Legal Terms and Documentation (Hedge Funds)

Interview preparation summary · HF track

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INT.HL.1.a · The fund and its investors

Explain how management fees, performance fees, high-water marks, hurdles and crystallisation work, and turn the wording into a net return.

Hedge fund fee terms decide how much of the gross return reaches the investor. The management fee, charged on net asset value and typically somewhere between 1 and 2 percent, is paid whatever the result. The performance fee, often around 15 to 20 percent of profit, is where the wording matters. A high-water mark means the manager earns a performance fee only on gains above the highest net asset value on which a fee was previously paid, so an investor does not pay twice to recover the same loss. A hurdle sets a minimum return: under a soft hurdle the fee is charged on the whole gain once the hurdle is cleared, under a hard hurdle only on the excess. Crystallisation frequency matters because annual crystallisation lets a later loss offset an earlier gain within the year. Market practice varies with strategy, fund size and negotiating leverage. Interviewers ask this to see whether you can turn clause wording into net returns. The usual mistake is to quote the headline fee and ignore the high-water mark, the hurdle type and the crystallisation date.

WORKED EXAMPLE: NET RETURNS FOR A FUND WITH A HIGH-WATER MARK

Kelvin Ridge Partners is an invented fund starting at £100.0m. The management fee is 1.5 percent of opening net asset value, and the performance fee is 20 percent of any gain above the high-water mark after the management fee, crystallised once a year. Gross returns before fees are +12 percent, -6 percent and +9 percent over three years. Conventions: no subscriptions or redemptions, fees settled at year end, ignore tax and fund expenses. Find the fees each year, then show what the high-water mark saved the investor in year 3 and what a 5 percent hurdle would have done in year 1.

Answer: The high-water mark means no performance fee in years 2 and 3, saving the investor 1.504m in year 3. A 5 percent hurdle cuts the year 1 fee from 2.1m to 1.1m if it is hard and leaves it at 2.1m if it is soft.

Interview tip: Say the order aloud: net of the management fee, compare with the high-water mark, apply the hurdle wording, then charge the fee. State your assumptions about timing first.

INT.HL.1.b · The fund and its investors

Explain lock-ups, notice periods, gates, side pockets and suspension, and judge how well a fund's liquidity terms match its portfolio.

Liquidity terms decide when an investor can get money out, and whether the fund can sell assets at fair prices to pay. A lock-up bars or penalises redemption for an initial period, hard if redemption is barred and soft if it carries a fee. The notice period tells the manager how long it has to raise cash. A gate limits total redemptions on a dealing date, often to a percentage of net asset value, either for the whole fund or per investor, with requests normally scaled back pro rata and carried forward. A side pocket separates illiquid or hard-to-value assets so that redeemers and new investors do not trade at stale values. Suspension is a last resort, usually when the fund cannot value or sell a material part of the portfolio. Interviewers ask about the mismatch between dealing frequency and the time needed to sell positions. A common mistake is treating the gate as protection for the investor, when it mainly protects those who stay. Terms vary widely by strategy and by law.

WORKED EXAMPLE: A GATE IN A REDEMPTION QUEUE

Marlow Heath Fund is an invented fund with a net asset value of £600m. Redemptions are quarterly, with a fund-level gate of 10 percent of net asset value per dealing date. Requests below are received for the next date. Unpaid amounts are carried forward with no priority over later requests, and no new requests arrive. Investor Delta asks for 24m. Total requests are 96m. Work out what Delta receives and when it is fully paid, and test the effect on the fund.

Answer: Delta receives 15m on the first date and 9m on the second. The gate limited cash raised to 60m rather than 96m, at the cost of a one-quarter delay for part of each redeemer's money.

> **Interview tip:** Say what the gate does for the fund, then what it does to the redeeming investor, and show the figures in that order.

INT.HL.1.c · The fund and its investors

Explain side letters, most-favoured-nation rights, key-person provisions and expense terms, and say what an allocator diligences in the documents.

A side letter is a separate agreement between the manager and one investor that gives terms beyond the fund documents, such as a fee discount, extra reporting, capacity rights or a special redemption right. A most-favoured-nation clause lets an investor elect terms given to others, usually limited to investors of the same size or smaller and excluding things like size-based fee breaks, so the carve-outs matter more than the headline. A key-person provision names the individuals whose departure triggers a remedy, often a right to redeem outside normal dates or a stop on new investing. Expense terms matter because pass-through costs such as research, data and travel can add as much as a point to annual costs unless capped. Allocators diligence the documents together with operational matters: independent administration and valuation, auditor, custody and governance. The usual mistake is to treat preferential liquidity as the same kind of term as a fee discount, when it can harm the other investors. Terms vary with leverage and fund size.

WORKED EXAMPLE: THE COST OF A FEE DISCOUNT THAT SPREADS THROUGH AN MFN

Brenwick Capital is an invented manager with £400m of net asset value and a headline management fee of 2.0 percent. An anchor investor A with £60m negotiates a side letter reducing its fee to 1.75 percent. Investor C, with £80m, holds an MFN right that lets it elect any fee term granted to an investor of the same size or smaller. Investor C is larger than A, so C can elect A's discount. Work out the cost to the manager, and the fee revenue as a share of the headline revenue.

Answer: The discount costs 0.35m a year in total, reducing fee revenue from 8.0m to 7.65m, or about 4.4 percent. The point is that one negotiated term can reach every investor with a matching MFN right.

> **Interview tip:** State the revenue effect first, then say who can elect the term, and then mention what carve-outs the manager would want.

INT.HL.2.a · Trading documents and conduct

Explain the key terms of a prime brokerage and stock borrowing relationship (margin, rehypothecation, cross-default, recall, borrow fees) and show how they can create liquidity stress.

A prime brokerage agreement gives a fund custody, financing and stock borrowing from one bank. The terms that matter are margin, rehypothecation, cross-default and recall. Margin is the collateral the fund must hold against positions, and the broker often reserves the right to change margin or haircuts on short notice, so leverage that looks stable can be cut quickly. Rehypothecation lets the broker re-use the fund's pledged securities for its own funding, usually up to a limit; if the broker fails, the fund may rank as an unsecured creditor for those assets, and protection differs between jurisdictions and account types. Cross-default means a default elsewhere, often above a stated threshold, can trigger default here, so a problem with one counterparty can spread to all. Stock lending adds a borrow fee, which is higher for scarce shares, and a recall right, which can force a short seller to buy back at a bad time. Interviewers ask how a manager reduces these risks. The usual mistake is to look only at the financing rate and ignore notice periods and thresholds.

WORKED EXAMPLE: A MARGIN INCREASE AFTER A MARKET MOVE

Pinehurst Fund is an invented hedge fund with net asset value of £100.0m, long positions of 200.0m and short positions of 100.0m, financed by one prime broker that requires margin of 15 percent of gross exposure. After a sharp move, the longs fall 15 percent and the shorts rise 15 percent. The broker then uses its right to raise margin to 25 percent on notice. Conventions: margin is on gross exposure, positions are marked at market, and the fund holds no other cash. Work out the margin call and what it forces.

Answer: The change in margin from 15 to 25 percent creates a call of 16.25m that forces a cut of 65.0m of gross exposure, about 22.8 percent of the book, with no additional loss.

> **Interview tip:** Say that the risk lies in the terms, not only the market: who can change margin, how fast, and what a failure to pay triggers.

INT.HL.2.b · Trading documents and conduct

Explain close-out netting, collateral under a credit support annex and termination events in a derivatives master agreement, and show how a net asset value trigger can end a trading relationship.

Over-the-counter derivatives between a fund and a bank are usually documented under a master agreement, a schedule of negotiated terms and a credit support annex, based on industry standard forms that parties amend. The key feature is close-out netting: on default or termination all transactions are valued and combined into one net amount payable by one party, which reduces exposure from gross to net where the netting is enforceable, something counterparties check by jurisdiction. The credit support annex governs collateral: variation margin follows the net mark-to-market, subject to a threshold below which no collateral is called and a minimum transfer amount; an independent amount is an upfront buffer. Termination events include additional events negotiated for funds, such as a fall in net asset value over a period, a key-person departure or a change in manager, which allow the bank to close out even though the fund has missed no payment. Interviewers ask which terms are negotiable. The usual mistake is to read only the economic terms and miss the triggers.

WORKED EXAMPLE: NETTING AND A COLLATERAL CALL

Larch Partners is an invented hedge fund with four trades against one bank under one master agreement. From the fund's view the values are +14.0m, -9.0m, +3.5m and -£11.5m. The bank becomes insolvent. Compare the fund's loss with netting that is enforceable and without netting, assuming the bank's estate pays 40 percent of what it owes as an unsecured claim. Then, on the live book, the bank looks at its own exposure under a collateral annex with a threshold of 1.0m, a minimum transfer amount of 0.25m, and 0.4m of collateral already posted by the fund. Conventions: ignore interest and costs, and round to one decimal place.

Answer: Netting limits the loss to 3.0m instead of 13.5m, and the collateral call on the live book is 1.6m. The takeaway is that netting depends on the legal enforceability of the master agreement.

> **Interview tip:** Say what the agreement does in a default, then what the annex does while all is well, then which terms you would negotiate.

INT.HL.2.c · Trading documents and conduct

Explain inside information and market abuse, personal account dealing, fair allocation and investor communications, and say what you would do in a situation that tests them.

Conduct rules matter because a single breach can end a fund. Inside information is generally information that is specific, not public and likely to move a price if it were known, and trading on it, passing it on, or recommending trades based on it is typically prohibited, although the legal tests differ between the UK and EU regime and US law. The safe response to information that might be inside is to stop, not trade, and tell compliance, who decide whether to restrict the name. Mosaic research, building a view from public and non-material pieces, is lawful, but it does not cleanse one piece of confidential information. Personal account dealing policies typically require pre-clearance, holding periods, restricted lists and reporting. Allocation of trades must be fair: pre-agreed rules, a common average price and no cherry-picking of better fills for favoured accounts. Investor communications must be fair, clear and not misleading, with hypothetical or back-tested figures labelled. Interviewers ask for judgement, not recitation. The usual mistake is to try to gather more detail first, which deepens the taint.

WORKED EXAMPLE: CHERRY-PICKING AN ALLOCATION

Oakhurst Capital is an invented manager running two funds, A and B, with a pre-agreed 60:40 split for a trade in a stock. The trader buys 100,000 shares: 60,000 at £10.00 and 40,000 at £10.60. At the day's close the price is £11.00. Fund A pays a performance fee and is the portfolio manager's main focus. Compare the profit of each fund under pro rata allocation at the average price with an allocation that gives fund A the 60,000 cheaper shares. Conventions: ignore costs and compare one-day profits at the 11.00 close.

Answer: Pro rata at 10.24 gives A 45,600 and B 30,400. Cherry-picking gives A 60,000 and B 16,000, moving £14,400 from B to A.

> **Interview tip:** Say that the total is unchanged, but the shift is a conduct failure; then name the pre-trade rule, the single price and the review as controls.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.