Morgan Lewis

# ADVANCED TOPICS IN HEDGE FUND PRACTICES CONFERENCE

## Manager and Investor Perspectives

### NEW YORK

Tuesday, June 11, 2024

# Hedge Fund Terms

## Speakers

**Gregg S. Buksbaum**
+1.202.739.5080
gregg.buksbaum@
morganlewis.com

**John D. Cleaver**
+1.212.309.6931
john.cleaver@
morganlewis.com

**Christopher J. Dlutowski**
+1.212.309.6046
christopher.dlutowski@
morganlewis.com

**Justine Le**
+1.617.341.7589
justine.le@
morganlewis.com

# Agenda

## Fundraising

## Terms

- Management Fees
- Performance Compensation
- Liquidity
- Fiduciary Duties, Exculpation, and Indemnification
- Confidentiality
- Transparency

## Side Letters

## GP Seed and Stake Arrangements

# Update on Hedge Fund Terms: Fundraising Environment

- Despite lingering fear of recession, high interest rates and stubborn (above 3%) inflation, hedge fund industry AUM at record high
  - Total Hedge Fund Industrywide AUM: $4.4 trillion
  - 4.6% increase since end of 2022
  - Preqin estimates that hedge fund interest will grow at annual rate of 3.6% between end of 2022 and 2028, to an estimated $5.2 trillion
- Hedge funds returned 6.4% over first 3 months of 2024, during positive equity environemnt
- Hedge funds also providing downside protection for turbulent market over past 1-2 years
- Strategy Leaders: Equities, Event-Driven, Credit, Multi-strategy, Relative Value
- Strategy Laggards: Macro, Commodities, Foreign Exchange
- Geographic Leaders: North America
- Geographic Laggards: Europe, Asia-Pacific

Source: *Preqin* – 2024 Global Report, Q1 2024 Quarterly Report

# Update on Hedge Fund Terms: Fundraising Environment

Considerations for Fund Managers and Investors:

**Uncertain macro-economic environment with monetary policy changes, banking sector instability, and geopolitical tensions**

**Equities up to start 2024, but longer-term volatility in public markets in recent years**

**Number of new managers continues to be down from 2017 peak (but number of funds in market is stable)**

**Lower fees and uncertainty over next steps in light of Fifth Circuit decision – pressures on smaller/newer managers**

**In recent years, allocations slowed in favor of other alternative asset classes – tide may be turning given strong performance to begin 2024**

**Positive performance to start 2024 causing investors to consider larger allocations – more anticipated $50M+ and $100M+ deployments**

# Management Fees

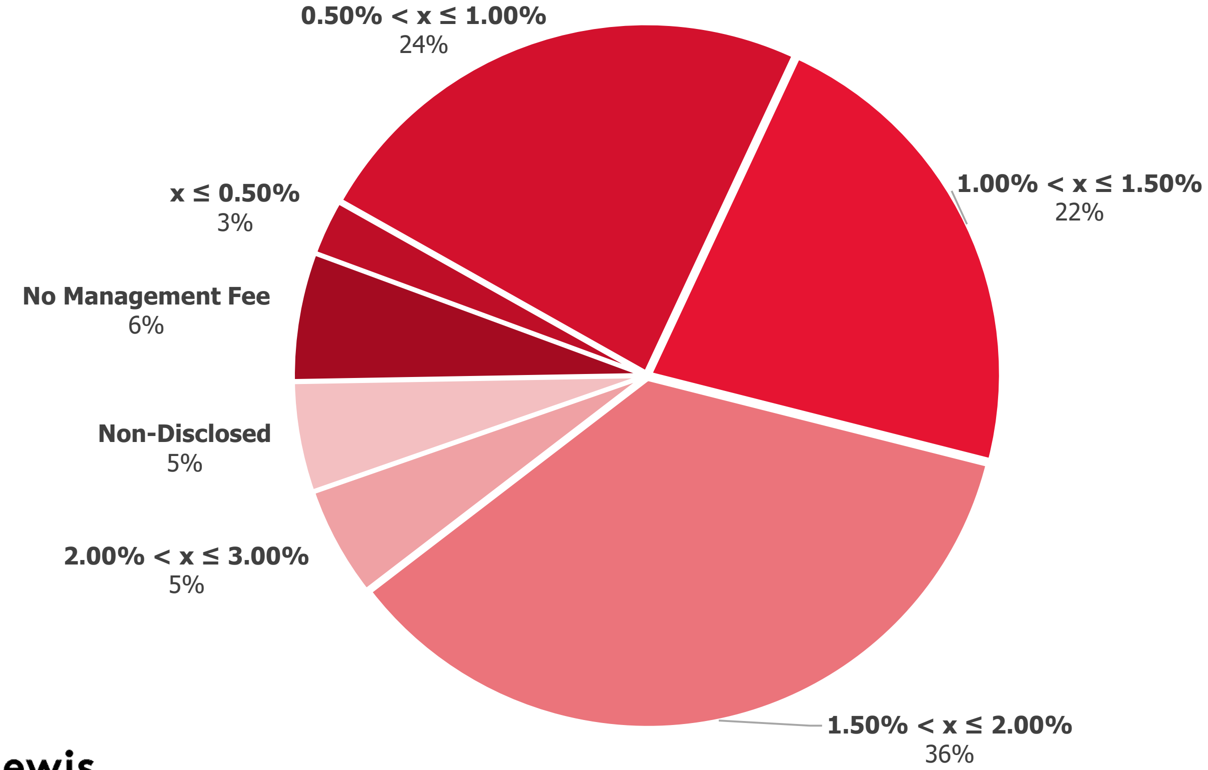
## Management Fees

- Continued downward pressure on management fee rates
  - Average management fee in 2023: 1.3% *
- Expanded use of tiered fees, with a sliding rate scale tied to investor NAV or net contributions
- Expanded use of multiple classes
  - Higher management fee rates tied to lower rate of (or no) performance compensation
- With the Fifth Circuit decision in mind, will managers move away tying management fee rates to liquidity terms?

*Source: *Preqin* – Preqin Global Report, Hedge Funds, 2024

# Management Fees

% "Base" Subscriber '22 - '24



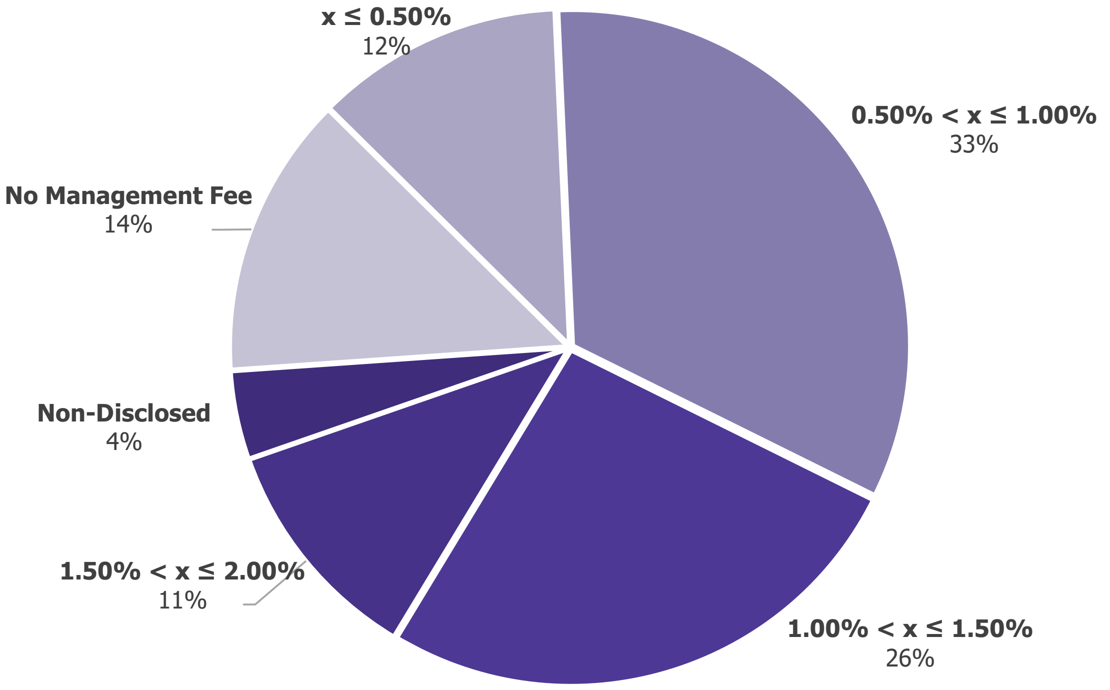
# Management Fees

## Management Fees

- Calculated and payable monthly or quarterly is the norm
- Discounts and waivers
  - Affiliated investors: principals, employees, family members, etc.
  - Founders and seed and anchor investors
  - Large-ticket investors and other strategic investors, including marquee names and loyal investors
  - GP stake investors

# Management Fees

% "Base" Subscriber

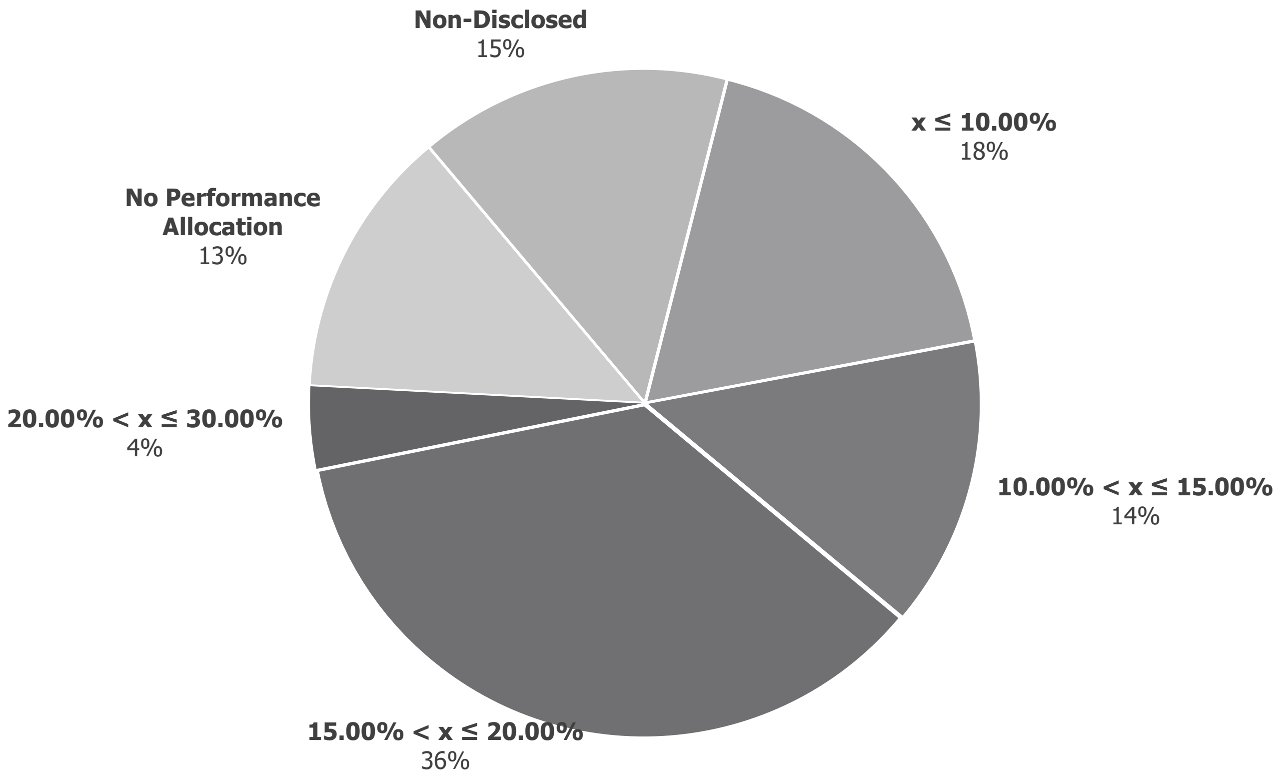


# Performance Compensation

- Continued downward pressure on performance fee rates
- Use of multiple-class structures
- Lower performance compensation rates tied to higher management fee rates
- Occasionally, highest performance compensation rates tied to no management fee
- Loss carryforwards/high-water marks remain market standard
- With Fifth Circuit decision in mind, will managers continue to tie performance fee rates to liquidity terms?

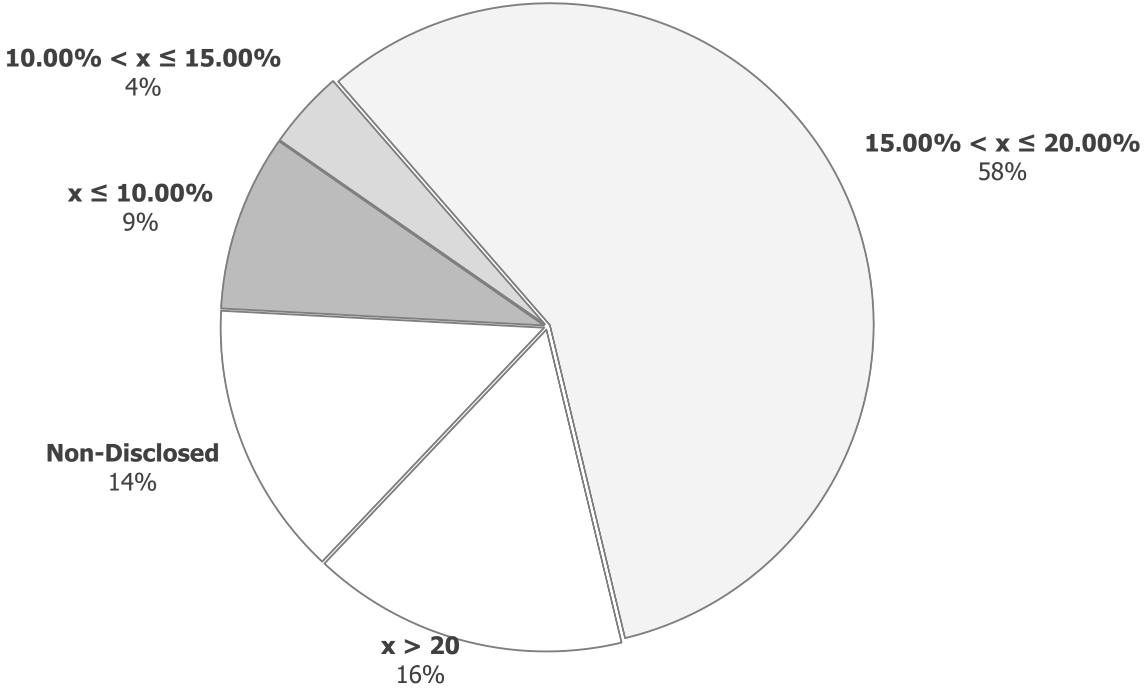
# Performance Compensation

## Performance Allocation Lowest Rate - No Hurdle



# Performance Compensation

## Performance Allocation Highest Rate - No Hurdle



# Performance Compensation

## Hurdles and benchmarks, different permutations

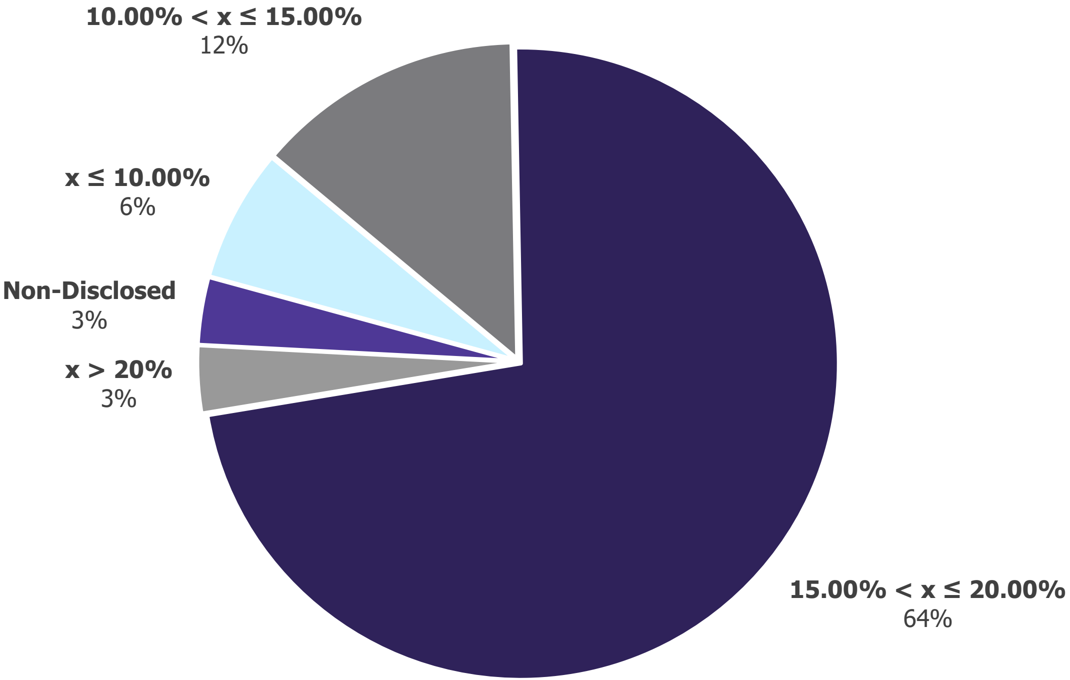
- Hurdles may come with higher performance rates
- Annual reset of hurdles
- Outperform benchmark, but negative performance = payment of performance?

## Alternative approaches

- Multiyear (e.g., 2-3 year) crystallization structures
  - Longer-term strategies, matching lockup period, subject to clawback
- "1 or 30" approach – not supplanting "2 and 20"
- Performance compensation paid on side pockets/designated investments upon realization

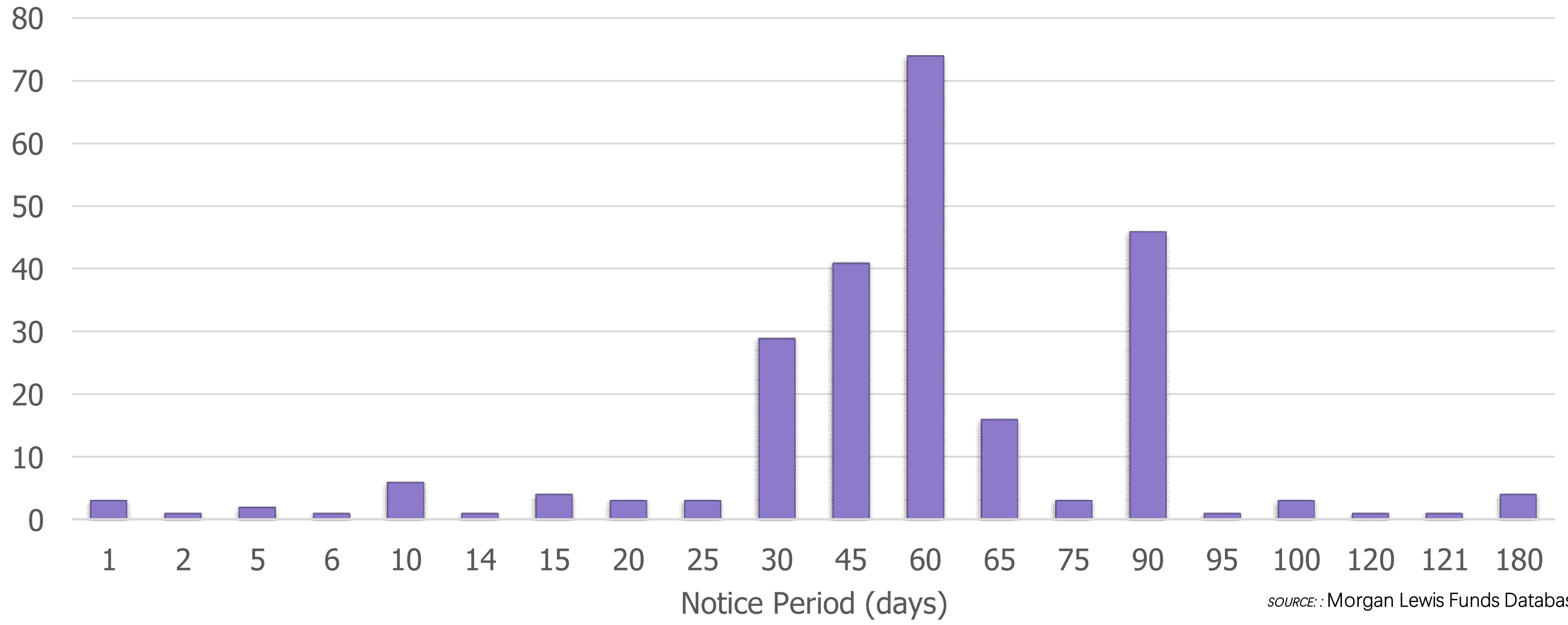
# Performance Compensation

## Performance Allocation Highest Rate – Hurdle Met



# Liquidity: Notice

## Notice Period




*SOURCE: :* Morgan Lewis Funds Database

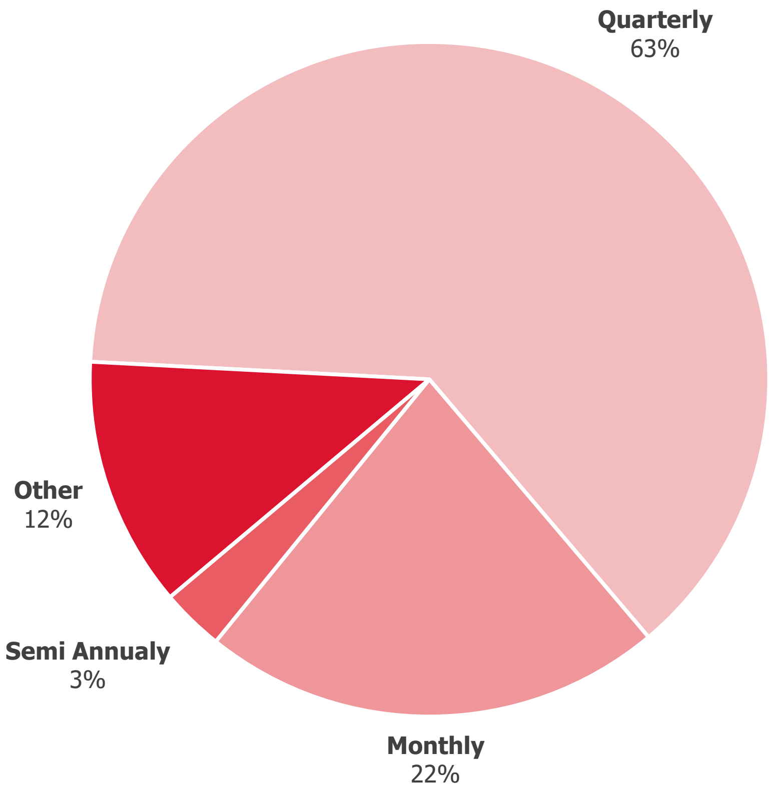
# Liquidity: Notice

**Notice**

- 30-60 days remains the norm
- Trend toward less notice continues (such as 5 or 10 days) for more liquid funds

# Liquidity: Frequency

## Frequency




SOURCE: MORGAN LEWIS FUNDS DATABASE

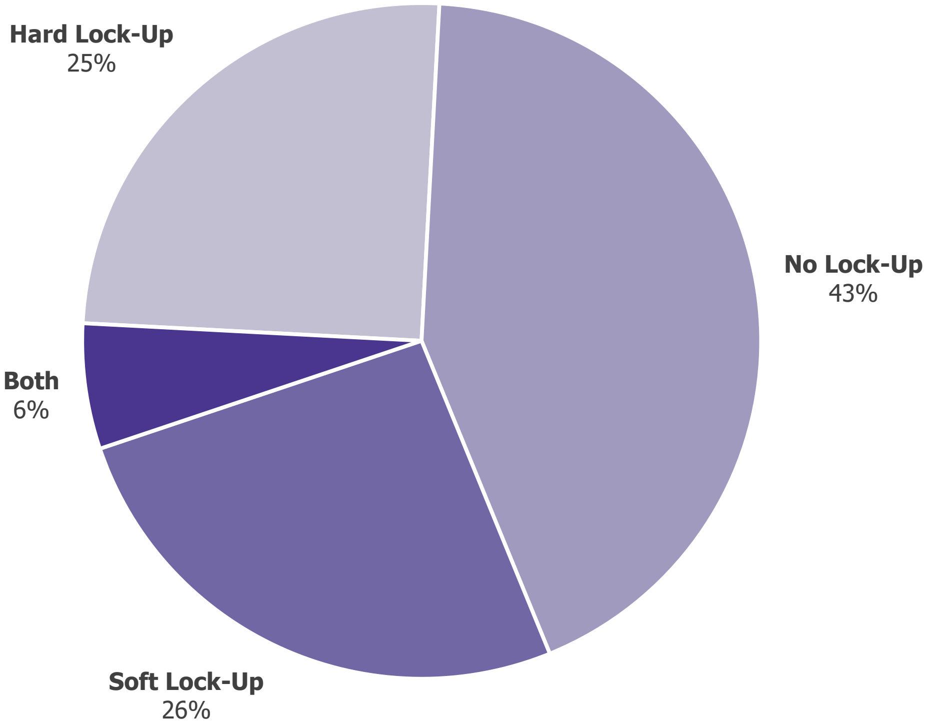
# Liquidity: Frequency

**Frequency**

- Monthly or quarterly remains the norm
- Trend toward more frequency (such as weekly, even daily) for more liquid funds

# Liquidity: Lock-ups

## Lock-up Type



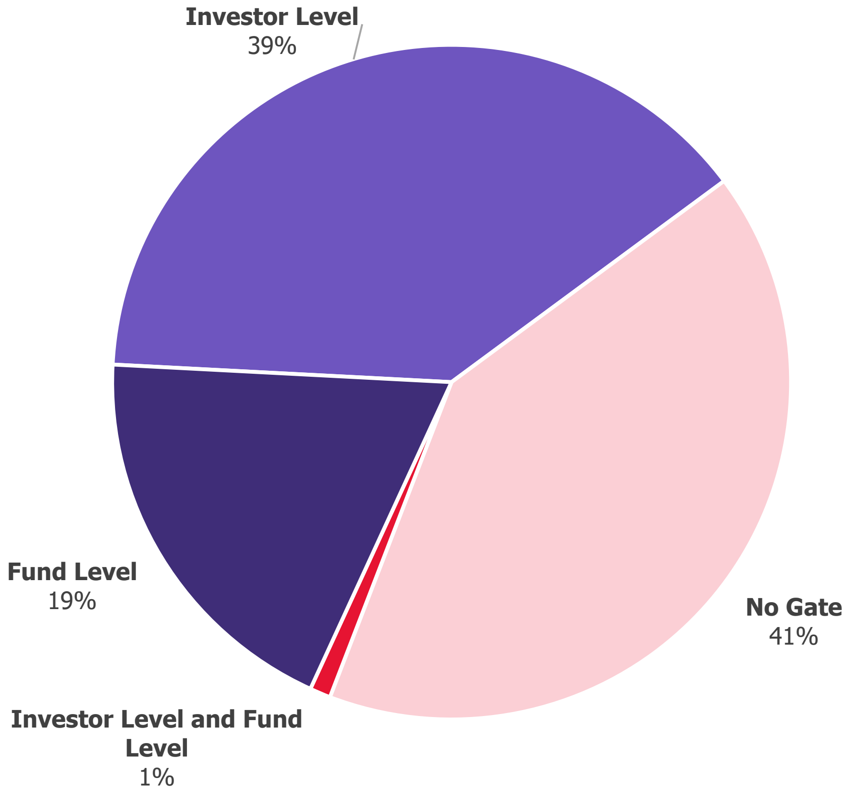
# Liquidity: Lock-ups

## Lock-ups

- Lock-ups are still common in the market
- Hard lock-ups are typically 1 or 2 years
- Soft lock-ups are typically 2% to 5%, with trend toward lower rates
- Continued investor push to change hard lock-ups to soft
- Better lock-up terms sometimes tied to higher management and/or performance fee rates

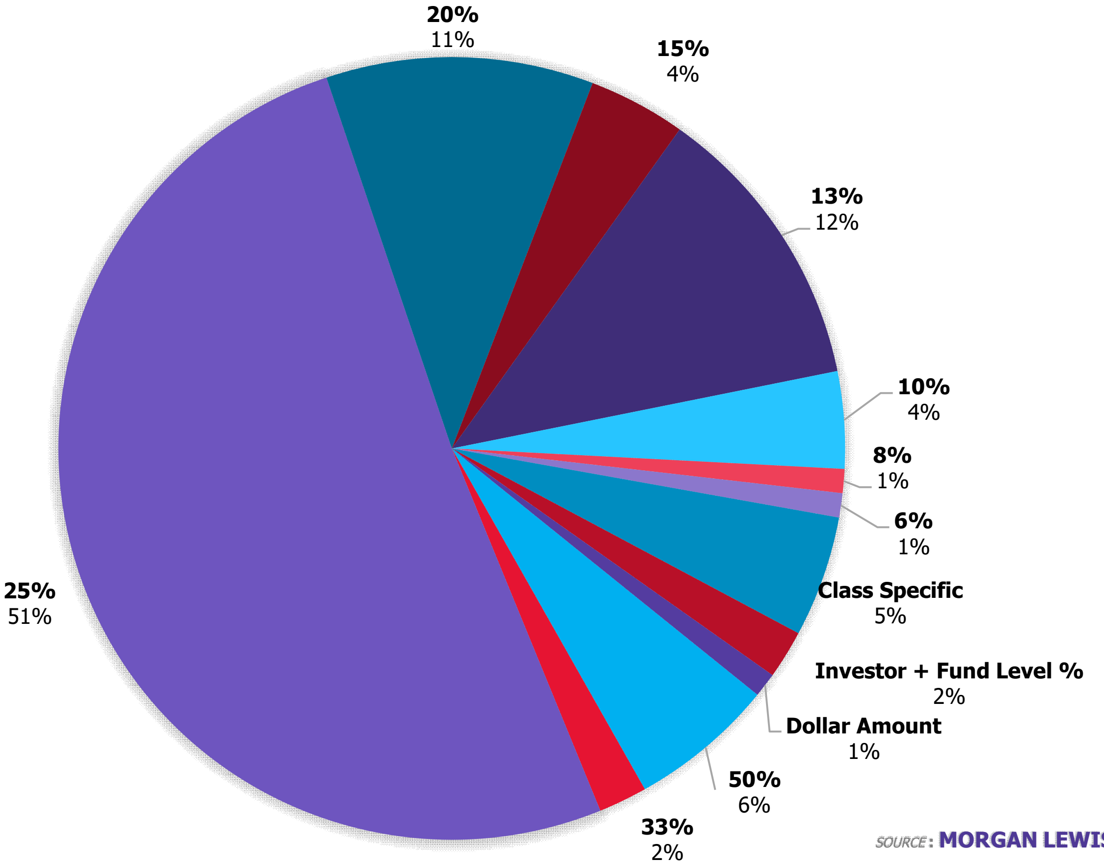
# Liquidity: Gates

## Gate Type



# Liquidity: Gates

Gate %




Morgan Lewis

SOURCE: MORGAN LEWIS FUNDS DATABASE

# Liquidity: Gates

## Gates

- Continue to be common, especially in new launches
- Investor-level gates more prevalent than fund-level gates
- Gate triggers vary
  - 25% trigger is most common
  - Many funds have lower triggers
  - Small percentage have higher triggers
- 12-month duration limit is market standard

# Liquidity: Accelerated Withdrawal Rights

## Tailwinds

- Trend toward accelerated withdrawal rights upon key-person events and, at times, other material events
- Continued push by investors for a broader scope of triggers: bad acts, regulatory withdrawals, material insider withdrawals, and amendments

## Headwinds

- **Private Fund Adviser Rule:** Preferential treatment rule would have prohibited granting a fund investor liquidity on terms that the fund adviser reasonably expects to have a material negative effect on other investors, *unless:*
  - the liquidity right is required by laws, rules, regulations, or orders to which the investor or the fund is subject, or
  - the same liquidity right is offered to all other existing and future fund investors

# Liquidity: Accelerated Withdrawal Rights

## Impact of Court Ruling Vacating Treatment Rule on Sponsors and Investors

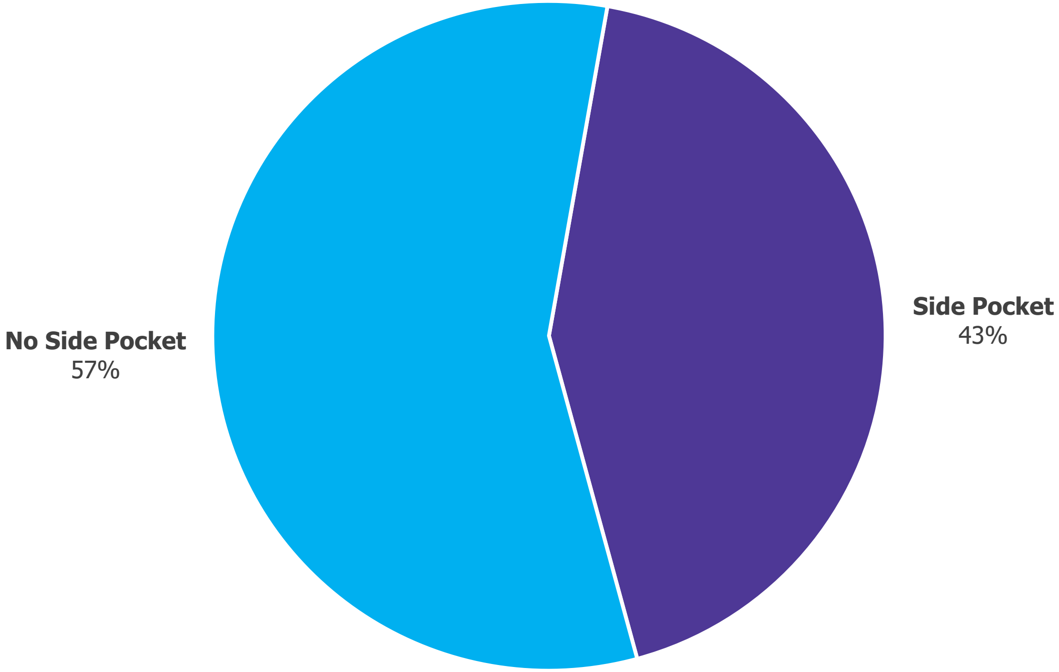
### Sponsors

- Continued trend in reluctance by some sponsors to provide accelerated or other preferred liquidity rights, unless required by law, rule, regulation, or order?
- Fiduciary concerns and regulatory scrutiny concerns persist

### Investors

- Push for accelerated or preferential liquidity rights
  - Including to address policy concerns or best market practice
  - Either just for investor or across entire fund
- Alternatively, form funds of one and SMAs

# Liquidity: Side Pockets/Designated Investments



# Liquidity: Side Pockets/Designated Investments

## Side Pockets/Designated Investments

- Use of side pockets still prevalent
- Can be integral part of the investment strategy, permissive or solely reactive
- Hard-wired formal side pocket
- Circumstantial side pocket
- Impacts fundamental aspects of fund operations
  - Subscriptions
  - Redemptions
  - Management fees
  - Performance allocations
- Significant considerations
  - Adequacy of valuations
  - Fund manager handling its fiduciary duties

# Fiduciary Duties, Exculpation, and Indemnification

## Fiduciary Duties

- Continued investor focus on fiduciary duties of fund managers, often addressed through side letters
  - Some managers agree not only to acknowledge fiduciary duties under the Advisers Act, but also to manage the fund in accordance with such duties
  - Some managers agree to modify limitations on common-law fiduciary duties, especially the duty of loyalty
  - Some managers agree to a state or municipal statutory "ERISA-like" standard of care, especially where investor's investment is significant

## Exculpation/Indemnification

- Expanded carveouts in exculpation and indemnification provisions to include (1) material breach of LPA and (at times) any side letter, and (2) some version of violation of law or criminal wrongdoing
- Expanded limitations on indemnification in certain claims and situations
- Continued investor focus on notice of indemnification claims and payments
- Continued investor focus on amount and duration limits on LP givebacks (although more prevalent in private equity and other close-end funds)

# Fiduciary Duties, Exculpation, and Indemnification

- Continued focus on an adviser waiving its fiduciary duties:
  - Indemnification or exculpation of an adviser for conduct could constitute a waiver of the adviser's fiduciary duty

- "Hedge Clauses" - Exculpation and Indemnification provisions:
  - Inclusion of a "savings clause" to clarify that the adviser is not waiving its fiduciary duties under the federal securities laws

# Confidentiality

- SEC Enforcement on Whistleblower Rule (Rule 21F-17 of the Exchange Act)
  - The SEC is looking at fund governing documents for prohibitions of activities protected by the Whistleblower Rule

- Confidentiality Provisions: Clarify that the confidentiality provisions (or nothing in the governing documents)

# Transparency

## Portfolio Holdings and Exposures Reports

- **Private Fund Adviser Rule:** Preferential treatment rule *would have* prohibited the provision of portfolio holdings or exposures information if the fund adviser reasonably expects that providing the information would have a material, negative effect on other fund investors, *unless* the such information if offered to all other existing fund investors.
- **Impact of Court Ruling Vacating Preferential Treatment Rule**
  - Sponsors:
    - Continued reluctance by some sponsors to provide portfolio holdings or exposures information, even if to all investors?
    - Concerns about fiduciary duties and regulatory scrutiny of selective disclosure persist
  - Investors:
    - Push for disclosure of portfolio holdings or exposures information to the investor or all fund investors, subject to an appropriate time lag

# Transparency

## Performance Reports and Fee Reports

- **Private Fund Adviser Rule:** Quarterly Statements rule *would have* required quarterly fee and expense as well as performance reporting.
- **ILPA Quarterly Statement Templates:**
  - ILPA released performance and fee/expense reporting templates on June 3, 2024, based on the requirements included in the Quarterly Statements rule.
  - ILPA templates contain certain recommended items in addition to those that would have been required under the PFA rule.
  - ILPA is accepting comments through July 12, 2024, which will likely be extended due to the ruling.
  - ILPA indicated that, even if the PFA rule requirements were vacated by the court ruling, they still planned to roll out parts of the templates as a recommended best practice and would aim for a Q4 2025 or Q1 2026 rollout.

# Side Letters

**Private Fund Adviser Rule:** Preferential treatment permitted with disclosure

- Would have required written notice to prospective and current investors disclosing preferential terms
  - Prospective Investors
    - Material economic terms – advance notice
    - All other preferential terms – as soon as reasonably practicable after investment
  - Current Investors – annual disclosure of any preferential treatment since prior notice

# Side Letters

## Impact of Preferential Treatment Rule on Sponsors and Investors:

| Sponsors | Investors |
|---|---|
| • Potential increase in unwillingness to give preferential terms<br>• Disclosure of preferential terms (in particular fee discounts) in offering materials | • Push for disclosure of all preferential terms (not just material economic terms) in advance<br>• Push for MFN provision to cover all preferential terms (not just material economic terms) |

# Side Letters

## Impact of Court Ruling Vacating Preferential Treatment Rule

### Sponsors

- Continued trend in reluctance by some sponsors to agree to any preferential terms?
- Fiduciary concerns and regulatory scrutiny concerns persist
- Continued focus on
  - Cost and expense of preferential terms
  - Operational risk from oversight and compliance
  - Litigation exposure
- Continued trend in incorporating investor demands into DDQs and fund offering documents, in part to reduce complexity of side letters

### Investors

- Push for advance disclosure of all preferential terms
- Push for MFN to cover all preferential terms (not just economics)
- Continued demand for preferential terms, such as fee discounts, better liquidity and enhanced transparency, through side letter
  - Leverage Factors: Investor’s name, ticket size, history and strategic relationship with sponsor vs. Fund’s performance and fundraising status

# GP Seed and Stake Arrangements

Advantageous for startup managers who need working capital for operations and seed capital for fund

Various types of seeders: former employers, institutional, strategic advisers, friends, and family

As consideration for seed capital:

- Minority equity in management company and/or general partner, and/or
- Top-line revenue share

Strong minority protections: consent rights over major matters, fee waivers/reductions, MFN treatment, capacity rights in fund products, buyout and exit rights, founder/key employee restrictive covenants, etc.

Fund manager protections: seeder lock-ups, ROFR on transfers