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Seeding

Primary Legal and Business Considerations in Hedge Fund Seeding Arrangements

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Over the last ten years it has become increasingly difficult for an emerging fund manager to start a hedge fund with minimal assets under management, establish a track record and use that record to attract additional capital. With increased regulation on the horizon and its attendant compliance costs, not to mention investor wariness in the face of current economic conditions, the barrier to entry for hedge fund managers likely will increase even more. One way for a manager to break through this barrier is to enter into an agreement with a seed investor. In a typical seeding arrangement, the hedge fund manager or seedee receives start-up capital from a seed investor or seedor, typically a banking or other financial entity or else a fund of funds whose strategy is to invest in promising emerging managers. In return, the seedor participates in the manager's revenues (more often than not though a contractual right to a portion of the revenues of the seedee rather than a direct ownership interest). As a result, the seedor's and the seedee's interests appear to be aligned. Each benefits from an increase in the manager's assets under management (AUM) and positive performance. Yet, the seedor and the seedee have different expectations from a seeding arrangement. These expectations color how the two parties look at the terms of the seeding arrangement. This article explores, from the perspectives of both sides, the primary legal and business issues that frequently arise in seeding arrangements.

Issues to be Considered by Seedees

Objectives

A hedge fund manager seeking a seed investor generally has two objectives. The first is initial capital. The manager needs enough capital to enable him to fully implement his investment strategy. In addition, the management company must be sufficiently capitalized such that it can afford the installation and ongoing costs associated with a robust back office, including employees, consultants and administrative and risk management systems. Fortunately, many seedors are willing to supply capital to the management entity in addition to making a seed investment in the manager's fund. Some seedors also are willing to supply access to back office support. How much capital is needed and where it should be deployed is the first, and simplest, question for the seedee to answer.

The second objective of a manager is ongoing capital. While a manager may be able to earn a living by managing money for a single significant investor, a long term successful business means having multiple investors. Frequently a manager needs help in capital raising. Since a seedor

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typically has more industry contacts and stands to benefit if these contacts invest in the manager's fund(s), it is only logical that a seedee look to its seedor for this assistance. For their part, seedors frequently tell managers that they will help with capital raising. Yet seedees and seedors may not be on the same page as to exactly what capital raising assistance the seedor will provide. A seedor may think that its investment in a fledgling manager provides the manager with a legitimacy which, when combined with positive word-of-mouth, provides a boost to capital raising. This may be so.

However, if the manager was hoping that the seedor would market his funds actively, as is frequently the case, the manager will be dissatisfied. A manager that is expecting that a significant portion of its future assets under management will come from the capital introductions made by its seedor should investigate whether this is a realistic expectation. If the seedor is not a registered broker-dealer or affiliated with a registered broker-dealer, it's not a realistic expectation. Even if there is registered broker-dealer entity, however, that in and of itself does not mean that the seedor will engage that broker-dealer in a manner that matches the manager's expectation. Frequently a seeding agreement will refer to a separate selling agreement. Just like a seedor looks to the manager's track record before it decides to seed the manager, the manager, if it is relying on capital being raised by the seedor, should look at the seedor's track record in marketing new funds and managers. If the seedor has seeded other managers, it is reasonable to expect that the seedor has a prepared form of this selling agreement. If no such form exists it may be because the seedor's broker-dealer entity has not previously marketed funds run by other managers that it has seeded. A manager should also look for clarity on when the seedor's marketing efforts would begin. While it will be easier for a seedor to market a fund that has an established track record, a manager who is entering a seeding arrangement likely is seeking additional capital as soon as possible in order to offset expenses.

Term of Commitment

In order for the manager's objectives to be met, the seedor must commit to maintain its investment in the fund(s) for a period of time. The optimal length of time depends on two factors: the manager's investment strategy and the manager's business plan. If the manager pursues a strategy that involves long-term investments, the lock-up period needs to be long enough to allow the manager's investment thesis to come to fruition and be reflected in the fund's performance numbers. Equally important is that the lock-up period run until the time when the manager's business plan projects that the fund's AUM will be at a level such that the redemption of the seed investor will not force the manager to unwind the fund. In light of recent events, however, the seedor likely will want the lock-up period to be as short as possible.

In addition, the seedor will ask for various redemption triggers. In negotiating these redemption triggers the manager should object to any triggers that are inappropriate to the manager's strategy, are overly broad, or are not objective. For example, a redemption trigger in the event of the manager's or its principal's violation of law, rule or regulation appears appropriate. Unless it is narrowed, for example, to a material violation that can be reasonably expected to impact the manager's business, however, it is overly broad and would permit a redemption by the seedor in the event of a traffic violation by the principal. Further, once triggered the seedor should have a discrete period of time in which to exercise its right to redeem. A violation of a redemption trigger that was known by the seedor in year one should not afford the seedor a right to redeem in year three.

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Another point to bear in mind is that an investment adviser is subject to a fiduciary duty. This duty, and to whom it is owed, has become a recent topic of discussion. See "What Precisely is 'Fiduciary Duty' in the Hedge Fund Context and To Whom is it Owed?," Hedge Fund Law Report, Vol. 2, No. 29 (Jul. 23, 2009); "For Hedge Fund Managers, How Would a Statutory Definition of 'Fiduciary Duty' Affect the Scope of the Duty and the Standard for Breach?," Hedge Fund Law Report, Vol. 2, No. 34 (Aug. 27, 2009). When giving effect to a substantial redemption a hedge fund manager needs to protect the interests of the fund's remaining investors. As a result, when negotiating redemption triggers, it is necessary to consider, prospectively, the probable effects of these triggers on other investors in the manager's fund(s), as well as the manager's disclosure obligations with regard to the seedor's special rights.

Capacity Rights

It is difficult to predict the manner and degree to which the granting of capacity rights to a seed investor and the structuring of such rights will impact the future success of a hedge fund manager. Generally, it is in the best interests of the manager to have a diverse investor base. Many funds that had a majority of their AUM held by a single investor or a group of affiliated investors were forced to close during the past year when that investor or group decided to redeem. In many cases, the redemption was prompted not by the fund's poor performance but by the fund's favorable liquidity in comparison to the balance of the investors' portfolios. This cautions against granting capacity rights such that the seedor always likely would be a majority investor. Of course, the seedor may not exercise all or even any of its capacity rights. Yet if there is a limit as to how much the manager can realistically manage, the manager nonetheless may be constrained. A hedge fund manager does not want to be in a position where it has to turn away money because that money, when combined with the amount reserved for seedor, would be more than the maximum AUM the manager could manage without adversely impacting returns. This potential issue can be resolved by structuring the capacity rights as both a dollar amount and as a percentage of the total capacity that the manager feels it can manage.

An additional issue arises in the context of seedors that are, or invest via, funds. That is ERISA. The manager needs to protect itself from a situation where the seedor's exercise of its capacity rights would cause the manager's fund(s) to become considered plan assets. It is best to make this a condition to the exercise of the capacity right such that it is clear from the outset that the manager will not be required to mandatorily redeem other ERISA money in order to accept the seedor's ERISA money.

Issues to be Considered by a Seedor

Objectives

The seedor's primary motivation in seeding a manager is the ability to share in the upside of a future superlative manager. It also wants capacity in that manager's funds. The seedor therefore needs to protect its interest in the manager's business. It should do this using the same methods that employers of portfolio managers use, a rigorous (but not so much that it is unenforceable) no-compete provision. The non-compete should prevent the circumvention of the terms of the seeding arrangement by prohibiting the principal from establishing new advisory entities unless the seedor shares in the revenues of those entities. It should also prevent the principal from providing advisory services to any other entity during the term of the seeding arrangement.

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Reputational Concerns – Due Diligence

Prior to entering into negotiations with a manager, the seedor should conduct a thorough background check on the manager (if it exists yet) and all of its principals and employees. But its obligations do not stop there. It needs to conduct ongoing due diligence. While there may be representations in the seeding agreement that obligate the manager to inform the seedor of lawsuits, alleged violations and the like, it is not sufficient to rely on the manager providing such notification. In the event that the manager does engage in some sort of unscrupulous behavior, the sooner the seedor is aware of it, the better the seedor's chances of preventing or mitigating any harm to its reputation. The seedor will want to insert a redemption trigger that permits the seedor to redeem in the event that an act of the manager could cause reputational harm to the seedor. The exact wording of this type of trigger typically is controversial. The manager naturally will want to ensure that the language is not too open-ended. It is difficult to predict what sort of issues might arise that could potentially cause reputational damage, however. Therefore, the seedor will want language that is somewhat flexible and broad enough to cover the likely scenarios. But while flexibility may benefit the seedor, ambiguity may not. The more ambiguous the wording of this (or any) term of the seeding agreement, the more likely the agreement will end up in arbitration (or litigation), which is not beneficial to either party's reputation.

Back Office Concerns – Due Diligence

An individual who has experience running a portfolio at a prop desk does not necessarily have any experience running a business. Success on a prop desk or working for another advisory firm depends on being able to manage money. To run an investment management firm, however, one needs to have the ability to run a business. The seedor will want to ensure that the manager has sufficient financial and administrative capabilities and that its compliance capabilities are sufficient not only to comply with the current regulatory regime but also with all proposed regulations applicable to the manager. The seedor should impose some risk guidelines on the manager, any uncured violation of which will trigger a right of redemption. Yet such guidelines lack substance and may fail to protect the seedor if the manager does not have sufficient controls to monitor, on a real time basis, the amount of risk in its portfolio. Therefore the seedor should examine both at the onset and on an ongoing basis, how robust the manager's risk control measures are. See "What Is a Chief Risk Officer, and Should Hedge Fund Managers Have One?," Hedge Fund Law Report, Vol. 2, No. 31 (Aug. 5, 2009).

The manager's ability to market (either itself or through a third party) its fund successfully is determined in large part by the manager's track record. Yet, in the case of a new manager, the manager itself will not have a track record. Therefore, what typically is cited is the track record of the principal in prior endeavors. A prior track record, however, can only be used to market a fund managed by a different entity under certain specific conditions, and even then will require certain disclosures. First, the track record has to be of a portfolio managed according to substantially the same investment strategy. Typically, this is the case. Secondly, the track record must result solely from the principal's decision making. If two people had decision making authority over an account it is considered misleading to allege that the account performance constitutes the track record of one of those people. Finally, because the track record is the property of the principal's prior employer and not the principal, the principal must have permission to use the track record. A seedor should check to see if the principal's prior track record meets these conditions before it enters into any commitment to help market the manager's fund. This is not to say that a seedor should not seed a manager whose track record

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is not portable. If the track record is not portable, however, it will take longer for the manager to grow its business and this is something that the seedor will want to know before it negotiates the terms of the seeding arrangement, particularly the length of time the seedor shares in the manager's revenues.

Economics – An Issue for Both Sides

Probably the biggest issue faced in seeding agreements is the length of time for which the seedor's entitlement to a slice of the manager's business continues. There are a great many variations and permutations and no two seeding agreements are identical on this point. It is common, however, for there to be a buy-out that is structured as a call and/or put option. While there are agreements that allow for the price to be determined at the time of exercise, such an approach begs the question of what happens if a price is not agreed upon. Typically prices are set forth in the seeding agreement and are formulaic based on AUM. In order to reflect the assumption that AUM increases over time, sometimes one input in the option price formula will be higher or lower depending on when the option is exercised.

From the seedor's perspective the buy-out does two things. First, in the event that the manager is highly successful, it compensates the seedor for giving up its share in the manager's income stream. Second, in the event the manager is unremarkable, it compensates for any lackluster returns on its sizable investment in the manager's fund(s).

From the manager's perspective, the buy-out is another substantial expense. A manager therefore should include its possible obligations under a buy-out provision when it performs a prospective cash flow analysis of its business, assuming minimum projected performance and AUM. More than any other provision, the question of when and how the seedor's entitlement to a slice of the manager's business ends exemplifies the difference between what the seedor and the seedee hope to gain from the seeding arrangement. The seedor enters the seeding agreement hoping to get a significant return on its investment. The seedee enters the seeding arrangement hoping to get its business off the ground.

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