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Contributed by Christopher Wells, Proskauer

The Covid-19 pandemic has created significant challenges, as well as significant opportunities, for both hedge fund managers and investors. This article shares practical advice for a new or existing manager trying to launch a hedge fund in this environment.

Opportunities

Even in challenging times, there are opportunities for hedge fund managers. Those managers who have outperformed market indices, identified attractive buying opportunities, or both, particularly in the credit space, are now successfully raising new capital. Some large investors also see buying opportunities and are allocating new capital to both new and existing managers. There are opportunities for cash inflows into newly-launched funds, existing funds, single investor vehicles, separately managed accounts, and special-purpose vehicles targeted at a particular investment or class of investments.

Special-Purpose Vehicles

Special-purpose vehicles (SPV) have grown in popularity, even in the Covid-19 market environment. SPVs are often focused on a single investment, investment theme, or class of investments, and are sometimes also referred to as co-investment vehicles, "best ideas" funds, or "side cars." These SPVs can be structured in advance, for example, as a Delaware series limited liability company or limited partnership or as a Cayman Islands segregated portfolio company. They can also be pre-negotiated with key investors so that they can be launched quickly, efficiently, and in a cost-effective manner, in order to take advantage of a specific market disruption or opportunity.

SPVs can be either open-ended vehicles, typically subject to a lock-up for some period of time after which redemptions are permitted, or closed-end, self-liquidating vehicles with a specified limited life. Both open-ended and closed-end structures can provide for multiple closings, capital commitments or both. They are often subject to lower management fees and a private equity style carried interest, or waterfall, that is paid only on actual realized gains upon the final liquidation of the underlying investments, rather than the more traditional annual incentive allocation payable by hedge funds as a percentage of annual net mark-to-market gains.

Narrower Investment Focus

In a difficult market environment, both new and existing managers may find that a vehicle to take advantage of a narrower investment opportunity, or a disruption in a particular market, may be easier to sell than raising money for a typical blind pool fund with a broader investment mandate. This can be especially true for a new manager without an established track record.

Sophisticated investors often like a more focused investment target or style, and more targeted marketing pitch, and have generally experienced good investment results with co-investment vehicles that seek to leverage the best ideas or specialized experience of a hedge fund manager. A new manager should consider using a more detailed strategy description, possibly with more precise limits on leverage and other investment guidelines or parameters, instead of a broad or vaguely described black box investment strategy that may be harder to sell to some investors.

Founding Investors, Seed Investors, and First Loss Investors

In spite of Covid-19, large anchor investors, seed investors, and first loss investors have been willing to commit capital to new hedge fund managers and products. Large anchor investors in a new fund continue to expect, at a minimum, more favorable founders terms in exchange for providing capital sufficient to launch the fund. Founders interests typically offer a significant discount to either or both of the management or incentive compensation relative to the fees charged to investors in the standard classes.

Seed investors generally agree to lock up an agreed amount of capital, typically $50 to $100 million, for two to three years, in exchange for a percentage of overall revenues generated by a manager from other investors, typically 10-30%. The terms of these seed arrangements can vary significantly from one transaction to the next, depending on a wide range of factors related to the manager.

There have been first loss transactions in which a first loss investor commits capital to a manager through a separately managed account. The manager is required to make a smaller co-investment in the account that will bear 100% of any losses in the account, in exchange for a higher percentage, typically 50%, of trading profits generated in the account.

Opening Prime Broker Accounts

One of the key time constraints affecting the launch of a new fund is the opening of one or more prime brokerage accounts and establishing counterparty arrangements with swap dealers, lenders and other trading counterparties. During the Covid-19 pandemic, the time required to complete this process has increased, not shrunk, with less favorable or more onerous financing terms being offered, as a result of market conditions. In addition, certain administrative and procedural steps required to launch a new vehicle, including obtaining a tax identification number from the IRS, have been impacted by the crisis.

Dealing with Illiquidity

A hedge fund manager launching a new fund in a challenging market environment should give careful consideration to the fund's liquidity provisions. A fund's terms can send important messages to prospective investors about the portfolio's expected composition and can inadvertently heighten a prospective investor's perception of the risk of strategy drift by the manager. Sophisticated investors are increasingly pushing back against limitations on liquidity that do not match, or logically follow from, a manager's description of its proposed investment strategy or contemplated portfolio investments.

On the other hand, sophisticated investors will also question the ability of a manager of a fund that proposes to invest in less liquid assets, or assets that risk becoming less liquid in difficult market conditions, to deal with unanticipated liquidity events without appropriate provisions incorporated into fund documents. There are a wide range of provisions that can be added, such as gates, in-kind distributions, suspension of redemptions, liquidating vehicles, side pockets, and slow-pay provisions, but all should be reviewed and considered carefully in light of a manager's stated investment strategy.

Side Pockets

A side pocket is an extreme example of a provision that can generate a very strong negative reaction from some investors. Many investors recall perceived abuses of side pocket provisions after the 2008 market downturn. Side pockets are more common in newly-launched funds looking to make less liquid investments, although more frequently on a voluntary basis, so that an investor can elect at the time of investment in a fund whether or not the investor will participate in future side-pocketed investments. A manager seeking to launch a new fund in this environment should consider carefully whether the ability to side pocket investments is necessary or appropriate, or whether it may be sending the wrong message to prospective investors.

Managers should also consider whether some of the key objectives of a side pocket can be achieved through other, less contentious provisions. One option is the slow pay provision, a provision that permits a manager to segregate a redeeming investor's proportionate share of an illiquid investment, and then sell that investment over time for the benefit of the redeeming investor, in lieu of immediately paying the redeeming investor in full in cash. While the investor's percentage share of the investment is effectively locked in as of the redemption date, the investor bears the risk of the investment's performance through the date of final liquidation.

In addition, any incentive fee or allocation payable by the investor with respect to the deferred redemption proceeds will be paid only on actual realized gains upon the final liquidation of the underlying investment. Such a provision can effectively deal with assets that are not side pocketed at the time of acquisition, but that become illiquid in a challenging market environment, without creating some of the perceived negative consequences of a traditional side pocket.

Infrastructure

The importance in a difficult market environment of having, and being able to demonstrate, adequate internal operating systems and controls cannot be overemphasized. The Covid-19 pandemic may increase the trend toward virtual offices and working remotely, but that will inevitably result in additional due diligence requests and greater scrutiny from investors on business continuity plans, cybersecurity policies, procedures and controls, back and middle office operations, risk management policies and practices, compliance systems, and other controls. A manager should keep in mind that, as a practical matter in this environment, it is far easier to scare an already wary investor than it is to eliminate any concerns.

Conclusion

Launching a hedge fund during a pandemic, or any crisis, is no easy task. However, managers are finding attractive opportunities amid the challenges. Proper consideration of all the factors, tools, and potential hurdles discussed above can set a manager on the course for success