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Alternative Funds 2022

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Introduction
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INTRODUCTION

Contributed by: Christopher Hilditch, **Schulte Roth & Zabel**

Introduction to Alternative Funds

The introduction to the previous edition of this Chambers Practice Guide reflected upon a degree of cautious optimism in the alternative funds sector after the vicissitudes of the COVID-19 pandemic and widespread uncertainty in the financial markets arising from a variety of geopolitical factors. Indeed, many managers delivered good returns in 2021, the hedge fund sector saw positive inflows across a wide range of strategies and the private equity sector reported significant fundraising successes.

Fast forward to the beginning of Q4 2022 and it seems that the headwinds are stronger than ever with fears of a global recession, high inflation and high energy prices amongst other things. Global markets have seen large declines, with some sectors especially vulnerable. Equity hedge funds, especially those focused on the technology, healthcare or energy sectors, which flourished in 2020 and 2021, have struggled this year. Nevertheless, some strategies continue to perform well, including macro, systematic and credit, and these strategies continue to see inflows. Even strategies which have seen large drawdowns, such as digital assets, continue to attract new allocations as managers and investors seek returns. Whilst a number of anticipated private equity raises have either taken longer than expected or even been postponed, there remains a significant amount of dry powder in private equity funds and the closed-end nature of such funds allows managers to wait for their exit opportunities.

One previously reported trend that continues is for established managers to offer customised or bespoke products alongside flagship funds. These might be long-only or long-biased funds, "best ideas" or have a narrower sector or geographic scope than the flagship fund. In addition, managed accounts and single investor funds continue to find favour with longer-term investors, especially those seeking to be insulated from the impact of redemptions by other investors.

A developing, or perhaps re-emerging, trend is for liquid fund managers to explore opportunities in the less liquid and illiquid spaces. As a consequence, the use of side pockets in hedge funds has been increasing, especially where there are valuation concerns, as well as other liquidity management measures.

Co-investments remain popular both with managers and investors and may be offered by both hedge funds and private equity funds. These allow managers to take concentrated positions without some of the concerns around liquidity and capacity. A good number of managers are looking to establish vehicles to accommodate multiple co-investments – often via a segregated portfolio company with a segregated portfolio per investment or per investor. However, fees on such vehicles are low. Often, there is no management fee and any incentive compensation will typically be at a low rate and determined on the basis of realised returns over a preferred return. Where a co-investment vehicle sits alongside another fund, the different liquidity requirements between the two funds can raise conflict issues. A different conflict arises if the manager seeks to use the main fund as a warehouse for the co-investment vehicle; consent from main fund investors should be sought for this.

Commitment classes are now sometimes seen in some hedge funds, allowing capital to

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be deployed more smoothly. This can also be attractive to large investors in both liquid and illiquid funds who may not want to constitute too large a percentage of the investor base at any one time.

Funds in the credit space could be open-ended or closed-ended; the latter especially for distressed, opportunistic and emerging markets credit, but not necessarily so. Open-ended credit funds in the less liquid space are adopting a wide range of liquidity measures, including fast pay/slow pay mechanisms.

For all managers, it remains vital to pitch their funds correctly. In economic terms, management fees of around 1.25-1.5% (a bit higher in the USA) are the norm (although there are, as ever, many outliers) and incentive fees range between 15% and 20%, with the norm around 17-18% in practice. Some managers have introduced tiering in their management fees (ie, reducing the fee rate as assets increase) and others have added hurdle rates to their incentive fees, albeit this can give rise to tax issues if there is a possibility that a fee may accrue when the fund outperforms the hurdle (eg, an index), even though the fund itself has negative returns.

An area of scrutiny both from regulators and investors is fund expenses. In recent years, there has been a focus by regulators, especially the US SEC, on expenses charged to the fund and there have been a number of enforcement cases. The regulatory perspective is that, unless it is clear from a fund's offering document that a certain category of expense is to be borne by the fund, the expense is for the account of the manager. Conversely, some managers have sought to charge expenses which might otherwise be thought of as manager overheads to the fund under general headings. Either way, there is much more granularity in expense disclosures, which in turn has raised questions amongst investors as to whether it is reasonable that some types of expenses are borne by the fund. In particular, investors may seek to limit or even prohibit managers charging items like travel costs or compliance costs and/or to impose an overall cap on the level of expenses that will be borne by the fund. Where this is the case, it is important to be clear what is and what is not covered by the cap. For example, trading costs are often excluded, as are litigation and indemnity expenses.

It has always been important to ensure that the liquidity terms are right for the strategy and the investor base, and this remains the case. Notwithstanding the comments above about liquidity terms, emerging managers with long lock-ups, infrequent redemptions, long notice periods and the like struggle to raise capital and so need to ensure there is sufficient liquidity within the portfolio to meet ordinary course redemptions.

Investors continue to negotiate actively the terms of their investment. Managers need to go through multiple rounds of due diligence from potential investors and may be faced with a veritable shopping list of requirements and requests at the end of the process. This is not just limited to the closed-ended market; it is also seen in open-ended funds at any time in the life cycle of a fund. Clearly, what can be agreed in an existing fund with established investors may be very different from what can be agreed during the initial fund raise and can give rise to tricky MFN (most-favoured nation) issues.

A developing trend is for certain investors to require managers to comply with restricted lists or to offer classes which exclude certain types of investment. This is especially the case in the context of sanctions, especially US sanctions, but also around ESG (environmental, social and governance) principles and similar considerations. Closed-ended funds are used to dealing with this with excuse mechanisms and, of course, single investor funds are well able to handle such requirements whether closed-ended or open-ended, but such requirements are also arising in commingled open-ended funds. Whilst it may be possible to allocate P&L away from certain classes, it adds operational complexity and gives rise to other issues, for example the US Employee Retirement Income Security Act (ERISA).

A manager's approach to, and application of, ESG principles, including diversity, equity and inclusion (DEI), remains a core theme both for investors and managers. Increasingly, investors are not only concerned about how managers apply their ESG policies to their investment strategy, but also to their own operations. Many due diligence procedures now include sections on a manager's own approach to recruitment and retention and ensuring equal opportunity for all.

Whilst the wider adoption of ESG principles may be welcomed, there is also increasing concern about greenwashing, especially from regulators who are concerned that products are being mis-sold. Whilst this may be a greater concern for the retail sector, any regulatory initiatives will undoubtedly apply to the alternative funds sector as well. At the same time, many previously strong advocates of ESG, both in the asset management sector and amongst investors, are revisiting their approaches either acknowledging that ESG considerations should not take the place of financial considerations or even should not be considered at all. This may be an area where different approaches may be taken by managers and investors in different sectors or in different geographies. For example, it is hard to see that European investors will scale back their ESG requirements and funds which are marketed with a clear ESG mandate will continue to be attractive to many investors. Irrespective, what is clear is that the application of ESG or DEI policies does not absolve a manager of its fiduciary duties; rather, such policies should work in tandem with, and be complementary to, the manager's fiduciary and contractual obligations. As such, it is vital that all the investment team is actively involved in developing a policy and actively implementing it in their day-to-day roles. Investors have high expectations, but delivery on a realistic set of principles is far more important than empty promises.

A developing trend from previous editions that looks to be reversing is the use of special purpose acquisition companies (SPACs). After a very significant amount of activity in the SPAC market over the last couple of years, a number of high-profile SPACs have been wound up without ever making an investment and there are far fewer IPOs. In addition, there has been increased regulatory scrutiny, especially by the SEC, which seems likely to limit the market for the foreseeable future.

Finally, there are a number of options as to where a fund could be domiciled and the chapters within this Practice Guide will outline the pros and cons of a variety of jurisdictions as well as give an overview of the relevant markets. Whilst, in many cases, the choice of domicile for a new fund will not be a topic for much discussion between a manager and its advisers, the changing tax and regulatory environment affecting markets, managers and investors does mean that careful thought needs to be given to the jurisdictions in which the fund will invest, the strategy and asset class(es), and, more particularly, the target investor base. Continental European investors generally prefer European-domiciled funds and so a manager targeting European investors may opt for a European jurisdiction. In the credit fund space, limiting the impact of withholding taxes has always been a key consideration and international initiatives requiring real substance to underlie the use of trading subsidiaries with access to double-tax treaties has seen a number of managers seek to raise funds domiciled in a jurisdiction such as Luxembourg or Ireland where previously they used the Cayman Islands, particularly to invest in European opportunities. In this context, it will be interesting to see how much traction the new UK qualifying asset holding company (QAHC) has over the coming years, given its apparent attractiveness and ease of use.

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Schulte Roth & Zabel (SRZ) is widely regarded as the preeminent firm for hedge, private equity, credit and regulated funds. With more than 80 lawyers focused exclusively on representing investment funds and their managers, we expertly guide our clients through the creation and structuring of investment funds across every conceivable strategy. We focus as much on setting up the managing entity as we do on the fund itself, assuring its successful operation over the long term, and our vast knowledge about regulatory and compliance issues means that we provide our clients with the most incisive advice as they operate the fund.

Contributing Editor

Christopher Hilditch is co-head and co-founding partner of SRZ's London office. He advises institutional and entrepreneurial managers on structuring and establishing funds of all types, especially hedge funds. Chris counsels promoters and managers worldwide on operational, fundraising and investment issues. He also advises on regulatory issues affecting funds and their managers, and on corporate, securities and partnership law issues. Chris has been an active participant on various industry committees, has authored or co-authored numerous articles and other publications and is a regular speaker at seminars and presentations.

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