SEED CAPITAL ARRANGEMENTS

WITH THE INITIAL CAPITAL BARRIER FOR START-UP MANAGERS BECOMING AN INCREASINGLY CHALLENGING HURDLE, THE OPTION OF SEED CAPITAL IS BECOMING MORE POPULAR. **KEVIN SCANLAN**, OF **DECHERT**, DISCUSSES THE DETAILS OF ENTERING INTO SUCH AN ARRANGEMENT

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Since the credit crisis hit in 2008, it has become increasingly difficult for new hedge fund managers to raise capital for a hedge fund they are marketing. In addition, due to the various rules recently finalised by the Securities and Exchange Commission (SEC) that make it much more difficult to avoid registration as an investment adviser and impose numerous filing and compliance obligations, the legal and compliance costs associated with starting a hedge fund organisation make it much more important for a start-up hedge fund manager to raise a substantial amount of capital at its initial closing.

Based on a recent analysis of Preqin's Hedge Fund Investor Profile database, institutional investors (particularly fund of funds and endowments) retain a significant appetite for first time funds given their potential to generate higher returns than the larger, more established managers. In order to attract this capital, it is often helpful if the start-up manager is able to secure an investment from a hedge fund seeder. Fortunately, *HFMWeek* research from late 2011 indicated that hedge fund seeders have at least $4.59bn available to allocate to new hedge fund managers, which should create a lot of opportunities for emerging managers in 2012.

ESSENCE OF THE BUSINESS DEAL

The basics of the business deal are rather simple. A start-up manager (manager) obtains a large slug of capital (often $50-100m or more) from a seed capital provider (a seeder) in return for sharing a portion of its asset-based and incentive-based compensation with the seeder.

Delving deeper into the details of the arrangement, the manager is provided with the following benefits from this: (i) additional credibility with prospective investors given the investment by the seeder, (ii) the potential to receive additional capital from the seeder or other persons (such as other advisory clients of the seeder) that the seeder may be willing to introduce to the manager and (iii) significant ongoing cash flow and payment of start-up expenses from the seeder's investment that enhances the manager's ability to deepen the portfolio management team and build out its back-office and compliance infrastructure. The seeder's investment generally is subject to a lock-up of two to three years. However, the lock-up often expires upon the occurrence of certain events (for example the violation of certain investment guidelines/restrictions imposed by the seeder, commitment of specified bad acts by the principals of the manager, a major decline in value of the seeder's investment (for example loss of 20% in one year or 10% over a longer period of time or a change in control of the manager, and so on).

It is very important for the manager to analyse the events that terminate the lock-up period to make sure they can be objectively determined and that they are drafted as narrowly as possible. It is also important for the manager to work with experienced counsel to appropriately disclose the risk to investors in the hedge fund should one of these triggers be satisfied and the seeder decides to withdraw.

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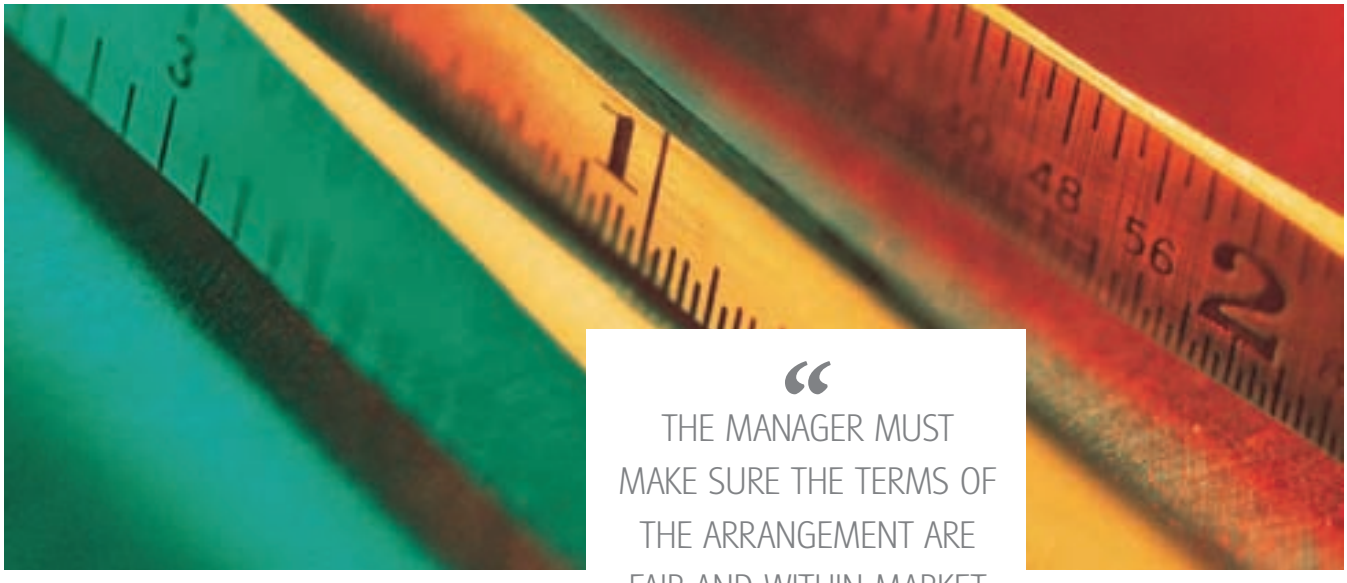
STRUCTURE OF THE BUSINESS DEAL

Seeding arrangements are effectuated either through the entering into a revenue share agreement or through the seeder taking an ownership interest in the manager's advisory entities. The seeder's share of the manager's revenue will vary greatly from deal to deal, but the manager should expect to surrender somewhere in the range of 15-25% of its revenue to the seeder. The sharing ratio may also be subject to reductions should the manager's assets under management reach specified thresholds.

If a revenue-sharing agreement is used, the seeder's share of the manager's revenue generally would be calculated on a gross basis. If the seeder receives an ownership interest in the manager's advisory entities, the revenue sharing would be done on a net basis (however, the seeder would generally insist on budgetary controls over the manager's business to ensure these revenues are not offset by additional expenses).

The revenue-sharing agreement approach suits both parties – the manager is afforded greater freedom to operate its business and the seeder is not bogged down in budg-



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et negotiations. As a result, the use of a revenue sharing agreement has become more popular than the other approach.

OBLIGATIONS AND RESTRICTIONS THAT MAY BE IMPOSED ON A MANAGER

In connection with its investment, the seeder will obtain (i) enhanced transparency with respect to the fund's portfolio positions (this may include information provided by a risk aggregation and reporting service), (ii) most favoured nations treatment, (iii) various consent rights (for example obligation to consent to (a) the establishment of a new fund, (b) the use of any new service provider to the fund and (c) any corporate events affecting the manager's advisory entities) and (iv) a variety of covenants from the manager and its principals, as set forth in more detail in the following sentence. The manager and the principals will be required to agree that the seeder's revenue share will apply to all investment management-related activities in which they may engage. The principals will also be required to agree to maintain a specified level of investment in the fund for the duration of the seeder's lock-up and to reinvest a certain percentage of the performance allocation and excess asset-based fees (in particular fees remaining after payment of all expenses of the manager's advisory entities) in the fund.

Finally, the principals will be required to agree to a non-compete and non-solicitation covenant (in particular a prohibition on soliciting any employee or investor of the fund or the seeder for one to two years), the devotion of certain time and attention to the affairs of the fund and the maintenance of a certain minimum ownership percentage in the manager.

ISSUES A MANAGER SHOULD CONSIDER

Because each deal can vary greatly from others, it is important to get experienced counsel's opinion on whether the terms are within market for this type of arrangement. It is also important for the principals of the manager to review with counsel the obligations and restrictions to which they are agreeing in connection with the seeder's investment. For example, it is fair that the seeder's revenue share would apply to any new funds the manager or the principals form, whether at the manager or as a principal of a new hedge fund group. Otherwise, it would be easy to circumvent the seeder's right to a share in revenue. However, the initial draft of the documents for these types of arrangement often could be interpreted to allow (and may be intended to permit) the seeder to participate in a departed principal's salary and bonus received as an employee at an investment bank in connection with the management of a fund. Also, to the extent the manager has grown in size and no longer needs the capital and credibility associated with an investment by the seeder, the manager should be able to buy-out the seeder and eliminate its revenue share. The price associated with the buy-out right will vary from deal to deal but counsel can provide some guidance as to what is an appropriate formula.

Finally, another area on which the manager should focus is any software or intellectual property the manager may own. Should any revenue arising from the licensing of this software be subject to the revenue share of the seeder? Is the intellectual property owned by the manager an asset that the seeder has bargained for in connection with its investment?

Accordingly, although there should be abundant opportunities to receive capital from a seeder, the manager must make sure the terms of the arrangement are fair and within market standard and are appropriately tailored to its investment strategy and expected business operations. ■