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# Coming Together After the Crisis: Global Convergence of Private Equity and Hedge Funds

*Houman B. Shadab\**

## INTRODUCTION

Two of the most significant types of alternative investment funds worldwide are hedge funds and private equity funds. A hedge fund typically engages in short-term trading of financial instruments and compensates its manager on an annual or quarterly basis. A private equity fund typically takes long-term management positions in companies and compensates the fund manager once every several years upon the sale of the fund's assets. Although primarily centered in the United States and Europe, numerous markets worldwide are home to each type of fund. Prior to the subprime mortgage-initiated financial crisis, there was a trend within the alternative investment sector toward the convergence of strategies and structures of certain private equity and hedge funds. This article suggests that although the financial crisis will slow the process of convergence, the trend toward convergence will ultimately continue and strengthen, albeit in some ways along a different trajectory than before and with some important variations across national boundaries.

## I. PRIVATE EQUITY AND HEDGE FUNDS AROUND THE GLOBE

### A. The Global Private Equity Fund Industry

Four types of private investment funds fall under the "private equity" moniker. Venture capital funds finance new companies and then take on an

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active role as the advisor or director to help the new company grow and mature.<sup>1</sup> Leveraged buyout (LBO) funds borrow capital to take a public company private or to place control in the hands of company managers, and then seek to increase the company's value by improving its operations or structure.<sup>2</sup> The phrase "private equity fund" is often used loosely to refer to LBO and/or venture capital funds. Mezzanine private equity funds invest in securities that have the properties of both debt and equity, such as debt securities convertible to equity, because such securities may enable a company to raise funds it otherwise would not be able to raise.<sup>3</sup> Distressed private equity funds purchase debt securities of companies near or in bankruptcy at a fraction of their face value with the goal of actively turning around the company, taking part in the bankruptcy process, or otherwise generating long-term value from the securities.<sup>4</sup>

The size of the private equity industry is measured by how much capital the funds raise and how much they actually deploy in investments, the latter of which may be significantly smaller. Global investment in private equity funds began to substantially increase in the early 1990s. However, during the recession of 2000 to 2002, private equity fund investments decreased and did not begin to increase again until 2004.<sup>5</sup> At year-end 2007, global LBO and venture capital funds invested a record \$297 billion.<sup>6</sup>

From 1990 to 2007, private equity transactions that took place across one or more national jurisdictions increased from 15%–40%.<sup>7</sup> The fastest growing regions of private equity fund investment from 1997 to 2007 were the Asia Pacific Region and Africa.<sup>8</sup> Private equity deals outside of the United States consist of a much higher rate of cross-border participation, while in the United States they are primarily domestically funded.<sup>9</sup> Nonetheless, the overwhelming majority of private equity transactions still take place in North America and Europe. From 2001 to 2007, 81.1% of all LBO transactions took place in those two regions alone, not including Canada or Scandinavia.<sup>10</sup> The United States is a "net exporter" of venture

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<sup>1</sup> MARK J.P. ANSON, HANDBOOK OF ALTERNATIVE ASSETS 386, 397–98 (2d ed. 2006).

<sup>2</sup> *Id.* at 419, 428–36.

<sup>3</sup> *See generally id.* at 455–76.

<sup>4</sup> *Id.* at 477–78, 480–81, and 487–89.

<sup>5</sup> *Id.* at 554; PRICEWATERHOUSECOOPERS, SEEKING DIFFERENTIATION AT A TIME OF CHANGE: GLOBAL PRIVATE EQUITY REPORT 2008 41 (2008).

<sup>6</sup> *See* PRICEWATERHOUSECOOPERS, *supra* note 5, at 40.

<sup>7</sup> Joshua Aizenman & Jake Kendall, *The Internationalization of Venture Capital and Private Equity* 3 (Working Paper, Sept. 2008), available at <http://ssrn.com/abstract=1275544>.

<sup>8</sup> PRICEWATERHOUSECOOPERS, *supra* note 5, at 38.

<sup>9</sup> Aizenman & Kendall, *supra* note 7, at 3.

<sup>10</sup> Per Stromberg, *The New Demography of Private Equity*, in GLOBALIZATION OF

capital deals, and from 2003 to 2007 U.S. venture capital firms participated in 3,000 more cross-border deals than non-U.S. firms conducted deals in the United States.<sup>11</sup> The largest importers of venture capital are France, Israel, Canada, India, and China.<sup>12</sup> Factors that tend to increase the attractiveness of a particular jurisdiction to private equity flows include highly skilled workers, developed stock markets, quality corporate governance, linguistic and cultural connections, and business and entrepreneurship-friendly environments.<sup>13</sup>

### B. The Global Hedge Fund Industry

A hedge fund is a private investment company not subject to the full range of restrictions on investment activities and disclosure obligations imposed by national securities laws that compensates management in part with an annual performance fee and typically engages in the active trading of financial instruments.<sup>14</sup> Although the specific trading strategies and instruments utilized by different hedge funds vary greatly, hedge funds can be classified into four broad groupings.<sup>15</sup> Equity-based hedge funds are those that primarily invest in stocks and equity derivatives (such as stock options) on both the long and short side. Event-driven hedge funds are those that seek to profit from price changes subsequent to major corporate transactions such as bankruptcies or mergers, and also include activist hedge funds that seek to influence company management and operations. Global macro funds use a wide variety of financial instruments to profit from broad worldwide changes in economic factors such as currency rates, national income, and demographics. Relative values hedge funds seek investment gains based upon changes in the relative value of two or more financial instruments, such as bonds, whose price changes are related.

Subsequent to the collapse of the Internet bubble in 2000, the global hedge fund industry grew at a record pace from an estimated \$491 billion in

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ALTERNATIVE INVESTMENTS: THE GLOBAL ECONOMIC IMPACT OF PRIVATE EQUITY REPORT 2008 3, 16 (World Econ. Forum 2008).

<sup>11</sup> See Aizenman & Kendall, *supra* note 7, at 6.

<sup>12</sup> *Id.* at 6–7.

<sup>13</sup> *Id.* at 4; Alexander P. Groh, Heinrich von Liechtenstein & Karsten Lieser, *The European Venture Capital and Private Equity Country Attractiveness Index(es)* §§ 1–2 (IESE Bus. Sch. Univ. of Navarra, Working Paper No. WP–773, 2008).

<sup>14</sup> See generally Housman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. (forthcoming 2009), available at <http://ssrn.com/abstract=1066808>.

<sup>15</sup> These hedge fund strategy groupings are based on the strategy classification system of Hedge Fund Research, Inc. See HEDGE FUND RESEARCH INC., HFR STRATEGY AND REGIONAL CLASSIFICATIONS 2 (2009), available at [https://www.hedgefundresearch.com/pdf/new\\_strategy\\_classifications.pdf](https://www.hedgefundresearch.com/pdf/new_strategy_classifications.pdf).

assets under management to a peak of \$1.93 trillion in mid-year 2008.<sup>16</sup> Despite their relatively small size, hedge funds are active participants in the financial markets. By 2007, hedge funds accounted for an estimated 30% of U.S. fixed-income trading volume<sup>17</sup> and 45% of emerging market bonds trading volume.<sup>18</sup> Hedge funds' prominence in the marketplace owes in part to their use of leverage, which permits them to trade a higher value of instruments than the assets they manage.

Several fundamental aspects of the hedge fund industry implicate international issues in law and finance. First, in part to minimize tax burdens on certain fund investors, most hedge funds are comprised of a hedge fund management company (investment adviser) operating in a relatively large and economically diverse country while the fund itself is domiciled in a small offshore jurisdiction. In 2008, approximately 36% of hedge funds were domiciled in the Cayman Islands, 10% in the British Virgin Islands, and funds domiciled in Bermuda, the Channel Islands, and the Bahamas made up another 10% of the industry.<sup>19</sup> Second, hedge fund investment strategies are often directly tied to global economic conditions. This is particularly true of global macro hedge funds, which in 2008 accounted for approximately 17% of global hedge fund assets.<sup>20</sup> Third, hedge funds often focus their investment strategies on assets originating from or related to a general geographic region such as Asia, Europe, the Middle East, or even more narrowly defined regions.<sup>21</sup>

Finally, although the hedge fund industry first began in the United States and is the largest there, the industry is global, with the United Kingdom, Europe, and Asia constituting the other primary jurisdictions in which hedge fund managers operate, and the Middle East as a region likely to experience substantial growth.<sup>22</sup> Hedge funds in non-U.S. jurisdictions are in some ways more advanced than those in the United States. For example, publicly listed hedge fund managers in Europe predated those in

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<sup>16</sup> FRANÇOIS-SERGE LHABITANT, HANDBOOK OF HEDGE FUNDS 21 (2006); Press Release, Hedge Fund Research, Investors Withdraw Record Capital from Hedge Funds as Industry Concludes Worst Performance Year in History (Jan. 21, 2009), available at [https://www.hedgefundresearch.com/pdf/pr\\_01212009.pdf](https://www.hedgefundresearch.com/pdf/pr_01212009.pdf).

<sup>17</sup> *Hedge Funds Driving Fixed Income Trading in the U.S., Says Greenwich Associates*, TRADE NEWS, Sept. 3, 2007, <http://www.thetradenews.com/hedge-funds/prime-brokerage/1197>.

<sup>18</sup> Adrian Blundell-Wignall, *An Overview of Hedge Funds and Structured Products: Issues in Leverage and Risk*, 92 FIN. MARKET TRENDS 37, 42 (2007), available at <http://www.oecd.org/dataoecd/36/62/40972327.pdf>.

<sup>19</sup> HEDGE FUND RESEARCH INC., HFR GLOBAL HEDGE FUND INDUSTRY REPORT—THIRD QUARTER 2008 31 (2008).

<sup>20</sup> *Id.* at 15.

<sup>21</sup> *Id.* at 35–39.

<sup>22</sup> *See generally* HEDGEWEEK SPECIAL REPORT, MIDDLE EAST HEDGE FUND INVESTMENT 9 (2008).

the United States by several years. In addition, federal law in the United States prohibits retail (non-wealthy) investors from investing in hedge funds. By contrast, numerous other jurisdictions permit retail investors greater access to hedge funds than in the United States. For example, in Australia hedge funds that register with the government and make basic disclosures are permitted to market and sell securities to retail investors without any restrictions on their investment activities.<sup>23</sup> Japan, Singapore, Spain, and Switzerland have also established regulatory frameworks that permit retail investors to invest in hedge funds, either directly or through a fund of funds structure.<sup>24</sup>

## II. GLOBAL CONVERGENCE AFTER THE CRISIS

In part because both private equity and hedge funds are nonpublic funds that seek returns uncorrelated with overall markets, there is a natural synergy between certain aspects of the funds that makes convergence between the two attractive. Indeed, institutional investors often view their allocations to each type of fund as relatively interchangeable components of their overall allocation to alternative investments.<sup>25</sup> Convergence prior to the financial crisis was motivated in part because the rapid growth and increasing sophistication of the hedge fund industry through 2007 reduced many previously existing opportunities for profit. The increasingly crowded hedge fund sector had arbitrated away prior market inefficiencies such that many funds were making the same investments and thereby reducing their potential value. Accordingly, hedge funds were seeking out private equity strategies as a new type of investment opportunity.<sup>26</sup> Some private equity funds, for their part, were also seeking to affiliate with hedge funds. They did so to give their investors certain benefits that come from investing in hedge funds, such as greater investment liquidity and diversification, and also to increase the likelihood that investors' gains would stay with the private equity manager when paid out.<sup>27</sup> Exemplifying

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<sup>23</sup> AXISS AUSTRALIA, THE HEDGE FUNDS INDUSTRY IN AUSTRALIA 13 (Axiss Australia 2006-07), available at <http://www.aima-australia.org/forms/HedgeFundIndustryAust2006-07.pdf>.

<sup>24</sup> KPMG, JAPAN: REGULATION, HEDGE FUNDS (2008), [http://www.kpmg.ie/funds2008/hedgefunds/pdfs/Japan\\_HF\\_regulation.pdf](http://www.kpmg.ie/funds2008/hedgefunds/pdfs/Japan_HF_regulation.pdf); KPMG, SINGAPORE: REGULATION, HEDGE FUNDS (2008), [http://www.kpmg.ie/funds2008/hedgefunds/pdfs/Singapore\\_HF\\_regulation.pdf](http://www.kpmg.ie/funds2008/hedgefunds/pdfs/Singapore_HF_regulation.pdf); PRICEWATERHOUSECOOPERS, UNDER THE SPOTLIGHT: THE REGULATION, TAXATION, AND DISTRIBUTION OF HEDGE FUNDS AROUND THE GLOBE 37-39 (2007).

<sup>25</sup> Alan Briefel & Joseph Mariathan, *Hedge Funds and Private Equity: Conflict or Convergence?*, GLOBAL PENSIONS (Apr. 2005), available at [http://www.kpmg.ie/funds2008/hedgefunds/pdfs/Singapore\\_HF\\_regulation.pdf](http://www.kpmg.ie/funds2008/hedgefunds/pdfs/Singapore_HF_regulation.pdf).

<sup>26</sup> George Saffayeh & Guy Lottem, *Opportunities and Obstacles of Private Equity and Hedge Fund Convergence*, CROSS CURRENTS (Winter 2005-06).

<sup>27</sup> *Id.*

this trend, in 2004, the prominent Boston-based private equity fund Bain Capital launched a global macro hedge fund named Absolute Return Capital.<sup>28</sup>

#### A. Strategic and Structural Convergence

In practice, private equity and hedge fund convergence can take place along two different paths which may overlap. First, convergence may take place on the investment strategy or activity level (strategic convergence). Hedge funds may make long-term investments in illiquid assets that are typically the domain of private equity funds. Hedge funds may compete with private equity funds for buyouts of large public companies or the purchase of mezzanine debt, or like private equity funds, take long-term equity stakes in companies with the goal of changing how management operates to increase the value of the company.<sup>29</sup> When hedge funds make relatively long-term investments in illiquid securities or in assets that are otherwise hard to value, they typically do so through a structure known as a “side pocket.” A side pocket is held as a separate investment from a hedge fund’s liquid assets and not involved with general redemption requests or valuation of the fund’s other assets.<sup>30</sup>

Strategic convergence may take place either at the manager level, with a multi-strategy hedge fund pursuing private equity strategies, or through a fund of funds structure, where a feeder fund allocates investor capital to various private equity and hedge funds.<sup>31</sup> To the extent strategic convergence takes place, it is most likely to consist of hedge funds utilizing private equity strategies rather than vice versa. This is because hedge funds are generally more flexible and opportunistic in their strategies than private equity funds and are able to hire the requisite professionals where needed.<sup>32</sup>

Convergence can also refer to the ways in which the already similar fund structures of private equity and hedge funds may become even more similar. The two types of funds are both typically structured and operated as private limited partnerships that charge their investors a 2% management fee and a 20% performance fee based upon the profits of the fund.<sup>33</sup> Thus, structural convergence takes place to the extent either fund adopts structures typical of the other. For example, hedge funds may use lock-up provisions

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<sup>28</sup> Absolute Return Capital, About Us, [http://www.absolutereturninvestor.com/about\\_us.html](http://www.absolutereturninvestor.com/about_us.html).

<sup>29</sup> Briefel & Mariathan, *supra* note 25.

<sup>30</sup> See SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 2:3.3 [E] [1] (2007).

<sup>31</sup> Briefel & Mariathan, *supra* note 25.

<sup>32</sup> *Id.*

<sup>33</sup> See Ann-Kristin Achleitner & Christoph Kaserer, *Private Equity and Hedge Funds: A Primer* 9–10 (Center for Entrepreneurial and Fin. Studies, Working Paper No. 2005–03, 2005), available at <http://ssrn.com/abstract=1109100>.

that require investors to commit their capital for several years, a practice that is typical of private equity funds and reflective of their long-term investments. Hedge funds may also employ “hurdle” rates as private equity firms do, and thereby place an absolute minimum return above which the fund must perform before the manager is entitled to a performance fee allocation. In addition, hedge funds may compensate managers on a longer-than-annual basis, not only to align manager and investor incentives on a longer-term basis than annual fees,<sup>34</sup> but also so that, like private equity funds, hedge funds do not compensate managers with performance fees until long-term assets are actually sold and gains are realized.

#### B. The Impact of the Financial Crisis on Private Equity and Hedge Funds

The subprime mortgage-initiated credit crunch, stock market crash, and ensuing international financial crisis have deeply impacted both the global private equity and hedge fund industries. This impact stems from sharp drops in highly volatile asset prices, less investor capital available for equity investments, and investors seeking to withdraw their funds in response to fund losses, uncertainty, or to meet their own needs for capital. In 2008, the value of private equity investments decreased by two-thirds,<sup>35</sup> and the funds raised nearly 75% less capital in the fourth quarter than in the fourth quarter of 2007.<sup>36</sup> With curtailed lending from banks and other institutions, venture capital activity will slow, large LBOs will likely cease altogether, and private equity funds will likely focus on mezzanine investments, distressed securities, and infrastructure.<sup>37</sup> Private equity funds may also consolidate, increase their international transactions, find new sources of capital from sovereign wealth funds and others, and lower their fees.<sup>38</sup> In the hedge fund sector, historic stock market losses and economic volatility in the fourth quarter of 2008 led to declining asset values, lender margin calls, and investor redemptions that resulted in the hedge fund

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<sup>34</sup> Jenny Anderson, *Starting a Revolution in the Pay Structure for Hedge Fund Managers*, N.Y. TIMES, Nov. 17, 2006, at 6.

<sup>35</sup> *The Evolution of Private Equity*, FIN. TIMES, Feb. 5, 2009, available at [http://www.ft.com/cms/s/0/ae9a607c-f3cf-11dd-9c4b-0000779fd2ac.html?nclick\\_check=1](http://www.ft.com/cms/s/0/ae9a607c-f3cf-11dd-9c4b-0000779fd2ac.html?nclick_check=1).

<sup>36</sup> Cyrus Sanati, *Huge Drop in Private Equity Fund-Raising* N.Y. TIMES.COM DEALBOOK BLOG, Feb. 5, 2009, <http://dealbook.blogs.nytimes.com/2009/02/05/huge-drop-in-private-equity-fund-raising/>.

<sup>37</sup> Megan Davies & Philipp Halstrick, *Private Equity Dives into Alternatives, LBOs Dead*, REUTERS, Feb. 3, 2009, <http://www.reuters.com/article/americasDealsNews/idUSTRE5125A020090203>; Daniel Hausmann, *The Coming Private Equity Fund-Raising Drought*, WSJ.COM DEAL JOURNAL BLOG, Jan. 28, 2009, <http://blogs.wsj.com/deals/2009/01/28/the-coming-private-equity-fund-raising-drought/>.

<sup>38</sup> Rhea Wessel, *Super Return: Fees in the Glare*, NYTIMES.COM DEALBOOK BLOG, Feb. 3, 2009, <http://dealbook.blogs.nytimes.com/2009/02/03/will-private-equity-fees-take-a-hit/>; Rhea Wessel, *Super Return: The Coming Shakeout*, NYTIMES.COM DEALBOOK BLOG, Feb. 4, 2009, <http://dealbook.blogs.nytimes.com/2009/02/04/super-return-the-coming-shakeout/>.



industry losing approximately \$582 billion in assets in 2008 to end the year with \$1.5 trillion.<sup>39</sup> In response to investors' frustrations and new commercial realities, hedge funds may lower fees, have smaller minimum investments, give investors more timely access to their own capital, increase disclosures, and rely even more on independent service providers able to verify fund returns.<sup>40</sup> The hedge fund industry is also likely to decrease its use of borrowed funds, face greater competition from passive replicator funds, and consolidate as smaller funds close or are bought out.<sup>41</sup>

### C. Impact of the Financial Crisis on Convergence: General Considerations

The financial crisis is likely to substantially stem the process of convergence, at least in the near term. Due to the poor economic health of private equity fund portfolio companies and the closures of many hedge funds, private equity and hedge funds will likely first seek to stabilize their own funds before venturing out into new territory through convergence. As the prominent private equity fund manager Henry Kravis remarked on February 3, 2009, "[i]t's portfolio, portfolio, portfolio" that should be the focus of managers during the crisis.<sup>42</sup> Hedge funds suffering from losses and seeking to become profitable are unlikely to look to relatively untested opportunities like convergence for renewal. Hedge fund losses also seem likely to undermine one of the chief economic rationales for convergence that was driving the trend before the crisis. The dislocations created by the financial crisis and governmental responses, and the smaller size of the hedge fund industry worldwide, have given new life to traditional hedge fund investment strategies and created entirely new strategies for the funds to utilize. Hedge funds have less of a need to look to private equity strategies for new opportunities.

On the other hand, there are forces that may drive more convergence in the longer term, even if convergence experiences a temporary lull until financial conditions improve. First, time will continue to be on the side of convergence because sophisticated fund investors seem to become more comfortable with hedge funds taking on private equity investment strategies as they gain experience with alternative investments.<sup>43</sup> Second, national

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<sup>39</sup> CREDIT SUISSE TREMONT HEDGE FUND INDEX, ONE FOR THE HISTORY BOOKS: HEDGE FUND PERFORMANCE IN 2008, at 1 (2009).

<sup>40</sup> See *New Hedge Fund Platform Provides Access to Top Tier Managers*, FINALTERNATIVES Jan. 30, 2009, available at <http://www.finalalternatives.com/node/6797>; Tom Sullivan, *Better Disclosure, Courtesy of Madoff*, BARRON'S, Jan. 26, 2009, at 45.

<sup>41</sup> Joseph A. Giannone, *As Hedge Funds Flop, Replication Funds Get Chance*, REUTERS, Jan. 26, 2009, available at <http://www.reuters.com/article/rbssInvestmentServices/idUSN2633056520090126>.

<sup>42</sup> Davies & Halstrick, *supra* note 37.

<sup>43</sup> Briefel & Mariathan, *supra* note 25.

governments may take measures to mitigate the costs of the financial crisis by encouraging private equity or directly investing in private equity themselves through sovereign-wealth funds. China's government-owned Shanghai International Group, for example, has formed a joint venture with China's largest investment bank to manage a \$2.9 billion private equity fund, and is also encouraging private equity by granting new licenses to local brokerages.<sup>44</sup> To the extent convergence depends on the health of the private equity sector, such actions will sustain convergence practices. Third, the development of secondary markets to trade illiquid securities of the type purchased by private equity funds and interests in private equity and hedge funds themselves may further enable convergence. One problem with hedge funds converging by purchasing long-term debt securities of the type purchased by mezzanine private equity funds is that the duration of such securities is much longer than hedge funds are able to lock in their own investors' capital, leaving hedge funds vulnerable to capital withdrawals before investment returns are realized.<sup>45</sup> However, the growth of secondary trading platforms for illiquid securities, which have arisen in part due to the financial crisis, may allow hedge funds to overcome this investor-asset maturity mismatch.<sup>46</sup> Hedge funds could use a secondary market to sell their mezzanine debt interests. Alternatively, hedge fund investors could exit the fund without having to withdraw their capital by selling their hedge fund interests in a secondary market.

Fallout from the financial crisis will likely make certain types of strategic convergence more likely while decreasing structural convergence along at least one dimension. The current and likely continued decrease in LBO and venture capital activity means that private equity funds will focus on strategies where the opportunity for convergence with hedge funds happens to be greatest. Mezzanine debt is a strategy in which hedge funds can compete with private equity funds, in part because certain types of hedge funds have experience with mezzanine debt through using the securities as part of their investment strategies in fixed-income instruments. In addition, activist hedge funds—the small number of hedge funds which take relatively large equity stakes in public companies and seek to influence their operations or structure—have performed relatively well in recent years. Because such funds have been profitable, more hedge funds and

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<sup>44</sup> Samuel Shen, *China's CICC, SIG in \$2.9 Billion Private Equity Venture*, REUTERS, Feb. 4, 2009, available at <http://www.reuters.com/article/americasPrivateEquityNews/idUSTRE5131V020090204>.

<sup>45</sup> Briefel & Mariathan, *supra* note 25.

<sup>46</sup> James Mackintosh, *Hedge Funds for Sale: Going Cheap*, FIN. TIMES, Feb. 10, 2009, <http://www.ft.com/cms/s/0/5eb6b5f8-f7ab-11dd-a284-000077b07658.html>; Press Release, PR Newswire, SecondMarket Surges Past \$1 Billion in Assets Traded (Jan. 28, 2009), available at <http://sev.prnewswire.com/banking-financial-services/20090128/NY6361728012009-1.html>.

capital are likely to adopt and flow to such strategies. Even though hedge fund activists do not manage portfolio companies as closely as private equity funds do, activist hedge funds are much closer strategically and structurally to private equity funds, which means that more hedge fund activism could likely lay the foundation for a more complete strategy convergence.

Convergence may also take place through private equity funds beginning to manage their portfolios more like hedge funds. Private equity funds may utilize credit derivatives, such as credit default swaps, to manage the risks to which they are exposed through their equity and debt security investments. Currently, the credit default swap market is undergoing a structural evolution in providing greater transparency and lower counterparty risk through the utilization of central counterparties and other practices.<sup>47</sup> These developments may attract new types of firms, including private equity funds, to use the swaps to reduce their credit exposures. The increasing use of credit default swaps may, in turn, spur cross-border private equity investments to the extent private equity funds are able to hedge the unique investment risks to which they are exposed in emerging markets. For example, buying credit protection through a credit default swap index referencing emerging market bonds such as the CDX.EM may be a means for a U.S. venture capital investor involved in a cross-border deal to hedge its risk. This is because there is likely a correlation between the success of an emerging market start-up and the overall health of the local economy as measured by the sovereign bonds referenced by the swap index.

Distressed debt investing is another potential area for strategic convergence, both in the United States and abroad. Hedge funds have already been increasing their investments in distressed debt securities.<sup>48</sup> For example, in 2009, the hedge fund managed by John Paulson purchased mortgage-related securities, the debt of bankrupt companies, and high yield bonds.<sup>49</sup> A group of private equity and hedge funds converged in January 2009 by entering into an agreement to purchase the failed bank IndyMac,<sup>50</sup> which suggests that additional debt fund convergence is likely. Distressed debt securities are likely to be in large supply over the next few years as mortgage-backed securities and other bonds come under continuing price

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<sup>47</sup> Shannon D. Harrington, *Credit-Default Swaps' 'Big Bang' Loosens Banks' Grip (Update1)*, BLOOMBERG, Apr. 8, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=ax4VYBb9REow&refer+home>.

<sup>48</sup> Helia Ebrahimi, *Distressed Debt Funds Line Up New Year Raids*, DAILY TELEGRAPH, Dec. 22, 2008, at 5.

<sup>49</sup> Anita Raghavan, *Paulson Profits Again*, FORBES.COM, Feb. 4, 2009, [http://www.forbes.com/2009/02/04/john-paulson-hedge-funds-business-0204\\_paulson.html](http://www.forbes.com/2009/02/04/john-paulson-hedge-funds-business-0204_paulson.html).

<sup>50</sup> *Hedge, P.E. Firms Agree to Buy IndyMac Bank*, FINALTERNAIVES Jan. 5, 2009, <http://www.finalternatives.com/node/6510>.

pressure from defaults and delinquencies. Accordingly, hybrid private equity-hedge funds dedicated to distressed securities may emerge to offer investors different structures under which to invest in the securities. In addition, funds of distressed funds, which would allocate capital to private equity and hedge funds, may be a route for investors to have a structurally diversified exposure to distressed securities.

In terms of structural convergence, hedge funds after the crisis are *less* likely to adopt private equity structures that inhibit the ability of investors to withdraw their capital. In 2008, investors were frustrated with hedge funds imposing gates and using other contractual provisions to prevent investors from withdrawing their capital.<sup>51</sup> Accordingly, it is unlikely that hedge funds will be adopting stricter private equity-like redemption constraints unless clearly justified by the necessity to utilize capital for a long-term, illiquid investment. Hedge funds that permit greater liquidity of their shares are likely to attract more investors than those with longer lock-ups or other redemption restricting devices. In terms of liquidity for their own investors, hedge funds will thus increasingly diverge from private equity.

#### D. Impact of the Financial Crisis on Convergence: Global Considerations

At a general level, convergence is less likely to occur outside of the most developed private equity and hedge fund jurisdictions, such as those in the United States and Europe. Decreased investment fund activities simply present fewer opportunities for convergence to take place. However, U.S. mortgage-related securities were purchased by investors around the globe and emerging market companies have fared relatively poorly compared to those in more developed markets. Accordingly, non-U.S. jurisdictions may present significant opportunities for the convergence of distressed debt private equity and hedge funds, as is already taking place in the United States.<sup>52</sup>

In a 2004 MIT Sloan Working Paper, Josh Lerner and Antoinette Schoar studied private equity deal structures around the world.<sup>53</sup> The authors found that, in contrast to the United States where convertible preferred securities are typical in private equity deals, in developing nations more than one-half of the private equity deals utilize common stock and a significant portion use debt.<sup>54</sup> Lerner and Schoar also found that private

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<sup>51</sup> See Henny Sender, *On Wall Street: Hedge Fund Won't Let Go*, FIN. TIMES, Dec. 12, 2008, <http://www.ft.com/cms/s/0/68fc3972-c86a-11dd-b86f-000077b07658,s01=1.html>.

<sup>52</sup> See *supra* notes 49–51 and accompanying text.

<sup>53</sup> Josh Lerner & Antoinette Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity* (MIT Sloan Working Paper 4468–04, Feb. 2004), available at <http://ssrn.com/abstract=511202>.

<sup>54</sup> *Id.* at 3–4.

equity transactions in jurisdictions with French or socialist legal origins are more likely to involve obtaining a majority stake in a portfolio company.<sup>55</sup> These findings have important implications for the shape of private equity and hedge fund convergence in developing markets. First, they indicate that emerging markets are unlikely to see as much convergence between mezzanine funds and convertible arbitrage hedge funds. This is due to the different capital structures of different types of funds. Mezzanine private equity funds often utilize convertible preferred shares.<sup>56</sup> Convertible arbitrage hedge funds also often utilize convertible preferred shares as part of an arbitrage trading strategy.<sup>57</sup> Given the overlap between the financial instruments they utilize, these types of funds may be grounds for strategic convergence. Yet because developing nation private equity funds tend not to utilize convertible preferred securities, this basis for convergence is less likely to be present in such nations. On the other hand, because common stock is utilized by private equity firms in developing nations, opportunities for convergence between those private equity funds and hedge funds that invest in stocks may be greater in developing nations. Finally, the fact that private equity funds in French or socialist legal jurisdictions more commonly take majority ownership of companies makes convergence with hedge funds less likely in such jurisdictions. When hedge funds take large stakes in companies in their capacity as activists, their ownership position is typically somewhere between 5–10%,<sup>58</sup> which is far below the majority ownership common in French or socialist legal jurisdictions.

In an October 2008 study of how private equity funds in thirty-nine nations made disclosures to institutional investors, Douglas Cumming and Uwe Walz examined whether differences in accounting standards explain how well private equity funds disclosed the value of their investments to their investors.<sup>59</sup> The authors found that private equity funds in nations with lower-quality legal and accounting systems more often overvalued their unsold assets when making disclosures to investors.<sup>60</sup> This is because less stringent accounting standards give more discretion for private equity fund managers to value unsold investments and make it more difficult for investors to observe that assets were previously overvalued even once a real

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<sup>55</sup> *Id.* at 4.

<sup>56</sup> ANSON, *supra* note 1, at 456.

<sup>57</sup> LHABITANT, *supra* note 16, at 269–95.

<sup>58</sup> Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *The Returns to Hedge Fund Activism* 8 (European Corporate Governance Institute, Working Paper No. 098/2008, Mar. 2008), available at <http://w4.stern.nyu.edu/emplibray/Brav%20Jiang%20Partnoy%20Thomas%20-%20The%20Returns%20to%20Hedge%20Fund%20Activism.pdf>.

<sup>59</sup> Douglas Cumming & Uwe Walz, *Private Equity Returns and Disclosure around the World* (RICAFAE, Working Paper No. 009, Apr. 2004), available at <http://www.lse.ac.uk/collections/RICAFAE/pdf/RICAFAE-WP09-Cumming.pdf>.

<sup>60</sup> *Id.* at 3–4.

price is placed on them upon sale.<sup>61</sup> These findings suggest that convergence between private equity funds and hedge funds that make significant use of side pockets is more likely, all things being equal, to take place in nations with lower-quality legal and accounting systems. Hedge funds' side pocket investments in low-quality regimes are also likely subject to the same type of management discretion that Cumming and Walz found with private equity funds. Accordingly, in nations with weak accounting standards, strategic convergence may have a unique attraction to hedge fund managers that use side pockets to invest in illiquid assets.

### III. CONCLUSION

The financial crisis's impact on private equity and hedge funds will likely have several effects on convergence, and these effects will play out differently across the world due to international differences in regulation and underlying economics. Despite the toll that the financial crisis has taken on both private equity fundraising and hedge fund investment returns, convergence is likely to return to some parts of the industry as economic conditions stabilize. New reasons have emerged concomitant with the crisis that may also lead convergence to ultimately be a more widespread phenomenon in the alternative investment sector. Nonetheless, fundamental differences between hedge fund investment strategies, private equity deal making, and the interests of their investors will prevent the two types of alternative investments from ever converging completely. To the extent that regulatory regimes, economic conditions, and business practices relevant to private equity and hedge funds persist across national jurisdictions, private equity and hedge fund convergence will not only be a function of the differences between the funds, but will also reflect differences between the jurisdictions in which the funds operate.

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<sup>61</sup> *Id.* at 9–10.

