

Hybrid Funds and the Administrative Quandary

By David Ross and Henry Bregstein

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Hedge funds have evolved far beyond traditional structures and exotic instruments. Today, hedge funds seek new ways to generate returns by partially reigning in exposure to early investor withdrawals.

Little known outside the alternative investment cognoscenti, hybrid funds create portfolios that leverage their proprietary trading strategies while also incorporating private equity-like long-term capital features. The result? The ability to truly focus on returns wherever they may be found without worrying that fund investors will pull out at every dip of the market.

But this combination of liquid and illiquid investment vehicles also brings an array of accounting, operations, legal and administrative challenges.

Hybrids need more than savvy investment strategy: they need experts that can handle the abundant operational complexities.

Higher returns, longer hold, less liquidity

By definition, hedge fund managers have great latitude to place investments where they find returns, most typically in liquid and quasiliquid investment assets. But this liquidity comes at a cost: investors can pull out at select intervals and with just two or three months' notice and managers therefore need to avoid longer-term alpha-generative investments.

Perched down the spectrum of alternative: investment liquidity, private equity firms tend to concentrate their focus they choose a sector or two and stick with it. PE firms take the long view, gravitating toward illiquid assets, which might take years or even a decade (or longer) to realize full return potential. Investors agree that they will be subject to capital calls for a period of generally two to five years, will have no withdrawal rights and will simply be paid out when portfolio investments are liquidated.

Hybrid funds seek to bridge the liquidity gap between traditional hedge funds and private equity by combining key elements of both disciplines. And therein lies their challenges.

With a mix of liquid and illiquid assets, hybrid funds face increased complexity. Depending on the specific hybrid fund, illiquid assets can represent 30 to 80% of the entire portfolio.

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...invests both in conventional hedge fund assets and illiquids

and employs a varying mix of HF compensation and private equity capital mechanics

hybrids must address the accounting requirements of its liquid bucket and manage the private equity mechanics of its illiquid bucket

Consider some of the illiquid assets that hybrid funds are tapping into:

- Long-term loans
- Distressed credit assets
- Bank, emerging market and real estate debt
- Life settlements
- Real estate and real estate lending
- Infrastructure and other leveraged finance
- Royalties

Defining the “Hybrid Fund”; Administrative, Legal and Accounting Complexity

Many use the term “hybrid fund” colloquially to refer to any hedge fund with private equity characteristics (such as capital commitments and predetermined investment period), regardless of whether the fund makes any material allocation to illiquid assets, says Jonathan White of Viteos Fund Services.

But, according to Henry Bregstein, a senior partner in Katten's Financial Markets and Funds Practice, this loose approach tends to cloud the complex accounting, legal and administrative issues posed by true hybrid funds. We thus begin with a reasonably precise definition: in our view, a ‘true’ hybrid fund means a collective investment fund that:

- invests both in (i) what are generally considered to be conventional hedge fund assets, e.g., publicly traded securities, futures contracts, other exchange-traded instruments and other liquid or quasi-liquid assets (a so-called “liquid bucket”) and (ii) one or more of the illiquid assets mentioned above, with a material portion of its portfolio allocated to this second “illiquid bucket” and
- employs a varying mix of (a) traditional hedge fund mechanics (e.g., “2 and 20” compensation for the manager and periodic withdrawals, which may be gated or subject to lock-up periods) for its liquid bucket and (b) private equity capital mechanics (e.g., capital commitments, calculation of carried interest using a “waterfall,” and self-liquidation after its commitment period) for its illiquid bucket.

Defined this way, the complexities become clear. As a threshold matter, a hybrid fund must address the usual administrative and accounting requirements posed by its liquid bucket. These include but are not limited to the handling of subscriptions and redemptions, the calculation of net asset value and the calculation of management fees and performance allocations or fees (and the payment and allocation thereof, as applicable).

Concurrently, the hybrid fund must implement and manage the private equity mechanics applicable to its illiquid bucket. These mechanics may include some or all of the following, and raise some of the accounting and administrative complexities below:

administrative complexities:

capital commitments,

incentive compensation,

distributions,

management fees,

current income,

disposition

there is no single model for a hybrid fund

a combination of closed-end and open-end brings structure, pricing, and sales complexities

need highly sophisticated fund structures and terms to account for private credit funds debt financing and refinancing

- **Investors' capital commitments** are drawn down by the manager as needed for illiquid investments, and the capital contributions made in respect of each drawdown must be carefully tracked, including the purposes for which they were deployed (i.e., to make the illiquid investment, investment-specific expenses and general fund expenses);
- **the manager's incentive compensation** may, but need not, be calculated on the final disposition of one or more of the illiquid investments using a distribution 'waterfall,' which may be very complex and, alternatively, the incentive compensation may be calculated based on a typical hedge fund net asset value methodology, which puts a focus on valuing illiquid investments;
- **distributions to investors** and the manager must be accounted for carefully, because the governing agreement for the hybrid fund generally may provide for general partner/investment manager incentive compensation clawbacks;
- additional accounting complexity may arise with respect to **management fees** if they are calculated based on an estimated net asset value of the illiquid bucket on a periodic basis;
- to the extent the hybrid fund generates **current income**, the hybrid fund may make ongoing distributions of such current income, increasing the administrative and accounting complexity; and
- finally, the hybrid fund must account for any cash generated by the disposition of any of its illiquid investments, which the hybrid fund may return to investors, invest into the liquid bucket, recycle into additional illiquid assets (subject to certain limits), or some combination of the foregoing.

As their name implies, there is no single model for a hybrid fund. Each fund establishes its own target mix of liquid and illiquid investments and governing agreements, with varying terms.

Hybrid funds can handle their illiquid buckets in many different ways, using all or some of the private equity mechanics described above. In turn, each hybrid fund must contend with more complex investment accounting and pricing when compared to a traditional hedge fund. Moreover, the combination of closed-end and open-end characteristics brings increased complexities with structure, pricing and sales, given the varying duration of each investment bucket and the distribution mechanics that go along with them.

Hybrid funds with material allocations to private credit strategies raise further complexities. Bregstein says that "hybrids that concentrate on private credit need to employ highly sophisticated fund structures and terms to account for the debt financing and refinancing mechanics necessary for each investment and to address the tax issues involved."

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resources and expertise necessary to track and calculate distributions and allocations

hybrid funds present opportunities for managers to generate gains and mitigate liquidity issues

proper support, in-depth understanding of all capital markets liquid and illiquid and a wide knowledge of accounting, legal and administrative systems are crucial

According to Bregstein, private credit hybrids have seen substantial growth in recent years and he expects to see this trend continue. Managers for such funds would do well to engage sophisticated counsel and, on the business side, don their banker caps and put infrastructure in place to establish valuations and service both principal and interest payments, and ensure they have the necessary mechanics to keep track of each transaction, especially where intricate credit facilities are involved.

It is clear that hybrid funds need the assistance of a capable service provider with the resources and expertise necessary to track (and assist in calculating) the distributions and allocations that need to be made and provide the other sophisticated accounting and administrative support hybrid funds require.

Support for managers, assurance for investors

Accounting systems for liquid and illiquid assets are varied. An adjustment is in store for hedge fund managers that cut their teeth on real-time reports and daily market valuations/NAV, since illiquid assets bear pricing that's far less certain.

There are a host of issues that hybrid fund managers and investors should consider as well: partnership arrangements, differences in accounting cycles, variations in time horizons, location- and investor-type-based tax structures and the tax consequences of capital gains and trading income, as compared to ordinary income and potentially FIRPTA.

Hybrid funds present opportunities for managers to generate gains and mitigate liquidity concerns. The work can be highly rewarding for the fund managers and investors, but proper support is crucial. Hybrid funds require service providers with an in-depth understanding of all capital markets, both liquid and illiquid, and a broad knowledge of accounting, legal and administrative issues and their solutions.

If you are interested in learning more about hybrid fund accounting and fund administration, talk to Viteos. Our mission is to make complexity simple and it works.

If you are interested in learning more about hybrid fund legal issues, talk to Katten. We speak from long and deep experience.

Viteos appreciates the assistance of Phillip Koh, a senior associate at Katten, in the preparation of this article.