Private Equity Law Report
An Acuris company

pelawreport.com

August 3, 2021

FUND FORMATION

When East Meets West: Ten Considerations for VC Managers Launching "Evergreen" Funds and Hedge Fund Managers Launching PE Funds

By Udi Grofman and Lindsey L. Wiersma, *Paul Weiss*

The Fourth Industrial Revolution – *i.e.*, innovation in areas such as artificial intelligence, machine learning, quantum computing, robotics, the Internet of Things, genetic engineering and other technologies – has affected, and will continue to impact, people's lives in ways that were once unimaginable. As that revolution reshapes the U.S. economy, the continent that once seemed to separate the "West Coast" world of venture capital (VC) and growth equity investing and the "East Coast" world of hedge fund investing has shrunk.

The result is the current landscape where managers from each coast are deviating from their traditional fund products, either to launch counterpart products or those with hybrid characteristics. As that practice becomes more pervasive, it is valuable for fund managers to consider how the innate differences in the products necessitate certain practical modifications to manager's operations, compliance practices, fund structuring and other efforts.

This article identifies the prevailing trend within the private funds industry in which the East and West Coast worlds are melding. In light of that development, the article then delineates ten unique areas (*e.g.*, professional compensation, handling of recycling provisions, etc.) that require extra considerations by managers that are deviating from their traditional approaches to offer new types of fund products.

See "Structural and Operational Considerations for Hybrid Funds" (Feb. 23, 2021); and "Fund Managers Turn to Hybrid Fund Structures to Reconcile Fund Liquidity Terms and the Duration of Assets" (Feb. 4, 2009).

Background: Impetus for Evolution of Traditional Fund Structures

West Coast asset managers who historically invested with deep, specialized expertise in niche markets – *e.g.*, software or biotechnology start-ups – find themselves with traditional VC assets that transition quickly into expansion or growth-stage investments, then to traditional PE targets and into public companies – sometimes even appearing to skip stages altogether. Those managers' expertise to evaluate the technologies of Fourth Industrial Revolution companies can be used to identify

©2021 Private Equity Law Report. All rights reserved.

opportunities and create value in investments well outside the typical VC or expansion phases. Taking advantage of those opportunities at the public stage of the corporate lifecycle, however, requires a fund that can invest in public equities, which traditional closed-end VC-style funds are not designed to do.

Similarly, traditional East Coast managers specializing in understanding undervalued public companies – and in particular those focusing on the technology; media and telecom; artificial intelligence; or healthcare industries – often have the knowledge and expertise to guide a would-be public company through the expansion and growth stages of the process (or avoid or delay the public phase by attracting private institutional capital at the "pre-IPO" stage). That type of private-stage investment requires a fund with the capacity to manage the lack of liquidity and readily ascertainable market value, which a typical hedge fund lacks.

As the worlds in which those managers operate increasingly overlap, traditionally West Coast managers are increasingly going to the market with evergreen products more akin to those of East Coast managers than to traditional VC or growth equity funds. Similarly, traditionally East Coast managers are increasingly going to market with closed-end products more akin to traditional VC or growth equity funds than to traditional hedge funds. Launching those new types of products exposes each type of manager to both the benefits and the limitations of "the other kind" of fund and can require managers to rethink deeply engrained aspects of how they run their businesses.

See "Panel Discusses Operational and Tax Challenges of Hybrid Funds" (Nov. 5, 2019).

Ten Important Pre-Considerations

Although there are many issues and intricacies to be worked out in any fundraise, when contemplating raising a fund "of the other kind" asset managers should give special consideration to the following ten factors from early in the fund formation process.

1) Voluntary Liquidity Is Real in Hedge Funds; End-of-Life Is Real in VC Funds

Investors in hedge funds expect to have voluntary liquidity rights that can be exercised as agreed upon in the fund documents. That might require the manager to:

- sell a position prematurely to satisfy withdrawal requests;
- get comfortable with certain positions (including those with outsized organic growth) representing a significant portion of the fund's value;
- incur more leverage than initially expected to finance the satisfaction of withdrawal requests;
- suspend liquidity requests;
- perform in-kind distributions of positions into liquidating vehicles;
- perform in-kind distribution of actual securities; or
- install "spillover" liquidating vehicles.

Whereas investors in evergreen funds can express dissatisfaction with a fund by "voting with their feet" and demanding liquidity, closed-end investors are locked into their investments and can only express dissatisfaction with a manager by refusing to commit to a successor fund. They do expect,

©2021 Private Equity Law Report. All rights reserved.

however, that once the fund has reached the end of its life, they will recoup their capital within a reasonable time frame.

Due to increasing instances when assets at the life of the fund still have "room to grow," a whole industry of "end-of-life" solutions and "GP-led secondaries" has rapidly developed, including continuation funds, LP-tender offers and cross-fund sales funds. Although older funds are unlikely to have many "end-of-life" mechanics in their documents, sponsors raising new closed-end funds should consider incorporating them into their fund documents.

See "Evolution and Future of GP-Led Restructurings: Transaction Structuring Trends and Conflicts of Interest Management (Part One of Two)" (Jun. 2, 2020).

Each of those dynamics is anathema to managers of the "other kind" of funds, but to investors they are fundamental expectations for investments in the asset class that need to be addressed. A product that tries to skirt around either of those expectations will face an uphill climb in its fundraising.

2) Compensation-Wise, Satisfaction Is Quicker in Hedge Funds

Hedge funds are "mark-to-market" products in which realized and unrealized gains are calculated at certain predetermined times (*e.g.*, at the end of each year and when capital is withdrawn). If those gains exceed any past losses (*i.e.*, the "high watermark"), then an incentive allocation is taken by the manager at that time. That incentive allocation is not subject to a clawback if the investor's investment suffers subsequent losses; that is the price investors are willing to pay for a product with voluntary liquidity.

Closed-end funds pay the manager its "carried interest" upon the disposition of investments. Some funds may utilize a "European" waterfall where all contributions have to be returned before the carried interest is taken, while others would use a "deal-by-deal" waterfall requiring only capital relating to realized investments be returned before the carried interest is taken. In this model, the general partner (and therefore the investment professionals) receive compensation only when investments are disposed of, no matter how much unrealized appreciation has accumulated in the portfolio.

It may take many years for realizations by closed-end funds to start occurring, and in a European waterfall, it may be many more years after the first realizations before carried interest is actually received. Further, when a realization is actually received, it is generally subject to clawback if the remaining investments in the portfolio do not perform.

See "How Carried Interest Clawbacks Preserve Investor Returns and Affect Taxation (Part Two of Two)" (Jun. 11, 2019).

3) Differences Remain in How Borrowing and Leverage Is Obtained and Deployed

Borrowing and leverage are among the bedrocks of the alternative asset management industry. Borrowing is used to obtain levered exposure, but also to smooth out fund operations, to manage cash flows and to bridge

©2021 Private Equity Law Report. All rights reserved.

financing when equity financing has not been obtained in a timely manner. Leverage is used differently, however, in the open-end and closed-end parts of the industry.

In the closed-end context, borrowing – whether creating leverage or not – is typically obtained through "subscription line" facilities, using the undrawn commitment of investors as collateral, or by applying leverage on the individual portfolio company (*i.e.*, putting the "leveraged" in "leveraged buyout"). More recently, certain lenders have expressed an increased appetite to extend credit at the fund-level with recourse to certain, or sometimes all, of the fund's illiquid positions.

See "Five Obstacles When Negotiating NAV Facilities and Potential Ways to Overcome Them (Part Two of Two)" (Mar. 24, 2020); and "Trends in the Use of Subscription Credit Facilities: Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions (Part Two of Two)" (Feb. 7, 2019).

Investments in the hedge fund context can be valued reliably because the assets, upon the lender's request, can be liquidated rather quickly. Therefore, leverage and borrowing manifest as asset-based borrowing, usually using the fund's entire balance sheet as collateral. Fluctuations in market prices of underlying positions – which can be tracked on a "real time" basis – can lead lenders to margin calls that may require the fund to sell assets at inopportune times.

4) Recycling Is Automatic in Hedge Funds, and That Might Be a Problem

Closed-end funds have limited durations and typically impose limitations on how proceeds from liquidated investments can be reused (or recycled) for investment purposes. Closed-end sponsors, therefore, often carefully consider whether they have sufficient capital to pursue new investment opportunities later in their funds' lives, while also not wanting to leave capital unused unnecessarily.

The same issue does not exist in open-end funds, however. Notwithstanding the withdrawals permitted by open-end funds, they are typically operated as "closed systems" where the proceeds from liquidated investments are retained as cash on the fund's balance sheet. If the cash is not promptly deployed into new investments, it will become a burden by creating a drag on the fund's returns.

Each type of fund has its own concerns as it relates to an efficient use of capital. Those concerns are very different, however, and an investment team accustomed to one set of considerations needs to acclimate itself to those of the other.

©2021 Private Equity Law Report. All rights reserved.

5) Compliance Is Critical, but the Focus and Possible Landmines Vary

A robust compliance infrastructure is an intelligent, risk-focused system that categorizes relevant risks and probabilities and correlates the approach taken accordingly. Those efforts have become a "must have" for private fund managers of all varieties as they seek to reduce the possibility of SEC enforcement actions, shorten the time of routine exams by the Division of Examination and secure investments from institutional investors.

Closed-end and open-end funds share many similar areas of risk and probabilities, including:

- presentation of performance results;
- description of investment program; and
- fair assessment of the risks involved.

Differences between the fund structures and asset classes also lend themselves to bespoke types of risk and probabilities, however. On the closed-end side:

- capacity constraints make allocations of opportunities more challenging;
- the possibility of board service, consulting or similar relationships with portfolio companies requires a greater focus on fee offset mechanisms; and
- the prevalence of co-investments warrants a closer look at expense allocations, particularly as to broken deal expenses.

As for open-end funds, trading in public companies increases the risk of insider trading inquiries and liability, as well as concerns around market manipulation and allocation of new issues. Those concerns place additional pressure on personal trading policies; management of restricted lists; information sharing practices; and other policies and procedures that may be less high risk in the closed-end context.

See our two-part series on mitigating insider trading risks: "Relevant Laws and Regulations; Internal Controls; Restricted Lists; Confidentiality Agreements; Personal Trading; Testing; and Training" (Sep. 27, 2016); and "Expert Networks, Political Intelligence, Meetings With Management, Data Rooms, Information Barriers and Office Sharing" (Oct. 11, 2018).

In light of those differences, any expansion or evolution of an asset manager's business requires a review of its compliance policies and procedures to ensure they appropriately cover those changes and, potentially, significant revisions to address those differences.

6) Upper-Tier Arrangements Need to Be Reevaluated to Keep Professionals Happy

In the typical closed-end vehicle "upper-tier" arrangement, investment professionals vest into the carried interest of a particular deal or fund over a period of time (typically 4-7 years). That system works well with the fund compensation model and incentivizes professionals to stick around to monitor investments they originated. It also requires a significant amount of patience, however, as professionals must wait until carried interest is actually paid by the fund to receive their performance compensation – which often remains subject to clawback.

©2021 Private Equity Law Report. All rights reserved.

That starkly contrasts against performance compensation in the hedge fund context, as incentive allocations are usually crystalized at the end of every year if the firm performs well and professionals expect to be compensated similarly. Yet, to maintain longevity and minimize the probability of professionals exercising "the trader's option," it is not unusual for a portion of the compensation to vest over time or to be required to be reinvested into the fund.

A fund sponsor moving from one type of fund to another must carefully consider its compensation and retention programs to ensure alignment with the characteristics of the new fund and to manage the expectation of professionals who may now be getting part of their compensation on significantly different timetables and terms.

See "Structuring Compensation Vehicles and Profits Interests to Optimize Tax Treatment When Forming a PE Firm (Part Two of Two)" (Dec. 1, 2020).

7) Tax Considerations Vary With the Asset Features and Investment Durations

The same tax laws and regulations apply to all fund structures and investment strategies. Different economic terms, however, make management fee waiver programs more prevalent in closed-end structures; effectively connected income concerns more relevant for certain debt-focused strategies; and deductibility concerns around management fees more common in trading funds.

In the closed-end context, the longer holding period of investments may allow them to receive long-term capital gains treatment. As current laws require a longer holding period for a fund's GP to receive long-term capital gains treatment for carried interest, closed-end fund managers have certain considerations in structuring their funds and their investments that are not present in hedge funds. In addition, early-stage VC funds may have qualified small business stock considerations that are not generally on the radar of trading firms.

See our two-part series: "Techniques for Preserving Qualified Small Business Stock Benefits for Early-Stage Investments" (Jan. 19, 2021); and "Tips for Realizing Qualified Small Business Stock Benefits for Fund Investments and Certain Convertible Instruments" (Jan. 26, 2021).

Making tax results more efficient for the manager and the fund investors requires not only deep understanding of the various strategies but also significant experience in navigating tax nuances.

8) Different Approaches Are Required to Achieve the Same ERISA Status

Although both types of funds endeavor to manage themselves in a manner that does not make their funds "plan assets" under the Employee Retirement Income Security Act of 1974 (ERISA), they arrive at that goal via different approaches.

Closed-end funds that invest in private companies may avail themselves of the VC operating company (VCOC) exemption, which allows ERISA investors to constitute greater than 25 percent of each equity class.

©2021 Private Equity Law Report. All rights reserved.

The VCOC exemption is only available, however, if VC investments constitute more than 50 percent of the portfolio and if the fund exercises certain "management rights" over the underlying portfolio investments. VC, expansion and growth equity funds tend to meet the VCOC exemption rather ordinarily.

See "Tips for Avoiding ERISA Prohibited Transactions and for Satisfying Plan Asset Exemptions (Part Two of Two)" (Nov. 10, 2020).

Conversely, hedge funds tend to be passive investors in public companies and therefore must ensure the participation by ERISA investors is not significant (*i.e.*, below 25 percent of each equity class). There are, however, strict parameters for measuring that 25-percent test and distinct idiosyncrasies with respect to how that test is applied in the open-end and closed-end contexts.

9) Investor Relations Staff Needs to Talk the Talk

Skillful investor relations (IR) personnel are required to both perform successful fundraisings and to retain existing capital in the context of evergreen funds. The tasks are similar and require comparable skill sets, but different type of investors are attracted to different types of vehicles and have different motivations and limitations. Even where a single institutional investor is investing in both open-end and closed-end products, the individual teams managing those portfolios at the investor may be different. Therefore, the manager will need to build a new relationship with a new team of professionals with a different set of preferences and incentives, speaking the language of that particular team.

Understanding the different needs of those investors, and being able to articulate how the product addresses their needs, requires a deep understanding of the products sold and its features.

See "When IR and Compliance Clash: Contexts and Reasons for the Strained Relationship and Potential Ramifications (Part One of Two)" (Mar. 16, 2021).

10) Back-Office Staff Needs to Walk the Walk

Behind every successful fund product stands not only a skilled and highly performing portfolio management team and a persuasive IR department, but also a competent support system. Supporting an alternative asset manager is both an art and a science. Although motivated back-office teams can learn the science of new products and operate funds with different features, when it comes to the art, there is no substitute for the hard-won lessons of experience. Therefore, often the only shortcut on the road to smooth performance is to retain a team of professionals who have experience with both types of funds.

©2021 Private Equity Law Report. All rights reserved.

Udi Grofman is a partner in the New York office of Paul Weiss and the global co-head of the firm's private funds group. His practice focuses on fund formation, strategic advice and crisis management and spans all asset classes in the alternative management space.

Lindsey L. Wiersma is a partner in Paul Weiss's private funds group in its New York office. She focuses her practice on the organization and operation of a variety of private investment funds, including buyout funds, hedge funds, hybrid funds, distressed funds, credit funds, structured product funds, co-investment funds and funds of funds. In addition to advising on a wide range of fund formation issues, she also advises fund managers on regulatory issues, management company "upper tier" arrangements, investment management M&A transactions, seeding arrangements and secondary transactions.

©2021 Private Equity Law Report. All rights reserved.