Article

BVI Hybrid Funds

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In this series of articles we consider two of the more common requests we see in terms of fund structuring options: *Multi-Class Funds*, and *Hybrid Funds*. This second article in the series will consider Hybrid Funds. Multi-Class Funds will be considered in a separate article, available here.

Many sponsors looking to launch a new offshore fund will have well-defined ideas about the common terms that should apply with respect to the pooling of investments and liquidity rights for investors. However, for those clients looking for something more bespoke, two of the more common requests we see in terms of fund structuring options are for:

Multi-Class Funds

These can be described as funds with a mandate that allows them to pursue two or more different strategies (or to acquire two or more different investments or buckets of investments) within a single fund vehicle that are to be treated as distinct and separate from one another, such that investors in a given strategy only participate economically in that particular strategy and not any other strategies (or investment holdings) of the fund.

Hybrid Funds

These are funds which hold a mix of both liquid and illiquid investments and seek to combine elements of fund terms customary for both hedge funds (for liquid investments) and private equity funds (for illiquid investments) within a single fund vehicle.

Such alternative strategies can present certain unique issues and challenges from a structuring perspective but the British Virgin Islands ("BVI") fund industry is very well adapted to cater for this given the jurisdiction's flexible legal regime and unique set of well-regarded, innovative and cost-competitive fund products.

Hybrid Funds

Historically, hedge funds and private equity funds were considered two entirely different alternative investment classes. However, in more recent times, the distinction has been blurred to some extent, as reflected by the increasing prevalence of hybrid fund structures. Hybrid funds can be loosely described as funds which hold a mix of both liquid and illiquid (or otherwise difficult to value) investments and seek to combine elements of fund terms customary for both hedge funds (for liquid investments) and private equity funds (for illiquid investments) within a single fund vehicle. Hybrid funds that hold a material portion of their portfolio in liquid investments but more closely resemble traditional private equity funds rather than hedge funds are often referred to as 'private equity lite funds'.

Hybrid fund structures are most commonly utilised for activist investing, distressed investing and certain credit strategies, as well as by those sponsors which believe they can realise superior returns and/or material cost or administrative efficiencies by operating a broad mandate encompassing both liquid and illiquid strategies with a single fund vehicle (rather than setting-up and operating two or more separate funds).

For a hedge fund which is willing to cap its illiquid holdings to a relatively small percentage of total assets (often 10% to 30%), 'side pockets' and/or multi-year lock-ups within the context of an otherwise conventional hedge fund structure may be a viable alternative to a more fulsome and complicated hybrid fund structure. However, for a fund with a significant portion of both liquid and illiquid holdings, a more comprehensive set of hybrid terms may be required.

There are many different potential permutations of hybrid fund structures. Some of the more salient issues that often arise in practice from a dual liquid/illiquid investment portfolio include the following considerations:

i. Management Fees:

The conventional private equity approach to management fees, with fees calculated based off capital commitments during the commitment period and invested and unreturned cost of investments after the commitment period, may not be appropriate for a fund which holds a significant portion of its portfolio in liquid investments with readily discernible market values.

Conversely, a typical hedge fund structure of management fees based off prevailing NAV would not be practicable for a portfolio of investments which are illiquid or otherwise difficult to value.

ii. Performance/Incentive Allocations:

The conventional private equity approach to performance allocations (carried interest), based off realised returns (and potentially subject to a hurdle and GP clawback provisions), would not be appealing for the sponsor of a fund which holds a significant portion of its portfolio in liquid investments with readily discernible market values.

Conversely, a typical hedge fund structure of incentive fees/allocations calculated at periodic intervals throughout the term of the fund based off both realised and unrealised gains (on a mark-to-market basis) would not be appealing for investors or practicable for a portfolio of investments which are illiquid or otherwise difficult to value.

For those hybrid funds which do utilise a private equity approach to performance allocations, a European distribution waterfall (with back-ended whole-of-fund carry) would be more common because the deal-by-deal carry characteristic of American-style distribution waterfalls is burdensome to calculate for actively traded funds.

iii. Subsequent Closings:

The conventional private equity approach of allowing additional investors to be admitted to the fund pursuant to subsequent closings only during a finite offering period, at cost plus an interest factor ('accrued charge') may not be appropriate for a fund which holds a significant portion of its portfolio in liquid investments with readily discernible market values and/or in investments which may generate significant realised income or gains prior to the final closing date.

Conversely, a typical hedge fund structure of subsequent closings at periodic intervals throughout the term of the fund at prevailing NAV (evergreen) would not be suitable for a portfolio of investments which are illiquid or otherwise difficult to value.

iv. Investment Periods:

The conventional private equity approach of prohibiting or restricting re-investments of capital following the defined investment period may not be appropriate for a portfolio of liquid investments which are actively traded with frequent turn-over.

Also, the life-cycle of many investment strategies that naturally lend themselves to hybrid fund structures tend to be significantly shorter than a traditional private equity buy-out fund structure - often 3 – 5 years rather than the more usual 8 – 12 years.

v. Investor Disclosures/Transparency:

A fund that holds a material portion of its portfolio in investments which are traded on public markets will need to impose significant limitations and restrictions on the information it is required to report to its investors regarding its public investment holdings.

vi. Other Investor Demands:

A sponsor should be mindful that, if the fund appears more akin to a private equity structure, sophisticated investors may well demand the sorts of additional investor rights and protections commonly associated with private equity funds that are rarely offered by hedge funds (such as co-investment rights, key man provisions and minimum time commitments of key principals, GP/sponsor capital commitments, restrictions regarding future/subsequent funds and allocations of investment opportunities, and investor rights to replace the GP and/or terminate the fund).

Conversely, a hybrid fund which holds a material portion of its portfolio in liquid investments may be faced with investor demands for periodic redemption rights (at least with respect to the liquid holdings).

vii. Marketability:

Marketing can be a potential challenge for funds which pursue dual liquid/illiquid strategies, as investors may be confused about the core investment philosophy of the fund and whether it is more akin to a private equity fund or a hedge fund (which may be important for investors' own internal allocations and investment committee approval processes).

The sponsor may need to resist the temptation to try to cherry pick the most favourable aspects of both PE and hedge fund terms for the benefit of the sponsor group, as that may not prove acceptable to a sophisticated investor base.

viii. Regulatory Treatment:

For BVI regulatory purposes, a key distinction is drawn between:

a) Hedge funds and other open-ended funds (which provide investors the right to withdraw capital at periodic intervals by reference to NAV) – these are regulated as *mutual funds* in the BVI.

b) Closed-ended funds (which do not provide periodic redemption/withdrawal rights to investors) – such as a typical PE/VC fund structure these are generally regulated as *private investment funds* in the BVI (subject to certain limited exemptions).

The regulatory regimes regarding *mutual funds* and *private investment funds* are largely separate and distinct in the BVI, so for a fund that seeks to combine elements of fund terms customary for both hedge funds and private equity funds within a single fund vehicle, careful consideration would need to be given as to the correct regulatory classification and treatment (which would almost certainly involve discussions between BVI legal counsel and the BVI Financial Services Commission).

Hybrid funds are difficult to define and market practice has not developed anything resembling a standard set of fund terms for a hybrid fund structure. As noted above, a dual liquid/illiquid investment portfolio gives rise to a number of unique issues and challenges in terms of fund structuring and marketability to investors. However, for those sponsors which are set on a hybrid fund structure, the BVI has proven very well adapted in meeting such challenges with its flexible legal regime and well-regarded, innovative and cost-competitive fund products.

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