

Hedge fund side letter survey 2022

The 2022 survey

We have recently carried out a comprehensive survey of side letters entered in to by hedge funds and/or their managers on which the London office of the Simmons & Simmons hedge fund practice has advised during the twelve months ended 30 June 2022.

In our survey, we measured the prevalence of five common side letter provisions – most favoured nation (MFN), transparency/risk reporting, enhanced liquidity, fee discounts and capacity. We also tracked certain other terms as well as categorised the investors requiring side letters and the regions in which they are based.

This is the first year we have published this information which is part of our overall strategy to share our market leading insights on key topics affecting the hedge fund sector.





Key findings

Fund of funds and endowments represented the largest investor categories together representing a total of 63% of the reviewed side letters.

Side letters, with very few exceptions, included notification obligations of different types. Of these, key person event notifications were required in 52% of cases. This increased to 78% of cases when commitments made in the relevant fund's offering memorandum were added.

MFN clauses were by far the most prevalent of the five common provisions we measured, appearing in 74% of side letters.

Side letters with US investors were more significant for newer managers (60%) when compared with mature managers (47%). Mature managers appeared, from the survey's data, better able to access investors outside the US and Europe.

The next most prevalent of the five common provisions was transparency/risk reporting at 37% - and significantly only 7% of side letters reviewed committed to full transparency of the portfolio even on a time-lagged basis.

75% of the MFN provisions had a size qualifier - ie where the right to be offered benefits received by another investor is contingent on that other investor's investment being the same size or smaller - and 90% were restricted to rights relating to fees, liquidity and/or information rights.

⁴We have categorised managers as newer or mature based on a number of factors including date of establishment.

Investor types

Five investor types accounted for the whole survey in the following order of frequency:

1. fund of funds;
2. endowments;
3. Government plans and sovereign wealth investors;
4. pension plans (non-Government); and
5. family offices and high net worth investors.

Side letters signed in similar formats for related investing entities were only counted once in our survey. The fund of funds category includes professional allocators where the beneficial owner/client is not identified.

It is interesting to note the small proportion of side letters with family offices and high net worth individuals in our survey (at only 7%). This is perhaps

a reflection of the institutionalisation of the hedge fund investor base that has taken place over several years. Even in the area of digital asset funds launched by newer managers, where we see the majority of investors tending to be small family offices and high net worth investors, our experience is that those investors typically do not request a side letter. Requests for management fee discounts from early stage investors in such funds are often simply dealt with through the creation of early bird share classes.

Looking at investor type trends as between newer managers and mature managers, we observed that Government plans and sovereign wealth fund investors had no side letters with newer managers – which may be a reflection of their typical ticket sizes and not wanting to represent too large a proportion of any one fund or manager’s investor base.

7%

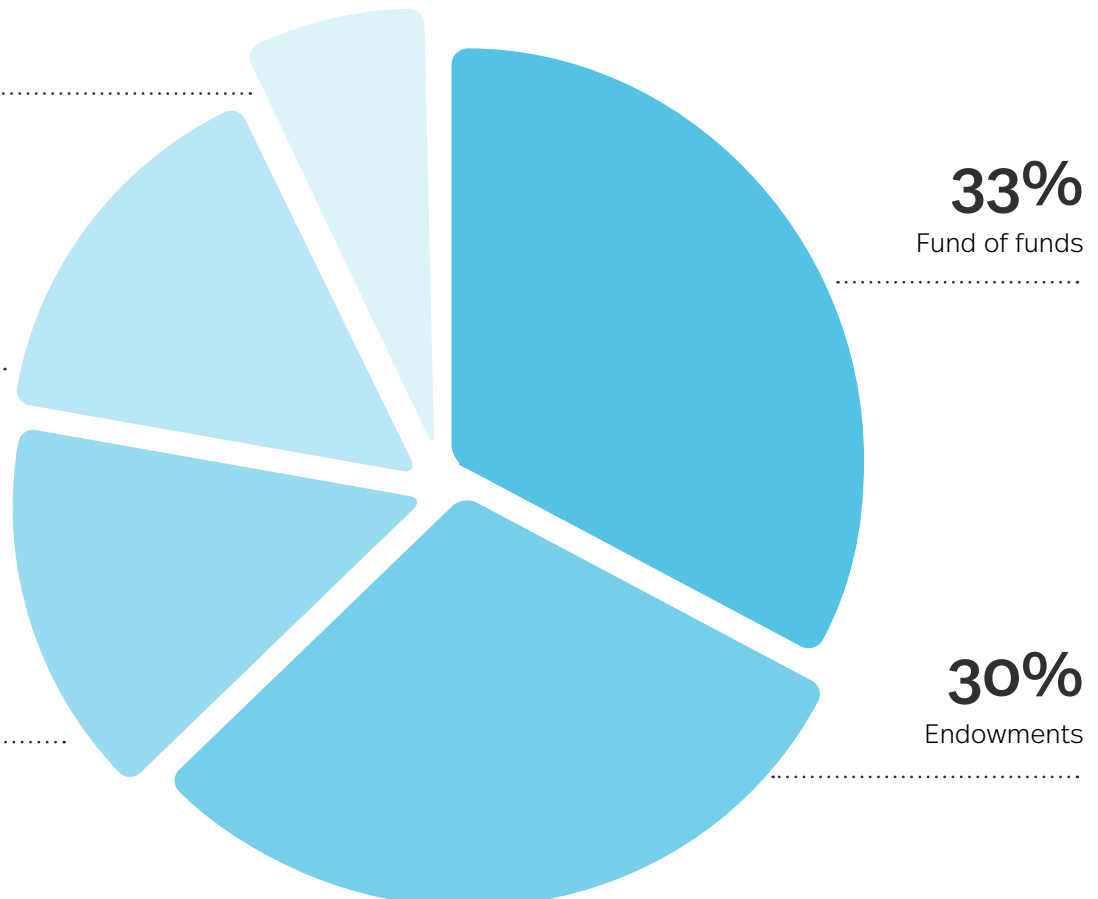
Family offices/HNWIs

15%

Pension plans
(non-Government)

15%

Government plans/
sovereign wealth





Investor regions

The investors covered in the survey were located in the four broad regions in the following order of frequency:

1. North America;
2. Australasia;
3. Europe; and
4. the Middle East.

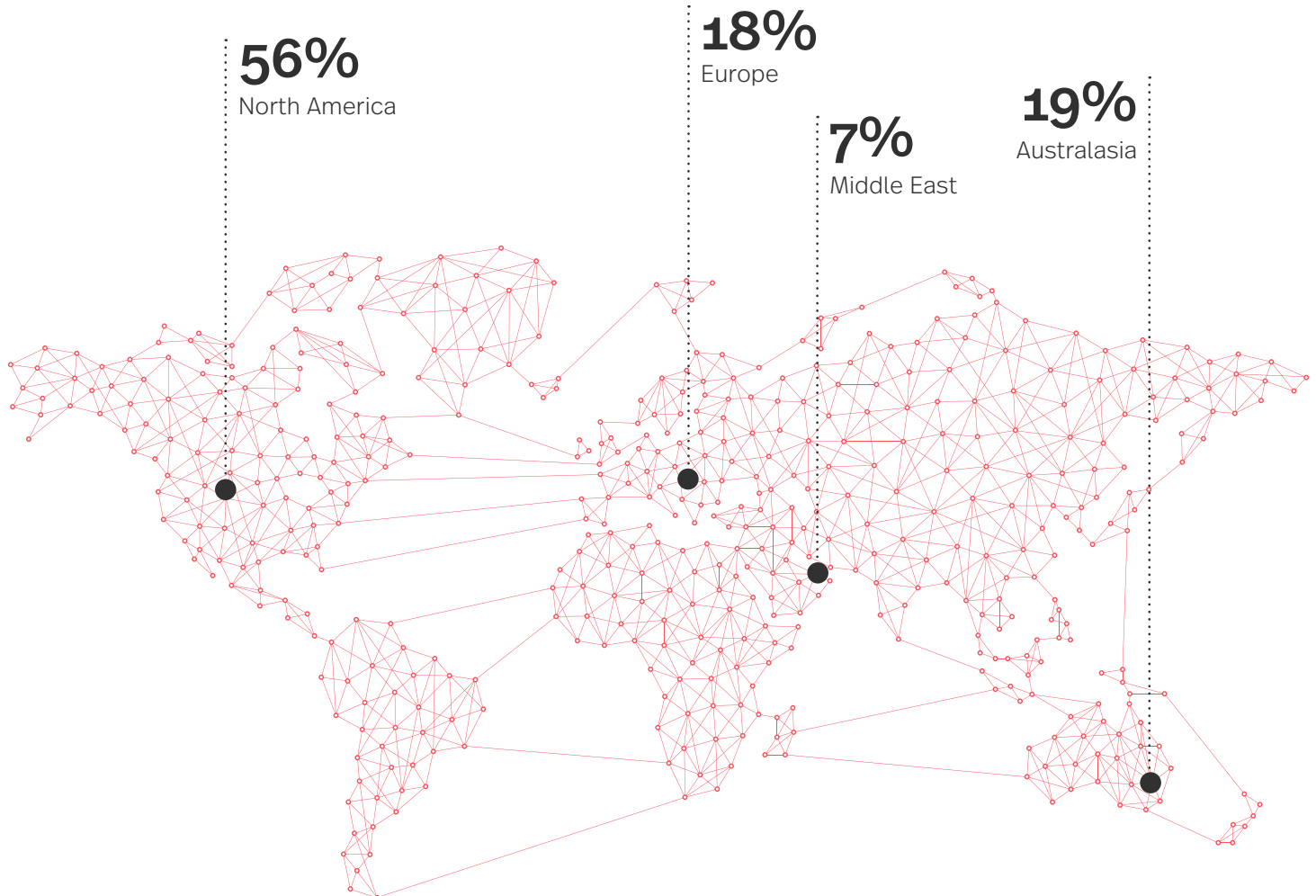
In addition to the relative greater significance of US investors to newer managers and the greater reach of mature managers beyond US and Europe referred to above, it is interesting to see that there are only four countries in Europe where investors with side letters were identified; these were the UK, Switzerland, the Netherlands and Germany.



US investor side letters represented the majority of the letters we reviewed.

The significance of US investors – and properly understanding their likely expectations on side letter requirements – remains key for newer managers.

Dev Saksena



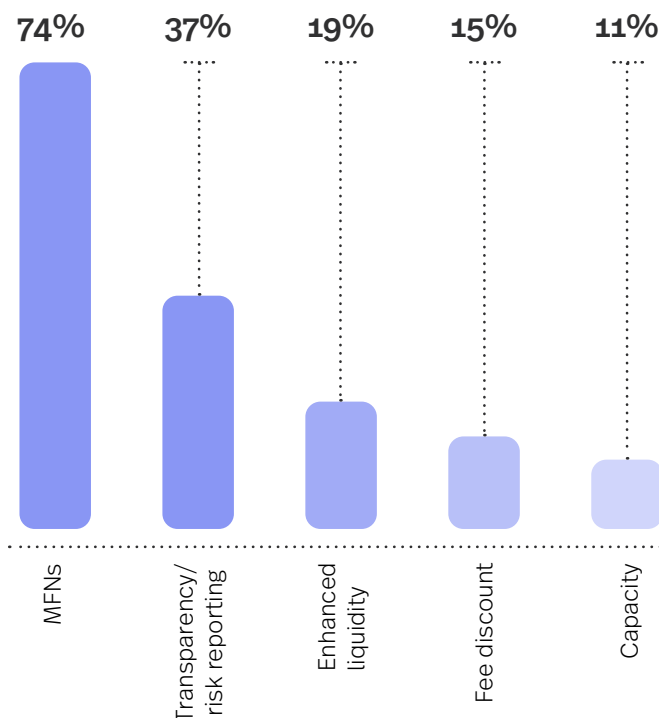
Most common terms

Our survey measured the frequency at which the following five common side letter provisions appeared across the reviewed side letters:

1. MFNs (74%);
2. transparency/risk reporting (37%);
3. enhanced liquidity (19%);
4. fee discounts (15%); and
5. capacity (11%).

MFNs are commitments to an investor that they will continue to receive the best terms available to any other investor in the same fund or group of related products. Our survey shows how common a provision an MFN is in a side letter but also how these commitments are routinely limited by size qualifiers (75% of cases) and restrictions on the class of rights to which they apply (90% limited to rights relating to fees, liquidity and/or information rights).

Commitments on transparency/risk reporting appear to be relatively common but it is interesting to see how infrequently (only 7% of cases) this included full portfolio transparency - even when provided on a time-lagged basis.



liquidity opportunity/reduction in redemption restrictions and (b) clarifications around redemptions in kind, suspensions and gating. A likely explanation for the low level of enhanced liquidity provisions is that the granting of them to only one investor can present difficult issues in the context of a fund board's fiduciary duties.

Fee discounts, in the context of a documented negotiation of terms of investment, are perhaps surprisingly low at 15% of reviewed side letters. A possible explanation may be that several investors in the reviewed side letters secured investments in low fee share classes (eg early bird share classes) where no fee discounts needed to be recorded.

Capacity rights to invest further amounts in a fund are a common feature of side letter negotiations but appeared in a relatively small proportion of the side letters in the survey.

There were no pronounced trends observed between newer managers and mature managers in respect of the five provision types.

“ This survey confirms that committing in a side letter to provide an investor with full transparency on a fund portfolio is in fact rare – even on a time lagged basis. This is a provision that is hard fought during negotiations. ”

Sarah Crabb

Enhanced liquidity provisions appeared relatively infrequently (19%). We excluded from the survey, both (a) side letter commitments where it was expressed that all investors (not just the side letter holder) would benefit from the relevant additional

Notification obligations

It is very common for side letters to include obligations on funds and/or their managers to notify an investor of different types of event occurring relevant to one of the fund parties or the investment generally.

The following types of notification event appeared in the reviewed side letters in the following order of frequency:

82%

Notice of regulatory action vs. a fund party.

82%

Notice of proceedings vs. a fund party.

78%

Notice of key person event (eg a portfolio manager no longer committing substantially all of their time) either in side letter or fund offering memorandum.

76%

Notice of change to one or more fund service providers.

71%

Notice of amendments to fund offering memorandum.

And finally...

Some of the reviewed side letters contained restrictions on types of investment to be made by the fund – either an outright ban on those investments or a requirement to give prior notice before they were first acquired. This appeared in 11% of the side letters covered in our survey. This is an area to watch with the increased focus of investors on ESG factors.



One in ten side letters we reviewed contained restrictions on types of investment to be made by the fund – either hard prohibitions or prior notification rights. This is an area to watch with the increased focus of investors on ESG factors.

Lucian Firth



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