

The impact of the evolving relationship between investors and managers on fund structuring

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In this article we address how the landscape for the structuring of offshore investment funds established in the Cayman Islands is changing—and how this change is being driven by the evolving relationship between investors and investment fund managers and, in particular, how the balance of power has in many cases shifted from the manager to the investor.

We briefly analyse some of the drivers behind such a shift, some of the most significant trends that we have seen emerge, and lastly, how the Cayman Islands as a key jurisdiction for offshore investment funds has successfully adapted to the increased demands for flexibility within fund structures.

Market drivers: the balance of power

A combination of diminished returns across the hedge fund industry amid challenging market conditions for generating alpha and a continued and increased focus on performance has given rise to a shift away from more traditional hedge fund products to the more attractive returns offered by private equity investments.

As a consequence of this shift, some traditional hedge fund investors moving into the private equity space are bringing along with their capital an expectation of receiving offering terms that they would be familiar with from their experience of investing in the hedge fund world.

In addition to the traditional hedge fund investors looking to make the transition across to private equity offerings, we have also seen a number of traditional hedge fund managers looking to put in place private equity styled offerings, or more hybrid structures, in order to retain or attract capital flows moving in the direction of private equity chasing better returns.

Such private equity or hybrid-style offerings by traditional hedge-fund managers often reflect many of the characteristics of a more traditional hedge fund, given the manager's mixed heritage.

The big allocators are getting even bigger and with an increase in size comes a consequential increase in bargaining power and the ability to demand increasingly favourable and bespoke offering terms from managers. Often this increased bargaining power can lead not only to specific rights or benefits within an existing fund structure (eg, by means of a negotiated side letter), but in certain cases the requests of institutional or strategic investors can lead to managers putting in place a tailor-made structure with bespoke terms established specifically to meet the investor's requirements commonly referred to as a 'fund of one'.

In times of challenging returns, there is often increased pressure on smaller managers to attract capital, as larger investors and allocators can be attracted by the relatively safe harbour of more tried and tested managers. In addition to expectations around performance and a healthy infrastructure with a capacity for growth, a manager's willingness to amend fund offering terms to adapt to the demands and requirements of large investors has become another common expectation, particularly for smaller and emerging managers (although as

we will discuss below this can often lead to a more collaborative and supportive relationship between investor and manager).

Having examined the 'blurring of the lines' between more traditional hedge fund terms and private equity style offering terms, and how this combined with other market pressures has led to a shift in the balance of power between investors and managers, it is interesting to note some of the common trends that we have seen emerge in offshore fund structures as a consequence.

Trends and the impact on fund structure

Management and performance fees is obviously a key, and in many cases, the first item for negotiation for large, institutional or strategic investors, particularly during a period of lower returns. Additional items that are typically requested include favourable lock-up periods, transparency and information rights.

For existing structures, the amended offering terms are typically addressed within side letters between the investor, the fund and the manager. We have seen a significant increase in both the number, as well as the length and complexity, of such side letters over the past two years.

One particular trend that we have seen develop recently within side letters has been an increased pressure from investors arguing for a 'most favoured nation' or MFN provision to be included within a side letter, whereby the investor would benefit from any improved terms successfully negotiated by any subsequent investor and the manager would be contractually obliged to extend such terms to the existing investor with the benefit of the MFN provision.

For existing structures it is increasingly common to see agreements with larger investors for the rebate of a portion (or all) of management fees, and in very limited instances we have seen certain investors successfully negotiate for a percentage equity interest in the general partner as a condition of investment.

For new fund launches, in an effort to attract institutional, large or strategic investors it is increasingly common to see a 'founder class' or 'seed class' of shares offered, whereby select investors are provided with beneficial terms in consideration for an early and significant investment.

One side effect of the negotiation process between investors and managers for preferential offering terms, which we have seen managers increasingly willing to provide as the price to pay for attracting capital, is that following such negotiation process, a trend has emerged for a more collaborative approach to investor relations as managers will often look to their larger investors for comfort before making significant or strategic decisions in an effort to retain such capital, and avoid upsetting an established investor base.

One particular characteristic more commonly seen within hedge fund structures that, in recent years, has become increasingly visible across private equity and hybrid structures is the presence of independent governance within the operations of the fund structure. This trend can take many different forms, but is often addressed by means of either direct representation for the investor's fund vehicle or representation at the general partner level.

In addition to independence at the level of the investor facing fund, there has been a marked increase in board representation or advisory board structures being put in place at the master fund level, with independent directors seen as providing investors with an additional layer of comfort that the level at which the assets are held benefits from the same degree of oversight as the feeder fund. In certain instances we have also seen institutional investors advocate to see the same independent representation on the governing body of an onshore entity also

(although we would suggest this continues to be the exception rather than the rule).

Prior to undertaking an investment in a fund, we have observed a notable increase in the length and depth of due diligence undertaken by investors on a fund. Historically the traditional focus for an investor or allocator may have started and finished with a review of the performance data or track record for a manager. However, recently the focus for investors appears to have expanded to include a much wider frame of evaluation criteria—to include the personnel and infrastructure of a manager's operations, the legal documentation in place for the fund, and extending in certain instances to a manager's commitment to corporate social responsibility in its investment and diversity within its team.

From Ogier's perspective, we have seen a marked increase in instructions from investors seeking to undertake a detailed review of the legal documentation and constitutional documents prior to making an investment rather than relying upon the work of the investment manager's own counsel. This review is often not only to identify any critical risks or red flag items, but also to identify possible pressure points for negotiation or amendment as a condition for an investment.

How has Cayman adapted?

For more than 25 years the Cayman Islands as a jurisdiction has successfully demonstrated itself capable of meeting the demands of investors and managers in the ever-changing investment funds industry.

While it is impossible to say with certainty how the relationship between investors and managers will evolve in the future, we can be confident that managers will continue to need legal counsel and service providers to come up with increasingly creative solutions to adapt to the ebb and flow of this delicate balance of power.

Recent examples of the dynamic approach taken by the Cayman Islands government in support of the investment funds industry have been the creation of new entities, such as the Cayman Limited Liability Company and Foundation Companies—in each case offering greater optionality for structuring solutions.

From a legislative standpoint, the introduction of legislation in respect of anti-money laundering and beneficial ownership have further strengthened the jurisdiction's reputation for regulatory excellence, transparency and investor protection, ensuring that whatever challenges the future may bring to the investor/manager dynamic, the jurisdiction will be able to offer imaginative outcomes that safeguard the interests of both sides of the negotiating table.

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