

Preamble

In spite of the current hedge fund market rout, we believe that investors have not been able to effectively negotiate compensation and liquidity terms offered by hedge funds to their investors. Originally the fee structure was intended to align the interests of the manager with those of the investor. Today management fees are excessively high given the amount of assets under management. The 20% incentive fee was always intended to ensure that the majority of the manager's compensation was generated from positive performance in a given year. The recent boom in the hedge fund industry has increasingly driven investors to accept terms and conditions that bear little or no resemblance to the incentive structure as originally intended. Clearly the marketplace has changed and we suggest that perhaps a "Hedge Fund LP Statement of Principles" adopted and promoted by investor LPs could improve the investors' relative negotiating position. We propose the following and ask your opinion in pursuing these principles.

With recent poor performance, investor redemptions, the use of various investor "gates" and the suspension of redemptions by hedge fund managers, many commentators estimate that between 25-75% of all hedge funds will go out of business in the next two years. Our hope is that those that remain are subjected to increased investor scrutiny and negotiation with respect to both fees and liquidity terms and that as a group we may be able to achieve what we cannot do individually.

Principle #1. Management fees should approximately reflect the appropriate amount of fund overhead necessary to carry out the fund strategy.

This is self-explanatory as the incentive fee (not the management fee) should provide the right opportunity for potential and earned outsized manager compensation. Otherwise hedge funds become asset gathering machines more akin to mutual funds and the incentive fee is inappropriate compensation. We suggest that the amount of management fee should decrease as the manager's assets increase. Institutions can occasionally negotiate better fees because of their size. We believe HNW investors should try to create some oversight group to counsel on what should be the fair amount of management fee for fund types and styles.

Principle #2. No incentive fee should be taken prior to such time as an investor is offered an exit pursuant to the fund's terms.

This is in keeping with the principles offered to investors in private equity and venture capital funds, where the manager collects her carried interest only upon realization and not on a mark-to-market basis. If an investor is not given the ability to realize returns then the manager should not receive an incentive payment for returns that could prove to be temporary. There are two reasons for this.

First, investors in hedge funds that are subject to multi-year lock-ups suffer the perverse result that their capital may be illiquid for multiple years and simultaneously drained by incentive fees taken by the manager during a bull-market with no "clawback" of fees should that investment later sour.¹ For example, consider an investor that makes an investment in an activist or other directional equity manager. The manager tells the investor that a multi-year lock-up is in keeping with the manager's investment strategy. Assuming this to be the case, why would a manager take a carried interest prior to the thesis being realized? If the investment requires 3-5 years to be realized, then the manager's incentives should be aligned with those of the investor and the incentive fee should only be payable after the expiration of the lock-up assuming the investment is profitable at that time. Otherwise an investor making a \$1M investment with this manager could end up paying a significant incentive fee to the manager during the first several years of her investment only to later watch the investment decrease in value significantly (potentially to less than was originally invested or even less than was paid to the manager as a profit sharing incentive fee). Consider this example (summarized in

¹ According to Morgan Stanley over 40% of hedge funds have lock-up periods of 2-years or more.

the table below). An investor makes a \$1M investment in a fund with a 3-year lock-up. During the first year the fund delivers a 50% return and the manager takes her 20% incentive fee (\$100K). The second year, the investment again performs well, this time delivering a 30% return; at this point the investor's account is worth \$1.74M and the manager again collects her incentive fee (\$84K). The next year however the investment sours and the value plunges by 50%. Now the investor's account is worth \$868K, a \$132K loss from the date of the original investment but the investor has nonetheless paid the manager \$184K in incentive fees! This results in the unjust enrichment of the manager who has taken a "profit share" but has generated no profit. Neither is it an acceptable answer that the manager may be subject to a "high water mark" and will not be allocated any further incentive fee until the investor's account is restored to its previous value. Because the account is starting from a lower base as a result of the manager's incentive allocation from prior years, the account will never achieve the same rate of capital appreciation as it would had the incentive fee been taken only upon realization – in other words **the actual incentive fee paid is much higher than 20%**. For example, consider what would happen to this investor's account should the fund deliver 30% returns in the next year. Even with a high water mark, at the end of the 4-year investment, the investor's account would be worth \$1.128 but the manager would still have collected \$184K in incentive fees or approximately **143%** of the total profit generated for the investor! The chart below illustrates the above example.

Year	Beginning Yr. Value	Gross Return	Manager Incentive Fee	End Yr. Value
1	\$ 1,000,000	50%	\$ 100,000	\$ 1,400,000
2	\$ 1,400,000	30%	\$ 84,000	\$ 1,736,000
3	\$ 1,736,000	-50%	\$ -	\$ 868,000
4	\$ 868,000	30%	\$ -	\$ 1,128,400
Total			\$ 184,000	

Second, if a manager's strategy requires multi-year liquidity to function properly, regular incentive fees paid to the hedge fund manager have a compounding effect that result in significantly higher fees for the manager and significantly poorer performance to the investor. Consider the example in the table below, which compares two investments over a 5-year period, one in a hedge fund and one in a private equity fund.

Year	Gross Return	Hedge Fund Year-End Value	Hedge Fund Incentive Fee (w/reinvestment)	Private Equity Year-End Value	Private Equity Incentive Fee
1	20%	\$ 1,160,000	\$ 40,000	\$ 1,200,000	\$ -
2	20%	\$ 1,345,600	\$ 94,400	\$ 1,440,000	\$ -
3	20%	\$ 1,560,896	\$ 167,104	\$ 1,728,000	\$ -
4	20%	\$ 1,810,639	\$ 262,961	\$ 2,073,600	\$ -
5	20%	\$ 2,100,342	\$ 387,978	\$ 2,488,320	\$ 297,664
Total		\$ 2,100,342	\$ 387,978	\$ 2,190,656	\$ 297,664

Both investments generate a 20% gross return each year, however the hedge fund investor suffers an annual reduction to her capital account to pay for the manager's fees. This results in compounding of the manager's fees and not the investor's assets.

We believe that this recommendation regarding incentive fees and liquidity terms is in keeping with the principles developed by longer-term investment funds (esp. private equity and venture capital). Accordingly, we strongly recommend that investors insist on such treatment for all investments where investors are subject to a lock-up of one year or more (including penalties for early redemption).

Principle #3. Fees paid on side-pockets should be netted against all other fees paid to the manager.

Unlike the private-equity or venture capital model, hedge fund managers do not have “collective guilt” with regards to their longer-term “side-pocketed” investments. More specifically, in a typical private equity fund, there may be 20 or more investments. The manager of the private equity fund collects a carry (or incentive fee) on the collective performance of *all* the investments at realization. If, for example, half of the private equity investments appreciate and the other half depreciate, the manager could be left with little or no carry as the profits of the fund may be small (or negative) despite the positive performance of a number of the portfolio positions. By contrast, in the hedge fund model, a manager may side-pocket 2 or 3 investments or even more. Each side-pocketed investment is typically assigned as separate share class and the manager collects the incentive fee (carry) when that particular investment is realized. If one investment goes up and the other goes down, the hedge fund manager would collect a fee from the appreciated investment with no chargeback for losses in the main fund or in the other side-pocketed investment. Consider the example below where an investor allocates \$3M to a private equity fund that has three investments and \$3M to a hedge fund that has two side pocketed investments and an allocation to the “main fund.”

Investment	Amount Invested	Gross Return	Hedge Fund Incentive Fee	Private Equity Carry Fee	HF Investor Return	Private Equity Investor Return
HF Main Fund	\$ 1,000,000	-10%	\$ -		\$ (100,000)	
HF Side Pocket 1	\$ 1,000,000	20%	\$ 40,000		\$ 160,000	
HF Sides Pocket 2	\$ 1,000,000	-10%	\$ -		\$ (100,000)	
Private Equity 1	\$ 1,000,000	-10%		\$ (20,000)		\$ (80,000)
Private Equity 2	\$ 1,000,000	20%		\$ 40,000		\$ 160,000
Private Equity 3	\$ 1,000,000	-10%		\$ (20,000)		\$ (80,000)
Total			\$ 40,000	\$ -	\$ (40,000)	\$ -

In the above example, while the investment performance of the three investments in the hedge fund and the three investments in the private equity fund are identical, the hedge fund manager has taken \$40K in fees despite the fact that the combined pool delivered a 0% return in each case.

Principle #4. The decision to implement a gating provision should be subject to a fiduciary standard considering only the best interests of the investors. Suspension of redemptions is a measure of last resort and is appropriate only for brief periods when pricing is unavailable or when a necessary to prevent a clear and immediate risk of liquidation of the fund. Many hedge funds have gating provisions designed to limit pricing pressure on the fund’s holdings that can result when a large investor (or several investors) redeem at any one time. While these rules are generally mechanical and are in

place to protect the investors in the fund, we have witnessed a number of funds imposing gates in circumstances where there was clear evidence that the fund had ample liquidity to meet redemption requests without significant cost to the remaining investors and without significantly unbalancing the portfolio. The mechanical use of a gate, without a clearly articulated fiduciary purpose is counter to the originally intended purpose of this provision; it creates an incentive for the manager to protect her fee income at the expense of what should otherwise be a contractual right of the investor to receive cash as per the terms of the documents. In a number of cases, the decision by the manager to impose a gate and not sell securities (especially in 2008) resulted in investors actually realizing a significantly lower value for their investments than would have been the case if the fund had honored the original redemption requests. While we recognize that hindsight provides clarity that may not have been available when the decision to impose the gate was made, it shows that the incentives of the manager are not properly aligned with those of the investor.

Even more disturbing is the suspension of redemptions in the absence of clear evidence that either: (1) pricing of the underlying securities is not available; or (2) paying the redemption will immediately endanger the existence of the fund (*e.g.* where the payment of the redemption would trigger a margin call). The decision to suspend redemptions should be applied with the utmost fiduciary standard (and the fund documents should clearly reflect this understanding) and should never be used by the hedge fund manager in circumstances where liquidity is available to pay the redemption requests. Moreover, the suspension of redemptions should generally be undertaken for only a brief period and the manager should be required to remove the suspension immediately once liquidity returns to the fund. The suspension of redemptions provision was never intended to allow the fund manager to substitute her own judgment for that of the investor with respect to the timeliness of the redemption request. And we believe that the acceptance and abuse of this practice endangers hedge fund investors and the entire hedge fund community.

Having pushed some of our funds on these issues, we have seen a number of funds alter their terms “going forward” which adopt some of our suggestions. I would appreciate hearing from any of you that have suffered unfairly in this environment and what suggestions or additions you may propose to pursue a more LP friendly world in the hedge fund community. Please call Ike Kier at 212-247-4590 x.13 or Ilya Zaides at x.11.