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Hedge Fund Law Report
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Fund Formation

Annual Walkers Fundamentals Seminar Spotlights Trends in Fund Structures, Strategies, Fees and Governance

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Walkers Global recently held its Fundamentals Hedge Fund Seminar in New York City, where experts addressed various issues relevant to the hedge fund industry, including the structures of new hedge funds and the typical terms being negotiated with investors, as well as trends in new fund strategies and fund governance. This article summarizes the key points discussed at the conference on each of these topics.

For the HFLR's coverage of Walkers Fundamentals Hedge Fund Seminars from prior years, see: 2014 Seminar; 2013 Seminar; 2012 Seminar; 2011 Seminar; and 2009 Seminar.

Fund Structures

With respect to the newly launched funds, in its survey entitled "Funds in Focus: The Outlook for 2016," Walkers found a continuing increase in the launch of new funds, by both start-up managers and institutional managers. In addition, these funds are often launched by managers who have spun out of institutional advisors, which Walkers noted was another continuing trend in 2015.

The number of standalone funds increased significantly in 2015, with a corresponding reduction in the launch of master-feeder structures. Of the new funds launched in 2015, 45% were structured as master-feeder funds, down from 59% in 2014. Standalone funds represented 41% of new funds launched in 2015, up from 37% in 2014. Funds using other structures (particularly unit trusts aimed at the Japanese market) made up 14% of new funds launched last year, up from a mere 4% in 2014.

New managers tend to favor standalone structures for two primary reasons: as a way to reduce start-up costs or because their targeted investors do not require an onshore feeder. In addition, some managers will deploy a structure consisting of an onshore master fund and offshore feeder fund, with no corresponding offshore master.

"It's no surprise that most of the funds we are seeing set up have a master-feeder structure," noted Walkers partner, Ingrid Pierce. "While the master-feeder structure has remained very, very popular, we have also seen the growth of standalone funds."

Pierce also noted a growing trend of U.S. managers distributing funds into Japan, with such funds typically established as umbrella structures and managed unit trusts that are not a part of

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a master-feeder structure. See also "Credit Suisse Survey Evaluates Investor Appetite for Alternative Investment Vehicles and Strategy Preferences" (Aug. 27, 2015).

Fund Strategy Trends

As banks continue to be replaced as credit providers, 2015 witnessed a sharp increase in credit-focused funds. Twenty-five percent of new funds launched employed credit strategies, compared to only six percent in 2014.

Hedge fund managers continue to employ different strategies, reflecting investor demands. Equity-focused strategies, such as market neutral and equity long/short, remain the most common strategy among new launches in 2015. Those strategies were employed by 35% of new funds in 2015 – a slight decrease from the 37% of funds employing equity-focused strategies in 2014.

While credit strategies saw the biggest increase since 2014, diversified fund strategies also saw a noted increase. Twenty-five percent of new funds launched in 2015 employed diversified strategies, compared to eighteen percent in 2014.

"In terms of strategies, again we have seen a majority of new funds being launched in the equity space," Pierce summarized, "particularly equity long/short and market neutral. One surprising thing this year was a rise in the number of credit strategies."

Hedge Fund Fees

Hedge fund managers continue to feel downward pressure on fees, particularly management fees. As managers try to attract capital in a competitive fund-raising environment, they have offered innovative fee structures, such as multiple share classes, tiered management fees (which reduce as certain AUM thresholds are met), or agreements with investors – often by way of a side letter – to scale management fees as the investor's subscriptions grow. For more on tiered management fees, see our two-part series: "Tiered Management Fees May Help Hedge Fund Managers Attract Institutional Investors" (Jun. 25, 2015); and "Practical Considerations for Hedge Fund Managers Implementing Tiered Management Fees" (Jul. 9, 2015).

Management Fees

"What we have seen over the last two years is that the typical two percent management fee has gone down," noted Pierce. "Many of the funds that were set up this year have had a management fee lower than 2%, usually about 1.6% on average." She remarked that this trend is unsurprising, given the reduced investor appetite for fees over the past few years and the corresponding recognition by managers that lowering fees is necessary, particularly from a marketing perspective.

According to the Walkers study, the average management fee for new funds is between 1.5% and 1.8%. A vast majority of managers – 77% of new managers – charge less than 2% in management fees. This is comparable to 2014, when 75% of new managers charged less than 2% management fees. Looking at the data, the number of managers who charged exactly 2% management fees remained relatively static, with 22% of managers (a slight decrease over the 23% in 2014). Very few managers (1%) charge management fees greater than 2%.

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Performance Fees

Pierce explained that trends with respect to performance fees have been a bit different, characterizing the 20% performance fee as "more robust." She remarked, "We have seen more funds being launched that have higher fees for performance. While the fees vary by class – with different investors in various classes being offered varied fee terms – we continue to see funds with higher performance fees."

The reason performance fees have remained high is because there has been less pressure on managers to reduce them; investors are willing to reward performance. Following the financial crisis, many speculated that 20% fees would be reduced in the coming years. However, that has not happened, and the 20% performance fee remains the industry norm, charged by 75% of managers.

Only 9% of managers charge performance fees of 10%, and an additional 9% of managers charge between 10% and 20%. Performance fees above 20% are relatively unusual, and only 8% of managers charge these higher performance fees, which are often reserved for portfolios of more complex or illiquid assets.

For more on fee trends, see "Seward & Kissel New Hedge Fund Study Identifies Trends in Investment Strategies, Fees, Liquidity Terms, Fund Structures and Strategic Capital Arrangements" (Mar. 5, 2015).

Fund Liquidity

Liquidity continues to be a hot-button issue for managers, as investors seek more flexible redemption options. Accordingly, managers continue to move away from lockups, and the most common liquidity structures allow for monthly or quarterly redemptions.

Logically, a fund's liquidity will be determined by the overall liquidity of the investment strategy, as a manager cannot offer more frequent liquidity than the amount of time necessary to liquidate positions or the entire portfolio. Walkers noted that, as more funds are offering equity-based strategies, there is a corresponding trend towards shorter liquidity periods. In its survey, Walkers reported that equity funds often allow for monthly liquidity and shorter lockups, while credit funds, which often have more illiquid portfolios, tend to have more restrictive liquidity terms, such as quarterly redemptions.

"Typically, the new funds that we've been seeing set up over the last year or so have tended to focus on liquidity, whether monthly or quarterly liquidity," explained Pierce. "We're not really seeing funds with semi-annual or annual liquidity, unless those funds are in private equity or employ another illiquid strategy. Nothing really changed significantly from last year."

Lockups and Gates

The number of funds that have lockups continues to decline, with only 34% of new funds in 2015 requiring a lockup, down from 42% in 2014. The majority of lockups (40%) last for 12 months. A similar portion of new funds (36%) imposed gating restrictions at either the fund level (based on total redemptions) or at an investor level. See "Dechert Global Alternative Funds Symposium Highlights Trends in Hedge Fund Expense Allocations, Fees, Redemptions and Gates" (May 21, 2015).

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Fund that have lockups tend to offer soft lockups. See "Soft Lockups Help Hedge Fund Managers Reconcile the Goals of Stable Capital and Investor Liquidity" (Nov. 19, 2010). Some managers have used lockups to offset pressure on other fund terms; for example, a manager may offer an investor a lower fee structure in exchange for that investor agreeing to a longer lockup.

For more on fund liquidity, see "Schulte Partner Stephanie Breslow Addresses Gates, Side Pockets, Secondaries, Co-Investments, Redemption Suspensions, Funds of One and Fiduciary Duty" (Dec. 4, 2014).

Fund Governance

Governance remains a key due diligence item for investors, with investors exhibiting a strong preference for independent directors to serve on the board of hedge funds.

Almost 80% of new funds have at least one independent director, a percentage that has remained consistent since 2013. "For 80% of new funds set up, there has been some level of independence on the board," noted Pierce. That percentage has remained consistent since 2013 and represents funds that have at least one independent director.

However, Pierce continued, "the vast majority of those funds have had a majority of independent directors on their boards. That's obviously a sign of the times and the desire of investors to see some independent oversight of the manager and who are insisting on a larger role for independent directors."

Pierce also identified a propensity for a split board, where a fund has multiple independent directors from different service providers. "Institutional investors seem to prefer funds that have split boards," she noted

Walkers found that funds with a majority of independent directors on their boards often have one or more principals from the manager on the board as well.

The focus on governance is evidenced by the Cayman Islands Monetary Authority's (CIMA) introduction of the Cayman Directors Registration and Licensing Law, which requires directors of entities covered by the law to either register or apply to be licensed by CIMA. See "Cayman Islands Government Introduces Bill That Would Require Registration and Licensing of Certain Hedge Fund Directors" (Mar. 28, 2014); and "Cayman Islands Monetary Authority Introduces Proposals to Apply Revised Governance Standards to CIMA-Regulated Hedge Funds and Require Registration and Licensing of Fund Directors" (Jan. 24, 2013).

Key Person Provisions

Pierce also identified an increasing trend in the negotiation of key person clauses in fund documents. Specifically, she explained, key person clauses are frequently being negotiated to serve as "key group" provisions covering the entire senior investment team.

To read the full survey, click here.

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