

Convergence of hedge funds and private equity funds

by Michael G. Tannenbaum¹, President, Hedge Fund Association

Is the grass really greener on the other side? These days it seems that the hedge fund folks are flocking to the private equity realm, while at the same time private equity managers are coming over to the hedge fund world. There can be several reasons for this and chief among them is the search for higher returns by the hedge fund managers who are finding that the markets they play in are getting more and more efficient, resulting in lower returns. As there is no shortage of investment capital given the huge interest by institutional investors in the hedge fund arena, the private equity area becomes fair game. And from the perspective of the private equity manager, the traditional hedge fund strategies with the attendant liquidity and relative predictability (albeit at a price: lower returns) is of interest. The desire to do this, in part, is brought about by the demands of the institutional investor seeking a lower volatility product. This convergence is an interesting one and creates a set of challenges brought about by the cultural differences between the two worlds. This article addresses those distinctions.

Different models

The hedge fund model usually involves an open ended fund, meaning a fund whereby the investors may enter and withdraw at some stated and rather frequent interval, i.e. monthly, quarterly, annually, etc. The assets in the fund generally consist of marketable securities, which makes subscriptions and redemptions easy because the net asset value (NAV) is easily determined. Fees are keyed to NAV and billed at intervals during the life of the investment. The subscriptions are made in cash (or sometimes marketable securities.) Lastly, the deal is not subject to a stated term of years – not really needed because the investor can redeem at will – subject, of course, to any lock-up.

The private equity model starts and ends in a different place. First and foremost, many private equity deals are commitment deals, namely the manager has a call on committed cash from an investor, as and when needed. Because by definition private equity deals are not investing in liquid assets, the manager would rather not have the cash without having first identified the investment; after all, cash is a drag on performance. These deals are basically closed ended – the investor signs up at the start (or almost at the start²) of the deal and signs the commitment at that time. There are no “ins” or “outs” in these kinds of deals.

Because the assets are not easily valued, they are usually maintained at book during the period the fund owns them. When disposed of the cash is usually distributed to the investors, and the fees are assessed at that time (at least, the performance fees). The deal lasts for about five years, often with a right on the

part of the manager to defer the end of the terms by a year or so to wind up. Lastly, some of the activity in a private equity fund may constitute trade or business activity – more about that important tax issue below.

Let’s now consider some of the issues that are derived from these characteristics.

Valuation and liquidity

Valuation is a serious issue and goes hand in hand with liquidity. For the hedge fund manager, the values are known and readily liquid because the portfolio is usually traded on an exchange. As a result, management fees can be assessed monthly without guesswork as to the value of the NAV and most importantly, as of the end of each year (usually) a performance fee or allocation³ is made in favour of the manager. Again, since the NAVs are readily ascertainable, it is not a difficult proposition to calculate the excess of the ending NAV over the beginning NAV, net out the fees, and debit the account 20%.

It is the ease of valuation that enables the hedge fund to provide the liquidity that many investors insist upon.⁴

The private equity model is not a terribly liquid one. Investments often involve early stage companies, debt offerings, high tech deals, private placements and the like. These are not traded on an exchange and, although theoretically anything can be sold at some price, these investments are not capable of accurate valuation. The presence of these two factors – illiquidity and difficulty in valuation – not only may be problematic from the investor’s viewpoint, but also creates an issue in terms of the manager’s

performance fee. If you can't calculate the NAV, how can you calculate the fee? For this very reason, most deals do not assess the performance fees until the portfolio investment is sold or at least until an event outside of the manager's control occurs which resets the value with some objectivity – another placement, or an appraisal, for example.⁵

ERISA

Valuation, liquidity and US pension laws (“ERISA”⁶) issues go hand in hand. When pension plans invest in an alternative investment programme, whether it be a hedge fund or a private equity fund, if the amount of so called “benefit plan investors” exceeds 25% of the fund or any class of the fund, the US Department of Labor rules and ERISA rules relating to prohibited transactions kick in.⁷ In the context of this article, suffice to say that self dealing between the fund and a fiduciary of the fund is quite restrictive and generally prohibited unless some specific exemption exists.⁸ The investment manager is a fiduciary so these rules apply to it. Fees are allowed provided they are fair and reasonable and consistent with industry standards. However, when the underlying asset is not capable of easy and credible valuation, the caution lights shine brightly. Without objective valuation methodology, there is too high a risk of self dealing – after all, the higher the NAV, the higher the fees to the manager. Independent third party appraisers are needed at great expense to the fund, an expense usually borne by the investors. These two issues: illiquid and hard to value assets – are problematic for pension funds.

Claw back of performance fees

Hedge funds charge performance fees periodically based on the profits and usually employ a “high water mark”. This means that a performance fee during a particular period will not be assessed unless and until all losses from prior periods are recouped and the account goes positive. Once such a fee is assessed, however, it belongs to the manager without regard to the overall profitability of the fund or future performance.

Private equity funds work differently. They often adopt a technique called a “claw back”. Here's how this technique works: Performance fees are assessed as the underlying investments are sold, presumably at a profit. Deals not sold at a profit generate no fees of course. At the end of the fund's term, the overall aggregate performance is determined and a fee computation is made at that time. If the manager has received fees (aggregating the fees on the profitable deals) in excess of that net overall amount, i.e. taking into account the losing deals, the fund “claws back” the excess from the manager.

This leads to all kinds of interesting questions, not the least of which is the credit worthiness of the manager. Accordingly, often the manager is required to leave some part, or even all, of the collected performance fees in an escrow account until the end so as to secure the obligation to pay back any unearned fees. No such arrangement exists on the hedge fund side of the fence.

Side pockets

One result of convergence is the “side pocket”. Very simply, private equity type investments are accounted for on a deal by deal basis in a “side pocket”, which as the name suggests is a segregated account that tracks that particular investment. Each side pocket is set aside for the investors who were such when the investment was made. Investors coming in after the side pocket was established (i.e. after a particular investment as made) would benefit only from future deals, not the deals entered into before such investors' investment in the fund. From that point, the side pocket follows the private equity model.

But the valuation still exists except now part of the fund is liquid and part not. The new convergence models, sometimes called “hybrids”, provide that as and when an investor exits the fund, it becomes entitled to that portion of the NAV represented by liquid assets (the hedge fund part, if you will.) The illiquid assets, in the side pockets, are left behind and usually placed in a liquidating trust or continued to be held by the manager in the fund until such investments are liquefied in the ordinary course.⁹

Non-US funds

Hedge usually come in two varieties: US based funds established in Delaware as limited partnerships or limited liability companies for US taxable investors and non-US funds usually established in places like the Cayman Islands or Bermuda as corporate vehicles for non-US investors. Because they often employ leverage, tax exempt investors gravitate towards the non-US vehicles to avoid being taxed on unrelated business taxable income (UBTI).¹⁰

US vehicles are “look through” vehicles for US income tax purposes, with each limited partner paying its pro rata share of investment gains or sharing in losses. The partnership itself pays no tax. Non-US hedge funds do not pay tax on the gains generated from their investment activities in the US. The reason is that as a policy matter, as reflected in the US income tax regulations, trading in stock, securities and commodities is not taxable to non-US persons.

This has served the hedge fund community well. But what of the activity of the private equity fund?

Trade or business matters

For US-based funds, it matters very little as to whether or not an investment strategy is a trade or business or purely an investment activity, the investors pay tax either way. But it is of critical importance to an offshore fund and in particular to the private equity model. Here's why:

Activities that rise to the level of trade or business in the US are taxable in the US. The stock or securities exemption does not apply. So when it comes to non-US funds which are established in a tax haven jurisdiction – i.e. those without a tax treaty with the US – which are engaged in a trade or business activity in the US, the amount of income attributable to that trade or business activity is subject to withholding tax at the rate of 35% in order to put the non-US fund on the same level playing field (tax-wise at least) as the US taxable investor.

The issue for the private equity fund, and the convergence funds, is the application of the trade or business rule to the actual activities of the fund. To be sure, an investment in a security is an investment in a security, whether the company is actively traded on a stock exchange or issued privately. The problem arises if the private equity manager occupies a seat on the board, begins to influence management decisions, or takes an active role in the company, for instance. These are all factors that might lead to a finding that a trade or business activity exists. Accordingly, care needs to be taken by the manager and the investor alike to set guidelines for what the manager can and can not do (in the offshore vehicle at least) so there are no "surprises" courtesy of the IRS.¹¹

Regulatory implications

All funds sold privately are subject to the private placement exemption issued under the Securities Act of 1933, as amended ("33 Act"). The Investment Company Act of 1940, as amended ("Company Act") provides the exceptions from registration in sections 3c1 and 3c7. State "blue sky" laws ought to apply to each type of fund and to the hybrid as well.

The models can diverge when it comes to registration of the investment manager under the Investment Advisers Act of 1940, as amended ("Advisers Act.") Under recently enacted SEC registration rules for hedge fund managers, a lock up of over two years will greatly reduce the need to register as an investment adviser. It remains to be seen how many hedge fund managers will avail themselves of this new exclusion from the definition of a "private fund" (SEC "speak" for what the rest of us call hedge funds.)¹² Private equity funds almost by definition are locked up for more than two years so those managers are not likely to need to register.

When the convergence model is followed, one downside may be that the private equity manager will now need to register if the hedge fund portion of the fund follows the liquidity generally attendant to hedge funds. We'll see.

Conclusion

There is clearly a trend towards the creation of convergence or hybrid funds, those funds that are hedge funds with private equity components. These funds likely have an investment sector bias with much trading in the public markets but which reserve the right to invest in private deals within that strategy or sector. The two models collide as the above characteristics are accommodated.

Notes:

- ¹ President, Hedge Fund Association, and Founding Partner, Tannenbaum Helpert Syracuse & Hirschtritt, LLP. This article is for information purposes only and is not to be construed as legal advice to any person in any jurisdiction.
- ² Sometimes there is a rolling start – investment, say, over the initial six month ramp up period and sometimes, with an interest component charged to cash coming in after day one.
- ³ Onshore funds usually allocate a portion of the gains to the general partner. The allocation of the incentive arrangement is preferable, for income tax purposes, to simply charging a fee. In the offshore world, the fee usually makes more sense.
- ⁴ This demand for liquidity is changing for sure. The SEC registration process is part of the reason – see below – but there is something more fundamental afoot. More and more investors are realizing that the managers need to provide reserves to have cash available to meet the liquidity demand. Cash brings down the investment return and takes capital away from the manager for trading. After all, that is why the manager was hired – to trade. So the more savvy investors are less concerned about liquidity.
- ⁵ And where's the money coming from to pay the performance fee? If the deals calls for an allocation to the GP of the fee, then this issue can be avoided, but if not, then a capital call would need to be made.
- ⁶ Employees Retirement Income Security Act of 1974, as amended, and the rules of the US Department of Labor.
- ⁷ The 25% rule, called the "plan asset" rule and its progeny, the Qualified Professional Asset Manager ("QPAM") exemption and the like are outside the scope of this article but should be fully understood by managers accepting pension money and

pension funds making such investments. In fact, at the time of this writing, Congress was in the process of, perhaps, increasing the 25% standard to 50%, a move that would favour alternative investing by pension funds. Additional information about this can be found on the author's website, HYPERLINK "http://www.thshlaw.com" www.thshlaw.com.

⁸ For example, the QPAM exemption or the rules set forth in the DOL's Exemptive Order 75-1.

⁹ The last thing the manager would want to happen is to be required to distribute fractured shares of illiquid assets to redeeming investors.

¹⁰ US taxable investors generally avoid investing in non-US corporate vehicles because of the passive foreign investment company rules ("PFIC.")

¹¹ Sometimes the business factors might arise involuntarily. The private equity investment runs into financial trouble and the manager tries to salvage the deal. This is more likely to occur on the private equity side than on the pure hedge fund side.

¹² As of February 1, 2006, an investment manager with 15 or more "clients" and who manages US\$30m or more needs to register as an investment adviser under the Advisers Act. The definition of client when applied to a fund can be tricky. The fund is counted as a single client unless it is a "private fund" in which case each of the investors in the fund is counted towards the 15. What's a "private fund"? It is a fund with the following characteristics: (1) The fund would be subject to the Investment Company of 1940 but for exception in section 3c1 or 3c7; (2) the fund

permits owners to redeem their interests two years or less after the investment is made; and (3) the fund offers its interests on the investment advisory skills, ability or expertise of the adviser. So if the lock up is more than two years, the fund will count as a single client for counting under the Advisers Act. Although outside the scope of this paper; note also the treatment of sub-advisers, especially non-US based sub-advisers which manage funds where the primary adviser is in fact registered with the SEC.

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This article appears in the International Investment & Securities Review 2006, published by Euromoney Yearbooks. For further information, please visit www.euromoney-yearbooks.com