Seward & Kissel LLP

The Seward & Kissel 2017/2018 Hedge Fund Side Letter Study

Driven by our ongoing commitment to understanding the dynamics of the hedge fund marketplace and bringing the latest industry color to our clients and friends, each year Seward & Kissel conducts various studies of the most important trends we are seeing that are impacting the hedge fund community. This year, for the third year in a row, we have conducted a Study covering side letters negotiated by our hedge fund manager clients during the period July 1, 2017 through June 30, 2018 (the "Study").

In the current Study, 75% of the side letters were with managers in business for two or more years at the time of execution ("Mature Managers"), as compared to a higher 87% in the 2016/2017 Study, and 25% were with managers less than two years old ("Newer Managers"). This change may indicate more aggressiveness on the part of emerging managers to offer side letters in order to entice early investors. Nonetheless, we believe that the relative underrepresentation by Newer Managers in this statistic is attributable primarily to the increase in the use of founders' classes over the past several years which generally decreases the need for side letters.

The Study is broken down into four parts: the Managers, the Investors, the Terms, and a Comparison to Separately Managed Accounts. The four parts of the Study, when read together, provide valuable insights into the negotiation with hedge fund investors in the current environment.

Key Takeaways

- Excluding certain outliers, the average regulatory assets under management ("RAUM") of the Mature Managers in the Study was approximately $4.8 billion (as compared to $4.37 billion in the prior Study)
- Funds-of-funds continued to be the most commonly seen category of side letter investor by far, representing 50% of all side letter investors
- There was a major increase in side letters granting preferred liquidity and a major decrease in those providing fee discounts
- Similar to side letters, in the context of separately managed accounts, funds-of-funds were the most frequently seen type of investor

I. The Managers

Excluding certain outliers, the average regulatory assets under management ("RAUM") of the Mature Managers in the Study was approximately $4.8 billion (as compared to $4.37 billion in the prior Study) and virtually all of them were registered with the SEC as investment advisers. With respect to Newer Managers, nearly 1/3 of them were SEC-registered (unlike in the prior Study, in which where there were none). These data points seem to indicate an overall higher average assets under management level, as managers strive to maintain sufficient capital to operate in a rising cost environment due to regulatory and investor demands.

II. The Investors

The six principal types of side letter investor categories that consistently appeared within the Study, in order of frequency, were:

(1) funds-of-funds

(2) non-profit institutions

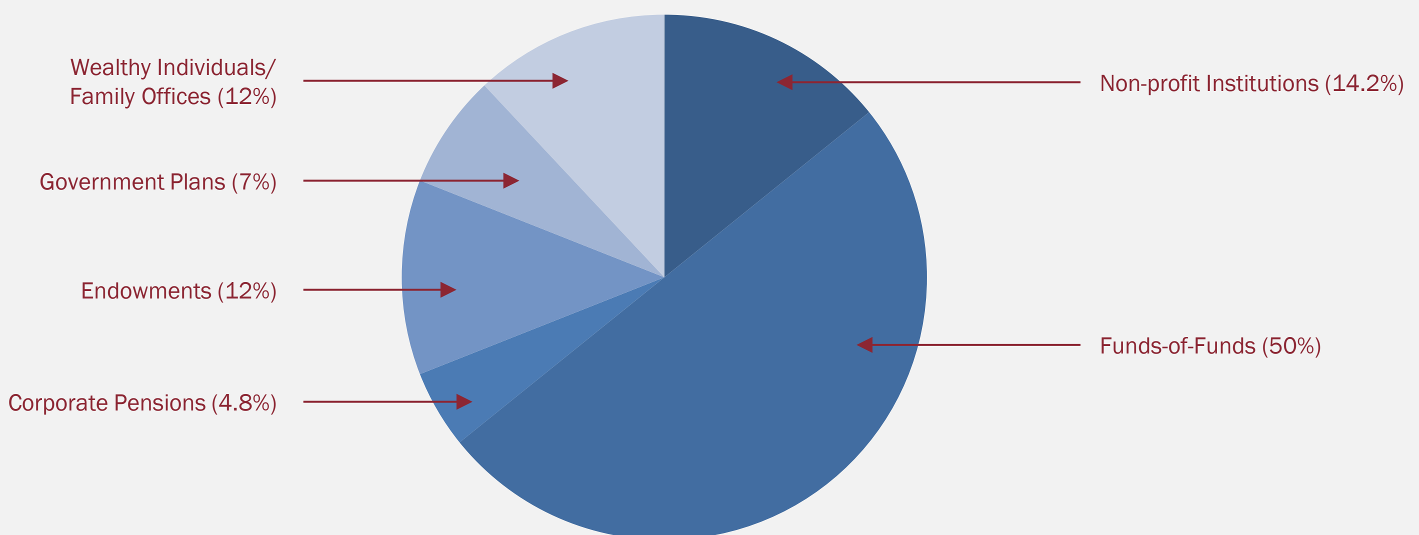
(3) wealthy individuals/family offices

(4) endowments

(5) government plans

(6) corporate pensions

The Investors



The Investors (continued…)

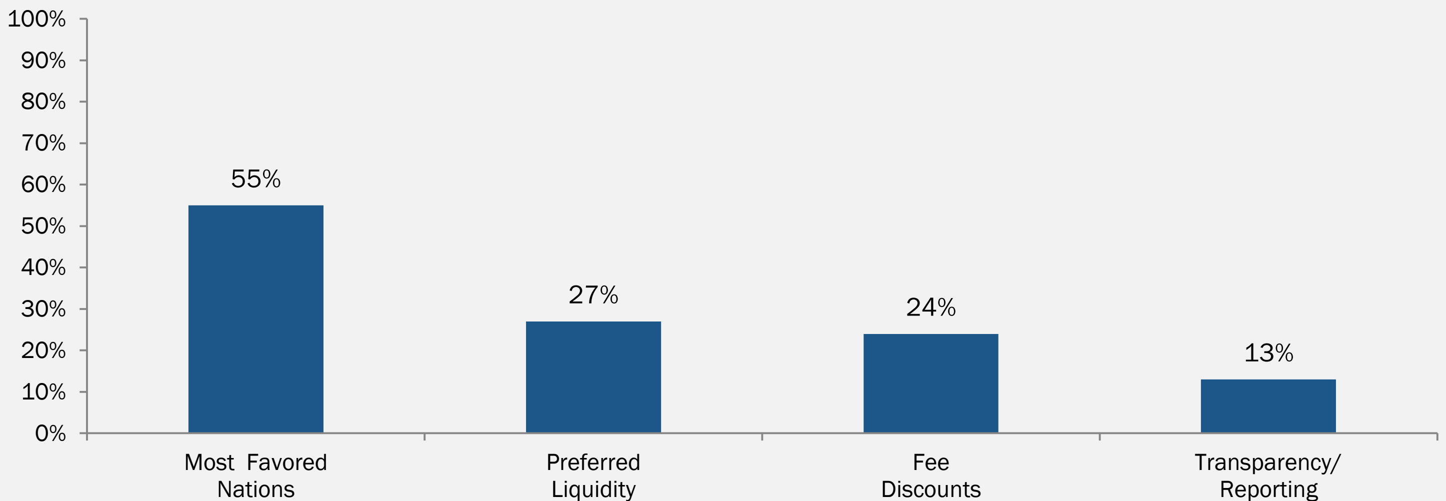
The most frequent category of side letter investor seen in the Study was the fund-of-funds category, making up a significant 50% of all side letter investors (which is slightly down from the 56% figure in the 2016/2017 Study). Note that for purposes of the fund-of-funds category, we included side letters with fund platforms that various banks now offer, as well as side letters with allocator firms where the beneficial owners were not listed. Somewhat surprisingly, the second largest side letter investor category was non-profit institutions at 14.2%, which represented a significant increase from the 4% figure in the 2016/2017 Study. Tied for third place were wealthy individuals/family offices and endowments, each at 12% (as compared to 17% and 6%, respectively, in the 2016/2017 Study). Continuing a major negative shift, government plans represented the next largest investor category with 7% of all side letter investors (which was down significantly from 14% in 2016/2017 and from 27.1% in 2015/2016). Finally, once again, the smallest side letter investor category was corporate pensions at 4.8% (versus 3% in 2016/2017).

Analyzing trends separately for Mature Managers and Newer Managers, some interesting takeaways were that: (1) 100% of the side letters with government plans, endowments and corporate pensions were with Mature Managers; and (2) 75% of the Newer Manager side letters were with funds-of-funds, which represented 28.5% of all the funds-of-funds side letters analyzed.

III. The Terms

The Study focused on four principal business terms: (1) some form of most favored nations protection ("MFN clause"); (2) preferred liquidity; (3) fee discounts; and (4) transparency/reporting obligations (of portfolio positions and/or portfolio exposures). With respect to liquidity, the Study focused solely on an investor's ability to redeem from a fund earlier than other investors (i.e., preferred liquidity), and not on other commonly seen liquidity-related side letter terms such as clarifications relating to gating, in-kind distributions and/or suspension clauses. The Study also did not cover other terms often seen in side letters that are of a regulatory or similar nature.

The most frequently observed business term within the Study was an MFN clause, which appeared in 55% (up from 47% in 2016/2017 Study) of the side letters (including in 52% of the Mature Manager side letters and 67% of the Newer Manager side letters). All of the MFN clauses contained a bundling or package concept providing that if a preferential term (e.g., a lower fee) was given to another investor contingent upon a less favorable term (e.g., a longer lock-up), the MFN holder would have to accept the bundle or package of rights, and could not select just the favorable term. The next most popular business term was a preferred liquidity clause, which moved up to second place from last place in the 2016/2017 Study. Preferred liquidity clauses were seen in 27% of all side letters (as compared to just 11.4% in the 2016/2017 Study and 6.8% in the 2015/2016 Study), with an approximately equal percentage representation across the two Manager categories. Moving down to third place from first place overall were fee discount clauses, which made up 24% of all side letters (down significantly from 49% in the 2016/2017 Study), with a similar percentage representation across the two Manager categories. 82% of the fee discount clauses covered both management fees and incentive allocations, while 18% applied only to management fees. This decrease in the frequency of fee discounts may indicate that fee levels are bottoming out across the industry. The least common side letter term was some form of lagged portfolio transparency/reporting obligation, which was seen in only 13% of the side letters (down substantially from 26% in the 2016/2017 Study), comprised of 10% of the Mature Manager side letters, but 33% of the Newer Manager side letters.



** Please refer to the qualifiers of some of these terms in the text in the preceding paragraph.*

IV. Comparison to Separately Managed Accounts

Certain institutional investors prefer investing with hedge fund managers via a separately managed account ("SMA") as opposed to investing directly through a hedge fund for a variety of reasons, including due to customized investment strategy needs, portfolio transparency requirements, tax reasons, and asset segregation preferences, among other things. Therefore, as part of the Study, we decided to look at SMAs entered into by our clients during the same period. The pertinent results were that: (1) 71% of the SMAs were with Mature Managers (down from 77% in the prior Study); (2) similar to the 2016/2017 Study, 64% of the SMAs were with funds-of-funds and 27% were with wealthy individuals/family offices; and (3) over 75% of the SMAs had fee structures typically not offered in the standard classes of hedge funds, including for example lower rates, sliding scale rates and/or hurdles on incentive fees.

We hope that you find *The Seward & Kissel 2017/2018 Hedge Fund Side Letter Study* helpful.
If you have additional input that you would like to share with us, or have any questions,
please contact your primary attorney in Seward & Kissel's Investment Management Group.

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