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# Investment Funds Group

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**Paul, Weiss Investment Funds Group**
The Investment Funds Group is a dedicated asset management practice that focuses on a wide variety of private and public investment funds. The Group participates in the organization, fund raising and maintenance of private investment funds of every type, including buyout funds, venture capital funds, distressed funds, mezzanine funds, sponsorship funds, infrastructure funds, co-investment funds, funds of funds and hedge funds. The Group is involved in organizing, registering, acquiring, merging, liquidating and advising both open-end and closed-end investment companies registered under the Investment Company Act of 1940. In addition, the Group represents a diverse group of domestic and foreign investors in connection with their investments in investment funds.

**Marco Masotti** will speak on "Best Practices in PPMs and Road Shows" at the Private Equity Analyst Fundraising Seminar on November 18 in New York.

Editors: Marco V. Masotti and Chris Jochnick



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# Consolidation of the Investment Funds Industry

## Acquisitions of Hedge Fund Managers Pose Unique Challenges

Paul D. Ginsberg and Marco V. Masotti

While mergers and acquisitions involving investment managers are not uncommon in the world of traditional money management firms, they have been until recently relatively rare in the human-capital intensive and enormously profitable world of hedge funds. However, the recent mini-wave of acquisitions of hedge fund managers by major institutional firms suggests that the industry is on the verge of a trend of consolidation. As described below, these acquisitions involve particular challenges.

*Valuing the Business*. A distinguishing feature of hedge fund M&A is the inherent difficulty in valuing the fund managers. The threshold challenge for acquirers of hedge fund managers is to properly evaluate the various fee-based revenue streams of the manager for purposes of determining an appropriate multiple to calculate a purchase price. That task is complicated by the fact that hedge fund managers typically derive revenues from "base" management fees which are relatively stable and "performance" or "incentive" fees which are relatively volatile. As the aggregate fee-based revenue of a fund manager becomes more heavily weighted towards the volatile performance fees, as is often the case with hedge fund managers (who typically command performance or incentive fees equal to 20% or more of trading profits), the importance of properly evaluating the sustainability of that fee stream, and assigning it an appropriate multiple, heightens. Moreover, the sustainability of the level of performance fees that a hedge fund manager enjoyed in the past can (and in the short term likely will) be adversely affected by the acquisition of the manager. The professionals in charge of investments may be distracted by the acquisition process or, worse, become insecure and seek other employment. Additionally, investors may use the catalyst of the change of control transaction to revisit their investment decision and the hedge manager's asset base may thereby diminish. The ability of an acquirer to address these two issues - retaining the investment professionals and the investor base - will largely determine the success of the acquisition.

*Structuring the Transaction*. The hedge fund manager's investment professionals are its key assets and those assets walk out the door each evening (and perhaps for good as a result of an impending change of control) and typically are being enriched in the transaction. It can be critical to employ a transaction structure that incentivizes key investment professionals to remain with the hedge fund manager and to continue to perform at historic levels. In addition to using non-compete and non-solicitation agreements that have scopes and durations at the limits of legal enforceability, common techniques used may include: (a) requiring investment professionals to retain significant economics in the fund manager; and (b) introducing earnout formulations into the purchase price payment mechanics that are dependent on future performance and continued service. Additionally, the use of earnout arrangements can bridge valuation gaps often rising from the competing views held by the seller and the buyer about the sustainability of historic performance fee streams or the preservation of the amount of assets under management.

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*Changes of Control.* Investment management M&A involves numerous structural, financial, tax and regulatory issues, including complex issues arising from the "change of control." Under the Investment Advisers Act of 1940, a manager may not "assign" a client's advisory agreement to another adviser without the consent of the client. While not readily apparent, even a merger or stock purchase transaction that does not involve an outright assignment is implicated under this provision. An "assignment" is broadly defined to include a change of control transaction that results in a transfer of voting interests that are sufficient to permit the holder to direct the management or policies of the adviser. Obviously, any such determination is factual and, to the extent client consent is required, the fund manager will need to consider the difficult issue of precisely who is the "client," or who is authorized to act on behalf of the "client," for purposes of providing the necessary consent. Finally, in acquisitions of hedge fund managers, where investors typically are afforded periodic liquidity opportunities such as quarterly or annual redemption rights, of equal importance to obtaining requisite client consents to satisfy Advisers Act requirements is obtaining, either through due diligence meetings with the key investors or contractual arrangements, comfort that the investor base will not dissipate as a result of the acquisition.

Market observers predict a wave of consolidation as hedge fund managers seek to diversify personal economic risk and capture the benefits of the economies of scale provided by larger institutions. As more transactions are completed, and hedge fund managers get integrated into larger institutions, the benefits of a thoughtful transaction structure will be evident.

## SEC Review of Performance Advertising

The SEC inspection staff is currently conducting examinations of performance information used by registered investment advisers in their marketing materials. As Lori Richards, director of the SEC's office of compliance inspections and examinations states: "The SEC has brought many enforcement cases against investment advisers who overstated their performance results. This is a high-risk area, and one that SEC examiners are focusing on." The SEC staff appears to be requesting information about (a) performance relating to composites (e.g., a single performance number constructed from an aggregation of portfolios or asset classes managed with a similar strategy or investment objective), including the methods used for including specific accounts in a composite, and (b) the performance calculation process used by advisers, including their related policies and procedures. More specifically, the staff appears to be requesting the following information: (i) a copy of all marketing materials provided to clients and prospective clients during the last three years that contain performance information, including a copy of each performance composite used during such period and any audit or verification of the performance results; (ii) a copy of the most recently completed questionnaire submitted to each third-party consultant during such period; (iii) a copy of responses to each request for proposals during 2003 and a list of all requests for proposals completed over the last three years; (iv) for each client account, the name(s) of the composite(s) in which the account is included if any, monthly market values, and monthly performance; (v) a list of any securities that were "fair valued" by the adviser for any client account included in its performance results; (vi) a detailed description of the adviser's performance calculation process; and (vii) a statement as to whether the adviser, on a retroactive basis, changed the composition of any composite and then used the resulting composite in any capacity and, if so, the circumstances and justification for doing so.

# Co-investing with Private Equity Funds

Yvonne Y.F. Chan and Robert M. Hirsch

## Co-investments are on the Rise

Private equity funds typically authorize their general partners from time to time to allow investors to co-invest in select opportunities alongside these funds. Stand-alone co-investment funds are on the rise and co-investing generally represents an increasing part of private equity investing. Recent studies confirm this trend in both the United States and Europe, and attribute it largely to investor interest in limiting advisory fees on their investments.

There are numerous reasons for a general partner to offer co-investment opportunities, such as: (i) the size of the transaction may exceed the investment limitations of a fund; (ii) a fund may need additional capital to make a meaningful investment; (iii) a fund may be unable or unwilling to provide all the required equity to a particular investment; or (iv) a fund may want to involve a partner who will bring benefits to a portfolio company or help consummate the transaction. Moreover, having limited partners co-invest in a particular opportunity may assist with building relations with them, while keeping competitors out of the investment.

For investors, co-investments offer a larger stake in particular opportunities, usually on better economic terms (*e.g.*, reduced management fee or carried interest). In addition, an investor may want to place more money with the fund manager, but would prefer to do so selectively by choosing between co-investment opportunities in place of increasing its fund commitment. For non-fund investors, co-investment opportunities will allow them to piggyback off the due diligence, execution and investment management skills of a fund manager.

By their nature, co-investment transactions raise a number of issues, including:

- the level of disclosure about the transaction and the portfolio company offered to the co-investor;
- the extent to which the co-investor will participate in the due diligence or negotiation of the transactional documents and in the management of the investment or portfolio company;
- the amount of management fees and/or carried interest borne by co-investors (modest fees and carried interests are common);
- whether management fee offsets from transaction fees received by the general partner or manager are shared with the co-investors; and
- governance or informational rights with respect to the co-investment vehicle.

Importantly, a co-investor typically funds only its pro rata portion of an investment, and does not expect to have any outstanding commitment, raising questions about follow-on opportunities, such as the exercise of pre-emptive rights. If co-investors have funded all of their commitments on the consummation of the acquisition, the general partner will need the flexibility to allow its affiliates and/or third parties to take up such follow-on opportunities. A similar issue is raised by potential investor givebacks in the event of an indemnification obligation or other contingent liability arising from the investment. Co-investors may be contractually obliged to fund their share of any such liability, often limited to a percentage of the original commitment or distributions received.

Co-investors typically want assurances that they will enter and exit a deal at the same price and on the same terms as the main fund. Furthermore, co-investors may want comfort that drag-along rights or other exit mechanisms enjoyed by the fund at the portfolio company level apply equally to the co-investment. Co-investors will expect all investors in the co-investment vehicle (perhaps with the exception of strategic investors) to receive the same treatment and may negotiate "most-favored nations" provisions or seek to prohibit the use of side letters.

While co-investment can provide benefits to all parties, general partners may tend to view co-investment opportunities as favors that can be granted or withheld from potential investors. This undoubtedly influences their willingness to negotiate the various co-investment terms.

# A Selection of Comments on the Hedge Fund Rule

## The SEC is Expected to Vote on a Final Rule on October 26

Marco V. Masotti, Chandler Bass and Jennifer Visconti

On July 20, 2004, the Securities and Exchange Commission ("SEC") published for comment a proposed rule that would require an adviser to a "private fund" to "look-through" its investment funds and count the number of investors in each (rather than counting each fund) as a single client when determining whether it is eligible for the private adviser exemption. Advisers to "private funds" with 15 or more investors would be subject to registration under the Investment Advisers Act of 1940 (the "Advisers Act"). Defined by reference to characteristics shared by most hedge funds in the marketplace, a "private fund" is one that, among other things, permits investors to redeem any portion of their ownership interests in the fund (*i.e.*, sell them back to the fund) within two years of the purchase of such interests. The proposed rule has elicited some interesting and controversial comments. According to the Managed Funds Association, of the 124 letters that took a position for or against the proposed rule, 91 letters (73%) were against and 33 letters (27%) in favor of the proposed rule. The following is a selected sample of the comments submitted:

- *National Venture Capital Association*. The NVCA believes that the proposed rule requiring compulsory registration fails to make a clear distinction between venture capital and hedge funds, and opposes it for creating a serious risk of burdensome new regulation of venture capital. Should the SEC proceed with the registration requirement, however, the NVCA believes that it should provide precise and clear exemptions from the requirement two-year lock-up period (a "private fund" captured by the rule is defined as permitting redemptions within two years of the purchase of the interests). Although the SEC intends to provide appropriate relief for exceptional redemptions within two years of purchase, the NVCA believes that the requirement of "extraordinary and unforeseeable" circumstances is ambiguous and argues for replacing the term "unforeseeable" with "unforeseen." The types of regulatory and legal circumstances addressed in venture capital fund partnership agreements (such as regulatory withdrawals by insurance companies, banks and pension plans) are clearly extraordinary and unforeseen, since such redemptions are contrary to the long-term purposes of both the fund and its investors. The NVCA also seeks clarification that the two-year lock-up period commences when an investor commits to a fund (rather than upon a drawdown of funds).

- *The Association of the Bar of the City of New York*. Although the Committee on Private Investment Funds of the Association does not take a position on the relative merits of compulsory registration of hedge fund advisers, it is concerned that requiring most hedge fund advisers to register would be an unnecessary burden for many advisory firms whose activities are otherwise subject to the anti-fraud provisions of the federal securities laws, who maintain effective compliance controls and whose clients are financially sophisticated. In general, the Committee believes that enforcement problems and incidences of fraud relating to private equity funds have been rare or limited and, like the NVCA, argues that many of the SEC's stated policy considerations relating to hedge funds do not apply to private equity funds. For example, private equity funds generally hold securities of private companies and, therefore, do not tend to participate in the public securities markets, and when they do, tend to be long-term holders of large blocks of securities, rather than active traders. Consequently, the Committee does not

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believe that these funds have a significant impact on the financial markets. Moreover, the standard methodology for compensating the advisers of private equity funds (*i.e.*, performance allocations based on realized proceeds rather than the value of the underlying investments) provides little incentive to manipulate the value of the fund's unrealized portfolio. The Committee also objects to the term "unforeseeable" with respect to redemptions within the two-year lock-up period, noting that the legal and regulatory circumstances that would compel an investor to redeem its interests are often expressly contemplated in the funds' constituent documents, making them "extraordinary," but not "unforeseeable." The Committee illustrates certain limitations of the "look-through" analysis and seeks clarification that it does not alter the duties or obligations owed by an investment adviser. By viewing a fund as a single client, the adviser is able to respond to the collective objectives and interests of the investors in each particular fund. The proposed rule should not in any way imply that an adviser must instead consider the diverse and specific investment objectives of each individual investor (notwithstanding that it is participating in a collective investment vehicle). Finally, the Committee recommends that "knowledgeable employees" be excluded from the "look through" analysis.

- *American Bar Association.* The Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law believes that there is insufficient basis on record to require the compulsory registration of hedge fund advisers and is concerned with the unintended consequences of changing the definition of "client." As an alternative to registration, the ABA proposes that the SEC develop a private fund registry and require each hedge fund adviser to file an annual form containing such information as the names of the funds it advises, the exemption relied upon by the funds under the Investment Company Act of 1940, the investment strategies pursued and the assets under management. Additionally, the ABA seeks clarification with respect to the definition of "private fund," including when the two-year lock-up period begins and how the SEC will determine whether a hedge fund is foreign (since they are generally passive vehicles that do not have offices). The ABA also recommends that hedge fund advisers required to register be given at least one year to comply with the requirements of the Advisers Act.

- *Wilmer Cutler Pickering Hale and Dorr LLP.* Wilmer Cutler believes that the SEC lacks the authority to eliminate the statutory exemption from registration for advisers with fewer than 15 clients. The Supreme Court has held that an administrative agency must defer to the intent of Congress, if that intent is clear, when interpreting a statute. Wilmer Cutler cites numerous provisions from the Advisers Act that show Congress's intent to define "client" as a person or entity to which advice is given, rather than an individual investor in that entity. Therefore, by requiring certain advisers to "look through" an entity in order to count the number of clients for registration purposes, the SEC is effectively changing the meaning of "client." Wilmer Cutler argues that this change, by allowing the SEC to regulate entities that Congress intended to exclude from its jurisdiction, would exceed the agency's rule-making authority.

- *Managed Funds Association.* The MFA strongly opposes registration of hedge fund advisers, as it believes that the existing regulatory framework sufficiently protects investors and that adequate information regarding the hedge fund industry is already available. Hedge funds must make certain regulatory filings, such as "blue-sky" and tax-related filings. In addition, numerous federal regulatory agencies, including the Commodity Futures Trading Commission and the Federal Reserve, receive information about the industry through examinations of related industries, such as hedge fund brokers, dealers, lenders and counterparties. Instead of unnecessarily burdening the hedge fund industry with registration, the MFA suggests that the various regulatory agencies coordinate to share currently available information related to hedge funds with the SEC.

These and other comment letters are available on the SEC's website at www.sec.gov. The SEC is expected to vote on a final rule on October 26.

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