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# Alternative Funds 2023

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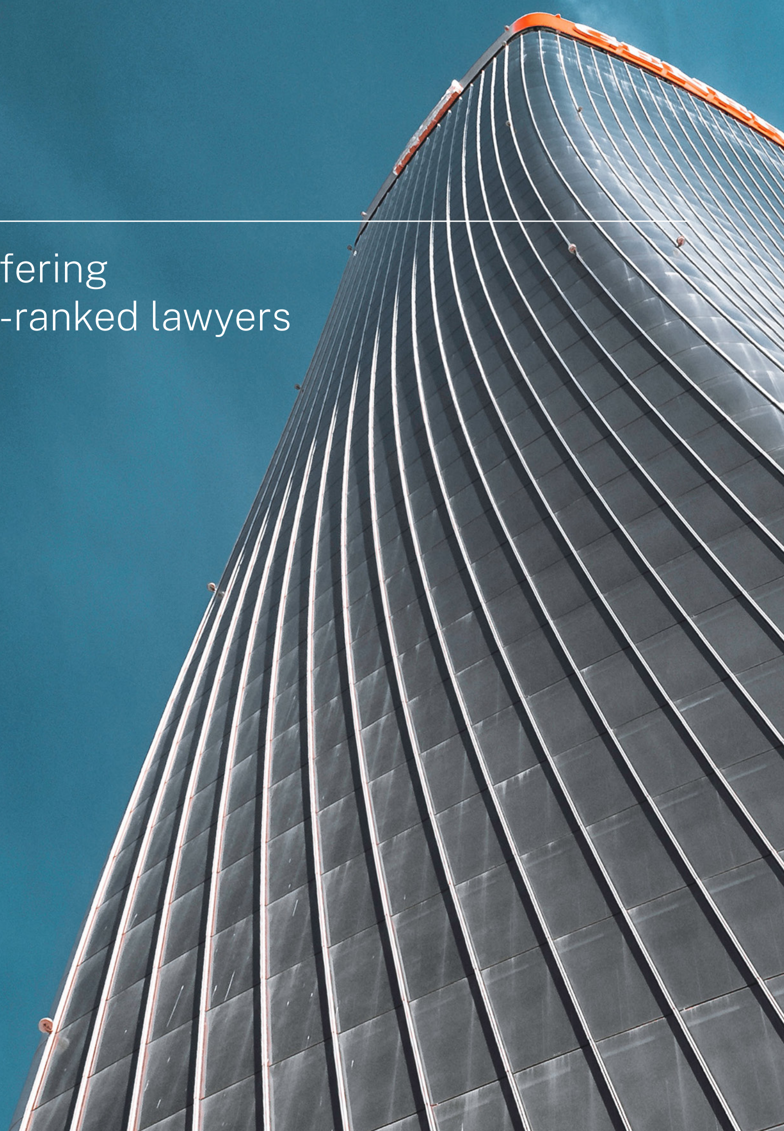

**Introduction**


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# INTRODUCTION

**Contributed by:** Elizabeth Shea Fries, **Sidley Austin LLP**

**Sidley Austin LLP** has a premier, global practice in structuring and advising investment funds and advisers. The Investment Funds practice group serves virtually every type of investment fund and investment manager, as well as many other market participants. The group has approximately 135 corporate, securities and derivatives lawyers dedicated to investment funds, investment management and derivatives work worldwide, with lawyers practising in New York, Chicago, Boston, Los Angeles, San Francisco, London, Munich, Hong Kong, Singapore, Shanghai and Tokyo.

## Contributing Editor

**Elizabeth Shea Fries** is the managing partner of Sidley's Boston office, global leader of the firm's market-leading Investment Funds practice, and a member of the firm's executive committee. Liz provides clients strategic advice on a broad range of transactions, business and investment structures, and regulatory matters. She has particular experience in creating and structuring asset management and other financial businesses, financial services mergers and acquisitions, innovative investment services and products, alternative investments, fiduciary issues and compliance matters. Liz serves on the board of the Managed Funds Association (MFA), has authored numerous articles, is a regular speaker at industry seminars, and has been recognised by various organisations including Chambers.


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## A Global Overview of Alternative Funds

Geopolitics, macroeconomic trends, volatility, and increased regulation have continued to shape the environment for alternative investment funds throughout 2023 and appear to be setting the stage for 2024. The drivers of these trends have, however, shifted from those discussed in prior versions of this Guide.

While early 2022 brought the war in Ukraine, the Israel-Hamas war commencing in October 2023 has further rocked the geopolitical environment, with China remaining a looming uncertainty. As a result, sanctions regimes are becoming more important in assessing investment opportunities as well as prospective investors. Also on the geopolitical front, divisions in the US House of Representatives and the upcoming 2024 US presidential election are increasing volatility in the USA and globally.

In terms of markets, stress in global cryptocurrency markets with the collapse of FTX in late 2022 gave way to the collapse of three US banks (Silvergate, Signature, and Silicon Valley Bank) in March 2023 and the rescue of Credit Suisse. The most significant effects of these collapses/rescues were felt in venture capital and certain hedge fund sectors and they appear to have faded in significance as Q4 of 2023 commences. Speculation persists about the possibility or likelihood of a recession or even stagflation in various global economies, with the United States appearing to be closer to stability than many other economies. The general trend toward higher costs of capital/financing seems to have become a constant as central banks seek to manage inflation.

Finally, regulation is increasing at an unprecedented pace, with enforcement poised to back it up and, in some cases, to lead the way. The US Securities and Exchange Commission (SEC) has adopted rules that could reshape the private funds industry even beyond US borders, and, for the first time, a coalition of industry groups has filed suit to overturn these regulations. The SEC also has adopted rules requiring the reporting of short sales and securities loans and has proposed rules relating to ESG, custody, the use of AI technologies, and oversight of service providers, among others.

Global regulators are making new proposals and rules relating to cryptocurrency and non-bank financial institutions. Crypto-asset financial promotions are now within the scope of the UK regulatory regime, and the UK Financial Conduct Authority (FCA) is bringing more regulation into effect. Cryptocurrency and non-bank financial institutions are also the subject of litigation brought both by and against the SEC, focused on the question of what constitutes a “security” and therefore what is within the jurisdiction of the SEC as a securities regulator. Regulators are testing the expansion of their authority as the alternative investment industry moves to explore and expand these newer investment opportunities.

### *Fundraising*

The fundraising environment for alternative investment funds has been particularly challenging, although performance for hedge funds was positive in the first half of 2023 in contrast to the generally negative results for 2022. Capital markets appear to have reopened somewhat in the second half of 2023, and the possibility of exits may allow for new activity in private equity and venture funds, although the private equity sector in particular continues to hold significant dry powder and the reduced number of exits has reduced distributions, further limiting capital available for redeployment from investors into new funds.

The slow and challenging fundraising environment has increased the focus on co-investments; both as a sweetener (including providing overall lower effective fees) in both draw-down funds and hedge funds and as a stop-gap to allow firms to continue to capture deal flow even when a full fundraising is paused or not complete. Another trend resulting from this environment is the focus on headline-grabbing, big ticket fundraises, which in the hedge fund sector is often facilitated by the use of a draw-down feature that allows the headline number to be a focus, while allowing investors to deploy capital more slowly.

### *Bigger is better*

This environment and a focus on large fundraising successes has proven rewarding for larger and more established managers or very well-credentialed new managers and spin-outs. As a result, there is increased activity in consolidations and acquisitions of alterative fund managers, with banks and other traditional asset managers acquiring teams and capabilities in the alternative markets, including on a cross-border basis. It remains to be seen whether and to what extent the resulting larger firms or platforms will continue to offer traditional alternative products and to what extent they will drive further “retailisation,” which is already emerging.

### *Credit*

In many ways, it is not surprising that banks and other institutions are once again focused on alternative investments. For the last several years, the alternative investment industry has made significant inroads as it stepped in to fill gaps as banks retreated and were more tightly regulated following the Great Financial Crisis of 2008. Credit funds, particularly those engaged in direct lending, have been growing in size and stature. Of course, global regulators are following this trend, and there is now increasing focus on possibly regulating credit funds as “non-bank financial institutions” in the United States and Europe, which could significantly curtail investment activity and limit access to financing. As macroeconomic trends drive interest rates up, credit funds will continue to attract attention.

A trend in credit funds is toward an evergreen structure, which is not the “liquid alts” of years past, but a more highly structured effort to match the liquidity of the fund with the liquidity of the portfolio assets. Increasingly, the goal is to allow deployment of capital into a single fund rather than multiple vintages, even if redemptions are met under a “slow pay” or “liquidating account” structure or are subject to gates. In the United States, fund structures may include those electing to be treated as “business development companies” under the Investment Company Act of 1940, and in the case of mortgages and other real estate-related debt, non-traded real estate investment trusts.

These products offer favourable tax treatment to many; often with treaty-based advantages from organising in Luxembourg, Ireland, or the UK (using the UK’s relatively new, qualifying asset holding company (QAHC) structure). They are often distributed through not only institutional but also high net worth channels. High net worth channels require particular attention to choice of jurisdiction for fund structures, with European investors having a strong preference for European structures (which are also easier to market in Europe) and certain Middle East and Latin American investors having greater flexibility but often preferring non-US structures.

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### *High net worth/retail*

High net worth investors are an increasing focus for alternative fund managers and strategies. As noted, institutions are purchasing teams and strategies to acquire the capacity to offer alternative investments. Changes to the private placement rules are on the SEC's regulatory agenda but not detailed as of this writing (although the presumption is that they would raise the standards). Alternative fund managers are still dealing with implementation of the SEC's marketing rules, which went into final effect 4 November 2022, and require that managers exercise greater caution when dealing with non-institutional investors. While the channel is an opportunity for alternative fund managers facing challenges in institutional fundraising, alternative investments are increasingly attractive to more retail oriented investors as the global economy has not been kind to traditional 60/40 stock/bond portfolios.

### *Newer strategies and structures*

A positive development in the current environment is the increasing use of creativity in both establishing investment strategies and structuring funds. Managers are looking at more niche sectors across a variety of industries and being more creative. In private equity, managers are looking at how to add value to existing portfolio companies and working on add-on deals. They are considering credit opportunities and looking at the infrastructure and energy sectors. Healthcare and life sciences are also key areas. In Asia, the focus is more on growth and venture and building for the future. Even within sectors, creativity is rewarded. While office/commercial real estate is still suffering from the post-pandemic failure to return to the office, other sectors such as single family residential, student housing, and storage are being pursued, together with real estate credit strategies.

On the structuring side, nimble managers are seeking co-investments, offering tailored fees and services (including separate account management), and considering evergreen models and even retail products. Fees and expenses are an area of focus, both as investors seek to target better net returns in tough markets and as regulators focus on transparency for all. Tax is, as always, a key structuring consideration and often drives the choice of structure and jurisdiction.

Expenses are more likely to be passed through (including manager costs, such as internal legal and accounting, and the use of affiliated service providers) but there is significant regulatory focus on clear authorisation, proper calculation, and transparent reporting of such expenses in particular and on what the regulators perceive to be "high" expenses more generally. It is also worth noting that the multi-strategy "pass through" model continues to be of interest and the recent US regulations affecting private funds will not prohibit the use of such models, as some had predicted.

### *AI and other technology*

Artificial intelligence is another area in which alternative fund managers are becoming creative. In some cases, it is part of an investment strategy, often in a venture or growth portfolio strategy. In other cases, AI is being used as part of a research or trading process, and it is integral to the firm's investment operations. A key issue is understanding the capabilities and weaknesses of the technology being used and ensuring that the manager is nevertheless fulfilling its duties and responsibilities to clients. Of course, technology raises cross-border investing issues and also can lead to security breaches.

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*Environmental, social and governance (ESG) considerations*

In September 2023, the European Commission (the "Commission") published a public consultation and a targeted consultation on the EU Sustainable Finance Disclosures Regulation (SFDR). The EU remains ahead of Asia, Latin America, the Middle East, and the USA in pursing ESG principles and in related regulation. Managers continue to struggle with the accessibility and reliability of ESG-related data, and key themes include ensuring a manager is doing what it has said it would do from an ESG perspective. Here too, the regulators in the United States and Europe have pursued enforcement and litigation claims. US regulations are expected soon after the publication of this Practice Guide and will no doubt further change the landscape.

*Where to organise/operate?*

Given the unequal playing field of cross-border regulation and the geopolitical issues affecting alternative investments, the selection of a jurisdiction in which to organise and operate a fund manager and its funds is more important than ever. The sections in this Practice Guide are designed to give an overview of the costs and benefits of various jurisdictions and provide a broad overview of key considerations. At the highest level, a prospective fund manager will want to consider both the investment strategy and expected jurisdiction of portfolio investments on the one hand and the location and type of prospective investors on the other. From an economic standpoint, certain strategies, such as private credit/direct lending, entail significant tax considerations and careful planning is essential. Increasingly, the regulatory regimes in which both the fund and the manager will operate and invest generate compliance costs and, in some cases, restrictions, which require further consideration. Carefully tailoring jurisdictional choices to the needs of the business and investors, rather than relying exclusively on past practice or trends, is essential to building a successful alternative investments business.

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