Ep. 07: Akin Gump Post-Funds Conference Report

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Jose Garriga: Hello and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga.

For more than a decade, one of the highlights of each autumn is the annual New York Private Investment Funds Conference sponsored and conducted by Akin Gump's investment management practice. Speakers drawn from the practice and the industry address the large audience assembled to brief them and offer their insights on trends and develops in the field over the year to date.

We have with us today Akin Gump partners Kelli Moll, who took the point in organizing the event, and practice co-head Stephen Vine. They'll discuss this year's conference, what topics were covered from the dais and what are the hot topics going into 2019.

Welcome to the podcast.

Kelli, Steve, thank you for appearing on the show today. As always, the conference featured a full agenda of interesting topics, so, can you please tell listeners, what were the main themes covered this year?

Kelli Moll: Well, as always, in designing the conference, we were looking at the broad spectrum of the alternative investment fund universe and want to cover topics that address both the hedge and private equity fund industry from a capital formation perspective, regulatory perspective, as well as tax issues. Steve's going to cover private equity trends in the marketplace, and I'm going to talk a little bit about the key overarching themes that are affecting the hedge fund industry.

Stephen Vine: Thanks Kelli. Our first panel in the main session covered some key issues that are mooted between sponsors and investors in private equity funds. What our panel covered are some of the key issues that are being debated in connection with fund investment, and some of the compromise solutions we are seeing in terms of how these issues are resolved.

One of the things that I think was noticeable is that the issues being discussed by investors and sponsors tend not to relate to the core economics. I think there are several reasons for that. First, I think it has to do with the fact that the industry is so robust at the moment—there is enormous demand for access to private equity funds. I think that has diminished the desire of sponsors to question basic terms and the influence of investors to try to change it.

I think a second factor is the maturity of the industry. I think we are really seeing the industry reach a point where the basic core terms have become widely accepted, both by sponsors and by investors. I think as a result of that, in some ways, the areas of focus have become narrower and relate to issues that are really peripheral to the main strategic and economic issues of the fund.

The other thing that, I think, came out of the panel is that the issues that are being focused on are not necessarily issues where sponsors and investors have adverse interests. In fact, a number of the issues are ones in which different investors have adverse interests to each other. For example, we talked about the expanding role of the limited partner advisory committee in being able to modify terms of the fund partnership agreement. That's an area where the investors who end up being on the advisory committee end up having more power than investors who are not on that committee. The issues really are ones where the sponsors are trying to find the right balance between the flexibility of a powerful advisory committee and making sure that all investors feel that the integrity of the deal terms will be respected throughout the life of the fund.

Another topic that's similar to that relates to the enhanced used of subscription line financing, and we'll talk more about that later. But that's another area where the interests of sponsor and investor are, to some extent, aligned, depending on the investor. I think what we saw from this panel is, what's happening on negotiation and private equity is really becoming more refined, and the areas of focus are becoming increasingly technical.

Kelli Moll: I was going to say, on the hedge fund side of the world, I think, it's a tale of two cities. Hedge funds have been struggling for a number of years. The recent *Wall Street Journal* article in September cites that 2018 is shaping up to close out 10 years of under-performance of the hedge fund industry against the S&P 500. With that backdrop, the industry is more challenged on capital formation, and the focus of the other main panel on stage was really what managers were doing to address those concerns. A lot of it, we found, is focused on product development, with two divergent trends taking place. One, managers looking at more liquid, long-only strategies to compete with traditional asset managers or other retail products from an asset-gathering perspective. This is both long-only equity as well as long-only credit and often management fee-only, oftentimes sub-1 percent.

On the opposite end of the spectrum, some managers are trying to increase their alpha by dipping their toe into more and more illiquid investments, borrowing from their private equity brethren and needing the tools in their fund document to address that. Some of that is through co-investment arrangements and co-investment structures, others is through the use of side pocket and slow pay mechanics to be able to provide for the additional illiquidity within the portfolio.

Lastly, unlike private equity, fees is a big focus in the hedge fund industry, with continued pressure in that area and a number of creative, discounted arrangements still taking place when managers are going out to seek capital.

Jose Garriga: Beyond then, the themes that were covered in the main program, what were some of the topics that were covered in the breakout sessions? I know that there were a lot of interesting and very much of-the-moment discussions being held there.

Kelli Moll: I'll start off. I think one of the key features of our private funds conference is our regulatory panels, and we run two regulatory panels back to back to cover trends in the industry. We typically focus on both the U.S. regulatory environment and Europe, particularly in the U.K. This year was really no different. What came out of it is a couple of things. From an enforcement perspective, the SEC has really turned its page from the "broken windows" enforcement policy to exercising more discretion, with the focus on retail investors as a main area as opposed to institutional investors, just like private fund managers. Do note that, from the U.S. regulatory side, we saw pay-to-play and Form PF sweeps in the past year, as well as cyber security continuing to be an area of focus.

On the U.K. side, it's very similar themes, looking at more retail-focused and wholesale investor issues. Market abuse continues to be a focus in the U.K., but in the U.K., these investigations are getting longer, more involved, more expensive, with bigger fines. So, a slightly different trend in terms of the way the examination process in the U.K., but the area of focus is very similar to what's going on in the U.S.

One other thing: Europe had two big regulatory developments that we also covered, which was privacy policies, with GDPR being implemented and that effect on U.S. managers, as well as MiFID II for those raising capital from European managed accounts.

Jose Garriga: Was there any discussion in all this of the potential impact of Brexit on the U.K. regulatory environment in this regard?

Kelli Moll: At this point, I think there's still a wait and see on Brexit that I think will be a focus for next year as those details finally come to fruition in terms of how managers, particularly those sitting in the U.K., deal with those issues.

Jose Garriga: What were some of the other topics, then, that were covered in the breakouts?

Stephen Vine: Let me pick up on another one we covered, which related to developments in financing of fund investments. We covered topics both relating to hedge funds and private equity funds. I think the development that we think has been the most significant and that we've spent a fair amount of time on relates to the use of subscription line financing by private equity funds. The basic product financing, which relies on investor capital commitment as a source of collateral, is not new. What's new is that, historically, these were used only for very short-term bridging purposes, so the sponsors didn't need to keep cash on hand in order to execute transactions. They could tap into the line, close a transaction and then call capital in a matter of days or weeks rather than, as I say, having to have cash on hand.

What's happened over the past year or so is these lines are now being used for much more extended periods of time. It's happening for two main reasons. One reason is that it helps smooth out the so-called J-curve, the mismatch between the heavy expenses that funds tends to incur in their early days prior to the time that they've made investments that then begin to generate returns and the fact that that depresses the IRRs [*internal rates of return*] in those early years. By not using investor capital in that early period, some of that impact is mitigated. That's one benefit. A related benefit is that, by not calling down the capital, the IRR is enhanced whether you're in the early stages or even in a later stage—that's just the way the investor-level arithmetic works. That can be beneficial both for investors and also for the sponsor, because the sponsor, in addition to being able to post more favorable returns, is also able to generate carried interest more quickly.

As a result of those benefits, we are seeing much more prevalent use of these lines for longer periods of time. Most investors, I think, are sympathetic to the reasons and generally in favor of it, particularly in a low-interest-rate environment. There are some investors who have concerns about it, both tax related and related to whether it properly aligns their incentives with the sponsor's incentives. But definitely a trend that we've been observing and we think is going to continue.

Jose Garriga: I know that there were a couple of other topics, going back to something I'd mentioned about stories of the moment, one of them being human resources, human capital issues, including the #MeToo movement, and, separately, panel on cryptocurrencies. Can you give us just a couple of takeaways from those in terms of what was covered and what conclusions might have been offered?

Kelli Moll: Sure. I'm going to start off on the cryptocurrency, since seems that seems to be the asset class flavor of the month. There's a rash of cryptocurrency funds. There are managers looking at cryptocurrency trades as something that they might want to add to their fund as an asset class. There's cryptocurrencies that both managers themselves want to invest in on a personal level or thinking from a compliance perspective on personal trading policies and procedures.

Cryptocurrency is a hard thing to define, and one of the things that the panel I think did really well is actually listing out a definition of the terms in the marketplace so that people have a plain-English definition of what these things are when you're starting to talk about mining, staking, master nodes. Because all of this eventually comes down to: What's the security regulatory analysis, and what's the tax implications for the investments? The panel went through whether something is a security, whether something is a commodity, whether it's neither, whether it can flip over, depending on where you are in the transaction. All of these factors take place when you're talking about this particular asset class.

They touched on valuation issues, problems with custodying cryptocurrency assets, what do you do if you're a manager where you are subject to the custody rule, personal trading policies, and, lastly, tax issues: How are these things treated from a tax perspective in terms of a property right? I think it was a very engaged panel really trying to provide some clarity, both on a regularity and tax perspective to this particular unique asset class.

Jose Garriga: I'm sure that was valuable for the audience. Just touching on, briefly, the panel that spoke on human capital issues, what could we say was the big takeaway there?

Stephen Vine: I think the big takeaways really are the fact that the issues that are affecting large employees in the economy generally are now front and center for hedge fund and private equity fund managers. It's really a sign of the size that those firms have taken on as the industry has matured, and as firms have increased in size and heft, they have become subject to greater scrutiny and have also reached a size where they are subject to employment laws that, in the past, they were small enough not to have to worry about. Our labor and employment practice group spends an enormous amount of time focusing on pay equity issues, discrimination issues, #MeToo issues, involving hedge fund and private equity fund managers. I think what we've seen over the past 12-18 months is that, although there has been some federal legislative presence, developments have mainly come from state and local governments, and they've been coming fast and furious. So, our labor and employment lawyers have spent a lot of time on education and just making sure that fund managers are aware of the latest pronouncements coming out of the state capitals and the local governments, particularly New York and California.

Jose Garriga: Thank you, Steve.

Kelli Moll: One follow-up to what Steve said, talking about the overlay of employment, we had as our last panel an arbitration panel really talking about use of arbitration clauses in a variety of contexts, including managed accounts, side letters, but also in the employment context. And #MeToo really is having an effect in terms of using arbitration in an employment context. An arbitration was intended to keep things out of the public light and keep things confidential. There's both New York law passed, which prohibits arbitration for sexual harassment cases, and proposed federal legislation covering the same, so, we really had an overlap of how #MeToo is not only affecting your policies and procedures but also the basic agreements you have governing your employee relationships.

Jose Garriga: Thank you. A reminder, listeners, that we're here today with Akin Gump investment management partners Kelli Moll and Stephen Vine discussing some of the themes and the takeaways from the practice's annual private investment funds conference.

Pulling back a bit and perhaps as a larger and overarching issue that may have been discussed at the conference: trade wars, Twitter wars, Fed rate hikes—there's a lot going on right now both in the news and in the marketplace. How have political and economic issues, the environment in general in the United States and globally, affected the funds market?

Kelli Moll: I think on the hedge fund side, there are a couple of things. On the public trading markets, they have continually gone up. This has made the environment for performance on the hedge fund side extremely challenging. I think managers are continuing to try to find an edge in the marketplace. One of the things we've seen as an outgrowth of that is more of an embrace of alternative or big data, which creates both issues on privacy, insider trading, quality and sourcing of the data, and a bunch of regulatory issues. In addition, really hiring different kinds of people into hedge funds, quantitative, analytical people to process and analyze data in a way that hasn't been done before, again, in order to provide an edge on trading.

I think the other thing you're going to see in the future and that we've heard more and more of is machine learning, and how is machine learning and AI going to affect the trading markets on a going-forward basis? Again, I think, how is that value going to get extracted out of the marketplace? And is traditional value investing going to be replaced by a lot of technology and quantitative tools?

Jose Garriga: Steve, what are you seeing on your end of it?

Stephen Vine: I think we've seen that private equity has benefited enormously in recent years from a low-interest rate-environment. We now seem to be trending upward over time. I expect that will have a depressive effect on private equity returns, and it remains to be seen whether that will push investors to other asset classes. But I think we will expect to see some movement away from core private equity as rates continue to rise.

Jose Garriga: Going into, certainly, the next few weeks at this point, we have mid-term elections in the United States, which may or may not have a discernible impact on the various markets you discussed. Beyond the elections, what are the hot topics that you see based on your own observation, based on what you may have heard at the conference and elsewhere, what are the hot topics going into 2019?

Kelli Moll: I think one of the hot topics, at least on the regulatory side, that we're keeping an eye out for 2019 is this proposed fiduciary rule that the SEC put out this year and whether or not it gets adopted. The rule really changes, I think, what most practitioners thought the fiduciary standards were. It will make it harder to deal with particular legal issues. It will change the standard of liability that managers are subject to. It will affect private contracts that specifically speak to federal fiduciary law, including side letters. I think it is a development that we're watching as the character of the interpretation of fiduciary standards evolve and change.

Stephen Vine: Another one that we're keeping an eye on relates to the recent legislation affecting review of foreign investment in key sectors of the economy. The legislation has just been enhanced with regulations to implement it, which came out within the past couple of weeks. Although the legislation and the regulations are primarily directed at trying to restrict piracy of U.S. technology by China, it potentially has much more far-reaching effect on foreign investment generally in broad sectors of the economy. As that legislation and regulatory regime comes into force beginning next year, we're keeping a close eye on whether that is going to tilt the scales in terms of foreign capital flows into the U.S. capital markets.

Jose Garriga: Thank you. It sounds like, well, it sounds like the conference, as always, has brought forward a fascinating menu of topics of discussion and consideration. Listeners, you've been listening to Akin Gump investment management partners Kelli Moll and Steve Vine. Thank you both for joining us today and for bringing us up to speed on what sounds to have been a fascinating and lively series of discussions.

And thank you, listeners, for your time and attention.

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Until next time.