



Investment Funds

Changes to fund terms and conditions

January 2010

As with most other asset classes, the alternative investment funds industry has suffered in the current financial crisis. Private equity funds have witnessed falling valuations, the risk of defaults because LPs have restricted cash-flow and difficult conditions for new fundraising due to potential investors being overcommitted to the asset class. Hedge funds have been dramatically affected by liquidity issues, the need to restructure and investors demanding redemptions.

Despite these issues, there are early signs of an increase in activity for both the private equity and hedge fund markets. There has not been any fundamental change in either the economic terms of alternative investment funds or the usual structures employed by funds. However, it's clear that a shift has occurred in negotiating power towards investors, which has led to a realignment in certain key areas. This note summarises a number of trends that we are witnessing on fund terms for both private equity funds and hedge funds.

PRIVATE EQUITY FUNDS

- *Management fees.* Management fees are certainly under downward pressure. The typical 2% amount has been under scrutiny for some time for buyout funds with high levels of commitments, but now the fees charged by other funds are being challenged. For the moment, it may be that there is no standard approach on fees but rather the market will look at each fund on a case-by-case basis – only if a higher fee is essential for the running of the manager's business (e.g. if it is a debut fund) will it be accepted. Investors are also increasingly concerned about transaction fees and are requiring managers to credit 100% of such fees against the management fee.
- *Carried interest.* The common 20% carried interest amount appears to be safe...for the moment. However, investors are paying closer attention to the timing of payment of the carried interest with more emphasis on it only being released when there is greater certainty that any clawback will not be needed.
- *Default terms.* For both managers and investors, more time is being spent considering what happens if an investor defaults on its drawdown obligations. Although the ultimate penalties for any default remain onerous, cure periods are being considered as well as limiting the amount that the manager can draw down in during any 12 month period.
- *Investor pressure.* Investors are focussing on ways to team together to get terms they want from managers. The Institutional Limited Partners' Association have issued the ILPA Private Equity Principles, a best practice document aiming to establish a set of guidelines for private equity investors to which more than 120 institutional investors have lent their names.

A shift has occurred in negotiating power towards investors, which has led to a realignment in certain key areas.

For private equity funds these include:

- *management fees*
- *carried interest*
- *default terms*

- *Other opportunities.* Within this asset class, investors are looking at funds which do not fall into the leveraged buy-out category, for example distressed debt, infrastructure or renewable energy. Investors are also increasingly keen to tighten the investment policy and investment restrictions for any new fund to ensure that the fund remains focused on its particular strategy and not drift into other areas.

HEDGE FUNDS

- *Redemption terms.* The financial crisis coupled with shocks to the hedge fund industry, such as the Lehmans collapse and the Madoff scandal, have all combined to produce a well-documented liquidity squeeze for hedge funds. Managers have had to enforce gates, suspend redemptions or engage in more detailed restructurings such as side-pocketing the illiquid assets. Investors are concerned to ensure that any redemption terms contained in new hedge funds are more tightly-drawn, for example if a fund redeems in kind then provisions are included to avoid the custody risk passing to the investors and suspending redemptions can only be done in the most extreme circumstances.
- *Independent valuations.* Investors are spending more time looking at how the assets of the fund are valued and whether there is any independent oversight of the process. Some funds are introducing 'valuation committees', with input from key investors, to improve transparency. At the very least, investors will expect a third party administrator to be responsible for producing the NAV, even if this is based on financial information provided by the manager. It is interesting to note that one of the requirements of the draft EU directive on Alternative Investment Fund Managers is to ensure that an independent valuer is appointed.
- *Segregation.* Investors are also looking at how the assets of the fund are held. Relevant factors include whether assets are spread between different custodians and the reputation of such custodians. Assets of the fund should ideally be held in a separate account in the name of the fund, and cash in a segregated client account subject to the client money rules of the relevant regulator (although such account will still most often be shared with other clients of the custodian).
- *Fees.* Further attention is being given to the quantum of fees being paid to the manager and there is a significant shift away from the 2/20 model. Investors were prepared to suffer this level of fees on the basis of the returns on offer and the flexibility of being able to redeem at regular intervals – attractions that are under threat in the current market. It is possible that some form of hurdle will be introduced before performance fees are due to the manager.
- *More regulated funds?* Some investors appear to be moving towards regulated funds, such as UCITS and QIS's, because they appear to offer a greater degree of safety. Given the expected tougher regulation that may be imposed on managers, it's possible that more hedge funds will be established as regulated funds although this may affect the investment strategy of these funds e.g. the amount of leverage that may be utilised will be reduced.

Being aware of the current market approach on terms will be increasingly important.

For hedge funds, this has resulted in an increased scrutiny on:

- *redemption terms*
- *independent valuations*
- *segregation*
- *fees*

HOW CAN WE HELP?

With fund-raising conditions set to remain competitive, there will be opportunities for investors to negotiate favourable terms. Being aware of the current market approach on terms will be increasingly important and will help the investor ensure it is properly protected.

We have a wealth of experience in advising institutional investors on their investments into a wide range of alternative investment funds, including private equity and hedge funds.

We also have the know-how to advise on other types of investment funds (for example, infrastructure or distressed debt funds) and can help on other investment fund issues, such as secondary sales of interests in funds, advising on the terms of fund restructurings and keeping clients up to date with developments in the funds market.

If you would like to discuss any of the issues covered by this note, or any other aspect of our investment funds practice, please contact any of the following members of our Investment Funds department:

**Sam Kay**

Partner

samuel.kay@traverssmith.com

+44 (0)20 7295 3334**Aaron Stocks**

Partner

aaron.stocks@traverssmith.com

+44 (0)20 7295 3319**Ian Shawyer**

Partner

ian.shawyer@traverssmith.com

+44 (0)20 7295 3269

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

www.traverssmith.com