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INVESTORS AND INVESTING

The Power of the Pause for Institutional Investors

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Investing in alternative assets implicates a myriad of legal, economic and business issues that require consideration by sovereign wealth fund and other large entity investors, including, without limitation, banks, finance companies, insurance companies, labor union funds and pension funds (collectively ''Institutional Investors''). The universe of these issues continues to expand, largely due to increasing regulatory requirements affecting the alternative asset industry and the enduring emphasis on risk reduction since the financial crisis of 2008. When considered in the context of the current economic climate, the bargaining power of Institutional Investors has created an opportunity that makes them well positioned to address these issues in a manner they deem satisfactory. As such, it is an ideal time for Institutional Investors to exercise the ''power of the pause'' in an effort to take a more critical view of how they structure investments in alternative investment funds and the terms upon which such investments are made. Institutional Investors would also be well served to reexamine their internal policies and procedures related to investments in such funds in order to ensure that they have a robust compliance regime that adequately addresses the regulatory requirements that are often implicated by large scale allocations. This article highlights certain considerations fundamental to Institutional Investors making investments in alternative investment funds managed by third party asset managers (''Investment Managers'') that either accept subscriptions from multiple unrelated investors (each, a ''Commingled Fund'') or that are structured as funds-of-one and accept subscriptions from a sole investor (each, a ''FOO'' and together with Commingled Funds, ''Investment Funds''). This article specifically addresses (i) regulatory, (ii) structural and (iii) commercial considerations for Institutional Investors and provides a lens with which to scrutinize such considerations.

(i) Regulatory Considerations.

A. Jurisdictional Concerns. A multitude of global regulatory requirements may be implicated in connection with an investment in an Investment Fund in a manner that may take even the most sophisticated Institutional Investors by surprise. Such requirements are often a function of an Investment Fund's jurisdiction of formation and the global markets in which it invests. More often than not, such requirements only have application to sizeable investments, such as those made by Institutional Investors. These global regulatory requirements can result in disclosure obligations for an Institutional Investor (and in some cases of its ultimate beneficial owner), reporting obligations, and aggregation of the Institutional Investor's and/or its beneficial owner's investments with those of the Investment Fund. Given the potentially serious consequences for failing to comply with these types of regulations and taking into consideration reputational and regulatory risk, implementing policies and procedures that are designed to develop a compliance regime to avoid or address these requirements is imperative. Critical to doing so is formulating a comprehensive analysis of the regulatory requirements implicated in each jurisdiction in which applicable Investment Funds invest. In order to accomplish the same, an Institutional Investor will need to take into account the types of instruments being traded, the manner in which an investment is made (e.g., whether exposure to a financial instrument is obtained directly or synthetically) and certain attributes of the applicable Investment Funds as well as the investor composition thereof. Institutional Investors would therefore be well served to reexamine the policies and procedures that are designed to ensure compliance with these global requirements to make sure they take into account the nuanced issues embedded within global reporting requirements.

B. Consolidation and Aggregation Considerations. Institutional Investors should be aware that under certain circumstances, such investors and/or their beneficial owners may be required to aggregate investments held by Investment Funds that they are invested in with their own direct investments for various reporting and other purposes. Such aggregation requirements apply to a substantial majority of the asset classes in which many Investment Funds invest. As a practical matter, this dictates that each Institutional Investor be conversant in the aggregation rules of the jurisdictions to which it is exposed by virtue of its investments in Investment Funds. Doing so will also allow Institutional Investors to think prospectively about the regulatory implications of using certain structures in different jurisdictions. For example, an Institutional Investor that determines to make an investment through a FOO rather than through a Commingled Fund, should consider that under Article 4(1) of the MiFID II Position Limits RTS, such Institutional Investor may be required to aggregate its net position in a given commodity derivative with the net position of such FOO. Compliance with these aggregation requirements may be feasible for certain Institutional Investors, but Institutional Investors must have the requisite knowledge before an investment is made. In addition, Institutional Investors are often keen to make certain that there is no financial consolidation of their holdings with the holdings of Investment Funds in which they are invested. Whether an Institutional Investor has certain rights to ''control'' an Investment Fund is often the determinant with respect to financial consolidation. Much like the aggregation and reporting rules, this determination can also be nuanced and addressing financial consolidation issues in a uniform and cohesive manner requires careful coordination between the legal and accounting divisions of an Institutional Investor.

C. Tax Considerations and Availability of New Tax-Efficient Structures. When considering any investment, tax implications with respect to the structure, type and location of the investment should be considered. For example, Institutional Investors that are sovereign wealth funds should ensure that their investments in Investment Funds qualify for the benefits provided pursuant to Section 892 of the Internal Revenue Code of 1986, as amended. In addition, depending on the type of investment and particularly relevant in the private equity context, such investors should consider whether an investment will require them to make filings in various states or subject them to taxes in multiple/foreign jurisdictions.

Specific tax sensitivities of Institutional Investors such as pension plans and endowments should be considered in terms of structuring investments to avoid unrelated business taxable income (''UBTI'') and offshore investors should be mindful of gains from the sale of U.S. real property interests (''FIRPTA'') and/or effectively connected income (''ECI''), both of which may subject such investors to U.S. tax. These investors may want to consider the costs and benefits associated with investing through a blocker. In addition, sovereign wealth funds, endowments and pension plans have historically had difficulty gaining economically efficient access to certain strategies that produce adverse tax consequences for them such as UBTI, FIRPTA and ECI. Through the use of innovative structuring such as insurance dedicated funds, such investors may be able to significantly reduce or eliminate these adverse tax consequences. This is not a complete list of tax provisions that could impact a particular Institutional Investor. It is advisable to consult with a tax advisor on all tax matters involved in making investments of this type.

Inherently related to regulatory consideration and how to address them, is the concept of structuring an investment in a way that seeks to avoid onerous regulatory requirements. However, while creative and thoughtful structuring may be used as a means to solve for certain regulatory issues, Institutional Investors need to be mindful of the full breadth of consequences that may result from their structuring choices.

(ii) Structural Considerations.

A. Commingled Fund vs. Fund-of-One. When evaluating whether to make a significant allocation to an Investment Manager, a threshold issue is whether the allocation should be to a Commingled Fund or a FOO. Whether an Investment Manager is willing to make the FOO structure available is often contingent upon the significance of the amount being invested. As Institutional Investors often make substantial allocations, they should carefully compare the relative benefits and risks of an investment in a FOO as opposed to a Commingled Fund. While there are many perceived benefits to investing in a FOO rather than a Commingled Fund, doing so may have negative consequences for an Institutional Investor and the benefits may not outweigh the costs.

The sole investor in a FOO generally believes that the terms of Commingled Funds managed by the same Investment Manager and the actions of investors in those Commingled Fund will have little impact on its FOO investment. However, a FOO investor that considers itself isolated from considerations given to investors in such Commingled Funds may have a false sense of security. For example, a FOO investor may think that redemptions from the FOO should be unconditional with no possibility of a suspension. However, Investment Managers often consider implications that redemptions from a FOO may have on Commingled Funds they manage and may therefore impose limitations on such redemptions, including the ability to suspend such redemptions or payments thereon under certain circumstances. Whether an Investment Manager intends to take this position is often not readily apparent to Institutional Investors, and, therefore, it is critical that the terms of the FOO be properly structured to have the desired effect of being isolated from other Investment

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Funds managed by the relevant Investment Manager. For example, the scope of circumstances under which an Investment Manager should be permitted to suspend redemptions, payment of redemption proceeds and/or the calculation of the net asset value of a FOO should be carefully tailored to address this issue.

In addition, a FOO investor is often keen to customize the strategy and certain other terms that would be applicable if it invested in a strategy through a Commingled Fund. However, utilization of a FOO in this manner may increase the likelihood that an Institutional Investor is deemed to have control over a FOO's assets and could result in such Institutional Investor and the relevant Investment Manager becoming subject to complex and burdensome reporting and other regulatory requirements in various jurisdictions (see ''Consolidation and Aggregation Considerations'' above for a more detailed discussion). While compliance with the regulatory requirements that flow from having ''control'' may not be prohibitive to structuring an investment as a FOO, an Institutional Investor should be in a position to make an informed decision.

Another factor that bears consideration is the organizational and ongoing costs of investing in a FOO rather than a Commingled Fund. Unlike an investment in a Commingled Fund which can achieve economies of scale to reduce operational costs, the sole investor in a FOO must bear all of the start-up and ongoing costs of the FOO. As a practical matter, this means that a FOO investor often pays for 100% of the legal fees incurred by the Investment Manager in connection with establishing the FOO including the costs of negotiating the transaction documents with such investor. A FOO investor would therefore be well served to require the Investment Manager to put a cap on these expenses or otherwise structure the terms to incent the Investment Manager to keep costs down.

B. Corporate Governance. ''Corporate governance'' generally refers to the system of rules, practices and processes by which a company is directed and controlled. In the context of Investment Funds structured as corporations, corporate governance is under the control of a board of directors. Many such boards now contain at least one director that is considered ''independent'' of the Investment Manager and its principals. Institutional Investors often equate a board with an independent director with a governance regime that provides for oversight which results in more efficient management and less risk. Nevertheless, though a director may technically be unaffiliated with an Investment Manager, he/she may serve on the board of multiple funds advised by the same Investment Manager such that there is an alignment of interests between the parties. This alignment of interest can call into question the extent to which the relationship can be considered truly independent. Institutional Investors should therefore consider performing enhanced due diligence on an Investment Fund's directors to evaluate whether a particular director can truly be considered independent.

It is also important to note that an Investment Fund's constituent documents rarely require that its governing body contain any independent representative, or that the consent of the independent representative be required in order to take certain non-ordinary course actions. With that in mind, Institutional Investors that make an investment on the basis that an Investment Fund has the benefit of an independent governance regime must establish a legal framework to ensure that such Investment Fund will maintain the independent governance regime until the Institutional Investor is fully and finally redeemed. In addition, to the extent that an Investment Fund invests through a master fund or any other trading vehicle or subsidiary, it is imperative to consider whether a requisite level of truly independent oversight exists at each investing fund level. Without doing so, the efficacy of having a corporate governance regime that has an independent director could be severely compromised because the entity with actual ownership of the assets would not have the benefit of independent oversight.

While it is possible to instill an independent governance regime with desired protections, including, without limitation, consent of an independent person with respect to enumerated non-ordinary course actions into any kind of structure, including limited partnerships, Institutional Investors also need to consider the actual impact of commercial terms they are being offered and whether they achieve the results that they seek.

(iii) Commercial Considerations.

A. MFN Considerations. An investor that is granted an MFN (i.e., a ''most-favored nation'' right) often expects that it will be protected from the risk that other investors allocating smaller amounts to the same strategy will be afforded more favorable rights. Because they often make very significant allocations, most if not all Institutional Investors expect to be granted an MFN. While an MFN provision may seem relatively straightforward, there are many components that must be carefully vetted to ensure that the MFN mechanic has optimal utility and satisfies the expectations of an Institutional Investor. For example, an Institutional Investor afforded MFN rights should be protected not only with respect to other investors in the same Investment Fund, but also with respect to other Investment Funds, managed accounts, parallel funds and co-investment products that employ a substantially similar strategy as the relevant Investment Fund. In addition, MFN rights that apply to multiple products advised by an Investment Manager are often keyed off of whether the other products employ a strategy that is ''substantially similar'' to the strategy of the relevant Investment Fund. Therefore an investor should carefully consider what attributes of a strategy make that strategy distinguishable from, or ''substantially similar'' to, another strategy in order to further reduce the risk that the MFN protection does not have its desired effect. This is particularly true in the case of strategies that may be differentiated solely by reference to leverage or volatility constraints. Furthermore, the trigger that allows an Institutional Investor to opt into terms made available through an MFN can be based on net subscriptions, the net asset value of an investment in the relevant product or other thresholds, and the triggers may be defined by reference to not only a particular investor but also investments made by an investor's affiliates. The multitude of permutations that an MFN clause can take results in the risk that an Institutional Investor that does not carefully scrutinize and negotiate its MFN will not have the true benefit of MFN protection.

B. Confidentiality and ''Use of Name'' Issues. Institutional Investors, and specifically sovereign wealth funds, often have heightened concerns over whether and to what extent Investment Managers may use their names (in marketing materials or otherwise) or any confidential information obtained in connection with their investments (collectively "Confidential Information"). With regards to the inclusion of restrictive covenants in a side letter to try and limit the extent to which an Investment Manager and its affiliates may use Confidential Information, Institutional Investors should make certain that the scope of the restrictions are sufficient. For example, a prohibition on the use of an Institutional Investor's name for marketing purposes would have limited utility if an Investment Manager may disseminate enough information such that anyone could readily identify the Institutional Investor. Furthermore, many Investment Managers are seeking to narrow the scope of their confidentiality obligations on the basis that they are being faced with increasing demands for information on short notice from government agencies. Institutional Investors giving deference to such Investment Managers should still scrutinize an Investment Manager's right to meet such demands and the basis upon which such demands may be met without prior notice to the Institutional Investor. Lastly, Institutional Investors with heightened concerns regarding their confidentiality should consider the implications of the structure of the Investment Funds that they are contemplating investing in. For example, under current law, more information is publicly available in respect of Cayman Islands limited partnerships than in respect of Cayman Islands corporations and even more information may be made available with the consent of a limited partnership's general partner.

C. Side Pockets. Under certain circumstances, including if an asset becomes illiquid, it may be put in a "side pocket" on the books and records of an Investment Fund. Investors are typically prohibited from voluntarily redeeming the portion of their investment attributable to a side pocketed asset and such asset is accounted for separately from the Investment Fund's more liquid investments. In most cases, an Investment Manager will continue to earn a management fee on assets in a side pocket and will only earn an incentive fee or allocation with respect to side pocketed investments upon their disposition. While side pockets can be a useful tool for Investment Funds in certain contexts, they are often considered an Investment Manager friendly mechanic with risk for investors. If an Investment Fund's constituent documents allow side pockets, Investment Managers often prefer not to give investors preferential rights with respect thereto. However, Institutional Investors may have enough bargaining power to incent an Investment Manager to eliminate the side pocket mechanic when it is not appropriate for a given strategy or to otherwise modify the terms related to side pockets with the effect of making them more balanced.

Institutional Investors should carefully evaluate under what circumstances an asset may be side pocketed, whether it is appropriate to impose a limit on the percentage of an Investment Fund's assets that may be side pocketed and if it is appropriate to require that side pocketed assets be liquidated or otherwise written down after a certain period of time. These exercises will facilitate a thorough evaluation of an Investment Fund's liquidity profile. In addition, there are other commercial elements to a side pocket mechanic that Institutional Investors should consider. For example, if an Investment Manager receives performance compensation upon disposition of a side pocketed investment irrespective of whether the balance of the portfolio has gains, this effectively creates a construct whereby losses incurred with respect to a particular investment do not have to be offset by gains from other investments in order for the Investment Manager to take an incentive fee or allocation. Institutional Investors should consider whether in certain cases Investment Managers should be subject to clawback obligations with respect to side pocketed investments that result in losses. Furthermore, to the extent that an Investment Manager is not willing to agree to dispose of a side pocketed investment within a certain time frame, it may be appropriate to require that the Investment Manager write down the value of the investment so that it is not entitled to management fees with respect to the portion of the Investment Fund's net asset value attributable to the relevant asset.

D. Co-Investments. A rapidly growing trend among Institutional Investors is the co-investment model. Co-investments may be structured in many ways, but are generally used to describe an investment alongside a third party rather than through a product offered by the third party. As co-investments are independent investment decisions, investors utilizing a co-invest structure need to have in place adequate internal resources. These resources include back-office functions and more importantly, the ability to properly analyze an investment including the risks, timing and expected returns. In addition, while the ability to effect a co-investment is often considered to be a unique investment opportunity, an Institutional Investor must evaluate whether it will incur additional liability as a result of investing in a project directly and not through an Investment Fund. For example, prior to accepting a co-invest opportunity, an Institutional Investor will generally require an Investment Manager to provide it with the materials it compiled in the course of its due diligence with respect to the particular investment. However, an Investment Manager generally will not release such information without receiving a liability waiver from the Institutional Investor with respect to reliance on any such information. As such, in order for an Institutional Investor to make an informed decision with respect to a co-invest opportunity, it needs to carefully consider whether the scope of the opportunity is within its expertise such that it can perform proper diligence, not only from a legal perspective but also from a business perspective.

This article highlights a subset of issues that in the past may have been fully or partially overlooked or thought to be too esoteric to address. However, as the current economic climate is one in which Institutional Investors have a significant amount of leverage, it is an optimal time for them to "pause" and consider all of the regulatory, structural and commercial implications of making different investments and how they would like to address them.

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