

# NAPPA 2012 WINTER SEMINAR MEETINGS

## INVESTMENT SECTION MEETING

### **The Anatomy and Challenges of Captive Funds and Separate Accounts in Private Equity and Hedge Funds**

**Moderator:** Georgette Schaefer, Partner  
Morgan, Lewis & Bockius LLP

**Panelists:** Joseph D. Glatt, General Counsel,  
Apollo Capital Management LP  
Sherri M. Rossoff, General Counsel and  
Chief Compliance Officer, Rock Creek Group  
Nancy E. Shealy, General Counsel, South Carolina  
Retirement Systems Investment Commission  
Jedd Wider, Partner, Morgan, Lewis & Bockius LLP

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## Alternatives to Commingled Vehicles

- Captive Funds and Managed Accounts
  - Purpose of these alternatives?
    - *Managed accounts/captive funds vs. commingled funds*
  - Frequency of use by limited partners and general partners
  - Structure and documentation
  - Customization

## Focus on Investment Terms: Fees and Expenses

- Performance Fees/Allocations
  - Managed Accounts and Captive Funds
    - *Concerns with the traditional carried interest formula*
    - *Lower carried interest*
    - *No payment or a portion held back until end of a defined multi-year crystallization period (e.g., 2 or 3 years)*
    - *Imposing a hurdle rate*
    - *Imposing a clawback (carry is clawed back if there are later losses)*
    - *Other holdbacks*

## Focus on Investment Terms: Fees and Expenses (continued)

- Management Fees
  - Managed Accounts and Captive Funds
    - *Lower fee rates*
    - *Fees payable in arrears*
- Expenses
  - Managed Accounts and Captive Funds
    - *Each party bears own organizational expenses*
    - *Caps on operating expenses*

## Focus on Investment Terms: Liquidity

- Notice Period
  - Managed Accounts and Captive Funds
    - *No notice, with or without cause*
    - *Little notice, sometimes with no notice if for cause*
- Redemption Frequency
  - Managed Accounts and Captive Funds
    - *Redemption at any time following required notice (if any)*

## Focus on Investment Terms: Liquidity (continued)

- Lock-up Provisions
  - Managed Accounts and Captive Funds
    - *No lock-up*
    - *If any lock-up, ability to redeem before lock-up expires, either with cause (with no reductions, holdbacks, reserves, withholding, suspensions, gates, delays or any fees, charges or penalties) or without cause (but subject to some penalty, including higher management fee and/or performance fee rates)*

## Focus on Investment Terms: Liquidity (continued)

- Redemption Gates
  - Managed Accounts and Captive Funds
    - *None*
    - *MFN issues relating to affiliated commingled funds*
- Suspension of Redemptions
  - Managed Accounts and Captive Funds
    - *None*
    - *Suspensions under limited circumstances*

## Focus on Investment Terms: Liquidity (continued)

- Redemption Payments/Holdbacks
  - Managed Accounts and Captive Funds
    - *Within time frame specified in the redemption notice, without any reductions, holdbacks, reserves, withholding, suspensions, gates, delays or any fees, charges or penalties*
    - *No holdbacks pending audit*
- Distributions in Kind
  - Managed Accounts and Captive Funds
    - *Redemption proceeds must be paid in cash, unless the investor otherwise directs*

## Focus on Investment Terms: Liquidity (continued)

- Accelerated Redemption Rights
  - Managed Accounts and Captive Funds
    - *If any lock-up or other redemption limitations, accelerated redemption right triggers apply*
    - *Triggers are tied to occurrence, or receipt of notice of occurrence, of a particular event*
      - Material decline in net asset value -- certain percentage over a certain period, often net of redemptions
      - Key person event
      - Conviction/plea of nolo contendere
      - Violations of securities laws
      - Breach of fiduciary duties

## A Shift in Focus on Investment Terms: Liquidity (continued)

- *Triggers (cont.)*
  - Bankruptcy/insolvency of the General Partner/Investment Advisor/Key Person
  - Change in corporate structure of the fund
  - Change in control of the General Partner/Investment Advisor
  - Breach of fund documents
  - Modification of valuation procedures
  - Changes in investment objective/strategy
  - Leverage above a certain level
  - Valuations not in accordance with the valuation procedures
  - Valuations not based on market sources or service providers but determined by the General Partner/Investment Advisor

## Focus on Investment Terms: Transparency and Reporting

- Underlying Position Level Transparency
  - Managed Accounts and Captive Funds
    - *Direct feeds from prime broker to investor and/or third party risk aggregator*

## A Shift in Focus on Investment Terms Transparency and Reporting (continued)

- Reports – Types and Timing
  - Managed Accounts and Captive Funds
    - *Monthly capital account statements*
      - Accelerated delivery of estimates and finals (i.e., within days of month-end)
    - *Weekly or monthly security files and/or risk reports*
    - *Quarterly unaudited financial statements*
    - *Annual audited financial statements*
    - *Greater transparency*
    - *Ability to customize reporting*

## Focus on Investment Terms Transparency and Reporting (continued)

- Access to Information/Audit Rights
  - Managed Accounts and Captive Funds
    - *Access to fund information and audit rights at any time*
    - *Records to be maintained in the same national jurisdiction as investor*
    - *Meetings with investment personnel upon reasonable notice*

## Focus on Investment Terms Transparency and Reporting (continued)

- Notice Requirements for Certain Events
  - Managed Accounts and Captive Funds
    - *Notice of an event of cause, bad acts and other circumstances (i.e., other accelerated redemption right triggers)*
- Most Favored Nations
  - Managed Accounts and Captive Funds
    - *MFN rights for any preferential terms granted to any investor in any other account or fund managed by the Investment Advisor or its affiliates*

## Other Terms of Managed Accounts and Captive Funds

- Enhanced Investor Rights
  - Increased control over the investment portfolio
    - *Directed trading*
    - *Suspended trading*
    - *Direction of service providers by investor*
    - *Approval of and ability to change service providers, including, prime brokers, executing brokers, administrators, custodians and auditors*
    - *Amendment of investment guidelines*
  - Increased control over management and term
    - *General Partner removal*
    - *Termination of Investment Advisor*
    - *Termination or dissolution of managed account/captive fund*

## Other Terms of Managed Accounts and Captive Funds (continued)

- Enhanced Investor Rights (continued)
  - Heightened Standard of Care and Indemnification
    - *Fiduciary standards tied to investor's regulatory or policy needs*
    - *Indemnification of General Partner and Investment Advisor tied to heightened fiduciary standards*
    - *Indemnification of investor for losses resulting from breach of the fiduciary standards or any other provision of the governing agreement*
- Additional Obligations
  - Closing opinions (e.g., due authority/enforceability, securities, ERISA, tax)
  - Governing law and jurisdiction provisions favorable to investor

## Challenges Confronting Managers of Captive Funds/Managed Accounts and Commingled Funds

- Allocation of investment/disposition opportunities
- Disclosure issues
- Side Letter concerns
- Conflicts of interest