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Alternative Funds

Introduction
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INTRODUCTION

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

At the beginning of 2020, many alternative (or private) fund managers might have been cautiously optimistic. In the year ending 31 December 2019, hedge funds had seen average returns in excess of 12% which, whilst not stellar compared to the extraordinary returns seen in the market, was a welcome return to good performance after a number of years of poor returns. Private equity funds also showed double digit returns over one-year, three-year, five-year and ten-year time horizons. Of course, some strategies performed better than others – macro and long equity amongst hedge fund strategies and buyout among private equity strategies.

Notwithstanding, the fund-raising environment continued to be challenging for many, especially for hedge funds. Growth in assets under management (AUM) tended to be focussed on the largest funds. In the hedge fund sector, funds with in excess of USD1 billion in AUM accounted for nearly half of the net asset inflow in 2019 and a significant chunk of the positive returns. In the private equity arena there were not less than nine funds seeking to raise USD10 billion or more from investors in the fourth quarter of 2019.

This then was the backdrop as the COVID-19 pandemic took sway, hot on the heels of a high level of volatility in the oil market and as other geopolitical factors created extreme uncertainty in the financial markets. In short order, many managers (and their service providers) had to implement their business continuity plans as offices were closed and everyone moved to remote working. Leaving aside the challenges of remote working (although few managers reported any significant issues in terms of portfolio management and operations), what issues did managers face?

Valuation is always a key issue, but especially so in a period of market volatility. Whilst most, if not all, managers have robust valuation procedures for Level 1, Level 2 and Level 3 assets, the market volatility, especially in the first few months of the year led to particular focus on valuations, especially in open-ended funds given that such valuations are the basis for fees and for any subscriptions (if accepted) and redemptions. Both investors and regulators have a keen eye on the topic and some regulators now have specialised senior staff with a particular remit to examine not just policies and procedures but actual valuations. In the USA, there have been enforcement referrals on valuation topics from US Securities and Exchange Commission (SEC) examination units and that trend is likely to continue. Apart from making sure the procedures adapt to changing situations and use the right inputs, what is clear is the critical importance of full and complete documentation of the valuation process. Essentially, all the evidence, be that multiple broker quotes, third-party valuation agent inputs, or whatever, needs to be readily at hand in the event of a challenge. At the same time, it is important to maintain an open dialogue with the fund auditors to ensure that they are on the same page come audit time.

In times of turmoil, there is a renewed focus on liquidity. The standard redemption terms of an open-ended fund are predicated on the anticipated usual liquidity of the underlying portfolio. However, a crisis such as the COVID-19 pandemic not only causes liquidity issues in the market (potentially exacerbating the valuation concerns mentioned above), but is also likely to create liquidity pressure on a fund as investors seek to redeem their interests whether because they have their own liquidity issues, performance concerns or simply want to be out of the market. This gives rise to additional issues for managers as they will face the need to generate sufficient cash to pay expenses, meet margin requirements and pay redemption proceeds, potentially for a period of a number of months, especially if a core part of the portfolio has or might become illiquid

Fortunately, most open-ended funds have a variety of measures available to them to limit the impact of redemptions, ranging from redemption gates (whether on an investor- or a fund-level), through distributions in kind (whether of an asset itself or an interest in a special purpose vehicle holding the asset until it is realised), "side pockets" (allowing illiquid or hard to value assets to be segregated) to suspension of redemptions in whole or in part and, ultimately, dissolution. What is right for an individual fund obviously depends firstly upon what powers it actually has and what the precise mischief it is that is being dealt with. For example, redemption gates (which limit the amount which can be redeemed at a particular time) are of very limited use if there is a fundamental valuation issue. A "side pocket" may be more appropriate, but the ability to side pocket assets is relatively rare and may be limited to newly acquired assets only.

Liquidity issues are less fundamental in closed-end funds as investors do not have a redemption right. Nevertheless, market liquidity issues can impact on portfolio companies, either directly or indirectly. For example, a portfolio company may be restricted in drawing on a credit line or may find it difficult to put in place credit facilities. Further, a closed-end fund may itself be restricted in incurring leverage, especially if it is running up against leverage limitations following a fall in asset values. In addition, there is a heightened risk of investors defaulting on capital calls (and in a liquidity crisis there is also perhaps more need to take action against defaulting investors to keep the fund on track).

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Whilst the impact of the pandemic is, at the time of writing, far from over, the markets perhaps weathered the storm better than might at first have been anticipated. As such, whilst many funds have seen outflows, and some have regrettably wound-down their operations, the vast majority have not found it necessary to go into crisis mode and there have been relatively few defensive restructurings, especially compared to the global financial crisis.

A lesson learned from the global financial crisis which remains true in good times and otherwise is the value of good communication. Good, clear and regular information is vital in any stress situation. It maintains trust and good relations and can make a massive difference, whereas poor communication erodes goodwill and creates mistrust.

In any uncertain situation, investors appreciate as much information as can be provided. Managers must be ready to talk about what is going on, the implications for their investment strategy and the portfolio and the possible effects on the very concept of the fund, especially if there are liquidity concerns or other potentially adverse events which might arise.

It is especially important that all relevant information is provided consistently to all investors. This does not mean that there cannot be any prioritisation – it is only natural that the first calls should be to key investors – and it does not mean that the responses to specific questions raised by individual investors need to be passed to all, but it is vital that all investors have all relevant information.

On a related point, it is important to make sure that offering materials remain accurate without any material misstatements or omissions of material facts necessary to avoid misleading statements. In March 2020, the SEC published guidance around disclosure with respect to the impact of COVID-19 and related business and market disruptions. Whilst this was directed at public companies, it is indicative of the likely approach taken by the SEC with respect to disclosures in private fund documents. What this means in practice depends upon the strategy of a fund and the investments in its portfolio. An open-ended fund investing in, for example, the travel and hospitality industries is likely to need more disclosures than one investing in less-affected industries. The key point to bear in mind is that whether or not offering documents meet the required standards will be judged with the benefit of hindsight.

Similar considerations apply to other marketing materials, such as presentations. If a material part of a portfolio has been particularly volatile or been subject to valuation issues, additional disclosure may be required. Similarly, if the composition of the portfolio has had to change (beyond usual investment/divestment considerations), additional disclosure might be required, especially around the track record. Again, investors and regulators will be looking at these with the benefit of hindsight.

As indicated above, even before the pandemic, for all but a select few large managers, fund-raising has been a "slow burn". In recent years, the trend has been towards creating customised or bespoke products (for larger investors) and making funds more investor-friendly (within reason) and this continues to be the case. In an effort to attract investors, many managers have sought to address common investor requests (previously dealt with by side letters) in their fund documents and this has often included a "most favoured nations" provision for all investors.

In the hedge fund sector, early bird classes offering a fee discount and sometimes capacity rights (often at the same discount) remain common. More broadly, management fees have stabilised (albeit with many outliers) around 1.5% and incentive fees around 17.5%. In some cases, the incentive fee is subject to a hurdle rate, typically a relevant index but sometimes a fixed rate.

In the private equity world too, discounts are seen especially for large commitments. By the same token there has been an increase in the number of funds holding only a single closing. Also increasingly common is the number of successor funds which, whilst accepting commitments, do not charge any management fee until they actively began sourcing investments (ie, once the prior fund had reached the end of its investment period).

One of the problems faced by many new and/or smaller managers is the difficulty faced by investors in undertaking their due diligence, given travel and other restrictions. This too has favoured the larger and better established managers. From an investor perspective, one of the positives has been that a number of previously closed high profile open-ended funds have reopened either to replace outflows or other AUM decline or because the managers have identified specific investment opportunities in the market. Moreover, a number of such managers have looked to raise "best ideas" funds; others have sought commitments (private equity style) rather than the more usual subscriptions so as to give them capacity to make additional investments without reducing returns pending making such investments. Overall, the market appears fairly stable; allocations to the private funds sector are down but not significantly so.

Co-investments remain popular both with managers and investors, especially in the activist and distressed debt space. These allow managers to take concentrated positions without some of the concerns around liquidity and capacity. Many of the largest and most active investors are actively seeking opportunities to invest significant amounts of money in concentrated positions. There are an increasing number of managers 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.

Environmental, Social and Governance (ESG) considerations and other forms of responsible investing continue to gain ascendancy, not just in the asset management arena but in the financial and commercial sector generally. In August 2019, the Business Roundtable, a group of nearly 200 CEOs of major US corporations, including Jeff Bezos of Amazon and Tim Cook of Apple, sought to redefine the purpose of a corporation so as to serve all stakeholders rather than just shareholders. They envisaged that a company would invest in its employees, deliver value to its customers, deal ethically with its suppliers and support the broader community. More particularly, a 2019 survey by accounting firm Ernst & Young found that 63% of investors in hedge funds considered the effectiveness of a manager's ESG policy to be critically important in determining whether or not to invest with a manager. Nearly 90% thought the manager's ESG policy at least somewhat important to their decision. As such, ESG considerations will continue to shape the asset management industry as a whole.

There remain multiple challenges including the lack of an agreed-upon universal methodology. At this time, there are enormous disparities in the methods used by investment managers with regards to ESG calculation and analysis as part of their investment decision making process. Another challenge is the lack of publicly available data from issuers making it hard to evaluate the ESG impact of a potential investment. However, this is starting to be addressed by initiatives such as the Sustainability Accounting Standards Board and the Carbon Disclosure Project and large companies are increasingly embracing these disclosures, in large part due to investor pressure, including pressure from private fund managers.

The sheer size and importance of the alternative funds market, including in the non-bank finance sector, means that it is very much mainstream from a regulatory perspective. The trend over a number of years has been to increasing regulation of the sector in a number of areas, especially around disclosure, transparency and governance. Thankfully, it seems that the private funds sector has not only weathered the storm but been a positive contributor towards economic stability and market robustness.

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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.

Contributing Editor

Christopher Hilditch is co-head and co-founding partner of SRZ's London office. Chris advises institutional and entrepreneurial managers on structuring and establishing funds of all types, especially hedge funds. He counsels promoters and managers worldwide on operational, fundraising and investment issues. He also advises on regulatory issues affecting funds and their managers, as well as 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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