Hedge fund structuring: lessons of the financial crisis

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The offshore fund sector, from managers and their service providers to the world's leading offshore domiciles, has not been left in disarray by the economic and financial crisis that began more than two years ago. Although performance issues and redemptions have seen total assets of hedge and other alternative funds decline appreciably – a trend that now seems to be reversing – members of the industry are already responding to the new environment with changes in the way they do business, the development of new products and fresh initiatives to publicise and market their products, services and infrastructure.

"In the future, offshore funds and funds in general will differ from the kind of funds we've seen in the market up to this point," says Simon Schilder, a partner with law firm Ogier in the British Virgin Islands. "How they differ will very much depend on how things end up playing out [in the regulatory environment]. What is for certain, though, is the continuing role of offshore funds and their importance in both the fund industry and the broader financial community."

Schilder notes that major legislative measures are afoot on both sides of the Atlantic that will certainly increase oversight of the offshore fund industry, at the very least. In Europe, the European Union's proposed Directive on Alternative Investment Fund Managers is likely to have a significant impact on non-EU funds and managers, although its extent is still unclear as the legislation makes its way through a protracted process of revision and amendment.

"The AIFM Directive will cover onshore and offshore funds of EU-based managers as well as offshore funds with EU investors," says Anja Breilmann, an associate with law firm Clifford Chance in Frankfurt, who notes that the legislation may be subject to further input along the way from the European Parliament, Council and Commission, and that it may well not come into force before 2013. "However, we expect a lot of changes."

The Private Fund Investment Advisers Registration Act, which would require hedge fund managers to register with the Securities and Exchange Commission, was approved by the US House of Representatives' financial services committee in October, while the Hedge Fund Transparency Act, first introduced to the US Congress in January, seeks to regulate funds as opposed to their investment advisers.

The Congress is also considering two other pieces of legislation that would directly or indirectly target offshore jurisdictions, the Stop Tax Havens Abuse Act that President Barack Obama originally supported as a senator and which targets tax avoidance by US corporations, and the Foreign Account Tax Compliance Act, which would require institutions seeking to access US capital markets to provide details of US account holders.

Says Schilder: "In this brave new world, transparency is the key, particularly tax transparency. The OECD has made entering into tax information exchange agreements the criterion according to which jurisdictions are white-listed, grey-listed or black-listed. The BVI is a white-listed jurisdiction with 15 Tieas currently in place. We recognise that the criteria for being white-listed will change, and the BVI continues to discuss further Tieas with OECD member states."

Alicia Green, a senior research analyst with the BVI International Finance Centre, which promotes the islands' financial industry globally, says the regulator, the BVI Financial Services Commission, offers a secure and robust regulatory regime that encourages high-quality fund business. "We've pretty much held our ground in funds over the past year," she says. Noting that this year has seen the arrival of another international law firm, Withers, Green adds: "It's been a challenging time for everyone but the BVI still seems to be attracting business.

She believes the forthcoming Securities and Investment Business Act will further enhance the regulatory regime applicable to the fund industry and make the jurisdiction more attractive to managers, administrators, lawyers and custodians. Says Schilder: “Siba gives the BVI the opportunity to put in place a legal and regulatory framework attuned to requirements onshore among institutions, managers and investors for the regulation of funds and the kind of fund platform these participants want.”

He argues that the difficult market environment and the problems faced by hedge and other offshore funds over the past two years have proved to be an educational process for members of the industry, and particularly lawyers. “The lessons learned will influence how funds are structured in the future,” Schilder says. “One example is the use of gates, which enable managers to control how much money is coming out on any given redemption day and which can be structured on a class-by-class basis or for the fund as a whole.”

Another, he says, is the sudden surge of redemptions in kind, which until recently were relatively unknown even where they were authorised by a fund’s prospectus and articles. “For many years, the in-kind redemption provisions were boilerplate clauses in fund documentation that no-one really looked at,” he says.

“However, in the current environment their importance has become such that the drafting of such clauses requires expert attention. Among the points to consider from a practical perspective is the importance of providing investors with prior notice of intentions to pay out interests in kind, for no other reason than that for redeeming investors looking to realise cash, the fact that they will receive an in-kind redemption instead may prompt them to withdraw their redemption request.

“Other considerations include whether the investors will actually take custody of the asset itself or participate in a special-purpose vehicle or trust set up by management, as well as the kind of assets being transferred, whether underlying positions or interests in an SPV. There is also the question of whether the transfer takes place on the redemption date or later, to avoid a mismatch between NAVs on the redemption day and the date on which they actually receive the asset. We recommend a full exposition of what kind of assets can be paid out, which could include short positions.”

Schilder says side-pockets are another feature of fund structuring that has required re-examination in the light of experience during the crisis. “Traditionally side-pockets have been set up to enable managers to acquire positions that are illiquid at the time of acquisition and hold them until such time as they become liquid, when that position can be moved into the main body of the fund. The current environment has highlighted the importance of drafting side-pockets broadly enough to capture not only investments that were illiquid at the time of acquisition but also those that become illiquid because of market conditions.”

Drafters of fund documentation are also having to pay attention to court decisions, such as a case involving the suspension of redemptions by a Cayman-domiciled fund called Strategic Turnaround. According to Schilder, the Cayman court’s decision in the case will be considered persuasive – albeit not binding – in the BVI and other offshore common law jurisdictions.

“In the case of Strategic Turnaround, the Cayman court considered the redemption process a three-stage process that began at the time the redemption request was submitted and ended when the investor received the proceeds. In the court’s view, a redeeming investor became a creditor of the fund on the redemption date, but the point at which the investor ceased to be a member of the fund, and thus entitled to membership rights such as voting at a shareholders’ meeting, depended on the drafting of the documents. The redeeming investor might cease to be a member when his name was removed from the register of members, or when he received the redemption proceeds in full.

“This creates a number of anomalies. It is theoretically possible that you can have two investors with the same share, the redeemed investor who is still technically a member, and a new investor that subsequently invested in the fund. Also, if a redeemed investor can continue to exercise his rights as a member, a situation could arise where redeemed investors that are creditors could vote on resolutions requiring shareholder consent. There could be a mismatch between the interests of continuing investors in the fund and the interests of creditors.

"To remove these anomalies and concerns, it's important that the funds documents state that on a redemption date, redeeming investors shall cease to be a member of the fund in respect of shares being redeemed, and they shall forthwith be removed from the register of members and the shares cancelled. The articles should also state expressly what rights a redeeming investor has in his new role as a creditor of the fund."

Schilder says that another structuring lesson drawn from the current market is the importance of retaining flexibility in provisions regarding the suspension of redemptions. Historically, suspensions have imposed a total lock-down in the funds, covering redemptions, NAV calculation and the issue of shares.

"In many cases that will be necessary, but on other occasions when the purpose of the suspension is to control liquidity, the fund wants to keep operating, taking in money – assuming there is demand from investors– and importantly, keep striking NAVs. In the future it's important that funds draft suspension provisions with sufficient flexibility that if it needs to, it can suspend just the redemptions."

He adds that the search for increased transparency toward investors is prompting initiatives such as the establishment of valuation committees, either at the structuring stage or if a fund subsequently runs into problems. "A further aspect of transparency I expect to see more and more going forward is the use of independent boards of directors that are all functionally independent of the investment manager," Schilder says.

The collapse of Lehmann Brothers in September 2008 has prompted a new focus on the relative merits of exchange-traded and over-the-counter derivatives, according to Peter Noha, a senior consultant with derivatives exchange Eurex in Frankfurt. "September and October last year saw a surge in trading volume because every investor was coming back to the exchange and refraining from trading over the counter," he says.

"Since then we had a lot of customers who wanted to transfer their bilateral positions to our on-exchange platform in order to enjoy the benefits of the central counterparty. If they had bilateral positions with Lehmann, they would have lost all their money. The benefits of on-exchange trading include not only mitigation of counterparty risk but pricing transparency at all times and 24-hour risk management. We offer delivery management and control the fulfilment of obligations on both the buy and sell sides."

Noha's colleague in Zurich, executive director Markus-Alexander Flesch, adds: "Eighty-six per cent of derivatives are still traded OTC, on a bilateral basis. If one crucial bank fails, there is a danger that the whole financial system will fail. With a clearing house in the middle, all positions are collateralised, and if one bank defaults, the others are not affected and there should be enough collateral to cover losses from closing positions. When Lehmann defaulted, all positions on Eurex were closed and there was collateral left. There was no damage to anyone who traded with Lehmann on our platform."

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