

The logo for K&L GATES, featuring the text in white on an orange rectangular background. The background of the slide is a colorful, abstract pattern of diagonal lines in shades of red, orange, yellow, green, blue, and purple.

K&L GATES

How to Attract (Family Office & Institutional) Investors to your (Hedge) Fund

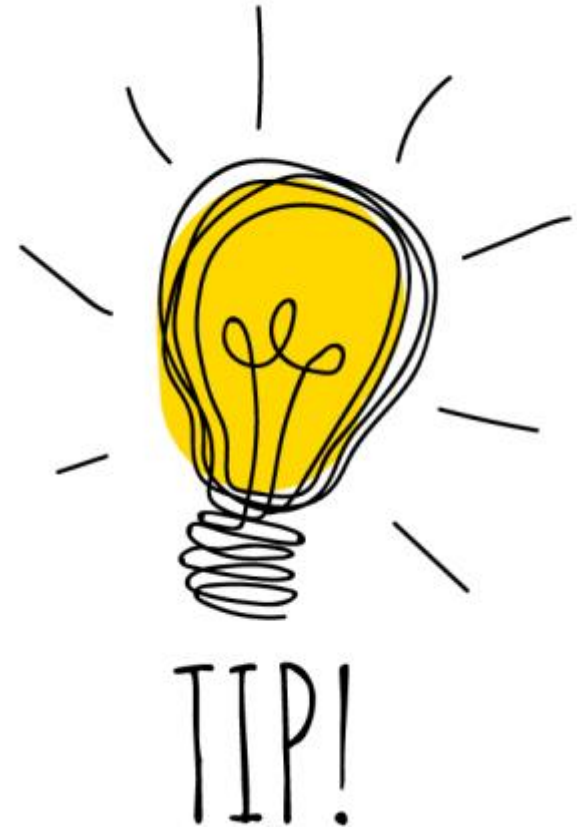
Presented by Scott Peterman, Ph.D., CFA
8 July 2021

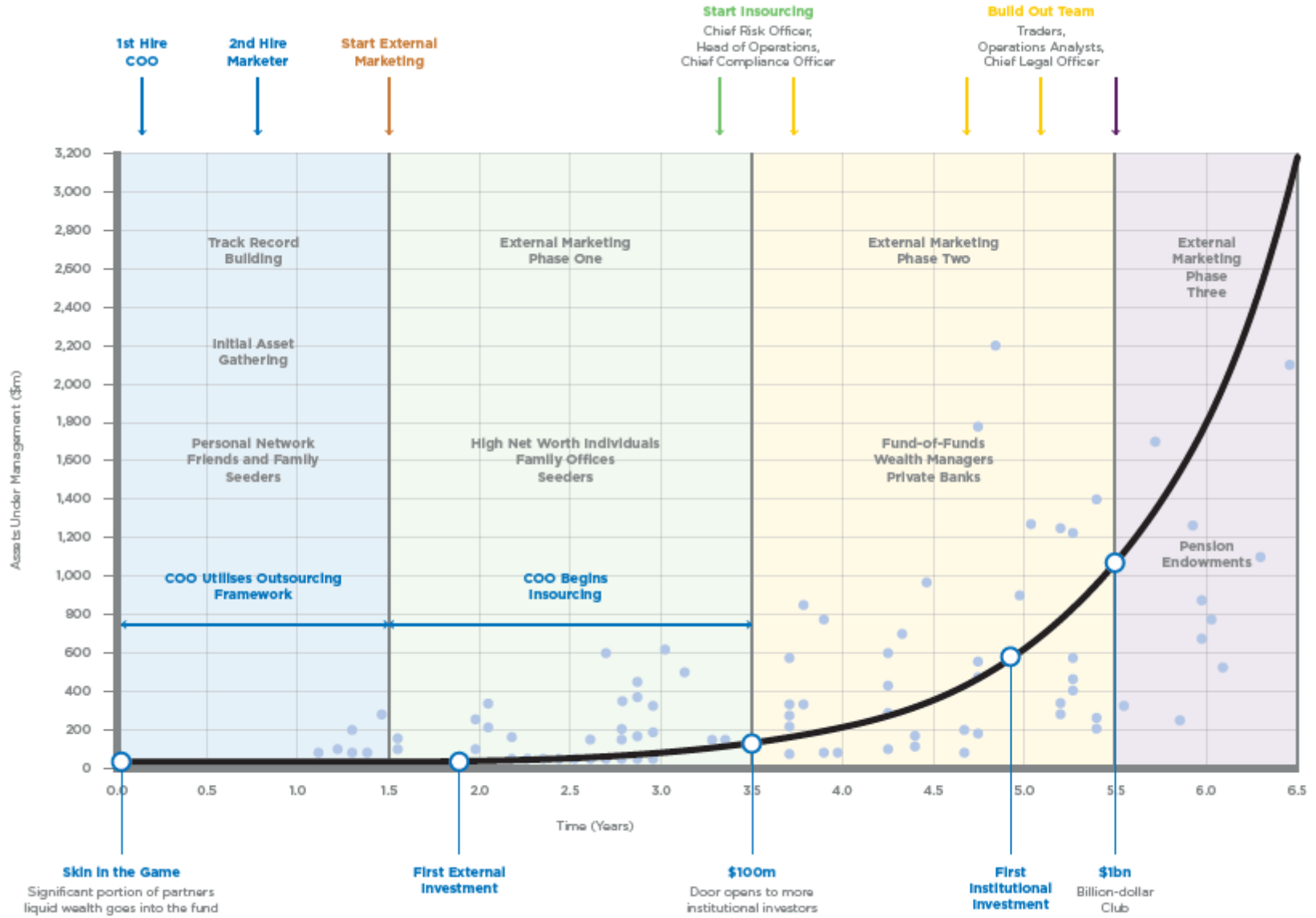
RUNDOWN OF TOPICS TODAY

- How much should you rely on your track record to sell your fund?
- Governance – 10 minutes
- Individual share classes / series – 5 minutes
- Side letters and MFN status – 5 minutes
- Portfolio transparency – 5 minutes
- Moving to Delaware? SEC / CFTC registration? – 5 minutes
- Trade error policies – 5 minutes
- Gates / liquidity profiles – 5 minutes
- Notification and redemption rights – 5 minutes
- Standard of care – 5 minutes
- Limits to indemnification and exculpation – 5 minutes
- Tips for raising capital – 5 minutes

WHAT SELLS A FUND?

- Length of track record, performance against beta, size of fund – just the beginning of a conversation
- Who is your optimum investor?
- What are you actually selling? Tip: it's more than the fund.






Source of AUM vs time data: Hedge Fund Intelligence

- Developing governance frameworks
 - Do strong operations imply good governance?
 - Is governance a moving target?
 - Institutional Investor Governance: the CalPERS Model
 - Investment vs. Operational Governance
 - Developing a governance program
 - Understanding governance evaluation standards
 - Beginning governance assessments
 - Analysing director governance
- Governance Analysis of Service providers
 - Governance Analysis: Audited financial statements examples
 - Governance Analysis: Business continuity examples
 - IT governance reviews



The background of the slide features a silhouette of several business professionals in a meeting, overlaid on a city skyline at sunset. The scene is reflected in a mirror-like surface below. A semi-transparent white circle is positioned on the left side, partially overlapping the text area.

Developing governance frameworks

- Typically falls within ODD, which focuses on purely non-investment-related risks of investing in a fund
- Is investment due diligence the same as governance?
- Does governance stop and start with the governing body of the fund (board of directors / general partner)?
- Most US funds do not have a BOD although offshore funds do

WHAT IS GOVERNANCE?

In etymological terms, the origin of the word "governance" comes from the ancient Greek verb *kybernein* (κυβερνεῖν, infinitive) or *kybernao* (κυβερνάω, first person) that meant steering, guiding, or maneuvering a ship or a land-based vehicle, and was used the first time metaphorically by Plato for depicting the governing of men or people (people would be here the modern application). This etymological component of "steering" also is being reflected in the prefix of "cyber" (for example, in words such as "cybernetics"). In the modern English language, "governance" is related to "government" and to "govern". Cybernetics deals with feedback and regulatory systems. If this close link between government and governance be continued conceptually, then a definition of governance may be: governance describes how a government governs. One may also say, alternatively: **governance addresses how government governs based on feedback**. Or simply—the exercise of power over entities.

https://www.researchgate.net/publication/299759472_Conceptual_Definition_of_Two_Key_Terms_Governance_and_Higher_Education



Fund and Administrator Interaction as a Governance Indicator

1. How often do you speak to the fund? Do you ever visit the fund's offices? Does the fund ever visit you?
2. Has the fund accounting team that services the fund accountant experienced personnel turnover? If so, how does this turnover compare with industry standards? How did the firm deal with that turnover?
3. What systems and technology does the fund admin use? How does this compare with the software, such as fund accounting systems, used by the fund itself?
4. Has the administrator undergone a SSAE 16 or equivalent review? If so, will they share a copy of the report with the investors?
5. How does the administrator deal with fair valued positions? Are they actually making any attempt to independently value these positions themselves? Or, is the administrator simply collecting documentation and taking the manager's word for it?
6. Can the administrator, independent of the fund, provide a list of brokers used by the fund? If so, how does this compare with any broker information used by the fund? How is the administrator notified of new brokerage accounts?
7. What is the administrator's role in overseeing cash movements? How often does the administrator reconcile cash (daily or monthly?). Is the administrator involved in reviewing invoices to process fund expenses?
8. What pricing sources does the administrator use? How does this compare with valuations sources used by the fund?
9. How does the administrator resolve pricing variances or disputes between itself and the fund manager?
10. What is the month-end NAV distribution timeline? Has this timeline changed over time? How does this compare with the timeline presented by the manager?

AND . . . YOU CAN JUST ASK FOR STUFF!



Evaluating Prime Broker Governance

- How soon they forget! Recent data shows investors increasingly minimize role of PBs.
- Take care: different managers receive different levels of services from PBs.
- So -- Don't rely solely on a big name!
- PBs are a valuable source of independent fund manager asset verification.
- How are you going to deal with a generic response from a PB?

Analyzing Legal Counsel Governance— Does "service provider clustering" improperly minimize governance weights?

- As with all service providers, they are not created equal.
- This is particularly true when it comes to fund counsel.
- So, let's start with the basic nuts and bolts of the relationship with a law firm.



- What is the hourly billing rate charged to the fund?
- Are any hourly billing rate caps or annual retainers in place?
- Is a blended rate charged or does the rate vary by experience?
- Is the hedge fund notified if fee limits are reached?
- Does the law firm have any particular expertise applicable to the fund, such as investment products or jurisdictional expertise?

Question: does what a fund pays its attorneys have any necessary relationship with governance?

Analyzing Legal Counsel Governance— Beyond the basics

Understanding the extent of the law firm's work with the fund

- Does the law firm provide compliance-related services to the fund?
- Has there been personnel turnover among the key individuals servicing the fund?
- Can the law firm provide an example of a recent matter on which it has worked for the fund?
- If the fund or manager was or is involved in litigation, can the law firm walk the investor through the litigation?
- Does the law firm interact with any other law firms used by the fund?
- Can the law firm provide a summary of routine legal tasks performed for the fund or the manager?

How much does the law firm interact with and understand the fund's business?

- Does the law firm generally understand the fund's investment strategy?
- If there have been any recent material developments that have occurred at the fund, is the law firm aware of them?
- Who at the fund / manager does the law firm primarily deal with?
- Has the scope of the work the fund has given the law firm increased or decreased over the past two year? If so, why?

HOW ARE ALLOCATORS SEEING US?

- Most allocators agree that poor governance would cause them to avoid investing in a fund, even if it met other operational and performance criteria
- Allocators would like to engage with managers and boards on a more regular basis on the issue of governance
- Most allocators have already decided against investing on at least one occasion due to governance concerns
- Most investors rate fund governance as "extremely important"
- The majority of allocators are unhappy with the current governance levels of Cayman Islands funds. Can HK do better?
- Most allocators have experienced difficulty in discovering how many directorships are held by independent directors on fund boards
- Allocators overwhelmingly agree that the issue of the number of total directorships held by certain independent directors must be addressed
- Should an independent director have no more than 20 to 30 manager relationships?
- Do your investors carry out ongoing due diligence independently of fund boards and place reduced reliance on the boards?
- Allocators are more content with governance levels on fund boards promoted by European fund managers than North American or Asia Pacific managers
- Most allocators would like to see the majority of fund boards' membership held by independent directors and want to see independent directors filling the role of chairman
- Defining independence and identifying conflicts of interest of directors is a key issue for investors. The relative independence of directors related to the fund's administrator or legal advisor becomes more of an issue for investors if they are the only independent directors on the fund board, due to potential conflicts.

LOW COST – HIGH IMPACT GOVERNANCE "GIVE-AWAYS"

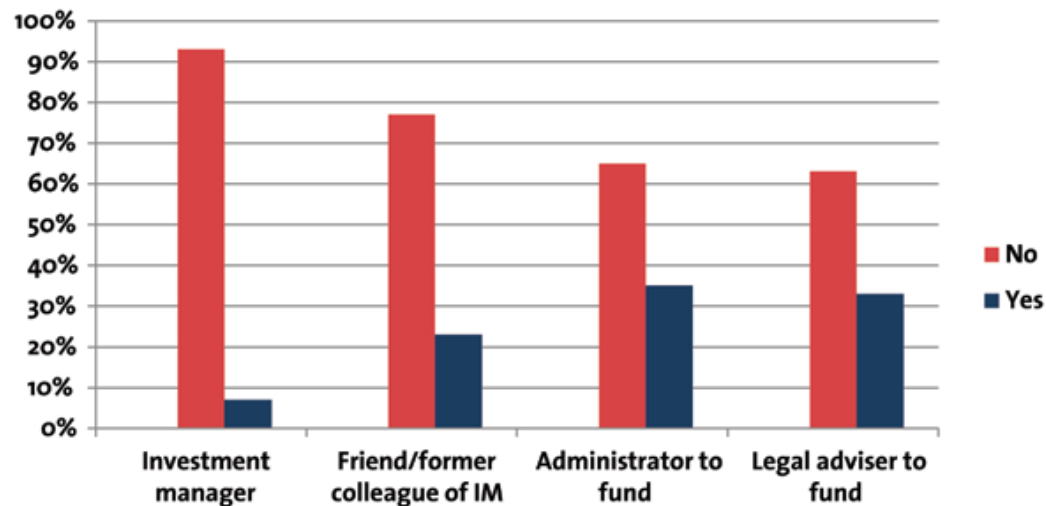
- Give investors option to subscribe for voting shares in fund
- appointment and removal of the investment manager;
- the election of directors;
- approval of directors' fees;
- variation of shareholder rights;
- winding up the fund at annual or extraordinary general meetings;
- nominate directors;
- file a resolution at general meetings; and
- convene an extraordinary general meeting.

INVESTORS BELIEVE THAT:

- It should be easy to implement the above recommendations within a reasonable time frame;
- Improved governance procedures will not require a huge effort from managers once put in place;
- This should not represent a cost to managers. Investors said they were willing to bear the cost of additional directors' fees, if necessary in the funds, in return for what they see as a material reduction in risk;
- Good governance should be seen as an integral part of the fund's and manager's operational infrastructure, and will become a key part of the due diligence process going forwards;
- Ambitious managers should embrace good governance rather than let it be an obstacle in the investor manager relationship.

WOULD YOU CONSIDER ANY OF THE FOLLOWING AS INDEPENDENT DIRECTORS IF RELATED TO:

What is the true meaning of "independence" in the context of directors?



The majority of directors did not consider directors related to the manager or key service providers as independent. Allocators still look to see at least one fully independent director, not related to any service provider, on the board. The focus is very much on the potential for conflicts of interest and directors that can form an independent view. It can be difficult to assess the real relationship between the manager and some of the directors, particularly with Asian managers. **HOW DOES THE SFC DEFINE INDEPENDENCE?**

WHAT CAN YOU DO TO IMPROVE THE PERFORMANCE OF YOUR FUND'S BOARD?

- Make sure that the majority of your directors are independent from the manager. "Independent" has a regulatory definition in some countries. In practice, this often means directors appointed from a company providing director services, though investors should not be faulted for expressing at least a modicum of skepticism since the directors were chosen by the investment manager and not by investors.
- Hire directors that have appropriate backgrounds associated with investment management, investment banking, due diligence, and legal / regulatory experience.
- Widen the pool of talent outside fund accounting or fund administration to meet investors' needs for relevant investment and operational experience.
- Recruit directors from developed market economies where there are more-developed governance situations.
- Recruit directors from different director services firms to avoid "group think." For a variety of sound reasons, investors prefer so-called split boards. In practice, fund managers quite often prefer to appoint directors from the same director service firm on a discounted fee basis. But, since one of the two directors from the same firm is generally the "lead" director, the second director can often be quite passive and "along for the ride." Net-net: you're paying for $1\frac{1}{2}$ directors, but getting only 1.
- Is the composition of your board appropriate for the AUM of your fund? Small funds nearly always start with one or two "insider" directors (i.e., the fund manager), but then never change the board composition as they grow. Instead, as you scale up, level up. Your business is not static, neither should your board be static. In that connection, it makes sense to consider term limits for directors.

INDIVIDUAL SERIES ACCOUNTING

- Performance Fees should be allocated based on the performance of each individual investor's investment
- Series accounting — whether single or monthly series — calculates Performance Fees equitably with respect to each investment, but not with respect to each investor
- Individual series accounting is effectively using partnership accounting for corporate funds. Each investor receives an individual series of Shares, which is accounted for exactly as a partnership capital account, without the "noise" of having to maintain a uniform Net Asset Value per Share.

INDIVIDUAL SERIES ACCOUNTING: PROS & CONS

- Downside: the audited financial statement footnotes for the offshore fund will have to list each individual series (although not, of course, identifying the investors).
- Another Downside: fund administrators don't like individual series
- Unexpected Boon: With individual series, the Cayman lawyers will let you make virtually any restructuring changes you want without need of a vote. Each investor — for voting purposes owning his/her own class of Shares — simply decides (as a "majority of one") whether to go into whichever options you may offer.
- Gross Asset Value Shares: A variation on individual series of Shares which permitted listing effectively individual capital accounts on the Irish Stock Exchange was to issue Gross Asset Value Shares — i.e., Shares whose value does not reflect the Performance Fee. By externalizing the Performance Fee from the Share accounting and simply redeeming Shares in order to pay the Performance Fees under the Subscription and Shareholders' Agreement, we were able to have totally fungible Shares but individualized Performance Fees.
- If a fund has a significant special / designated investment commitment, a multitude of accounting problems argue strongly for individual series of shares. Otherwise, just use a partnership.

A Long-Term Alignment Solution – FARs®

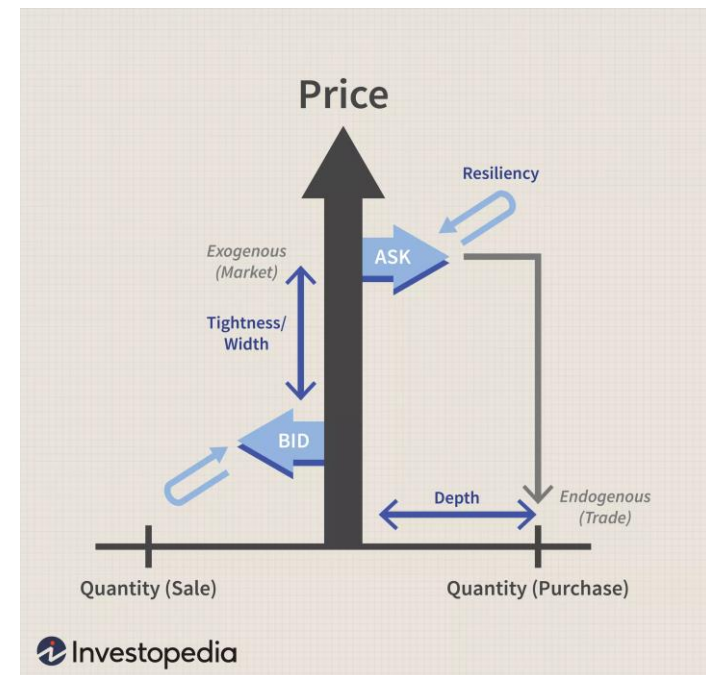
- Stock Appreciation Rights (SAR) settled in Fund Shares or net-settled call Option to buy Fund Shares (these are identical in operation) are exempt from 457A (and 409A) if properly structured
- Fund issues FAR® to Manager on percentage of Investor's investment
- Manager's benefit is "Spread" – excess of NAV over Strike Price
- Strike Price is equal to or greater than NAV on grant date
- Spread grows pre-tax, tax-deferred, at gross performance until FAR® exercised
- Manager can exercise at any time during the Exercisability Term
- Spread received is taxable as ordinary income

THE MOST SIGNIFICANT CHALLENGES IN HEDGE FUND INVESTING

- Following transparency and meeting performance expectations (tied for 1 and 2), the following are the most important challenges faced in hedge fund investing, from more important to less: (3) fees/value for money; (4) **liquidity**; (5) earning non-correlated returns; (6) understanding risk; (7) manager selection; (8) headline risk/bad press; and (9) educating the board.
- Digging down on what "transparency" means, institutional investors are demanding the following categories of information from their managers; the categories are listed from those demanded most frequently by investors to those demanded least frequently: (1) sector level detail; (2) valuation; (3) leverage detail; (4) risk analytics; (5) counterparty exposure; (6) geographic exposure; (7) hedging positions; and (8) position level detail.

LIQUIDITY RISK

- Is "liquidity risk" the biggest worry of investors? Is your fund subject to [gates or redemption suspensions](#)?
- But, what is liquidity? Liquidity is an odd creature, in that only rough quantitative measures exist to track it. Most common examples include average daily or weekly trading volume, average bid-offer spread or concentrations of largest block traders as a proportion of total trading volume. As such, liquidity does not easily lend itself to quantitative asset allocation, and most investors address it with crude limits and guidelines, such as:
 - "no more than x% of total daily trading volume", or
 - "no more than x% of total allocation into a given fund", or
 - "no more than x% of total assets of any fund".



SEVERAL DEFINITIONS OF LIQUIDITY

[HTTPS://WWW.EUREKAHEDGE.COM/RESEARCH/NEWS/1165/THE-REAL-LIQUIDITY-RISKS-IN-ALTERNATIVE-INVESTMENTS](https://www.eureka hedge.com/research/news/1165/the-real-liquidity-risks-in-alternative-investments)

Definition	Meaning	Remarks
A) Exit liquidity	The speed with which one can liquidate the investment in a fund	The most common definition for fund investors.
B) Trading liquidity	Ability and cost of liquidating a position	The most general definition in the trading world.
C) Funding liquidity	Ability and cost of financing a trading inventory	The classic funding definition. Most important for strategies – such as Private Equity or Distressed – that have extended holding horizons.
D) Spread liquidity	The difference in liquidity between similar comparable securities/strategies	It is the impact of liquidity on market risk and the requirement for a liquidity premium that it causes. Involves the differential of change in market value between the most liquid comparable security/strategy and the security/ strategy that one holds. Most critical for relativevalue strategies, since these rely on major complex hedging assumptions.
E) Strategic or systemic liquidity	Sensitivity of AI industry's aggregate flows to the absolute level of risk-free yields	From a macro perspective, it refers to the decision to allocate to AI vis-à-vis default risk-free government securities.

HEDGE FUND REDEMPTION FREQUENCY

[HTTPS://WWW.AIMA.ORG/STATIC/UPLOADED/7656E745-4DB1-4BF9-A09924216E53225C.PDF](https://www.aima.org/static/uploaded/7656E745-4DB1-4BF9-A09924216E53225C.PDF)

Average Number of Days	Redemption Notice Period			Redemption Frequency		
	Pre-2008	2017	% Change	Pre-2008	2017	% Change
Arbitrage	46	27	-42%	57	12	-79%
CTA/Managed Futures	14	12	-16%	22	16	-26%
Distressed Debt	67	81	21%	110	56	-49%
Event Driven	62	48	-22%	84	94	13%
Fixed Income	37	35	-4%	46	89	93%
Long/short equities	38	28	-27%	55	41	-26%
Macro	28	18	-36%	35	31	-10%
Multi-strategy	39	30	-21%	50	24	-52%
Relative value	41	26	-37%	66	30	-54%
Private credit strategies	71	66	-7%	88	70	-21%

Eurekahedge, AIMA Research

LIQUIDITY TERMS

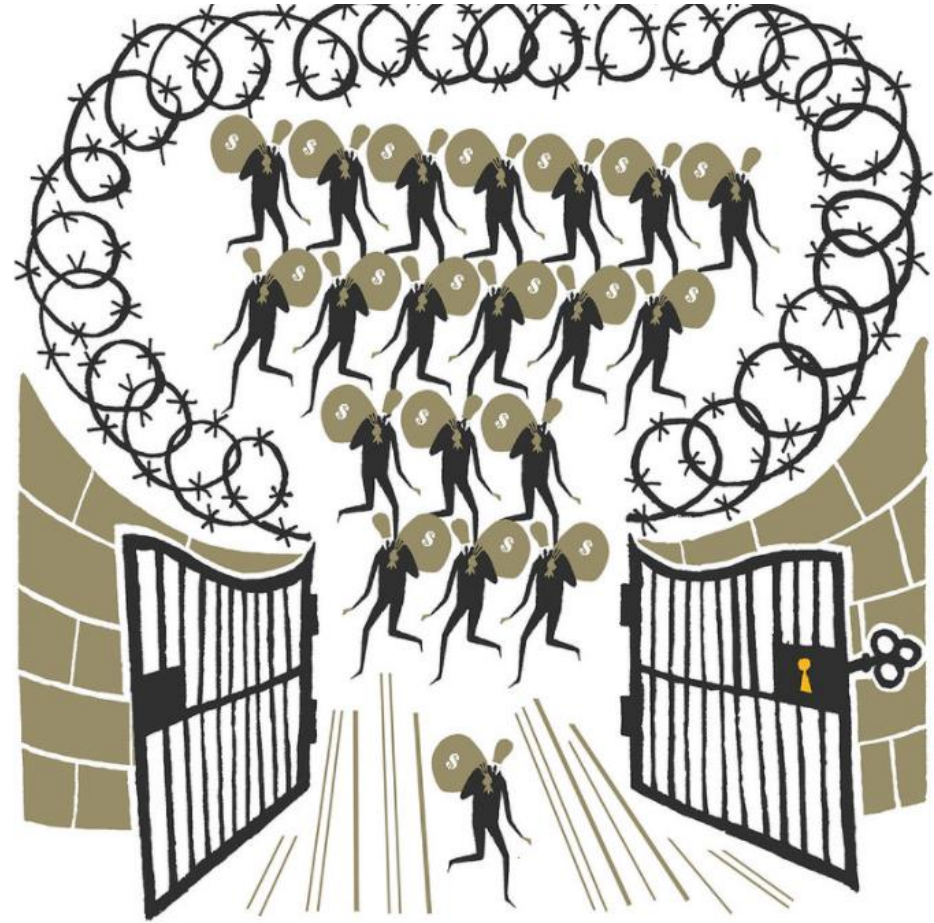
- Simpler and investor friendly liquidity terms more common
- Fewer and shorter soft lock-up periods, no hard locks
- Individual gates rather than fund level gates
- Individual gates triggered by overall redemption levels
- Back-ended declining redemption fee rates over time
- The use of platforms and leverage to increase FOF liquidity
- Individual gate that does not require successive redemptions to avoid infinite regress
- Reduction in manager discretion and time limit on suspension
- Promotion of secondary market liquidity in fund interests

LIQUIDITY TERMS

- A redemption process rather than fixing redemption NAV as of a date certain
- Limits on side pocket and SPV authority
- Requiring global redemption opportunity following suspension with no priority for prior redemption requests
- Fewer liquidity waivers for manager and its personnel, except for employee deferral plans

NEGOTIATED LIQUIDITY IMPROVEMENTS

Though investor attitudes are in flux about investing in funds with side pockets, still most investors avoid these funds. Investors prefer shorter lockups and less restrictive gate provisions. With respect to liquidity negotiations and allocation decisions based in part on liquidity, endowments and corporate pension plans have been more active than public pension funds.



SAMPLE WITHDRAWAL PROCESS

A Limited Partner may, as of any Withdrawal Date after the expiration of the Lock-in Period, withdraw up to the "**25% Notional Balance**" of its Capital Account. The 25% Notional Balance attributable to a Capital Account equals the notional Net Asset Value of the balance attributable, as of any Withdrawal Date, to 25% of each Capital Contribution, assuming that the balance had experienced the same monthly rates of return as the Capital Account from the Effective Date of the Capital Contribution. This limitation on the maximum withdrawal that may be made by a Limited Partner as of any given Withdrawal Date (the "**Withdrawal Process**") is applied regardless of the redemption behavior of any other Limited Partners and largely regardless of the prior redemption behavior of the withdrawing Limited Partner itself. The Withdrawal Process permits any Limited Partner to withdraw its entire Capital Account balance in no more than four Withdrawal Dates (which need not be successive calendar quarter-ends) following the date of a Limited Partner's most recent Capital Contribution.

THE TROUBLE WITH LIQUIDITY

(ALLABOUTAPHA.COM/BLOG NOV. 28, 2011)

Investor horizons have become increasingly shorter – a logical consequence of this greater desire for liquidity. For managers, it is their clients' preferences on these matters that drive their investment philosophy and strategies.

Risk on, risk off is the new tap dancing. Investors now live day to day from each central bank opining to every political posturing, slaves to their daily P&L. Where pension funds may have taken five year views, they now scrutinise every monthly and quarterly report. Where a hedge fund may have held positions for 3-6 months in the past, they now trade with a 1-2 month view. Where traders and algorithms had a horizon of days, they now are looking intra-day.

There is a problem with this. The more investors crowd into the short end, the more efficient it becomes. Technicals and trading dominate, making crowd behaviour all important. Correlations rise across all asset classes, beta dominates and the lower the future returns are for investors. For many, their experience will be akin to a weather buoy – for all of their furious movement, they will be where they began at the end of it all.

CLARITY AND INFRASTRUCTURE

"Clarity of investment philosophy" and "risk management infrastructure" are the first and second most important hedge fund selection criteria for institutional investors.

The following factors are important in selecting hedge funds, listed from most important to less important: (3) quality of firm's investment team; (4) identifiable sources of alpha; (5) liquidity terms; (6) portfolio transparency; (7) fees; (8) suspended redemptions or gates during crisis; (9) separation of investment and operations management; (10) quality of reporting and communications; (11) **investment performance over the past two to three years**; (12) overall client service; (13) firms that serve as prime brokers; (14) level of assets under management; (15) *willingness to accept managed accounts*; and (16) use of multiple prime brokers.

TAKEAWAYS FOR HEDGE FUND MANAGERS

- **Clearly articulate your strategy.** Have clear, succinct explanations of how your strategies fit within a diversified portfolio and are expected to perform under varying scenarios." But -- an overly complex description of the investment process is an impediment to asset raising and retention.
- **Embrace transparency.** In particular, managers should: (1) recognize that investors require a growing body of information to satisfy a range of constituencies; (2) institutionalize their transparency policies to offer a consistent investor experience; and (3) be mindful of conflicts of interest when seeking to accommodate the needs of individual investors.
- **Investment in risk management infrastructure and personnel is money well spent.** Strong risk management is essential not only to mitigate financial loss and attract new capital, but to protect the firm's reputation – its ultimate asset.
- **Increase client service and retention efforts.** "Marketing" must not only be directed to new investors, but also to existing investors. No substitute for timely, two-way communication and consistent investor reporting.

The Gates of Redemption?

Types of gates:

(i) Fund gate:

A fund gate limits the amount that all investors in a fund are permitted to withdraw from a fund at a given point in time (a redemption period). For a fund gate, the amounts that all investors request to redeem are combined and measured against an overall threshold. To the extent the threshold is exceeded, the requested redemption amounts are reduced as provided for in the fund's offering documents.

For instance, if redemptions totalled more than 25% of a fund's assets, the manager could put up a gate limiting total withdrawals to 25%. This means that redeeming investors will only have a portion of their redemption requests fulfilled.

(ii) Investor gate:

An investor gate is an investor-by-investor limitation that restricts the amount which an individual investor may redeem, regardless of the amount that other investors are redeeming. Having an investor gate in place effectively staggers each investor's partial or complete redemption from a fund.

Proportion of Equity Strategy Hedge Funds with a Gate Provision			
Gate Provision	2008	2017	2017 Investor-level liquidity
None	68%	70%	Medium
Fund-level	22%	14%	High
Investor-level	10%	16%	High

Source: Preqin, AIMA research

Proportion of CTAs with a Gate Provision			
Gate Provision	2008	2017	2017 Investor-level liquidity
None	88%	90%	High
Fund-level	12%	9%	High
Investor-level	0%	1%	High

Source: Preqin, AIMA research

Proportion of Macro Strategy Hedge Funds with a Gate Provision			
Gate Provision	2008	2017	2017 Investor-level liquidity
None	81%	80%	High
Fund-level	15%	15%	Medium
Investor-level	4%	5%	High

Source: Preqin, AIMA research

Proportion of Event Driven Hedge Funds with a Gate Provision			
Gate Provision	2008	2017	2017 Investor-level liquidity
None	40%	48%	Low
Fund-level	37%	19%	High
Investor-level	23%	34%	Low

Source: Preqin, AIMA research

GATES / LIQUIDITY RISK PROFILE

- Investors asking managers to report the liquidity of their investment portfolios, by specifying which portion of the portfolio belongs to a particular liquidity category, and establish liquidity limits for their investments. Liquidity categories should be defined via measurable and verifiable metrics that include the ratio of position size to an average trading volume over a pre-defined period of time (e.g., which percentage of the portfolio is made up by positions whose size is <0.1%, <1%, <5%, >5% of the average daily trading volume).
- Liquidity profile of the portfolio should be aligned with the fund's redemption terms.
- Language needs to be specific as to why gates are imposed and for what duration of time they will be in place. Withholding capital for longer than one year needs to be explained. More importantly investors expect to be provided with a specific time frame as to when it will receive its capital in full without further constraints.
- However, investors should not have the ability to compromise the hedge fund manager's business or other clients' capital by having too much latitude in forcing liquidity.

WHAT IS A FIDUCIARY?



"These new regulations will fundamentally change the way we get around them."

Source: *The New Yorker*

FIDUCIARY DUTIES; STANDARD OF CARE

ABC investors requires a duty of care reflecting the prudent person standard and a **duty of loyalty** that provides that the **manager will not put its interests above the interests of ABC**. A manager ought to carry out these duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matter would use in the conduct of a like character and with like aims.

SAMPLE FROM A MANAGED ACCOUNT

1. The Manager acknowledges that it is a fiduciary with respect to the Client and the management of the Managed Assets under this Agreement. The Manager shall
 - a) fully and faithfully discharge all its obligations and duties pursuant to this Agreement and with respect to the receipt of compensation for services under this Agreement;
 - b) **act solely in the interest of the Client** and its beneficiaries and for the exclusive purpose of providing benefits to the Client and its beneficiaries; and
 - c) act with the care, skill, prudence, and diligence that a prudent, experienced, sophisticated, and expert professional investment adviser would use in providing investment advisory and portfolio management services to a client.
2. The foregoing standard of care and prudence applies to all investment decisions, delegations of authority, and all other acts or omissions of the Manager under this Agreement.

CONTRACTUALLY WAIVING THESE DUTIES

- Statement that manager will not act as fiduciary
- Blanket waiver of all conflicts of interest
- Waiver of any specific obligation under Code of Conduct, Advisers Act, etc.
- Acknowledgment that investor's interest is subordinate to manager

MODIFYING FIDUCIARY DUTIES

Current standard: GP can consider only those interests and factors it desires – including its own interests – with no duty or obligation to give any consideration to any interest or factors affecting the fund or any other person

INVESTOR RESISTANCE

1. Sponsor cannot give greater weight to its own interests
2. Express obligation that sponsor must prioritize interest of the fund and its investors

WHAT DO I HAVE TO NOTIFY INVESTORS ABOUT?

- Receives notice and the opportunity to withdraw at month-end, and/or that the investor-level gate is waived, upon the occurrence of any of the following events:
 - Key person event;
 - The general partner, investment manager, affiliates and principals, in the aggregate, redeem more than 50% of their co-investment during any 365-day period;
 - Any "change in control" of the general partner or investment manager (as this term is defined under the Investment Advisers Act of 1940);
 - Material change to the investment strategy of the fund to the extent that more than 10% of assets are invested in a manner different from the description in the offering materials;
 - If total assets under management for the fund or strategy fall below a certain threshold;
 - Any amendments to the organizational documents of the fund which are adverse to an investor without the investor's consent;
 - Due to a change in law or opinion of counsel continued investment is illegal or violates a fiduciary duty owed by an investor.

ADDITIONAL NOTIFICATIONS

(IN RELATION TO CERTAIN EVENTS)

- | | |
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| <ul style="list-style-type: none"> ➤ Amendments to the organizational or offering documents of the fund, or the master fund, if applicable; ➤ Amendments to the valuation or allocation policies of the investment manager or the fund; ➤ Any use of soft dollars outside the "safe harbor" afforded by Section 28(e) of the U.S. Securities Exchange Act of 1934; HK corollary also applies ➤ An allocation of expenditures, charges, deductions, reserves or losses to an investor's account which are not allocated proportionately to all investors; ➤ Any lawsuits, arbitrations, investigations, proceedings, notices, subpoenas or demands relating to any party to the side letter which are likely to have an adverse effect on URS; ➤ Resignation of the independent public accountant responsible for auditing the financial statements of the fund or the master fund; ➤ Dismissal of the independent auditor of the fund or the master fund; ➤ Indemnification expense that affects an investor's account; ➤ The general partner, investment manager, affiliates and principals, in the aggregate, redeem more than 25% of their co-investment during any 365-day period; | <ul style="list-style-type: none"> ➤ Any material loss, damage, expense or liability incurred by the fund or master fund as the result of fraud, willful misconduct, gross negligence, recklessness or violation of law by the general partner or investment manager of the fund or any party to a side letter or their respective officers, directors, employees, agents or affiliates; ➤ Redemption requests during any three-month period the fund receives that, in the aggregate, represent more than 20% of the net asset value of the fund; ➤ Any of the principals being charged with or convicted of a felony; ➤ The fund or master fund retains any new prime broker, administrator or custodian, or the fund or master fund terminates any such relationship; ➤ Creation of any new class of share in the fund or master fund; ➤ Suspension of redemptions or suspension of calculating net asset values for the fund or master fund; ➤ Any termination of the investment management agreement with the fund or master fund; ➤ If a "master-feeder" structure, if more than 5% of feeder assets are not invested in the master fund. |
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THE PERILS OF SIDE LETTERS

- Side letters raise four problems:
 - Does the particular side letter pass muster under the constitutional documents of the fund? Is there authority to issue the letter?
 - Is the grant of the side letter a breach of the contractual commitments of the fund or the fund manager, including those in other, existing side letters?
 - Is there adequate disclosure to other investors that a side letter of this sort may be granted? The fund manager in this regard may be more onerous than the requirements of the fund documents themselves are.
 - Is the side letter substantively problematic? Side letter terms are generally constrained by fiduciary duties to other investors in the fund.

GENERALLY ACCEPTABLE SIDE LETTER TERMS

- Side letter provisions granted by a hedge fund manager that do not relate to their status as a fiduciary generally pose fewer difficulties, such as fees. However: compare fees paid to manager vs. fees paid to fund.
- Side letter provisions that address an investor's idiosyncratic regulatory circumstances also are often acceptable from a fiduciary standpoint, such as limitation in voting rights under BHCA.
- **However, not all side letter requests from regulated investors are innocuous.** A regulated investor's request for a side letter provision to allow it to withdraw its investment under certain circumstances or to require the manager to consider tax or regulatory consequences to the investor in making its investment decisions for the fund can be problematic. Provisions that would grant the investor preferential redemption rights or require the manager to put the interest of the requesting investor ahead of those of the fund and the fund's other investors, require a measured analysis of all the relevant considerations to determine whether granting such rights is in the fund's best interest.

USUALLY PROBLEMATIC SIDE LETTER TERMS

Provisions that raise possible conflicts of interests among investors or that may provide one investor with a benefit to the potential detriment of others raise core fiduciary duty concerns. The classic example is a provision which grants an investor preferential liquidity terms, such as greater redemption frequency, a reduction or waiver in the required notice of redemption or the waiver of lock-ups or gates. Investors may also seek additional notice and withdrawal rights upon the occurrence of a "key man" or other material event (e.g., if fund assets fall below a specified threshold or the adviser is subject to regulatory action or a lawsuit). These types of agreements put significant pressure upon obligations to treat all investors fairly.

SOMETIMES PROBLEMATIC SIDE LETTER TERMS

- An agreement to permit an investor to transfer its interests in the fund to a designated party or affiliate or a covenant not to make in-kind distributions to an investor may appear unlikely to result in a conflict with other investors or cause significant harm to the fund and its investors. Transfer could have negative tax consequences to the fund. Similarly, a hedge fund manager may not be able to convert a fund's portfolio to cash or it may be detrimental to prematurely liquidate positions to provide an investor with a cash distribution.
- Greater portfolio transparency or information rights.
- MFN provisions magnify the fiduciary considerations a hedge fund manager must examine when granting a particular side letter provision. To the extent a provision would pose a fiduciary issue if granted to one investor, the MFN holder's ability to also capture this benefit will only compound this dilemma. On the other hand, provisions that do not trigger these concerns are not likely to be problematic if accepted by an investor with an MFN right. Many MFN provisions are negotiated so that they only are triggered if a similarly situated investor, typically based on investment size or regulatory constraints, is granted a beneficial term or right. This feature allows a hedge fund manager to treat similarly situated investors on the same basis, which may help alleviate some fiduciary duty concerns.

TRADE ERROR POLICIES

- **Definitions – can a trade error be defined?**
 - "The firm views a trade error as involving an unintentional mistake in placing a trade or in making an investment decision that is not detected until after the trade is settled and for which the firm is responsible. Trade errors include, but are not limited to: (a) purchasing an investment not legally permitted for a client, or not within a client's investment guidelines; (b) purchasing or selling the wrong investment for a client; (c) purchasing or selling an investment for the wrong client; (d) purchasing the wrong amount of an investment for a client; or (e) allocating an investment to the wrong client. A trade error does not include an intentional act, error that is corrected prior to settlement or error that is clearly the fault of an unaffiliated third party, such as an executing broker."
 - "In general, examples of trading errors include: (i) buying or selling a security or financial instrument at a price or quantity that is inconsistent with the specific trading instructions generated by a particular strategy; or (ii) buying rather than selling a particular security or financial instrument (and vice versa)."

ARE THESE TRADE ERRORS?

- *Style drift* – "If your documents say you won't trade X but you do anyway, is that a trade error?" Whether style drift should be considered a trade error depends on the facts and circumstances. Otherwise, if all style drift is automatically deemed to be a trade error, the policy would capture a particular trade that is not part of the strategy but that the trader deliberately made because he thought it would be a prudent investment.
- *Unexecuted trades* – Calling situations where a trade doesn't get executed is "tricky" because it is difficult to quantify those errors.
- *Uncorrected errors* – "What if a trade error occurs, but the portfolio manager is happy with the outcome and so decides not to make a correction? Is that still a trade error?"

WHO GETS THE BLAME? AND BEARS THE LOSS?

- Who is responsible for trade errors? The Manager? How to avoid conflict of interest in making this determination?
- Would size / materiality of the trade error be a factor?
- Do managers have a fiduciary duty to disclose trade errors? Should investors have the right to review trade error logs?
- Should trade error policies be disclosed in fund's PPM or governing documents? How about regulatory reports?
- ERISA investors? Sorry, Charlie, manager eats these losses.



WHAT ABOUT DELAWARE?

OVERVIEW OF IA, CPO AND CTA REGISTRATION

- Registration requirement triggered by providing advisory services as to securities for compensation to U.S. persons directly or through a fund
- No SEC jurisdiction if non-U.S. advisor provides advice only to non-U.S. clients and does not use U.S. jurisdictional means, but advising fund sold to U.S. persons viewed as over the line
- Advisers Act substantive provisions generally do not govern relationship between non-U.S. registered IA and non-U.S. clients ("Advisor Lite"), with non-U.S. fund viewed as non-U.S. client for this purpose
- Section 203(b)(3) private adviser exemption eliminated awhile ago

PRIVATE FUND ADVISER EXEMPTION

- Section 203(m)-1 and Rule 203(m)-1
- For U.S. resident adviser, can only manage private funds (not accounts) with aggregate AUM below \$150 million
- For non-U.S. advisers, can manage any type and amount of assets for non-U.S. clients
- Non-U.S. adviser only needs to count assets managed from U.S. place of business toward \$150 million limit. What is a "place of business"?
- No U.S. place of business if just do research and diligence in the U.S.
- Does not matter if fund organized in U.S. or outside U.S. so long as adviser acts outside of U.S.
- Non-U.S. adviser cannot advise a U.S. person other than a qualifying private fund
- A single investor fund generally not considered a private fund (managed account)
- Annual report to claim exemption
- Sub-advisors can use exemption if IA's clients are just private funds

"ADVISER LITE"

- Non-U.S. registered advisers subject to all Advisers Act and SEC rules as to dealings with U.S. clients, but only limited requirements in respect of non-U.S. clients
- Generally may rely on SEC Reg. S definition of U.S. person for this purpose, with non-U.S. funds generally being non-U.S. persons
- Applicable provisions include Form ADV filing, SEC exams, certain recordkeeping, anti-fraud, fiduciary duty, pay to play and Form PF
- Non-applicable provisions include Form ADV delivery, advertising, custody, referral fees, principal trades, performance fees, compliance policies, proxy voting and code of ethics
- Given application of anti-fraud and fiduciary duty provisions, best practices suggest array of compliance policies

CPO REGISTRATION REQUIREMENT

- Commodity pool operator ("CPO") essentially means a sponsor or promoter of commodity pool, meaning fund that trades any futures, futures options and (soon) non-securities based swaps and FX contracts
- Applies to managers of funds of funds that invest in pools
- CFTC takes view it has jurisdiction over non-U.S. CPO of any pool sold to U.S. persons
- CFTC has eliminated Rule 4.13(a)(4) sophisticated investor exemption used by most non-U.S. CPOs
- Effective late April for new pools and December 31, 2012 for existing exempt pools

RULE 4.13(A)(3) ALTERNATIVE

- Rule 4.13(a)(3) exemption for CPOs of pools with limited use of futures (and swaps) and sold privately in U.S.
- Have to limit initial margin and premium for futures, FX and swaps to 5% of liquidation value of pool or limit aggregate notional value of futures, FX and swaps to 100% of liquidation value of pool
- No hedging exemption
- No attractive application to funds of funds pending expected relief

OTHER ALTERNATIVES

- Stop trading commodity interests
- **Don't accept U.S. investors in funds. Conservative view: don't offer to U.S. investors.**
- For family vehicles, rely on line of "not a pool" interpretive letters
- New CFTC exemption in late 2020 for pure non-US pools
- Register and obtain relief under Rule 4.7 (note annual audit requirement)

LIMITS TO INDEMNIFICATION & EXCULPATION

- **"Indemnity"** means "I agree to be liable for your wrongs." Indemnity is a shifting of the risk of a loss from a liable person to another. It is like insurance between the parties. Sometimes, an indemnity provision is no more than a restatement of existing duties, "I will indemnify you for my wrongs;" "You will indemnify me for your wrongs."
- **"Exculpation"** means "I am not liable to you for my wrongs." An exculpatory provision is designed to exclude, as between the parties to a contract, certain designated duties, liabilities or costs due to the occurrence or non-occurrence of events.
- **"Release"** means "You are not liable to me for your wrongs." A release is an agreement in which one party agrees to hold the other without responsibility for damage or other liability arising out of the transaction involved.

TIPS TO HELP RAISE CAPITAL

- Get close to the family office community IF your fund offers high return, high vol. If you have low returns, low vol 加油
- Show correlation of your fund to major index
- Don't overlook OCIOs
- Market only when your fund is investor ready
- Service providers are not created equal
- Don't get overly creative with fee structures
- Delaware and Cayman are preferred. HK – let's see how it plays.
- Hire a smart fundraiser who knows your strategy
- Make a short fund video
- Contact prospects about once a month

TIPS TO HELP RAISE CAPITAL

- Never email investors on nights, weekends, or holidays
- Don't send your fund docs as Dropbox links
- Don't use an URL shortener -- many get blocked
- Attach your docs as PDFs
- Don't send all your fund docs right away with your first email
- Don't give up – keep following up
- Use a monthly performance histogram
- In your email, don't simply state "Please see the attached update"
- TLDR: make sure your email doesn't take up multiple screens

CHECK OUT OUR RECENT THOUGHT PIECES



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