Practical Guidance

Hedge or Hybrid? Terms and Structuring Considerations

A Practical Guidance® Practice Note by
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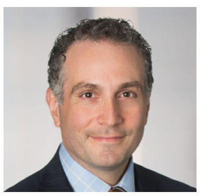

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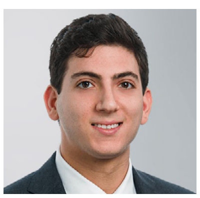

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This practice note discusses the key differences between hedge fund and hybrid fund structures, and the factors that fund sponsors and their counsel should consider when evaluating the type of fund structure and strategy to pursue.

For additional information on hedge fund formation and regulation, see Hedge Fund and Its Offering: Drafting and Reviewing the Key Documentation, Regulation of Hedge Funds and Their Trading Activities, and Operating Agreement (Hedge Fund) (Delaware LLC).

Traditional Hedge Fund Terms

The term "hedge fund" has been used for decades to describe private, professionally managed investment funds. The traditional hedge fund was based on a "long/short equities" model, taking long positions in stocks thought to be "underpriced" and taking short positions in stocks thought to be "overpriced." Other common investment strategies include market neutral, event-driven, credit, and global macro. A hedge fund is generally open-ended, in that it permits periodic subscriptions and redemptions at net asset value, has an indefinite life, and pays the investment adviser an asset-based management fee and performance-based compensation. Where hedge funds found themselves holding illiquid assets, or managers came across the occasional illiquid investment opportunity, hedge fund managers were able to create "side pockets" to hold these assets and investments outside the larger liquid fund structure.

The Growth of Hybrid Funds

Hybrid funds gained in popularity after the 2008 financial crisis, and are again becoming increasingly popular, as hedge fund managers seek exposure to credit and other instruments which may be less liquid than equities, and pursue longer-term, more concentrated strategies to supplement their primary investments.

With the investor landscape becoming increasingly competitive, and with sophisticated investors expecting the liquidity of their fund investments to match the liquidity of the fund's underlying investments, hedge fund firms are looking for ways to innovate and offer investors more choice, flexibility, and returns. To that end, an increasing number of firms are launching hybrid funds, which are private investment vehicles that have attributes of both traditional hedge and private equity funds. Where a manager is considering whether to launch a hybrid fund versus a traditional hedge fund, a hybrid fund may be the more appropriate choice when making longer-term, more concentrated investments is a central focus of the manager's investment strategy.

Hybrid funds may combine the illiquid investment strategies associated with closed-ended private equity funds with the liquidity and hedging strategies of open-ended hedge funds, offering investors a more diversified portfolio across asset classes and return profiles and flexibility around liquidity options. In our experience, investors are becoming increasingly comfortable investing in longer-term vehicles, foregoing liquidity in exchange for returns.

In general, hybrid funds offer several advantages over more traditional investment vehicles, both for investors and managers. Managers have flexibility in structuring a fund tailored to specific investment goals. For example, hybrid funds may provide returns similar to those offered by alternative investment strategies, but also include stable cash flows and more predictable liquidity. A hybrid fund may also include mechanisms providing flexibility around investor liquidity, unlike in a private equity fund, allowing investors to redeem their capital at any point permitted by the hybrid fund's redemption terms.

A hedge fund manager who does not want to launch fully closed-ended vehicles for its illiquid investments may be able to launch a single hybrid fund structure, rather than multiple closed-end vehicles, allowing the manager to save on costs and effort, including organizational and fundraising costs and the onboarding of service providers, involved with launching multiple sequential closed-end funds. Alternatively, a hedge fund manager may structure a hybrid fund with capital commitments from time to time and a lock-up period, enabling investors to redeem capital at set intervals. This structure can provide a more permanent source of capital and allow the fund to be marketed on a permanent basis, avoiding the typical process for closed-ended funds of fundraising only when a new fund is being marketed.

Hybrid funds are providing exposure to a wide variety of new asset classes, such as unlisted and OTC equities (including later-stage and other "growth" equities), real estate, infrastructure, derivatives, distressed debt, private credit, and CLOs.

Hybrid vs. Hedge – The Key Differences

Hybrid funds can be "hybrid" in terms of the investments they hold or in terms of the withdrawal or liquidity terms they offer investors, or by a combination of the two. Hybrid funds may hold more than one type of asset or may be used by managers focused on a single investment or theme, including seeking to "lock up" capital from investors for a longer period of time in the event of a restructuring, proxy contest, or other activist investment strategy. Hybrid funds may take various forms, including an "evergreen" fund or an "open-ended" or a "semi-open-ended" hybrid fund.

In an evergreen fund, returns from realizations are recycled back into the fund to finance new investments rather than distributed to investors, unless the investor elects to become a liquidating investor and receive distributions upon the realization of investments.

Open-ended hybrid funds also have no fixed termination date, but distribute the capital returned after realizing investments to investors. Semi-open-ended hybrid funds sit between open- and closed-ended funds, in that they may have a fixed termination date, but also extension periods, and the ability to reinvest and to admit new investors under certain conditions.

A hybrid fund may offer a range of fee and liquidity structures and allow investors to choose the one to which they are best suited. For example, a hybrid fund may offer a higher management fee with a lower performance fee, a range of hurdle rates structured as either a "hard" hurdle (i.e., where the performance fee is collected on only that portion of the return of the portfolio that exceeds the hurdle rate) or less commonly, a "soft" hurdle (i.e., where the performance fee is collected on the entire return of the portfolio so long as the return is greater than the hurdle rate), or lower management fees and/or incentive allocations in exchange for a longer capital lockup.

Liquidity

A hybrid fund may be structured to give investors different withdrawal options at different times. Those withdrawal options may be achieved using any combination of slow-pay provisions, withdrawal capital accounts, in-kind distributions, side pockets, and suspensions.

A hybrid fund manager may use a "slow-pay" provision to segregate a withdrawing investor's proportionate share of an illiquid investment and, rather than being forced to sell the asset prematurely, wait to realize the illiquid investment over time as it sees fit and distribute the net proceeds afterwards. A slow-pay provision locks in the withdrawing investor's percentage share of the illiquid investment as of the withdrawal date. A slow-pay provision is only invoked upon a redemption and only affects the withdrawing investor.

A hybrid fund may instead use a "withdrawal capital account," which is similar to a slow-pay provision and allows a fund manager to segregate a withdrawing investor's "vertical slice" proportionate interest in each of the fund's underlying investments as of the withdrawal date. A hybrid fund manager may pay some redemption proceeds in cash as of the redemption date and segregate the remaining investments in a withdrawal capital account. In both the slow-pay and withdrawal capital account scenarios, the investor bears the risk of future performance of the investments in the withdrawal capital account until they are realized.

A hybrid fund may distribute illiquid investments in-kind to satisfy a withdrawal request. If an investor does not want to receive distributions in-kind, the fund may offer to sell the investment on the investor's behalf and to distribute proceeds to the investor. Alternatively, a manager may use a liquidating special purpose vehicle to satisfy a withdrawal request, in which case an investor would be distributed shares in a special purpose vehicle and only receive cash once the assets are sold.

A hybrid fund may utilize "side pockets," which segregate certain illiquid investments from the fund's liquid portfolio. An investor invested in a side pocket will have its participation percentage "frozen" with respect to the side-pocketed investment as of the date it is side-pocketed. An investor may not redeem its interest in a side-pocketed investment; upon realization of the investment, the net proceeds are paid out and distributed to the investors investing in the side pocket. Side pockets provide flexibility, as a manager may side pocket an investment at any time for all or certain investors, including before a redemption date to segregate illiquid assets that the manager does not believe can or should be sold to satisfy redemptions. Side pockets are becoming a more popular option again after falling out of favor in hedge funds for several years. It is not uncommon for side pocket participation to have either a fund-level or investor-level cap and/or to be at the option of the investor (such election to be made at the time the investor makes a capital contribution). Neither the cap nor the option feature, however, would apply to an investment that was side-pocketed subsequent to the time that it was made, namely because it created illiquidity concerns. In that scenario, each investor at the time the investment is designated a side pocket would be required to participate, regardless of the fund-level or investor-level cap or whether the investor opted out of participating in side pockets.

Finally, upon certain events (including an exchange closure, difficulty in determining an underlying investment's valuation, or if the disposition of investments might not be practical), a hybrid fund can permit the fund manager to temporarily suspend the right of investors to withdraw capital. A manager will generally suspend withdrawals only as a last resort.

Management Fees

In a traditional hedge fund, the management fee is typically calculated based on the net asset value of the fund. A hybrid fund, which may face difficulty calculating net asset value with respect to its less liquid assets, may charge a management fee based on a combination of a percentage of the fund's net asset value, its invested capital or its committed capital (if the fund requires capital commitments).

Incentive Calculation

A hybrid fund may utilize the traditional hedge fund style incentive fee or allocation, which would normally be payable annually as a percentage of both realized and unrealized gains on a "mark-to-market" basis, often subject to a high watermark or a loss carryforward. A hybrid fund may also use a private equity style "carried interest" structure, more common in private equity vehicles. Alternatively, a hybrid fund may blend these two incentive structures to match the underlying assets or investor demands.

Investment and Harvesting Periods

Hedge funds have faced challenges when the duration and liquidity of the fund do not match that of its underlying assets. In those situations, hedge funds may need to sell assets at inopportune times or implement solutions like side pockets and redemption suspensions. Hybrid funds may be structured to include mechanisms allowing managers to raise further capital for the fund, or to offer the option for investors to redeem capital, allowing the fund to retain its investment in its underlying assets until a more opportune time to sell.

Fund Term and Duration

Like traditional hedge funds, many hybrid funds have an indefinite life and offer investment on an ongoing basis. Some hybrid funds, however, may include a fixed termination date like a closed-ended fund, but also offer extension periods and the ability to reinvest, and admit new investors, in certain cases.

Capital Commitments and Contributions

In a typical closed-ended fund, investments may only be made in a specified fundraising period (typically, 12 months from the first closing), where investors pay the cost of investments and an interest charge when they make their commitment. Hybrid funds, however, may permit new capital contributions on an ongoing basis. New capital commitments may be accepted in full or drawn down over time in a private equity-style “capital commitment” structure. A hybrid fund may use a line of credit tied to the fund’s capital commitments to make investments if subscription monies have not yet been received. As such, a fund may participate in investment opportunities when they arise, rather than waiting for investors to make capital contributions pursuant to a drawdown notice or waiting until a later subscription date.

A hybrid fund may be structured to address a material change in the fair market value of the fund’s underlying portfolio investments after the initial closing but before the final closing. Instead of treating later-admitted investors as if they invested at the first closing, which may raise “last-look” fairness issues for those earlier investors, a hybrid fund may adjust the capital account balances of existing investors to reflect the fair value of the fund’s underlying assets as of any later closing date on which new capital contributions are accepted. A hybrid fund may also be structured to limit investors in later closings so that they only participate in new investments made at or after the time of their investment.

Valuations

Hybrid fund structures with ongoing subscriptions and withdrawals must determine the fund’s net asset value as of any subscription or withdrawal date. For any assets that are difficult to value on any such date, a fund may permit valuations based on formulaic (“mark-to-model”) valuations or based upon periodic third-party valuations, which typically occur semi-annually or annually. A manager should be aware that a hybrid fund structure may not be viable if it is too difficult to value a significant portion of the fund’s investment portfolio on a regular basis.

Structural Considerations

Hybrid fund structures may take the form of the familiar hedge fund standalone, parallel, and master-feeder structures. A hybrid fund manager would likely take into consideration the same factors that they would for a hedge fund: tax and administrative efficiency, investor demand, and the anticipated underlying investment portfolio.

Administrative and Regulatory Complexities

There are considerable administrative and regulatory complexities facing hybrid funds, particularly those with differing fee structures and multiple asset classes. Again, a hybrid fund should be structured so that the liquidity offered to investors matches the cash flow profiles of the underlying assets, while also preventing a “run” on the fund. Accounting and reporting requirements for hybrid funds will likely be more complex as well, as a manager may need to calculate the value of hard-to-value assets.

A hybrid fund manager may address fee calculation issues by tailoring fees, based on a combination of net asset value, its invested capital or its committed capital, depending upon the circumstances, and utilizing either an incentive fee or carried interest structure. The manager may also consider incorporating mechanisms to address liquidity concerns, including lock-up periods (which are common in traditional hedge funds) and gates (typically investor-level gates). To address the complex reporting requirements, a hybrid fund manager may need to expand its administrative and accounting infrastructure, which may involve more back-office functions or the use of external service providers.

Hybrid Fund Marketing

Hybrid funds may be marketed on an ongoing basis, depending upon their structure. A hybrid fund manager would generally highlight that a hybrid fund combines the access to alternative investment strategies provided by closed-ended funds with more consistent cash flows and predictable liquidity provided by hedge funds, as well as the other benefits discussed above.

The Ideal Hybrid Investor

Hybrid fund investors should, compared to traditional hedge fund investors, be willing to have their capital “locked up” in a fund for a longer period of time before being able to withdraw it. As such, hybrid funds may not be appropriate for investor classes that require more immediate access to their capital. Investors that are wary of more “alternative” asset classes, compared to listed equities, may also not be appropriate for investment in hybrid funds.

Key Takeaways for Potential Sponsors and Investors

As discussed above, hybrid funds offer several advantages over more traditional investment vehicles. Hybrid funds may provide returns similar to those offered by alternative investment strategies, but also include stable cash flows and more predictable liquidity. A hybrid fund may also include mechanisms providing flexibility around investor liquidity. Hybrid funds may hold more than one type of asset or may be used to focus on a single investment or theme. Hybrid funds may take various forms, and managers have flexibility in structuring a fund tailored to specific investment goals.

There are, however, considerable administrative and regulatory complexities facing hybrid funds, particularly those with differing fee structures and multiple asset classes.

For investors, hybrid funds may combine the illiquid investment strategies associated with closed-ended private equity funds with the liquidity and hedging strategies of open-ended hedge funds, offering them a more diversified portfolio across asset classes and return profiles and flexibility around liquidity options. Hybrid funds, however, may take various forms and differ significantly from traditional alternative investment products. As such, before investing in a hybrid fund, it is very important for an investor to familiarize itself with the fee terms and liquidity options offered by the fund, as well as the nature of the fund's underlying investments and the risks associated with an investment in a longer-term, less liquid vehicle.

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Michael F. Mavrides is a partner in the Hedge Funds Group. Mike focuses his practice on representing domestic and offshore hedge funds, funds of funds and other private investment funds, including private equity and real estate investment funds. He regularly advises funds and their managers on a wide variety of issues, including formation and structuring, seed capital, anchor capital and other strategic arrangements, placement agency, solicitation and other marketing arrangements, succession planning, separately managed accounts, and all types of portfolio management, trading and operational issues.

Mike advises clients on federal and state investment adviser registration, commodity pool operator and/or commodity trading adviser registration, regulatory reporting (including Form PF, Forms 13D, F, G and H and the various Treasury Department and Bureau of Economic Analysis forms), and a wide range of other compliance matters. He has significant experience advising clients on structuring their management companies and acquiring and retaining talent, including through employment, equity and "phantom equity" arrangements. In addition, Mike advises clients on a variety of transactional matters, including joint venture agreements, derivative and structured product transactions and credit arrangements. He also counsels clients in connection with examinations and investigations by the SEC, the NFA and other federal as well as state regulators.

A recognized leader in the industry, Mike has been named one of the leading up-and-coming lawyers in the U.S. by *The Lawdragon: 500 New Stars, New Worlds*.

Mike is a frequent speaker at conferences on investment funds and money managers, as well as hedge fund and other investment management-related seminars and workshops, and is the author of various articles and alerts.

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His practice focuses on advising private investment fund sponsors and investment advisers on the formation, structuring, offerings, governance and regulatory compliance of domestic and offshore funds. He has experience advising sponsors of hedge, private equity, hybrid and credit funds.

Steven received a B.A., *cum laude*, from Binghamton University, where he studied geography and philosophy, politics and law, and a J.D. from Cornell Law School, where he was a member of the Journal of Law and Public Policy.