Morgan Lewis

Morgan Lewis Hedge Fund University™

LATEST UPDATES ON HEDGE FUND TERMS

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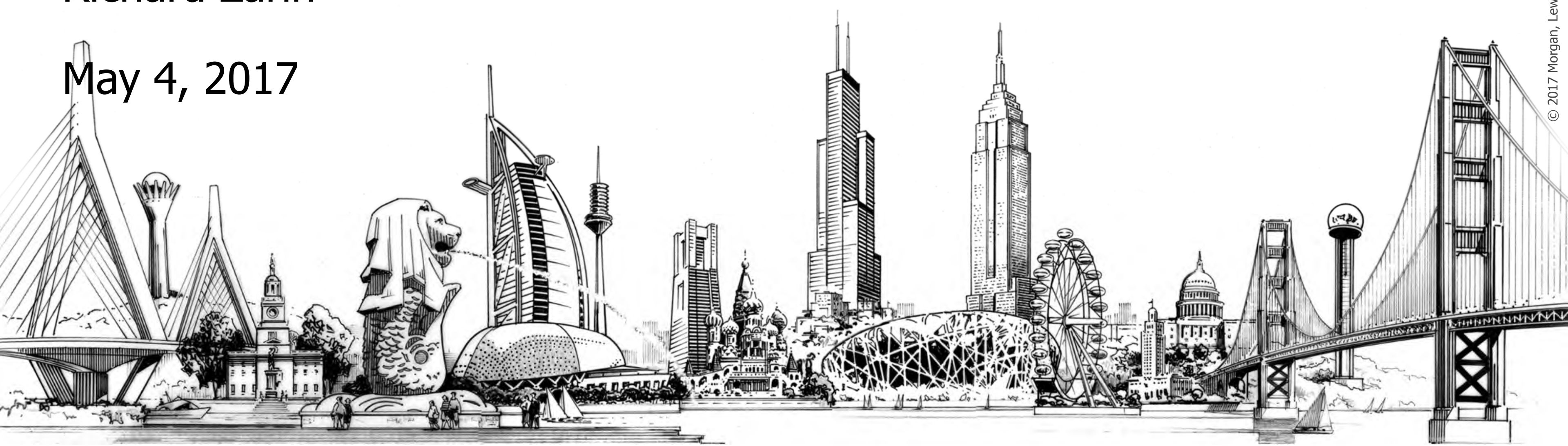

SECTION 01

UPDATES ON FEES, TRANSPARENCY AND LIQUIDITY

Fee Terms

- Management Fees
  - Downward pressure, particularly on long-short equity funds and quant funds
  - Discounts for founders
  - Discounts through new classes or through side letters, often based on investment minimums

Fee Terms

- Performance Allocations/Fees
  - 20% still the norm, subject to certain discounts
  - Types of Discounts
    - Founders
    - Strategic Investors
    - Large Investors
  - Founders (not just seed investors) share in a cut, typically subject to a minimum initial and ongoing investment level
  - "1 or 30" approach advocated by some investors
    - 30% performance allocation/fee on alpha (typically above an alpha hurdle/benchmark)
    - Subject to a management fee clawback

Fee Terms

- Founder Investor Discounts
  - Timing
    - Some funds extend the discount only to investors participating in the initial launch
    - Some funds will extend the discount for an additional three or six months
  - Size of Investment
    - Some funds do not have a minimum investment requirement
    - Some funds have a minimum initial investment requirement, which typically is tied to a minimum ongoing investment requirement

Transparency Terms

- Disclosure – Notice of Certain Events
  - Bad Acts
    - Breaches of standard of care/fiduciary duty
    - Breaches of fund documents or side letters
    - Nonroutine investigations or findings of violations of securities laws or regulations
    - Convictions, pleas of *nolo contendere,* or guilty pleas to felonies or crimes involving fraud
    - Violations of other applicable laws, regulations, or investor policies

Transparency Terms

- Disclosure – Notice of Certain Events
  - Other Events Impacting Manager/General Partner
    - Key person events
    - Changes in ownership or control
    - Changes in investment and operations personnel or policies
    - Bankruptcy or insolvency
    - Material adverse change to business, operations, or conditions

Transparency Terms

- Disclosure – Notice of Certain Events
  - Events Impacting Fund
    - Changes in corporate form or domicile
    - Changes in overall investment objective or strategy
    - Amendments to fund documents (including changes to valuation procedures)
    - Changes in fund administrator, prime broker/custodian, auditor
    - Fund assets becoming "plan assets" under ERISA
    - Failure to value fund assets in accordance with valuation procedures
    - Manager/General Partner valuing more than specified percentage of assets
    - Material decline in fund's NAV
    - Investments in "side pockets" or other illiquid investments

Transparency Terms

- Disclosure – Notice of Certain Events
  - Events Impacting Fund (cont.)
    - Use of soft dollars outside of Section 28(e) safe harbor
    - Indemnification claims
    - Indemnification advances/expense reimbursements
    - Legal claims or governmental proceedings
    - IRS audit
    - Imposition of a withdrawal gate
    - Suspension of determination of fund's NAV
    - Suspensions of withdrawal rights or payments of withdrawal proceeds

Transparency Terms

- Disclosure – Notice of Certain Events
  - Events Impacting Investor
    - Acts or omissions by Manager/General Partner/Investment Personnel causing investor to receive materially adverse publicity
    - Acts or omissions by Manager/General Partner/Investment Personnel otherwise materially adversely affecting investor’s reputation

Transparency Terms

- Reports
  - Monthly performance estimates
  - Monthly capital statements (including, e.g., gross long and short positions, top-five long positions, performance attribution, and leverage levels)
  - Monthly or quarterly portfolio holdings reports on real-time or lagged basis
  - Monthly or quarterly risk reports provided through risk aggregator
  - Monthly or quarterly statements of management fees and performance compensation
  - Monthly or quarterly valuation reports, including ASC 820 classification
  - Quarterly performance reports

Liquidity Terms

- Notice
  - Trend toward less notice (e.g., 30 days instead of 45 or 60 days) for more liquid funds
    - Existing funds
    - New Funds
- Frequency
  - Trend toward more frequent withdrawal rights (e.g., monthly instead of quarterly) for more liquid funds
    - Existing funds
    - New Funds
- Lock-ups
  - Investor pressure to change hard lock-ups to soft lock-ups
  - Movement toward lower rates of soft lock-up fees

Liquidity Terms

- Gates
  - Investor pressure against gates
  - Trends
    - New Funds: Fewer investor-level gates
    - Existing Funds: New classes without gates
  - Movement to limit duration of gates to 12 months
  - Some funds allowing a withdrawal fee in lieu of a gate
- Payment of Withdrawal Proceeds
  - Limit holdbacks
    - 95%/5% is the norm
    - Investor pressure to reduce holdback (often to 2% - 3%) for more liquid funds
  - Prior notice of distributions in kind and investor right to elect/opt out
- Suspensions
  - Investor pressure to limit suspension triggers
  - Trend toward requiring notice of imposition and lifting of suspension

Liquidity Terms

- Accelerated Withdrawal Rights
  - Basis:
    - Some offered by funds
    - Others resulting from investor pressure
  - Triggers:
    - Bad acts
    - Other events impacting General Partner, Investment Manager, or Key Persons
    - Events impacting fund
    - Events impacting investor
    - Amendments of fund documents
  - Form
    - Fund documents
    - One or more side letters, but typically made applicable to all investors while side letter(s) remain in effect

SECTION 02

ERISA/FIDUCIARY UPDATES

New Department of Labor "Investment Advice" Rule

- New Department of Labor (DOL) rule defining "investment advice" has been in the works since October 2010
- Final regulation issued April 2016
- Final rule was to be applicable starting April 2017, with full rollout by January 1, 2018
- However, looks like applicability date will now be June 9, 2017 if not changed further by DOL, Congress, or Trump administration
- Will have a profound impact on how all types of investment products and services are sold to ERISA plans and IRAs
- In the hedge fund space, will affect how interests in hedge funds are marketed and distributed
- Marketing to the large ERISA pension plans that are the typical plan investors in hedge funds should be manageable, but
- May be very difficult to market to or even accept IRA investors not associated with the manager

Can a Hedge Fund Manager's Marketing Activities Make It a Fiduciary?

- ERISA plan fiduciaries must:
  - Adhere to prudent expert standard of care
  - Act solely in the interest of plan participants and beneficiaries
- ERISA plan and IRA fiduciaries must comply with highly prescriptive prohibited transaction rules which (absent an exemption):
  - Forbid the fiduciary from setting its own compensation
  - Bar variable compensation
  - Prevent the fiduciary from using the plan assets for its own benefit
- Primary impact of new fiduciary rule falls on broker-dealers who receive variable compensation for "advising" retail IRA clients (e.g., commissions, loads, 12b-1 fees)
- For hedge fund managers, the primary concern is whether marketing one's own hedge funds and investment management services could be considered to involve the provision of investment advice, making the manager a fiduciary
- Conundrum – the manager would then be unable to act in its own interest in marketing its wares or even negotiating its own fees, regardless of whether the hedge fund holds "plan assets"
  - Manager's financial interest in earning fee-based compensation from the hedge fund upon being engaged results in a conflict that would itself require exemptive relief

Basics of the New Definition of "Investment Advice"

A person renders "investment advice" and becomes a fiduciary if –

- He or she makes a **recommendation** – a **suggestion;** something reasonably considered an **encouragement to act** – to a plan, plan fiduciary, participant or beneficiary, IRA, or IRA owner
- For a fee or other compensation
- To act or refrain from acting with respect to:
  - **Investment decisions:** purchasing, holding, exchanging or selling investments
  - How to **invest rollovers or distributions** from a plan or IRA
  - How to **make rollovers, transfers, or distributions** from a plan or IRA, including, in what amount, in what form, and to what destination
  - **Investment management:** investment policies or strategies, portfolio composition, selection of investment advisers or investment managers

“Seller’s Exception” to Fiduciary Status

- Allows transactions with independent plan fiduciaries with financial expertise
- Sales pitches to an institutional plan client can include fund recommendations, but the advice must be to an independent fiduciary of the plan:
  - with responsibility for AUM of at least $50 million (e.g. investment committee of large plan), or
  - who is a bank, insurance company, registered investment adviser, or registered broker-dealer
- Applies to “exchange or other transaction related to the investment of securities or other investment property”
- Seller must know or reasonably believe that independent fiduciary is capable of evaluating investment risks, in general and as to particular transactions and investment strategies
- Seller must reasonably believe that independent fiduciary is a fiduciary with respect to the specific transaction
- Seller may rely on written representations of the independent fiduciary
- Independent fiduciary must be informed that information provided is not impartial or fiduciary in nature
- Seller cannot receive direct compensation from the plan, plan fiduciary, plan participants or beneficiaries, IRA, or IRA owner for providing investment advice in connection with the transaction
- Use of exception by placement agents

“Hire Me” – Can You Sell Your Services Without Becoming a Fiduciary?

- DOL says that you can “tout the quality of [your] own advisory or investment management services” without becoming a fiduciary
- But…
  - If recommendation is coupled with an *investment recommendation*, the exception is unavailable
    - Thus, a fee-based adviser can freely “recommend” his or her services. However, most “hire me” recommendations are made in conjunction with an investment recommendation
  - In addition, recommendations as to account types (brokerage vs. advisory) and particular platforms or programs can result in fiduciary status
  - A series of actions that may not constitute a recommendation when viewed individually may be deemed a fiduciary recommendation when considered in the aggregate

Other Important Exceptions for Hedge Fund Managers

- **General communications** that a reasonable person would not view as an investment recommendation
  - **Offering memoranda** and prospectuses
  - General marketing materials
  - Performance reports
  - General circulation newsletters
- **Appraisals and fairness opinions** have been excluded from the new rule and are not fiduciary advice
  - Had been a concern that striking a net asset value (NAV) would involve investment advice
  - Issue reserved for future rulemaking

A Way Forward

- Use the seller's exception for plans represented by sophisticated independent fiduciaries:
  - Recommendations to most ERISA plans investing in hedge funds should be covered
  - Blueprint in the final regulations – new set of written representations in subscription documents
- IRAs are a different matter:
  - Most IRAs, even large ones, are not represented by an independent investment professional, making the seller's exception unavailable
  - While alternative investments can be offered under the "BIC exemption," the conditions of that exemption are impractical in the private investment fund context
  - Possible approaches, short of the BIC:
    - Only accept IRAs that can show that they are advised by a qualifying independent fiduciary
    - Only accept IRAs if there are no communications with the owner other than the provision of offering documents – likely not feasible
    - Exclude IRAs, other than those of principals and employees of the manager

SECTION 03

TAX UPDATES

Tax Update

- Tax reform legislation proposals
- New partnership tax audit rules
- Related party debt rules
- Changing tax audit landscape

Tax Reform Legislation Proposals

- The Trump administration has announced proposals for significant changes to the federal income tax system, including changes that could have significant consequences for hedge fund investors and managers
- Key proposals include:
  - Introducing a new 15% tax rate for a broad range of businesses, including businesses operated through corporations and pass-throughs
  - Lowering the top ordinary income tax rate for individuals from 39.6% to 35%, and eliminating the 3.8% net investment income tax
  - Eliminating going-forward US tax on non-US business operations, with a one-time reduced rate for repatriating non-US income
  - Eliminating the alternative minimum tax and the estate tax
- Other proposals previously suggested by the House and Senate tax committees may reappear
- Significant uncertainty as to what changes may become law, and when

New Partnership Tax Audit Rules

- The Bipartisan Budget Act of 2015, enacted on November 2, 2015, replaces the current rules for tax audits of partnerships, effective for tax years beginning in 2018
- Key changes include (i) potential liability of a partnership itself for taxes as a result of an audit, (ii) limited rules permitting a partnership to push the consequences of an audit up to the level of its partners, (iii) a new "partnership representative" mechanic (in place of a "tax matters partner") as the party with whom the IRS deals on audits, and (iv) removal of provisions requiring notice to partners of partnership audits
- Most investment funds won't be able to elect out of the new rules (election out only available if fewer than 100 partners, none of which are themselves partnerships, among other requirements)
- Detailed regulations were proposed in January 2017, but were withdrawn with the new administration, and no new guidance has yet been issued

New Partnership Tax Audit Rules

Concerns for hedge funds and their investors:

- Tax-exempt, government plan, sovereign wealth and other investors that otherwise may be exempt from, or subject to reduced rates of, US tax, will want partnership provisions protecting them from bearing the economic burden of taxes imposed at the partnership level, as a result of a tax audit
- Funds and investors will want to ensure that former partners remain responsible for their share of any taxes (this is a particular concern in hedge funds)
- The new rules have "Heads I win, tails you lose" aspects—e.g., if the IRS successfully challenges allocation methodologies, the overall amount of taxable income, or tax, may not change, but a current payment may be required from the partnership or partners, with offsetting benefits only taken into account over time
- Especially pending further guidance, fund sponsors will want to retain maximum flexibility, including the possibility of resolving audit results at the partnership level for administrative convenience—implications on economics require careful thought
- There are practical concerns with multi-tier structures—e.g., ability of a fund of funds, for example, to be aware of, much less effectively deal with, an audit of an operating partnership below a private equity fund

Related Party Debt Rules Under Section 385

- The IRS proposed expansive related party debt regulations under Section 385 of the tax code in April 2016, and finalized these regulations in a significantly narrower form in October 2016.
- The narrower regulations require, among other things, better documentation and terms for various related-party debt transactions.

IRS Proposes Limits on Management Fee Waivers

- After several years of study, the IRS on July 22, 2015 issued proposed regulations that, if adopted, would restrict management fee waiver mechanics that are used by many private equity funds, and could apply in other contexts as well (e.g., including alternative arrangements for keystone investors sharing in hedge fund economics).
- The IRS had indicated it would press to finalize these regulations during 2016, but did not do so, and it is unclear whether the regulations remain a priority under the Trump administration.
- Significant tax audit activity has been ongoing, involving various funds and issues that are within or analogous to the topics covered by the proposed regulations, with indications that the IRS may regard some of the principles of the regulations as reflecting its current interpretation of law.

IRS Proposes Limits on Management Fee Waivers

- Management fee waiver mechanics, in general terms, seek to allow a fund manager or its affiliates to defer recognizing the ordinary income the manager otherwise would recognize on receiving management fees that are reinvested in the fund and instead recognize long-term capital gains, reflecting the fund's gains when realized on its investments.
- Management fee waivers that don't meet the requirements of the proposed regulations would be treated as current ordinary compensation income for the fund manager, and could be subject to additional tax under sections 409A and 457A as "bad" deferred compensation arrangements.

Key Factor Is Entrepreneurial Risk

- The proposed regulations provide six nonexclusive factors to be used in determining whether an arrangement constitutes a disguised payment for services.
- The most important factor is whether the arrangement has significant "entrepreneurial risk." Facts and circumstances suggesting a lack of entrepreneurial risk include (i) allocations of partnership income that are reasonably certain; (ii) allocations of gross income; and (iii) nonbinding waivers.
- The IRS also noted a particular concern with a right to receive an allocation based on an accounting period of 12 months or less, or where fund assets are hard to value and the manager or an affiliate controls the valuation or the entities in which the fund invests.

Possible Changes in Future Arrangements

- Various approaches to a management fee waiver are more likely to be respected going forward, including:
  - Hard-wired arrangements, in which the fund manager agrees up front to receive less in the way of management fees in exchange for a larger interest, for the manager or general partner, in fund profits;
  - Waivers of fees for a particular year that are made, on a binding basis, at least 60 days prior to the beginning of that year;
  - Allocations of increased profits that require looking at the cumulative performance of a fund, and not just in a single year, and with distributions subject to claw-back in the event of later losses;
  - Allocations reflecting a pro rata interest in fund taxable income generally (rather than only of "tax-favored" income, e.g., long-term capital gains and qualified dividends).

Other (and Current) Implications

- The proposed regulations would become effective only if and when finalized.
- The IRS indicated, however, that the principles in the proposed regulations reflect its existing view. This suggests that the IRS may be scrutinizing, and challenging, various management fee waiver mechanics as deficient under current law.
- The IRS also indicated, in the preamble to the proposed regulations, its intent to modify other guidance regarding profits interests.
  - This includes, in particular, removing from the coverage of the existing profits interest safe harbor situations where one party (e.g., a manager) waives the right to be paid for services and a second party (e.g., a general partner) receives in return a profits interest. For New York City unincorporated business tax and other nonfederal income tax reasons, many funds adopt this sort of structure.

Other Potentially Relevant Tax Changes

- Earlier deadline for filing partnership tax returns—for this year and going forward, March 15
- Expanded safe harbors for non-US pension investors in US real estate

Biography

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Jedd H. Wider focuses on global private investment funds and managed accounts, particularly global hedge, private equity, secondary, and venture capital funds. As co-head of the global hedge funds practice, he represents leading financial institutions, fund managers, and institutional investors in their roles as fund sponsors, placement agents, and investment entities. He assists clients through all stages of product development and capital raising as well as customized arrangements, seed and lead investor arrangements, and joint ventures. He specializes in all aspects of secondary transactions, and complex financial structurings.

Biography

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Christopher J. Dlutowski counsels private investment funds—including US domestic and offshore hedge funds, private equity funds, and funds-of-funds—and investment management firms on forming and structuring funds, trading and other investment activities, raising capital, and ongoing operations. Christopher also represents institutional investors—including governmental and corporate pension plans, universities, family offices, and funds of funds—on their investments in hedge, private equity, and other private funds, managed accounts and co-investments, and advises clients on registration and other regulatory issues under the federal securities and commodities laws. Christopher has significant experience in customized investment products, including strategic partnerships, captive funds, and co-investment funds.

Biography

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Craig A. Bitman provides clients with a range of knowledge and skills in all aspects of employee benefits and executive compensation law. He not only serves as deputy practice leader, but also as leader of the practice's Fiduciary Task Force and co-chair of the firm's institutional investor practice. Craig also practices in the firm's private investment funds practice and is a member of the firm's Advisory Board.

Biography

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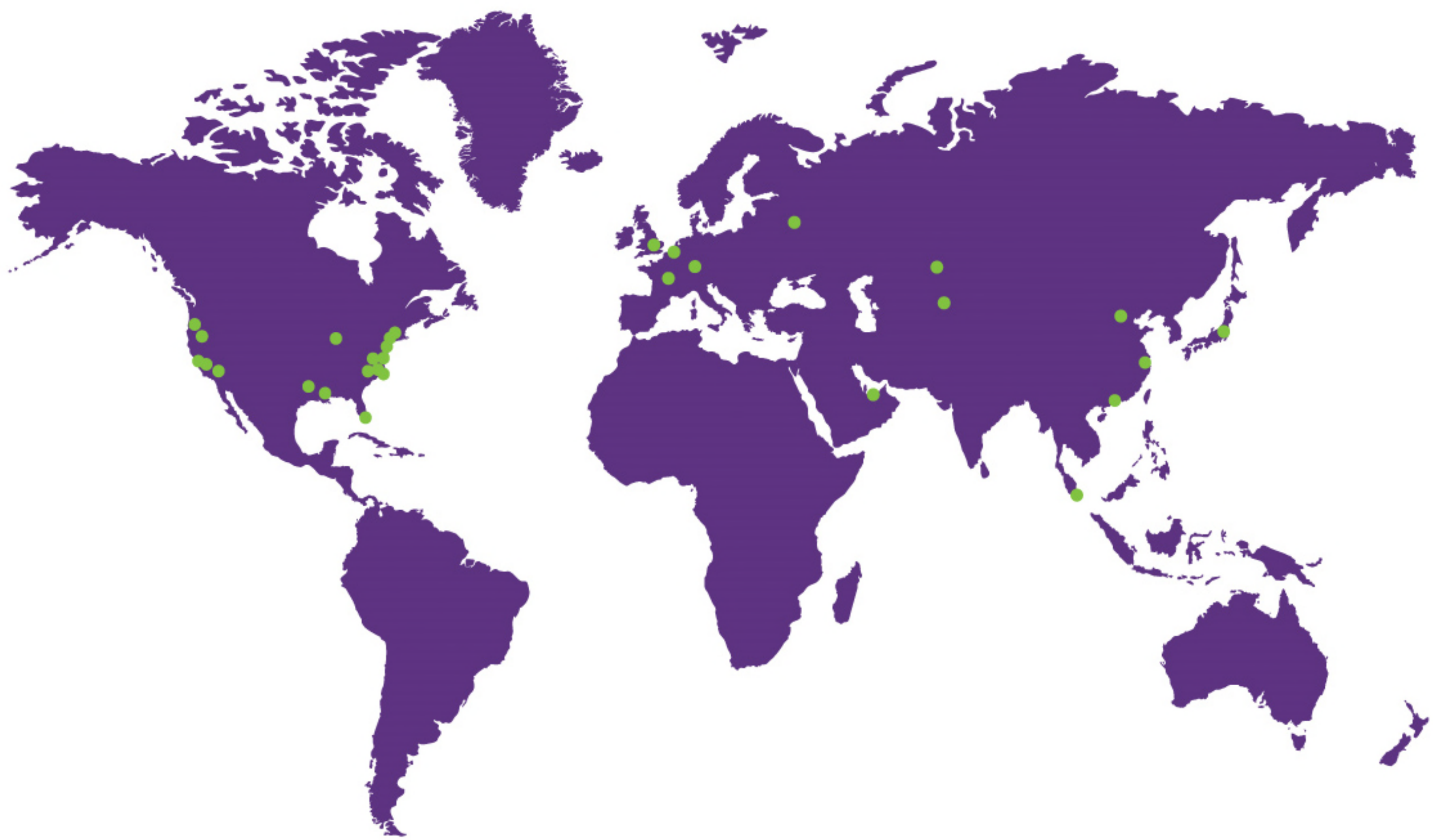
Working with businesses in industries such as media, financial services, aviation, shipping, and education, Richard S. Zarin counsels clients on tax matters involving international and US transactions. He also advises clients on ongoing tax planning. Richard's experience includes mergers, acquisitions, the formation and operation of joint ventures, debt and equity restructurings, and securities offerings. In addition, he represents organizers of and investors in onshore and offshore investment funds and other alternative investment vehicles.

Our Global Reach

- Africa
- Asia Pacific
- Europe
- Latin America
- Middle East
- North America

Our Locations

Almaty	Dallas	London	Paris	Shanghai*
Astana	Dubai	Los Angeles	Philadelphia	Silicon Valley
Beijing*	Frankfurt	Miami	Pittsburgh	Singapore
Boston	Hartford	Moscow	Princeton	Tokyo
Brussels	Hong Kong*	New York	San Francisco	Washington, DC
Chicago	Houston	Orange County	Santa Monica	Wilmington



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*Our Beijing office operates as a representative office of Morgan, Lewis & Bockius LLP. In Shanghai, we operate as a branch of Morgan Lewis Consulting (Beijing) Company Limited, and an application to establish a representative office of the firm is pending before the Ministry of Justice. In Hong Kong, Morgan Lewis has filed an application to become a registered foreign law firm and is seeking approval with The Law Society of Hong Kong to associate with Luk & Partners.

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