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SEEDING

Seward & Kissel Private Funds Forum Analyzes Trends in Hedge Fund Seeding Arrangements and Fee Structures (Part One of Two)

By Jennifer Banzaca

A hedge fund manager must keep abreast of current trends in hedge fund structures and terms in order to raise capital from investors, anticipate prospective changes in the marketplace and adapt accordingly. At the recent Seward & Kissel Private Funds Forum, panelists discussed key capital raising and fund structuring trends in the hedge fund industry. This article, the first of a two-part series, summarizes the panelists' discussion of seeding arrangements and fee structures as well as the impact of ERISA and taxation considerations upon hedge fund structuring. The second article will explore the use of special fund structures, activist strategies and alternative mutual funds.

For additional insight from the firm, see "*Seward & Kissel New Hedge Fund Study Identifies Trends in Investment Strategies, Fees, Liquidity Terms, Fund Structures and Strategic Capital Arrangements*," The Hedge Fund Law Report, Vol. 8, No. 9 (Mar. 5, 2015). For more on hedge fund seeding arrangements, see "*Report Offers Insights on Seeding Landscape, Available Talent, Seeding Terms and Players*," The Hedge Fund Law Report, Vol. 8, No. 1 (Jan. 8, 2015); and "*New York City Bar's 'Hedge Funds in the Current Environment' Event Focuses on Hedge Fund Structuring, Private Fund Examinations, Compliance Risks and Seeding Arrangements,*" The Hedge Fund Law Report, Vol. 7, No. 11 (Mar. 21, 2014).

Seeding Arrangements

Heightened regulation, rising compliance costs and investor demands for institutional products have made it increasingly difficult in recent years for emerging managers with minimal assets under management and without established track records to attract capital for new hedge funds. One way fund managers have been overcoming these difficulties is through seeding arrangements with strategic investors. See "*Primary Legal and Business Considerations in Hedge Fund Seeding Arrangements*," The Hedge Fund Law Report, Vol. 2, No. 38 (Sep. 24, 2009).

Seeding arrangements can be instrumental in enabling funds to attract institutional investors. Michael Weinberg, senior managing director at Protégé Partners, explained, "Seeding is important because institutional investors don't want to hold more than a certain percentage of a fund's assets. Seeding helps managers bulk up the assets under management so institutions can invest and not represent a disproportionate percentage of assets." Weinberg also noted that seeding provides the capital to get institutional-quality service providers and infrastructure in place at the start.

Given the above, the quality and stability of seed capital is critical. "Managers are most interested in the permanence of capital that seed investors can provide for them," said Seward & Kissel partner Meir Grossman. "The goal is to get themselves to a critical mass so that they can attract the most capital from outside investors, and in order to do that, people need to see that they have an anchor."

"It's very important that there's a lockup on seed money," continued Grossman. "Typically, seed investors and family office-type investors are willing to lock up their money for two or three years. A strategic seed investor can offer a kind of 'seal of approval' to others – signifying that someone else has vetted the fund's operations and risks. That's very lucrative to a manager."

Managers may draw additional benefits from seeding relationships, in the form of improved access to services or infrastructure. Weinberg noted that seeders can also provide valuable advice to managers who may not have previously run their own funds. "Often, we will see managers who were great analysts or portfolio managers at top funds but who may not have the expertise on the business side to run a firm. Seeders can provide services and advice to managers looking to start their first firm and help them to get their businesses up and running."

Weinberg provided further insight from a seeder's perspective, detailing certain stipulations for the provision of seed capital. "When we're looking at seeding a founder, we're looking for someone who's entrepreneurial and has the ability to build a team which we believe can work well together. We're looking for an excellent portfolio manager and an excellent analyst." Rigorous processes and controls are also key. "We'd like to see a consistent, repeatable process and strong risk management," he continued. Weinberg additionally demands investment by the founder and the team of a "substantial amount of their net worth" in the fund, citing this as an important reflection of their commitment.

Seeding Capital

Managers must consider the amount of capital that a seed investor will allocate. According to Weinberg, the minimum seed capital required to attract follow-on investment from institutional clients has risen in recent years. "It used to be that $25 million was the right amount to seed a fund and get it started. Now the world has become much more institutional, and that amount no longer cuts it. We think $75 million to $100 million is the low end of the range for seed capital these days, and $100 million to $150 million is the higher end of the range. $100 million gets a manager into an institutional landscape where, if an institutional investor doesn't want to be more than a certain percentage of assets, they likely won't be, and the firm can start growing from there."

Seeding Terms

Increased alignment in seeding practices in the hedge fund industry has made it more difficult for managers to resist the inclusion of commonly sought, investor-friendly terms. "Over the last five or ten years, the seeding business has become much more standardized in terms of the provisions seed investors will require," observed Grossman. "Now, there are many institutional seed investors asking for similar terms, so you're not going to have a lot of leverage in terms of a seeder's desire for most favored nations provisions, capacity rights, transparency, information rights, consent rights and notification rights."

Grossman added that the most heavily negotiated terms often include the duration of the lockup and the "down and out" clause, which specifies the level of negative performance that will permit a seed investor to redeem. The financial terms of any seeding deal are also key. "The revenue share is obviously one of the most important points," he remarked.

Exit Strategy

Seed arrangements have a finite life, and as such, any well-negotiated seed arrangement will have clearly defined exit provisions. It is important for a manager to understand its exit strategy, as this may impact its future revenue streams in the event that a seeding deal turns sour.

"When negotiating the exit strategy, the non-compete provisions need to be considered," advised Grossman. "In the past, seed investors would include a one- or two-year non-compete clause that would protect the seed investor by ensuring that a manager wasn't going to go elsewhere and set up an identical shop, usurping the seed investor's ability to get its revenue share. These days, seed investors are a lot more aggressive in protecting themselves against these situations."

"Seeders will often ask for tail payments or sunset payments," continued Grossman, "so that if a manager were to wind down, it wouldn't be able to perform any significant portfolio management activities in the next three to five years without having to pay the seed investor in accordance with the exact deal that was in place with the original fund. There are ways you can negotiate around that, but the exit strategy is a significant issue for a manager. If, for whatever reason, things don't work out, the manager wants to ensure they can get a job somewhere else and not have to worry about paying out the seed investor."

The exit strategy may include a step down in the fee level over time. Buyout provisions may also be included. "Some seeders have clauses where they can require the manager to buy them out at a certain point," noted Weinberg. "We don't require that, but we give the managers the option." According to Grossman, however, "many managers view buyouts as unlikely to happen, given that it is often hard to justify the economics."

See also "*How to Structure Exit Provisions in Hedge Fund Seeding Arrangements,*" The Hedge Fund Law Report, Vol. 3, No. 40 (Oct. 15, 2010).

Fee Structures

Hedge fund managers also seek to entice investors by offering different fee structures, such as founder shares, tiered management fee arrangements and multiple share classes.

Christopher Riccardi, a partner at Seward & Kissel, noted, "I think it's fairly standard now that new or smaller funds will have some type of founder's class, designed to incentivize investors to invest on 'day one' or in the early stages when the fund is launching." See "*How Can Hedge Fund Managers Use Founder Share Classes to Raise and Retain Capital?,*" The Hedge Fund Law Report, Vol. 5, No. 28 (Jul. 19, 2012).

"One of the key features of a founder's class," explained Riccardi, "is a discounted fee structure – sometimes a 25% to 50% discount on the standard fees the fund is going to charge. Another feature of the founder's share is capacity rights, so that even after the founder's period closes, investors who came in during that period will have the ability to invest an additional amount at the reduced fee level."

Tiered management fee structures are also popular, becoming increasingly prevalent with startups and established managers alike. Riccardi explained, "The way these structures work is that when a manager matures to a point – say $500 million in AUM – the management fee will reduce as further assets are raised, to keep the management fee from becoming a profit center. That reduction will benefit all of the investors in the fund." See "*Tiered Management Fees May Help Hedge Fund Managers Attract Institutional Investors (Part One of Two),*" The Hedge Fund Law Report, Vol. 8, No. 25 (Jun. 25, 2015); and "*Practical Considerations for Hedge Fund Managers Implementing Tiered Management Fees (Part Two of Two),*" The Hedge Fund Law Report, Vol. 8, No. 27 (Jul. 9, 2015).

ERISA Concerns

Managers seeking to attract ERISA investors need to be aware of the ERISA implications of entering into seeding arrangements or introducing new share classes, said Seward & Kissel partner John Ryan.

Since the ERISA 25% test is applied on a class-by-class basis, managers offering founder shares will often seek to avoid treating those founder shares as a separate class in the legal documentation. "For ERISA purposes, you want to make sure your initial seed capital can be used toward your 25% calculation when you're more mature and more likely to attract ERISA assets. You want to have your founder's shares be a series or a tranche so you can use that initial capital toward your ERISA calculations," advised Ryan.

"The major structuring mechanism used to enable younger managers to attract ERISA assets without crossing the 25% threshold and becoming ERISA fiduciaries is the hardwired master/feeder structure, where the feeder is required to invest all of its assets into the master fund," Ryan noted. "The master fund is designed to stay below the 25% threshold, so the activity of the manager at the master fund level is not subject to ERISA. The feeder funds are permitted to cross the 25% threshold, but because there is extremely limited fiduciary and investment activity at the feeder fund level, the ERISA liability for running the feeder fund over the 25% threshold is incredibly limited."

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For more on ERISA, see "*Structuring Hedge Funds to Avoid ERISA While Accommodating Benefit Plan Investors (Part Two of Two)*," The Hedge Fund Law Report, Vol. 8, No. 6 (Feb 12, 2015); and "*How Can Hedge Fund Managers Accept ERISA Money Above the 25 Percent Threshold While Avoiding ERISA's More Onerous Prohibited Transaction Provisions? (Part Three of Three)*," The Hedge Fund Law Report, Vol. 3, No. 24 (Jun. 18, 2010).

Tax-Efficient Structures

Managers must also be aware of the tax implications of any seeding arrangements, according to James Cofer, a partner at Seward & Kissel. "I would say the buyout is one of the key issues. If the seeding deal is structured so the seeder is effectively receiving a partnership interest, there is a question as to whether any subsequent buyout payment is going to be tax-deductible or capitalized (not tax-deductible) for the manager. If it's capitalized – and you're essentially buying out a seeder's partnership interest for a one-shot payment – you have a real concern."

"What we try to do for the manager is to structure the buyout so that it constitutes an increased share of profits for a period of time, to effectively get to a cap," Cofer stated. "However, that may not work from the seeder's tax perspective, depending on the strategy of the fund and in cases where the fund is producing short term gains and ordinary income."

Tax-efficient fee structures may also be used by hedge fund managers to attract investors. "One thing we've seen – and it only works with certain managers – is structuring the management fee as an administrative allocation," Cofer observed. "Rather than taking a management fee that's based on an asset value no matter whether you're profitable or not, you convert it to an allocation that is dependent on whether or not you have profits in a particular period, similar to an incentive allocation."

"The advantage of this structure for a manager," Cofer continued, "is that it converts what is normal income to long-term capital gains, depending on the trading strategy of the fund. This works best for funds that have a significant amount of long-term capital gains or a manager that has multiple funds if it doesn't need a guaranteed management fee every year." Cofer added that this structure is also advantageous to investors because, with respect to funds that follow long-only or buy-and-hold strategies, the management fee payable by investors is normally subject to a variety of limitations on deductions; "however, if you convert the management fee to an allocation then the investor gets the deduction for that full amount. This is really a win-win for everyone."

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CO-INVESTMENTS

Seward & Kissel Private Funds Forum Analyzes Trends in Hedge Fund Seeding Arrangements and Fee Structures (Part Two of Two)

By Jennifer Banzaca

As hedge fund managers adapt to changes in the marketplace, they are employing special fund vehicles, such as pledge funds, activist funds and alternative mutual funds, in order to take advantage of special opportunities. During the recent Seward & Kissel Private Funds Forum, panelists discussed these and other hedge fund industry trends with respect to fund structuring and capital raising. This article, the second of a two-part series, explores how hedge fund managers are employing such fund structures and strategies. The first article highlighted current trends in seeding arrangements and fee terms, and examined the impact of ERISA and tax considerations on hedge fund structuring.

For additional insight from the firm, see "*The First Steps to Take When Joining the Rush to Offer Registered Liquid Alternative Funds*," The Hedge Fund Law Report, Vol. 7, No. 42 (Nov. 6, 2014); and "*Private Investment Funds Investing in CLO Equity and CLO Warehouse Facilities*," The Hedge Fund Law Report, Vol. 7, No. 18 (May 8, 2014).

Pledge Funds

Pledge funds (or co-investment funds) are used by managers to raise money for a specific investment opportunity, and can be thought of as "deal-by-deal funds," explained Seward & Kissel partner Christopher Riccardi. "The manager will present an opportunity to the investor and set up a fund just for that investment. The investors can do their own due diligence on the opportunity itself," said Riccardi.

"From the manager's perspective, it's another way to get additional capital, but they're also able to structure the fee and liquidity terms so that they are better correlated to the opportunity that exists," Riccardi continued. These structures are particularly attractive to certain institutional investors who may not be comfortable giving a large allocation to a co-mingled fund for a manager to invest on a blind pool basis.

However, all parties are forced to act rapidly when a compelling opportunity presents itself, noted Riccardi. "The manager has to quickly come up with the documents to send to investors, and investors will also have to act fast. Otherwise, the opportunity will pass." Despite this risk, Riccardi said that the establishment of pledge funds by managers has been increasing, along with investor requests for such funds.

Managers must also consider certain compliance issues before creating this type of structure. The greater the number of existing vehicles already under management, the more complexities may arise. For example, Riccardi pointed out that most favored nation (MFN) provisions may be impacted by these arrangements, and any investment allocation issues should also be taken into account. "You really need to consider how you're going to integrate these funds into your platform and how they will invest in relation to your other funds."

Tax Implications for Pledge Funds

Additionally, the chosen structure can have tax implications. "Hedge fund managers need to understand that pledge funds are structured much more like private equity funds," noted James Cofer, a partner at Seward & Kissel. "Instead of taking 20% of profits every year, the performance fee is usually structured as a waterfall. This means investors get their capital back first, and then the manager gets paid."

Cofer explained that the tax allocations work differently under a waterfall than with a traditional profit allocation structure. "They don't exactly follow the cash that's coming out of the vehicle but work on a target capital cap basis. What this means is that, if there is taxable income coming in every year, it has to be allocated to someone. Thus, 20% gets allocated to the manager, even though the manager isn't entitled to anything immediately because the initial cash is returned to the investors."

Cofer clarified that hedge fund managers used to structures where the cash flow roughly follows the tax may be thrown off by the tax treatment of pledge funds. "The way to ameliorate the tax consequences is to mandate that the manager will get a tax distribution every year to pay their taxes. There also may be a clawback if the manager is paid too much."

ERISA Consequences for Pledge Funds

The fund manager's fee structure in a pledge fund can also create issues with ERISA compliance. "The ERISA analysis is counter-intuitive," said Seward & Kissel partner John Ryan. "ERISA provides that if a manager can set the timing of its fee, it constitutes a prohibited transaction. In these types of arrangements, when the fee is paid on a realized only basis, the manager controls the timing of the sale and therefore controls the timing of the fee."

According to Ryan, however, there is a way to alleviate this problem. "If the fund is over the 25% ERISA threshold and subject to ERISA, we ensure that payment to the manager occurs on a fixed date, which is usually at the end of the partnership's term or upon its termination."

Activist Funds

In recent years, managers have expanded their investment practices to cover a greater range of activist strategies and sectors. "We have seen increasing interest from managers and allocators in more specialized strategies," observed Spiros Maliagros, president of Tiedemann Investment Group. David Mulle, a partner at Seward & Kissel, agreed. "The trend we're seeing with activism is simply 'up.' There are a greater number of activist campaigns, and they also tend to be bigger than a few years ago."

Activist funds may allow managers to pursue investment opportunities outside the scope of their other hedge funds, whether because of liquidity concerns, duration or specific restrictions in the investment mandate. According to Maliagros, activist funds can also provide managers with a longer-term capital base.

Activist funds similarly offer attractions for investors, particularly those with holdings in a manager's other funds. "From the allocators' perspective, these specialized strategies allow an investor to have a differentiated portfolio of investment opportunities. They also allow allocators to signal support for particular investment strategies and to have a broader, perhaps stronger, relationship with the manager," said Maliagros.

Mulle agreed that activist strategies are often viewed positively by allocators, citing investor demand as a key factor behind the rise in this type of fund. "One of the reasons for the trend is that investors are willing to put a lot more capital to work with managers who have plans for activist campaigns. Not surprisingly, we're seeing an increase in the broad range of activist strategies from M&A targeted strategies to campaigns focused on corporate governance," he observed. "One area where we've seen a particular increase is cash utilization."

"Post-2008, companies have been shoring up their balance sheets, and with corporate cash balances at all-time highs, you would expect investment managers to be focused on cash utilization," Maliagros agreed. "Companies are looking to either increase dividends, conduct share repurchases or participate in M&A opportunities. All of these options are company specific, based on a particular company's financial position, the state of its balance sheet, the willingness of the board to be creative and the opportunity that offers the best rate of return for shareholders. Investment managers can look to replace board members who are reluctant to listen to new ideas. Alternatively, they can employ 'silent activism' and work with the board, offering positive suggestions." Maliagros noted that managers are increasingly employing the silent activism strategy.

Hedge fund managers considering activist investing first need to consider their form of approach, noted Mulle. "One thing to think about when contemplating an activist campaign is whether you can get things done cooperatively with the company. It's expensive and time-consuming to carry out a proxy fight, and it's a huge drain on the company's resources. So, more managers are looking at working in the background with the company to implement changes," observed Mulle. "Although not particularly high profile, we've found that managers have had a lot of success working with company management in this way."

For managers wishing to develop an effective "soft" approach, "one of the most important things is thinking about the tone that you use with management early on, both in your private communications and any public statements you may make," advised Mulle. "You're trying to direct management toward the outcome you'd like them to achieve, but you want to at least give them the appearance of having different options available to them so they don't feel backed into a corner." He suggested that managers choosing to take a cooperative route should, however, ensure they leave other paths open in case a more adversarial approach is required in the future.

Maliagros provided additional insight with respect to factors that managers should consider when determining an activist approach. "When deciding what path to take for a successful activist campaign, you have to consider whether you have the internal corporate apparatus to manage the process, whether you can actually manage the operating company and what will resonate in the marketplace to effectuate the result you're looking for," he stated. "Sometimes publicly suggesting a path for a company to take is enough to effectuate that result." For more on activist investing, see "*Structures and Characteristics of Activist Alternative Investment Funds*," The Hedge Fund Law Report, Vol. 8, No. 10 (Mar. 12, 2015).

Alternative Mutual Funds

Alternative mutual funds employ investment features traditionally only found in hedge funds, including the use of leverage, derivatives and short selling. In the U.S., such funds are governed by the Investment Company Act of 1940 and, as such, must meet a broad array of regulatory and compliance requirements. See "*The First Steps to Take When Joining the Rush to Offer Registered Liquid Alternative Funds*," The Hedge Fund Law Report, Vol. 7, No. 42 (Nov. 6, 2014). For a general discussion of ways that hedge fund managers can enter the retail alternatives space, see "*How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital (Part Two of Two)*," The Hedge Fund Law Report, Vol. 6, No. 6 (Feb. 7, 2013).

The launch of an alternative mutual fund can allow a hedge fund manager to expand and diversify its product offering and investor base. "Alternative mutual funds have really exploded in the last two or three years," noted Seward & Kissel partner Paul Miller.

"Before launching an alternative mutual fund, a manager needs to consider the investment restrictions and liquidity restrictions of these structures, to make sure their strategy is able to be ported into the mutual fund structure," he cautioned. "That said, the liquid alternatives space has grown dramatically and offers a new product and distribution platform for managers. If you can utilize the strategy, it gives you more diversification."

An alternative mutual fund's investments in illiquid assets are limited to 15% of its portfolio. Under SEC rules, a "liquid" asset is one that can be liquidated in the ordinary course within seven days. Similarly, the fund must be able to make any requested redemption payment within seven days. As Miller noted, "If your strategy is focused on holding 90% of the fund's assets in illiquid securities, that's not going to work in the liquid alternative context."

"Another consideration is the valuation component around your portfolio holdings," continued Miller, who noted that holdings in alternative mutual funds are required to be valued daily. Valuation can be a significant concern for funds that invest in "hard to value" assets, where prices are not readily available. Hedge funds managers are often given valuation discretion in such circumstances. With mutual funds, the board typically has the power to value investments for which market prices are not readily available. "You have to look to market quotations that are readily available for valuing the securities or holdings. If they're not available, you have to follow fair valuation strategies," said Miller.

An additional concern for managers launching alternative mutual funds is the risk of cannibalization of existing hedge fund products. To the extent a manager offers the same strategy through a mutual fund and a hedge fund, the fear is that that investors in the hedge fund may redeem their holdings and move over to the mutual fund, to avoid paying the hedge fund's higher fees. There are, however, various means to combat this risk. "Some managers are offering different versions of their strategies or taking the multi-manager approach, whereby investors can't get pure exposure to the manager because they are commingled with other managers," revealed Maliagros.

"Another option is a subset approach, where investors don't get exposure to the full portfolio and strategy. However, this adds to the portfolio management complexity," Maliagros continued. "It's difficult enough to run one portfolio, but when you add individual portfolio management decisions on sizing, exposure management and hedging of a separate portfolio, it's even more complicated," he cautioned.

Managers considering the launch of an alternative mutual fund product should also understand the distribution options, which differ from those used for the hedge fund model. With an alternative mutual fund, options include distribution by the manager itself and the use of distribution partners. Alternatively, managers may utilize a subadvisory model, subadvising either an entire fund or a sleeve of a multi-strategy fund.

For more on alternative mutual funds, see "*FRA Liquid Alts 2015 Conference Highlights Due Diligence Concerns with Alternative Mutual Funds (Part Three of Three),*" The Hedge Fund Law Report, Vol. 8, No. 19 (May 14, 2015); and "*Five Key Compliance Challenges for Alternative Mutual Funds: Valuation, Liquidity, Leverage, Disclosure and Director Oversight,*" The Hedge Fund Law Report, Vol. 7, No. 28 (Jul. 24, 2014). See also our series on the Conflicts Arising Out of Simultaneous Management of Hedge Funds and Alternative Mutual Funds Following the Same Strategy: "*Investment Allocation Conflicts*," Vol. 8, No. 13 (Apr. 2, 2015); "*Operational Conflicts*," Vol. 8, No. 14 (Apr. 9, 2015); and "*How to Mitigate Conflicts,*" Vol. 8, No. 15 (Apr. 16, 2015).