Seward & Kissel LLP

2013

The Seward & Kissel New Hedge Fund Study

2013 Edition

Introduction and Key Findings

Driven by our commitment to understanding the dynamics of the hedge fund marketplace, each year Seward & Kissel conducts *The Seward & Kissel New Hedge Fund Study* of newly-formed hedge funds sponsored by new U.S.-based managers entering the market. This Study covers the 2013 hedge fund launches of relevant Seward & Kissel clients meeting the above criteria. We believe that the number of funds within the Study is large enough to extract a representative sample of important data points that are relevant to the hedge fund industry. The Study analyzed investment strategies, incentive allocations/management fees, liquidity and structures, as well as whether any form of founders or seed capital was raised. The Study did not cover managed account structures or “funds of one” that may have a wider variation in their fees and/or other terms.

The Study's key findings, set forth in greater detail below, include the following:

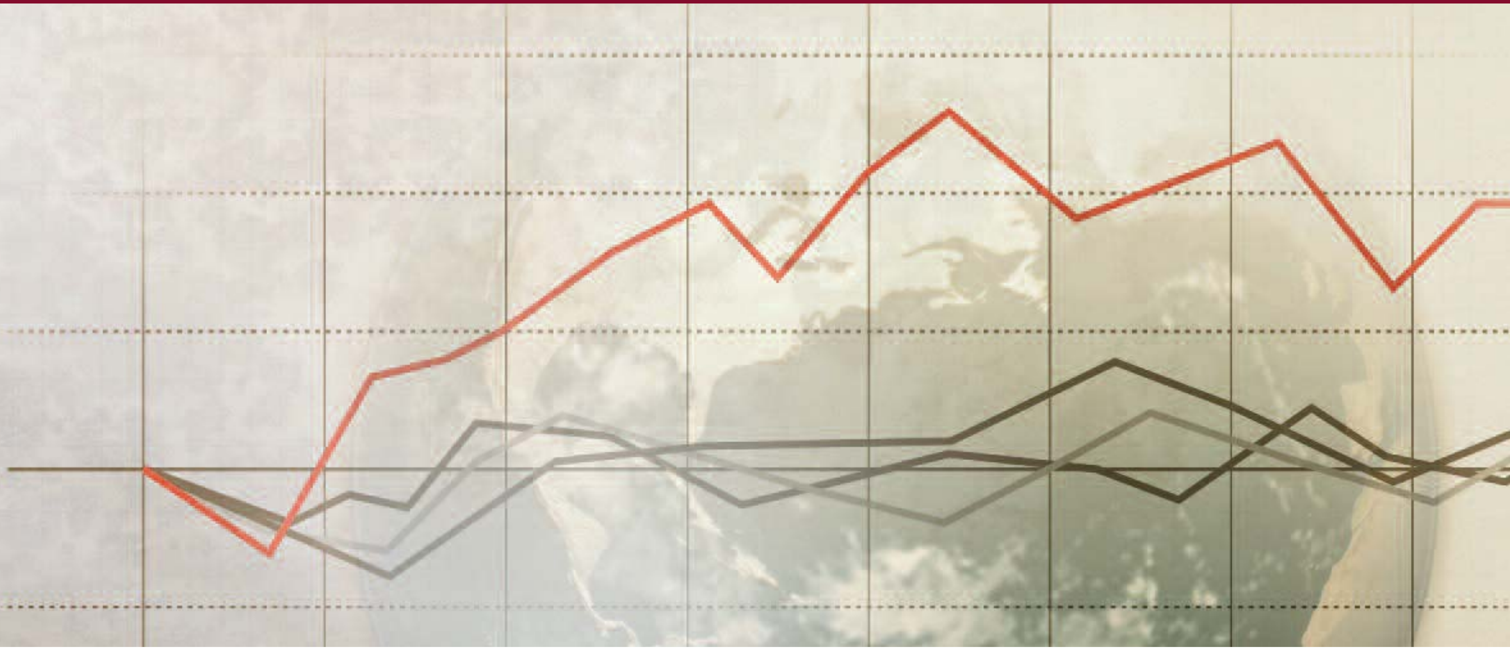
- 65% of the funds had equity or equity-related strategies (about the same as in the 2012 Study).

- Management fees were on average higher for non-equity strategies (although not as high as in 2012), while incentive allocation rates continued to be pegged at 20% of net profits across all strategies.

- 89% of funds permitted quarterly or even less frequent redemptions, while only 11% of funds permitted monthly redemptions in 2013 (as compared to a substantially higher 36% of funds in 2012). Moreover, 85% of all funds had some form of lock-up as compared to only 58% in 2012.

- Sponsors of both U.S. and offshore funds set up master-feeder structures over 90% of the time, generally utilizing the Section 3(c)(7) exemption. Most offshore funds were established in the Cayman Islands, although other jurisdictions (e.g., Bermuda, Bahamas) sought to reestablish their respective presences in the industry. Lastly, no fund within the Study chose to go down the path of engaging in general solicitations and advertising as is now permitted under new Securities Act Rule 506(c) promulgated pursuant to the JOBS Act.

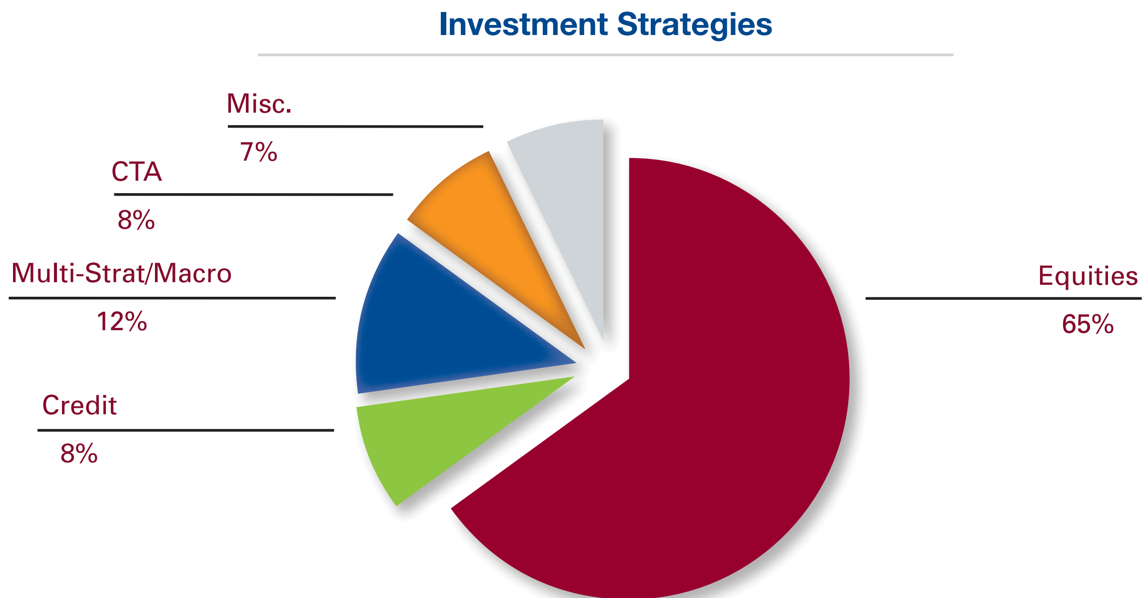
- 43% of funds within the Study obtained some form of founders capital and we estimate, based on conversations with various industry participants, that within the entire hedge fund industry for the calendar year 2013, at least 40% of all launches greater than $75 million (and an estimated 15% of all fund launches) had some form of seed capital.



Investment Strategies

About 65% of the funds included in the Study utilized an equity or equity-related strategy (not including multi-strategy offerings that generally involved both equity-related as well as other strategies). This represents no real change from the 2012 Study. Of the remaining 35% of the funds in the Study (i.e., the non-equity strategies), about 12% of the funds included in the Study were multi-strategy/macro offerings, approximately 8% were credit or CTA strategies, and the balance consisted of various other strategies.

Investment Strategies

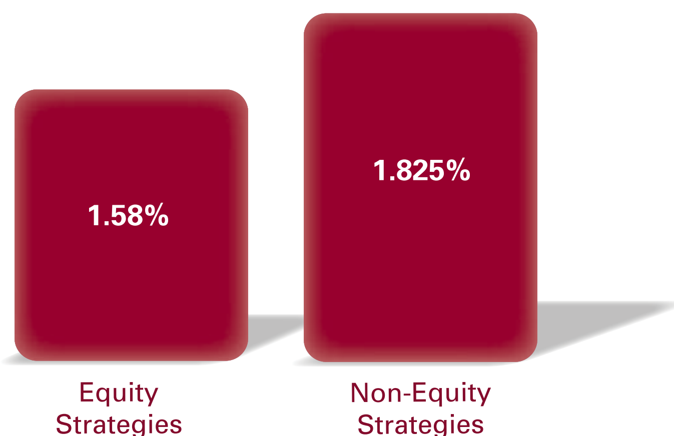


Incentive Allocations/Management Fees

Generally, incentive allocation rates continued to be pegged at 20% of annual net profits. Moreover, every fund in the Study had some type of high water mark provision. In total, less than 8% of the funds in the Study had either a modified high water mark provision, hurdle rate or incentive allocation measured over a multi-year period.

With respect to management fees, there continued to be a disparity between the average management fee rates charged for equity strategies and non-equity strategies, although the gap narrowed as compared to 2012. Across all strategies, the average per annum rate decreased slightly in 2013 to 1.663% (from 1.6875% in 2012), although the median rate remained at 1.75% per annum. Following the trend we noticed in 2012, there still was a difference in management fee rates charged based on strategies employed, with funds utilizing equity strategies charging on average a 1.58% management fee (as compared to about 1.67% in 2012) and funds utilizing non-equity strategies charging an average per annum rate of 1.825% (down from a much higher 1.95% average in 2012). It is likely that this rate differential is due primarily to the higher overhead typically needed to implement many non-equity strategies.

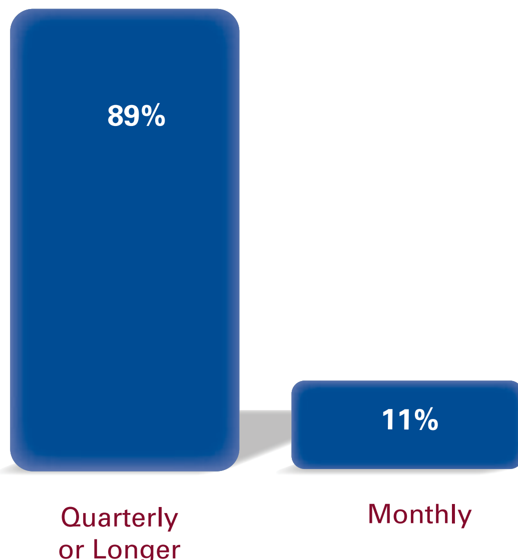
About 62% of the funds offered lower incentive allocation and/or management fee rates either to investors who agreed to greater than one year lock-ups (typically represented in the offering documents by different fund series, classes or sub-classes, or sometimes evidenced in a side letter) or to "founding" type investors (that may not have necessarily been tied to longer liquidity). Longer lock-up classes were present in 19% of the funds. Founders classes (which weren't tied to a longer lock-up) were found in 43% of all funds, although as between equity and non-equity strategies, only 35% of the equity funds had founders classes, while a much higher 65% of the non-equity funds had founders classes. Typically, the founders classes on average had a management fee rate that was about 30 basis points less than the management fee charged in the flagship class (i.e., the standard class typically charging a 1.5%-2% management fee and a 20% incentive allocation), and they had an average incentive allocation of 16.1%.

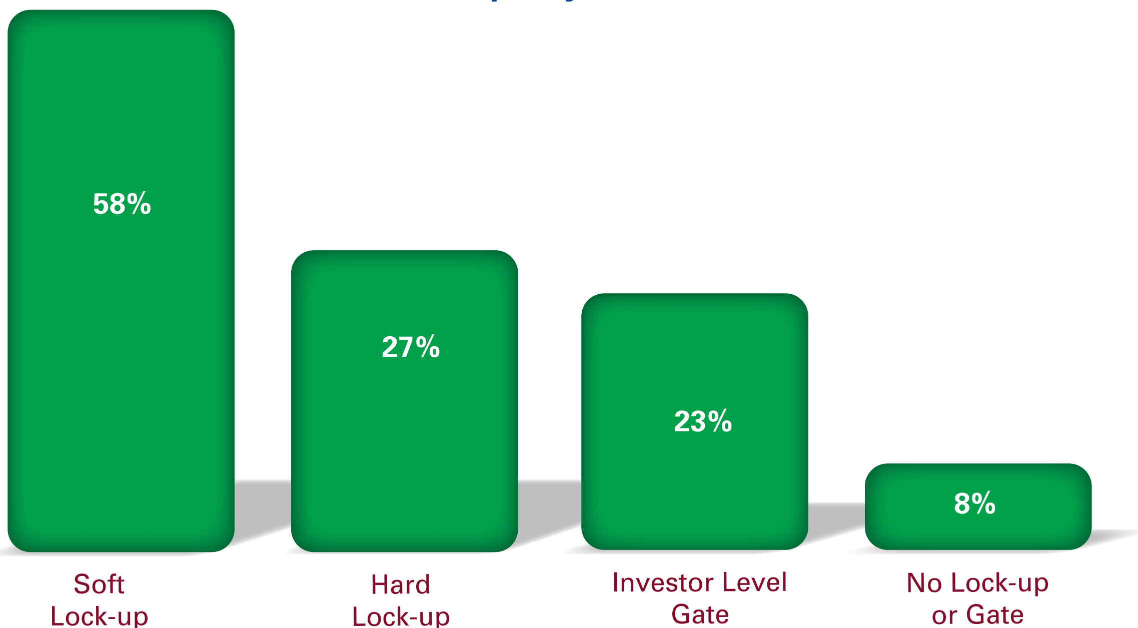


Liquidity

89% of funds permitted quarterly or even less frequent redemptions, while only 11% of funds permitted monthly redemptions in 2013 (as compared to a substantially higher 36% of funds in 2012). Note further that some of these funds did have lock-ups or gates, as discussed in further detail below. Notice periods were usually 30, 45 or 60 days, however, about 15% of funds required 90 days notice.

In the flagship class of the fund, approximately 58% of the funds had a soft lock-up (usually, one year with a 2% - 4% redemption fee payable to the fund) as compared to 50% in 2012; a somewhat surprising 27% had a hard lock-up (usually, one year and non-rolling) as compared to only 8% in 2012; 23% had an investor level gate (up from 15% in 2012); and only 8% had no lock-up or gate of any sort (down from 27% in 2012). In addition, there were no fund level gates employed by any of the funds within the Study.





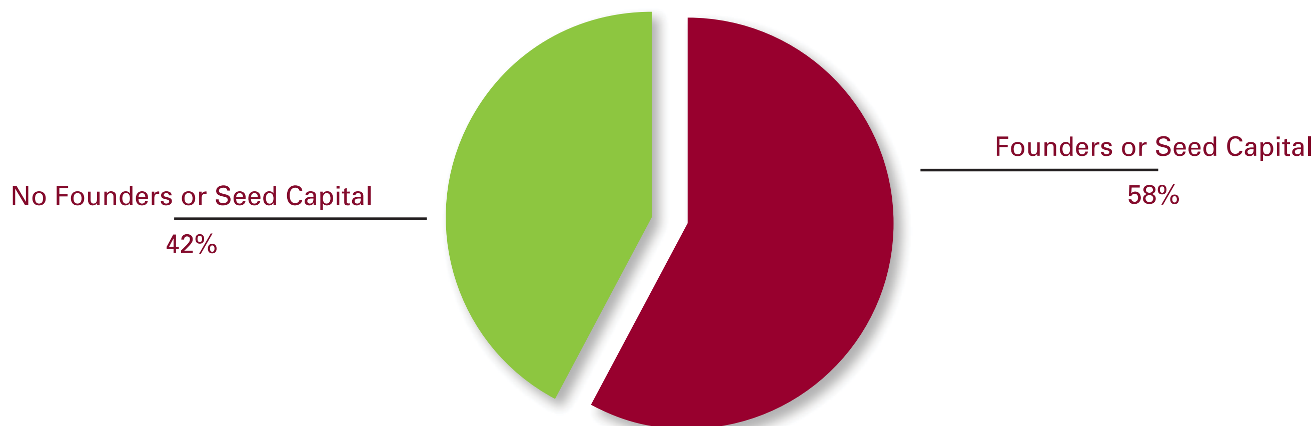
Structures

Sponsors who offered both U.S. and offshore funds set up master-feeder fund structures over 90% of the time. Most offshore funds were established in the Cayman Islands, although other jurisdictions (e.g., Bermuda, Bahamas) sought to reestablish their respective presences in the industry. Following the trend we first began to see in 2012, there continued to be a fair number of managers who initially launched just a U.S. stand-alone fund (approximately 25%), many of whom were seeking to build a track record in order to attract offshore and U.S. tax-exempt investor interest down the road. Most master-feeder funds continued to opt to rely on the Section 3(c)(7) exemption, however, most of the stand-alone funds relied on the Section 3(c)(1) exemption. In addition, the stated minimum initial investment was set at $1,000,000 in approximately 70% of the funds, with 10% of the funds having a minimum of $250,000 and 20% of the funds having a minimum of $5,000,000 or more. Lastly, no fund within the Study chose to go down the path of engaging in general solicitations and advertising as is now permitted under new Securities Act Rule 506(c) promulgated pursuant to the JOBS Act.

Founders or Seed Capital

Given the still rather challenging capital-raising environment that existed in 2013, it is not surprising that 43% of funds within the Study obtained some form of founders capital and we estimate, based on conversations with various industry participants, that within the entire hedge fund industry for the calendar year 2013, at least 40% of all launches greater than $75 million (and an estimated 15% of all fund launches) had some form of seed capital.

With respect to seed deals, of the funds we studied, the 2013 environment saw a number of new prominent firms enter the seeding arena, as well as the emergence of some smaller opportunistic one-off investors such as certain high net worth individuals (acting alone or collectively through club deals) and family offices. For more prominent managers who were in high demand, the increase in the number of seeders sometimes translated into more favorable deal terms such as scaling down or reduced revenue shares, better buyout multiples, more attractive working capital arrangements and other beneficial provisions. Seed investments in many of the bigger deals remained in the $75 million to $150 million range, typically including a two to three year lock-up. For the smaller deals, usually with less well-known managers, the seed amounts generally ranged from $10 million to $50 million.



We hope that you find *The Seward & Kissel New Hedge Fund Study* helpful. If you have additional input that you would like to share with us, or have any questions, please contact your primary attorney in Seward & Kissel's Investment Management Group.

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