

SEWARD & KISSEL LLP



THE SEWARD & KISSEL

2015

NEW HEDGE FUND STUDY

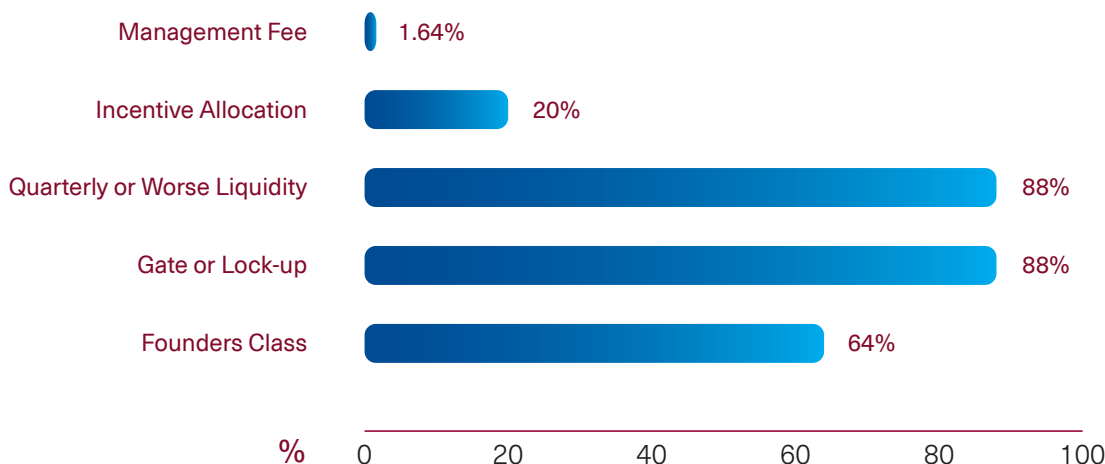
Introduction and Key Findings

Driven by our ongoing commitment to understanding the dynamics of the hedge fund marketplace and bringing the latest industry color to our clients and friends, 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 2015 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 analyzes investment strategies, incentive allocations/management fees, liquidity and structures, as well as whether any form of founders or seed capital was raised. The Study does not cover managed account structures or “funds of one” that may have a wider variation in their fee arrangements and/or other terms.

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

- 80% of the funds had equity or equity-related strategies (up from 73% in the 2014 Study).
- Incentive allocation rates generally continued to be set at 20% of net profits across all strategies for the flagship class and no funds had a modified high water mark or multi-year incentive allocation.
- The past disparity in management fee rates between equity and non-equity strategies resurfaced, with equity strategies at about 12 basis points higher than non-equity strategies. This differs from prior years, where typically non-equity strategies were found to be higher.
- 35% of equity funds (and none of the non-equity funds) implemented a management fee rate in their founders classes that tiered down to lower

Key Findings for Average 2015 New Hedge Fund



rates as assets surpassed certain benchmarks. Moreover, 82% of all equity funds implemented founders classes (while just 29% of non-equity funds had them).

- 88% of funds permitted quarterly or even less frequent redemptions (as compared to 81% in 2014), while 12% of funds permitted monthly redemptions (as compared to 19% in 2014). Moreover, 88% of all funds had some form of lock-up or gate.
- Sponsors of both U.S. and offshore funds set up master-feeder structures over 95% 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) continued to increase their presences in the industry.
- 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.
- We estimate that, for calendar year 2015, there were at least 35 to 45 seed deals consummated (many being less publicized, opportunistic, one-off investments by lower profile investors).



Investment Strategies

About 80% 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 about 7% more than the 2014 Study. Of the remaining 20% of funds in the Study (i.e., the non-equity strategies), about 15% of the funds included in the Study were multi-strategy/macro offerings, and the balance consisted of credit, CTA and various other strategies.

Incentive Allocations/Management Fees

Generally, for hedge fund flagship classes (i.e., the standard classes typically charging a 20% incentive allocation and a 1.5% to 2% management fee), incentive allocation rates continued to be set at 20% of annual net profits. Moreover, every fund in the Study had some type of high water mark provision. None of the funds in the Study had a modified high water mark or an incentive allocation measured over a rolling multi-year period, and very few had a hurdle rate.

With respect to management fees charged in flagship classes, there were a number of important take-aways. First, the past disparity between equity and non-equity strategies (which disappeared in 2014) resurfaced, as the average rate was 1.68% for equity strategies and 1.56% for non-equity strategies, as compared to an average rate for each of the two categories of 1.7% in 2014. This is particularly interesting, in that in prior years where there was a disparity, the average management fee rate for non-equity strategies was higher than the rate for equity strategies. We believe this may be due, in part, to the greater demand for equity strategies. Moreover, the biggest trend that has continued to develop over the past few years is the tiered management fee in founders classes (specifically for equity funds). In

2015, 35% of the equity funds (and none of the non-equity funds) in the Study had a tiered management fee in the founders class, as compared to 25% in the 2014 Study. Lastly, for the first time in our Study, one fund had a tiered incentive allocation.

About 68% of the funds (as compared to 72% in 2014) offered lower incentive allocation and/or management fee rates 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) and/or to “founding” type investors (that may not have necessarily been tied to longer liquidity). Longer lock-up classes were present in 24% of the funds (which was about the same as the 23% in 2014). Founders classes (about 15% of which also had a longer lock-up provision for founders) were found in 64% of all funds (also about the same as the 65% in 2014). As between equity and non-equity strategies, 82% of the equity funds had founders classes (as compared to a lower 75% in 2014), while only about 29% of the non-equity funds had founders classes (as compared to a higher 43% in 2014). Typically, the founders classes on average had a management fee rate that was about 50 basis points less than the management fee charged in the flagship class (which is about the same differential as in 2014, although this average doesn’t account for decreasing fees due to tiering management fee rates in certain funds), and they had an average incentive allocation of 16% (a jump up from the 15.51% average in 2014).

Management Fees in Equity Strategy Founders Classes

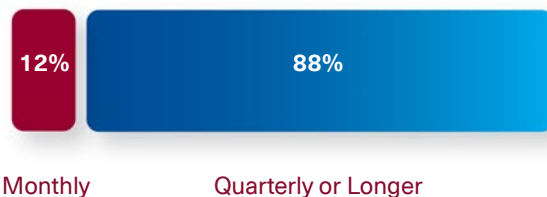


Liquidity

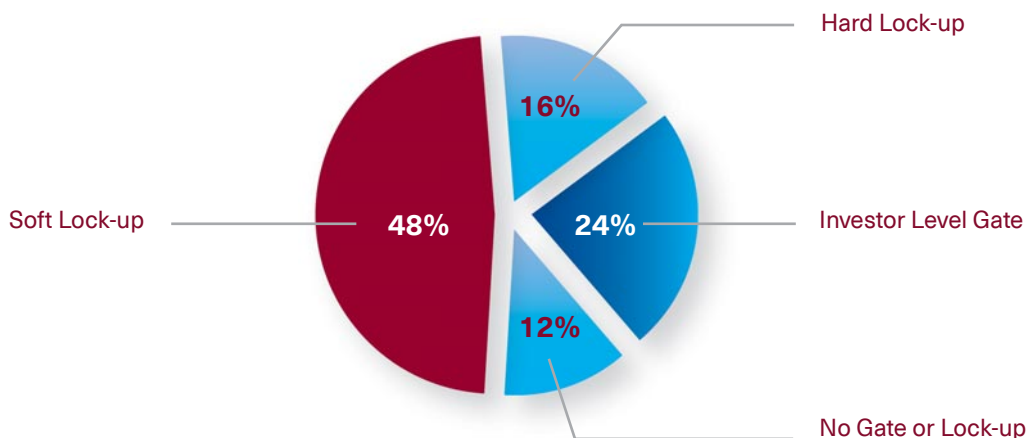
88% of funds permitted quarterly or even less frequent redemptions, while just 12% of funds permitted monthly redemptions in 2015 (as compared to 19% of funds in 2014). Note further that most of these funds had lock-ups or gates, as discussed in further detail below. Notice periods were usually 30, 45 or 60 days, however, about 16% of funds required 90 days’ notice. The average notice period was 52.2 days.

In the flagship class of the fund, similar to the 46% in 2014, approximately 48% of the funds had a soft lock-up (usually, one year with a 2% to 4% redemption fee payable to the fund); 16% had a hard lock-up (usually, one year and non-rolling) as compared to 12% in 2014; 24% had an investor level gate (about the same as 2014); and only 12% had no lock-up or gate of any sort (down from 15% in 2014). In addition, continuing a recent trend, none of the funds within the Study had a fund level gate, nor did any have sidepockets.

Redemption Frequency



Liquidity Terms





Structures

Sponsors who offered both U.S. and offshore funds set up master-feeder fund structures over 95% of the time, as opposed to side-by-side structures. Of the master-feeder fund structures, there was a noticeable increase in the number of master funds established as partnerships, as opposed to corporations (primarily due to easier administrative and accounting capabilities available in partnerships). Most offshore funds were established in the Cayman Islands, although other jurisdictions (e.g., Bermuda) continued to increase their presences in the industry. Note that given the recent publication of a LLC statute in the Cayman Islands, we will be monitoring this development closely to see whether it impacts future fund structuring. In addition, 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, about half of the stand-alone funds relied on the Section 3(c)(1) exemption. The stated minimum initial investment was set at \$1,000,000 in approximately 64% of the funds, with about 16% of the funds having a minimum of \$500,000 or less and 16% of the funds having a minimum of \$2,500,000 or more. Typically, founders classes had a higher minimum than the flagship classes. 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 2015, it is not surprising that 64% of all of the funds within the Study (as compared to a similar 65% in the 2014 Study) obtained some form of founders capital. In addition, we estimate, based on conversations with various industry participants and our own internal data, that within the entire hedge fund industry, for calendar year 2015, there were at least 35 to 45 seed deals consummated (many being less publicized, opportunistic, one-off investments by lower profile investors), with about a third of the deals being over \$50 million and about a quarter being over \$100 million.

With respect to seed deals, of the funds we studied, the 2015 environment continued a recent trend with an increasing number of opportunistic, one-off investors entering the space (such as certain high net worth individuals acting alone or collectively through club deals and family offices). In addition, there were some new fund raises by a number of well known seeders, and several fund-of-funds businesses were repositioning their offerings as seed investment platforms. Seed investments in many of the bigger deals remained in the \$75 million to \$200 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, often with a two year lock-up.

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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