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Private credit: Open-end and closed-end structures with overlapping investment mandates

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Increasingly, private credit fund managers are seeking to adopt dynamic fund structures utilizing open-end and closed-end vehicles investing side-by-side to appeal to competing investor demands for liquidity on the one hand, and returns, on the other. In this article, we consider this trend in brief, what is driving it, and we examine some of the issues sponsors must consider to implement these structures successfully.

Investor desire for liquidity in private debt investments is encouraging sponsors to rethink the traditional closed-end fund model. The principal objective is to facilitate an efficient fundraising process by adapting to investor demand. Open-end fund structures appeal to many investors with specific regulatory, internal policy, or portfolio exposure requirements. Certain types of private credit fund investments are inherently more liquid and income-generating than traditional equity investments held in private equity closed-end structures. These asset types provide sponsors with an opportunity to offer a more flexible structure to a more fluid investor base and ultimately achieve a larger fundraise and, as a consequence, grow their funds under management.

Why deviate from a closed-end fund structure?

Some advantages of having an open-end fund structure include:

1. More significant economies of scale afforded by deploying capital from both closed-end and open-end structures may benefit sponsors pursuing larger transaction sizes.
2. Taking advantage of capital commitments from funds with overlapping investment periods provides sponsors with an uninterrupted flow of dry powder and may overcome certain limitations on recycling provisions in traditional closed-end structures.
3. Sponsors and investors being able to avoid fluctuations in their portfolio composition when the closed-end structure winds down.

Structure overview

Closed-end funds follow the familiar private equity model with a limited fundraising period; investor capital commitments that are drawn down over time; a defined investment period and fund term; and no ongoing subscription or redemption rights. Open-end funds generally have an indefinite life with evergreen potential for subscriptions and redemptions. However, we often see

draw-down mechanics in the open-end vehicle, which are similar to that of the closed-end vehicle. To provide an example of the kind of structure contemplated, a vehicle with a three to five year investment period and five to seven year term and an evergreen vehicle offering periodic redemptions, may pursue an investment strategy to invest in the same, or a substantially similar, portfolio of loans and other credit assets managed by the same manager.

In one way, this is not such a radical shift – we have already seen somewhat of a blurring of fund terms whereby closed-end structures rely on broad recycling provisions and open-end structures employ draw down structures and redemption mechanisms such as lock-ups, redemption gates, limited withdrawal dates, and side pockets to manage illiquid assets. Indeed, many managers will already have the resources and skills to manage credit assets under each type of structure. Nevertheless, there are some inherent tensions that sponsors must navigate when establishing and operating these structures on a side-by-side basis.

Liquidity management

For one, sponsors must implement fund terms that cater to appropriate liquidity management when investing in less liquid positions and with limited interest income. The risk is that redemption requests may force the asset disposals at inopportune times at suboptimal prices. As mentioned above, sponsors create breathing space in open-end structures to accommodate illiquid or longer-dated credit investments. Such methods include:

1. Robust lock-up periods at the beginning of the fund's life during which investors cannot redeem their fund interests.
2. Redemption request limitations in the form of investor-level gates or fund-level gates.
3. Early redemption fee mechanisms.
4. An ability to defer redemption requests to avoid the requirement to sell assets.

Also, an open-end fund will typically maintain a cash reserve to facilitate future redemptions – the target returns of the open-end structure will usually be lower to reflect this.

Potential conflicts

Sponsors must implement robust conflicts of interest policies, which address matters such as investment allocation, asset disposals, and the circumstances in which the sponsor may take different corporate actions on behalf of each vehicle for a common position to reflect the liquidity profile of the vehicle. For example:

1. If assets common to the open-end vehicle and the closed-end vehicle are disposed of before the end of the closed-end structure term, closed-end vehicle investors might consider that such assets have been realized prematurely to provide open-end vehicle investors liquidity.
2. The open-end structure may not be in a position to invest in certain investments on a proportionate basis with the closed-end vehicle if there are a series of material redemption requests.
3. Information requests from either open-end vehicle and the closed-end vehicle investors may result in investors in one side of the structure having enhanced portfolio information relative to the other.

Valuations

Valuations must be considered carefully. In closed-end vehicles, valuation is typically important for performance advertising and for reporting purposes (enabling the investors to determine the

valuations of their entire investment portfolio). In contrast, in open-end structures valuations generally dictate investor investment/divestment decisions because sponsors usually facilitate redemptions and subscriptions based on net asset value (NAV). NAV may also form the basis of sponsor and manager remuneration in open-end structures. NAV calculations may be problematic because certain assets are, by their nature, difficult to price accurately until a liquidity event occurs. Furthermore, redemptions for an open-end structure may impact the valuations of the same or related positions held by the corresponding closed-end structure. Sponsors may address potential valuation issues by adopting a robust valuation policy, by appointing an independent auditor and establishing a valuation committee with members common to the closed-end structure and open-end structure, and by disclosing the impact of any redemptions in the open-end vehicle on the price of the same investments in the closed-end vehicle.

Preferential information rights

Sponsors must approach information provisions thoughtfully. To the extent preferential information rights are negotiated by certain investors or information is shared during the rolling fundraising process, there may be concerns regarding an asymmetry of information across the investor base.

Style drift

To the extent an open-end structure invests side-by-side with successive vintages of closed-end structures, style drift can become an issue. It can potentially form the basis for claims against the general partner or manager of, among other things, fraud, breach of contract, or violation of securities laws. Sponsors will need to address this issue by maintaining the currency of disclosure documents.

Managing challenges

Many of the challenges sponsors face establishing open-end and closed-end structures investing side-by-side can be overcome or mitigated with the right terms, policies, and disclosure.

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