

A Shift in Funds

A talk with Ira Kustin

- Traditionally, the line between alternative asset vehicles like hedge and private equity has been distinct. Over the past decade or so, that line has blurred as fund managers respond to changing markets and investment appetites. Ira Kustin, Paul Hastings investment management group partner, explains the traditional mechanisms in hedge funds to house illiquid assets, changing trends in fund structures like hybrid vehicles for illiquid assets and special purpose vehicles for zombie assets, and the challenges for new launches today.
- Private vs. retail funds
 - Private investment funds: pooled investment vehicles that do not solicit capital from retail investors or the general public, e.g. hedge and private equity funds.
 - Retail funds: investments from the general public, ordinary investors, e.g. mutual funds and ETFs.
- Governing statutes
 - Securities Act of 1933: requires that investors receive financial and other information concerning offered securities and prohibits misrepresentation and fraudulent activities in the sale of securities. Requires registration of securities.¹
 - Investment Company Act of 1940: regulates organization of companies that trade in publicly traded securities. Private funds are excluded from the definition of investment company under §§3(c)(1) and (7).²
 - Investment Advisers Act of 1940: regulates registration of investment advisers.³
- Hedge vs. PE
 - Typical hedge characteristics
 - Open-ended
 - Liquid assets that can be valued
 - Redemptions permitted, usually with lock-ups
 - Indefinite life

¹ Securities Exchange Act of 1934:

<https://legcounsel.house.gov/Comps/Securities%20Exchange%20Act%20Of%201934.pdf>

² Investment Company Act of 1940:

<https://legcounsel.house.gov/Comps/Investment%20Company%20Act%20Of%201940.pdf>

³ Investment Advisers Act of 1940:

<https://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20Of%201940.pdf>

- Private equity
 - Investments in private companies
 - Illiquid assets
 - No redemptions
 - Fixed life
- From mid-2000s, convergence of hedge and PE
 - Hedge funds taking on the characteristics of closed-ended funds in some aspects.
 - Use of **side pockets**: accounts to hold illiquid, hard to value, or highly risky assets, like real estate or stocks with low trading volume, separated from liquid assets of the fund.
 - Side pockets are usually capped at a percentage of the fund or investor net assets.
 - Mechanics of the side pockets vary and should be discussed in the offering documents. Withdrawing investors cannot receive investments in a side pocket until it is liquidated. New investors do not participate in the side pocket. Usually operate on a different fee structure.
 - As side pocket capacities fill up, managers look to other mechanisms:
 - **Slow pay/fast pay**: two streams of redemption proceeds for those related to illiquid and liquid assets.
 - Multiple classes/series with different liquidity profiles
 - **Gating**: redemptions are limited to a set percentage of net assets as of any redemption date.
 - Redemption suspensions are more rarely used.
 - Co-investment structures like **sidecar/overflow vehicle**
 - Vehicle holds less liquid assets and invests alongside the main fund.
 - Sidecars can be structured in a variety of ways depending on the types of investments and investors.
- Zombie asset problem
 - Typical life of a PE fund: formation, investment, harvest, dissolution.
 - Zombie assets can be a problem in PE or other closed-end funds. Zombie assets are those that have not yet been realized or have longer exit horizons. To avoid a loss of realization, fund managers need mechanisms to deal with those assets.
 - Mechanisms:
 - Extensions are typically short, e.g. one or two year periods, and limited. Extension periods are used to windup and dissolve the fund.

- Liquidating vehicle, special purpose vehicle separate from the fund. Depending on the asset and how much oversight is necessary, the fund manager may or may not be the adviser.
- Roll the assets into a new fund
- Shifting trends in new launches
 - New launches facing more oversight and regulatory hurdles.
 - Trending toward consolidation
 - Smaller managers have specialized expertise or are in highly niche markets.