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Recent Trends in Alternative Funds

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Introduction

The past year has been mixed for alternative funds. In the hedge fund space, industry assets under management increased by $70 billion to $3.22 trillion,[1] despite lackluster overall returns[2] and noisy withdrawals by certain institutional investors.[3] In the private equity space, industry assets under management grew 4.2% to $2.49 trillion,[4] and 897[5] new funds were launched.[6] Regulatory requirements and investor preference for established managers have increased barriers to entry in both sectors. Meanwhile, competition for investor capital has created a buyer's market with significant negotiation of fund terms.

Hedge Fund Trends

Current industry conditions are affecting how hedge fund sponsors raise capital and structure their funds. Seed capital providers can generate investor interest; however, the amount required to put a fund on the map and ensure sustainability has increased. Though there are many players in the seeding business, including certain family offices, there are comparatively few that are willing and able to inject capital sufficient to sustain a fledgling sponsor, and surrendering equity to a seeder who does not create a clear path to viability may be unattractive to a startup sponsor. To address this market reality, many funds have become less reliant on seed capital, and more reliant, instead, on creating flexible fund terms – especially for early "founding" investors and subsequent large investors.

The full-fee "2 and 20" compensation paradigm is no longer assured. Funds are often launched today with a reduced fee mechanism that is a foundational component of the product (distinguishable from the long-standing practice of offering lower fees selectively through side letter agreements). As referenced above, one such mechanism, the so-called "founders class," is often offered to early investors (either only at the initial closing or for a limited period of time thereafter). Unlike seed investors, holders of founders shares do not hold an equity stake in the sponsor. Founders may also be granted capacity rights. Many hedge funds also provide non-founders with a mechanism to reduce their fees. Lower management fee and incentive allocation rates may be triggered (on a single or tiered basis) if the fund's net asset value or an investor's subscription amount reaches a target (or series of targets). Lower fees may also be offered in exchange for longer lock-up periods.

The financial crisis and subsequent fundraising challenges have also had an effect on liquidity features of hedge funds. Previously ubiquitous fund-level gate mechanisms that contributed to substantial withdrawal requests during the crisis have been eclipsed by the investor-level gate (typically 20%-25%).[7] Side pockets are also far less common today than they once were, due to investor push-back.[8] New products use them rarely (with some exceptions in the distressed credit space), and some older funds have promised investors that existing mechanisms will not be used. As a result, hedge fund sponsors that want to provide investors with illiquid opportunities are moving toward offering co-investment vehicles and private equity funds rather than integrating illiquid investments into a hedge fund structure.

> COMPETITION FOR INVESTOR CAPITAL HAS CREATED A BUYER'S MARKET WITH SIGNIFICANT NEGOTIATION OF FUND TERMS

Private Equity Fund Trends

Private equity fund launches have been strong during the past few years, buoyed by strong performance.[9] However, this sector also faces pressures emerging from a shifting investment and regulatory environment and the evolving interests of investors. Investors continue to put pressure on private equity fund terms, including fees, expense allocations, transparency and governance rights. Some of the newer issues that have arisen include interest in environmental, social and governance (ESG) practices and concern about the impact of protectionist tax policies on investment strategies that involve expatriation. The trend toward using the "return of cost" (also known as "European" or "back-end-loaded") waterfall structure type instead of the "realized investment" (also known as "deal-by-deal

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with loss carryforward") waterfall structure type has continued to the point where the return-of-cost structure is the norm. Consistent with fee pressure (and some regulatory focus), transaction fee offsets are now typically 100%.

Secondaries

The secondary market for private equity fund interests has also become more active. Part of this market includes trading in interests in crisis-era special purpose vehicles (which were used to effect "synthetic side pockets"). Such baskets of assets that were once considered toxic are now of interest to a growing number of buyers. While the trading of interests in a sponsor's fund used to be regarded as a sign of a weak product, the stigma of secondary trading appears to have lessened as liquidity needs have grown in the private equity (and orphaned hedge fund assets) space.[10]

Hybrid and New Products

Certain investment strategies, particularly in the credit, distressed credit and activist areas, involve a mix of liquid and less liquid investments. Sponsors using these strategies can choose to pursue them through hedge, private equity or hybrid (or "private equity lite") structures, depending on the mix of liquid and less liquid assets in the portfolio, the expected timeline to realization on the assets, concentration and investor expectations. Customized terms are common to funds that invest in these areas.

Whether as a way to reach other investor bases, to capture alpha in a less saturated marketplace or to simply diversify their businesses, many fund sponsors are branching out into new, niche product lines. Institutions are showing an interest in offering multiple products, such as running funds of different strategies that are managed by different portfolio managers. Managed accounts or funds-of-one for institutional investors are common. New products gaining traction in the current market include capital manager vehicles (or CMVs, which are risk retention vehicles used to hold CLO equity for managers involved in CLO issuance), insurance-dedicated funds (for investment by insurance companies) and litigation financing funds. Activist strategies sometimes appear now in softer, less confrontational forms than they used to, resulting in less reputational risk for institutions. Of course, as the product offerings grow, so does the complexity of the sponsor's back office administration and its regulatory and compliance functions. Compensation challenges also emerge, as profit sharing at the silo level, rather than the enterprise level, may be demanded by individual managers, which might not be contemplated by the firm's existing allocation structure.

US Regulatory Developments

In the United States, there remains great uncertainty around the future of market regulation generally and tax policy. Though markets have generally responded favorably to the new conservative agenda, uncertainty remains, especially in the banking and healthcare sectors, areas where the Trump administration has promised change. On the tax front, the Trump administration has promised to end the so-called "carried interest loophole" and has proposed to end the deductibility of debt interest expense. However, the extent and timing of tax and regulatory reform remains unclear.

EU Regulatory Developments

The revised EU Markets in Financial Instruments Directive (MiFID II) framework is likely to dominate the compliance agenda of European managers in 2017. MiFID II, due to take effect in January 2018, will bring sweeping changes to the EU market infrastructure. Among its many reforms are the new pre- and post-trade transparency obligations, which are likely to impact the availability of dark pools in Europe and trading in fixed-income securities. Another key reform is, for the first time, a regulatory framework for a European consolidated tape.

MiFID II will also bring in new obligations for European investment managers. Some of the key reforms include a ban on soft dollar arrangements, requirements to publish information on best execution arrangements, telephone taping rules, changes to trade reporting obligations (that is, printing to tape) and enhanced regulatory reporting of transactions.

MiFID II reforms are also expected to impact non-EU managers. From 2018, it may become more difficult for non-EU firms to offer managed account services to clients in certain EU jurisdictions. Non-EU managers that access European trading venues will find that their brokers are imposing additional compliance and organizational requirements as a condition for providing direct electronic access. The commission unbundling rules will mean that any broker-dealers that provide research and corporate access to European managers will be required to receive hard dollars for research or be paid through a so-called research payment account allowing for research payments to be collected alongside commissions (but always as a distinct charge).

1 See *2017 Preqin Global Hedge Fund Report.*

2 Hedge funds underperformed the S&P500 index by 6.2% in 2016. See Tyler Durden, *How Hedge Funds Closed Out 2016, And Why Hopes For A 2017 Rebound May Disappoint* (Jan. 1, 2017), *available at* http://www.zerohedge.com/news/2017-01-01/how-hedge-funds-closed-out-2016-and-why-hopes-2017-rebound-may-disappoint.

3 Many state pension plans, including those of Illinois, New Jersey and New York, reduced or eliminated their exposure to hedge funds. See Christine Williamson, *Investors Quick to Cut Managers Not Performing* (Jan. 9, 2017), PENSION & INVESTMENTS, *available at* http://www.pionline.com/article/20170109/PRINT/301099979/investors-quick-to-cut-managers-not-performing. See also *Redemptions From Hedge Funds Rise In December, Over $100B Out In 2016* (Jan. 18, 2017), VALUEWALK.COM, *available at* http://www.valuewalk.com/2017/01/redemptions-from-hedge-funds-rise-in-december-over-100b-out-in-2016/.

4 See *Private Equity & Venture Capital Spotlight* (Feb. 2017).

5 Number of funds provided by Preqin. "[T]here is a clear trend towards greater concentration of capital among fewer funds – 12% fewer funds closed in 2016 than in 2015, resulting in the average fund size increasing to $471mn, an all-time high." *Private Equity & Venture Capital Spotlight* (Feb. 2017).

6 Note that 1,704 initial Forms D were filed in 2016 by issuers that classified themselves as private equity funds and relying on one or more exceptions under section 3(c) of the U.S. Investment Company Act of 1940, which is an increase of 13% over 2015. (Calculated using Lexis Securities Mosaic Exempt Offerings Search.)

7 Approximately 50% of the hedge funds advised by Schulte Roth & Zabel that held their first closings after 2013, and were sponsored by managers that launched after 2013, used an investor-level gate, while only 9% of such funds use a fund-level gate.

8 Approximately 12% of the hedge funds advised by Schulte Roth & Zabel that held their first closings after 2013, and were sponsored by managers that launched after 2013, use side pockets, while approximately 35% of the hedge funds advised by Schulte Roth & Zabel that held their first closings during 2005-2007, and were sponsored by managers that launched after 2004, used side pockets.

9 "In the three years to June 2016, private equity investors have seen annualized returns of 16.4%, the highest among all private capital strategies." *2017 Preqin Global Private Equity & Venture Capital Report.*

10 See Cesar Estrada, *The Emergence of Private Equity's Secondary Market* (June 18, 2016), INSTITUTIONAL INVESTOR, available at http://www.institutionalinvestor.com/gmtl/3563232/the-emergence-of-private-equitys-secondary-market.html#.WLngsNLruUk.