Credit Funds

Structuring & Management

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Schulte Roth & Zabel

1. About the Speakers

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Stephanie is co-head of Schulte Roth & Zabel's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (LBO, mezzanine, distressed, real estate, venture) and liquid-securities funds (hedge funds, hybrid funds) as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses, and she represents funds of funds and other institutional investors in connection with their investment activities.

Stephanie is chair of the Private Investment Funds Subcommittee of the International Bar Association, a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a member of the board of directors of 100 Women in Hedge Funds and a member of the Columbia Law School Board of Visitors. She is listed in *Chambers USA*, *Chambers Global*, *The Legal 500 United States*, *Best Lawyers in America*, *America's Leading Lawyers*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which placed her on its "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Investment Funds Lawyers*, *Expert Guide to the World's Leading Women in Business Law* (Investment Funds), *Expert Guide to the World's Leading Private Equity Lawyers* and *PLC Cross-border Private Equity Handbook*. Stephanie was named the "Private Funds Lawyer of the Year" at the Who's Who Legal Awards 2014 as well as a New York State Bar Association Empire State Counsel honoree in 2014 and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. Stephanie is a much sought-after speaker on fund formation and operation and compliance issues, and she also regularly publishes books and articles on the latest trends in these areas. She contributed to the 2014 *Fund Formation and Incentives Report* (published by SRZ in association with Private Equity International) and co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute), the leading treatise on the subject. She also contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private Equity Handbook 2005/06* (Practical Law Company), contributed a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation* (Practising Law Institute, Volume 2), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

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Susanne is a Senior Managing Director and the General Counsel of Centerbridge Partners LP, an investment management firm focused on private equity and distressed investing with offices in New York and London. Prior to joining Centerbridge, she was the General Counsel and Chief Compliance Officer of Basso Capital Management LP, an SEC-registered investment adviser managing multi-strategy, convertibles and credit funds. Prior to Basso, Susanne was the Deputy General Counsel of Amaranth Group Inc., an investment adviser for multi-strategy and long/short equity funds. Before that, she served as Vice President and Assistant General Counsel at Goldman Sachs, where she was responsible for finance and corporate legal matters involving The Goldman Sachs Group, Inc. and, prior to that, for legal matters involving the investment banking business of Goldman, Sachs & Co. She started her career as an associate in the New York office of Shearman & Sterling LLP.

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Adam is chair of Schulte Roth & Zabel's Business Reorganization Group and a member of the firm's Executive Committee. He practices in the areas of corporate restructurings, workouts and creditors' rights litigation, with a particular focus on representing investment funds and financial institutions in distressed situations. Adam represents a variety of clients in connection with distressed acquisitions by third-party investors or existing creditors through "credit bid" or similar strategies, as well as in court-supervised and out-of-court restructurings. Adam's recent representations include advising Cerberus Capital Management LP in connection with the Chapter 11 bankruptcy of RadioShack Corp., Mount Kellett Capital Management in the Chapter 11 case of The Great Atlantic and Pacific Tea Company (as both lender and equity holder), and a group of private equity funds in the Allied Systems Holdings bankruptcy, in their capacity as first lien lenders, in a successful challenge to the efforts of a private equity sponsor that tried to acquire a controlling interest in the first lien debt. Recently, Adam also advised the first lien lenders in the Global Geophysical Chapter 11 case, and the first lien lenders in a separate restructuring and sale of their debt held against a leading technology company (in each case resulting in the lenders receiving payment of their debt in full, plus a premium). Adam also advised a group of private equity funds, in their capacity as term loan holders, in connection with the "credit bid" acquisition of substantially all of the assets of Real Mex Restaurants Inc. and its affiliates, and Cerberus Capital Management LP and Chatham Lodging Trust in their Chapter 11 acquisition of the assets of Innkeepers USA.

Adam has been recognized by numerous ranking publications, including *Best Lawyers in America*, *Chambers Global*, *Chambers USA*, *The K&A Restructuring Register* and *The Legal 500 United States*. He co-authored publications addressing priming DIPs, out-of-court restructurings and proposals to reform Chapter 11. He also contributed to *Distressed Investing M&A*, a report created in association with Mergermarket and Debtwire, and for the last four years he co-authored "Out-of-Court Restructurings, the Bankruptcy Context, and Creditors' Committees" in PLI's *Insider Trading Law and Compliance Answer Book*. He presents frequently on topics of concern to the distressed investing community, including, most recently, distressed investing in the health care sector, fraudulent conveyance laws and distressed private equity investments.

Adam received his J.D., *magna cum laude*, from Georgetown University Law Center and his B.A. from Emory University.

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Dan is a partner at Schulte Roth & Zabel, where he concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid funds and private equity funds. He regularly advises funds that invest in distressed debt, asset-backed securities and bank loans. Dan also provides day-to-day regulatory, operational, merger and acquisition and restructuring advice to his fund clients and advises funds regarding the receipt or allocation of seed capital. As part of his compliance practice, Dan advises clients on the Treasury Forms (TIC Forms) and Bureau of Economic Affairs Forms (BEA Forms). Among the various investment advisers he represents are some of the larger and more well-known fixed income, bank loan and distressed debt managers.

Dan has been recognized in *The Legal 500 United States* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented on regulatory and compliance issues, ERISA's impact on private funds, and general counsels' preservation of legal privilege, and he is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). Dan has served as a guest lecturer at the New York University School of Continuing and Professional Studies, where he taught "Introduction to Hedge Funds," and he is a member of the University of Michigan Honors Alumni Council.

Dan received his J.D. from the University of Michigan Law School, and his A.B., *cum laude* and with high honors in history, from the University of Michigan.

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Will is a Tax partner in the New York office of PricewaterhouseCoopers LLP. He is also the firm's Global Tax Asset Management Leader. He specializes in the structural and operational aspects of domestic and offshore private investment partnerships, and other alternative investment products, as well as the tax aspects of complex derivative instruments and investment strategies.

Will has lectured extensively around the world on various issues associated with alternative investment products, as well as the economic and tax aspects of securities transactions. He is co-author of the publication *Hedge Funds: A Comprehensive Tax Planning Guide*, the leading publication on tax issues associated with domestic and offshore private investment partnerships.

Will received his B.S. in Metallurgy and Materials Science Engineering from Case Western Reserve University. He also attended Case Western Reserve University School of Law, where he received a J.D., *cum laude*. Will also received an L.L.M. in Taxation from New York University School of Law. Will is a member of the board of Hedge Funds Care and serves on the East Coast grant selection committee. He is also a member of the Managed Funds Association and the New York Bar. He is a Certified Public Accountant licensed in New York and Maine and with reciprocity privileges in California. He is also an active member of the National Parks Conservation Association and has served on the Board of Recreation and the Zoning Board of Adjustments for the city of Summit.

2. Co-Investments and Sidecars: Structuring Opportunities

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I. Trends Toward Co-Investments and Sidecars

A. Co-Investments and Sidecars: What They Are

1. A co-investment opportunity is an opportunity to invest alongside (or outside of) a private investment fund in an investment that is too large (or not appropriate) for the private investment fund. These investments are typically less liquid assets.

2. A sidecar is an investment vehicle established to invest in a co-investment opportunity. Sidecars can be structured to invest in one or more co-investment opportunities, can be blind pool or not, and may be established for a single investor or may be offered to multiple investors.

B. Disappearing Side Pocket

1. Historically, hedge funds invested in liquid assets, whereas private equity funds invested in more illiquid assets.

2. A side pocket is a mechanism utilized by a private investment fund to segregate less liquid (or difficult to value) investments from the liquid portion of the fund's portfolio. The side pocketed investment is segregated from the rest of the portfolio, and incoming investors do not participate in existing side pockets. Investors generally are permitted to redeem amounts that are side pocketed only after the side pocketed investment is realized, and typically, performance compensation on the side pocketed investment is not taken until the time of realization. As hedge fund managers started to invest in illiquid assets, the industry saw a trend in the growth of side pockets. Prior to the financial crisis in 2008, managers were launching funds with side pocket thresholds that exceeded 30 percent in some cases and were able to make meaningful illiquid investments.

3. Since the financial crisis in 2008, funds with side pockets have been more difficult to market to prospective investors, and there are far fewer new hedge funds being launched with side pockets as a result. Many managers have eliminated the ability to use side pockets in new (and sometimes even in existing) funds due to investor concerns, which include concerns that: (1) side pockets lack sufficient investor protections; and (2) managers spend too much time managing side pocket assets at the expense of the liquid portion of the portfolio.

4. Some managers have attempted to launch products with side pocket opt-in/opt-out provisions, but the opt-in classes of such products have seen less interest among investors than the opt-out classes.

5. Deferred compensation laws that went into effect at the beginning of 2009[1] have also made structuring performance-based compensation from side pockets in a tax-efficient manner more challenging.

[1] *See* U.S. Internal Revenue Code of 1986, as amended (the “Code”), § 457A.

C. Illiquid Investing Without Side Pockets

1. The decline of side pockets has created a need for alternative ways to fund illiquid investment opportunities.

2. Co-investments, sidecars and traditional private equity funds are the alternatives available to achieve this.

3. There has been significant manager interest in co-investment opportunities. According to a recent survey, 38 percent of managers have offered co-investment opportunities to investors, and 28 percent would consider or are currently considering offering such opportunities.[2]

4. North America is the leading continent for co-investment appetite among investors. According to a 2012 survey, 44 percent of investors that seek to make co-investments are based in North America, 31 percent in Europe and the remaining 25 percent in Asia and the rest of the world.[3]

D. Common Co-Investment and Sidecar Strategies

1. Activism: Acquiring a significant position in the equity of a public company in order to effect changes in the company's strategy. These funds often need additional assets to make concentrated bets, especially when pursuing tender offers or proxy fights.

2. Distressed Credit: Acquiring securities of a company in bankruptcy or financial distress across the capital structure. These funds may need extra capital to, e.g., take control of the "fulcrum security" in a bankruptcy.

3. Concentrated Versions of Existing Strategies: Vehicles may have position limits, and a manager will structure a sidecar to make co-investments in opportunities to the extent the fund has filled up with its share of an investment.

4. Sector Opportunities: Managers focused on particular industry sectors may, in the course of their public markets investing, become aware of related private market or otherwise illiquid opportunities.

5. Hedge Funds and Private Equity Funds Run Side by Side: Strategies that lend themselves to both hedge and private equity vehicles often include investments in illiquid opportunities. Often, these managers will find opportunities that are appropriate for co-investments because their hedge funds have limited capacity for illiquid investments and their private equity funds have position limits.

II. Structuring/Terms

A. Flexibility

1. Since a sidecar is a newly formed vehicle, managers have flexibility to customize the terms and structure to attract capital. In some cases, managers may structure a sidecar with terms that mirror the main fund, and in other cases, investors may seek more private equity-style protections in recognition of the fact that the sidecar is illiquid. For instance, investors may ask that the sidecar be structured to include a key person event concept, a no-fault removal mechanism and back-ended carry structure.

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[2] *See* Aksia's 2014 Hedge Fund Manager Survey.

[3] *See* Prequin Special Report: LP Appetite for Private Equity Co-Investments (2012).

2. Tax Structuring

(a) If an asset sought by a sidecar is a United States real property interest,[4] including stocks in certain U.S. corporations that are considered "United States real property holding corporations,"[5] the sidecar or a special purpose vehicle ("SPV") may need to be structured as a U.S. vehicle so as to prevent a U.S. withholding tax from being imposed on such sidecar or SPV upon its disposition of the asset under Section 1445 of the Code,[6] even with respect to U.S. investors who would not otherwise be subject to any U.S. withholding tax on their investments.

(b) For European deals and deals in certain other jurisdictions, base erosion and profit shifting ("BEPS") proposals[7] may require in the future that the sidecar or SPV be structured in a jurisdiction (e.g., Ireland) that is more heavily regulated than jurisdictions commonly used today.

(c) Attention should be given to the Foreign Account Tax Compliance Act ("FATCA") and the expanded affiliated group ("EAG") rules.[8] If the sidecar may at some point in time have a majority owner that is a corporation (other than a tax-exempt U.S. entity), a non-U.S. sidecar or a non-U.S. SPV that is not a disregarded entity for U.S. tax purposes may be considered part of such owner's EAG, in which case, such sidecar's or SPV's FATCA-compliant status may be linked to that of the other members of such an EAG (which may include other investment funds unrelated to the sidecar's manager). Failure to comply with FATCA due to being part of such a noncompliant EAG can eventually lead to a 30-percent U.S. withholding tax on U.S. source interest, dividend and similar payments and, starting in 2017, a 30-percent U.S. withholding tax on gross proceeds from the sale or disposition of property that may generate U.S. source interest or dividend payments.

B. Fees

1. Fees depend on the rationale for the sidecar.

(a) For higher conviction opportunities that run parallel to a manager's main fund, fees are more likely to mirror the fees in the main fund.

(b) In deals where excess capital is needed from investors in order to close the transaction (e.g., in a control scenario), fees may be lower or, in some cases, zero, if the bargaining power lies more with the investor than the manager.

(c) When capital is used to enhance a strategy (e.g., an activist co-investment), fees are typically lower compared to the main fund, but the discount is usually smaller than the opportunities where capital is required to consummate a transaction.

[4] As defined in Code § 897(c)(1).

[5] *See* Code § 897(c)(2).

[6] Foreign Investment in Real Property Tax Act ("FIRPTA").

[7] *See, e.g.*, Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries (July 2014), *available at* http://www.oecd.org/tax/tax-global/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf and Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries (Aug. 13, 2014), *available at* http://www.oecd.org/ctp/tax-global/part-2-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.

[8] *See, e.g.*, Code §§ 1471(d)(1) and (e)(2).

2. Netting of P&L for Fee Purposes

   (a) In general, netting of profits and losses across investments within a fund is common within blind pool vehicles, but less common where investors have discretion over whether to invest in a deal.

   (b) Some managers that have investors below water in their main fund also offer netting arrangements for opt-in co-investment opportunities.

   (c) In such arrangements, the investor's high-water mark in the main fund would count toward the fees charged to that investor in the sidecar vehicle, and the sidecar would not charge separate fees until the losses in the main fund are recouped.

3. Management fees for co-investments may be charged on capital commitments or capital contributions. Sidecars structured to invest in multiple co-investment opportunities may accept capital commitments from investors and charge fees on those commitments. Sidecars that make a single investment are more likely to charge on contributed capital (or net asset value), even if investors make capital commitments instead of a one-time contribution.

4. Performance fees and allocations with respect to co-investments vary on a case-by-case basis, but they often take the form of a back-ended private equity carry structure. Such compensation needs to be structured carefully to take into account tax considerations, both from the manager's standpoint and an investor's standpoint. Activist strategies that invest in publicly traded securities that are more easily marked to market may charge an annual incentive allocation based on realized and unrealized gains in the sidecar.

5. Time Sensitivity: Co-investment opportunities often present themselves on a relatively short timeframe, particularly where publicly traded securities are involved (e.g., activism). If a co-investment opportunity is time sensitive and the manager needs to raise co-investment capital quickly, the manager may offer lower fees to attract capital quickly.

C. Expenses that are specific to a particular sidecar vehicle (such as the vehicle's organizational costs) will generally be borne by the investors in such vehicle. If the expenses are common to the sidecar and the main fund (and other funds), each vehicle typically will bear its pro rata share of such common expenses. Expenses attributable to a particular opt-in co-investment opportunity are typically borne by the investors that opt into that particular opportunity.

D. Separate sidecar vehicles may be focused on a single investment or multiple related investments, and they may be organized at the same time or after the main fund is organized.

III. Conflicts and Regulatory Issues

A. Offering Co-Investments to Investors

1. Investors in the main fund (more often in private equity funds) may request the right to participate in co-investment opportunities offered by a manager. Managers should consider contractual obligations, investor relations concerns and fiduciary concerns when determining the allocation of co-investment opportunities across funds and investors.[9]

[9] *See* Igor Rozenblit's (Co-Head of the Private Funds Unit at the SEC's Office of Compliance Inspections and Examinations) speech at the Compliance Outreach Program Seminar (Jan. 30, 2014).

2. Fund documents typically provide managers with broad discretion to allocate co-investment opportunities and contain the allocation methodology for determining when an investment may be allocated to a sidecar.

B. Allocation of Purchases and Sales

1. From a conflicts perspective, it would be ideal to buy and sell assets at the same time in all vehicles — and co-investors often request this — but simultaneous transactions are often not achievable because:

(a) Funds may have investment restrictions and guidelines in their governing documents that limit potential exposure to illiquid investments. These provisions guide the allocation of purchases of investments. For instance, if a fund has reached its limit with respect to a particular investment opportunity, it may cease purchasing an investment while the sidecar continues to purchase the same investment.

(b) Differing terms between a fund and a sidecar (e.g., liquidity provisions, investment periods) may result in a manager pursuing different exit strategies, even though both vehicles own the same asset. For instance, a manager may be forced to sell a co-investment in the fund in order to meet withdrawal requests, while the sidecar that holds the same co-investment may not have the same liquidity considerations.

(c) A manager may sell a co-investment on behalf of a sidecar at the end of its term, while the manager's main fund may not be required to liquidate the position because it is evergreen.

(d) A manager's main fund may have a cap on follow-on investments, which could lead to an over-allocation of a particular co-investment to a sidecar as compared to the manager's main fund.

(e) Tax considerations may cause one vehicle to acquire or dispose of the asset at a different time from another and/or delay distributions to investors.

2. Managers often reserve the right to run multiple funds side-by-side and allocate investment opportunities across funds and investors. Managers should have a clearly written allocation policy that describes how such opportunities will be allocated across the manager's funds and investors. In some cases, managers may choose to structure a sidecar outside of the main funds in order to make a co-investment.

C. Confidentiality

1. Managers may offer blind pool co-investment opportunities where the investor does not learn what the target company is. In such cases, the investor does not typically need to sign a nondisclosure agreement to make the investment in the sidecar.

2. In other cases, a manager may disclose the name of the target company to prospective investors. In such case, a confidentiality undertaking from the prospective investors may be important to protect the interests of both the manager's main fund and the sidecar vehicle.

3. When a limited subset of investors from the manager's main fund participate in the sidecar, the manager must consider selective disclosure issues. Investors in a sidecar may receive detailed information about the co-investment opportunity. If that is the case, the manager should consider disclosing the same information to the investors in the main fund to avoid providing some investors with better information about the main fund's portfolio.

D. Regulatory Scrutiny

1. Regulators have focused on the allocation of co-investment opportunities in their examination activities. In particular, regulators have focused their attention on whether the governing documents of a fund address co-investments, noting that governing documents often lack clearly defined protocols for mitigating conflicts of interest associated with co-investments.[10]

2. One area of focus is the allocation of co-investment opportunities to some but not all investors in the main fund without proper disclosure in the governing documents of the main fund.[11]

E. Conclusion

1. The decline of side pockets has resulted in increased use of alternative means of accessing illiquid investments, including one-off co-investments, sidecars and private equity funds.

2. These alternative techniques present new challenges for managers and investors with respect to legal structure, business terms and fiduciary issues.

3. Despite these challenges, co-investments are likely to be an increasingly important component of the offerings of investment managers, even where liquid investments are a primary focus.

[10] *See* Andrew Bowden's (Director of the SEC Office of Compliance Inspections and Examinations) speech at the Private Equity International Private Fund Compliance Forum 2014 (May 6, 2014).

[11] *See* Rozenblit's speech at the Compliance Outreach Program Seminar (Jan. 30, 2014).

3. Running Hedge and Private Equity Strategies Side by Side

Running Hedge and Private Equity Strategies Side by Side

I. Types of Strategies That Are Typically Run Side by Side and the Benefits of Doing So

A. Types of investment strategies that typically use hedge and private equity structures to run the same or a similar investment program side by side:

1. Often involve investment strategies in the middle of the spectrum between illiquid and liquid assets.

2. Contain assets that typically are capable of being valued by the manager.

3. The most common examples are:

(a) Credit;

(b) Distressed;

(c) Asset-Backed Securities; and

(d) Activist.

B. Benefits of Running Strategies Side by Side

1. Allows managers to access different pools of capital than if they were to only manage one type of fund.

(a) Some institutional investors have mandates that only allow them to invest (or only invest up to a cap) in hedge or private equity funds.

(b) Some investors prefer the additional protections a private equity fund offers, including key man, hurdles, clawbacks, distribution-based carry, investment restrictions, GP removal provisions and a greater ability to negotiate fund terms.

(c) On the other hand, some investors prefer the liquidity offered by the hedge fund model.

2. Allows managers to pursue similar strategies with a different twist.

(a) For example, the hedge fund and the private equity fund may invest in the same illiquid asset, but the investments made by the private equity fund may be more highly concentrated.

(b) As another example, the two funds may invest in the same company, but the private equity fund would take a control position while the hedge fund would not.

(c) Hedge funds may have a more flexible investment program, including, for example, the use of hedging and leverage.

(d) Managers can leverage knowledge obtained in the course of running one fund to take the same or a similar position in another fund.

3. Provides managers with different options for liquidity management.

    (a) Private equity funds do not allow withdrawals, but they must buy and sell according to their investment cycle.

    (b) Hedge funds allow withdrawals but do not have to buy and sell according to a cycle and can continue to invest.

II. Fund Terms

A. Although a traditional hedge fund may have quarterly liquidity and a traditional private equity fund may have a 10- to 12-year term, hedge and private equity funds that are run side by side may have more similar terms.

   Convergence of terms enables hedge funds and private equity funds to invest in the same or similar assets.

   1. Hedge funds that invest side by side with private equity funds can have longer lock-up periods and features like fast-pay, slow-pay that enable them to invest in less liquid assets.

   2. Private equity funds that invest side by side with hedge funds can have shorter investment periods and terms and often charge management fees based on net asset value rather than committed capital.

B. There are also examples of managers that run hedge and private equity funds side by side where the hedge fund and private equity fund each has traditional terms.

C. GP removal and no-fault termination clauses are sometimes given to investors in private equity funds. However, managers need to consider the fact that a fund for which the investment period has been terminated or the GP has been removed will still be holding its assets side by side with other funds the manager is still running.

D. Most Favored Nation ("MFN"): Investors, including investors that are invested in both the hedge and private equity fund being run by side by side, may seek to receive MFN rights across funds, but it is generally not practical to give an MFN that runs across hedge and private equity funds.

E. Differing expense and indemnification provisions, which often occur as a result of the terms of private equity funds being more heavily negotiated, can cause a manager to bear some expenses with respect to one fund but not another.

F. There are tax issues that arise in connection with the types of strategies that are typically managed side by side, including direct lending and FIRPTA withholding issues. In order to address these tax issues, private equity funds typically include terms such as the ability to create parallel funds and alternative investment vehicles as well as excuse provisions.

III. Compensation Considerations

A. Managers of hedge funds typically receive incentive compensation yearly on realized and unrealized gains.

B. Managers of private equity funds only receive carried interest when investments are realized, and the carried interest is typically subject to a preferred return and a clawback. Carried interest with respect to strategies that are most commonly managed side by side with hedge funds (i.e., distressed and activist) is typically back-end loaded.

C. Managers are more likely to compensate employees based on particular deals done with respect to private equity funds than hedge funds. As a result, an employee's compensation can differ across funds with respect to the same investments as a result of the employee not participating in the private equity fund's deals prior to their employment.

   Private equity-style compensation has advantages for founders with respect to retaining talent because employees will not be compensated with respect to a particular deal if they depart before the deal is realized.

D. As a result of the different approaches to the payment of compensation, managers should give thought to harmonizing the way employees are compensated across funds.

IV. Conflicts of Interest

Managers that run hedge and private equity strategies side by side may face a range of conflicts of interest between the funds. Such conflicts should be identified, disclosed, mitigated and managed consistent with the investment advisers' fiduciary duties.

A. Allocation of Investment Opportunities: Managers that run hedge and private equity strategies side by side often face issues in allocating investment opportunities between funds, and purchases of investments as well as exits from investments may not be *pari passu* for several reasons.

   1. Return Thresholds/Investment Objectives

      (a) Hedge funds and private equity funds run side by side may have different return thresholds and investment objectives resulting from the fact that private equity investors usually demand a return premium for illiquidity.

      (b) A hedge fund's ability to leverage may make an investment appropriate for the hedge fund that would not otherwise yield an adequate return.

   2. Liquidity: The differing liquidity between hedge and private equity funds can mean a particular illiquid investment (or a particular concentration in an illiquid investment) is not appropriate for the hedge fund.

   3. Available Capital: The available capital of a hedge fund and a private equity fund run side by side may differ as a result of the differences in the nature of fundraising between the two vehicles. While hedge funds have capital coming in and out as a result of subscriptions and withdrawals, private equity funds raise money based on a more formal investment cycle.

   4. Differing Exit Strategies: The differing liquidity terms and investment periods between hedge fund and private equity funds can lead to differing exit strategies.

      (a) A hedge fund may be forced to sell an investment in order to meet withdrawal requests, while a private equity fund does not have the same considerations.

      (b) A private equity fund may sell an investment during its harvesting period when a hedge fund does not because the hedge fund is an evergreen vehicle.

5. Investment Restrictions: Private equity investors are more likely to negotiate investment restrictions on the type of investments that may be made by the fund and the concentrations thereof. This can lead to differing investments and/or concentrations between funds.

6. Tax Considerations: Private equity funds often provide investors with tax covenants regarding ECI and UBTI, which can result in a difference between the way the two funds structure and make investments.

B. Investing in Different Levels of the Capital Structure of the Same Asset

1. A fund may make an investment in a position that is subordinated or senior to a position held by another fund, which can create conflicts, for example, when participating in creditors' committees.

2. A fund may invest in the debt securities of a company while another fund managed by the same manager invests in the equity securities, which can create conflicts regarding whether obligations and covenants on the debt should be enforced.

C. Activities by One Fund That May Adversely Affect a Fund Being Run Side by Side

1. Hedge and private equity funds run side by side may invest in opportunities that are limited, which may affect the price and availability of investments.

   If investors view there to be a limited opportunity set in an investment strategy, they may negotiate caps on the size of both the fund they are investing in and in other funds investing in similar strategies. This request will commonly originate from private equity investors because hedge fund investors can typically withdraw if they feel a manager is managing too much capital in a particular investment strategy.

2. Time and attention that a manager devotes to one fund is time and attention that is not being spent on the fund being run side by side to the extent their investments differ.

D. Activities by One Fund That May Benefit a Fund Being Run Side by Bide

1. There are instances where a private equity fund cannot make a follow-on investment that could increase the value of an existing investment because it is no longer in its investment period. In some cases, a hedge fund being run side by side can make this investment. However, in order to fulfill its fiduciary obligations, a manager must view investments of these types on a stand-alone basis with respect to the particular fund making the follow-on.

2. One fund may use the services of the portfolio company of another fund (e.g., a loan servicer).

3. Fee-sharing arrangements may benefit hedge funds (which may not have fee offsets) more than private equity funds.

4. An increase in the amount of the total capital managed by a manager in a particular investment strategy can provide benefits to funds run side by side.

   (a) Increased size often leads to volume discounts across funds.

   (b) Improves a manager's ability to run a successful activist campaign.

V. Presentation of Performance Results

A. Performance results are often presented differently by private equity and hedge funds.

1. Private equity funds typically present more detailed performance information that includes deal-by-deal gross returns, projections and IRR calculations.

   Certain investors who invest in both a manager's hedge fund and private equity fund may seek to receive more extensive information regarding the private equity fund's investment portfolio than is generally available to the hedge fund investors. This could present selective disclosure issues since the investor could act on this information by withdrawing from the hedge fund to the potential detriment of the other investors.

2. Hedge fund performance metrics are typically only based on NAV and annual performance information.

   (a) Hedge fund performance information is typically more limited because investors can act on this information to subscribe and redeem.

   (b) Hedge fund performance also will typically reflect cash drag as a result of holding more in cash reserves than a private equity fund run side by side.

3. As a result of the differences in presentation, performance numbers presented by hedge and private equity funds being run side by side can differ, even when the investment portfolios are substantially similar.

4. Different structuring for tax issues between the hedge and private equity funds can also cause differences in performances due to "tax drag."

VI. Issues for a Manager Transitioning from Managing One Asset Class to the Other

A. Managers with experience managing hedge funds that seek to branch into managing a private equity fund are often surprised with the level of negotiation that private equity investors expect. This is not always the case where the investor base of the new private equity fund consists of the manager's existing hedge fund investors.

B. Managers with experience managing private equity funds that seek to form a hedge fund will often need to re-educate their investor base as to hedge fund terms.

4. Market Update

Market Update

I. Macro-Level Trends in Private Fund Terms

A. U.S. private equity fundraising accelerated in 2014, and this trend appears to be continuing. Record distributions from existing funds continue to instill confidence among investors while putting them under some pressure to allocate the returned capital. Since the nadir of 2010, when North American-focused funds raised only $161 billion, fundraising activity gradually recovered to $282 billion in 2014.[1] Our anecdotal experience here at SRZ suggests that 2015 will exceed this.

B. Although established investors demonstrate their continued commitment to the private equity sector, they are well aware that the balance of negotiating power has shifted since the fundraising peak prior to the global economic crisis. LPs now scrutinize management teams and fund terms in greater detail, consolidate their investments with a smaller number of managers and are engaged in a general "flight to quality." In addition, a new wave of separately managed accounts and other bespoke investment solutions has augmented the classic commingled approach to private equity fundraising. This has made the aggregation of discretionary capital more difficult for some managers, especially if they are new market entrants or have inconsistent track records.

C. Investors, acutely aware of the current fundraising challenges and impact of their own expanded diligence protocols, have demonstrated that they understand these circumstances by generally approving requests to extend fundraising periods by a further three to six months — or even leaving such extensions to the discretion of fund managers.

D. Conversely, for some managers, fundraising has been easier. In a striking reversal of the trend in recent years, 2014 saw the average fundraising period shorten significantly to 16.5 months, from 18.2 months in 2013.[2] Strongly favored funds are continuing to reach (and often exceed) their targets in under 12 months.[3]

E. The speed and strength of these "best of breed" fund raises, combined with an awareness by LPs of the perils of "adverse selection" (i.e., problems expected to arise from selecting managers primarily on the basis of fund terms, rather than performance), have sustained the relative durability of traditional private equity fund terms and conditions.

F. Increased regulatory burdens have also created higher barriers to entry.

G. Larger fund managers, buoyed by the "flight to quality" and their ability to leverage both existing institutional relationships and operational infrastructure, have sought to diversify their platforms by offering new products. These new products frequently exhibit investment strategies complementary to the manager's existing vehicles, or further specialized variants thereof, and can be tailored to the individual requirements of larger investors. Unsurprisingly, such structures have been the subject of intense investor scrutiny in terms of deal flow allocation and potential conflicts of interest, underscoring the need for fund managers to have in place effective and articulable policies and procedures to address these concerns.

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[1] Preqin Private Equity Spotlight (December 2014), at 2.

[2] *See id.* at note 8.

[3] *See, e.g.*, *The Wall Street Journal*, "Private Equity Fundraising Topped $266 Billion in 2014," Jan. 13, 2015; *Reuters PE Hub*, "Hellman flies through mega-fundraising on Fund VIII," www.pehub.com/2014/09/hellman-flies-through-mega-fundraising-on-fund-viii (accessed Jan. 26, 2015); *Reuters*, "CD&R private equity fund oversubscribed, raises $6.25 bln," www.reuters.com/article/2014/02/26/cdr-fund-idUSL6N0LV3CT20140226 (accessed Jan. 26, 2015).

H. Notwithstanding the migration of capital to ever-larger fund management firms, new managers with excellent pedigrees or expertise in innovative market niches can find fundraising success. Many LPs are concerned that larger managers deploying vast sums of capital may be unable to maximize performance. Moreover, many institutions that had once considered themselves to be particularly favored by established managers now find that, in the context of the growth of mega-funds and the new arrival of "mega LPs" (such as sovereign wealth funds), they no longer command favored terms or access to co-investment opportunities. Accordingly, many of these institutions now have an enhanced appetite to develop relationships with new managers.

I. An additional factor that perpetuates traditional fund terms is the upward pressure on fees created by additional regulatory requirements, demand for investor relations capacity and investor concern as to whether a fund manager can maintain a stable team of investment professionals. In our experience, many investors refrain from negotiating fees and decline to commit capital until a fund can raise a threshold level of aggregate commitments, so as to be assured that the manager can maintain a sufficient fee stream to conduct operations. To some extent, this phenomenon may result in greater downward pressure being placed on the fees charged by established, rather than new, fund managers.

II. Micro-Level Trends in Private Equity Fund Terms

A. No-Fault Kick-Out and Termination Rights

1. Limited partners are continuing to request a panoply of kick-out and termination rights, both for cause and without cause, with respect to removal of the general partner, dissolution of the fund and termination of the fund's investment period. In particular, limited partners have been requesting no-fault rights to remove general partners, terminate funds' investment periods or dissolve funds. These rights typically require the vote of a supermajority in interest of limited partners not affiliated with the general partner.

2. While many private equity funds have historically granted general partners the right, typically following the vote of a majority in interest, to remove the general partner for "cause," general partners are increasingly acquiescing to also include no-fault removal rights providing for a supermajority of limited partners to be able to vote to remove the general partner. Limited partners argue that they need this right to remove the general partners, without the occurrence of a "cause" event, because typical definitions of "cause" require a court finding of "cause" (i.e., fraud, gross negligence, willful misconduct, material breach of the limited partnership agreement, criminal misconduct, etc.) and too long a period of time to determine. From the limited partners' perspective, provisions that require that the determination of cause by a court should be non-appealable are even worse as they could potentially take years to resolve. In addition, if limited partners believe that (1) a "cause" event has happened, even though a court has not yet found such event to have happened or (2) the general partner has acted in a manner that is not in the best interests of the fund, even if such action is not technically a "cause" event, then limited partners would like to have the right to vote to remove the general partner.

3. There are also circumstances under which the limited partners want to restrict the activities of the general partner but do not want to go as far as to remove the general partner. For example, limited partners may want the general partner to cease making new investments, either because they think the general partner has not been acting in the best interests of the fund (but have decided that the general partner is the person best placed to continue to manage the fund's existing investments) or because they think (and they may have a different opinion from the general partner) that economic or regulatory conditions are not suitable for the fund to continue investing. In anticipation of such

circumstances, limited partners are increasingly negotiating for the ability to terminate (without cause) the investment period of the fund.

4. Often limited partners simply negotiate for a no-fault dissolution right. In the no-fault scenario, limited partners are typically okay with having the general partner manage the liquidation process (particularly since general partners will often understand the underlying fund assets better than a third-party liquidator). There are, however, a minority of large institutional investors that are very insistent on negotiating for the right to appoint a third-party liquidator even if the right to vote for dissolution of the fund is not triggered by the occurrence of a "cause" event.

5. Accounting deconsolidation requirements may also result in general partners agreeing to include a no-fault dissolution right or general partner removal right in a fund's limited partnership agreement. Inclusion of these no-fault rights allows the general partner/investment manager to avoid having to consolidate its financial statements with those of the fund as would otherwise be required under U.S. generally accepted accounting principles.

6. Definition of Cause/Disabling Conduct: The definition of "cause" that triggers a for "cause" removal of the general partner, termination of a fund's investment period or dissolution of a fund typically requires a finding by a court of competent jurisdiction (or a finding by a regulatory agency) that the general partner has engaged in conduct constituting fraud, gross negligence, willful misconduct or material breach of the agreement. Limited partners have been increasingly insistent that the "cause" definition also cover breach of the general partner's fiduciary duty or standard of care.

B. Indemnity

A typical fund limited partnership agreement exculpates and indemnifies the general partner and its partners, members, officers, affiliates, agents, etc. for all actions or inactions relating to the fund's activities, unless the applicable indemnified party has engaged in specified bad conduct (i.e., fraud, gross negligence, willful misconduct, material breach of the agreement). Sometimes the standard of conduct for exculpation/indemnification includes material violation of securities laws. There has been a trend toward more transparency over exactly what expenses are indemnifiable expenses under a fund's limited partnership agreement. For example, limited partners have been expressly requesting, both in their side letters and in their comments to limited partnership agreements, that expenses such as the legal costs relating to regulatory investigations of the general partner/investment manager and the legal costs relating to defending allegations of breach of side letters be excluded from indemnification. Along with the forgoing limitations on what is indemnifiable have come requests by limited partners for the general partner to disclose to limited partners (or the limited partner advisory committee members of a fund) any material payments made by the fund to indemnified persons pursuant to the indemnity.

C. LPAC

1. The provisions set forth in the limited partnership agreements of private equity funds relating to the operation of limited partnership advisory committees ("LPACs") have been getting increasingly more robust.

2. There is an increased emphasis by limited partners on giving the LPAC the right to hire legal counsel and other advisors (e.g., accountants and valuation agents) at the fund's expense.

3. Limited partners also want to know exactly who their fellow limited partners are and how to contact them. The rationale behind having this right is that otherwise it could be very difficult for limited partners to exercise their rights to vote to remove a general partner, dissolve a fund or terminate a

fund's investment period. Limited partners want to be able to discuss issues with fellow limited partners and, if necessary, mobilize themselves to take appropriate action by voting to remove a general partner, dissolve a fund or terminate the fund's investment period.

4. Limited partners have been increasingly asking for the LPAC to have the authority to review fund valuations and, in some cases, to the extent the LPAC disagrees with such valuations, hire third-party valuation services to revalue the applicable assets.

5. It is fairly standard now for the LPAC to be expressly covered by indemnity in a fund's limited partnership agreement (usually only to the extent that LPAC members do not act in bad faith). In addition, the typical LPAC provision often includes express language to the effect that LPAC members have no fiduciary duty to other limited partners and are permitted to consider only their own interests when voting on the LPAC.

D. Standard of Care/Exercise of Sole Discretion

Limited partners are increasingly requesting that limited partnership agreements contain express provisions setting forth the standard of care to which the general partner is subject. In addition, limited partners sometimes ask for confirmation (either in side letters or in the limited partnership agreement) that the general partner's fiduciary duties to limited partners and the fund are not eliminated in instances where the general partner is authorized under the limited partnership agreement to act in its sole discretion. The concern here is that the exercise by the general partner of its "sole discretion" could result in the general partner taking only its own interests into account (to the detriment of its fiduciary duty) when making decisions on behalf of the fund.

E. Carried Interest; Management Fees

1. For established general partners who have historically sponsored funds with deal-by-deal waterfalls, there continues to be pressure to convert deal-by-deal waterfalls to "European style" waterfalls. Those general partners able to successfully push back have done so by agreeing to a number of alternatives (to be used individually or in combination): agreeing to interim clawbacks, escrowing all or some portion of the carried interest otherwise distributable to the general partner during the investment period, or agreeing not to receive carried interest unless the fund has "overperformed" by some specified percentage (e.g., the sum of realized proceeds and the fair value of unrealized investments is greater than all capital contributions made to date by some specified percentage).

2. For new or less-pedigreed general partners, "European style" waterfalls are standard. And indeed, many established managers are accepting this as the new paradigm.

3. Also, the type of credit support for clawback obligations is changing. We see fewer escrow arrangements and more guarantees.

4. Limited partners are also very sensitive to the issue of a fund paying management fees following the expiration of the fund's term and often ask for a limitation (e.g., a reduction in the management fee rate and/or a limit on the amount of time during the wind-down and liquidation of the fund that management fees can be charged). This sensitivity to extended management fees also carries over to a reluctance to agree on giving general partners the right to unilaterally extend the term of a fund (in particular beyond one additional one-year extension).

F. Conflicts

1. While the SEC has been particularly concerned with expense allocations, investors have been more concerned with investment allocations among general partners' various funds and accounts and, specifically, with trying to understand exactly how such allocations are done, including allocations with predecessor funds, successor funds, managed accounts or funds of one, and funds with overlapping investment programs.

2. There has been a continued emphasis on giving the LPAC approval rights over affiliate transactions as well as requiring general partners to disclose all transaction fees (and management fee offset calculations) and services provided by affiliates.

3. Alternative Investment Vehicles ("AIVs"): A certain category of investor (i.e., larger institutional tax-exempt investors) has been particularly concerned with being required to participate in AIVs without their consent. The concern is that the general partner may not necessarily be able to take into account the unique tax constraints/concerns of such investors and therefore such investors need to have a say in the decision to require them to participate in an AIV in order to ensure that the tax impact on such investor is not adverse and/or they are treated in the same manner as other similarly situated investors.

4. Co-Investments: Investors continue to request co-investment rights or, at a minimum, that the general partner acknowledge (in the investor's side letter) that the investor is interested in co-investments. The attraction for limited partners is that co-investments can effectively reduce the fee load such investors pay the manager, as most co-investments are offered on reduced (or completely waived) fee terms. While such requests for co-investment rights will often be negotiated on an investor-by-investor basis (i.e., general partners may be willing to agree with large investors to first offer them co-investment rights or, alternatively, offer all limited partners available co-investment opportunities on a pro rata basis), ultimately whether general partners charge fees/carry will depend on whether the fund needs additional capital to complete a deal or whether the investment in question is a more scalable investment where incremental increases in the size of the investment necessarily are not required to materially increase profitability of the investment in question.

III. Final Observations: Fund Formation Costs — Where 'Macro' and 'Micro' Meet

A. As demonstrated by this discussion, although fund terms have become somewhat more "LP-favorable" since the global economic crisis, our primary observation is that the fundamental closed-end private equity economic model is nothing if not cycle-durable. Perhaps the most telling evidence of this assertion is that caps on fund formation costs have generally not decreased. This reflects an understanding by LPs that, notwithstanding some exceptionally quick fund raises by the most desirable managers, fund-raises usually take longer than ever before, involve more complicated negotiations, cumbersome know-your-customer diligence and other "project management."

B. We have taken an informal poll among our partners and associates who represent GPs, as to the most time-consuming issues — not the most important, but the most time-consuming — that drive-up fund formation costs. In the context of large fund raises, issues such as Freedom of Information Act compliance, carve-outs to confidentiality, sovereign immunity, the particularities of jurisdiction and venue, and indemnification mechanics all took extremely significant amounts of time to negotiate and document. In the context of small, first-time fund raises, these very same issues arise, but are augmented by the additional costs of fundamental economic negotiations, as well as the costs of negotiating the excess demands sometimes made by established LPs who enjoy an imbalance of negotiating power with new managers.

C. We took the same informal poll of our partners and associates who primarily represent LPs, and learned something even more important: Negotiations became most protracted and expensive where sponsors are represented by counsel who have the least technical skill and market knowledge, and therefore take “off-market” positions or otherwise present technically deficient fund documentation. Conversely, negotiations were most efficient where the parties and their counsel enjoyed a balance of both economic power and technical sophistication.