Private Equity Newsletter

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A Fund By Any Other Name: The Convergence of Hedge Funds and Private Equity Funds

Hedge funds increasingly have been broadening their investment strategies in the past several years. We now regularly see hedge funds holding control positions in major U.S. public companies, acting as activist proponents of changes in corporate strategy, participating in auctions for private equity stakes and purchasing middle-market loans and other illiquid financial assets. Meanwhile, private equity funds have launched hedge fund arms of their own, drawing upon the firms' extensive research database and investment expertise. It is thus becoming more and more difficult to differentiate between hedge fund and private equity fund strategies, and quite interesting to consider the convergence resulting from these developments.

Traditional Hedge Funds

Hedge funds have traditionally been characterized by relatively liquid, short-term investment strategies such as convertible arbitrage, merger arbitrage or long-short public equity portfolios. In return for agreeing to pay annual performance fees based on realized and unrealized capital gains, hedge fund investors have a short-term commitment and are accustomed to a certain degree of liquidity, such as quarterly redemption rights. Hedge funds do not typically have a fixed term, but rather continue on a year-to-year basis until dissolved.

In many ways, the hedge fund model is very appealing for asset managers. The typical hedge fund agreement is not heavily negotiated, does not impose significant restrictions on investment strategies and permits the manager to receive incentive compensation on unrealized capital gains rather than wait until the actual disposition of investments. Usually, there is a significant counterweight to these benefits, in that investors retain the right to withdraw their capital on a quarterly basis (with perhaps the payment of a redemption fee in the first year). Thus, investors provide the manager with substantial latitude, but retain the right to walk away from an unproductive fund.

Traditional Private Equity Funds

Private equity funds, on the other hand, generally permit relatively specific and focused investments in private companies based on strategies developed from extensive track records and have fixed terms extending over a decade. During the first six years of these funds, the fund's manager has the right to require investors to contribute capital contributions from time to time for new investment opportunities, and the investors may not receive any return of (or on) these capital contributions until the end of the fund's 10-year term. Fund documentation is often negotiated at length over many months between the manager and the lead institutional investor regarding key person events, clawbacks and other investor protections. Generally, additional investors are permitted to join the fund only during an initial 12-month formation period. There is generally less significance to the pricing of the investments in the private equity fund portfolio because there is no transfer of economic risk from existing investors to new investors as there would be if the fund were open to new commitments.

Introducing the Hybrid Fund

Increasingly, there is a new type of hedge fund with more private equity type features in its investment strategy, while retaining the basic benefits of a hedge fund structure for its manager. These funds are often sponsored by managers that have an extremely strong reputation with investors, have multi-year lockups on investor capital and take illiquid, longer-term positions in securities that may be designated as "side pockets," which may result in a further lockup on the assets of investors. Some of these funds invest in distressed and/or private companies and obtain equity positions to obtain management control. Recently, hedge funds have launched high-profile attempts to influence management or obtain control of companies. A survey by Freeman & Co. shows that investments in private equity type investments represented 7% of total hedge fund investments in 2005 and is likely to increase.

A number of hedge funds have recently been developed in conjunction with well-known private equity groups, such as The Blackstone Group and Texas Pacific Group. These hedge fund arms expect to draw upon the research database and other expertise of the private equity firm to invest in longer-term positions in companies as compared to the typical long-short equity fund. The Carlyle Group and Bain Capital have also launched their own hedge funds to take advantage of the synergies of having multiple private fund investment strategies under one roof.

Given the surge in investments in hedge funds and the prestige of the managers who are raising new funds, investors have committed themselves to this hybrid type of fund, which has reduced the protections that they have otherwise achieved in either a typical hedge fund or private equity fund model.

Issues to Consider for Hybrid Fund Managers

As a hedge fund's investment strategy focuses on more illiquid private investments, hedge fund managers will encounter new issues, both legal and practical in nature, including those outlined below.

Side Pockets

Some funds have simply indicated that much of investors' capital will be invested in illiquid investments, but the more accepted means to engage in private illiquid investments is to use a "side pocket." The term "side pocket" refers to a portion of the hedge fund that is segregated from the remainder of the assets for certain illiquid investments as determined by the manager. The profits and losses derived from a side pocket investment are allocated solely to those investors that are in the fund at the time of the particular investment and the capital related to that investment is not available for withdrawal until the investment is realized or otherwise becomes marketable securities. Typically about 10-15% of a fund may be reserved for side pocket allocation. However, a few recent fund offerings suggest that this traditional limit may be changing. For example, Eton Park, a hedge fund that raised $3 billion within a short time in 2004, is said to have the flexibility to allocate up to 30% of its investors' capital in side pocket investments.

Cash Flow Pressures

If more of a fund's investments are in illiquid securities, the hedge fund may be under cash-flow pressure if investors decide to redeem capital out of the fund. A hedge fund manager will usually manage a fund's portfolio to maintain sufficient liquid investments to cover any expected redemptions. Funds have increasingly relied on redemption gates to avoid excessive redemptions in any particular fiscal quarter. These gates will typically provide that investors may not, in the aggregate, redeem more than approximately 15-25% of the fund's capital on any redemption date. Generally these gates have been acceptable to investors. On the other hand, investors tend to resist the use of side pockets because redemptions of their invested capital are more restricted. When a side pocket is used, an investor is required to retain that portion of its capital in the fund even if the investor has otherwise decided to sever its investment relationship with the manager. This makes it more difficult for an investor to determine whether there will be a gain or loss on its overall invested capital and has limited the use of side pockets to the more highly successful managers and those with significant market clout.

Liquidity and Valuation/Fee Concerns

Potential concerns regarding valuation of illiquid investments pose a roadblock on the road to convergence. Hedge fund managers value their portfolio both for purposes of determining the price at which investors come into and out of the fund and determining the amount of fees that are payable to the manager. Liquid securities are valued simply by using reported market prices. Illiquid investments are valued using "fair value" (the expected sale price for such investment as determined by the general partner), which raises valuation issues for hedge fund managers (and investors) who are more accustomed to valuations based on more readily ascertainable market prices. Paying annual fees on locked up investments with illiquid investments—valued subjectively by a fund manager—may be unfamiliar to investors. In fact, one successful hedge fund manager has even suggested that managers with multi-year lockups on their investors should also be willing not to take performance fees until the end of their lockup period rather than annually as is almost universal.

It is worth noting that side pocket investments could alter the reported track record of a hedge fund depending on how the side pocket performance is reported. If reported separately from the main assets of the fund, then the primary track record may not fully reflect the performance earned by particular investors.

Side pockets may present new risks if they are used by managers following the date on which the investment is originally made or if a previously designated side pocket is later re-designated to become part of the fund's main portfolio. In such instances, the manager is essentially selling a relatively illiquid investment from all of his fund investors to a selected group of those investors (or vice versa), which could produce some surprising results and is without any checks or balances on the exercise of the manager's discretion.

Reporting Obligations

Private equity investments by a hedge fund may expose the hedge fund to regulated areas that it would otherwise not be concerned with as a passive investor. Hedge fund advisers that pursue both privately negotiated investments and publicly traded strategies need to consider the adequacy of their policies and procedures with respect to inside information. While large investment advisers have substantial experience implementing informational walls between different teams of portfolio managers, such a system is quite difficult to implement among a small team of individuals who are accustomed to interacting with each other on a daily basis.

Private equity funds and hedge funds should develop internal policies to ensure that inside information on portfolio companies or potential M&A activity is not accessed by professionals who trade in the public markets.

Control positions can also lead to requirements to comply with the reporting obligations under Section 13 of the Securities Exchange Act of 1934, as well as the short-swing profits restrictions under Section 16 and even the filing requirements under the Hart-Scott-Rodino Act.

Recent SEC Hedge Fund Adviser Regulation

Against the backdrop of these market developments are the recent activities undertaken by the SEC following an extensive study of the hedge fund industry. Despite that study, the SEC was generally unable or unwilling to adopt a meaningful definition of what constitutes a hedge fund. As promulgated in the new Rule 203(b)(3)-1, adopted in October 2004, a new definition of "private fund" was adopted that was intended to capture most of the hedge fund industry, while avoiding additional regulation of private equity and venture capital fund advisers.

In pertinent part, the definition adopted by the SEC turns on whether a fund permits redemptions by investors within two years of the making of an investment in the fund. This definition was originally suggested by the Treasury Department in the context of money laundering regulations applicable to funds. While the definition marks a clear basis for determining whether an investment fund could be used in an inappropriate manner by an investor, it appears more arbitrary as a means of determining whether a fund manager should owe different duties to its investors.

The SEC has explained that its definition of a hedge fund purposely avoided any reference to the type of investments made by a fund. In so doing, the SEC wisely stayed away from a definition of hedge funds that would impose additional regulation on certain investments because that would no doubt result in a skewing of the types of investment strategies that might be pursued by managers to the possible detriment of the financial markets. However, the definition promulgated by the SEC may still have had these unintended consequences.

The adoption of the rule has given successful managers an additional reason to insist on a fund structure with a longer lockup, a feature that now appears regularly in the hedge fund industry. These managers, who often are in a position to raise and deploy billions of investment capital, have used the new SEC rule as leverage to convince investors to accept a longer lockup. And in turn, this feature permits the managers of these funds to pursue illiquid investments more readily. Thus, in addition to the typical short-term hedge fund with regular quarterly liquidity, there are now a substantial number of major investment funds with over two to three year lockups on investor capital.

We expect that most of these new large hybrid funds will flourish, whether or not their managers choose to register with the SEC. Investors have found that the terms of investment funds may matter less than the capability of the managers and are therefore eager to commit money to talented investment advisers.

Conclusion

Hedge funds and private equity funds, once individually distinct means to pursue alternative investments, are now beginning to pursue similar strategies and share the regulatory and legal requirements. As private equity and hedge funds converge, new hybrid funds will play a meaningful role in offering new methods to pursue alternative investments. In time, we will see whether these new hybrid entities evolve into a distinct asset class.

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