SEWARD & KISSEL LLP

New Manager Hedge Fund Study

2023 Edition

Prepared by the Investment Management Group at Seward & Kissel LLP

STUDY

Seward & Kissel — 2023 New Manager Hedge Fund Study

Introduction & Key Findings

Seward & Kissel has advised the investment management industry for more than 75 years and we continue to be committed to understanding the dynamics of the investment fund marketplace while bringing the latest industry color to our clients and friends. Accordingly, each year Seward & Kissel conducts numerous studies intended to provide valuable insights that will help inform fund managers' key operational and business decisions.

The annual Seward & Kissel New Manager Hedge Fund Study evaluates newly formed hedge funds sponsored by new U.S.-based managers entering the market. This Study covers the 2023 hedge fund launches of relevant Seward & Kissel clients meeting these criteria and 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 tend to 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:

- 74% of the funds had equity or equity-related strategies, slightly down from 76% in 2022.
- With respect to management fees charged in the standard (i.e., non-founders) classes, the average rate was 1.48% for equity strategies (up from 1.42% in 2022) and 1.40% for non-equity strategies (down from 1.67% in 2022).
- Incentive allocation rates in standard classes across all strategies averaged 18% of annual net profits (down from 18.75% in 2022). In addition, approximately 40% of all funds had an incentive allocation hurdle (a significant increase from 15% in 2022). 54.5% of hurdles were soft hurdles and 45.5% were hard hurdles.
- Approximately 49% of the equity funds (down from 59% in 2022) and 47% of the non-equity funds (down from 53% in 2022) offered lower management fee and/or incentive allocation rates through their founders classes.
- 74% of the equity funds (down from 88% in 2022) and 95% of the non-equity funds (up slightly from 93% in 2022) offered quarterly (or less frequent) withdrawals, with the balance allowing for monthly withdrawals.
- Lock-ups or investor level gates were used by approximately 78% of the equity funds (up from 69% in 2022) and 71% of the non-equity funds (up from 67% in 2022), with 35% of all funds including both (down from 42% in 2022). Of particular interest, the usage of investor level gates in the standard classes of equity funds in 2023 (53%) remained fairly consistent with 2022 (60%), which saw a significant increase from 2021 (18%).
- Sponsors of both U.S. and offshore funds continued to almost exclusively set up master-feeder structures (as opposed to side-by-side structures) and utilized the Section 3(c)(7) exemption 75% of the time (down from 87% in 2022). Sponsors launching with just a U.S. standalone fund in 2023 (68%) remained fairly consistent with 2022 (60%).
- Overall, hedge fund seed investment activity in 2023 (i.e., typically, where money is invested by an investor for a locked up time period in exchange for some sort of revenue share in the fees) was comparable to 2022. Institutional seeders remained fairly active, representing the majority of observed seeding activity.
- Looking back five years to 2018, fund terms regarding fees and liquidity have remained fairly consistent.

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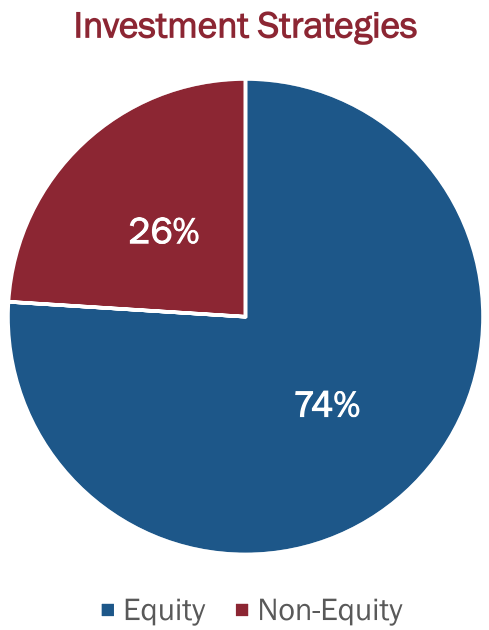
Key Terms for the Average Hedge Fund Standard Class Across All Strategies (over a five-year period)

	2018	2023
Management Fee	1.40%	1.46%
Incentive Allocation	18.72%	18%
Quarterly or Less Frequent Liquidity	81%	81%
Gate or a Lock-up	71%	67%
Founders Capital	57%	48%

Investment Strategies

About 74% 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). The remaining 26% of funds in the Study (i.e., the non-equity strategies) were split among quantitative, global macro, credit, crypto and commodity-related strategies.

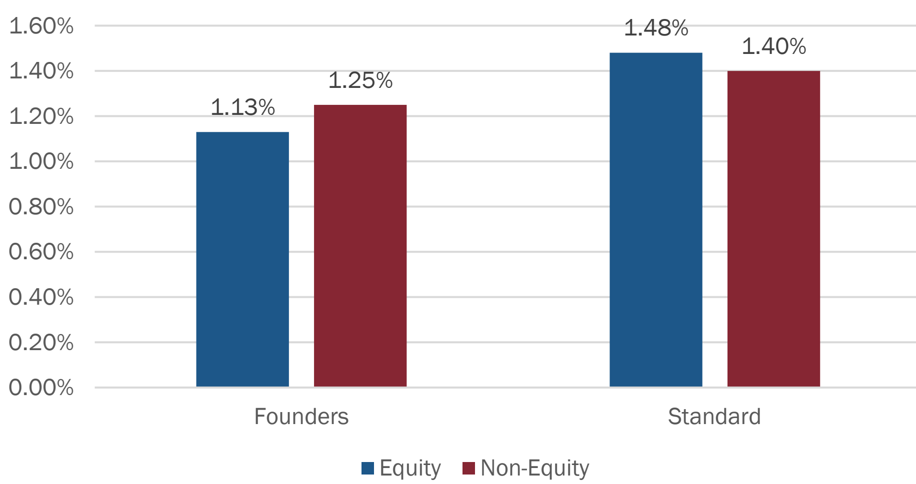


Management Fees and Incentive Allocations

From 2022 to 2023, management fee rates in standard (i.e., non-founders) classes for funds with equity strategies increased slightly by about 6 basis points and management fee rates for funds with non-equity strategies decreased by about 27 basis points. The average rate was 1.48% for equity strategies (up from 1.42% in 2022) and 1.40% for non-equity strategies (down from 1.67% in 2022). In a shift from prior studies, management fee rates in standard classes among equity and non-equity strategies are beginning to align. Note, however, that these averages do not take into account the possible tiering down of management fee rates as assets increase or time passes, which was present in 15% of all funds (down from 35% in 2022). In 10% (down from 17% in 2022) of those funds that also contained a dual class structure, the tiered rate applied to both founders and non-founders classes.

Incentive allocation rates in standard classes across all strategies averaged approximately 18% of annual net profits (down from 18.75% in 2022). Moreover, every fund that charged an incentive allocation had some type of high-water mark (or loss carryforward) provision. Lastly, while less than 5% of the funds in the Study had a modified high-water mark, approximately 40% of all funds had an incentive allocation hurdle (a significant increase from 15% in 2022). 54.5% of hurdles were soft hurdles and 45.5% were hard hurdles. We think the significant increase in funds with an incentive allocation hurdle in part reflects investor demand for strong returns in a high interest rate environment.

Management Fee by Class and Strategy

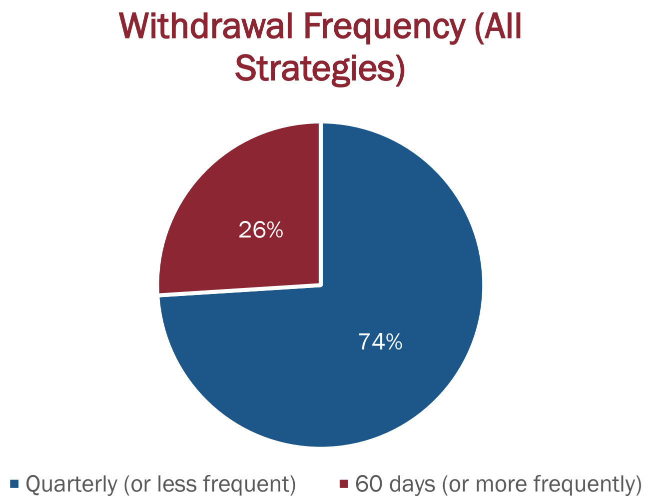


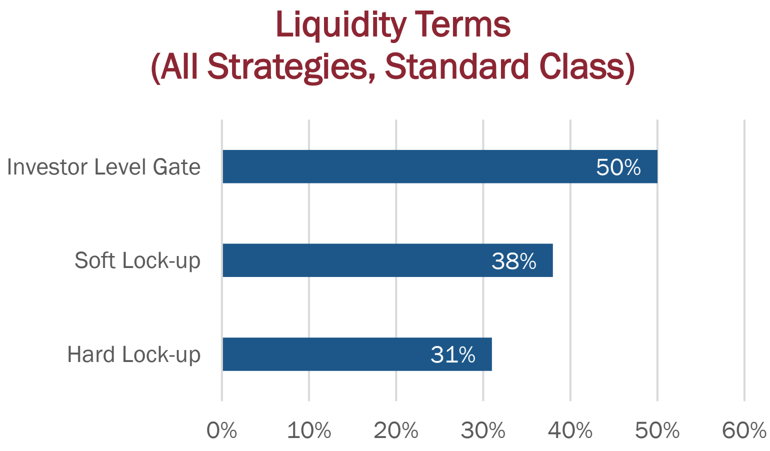
Approximately 49% of the equity funds (down from 59% in 2022) and 47% of the non-equity funds (down from 53% in 2022) offered lower management fee and/or incentive allocation rates through their founders classes. We believe that the large decrease in the number of funds offering founders classes may be partially attributable to the increased operational costs associated with running a hedge fund putting pressure on managers to maintain a certain level of fees. About 17% of the funds (consistent with 2022) conditioned lower management fee and/or incentive allocation rates on longer lock-up terms. The average founders class management fee was 1.13% for equity funds (down from 1.36% in 2022) and the average for non-equity funds was 1.25% (down from 1.58% in 2022). The average founders class incentive allocation was 14.75% for equity funds (down from 16% in 2022), while the average for non-equity funds was 15% (similar to 2022).

Liquidity

74% of the equity funds (down from 88% in 2022) and 95% of the non-equity funds (up slightly from 93% in 2022 and up significantly from 55% in 2018) offered quarterly (or less frequent) withdrawals, with the balance allowing for monthly withdrawals. We believe that the high percentage of non-equity funds offering quarterly or less frequent liquidity in recent years indicates that a larger proportion of non-equity funds pursue less liquid strategies, such as macro and debt-focused strategies. The notice period for equity funds was 30 days or less 22% of the time, 45 days 11% of the time, 60 days 33% of the time, and at least 90 days 34% of the time. The notice period for non-equity funds was 30 days or less 17% of the time, 45 days 16% of the time, and at least 90 days 67% of the time. The average notice period was 65.2 days (similar to 65.5 days in 2022) broken down as an average of 61 days for equity funds and 78 days for non-equity funds.

Moreover, across all classes, 78% of the equity funds and 71% of the non-equity funds had lock-ups or investor level gates (with 35% of all funds including both). Last year, we saw 69%, 67% and 42%, respectively. In the standard classes of the funds, 53% of the equity funds (slightly down from 60% in 2022) and 50% of the non-equity funds (the same as in 2022) had an investor level gate, 37% of the equity funds (up from 27% in 2022) and 42% of the non-equity funds (up from 25% in 2022) had a soft lock-up (usually, one year with a 2% to 4% withdrawal fee payable to the fund), and 26% of the equity funds and 50% of the non-equity funds had a hard lock up. We believe that the uptick in investor level gates and lock-ups that we have seen over the past few years may in part be due to the particularly high demand for alternative investment strategies with somewhat longer liquidity profiles.





Structures

Sponsors of both U.S. and offshore funds continued to almost exclusively set up master-feeder structures (as opposed to side-by-side structures) and utilized the Section 3(c)(7) exemption 75% of the time (down from 87% in 2022). Of the master-feeder structures, there was continued growth in the number of master funds established as partnerships, as compared to corporations (primarily due to easier administrative and accounting capabilities available in partnerships). In addition, 68% of all managers initially launched just a U.S. stand-alone fund (up from 60% in 2022), primarily to build a track record in order to attract offshore and U.S. tax-exempt investor interest in the future. About 61% (up significantly from 35% in 2022) of the stand-alone funds relied on the Section 3(c)(1) exemption, suggesting that new managers face increased competition for institutional investors. The average minimum initial investment for 3(c)(7) funds across all strategies was about $1,800,000 (somewhat consistent with $1,700,00 in 2022). Breaking down the 3(c)(7) fund numbers, the average minimum initial investment for equity funds was about $2,000,000 (up from $1,350,000 in 2022) and $1,500,000 for non-equity strategies (down from $2,500,000 in 2022). With respect to 3(c)(1) funds, the average minimum initial investment was about $750,000 (with equity funds at about $800,000 and non-equity funds at about $600,000). We believe that the significant changes in the minimum initial investment requirements for equity versus non-equity strategies may indicate a shift in investor sentiment based on 2023 overall stock market performance. Lastly, no fund within the Study chose to go down the path of engaging in general solicitations and advertising as is now permitted under Securities Act Rule 506(c) promulgated pursuant to the JOBS Act.

Seed Capital

Overall, hedge fund seed investment activity in 2023 was comparable to 2022. Institutional seeders remained quite active and, based upon our observations, accounted for the vast majority of hedge fund seed investments in 2023; however, family office participation in these transactions ticked up somewhat in 2023, building on the observed reentry into the seeding arena for these investors following minimal activity during the height of the COVID pandemic. Terms of seed investments were broadly consistent with historical observations, and seed investment ticket sizes often exceeded $75mm, following a trend of increasing check sizes by seed investors. While traditional long/short, macro and other strategies with high AUM capacities remained a popular choice for seeders, also observed were a number of seed investments in multi-manager platforms and hybrid funds.

As in past years, seeding activity was concentrated among several well-known seeders, though a number of new seeding platforms are making their way onto the landscape. This dynamic, combined with additional regulatory focus on similar treatment of all investors, continues to orient seed investments – and the corresponding deal terms – to reflect alignment and partnership with the seeded manager.

As was the case in 2022, in 2023, the larger tickets for seed investment deals in many cases significantly exceeded $100 million. These transactions often had multiple seeding parties and typically included a two- to three-year lock-up. Our data indicates that deferrals of seeder economics as a means of making more working capital available to new managers continues to be increasingly common in seed deals, which is broadly consistent with what we have been observing for the past several years; however (and perhaps correspondingly), the duration of the revenue share remains perpetual in the vast majority of these investments.

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We hope that you find *The Seward & Kissel New Manager 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.

Recognitions

The Investment Management practice and partners have been widely recognized by industry organizations for our representation of investment managers, including but not limited to recognition by the following organizations:

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