

## Setting up a hedge fund - Brave new world for hedge funds

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### Feature

**Massive redemptions and other problems that have beset hedge funds in 2008 have caused some seismic shifts in the way managers and investors now view the documentation setting up a fund. US Editor Kris Devasabai and Stephen Quigley in London talk to a range of on- and offshore legal experts**

Hedge funds are revisiting the standard terms offered to investors. They argue the clauses permitting a fund to establish gates or suspend redemptions and create side pockets should be included as a matter of course in order to protect the fund in a crisis. On the other side investors are demanding improved terms and changes in the way fees are calculated and paid. They want to see much greater operational risk management as well as transparency.

Peter Astelford, head of the financial services group in Europe at the law firm Dechert, says there is an important debate raging in the industry about the appropriate terms and conditions to be included in a hedge fund's offering documents and articles of association.

"The managers are thinking about the powers they need to deal with a liquidity crisis or a market meltdown. They are focusing on the liquidity terms offered to investors. The investors want to have a conversation about the appropriate fee model," he says.

In 2008 many hedge funds faced an unprecedented run on redemptions as investors bolted to the exits at the first sign of trouble or in an effort to cash in any liquid investments in case others stopped payments.

In some cases redemption requests flooded in, despite strong performance. Some healthy hedge funds came under pressure as investors sought to access liquidity wherever it was available after being locked out by other managers.

Managers were forced to choose whether to liquidate assets at fire-sale prices to redeem investors or to suspend redemptions.

Drew Chapman, chair of the alternative asset management practice group at DLA Piper in the US, argues there was a fundamental mismatch between the redemption terms offered to

investors and the real liquidity of many hedge funds.

"The managers and their legal advisors have to shoulder the blame for this. In many cases the liquidity terms were not properly thought through. In a crisis situation this can be the difference between survival and failure," Chapman says.

Chapman is highly critical of law firms that provided what he terms "a commoditised legal service" to hedge funds. "The mid- and lower-tier firms offered fund formation services at very low fees. They used standard form documents and simply changed the name and the investment strategy when a new fund came along. This causes a lot of problems if the fund gets into difficulties further down the road," he says.

Ross Munro, a partner at Harneys in the British Virgin Islands, agrees that in many cases the redemption terms offered to investors failed to reflect the strategy of the underlying hedge fund. "With hindsight, it was wholly inappropriate for many hedge funds to be as liquid as they were. The past six months have been a wake-up call," he says.

He believes redemption terms will, on average, be more restrictive in the future, particularly for certain types of hedge fund strategies.

Munro says the central question is whether the liquidity terms match the strategy of the fund and the profile of its investors. "There is no such thing as one size fits all in this industry. The requirements will differ according to strategy and style. A fund with predominantly institutional investors will require different terms to a fund that has mostly fund of fund and high net worth investors," he argues.

Munro believes most investors will respond positively to well thought out liquidity provisions. "In most cases they understand that demanding fantastic terms is not always the best foundation for a long-term investment. If the liquidity terms hamper the performance of the fund the investors ultimately end up paying for it," he adds.

On the defensive

Another issue high on the priority list for many hedge fund managers is reserving sufficient powers to protect the fund in a crisis. The offering documents and articles of association can include a huge selection of defensive mechanisms that can be deployed to stabilise a fund in difficult times.

The fund is usually granted the power to suspend redemptions or impose gates to prevent a mass outflow of assets. The manager can also reserve the right to offer redemptions in kind or establish side pockets to house illiquid assets.

Nick Rogers, a partner in the investment funds group of Walkers' Cayman Islands office, says a balance must be struck between protecting the interests of investors and ensuring the fund has the tools to weather a crisis. "Some managers want to throw everything but the kitchen sink into the fund documents, but that can create tensions with the investors," he says. The new funds that have launched in 2009 have taken a sensible approach, he adds, with the trend towards longer lock-ins rather than restrictive redemption clauses or gates.

Gene DaCosta, head of the investment funds team at Conyers, Dill and Pearman in the Cayman Islands, emphasises the need to ensure that the powers reserved by the fund are properly defined and targeted at specific scenarios.

"In the past there was a tendency to grant the directors of the fund some very general and broad powers to be exercised in the interests of the fund," he says. "There was nothing specific to deal with a liquidity crisis, for instance. This caused confusion and made it more

difficult to deal with the specific issues that many hedge funds have been facing over the past several months."

In many cases hedge fund managers were forced to jump through hoops to suspend redemptions due to shortcomings in the fund documents. One common clause meant funds had to suspend net asset value (NAV) before being able to restrict redemptions, even when there were no specific problems valuing the portfolio.

"There needs to be more precise drafting in relation to redemption clauses. The terms need to address a range of specific scenarios," says DaCosta. "For instance, the fund needs to have the ability to restrict redemptions without suspending the NAV and should NAV be suspended to then allow for suspension of payments on redemptions in the event of liquidity crunch."

#### Bit on the side

An issue that has received significant attention in recent months is side pockets. Lawyers and fund managers support side pocket clauses on the grounds that they enable the fund to maintain some level of liquidity while protecting the interests of investors who choose to remain in the fund.

"Side pocket clauses were at the top of every manager's wish list when the liquidity crisis hit. These are now being included in legal documents as a matter of course," says Ingrid Pierce, a partner in the corporate and international finance department at Walkers in the Cayman Islands.

In 2008 a number of hedge funds established special purpose vehicles (SPVs) to hold illiquid assets where the fund's documents did not allow for the creation of conventional side pockets. The practice caused unrest among investors who were given shares in these SPVs in lieu of cash redemptions.

"There is still a debate over whether the use of these SPVs to hold illiquid instruments is acceptable. Investors did not at the time of subscription anticipate holding shares in these vehicles in lieu of payment in kind, and in a number of instances did not consent to receiving shares in such SPVs on redemption. In fact, many investors were left in no better a position by receiving these SPV shares than if they had remained in the fund in the first place," DaCosta says.

The best option, he says, is to include side pocket clauses in the original documents and flag this up to investors at the outset.

Hedge fund lawyers say fund documents are evolving, with novel terms now being incorporated into many new fund launches. One term flagged up by many lawyers is the introduction of an investor-level gate which prevents any single investor from withdrawing more than a certain percentage of their assets at a given time.

"I think this is a sensible term. It gives the manager real control over liquidity and stops the fund being held to ransom by one big shareholder," says Munro at Harneys.

DLA Piper's Chapman says some managers are establishing new funds as closed-ended vehicles with very short terms, particularly if they are going into areas like distressed debt. "This type of model takes the redemption issue out of the equation entirely," says Chapman.

He also points out that some clauses, such as stacked gate provisions, which allow only a limited number of investors out at any one time, have fallen out of favour. "This type of clause backfired on managers last year because it incentivised investors to put in pre-emptive redemption requests to avoid being stuck at the back of the queue if the fund got into trouble,"

he explains.

#### Two-way traffic

The traffic is not all one way. Investors are flexing their muscles too, checking the fine print in legal documents more closely and negotiating better terms. Cherine Radwan, a solicitor at Eversheds in London, says there is much more negotiation now between investors and managers on issues such as gates, redemption notice periods and side pockets.

"Launching a fund takes longer. Managers are more willing to structure a fund in a manner that suits the investor, for instance, choosing a jurisdiction which the investor prefers. In short, negotiations tend to be investor-led. In the current climate this is often the only way to get to launch," she says.

Investors are also pressing hedge funds to reconsider their fee models. Where previously fees had been offered on a "take it or leave it" basis for all but the largest investors, now managers are being forced to be competitive and flexible in their approach, Radwan says.

David Williams, a partner at DLA Piper's London office, has not seen any immediate move away from the traditional 2% management/20% performance fee model. "We may see investors negotiate lower fees in cases where the fund is restructured or seeks to introduce lock-ins," he says.

The emergence of quasi-private equity-style hedge funds with longer lock-ins may lead to a fundamental re-think of the way fees are calculated, he says. "It is quite likely that investors will insist that fees are linked to realised gains if they are locked in for a substantial period of time," says Williams.

Gawain Hughes, a partner at CMS Cameron McKenna in London, says investors are pushing hedge funds to restructure their fee models in exchange for greater powers to suspend redemptions or impose longer lock-ins.

"There has to be quid pro quo. If a fund imposes a longer lock-in, investors will insist that the manager only collects performance fees on realised gains rather than theoretical increases in the asset price," he says.

Investors are much more likely to negotiate in the current environment. Managers launching new funds are being pushed to adopt the use of escrow arrangements and clawback for carried interest to ensure managers are not over-rewarded in certain periods if performance of the fund suffers later on.

Another concept borrowed from private equity is the 'no fault divorce' where investors have the possibility of removing a manager even if he is not at fault for poor performance or poor practices.

Other novel terms that are becoming more common include exclusivity agreements, which prevent managers from launching new funds until certain conditions are met, and key man provisions where investors can suspend a fund if key personnel leave, Hughes says.

"Managers are realising that there are real concerns among investors that need to be addressed. This will lead to more bespoke provisions in funds to deal with redemptions and lock-ups," concludes Hughes.

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