Proskauer

Proskauer's Hedge Start: Key Hedge Fund Terms

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One of the first decisions faced by a new hedge fund manager is what terms to offer. The key terms to consider are liquidity terms (the terms of permitted redemptions or withdrawals from the fund) and the compensation payable to the hedge fund manager.

Liquidity Terms

The terms most frequently offered by hedge funds permit subscriptions on a monthly basis and redemptions on a quarterly basis, typically on 30 to 90 days' prior notice to the fund manager, with the redemption proceeds payable within 30 days. But there are many different variations of redemption terms that can and should be considered by a new hedge fund manager, especially if the underlying investments held by the hedge fund cannot be easily or promptly liquidated. Some key variations to consider include:

- **Redemption Dates**: Instead of permitting redemptions as of the end of each calendar quarter, redemptions can be permitted only semi-annually, annually or even less frequently. Some funds are structured so that different investors have different redemption dates in order to spread out the effect of redemptions.

- **Lock-Ups**: Redemptions are permitted only after a specified initial period of time, typically 1-3 years.
    - Lock-ups are often subject to a "key-man" clause that permits investors to redeem their investment if key personnel depart the management firm and may be subject to other exceptions.

- **Gates**: Redemptions on each redemption date are limited to a specified percentage (typically 5-25%) of either the fund's net assets (a "fund-level" gate) or of the redeeming investor's investment in the fund (an "investor-level" gate).
    - A common structure for many funds investing in less liquid assets is a so-called "rolling" gate that caps withdrawals on each redemption date (e.g., as of the end of each calendar quarter) to a percentage (e.g., 25%) of the redeeming investor's total investment. An investor can effect a full withdrawal

over four quarters by giving notice to that effect before the first withdrawal date.

- **Redemptions in Kind**: Most hedge funds can elect to pay redemptions by distributing assets in kind to redeeming investors instead of paying cash.
    - Significant investors often request a side letter requiring a fund manager to use reasonable efforts to pay all redemptions in cash, or to give advance notice of in-kind distributions and to sell illiquid assets for the account of a redeeming investor if requested by the investor.

- **Suspension of Redemptions**: Most hedge funds have the right to suspend redemptions under certain circumstances including in order to prevent forced sales of assets in unfavorable markets.
- **Side Pockets**: Some hedge funds are permitted to set aside illiquid assets in a "side pocket" (often referred to as "special" or "designated" investments), which is a separate pool of assets represented by a new class of non-redeemable interests or shares in the fund.
    - Existing investors cannot redeem their interest in the side pocket until the underlying investment(s) held in the side pocket are sold.
    - New investors coming into the fund do not participate in the side pocket.
    - Side pockets are often capped at a percentage (typically 5-25%) of a fund's or each investor's net assets.
    - Participation in side pockets can be optional (typically the investor must decide to either opt in or opt out of all side pockets).
    - Side pockets are often subject to different fee terms. In particular, side pockets are typically not subject to the normal annual mark-to-market incentive-based compensation, but instead only pay incentive compensation when the underlying investment(s) held in the side pocket are liquidated.
    - Side pockets are not looked upon favorably by all investors, particularly if the fund's investments are relatively liquid, so a new fund manager should consider carefully the potential benefits and disadvantages before adopting side pockets.

- **Slow-Pay**: Some funds are permitted to set aside for the benefit of redeeming investors a pro rata portion of any illiquid assets. Sometimes this is accomplished through a special purpose company, liquidating trust or other similar vehicle. The redeeming investor receives the net proceeds of the liquidation after the fund is able to sell the underlying assets.

- The “slow-pay” provision described in the preceding paragraph is different than a traditional side pocket because only the portion of the illiquid assets attributable to redeeming investors is set aside, and the remainder of the illiquid assets are still held in the fund and therefore are still part of the fund in which new investors participate.

Compensation

The typical hedge fund is subject to a fixed quarterly or monthly management or advisory fee and an annual performance-based incentive fee or allocation.

- The management or advisory fee is typically paid either monthly or quarterly, and is calculated as a percentage of the fund’s net asset value, typically between 1.5% and 2% of net assets annually.
    - It is very common to offer a discount to founding investors.

- The fund manager (or an affiliate) also typically receives performance-based compensation, typically as of the end of year, equal to a percentage (typically 20%) of the annual net appreciation in the value of each investor’s investment in the fund during the year.
    - The annual incentive compensation can be structured as either a fee (treated as 100% ordinary income for tax purposes) or as an allocation of profits (treated as long-term capital gain, but only to the extent that the underlying appreciation is attributable to investments that have been held for at least three years).

    - The performance-based compensation is typically subject to a “high water mark” or “loss carryforward” that ensures that the fund manager does not receive any incentive compensation on any new appreciation until any net losses in any prior years have been recovered.
        - Some funds use a “modified” high water mark, which permits the fund manager, after a period of losses, to continue to receive incentive compensation at 50% of the normal rate (for example, the fund manager receives 10% instead of 20% of any new net appreciation), but the fund has to recover 200% of the prior losses.

    - In recent years, some funds have adopted a “1 or 30” compensation structure in which investors pay either a 1% annual management fee or a 30% annual incentive fee or allocation (but not both).

    - Some managers offer different classes with different combinations of fees and liquidity terms (for example, lower fees in exchange for a longer lock-up).

Hybrid Terms

As hedge fund structures and terms have evolved and been modified to address the variety and liquidity of the underlying assets in which hedge funds invest, the compensation of fund managers is often also modified from the traditional hedge fund compensation structure. Some common variations include:

- Incentive compensation is only payable only at end of any lock-up.
- Incentive compensation is only payable on realized (not unrealized) gains.
- Incentive compensation may be subject to a "hurdle" or preferred return to investors.
    - The hurdle can be cumulative or annual, and can be subject to a catch-up to manager, so that the manager receives 20% of the total net appreciation.
- Performance compensation periods can be longer than one year and incentive compensation can be subject to a clawback or calculated on a rolling basis.

Decisions about key fund terms can involve difficult decisions that can send significant messages to prospective investors. Variations from standard terms can also involve different tax and regulatory consequences, so it is important to consult with experienced legal counsel.

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