SEWARD & KISSEL LLP

Seed Transaction Deal Points

2019 Study

Introduction

While seeding activity remained strong overall during 2019, volume was down modestly year over year, particularly in strategies that traditionally are able to command the largest seed investments given their significant investment capacities. This dynamic has been observed in past circumstances when the markets were perceived to be expensive, such that strategies which are highly correlated to overall market performance become somewhat less desirable as investors foresee an imminent correction. However, the return of extreme volatility in the first quarter of 2020 due to the COVID response may well provide an opening for these strategies, and there are already signs in 2020 of an uptick in the seeding of these products.

While fewer in number, traditional long/short and macro strategies remained a significant share of seed investment activity (particularly in terms of their share of the aggregate dollars invested in seed investments), as did other strategies which tend to have significant investment capacity. Credit focused strategies also received significant attention from seed investors, as did other "hybrid" strategies whose investment composition includes allocations to both liquid and positions. Indeed, seeders are increasingly providing medium duration capital (through the lock-up of the seed investment) that can provide an anchor base of capital to support the ability of other LPs to access liquidity despite illiquids being a significant portion of a fund's portfolio, thus creating a stronger offering for the seeded product.

As in prior years, strategies that are more resistant to fee compression pressures were in high demand, as were strategies that are able to provide favorable liquidity to their investors – though a notable increase in investor level gates was observed in funds that were seeded, reflecting broader industry trends (including the broadening of investment mandates into illiquids and less liquids as mentioned above).

With capital formation remaining a challenge for new funds, managers who were able to obtain a seed investment had a considerable head start for their businesses and ability to attract additional investors. The persistence of two-year (and longer) lock-ups as the market standard incentivized seeded managers to invest greater resources in their businesses and orient their decisions – both investment and operational – with an eye towards the long-term.

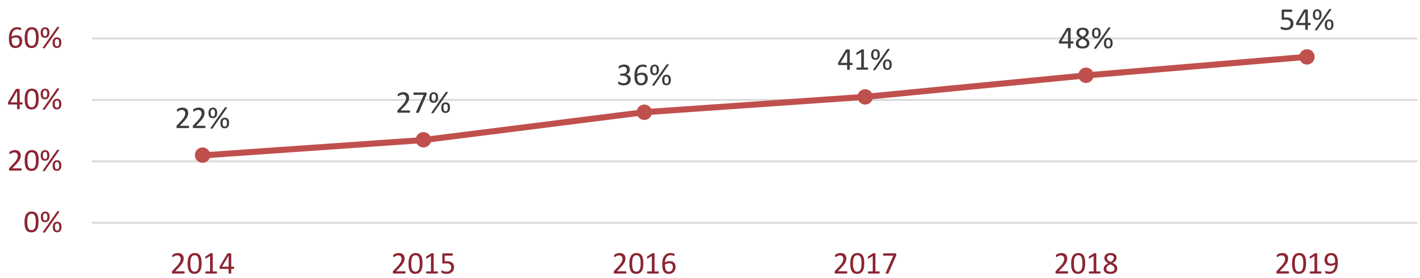
Our 2019 data suggests that the core economic terms of seed deals continue to reflect a trend toward more "manager-friendly" structures; two key continuing trends are seeders' willingness to (i) bear some of the start-up costs of the new business, and (ii) remain subject to a liquidity profile (post-lock-up) that is similar to other investors in the fund.

Our 2019 study continues last year's approach of comparing our most recent data with our historical data sets, highlighting relevant market trends. As noted in the past several years, our data suggests an increased willingness of seeders to be responsive to managers' concerns of how to provide the best launchpad for their new businesses. This improved alignment between seeders and managers will help ensure that there remains a robust opportunity set for seeders and managers alike. Accordingly, we expect that seed capital will remain a key factor in a new manager's path to success.

For more information about the current state of seeding, or seed transactions generally – or to receive a copy of our recent HFMWeek article "Recent Developments in Hedge Fund Seeding" – contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com.

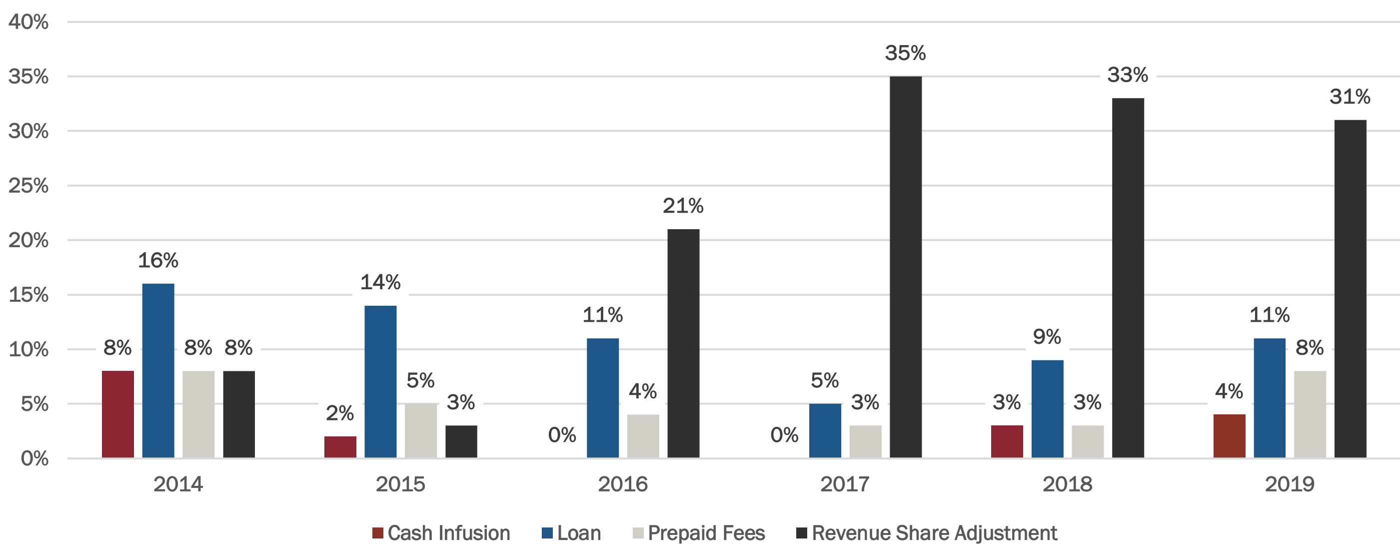
Working Capital Support

Percentage of Deals with Working Capital Support



Forming a new asset management business with sufficient operational depth and capacity to manage often $50+ million of day-one assets requires a significant amount of working capital. Moreover, in today's environment, large allocators increasingly require institutional level capabilities as a prerequisite for their investment managers. While historically founders have relied upon their own assets to finance these working capital requirements, asset managers are increasingly looking to seeders to provide capital assistance to fund the anticipated expenses of the business for the short to medium term. This assistance takes multiple forms, including direct capital investments, working capital loan facilities, prepaid management fees, or, most commonly, a deferral of the seeder's revenue share. Each of these approaches must be carefully structured to avoid distorting the underlying business deal and/or tax posture of both the seeder and the manager. Of the deals where working capital support is provided – which is now a majority of seed deals – a clear preference is emerging for using deferrals or other adjustments to the revenue share as a way of increasing the amount of capital available to fund the manager's operations. *For more information, contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy of our HFM Global article "Working Capital in Hedge Fund Seeding".*

Structure of Working Capital Support



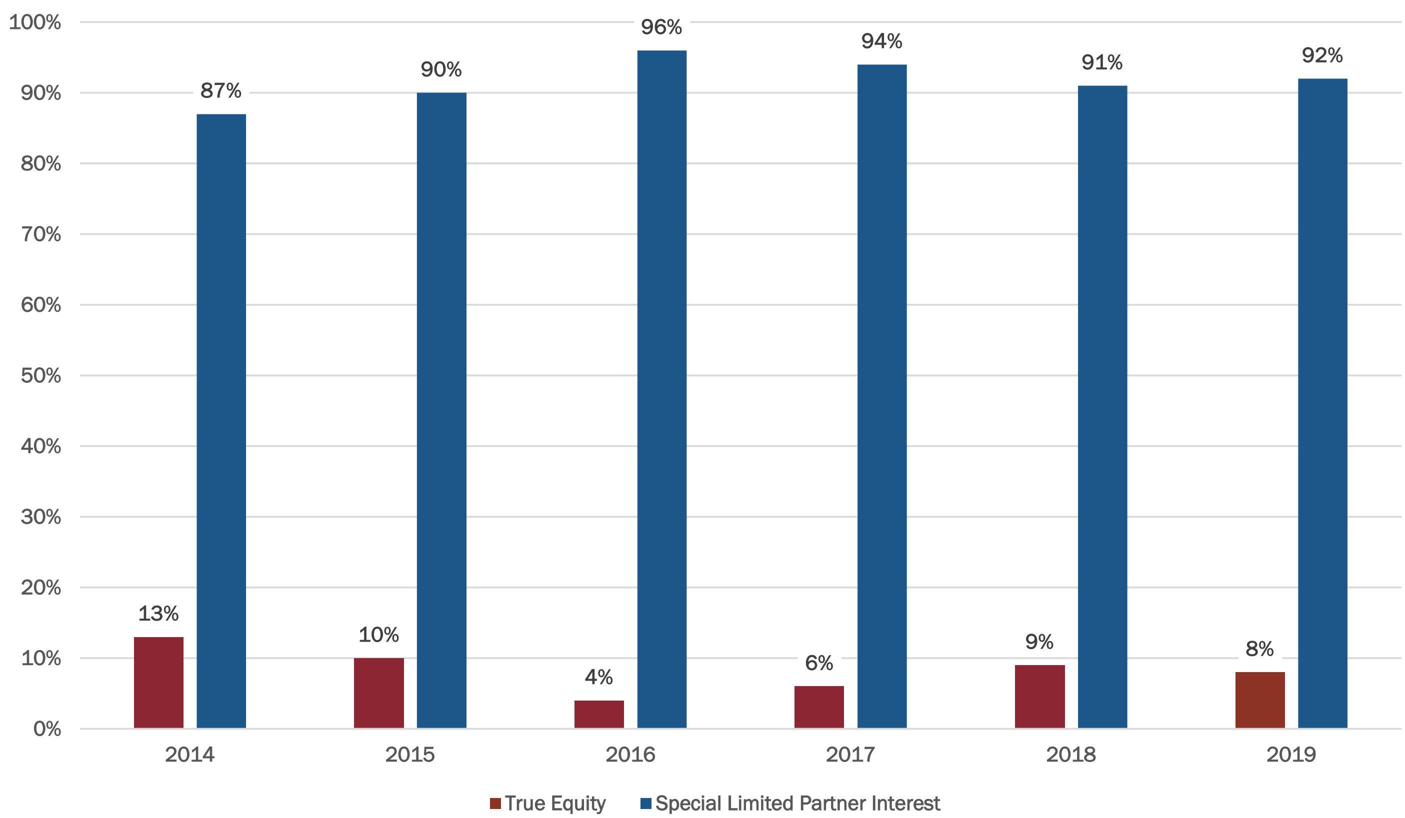
Structuring a Seed Deal

A threshold question in any seed deal is whether to structure the seeder's interest as a top-line revenue share (which occasionally nets out certain third-party expenses, such as placement agent fees, but is still at its core calculated by reference to revenue), or a bottom-line equity interest (which is almost always adjusted to exclude the impact of compensation to the owners of the manager in excess of modest base salaries). While a contractual revenue share remains the overwhelmingly preferred means of structuring seed economics, certain seeders require that their interest in the manager take the form of a direct equity ownership stake. The advantages of the latter structure include greater governance/control and greater transparency. However, there is some theoretical risk that owning an equity interest increases the seeder's liability exposure to investors in the fund or other third parties. Moreover, in such circumstances the seeder may need to be listed on the manager's Form ADV and be subject to its compliance manual and/or Code of Ethics.

Nonetheless, because the general benefits of equity ownership can almost always be achieved through careful structuring (most commonly by making the seeder a special limited partner or a holder of allocation class shares in the funds) and without negatively impacting the seeder's liability and disclosure profiles, a revenue share structured as a special limited partnership interest in the master fund remains the dominant method of establishing a seeder's interest in the manager's business.

As in all prior years, in 2019 seed deals structured as true equity were extremely rare, reflecting the continued preference of seeders for the contractual approach. *For more information, see our HFM InvestHedge article "State of the Art", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy*.

Structure of Seed Deals



Lock-Ups

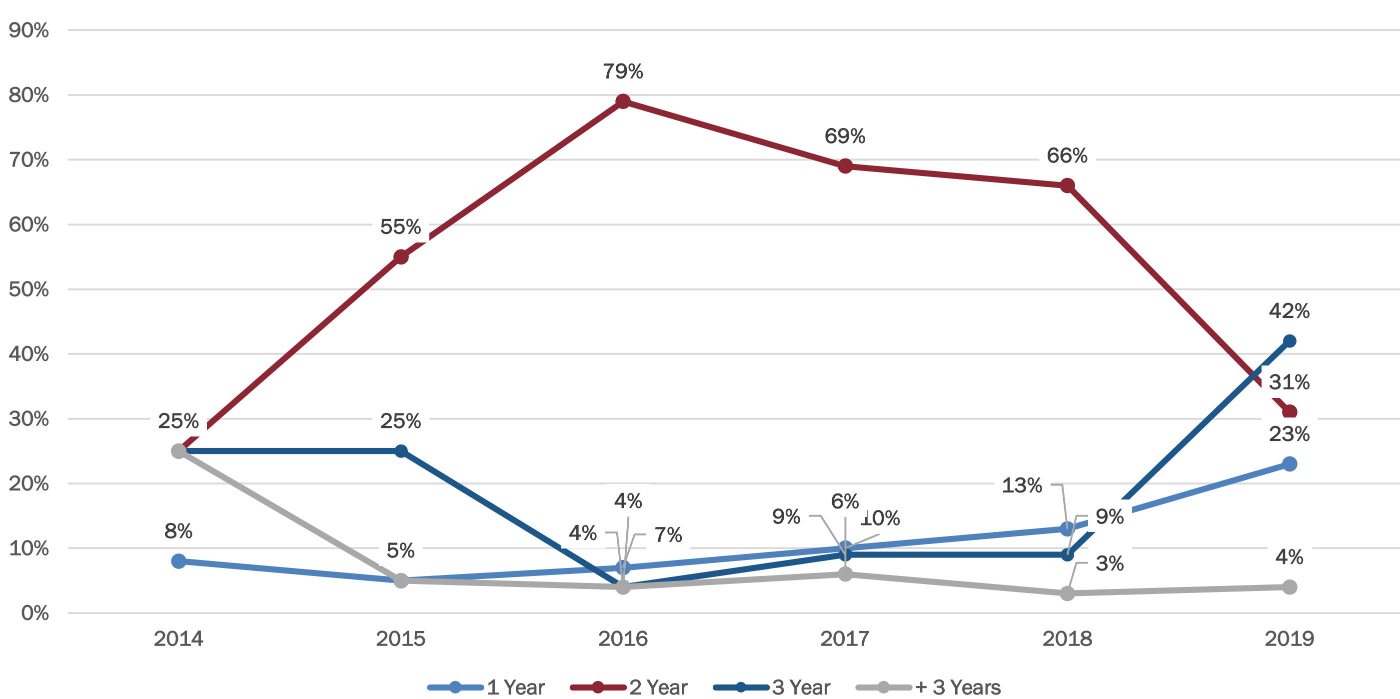
The primary currency of any seed deal – i.e., the reason a manager will grant a seeder a significant economic interest in their business – is the seeder's provision of significant and durable capital, providing scale and liquidity support for the first fund. To ensure this capital is "sticky", managers require the seed investment to be "locked-up" for some duration of time, most often for 1-3 years.

The nature of the lock-up varies between seed deals, with many managers preferring a "hard" lock-up, where the seed investment may not be redeemed for the entire duration of the lock-up period (subject to certain special redemption rights in the event of material adverse events, as discussed on the following page), while others are willing to agree to have a "soft" lock-up apply to the seed investment for some portion (or sometimes the entirety) of the lock-up period. "Soft" lock-ups traditionally take the form of early redemption charges and/or the loss or reduction of the economic sharing rights of the seeder.

Following the expiration of the lock-up, the seed investment most commonly rolls into the underlying liquidity of the class into which it was invested. To the extent that such class is subject to separate lock-ups or investor/fund level gates, the seed investment often gets credit for "time served", such that the full amount of the seed investment would be eligible for redemption at the end of the lock-up period. In such events, to balance the underlying portfolio liquidity concerns that inform the need for general lock-ups and/or gates, the seeder will be required to provide irrevocable notice of its election to redeem the seed investment during the lock-up period (with effectiveness as of the expiration of the lock-up period) so as to give the manager sufficient notice to create the requisite portfolio liquidity. For example, a seed investor might be required to give such notice a year before the expiration of the lock-up if the underlying share class has quarterly liquidity subject to a 25% investor level gate.

While the early stages of our observation period showed a wide variety of lock-up period durations, a clear trend has emerged for 2-3 year lock up periods – most typically these are "hard" lock-ups for the entire period, though a combination of 1-year "hard" lock-up and 1-year "soft" lock-up are not unheard of. *For more information, see our HFM Global article "Aligning Seed Investor Liquidity Rights", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.*

Duration of Lock Ups

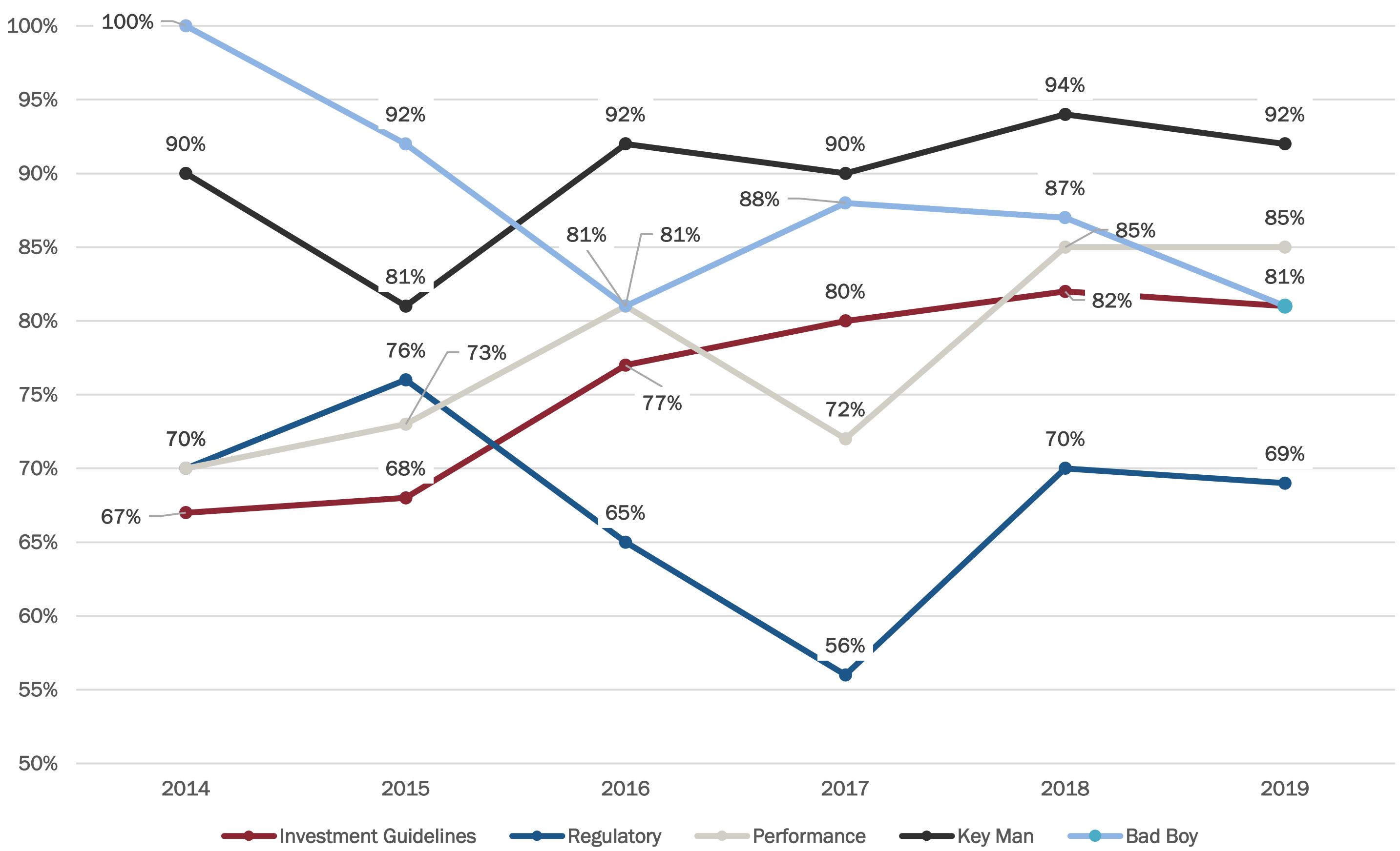


Lock-Up Releases

Notwithstanding the general restrictions on the liquidity of a seed investment as a result of the lock-up, seeders require the ability to redeem their capital in the event that the fund or manager experiences a variety of specific harmful events – whether these events represent damage to the seed investment itself or compromise the manager's ability to successfully manage assets in the future (thus eroding or eliminating the value proposition of the revenue share). These events include certain levels of losses (which are typically calibrated to the volatility implicit in the applicable investment strategy) or if the manager and/or its key personnel engage in certain types of "bad boy" behavior or are otherwise subject to legal or regulatory censure.

If any such events occur, the lock-up terminates and the seeder's investments become redeemable, often on an accelerated basis, regardless of whether the redemption notice window for the fund is open or closed, and often before the date of the next scheduled liquidity (e.g., quarterly). As noted, the most common of these liquidity rights are keyed to the integrity of the seed investment (e.g., breaches of, or changes to, the investment guidelines; negative performance) and events adversely affecting the manager's future as a business (key man; bad boy; regulatory matters). Key man events remain the most common of these liquidity rights, arising in almost all seed transactions over the observation period, and liquidity for investment guidelines breaches/changes has become almost as ubiquitous as more seeders have focused on protections for the seed investment. Performance and adverse legal events remain extremely common liquidity rights as well.

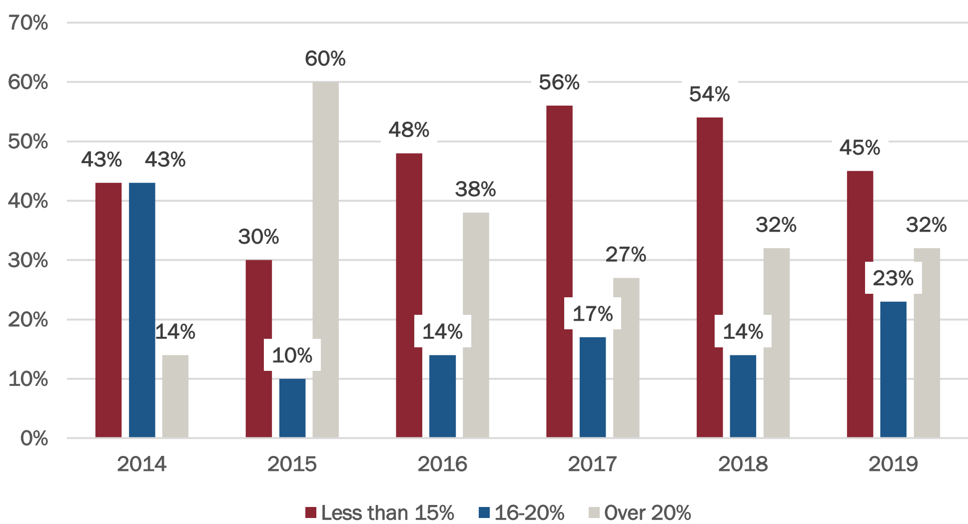
Top 5 Special Liquidity Rights



Lock-Up Releases

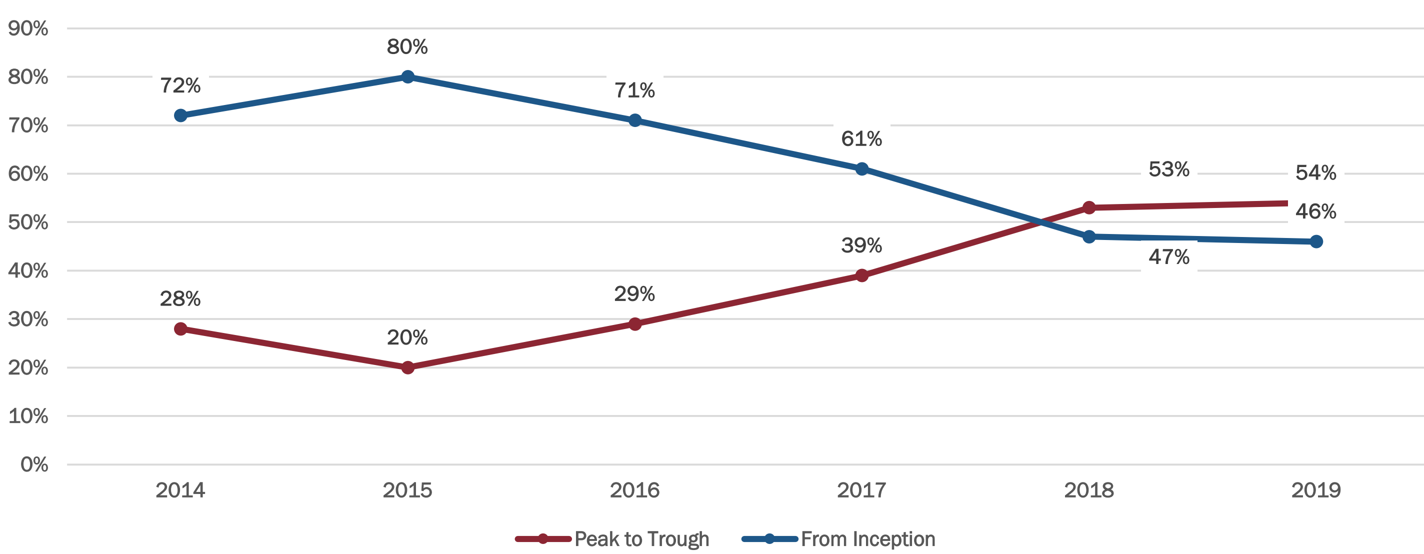
As a primary goal of almost any investment (seed or otherwise) is preservation of capital, and because the strongest indicator of the success of an asset management business remains its ability to generate alpha, seeders typically negotiate performance-related tests which allow a seeder to "cut its losses" if an investment with a manager significantly underperforms. These tests are typically structured either as absolute declines or declines relative to a benchmark. Consistently over the 2014 - 2019 observation period, negative performance tended to be 15% or less (approximately half of the observed transactions), which in part reflects the relatively low volatility expected in the investment strategies that attract seed capital. However, one item we will be tracking in next year's study is whether the extreme volatility in Q1 of 2020 will led to wider tolerances.

Negative Performance Threshold



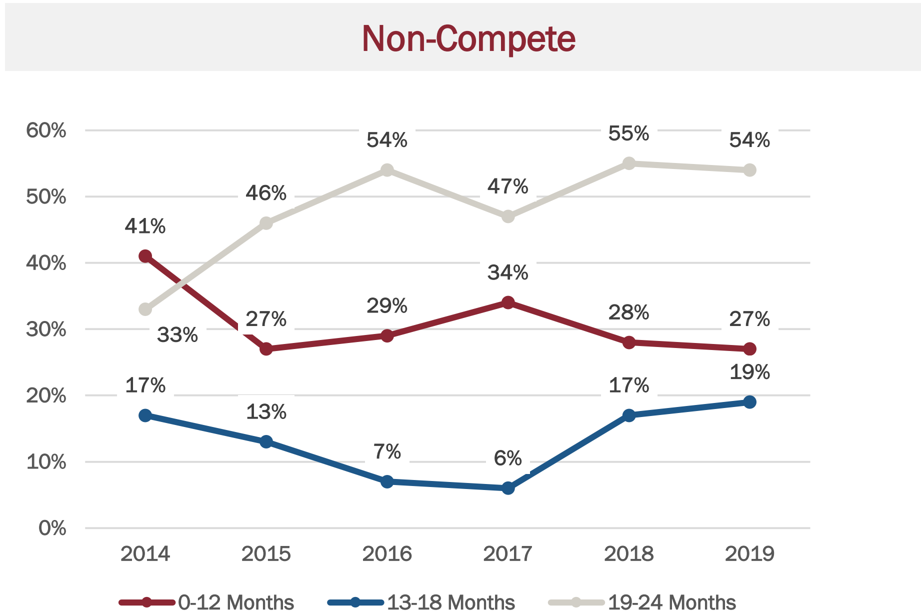
Notwithstanding the stated performance threshold which gives rise to a lock-up release, the effect of the applicable percentage may be adjusted by changes in the measurement period (e.g., a peak-to-trough test may yield a lock-up release, even for a very successful fund, which gives back a portion of its returns, despite overall returns remaining highly positive). Performance calculations on a "from inception" basis historically were the typical approach, though a convergence trend has been growing over the past couple of years and in 2019 the observations of each of the approaches were roughly the same.

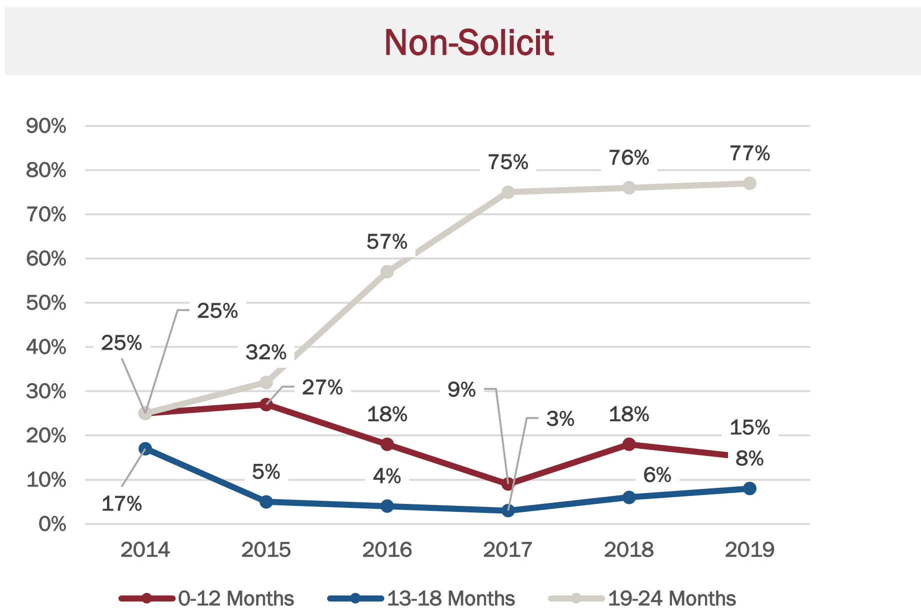
Negative Performance Measurement Period



Preserving Goodwill / Business Integrity

Owning an interest in an asset management business carries unique risks due to the inextricably essential relationship between the key persons who are charged with running the business, producing the track record and creating the value of the business. In a very real sense, the goodwill of an asset manager walks out the door each evening, and this requires special provisions for the benefit of a seeder to ensure that this goodwill (and therefore the value of the revenue share) remains intact and that the key persons cannot walk away from their fund and launch another fund business free of the seeder's revenue share. Seeders likewise worry about protecting an investment management business that has been institutionalized and can survive the departure of a key person – for these firms it is important to prevent a departed key person from engaging in trading strategies that can reduce the investment capacity in the fund's strategy or otherwise harmfully affect the fund's investments or ability to attract additional capital. Therefore, key persons are typically restricted from engaging in certain competitive activities for 12-24 months following their disassociation and/or withdrawal from the manager; over the observation period, the duration of this period trended somewhat upwards with 24 months being the most frequent and with 12 and 18 months, respectively, being the other most common durations. Key persons are also restricted from soliciting the legacy clients/investors and employees for a period of time at least as long as the non-compete period (and quite often longer, with 24 months becoming the most standard duration over the last several years). However, managers typically seek to have the non-compete covenants mitigated in certain ways, such as retaining the ability to work at a non-portfolio manager level for non-fund trading platforms (i.e., at a family office or prop desk) or reducing the non-compete period in the case of failure by the manager/fund to build a business capable of supporting itself after the lock-up period.



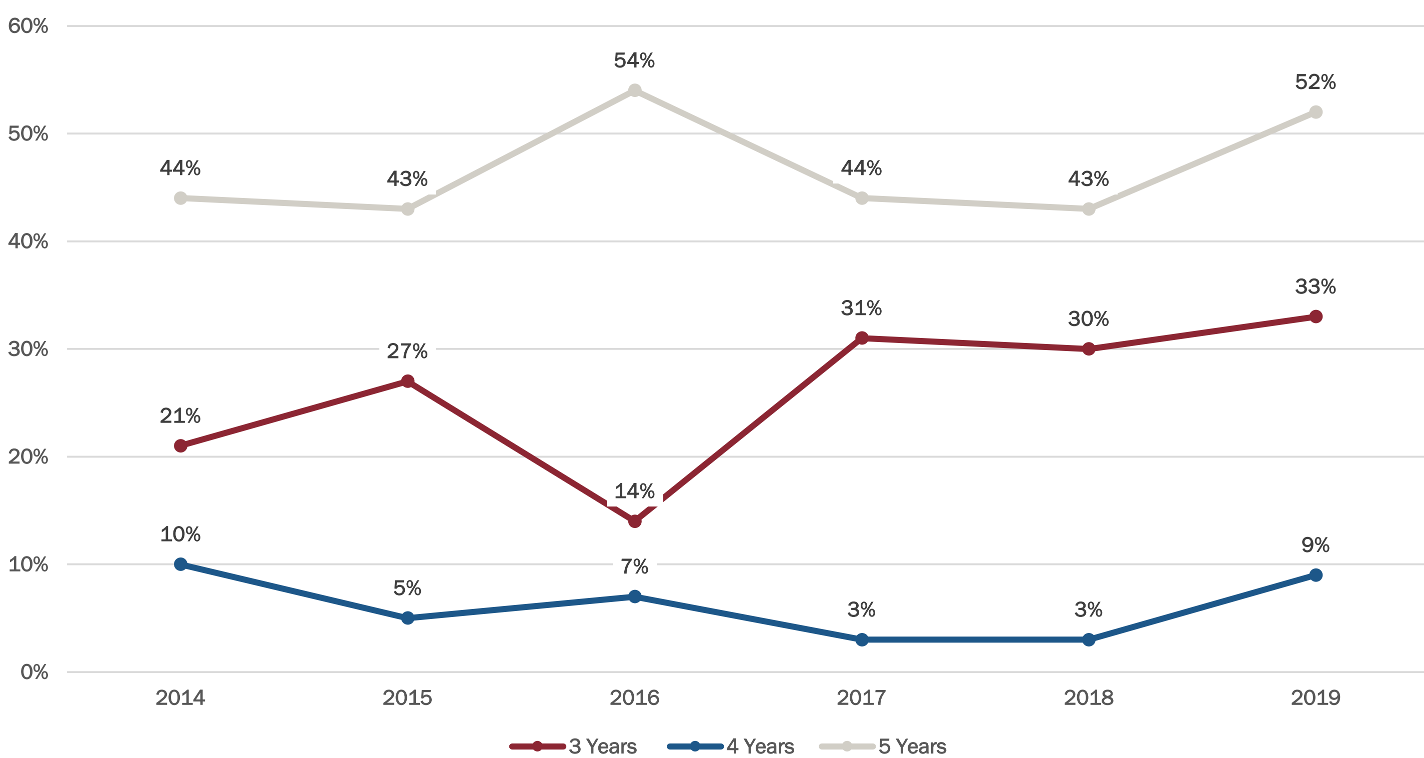


Preserving Goodwill / Business Integrity

While non-competition and non-solicitation provisions are, at their core, designed to ensure that a key person's post-withdrawal activities would not permit trading against the fund's positions or poaching talent and/or investors (e.g., in circumstances where the business remains viable following the key person's departure), seeders also commonly request "tail rights" which allow them to receive their seed economics in any businesses started or managed by the applicable key person within a defined period following such key person's withdrawal from the business (subject to certain limitations).

The rationale for this term is that the value of the goodwill that was created in the business that was seeded (a portion of which goodwill should accrue to the seeder), which is generally the key person's reputation based upon the investment performance of the fund, is generally thought to have a currency which would last beyond the relatively short non-compete period; therefore the seeder should retain some rights to any new business where this currency is used. Accordingly, the scope of the tail right is carefully limited to distinguish between acting as an ordinary employee of another asset management business (where the tail right would not apply) and becoming the key person(s) of another asset management business. A tail duration of five years has historically been the most observed period (slightly less than half of seed deals), with three or fewer year tails being the next most common. *For more information, see our HFM Week article "Restrictive Covenants and Tail Right Provisions in Seed Transactions: Balancing Seeder Protection and Key Person Autonomy", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy*

Tail Rights

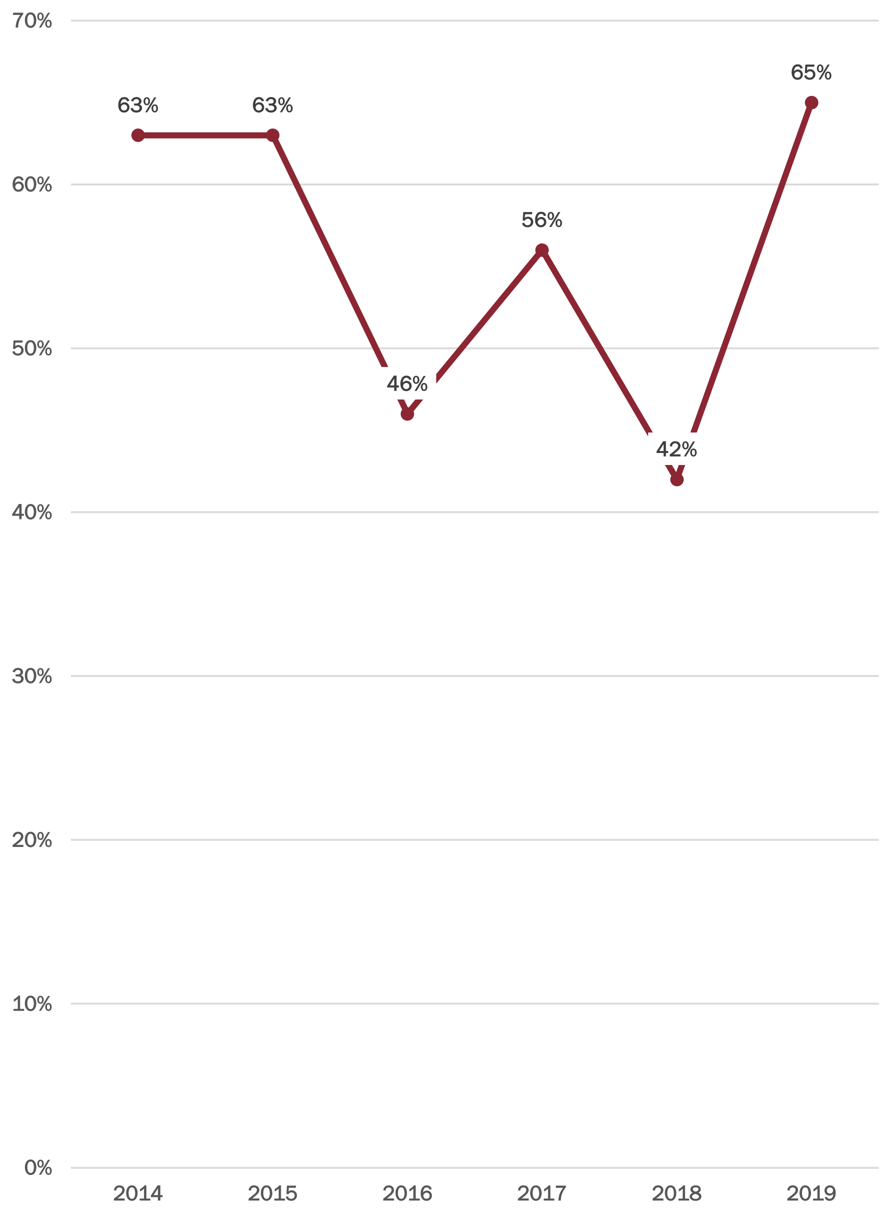


Buyouts

While it is customary for seed economics to remain in place perpetually (to the extent not structured to terminate automatically after a fixed period, as discussed in the following pages), managers often seek a buy-out right so that they may eventually reclaim full ownership and control of the business. Buy-out rights typically become exercisable after a number of years following expiration of the lock-up (so as to ensure the business has time to mature), and managers prefer buyout rights to be "evergreen" (i.e., exercisable at least annually), while seeders prefer that a manager only have the right to exercise the buyout once, such that if the manager declines to exercise within the applicable period, the buyout right will be lost. Of course, the parties can always agree to a buyout or similar transaction outside of any contractual buyout - such an approach allows for then-current market and other factors to be incorporated into the transaction pricing and structure, while the pre-negotiated buyout terms may be less reflective of the then-current "state of the art". Buyouts, while in decline over the last several years, once again appeared in roughly 2/3rds of observed transactions.

In structuring buyouts, much attention should be paid to the timing of payments: e.g., paying the entire buyout price upfront vs. paying in tranches over a period of time (in which event each tranche may or may not be repriced based upon the then-applicable performance of the business). Also to be considered is the tax effect of the buyout; as a simple buyout would require use of post-tax dollars (i.e., the buyout price paid is not a deductible expense), the parties may consider certain structures which allow for pre-tax dollars to be used — though generally speaking, unless carefully structured, use of these approaches can have distortive tax and/or economic effects for the seeder. *For more information, see our HFM Week article "Buy-out Provisions in Seed Transactions", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.*

Percentage of Seed Deals with Buyouts

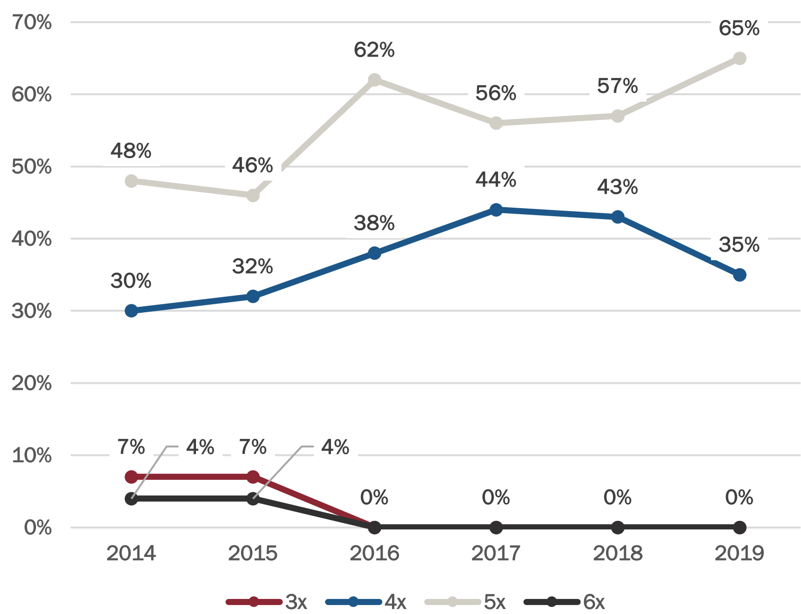


Pricing a Buyout

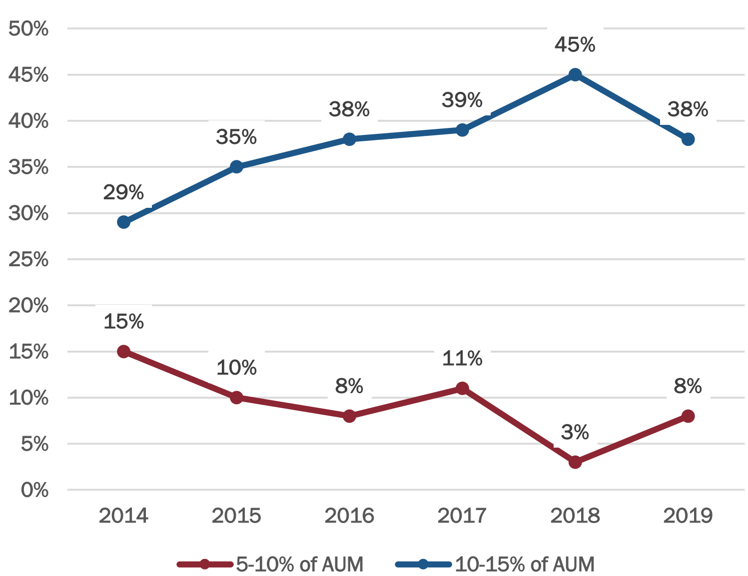
Pricing a Buyout — Revenue Multiple

Almost every seed deal that includes a buyout feature uses a formulaic buyout price. Another approach is to have a valuation expert make the determination of the buyout price at the applicable time (assuming the parties are unable to agree on a number), but this is generally only used where the seeder's economics are subject to a number of adjustments based upon unknowable events that render a formulaic buyout methodology inapt.

The most common formulaic buyout price – used in nearly every buyout formula – is based upon a fixed multiple of the payments made to the Seeder in the trailing 12/24/36 months. The backward-looking duration of the reference period is designed to smooth out volatility in fund performance (particularly incentive fees), though this approach can also yield a relatively lower buyout price vs. a run rate revenue-based multiple if the business is on an upswing. A multiple of 5x has remained the most common over the observation period, followed by a 4x multiple, with no observations of greater or lesser multiples in the past several years.



Pricing a Buyout – AUM Percentage

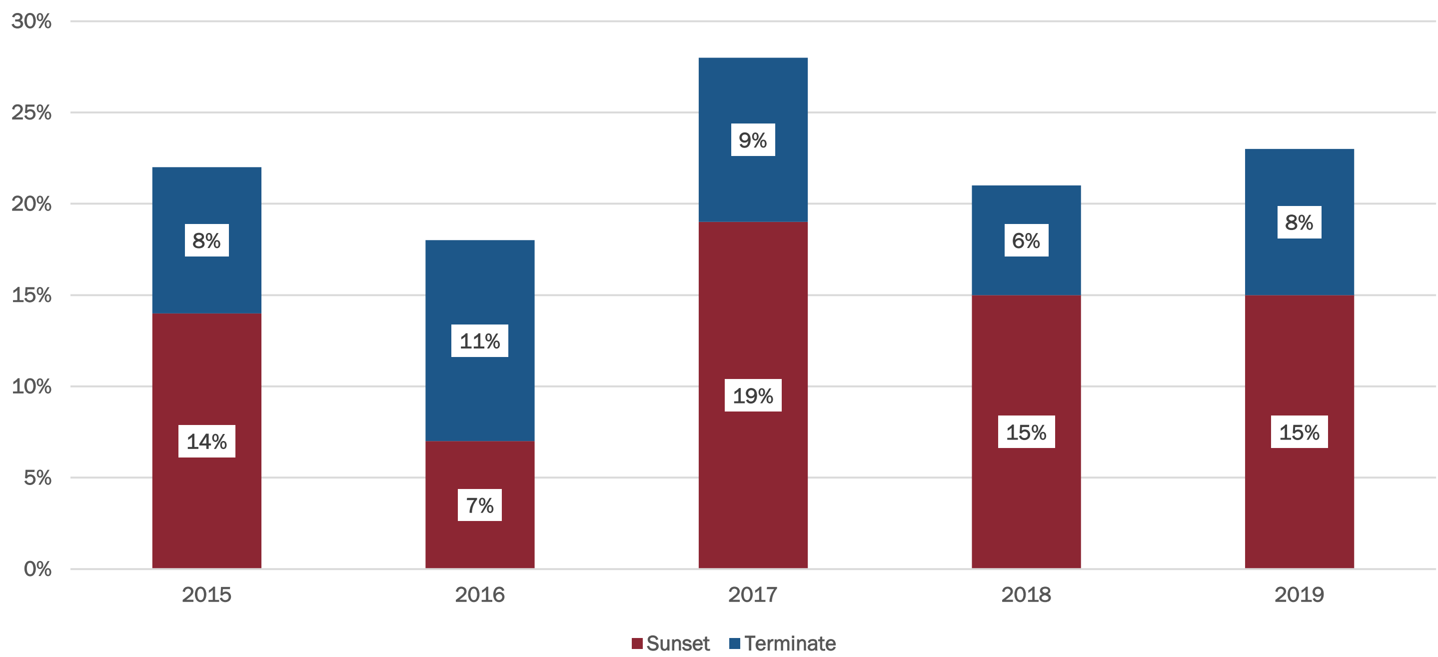


Recently seeders have sought to also include in the calculation of the buyout price an additional test based upon AUM (so as to ensure that any buyout price will not be negatively skewed by recent poor performance) – in which event the seeder would receive the "greater of" the price implied by the two methodologies.

Where AUM tests are used, a manager should ensure that the AUM is weighted for the fees actually paid (as due to special fee terms, some AUM generates greater fee income and therefore is more lucrative than reduced fee AUM). These tests arise in nearly half of all buyout provisions, and where they are used, an AUM percentage of 10-15% is by far the most common calculation.

Scope and Duration of Revenue Share

Terminating Economics



While still somewhat uncommon (holding steady at 20%-30% of our annual observations), a number of seed deals include a step-down, sunset or outright termination of the seeder's revenue share. Sometimes the decrease to the revenue share occurs on a fixed schedule or at a fixed time, regardless of other factors, where other approaches require the seeder to maintain its seed investment – even beyond the lock-up period – for the revenue share to continue. Predictably, these types of arrangements typically do not have buy-out clauses (as paying a high multiple when the seeder's economics are impermanent has little justification or appeal) and are mostly accepted only by seeders whose seeding motivations extend beyond pure revenue sharing economics. For example, a seeder whose core business is a fund-of-funds strategy and who has extended its manager selection expertise to seed investments may ultimately be more focused on receiving significant capacity rights at reduced fees and therefore be willing to forego some amount of seed economics to be able to place capital (at favorable rates) with highly sought after managers.

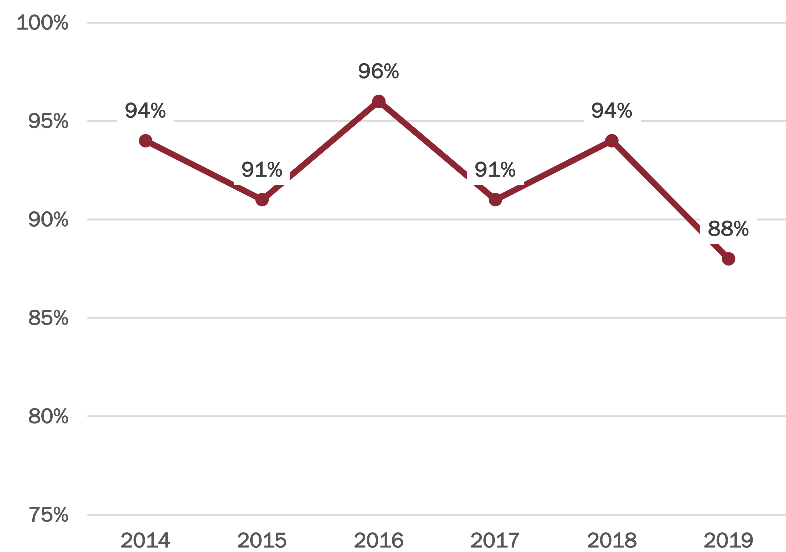
Additionally, given the relatively little value associated with cash flows that will be realized perhaps ten or more years out under a conventional discounted cashflow analysis, it is not necessarily economically irrational for a seeder to forego these distant and highly uncertain future payments. Because terminating seeder economics are so favorable to managers, a seeder whose motivations are more closely linked with capacity rights has a real opportunity to source and close a deal with a best in class new manager who may otherwise either pursue a larger seed deal or forego a seed deal altogether.

Participation in Evolutions

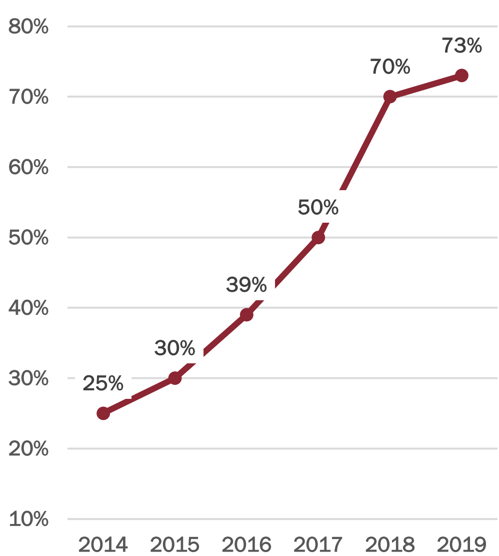
Participation in New Funds/Products

Regardless of the duration of the revenue share, a seeder will almost always require that its economic interest extend to any additional products or vehicles managed by the manager. The rationale is that because the seed investment forms the initial asset base of the manager's business which creates the goodwill that allows for the successful marketing and launch of subsequent products, the seeder should have full participation in all value streams arising from the entire business. Moreover, this protects a seeder against a manager essentially stripping value away from the revenue share (and therefore restoring economic value to the manager) by creating and favoring new products whose strategy/fee terms/liquidity profile/etc., are more favorable than the fund which is subject to the revenue share.

As a result of these considerations, roughly 90% of all seed deals over our observation period have included participation rights for the seeder in all new products of the manager.



Participation in Sales (Tag-Along)



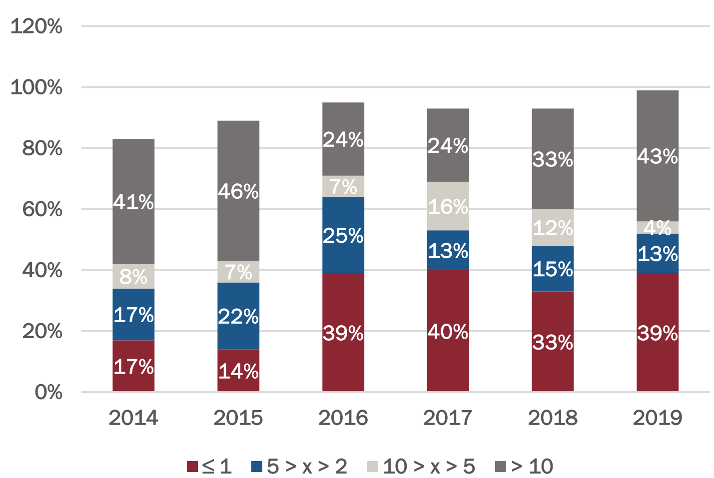
As a partner in the manager's business (regardless of whether the economics are structured as true equity or as a special limited partnership interest in the fund), seeders expect that they will be permitted to participate in sales and other liquidity events of the manager (and few buyers in such transactions are willing to purchase a stake in an asset manager who is subject to a revenue share – in no small part because many of these buyers will themselves be purchasing a revenue share). While in many instances a seeder simply requires an outright consent right over any sale or issuance of equity (and presumes that it will condition its consent on being permitted to participate in the transaction), it is also common for a seeder to pre-negotiate a "tag-along" right to participate in any sales. In the case of seed transactions where the seeder's economics are calculated by reference to revenue (the overwhelming majority of seed transactions), the tag-along right often will also include a conversion mechanic to account for the fact that the seeder's top-line interest in the business is considerably more valuable than a traditional bottom-line equity interest. As the number of buyers for stakes in asset managers has increased over the last several years – thus making an exit or partial exit through a sale more likely – seeders have been increasingly likely to require this right, with the frequency of this feature nearly tripling over the observation period.

Traditional Side Letter Terms

Seed transactions typically provide seeders with some degree of information rights beyond what they are eligible to receive as ordinary investors under the fund's governing documents. These information rights often provide the seeder with a level of transparency that allows them to validate compliance by the manager with the fund's investment guidelines and also ensure that the seeder receives its full entitlement under its economic sharing rights. Managers typically seek to limit these rights to ensure that the seeder cannot use this information in any manner negative to the fund (such as trading ahead of the fund) or to replicate fund positions without paying the related management/incentive fees.

While T+1 or even more immediate transparency remains extremely common (30%-40% of all seed deals in recent years), our data suggests that seeders, as a whole, are becoming somewhat more comfortable with a longer lag on transparency – frequently asking for trade and position reports at the end of each month or beyond, rather than at the end of each trading day.

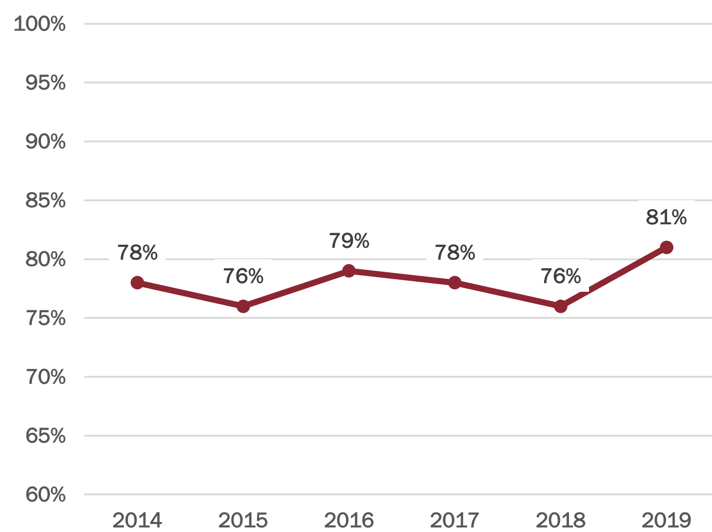
Portfolio Transparency



In addition to the seed capital, seeders typically require that a manager reserve investment capacity in their fund and other products to ensure that the seeder can invest additional amounts with the manager. Typically, these amounts are structured as either a fixed amount or a percentage of an investment vehicle's AUM. Seeders typically seek to ensure that dollars invested pursuant to their capacity rights will be made on the same preferential terms (e.g., fees and lock-up releases), and further will be subject to a "most favored nations" provision, to the extent applicable.

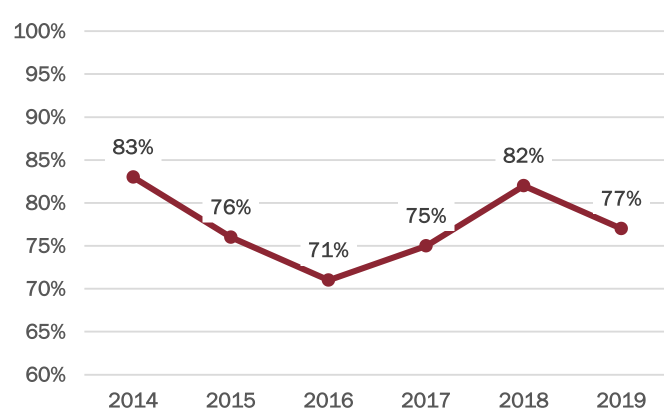
Seed Transaction Deal Points — 2019 Study

Most Favored Nations Rights



To ensure that a seeder's deal terms are at least as favorable as other investors in a fund, seeders will typically seek a standard "most favored nations" provision that allows seeders to elect to receive the benefit of any more favorable terms granted to other investors. Managers often seek to carefully define a seeder's right to receive these terms through restrictions on "cherry picking" (i.e., taking more favorable terms but not agreeing to be subject to any corresponding obligations which are more onerous) or by requiring the seeder's investment to equal or exceed the investment size of any investor to whom more favorable terms are offered.

Side Letter Terms Capacity



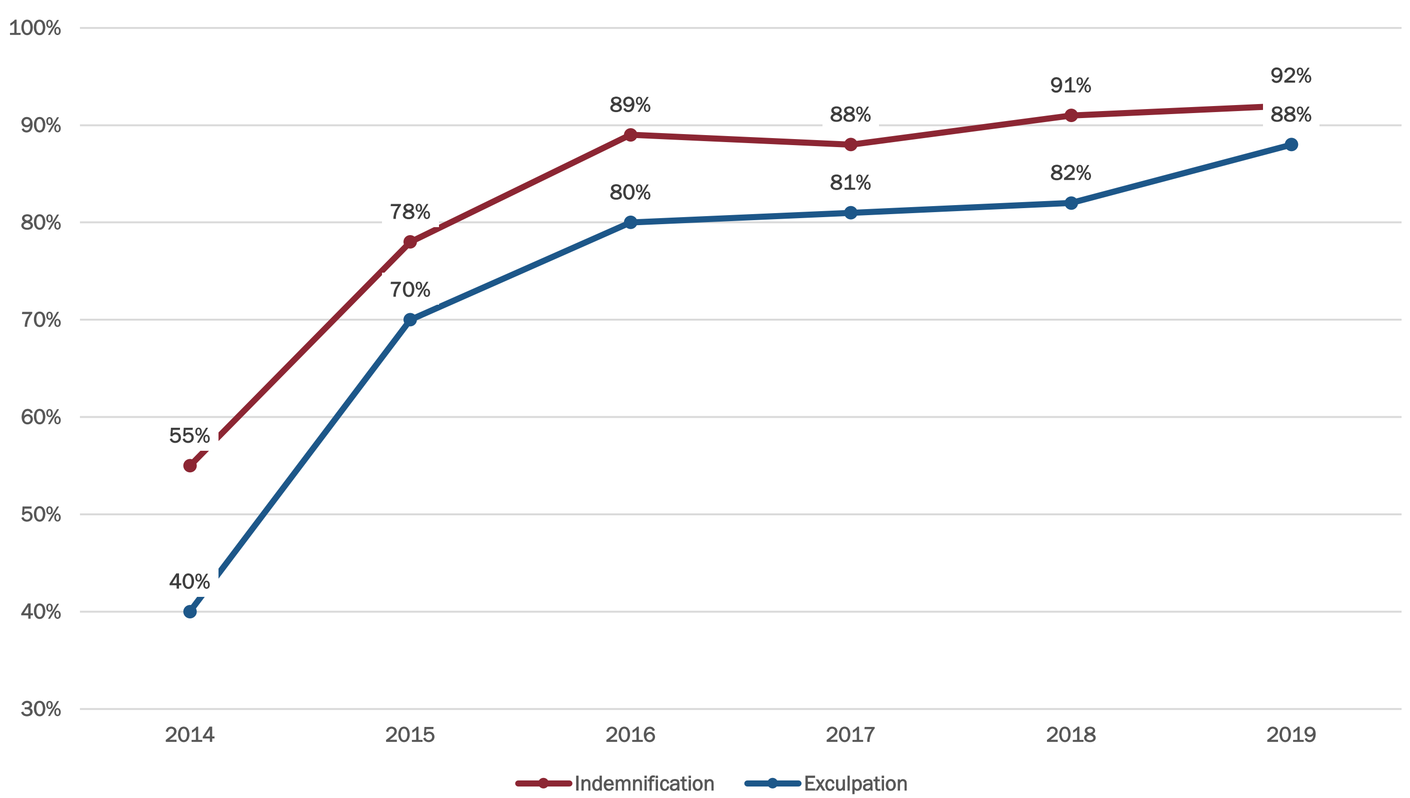
Indemnification and Exculpation

While a seed deal requires a willingness to expose a seeder's assets to the risks inherent in the underlying strategy (and with minimal liquidity) for a number of years, seeders traditionally are very concerned about non-investment risks such as being named in lawsuits from investors in a fund that they have seeded – particularly given that seeders tend to be viewed as "deep pockets" by litigious parties.

Accordingly, seeders typically require that they are explicitly exculpated (removed from liability) and indemnified (made whole for any damage sustained) by the *fund* to the same extent that the fund indemnifies the manager (e.g., including the seeder as an "indemnified party" under the fund documents). Further, seeders customarily are indemnified by the *manager* if the seeder is damaged in connection with the seed investment (other than for ordinary investment losses). Managers are often also required to indemnify the seeder for breaches of the seed agreement (and any representations and warranties in the seed agreement) or the manager's fraud, willful misconduct or gross negligence. Some seeders further require the *key person(s)* to indemnify seeder for such key persons' own bad acts – in these instances, an overall cap on the key person's liability may be included in the indemnity package.

Some seeders request that, in addition to being exculpated and indemnified by the fund to the same extent applicable to the manager, the *fund* additionally commit to indemnify the seeder for the managers bad actions (e.g., breaches of the seed agreement); however, such indemnification may create serious conflict of interest and fiduciary duty issues for the manager, and therefore such indemnification arrangements should be avoided at all costs. While specific exculpation and/or indemnification terms were relatively common in the beginning of our observation period, these terms have become nearly standard in all seed transactions.

Indemnification & Exculpation

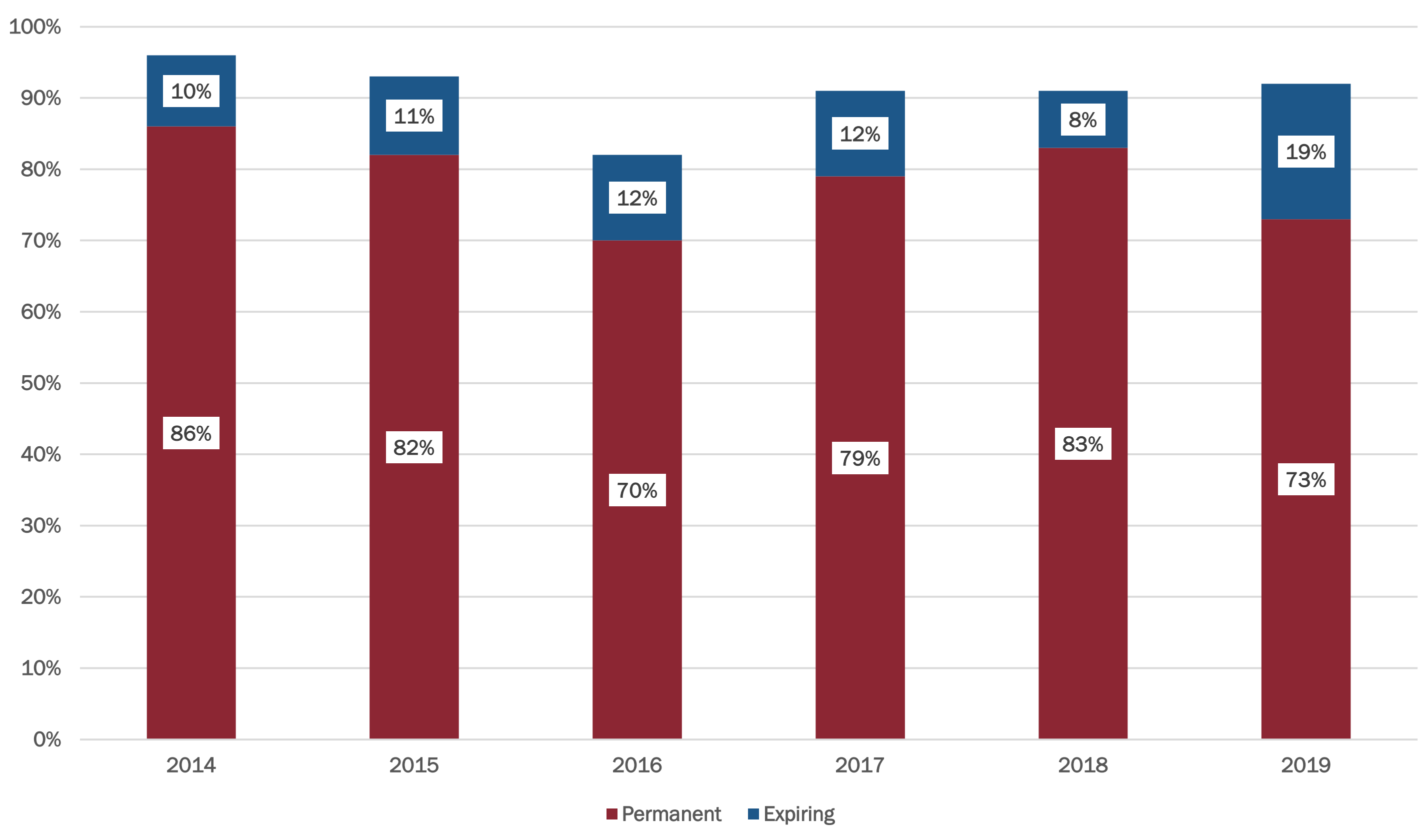


Consent Rights

Seeders typically require a variety of consent rights in connection with making a seed investment. At their core, these rights should ensure both that the seeder's economic interest cannot be adversely impacted by unilateral action of the manager and that the manager cannot change the fundamental terms of the fund in a manner adverse to the seeder (particularly during the lock-up period where the seeder is unable to "vote with its feet" on any changes). Many seeders - particularly institutional seeders - also ask for additional consent rights that relate to the operations of the manager's business (i.e., incurring indebtedness or launching new products). Seeders also typically request veto rights on certain issuances/sales of equity, both to ensure that the manager retains a minimum ownership of the business (and "skin in the game") and also to prevent the manager from selling a piece of itself to a strategic or financial buyer without the seeder having an opportunity to consent to (and participate in) the transaction. Our review of data through our observation period suggests that consent rights, as a general category, remain a foundational part of any seed deal (appearing to some degree in virtually all transactions reviewed), and further that the scope of these consent rights remained relatively broad.

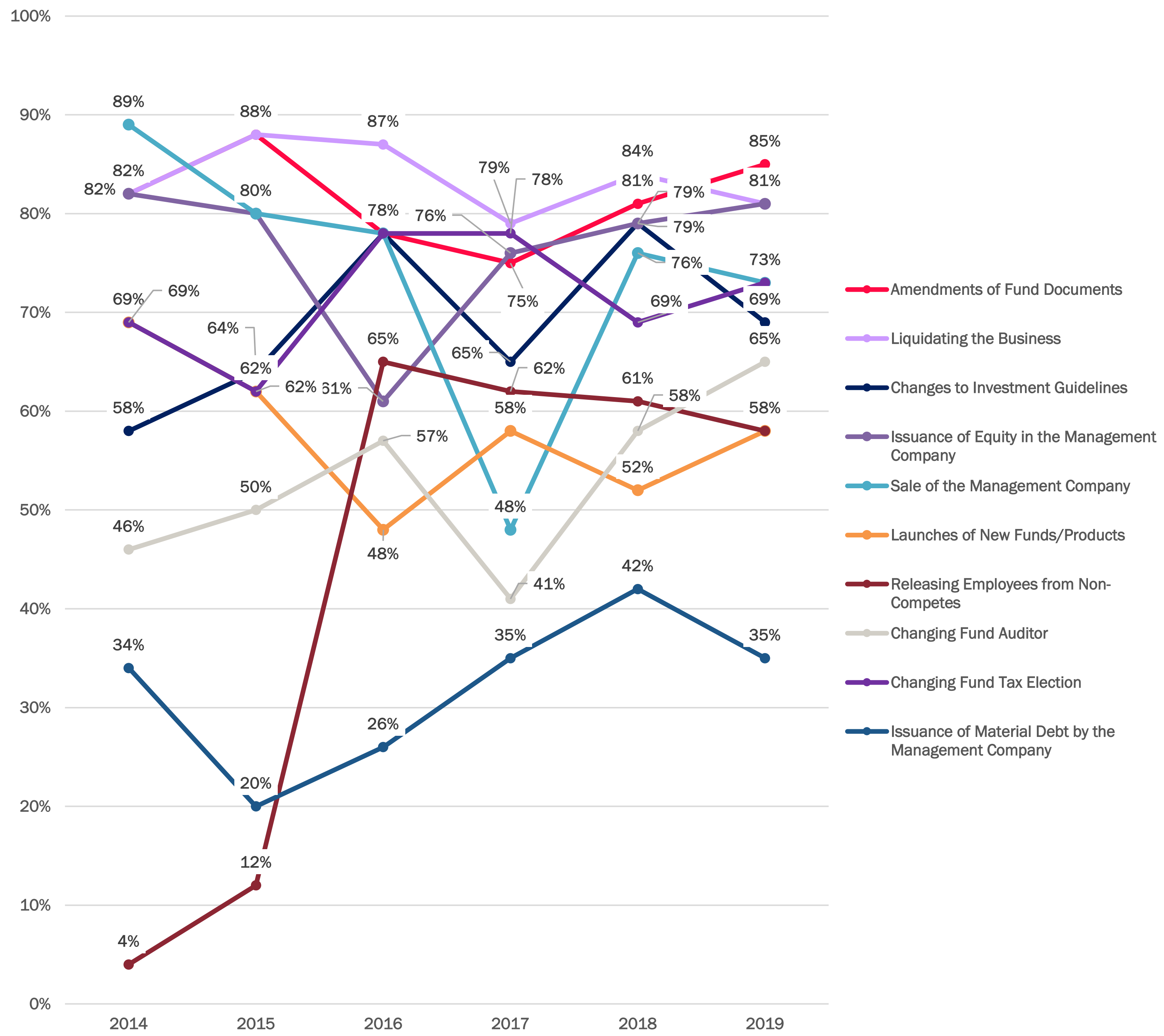
While consent rights are often perpetual throughout the seed relationship, these rights sometimes expire after a certain period of time or upon the occurrence of certain events (i.e., the end of the lock-up period or at the time the seeder's investment falls below a defined threshold amount). During our observation period, perhaps 10%-20% of seed deals with consent features had many of these consent rights subject to expiration. Where these rights did expire, it was increasingly common for this to be keyed to the expiration of the lock-up. *For more information, see our HFM Week article "Consent Rights in Seed Investment Transactions", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.*

Consent Rights



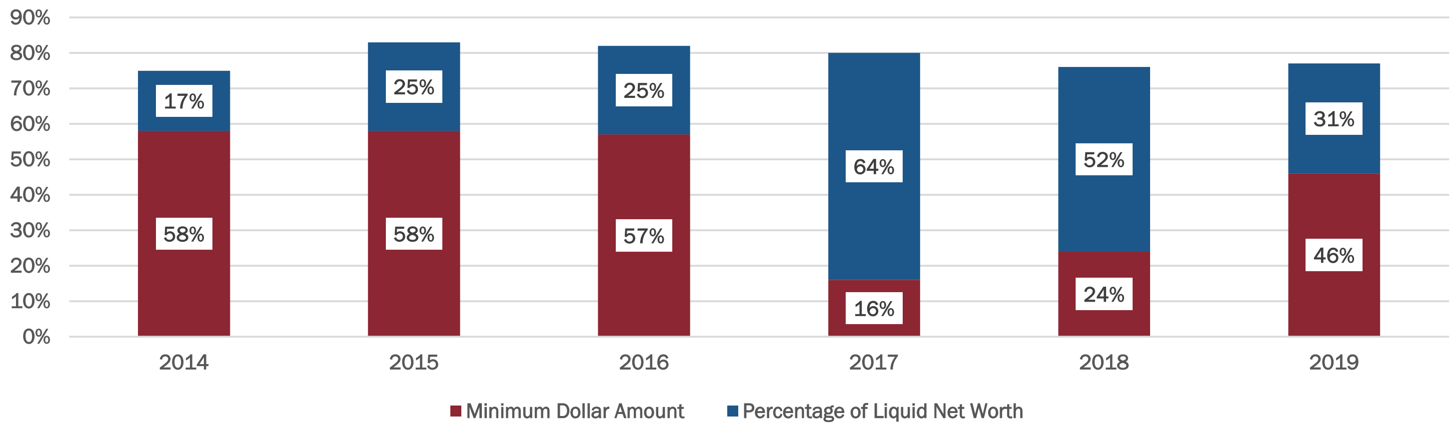
Consent Rights

Top 10 Consent Rights



Key Person Obligations

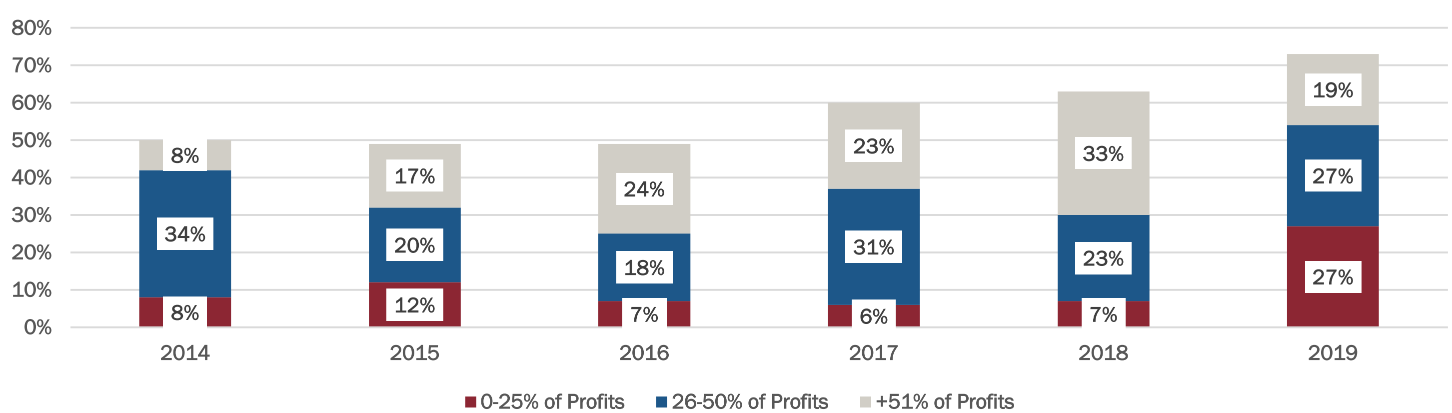
Key Person Investment Obligation



In addition to requiring that a manager retain a minimum amount of ownership and control of its business, seeders also require that the key person make and maintain significant investments in the fund, typically representing a significant portion of the key person's liquid net worth. As indicated above, this obligation may take the form of a specific dollar amount or a percentage of liquid net worth. Early in our observation period most seed deals required the manager to invest a set dollar amount – an approach that had faded in recent years in favor of a percentage of net worth, but that has reasserted itself as the preferred approach in our 2019 data set (in part due to the certainty provided to seeders and managers alike).

Further, seeders often require that the key person reinvest a percentage of its after-tax profits to ensure that, as the key person's net worth increases due to the success of the business, the key person's economic exposure to the fund remains a significant portion of their liquid net worth. These requirements often build in some tolerances to accommodate the expense burden of the manager's business, and therefore are often calculated net of ordinary business expenses (other than key person compensation). Minimum investment obligations remained a common part of seed agreements throughout the observation period; where featured, the most typical percentage was 51% or more of net profits, though as noted above this number generally takes into account expenses such that the effective percentage is often considerably lower.

Reinvestment Obligation



Using Seed Investments to Stabilize a Portfolio

Although traditionally a capital formation tool for launching new investment vehicles, or, in certain situations, more mature funds seeking to "accelerate" their fundraising using a seed investment as a catalyst, the recent market events surrounding the response to COVID have suggested other roles that seed investments can play in the life cycle of a fund. For example, in periods of significant market dislocation it is not unusual for smaller – but successful and established – managers to experience significant redemption requests as investors repurpose capital from their relatively liquid investments to support any impaired portions of their portfolios. This pattern has been observed over the years in sharp corrections and/or significant macroeconomic events.

In such circumstances, seeders are well positioned to make a "stabilizing" investment in the fund, such that the seed investment provides fresh and long-duration capital to (partially or fully) replace the assets being redeemed. If timed correctly, the influx of capital could avoid – or at least mitigate – any need by the fund to (i) quickly liquidate investments (often at artificially low prices) to raise cash and rebalance its portfolio in anticipation of funding redemptions, or otherwise (ii) gate – or even suspend – redemptions.

Because seeders are uniquely positioned to provide this sort of funding, it is expected that these investments would be structured similarly to conventional seed investments and on traditional seeding terms. From the seeder's perspective, such an investment has very compelling attributes, as the investment would be in support of an established business that already has an infrastructure and strong track record (all the more so if it held up well during the market upheaval) with a proven history of successful asset raising. These factors would imply for the seeder a considerable de-risking of the classic seed investment thesis where so much is unknown and unproven, in addition to the seeder having a "free look" at the portfolio of the fund before actually investing, thus allowing the seeder to further manage its exposure.

Accordingly, these investments represent a very compelling opportunity for seeders and managers alike across the entire investment cycle of the markets and the life of the funds.

For more information, see our HFM Week article "Using Seed Investments to Stabilize Mature Funds in Liquidity Crunches", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

Seed Investments in Private Equity / Private Credit Firms

While most seed investments involve managers focused on liquid strategies (e.g., hedge funds and liquid-credit focused products), each you we also see numerous seed investments in private equity or private credit funds.

GPs of these products are interested in obtaining a seed deal for largely the same reasons as hedge fund managers: a critical mass of AUM at launch (or first close) and the endorsement by a large allocator of the GP's strategy, track record, and team. However, because one of the core value propositions of a seed deal – the lock-up – is implicit in any closed end fund structure given the long-term, illiquid nature of these vehicles, many GPs will resist conventional seed deal terms. In addition, from a seeder's perspective, private equity and private credit vehicles have more complex economics (management fee stepdowns after the investment period, an often 5-10 year lag before the harvesting and sharing of profits, and the potential for clawbacks) and are not immediately scalable (vehicles close to new investors after 12 months or so and new vehicles with similar strategies often cannot be launched until a certain amount of the prior vehicle's assets have been deployed). Private equity GPs also often have leaner profit margins (at least until performance amounts are harvested), and therefore the seeder's economic rights are often weighted more heavily to long-term performance/incentive amounts.

However, a seed investment remains an attractive tool as a catalyst for creating an initial closing of the fund. Some structures can create near-term benefits for seeders and GPs alike, such as a seeder providing capital for a pre-launch warehoused investment that would ultimately be contributed to the fund as part of the seed investment – a good opportunity for a seeder to get to know the GP as they work together to close the investment in the target, the seeder getting a "free look" at an investment in the portfolio, and the warehoused investment being a nice story around which the GP could build its fundraising. Seed investments can also be used to finance part of the GP commitment to a fund, particularly where the seeder is able to be included as part of the GP group.

We have observed a clear uptick in 2019 in both seeders and private equity GPs considering seed investments, and expect activity in this area to grow in the foreseeable future.

For more information, see our Private Equity Law Report article "The New Trend in PE Fund Seed Investments, Unique Deal Features and Several Options for Seed Sources", or contact your primary attorney at Seward & Kissel or Gary Anderson at anderson@sewkis.com for a copy.

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