FUND MANAGERS AND THEIR LEGAL ADVISERS: WHAT DOES THE FUTURE HOLD?

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One of the outstanding features of the record-breaking bull market of the last decade has been the extraordinary growth of the Alternative Investment (AI) industry.

We've seen rapid expansion across all the six main asset classes – private equity, debt, real estate, hedge, infrastructure and energy. Given that their interests spread over so many key sectors of the economy, it is not surprising that they have felt the affects of the Covid-19 crisis deeply.

Indeed, they provide a picture of the effects of the pandemic in microcosm, and how they respond will have a major influence on where the wider economy goes next.

As transactions become more complex, geographically diverse and sector specific, the demand for ever-more sophisticated legal advice will grow.

But there are other pressures building up – in terms of regulation, investor and public expectation and in terms of how funds are organised and operate – that will also change the relationship between funds and their legal advisors.

Impact of the crisis

In the short-term, the reaction of AI funds to the crisis has been both defensive and offensive, says Peter Myners, a Luxembourg-based partner with Allen & Overy and co-head of the firm's Alternative Investment Initiative.

They have focused on mitigating the effect of the crisis on existing investments, injecting liquidity where it makes sense. Some buyers have looked to defer or even abandon deals rendered uneconomic, while sellers have sought to keep transactions alive, in some cases, forcing buyers to complete.

But on the offensive side, the crisis has opened up opportunities, particularly but not exclusively on the distressed debt side, that have been eagerly anticipated.

"This market is creating opportunities and many of the big players have been waiting for something to happen to create dislocation," he says. **"The industry had been massively competitive in terms of sourcing and bidding on deals."**

The initial focus once the crisis hit was on liquid investment opportunities, as fund managers took advantage of debt and equity trading down to buy in to assets they'd been tracking for a while.

In recent weeks, however, the more illiquid side of the industry has started to pick up, across different asset classes.

To take advantage of these opportunities, distressed, credit and special situation funds, moved quickly to raise fresh capital from investors, or to pivot existing funds, and the industry as a whole was estimated by Preqin to be sitting on some USD2.6tn of accumulated capital ahead of the crisis.

It is likely that we will see a rapid acceleration of transactions once the economic outlook is clearer and valuations stabilise, adds Myners, helped, not least, by the likelihood that interest rates will remain low and that businesses will continue turning to private debt funds for liquidity.

"As they grow, diversify, become more sector specific and expand into new geographies, fund managers are becoming more institutional in the way they operate and more organised in how they source legal services.

But they remain lean organisationally, compared to traditional banks and corporates. They are seeking support from law firms that have a detailed understanding of their needs."

Regulatory and investor pressure

Private debt funds remain relatively lightly regulated[1] , compared with the traditional banking sector, and regulators are likely to be observing the private debt sector closely as the crisis unfolds.

Specific new regulation is also in the pipeline, not least the European Commissions latest version of the Alternative Investment Fund Managers Directive (AIFMD II), which will take effect next year.

But it remains to be seen how far governments and regulators will clamp down on the industry, argues Paul Loynes, formerly European general counsel at Apollo and deputy GC at SoftBank's Vision Fund. Instead, he expects the biggest pressure to come from the funds' own investors.

They are demanding much greater transparency, improved reporting, and tangible evidence that funds are addressing pressing environmental, social and governance (ESG) issues.

Investors may, as a result, be a lot more discerning about where they put their money, a trend that could bolster the bigger funds with greater capacity to respond.

"Investors are likely to be asking a lot more questions about ESG, such as how funds have treated their employees during lockdown and about community investment. So compliance pressures will only increase, even if that pressure is coming more from investors rather than from legislation."

Myners agrees that this trend will demand new kinds of support from legal teams. **"Most fund managers are embedding ESG much more structurally into their decision making processes, making it a key element of diligence and reporting. They are being more transparent about meeting investor demands. This tends to require additional resource."**

However, he believes another equally complex pressure is back on the table for the legal and compliance teams of fund managers in the short term – the growing likelihood of a hard Brexit at the end of this year, which is likely to create significant trading challenges for the industry, compounded by travel restrictions put in place as a result of the crisis.

Resourcing challenges

Myners and Loynes expect to see funds deploy technology, automation and alternative resourcing models, such as interim consultant lawyers and project management experts, to keep their costs under control and increase productivity.

Opportunities to bring in legal support at key points of the investment cycle will be a driving factor, argues Loynes, with the fundraising processing requiring the greatest need for support.

"Investors are demanding more and more specific deal terms which may mean side-letters or an increasing number of bespoke terms being negotiated." It is at this time that in-house teams most need to call on additional support and a lot of funds look for secondments from law firms during this phase, he says.

But needs will be different at every stage of the investment cycle. **"If the average life of a fund is 7 years, you spend a year setting up, four years deploying capital and the final two managing and exiting those investments. During that time, your legal needs are going to vary enormously. That calls for flexibility."**

Forward-looking funds, he believes, are using this slightly quieter period in the wake of the pandemic to re-assess those needs, to look at their infrastructure and prepare themselves for the next wave of heightened deal activity.

"The good firms are thinking about how they can best structure their legal functions to be nimble and capable of turning things round quickly."

Funds remain focused on working with external legal advisers who understand their strategic priorities, can co-ordinate and deliver insights from across relevant geographies, sector and practice areas, and demonstrate innovation in delivering services efficiently. It is a trend that was already there, says Myners, but one that has been accelerated by the crisis.

"These are demanding clients – but demanding in a good way," he says. **"They want to work with lawyers who understand them and can act as trusted business advisers. The key to success for any law firm supporting this industry in future will be the ability to deliver advice in a dynamic, commercially relevant and efficient way."**

1 Non-bank Lending in the European Union