

Overview of Topic:

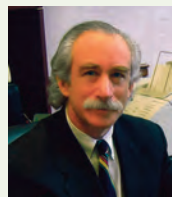
We've heard talk amongst industry commentators that hedge funds are regaining negotiating power with investors, the result of improved performance more generally and an increase in investor interest as sophisticated investors begin to re-engage with the marketplace. The HFBOA was curious: How much has leverage in negotiations been affected by the fiscal crisis? And are investors really expecting better terms and lower fees, or just greater transparency and openness during more rigorous and ongoing due diligence? So we sat down with a panel whose members represent a wide range of investors and asked them what they think about fees, liquidity, leverage, and the outlook for negotiating power in the hedge fund space.

Meet our Panelists:



John Griswold, *Executive Director, COMMONFUND INSTITUTE*
John S. Griswold directs Commonfund's educational, market research and professional development activities as head of Commonfund Institute. John joined Commonfund as head of Client Services in 1992.

John initiated and has supervised the Commonfund Benchmarks Studies® of the performance of educational endowments, foundations, operating charities and healthcare institutions, which collectively survey the investment performance and practices of over 1400 nonprofit institutions annually. In addition, he supervises and speaks at Commonfund's annual Endowment Institute, Commonfund Forum, monthly Trustee Roundtables and nonprofit and investment industry conferences in the U.S., Europe and Canada. John has authored many articles and book chapters on endowment management, governance and the management of investment committees. John is a member of numerous non-profit boards and investment committees, including the board of trustees of BoardSource, The Boys and Girls Clubs of America, the Greenwich Roundtable, the National Business Officers Association (NBOA) and the Regional Plan Association of New York. He is a graduate of Yale University.



Hugh Lamle, *President, MD SASS*
Hugh R. Lamle is President and a Director of M.D. Sass Investors Services, Inc. He has been a Partner in M. D. Sass since 1974. Among his many professional accomplishments are: He currently serves as President and founder of M.D. Sass-Macquarie Financial Strategies Management LLC, (FinStrat) which invests in new investment management company start

ups and buy outs. From 1995 to 2001, Mr. Lamle was also President, Chief Investment Officer and Chief Executive Officer of Chase & MD Sass Partners, a joint venture between The Chase Manhattan Bank and M.D. Sass Investors Services, Inc. M.D. Sass sold its interest in this \$20 billion joint venture to J.P. Morgan Chase after the acquisition of J.P. Morgan by Chase. Mr. Lamle was formerly Vice Chairman of the Board of Directors of the FINEX (a regulated Commodities Exchange) and was on the Board of Governors the New York Board of Trade (a regulated Commodities Exchange) until it was acquired in 2007 by the Intercontinental Commodities Exchange (ICE). He is now on the Board of ICE Futures US. Mr. Lamle was a founder of Real Estate Capital Partners (RECP) in 1989 and served as its Managing General Partner until 2005 when M.D. Sass sold its interest in this \$5.5 billion real estate investor and developer to its partners.

He has authored numerous articles for professional publications and is a frequent lecturer at professional conferences and universities. Mr. Lamle has 40 years of investment experience and has an MBA (finance and investments) from Baruch College.



Rachel Minard, *Partner and Managing Director, OPTIMA FUND MANAGEMENT, LLC*

Ms. Rachel S.L. Minard is Partner and Managing Director with Optima Fund Management, opening and running the firm's San Francisco office. She is responsible for building the global institutional brand for Optima, a 22-year old alternative investment advisory firm specializing in fund of hedge funds as well as raising assets for the firm across all channels globally.

Ms. Minard has 19 years of institutional investment experience including the past 9 years building fund of hedge fund firms, notably her roles as President and Partner of Cogo Wolf Asset Management, Partner and Director of Global Marketing for Corbin Capital Partners (a firm she renamed) and Director of Marketing at Cadogan Management. Before Cadogan, Rachel was Vice President and Consultant Advisor for J.P. Morgan Investment Management and served as Director of Business Development for Dakin Partners, opening and managing their New York office. Earlier, Ms. Minard served as Assistant to the Director of Marketing and Client Service for Pareto Partners. Named "Non-Profit Marketer of the Year" (FEMM), Honored Member, Cambridge's Who's Who Among Executives (2005-2010) and a featured speaker on CNBC and global industry conferences, Ms. Minard started her marketing career in 1991 after her marketing company was hired to build the Ronald Reagan Presidential Library.

Ms. Minard holds a B.A. degree in Journalism with honors from Northeastern University with notable distinction as a Wesley W. Marple Distinguished Lecturer (2009) and Profiles in Leadership: Business Luminaries (2006-2010) by the university. A graduate of the AIMSE/Wharton Institute, Ms. Minard serves on the Advisory Board of the Professional Association of Investment Communication Resources (PAICR), The World Pension Forum and the Investment Management Institute (IMI). Ms. Minard also serves on the Executive Board of the Association of Women in Alternative Investing (AWAI) for which she is also a Founding Member, serves as Chairman of the ProTrak International Advisory Board and the Investment Sub-Committee of the Westover School Endowment.

1. Are fees and terms surrounding liquidity more negotiable? Has the standard changed from 2 & 20 to something else now? Has quarterly liquidity with 30 days notice changed to something else as well?

“I don’t see the business from this standpoint having changed a great deal, despite the last few years’ trauma in this field,” says Griswold. “In general – and this applies to most of the questions below – the rules that have applied for 20+ years are still in place. The solid performers, the larger and more established firms and managers really do not have to negotiate on fees or lock ups.”

Lamle points out that “it’s basically a tale of two types of funds.” While larger funds like those cited by John haven’t had to give much on fees or liquidity negotiations, the “start ups, smaller funds, or funds with less good performance – there, managers are much more willing to make concessions in order to get their businesses up to scale.” The 2&20, Lamle argues, should also be a question of performance and capacity: “If you’re in a large market with no capacity constraints, then it’s a trade off of fee structure that makes you more competitive in the market place, what will get you more assets, and won’t diminish the likelihood of earning the incentive fee. On the other hand, if you’re a small fund, hungry for revenue and assets to manage, maybe you’ll make concessions here in order to get more assets.” Generally, Lamle believes that any fund below a couple hundred million should at least examine the fee structure because 2&20, while prevalent, isn’t the only option out there anymore.

Minard cites these additional options as precisely why managers should be closely examining their terms when negotiating with investors: “The power lies with the client now more than ever and there is always the chance for better options elsewhere.” And when it comes to negotiations, effective communications are crucial for every manager. “Buyers [are] actively making their needs and wants known. In response to this request, alternative asset management firms are re-evaluating their terms to ensure an alignment of interest with their investor base else more clearly validating how and why they are sticking to the terms they’re offered.” Even in those cases where a fund does not give on terms, more complete communication and transparency surrounding liquidity is becoming the norm, Minard argues. “HFOF firms are taking a greater look at their underlying managers and the risks associated with those investments given their liquidity terms. Liquidity calendars are being provided to institutions and consultants to prove a position or manager can be unwound should it need to be.”

But the need for clear communication is a two-way street. Lamle says that “any investor that goes into a fund and doesn’t ask for ‘most favored nation’ status – or at least understand the terms of liquidity – is a fool. The investor must ensure that s/he is getting the same terms as others.” At the very least, Lamle, continues, “sign a side letter which guarantees there are no better terms for others. Any sophisticated investor wouldn’t want to be in a fund where others have more favorable liquidity. In the cases where they choose to invest even with less favorable liquidity terms, they should at least know about it. In some

cases fees are reduced for investors with longer lock ups or other forms of reduced liquidity. In other cases early redeeming investors pay a fee to the fund for the benefit of the other LP’s (not the manager) for early redemption. The role of the manager is to protect all of the LP’s interests.”

2. How have expectations surrounding transparency changed?

Minard: “Interestingly, the discussion has changed from the **quantity** of the transparency provided to the **quality** of that transparency. Backing up an 18-wheeler to the investor’s door and proclaiming “here’s your transparency” shows lack of empathy to the trustee or consultant who has to sift through it all and determine what’s important, what’s not. In fact, many US consultants have been fired by their clients because of not taking the time or having the know-how to translate reams of reports into something meaningful a Board or Trustee can rightfully act on. And so, expectations have changed insofar as the investor needs to decipher, aggregate and format this information in a meaningful way to the consultant and investor – to show them what facets of these transparency reports **actually** matter when constructing a portfolio, evaluating operational, investment, and business risks.”

From the fund perspective, Lamle argues that the superficial question, “why not give more transparency?” can be more difficult to answer, as disclosing positions without a sufficient time lag can “compromise our investment process and the other investors.” The question he asks himself is: “What would smart investors want from us, and how do we give it to them without opening ourselves and our investors up to the risk of front runners and piggy backers?”

Griswold cites the growing role of intermediaries in the past ten years as the means to bridge the expectations gap between investors and the manager. “Transparency can be achieved through prime brokers and administrators.” But here again Minard cites a shortcoming: “It remains clear more managers than ever are offering transparency but there remains a standing caveat: generally managers are only sending general information to the risk aggregators, leaving clients with reports without specific details or positions by individual names.”

3. How have expectations regarding your access to service providers changed?

From the investor perspective, Griswold cites service providers as an excellent way of “conducting due diligence without being terribly disruptive. You can get an enormous amount of information once you have access to the service provider.”

Lamle supports this stand as a HFOF: “Serious investors will always ask who your service providers are – you have to be able to give it to them – period. If

you're a serious investor, in the middle of your due diligence process, I'm going to make it happen. The money manager should give the service provider a heads up to ensure the investor can connect with them."

A word of caution from Minard regarding choosing your service providers: "Selecting service providers on pedigree alone or because another 50 managers you may know use the firm does not mean one's absolved from performing their own due diligence. It's simply smart business and you can point to the growth of operational and risk management teams as a reflection of these new expectations. Having said this, some service providers are putting hoops in the way, including formal restrictions and prior written approvals before releasing information. It's therefore more important than ever to match the type of trading to the expertise of the service provider."

4. Are there expectations that hedge funds now be SEC registered?

"An interesting question," Griswold says. "While the concept is laudable, registration itself doesn't do much good. It's what you do with the information you collect that makes the difference. We don't yet know what the purpose of registration will be or what the SEC will do with the data. To the extent that SEC registration perhaps provides a seal of approval, it could also be somewhat misleading to investors who might believe that a registered fund is somehow better than one that is not." Per discussions with other institutional investors, however, Minard says that "registration provides additional 'comfort' that the firm and funds are open to scrutiny. The monitoring and oversight takes second seat to the larger impact such a designation confirms: The willingness to allow for firm and fund-wide third-party scrutiny."

Lamle's HFOF has been registered since 1972 and he doesn't "get why other [funds] have a problem with it. Sure it's a little more complex administratively, and there are audits every now and then, but it's definitely not a negative in any way. But it is hard to know if this is the great selling point that makes an investor choose us. It is appropriate for investors to ask why a manager is not registered if they are not"

For smaller funds, Minard notes that registration has been put off "due to the laboriousness of the process, the cost and infrastructure necessary given the additional reporting requirements or the view it's just simply unnecessary given the perceived caliber of in-house reporting. One can pick any of these reasons but the fact still remains: registering gives an additional check and balance to a firm's operational and risk management process."

5. Does a manager's level of negotiating power depend in part upon whether or not he gated or suspended redemptions in 2008?

"Certainly there were many unhappy investors when funds were gated and redemptions suspended in 2008, but in that point in time there was such a widespread crisis that even the angriest investor probably understood that there was a reason why this was going on," Griswold says. Lamle agrees: "If the strategy was inherently a liquid strategy, there was liquidity in the marketplace and you gated to protect your fee base, then investors should be upset. If you gated to protect the fund because cashing in at an inappropriate time would hurt the LPs, due to illiquid or hard to price investments then it was a smart decision. During due diligence, every investor should ask why a manager gated and the manager should have the documentation to back up the reasons for the decision."

Minard points out the contradiction that exists – "there are dozens of hedge fund managers and fund of funds pursuing growth despite their clients' inability to unwind their positions or get their investments back in full. This is a point of contention with the institutions and consultants I've spoken with... but strong non-correlated returns speak loudly now and many investors are willing to put those issues aside to secure capacity and access with once closed managers, irrespective of their current gating and illiquidity issues."

Lamle underscores Minard's concern: "The reality is, a manager's negotiation power will depend on their performance in good markets and bad. The uniqueness of their strategy and their capacity – how much money can this particular strategy take?" No matter what, Griswold cautions, "potential investors should understand the risks of having a fund gated at exactly the wrong time. It should be part of their consideration of whether or not to invest in this type of fund or strategy."

6. Are emerging managers able to negotiate with investors or is it just the large players?

"Given this is a buyer's market, I think the question would best be asked the other way around," Minard says. "Are investors willing to consider negotiations with emerging managers or just the large players? And the answer is... it depends. There are several strong emerging managers that have the past track record, investment prowess, compelling edge and tight capacity to warrant the right to set their terms and stick with them. Most, however, need to butter their bread and in doing so, will likely accept the terms provided them by the investor to start building their repartee client lists and start actively allocating new capital." Griswold agrees that emerging managers have more incentive to negotiate with

investors, but “negotiations will be centered among large plan sponsors. The leverage always has and always will be with the large players.” Lamle furthers the point: “Larger players don’t need small and medium size investors as much as small players do.”

For the smaller investor, however, Lamle cautions that “it’s one thing to give a larger investor a preferential fee structure; it’s another thing entirely when it comes to preferential liquidity – that could hurt other investors. Some funds have addressed this with lock ups – hard lock for one year and soft locks for two or three years, then the redemption fees go to the fund instead of the manager. This helps the LPs that stay in. The question is: ‘Who bears the cost of the preferential treatment – the LP or GP? LP’s interests should not be sacrificed to add fees for the GP. Accordingly, transparency should be available to all LP’s regarding fees and terms offered to any investor”

7. Now that the 2008 panic is beginning to settle, how important is it that a manager has more than one prime broker and at what level of fund AUM is it expected?

“Lehman Brothers has taught the hedge fund industry the need for proper counterparty due diligence (including your own prime broker), and that more is better. Even for small hedge funds, the ability to diversify your prime broker exposure has been enhanced by smaller players now catering to this niche market,” Minard says. “The greater question for debate is what one achieves by having two when the fund and firm are small and, outside of another ‘set of eyes’ if the value add warrants the time.” Griswold agrees with this point: “From a purely business standpoint, as long as costs and fees are maintained, more than one prime broker is a good idea.”

Minard continues: “What’s paramount to that question are the safeguards a hedge fund imposes to ensure duplication – a checks and balances approach – to operational and risk management. While many smaller hedge funds may only afford one prime broker, most are disposed to getting more than one as assets and the firm grows. The intent is there and it’s a new question on institutional RFPs of late.” Lamle summed his thoughts on the subject thus: “Risk management doesn’t change just because the environment seems a little more benign. Risk management stays constant.”