Seeding and Acceleration Deals

Authored by Dechert's Financial Services Practice Group

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Introduction

The concept of seeding is straightforward. A fund manager receives an allocation from one or more investors of sufficient size in order to ensure the launch of his hedge fund strategy. Unfortunately, that is where the simplicity broadly ends. Whilst the larger and more established seeders do have their own 'standard' terms, there is no such thing as a 'standard' seed deal. Seeding deals can vary widely, from seed investors who seek preferential investment terms, to seed investors who also seek control over the constitution of the fund and its offering terms together with a share of future revenues and/or an equity stake in the investment management business. In return for such terms, the fund manager should secure committed seed capital which will remain in the fund for an extended period allowing the manager time to build its track record and attract new capital.

In recent years, would be start-ups have also turned to what might be considered 'alternative' seeding arrangements as a result of a depletion in the availability of traditional seed capital and higher barriers to entry caused by an increase in regulation and also the costs required to establish and run an investment management business. Even if it is possible to establish and run an investment management business with very low costs (and with relatively low assets under management), a fund will often need to be of a certain size to attract institutional quality investors.

Seed deals may include or be separate from 'early bird' or seed/founder share classes which are often offered to early stage investors. These classes will usually bear lower fee rates, often in return for a longer lock-up period and perhaps a higher minimum investment amount. The availability of these classes is often limited to a specified investment amount and/or time period.

Why is seeding important? The benefit of new hedge fund managers

Despite the current negative publicity associated with the hedge fund industry following a period of underperformance, advocates of the industry argue that hedge funds and their alternative strategies have an important role to play in modern day finance, both in driving superior returns over the long term and in diversifying risk for investors. Accordingly, interest in absolute return and alternative asset management strategies, responsible for significant growth in the hedge fund industry between the late 1990s and early to mid-2000s, is expected to return, particularly as we appear to be moving into the next stage of the market cycle. Given that hedge fund assets under management remain a relatively small proportion of global assets under management, which is dominated by long-only and benchmarked investment strategies, there remains plenty of room for growth.

The success of the hedge fund industry will depend on its ability to perform and to remain diversified. This requires the industry to remain competitive and innovative, principally by being open to new fund launches and the establishment of new managers. The availability of seed capital is vital to ensuring that this is possible.

Studies have shown that emerging managers and smaller funds have consistently out-performed their larger and more established competition. Preqin's report "*Emerging Hedge Funds: Can they Outperform?*" dated June 2017 showed that funds with a track record of three years or under, and funds with less than US$300,000,000 in assets under management, outperform the wider hedge fund industry over a 12-month, three-year and five-year time frame.

Research by Cass Business School in 2015 commissioned by Gatemore Capital found that between 1994 and 2014, the largest 10% of hedge funds underperformed the smallest 10% of hedge funds returning an average 0.61% per month versus 0.75% per month (7.32% per year versus 9% per year). A study by

PerTrac Financial Solutions in 2009 found that funds with less than US$100 million outperformed funds with more than US$500 million by 3.77% per year between 1996 and 2008, with only slightly higher volatility.

One of the key reasons for this out-performance is the ability for smaller investment funds to be more nimble in their trading activities. In particular, smaller funds can often take and exit positions without moving market prices. Further, smaller funds with less capital to deploy have more trading opportunities available to them (larger funds with more assets to deploy will need to focus on positions which have greater capacity). This appears to have led to concentration issues amongst the largest hedge funds. Too many hedge funds are holding the same positions.[1]

Another potential factor in smaller fund managers' out-performance is that they live and die by their investment returns. Performance is key to driving revenue and raising assets (as the management fee alone may not be enough to adequately cover costs or to remunerate the management team). Conversely, larger managers will likely earn significant revenue from the management fee alone and may be principally incentivised by capital preservation rather than absolute performance. Lower risk tolerance can lead to poorer relative performance.

Despite the benefits offered by smaller managers, concentration levels have increased significantly in recent years.[2] It appears that investors have a preference for larger hedge funds with a longer track record and a 'brand name' that inspires confidence from a risk management and governance perspective. Increased regulatory and cost barriers to entry has accelerated the trend towards a concentration of assets.

To a large extent, the concentration of the hedge fund industry is a natural consequence of a maturing and more institutionalised industry. However, this concentration risks stifling competition and innovation in the industry with a negative impact on the industry as a whole. Accordingly, a balance needs to be struck and the availability of seed capital to emerging managers is key to that being possible.

Traditional Seed Deals

A decline in the amount of assets invested into fund of hedge funds (FoHFs) over the last decade or so has led to a reduction in the amount of 'traditional' seed capital available. The decline of investment in FoHFs has largely been a result of investors seeking direct allocation to hedge funds, often for the purpose of increasing liquidity and avoiding the two layers of fees that arise if investing through a FoHF structure. A better understanding of hedge fund strategies, including as a result of an increase in the number and sophistication of hedge fund consultants has also reduced the role for FoHFs. However, FoHF remain an important source of capital for emerging managers and new funds, particularly as many institutional investors and consultants appear to favour more established managers and larger funds when allocating capital (whereas HoHFs have traditionally been willing to allocate to new funds).

In many ways, the depletion in capital offered to emerging managers has arguably increased opportunities for seeders. Less competition means that seeders have access to higher quality managers on better terms. Revenue sharing arrangements also offer an attractive alternative source of return.

What do Seeders Offer?

Seeders offer emerging managers capital to launch their strategy. Depending on the terms of the deal, seeders might also provide working capital to the investment management business together with business support, whether that be the sharing of resources (in particular with middle/back office support and/or the marketing and distribution of the fund) or simply providing guidance on how to run a successful investment

[1] In June 2016, Goldman Sachs reported that concentration stood at the highest level on record, with the average hedge fund in its study holding 69% of its long assets in its top 10 largest positions.

[2] Preqin data from 2015 showed that 92% of hedge fund capital was concentrated among the top 11% of fund managers.

management business. Reputable seed investors also offer a ‘stamp of approval’ which can help the seeded fund raise assets.

Minimum investment requirements will depend on a number of factors, including the pedigree of the manager and the terms the seed investor is seeking to achieve in return for its investment. Further, the manager will look to secure a lock-up period during which time the seeder may not redeem its investment from the fund. That period will depend on the level of investment made in the fund and whether or not a revenue or equity share is on offer. There has been an increase in the utilisation of ‘soft-locks’ in recent years, whereby the seeder is entitled to redeem early but will lose its revenue share and will be subject to a redemption fee (which may allow the manager to remain financially viable whilst it seeks new investment). Some seeders seek the right to redeem all or some of its investment in the event that the manager reaches a certain level of assets under management within a certain period of time (typically where the seeder has agreed to pay headline fees and therefore is not benefiting from preferential fee terms).

Whilst seeding deals help ensure that a hedge fund launch is viable, care needs to be taken to ensure that it does not materially prejudice the long term viability of the fund and the investment management business. Prospective investors may be put off by a fund with high investor concentration and with one key investor exercising significant control over the fund and management business. Further, if the terms offered to seeders are too generous, it may have a negative impact on a fund manager’s ability to attract and retain key staff (and the incentive for a fund manager to perform might be diminished).

As noted above, there is no such thing as a standard seed deal and seed deals have become increasingly more complex and onerous compared to the types of seed deals entered into when the industry was in its infancy. Some seeders will merely require preferential terms of investment, others will seek a share in the future success of the business, either through a revenue sharing arrangement or through an equity stake in the investment management business. We deal with each in turn.

Preferential Terms of Investment

The following is a high level overview of some of the key preferential investment terms often sought in seed deals.

Management Fees and Performance Fees. A seed investor will likely seek a lower management fee than that paid by ordinary investors. In order to support the manager in its formative years, the seeder might agree to pay management fees at headline rates or, more commonly, on a sliding scale depending on the amount invested (whereby a higher management fee is payable by the seed investor whilst the fund is small with the management fee decreasing as the fund reaches a viable size or after a certain period of time).

The seed investor will also usually pay a lower performance fee in respect of its investment in the fund. For traditional hedge fund strategies, a performance fee of between 5% and 10% might be typical where a significant amount has been invested (for example US$100 million to US$200 million). Where less capital has been invested, a performance fee of up to 15% might be achievable. Where the seeder also receives a revenue or equity share, consideration should be had as to whether it is appropriate to reduce the performance fee (and to what level).

Given the recent pressure on the level of fees charged by fund managers, and with some (albeit arguably limited) success of alternative fee arrangements, the level of fees that are appropriate should be discussed with the manager’s advisers.

As noted above, a number of seeders who receive a share of the manager’s revenues or equity may be willing to pay headline rates on fees. However, for tax purposes, such fees may be offset by revenues received.

Transparency and Information Rights. The seed investor will likely require transparency and access to certain information that a fund manager would not otherwise offer to investors (often for the purposes of ensuring compliance with any investment restrictions or guidelines). This might include regular performance and risk reporting, position level transparency and access to third parties so as to verify the information provided. The legal and compliance ramifications of this require special thought. In particular, AIFMD[3] imposes certain disclosure obligations where preferential treatment is offered to investors and the seeder is not permitted to receive preferential treatment where this may result in an overall material disadvantage to other investors. In practice, it may be that transparency sought by seeders should be offered to all investors to ensure compliance with AIFMD's requirements (and/or the level of transparency sought by seeders should be limited to the extent possible, including for the purposes of protecting the confidentiality of the fund manager's strategy and positions). The right to enhanced transparency is often a significant point for seeders. Accordingly, the regulatory implications should be addressed early on, particularly for seeders less familiar with AIFMD's requirements. Where transparency rights are granted, care should be taken to enhance confidentiality obligations.

Limits on Concentration and Leverage. The seed investor might specify certain limits on the fund's investment strategy. The limits might include (i) overall portfolio notional limits (gross, long and short), (ii) overall portfolio risk limits, (iii) initial margin limits, (iv) individual security limits, (v) geographical or industry exposure limits and (vi) limits on exposure to certain instruments. Managers should seek to ensure that any such restrictions do not impact on its ability to achieve the fund's stated investment objective and strategy.

Founder Investment. The seed investor will often require that the founder and/or key staff make a minimum investment in the fund (which may be an absolute dollar amount or a percentage of the individual's net wealth). Such amounts vary widely. Often the founder is not entitled to withdraw his investment until after the end of the seed investor's lock-up period (albeit carve outs should ideally be sought to deal with the founder's personal tax issues or family requirements). Alternatively the founder might be permitted to withdraw his investment subject to a minimum level remaining invested in the fund.

The founder an key staff may also be required to re-invest a certain percentage their remuneration back into the fund for a specified period of time (for example, 50% for at least one to two years).

Additional Investments/Capacity Rights. A seed investor is often granted the right to make additional investments in the fund on the same terms as the initial investment (often subject to an MFN, as detailed below). The right to invest is typically expressed either in dollar amounts or as a percentage of the fund's net asset value. The right often extends to other investment funds established by the investment manager (albeit the right should be excluded for managed accounts and 'fund-of-ones'). If the capacity of the fund's strategy is limited, a manager should seek to limit the seed investor's right to make further investments so as to avoid potential risks attached to having the fund's investor base concentrated in one large investor (and potentially at a lower rate of fees). Capacity rights should also be time limited (if possible).

Additional Fund Investors. The seed investor might specify the dealing terms upon which other investors will invest in the fund (for example, minimum investment amounts, management fees and performance fees and redemption rights). The manager should seek to limit the right of the seeder to specify such terms to the extent that it would negatively impact its ability to raise capital for the fund.

Devotion of Time. The founder is usually required to devote substantially all of his business time and attention to the affairs of the fund and the investment management business. If he ceases to do so, the seed investor usually has the right to redeem. The manager should, if possible, seek to carve out reasonable periods of leave, such that a redemption right is not triggered by the founder taking an extended break (including for medical reasons) on the basis that the strategy would not be adversely affected by such leave and that the founder's team can adequately cover in the founder's absence. By way of example, a founder notification event might be specified to occur at such time as the founder has ceased to devote substantially all of his business time and attention to the affairs of the fund and the investment management business for 35 consecutive days or for 50 days within any 100-day period.

[3] Alternative Investment Fund Managers Directive, Directive 2011/61/EU of the European Parliament and the Council of the European Union of 8 June 2011 on alternative investment fund managers.

Personal Account Dealing. Each of the founder and the fund manager's staff might be required to agree not to undertake any personal account dealing and to make his or her personal investments through the fund. Carve outs should be considered for investments made by the relevant individual's family trust and investments made by the individual that are not associated with the investment strategy being pursued by the fund.

Approval Rights. The seed investor might seek approval rights in respect of the fund, including pre-approval of: (i) any material amendment to the fund's material documents, including any material change to the investment strategy and process and any change to the fund's liquidity management tools (for example the imposition of any gates or side pockets); (ii) the appointment of key service providers (prime brokers, auditors, administrators, legal counsel etc); (iii) the entering into of any side letters and/or the offering of more favourable terms to other investors (see also MFN rights below); and/or (iv) where relevant, any amendments to the fund's tax elections or regulatory status. Where the seeder takes a revenue share or an equity stake in the business, further approval rights will often be sought in relation to the running of the business and the launch of new products and acceptance of new investment management mandates (see further below). In any event, the seeder's request for approval rights should be considered carefully, including where such approval rights may restrict the manager's ability to grow and, if desired, diversify (albeit a seeder will be keen to retain control over such issues, especially in a manager's early years).

Most Favoured Nations ("MFN"). The seed investor often includes a "*Most Favoured Nations*" clause in any seed deal meaning that it must be offered any preferential term which is offered to another investor. This is aimed at preventing another investor from receiving better terms of investment. Managers should seek to limit the MFN so far as possible such that it does not negatively impact the manager's ability to raise assets from significant new investors. This might be achieved as follows (without limitation):

- restricting the application of the MFN to the fund in which the seeder is invested (and funds and accounts running substantially similar strategies);

- restricting the application of the MFN to amounts invested which are the same as or less than the seeder's investment in the fund;

- for the purposes of clarity with regard to the application of the MFN, restricting the MFN to key investment terms, for example fees, liquidity and transparency;

- requiring the seeder to take the investment on the same terms as the new investment (so as to avoid the seeder 'cherry picking' the new investor's terms which, by way of example, might include a longer lock up period in exchange for lower fees – thus to the extent that the MFN is triggered due to the lower fees, the seeder could elect to receive such lower fees but would also be subject to the longer lock-up period);

- requiring the seeder to make a decision as to whether to take advantage of the MFN within a reasonable period of time following notification of the same (such period should be specified, for example 20 days); and

- dis-applying the MFN if the seeder's investment falls below a certain amount (save where as a result of performance).

Managers should also exclude the terms of management class from the scope of the MFN (i.e., the class through which the founder and the fund manager's staff invest in the fund). The manager might also seek to reserve capacity in a class of shares for investment by the manager's family and friends which should also fall outside the scope of the MFN.

Redemption Rights.[4] The seed investor's initial investment will likely be subject to a lock-up period, typically between 1 to 3 years but it may be longer depending on the fund's strategy. During the lock-up period, the seed investor will typically seek the right to redeem on the occurrence of certain events, for example if: (i) the founder dies, becomes disabled (i.e., has physical or mental incapacity) or otherwise ceases to devote substantially all of his business time and attention to the affairs of the fund and the investment management business[5] (and is not replaced by someone reasonably acceptable to the seeder); (ii) the founder has reduced his investment in the fund (or the strategy) below a certain amount; (iii) the founder or any member of the investment management business has been convicted of a dishonesty offence or committed acts or omissions that constitute fraud, bad faith, gross negligence or willful misconduct in carrying out its or his duties (the seeder might seek a wider redemption right triggered by the instigation of a material (non-routine) regulatory or criminal investigation); (iv) the founder no longer controls (has less than a 51% equity stake), or is no longer responsible for, the day-to-day management of the investment management business; (v) the manager materially breaches the seed agreement, the fund documents or an active breach occurs with respect to certain investment restrictions, in each case where such breach has a material adverse effect on the seeder; or (vi) there has been a decline in the fund's net asset value over a certain threshold (depending on the strategy, a threshold of between 15% to 25% in a twelve month period (or peak-to-trough or from inception), depending on strategy, would not be unusual).[6]

It is important that the manager ensures that any redemption rights offered to the seed investor do not materiality disadvantage the interests of other investors, including in light of the manager's obligations under AIFMD. Accordingly, the seed investor's right to redeem should be stated to remain subject to the liquidity management terms detailed in the fund's constitutional and offering documentation (including in particular, any gates, suspension rights and the ability to redeem *in specie* or in kind rather than cash).[7] Further, following the lock-up period applicable to the seeder, the manager should seek to ensure that the seeder is subject to the same liquidity terms as other investors. This is particularly important for less liquid strategies where a significant redemption could result in the realisation of the fund's assets on less favourable terms.

Gates. The seed investor might request that it has veto rights over the imposition of any fund level gate, albeit that this should be resisted if possible. A compromise might be for this veto right to exist for so long as the seed investor holds more than a certain amount of the fund (in percentage terms).

Ability to Forcibly Redeem the Seeder. Whilst the seeder will often seek to limit the fund's right to forcibly redeem its investment from the fund, the manager should ensure that it retains the ability to do so where it is required in order to meet its legal and regulatory obligations (for example, to prevent the fund exceeding its ERISA thresholds).

Co-Investment Rights. Investors are increasingly seeking the right of first refusal in respect of participation in co-investment opportunities. If given, a manager should seek to ensure that this right is restricted such

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[4] Notification of the occurrence of any redemption rights will also typically be sought. Appropriate grace periods should be considered.

[5] As noted above under the heading 'Devotion of Time', the manager should seek a carve out to avoid a redemption right being triggered by the founder taking an extended break (including for medical reasons) on the basis that the strategy would not be adversely affected by such leave and that the founder's team can adequately cover in the founder's absence. By way of example, a founder notification event might be specified to occur at such time as the founder has ceased to devote substantially all of his business time and attention to the affairs of the fund and the investment management business for 35 consecutive days or for 50 days within any 100-day period.

[6] The manager should seek to ensure that net asset value triggers are limited to performance related declines (and not a reduction the fund's net asset value).

[7] Whilst seeders will often seek to push back on the right of the fund to redeem in specie or in kind rather than cash, in the event that there are illiquid assets in the fund, it may not be fair to allow the seeder to be redeemed in cash leaving the remaining investors with the illiquid assets. The need to redeem *in specie* or kind will depend on the size of the seed investor relative to the total net asset value of the size of the illiquid position(s) as a proportion of total net asset value.

that the investor is required to participate in such co-investment opportunities on the terms made available to other investors.

Revenue sharing arrangements

A significant seed investor will often seek a certain percentage of any management fees and performance fees received from third party investment in the fund.[8] A revenue sharing percentage of 20% to 25% would not be unusual. If a fund is successful, the return from these revenue sharing arrangements can be significant. The seeder will seek to ensure that the revenue share covers all funds and products managed by the manager. Ideally, a manager should restrict this to funds and products being managed which are substantially similar to the strategy being by the fund in which the seeder is invested.

A deal based on gross revenues received by the manager is generally easier to structure than a deal based on net income or net profits. In the latter case, the seeder will need to maintain a certain amount of control over the expenditure of the management business and will require transparency rights over accounts and financial statements. Accordingly, revenue sharing deals tend to be favoured by managers and seeders alike (albeit in some cases there might be certain tax efficiencies to the seeder resulting from structuring the seeding arrangements as an equity deal).[9]

A number of seeders may agree to adjust their revenue share rights in order to support the manager in its early years. This might be achieved by the seeder initially deferring or reducing its revenue share, including: (i) for a certain period whilst the manager's assets under management remains below a certain amount (e.g., for six months whilst AUM is less than US$200 million); (ii) until the manager is receiving a minimum level of fee revenue over a specified period (e.g. US$2 million - US$3 million over 12 months); or (iii) by calculating the revenue share net of certain key manager expenses. These 'grace periods' may be subject to catch up arrangements benefiting the seed investor.

The right to receive a share of revenues might cease once the seeder redeems from the fund (or when a seeder's investment falls below a certain threshold (again, save where this results from performance of the fund)). Alternatively, the right might continue for a certain period of time following the seed investor's redemption (or perhaps indefinitely). The manager should consider its exit strategy at the outset (see further "*Exit Arrangements*" below).

The seeder might require that the revenue share be structured in a certain way so as to allow it to receive the revenue share in a tax efficient manner. This might include the seeder receiving allocations of profit from the fund directly as a holder of interests in the fund and/or the revenue share reducing the fees payable by the seeder in the fund. Revenue shares may also be automatically re-invested in the fund by way of the issuance of new shares.

Equity in the investment management business

A significant seed investor might look to take an equity stake in the management business, perhaps in return for the injection of material working capital. An equity stake will usually allow the seed investor to benefit from the sale of all or part of the investment management business and will typically be structured in a tax neutral jurisdiction for tax efficiency in such event.

A typical equity stake might be between 15% to 30% in return for a US$2 million to US$3 million capital contribution (in additional to the seed investment made in the fund), although the capital contribution might

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[8] Managers should consider reducing revenue share by the amount of any rebates and third party distribution fees payable in respect of investments received. NB: Seeders may seek control over distribution arrangements.

[9] It should be noted that revenue shares have become increasingly complex in recent years. Accordingly, revenue deals often operate like 'shadow equity' and/or often contain a right to convert into equity upon certain events. In these cases, the seeder's desire for control and transparency might be analogous to that of a typical equity deal.

be lower if a loan is also advanced to fund the business in its establishment phase. Where a loan is advanced, a relatively low amount of interest is usually charged and the loan obligation is often secured against future revenues. However, the impact of any loan must be considered in the light of its impact on the manager's regulatory capital requirements (unless it is subordinated, loan capital cannot form part of an FCA regulated manager's regulatory capital requirements).

Other ways in which capital is injected in the management business include revenue share adjustments and prepayment of fees.

Key Terms Sought in Equity or Revenue Sharing Deals

In the event of a revenue sharing arrangement and/or the granting of any equity stake in the investment management business, the seed investor will typically require a certain level of control and transparency over the business. This might include:

Annual Budget. The seed investor might have pre-approval rights over the investment management business' budgets. This is more common where the seeder has an equity interest and is more concerned with the 'bottom line.'

Compensation Limitations. The seed investor might seek to restrict the compensation of the founder and other staff of the investment manager (and transparency over the same). Again, these types of restrictions are more common in equity deals.

Issue of Further Equity. The founder might be required to obtain prior approval from the seed investor before issuing any further equity in the investment management business. In these circumstances, the founder should look to carve out a right to issue up to a certain amount of equity without prior approval. The founder should also ensure that it has appropriate flexibility to grow the business through the issuance of equity to new business partners. In the context of equity deals, in the event new equity is issued, the founder should seek to ensure that the seed investor is subject to a pro-rata dilution (otherwise the seed investor might unfairly benefit from any further capital injection in the business). The seed investor would likely require that it has a pre-emption right such that it can elect to make a pro-rata capital contribution to the business meaning it is not diluted.

Approvals. Seeders entering into revenue or equity sharing deals will typically require certain approval and/or notification rights in respect of the management business so as to ensure that their interests are protected. Such approval rights may include: (i) any material amendment to the management group's structure or material documents (including the delegation or outsourcing of key responsibilities); (ii) the payment of dividends and distributions; (iii) the merger or consolidation of any entity of the investment management business with, or sale of substantially all of its assets to, any other person; (iv) the launch of any additional funds or products (or investment management businesses) managed by the founder or the investment management business and the key terms thereof; (v) entering into of distribution arrangements; (vi) dissolution of the fund or any entity of the investment management business; (vii) any loans made to or by an entity in the investment management business (other than in the ordinary course of business); and (viii) the entering into of any transactions with any of the manager's funds or investment products; (ix) advance notice of the hiring of key staff and of key staff departures; (x) the release of any key staff from non-compete or non-solicitation arrangements; (xi) where relevant, any amendments to the manager's tax elections or regulatory status; and/or (xii) the entering into of any onerous obligation outside the ordinary course of business. Certain of the foregoing approval rights will be more relevant and important to the seeder in the context of equity deals.

Transparency. Seeders benefiting from an equity share will also require a certain level of transparency over the manager's financial statements to ensure that the seeder can check that it is receiving the right amounts. This may include access to the manager's auditor.

In particular, seeders benefiting from revenue shares will require a certain level of transparency over the fund's valuation and financial statements and the administrator's reports to ensure that the seeder can check the revenue share being calculated. Given the importance of the fund's valuation policy, the seeder might seek advance notice of any changes to the valuation policy (any request for an approval right over changes to the valuation policy should be rejected).

Seeders might also require access to the founder, key staff and key service providers to discuss the fund's and/or the manager's financial performance.

Non-Compete / Non-Solicitation of Investors and Staff. Each of the founder and other key staff will likely be under an obligation not to compete with the investment management business upon his or her departure (for a certain period of time, say 12 to 24 months). In the case of the founder, this prevents him or her from circumventing the seeder's rights by closing the business and starting again. Another method utilised by seeders is the negotiation of 'tail' rights, namely the right of the seeder to receive the same seed deal in respect of any new separate investment management business pursued by the founder once they exit the manager (with such rights existing for a certain period of time following the founder's exit – typically between three to five years).

Similarly, the seeder will often seek to ensure that key staff are subject to robust terms relating to the non-solicitation of investors and staff.[10]

Marketing. Where the seeder assists with marketing and distribution efforts, the manger should seek to impose obligations with regard to the types of investors that may be targeted and the jurisdiction of such investors. The manager should seek to ensure that it approves any marketing material utilised by the seeder (including for the purposes of ensuring that the manager can control the marketing message).

Exit arrangements

Arrangements may be put in place between the parties for an agreed future exit.[11] For example, the rights of the seed investor may terminate upon the seed investment in the fund being withdrawn in full or below a certain threshold (or after a certain period of time thereafter) and/or may be subject to buy out rights in favour of the management group (linked to multiples of revenues or valuations). The multiple is typically between 3x to 5x of the annual payments made to the seeder, either by reference to the previous year or taking an average over more than one year. The buy-out right is often exercisable over a number of years such that it cannot be exercised all at once. In order to avoid the buy-out right being reduced by negative performance, some seeders will require that the buy-out right also be linked to the manager's assets under management, whereby the buy-out right is stated as being the greater of the buy-out multiple and a specified percentage of the manager's assets under management. Alternatively, the seeder investor might agree to sunset provisions, whereby the seed investor's rights decline over a period of time to zero (albeit this is less common).

The seed investor might seek a tag along right such that, if the founder desires to sell all or any portion of his interests in the investment management business, the seed investor will also be granted the right to sell all or the pro rata share of its interests in the investment management business on the same economic terms and conditions (a seed investor holding a revenue share may be granted the right to convert to equity in the event of a sale in order to benefit from such tag along rights).[12]

The founder should seek to place restrictions on the transfer of the seed investor's interest in the investment management business. It is common for the seed investor to be precluded from transferring its interest for

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[10] The manager should also seek covenants from the seeder regarding the non-solicitation of staff and investors.

[11] It is worth noting that some take the view it is better not to negotiate these terms at the outset given the weaker bargaining power the manager will have at this stage (on the basis such terms will be harder to row back from later on).

[12] If an equity conversion right is included, this should be adjusted in line with the manager's buy-out rights or, if applicable, sunset provisions.

a certain period (for example during the lock up period). Following the expiry of the lock-up period, the seeder's right to transfer its interest might be subject to a pre-emption right whereby the founder has the right of first refusal at a commercially agreed price. It is also common for the seed investor to agree not to transfer interests to any third-party who would be reasonably objectionable to the founder (for example, a competitor).

Alternative Seed Arrangements

A reduction in the availability of traditional seed capital has led to an increase in what might be referred to as 'alternative' seed arrangements. The following is a high level overview of three such 'alternative' arrangements.

Third party fund platforms. Third party fund platforms are not strictly new offerings. However, the structure and offering of such platforms has increased and varied significantly in recent years. As such, it is no longer easy to define a third party fund platform. The term 'platform' can be used simply to refer to multi-manager platforms where the portfolio manager joins an existing investment management business as a partner or employee to run a portfolio of assets or a fund. However, it can also be used to describe a third party operation offering one or more of the following:

- a fund vehicle, either a standalone fund or, more typically, a sub-fund of an umbrella fund structure or a the right to manage a portfolio of assets within a fund 'housing' multiple managers. In each case the sub-fund or portfolio is likely to utilise common service providers and trading counterparties appointed over the structure as a whole;

- initial seed capital;

- business support, through shared resources and personnel, and perhaps office space;

- marketing and distribution services for the fund; and/or

- regulatory cover such that the manager does not need to obtain its own regulatory authorisation.

The key advantage of these third party platforms is that they reduce cost in the short term and allow the manager to maintain a small operation in its formative years.[13] Further, the use of a platform allows the manager to build a track record which, if successful, may enable the manager to spin-off the platform and go it alone in the future.[14]

The downside of launching on a platform include longer term cost (with costs often calculated on an assets under management basis, platforms can be more expensive for larger funds – and revenue shares typically are higher on platforms), a lack of control (the manager will be an appointed service provider and will not have a direct contractual relationship with the fund/portfolio of assets of which it is manager and will be unlikely to have any representation on the platform's board), the manager may have limited choice in terms of service providers, and problems may arise if the manager wishes to move to its own fund structure or the platform itself goes out of business (for example, where moving the fund/portfolio of assets to another vehicle, there is a risk that any investment gain will be crystallised for tax purposes).

Notional capital. A model we have increasingly seen utilised in recent years is the provision of capital to managers through non-segregated structures. Broadly speaking, this involves a third party capital provider putting capital into a structure with that capital then being allocated to multiple managers on a leveraged

[13] Albeit it is important to agree in detail the services that will be provided and the costs that will be met by the platform (certain direct and shared costs will be expected to be met by the manager).

[14] If the intention is to set-up alone in due course, it is important that managers utilising platforms seek appropriate rights over the track record they build whilst on the platform.

basis. These arrangements can be utilised by platform providers or these can be standalone arrangements whereby the manager will set up his own management business (unsupported by a platform) and will merely manage the capital on a delegated basis (i.e., a managed account).

So for example, a capital provider may put US$100 million into an account and utilise leverage such that the capital available is US$300 million. The US$300 million will then be allocated among multiple managers.

Those leverage terms can be provided because a prime broker is appointed over the account as a whole and has recourse over the assets of the account as a whole.

The obvious impact of this means that further leverage is restricted (albeit the capital provider will select managers whose investment strategy allows it to operate within such constraints).

Another impact is that in the event one strategy loses money, the assets of the account as a whole will be used to meet such losses (which means that a manager may be required to liquidate part of its portfolio of assets). The overriding concern we have in negotiating these arrangements on behalf of clients is that they do not have any liability for losses caused as a result of the lack of segregation of assets (for example, if the account is in default with a counterparty as a result of the account as a whole not having posted sufficient margin).

First-loss capital. The first-loss capital model is an interesting source of capital for new managers. The capital provider will generally provide access to a managed account for the manager to trade. In order to receive an allocation, the manager will be required to contribute capital equal to a fixed percentage, say 10% of the total size of the account (so using the 10% example, if the capital provider provides capital of US$90 million, the manager would need to contribute US$9 million). The manager's capital absorbs losses prior to the capital provider but the manager generally receives all of the account's future profits until the manager's loss is made whole. Any profits remaining will be shared between the capital provider and the manager on a pre-agreed (perhaps equal) basis.

One key benefit of the first-loss model to new managers is that it allows them to build a reputable track record (assuming that a reputable provider is engaged). The model is also usually cost effective for the manager as the capital provider will set up the account and engage service providers and trading counterparties over multiple accounts (thereby benefiting from economies of scale).

However, it is important that managers fully understand the terms of any first-loss deal. In particular, managers should understand the consequences of incurring a loss in the account. Some capital providers may require the manager to contribute further capital to meet the loss. Alternatively, the capital provider might reduce its exposure to the account, making it harder for the manager to make back its loss.

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