

HEDGE FUND INVESTMENT TERMS

Key Terms In Hedge Fund Strategies

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KEY TERMS IN HEDGE FUND STRATEGIES

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One of the most important aspects of forming a hedge fund is setting the terms of the investment. When properly structured, hedge fund offering documents contain terms that adequately protect the fund sponsor and are attractive to investors. Hedge fund terms are driven by the fund's strategy, the market trends within the fund's asset class and the particular needs and objectives of the fund. It is crucial that the investment fund legal counsel has an in-depth understanding of current investment market trends and how those trends affect the strategy the fund will employ.

This white paper describes some of the most common hedge fund terms and how they apply to various hedge fund strategies.

SPONSOR COMPENSATION

Hedge fund sponsor compensation typically consists of: (i) an annual management fee (paid monthly or quarterly); and (ii) a performance allocation, also referred to as incentive allocation, or carried interest. The latter is not technically a “fee,” but rather a capital allocation, as will be discussed below.

Management Fees

A management fee is assessed annually, typically ranging from 1% to 2%, of the aggregate assets under management of a fund, regardless of the fund’s performance. The management fee is intended to cover manager salaries and general overhead. The management fee is deducted from each investor’s account periodically (usually in advance) as set forth in the offering documents. Prior to 2008, a 2% management fee was standard for most funds, with some funds even charging up to 3%.

Following the economic contraction, there was a general trend to significantly lower management fees, and rely more heavily on performance allocations, where compensation is earned only when funds perform in positive territory.

In recent years we have seen the management fees creep back up to the 1.5% to 2% range. Emerging funds seeking to entice investors often elect to initially maintain a low management fee or to forgo it entirely until the fund has shown proven success.

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Performance Allocation

The performance allocation is one of the defining characteristics of hedge funds and private equity funds and distinguishes them from mutual funds, which charge only a management fee. A performance allocation is a percentage of the increase in the value of the fund's assets (usually around 20%) allocated to the fund’s general partner as an incentive for positive performance. The performance allocation is intended to align the interests of the fund manager with those of the investor and provide significant upside potential for fund managers. As with the management fee, there is variance among funds in the performance allocation.

Performance allocation can range from 10% to 50% depending on the fund's structure and performance, but is typically in the 20% range.

"Fund Sponsors Should Work Closely With Experienced Legal Counsel When Negotiating Seed Funding Arrangements."

Tax Advantages of the Performance Allocation

As mentioned above, the performance allocation is not designated as a "fee," but rather a "capital reallocation of the profits" of the fund, which, if permitted by the offering documents, can be drawn by the manager at the manager's discretion or at regular intervals. The distinction is for tax purposes. A fee is compensation for services rendered. For a fund manager, the investment management fee is always subject to ordinary income rates and is considered self-employment income and subject to FICA taxes (in addition to the Unincorporated Business Tax for fund managers located in New York City).

When properly structured, a performance allocation is not considered a "fee," but a reallocation of partnership profits from an investor's capital account to the fund manager's capital account.

In other words, the investors are never allocated the 20% profit allocation, and the amount is treated as profit allocated directly to the fund's general partner. Where the fund holds positions longer than one year, the performance allocation can result in long-term capital gains treatment. Where the fund holds short-term investments, the allocation would be considered short-term capital gains (which is the same as ordinary income). However, short-term capital gains are not considered self-employment income and with certain exceptions are not subject to social security taxes.

High Water Marks

To prevent a manager from receiving duplicate performance compensation following periods of volatility, most funds require investors to recoup past losses before the fund manager is entitled to receive additional performance compensation. To accomplish this, a high water mark is established immediately following the allocation of incentive compensation. Under the "loss carry forward" terms, fund management is only be entitled to be compensated for performance that exceeds the prior "high water mark."

HURDLE RATES

Some funds require the investment manager to achieve a certain level of return, either as a fixed percentage or a benchmark rate (such as LIBOR or the S&P 500) before managers are entitled to receive performance compensation. A hurdle rate can be established as either a “hard hurdle” or “soft hurdle.”

A hard hurdle means that the manager only receives performance compensation that exceeds the hurdle rate. A soft hurdle means that no performance compensation is received if performance falls short of the soft hurdle rate, but once the soft hurdle rate is exceeded, the manager is entitled to the entire performance compensation.

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CONTRIBUTION AND WITHDRAWAL

Contribution and withdrawal provisions are among the most important terms of the fund offering. Provisions vary significantly from one fund to another to meet the needs of a given fund’s strategy and investor base.

Minimum Initial Contributions

Hedge fund offering documents typically contain minimum investment thresholds as a condition to investment. Each additional investor adds an administrative burden and a degree of liability to the fund. Additionally, the number of investors allowed in any given fund is finite.

In a 3(c)(1) fund the number of investors is limited to 100 investors.

Generally the investment minimum amounts are set in the discretion of the fund manager. Note however, that funds organized under the laws of the Cayman Islands require a statutory minimum initial investor contribution of \$100,000. We generally recommend setting a minimum between \$100,000 and \$250,000 for most funds.

Lock-Up Period

It is typical for a hedge fund to require an initial lock-up period of one year or more, before investors can withdraw invested funds, after which monthly, quarterly or semi-annual redemption is allowed. The lock-up period can be shortened or lengthened depending on the fund’s investment strategy. Lock-ups usually range from six months to two years.

If a fund strategy involves fairly illiquid investments, such that a one to two year lock-up period is insufficient, the sponsor should consider a closed-ended private equity fund.

Gates

To prevent funds from being forced to inconveniently liquidate investment positions to satisfy large redemption requests, many hedge funds limit the percentage of the portfolio that can be withdrawn in any given redemption period (often 10%-35%). This is known as a gate. In 2008-2009 a large number of funds invoked gate provisions to prevent being forced to sell assets at unfavorable terms.

FUND EXPENSES

During the formation process, the fund sponsor designates which of the fund's expenses will be borne by the manager and which will be borne by the fund. Typically, the fund bears expenses directly related to forming and operating the fund, including: legal formation costs, accounting and administrative services, regulatory filings, brokerage costs, clearing costs, etc.

Most funds amortize startup costs over a 60-month period, to prevent early investors from being unfairly impacted, even though it is not in alignment with GAAP.

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SIDE LETTERS

Most offering documents allow the management team to negotiate special terms (known as side letters) that are not applicable to other investors. Often the special arrangement involves better economic terms, such as reduced management or performance fees, or more convenient withdrawal terms. Care must be taken, however, not to allow side letters to prejudice other investors. For example, side letters that provide additional information rights or preferential liquidation treatment should be avoided.

John S. Lore, Esq. is the managing partner of Capital Fund Law Group, a boutique law firm providing expertise focused on the alternative investment industry. Call **801.456.3620** or email us to schedule a consultation to discuss your fund.
