Profile: Stephanie Breslow

SRZ's Leading Investment Management Practice

HAMLIN LOVELL

Amongst many awards received by the firm, Schulte Roth & Zabel (SRZ) was selected as "The Leading Global Law Firm" at *The Hedge Fund Journal's* Awards for 2015, and SRZ partner Stephanie Breslow was selected as one of EY and *THFJ's* "Leading 50 Women in Hedge Funds" for 2015, having appeared in the biennial survey since its inaugural publication in 2009. Breslow and SRZ partner Steven Fredman serve as co-heads of SRZ's Investment Management Group, which is chaired by founding partner Paul Roth.

THFJ interviewed Breslow to hear her views on a selection of hedge fund industry trends in several areas of the investment management practice – liquid alternatives, fund formation, fees, hybrid structuring, conflicts between vehicles, seeding, start-ups and mergers and acquisitions. We also touched on a few other topics relevant to other parts of SRZ's multidisciplinary practice – regulatory reporting, compliance and governance.

Breslow is currently chairing the International Bar Association (IBA) Private Investment Funds Subcommittee. She finds the annual IBA conference held in March in London, which is co-chaired by Roth, to be informative for "outside counsel and in-house lawyers, who can hear current issues faced by other senior practitioners in the field."

Indeed, SRZ increasingly has a two-way traffic of lawyers with its clients. Breslow says "traditionally, associates who did not want a lifetime career at a law firm viewed us as a graduate school before they went in-house," but now there is more of a dual flow, and SRZ welcomes this because "in-house lawyers bring valuable regulatory knowledge on the inner workings of funds and insights into practical aspects, such as how trades are allocated."

SRZ's latest hire in the Investment Management Group, John Mahon who is based in the firm's Washington, D.C. office, specializes in business development companies (BDCs) and other publicly traded permanent capital vehicles that some hedge funds are setting up, as well as other '40 Act funds that focus on the alternative asset management space.

BIOGRAPHY

Education

- B.A. from Harvard University, cum laude, in 1981.
- J.D. from Columbia Law School in 1984, and was a Harlan Fiske Stone Scholar from 1982 to 1984.

Current role

- Partner in the New York office, co-head of the Investment Management Group and a member of the Executive Committee, Schulte Roth & Zabel LLP.

Other

- Chair of the Private Investment Funds Subcommittee of the International Bar Association.
- Founding member and former chair of the Private Investment Fund Forum.
- Member of the Advisory Board of Third Way Capital Markets Initiative.
- Member of Board of Directors of 100 Women in Hedge Funds.
- Member of the Board of Directors and named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York.

Stephanie Breslow was selected as one of The Hedge Fund Journal's "50 Leading Women In Hedge Funds" for 2015.

While Breslow has clients setting up these vehicles, and sees significant interest in BDCs in particular, she also sees limits to the growth of lower-fee paying forms of traditional "liquid alternatives," or to hedge fund managers running long-only funds, for various reasons. "Their lower fees can cannibalize existing products, yet other costs can lead to higher overall expense loads and there is even more regulation to deal with" – hence some single-strategy hedge funds that cannot differentiate these products from their main offerings, will not launch liquid alts, Breslow predicts. Instead, they may set up funds-of-one or dedicated managed accounts for big institutional investors, who may demand lower management fees, but not lower incentive fees. Breslow finds that "20% carry remains universal, and hurdle rates are rare."

Where fee structures are changing more radically is at the other end of the liquidity spectrum – in hybrid or private equity-type structures. "Some funds, particularly in distressed debt or activist strategies, have private equity-style back-end loaded fees, particularly in co-invested vehicles, where investors want to await realizations," Breslow observes. Sometimes, identical investment portfolios are being offered with two different fee structures – one with traditional mark-to-market hedge fund-style fees, and another charging only as investments are monetized.

But such twin portfolios can later decouple due to the asynchronous time frames of the fund structures. "A hedge fund is an evergreen structure that can carry on making follow-on investments, but private equity funds may not be able, or allowed, to do so, if they have passed their investment period," Breslow explains.

Different timing of entries and exits is one potential conflict of interest between investment vehicles, and SRZ advises managers on how to mitigate or avoid such conflicts. Another instance of potentially divergent interests amongst vehicles can occur when different tranches from the same issuer are owned by different funds. This might simply be debt versus equity, or it could involve senior debt versus junior debt, but in either case, the owners of higher-ranked instruments may not have any incentive to see recoveries on more subordinated paper.

"We need to be sensitive about how to manage these issues," says Breslow, who works closely with clients on possible approaches, which might include "being passive on one side, ensuring the same tranche is in both places, or ensuring one holding is not too large." Sometimes independent valuation agents are brought in to advise on fair value.

Occasionally, opposite ends of the liquidity continuum can be married in the same product. Some fund-of-funds and private equity-style products are parking investors' committed capital in liquid alternatives, or other liquid asset classes, pending drawdown requests from the manager. This neatly addresses the problem that "realistically, private equity requires liquid funds to cover capital calls, but you don't know the timing of the draws," Breslow says. Liquid alternatives can be disposed of in time to meet the typical 10-business-day deadline for capital calls, reducing the risk that investors miss the calls.

Certainly, a growing number and diversity of investment vehicles are housed under common corporate umbrellas as the industry consolidates. SRZ is actively advising on M&A deals amongst alternative investment managers, and Breslow thinks corporate activity will continue, as it "makes sense on a lot of levels." There are supply-side and demand-side drivers. The opportunity set for hedge funds is expanding as "investment banks are less present, thanks to Dodd-Frank and Volcker, so large multi-strategy hedge funds can play the roles banks have vacated." Meanwhile, "big institutional investors writing large tickets like to see strong operational controls and a robust back office," and more regulation favours size.

Regulatory demands may grow yet further. Teething troubles around regulatory reporting such as Form PF have now been overcome, Breslow hears, but hedge funds may soon expand the scope of their Form ADV submissions to include managed accounts. Form PF is confidential, whereas Form ADV is public, but Breslow does not view the latter as sensitive because it does not report portfolio positions or compensation.

Regulation is one factor making life tougher for start-ups, but she does think the climate has improved since immediately post-crisis. Still, the average start-up must be bigger – though not necessarily as large as Rokos' breakaway from Brevan Howard, or Scott Bessent's planned spin-out from Soros.

"Most funds cannot achieve a billion-dollar size launch, but the days of $25-million seed deals are behind us," says Breslow, who reckons "the bare minimum is now $100 million to build something that makes sense." The Volcker Rule means US banks are more likely to be divesting from, than investing in, hedge funds, but SRZ is seeing small amounts of seed capital coming from high-net-worth individuals and family offices with larger amounts from selected institutions.

Those seeking to start new firms or funds face "more pressure to differentiate themselves," Breslow has noticed. The most popular areas for fund formation in mid-2015, according to Breslow, include activism (for which *THFJ* recently interviewed London-based SRZ partner Jim McNally to discuss how the landscape for activists in Europe differs from the US), multi-manager platform activity, the energy sector for both private equity and hedge funds, and credit and distressed, where Breslow thinks "investors look for alpha, so those strategies have a lot of traction right now."

Distressed debt as a strategy tends to use little or no leverage on the fund's balance sheet, and generally, Breslow observes there is much less leverage in the system now. This is partly because "post-Lehman people grew more sensitive to risks they had not focused on so fully, leading to more demand for cash sweeps and tri-party repos, more asset segregation and less re-hypothecation." She also thinks that "the low inflation and low interest rate environment discourages funds from leveraging."

The relatively low leverage of the hedge fund industry is one reason why Breslow says she does "not expect regulators will seek to levy fines on hedge funds in the way that they do with banks." SRZ may advise funds on negotiating settlements with regulators, and fines for a handful of hedge fund managers have been a fraction of those applied to banks as "hedge funds are not as large and are not as engaged in activities that create the same giant market exposure that a LIBOR case does."

But some individuals working at hedge funds do face increasing potential personal liability. One affected group is chief compliance officers (CCOs), who Breslow says "can be held liable, and SEC fines may not be covered by insurance, so they may see their careers destroyed." Moving onto Cayman fund directors, although the fines for Weavering's directors were ultimately overturned, Breslow thinks the case "still had a transformational effect as it made people more conscious that they need to document involvement and ask questions, as the Weavering facts were egregious." This raises the bar for investor due diligence and increases the standards investors demand of fund governance bodies, including fund directors. **THFJ**

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