SEWARD & KISSEL LLP

The Seward & Kissel 2018/2019 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 important trends impacting the hedge fund community. This year, for the fourth year in a row, we have conducted a Study covering side letters negotiated by our hedge fund manager clients during the period from July 1, 2018 through June 30, 2019 (the “Study”).

In the current Study, 81% of the side letters were with managers in business for two or more years at the time of execution (“Mature Managers”), and 19% were with managers less than two years old (“Newer Managers”). As we noted in last year’s study, we believe that the relative underrepresentation by Newer Managers in the data set is attributable primarily to the continued popularity of founders’ classes over the past several years which generally decreases the need for special terms in 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 for managers into the negotiation of certain terms 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 $4.9 billion (as compared to $4.8 billion in the prior study)
- While funds-of-funds continued to be the most common category of side letter investor, representing 37.5% of all side letter investors, this category has continued to trend downward
- A significantly higher percentage of Newer Manager side letters contained an MFN clause than in prior Studies
- There was a significant increase in side letters with government plans and corporate pensions, suggesting a revived interest in hedge funds by these types of investors
- Similar to side letters, in the context of separately managed accounts, funds-of-funds were the most common type of investor

(I) The Managers

Excluding certain outliers, the average RAUM of the Mature Managers in the Study was approximately $4.9 billion (as compared to $4.8 billion in the prior study), and all of the U.S.-based Mature Managers were registered with the SEC as investment advisers. With respect to Newer Managers, nearly 1/4 of them were SEC-registered (less than nearly 1/3 in the prior study). These data points seem to indicate an overall average higher assets under management level for Mature Managers, as managers strive to maintain sufficient capital to operate in a rising cost environment due to regulatory and investor demands.

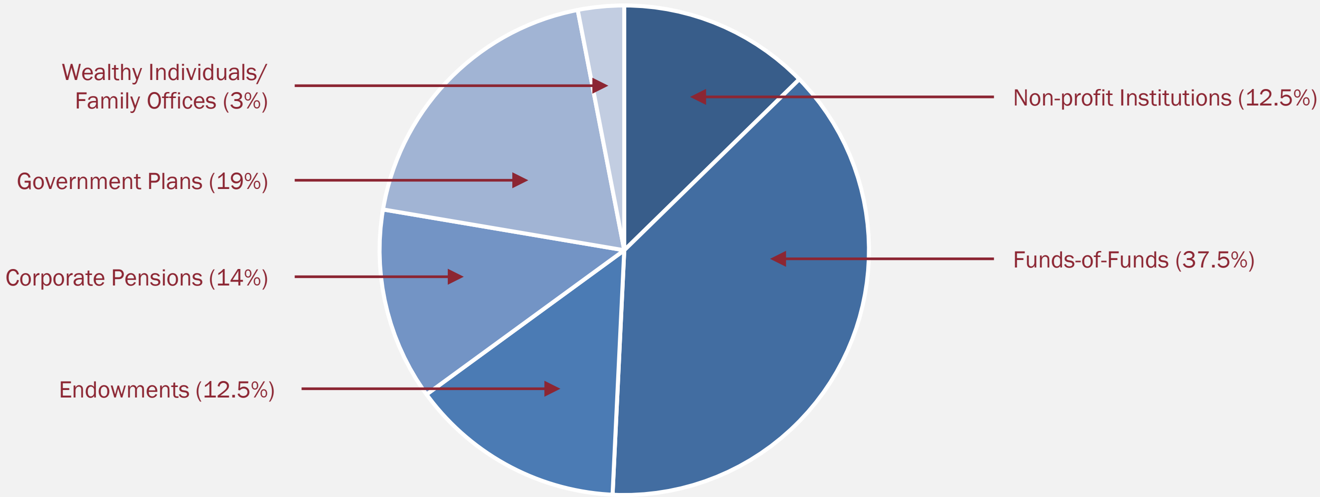
(II) The Investors

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) government plans; (3) corporate pension plans; (4) non-profit institutions; (5) endowments; and (6) wealthy individuals/family offices.

The largest category of side letter investor included in the Study was the fund-of-funds category, making up 37.5% of all side letter investors (which continues a downward trend from the 2016/2017 study (56%) and the 2017/2018 study (50%)). Note that for purposes of the fund-of-funds category, as in prior studies, 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. The second largest side letter investor category was government plans at 19%, which represented a significant increase from the 7% figure in the 2017/2018 study. Third place were corporate pension plans at 14% (up significantly from 4.8% in the 2017/2018 study and 3% in the 2016/2017 study). Tied for fourth were non-profits and endowments at 12.5% each, which is relatively consistent with the data from the 2017/2018 study when these categories were at 14.2% and 12%, respectively. Finally, the smallest side letter investor category was wealthy individuals/family offices at 3% (down significantly from 12% in the 2017/2018 study and 6% in the 2016/2017 study).

Analyzing trends separately for Mature Managers and Newer Managers, some interesting takeaways were that: (1) there was a significant increase in side letters with government plans and corporate pension plans, suggesting a revived interest in hedge funds by these types of investors; (2) 100% of the side letters with government plans and endowments were with Mature Managers; and (3) 50% of the Newer Manager side letters were with funds-of-funds (down from 75% in 2017/2018), which represented 25% of all the funds-of-funds side letters analyzed.

The Investors

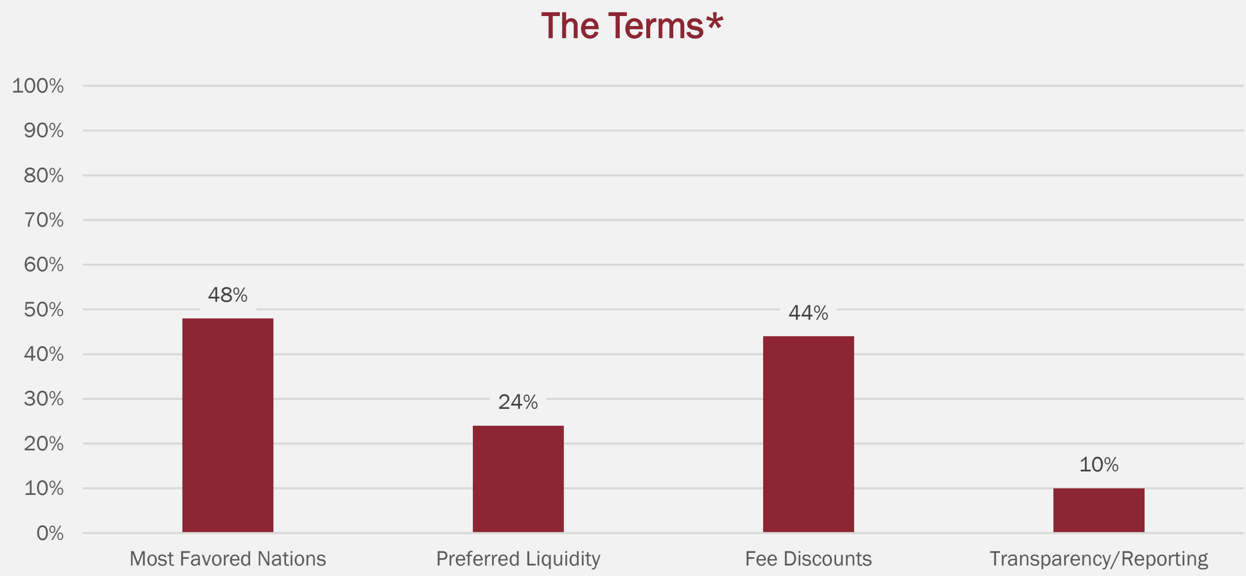


(III) The Terms

The Study focused on four principal business terms: (1) some form of most favored nations protection ("MFN clause"); (2) fee discounts; (3) preferred liquidity and (4) transparency/reporting obligations (of portfolio positions and/or portfolio exposures). With respect to liquidity, the Study solely focused 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 tax, regulatory or similar nature.

The most frequently observed business term within the Study was an MFN clause, which appeared in 48% (down from 55% in 2017/2018 Study) of the side letters. MFN clauses were included within 39% of the Mature Manager side letters (as compared to 52% in 2017/2018) and 90% of the Newer Manager side letters (as compared to 67% in 2017/2018). The significant increase in the percentage of Newer Manager side letters with MFN clauses suggests that, despite frequently receiving founders fees, institutional investors investing with Newer Managers are continuing to insist on MFN protection. 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 common term was fee discount clauses, which were included in 44% of all side letters (up significantly from 24% in the 2017/2018 study, but generally consistent with the 49% in the 2016/2017 study), with a similar percentage representation across the Mature and Newer Manager categories. 64% of the fee discount clauses covered both management fees and incentive allocations, while 36% applied only to management fees or incentive allocations (up significantly from 18% in 2017/2018). Preferred liquidity terms were the next most common, appearing in 24% of all side letters (down slightly from 27% in 2017/2018). This term was more common in Newer Manager side letters (36%) than in Mature Manager side letters (21%). The least common side letter term was some form of lagged portfolio transparency/reporting obligation, which was included in only 10% of the side letters (down from 13% in the 2017/2018 Study). This term was significantly more common in Newer Manager side letters, appearing in 45% of those in the data set. The higher prevalence of portfolio-level transparency terms in Newer Manager side letters than in Mature Manager side letters suggests institutional investors require more extensive diligence and monitoring with respect to funds managed by Newer Managers than they do for funds managed by Mature Managers.



** 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 engaging a hedge fund manager to manage a separately managed account ("SMA") as opposed to investing directly in a hedge fund. The reasons for this preference include, among other things, the need for a customized investment strategy or portfolio transparency, tax considerations, and asset segregation preferences. Therefore, as part of the Study, we analyzed the use of SMAs by study participants during the same period.

The pertinent results from this study were that: (1) 67% of the SMAs were with Mature Managers (down from 71% in the prior study); (2) similar to the 2017/2018 Study, 59% of the SMAs were with funds-of-funds and 28% 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 2018/2019 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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