CAYMAN FUNDS | INDUSTRY INFORMATION

Hedge Fund Co-Investments Vehicles - Tools of the Trade

In light of recent and ongoing market disruption and uncertainty, Hedge Fund Co-Investment Vehicles ('**CIVs**') have become an increasingly attractive option for investors.

In essence, CIVs allow investment managers to take advantage of investment opportunities that do not fit within the strategy or model of their flagship fund, while at the same time providing investors with a way to reduce the average fees paid to managers across the funds that they invest in.

Over the past 12 months, we have seen a significant increase in the interest and instructions on CIVs, and our view is that this trend is likely to continue.

In our experience, the use of CIVs is typically driven by investor demand – the largest and most active investors are seeking to allocate large sums to concentrated positions, and they see CIVs as a way to take advantage of an investment manager's 'best ideas'.

What's their X-Factor?

Opt-in/opt-out side pockets have seen, at best, moderate success - instead, we see the type of investments that were previously going into side pockets going into CIVs, and in doing so, working around the concentration limits in the fund's governing documents.

The key benefit of this approach is that it generates economies of scale. CIVs are used for 'high-conviction ideas' as a way to monetize the by-products of research, which may otherwise go to waste. Also, for activist investment managers, they are used as a channel to increase influence by amassing sufficiently large positions to effect corporate change through board representation over time.

Finally, because CIV opportunities are typically offered with advantageous fee terms, many investors believe that co-investing provides strong alignment of interest with fund managers.

Structuring Options

Structuring is primarily driven by onshore tax and regulatory considerations, led by onshore advisers. From an offshore law perspective however – and focusing on Cayman law, which is the predominant jurisdiction of choice for this kind of activity – there are some key considerations stemming from the requirements of the Mutual Funds Act and the Private Funds Act.

Early assessment of whether the CIV requires registration under either act will be beneficial in almost all cases.

Structuring options include:

- The simplest structure is no structure at all. One approach is a simple contract and a managed account, giving the fund manager authority to trade investors' assets. The issue that this creates is that the fund manager gives up 'control' of the assets. Managed Accounts can also be administratively cumbersome for some investors.
- A single entity structure. Another simple option is a Cayman Exempted Limited Partnership or Cayman Exempted Company. This structure is particularly well-suited for single investments. It could also be used for multiple investments so long as there is only one investor, or a group of participating investors sharing pro-rata in each co-investment made through the vehicle, allowing investors and creditors of a bad investment to use the good investments to cover their losses.
- A multiple-entity structure: A further approach is a series of separate entities, allowing segregation for each investment to prevent a bad investment cross-contaminating the good investments. Despite the multiple entities, this structure can be cost effective if done properly, even with the new audit requirement under the Private Funds Law, assuming each entity only holds one investment.
- An Umbrella structure. Where fund managers are looking at multiple investments with multiple investors, and where speed of execution really matters, a Cayman Segregated Portfolio Company could be particularly well-suited, with potential economies of scale depending on the number of investments or portfolios.

Further considerations

There are a further set of considerations which managers contemplating CIVs cannot ignore in respect of onshore legal and regulatory considerations around conflicts of interest relating to allocations of co-investment opportunities, allocation of trades and allocation of expenses.

As a starting point, GPs have a fiduciary duty to their investors and accordingly, fund managers might consider having in place, long before even considering launching a CIV, very clear policies and procedures in their existing fund documents. The goal should be to avoid conflicts of interest through clear policies and procedures wherever possible, and to provide specific disclosure in fund documents when they are unavoidable.

Similarly, close attention should be given to the negotiation of side letters as they can come back to bite when fund managers look to launch a CIV, with regards to capacity and Most Favored Nations rights over future funds in particular.

Conclusion

In summary, the appetite for CIVs is here to stay, and we have even seen in the past 12 months traditional launches enhanced by pre-determined allocations to CIVs for first close or early investors. The key takeaway is that early planning is crucial, as it enables managers to take advantage of significant opportunities to grow AUM.

Further information

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