



SEWARD & KISSEL LLP

The Seward & Kissel 2020/2021 Hedge Fund Side Letter Study

Introduction

Driven by our ongoing commitment to understanding the dynamics of the alternative investment industry and bringing the latest industry color to our clients and friends, Seward & Kissel conducts various studies of important trends impacting the industry and our clients. This year, for the sixth 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, 2020 through June 30, 2021.

In the current Study, 79% of the side letters were with managers that founded their business two or more years prior to the time of the side letter execution (“Mature Managers”), and 21% were with managers that founded their business less than two years ago (“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. To illustrate this point, we observed a decrease in letters with Newer Managers, down from 26% last year.

Given that this Study covers the period from July 1, 2020 through June 30, 2021, the full impact of the COVID-19 outbreak should be reflected, whereas last year’s report only included about three months of the pandemic in its coverage period. It is hard to believe given all of the forced innovation that occurred in the hedge fund industry over the course of the pandemic, but, with a couple of exceptions, our findings in this Study have remained relatively consistent with the findings in last year’s Study.

The Study is broken down into three parts: the Managers, the Investors and the Terms. The three 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.

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In prior Studies we have included a comparison of hedge fund side letters observed over the relevant period to separately managed accounts. This year, as an extension to our Side Letter Study and due to the increased demand by investors for separately managed accounts, we have instead published the [SMA Snapshot Report](#), which highlights the trends we have observed with separately managed accounts. The [Snapshot Report](#) contains a more detailed analysis of SMAs, their investors, investment strategies and key terms.

Key Takeaways

- Excluding certain outliers, the average regulatory assets under management (“RAUM”) of the Mature Managers in the Study was approximately \$6.3 billion (as compared to \$5.1 billion in the prior study).
- The average RAUM of Newer Managers in the Study was approximately \$152 million, as compared to \$387 million in the prior study. The decrease in the RAUM of Newer Managers may reflect the difficulty that Newer Managers faced raising capital during the pandemic given the inability of meeting in person with prospective investors.
- Funds-of-funds continued to be the most common category of side letter investor, representing 54% of all side letter investors. This category experienced an uptick from the downward trend we have observed in recent years.
- While the RAUM of Newer Managers is down from the 2019/2020 study, we believe this to be attributable to a larger number of Newer Managers receiving allocations as investors become comfortable with the “new” fundraising environment and leverage virtual manager and diligence meetings.

(I) The Managers

Excluding certain outliers, the average RAUM of the Mature Managers in the Study was approximately \$6.3 billion (as compared to \$5.1 billion in the prior study), and all of the U.S.-based Mature Managers were registered with the SEC as investment advisers. These data points indicate an overall average higher assets under management level for Mature Managers.

With respect to Newer Managers, the RAUM was approximately \$152 million (as compared to \$387 million in the prior study), and 55% of them were SEC-registered (less than last year’s 75% number, but still significantly more than 2018/2019’s 25% number). While managers continue to be under pressure to maintain sufficient capital to operate in a rising cost environment due to regulatory and investor demands, we believe the lower RAUM for Newer Managers reflects an increase in allocations to Newer Managers as investors have become comfortable with the virtual fundraising environment as a result of the COVID-19 pandemic.

(II) The Investors

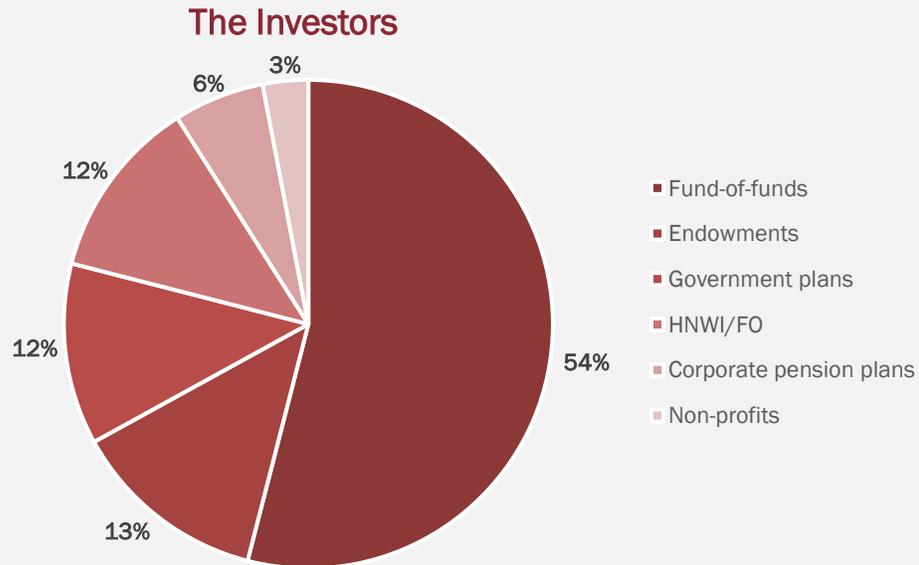
The six principal types of side letter investor categories that consistently appeared within the Study, in order of frequency, were: (1) funds-of-funds; (2) endowments; (3) government plans; (4) high net worth (HNW) individuals/family offices; (5) corporate pension plans; and (6) non-profit institutions.

Once again, the largest category of side letter investor included in the Study was the fund-of-funds category, making up 54% of all side letter investors, returning to 2017/2018 levels after dropping to 37.5% in 2018/2019 and 42% in 2019/2021. For purposes of the fund-of-funds category, as in prior studies, we included side letters with fund platforms that various banks offer, as well as side letters with allocator firms where the beneficial owners were not listed.

The second largest side letter investor category was endowments, at 13%, which represented 10% of side letters in the 2019/2020 study. Tied for the third largest side letter category were government plans and HNW individuals/family offices, at 12%, each of which represents a change from the 2019/2020 study (18% and 7.5%, respectively). Moving down from the third to the fifth largest side letter investor category was corporate pension plans at 6%, which represented a fairly significant decrease from the 15% figure in the 2019/2020 study. In sixth place were non-profit institutions at 3%. This continues the downward trend of non-profits which represented 12.5% in the 2018/2019 study and decreased to 7.5% in the 2019/2020 study.

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Analyzing trends separately for Mature Managers and Newer Managers, some interesting takeaways were that: (1) notwithstanding the slight decrease in this Study, there appears to be sustained interest in hedge funds from government plans and corporate pension plans, which we had identified as trends in the 2018/2019 and 2019/2020 studies; (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) 78% of the Newer Manager side letters were with funds-of-funds, which is an increase on our observation from last year of 50%. It also appears that the downward trend in side letters with funds-of-funds that we had observed over the past three years has reversed.



(III) The Terms

The Study focused on five principal business terms: (1) some form of most favored nations protection (“MFN clause”); (2) fee discounts; (3) preferred liquidity; (4) transparency/reporting obligations (of portfolio positions and/or portfolio exposures); and (5) capacity rights (for the first time). 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.

Consistent with last year’s Study, tied for the most frequently observed business term were fee discount clauses, which were included in 43% of all side letters (generally consistent with the 46% in the 2019/2020 study and with the 44% in the 2018/2019 study, however significantly increased from 24% in the 2017/2018 study). This term was more common in Newer Manager side letters (67%) than in Mature Manager side letters (29%). 54% of the fee discount clauses covered both management fees and incentive allocations, while 46% 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 endowments and government and corporate pension plans, evidencing that these kinds of entities continue to push for fee breaks in their side letter arrangements.

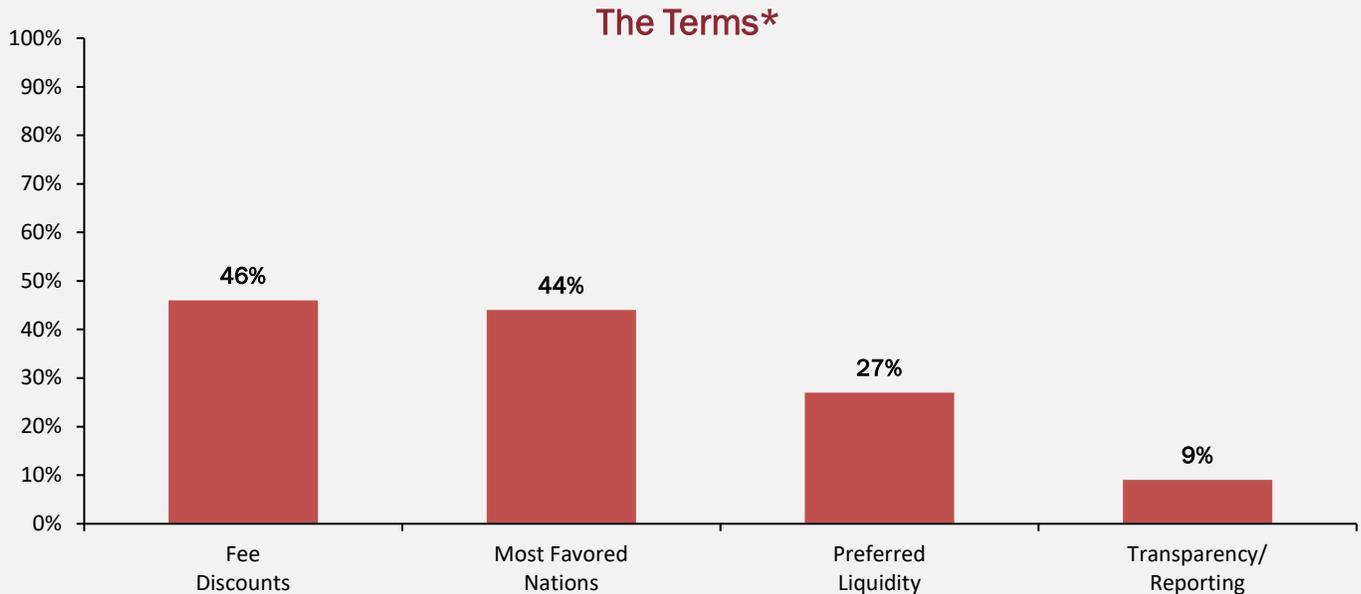
MFN provisions were tied for the most common term, also appearing in 43% of all side letters (down slightly from 44% in 2019/2020). All of the MFN clauses contained a bundling or package concept providing that if a preferential term (e.g., a lower fee) was given to another investor contingent upon a 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 35% of the side letters (up from 27% in the 2019/2020 Study). As was the case last year, this term was more common in Newer Manager side letters than in Mature Manager side letters.

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Capacity rights, which is a new addition to the Study from prior years, appeared in a significant number of side letters we reviewed – 17%. Not surprisingly, it was more common with Newer Managers (39%) compared to Mature Managers (12%) given the anticipated future capital raises of Newer Managers.

The least common side letter term, as was the case in previous Studies, was lagged portfolio transparency/reporting obligations, which appeared in 8% of all side letters (generally consistent with 9% in 2019/2020 and 10% in 2018/2019 Study).



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

We hope that you find *The Seward & Kissel 2020/2021 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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