SEEING FEES IN A NEW LIGHT

How the Hedge Fund Industry Is Responding to Fee Pressures

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The 2 and 20 fee structure has been a pillar of the hedge fund model since the industry's infancy. But as the industry has matured, so have its practices. While fees have long been a point of negotiation between managers and their investors, increased competition and growing investor demands have some managers re-thinking their approach to management and incentive fees.

RETURNS NO LONGER SHIELD FUND MANAGERS FROM PRESSURE

Investment managers have always faced pressure to lower fees. Historically, strong returns helped to shield hedge fund managers from these demands. Investors were willing to pay in exchange for the potential of substantially higher returns than they could realize elsewhere. In today's environment, however, pressure on hedge fund managers has increased, and the 2 and 20 fee structure is no longer sacrosanct.

Several factors have contributed to the need for managers to be more flexible with their fee structures:

- Competition for capital has grown more intense, leading some managers to look at innovative fee structures as a way to differentiate in a crowded marketplace.
- Institutional investors – typically very sensitive to fees – have grown to represent a major source of capital for hedge funds, and are using their scale and purchasing power as leverage to gain better terms.
- Managed account platform (MAP) sponsors are growing and have the ability to direct capital to hedge funds. MAPs use this leverage to negotiate better incentive fees, and some even have negotiated management-fee-only arrangements.
- The growth of alternative strategies in registered products, so called "liquid alternatives," offers the market many of the benefits of hedge funds in a 40 Act wrapper. The lack of incentive fees in 40 Act products is forcing private fund managers to either justify their value proposition or negotiate lower incentive arrangements.

These and other challenges are driving hedge fund managers to rethink their approaches to fees.

Recent events have served to intensify the conversation. CalPERS Chief Investment Officer Ted Eliopolus recently told Bloomberg TV that the primary driver of its decision to divest itself of nearly $4 billion in hedge fund investments was not fees per se, but rather the challenges of building a meaningful hedge fund allocation for a firm of CalPERS' scale. Still, the mega-fund's announcement and subsequent disclosure that it paid $135 million in hedge fund fees for the 2014 fiscal year has led many to question the issue of hedge fund fees. Shortly after CalPERS' announcement, Pennsylvania's Auditor General, Eugene DePasquale, urged the state's public pensions to evaluate whether the costs of hedge fund investment are justified at a time when public pensions are "already stressed and high fees cost state taxpayers more each year."

ONE SIZE NO LONGER FITS ALL

While many funds may still indicate a more traditional fee structure in their offering memoranda, in reality, larger institutional investors are negotiating different terms before making their investments. Larger investors, such as pension or sovereign wealth funds, in particular, are bringing their weight to bear in requesting changes. Preqin data suggests that the true average today is more along the lines of 1.5 and 18.7.

To address this, some managers are using tiered fee structures to reward larger investments – the more capital an investor commits, the lower the incentive fee it will pay. Others are using share classes creatively through arrangements such as a "founder's" share class with preferential terms for early seed investors.

THE GROWING USE OF PERFORMANCE HURDLES

Another approach that is increasing in popularity is the use of hurdles with incentive fees. Historically, hurdles were set at a fixed rate or were based on short-term interest rates, such as the London Interbank Offer Rate (LIBOR). Recently it has become more common to use hurdles to benchmark a fund's performance against a more relevant index specific to the fund's strategy. A manager only earns incentive fees on performance that exceeds the index performance.

A slight twist on the standard hurdle structure that funds are using more often is the underperformance hurdle. In this structure, during market declines, incentives are in place to reward managers if their fund drops by less than the agreed benchmark. Underperformance hurdles acknowledge the reality that under some conditions, limiting losses can be as valuable as strong returns.

ASSESSING PERFORMANCE: THE BIG PICTURE, NOT A SNAPSHOT

In addition to hurdles, managers are also increasingly being asked to change how they assess their incentive fees. Some investors are demanding clawbacks of incentive fees paid in good years when the performance subsequently lags. An alternative to clawback provisions that some managers are considering is to assess performance over an extended period of perhaps two to five years, or at the end of the lock-up period.

A recently issued IRS Revenue Ruling (Revenue Ruling 2014-18) may make granting investors longer performance assessment periods more palatable for fund managers. This Ruling clarified that incentive fees paid as nonqualified stock options and stock-settled stock appreciation rights (SARs) are not subject to the annual payment rule under Section 457A that prohibits deferred compensation. This clarification makes it possible for the fund manager's incentive fees to be paid out in options or SARs from the fund, though it may include restrictions as to how long a manager must wait to redeem them. Investors feel the time horizon for incentive compensation is better aligned to when the manager's services are being provided.

The arrangement also provides what essentially is a built-in clawback for years in which the fund underperforms. The advantage to fund managers over simply providing a clawback is that they may be able to defer income taxation on the incentive fees until the options or SARs are exercised. This approach can have consequences to other tax considerations, such as character of income and PFIC rules, so managers contemplating this approach should do so in close consultation with their tax advisers.

TAKING A HOLISTIC APPROACH

Investors are no longer looking solely at management and incentive fees, either, when considering a fund. Creative fund managers are looking at investors' requests more holistically, rather than trying to address them piecemeal. As a result we're seeing some innovative approaches emerge, in which the fee discussion becomes a base for negotiating other tradeoffs from investors. Some examples we've seen managers use successfully include:

- **Provide more transparency.** Transparency is increasingly important to investors, and funds that offer fuller transparency may be able to command higher fees in return.
- **Offer better liquidity terms.** Managers may be able to negotiate fees in conjunction with liquidity demands. For example, a manager could agree to provide shorter redemption notice periods in exchange for higher incentive fees, or vice versa. Alternately, we have seen some managers offer reduced incentive fees in exchange for longer lockup periods.
- **Use fewer redemption restrictions.** Since the recent financial crisis, investors have been more aware of, and in some cases wary of, gates, side pockets, and other capital structures that can restrict redemptions. As a result, more funds are finding they need to address restrictions when discussing fees with potential investors.

FINDING THE FEE BALANCE

Funds with superior performance and funds that offer investors higher levels of transparency and flexibility still can, and should, demand higher fees. Despite the increased competition, a fund that is outperforming its competitors will remain attractive to investors, and enjoy a stronger negotiating position as a result. Creativity and the ability to consider investors' needs holistically will help funds remain attractive to investors, as will flexibility with other terms of the investment agreement.

Fortunately, hedge funds have become more nimble as they have adapted to the changing regulatory and economic environments. This is allowing fund managers to find ways to satisfy investor demands and expectations in a variety of ways.

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