(2) distributions are made to the partners using the same methodology as other types of private equity funds, which is that a mezzanine fund would return the principal on any loan made to a portfolio company to investors before beginning to make performance-based allocations to the general partner.

Generally, these two alternatives represent a difference only in the timing of distributions, as the clawback owed by the general partner at the end of the life of the fund[74] will require the general partner to have received no more than 20% of such interest payments on any investment (as well as 20% of the profits on any equity-related investments made by the fund), and a return on its invested capital. With that said, investors prefer the latter approach because the general partner's maximum clawback obligation is typically capped as an "after tax obligation" (that is, the clawback will not exceed total carry net of any taxes payable in respect of the carry). Management fees tend to be lower in mezzanine and credit opportunity funds.

§ 1:3.4 Distressed Debt Funds

[A] Typical Investments

Distressed debt funds are private equity vehicles that acquire securities, obligations, assets, trade claims, and businesses of, or relating to, financially distressed companies, typically with the objective of obtaining control or substantial influence over such companies. Such securities or other assets often consist of loans, but may also consist of the equity of these businesses.

[B] Distinguishing Organizational Features

Shorter-term investment. Like credit opportunity funds, distressed funds may have shorter terms and shorter investment periods than other types of private equity funds. It is generally expected that the sponsor will be able to locate investments more quickly and should therefore be able to dispose of the funds' overall portfolio during a period that ends earlier than a typical ten-year term of a buyout fund.

Restrictive investment policies because of high risk. Distressed funds often invest in both publicly traded securities as well as privately placed securities, so it would be unusual to have a restriction in the partnership agreement limiting investments acquired on the open market. Because distressed funds are considered relatively risky investments, like venture capital funds, there are significant restrictions

74. *Id.*

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on the investment activities of these funds. In addition to limits on the amount that can be invested in a single portfolio company, other typical restrictions include limits on investing in real estate and limits on investing in a particular country or industry.

§ 1:3.5 Real Estate Funds

[A] Typical Investments

Real estate funds are those formed for the purpose of investing in some aspect of real estate. In addition to physical real property, target assets may include loans secured by real property, interests in businesses (such as hotels or retail stores) substantially reliant on real property, businesses (such as real property development, management, or brokerage) that relate to real property but do not hold it, and debt or equity securities of these businesses.

Real estate funds sometimes focus their investment strategy on particular geographic locations. However, other typical investment strategies of real estate funds could be based on residential versus commercial properties, development versus developed properties, and investments in more liquid securities such as real estate investment trusts (REITs).

[B] Distinguishing Organizational Features

Complexly structured entities. Real estate funds, particularly those formed to make investments outside the United States, often involve significant structuring through the formation of one or several layers of subsidiaries in order to achieve the most efficient results for investors. Accordingly, it may be necessary to have several parallel entities as well as several levels of subsidiaries formed to make a single real estate investment.

Short-term investment, higher preferred return. Other common characteristics of real estate funds include a shorter investment period, shorter term, and (in some cases) a higher preferred return than are typical of buyout or most other types of private equity funds.

Leverage incurred. Real estate funds generally incur leverage in order to make investments. Unlike private equity buyout funds, where the leverage is often incurred by a C-corp beneath the partnership, real estate funds generally incur leverage at subsidiary levels by partnerships or other "pass-through" entities. Tax-exempt U.S. investors who are either pension plans or educational institutions may require real estate funds to seek to comply with the "fractions rule" requirements of section 514(c)(9) of the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code"), which may permit income from such real estate funds that use leverage to exclude such income from the

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computation of unrelated business taxable income (UBTI) for such investors. Real estate funds also typically have caps on the amount of leverage they are allowed to incur, often expressed as a percentage of the aggregate cost of the portfolio.

Management fees based on debt and equity invested in properties. Unlike the private equity fund model in which management fees are charged as a percentage of committed capital during the investment period and invested capital thereafter, real estate funds may charge management fees based on the debt and equity invested in properties, rather than committed investor capital.

Also, real estate funds are often formed by sponsors who are otherwise engaged in some aspect of the real estate business. For instance, a real estate developer or asset manager may form a real estate fund. In that case, in addition to management fees charged to the fund by the management company, the asset manager in charge of managing the day-to-day real estate investments may also earn income from the fund's investments. There is generally no offset to the management fee charged to the fund for the real estate property management fees charged to the property and paid to an affiliate of this type of general partner. The theory behind this is that these are the types of services the fund would otherwise have to pay a third party to provide.

§ 1:3.6 Funds of Funds

[A] Typical Investments

A fund of funds is formed to invest in other funds. Private equity funds of funds invest in other private equity funds, which may include buyout, venture capital, distressed, real estate, mezzanine, credit opportunities, or a combination of these funds.

Funds of funds often have co-investment rights with the funds in which they invest, thereby allowing the sponsor of the fund of funds to gain access to other investment opportunities in the target companies of its underlying private equity funds. Funds of funds serve a useful purpose, given the increase in size of most private equity funds and the corresponding increase in the minimum investment they require from investors. Funds of funds also offer an additional layer of diversification. Some funds of funds are limited to a particular underlying strategy (for example, real estate), while others also diversify across strategies. In either case, with the exception of funds of funds formed by a sponsor to invest in its own underlying funds, a fund of funds will typically invest in funds offered by multiple underlying managers, reducing reliance on a particular sponsor.

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[B] Distinguishing Organizational Features

Smaller management fees and carried interests. Funds of funds' economic terms vary greatly from those of a typical private equity fund. Because the sponsor's management fee and carried interest are in addition to that charged by the underlying funds in which it invests, the management fees and carried interest in funds of funds are substantially smaller.

Provisions that allow recall of distributions. Since private equity funds often have provisions that require investors to return some or all of their distributions (in order to cover liabilities of the private equity fund), funds of funds that invest in private equity funds must be careful to provide that they are able to recall distributions from their own investors.

Long-term investment. The term of the fund of funds is often much longer (and its investment period is often shorter) than that of private equity funds. The fund of funds will make its initial commitments to underlying funds over a period of years, and has an ongoing obligation to honor its commitment to underlying funds, which may itself go on for as long as ten years after the initial commitment is made by the fund of funds to a private equity fund.

§ 1:3.7 Structured Product Funds

[A] Typical Investments

Investments made by asset-backed securities (ABS), mortgage-backed securities (MBS), and collateralization loan obligation (CLO) funds consist of securities that are secured by, represent an equity interest in, or receive payments from a portfolio of financial assets consisting primarily of corporate debt securities, loans, securitized receivables, ABS, CDO securities, or other financial assets and/or credit default swaps referencing any of the foregoing.

A collaterized debt obligation (CDO) is a special purpose vehicle that typically issues several tranches of debt and equity securities pursuant to an indenture (or trust agreement or similar agreement) and a preference share paying agency agreement (or fiscal agency agreement or similar agreement), and invests the net proceeds thereof primarily in a portfolio of financial assets. The portfolio of financial assets that secures the debt securities issued by the CDO may include any combination of bonds, loans, securitized receivables, asset-backed securities, CDO securities, or other financial assets and/or credit default swaps referencing any of the foregoing. The equity securities issued by a CDO typically are unsecured.

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A "synthetic" CDO is a CDO that obtains credit exposure to companies or asset-backed securities primarily by entering into credit default swaps or total return swaps (and a security issued by it is referred to as a "Synthetic CDO Obligation").

A "cash" CDO is a CDO that primarily invests in loans or securities in order to obtain credit exposure to companies, asset-backed securities, CDO securities, or other financial instruments.

[B] Distinguishing Organizational Features

"Managed" versus "static" CDOs. A "managed" CDO is a CDO with an underlying portfolio of assets (or, in the case of synthetic CDOs, an underlying portfolio of reference entities and/or reference obligations) that is actively managed by a collateral manager or portfolio manager.

A "static" CDO is a CDO with an underlying portfolio of assets (or, in the case of synthetic CDOs, an underlying portfolio of reference entities and/or reference obligations) that is not actively managed by a collateral manager or portfolio manager, and in which new assets generally cannot be added after the closing (or a brief ramp-up period thereafter).

The collateral or portfolio manager of a managed CDO generally has the ability to do the following:

(i) buy and sell assets (or, in the case of a synthetic CDO, add and remove reference obligations and/or reference entities) for the CDO based on predetermined guidelines, and

(ii) in the case of a cash CDO, reinvest certain cash flows received by the CDO in additional assets for a specified period of time.

CDO structure. The indenture (or other governing document) pursuant to which CDO securities are issued will limit the types of assets that the CDO may purchase. In general, the cash flows received by a CDO in respect of its portfolio of assets that are not used to purchase additional assets during the applicable reinvestment period (net of the administrative expenses of such CDO) are used as follows: first, to make payments to the holders of the related CDO senior tranche; second, to make payments to the holders of the related CDO mezzanine tranches; and finally, to make payments to the holders of the related CDO equity. However, almost all CDOs (whether synthetic or cash, or managed or static) are structured such that, in certain circumstances (for example, if predetermined overcollateralization tests or interest coverage tests are not satisfied), cash flows that otherwise would have been paid to the holders of the CDO mezzanine tranches and the CDO equity tranches will be used to redeem the related CDO senior tranches. Such structural features enhance the credit quality of

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the CDO senior tranches at the expense of the credit quality of the related CDO mezzanine tranches and CDO equity tranches.

"Cash flow" versus "market value" CDOs. CDOs may be characterized either as one of the following:

(i) "cash flow" CDOs, which have overcollateralization tests based on the relationship between the principal amount (or "par coverage") of the CDO collateral securing the related CDO securities and interest coverage tests (but no tests based on the market value of the CDO collateral), or

(ii) "market value" CDOs, which have overcollateralization tests that take into account the market value of the CDO collateral.

As a result of the global financial crisis of 2008, the issuance of new CDOs collapsed[75] and many private equity funds that held these instruments incurred substantial losses. However, in the wake of the financial crisis, a number of "credit opportunity" funds were formed to purchase CDO securities, or the underlying assets of CDOs at distressed prices.

§ 1:3.8 "Club" or "Pledge" Funds

[A] Typical Investments

"Club" or "pledge" funds are private equity funds that permit investors to opt in or out of individual investments, rather than investing on a "blind pool" basis in whatever the sponsor selects. Investors in club funds typically pay a management fee for the privilege of receiving a first look at investments, and can be removed from the club if they veto too many investments meeting the fund's investment parameters.

Club funds are often used by managers who do not yet have a sufficient track record to be able to raise a blind pool fund to pursue their objectives, or who want to take advantage of immediate market opportunities instead of going through the waiting period necessary when raising a blind-pool fund. The track record from the club fund can be helpful to the manager when later raising a blind pool; however, if the club fund includes members who themselves have substantial investment experience in the area, then the track record generated may appear to be a collaborative effort.

Club funds tend to attract strategic investor-types, rather than purely passive financial investors. In order to take advantage of the

75. Nicole Bullock & Paul J. Davies, *CDO Volumes Take Big Hammering*, FIN. TIMES, July 11, 2008.

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club feature, the investor must be able to independently evaluate each investment opportunity. The club offers an investor a guaranteed first look at investment opportunities generated by the manager. Investors in club funds are often industry players who already have a history of co-investing with the manager on individual deals, and who are looking to formalize this arrangement. In addition, the club fund also typically provides uniform, pre-negotiated documentation and fee terms for each deal, which enables transactions to be completed more quickly.

§ 1:4 Other Investment Strategies in Private Equity

§ 1:4.1 Private Investments in Public Equity (PIPEs)

One of the investment strategies in the private equity field is private investments in issuers whose securities are already publicly traded, otherwise known as Private Investments in Public Equity (PIPEs). PIPEs provide financing to public companies through a private placement (as opposed to a registered public offering). PIPEs may consist either of preferred equity or debt that is convertible to stock.[76] This is significantly different from a traditional private equity investment, not only because funds that make PIPEs target public companies, but also because the time period for holding this type of investment is typically much shorter. Additionally, a PIPE investor generally is not interested in the management and direction of a company, and often does not offer assistance in running the company.[77]

Although PIPEs have been a part of the private equity landscape for some time,[78] the global financial crisis of 2008 refocused private equity firms' interest in using them. Indeed, 2015 saw a spike in PIPE transactions involving private equity and venture capital investors.[79] PIPEs are advantageous for companies that need to raise money

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76. Megan Davies, *DEALTALK—In credit crunch, private equity turns to PIPEs*, REUTERS (Dec. 6, 2007), http://www.reuters.com/article/mergersNews/idUSN0663716720071206?sp=true. They are typically smaller than leveraged buyouts and rarely rely on leverage, thus making them almost immune to financial markets. *Id.*
77. Joseph Kuzneski & Ron Landen, *Looking Through the PIPE—Opportunities for Private Equity Investors*, PRIVATE EQUITY ALERT (Weil, Gotshal & Manges LLP, New York, NY May 2006), http://www.weil.com/~/media/files/pdfs/PEAMay06.pdf.
78. From the years 2006–2007, according to Sagient Research Systems, the average deal size for PIPEs more than doubled from $21 million to $45 million, http://www.sagientresearch.com/pt/GStats.cfm?Type=6.
79. Angelo Bonvino, Matthew W. Abbott, Justin G. Hamil & Frank Lamicella, *Key Considerations For PE Investors In Growing PIPE Market*, LAW360 (May 5, 2016), http://www.law360.com/articles/792567/key-considerations-for-pe-investors-in-growing-pipe-market.

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quickly without the expense of an underwritten secondary offering, as well as for investors who receive discount shares and warrants in the transaction.[80] Lately, with the staggering amount of capital raised, funds are searching for investments that do not rely on large loans. In a market where it may be difficult to secure financing for control of a company, use of PIPEs is increasingly seen as a promising strategy.

However, an important consideration is that private equity funds are ultimately passive investors in PIPEs and do not control the board of directors. Private equity funds must reconcile this shift away from their traditional investment strategy in order for PIPEs to be a viable option.

§ 1:4.2 Special Purpose Acquisition Company (SPAC)

SPACs are blank check public companies with no current operations that are formed for the purpose of consummating an acquisition of a to-be-identified business in the future. In a number of instances, SPACs have been formed by institutional fund managers. The promoters of many of the more recent SPACs are extremely well-known names from the buyout and alternative asset management communities.

SPACs are different from traditional private equity funds in several significant respects. First, interests in SPACS are publicly offered and consist of common stock and warrants, rather than privately placed limited partnership interests. Second, all of the investor capital is paid in at completion of the SPAC's initial public offering, rather than over time via capital calls. Most significantly, unlike a private equity fund, which is established to make multiple investments, the SPAC structure is designed for a single initial investment, although many SPACs seek to pursue a roll-up strategy after they complete their initial business combination. Some SPACs are focused on specific industries or geographic areas of the world, while others take a more generalist approach.

[A] Investment Advantages

SPACs can be attractive to investors as they not only allow for greater liquidity than traditional private equity funds, but also give institutional investors more "control" over the types of private equity

80. *Interview with Christopher S. Auguste, Kramer Levin Naftalis & Frankel LLP: SPACs and PIPEs: A User's Guide*, METRO. CORP. COUNS. (Feb. 1, 2008) [hereinafter Auguste Interview], http://www.metrocorpcounsel.com/current.php?artType=view&artMonth=February&artYear=2008&EntryNo=7873.

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investments in which they choose to invest. SPACs provide private equity sponsors with an adjunct opportunity to make acquisitions. An initial business combination with a SPAC also may be attractive to a target that would not be interested in a traditional sale to a private equity fund, since a transaction with a SPAC will enable the owners of the private target to monetize a piece of their ownership interest while still preserving the possibility for additional public market appreciation. SPACs may play a more significant role in providing exit opportunities to sponsors. SPACs are attractive to private companies because they allow a private company to become public in less time and at a lower cost than would be required if the company conducted its own initial public offering.

Traditionally, SPACs were unattractive because they require shareholder approval for all acquisitions. Following the global financial crises of 2008, when both credit and exit opportunities for private equity sponsors have been more limited, SPACs have become an attractive option.[81] As they grow in popularity and use, their structure has changed to reflect the concerns of the U.S. Securities and Exchange Commission (SEC), investors and management.

[B] Structural Considerations

SPACs raise a number of structural considerations not often faced by other more traditional private equity offerings.

Potential conflicts of interest must be carefully analyzed. Existing business activities raise both disclosure and, in some cases, consent issues, especially for fund sponsors. On the flip side, the SPAC must be structured to mesh with future business activities, including future permanent capital vehicles. These considerations are further complicated if the sponsor wishes to sponsor multiple SPACs.

Fund sponsors often prefer a holding company structure for holding the carried interest and making their real equity investment. Structure will be dictated by co-investment considerations and who will receive an interest in the carried interest.

Given their cash resources, fund sponsors often wish to make a larger co-investment in the SPAC, and are more amenable to a 10b5-1 repurchase component,[82] both of which raise additional structural considerations.

81. Bill Meagher, *Another Way to Invest With the Smart Money: SPACs*, LDNEWS (Aug. 12, 2016), http://business-news.thestreet.com/ld-news/story/another-way-to-invest-with-the-smart-money-spacs/13673877?page=1.

82. Rule 10b5-1, Securities Exchange Act of 1934.

As a public company, a SPAC is subject to periodic public company reporting. The reporting regimen generally is not as complicated as for an operating company, although there are a few twists. Many fund sponsors need to build out their financial reporting and/or legal compliance function in order to adequately handle public company compliance for the SPAC. In many cases, this will require a great amount of lead time prior to the SPAC offering.

Finally, SPACs raise Investment Company Act considerations for fund sponsors. All sponsors, whether or not registered as investment advisers with the SEC, must be mindful of the issues raised by the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act").

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[C] Investment Risks

For a fund sponsor, the major structural limitation of a SPAC is that shareholder approval of an initial business combination is required. In addition, shareholders who oppose a proposed transaction can convert their shares into cash and, if more than a specified percentage (typically between 20% and 40%) of the public shares exercise redemption rights, the SPAC will be prohibited from consummating the transaction.[83] Furthermore, the transaction value must equal at least 80% of the SPAC's trust account.[84]

SPACs have a limited time frame (generally eighteen to thirty-six months) in which to complete an initial business combination.[85] If the transaction is not consummated in the time allocated, the SPAC must liquidate and return its IPO proceeds to the shareholders.[86]

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83. *See* Carol Boyer & Glenn Baigent, *SPACs As Alternative Investments: An Examination of Performance and Factors That Drive Prices*, 11 J. PRIV. EQUITY 8 (2008). Because the founders of SPACs are generally required to vote in accordance with the public shareholders, they have little influence. *Id*.
84. McDermott Will & Emery, Corporate Practice Group, *Overview of SPACs and Latest Trends: Special-purpose Acquisition Companies*, NAT'L L. REV. (Oct. 22, 2015), http://www.natlawreview.com/article/overview-spacs-and-latest-trends-special-purpose-acquisition-companies.
85. This short time period not only puts a great deal of pressure on management (and gives the target company a significant advantage), but can be unrealistic given the proxy and regulatory issues associated with acquiring companies in certain industries or foreign countries. *See* Kit R. Roane, *Business Buffet: When hungry investors want to make a meal of a company, they can pool their millions in something called a SPAC*, U.S. NEWS & WORLD REP., Jan. 30, 2006, at 1.
86. An emerging trend is to extend the twenty-four-month term, which can generally be accomplished with a signed letter of intent or an acquisition agreement before the end of the time period. *See* Auguste Interview, *supra* note 80.

§ 1:4.3 Mezzanine and Credit Opportunity Funds

The global financial crisis of 2008 fostered a number of credit opportunity funds.[87] In particular, these funds pursue opportunities in CDOs, CLOs and related assets. The catalyst for the surge of mezzanine funds was the tightening of the credit markets in 2007.[88] With commercial banks imposing more conservative lending standards and restrictive terms, private mezzanine securities are frequently used in weak economic environments as a more flexible alternative to traditional financing. Because mezzanine investors generally follow a "buy and hold" investment strategy, they are less susceptible to market fluctuations.[89] Ultimately, mezzanine debt is more expensive than other lending sources because it is available even in times of economic turmoil[90] and because it functions as a mechanism of last resort to raise capital before a company must start selling its equity.

§ 1:4.4 Sovereign Wealth Funds (SWFs)

Another current trend in the private equity industry is the prevalence of sovereign wealth funds (SWFs), which are government-funded investment funds composed of financial assets such as stocks, bonds, property, or other financial instruments. While SWFs have been in existence for over fifty years, their recent rapid growth, both fiscally and geographically, is stirring up interest. SWFs are funded by money derived from a country's reserves that are diverted into the fund for the benefit of the country's economy and citizens. This can involve either investments of the central bank's reserves in foreign treasuries, or funds that the government earns through exports, such as natural resources.[91] Countries that export large quantities of oil tend to have larger SWFs.

The financial resources of SWFs vary by nation, but represent a substantial amount of capital in the world market.[92] The estimated

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87. *See supra* section 1:3.3.
88. *Id.*
89. Miller, *supra* note 44.
90. Nicolette Davey, *Mezzanine Makes Comeback As Market Suffers Fundraising Squeeze*, FIN. NEWS ONLINE (Feb. 4, 2008), http://www.efinancialnews.com/investmentbanking/peoplemoves/content/2449714905.
91. *Sovereign Wealth Funds: Foreign Policy Consequences in an Era of New Money:* Hearing Before the S. Comm. on Foreign Relations, 110th Cong. (June 11, 2008), https://www.gpo.gov/fdsys/pkg/CHRG-110shrg48061/html/CHRG-110shrg48061.htm (statement of Jagdish Bhagwati, Senior Fellow in Int'l Econ. Council on Foreign Relations, and Prof. of Econ. and Law, Columbia Univ.).
92. WILLIAM MIRACKY ET AL., MONITOR GRP., ASSESSING THE RISKS: THE BEHAVIOR OF SOVEREIGN WEALTH FUNDS IN THE GLOBAL ECONOMY (June 2008).

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value of all SWFs as of June 2016 was approximately $7.3 trillion.[93] To put the composition of this number in perspective, six SWFs control more than half of these funds.[94] The SWFs are significant by virtue of the assets they control. In comparison with the alternative investment industry, the total assets of SWFs surpass the $2.89 trillion managed by hedge funds worldwide,[95] but global institutional pension fund assets in the sixteen major markets is valued at $36 trillion.[96]

A SWF's investments are limited by the needs of its country. Nations that are more concerned with liquidity tend to shy away from investing in private equity. This money frequently is instead invested directly in foreign companies and financial institutions, which generally welcome not only the influx of capital but the confidentiality and speed typical of SWFs.[97] In the United States, some contend that SWFs were an indispensable component of preventing the global financial crisis of 2008 from worsening by infusing a large amount of liquidity into the market.[98]

[A] Foreign Policy Concerns with SWFs

Although some feel that SWFs are a stabilizing force in the world economy due to their unleveraged and long-term status, others argue that SWFs are a potential foreign policy issue and have advocated

93. SWF INSTITUTE, SOVEREIGN WEALTH FUND RANKINGS (June 2016), http://www.swfinstitute.org/sovereign-wealth-fund-rankings/.
94. The six funds with the largest amount of assets under their control are Norway's Government Pension Fund Global ($850 billion), China's China Investment Corporation ($813.8 billion), the United Arab Emirates' Abu Dhabi Investment Authority ($792 billion), Saudi Arabia's SAMA Foreign Holdings ($598.4 billion), Kuwait's Kuwait Investment Authority ($592 billion), and China's SAFE Investment Company ($474 billion). SWF INSTITUTE, SOVEREIGN WEALTH FUND RANKINGS (June 2016), http://www.swfinstitute.org/sovereign-wealth-fund-rankings/.
95. Press Release, Hedge Fund Research, Inc., Hedge Fund Assets Rise on Brexit Gains (July 20, 2016), https://www.hedgefundresearch.com/sites/default/files/articles/pr_20160720.pdf.
96. *See* Press Release, Towers Watson, Global Pension Fund Assets Reach New Highs (Feb. 9, 2015), http://www.towerswatson.com/en/Press/2015/02/Global-pension-fund-assets-reach-new-highs.
97. Ahmed A. Elewa, *Standard Chartered Invites UAE Funds to Buy Stake*, GULF NEWS (Jan. 31, 2008), http://www.gulfnews.com/business/Banking_and_Finance/10186074.html.
98. Lee Hudson Teslik, *Sovereign Wealth Funds*, COUNCIL ON FOREIGN RELATIONS (Jan. 28, 2009), http://www.cfr.org/publication/15251/sovereign_wealth_funds.html?breadcrumb=%2Fbios%2F12286%2Flee_hudson_teslik.

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protectionist policies against their activities.[99] Because SWFs are a financial vehicle of the state, some critics have expressed the concern that SWFs may invest in foreign industries that are developing technology in order to appropriate the technology to their own country. Also, some of the most considerable SWFs are affiliated with non-democratic governments. This bestows an enormous amount of investing power, and consequently, a meaningful influence on the global market, in the hands of a few. There is some concern in the industry that this type of situation could set the stage for an investment program that concentrates not solely on economic gain, but also on furtherance of the nation's political goals and aspirations.[100]

To address these concerns, the International Monetary Fund (IMF) held talks in the fall of 2008 to develop a set of principles aimed to ensure that investments by SWFs were, among other things, commercially motivated.[101] The International Working Group of Sovereign Wealth Funds (comprised of twenty-six IMF member countries with SWFs) agreed on a set of principles while meeting in Santiago, Chile (known as the "Santiago Principles").[102] Published in October 2008, the Santiago Principles set out twenty-four voluntary guidelines intended to "contribute to the stability of the global financial system, reduce protectionist pressures, and help maintain an open and stable investment climate."[103]

§ 1:4.5 Secondaries

Secondary funds have experienced rapid growth due to the interest of investors focused on the purchase of existing interests in existing private equity funds, frequently sold at substantial discounts. Secondary purchases involve the assumption of the existing investors' unfunded commitments to a private equity fund and the existing underlying investments in such fund's portfolio.

The growth of a secondary market serves a number of purposes for investors. First of all, the secondary market offers investors the ability to exit their private equity fund investments before the funds make distributions to investors. This liquidity may be attractive for a variety of reasons that are not necessarily correlated to the attractiveness of

99. *Sovereign Wealth Funds Draw Scrutiny*, OXFORD ANALYTICA (Mar. 3, 2008), http://www.oxan.com/display.aspx?ItemID=DB140996?ItemID=DB140996.
100. Bhagwati Testimony, *supra* note 91.
101. Elewa, *supra* note 97.
102. IWG, SOVEREIGN WEALTH FUNDS, GENERALLY ACCEPTED PRINCIPLES AND PRACTICES, SANTIAGO PRINCIPLES (2008), http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.
103. *Id*.

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the investment being sold: the investor may need cash, its investment strategies may have changed, or it may need to re-balance its portfolio.[104] Secondaries are particularly popular in a fluctuating and uncertain market because investors may be able to avoid the long-term commitment of private equity fund investments. For example, if an investor wanted to invest in a fund for half the time of the fund's specified term, it could buy an original interest and then sell it before the term was up. Conversely, an investor could find a private equity fund nearing the middle or end of its life and buy the original investor's interest.[105]

Historically, buyers in the secondary market were able to purchase interests at a highly discounted rate to their net asset value. Notably, during the Internet boom of the 1990s, the secondary market grew rapidly after the investors were forced to liquidate their private equity portfolio.[106] By 2006, however, with the massive amount of capital in the market, secondaries had become less purely a buyer's market.[107] The competition for deals in the primary market overflowed to the secondaries market and the discounts previously offered substantially declined.[108] However, the global financial crisis of 2008 once again created a buyer's market for most illiquid investments, including secondaries. As private equity investors saw their investments shrink, their need for liquidity increased and many saw the secondary market as the solution to their liquidity problems. Offers of secondary interests flooded the market, resulting in significant discounts.[109] In 2010,

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104. William Alden, A *Boom in Private Equity's Secondary Market*, N.Y. TIMES (Feb. 18, 2015), http://dealbook.nytimes.com/2015/02/18/a-boom-in-private-equitys-secondary-market/?_r=0.

105. Cesar Estrada, *The Emergence of Private Equity's Secondary Market*, INSTITUTIONAL INVESTOR (June 18, 2016), http://www.institutionalinvestor.com/gmtl/3563232/The-Emergence-of-Private-Equitys-Secondary-Market.html#.V7XSx9Lrt9A.

106. Rob Marks & Bart Walker, *Pros and Cons of Secondary Private Equity Buyouts*, ALTASSETS (Dec. 5, 2007) [hereinafter Marks & Walker], http://www.altassets.net/casefor/sectors/2007/nz12293.php.

107. ALTASSETS, PRIVATE EQUITY AND VENTURE CAPITAL GLOSSARY OF TERMS, http://www.altassets.net/private-equity-and-venture-capital-glossary-of-terms (last visited Apr. 28, 2015).

108. Stephen Harris, *Overlooking Private Equity Partnerships Can Be Costly Mistake Secondary Market Offers Liquidity for Limited Partners*, J. CORP. RENEWAL (Nov. 2006), http://www.turnaround.org/publications/articles.aspx?objectID=6735.

109. Sabrina Willmer & Gillian Wee, *Harvard Said to Seek Sale of $1.5 Billion in Private-Equity*, BLOOMBERG BUSINESSWEEK (Nov. 25, 2011), http://www.bloomberg.com/news/articles/2011-11-14/harvard-said-to-seek-sale-of-1-5-billion-in-private-equity-stakes.

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following the recession in the United States, discounts reduced[110] as the market cycle moved once again to improve sellers' prospects. Nonetheless, as a result of the larger number of players in the secondary space, there continues to be a significant market for secondary interests. In fact, 2015 was the second-most-active year in the history of the secondary market.[111]

The development of a secondary market speaks to the robustness of private equity funds as an asset class.[112] The secondary market provides investors both with liquidity in an extremely illiquid market and flexibility by allowing investors to modify their investment strategies, respond to changes in public markets, and more ably manage their liquidity.

§ 1:4.6 Distressed Funds

Historically, traditional private equity sponsors in the United States were not focused on buying distressed companies because of a number of concerns. First, managers were apprehensive of their ability to conduct operational turnarounds. Second, there was a perception that buying financially distressed companies was a long and complicated process that was best left to specialists in distressed or special situation funds. Third, private equity fund managers also feared that they would face competition with a management-sponsored plan of reorganization. And finally, distressed funds have existed for some time, but they traditionally were not sponsored by the same players seen in the buyout area.

However, the changing dynamics of the market as a whole suggested that investments in distressed debt could be extremely lucrative.[113] Prior to the financial crisis of 2008, many companies with extensive leverage had little difficulty refinancing their debt. Post financial crisis of 2008, "given the unprecedented market dislocation,"[114] such companies turned to private equity for liquidity. This

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110. In October 2010, discounts on the secondary market averaged approximately 8%, compared with 35% in early 2009. *See* Anita Raghavan, *Stronger Secondary Market in Private Equity*, N.Y. TIMES (Dec. 9, 2010).

111. Cesar Estrada, *The Emergence of Private Equity's Secondary Market*, INSTITUTIONAL INV. (June 18, 2016), http://www.institutionalinvestor.com/gmtl/3563232/The-Emergence-of-Private-Equitys-Secondary-Market.html#.V7XSx9Lrt9A.

112. Marks & Walker, *supra* note 106.

113. Richard Widows, *Look Here to Invest in Distressed Assets*, THESTREET (June 20, 2008), http://www.thestreet.com/story/10422276/1/look-here-to-invest-in-distressed-assets.html.

114. Marti Murray, *Babson Plans Mortgage Fund Launch*, ALTERNATIVE INV. NEWS at 3 (May 5, 2008), http://www.iialternatives.com/pdf/AIN050508.pdf.

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provided an entry opportunity for private equity funds that do not usually specialize in distressed companies.[115] In 2008, forty-nine distressed private equity funds raised $54.7 billion. As the global economy has improved in the years following 2008, the number of funds and amount raised per year have generally been lower than the highs seen in 2008, and fundraising for distressed private equity funds is expected to remain challenging (except for funds focused on the energy sector, which has presented managers with opportunities fueled by the collapse of oil prices).[116] However, some managers are attracting investors once again to distressed strategies with the belief that a corporate default cycle may be approaching.[117]

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§ 1:4.7 Seed Capital Funds

Increasingly, institutional investors and new fund sponsors looking to form private equity funds are entering into arrangements known as "seed" investments whereby institutional investors make a "seed" investment in a new fund sponsor's private equity fund in exchange for an equity or profit sharing stake in the management entities and general partner established by the fund sponsor and/or the right to invest in future fund products formed by the fund sponsor. The fund sponsor benefits by gaining initial capital required to sustain its operations during the initial phase of its business, while the institutional investor gains access to talented investment personnel and new investment opportunities in which its own clients may be interested to invest.

In a related development, institutional investors are also increasingly making investments in the funds and management entities of more well-established fund sponsors. These later-stage strategic investments allow the fund sponsor to "monetize" some of the profits generated in managing its fund products, while giving the strategic investor access to talented investment professionals.[118]

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115. Daniel Holzman, *Shopping for Distressed Companies*, ALTASSETS, Dec. 12, 2007, http://www.altassets.net/casefor/sectors/2007/nz12275.php.
116. 2016 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT (Preqin Ltd. 2016).
117. Devin Banerjee, *KKR Gets $3.35 Billion for Distressed Fund as Defaults Loom*, BLOOMBERG (Apr. 5, 2016), http://www.bloomberg.com/news/articles/2016-04-05/kkr-said-to-get-3-3-billion-for-distressed-fund-passing-target.
118. A more in-depth discussion of "seed" investments and later-stage strategic acquisitions can be found in chapter 16, Seed Investors and Other Strategic Investors.

§ 1:4.8 Permanent Capital

In recent years, fund sponsors have sought to form funds designed to achieve "permanent capital" for themselves by offering liquidity exclusively through secondary market transactions (that is, transfers of fund interests to new or existing investors) in funds with a potentially indefinite life. These vehicles may be formed as "business development companies" under U.S. law, or structured as listed public vehicles in non-U.S. jurisdictions, which, to avoid falling under the laws applicable to U.S.-registered mutual funds, are offered in the United States only through private placements to qualified investors.

In 2005, several prominent private equity managers successfully formed multi-billion-dollar private equity-style funds focused on fund of funds investing and co-investments. However, there has been less interest in creating these funds in recent years. These funds seem, like many U.S.-registered closed-end funds, to trade at substantial discounts and to bear such a significant, non-scalable additional expense load (when compared to a traditionally structured private equity fund) that the structure is only viable for funds of a very large size.

From an investor's standpoint, its investments in permanent capital vehicles are favorable because they can be resold in smaller pieces, permitting access by retail investors, in the United States and beyond, who may not otherwise have access to private equity fund products. In the future, retailization could occur; however, press coverage in connection with the recent round of permanent capital launches suggests that the initial holders were a small number of large institutional investors, who are well able to access the best private equity funds through more traditional means.

§ 1:4.9 Status of Existing and New Deals Post Financial Crisis

[A] Existing Deals

During the global financial crisis, private equity funds had to evaluate the performance of the deals already in their portfolio. Unlike the value of investments in liquid funds with readily ascertainable market values, the value of investments in most types of private equity funds is not easily determined. However, indicators such as unmet performance targets, loss of significant customers and revenues, and data on the price of comparable investments may lead a private equity fund to write down an investment. Write-downs may affect management fees paid by a fund and, if the fund has other profitable realizations, will reduce the general partner's performance-based allocation.

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In order to support an investment, fund sponsors may need to seek additional capital for follow-on investments, including rescue financings. These situations can create great unease. If the fund has available capital, it will be deployed, but if diversity limits have been met, then such capital must be sourced from third parties. Cooperation of investors at different levels of the capital structure of a portfolio company is required. Ultimately, if investor capital is not available, the portfolio company will look for third-party sources of capital. During a period of economic downturn, leverage can be expensive or simply unavailable, and other sources of rescue financing can shrivel. This makes it more likely that the fund sponsor will have to turn to existing investors to add capital to rescue existing deals.

[B] New Deals

During the global financial crisis, buyout and other funds that rely on debt, such as real estate funds, had virtually been precluded from proceeding with deals and drove down the prices at which transactions were accomplished. Funds that relied less on debt, such as venture capital funds, were likely to pursue deals at a much slower pace. Like the dot-com era, managers of funds derive benefits in showing investors that they are extremely careful in selecting deals so as to avoid future losses. Funds that cease to make investments typically receive pressure to reduce management fees, as the manager is deemed less than fully engaged and investors do not want to pay fees on capital that never gets deployed.

In the downturn of 2008–2010, distressed debt funds and "credit opportunity" funds seemed to have the greatest popularity. Managers seized opportunities to purchase debt instruments and related securities at enormous discounts to face value. These funds are also more likely to offer a degree of liquidity, either by their own terms or (because their assets are easier to value than most other types of private equity investments) through the secondary markets. The investment periods and terms of these funds are often shorter, and, as discussed below, investors may be more comfortable with the impression of earlier releases from private equity funds.

As a result of constrained investment opportunities of private equity funds, we have observed a trend of shifting investment strategies from equity to debt. Buyout fund managers who have determined that distressed debt investments are more attractive than many equity investments may seek this shift in strategy in order to provide returns to investors—even in challenging economic times. It is highly advisable that the sponsor obtain the requisite consent of investors to pursue such a strategy absent sufficient and specific authority in the fund's partnership agreement. Investors objecting to such a shift in strategy could argue that the general partner, absent consent from

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investors, would not have the authority to implement such a fundamental change to the fund.

On the equity side, activism is growing in popularity as an investment strategy. Like distressed investing, activism is a method of extracting value from mature assets that are currently not optimized using the skill of the manager.

§ 1:5 Current Trends in Fundraising

§ 1:5.1 Overview

Private equity funds continue to navigate the adverse consequences of recent global financial crises, which have dramatically changed the private equity landscape and the way that fund sponsors, investors, and their attorneys view their respective roles. Investors have continued to expand their demands on sponsors before committing to a fund, with a particular focus on fees.[119] Nevertheless, aggregate capital raised each year since the financial crisis has generally been increasing, with larger, more established managers favored over smaller, emerging managers.[120]

§ 1:5.2 Other Sources of Capital; Co-Investors

Fund managers must use a broad array of strategies for sourcing capital. In addition to capital sourced through placement agents, sponsors have also looked to seed arrangements with investors to secure capital. As further discussed in chapter 16, in seed deals, investors will often receive an equity interest in the general partner in exchange for a large investment. Although a seed investor will often receive substantially better terms and concessions, the arrangement provides the general partner with a much-needed inflow of capital both for investment by the fund and often for working capital of the manager of the fund.

Reliance on co-investors has remained an important means for private equity funds to pursue investments, particularly where a fund has achieved a smaller than expected amount of committed capital. From an investor's perspective, the investor can have a base commitment to a private equity fund and the flexibility to increase its exposure to certain of that fund's deals as a co-investor. The co-investment capital is often invested at reduced fees and carried interest (or none at all).

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119. PREQUIN LTD., PREQUIN INVESTOR OUTLOOK: ALTERNATIVE ASSETS H1 2015, NEW CHALLENGES OF A GROWING ASSET CLASS 9 (2015).

120. PREQUIN LTD., THE PREQIN QUARTERLY UPDATE: PRIVATE EQUITY, Q3 2014 (2014).

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Therefore, general partners often find that their investors are willing to make additional capital available for co-investments.

The concept of co-investment capital has developed into a more noticeable fund category—often referred to as an "add-on fund" or a "spillover fund." These vehicles obtain committed capital from investors that, in turn, co-invest with an existing private equity fund under management by the same sponsor. Add-on funds are relatively easier to raise because they call for a smaller amount of capital, and often provide for lower fees (frequently charged on actively invested capital rather than based on committed capital) and carry. However, due to conflict and valuation issues, these funds are rarely permitted to make investments in existing portfolio companies of the existing fund.

§ 1:5.3 Fund Terms—Bargaining Power of Limited Partners

In the current fundraising environment, general partners continue to brace themselves against demands for terms that are more favorable to investors. Unimpressive past performance has exposed some sponsors to pressure to negotiate terms, even if the poor performance combined with competition for capital is more indicative of the industry as a whole rather than of the sponsor. Despite the uptick in fundraising activity, limited partner demands on partnership agreement terms have not let up. Due to the heightened risk of default by some limited partners, and the difficulty in obtaining funding from banks, private equity fund sponsors find themselves in the unenviable position of searching for new sources of capital. As a result, the new or altered terms of fund documentation currently reflect a shift in favor of limited partners (for all but the most successful managers and strategies).

Pressures on management fees are noticeable, while the carried interest does not seem to have been reduced. Unlike profits of a fund, management fees are paid regardless of the fund's success and, in that respect, misalign the manager with its investors. Investors prefer that the general partners have an incentive to generate profitable returns on investments. In fact, very early private equity funds paid management fees in accordance with budgets approved by investors—no frills allowed. Offsets to management fees arising from transaction fees have been heavily negotiated following the financial crisis, with many funds being forced to accept demands for 100% offsets for transaction fees.[121] Many funds now use back-end-loaded "total capital return" waterfalls (meaning that the carried interest is distributed only once

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121. *See infra* section 4:8.2[D][1].

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the investors receive a total return of their invested capital). In addition, to address investor concerns about the availability of sufficient monies to satisfy potential clawback obligations, more sponsors are agreeing to personal guarantees and interim clawbacks. Zombie funds have paved the way for limits on management fees beyond stated dates.

Beyond basic economic terms, and as a corollary to the sponsor's desire to expand its fundraising ability, investors seem to be focusing on fund terms that give them greater flexibility in terms of exit rights in a private equity fund. As discussed in chapter 4, these rights may include a "no fault" dissolution right and/or a "no fault" right to terminate the investment period of the fund.[122] Simply, with a relatively high level of votes (greater than that needed for simple amendments) investors may elect to dissolve the fund or terminate the investment period without any reason. These rights have existed in many funds over many economic cycles but are becoming increasingly extremely prevalent. General partners may also choose to offer a shorter investment period and a shorter term for newer funds. However, while these features from a marketing perspective give the appearance that an investor will not be tied up for as extensive a period as was historically associated with private equity funds, there is no certainty that a private equity fund will actually be able to dispose of its investments within the stated term of the fund.

In 2011, the Institutional Limited Partners Association (ILPA) released an updated version of its "Private Equity Principles," referred to as the "ILPA" principles (the "ILPA letter"), to express their current view as to the best practices governing the General Partner–Limited Partner relationship.[123] Although groups representing limited partners have been present throughout the years, only during the economic climate of the past few years have limited partners been in a position to demand these rights or principles. In the past, groups that have focused on discussing what the fund industry should be like and what the appropriate terms of a fund should be have often been viewed as engaging in an academic exercise. The ILPA letter, by contrast, originally released in 2009, has been frequently cited in negotiations by limited partners requesting changes in fund documentation. Many, but certainly not all, of the principles espoused by ILPA are already common in private equity funds, such as the back-ended carry model

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122. One of the more frequent requests in the past few years by limited partners has been the addition of a "no fault" removal provision for the general partner, although these requests have almost exclusively been rejected.

123. INSTITUTIONAL LTD. PARTNERS ASS'N, PRIVATE EQUITY PRINCIPLES (2011) [hereinafter ILPA Letter]. *See infra* Appendix R.

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of distributing the carried interest and mechanisms to ensure clawback repayment. Although there has been a great deal of pressure on the general partners to lower management fees and to adopt a more investor-friendly approach to the distribution waterfall (that is, the back-end-loaded "total capital return" waterfall), the ILPA letter also advocates for more protections on non-financial terms, such as tightened key-man provisions, greater transparency in fund reporting, and a stronger role for the Advisory Committee.

More favorable investor terms may give certain private equity funds a fundraising advantage over competitors. However, granting overly favorable terms to limited partners may prove dangerous to general partners in looking toward the future. It is generally anticipated that many limited partners in their current funds will also invest in their future funds, and it is likely that such limited partners will not easily relinquish the concessions in the current fund.

General partners may consider forming a single investor account or managed account for a large investor to avoid setting a precedent for the terms of future funds for other investors. A single investor fund is basically a private equity fund tailored to one investor. Investors in these types of funds, like managed accounts, have the ability to control the advisory committee role and can have more rights over the decision-making process in terms of investments. Investors can also obtain greater portfolio transparency and more flexibility on terms. There are a number of differences in the tax treatment of the carried interest in funds as opposed to managed accounts (as more fully discussed in chapter 4). The benefits to the investor of a managed account or single investor vehicle pose a corresponding deterrent to the sponsor in many respects, including the lack of certainty as to the continued availability of capital and fees. In a single investor fund/managed account context, the general partner can generally be removed, or the arrangement terminated, by the single investor. If a general partner is building out overhead for the account and the investor terminates the account, then the general partner is not only left without any cash flow from the account in order to make the proposed investments, but has also expended resources on the overhead of the account.

Another issue to consider in forming managed accounts and single investor funds is the ability of the parties to terminate the investment advisory agreement. In a no-action letter related to termination of contracts at will,[124] the SEC concluded that advisory agreements that are only annually terminable breach the adviser's fiduciary duties to

124. Robert D. Brown Investment Counsel, Inc., SEC No-Action Letter, NAFT WSB File No. 102284013 (July 19, 1984).

its client, as well as section 206(2) of the Investment Advisers Act. If this determination were extended to sophisticated investors in managed accounts, the manager would be more at risk of termination than in a pooled fund context, where the fund is the investor and is controlled by the manager. This risk may also apply by analogy to single investor funds.

§ 1:5.4 Fundraising Periods

The provisions of partnership agreements that address the timing of new investor admissions may also be modified to take into account the pressures of locating investors. As stated in chapter 4 (Terms of Private Equity Funds), the fund sponsor typically is afforded a twelve-to-eighteen-month window to raise the capital for a single fund. It is not unusual for the sponsor to request an amendment (or several) to extend its fundraising period. Investors rarely oppose these extensions if requested judiciously and under the assumption that the extension will not enable new investors to dilute existing investors at a price below the current market value of the portfolio. For example, investors would typically approve a request from the general partner to extend the marketing period by three months with respect to prospective investors that were already engaged in discussions with the general partner as of the end of the existing marketing period. General partners may also find it prudent to seek to include an extended marketing period in the originally negotiated partnership agreement, although such extensions are frequently subject to advisory committee approval. Sponsors of funds with portfolios that are likely to demonstrate material appreciation during the offering period (for example, distressed funds and funds investing in fixed-income investments) may find it easier to justify an extended offering period if subsequent closings are priced at net asset value (NAV) rather than on a cost-plus basis, as discussed below. Notably, investors may agree to extend the marketing period, but will not necessarily extend the investment period or term of the fund.

Longer fundraising periods during economic downturns increase the likelihood that values of portfolio investments made while the sponsor is fundraising will significantly decrease during such periods. While many private equity fund partnership agreements grant general partners the discretion to permit investors that come in at a subsequent close to participate in existing investments at a valuation other than cost, it is expected that these provisions will be utilized by general partners with increasing frequency.

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§ 1:6 Industry Convergence

§ 1:6.1 Blurring the Line Between Private Equity and Hedge Funds

"Convergence" is a term commonly used to describe the decreasing distinction between the hedge fund and private equity industries. Historically, private equity and hedge funds represented two entirely different investment options. Since the turn of the century, however, hedge funds and certain private equity funds have taken on a number of the other's characteristics, and the same sponsors increasingly manage both hedge funds and private equity funds or hybrids between them. Although this trend has transformed hedge funds by the use of "gates," allocation of assets into "side pockets," and creation of "synthetic side pockets" in response to the global financial crisis of 2008, many investors are pushing against the forces of convergence. Private fund structures are expected to continue to evolve, shaped by the needs of investors, the needs of sponsors, and the bargaining power of each.

[A] Strategic Differences

Traditionally, the difference between private equity and hedge funds was starkly defined. Hedge funds invested in publicly traded securities with easily discernible values that could be liquidated at those values in relatively short periods of time. Hedge funds did not seek to play active roles in company management or to hold illiquid assets in the hope that liquidity would develop in the future. Instead, strategies relied on selecting attractively priced securities (and, possibly, hedging by selling overpriced securities "short"), and selling them once the market recognized their value.

Hedge fund terms reflect this strategic difference. Unlike private equity funds, hedge funds charge or allocate annual incentive compensation and quarterly management fees based on the net asset value (NAV) of their portfolios. Investors subscribe at NAV throughout the life of the fund, rather than buying in at cost plus an interest factor as they typically do in private equity, and investors can redeem at NAV as well. Subscriptions are often accepted monthly, and redemptions occur when the investor so chooses, subject to specified lockups (which traditionally permitted monthly, quarterly, or semi-annual redemptions after a perhaps one- or two-year lockup) and notice periods. Unless an investor redeems, proceeds from investment sales are automatically reinvested, and uninvested amounts are held by the fund in cash rather than being drawn down as needed. The fund itself has a potentially unlimited life, although the identity of its investors may change.

[B] Erosion of Differences Between Private Equity and Hedge Funds

In recent years, the distinction between private equity and hedge strategies, and the corresponding difference in fund terms, has considerably eroded. Hedge fund sponsors have increasingly ventured into the following traditional private equity strategies:

- distressed investment in both public and non-public securities;
- loan origination;
- activist investing; and
- investment in illiquid assets, including private company debt and equity.

Sometimes, the illiquid nature of certain assets requires that they be held in "side pockets," which mimic private equity fund characteristics in the following ways:

- new investors in the hedge fund do not dilute the side pocket investments of existing investors;
- incentive allocations on the side pocket are not made until the underlying asset is realized; and
- an investor who elects to redeem from the hedge fund must nonetheless stay invested in the side pocket until its sale.

In other cases, less liquid assets are held in the hedge fund's main portfolio, and are subject to redemption, dilution, and fees charged at NAV. However, the frequency with which investors may redeem is substantially reduced in hedge funds pursuing less liquid strategies, and redemptions may be staggered or subject to "gates" (that is, caps on the aggregate amount that may be withdrawn in a given period) in order to maintain stability.

The investment strategies of both types of funds have historically caused a greater separation than currently seen in the market. While both funds seek to capitalize on inefficiencies, hedge funds tend to look to, for example, short-term price movements or pricing anomalies in the market. Private equity funds also seek inefficiency in the market, but their traditional goal is not to exploit the inefficiency, but rather to create value by improving or replacing management and policies. Restructuring a business can often take an extended period of time, while profits can be made from public securities in a very short period of time. Traditional private equity funds, having longer hold periods, are very interested in the strategic direction of the companies and industries in which they invest. As such, private equity firms engage in a significant amount of research regarding

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both the targeted company and the industry in which it operates. On the other hand, hedge funds assess target companies' strategies but traditionally are more focused on company and industry hedging strategies. Today, a number of hedge funds are increasingly seeking to influence management decisions made by companies in which they have invested.

[C] Advantages of Convergence

The concept of industry convergence is manifested by a hedge fund engaging in private equity-like investments (often through the use of side pockets[125]) and vice versa. The current climate of the industry is increasingly competitive, and funds are becoming larger. As more and more hedge funds compete for investments, hedge fund managers are forced into new trading strategies and investments to produce the absolute returns that they seek every year.[126] Private equity investing affords new opportunities, leading to greater diversification of portfolios, and illiquid investments can often provide higher returns.[127] Conversely, private equity funds can benefit from hedging strategies. Because private equity investments are held for longer periods of time, it can often take ten years or more before profits on the investments are fully realized and flow through to the investors. There are currently a number of private equity firms that also operate hedge funds in order to capitalize on the opportunities, and in order to find a way to generate cash flow and deploy capital at times when immediate private equity opportunities are not available.

Yet another incentive for private equity and hedge funds to converge is basic efficiency. By managing funds that offer wide-ranging and innovative opportunities, these funds are able to attract better talent to work in such funds. And precisely because they gain exposure to both sectors, the employees are educated in the mechanics and nuances of both types of investing and are, therefore, better equipped to understand the market as a whole. Also, the fact that hedge funds charge or allocate annual performance compensation on unrealized gains, typically without a hurdle or a clawback, makes their compensation structure attractive to employees.

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125. *See* discussion in chapter 4, Terms of Private Equity Funds.
126. Mark Hulbert, *Just How Contagious is That Hedge Fund?*, N.Y. TIMES (Aug. 26, 2007).
127. *But see* Nicole M. Boyson, Christof W. Stahel & René M.M. Stulz, *Is There Hedge Fund Contagion?* (Nat'l Bureau of Econ. Research, Working Paper No. W12090, Mar. 13, 2007), http://ssrn.com/abstract=884202.

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[D] Convergence Concerns

[D][1] Valuation of Fund Assets and Computation of Compensation

Possibly the most conspicuous issue is with valuation of the fund's assets and computation of compensation. As mentioned previously, hedge funds are structured to provide frequent liquidity so that they may accept new investors and redeem existing investors at scheduled intervals. If the fund's portfolio consists largely of illiquid securities, the fund may find itself fiscally ill-equipped to redeem investors' subscriptions, and may discover that the marks at which it carries its portfolio are not achievable on sale.

Furthermore, attempting to value a private company in order to ascertain net asset value is highly subjective because the manager may be forced to estimate the value of such assets without an objective standard. Because hedge fund investors pay performance compensation based on the value of the assets in the fund's portfolio, investors may object to relying solely on the manager's opinion.

[D][2] Cultural Clash

There is a cultural clash inherent in a merger between hedge funds and private equity funds. Private equity employees are management-focused and are concerned with efficiently running a company. Private equity investments are generally complex and require protracted organizational and planning skills. These transactions may require a focus that is both long-term and patient. In contrast, hedge funds are often managed by traders from investment banks who are experienced in more short-term investing strategies and used to relying entirely on public data to evaluate opportunities. They may not possess the skill set to understand and improve upon the inner workings of a company. These two very different types of personalities may not necessarily work well together.

[D][3] Marketing Issues

A firm that conducts private equity and hedging strategies may face difficulties with marketing the performance of one of these models to investors interested in the other structure. Although certainly there may be some commonality in their investments, success in the private equity realm does not indicate that the same firm will be similarly successful running a hedge fund. An established private equity firm launching a hybrid fund may find itself similarly situated, in this respect, as a new firm.

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[D][4] Investor Expectations

Another issue presented by convergence is that private equity and hedge investors are themselves different cultures with different expectations, even when they are parts of the same investing entity. Private equity investors expect to be able to negotiate the fund's documentation and terms, and are used to receiving extensive side letters. By contrast, hedge fund investors must often take the documents that are presented as-is, and rely for control on their right to withdraw. Meanwhile, institutional investors often place investments in "buckets," allocating their assets across strategies before evaluating the relative attractiveness of managers in each strategy. A private equity manager who opens a hedge fund will likely find that fund in a new "bucket," being evaluated by different personnel and on different criteria than were used for private equity vehicles, even when the investor is an existing client of the firm. Hybrid funds that mix private equity and hedge terms in the same vehicle may find themselves outside both the investor's hedge and private equity "buckets," adding to the fundraising challenge.

Hedge funds that pursue the types of illiquid strategies traditionally pursued by private equity funds may be asked by investors to include the types of protection typically included in private equity funds, including such terms as third-party verification of valuations, fund size caps, exclusivity undertakings, and more extensive side letters. These demands reflect the erosion of the traditional compact between the hedge fund sponsor and its investors, in which the sponsor was given substantial latitude to opportunistically invest, while the investor was given the ability to "vote with its feet" if the sponsor's performance failed to satisfy. In the newer hedge fund model, investors may be unable to withdraw all or a portion of their investment for multiple years, and the constraints on sponsors have correspondingly tightened.

Despite this convergence, hedge fund terms continue to differ materially from those of private equity funds, and the two structures occupy different places in institutional portfolios. It is not uncommon for the same sponsor to run hedge funds and private equity funds side by side, with similar portfolios and strategies but differing terms; it is not clear which structure is better for the sponsor and which structure is better for investors. Investors in hedge funds typically give up a number of private equity protections, including realization-based compensation, hurdle rates, clawbacks, and limitations on dilution. On the other hand, hedge fund investors gain the ability to control (within limits) the length of their commitment to the fund sponsor, which can be highly valued. In addition, the ability of hedge funds to

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accept additional cash at all times can make them more nimble in exploiting investment opportunities as they arise.[128]

As investors become familiar with both hedge and private equity structures, and as the differences in their strategies and terms diminish, documentation is beginning to converge. Increasingly, hedge fund investors are demanding side letter protections and standards of liability long ago adopted by private equity fund managers. Negotiation of hedge fund documentation is becoming more common, especially where the hedge fund imposes long lockups and permits illiquid investments. In some cases, traditional private equity terms such as bundle rates, clawbacks, and key person provisions are finding their way into hedge fund documents. Conversely, private equity-style funds that include public markets investments are rethinking the basis on which subsequent investors are admitted, and the viability of giving investment transparency on a real-time basis.

Ultimately, the history of modern private equity has proven it to be a highly resilient and evolving industry, focused on growth and innovation. Whether the industry embraces or rejects the current trends is uncertain. Undeniably, however, the potential for new types of investing is infinite, as it continues its constant search for and development of new strategies, models, and vehicles.

§ 1:6.2 Hybrid Funds

"Hybrid funds" are those perceived as combining hedge and private equity fund characteristics in a single vehicle. This perception can have marketing implications, particularly in attracting institutional investors who have "hedge" and "private equity" buckets, and no allocation dedicated to products that cannot be classified.

It is hard to say exactly where to draw the line between hybrid funds and their more traditional counterparts, especially as the terms of private equity and hedge funds are already converging:[129]

- hedge funds with multi-year lockups may no longer be considered "hybrid";
- side pockets had become not uncommon in the years leading up to the financial crisis, although they have been increasingly disfavored in the period since then;
- some hedge funds draw down capital over time;
- some private equity funds (particularly those formed to exploit "credit dislocation") have shortened their investment periods

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128. For a comparison between private equity terms and hedge fund terms, see Appendix R.

129. *Id.*

and holding periods to the point where they are substantially in line with those of hedge funds with longer lockups; and

- the underlying assets purchased by funds considered "hedge" and those considered "private equity" are ever harder to distinguish.

That said, there continue to be boundaries, albeit moving ones, in what terms are considered standard for each type of fund, and a fund that crosses these boundaries will be viewed as a hybrid product. At the time of this writing, the outer edges of a traditional "hedge" fund are as follows:

- an outside cap of 10%–25% on "side pockets,"
- an outside cap of three years on initial lockup on capital, and
- rolling lockups not exceeding one to three years thereafter.

Funds that cross these boundaries may face a harder sell.

Hedge funds of funds, which constitute a material component of the hedge fund investor base, often offer annual liquidity to their investors and generally do not have side pockets. A hedge fund constructed to conduct less liquid strategies may lose access to these investors (although some fund of funds sponsors are beginning to build out new platforms with reduced liquidity and side pockets to access less liquid hedge funds).

On the other hand, it can also be difficult to sell and later on to manage a fund with terms that are not well-matched to the realities of the manager's strategy. For example, frequent redemption dates may seem protective of investors, but if the underlying portfolio is too illiquid to facilitate satisfaction of those redemptions in cash, then the fund may be forced to suspend redemptions, or to liquidate the more liquid portion of an existing portfolio while leaving existing investors concentrated in more illiquid assets. Similarly, a manager who tries to protect against this outcome by tilting the portfolio in favor of liquid assets and cash may be foregoing the opportunity for higher returns.

When the sponsor's investment strategy is itself a mix between private equity and hedge, a corresponding hybridization of fund terms may be the best course, even if it creates an additional marketing hurdle. However, managers should think carefully about the difference between the latitude they actually need to effectively manage their strategy, and terms that seem appealing simply because they add flexibility. It is easy to imagine the best mix of fund terms from a sponsor's perspective—combining the long lockups and resulting capital stability of a private equity fund with the more favorable compensation terms (no hurdles, no clawbacks, mark-to-market carry)

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and freedom from investment limitations, exclusivity undertakings and fundraising limits offered by hedge structures. It is more difficult to sell this mixture to investors.

Also, investors have recently become more resistant to liquidity constraints in funds that have investment programs that could support greater liquidity. As a result, in the current market for hedge funds it can be helpful to avoid the use of long lock-up periods and side pockets, if possible. This trend has pushed fund sponsors toward the use of coinvestment vehicles or true private equity funds, rather than hybrid vehicles that combine liquid and illiquid assets in a single portfolio.

§ 1:6.3 Private Equity Funds Versus Mutual Funds

Private equity funds are almost invariably privately offered, and do not rely on the special tax and regulatory regime offered to mutual funds. There are a variety of reasons for this, including the incompatibility of the mutual fund regime with such concepts as drawdowns, realization-based fees, affiliate party transactions and disclosure limits on information regarding underlying portfolio investments, as well as a perception that the illiquidity and risk profile of private equity funds is not well suited to a retail client base.

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