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Alternative Funds

USA: Trends and Developments

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Trends and Developments

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The following provides an overview of recent developments regarding alternative investment funds and their investment programmes.

COVID-19

The past months have been dominated by the spread of COVID-19 and the various reactions to it. Indeed, the COVID-19 pandemic has brought both challenges and opportunities to the alternative funds space. While the initial illiquidity in the credit markets, as the pandemic began to spread, has eased and alternative fund sponsors (GPs) and their investors (LPs) have generally been able to function with relative normality through this period of repeated lockdowns, one major change has continued throughout – reduced travel. This has made it particularly difficult for new fund managers to take off, as it has not been possible to hold in-person diligence meetings with LPs. Large asset managers with established LP bases have not been as disadvantaged. Ares Management Corporation successfully raised USD15.7 billion in new capital through the first half of this year and is on track to have one of its best fundraising years ever according to its CEO, at 25% more than over the same period last year. CVC Capital Partners raised EUR22 billion in the six months ending in July 2020 and Brookfield Asset Management referred to the three months ending in June as the "best fundraising period ever" in their letter to shareholders, having raised USD23 billion across strategies. However, overall fundraising in the first half of 2020 is down compared to 2019 and large managers have, in some cases, faced difficulty. For example, while New Mountain Capital has been able to successfully raise a fund six for its flagship product, reports indicate that it has resorted to offering discounted fees to its existing LP base in seeking to reach its hard cap of USD9 billion, presumably because it was more difficult to raise capital from less familiar LPs.

Large asset managers gain market share

We expect that the trend over the last decade of large asset managers gaining market share will continue despite the continued support for emerging managers from some of the largest state pension plans and some allocators. However, while it seems the large alternative asset managers may see market share grow as a result of their ability to rely on existing LP relationships, competing forces may affect the size of the industry as a whole. On the one hand, the California Public Employees' Retirement System (CalPERS) has indicated a desire to increase allocations to private equity and private debt, including by potentially leveraging its existing portfolio to make increased allocations to these asset classes (though the CIO of CalPERS who made this pronouncement has since resigned). Also, in 2014, CalPERS indicated a lack of need for external hedge fund managers, expressing confidence that its performance would not suffer and it would reap significant savings by migrating management of its public securities portfolio in-house; and in 2019, New Jersey's pension plan followed by cutting its allocation to hedge funds in half. On the other hand, a survey indicates that family offices have shown a loss of faith in private equity's ability to deliver outsized returns, as reflected in 51% of family offices, down from 73%, expecting private equity returns to exceed those from public investments. Thus, the debate continues as to whether private equity, after fees and expenses, outperforms the public markets. However, a recent Preqin survey indicates that 29% of investors aim to allocate more capital to the alternatives space in the long term, and we therefore conclude that investors have certainly not abandoned alternatives as an asset class.

Increased revision of mandates

Another development coming out of COVID-19, and related to the increased difficulty associated with raising new funds, is an increase in GPs seeking to revise their mandates, as noted in response to Private Equity International's recent surveys. The same survey responses indicate that GPs have sought to extend their ability to put capital to work through amendments that seek to revise recycling provisions, expand authority to consummate follow-on investments, extend investment periods and, to a lesser extent, allow for increased use of fund-level credit. GPs have also similarly sought extensions of fund terms. COVID-19's effects cannot be ignored and will have an effect on fundraising and the ability of new funds to launch and, as a corollary, will favour the existing large managers and funds that have dry powder or have increased access to existing capital by virtue of such amendments.

Liquidity crisis

While the above trends may be more relevant to closed-end funds than open-end funds, the latter have also faced challenges from the pandemic. In March 2020, as COVID-19's breadth and ease of infection was starting to be understood, public equity markets saw significant increases in volatility. Furthermore, while public equities experienced price volatility, formerly liquid credit markets, such as the repo market, began to dry up. At the time, many hedge funds, in particular in the credit space, had been highly reliant on repurchase arrangements to finance their operations and provide structural leverage for their funds.

As liquidity left the repo markets, short-term interest rates rose and hedge funds began to receive redemption requests. In a well-publicised reaction, EJF Capital LLC suspended redemptions in its over USD2 billion Debt Opportunities Fund due to "unprecedented volatility and dysfunction in the credit markets" (Wall Street Journal, "Credit Hedge Fund Suspends Redemptions in Sign of Market Stress"). At the time, investors seemed to expect further limitations on their ability to obtain liquidity from other structured credit funds. The expectations in March may have been for an expansion of a liquidity crisis into a solvency crisis and a death-spiral for leveraged funds. Although liquidity appears to have returned to the markets in the last few months, due to unprecedented involvement by the Federal Reserve, the volatility in March did reveal that certain fund managers were relying too much on short-term credit to fund and support long-term investing and other operations.

ILPA

The Institutional Limited Partners Association (ILPA) has been active on many fronts this year, particularly relating to themes that have been heightened due to the COVID-19-induced financial crisis.

Subscription lines of credit

In 2017, ILPA issued its first criticism of the expanded reliance by fund managers on subscription lines of credit, referring to these lines as "short-term financing" whose use evolved into a "broader tool used to manage the overall cash of the fund" (ILPA, "Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices For Limited and General Partners"). ILPA further noted the liquidity risk to LPs – as more and more managers relied on these lines to provide structural leverage and the size of eventual capital calls kept growing, the more likely it became that a single, wide-ranging market event could trigger "the simultaneous calling of capital across multiple lines at once". While managers, through sufficient disclosure, could prepare their LPs for the possibility of a large capital call to satisfy borrowings on subscription facilities that had been, or remained, outstanding for longer than the previously customary 90 days, ILPA felt such disclosures were inconsistent across GPs. ILPA also highlighted the potential conflict of interest between managers and investors, noting that increased use of a subscription facility generates a higher internal rate of return (as capital is invested in the fund by investors for shorter periods of time), though ultimately a lower investment multiple (because the interest and other expenses of the subscription facilities are borne by the investors).

Ultimately, while ILPA's recommendations in 2017 centred almost entirely on increased disclosures (whether to LP advisory committees in due diligence meetings or quarterly reports), ILPA did have some substantive, economic recommendations. The first, requiring the waterfall provisions in partnership agreements to calculate the preferred return from the date of capital draws off of a facility (as opposed to when ultimately called from LPs), would largely eliminate the conflict and would, were it broadly adopted, likely revert subscription facility usage to merely smoothing out capital calls as infrequently as once per quarter (which, it seems, is ILPA's stated appropriate use of a subscription facility). In addition, ILPA suggested caps of such borrowings at 15–25% of uncalled capital and requiring such borrowings to be repaid within 180 days. By and large, however, LPs have not pursued these recommendations. We believe that, because LPs experience a benefit from fund managers' taking advantage of the low interest rates applicable to these borrowings and from being able to manage reduced capital calls by investing elsewhere, we have not seen LPs negotiate for changes to the accrual of the preferred return, but have seen increased disclosure and communication regarding the use of subscription facilities. It is worth noting that while some smaller LPs may feel the need to reserve liquid capital in an aggregate amount equal to uncalled capital commitments in order to satisfy capital calls, larger LPs are able to, and do in fact, reserve less than all uncalled capital commitments, thereby benefiting alongside the GPs from the higher internal rates of return that these facilities make possible. In June 2020, ILPA elaborated on its recommendations, noting that the hard and fast amount and time limits were "most relevant to private equity" and reiterated the need for consistent and robust disclosure. Combining the ILPA recommendations with the lessons learned in the early days of the COVID-19 pandemic, we believe fund managers should be keenly aware of the leverage they have incurred and the risks they accept, and force their LPs to accept, when they make use of short-term financing options (whether subscription facilities or repos) to generate and support long-term investment performance.

ILPA templates

In addition to the aforementioned guidance on subscription lines of credit, ILPA revised its model LPA in July 2020, and also published a "deal-by-deal" version to complement its "whole of fund" distribution waterfall version. As part of these revisions, ILPA has expanded its reliance on its previously published reporting templates, requiring in its model LPA that capital call and distribution notices be consistent with the ILPA Capital Call and Distribution Notice Template. While broad-based adoption of the ILPA model LPA has yet to occur, more and more GPs are getting comfortable with at least complementing their existing notices with disclosures consistent with the ILPA templates.

Secondary fund restructurings

Furthermore, ILPA's previously published guidance with regards to GP-led secondary fund restructurings has also continued to gain support from both LPs and GPs, as the scope of secondary

transactions has significantly expanded over the years. As ILPA notes, these transactions originated in the context of "zombie funds" or in the "end-of-life" or "key person event" context, but have continued to grow in significantly different contexts. Now, more than ever, a GP-led secondary is not a solution to a bad problem no one wanted to have. Rather, GP-led secondaries are being structured as a solution to a good problem – how to inject capital into an investment that is performing so well that the fund and its sponsor would prefer not to dispose of the asset as the end-of-life date of the fund approaches. The GP-led secondary is now a broadly acceptable way to grow a business in a manner that allows LPs and GPs to benefit from continuing upside in a way that a traditional exit would not offer. We expect that, in light of the impediments imposed on fundraising by COVID-19, institutional limited partners' increased appetite for private equity and the uncertainty around prevailing market forces, and the industry's acceptance of the ILPA principles as a means of implementing GP-led secondaries in funds whose terms were agreed upon years ago, GP-led secondary volume will continue to grow, offering powerful flexibility to invest for extended growth.

Investors are also seeing growth in the secondary space as a whole and have been expanding their investment programmes to take advantage of this. BlackRock recently closed on USD1 billion for its debut secondaries fund, BlackRock Secondaries and Liquidity Solutions, targeting a total fund size of USD1.5 billion. Moreover, BlackRock's new fund explicitly targets investing in "complex deals", clearly expanding beyond the simple portfolio acquisitions from LPs seeking to rebalance or obtain liquidity on existing portfolios. BlackRock has described co-investments as a source of opportunities in the secondary space and made use of capital on its balance sheet before closing on its fund to lead, alongside Neuberger Berman, Coller Capital and GIC, a restructuring of Thomas H Lee Partners' Fund VI. Not surprisingly, given the increased reliance on subscription line credit facilities noted above, BlackRock has stated a belief that this use of credit facilities may also generate transaction volume. The common theme among secondary deals, investors and the GP-led process is that secondary transactions have evolved from being driven by a supply of LPs seeking liquidity on otherwise illiquid portfolios to a means of satisfying the change in investor appetites and portfolio company needs. As noted above, investors are seeking to increase their allocation to private equity, while also seeking to avoid the uncertainty that is inherent in the typical blind-pool private equity fund. Secondary funds and their related transactions have responded to that demand by becoming a strong source of private investments without blind-pool risk. Where the larger investors, such as CPP Investments, have been able to build their own direct private equity investment capabilities, and others, such as The California State Teachers' Retirement System, have indicated a plan to do so, secondary funds, dedicated co-investment funds and GP-led secondary transactions all work to provide increased access to private investments without that uncertainty.

ERISA

While the Employee Retirement Income Security Act of 1974 (ERISA) does not expressly restrict private equity as an investment in defined contribution plans, the inherent qualities of private equity have restricted it from being offered directly as an investment alternative in a participant-directed plan. Accordingly, investments in private equity are more commonly utilised by defined benefit pension plans. In compliance with general fiduciary principles imposed by ERISA, however, various defined contribution plans have also offered managed investment portfolios with private equity components (as well as other private investment fund components).

DOL information letter

In response to encouragement from the chairman of the SEC and the president of the United States, and requests from the Committee on Investment of Employee Benefit Assets Inc and others, the Department of Labor (DOL) issued an information letter concluding that a "plan fiduciary would not… violate the fiduciary's duties under… ERISA solely because the fiduciary offers a professionally managed asset allocation fund with a private equity component". In the letter, the DOL cites the "reduction in the number of public companies over the past 20 years, and that many companies access private capital in lieu of public markets for longer periods of time", echoing chairman of the US Securities and Exchange Commission Jay Clayton's sentiments. In particular, Jay Clayton honed in on the important issue that "public equity markets – eg, IPOs – are being used more for liquidity by venture capital and private equity investors than for accessing new growth capital". For the same reason, institutional investors have increased their exposure to the private markets (or, perhaps more as the cause than the effect, institutional investors' increased exposure to the private markets has had the effect of the public markets being the market of last resort – only once a company has exhausted all private sources of capital will it resort to the public markets, in which case, it is typically for liquidity instead of growth capital). We find it interesting that in response to the demonstrated aversion to being a public company by existing and potential issuers, the SEC has decided to increase investor access to the private markets as opposed to reducing the regulations that have made the public markets so disfavoured.

Noting the important differences between private equity funds and publicly traded investments (eg, more complex organisational structures, investment strategies, fee structures and longer-term horizons), the DOL information letter describes a number of considerations that plan fiduciaries of defined contri-

bution plans must evaluate when contemplating an investment portfolio using private equity. The DOL does not, however, clarify in its letter what weight plan fiduciaries should assign to each of these considerations. None of the considerations and issues noted by the DOL are unexpected and would likely otherwise have been a necessary part of a fiduciary's analysis to meet ERISA's obligations.

Among the reasons for the DOL's issuance of the information letter is "to address uncertainties regarding ERISA that may be impeding plan fiduciaries from considering private equity investment opportunities". Importantly however, the DOL also cautioned that the information letter "does not address any fiduciary or other ERISA issues that would be involved in a defined contribution plan allowing individual participants to invest their accounts directly in private equity investments. Such direct investments in private equity investments present distinct legal and operational issues for fiduciaries of ERISA-covered individual account plans".

Democratisation of investment

The pronouncement by the DOL is in line with the SEC's general policy changes over the years that seek to democratise investing. For instance, in August 2020, the SEC adopted revisions to the definition of "accredited investor" under Regulation D to allow more institutional and individual investors to participate in the private capital markets. Similarly, in 2013, the SEC revised Regulation D promulgated under the Securities Act of 1933 to allow for general solicitation. This revision to Regulation D was adopted as part of broader revisions to the regulations around the capital markets enacted as part of the JOBS Act, whose stated goal, according to the Obama administration, was to "expand access to capital for young firms in a way that is consistent with sound investor protections". Furthermore, the JOBS Act resulted in amendments to the Exchange Act, raising the threshold to 2,000 (or 500 non-accredited investors) that would trigger mandatory reporting under the Exchange Act. While the original purpose may have been to allow a private company to become more broadly owned (eg, by its employees) prior to becoming a reporting issuer (which historically would trigger an IPO whether an issuer needed access to the capital markets or not), one by-product was the increased breadth with which private funds could be marketed and, therefore, the number of investors that could be admitted. The combined aspects of this consistent march to democratisation of the private markets – (i) acceptance of general solicitation, (ii) increased ownership thresholds of private companies, (iii) access to private equity by defined contribution plans governed by ERISA, (eg, 401(k)s), and (iv) a proposed easing of the definition of "accredited investor" – while perhaps presented as a means of providing more equal access to the private markets, have had their intended effect of expanding access to capital within the private markets.

Given the expense associated with being a public company, it should be no surprise that companies now stay private for as long as possible. In response, institutional investors, who ostensibly do not need the protections afforded by SEC scrutiny of public companies, have continued to increase their focus on private companies, increasing their allocations to private equity and private credit.

The DOL and ESG investing

Cognisant of the growing focus on Environmental, Social and Governance (ESG) matters, as discussed below, the DOL also issued a proposed rule regarding ESG with the stated purpose of "providing further clarity on fiduciaries' responsibilities in ESG investing". The proposed rule confirms that "ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action". The proposed rule requires a plan fiduciary to confirm that it "[h]as not subordinated the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to unrelated objectives, or sacrificed investment return or taken on additional investment risk to promote goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan". Olena Lacy, assistant labour secretary heading the Pension and Welfare Benefits Administration (now the Employee Benefits Security Administration) during the Clinton administration, phrased the change in layman's terms – "Democrats say the standard is that it's OK for you do to this as long as [risk and returns] comes out the same. Republicans say it's illegal for you to do this unless it comes out the same" (New York Times, "Labor Dept Seeks To Restrict Social Goals in Retirement Investing"). While not a drastic sea-change in terms of the overall attitude of ERISA towards ESG, the proposed rule was met with significant criticism and comments. The proposed rule builds on prior pronouncements, consistent with the Democrat/Republican division Ms Lacy describes. In 1994, the statement was that ERISA does "not prevent plan fiduciaries from deciding to invest plan assets in an [investment that is selected for the economic benefits it creates in addition to the investment returns to the employee benefit plan as an investor (ETI)] if the ETI has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan" (Pension and Welfare Benefits Administration, "Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974"). Additional guidance was published in 2008 and again in 2015. All such guidance, consistent with even the latest proposed rule, provides that expected returns for the level of risk to the employee benefit cannot be subordinated to other interests.

However, the proposed rule, unlike earlier guidance, goes much further in requiring significant decision-making documentation regarding the decision to provide an ESG-focused fund, likely causing fiduciaries to avoid including such products.

ESG

The DOL's pronouncement on ESG matters discussed above are, of course, responsive to general interest in the topic pervading the industry. In its 2019 published principles 3.0, ILPA provided guidance to GPs on maintaining and communicating appropriate policies to assist individual LPs seeking to understand how a GP's investment strategy and operations align with an individual LP's ESG policies. This is in keeping with increased focus on systemic racism in the United States, continued interest in climate change and increased income inequality and wealth disparity, undoubtedly amplified by COVID-19 and the government's response. Combined with the outsized growth of the private markets relative to the public markets, it would seem that institutions seeking to effect change through renewed focus on ESG would be even more inclined to do so through their private investments. While activist strategies focusing on public companies may have been helpful and effective in the past, as more of the American economy remains private for longer, many institutional investors have taken the view that they must increase these efforts in their private investments to achieve results.

Disclosure and transparency

As investors have increased their exposure to private equity, in order to continue with their historic views on ESG, which is not by any means new generally, just new to private equity, these same institutional investors have now been scrutinising the gate-keepers of access to private companies (ie, private equity fund sponsors) through imposing ESG principles on their GP counterparties. Where a socially-conscious LP may have historically been able to voice its ESG opinions directly to a board of directors of a company it was invested in, it is now the case that, because such LP is invested in the same types of companies through a private equity fund, the LP must express its concerns through the GP. Given the blind-pool nature of such investments, the LP voices those concerns in advance of investing in the blind-pool. However, instead of solely seeking advance covenants, LPs are also seeking disclosure and transparency. Given the finite term of blind-pool funds, LPs can revise their allocations among GPs every few years, if they feel GPs are not adequately responsive to their ESG requirements. As for public investments, LPs can now invest in regulated products that avoid entire industries. Of course, institutional LPs that have the resources can take further control through increased participation in secondaries which can provide these investors with insight that a blind-pool investment would not.

SPACs

While the Special Purpose Acquisition Company (SPAC) is not per se an alternative fund or alternative investment, it provides an interesting intersection of the private and public markets. While the SPAC model has existed for well over a decade, SPACs have seen a significant uptick in popularity recently, as evidenced by Pershing Square Tontine Holdings, which raised USD4 billion through its IPO, but may have up to USD7 billion to spend when taking into account commitments from Pershing Square Capital. SPACs look to capitalise on the disparity between private and public markets noted above – if private companies only use traditional IPOs as an exit, then perhaps they are ripe for acquisition by large pools of capital while they are still private, particularly if it provides an alternative path to a public listing. As a result, not only have alternative asset managers increasingly sought to raise their own SPACs, but such managers with late-stage venture capital or traditional private equity portfolios have similarly looked to existing SPACs as potentially attractive acquirers for mature portfolio positions in lieu of a traditional IPO. Demonstrating the intersection between public and private markets, GCM Grosvenor, an alternative asset manager, went public through a merger with a SPAC affiliated with Cantor Fitzgerald. Of course, once a previously private company is acquired by a SPAC, the company is then public and subject to all the same requirements as if the company had gone through a traditional IPO, and is no longer as easily able to raise capital privately. If the capital is flowing in such a way as to cause private companies to become public, eschewing only the IPO process, then perhaps the issues noted by Jay Clayton, discussed above, are not issues with the costs of being a public company, but rather with the costs of becoming a public company. It is worth noting that, in view of the current iteration of the SPAC model, completing an acquisition by a SPAC may be a less rigorous process than the traditional IPO.

Conclusion

It is often commented that the COVID-19 pandemic has only accelerated recent trends, and this has proved true in the alternative funds space. As the private capital markets continue to grow, and GPs continue to lock up more long-term capital, the private equity industry may find itself in an ideal position to promote economic stability and long-term growth during, and in the wake of, the ongoing pandemic and other times of instability.

Schulte Roth & Zabel was founded in 1969 and has been at the forefront of the alternative investment management space from offices in London, New York and Washington, DC. SRZ lawyers provide advice on both UK and US law to a wide variety of funds, managers and investors worldwide. The firm's market-leading investment management group provides counsel on structuring hedge funds, private equity funds, debt funds, real estate funds, hybrid funds, structured products, UCITS and other regulated funds, as well as providing regulatory and tax advice. SRZ handles all aspects of fund formation and operations on a full-service basis, adopting a cross-disciplinary approach to client service by employing the expertise of multiple practice groups. Notably, SRZ is one of only a few law firms with a dedicated regulatory and compliance practice within its private funds practice.

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