The Seward & Kissel 2015 / 2016 Hedge Fund Side Letter Study

Introduction

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, we have conducted a study, The Seward & Kissel 2015/2016 Hedge Fund Side Letter Study (the "Study"), covering side letters negotiated by our hedge fund manager clients during the period January 1, 2015 through June 30, 2016. Since 87% of the side letters in the Study were with managers in business for two or more years at the time the side letters were executed ("Mature Managers"), and 13% were with managers in business for less than two years ("Newer Managers"), we have focused the Study solely on the side letters with the Mature Managers where the number of such letters was large enough to extract a representative sample of important data points relevant to the hedge fund industry. We believe that the underrepresentation by Newer Managers may be attributable to the increase in the use of founders' classes over the past several years which, to some degree, may have decreased the need for many Newer Manager side letters. The Study is broken down into three parts: the Managers, the Investors and the Terms. The three parts of the Study, when read together, provide valuable insights into the negotiation of hedge fund side letters in the current environment.

Key Takeaways

- The average regulatory assets under management ("RAUM") of the Mature Managers in the Study was $4.5 billion;
- Funds-of-funds were the most commonly seen category of side letter investor;
- Most favored nations ("MFN") clauses and fee discounts were the two most frequent side letter business terms;
- Managers with at least $1 billion in RAUM ("Larger Managers") were much less willing to give fee discounts;
- Only 6.8% of the side letters offered preferential liquidity and none of those side letters were with Larger Managers; and
- Side letters with wealthy individuals/family offices contained MFN clauses 87.5% of the time and fee discount provisions 63% of the time, both of which were significantly above the overall averages for those two business terms.

(I) The Managers

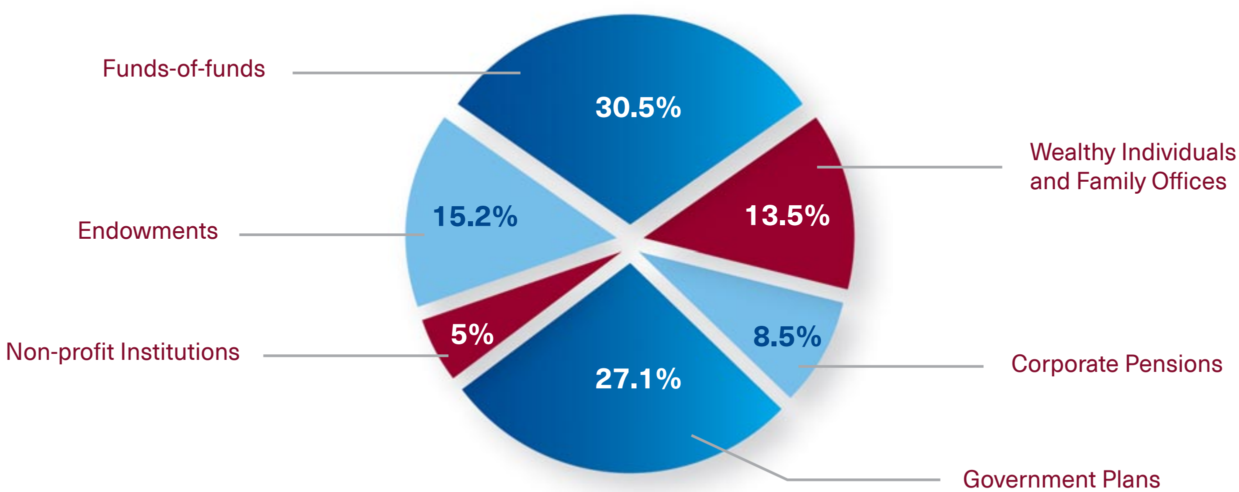
The average RAUM for the Mature Managers within the Study was $4.5 billion (based on their most recently filed Forms ADV) and approximately 88% of them were registered with the SEC as investment advisers, and the rest were exempt reporting advisers.

(II) The Investors

There were six principal side letter investor categories that consistently appeared within the Study: (1) wealthy individuals/family offices; (2) funds-of-funds; (3) government plans; (4) endowments; (5) corporate pensions; and (6) non-profit institutions.

The most frequent category of side letter investor was the fund-of-funds category, making up 30.5% of all side letter investors. Government plans represented 27.1% of side letter investors and the endowment category represented 15.2% of side letter investors. The next largest side letter investor category was the wealthy individual/family office category, which made

The Investors



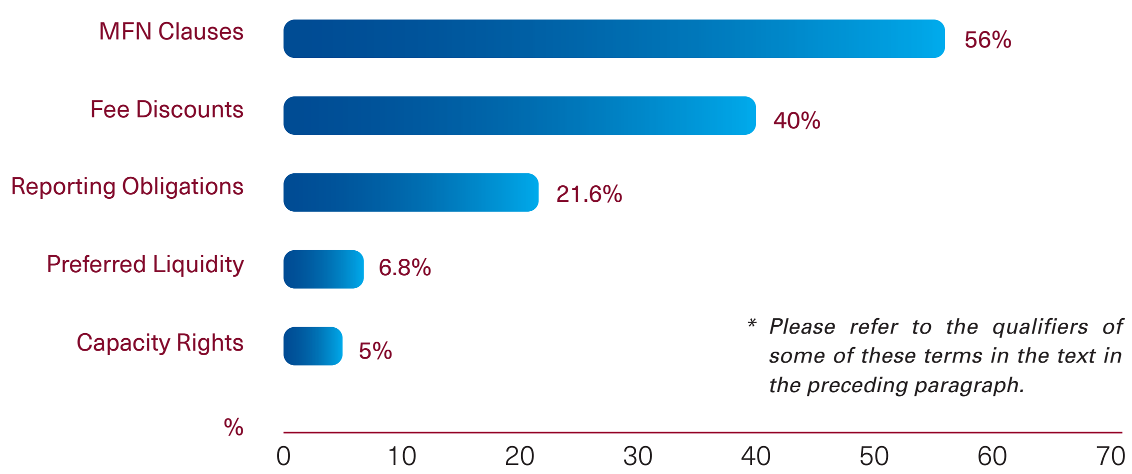
up 13.5% of all side letter investors in the Study. The final two side letter investor categories were corporate pensions at 8.5% and non-profits at 5% of the side letter investor total.

(III) The Terms

The Study focused on five principal business terms: (1) some form of MFN clause; (2) fee discounts; (3) preferred liquidity terms; (4) capacity rights; and (5) reporting obligations (either of portfolio positions or portfolio exposures). With respect to liquidity, the Study focused solely on an investor's ability to redeem or withdraw from a fund sooner than other investors (i.e., preferred liquidity), and not on other commonly seen liquidity-related side letter terms, such as clarifications of gating, in-kind distribution 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 seen business term within the Study was an MFN clause, which appeared in 56% of the side letters. With respect to the MFN clauses, 97% 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 common term involved fee discounts, which term was present in approximately 40% of the side letters (but in only 20% of the side letters with Larger Managers). Note that in a third of the side letters that included fee discounts, the discounts were contingent upon the side letter investor agreeing to a longer lock-up. Moreover, only one half of the side letters that included fee discounts gave it on both the management fee and the incentive allocation. The third most frequent side letter term was some form of reporting obligation, which was in approximately 21.6% of the side letters, and which can be further

The Terms*



broken down as follows: 5% of the side letters provided for complete portfolio transparency given monthly or quarterly, with a lag of between 10 and 60 days; 5% provided for the top five winners and losers either monthly or quarterly; 1.6% had complete transparency upon request (on timing to be agreed to by both sides); and 10% of the side letters contained lagged portfolio exposure reporting. Preferred liquidity terms appeared in 6.8% of the side letters, but in none of the side letters with Larger Managers. Lastly, capacity rights were found in about 5% of the side letters.

Our analysis of the business terms on an investor category-specific basis showed that, while in most cases the presence of the various business terms in side letters generally conformed to the overall averages shown above, there were a number of investor category outliers for MFN and fee discount clauses:

- MFN provisions were present in 87.5% of wealthy individual/family office side letters, 88.9% of endowment side letters and 69% of government plan side letters, but in only 33% of fund-of-funds and non-profit institution side letters; and

- Fee discount provisions were found in 63% of the side letters with wealthy individuals/family offices, but in only 20% of the side letters with corporate pensions and in none of the side letters with non-profit institutions.

We hope that you find The 2015/2016 Seward & Kissel 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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