



Morgan Lewis

**ADVANCED TOPICS IN  
HEDGE FUND PRACTICES  
CONFERENCE**

**Manager and Investor Perspectives**

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# Hedge Fund Terms

## Speakers



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# Update on Hedge Fund Terms: Fundraising Environment

- Total Hedge Fund Industrywide AUM by end of Q1 2023: \$4.25 trillion
  - 1.7% increase since end of 2022
- Q1 2023 Hedge Fund Industrywide Net Capital Inflows: \$6.7 billion
  - First time in last four quarters there were positive net inflows
- Strategy Leaders: CTA, Credit, Equities, Relative Value, Niche Strategies
- Strategy Laggards: Event Driven, Macro, Multistrategy
- Geographic Leaders: Europe, Rest of World
- Geographic Laggards: Asia Pacific, North America
- Fund Size: smaller funds received a greater percentage of inflows than larger funds

Source: *Preqin* – Q1 2023 Hedge Fund Asset Flows

# 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**

**Stock market volatility**

**Stagnant or low-performance track records may continue to hurt certain strategies**

**First-time fund sponsors historically have had more challenges in launching funds and comprise a much lower percentage of launches than experienced fund sponsors**

**On the whole, allocators are planning to commit less capital to hedge funds as compared to other alternative asset classes**

**One fund's headwinds may be another fund's tailwinds**

# Latest Updates on Hedge Fund Terms: Fees

- **Management Fees**

- Continued downward pressure on management fee rates
- 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 better liquidity terms (such as less notice, more frequency, and/or better or no lockups)
  - Higher management fee rates tied to lower rate of (or no) performance compensation



# Updates on Hedge Fund Terms: Fees

- **Management Fees**

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



# Updates on Hedge Fund Terms: Fees



- **Performance Compensation**

- Rates and Frequency
  - Downward pressure on rates
  - Big decision – multiple classes
    - Lower performance compensation rates tied to higher management fee rates and, at times, less frequent withdrawal rights or more frequent performance periods
    - At times, highest performance compensation rates tied to no management fee
  - Some liquid funds not charging any performance compensation
- Loss carryforwards/high-water marks remain market standard

# Updates on Hedge Fund Terms: Fees

- **Performance Compensation**

- Hurdles and benchmarks are increasingly common per market demand
  - Some funds with hurdles charge higher performance rates
  - Some funds reset their hurdles annually (no need for benchmarks recover any shortfall)
  - Some funds permit payment of performance fee/allocation if the fund outperforms the benchmark, even if the fund otherwise has negative performance
- Some use of alternative approaches to performance compensation
  - Multiyear (e.g., two to three years) crystallization structures, often for longer-term strategies and sometimes tied to a matching lockup period and subject to a clawback
  - “1 or 30” approach (still not common)
- No performance compensation on side pockets/designated investments until realization event





# Updates on Hedge Fund Terms: Expenses

- **Typical fund expenses include:**
  - Expenses incurred in relation to structuring, acquiring, holding, managing, operating, monitoring, financing, valuing, and disposing of investments
  - Travel, meals, insurance, taxes, reporting, and partner meeting expenses
  - Fees and expenses of service providers (i.e., fees of lawyers, consultants, custodians, administrators, and accountants)
  - Amendment of fund documents
  - Termination, liquidation, and winding up
  - Fund's compliance with regulations and governmental filings
  - Management fees
  - Insurance, litigation, and indemnification costs/expenses
  - Organizational expenses



# Update on Hedge Fund Terms: Expenses

- **A few potentially contentious categories of fund expenses:**
  - Broken deal, finder’s fees, and other “hidden expenses”
  - Certain kinds of travel (e.g., chartered flights)
  - Entertainment
  - Research, risk management, and related software and hardware
  - Negotiations and side letter (including MFN) compliance
  - Governmental filings (e.g., Form PF)
  - In-house legal counsel, accountants, and administrative services
  - General Partner’s and Investment Manager’s regulatory/compliance costs
  - Litigation/class action expenses
  - Offering and sale of interests
  - Valuation services and consultants (potentially reducing an adviser’s expenses)
  - Order management systems



# Update on Hedge Fund Terms: Expenses

## Increased scrutiny by the SEC and investors regarding expenses

- More specific expense disclosure and approach to allocation
- Allocation of certain expenses to manager and other accounts
- How do certain expenses relate specifically to the fund?
- Caps on operating expense ratios (e.g., overhead, legal, audit, administrative, research)
- Investor demands for revisions in expense disclosure and reporting of expenses

## Increased specificity: clarification or change in practice?

## Contractual limits vs. regulatory prohibitions

# Updates on Hedge Fund Terms: Liquidity

## Notice and Frequency



- **Notice**
  - 30 days remains the norm
  - Trend toward less notice (e.g., 10 to 15 calendar days) for more liquid funds
  - More notice (45, 60, or 90 days) for less liquid funds
- **Trend toward more frequency (monthly or weekly instead of quarterly) for liquid funds**
- **Accelerated Withdrawal Rights**
  - 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
  - Pratfalls of granting preferential liquidity
    - Regulatory scrutiny – SEC Private Fund Rule
    - Fiduciary concerns
    - Enforceability uncertainty in some jurisdictions
  - Alternatives
    - Offer more classes
    - Change liquidity terms across entire fund
    - Form funds of one and SMAs

# Updates on Hedge Fund Terms: Liquidity

## Lockups & Other Limits



- **Lockups**
  - Some hard lockups,
    - Startup funds, high performers
    - Typically one or two years
    - Sometimes tied to better fee rates
  - Some soft lockups
    - Typically 2% to 5%, with trend toward lower rates
    - Investor pressure to change hard lockups to soft
    - Better lockup terms sometimes tied to higher fee rates
- **Side Pockets/Designated Investments**
  - Can be reactive or proactive
  - No withdrawal rights until realization event

# Updates on Hedge Fund Terms: Liquidity

## Gates



- **Gates continue to be common, especially in new launches**
- **25% limit is most common**
  - Some funds have lower limits, ranging from 5% to 15%
  - Some funds have higher limits, such as 50% for funds with performance track records
- **12 months out has developed into the market norm**
- **Fund-level gates are more prevalent than investor-level gates**

# Updates on Hedge Fund Terms: Liquidity

## Payments and Holdback



- **Payments**
  - Within 30 calendar days is most common
  - Some more liquid funds pay in 2 to 10 business days
  - Some less-liquid funds provide for payment when fund has sufficient liquid assets
  - Careful: distributions in kind
- **Set redemption fees (0.5 to 2%) are rare**
- **Holdback**
  - Most funds still have a holdback for material withdrawals
    - 95% to 98% is most common threshold, some 90%
    - 5% holdback remains the norm, with lesser amounts (2% to 3%) for more liquid funds
- **Most funds pay holdback after release of audit, but some liquid funds pay holdback within 30 to 60 business days**

# Updates on Hedge Fund Terms: Liquidity

## Suspension



- **Scope of suspension events**
  - Objective versus subjective
  - Market push to narrow sponsor's discretion
- **Effect of suspension event**
  - Calculation of NAV
  - Withdrawal rights
  - Withdrawal payments
- **Notice of imposition and lifting of suspension: All are affected**
- **First in, first out vs. pari passu**
- **Discounts on fees during suspension is rare**



# Updates on Hedge Fund Terms: Reporting and Transparency

## Reporting

- Market demand for enhanced reporting, typically on a monthly or quarterly basis
  - Performance and valuation reports, including top longs and shorts, performance attribution, leverage levels, and ASC 820 classification
  - Portfolio holdings report on a real-time or lagged basis
  - Portfolio exposure data reports
  - Counterparty transparency reports



# Updates on Hedge Fund Terms: Reporting and Transparency

- **Notice of Certain Events**
  - **Bad Acts**
    - Regulatory proceedings and felony convictions
    - Violations of law
    - Disabling Conduct – gross negligence, willful misconduct, fraud
    - Breaches of fund documents and side letters
  - **Other events adversely affecting fund management and operation**
    - Key-person events
    - Change of ownership of the manager, bankruptcy, and other adverse changes to the business of the manager
    - Cybersecurity breaches



# Updates on Hedge Fund Terms: Reporting and Transparency



- **Manager challenges**
  - Regulatory scrutiny
  - Fiduciary concerns: materiality of information that is selectively disclosed
  - Operational concerns
    - Cost of bespoke reporting
    - Burden of tracking and disclosing required notice events
  - Investor concerns: Challenge of stopping reports if side letter investor withdraws
- **Some solutions**
  - Offer certain reports to all investors
  - Disclose material events to all investors as a matter of due course
  - Increased disclosure in fund documents of required notice events
  - Tie certain events to accelerated withdrawal rights

# Update on Hedge Fund Terms: Standard of Care, Exculpation, and Indemnification

## Standard of Care/Fiduciary Duties

- Increased investor focus on an affirmative standard of care and/or fiduciary duties of fund managers, typically addressed through side letters
  - Some managers agree to acknowledge fiduciary duties under the Advisers Act
  - Some managers agree to a state or municipal statutory “ERISA-like” standard of care
  - Some managers agree to modify limitations on common-law fiduciary duties, especially the duty of loyalty

## Exculpation/Indemnification

- Expanded carveouts in exculpation and indemnification provisions to include material breach of fund documents, violation of law, and criminal wrongdoing
- Expanded limitations on indemnification in certain claims and situations
- Notice of indemnification claims and payments
- Consider trend in LP clawbacks (more prevalent in private equity funds, but now seeing in traditional private funds)

# Update on Hedge Fund Terms: Standard of Care, Exculpation, and Indemnification

- Investor demands
- Specific disclosure of manager's responsibilities (e.g., trade errors)
- Large institutional investors
- Pension plans and sovereign wealth funds
- Consistency across funds
- Requests for indemnification amounts paid



# Update on Hedge Fund Terms: Conflicts of Interest

**Allocation of investment opportunities across multiple funds and accounts**

**Cross-transactions between funds and accounts managed by the manager**

**Different services provided to other clients and/or accounts and general management of other accounts**

**Time and attention of manager's personnel**

**Offering of co-investment opportunities**

**Manager's access to material nonpublic information**

# Update on Hedge Fund Terms: Side Letters

- **Continued market demand for fee discounts, better liquidity, enhanced transparency, and other preferential rights through side letters**
  - Leverage Factors: Investor's name, ticket size, history with sponsor vs. Fund's performance record, size, and longevity
- **Manager issues**
  - Fiduciary duty concerns
  - Regulatory scrutiny
  - Litigation exposure risk
  - Operational risk – monitoring and compliance, cost
- **Trend toward incorporating investor demands into DDQs and fund offering documents to address investor requests and reduce side letters**



# Update on Hedge Fund Terms: Customized Products

## Architecture and Structuring

- **Separately Managed Accounts**
- **Funds of One**
  - Onshore vs. Offshore
  - Partnership vs. Corporation
  - Single Class vs. Multiple Class/Series/Sub-Funds
- **Customization Spectrum** – may determine the degree of flexibility to customize
  - New and unique investment platform
  - Investing alongside the commingled fund structure
  - Investing as a vehicle within the commingled fund structure
  - Separate class within the commingled fund
- **Migrating from a commingled fund to a customized structure**
- **Other avenues for customized solutions** (e.g., seeding or acquiring interests in the manager)



# Update on Hedge Fund Terms: Customized Products

## Common Motivations and Areas of Customization

- Investors seeking customized structures and products to better align with their investment goals and capitalize opportunistically on market disruptions
- Investment strategy customization (e.g., asset and strategy mixes; risk and return profiles; volatility; leverage; internal policy, regulatory, legal, and tax considerations)
- Fees and expenses (e.g., management fees, performance fees/allocations, expense caps)
- Alignment between asset type and investor liquidity needs
- Address control, transparency, and governance terms (e.g., customized reporting, notice of bad acts, approval of service providers, removal/termination rights, directed trading/suspension of trading)
- Fiduciary duties and exculpation and indemnification provisions
- Leveraging the manager's infrastructure (e.g., access to sponsor knowledge; may include training for investor or secondment of personnel)

# Update on Hedge Fund Terms: Co-Investments

- Specific opportunities that do not meet the concentration, liquidity, or asset class requirements of main fund
- Less mature market than private equity co-investment market
- Differentiated risk/return
- Fees, transparency
- Control rights
- Introducing illiquidity, hold periods
- Rights to participate
- Manager investment
- Conflicts

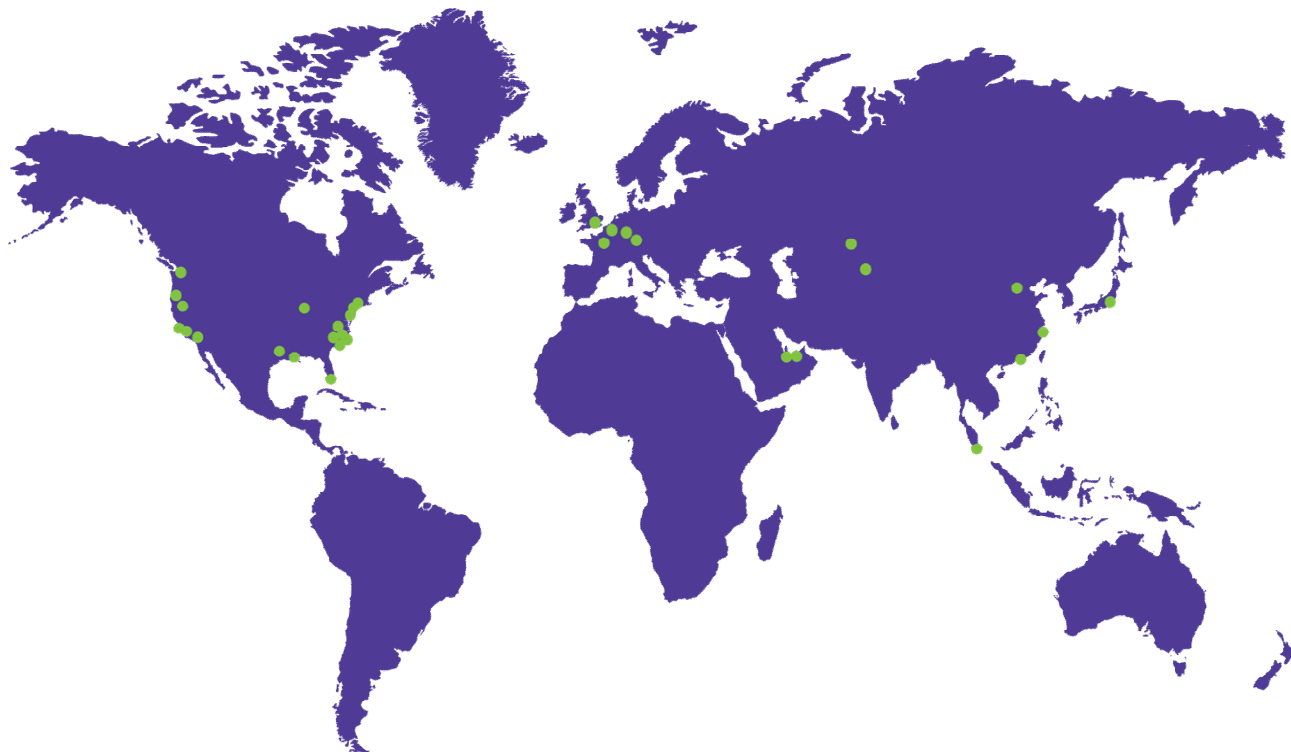


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