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The Tipping Point: The Hedge Fund Investor's Struggle for Legal Balance

by Jedd Wider

While the 2007 hedge fund industry has been marked by recently unparalleled levels of volatility due to the credit crisis and other economic factors, institutional investor allocations to hedge funds have increased dramatically year to date over the same period of 2006 with $126.5 billion of inflows for 2006 compared to $164 billion of inflows through the first three fiscal quarters of 2007.[1] As of September 2007, hedge fund assets were approximately $1.74 trillion,[2] a remarkable increase over 2000 when hedge funds managed approximately $490 billion in assets.[3]

As institutional investor allocations to the hedge fund industry continue to grow and hedge funds continue to become a core allocation strategy for government public pension plans, private pension plans, university endowments, foundations and family offices, legal due diligence on hedge funds targeted for investment together with the review and negotiation of their underlying legal documents and offering terms have become a routine part of the investment process and review of most significant institutional investors.

With the passage of the Pension Protection Act of 2006 and the liberalization of the calculation of significant benefit plan investor participation, the ability of hedge funds to accept enhanced levels of capital from government public pension plans, foreign plans and nonelecting church plans was secured.[4] As institutional investors have secured their perch as the predominant investor role players of the industry through their progressive step-in-step enhanced allocations over the past decade, hedge fund managers have begun to understand

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the importance of offering investment and legal terms and conditions that are required by these investors as well as to make appropriate accommodations with respect to important business and legal issues. This article addresses certain select customary terms and conditions that institutional investors should consider as part of their legal and business due diligence in connection with their investments into hedge funds and discusses the legal rationale for many of those terms.

Although many US and non-US hedge funds provide for legal terms and conditions that many institutional investors would deem acceptable and in parity with their sister private equity fund offering terms, including those terms relating to the Employee Retirement Income Security Act of 1974, as amended (ERISA), the US Internal Revenue Code of 1986, as amended (the Code), the US Bank Holding Company Act of 1956, as amended, the various rules, regulations, policies and orders of the US Federal Communications Commission, and various other terms and legal issues, many hedge funds still provide offering terms on a modified "take-it or leave-it" basis without providing any investor-level differentiating basis for such decisions. Often side letter comfort is either extremely limited or not provided at all on the premise that side letters encourage enhanced scrutiny by the applicable state and federal regulatory authorities including the US Securities and Exchange Commission (SEC). It is this type of approach to investor negotiation that fails to properly consider the individualized needs of each investor, many of whom require state public records act clarifications to the fund's confidentiality provisions, proper notifications and reports under ERISA, certain tax covenants relating to investments, reportings and filings and structure as well as other clarifications and terms which have long been accepted as market in the private equity fund industry.

To understand how hedge fund documentation has generally failed to develop over the last several years on the private investment fund evolutionary scale, one must simply line up a limited partnership agreement of a recognizable hedge fund manager next to that of a comparable private equity fund manager—the legal shortcomings are evident at a quick glance. Liquidity and the right of an investor to redeem its capital from a hedge fund cannot be the only justifiable rationale for such inequities. It is in this context that it is critical for investors to understand the value of such legal examination and diligence. It is also important for managers to appreciate the importance of these issues. Many of these terms are sought by investors simply to satisfy their own fiduciary obligations as well as to achieve a sense of equity and fair treatment with other investors in the fund.

These terms and conditions often differ greatly based on the nature of the investors and the types of funds they have targeted but often include issues relating to liability exposure, redemption rights, fund investment parameters and strategy drift, portfolio valuation methodology, reports and transparency, regulatory issues and concerns, and conflicts of interest. These issues regularly include but are typically not limited to:

- Limits on investment strategy drift and investment parameters
- Key person provisions
- In-kind distributions of securities
- Indemnification and exculpation conduct and standards
- Valuation of illiquid securities
- Restrictions on allocations to funds-of-funds and other pooled investment vehicles
- Redemption rights
- Conflicts of interest
- Rights to inspect books and records of a fund
- Brokerage commissions and soft dollars
- Transfer rights
- Legal opinions

Limits on Investment Strategy Drift and Investment Parameters

Most hedge funds will specifically disclose in their offering memoranda the specific investment strategy or strategies employed by the fund including use of leverage and debt exposure, geographic concentrations and diversification, and concentration limitations with respect to particular single issuers, geography, or industries. Although the disclosure in the memoranda may simply be informative, often it is not drafted in the form of a hard cap or a contractual obligation on behalf of the manager to limit the fund's investments to those target levels specified in the memoranda. Often those levels are not specified in the fund's underlying operative agreement. A customary provision in a fund's offering materials may provide that "the fund seeks to limit investments to issuers located outside the United States, Asia and the EU to [__]% of the fund's net assets." This is generally not a strict restriction and the fund may typically exceed this percentage limitation in its sole discretion. Many investors, depending on the investment

strategy and investment objectives of the fund, often will seek to limit volatility and investment overexposure by attempting to place strict limitations on the fund's investments including those with respect to:

1. Investments in particular geographical regions;
2. Investments in a single issuer; and
3. Investments in securities for which a market price may not be readily obtainable (for example, illiquid securities appropriate for a standard "side pocket").

Private equity investments typically allocated to a side pocket for management fee and performance fee calculation purposes and liquidity purposes are an important area for examination by investors. It is important to carefully scrutinize the valuation methodology employed by the manager with respect to these illiquid investments to ensure a disciplined and transparent process, the restrictions affecting an investor's rights to redeem from these illiquid investments, the basis of such investments for the calculation of management fees and performance fees, as well as the fund's treatment of the loss carryforward provision with respect to such investments in the event of a full redemption by an investor from the fund's liquid portfolio.

In addition, institutional investors may seek to ensure that the fund's detailed investment strategy does not "shift" away from the strategy disclosed in the fund's offering memorandum or operative agreement. To the extent that such modifications to the fund's investment strategies do not require consent of the investors in the operative agreement of the fund, many investors will seek modification of the underlying operative agreement or comfort in a side letter that such style drift will require such investor's consent or, in the alternative, provide for withdrawal rights. Additionally, a fund's use of leverage may be broadly provided for in the fund's offering memorandum or operative agreement without limitation thresholds. Although such limitations may not be appropriate in many circumstances, investors may seek clarifications of the fund's investment strategy and in many instances, restrictions on the employment of various levels of leverage under appropriate circumstances.

Key Person Provisions

A significant percentage of hedge funds in the market do not provide for a broad "key person" provision in the fund's operative agreements—a provision that can cause accelerated withdrawal rights on behalf of an investor as well as prompt notification if a key person:

1. Voluntarily or involuntarily leaves the fund, whether for cause or not for cause;
2. Dies or becomes permanently disabled or incapacitated for a specified period of time;
3. Ceases to devote substantially all of his/her time to the business activities of the general partner and/or manager;
4. Is declared bankrupt by a court with appropriate jurisdiction or files a petition commencing a voluntary case under any bankruptcy law; or
5. Is convicted of or pleads *nolo contendere* to a felony, or commits a violation of any applicable federal or state securities law.

To the extent that the fund does provide for a key person provision, the net effect of a key person trigger event is often simply prompt notification to the investor of such event, not accelerated withdrawal rights immune from any gating provision. Often if the fund does not provide for a key person event or simply provides for prompt notification of such event, many investors will generally seek a provision providing the investor with the right to promptly redeem its interests in the fund without penalty or other charge (including during any lock-up period) upon the occurrence of such events to the extent there are identifiable key persons.

In-Kind Distributions of Securities

Most hedge funds reserve the right to make distributions and satisfy redemption requests by paying all or a portion of such proceeds to investors in cash and securities. It is important to carefully examine the distribution provisions of the fund's operative agreements to ensure that if the general partner and/or investment manager of the fund is able to make in-kind distributions in its sole discretion, it does not have the right to make disproportionate distributions of illiquid securities or disproportionate cash and illiquid securities among its redeeming investors as of any particular withdrawal date. Many institutional investors are not able to or are unwilling to accept distributions of in-kind securities in satisfaction of a withdrawal. In such cases, many investors will require the fund's manager or general partner at the request of the investor to agree to liquidate such

in-kind distributions on behalf of the investor prior to distributing such securities.

Indemnification/Exculpation—Conduct and Standards

Most institutional investors are well-focused on the standards of care and indemnification and exculpation provisions applicable to the general partners, directors and/or investment managers of hedge funds. In many instances, investors are calling for parity with the standards they are used to analyzing on the private equity fund side of their portfolios and demanding heightened standards of care. Most hedge funds typically provide that the general partner and/or investment manager will be fully indemnified and exculpated by the fund provided that their actions do not constitute gross negligence, willful malfeasance or misconduct, fraud, bad faith, and/or dishonesty. Investors seeking to further insulate themselves from liability exposure also have sought additional carveouts from such indemnification provisions for such matters as violations of applicable law (including securities and criminal laws), material breaches of the applicable operative agreements (*e.g.*, limited partnership agreements, limited liability company agreements, and investment management agreements) and failure to hire, retain, and monitor fund experts, consultants, and agents with reasonable care.

In addition, many investors often will seek to eliminate indemnification provisions that require a material adverse effect to occur with respect to certain bad acts by the general partner/investment manager in order for a carveout to such indemnification to be effective. Additionally, indemnification advances made to indemnified parties should be carefully examined to ensure that indemnification advances are not being made under inappropriate circumstances including: (1) those relating to internal lawsuits between affiliates of the general partner and/or investment manager where investors should be insulated from funding such internal management disputes and (2) actions brought by a majority of the investors in a fund. The funding of any indemnification expenses also should be subject to the fund first exhausting its alternative sources of insurance and liability recovery before charging the fund for any such indemnification expense or cost.

Lastly, investors should carefully scrutinize the survivability of indemnification provisions in order to determine what liabilities exist for the investor after fully redeeming from the fund. In many instances, funds provide for an investor clawback provision requiring the investor to return distributions to the fund often up to the amount of its capital account at the time of withdrawal including any prior distributions made to the investor. Sometimes the clawback obligation will be capped by a period of time (*e.g.*, one year following full withdrawal) and other times the obligation will run indefinitely.

Valuation of Illiquid Securities

Illiquid investments and the increasing percentage of hedge funds and hybrid funds permitting significant percentages of their assets under management to be invested in illiquid securities has highlighted certain important issues for investors in the wake of greater convergence of private equity funds and hedge funds. Among these issues is the valuation methodology utilized by these funds with respect to the illiquid securities held by such funds. Many sophisticated investors regularly require that a disciplined valuation process for illiquids be implemented that is both transparent and logical. This issue becomes more acutely important when management fees and/or performance fees are charged to illiquid investments and when analyzing the processes implemented by a fund to sweep such illiquid investments back and forth between a fund's liquid account and its side pockets. Often, institutional investors will demand that a fund's actual valuations of its illiquid investments be confirmed by independent third party valuation experts. This is largely attributable to the fact that many funds provide that illiquid securities generally will be valued by the investment manager in its sole discretion absent readily available market or dealer quotations. Institutional investors continue to request that:

1. Illiquid investments be made through side pockets designed to hold such investments and that incentive allocations not be made with respect to such illiquid investments until such securities can be readily valued or have been disposed of;
2. For purposes of charging the management fees with respect to such illiquid securities, such securities not be marked-to-market but rather carried at cost until a valuation or disposition event; and
3. Independent valuations of illiquid securities be obtained by the fund manager prior to receiving any incentive fees/allocations in relation to such investments.

Restrictions on Allocations to Funds-of-Funds and Other Pooled Investment Vehicles

Many hedge funds that have broadly detailed investment strategies that trade directly at the fund vehicle level do not restrict the fund's right to allocate capital to underlying fund-of-funds vehicles or other pooled investment vehicles. Further, where this type of prohibition does not exist, most do not provide for a full offset of management and performance related fees at the fund level with respect to any such capital allocated to such fund-of-funds or other pooled vehicles.

While most investors sign on to a "direct" investment fund with the understanding that only a single layer of fees will be charged, others may or may not understand that such additional diversification is an integral part of the fund's investment strategy. When such diversification is not clearly specified in the fund's offering documents, many investors will seek either a restriction on such allocations or a full offset of management and performance fees at the fund level in order to ensure only one layer of fees. In addition, when fund offering documents do not specifically preclude a fund's right to allocate capital to other unaffiliated or affiliated managers in the form of a discretionary managed account, many institutional investors also will seek to restrict such allocations or secure an offset at the fund level of all fees chargeable by such underlying managers with respect to such allocated capital.

Redemption Rights

Certain enhanced redemption rights provided to investors will require appropriate disclosure in a fund's offering documents. If a fund provides for limited withdrawal rights or a lengthy hard lock-up period, negotiating for enhanced liquidity may become an important part of an investor's protective positioning as an investor in that fund. In circumstances in which bad acts have been committed by the fund manager or its affiliates, a key person event has occurred, performance has dropped below a specified level or reputational harm has resulted from certain fund or fund manager actions, the need to extricate oneself from a fund and redeem one's interests without fee or penalty becomes of paramount importance. Often these enhanced redemption rights are implemented despite a gating restriction or minimum redemption threshold and may be triggered upon:

1. A breach of fiduciary duty or violation of applicable securities law by the general partner or fund manager;
2. A change in ownership and/or control of the general partner or the fund manager;
3. The bankruptcy or insolvency of the general partner or fund manager;
4. A material decline in value of the assets under management of the fund over a specified period of time; and
5. A felony conviction of any principal or personnel of the general partner or fund manager.

Conflicts of Interest

Although many hedge funds will provide for policies and procedures to resolve actual or potential conflicts of interest involving the fund, general partner, board of directors, manager, principals, and employees and their affiliates, often these resolution mechanisms will involve simply the general partner or manager exercising its reasonable and good faith judgment consistent with its fiduciary duties to resolve such conflicts. When principal trades or cross-trades may be involved, a committee of unaffiliated investors, each underlying investor or an independent party on behalf of investors may be asked to determine such conflicts or provide consent to such transactions or an independent third-party valuation expert may be retained to value applicable securities.

When personal account trading by principals and employees of the fund and manager is permitted, unregistered fund managers are subject to Section 206 of the Investment Advisers Act of 1940, as amended (the Advisers Act) and Rule 10b-5 under the Securities Exchange Act of 1934, as amended (the Exchange Act) while registered fund managers are further subject to Rule 204A-1 and Rules 204-2 under the Advisers Act, among other provisions.

Although fund managers are subject under most circumstances to regulatory restrictions relating to conflict issues as well as antifraud statutes, prior to investing in funds that have material conflicts of interest, many institutional investors will further require that the fund implement detailed conflict resolution policies and procedures. These policies and procedures may vary based on the nature of the conflicts, the state or federal registration status of the fund manager, the investment strategy of the fund as well as certain applicable factors involving ERISA and the Advisers Act.

Rights to Inspect Books and Records of the Fund

Not all jurisdictions and operative fund agreements provide the right to an investor to inspect the books and records of a fund without the prior approval of the fund's board of directors, investment manager, or general partner. As a result, many institutional investors will seek to secure such rights as a defense to potential bad acts by the fund's general partner or investment manager but also to enable the right to inspect the fund's valuations and fee calculations under certain circumstances and assure compliance with the fee methodology specified in the fund's operative agreements. It is important in securing such rights to ensure that in a master-feeder structure, the master fund's books and records including the investor and shareholder lists and contact information are obtained as well, especially when the allocations of fees and expenses are made at the master fund level and certain voting provisions at the feeder fund and master fund level require the aggregate vote of all investors or shareholders of the master fund.

Although inspection rights may be less of a priority for those institutional investors who limit their allocations to those hedge funds that provide for frequent liquidity and limited lock-up periods, securing inspection rights becomes of greater concern when funds place more significant limitations on redemption rights and longer lock-up periods. It is under the latter set of circumstances that institutional investors sensitive to reputational risk and harm may be more concerned especially if such inspection rights can serve effectively to deter or mitigate the consequences of a fund manager's fraudulent activities or misconduct.

Brokerage Commissions and Soft Dollars

Many institutional investors seek to limit a fund manager's use of soft dollars. Such limitation typically takes the form of an outright restriction on soft dollar use or a covenant by the fund manager to restrict such use to those brokerage and research services within the safe harbor of Section 28(e) of the Exchange Act.[5] Some investors also will require periodic reports specifying soft dollar usage over a certain negotiated period. It is very important that the brokerage practices section of a fund's offering materials be carefully examined in order to ensure that certain unexpected brokerage "services" (for example, salaries and office rent) are not being provided to the fund in exchange for higher broker-dealer commissions than those otherwise available in the market.

Transfer Rights

The right of an investor to transfer its interests in a fund to affiliates and unaffiliated third parties is generally addressed in the fund's operative agreements and is often subject to the sole discretion of the general partner, directors or investment manager of the fund. Investors for whom the transfer right is important for regulatory, tax and/or other commercial reasons, often will seek enhanced transfer rights in a side letter. Such rights commonly provide that the general partner, directors and/or investment manager of the fund may not unreasonably withhold their consent to the transfer of its interests to affiliates and non-affiliated third parties subject to the transferee satisfying the qualification standards specified in the subscription agreement.

Additionally, one must carefully examine the transfer provisions involving transfers to multiple transferees. Under such circumstances, many funds will often limit the number of transferees and frequency of transfers and require the original transferor to remain liable for the obligations of the transferee.

Legal Opinions

Few hedge funds regularly provide tax, ERISA, securities, and corporate opinions to their new investors while most investors in private equity funds commonly require that funds deliver such legal opinions as of the closing date. Although the legal rationale for the provision of such opinions is generally identical in both the private equity fund and hedge fund industries, opinions are less frequently provided in connection with a hedge fund closing. Notwithstanding the foregoing, many institutional investors will routinely request that funds provide opinions on such matters as:

1. Due formation and good standing of the fund, the investment manager and/or the general partner and the valid power and authority of the fund, general partner and investment manager to perform their duties and obligations under the offering documents;
2. Offer, issuance, sale, or delivery of the fund's securities not requiring registration under the US Securities Act of 1933, as amended;

3. Limited liability of the investor;
4. Fund not being an "investment company" within the meaning of the Investment Company Act of 1940, as amended, which is not required to register with the SEC;
5. Under certain circumstances, the fund being treated as a partnership and not as an association taxable as a corporation for US federal income tax purposes; and
6. Under certain circumstances, the underlying assets of the fund not being considered plan assets of any ERISA investor for purposes of certain sections of ERISA and the Code.

The provision of these opinions can act as additional comfort and assurances to the investor especially where the fund manager's lack of legal expertise or knowledge would otherwise limit the investor's ability to rely on related representations, warranties, and covenants of the fund manager.

Conclusion

Hedge fund legal due diligence by institutional investors has consistently become more sophisticated over the last several years as capital allocations to the industry have grown dramatically over the same period. As institutional investors strive to achieve parity with their sister private equity fund investors in an industry that traditionally has turned its head away from investor over-accommodation, investors must continue to push for those terms and conditions that enable them to properly protect themselves against potential market downturns and fiduciary and regulatory breaches. It is only through a continued standardization of investor issues, careful accommodations and documentation that a proper balance can be reached between investor and manager, one that will serve to more productively and effectively shift the industry.

NOTES

1. Lawrence C. Strauss, "Pension Plans Play Catch-Up," *Barron's*, Oct. 29, 2007, at 45.

2. Pensions & Investments, *PIonline.com*, Oct. 9, 2007.

3. Hedge Fund Research (HFR) Year End 2006 Industry Report.

4. The Pension Protection Act of 2006 broadened the calculation of significant benefit plan investor participation in private investment funds by limiting the definition of benefit plan investors to only (i) plans subject to the fiduciary provisions of the Employee Retirement Income Security Act of 1974, (ii) plans subject to the prohibited transaction rules of the Internal Revenue Code of 1986, as amended and (iii) entities (*e.g.*, private hedge funds) deemed to hold plan assets under the US Department of Labor's regulations. As a result, governmental public pension plans, foreign plans and certain church plans were removed from the calculation.

5. Section 28(e) provides generally that no person in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or breached a fiduciary duty under state or federal law "solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion."

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