

Structural Changes in Hedge Fund Financing Transactions

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A fund of hedge funds (“FoHF”) is an investment vehicle that offers its investors exposure to a portfolio of hedge funds selected by the investment manager of the fund. The investment manager uses his/her knowledge, diligence and expertise to select and manage the hedge fund portfolio, saving his/her investors from the need and the operational and resource commitments to do so. In implementing their investment strategy, FoHFs often utilize financing transactions for various purposes, among them to provide leverage and liquidity. Regardless of purpose, because these funds have no natural life span, the financing transactions typically remain in place for lengthy periods of time. And because of their relatively long durations, these transactions often require amendments to accommodate changes to the fund, transaction or structure of the pledged collateral. While many such amendments are routine in nature and may require limited legal analysis, amendments related to, or arising out of, certain changes to the structure of the fund or its investment portfolio present potential legal issues that should be considered in detail.

Discussion

The hedge funds that comprise the investment portfolio of a FoHF typically offer liquidity only through redemptions, and these hedge funds have the ability to restrict redemptions upon certain events. During the 2008 financial crisis and the resultant reduction in the value and liquidity of

investments in hedge funds generally², many FoHFs were faced with investor redemption requests and often restricted or delayed access to their hedge fund investments (through to the implementation of gates or the suspension of redemptions). Among other things, the crisis highlighted the importance of financing transactions to FoHFs as a tool to manage their liquidity requirements— such transactions could be drawn upon to meet investor redemption requests if a FoHF was unable or reluctant to redeem its underlying hedge fund investments. As a result, such funds now typically maintain financing transactions even if they are not pursuing a leveraged investment strategy, potentially for the duration of the fund. Given the many changes that such a fund can undergo during its life, these financing transactions often require amendment or modification, and such amendments can be routine or they can be quite complex and present potential legal, regulatory, structural and other issues. This article will highlight some common changes to the structure of a financing transaction that present legal issues to be considered and addressed.

Change of Custodian

Most FoHFs hold their hedge fund portfolios through a third-party custodian (as opposed to holding the hedge funds directly), and this is especially true for funds with financing transactions in place. A typical FoHF financing transaction is secured by, among other things, a pledge of the fund’s hedge fund portfolio.

Having this portfolio held through a custodian in a securities account substantially simplifies the collateral structure and allows the bank³ to perfect its security interest by entering into a control agreement with the custodian.⁴ The custodian also serves as an institutional third party that the bank can rely on for reporting and to control ordinary-course investments, movements of cash and redemptions of the hedge fund portfolio (and ultimately to effect redemptions of the portfolio of hedge funds in the event the bank needs to enforce its remedies under a financing transaction following an event of default).

Because the custodian plays such a key role in these financing transactions, a proposed change of custodian by the fund raises issues that need to be properly considered and addressed (such as whether the bank will consent to the change), as well as the following:

Many custodians that serve FoHFs have a global presence, so it is not uncommon for a change of custodian to result in a change of applicable law with respect to the bank's security interest⁵, requiring local counsel in the new custodian's jurisdiction to be engaged and new security documents to be executed.

Operationally, re-registering the hedge fund portfolio to the new custodian may take several months, during which time the bank will require a perfected security interest over the custody accounts at both the prior and new custodian (as well as reporting from both custodians during this time).

The Hague Securities Convention, which became effective in the United States in April 2017, has been especially relevant for FoHF financing transactions due to both the nature of the pledged collateral and the global presence of the custodians that serve this market, as mentioned above. The Hague Securities Convention should be considered for any financing transaction, especially those

with a non-US custodian (in part due to its "qualifying office" requirement).⁶

Change of Fund Structure

A change in the structure of the fund would typically take the form of the addition or removal of feeder funds and/or guarantors, which could involve a new jurisdiction (if any such entity was formed in a different jurisdiction). This could be requested in order to provide leverage or liquidity at the level of a feeder fund, to gain access to additional collateral or to facilitate derivatives transactions (such as foreign-exchange transactions) at a feeder fund. While not as common as adding or removing an entity, a change of jurisdiction of the fund could be requested by the fund. Such a change with respect to the fund may be sought as a way to increase the investor base available to the fund. Some issues to be considered here include:

The ability of an entity to provide a guaranty, or the extent of such guaranty, may be limited and/or restricted (and, even if not strictly limited, may raise fiduciary concerns that should be considered). In addition, certain jurisdictions impose additional requirements with respect to guaranties.

Because of the affiliation between a feeder fund and a master fund, a pledge consent is typically obtained from the master fund (if the feeder fund is pledging its master fund shares), and such consent may grant other rights to the bank (which again may raise fiduciary concerns that should be considered). Whether any additional security is required (such as a guaranty from the master fund) will need to be determined.

Certain jurisdictions require funds to engage a local custodian. To the extent the fund wishes to continue to use its existing custodian, a sub-custody arrangement may be requested by the fund, which raises the points

mentioned under “Change of Custodian” above.

Change of Form of Transaction

A change to the form of the financing transaction (for example, from a note purchase or a derivative transaction to a credit facility) is not common and, when it does occur, it is typically at the request of the bank, most commonly in response to regulatory requirements or the transfer of the transaction to a different group within the bank. One example that led to such changes was the implementation of the Dodd-Frank Act, which affected certain FoHF financing transactions that were in the form of derivatives transactions.

Another change to be considered here is the addition or replacement of a bank in the transaction. Because financing transactions with FoHFs have traditionally been in the form of bilateral or occasionally club transactions, the financing documents do not always include the mechanics to easily add or replace a bank.

While a change to the form of a financing transaction presents a number of issues, one in particular to highlight here is the security interest of the bank. To the extent the pledged collateral remains the same (which may not be the case if the original transaction was a derivative transaction where the bank owned the hedge fund portfolio), the bank will want to maintain the priority of its security interest (or put in place a new or revised security interest, if necessary).⁷

A principal consideration when adding or replacing a bank is whether all banks will be party to the same financing agreement. While utilizing a single financing agreement (with an agent to act on behalf of the banks) may be mechanically simpler, the banks may wish to employ their own collateral valuation models and/or have different pricing and other terms

and therefore prefer separate agreements (and the fund may also prefer separate agreements for similar reasons), necessitating an intercreditor agreement and/or some form of sharing or segregation of the fund’s hedge fund portfolio as collateral.

Other Matters Requiring Consideration

While this article has focused on structural changes to financing transactions, there are other changes that arise in order to maintain such long-dated transactions that should be mentioned as well. To note just a few, these include: (i) facility increases (due to, e.g., organic growth of the fund or an increase in the use of leverage); (ii) maturity extensions (to keep the facility in place); (iii) revisions to investment guidelines and/or haircut models (e.g., to accommodate changes in the portfolio of hedge funds); and (iv) breach cures (e.g., to reflect changes in the collateral or the operations of the fund over time). While these changes tend to be relatively routine and often require a simple amendment, procedures and/or responsibilities should be put in place to ensure that these changes are properly authorized and addressed in a timely and proper manner and to ensure that any legal issues that may arise are identified and considered.

Finally, there is one last point that should be noted with respect to amendments to transactions. The form of the amendment to address any of the matters raised herein can affect the rights of the parties to these transactions. Care should be taken to ensure that the amendment does not constitute a novation of the existing transaction (unless this is desired), especially if any agreements are being amended and restated, as this could result in the termination of the related security interest.⁸

Conclusion

Financing transactions with FoHFs can be an attractive product. For the funds, they can address liquidity and leverage requirements and can be used to facilitate transactions such as derivatives that would otherwise require the fund to hold cash. As for the bank, as these

transactions often remain in place for as long as the fund itself remains active, they can provide long-term relationships with funds and fund managers. However, they require attention and maintenance to address the needs and changes of the fund and to protect the security interest, and other benefits, of the bank providing the financing.

Endnotes

- ¹ Bryan Barreras is a partner in Mayer Brown's New York office and a member of the global Banking & Finance and Fund Finance practices.
- ² Hedge fund industry assets under management (AUM) decreased from more than \$2 trillion in 2007 to less than \$1.5 trillion in 2008. Hedge fund AUM remained below \$2 trillion until late 2013. BarclayHedge – Hedge Fund Industry Assets Under Management – Historical Growth of Assets.
- ³ FoHF financing transactions take the form of, among others, credit facilities, note issuances and derivative transactions. For ease of presentation, this article generally discusses credit facilities—most issues presented herein are relevant to each of these transaction forms.
- ⁴ See www.mayerbrown.com/files/Publication/a444f5f4-2fa2-42a5-8779-12064cb84b24/Presentation/PublicationAttachment/c20e9433-1b84-4a67-a43e-1c896cbc79a1/Fund-of-Funds-Financing.pdf for a discussion of the pledge of a securities account holding assets that may be subject to transfer restrictions.
- ⁵ Because the pledged asset is the fund's custody account and the rights related thereto, a pledge under the law of the custodian's jurisdiction is usually required.
- ⁶ See www.mayerbrown.com/files/Publication/4aaa2cb9-a25f-4b4f-aa79-d282bc9d4032/Presentation/PublicationAttachment/3307e5af-af83-4ec9-847c-dad50de4cf9c/170511-UPDATE-BF-Lending-FundFinance.pdf for a discussion of the Hague Securities Convention, which includes the requirement to maintain a qualifying office.
- ⁷ See www.mayerbrown.com/Amended-and-Restated-Financing-Agreement-Should-Clearly-State-If-Not-Intended-as-Novation-11-29-2016/ for a discussion relating to maintenance of security interests.
- ⁸ See *ibid* for a discussion relating to amending and restating financing transactions.

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