

# Fund Finance Friday



## FoHF Security

May 30, 2025



By **Bryan Barreras**  
Counsel | Fund Finance

A lot of attention and press has been given to market volatility this year, including its impact on the fund finance industry. There is at least one sector of the fund finance industry that stands to benefit from this volatility. Because their investment strategies involve taking both long and short positions, many hedge funds are poised to benefit from market volatility, regardless of the direction of the market.

This has played out recently, at least for several of the largest multi-strategy and global macro hedge funds, in their ability to turn much of the tariff- and geopolitics-driven sharp volatility in the markets into steady gains that have outperformed the broader equity markets year-to-date. A primary beneficiary of strong hedge fund performance is the fund of hedge funds industry, which seeks to provide its investors with improved risk-adjusted returns through exposure to a diversified pool of hedge funds. In order to take advantage of opportunities in high-volatility markets, funds of hedge funds may increase borrowings to leverage their investments in underlying hedge funds, and we have recently seen evidence of this through an increase in the use of leverage by these borrowers, presumably buoyed at least in part by this strong performance.

This article highlights some of the key features of financing structures used by funds of hedge funds.

One central element of fund of hedge funds financing transactions is the use of a third-party custodian to “hold” the borrower fund’s portfolio of hedge funds in an account that the borrower pledges to the lender as collateral for repayment of the loan. The custodian subscribes for, and becomes the legal, registered owner of, the hedge fund portfolio, for the benefit of the borrower. The use of a third-party custodian, or securities intermediary, to hold the hedge fund portfolio has a number of benefits:

**Investor confidence.** A fund of hedge fund’s investors may see the use of an institutional, third-party custodian to hold the fund’s investments as a mitigant against operational errors and/or potential fraud. Indeed, some funds are required pursuant to the Investment Advisers Act of 1940 to hold investor assets through a qualified custodian, primarily as a means to ensure their safekeeping and to prevent potential misuse.

**Reporting.** Because the custodian is the legal owner of the hedge fund portfolio, it receives investor reports and valuation statements. This provides the lender with a third-party source that is able to provide reports detailing transactions in the hedge fund portfolio and pass through valuation information regarding the individual hedge fund holdings (often through on-line, view-only access), rather than having to rely on the borrower to provide this information.

**Control.** Again, because the custodian is the legal owner of the hedge fund portfolio, the lender is able to exercise a great degree of control over, among other things, dispositions of the hedge fund investments and use of proceeds of investor redemptions, through a tri-partite control agreement entered into with the custodian and the borrower. This can include requiring lender approval for all transactions and/or restricting the types of transactions that the borrower is able to instruct the custodian to execute (either completely or without written approval of the lender). All cash proceeds from redemptions of hedge fund interests are also paid to the pledged account at the custodian. The lender is thereby able to rely on the custodian, as an independent third party, rather than just a covenant from the borrower, to prevent unauthorized dispositions.

*Security Creation and Perfection.* Whereas a pledge over a directly-held equity investment would look to the jurisdiction of formation of the equity issuer to determine the applicable law governing the creation and perfection of that pledge (which, for a diversified portfolio, could require multiple local-law collateral documents in multiple jurisdictions), holding the portfolio through a securities intermediary streamlines this analysis. Because the asset owned by the borrower is the custody account and a series of security entitlements with respect to the assets credited to the account (*i.e.*, rights against the custodian, rather than rights in respect of the actual hedge fund interests), the applicable law is the jurisdiction of the custodian (subject to the Hague Securities Convention, the applicability of which would require legal analysis of the specific circumstances). While it is common to also take New York law security over the custody account, in addition to local law security (for non-U.S. custodians), having one or two collateral documents versus one in every jurisdiction where a hedge fund investment is formed, and complying with the various security perfection requirements in those jurisdictions (which would require engaging counsel in each jurisdiction) can make a big difference from a documentation, timing and cost perspective. Subject to exceptions in some circumstances, lenders also won't typically require the borrower to obtain pledge consents from the hedge funds held in a securities account. For financings where interests in hedge funds are directly pledged (*i.e.* not held in an account), a pledge consent agreement must be negotiated with each of the funds being pledged, which can be a time consuming and expensive process. For these reasons, holding the hedge fund interests in a securities account greatly simplifies the necessary documentation.

*Enforcement.* A universal feature of a tri-partite control agreement in this space is the ability of the lender upon the occurrence of a trigger event, such as the occurrence of an event of default under the credit agreement, to take control over the account, through the delivery of a notice of exclusive control (a "NOEC") to the custodian. Following delivery to the custodian of a NOEC, the lender is able to instruct the custodian to submit redemption notices to the hedge funds in the investment portfolio. As the custodian is the legal owner of the hedge funds, it can simply submit redemption requests to the underlying hedge fund administrations (*i.e.*, without having to find buyers or otherwise sell the hedge fund investments). The timing for payment of such redemptions depends on the terms specified in the offering memorandum for each fund being redeemed. Any cash redemptions will be paid to the pledged account and the custodian, where it can be applied by the lender to repay the outstanding loan.

While it is not always the case that a fund of hedge funds borrower will hold its investment portfolio through a custodian, it is the typical structure for a fund borrower holding a diversified portfolio of third-party managed hedge funds. We more often see hedge funds being directly held by the borrower where the hedge funds are affiliated with the borrower and/or managed by the same investment manager as the borrower (or an affiliate thereof). In these circumstances, we will often see a letter agreement entered into with the directly held fund, specifying the applicable liquidity of the hedge fund and including other protections for the lender (that are beyond the scope of this article to discuss).

While the indirect holding system provides a number of benefits, there are still issues that can arise under this security structure. One source of potential issues in the indirect holding system is the use by the custodian of a sub-custodian. Because the choice of law in the indirect holding system looks to the jurisdiction of the securities intermediary that is the legal owner of the hedge fund investments for the law governing creation and perfection of the lender's security interest, the use of a sub-custodian to hold legal title to the investments can raise questions regarding the applicable law for taking and enforcing security, especially where the custodian and the sub-custodian are located in different jurisdictions. As a result, it is not uncommon for the control agreement to prohibit the custodian from using a sub-custodian to hold hedge fund investments. And local counsel should be consulted whenever a non-U.S. custodian is involved in the structure, as the security creation and perfection requirements can vary greatly from jurisdiction to jurisdiction (and even within a single jurisdiction, as we recently came across an issue where the governing law regarding creation and perfection of a security interest over the securities account and the cash account were different, even though both accounts were held with the same custodian).