FUNDS-OF-ONE AND MANAGED ACCOUNTS: TOOLS FOR MANAGERS AND ALLOCATORS TO NAVIGATE CHALLENGING CAPITAL RAISING AND REGULATORY ENVIRONMENTS

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Funds-of-One and Managed Accounts: Tools for Managers and Allocators to Navigate Challenging Capital Raising and Regulatory Environments

Faced with continued regulatory changes and one of the most challenging fund-raising environments of the past 20 years, now is a vital time for investment managers and large institutional allocators to consider their fund structuring options.

The Investment Climate for Private Assets

Private asset funds, especially those run by new managers, are having a much harder time raising new capital. Several factors have converged to create these headwinds on the private markets:

- **Private asset targets:** After years of increasing exposure to private assets, many institutional investors now have a significant amount of their portfolios in private assets and are at or near those target allocation thresholds.
- **Private asset cash flows:** Managers had been making larger-than-normal commitments to private assets because of rapid returns of capital that were occurring as the market offered a strong IPO exit environment for private companies. The end of a vibrant IPO market and the increased allocations of recent years are both contributing to allocation levels ballooning beyond targets.
- **Dry powder:** Based on data from Preqin, BlackRock estimates in its 2024 private markets outlook that there is US$4 trillion in private capital dry powder. That figure is almost one-third of the global private capital market's AUM as of the end of March 2023. These commitments, when eventually called, will in many cases increase investor allocations beyond present targets.
- **Interest rate environment:** A rising interest rate environment has had a negative impact on the private asset industry in two significant ways. Higher rates have made structuring attractive private equity deals more challenging while increasing the appeal of traditional bonds, which are now competing with private assets and other holdings for a larger portion of investor portfolios.

The Regulatory Environment in 2024

The rules released by the SEC in August 2023 seek to enhance the regulation of Private Fund Advisors. Some of the recent SEC regulatory updates, such as the Quarterly Statement Rule, Private Fund Audit Rule, and Advisor-Led Secondaries Rule, seek to codify enhanced reporting standards in the industry and provide greater transparency to investors. The Preferential Treatment Rule and Restricted Activities Rule also disrupt some of the ways in which institutional investors have contracted with asset managers. It specifically prohibits investment managers from providing certain types of preferential treatment for one investor over another in a fund vehicle. Along those lines, the Preferential Treatment Rule also prohibits the disclosure of information that would cause material harm to a co-investor.

For investment managers steering through a difficult capital raising environment, aligning interests with present and potential allocators is paramount to fundraising. Traditional structures, in particular those within the scope of the SEC's August 2023 rules for Private Fund Advisors, tend to limit the ability of the investment manager to negotiate individual arrangements with an allocator. **This being said, there do remain vehicles through which investment managers and allocators can enter such customised mandates.** Structures such as Funds-of-One, Separately Managed Accounts and Managed Account Platforms offer a solution that works for the fund manager and allocator alike.

Separately Managed Accounts

Historically, large institutional investors have worked with investment managers to create separately managed accounts ("SMAs") to create buffers for their portfolio holdings and enhance their liquidity profile while exercising greater control.

SMAs helped create a solution that avoided the liquidity and transparency constraints and fee terms of some fund structures. They allowed investors to enjoy the liquidity of their own holdings, enabled them to take advantage of market dislocations without their capital being used to meet other investors redemptions, improved portfolio transparency, and often enhanced communication and fee terms with the manager. SMAs can be easy to establish. In addition to the contracting process, typically they only require creating an additional account with the allocator's existing custodian.

SMA structures can work well with strategies that are investing on a long-only basis in publicly traded liquid securities. They may, however, expose an investor to significant fee and agency risk in illiquid private assets. If held in the same name as the institutional investor, SMAs may even potentially expose the investor to liability risk beyond the value of the account. While these structures can be useful tools in some circumstances, better solutions are available to investment managers and large institutional investors who are seeking to improve transparency, pricing, liquidity, and control and may provide reduced risk and operational complexity and increased governance for alternative investment asset classes.

Funds-of-One

Funds-of-One are an outstanding fund-raising tool for asset managers and can enhance their alignment and engagement with investors. They allow investment managers to create segregated vehicles for their allocator clients. The structure can accommodate, for example, an investment portfolio in private assets or a hedged strategy managed exclusively for the investor's benefit that also provides a comprehensive governance structure. These vehicles benefit from full third-party fund administration and accounting while utilising the asset manager's existing slate of service providers.

Funds-of-One also only have one investor, meaning the investor and the investment manager can negotiate terms without contravening preferential treatment rules between investors in areas of such redemption rights, portfolio holdings disclosures and material economic terms which form part of the SEC Private Adviser Rules.

In addition, the Funds-of-One structure allows for easy tracking of investments across multiple vehicles. The fund administrator working on the structure can provide detailed, aggregated reporting solutions as well as middle office support and regulatory policy monitoring and compliance.
While private asset vehicles are a bit simpler to launch via Funds-of-One, the structure also allows for managers to utilise their existing prime brokerage relationships. This makes the Fund-of-One an optimal tool for the delivery of an array of complex hedged strategies to large allocators that are looking for a fully segregated vehicle that adheres to their policies and objectives.

Funds-of-One / Managed Account Platforms

For very large institutional investors, the creation of a proprietary platform may provide an ideal structuring solution. While the creation of a managed account or funds-of-one platform may require a large allocator to hire service providers to implement the construction and operation of such a platform, it is a similar process that is followed by asset managers when launching a fund. It requires legal support from a fund attorney who can assist with the legal structuring, a third-party administrator who can provide the accounting and book of record for the fund vehicles and should include an auditor. The creation of this type of fund infrastructure is a common process, even with small managers launching new funds.

For large allocators who want to also onboard hedge funds onto their platforms, there would be an additional requirement of establishing prime brokerage relationships for some strategies.

Key benefits of a managed account platform include:

- Costs: Large allocators may benefit from scale pricing that is better than that of their managers. Some large allocators have considerably more assets under management than the managers with whom they are investing. With a platform, such allocators could drive better pricing on many of these costs. Allocators could get scale pricing for administrative and audit-type services across multiple funds on the platform.
- Reporting: Transparency from reporting can be enhanced with a managed account platform. A service provider may create platform-level reports., in addition to fund-level reports. These platform-level reports can aggregate information such as asset class and entity exposures across the entire platform, as well as provide detailed information on fees and expenses. Risk reporting can be expanded to include correlation analysis of various platform components and scenario analysis, based on actual holdings.
- Contracting: Given the platform and its underlying accounts or funds have only one investor, the investor and the investment manager can negotiate terms without contravening some of the clauses that form part of the SEC Preferential Treatment Rule.
- In addition, allocators could streamline contracting processes with investment managers on their platforms through Strategic Relationship Agreements ("SRAs"). SRAs could enhance the ability to take advantage of market dislocations and enable portfolio teams to spend more time on investments rather than contracting. These agreements also enhance alignment of interest and potentially can improve investment performance while lowering contracting costs.
- Liquidity: Investor liquidity is generally driven by a particular fund's legal structure and redemption requirements. Managers usually try to match a fund's liquidity terms with the liquidity of the underlying investments and the strategy that is being implemented. This liquidity match may be disrupted, however, during periods of dislocation when other investors' need for capital forces managers to implement fund-gating provisions to protect fund holdings and investors. Under such market conditions, an investor who may be interested in buying into the dislocation may see muted results when trying to enter a fund as other investors are trying to exit. When

allocators have their own platform, they can fully take advantage of dislocations without impact from other investors or reduce their exposures when they are not being well compensated for risk.

- **Performance**: The investment performance of allocators who own their own fund platform infrastructure may benefit from enhanced performance driven by improved cost structures, better portfolio information and risk management, as well as harnessing the structure's full capabilities to take advantage of market dynamics and their own portfolios' liquidity.

About the Authors

James Perry

James is responsible for shaping the Maples Group's offerings and enhancing its service delivery to institutional investors including pensions, endowments, foundations, OCIOs and family offices. He brings more than 20 years of investment management experience, with 10 years serving in senior investment roles overseeing portfolios of public assets in California and Texas. In these roles, James played a pivotal role in the development of innovative industry solutions. He was a co-creator of the Strategic Relationship Agreement (SRA) structure, which now is taught at Harvard Law School. Leveraging this experience as an innovative allocator, James is committed to helping improve the relationships, structures and deal flow between allocators and asset managers. James is a recognised thought leader in the investment industry, including being named as one of the Top 30 Pension Fund Chief Investment Officers (Trusted Insight, 2016) and receiving the Investor Intelligence Award for Innovation (Institutional Investor, 2014). He is also a regular advisor and speaker with TEXPERS and the Texas Alternative Investment Association (previously the Texas Hedge Fund Association) and is a regular speaker at other industry conferences.

Nicholas Watson

Nicholas manages the operations team for the Maples Group's fund services business in Montreal, which provides accounting and administration services to a wide array of investment funds including hedge funds, private equity funds, multi-manager funds and emerging market funds. He has significant experience in business process improvement, managing operational risk and developing client relationships. Drawing on more than a decade of experience working with the Maples Group, Nicholas has held senior positions across a variety of service lines, including fund accounting, data management and middle office services, working from a number of the Maples Group's locations including Dublin, Hong Kong and Montreal. Nicholas has a Bachelor of Science (Honours) in Mathematics, Statistics and Finance from the University of Strathclyde in the UK.