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Structural Difficulties Posed by Hedge Funds Investing in Illiquid Securities

As the number of hedge funds pursuing similar strategies has grown, managers have increasingly looked to private equity and other illiquid assets to generate alpha. However, the traditional hedge fund structure is meant to facilitate investing in liquid securities that are readily marked-to-market. Housing illiquid assets under the traditional hedge fund model can result in a variety of potential problems in the area of taxation, valuation, liquidity, manager compensation, strategy drift and regulatory scrutiny.

As the chart below indicates, marketable securities (such as publically traded equities, options, commodities and futures) and illiquid assets (such as private company shares and early stage financing rounds) have different features and characteristics.

Characteristics	**Marketable Securities**	**Illiquid Securities**
Management Intensive:	No	Yes
Marked to Market:	Yes	No
Taxation:	Indirect	Direct
Liquidity:	Secondary Market	Illiquid
Subscription:	Open	Closed
Fees:	Marked to Market	Final Value
Allocations:	Fair Market Value	Target Return on Investment
Duration:	1-2 years	5-7 Years

Despite these important differences, hedge funds have been increasingly investing in illiquid securities through the implementation of terms in their governing documents allowing them to segregate illiquid assets in sub-accounts known as side pockets. However, the implementation of gates,[1] lock-ups[2] and redemption suspensions has also facilitated this shift.

[1] Gates are mechanisms allowing the manager to limit the percentage of net assets of the fund that may be redeemed on any one redemption day.

[2] Generally, a lock-up refers to the period of time after an initial investment into a hedge fund when an investor may not redeem. After this initial lock-up, which can last from several months to several years, an investor may redeem periodically, often on a quarterly basis.

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Side Pockets

Side pockets are sub-accounts segregated from a hedge funds main liquid account where illiquid assets are placed. Side pockets are established to shield illiquid assets from the valuation, liquidity and manager compensations terms applied to the fund generally and generally constitute a discrete, prescribed percentage of the fund's overall investment portfolio. Side pockets may be established at the time an investment is made in illiquid securities or assets may be transferred into a side pocket after being held a particular period of time. During the credit crisis, managers engaging the latter type of transfer, came under increased SEC scrutiny and elicited much investor ire for what was perceived to be an attempt to shield assets from redemptions.

Liquidity

The liquidity disconnect between a fund investing in liquid and illiquid assets is perhaps the most difficult to reconcile. If a fund's offering documents provide for monthly, quarterly or annual redemption, but an investment horizon of an illiquid asset is several years, the disconnect between investor expectations and reality of an illiquid investor will inevitably cause issues for the fund.

Valuation

Publicly traded securities are relatively easy to value since they are traded in liquid markets with discoverable prices. Valuation of illiquid assets is much more difficult because they are not consistently traded, if traded at all. Most hedge funds provide the manager with the discretion of value illiquid assets. But this discretion may be exercised by the manager in a manner that is arguably at odds with the interests of other investors.

Manager Compensation

Hedge fund managers have traditionally been compensated by collecting a management fee of 2% of assets under management and a carried interest allocation of 20% of fund gains on a yearly basis. Managers of private equity funds, on the other hand, are compensated through a waterfall mechanism upon liquidation of an investment where first a) investors receive full return of capital called for that investment, b) investors then receive a preferred return, c) then 80/20 split between investors and the general partner.

Strategy Drift

Most hedge fund governing documents limit the percentage of fund assets that can be invested in side pockets. If the value of the funds liquid assets decline or redemptions deplete liquid assets, an investor who joined the partnership believing the fund would primarily pursue a liquid strategy could find himself in a fund primarily invested in illiquid assets.

Recommendations

Due to the issues outlined above, a hedge fund manager is well advised to be very cautious when pursuing illiquid strategies within the traditional hedge fund structure, even if authorized to establish side pockets with the use of lock-ups and gates to limit redemptions. If the manager does decide to launch a new fund with the ability to invest in illiquid securities, the fund's offering documents should clearly and thoroughly disclose under which circumstances illiquid investments may be made, the manner in which side pockets can be established and how assets in side pockets will be managed.