The HEDGE FUND LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
www.hflawreport.com Volume 10, Number 21 May 25, 2017

HYBRID STRUCTURES

Beyond the Master-Feeder: Managing Liquidity Demands in More Flexible Fund Structures

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The private funds industry has been discussing the convergence of hedge and private equity funds for over a decade. The presence of "hybrid" fund vehicles, combining characteristics of both open- and closed-end funds, is nothing new. See "*Institutional Investor Forum Focuses on Hedge Fund Manager Fiduciary Duty, SEC Subpoena Power, Hybrid Hedge Fund Structures, Managed Account Platforms, Codes of Ethics and More*" (Feb. 4, 2010); and "*Can a Capital on Call Funding Structure Fit the Hedge Fund Business Model?*" (Nov. 5, 2009).

Creatively structured investment vehicles that address relevant investment objectives, or regulatory, tax or similar issues, are becoming increasingly common. As private fund managers struggle to outperform the market and meet investor demands for fee, liquidity and special terms that differentiate their rights vis-à-vis other investors, those managers will often need to look beyond the master-feeder structure that has served them well for quite some time.

Many managers of traditionally structured hedge funds with historically liquid portfolios are increasingly pursuing assets with longer investment horizons that, in the past, might have been housed in closed-end funds more common in private equity-style products. This article explores a number of tools that managers can use to effectively manage assets with different liquidity characteristics, while also addressing investor liquidity expectations.

Co-Investment Vehicles and Overflow Sidecars

Hedge fund managers may come across compelling investment opportunities but lack vehicles in which to house them. For example, a hedge fund's stated investment strategy, or explicit investment restrictions within the fund's governing documents, may prohibit a manager from pursuing certain illiquid investments. Because hedge fund investors typically have periodic redemption rights, sometimes after a lock-up period, the manager must actively monitor liquidity in its fund's portfolio to have cash available to satisfy investor redemption requests when they are exercised. While a manager may retain the right to suspend redemptions or use gates to manage a liquidity shortfall, advisers now need more tools at their disposal to accomplish liquidity management without resorting to preventing redemptions altogether.

One option to consider is a vehicle that invests alongside the manager's existing fund to serve as a venue for housing less liquid, yet nevertheless appealing, assets. This type of sidecar vehicle can also hold a portion of an investment that may not be appropriate for the main fund because of the main fund's primary investment strategy, concentration limits or other investment restrictions or liquidity-management needs. Using this type of vehicle also provides the manager with the marketing opportunity to offer co-investment opportunities alongside the main fund.

Using such a co-investment vehicle or sidecar presents a number of issues to be considered, including:

- how the manager will determine whether an investment is appropriate for the main fund vehicle, the side-car vehicle or both, and if appropriate for both, what the sharing ratio should be between the fund and sidecar;

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- whether the opportunity to participate in the sidecar vehicle will be offered to all investors in the main fund, only to a select group of investors or to a mix of existing fund investors and third parties not already in the main fund;
- whether the fund and the sidecar will enter and exit investment(s) on the same terms and at the same time; and
- how the sidecar will be structured.

As discussed below, there are fiduciary issues to be addressed when determining whether to allocate all or a portion of any investment opportunity to a side-car vehicle. Whether the opportunity to participate in a sidecar will be offered to some or all investors is likely more of an investor-relations issue than a regulatory concern, provided that the adviser and its affiliates are not given preferential access to investment opportunities that should be allocated to other clients and proper disclosure is given to investors about how those rights are granted. Likewise, the adviser will need to carefully disclose (and monitor from a fiduciary perspective) how the sidecar and any related or unrelated funds may or may not participate in any given investment on similar or different terms.

Structuring Options for Sidecars

Structuring any co-investment or sidecar vehicle involves some creativity and, naturally, depends on the number of investments expected to be pursued by the vehicle and the characteristics of the investors in the sidecar. A vehicle with a fixed number of investments in which all investors will share equally is obviously the simplest solution.

More managers, however, are beginning to use series vehicles (e.g., a Delaware series limited partnership) in which liability relating to specific assets can be isolated and tracked solely with respect to a particular group of investors. See "*Understanding the Benefits and Uses of Series LLCs for Hedge Fund Managers*" (Nov. 15, 2012). Because each series can accommodate a variable investor base, the manager is able to give investors the right to opt into or out of any investment opportunity allocated to the sidecar by creating a new series for each new investment. Naturally, the manager will need to give some thought to how much discretion will be given to investors about whether to participate in any proposed investment and whether participation by investors in the investment decision-making process could erode investors' limited liability protection, if such limitation is intended.

While vehicles designed with multiple classes or series with liability ring-fencing give advisers a good measure of flexibility with which to pursue multiple investment opportunities, they are not a perfect solution in every scenario. For example, while a Delaware series limited liability company is generally viewed as a reliable tool for isolating liability on a series-by-series basis, the effectiveness of that isolation is not clear in the context of a bankruptcy, and the tax treatment of the multiple series within that vehicle remains somewhat unclear.

The Next Generation of Hybrid Funds

Some advisers would rather house all investments in their main fund rather than create ancillary sidecar vehicles. As funds with historically liquid portfolios seek to invest in more illiquid assets, those funds need to incorporate mechanisms for monitoring liquidity needs in light of investor redemption requests. Assuming these funds continue to operate as open-end vehicles designed to permit periodic redemptions, managers will need to consider incorporating terms that treat the illiquid portion of the portfolio differently for liquidity purposes.

Some funds with side pocket capacity can accommodate a measure of illiquidity in their portfolios. Other funds may already utilize some sort of "fast-pay/slow-pay" mechanism that provides flexibility to pay redemption proceeds relating to illiquid assets at the time the assets are realized (and pay proceeds relating to the fund's liquid assets more quickly).

Funds can also offer multiple classes with different levels of exposure to the illiquid portion of the portfolio and similarly different redemption terms. Managers of

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these funds, however, need to be aware of the risk of cross-class liability unless a series vehicle, as discussed above, is utilized to isolate the liability associated with illiquid assets to the group of investors intended to benefit from those assets.

As more creative fund structures are adopted that go beyond the traditional master-feeder structure, some measure of investor education will be necessary. For example, when hedge funds venture into private equity-style illiquid investments (many not listed on an exchange or widely traded at all), the use of special purpose vehicles (SPVs) to address tax or regulatory concerns can become more important over time. While private equity investors may view the use of SPVs as commonplace and expect to see the manager given broad authority to utilize those SPVs, hedge fund investors may resist giving the manager unlimited flexibility in this regard. See "*Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools in Practising Law Institute Seminar*" (Nov. 15, 2012).

A hedge fund investor that understands the common master-feeder structure using Delaware and Cayman feeder entities into a Cayman master fund vehicle may not be comfortable granting the manager unfettered discretion to assign some portion of the investor's capital over to an as-yet-undetermined entity in an unspecified jurisdiction. Investors may require advance notice of the use of such SPV and representations from the manager or fund that the use of the SPV will not result in reporting obligations or adverse tax consequences for the investor. Therefore, striking a balance between unfettered discretion for the manager and the need for flexibility to efficiently invest in illiquid assets using SPVs will need to be carefully negotiated with investors after some diligence and discussion.

Life Boats and "Slices" – Dealing With Zombie Funds and Leftover Assets

As the pursuit of illiquid assets by open-end funds increases, so too will the possibility that assets cannot be disposed of in a timely manner, potentially resulting in a misalignment of investors' liquidity demands and a fund portfolio's life cycle. As the private funds industry learned during 2008 and 2009, funds now have an increasingly important need to include in their terms the flexibility to utilize mechanics designed to permit a slower disposition of assets to avoid a loss of realization value, which might occur from a "fire sale" of such assets.

The ability of an adviser to utilize a liquidating trust or similar vehicle could provide a means for protecting the value of an asset with a longer exit horizon. See "*Considerations When Winding Down Funds: Navigating Illiquid Assets, Unanticipated Windfalls and Fees and Expenses During Liquidation (Part Two of Two)*" (Mar. 16, 2017). Some liquidating vehicles hold one or a small number of related assets. Others provide investors with a "slice" of the fund's entire illiquid portfolio at the relevant redemption date.

The fund manager may or may not be appointed as the adviser of the liquidating vehicle depending on the nature of the assets and how much oversight is required for the realization of the relevant assets. If the assets will unwind by their own terms and portfolio-management expertise is not needed, a third-party trustee could monitor the process and direct distributions of cash that becomes available as assets are partially or finally realized. If the manager's expertise is required, however, investors may demand that the manager waive management fees relating to the liquidating vehicle from its inception or after a certain period of time. That being said, managers may be able to make the case that ongoing fees are fair in light of the complexity of the remaining assets.

A fund's governing documents must explicitly provide for the use of such a vehicle. During 2008 and the years that followed, some funds attempted to distribute interests in trusts or similar liquidating vehicles as a "distribution in kind" even though the terms governing such funds did not clearly provide for the use of such vehicles. To minimize the risk of investor dissatisfaction (and potential claims against the fund or manager), the fund and manager should proactively plan for the use of such a vehicle by providing investors with clear disclosure about the potential for its use.

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Platform Products or "Active Management"

Large institutional investors may approach a fund manager that offers multiple products with a request for a "platform-wide" investment, which would provide access to an array of products offered by the manager pursuant to an umbrella fee schedule. For example, the manager and investor may negotiate one master fee arrangement that will govern the investor's participation in numerous vehicles under a manager's umbrella. The investor may have the right to "re-allocate" its invested capital among the manager's products or investment strategies with various liquidity characteristics.

As discussed below, this may raise a number of compliance issues to be dealt with (e.g., allocations and cross trades). By utilizing some of the tools discussed previously, however, such as co-investment vehicles and entities that can appropriately manage liquid and illiquid assets simultaneously, a manager with a broad platform may be able to more effectively address such compliance concerns.

Adaptability of Service Providers

Service providers have had to adapt to serve hedge funds that incorporate terms mirroring those more commonly found in private equity-style vehicles. Fund advisers will need to ensure that their service providers are equipped to address the complications present in a hybrid fund structure. This may mean renegotiating agreements with these service providers or supplementing their services with those of third parties. For example, fund administrators to hedge-style vehicles are increasingly adjusting their internal systems and software to track vehicles with multiple classes of investors granted varying degrees of liquidity and exposure to different tranches of assets.

The valuation of fund assets has become increasingly complicated. When a hedge fund moves from investing in easily valued exchange-traded securities to more illiquid assets, which are typically more difficult to value, a fund administrator may not be in a position to value those assets, and a third-party valuation expert may be needed. See "*Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations*" (May 11, 2017).

Private fund managers will also need to work with their auditors to address tax issues that will arise from holding assets with varying investment horizons in the same portfolio. Managers will need to consider how to address different tax rates that may apply to short-term investments versus longer-horizon assets, which are taxed at rates applicable to long-term gains. Managers will also need to plan for tax liabilities that may arise from certain assets that have not yet distributed cash to the fund but nonetheless allocate income to the fund, which will accrue a related tax liability.

Compliance and Conflict Concerns – Cross Trades, Allocations and Valuation Issues

The SEC has become increasingly focused over the years on how registered advisers allocate investment opportunities between multiple vehicles, and this scrutiny is only likely to increase as advisers begin to use more complicated and creative fund structures. Likewise, any adviser to multiple vehicles investing in tandem will need to address the potential for cross trades and principal transactions. Any increased exposure to illiquid or esoteric assets not traded on an exchange or otherwise easily valued will require tailored valuation procedures, which may be new for a manager used to hedge-style products.

When private fund advisers incorporate into their funds terms that provide for the ability to use sidecars, liquidating SPVs and similar vehicles, those advisers will likely have a heightened responsibility to monitor potential conflicts of interest to ensure they are satisfying their fiduciary duties to their clients. In recent years, the SEC has signaled its interest in registered advisers' compliance procedures with respect to the use of co-investment vehicles. Therefore, it is prudent for advisers to clearly disclose to their investors the basis upon which co-investment opportunities are offered to investors, even if that policy is to promise no rights to

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any parties and reserve complete discretion for the adviser. In that case, the adviser would also be wise to have in place a robust but flexible written co-investment policy in its books and records.

For more on co-investment vehicles in the hedge fund context, see our three-part series: "*Pursue Illiquid Opportunities While Avoiding Style Drift*" (Feb. 21, 2014); "*Structuring Considerations and Material Terms*" (Feb. 28, 2014); and "*Fiduciary Duty Concerns, Conflicts and Regulatory Risks*" (Mar. 7, 2014).

Managers running multiple vehicles will also need to develop thoughtful allocation procedures that ensure each advisory client receives its fair share of any investment opportunity and allocations are made over time in a manner in the best interest of each such client. Factors that may influence allocation decisions include: the investment strategy of each client; capacity for the type of investment in question; long- and short-term liquidity needs; and any investment restrictions applicable to the client fund or account. See "*RCA Session Spotlights Risks With Investment Allocation, Trade Execution, Soft Dollars, Client Solicitation and Valuation*" (Apr. 14, 2016).

Likewise, providing advice to multiple accounts that give redemption rights to investors may necessitate periodic rebalancing and cross trades between those accounts if the adviser does not want to liquidate positions in a market transaction. The adviser should clearly disclose the potential for cross trades in a fund's governing documents and the adviser's Form ADV. If the adviser owns 25 percent or more of a vehicle participating in a rebalancing trade, it may be considered a "principal transaction" under Section 206 of the Investment Advisers Act of 1940, which would require consent of the client (or underlying investors) before the trade is consummated. See "*SEC Summary Judgment Emphasizes the Importance of Disclosure of and Client Consent to Cross Trades and Principal Transactions*" (Apr. 16, 2015).

Conclusion

As advisers to hedge funds seek new sources for profitable investment opportunities and pursue less liquid investments, those advisers and funds will likely benefit from more flexible fund structures and terms. That flexibility comes at a cost, including: increased complexity in the documentation, management and administration of the fund; time and effort involved in educating investors about the reasons for these new fund features and how they will be utilized; and additional compliance obligations to address potential scrutiny by the SEC. If designed and implemented properly, however, these more flexible fund structures can permit managers of traditionally liquid funds to incorporate less liquid assets with a potential to boost returns without abandoning a fund's core investment strategy.

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