Morgan Lewis

ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE

Manager and Investor Perspectives

WEBINAR SERIES

SESSION 2 | Thursday, May 7

Emerging Developments and Opportunities in the Hedge Fund Marketplace

Fiduciary Issues in Times of Crisis

www.morganlewis.com/2020hedgefundconference

EMERGING DEVELOPMENTS AND OPPORTUNITIES IN THE HEDGE FUND MARKETPLACE

SPEAKERS

BRENDAN KALB
+1.212.309.6778
brendan.kalb@
morganlewis.com

MIRANDA LINDL O'CONNELL
+1.415.442.1118
miranda.lindl-oconnell@
morganlewis.com

JOSEPH ZARGARI
+1.212.309.7020
joseph.zargari@
morganlewis.com

Recent Trends

1 **Increased use of customized structures that can be opportunistically formed to capitalize on market disruptions**

2 **Investment opportunities in certain asset classes, especially with respect to strategies focused on credit (including CLOs and TALF); healthcare; and distressed or opportunistic investments**

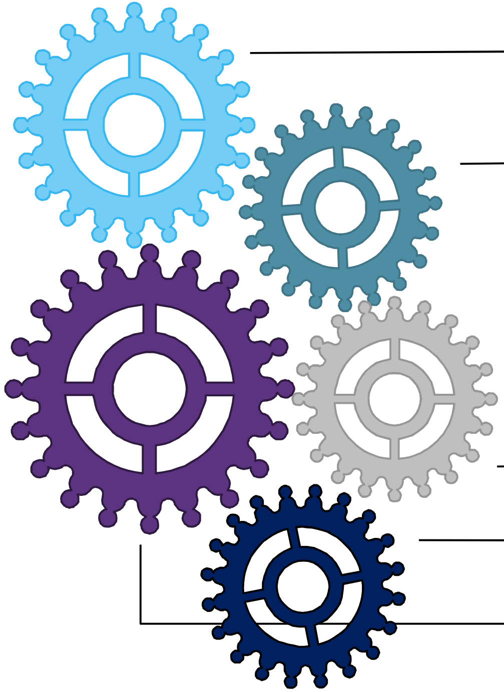
3 **Certain asset classes, such as energy, travel, retail, and entertainment, are at historically low prices**

4 **Certain strategies, such as quantitative macro strategies, have performed well in the downturn**

5 **Secondary sales of side pocket interests:**

- Greater likelihood of increased use of side pockets, while investors may need liquidity or to rebalance portfolios
- Increased amount of capital available for secondary purchases

Alternate Structures



- Accelerated fundraising windows (focus on investors that can close quickly)
- Terms may change for the particular opportunity set
  - Hedge funds: lockup periods to address current liquidity; greater ability to side pocket; valuation discretion
  - Private equity funds: shorter investment periods; shorter terms; recycling flexibility
- Short-lived products
- Greater ability to invest in illiquid assets
- Allocation of investment opportunities: Will the alternate structure receive deal flow?

Alternate Structures

MANAGED ACCOUNTS AND FUNDS-OF-ONE

- Greater investment size
- Customized investment programs – ease of modification
- Lower or different fee and expense structures, although greater setup costs for LPs
- Generally, more LP-favorable indemnification and standard-of-care terms
- Greater control, transparency, and governance terms
- Preferential withdrawal terms
- Additional rights that may be inapplicable to other investors
- Long-term relationships
- Leveraging the Manager’s infrastructure (e.g., access to sponsor knowledge; may include required training for investor)
- One governing agreement – side letters less prevalent

Advantages and Disadvantages of Funds-of-One vs. Managed Accounts

CAPTIVE FUNDS

- **Advantages**
  - Liability Protection
  - Operational Efficiencies
  - Tax Treatment of the Performance Compensation
  - Privacy
  - Tax Structuring
- **Disadvantages**
  - Lack of Ownership and Control
  - Expenses

MANAGED ACCOUNTS

- **Advantages**
  - Ownership and Greater Control
  - Risk Management
  - Liquidity
  - Affordability
- **Disadvantages**
  - Counterparty Liability
  - Fiduciary Liability
  - Unfavorable Tax Treatment of the Performance Compensation

Alternate Structures

- Hybrid Funds
  - Private equity–styled styled fund with a public securities portfolio and a long hold period (no incentive fee on unrealized appreciations and no redemptions)
  - Side-by-Side Fund
- "Best Ideas" Funds/Co-Investment Funds
  - Dedicated fund for a manager's "best ideas" or to co-invest alongside the flagship fund

Evolution of the Hedge Fund Market & Opportunities

MARKET DISLOCATIONS

- For funds that manage risk well through the COVID-19 and oil price wars, there will be no shortage of dislocations from which to take advantage.
- These events could also trigger the onset of the next distressed cycle. Hedge funds are well positioned to take advantage of greater discernment among credits given their ability to make such fundamental assessments and position themselves both long and short.
- Additionally, specific countries/regions/sectors will be impacted in very different ways, which could result in a variety of opportunities for macro investing in rates and FX.
- The risk to hedge funds would be from synchronized and coordinated monetary and fiscal actions that allow for a quick, V-shaped, beta-driven rebound that blunts the distinction between winners and losers through bailouts and an overabundance of undiscerning credit.

Raising New Capital During the COVID-19 Dislocation

- The pandemic will adversely impact fundraising for at least the next several months, but not for everyone — strategies perceived to be nonmarket-correlated or otherwise well positioned to take advantage of current conditions may still do well.
- For managers that want to raise new capital in the short term, it will be considerably easier to do so from existing investors rather than new investors.
- In the current environment, there should be opportunities for some managers to quickly and efficiently attract capital to variations on flagship funds.
- For investment managers which have a fund that is only supposed to be activated on a credit dislocation, they may now have an opportunity to do so.
- Investment managers which have set up overflow and co-investment vehicles or platforms may find that those funds provide the quickest path to market.

Considerations

- Structure
  - In terms of structure, variations are either:
    - A truly separate product (i.e., a new legal entity), but one with governing documents that are closely modeled on those of the flagship fund; or
    - A separate “sleeve” of the flagship fund (i.e., a new class or series of the existing legal entity)
- Each of these approaches (separate product or separate sleeve) can often be implemented without the consent of existing investors.
- Where a fund formed as a variation on a flagship fund will invest alongside the flagship fund or otherwise have an overlapping strategy, managers need to carefully consider their fund documents and their policies and procedures for addressing potential conflicts in the allocation of investment opportunities.

Considerations

- In addition, in the case of the separate sleeve option, care must be taken to disclose the risk of cross-class liabilities and, in certain situations, consent may be required, particularly if either the flagship fund's investment strategy or the new sleeve's investment strategy involves leverage.
- A true separate series requires considerable care in accounting and recordkeeping in order to ensure separation of liabilities (an exception being a new class that would add material risk for investors in the current class(es)).
- "Super Sub Doc" Approach vs. Supplemental PPMs
- Series/Segregated Portfolio Company Platforms
  - Other options that have gained currency in recent years and have potential under the current conditions are the separate series fund (Delaware) or segregated portfolio company (Cayman Islands) platform

ESG CONSIDERATIONS

Resilient Returns in a Downturn?

"ESG fund managers said their focus on nontraditional risks led to portfolios of companies that so far have been resilient during the COVID-19 downturn."

S&P Global Market Intelligence, *Major ESG Investment Funds Outperforming S&P 500 During COVID-19,* April 13, 2020

ESG Sectors in the Current Market

Environmental

- ❑ Renewable investment strategies more focused on long term returns.
- ❑ Renewables make an attractive alternative with the drop in oil prices.
- ❑ Global energy demand continues to rise.
- ❑ Governments and corporations promote clean and sustainable energy.

Many of the megatrends targeted by institutional grade impact strategies appear fairly resilient.

Healthcare

Education

Communications

Who Are the Investors?

Depends on Motivation Driving the Investment Decision

Not for Profit → **For Profit**

Program-Related Investments	Mission-Related Investments	Investment Restrictions	Primum non Nocere	ESG
Pursuing charitable purpose	Pursuing mission-related purpose	No investment in 'sin' industries such as weapons	No negative effects from investments	Take into account ESG considerations
A nonprofit **not** investing for a profit	A nonprofit investing for a profit	Investing for a profit	Investing for a profit	Investing for a profit

The Growing Market

$239 BILLION
in assets managed by impact investors

Nearly

66%

identify as fund managers

Investors are foundations, banks, CDFIs, family offices, and pension funds

Approximately

67%

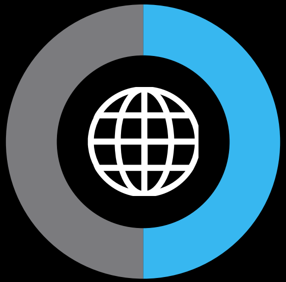
target market rate returns.
19% target close to market rate. 15% target capital preservation

$33 billion

invested in 13,000 impact investments in 2018

Expected growth to
$37 billion
in over 15,000 impact investments in 2019

All data from Global Impact Investing Network, Annual Impact Investor Survey 2019



Compound annual growth rate of impact investing assets of

17%

in the last four years

What is the Basis for ESG Policies?

- Define strategic impact objectives
  - International Finance Operating Principles for Impact Management
  - Overseas Private Investment Corporation (OPIC) Categorically Prohibited Activities List
- Incorporate objective in investment process
  - CDC Environment and Social Checklist
  - Pacific Community Ventures Due Diligence Guide
- Track performance – Measure the value of the social or environmental benefit created by an investment

How to Incorporate ESG

- TPG's Rise Fund created an "Impact Multiple of Money"* to assess the impact potential of an investment:
  - Estimate a company's output (e.g., number of people reached with an impactful service or program);
  - Attempt to quantify the social value generated through that output (e.g., value of lives saved or increased educational attainment); and
  - Factor in the amount of capital the fund planned to invest and its equity stake to calculate an impact multiple of money.
  - If a company did not score above a 2.5x, Rise would not invest.

*Vikram S. Gandhi, Caitlin Reimers Brumme, Sarah Mehta, *The Rise Fund: TPG Bets Big on Impact*, 310 Harv. L. Rev. 041, 1 (2019).

FIDUCIARY ISSUES IN TIMES OF CRISIS

SPEAKERS

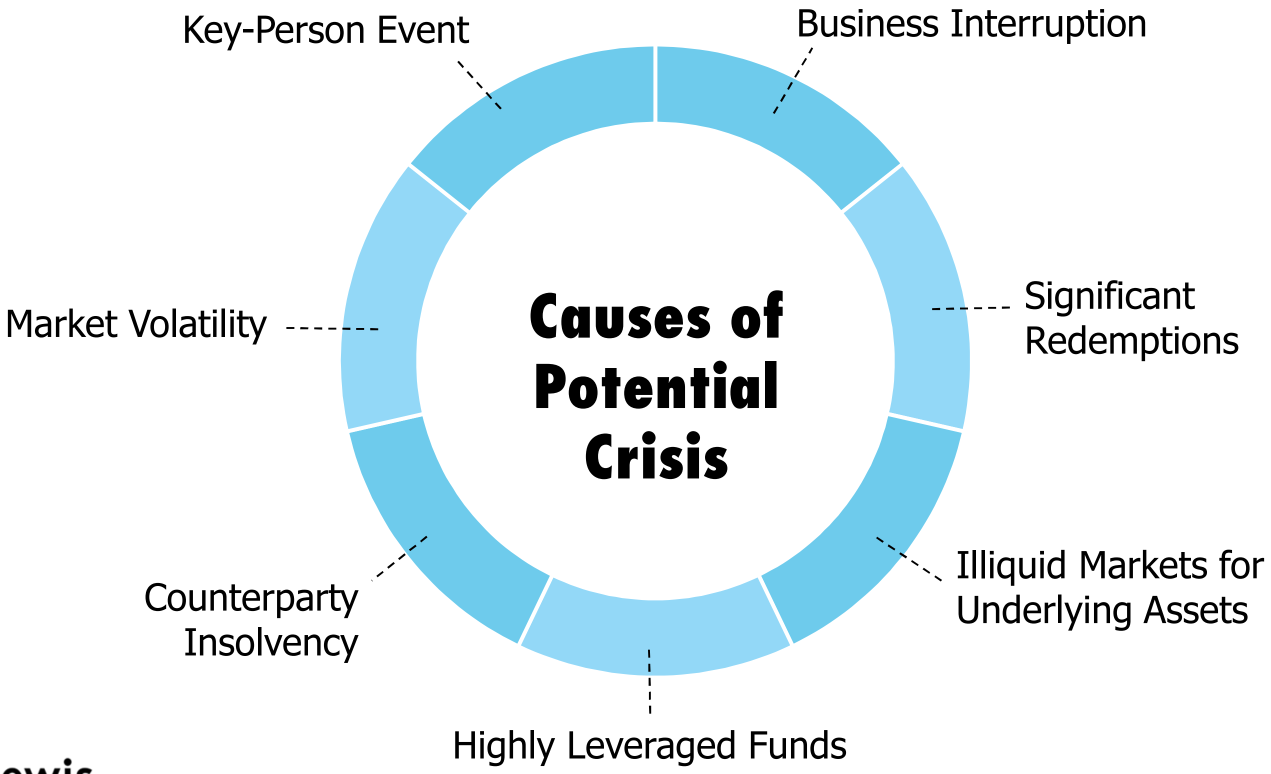
RICH GOLDMAN
+1.617.951.8851
rich.goldman@
morganlewis.com

IVAN HARRIS
+1.202.739.5692
ivan.harris@
morganlewis.com

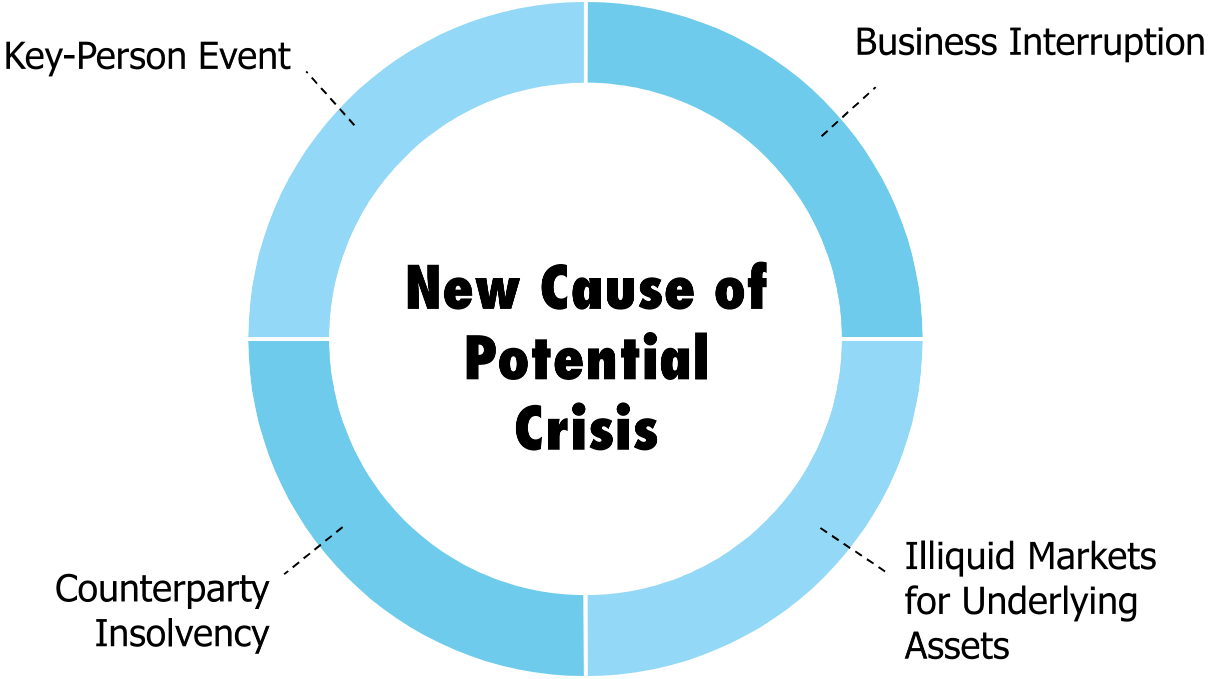
BRIAN HERMAN
+1.212.309.6909
brian.herman@
morganlewis.com

TIM LUDFORD-THOMAS (WALKERS)
+1.345.914.6386
tim.ludford-thomas@
walkersglobal.com

Some Causes of Potential Crisis for Hedge Funds



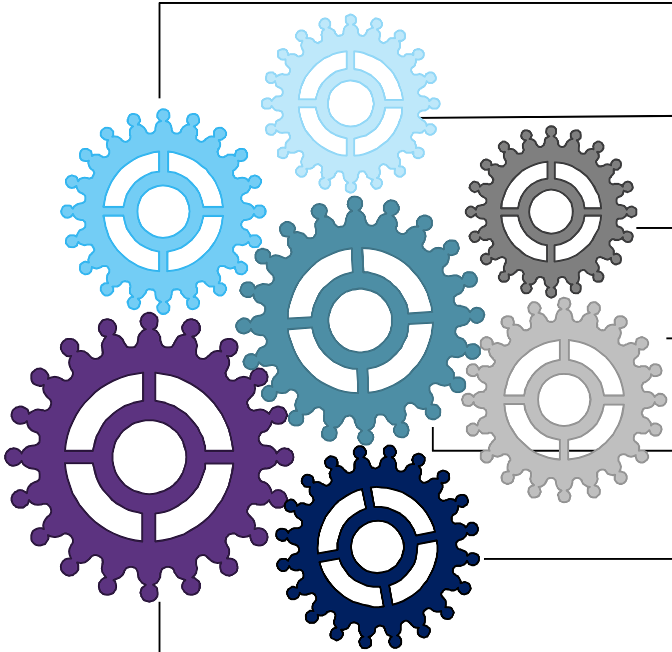
A New Cause of Potential Crisis for Hedge Funds Pandemic



Hypothetical Case Study

1. Master-feeder hedge fund has significant decline in performance during March
2. Quarterly redemptions on 90 days’ notice, subject to a one-year lockup period and investor-level gate
3. Intended that the Fund would be highly liquid; no side pockets
4. Manager implemented its BCP with some hiccups
5. One of the senior analysts may have the virus

Potential Issues That Could Result in Liability



- Strategy shift
- Valuation
- Illiquid assets; no side pockets
- Timing of disclosure to investors
- Selective disclosure
- Misleading statements
- Fiduciary duties

What Should Managers Do First?

- Contact US and Cayman legal counsel
- Review fund governing documents and side letters
- Continue to focus on seamless portfolio management and operations
- Consider objectives
  - Business objectives – Going concern or wind-up is inevitable
  - Legal objectives – Fair and equitable treatment of investors
- Fiduciary issues

Different Constituencies

General Partner/Manager (Delaware)

Board of Directors (Cayman)

Investors – Balancing interests and side letters

- Redeemed and awaiting redemption proceeds
- Investors desiring to redeem
- Investors not redeeming and not permitted to redeem

Counterparties

Employees

Service Providers

Protective Measures

- Suspensions and collateral consequences
  - Redemptions
  - Payment of redemption proceeds
  - Calculations of net asset value (NAV)
- Timing of suspensions
- Side pockets
- Liquidating special-purpose vehicle (SPV)
- Distributions in kind

Litigation and Regulatory Risks

- Breach of contract – potential conflict with side letter provisions regarding suspension, liquidation, side pockets, SPVs, distributions in kind, etc.
- Fraud in the inducement in connection with any representations by a manager made to encourage investment (or encourage withdrawal of redemption request) that turn out to be materially inaccurate
- Claims that funds were mismanaged
- Regulatory risks
- Consider self-reporting

What should we do now?

01 **Focus on seamless operations, compliance and investment processes**

02 **Monitor and enhance BCP**

03 **Valuation**

04 **Documentation**

05 **Investor communications**

LAWYER BIOGRAPHIES

Richard A. Goldman

Boston

T +1.617.951.8851

F +1.617.345.5015

rich.goldman@morganlewis.com

Richard A. Goldman represents US and international hedge funds and funds of funds, advising them on a broad range of issues, including fund formation, product structuring, strategic and seed capital arrangements, management company agreements, and all types of regulatory and compliance issues. The co-chair of the firm's global hedge fund practice, Rich also represents private equity managers in the formation of their funds and institutional investors.

Rich also regularly advises clients on registration as investment advisers with the SEC, structuring portfolio transactions and establishing separate accounts. Rich advises endowments and other institutional investors in connection with structuring and negotiating their investments in private funds.

He is the founder of the Boston Hedge Fund Group, an organization for chief financial officers, chief operating officers, general counsel and other senior legal, accounting, and compliance professionals involved with hedge funds in the greater Boston area. Rich is also a lecturer at Boston University's Morin Center for Banking and Financial Law, teaching a course on hedge funds in the LL.M. program.

Before joining Morgan Lewis, Rich was a partner in the investment management practice of another international law firm, where he was the co-chair of their global investment management practice. He was also the general counsel and chief operating officer for a hedge fund manager. He has been ranked for several years by *Chambers USA* as a leading attorney in the hedge funds industry in Massachusetts, national, and global business law guides, as well as listed in Legal 500 US.

Ivan P. Harris

Washington, DC

T +1.202.739.5692

F +1.202.739.3001

ivan.harris@morganlewis.com

With a background in senior positions at the US Securities and Exchange Commission (SEC) and as in-house counsel at a financial services firm, Ivan Harris brings insights to securities investigations, examinations, and litigation. He represents public companies, financial services firms, and individuals before the SEC, the Financial Industry Regulatory Authority (FINRA), the Chicago Board Options Exchange (CBOE) and various stock exchanges. Clients in the securities industry regularly seek Ivan’s advice on compliance and regulatory matters.

Ivan represents public companies, financial institutions including investment banks, regional broker-dealers, hedge funds and private equity funds, municipal issuers and their employees in investigations by the SEC, FINRA, CBOE and other securities regulators. In the public company and municipal arena, Ivan has handled matters for clients involving financial accounting practices, issuer disclosures, Foreign Corrupt Practices Act (FCPA) violations, and insider trading. He regularly counsels large investment banks, clearing firms and other broker-dealers on complex investigations involving trading practices, market structure issues, anti–money laundering compliance, and other rules and regulations. Ivan has also represented hedge fund and private equity firms facing regulatory investigations and examinations relating to valuation practices, complex trading issues, potential use of inside information, and issues relating to fees and expense practices.

Ivan previously served at the SEC from 1998 to 2005, and from 2001 to 2005 was an assistant regional director for enforcement in the SEC's Miami office. While at the SEC, he led the investigation of a major hedge fund collapse, brought the first SEC case involving illegal hedge fund short selling, and prosecuted cases involving accounting fraud, insider trading, FCPA violations, market manipulation and broker-dealer/investment adviser violations. Several of those cases involved cross-border issues and investigative efforts throughout Europe and Latin America. Also before joining Morgan Lewis, Ivan was regulatory counsel for a financial services firm, where he advised on trading issues and compliance matters. He also served on several securities industry committees that focused on fixed income trading and securitized products. Ivan frequently speaks at securities industry and hedge fund conferences.

Brian A. Herman

New York

T +1.212.309.6909

F +1.212.309.6001

brian.herman@morganlewis.com

With a focus on financial institutions, Brian A. Herman counsels clients in civil and class action litigation in US state and federal court, and in arbitrations. He represents banks, broker-dealers, hedge funds, private equity funds, investment advisers, public companies, and other complex businesses. Brian also advises clients facing examinations by the US Securities and Exchange Commission (SEC), self-regulatory organizations, state regulators, and other regulatory agencies. Clients also turn to Brian for guidance with internal examinations and enhancing their business practices.

Brian's practice spans litigation matters involving contract disputes, lending practices, mergers and acquisitions, residential mortgage-backed securities (RMBS), loan servicing and foreclosure practices, collateralized debt obligations, investment funds, Ponzi schemes, and consumer protection.

Prior to joining Morgan Lewis, Brian served as a law clerk to Judge Ruth Abrams of the Massachusetts Supreme Judicial Court.

Brendan R. Kalb

New York
T +1.212.309.6778
F +1.212.309.6001
brendan.kalb@morganlewis.com

Brendan R. Kalb utilizes his in-house asset management and corporate legal experience to counsel clients on issues relating to the establishment and ongoing operation of global hedge funds, private equity funds, commodity pools, UCITS funds, hybrid customized vehicles, and separately managed accounts, along with providing regulatory, compliance, and trading advice to managers investing in various asset classes in the United States and abroad. He also has deep experience advising on the structuring and operation of various registered fund products, including liquid alternative funds.

Prior to joining Morgan Lewis, Brendan was the managing director and general counsel at AQR Capital Management, LLC, a systematic global asset management firm based in Greenwich, CT, where he was responsible for managing the full spectrum of the firm's legal affairs, including involvement in all aspects of US and overseas regulatory exams, product structuring, derivatives and operational risk management, quantitative investment practices, drafting of investment guidelines and restrictions, creation and update of compliance policies and procedures, as well as implementation and interpretation of international rules and regulations regarding trading and marketing. Prior to joining AQR in 2004, he worked as an investment management associate in the New York office of an international law firm, where he regularly represented registered investment companies, investment advisers, commodity pool operators, commodity trading advisors, and broker-dealers.

Brendan has spoken at a number of industry conferences on regulatory matters affecting the financial services industry and previously served as chairman of the Managed Funds Association’s CTA, CPO, and Futures Committee and as a member of MFA’s Investment Adviser, International and Government Affairs Committees. In addition, he has served on the National Futures Association’s board of directors and is an active member of the Investment Company Institute’s Equity Markets, CPO Advisory and Derivatives Markets Advisory Committees. Brendan also serves on the board of advisors of the Institute for Law and Economics, a joint research center between the Law School, the Wharton School, and the Department of Economics at the University of Pennsylvania.

Miranda Lindl O’Connell

San Francisco
T +1.415.442.1118
F +1.415.442.1001
miranda.lindl-oconnell
@morganlewis.com

Miranda Lindl O’Connell represents fund of funds, private foundations, social entrepreneurs, pension plans and other institutional investors in private investment fund transactions. Miranda counsels clients regarding the investment in and secondary sale of interests in private investment funds of a variety of structures including private equity funds, co-investment funds, venture funds, captive funds, separate accounts and other customized private finance options. She advises social entrepreneurs, private foundations, and charities on a range of social impact investments including program-related investments, mission-related investments, and innovative investment vehicles and structures including social impact funds and debt and equity investments.

Miranda also counsels clients in the structuring, formation, and governance of US domestic and international private investment funds. She represents clients in the formation of funds of funds, funds sponsored by 501(c)(3) entities, corporate governance funds, venture funds, real estate funds, co-investment funds, and private equity funds.

The American Bar Association presented Miranda with its Outstanding Volunteer in Public Service Award for her work at the Homeless Advocacy Project. While in law school, Miranda served as an extern for Judge John T. Noonan of the US Court of Appeals for the Ninth Circuit. Prior to law school, she worked as the race director for the San Francisco Marathon.

Tim Ludford-Thomas, Walkers

Cayman Islands
T +1.345.914.6386
tim.ludford-thomas
@walkersglobal.com

Tim Ludford-Thomas is based in Walkers' Cayman Islands office where he is a partner in the firm's Global Investment Funds Group.

Tim has extensive experience in both open and closed ended investment structures and has advised some of the world's leading asset managers. He specialises in fund formations, seed capital arrangements, downstream investments, co-investments, alternative investment vehicles, parallel funds, acquisitions and disposals, restructurings, pooling arrangements, fund governance and joint ventures. Tim also advises on the registration of mutual funds and their ongoing regulatory compliance.

Tim is a part of the FinTech team at Walkers and advises FinTech businesses on projects associated with blockchain, digital assets and a range of related activities, including the establishment of cryptocurrency funds.

Joseph D. Zargari

New York
T +1.212.309.7020
F +1.212.309.6001
joseph.zargari
@morganlewis.com

Joseph D. Zargari focuses on the structuring, formation, investment in, and governance and regulation of US domestic and international hedge funds, private equity funds, funds of funds, venture capital funds, hybrid funds, captive funds, and other private investment funds. He also counsels on the investment activities of these funds, and provides legal and other transactional advice for investment managers.

Actively engaged in all aspects of the private funds practice, Joe represents many major financial institutions, fund managers, and investment banks in connection with the formation of their funds and their investment activities, as well as placement agents and other parties connected to these activities. He also represents managers and clients of separately managed accounts and captive funds.

Joe regularly represents clients engaged in secondary transactions (including traditional purchases and sales of fund interests, fund recapitalizations and restructurings, tender offers, and structured, stapled, and synthetic secondary deals) and is a frequent speaker on the subject. Joe advises secondary funds, institutional investors, pension plans, endowments, family offices, and other institutions in their capacities as buyers and sellers of private fund interests on the secondary market and has counseled clients in many of the recent leading secondary transactions.

Joe has presented at a number of industry conferences on investment management-related matters, including at conferences sponsored by the Managed Funds Association and the National Association of Public Pension Attorneys, as well as at conferences sponsored by Morgan Lewis in New York, London, Chicago, Boston, and Dallas. Joe has also published articles on fund formation, investment management, and secondary transaction matters in *Hedge Fund Legal & Compliance Digest*, HedgeFund Intelligence's *Absolute Return* magazine, PEI's *Secondaries Investor* publication, and the Morgan Lewis Hedge Fund Deskbook. Joe also serves as the New York office local practice group leader for the investment management practice.

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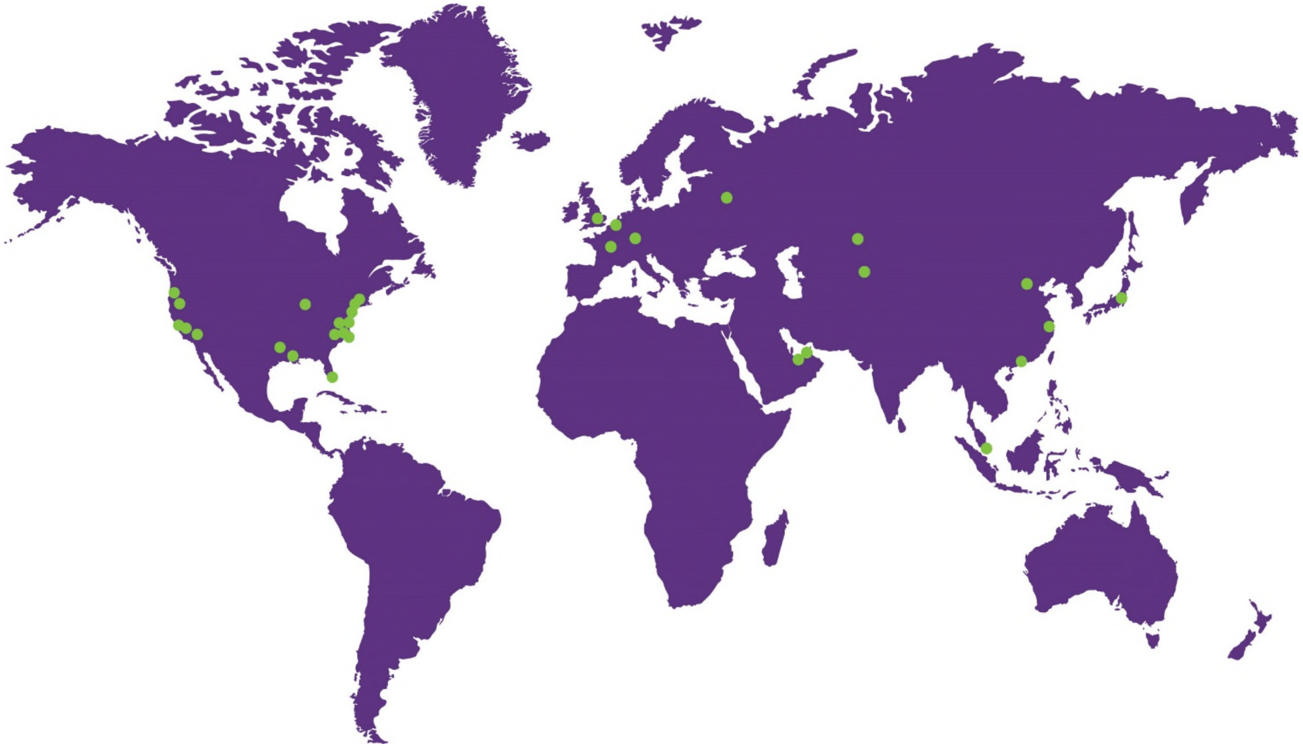

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