that, because it is required to invest its own capital, the adviser must put its own money at risk.

In addition, the first loss provider also has significant rights over determining the amount of capital that will be allocated to the adviser's portfolio. If there is marked depreciation of the assets allocated to the adviser, the first loss provider has the right to make a corresponding reduction in the adviser's strategy. For example, if the sub-adviser is given $50 million to manage, and the sub-adviser's capital account declines from $5 million to $3 million, the first loss provider can reduce the size of the portfolio from $50 million to $25 million or $20 million.

Sub-advisers may also be required to re-invest their performance fees, if any, into the first loss provider's fund complex.

Nevertheless, these arrangements may be a very viable source of capital for a manager under particular circumstances. We carefully review the termination section of the contract, given that an adviser seeking first loss capital may find itself with additional capital opportunities on more favorable terms in the not so distant future. Consequently, it often makes sense to terminate the agreement when the adviser achieves a critical mass and has the track record that it needs. We also heavily negotiate the indemnity provision in the agreement.

HFLR: What issues typically arise when negotiating the indemnity provision?

Bilfield: It's a function of risk allocation: the first loss provider wants to be indemnified for claims from third-party actions, whereas the adviser, on the other hand, wants to ensure that it is not liable for third-party actions as long as it is fulfilling its duties while performing its services under the sub-advisory agreement and not committing gross negligence or willful misconduct.

We will also seek to, among other things, limit the adviser's liability for consequential, incidental and other special damages. The indemnity is sacrosanct to the adviser, and careful attention should be paid to negotiating its right to adequate indemnity protections.

HFLR: In what other bespoke structures or products are you seeing a lot of interest?

Bilfield: As mentioned above, we are seeing a lot of interest in funds of one. We have seen some non-U.S. managers who are looking to crystallize their track records or improve upon previous track records enter into these arrangements with key investors from prior funds they may have managed. The SEC has taken the view that a fund of one is considered a separately managed account, and further discussions are necessary to ensure those non-U.S. manager are either registered under the Investment Advisers Act of 1940 or will be eligible to utilize the foreign private advisers exemption.

Investors may favor these structures for a number of reasons, including because of their own internal operations. The structure allows an investor to create its own customized product. Even though the fund of one may be styled as a hedge fund strategy, it may incorporate private equity-like provisions such as capital commitments for drawdowns. Instead of a full upfront subscription into the fund of one, the investor may negotiate that its subscription is made over time to cover certain trading events.

[See "Schulte Partner Stephanie Breslow Addresses Gates, Side Pockets, Secondaries, Co-Investments, Redemption Suspensions, Funds of One and Fiduciary Duty (Part Two of Two)" (Dec. 11, 2014).]

We are also seeing a significant regulatory burden – administratively and with respect to compliance issues – on non-U.S. managers, particularly those that have retained prime brokers in Europe. The recast Markets in Financial Instruments Directive (commonly known as "MiFID II"), in particular, imposes considerable burdens. If managers are trading derivatives and negotiating ISDAs, they must provide significantly more documentation to those prime brokers.

[See "BakerHostetler Briefing Provides Regulatory Update: Insight on the SEC Under Chair Clayton, Examinations by OCIE and Implementation of MiFID II (Part One of Two)" (Jan. 11, 2018).]

HFLR: Is tax structuring a major part of your cross-border practice?

Bilfield: Absolutely. We often liaise with non-U.S. counsel (particularly in the Cayman Islands, Australia, the U.K. and Hong Kong) to create tax-efficient U.S. vehicles on a cross-border basis, not only for the investors but also for the sponsors of these funds.

[See "The Effect of 2017 Tax Developments on Advisers to Private Funds: New Partnership Audit Rules, Tax Reform, Blockers, Discounted Gifting, Fee Waivers and State Nexus Issues" (Nov. 30, 2017).]

HFLR: How has the revised Form ADV affected managed accounts?

Bilfield: A manager must now provide significantly more detail on its Form ADV. This has posed a challenge both for advisers that are managing private investment funds and for advisers with separately managed accounts. This results in a huge data-collection effort, and we have had to counsel our clients (both U.S. and non-U.S. managers) on the new reporting requirements mandated in new Form ADV.

In particular, umbrella registration can be quite complicated, especially for an adviser that does not have a principal office in the U.S. For those advisers that are SEC registered, they may need to assess whether they can rely on the participating affiliate designation in the Unibanco letters with respect to their non-U.S. affiliated entities. The SEC has recommended that advisers submit

certain representations and undertakings about their participating affiliates to ensure those advisers will be granted relief, consistent with the SEC's focus on monitoring the activities of non-U.S. personnel. We have also found that not all non-U.S. affiliates may qualify for the participating affiliate designation, which may require that affiliate to utilize a separate exemption or register separately with the SEC.

[See "The SEC's Recent Revisions to Form ADV and the Recordkeeping Rule: What Investment Advisers Need to Know About Managed Account Disclosure, Umbrella Registration and Outsourced CCOs (Part One of Two)" (Nov. 3, 2016). For more on the Unibanco letters, see "SEC Urges Advisers Relying Upon Unibanco No-Action Letters to Submit Certain Documentation" (Apr. 20, 2017).]

HFLR: To what extent has the Trump administration lived up to its pro-business and anti-regulation promises?

Bilfield: SEC Chair Jay Clayton has been very careful about what he has said to the press about deregulation. In response to the Dodd-Frank Act, many of the larger fund complexes already have systems in place to deal with the current reporting requirements, and the larger institutional investors that are investing in those fund complexes expect to receive this information. Thus, I don't think there is significant appetite to course correct on all regulations.

There has been some movement in the other direction, however. In January, there was a deregulation bill introduced in the Senate seeking to limit the banks that are considered "systemically important" – moving the threshold from $50 billion to $250 billion.

There has also been some discussion about the role of the Financial Stability Oversight Council (FSOC) in designating who among non-financial institutions is going to have a systemic effect on the stability of the markets. I think the administration is looking closely at whether the FSOC should continue to have that power.

[See "Pro-Business Environment of New Administration Continues to Have Challenges and Pitfalls for Private Funds" (Sep. 14, 2017).]

HFLR: Do you see an increased focus at the regulatory level on individual liability, and in particular, the liability of CCOs?

Bilfield: Regulators have historically taken action against CCOs. Thus, there certainly is precedent for those sorts of moves. Nevertheless, I don't think the current administration is looking to have an aggressive, prosecutorial stance like that of the prior administration unless there is significant evidence of wrongdoing on the part of the individual involved.

We should definitely pay attention, however, to Clayton's recent comments about cryptocurrencies, initial coin offerings and certain professionals' obligations in providing advice to clients that are engaging in those sorts of activities, such as in assessing whether a cryptocurrency asset is a security and therefore subject to the federal securities laws. This issue may have implications not only for CCOs, but also for third-party providers that may be subject to claims of liability, such as lawyers, accountants and other professionals.

[See "SEC Signals Aggressive Stance on Individual Responsibility, Including Potential CCO Liability, in FY 2017 Annual Report" (Dec. 14, 2017). For additional insight about the SEC stance on CCO liability, see "Commissioner Gallagher's Dissent in SEC Enforcement Action Against Hedge Fund Manager Misses the Mark" (Jul. 30, 2015); "SEC Commissioner Issues Statement Supporting Hedge Fund Manager Chief Compliance Officers" (Jul. 16, 2015); and "SEC Commissioner Speaks Out Against Trend Toward Strict Liability for Compliance Personnel" (Jun. 25, 2015).]

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