SEWARD & KISSEL LLP

The Seward & Kissel 2019/2020 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, Seward & Kissel conducts various studies of important trends impacting the hedge fund community. This year, for the fifth year in a row, we have conducted a study examining side letters negotiated by our hedge fund manager clients (the "Study"). The Study covers the period from July 1, 2019 through June 30, 2020.

In the current Study, 74% of the side letters were with managers in business for two or more years at the time of execution ("Mature Managers"), and 26% 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 in the past several years, which generally decreases the need for special terms in side letters with Newer Managers. However, we did observe an uptick in letters with Newer Managers, up from 19% last year.

Note that given the time period covered by this Study, the full impacts of the COVID-19 outbreak are not reflected in this report, although the end of the period covered by this Study overlaps with the beginning of the COVID-19 outbreak in the United States, which ushered in a period of increased market volatility. Consistent with the view that hedge funds tend to be an attractive asset class in times of heightened volatility, we did not see a decrease in side letter activity at the end of the period. Next year's study will reveal whether the asset class sustained its momentum throughout the pandemic.

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 $5.1 billion (as compared to $4.9 billion in the prior study). The average RAUM of Newer Managers in the Study was approximately $387 million.
- Funds-of-funds continued to be the most common category of side letter investor, representing 42% of all side letter investors. This category experienced a slight uptick from the downward trend we have seen in recent years.
- A slightly lower percentage (44%) of side letters contained an MFN clause than in last year's study (48%).
- Side letters with government plans and corporate pension plans were the second and third most common investor categories, respectively, of side letter investors, suggesting that the revived interest in hedge funds by these types of investors that we first identified in last year's study has continued.
- Similar to side letters, in the context of separately managed accounts, funds-of-funds remained the most common type of investor.

(I) The Managers

Excluding certain outliers, the average RAUM of the Mature Managers in the Study was approximately $5.1 billion (as compared to $4.9 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, the RAUM was approximately $387 million, and 75% of them were SEC-registered (significantly more than last year's 25% number). These data points indicate an overall average higher assets under management level for Mature Managers, and an increase in registration for Newer Managers, as managers strive to maintain sufficient capital to operate in a rising cost environment due to regulatory and investor demands. This may also suggest investor preference for Newer Managers that are well-capitalized.

(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) endowments; (5) wealthy individuals/family offices; and (6) non-profit institutions.

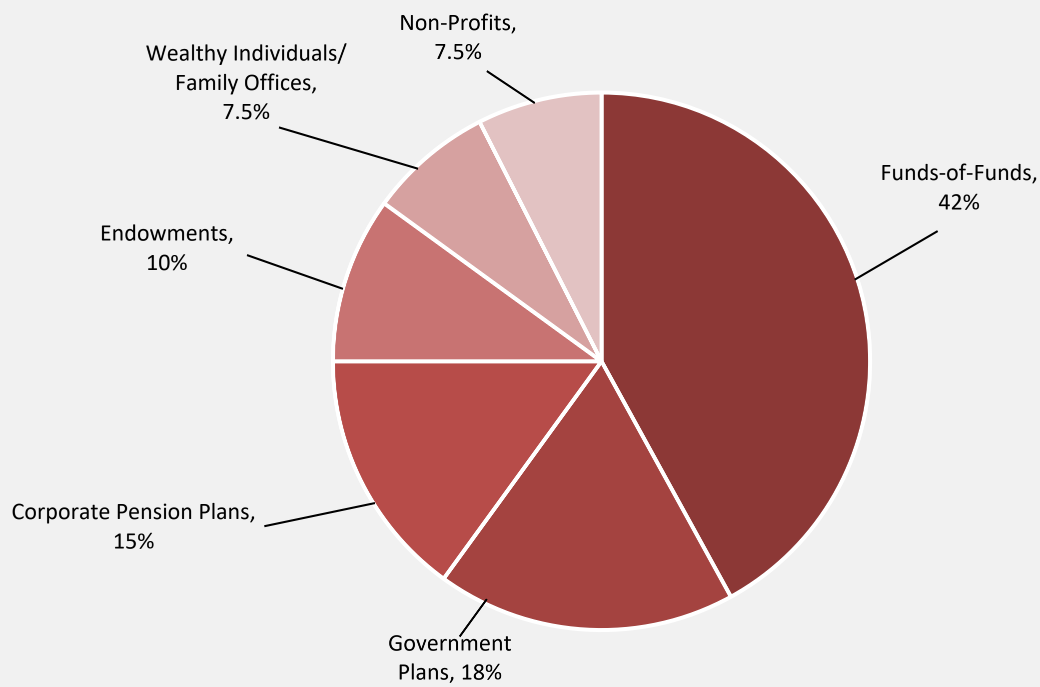
Once again, the largest category of side letter investor included in the Study was the fund-of-funds category, making up 42% of all side letter investors (which reverses the downward trend we had seen since the 2016/2017 study (65%), followed by 50% in the 2017/2018 study and 37.5% in the 2018/2019 study). 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 18%, and the third largest side letter category was corporate pension plans, at 15%, each of which is consistent with the data from the 2018/2019 study (19% and 14%, respectively), in which we had observed an increase in each of these categories.

Moving up from the sixth to the fourth largest side letter investor category was endowments at 10%, which represented a slight decrease from the 12.5% figure in the 2018/2019 study. Tied for fifth place were non-profits and wealthy individuals/family offices, at 7.5% each. We observed a decrease in non-profits (which represented 12.5% of the letters in the 2018/2019 study), and an uptick in wealthy individuals/family offices (which represented 3% of the letters in the 2018/2019 study).

Analyzing trends separately for Mature Managers and Newer Managers, some interesting takeaways were that: (1) there appears to be sustained interest in hedge funds from government plans and corporate pension plans, which we had identified in the 2018/2019 study; (2) as was the case in last year's study, 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, which is also consistent with our observation from last year. It also appears that the downward trend in side letters with funds-of-funds that we had observed over the past three years may be flattening out.

The Investors



(III) The Terms

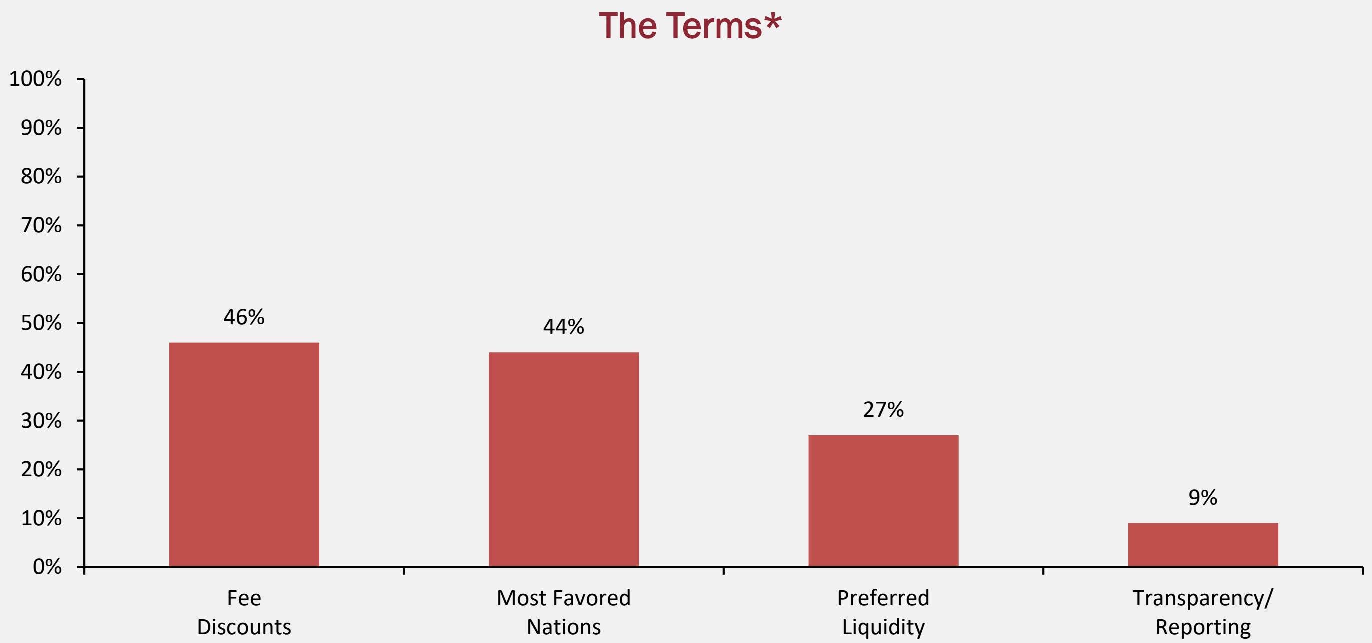
The Study focused on four principal business terms: (1) some form of most favored nations protection ("MFN clause"); (2) fee discounts; (3) preferred liquidity; and (4) transparency/reporting obligations (of portfolio positions and/or portfolio exposures). With respect to liquidity, the Study solely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

Displacing MFN clauses from the top position, the most frequently observed business term was a fee discount clause, which was included in 46% of all side letters (generally consistent with the 44% in the 2018/2019 study, which was significantly increased from 24% in the 2017/2018 study), with a similar percentage representation across the Mature and Newer Manager categories. 53% of the fee discount clauses covered both management fees and incentive allocations, while 47% applied only to management fees or incentive allocations. The continued prevalence of fee discount clauses is consistent with our observation of sustained interest from large institutional investors such as government and corporate pension plans, evidencing that these kinds of entities continue to push for fee breaks in their side letter arrangements.

MFN provisions were the next most common term, appearing in 44% of all side letters (down slightly from 48% in 2018/2019). 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.

Preferred liquidity was included in only 27% of the side letters (up slightly from 24% in the 2018/2019 Study). As was the case in the prior study, this term was more common in Newer Manager side letters (38%, generally consistent with 36% in the 2018/2019 Study) than in Mature Manager side letters (23%, generally consistent with 21% in the 2018/2019 Study).

The least common side letter term was lagged portfolio transparency/reporting obligations, which appeared in 9% of all side letters (generally consistent with 10% in 2018/2019 Study).



** Please refer to the qualifiers of some of these terms in the text in the preceding text.*

(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 we did last year, we analyzed the use of SMAs by study participants during the same period.

The pertinent results from this Study were that: (1) 59% of the SMAs were with Mature Managers (down from 67% in the 2018/2019 Study and 71% in the 2017/2018 Study); (2) 53% of the SMAs were with funds-of-funds (also down slightly from 59% in the prior study) and 22% were with wealthy individuals/family offices (28% in the prior study); and (3) approximately 68% 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 (compared with 75% in the prior study).

We hope that you find *The Seward & Kissel 2019/2020 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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