Aligning Seed Investor Liquidity Rights

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In any transaction involving a "seed investment" into a hedge fund, the investment will be subject to significant constraints on liquidity to provide the fund with a durable and stable capital base, promoting scale and liquidity support for the fund. To this end, seed investments are commonly subject to a lockup for two or more years, where the seeder's redemption rights during the lockup will be limited to a narrowly defined set of "black swan" type events.

Parties to a seeding transaction have two aspects of lockup liquidity to manage: (i) the liquidity of the seed investment during the lockup period in connection with a bad event, and (ii) the liquidity of the seed investment at the end of the lockup period.

From the perspective of other investors in the fund, the withdrawal terms applicable to the seed investment (during and after the lockup) should ideally be aligned with the liquidity profile of the fund's underlying investment portfolio, taking into account the size of the seed investment relative to the rest of the fund. Thus, the ideal structure of a seeder's liquidity rights would be a simple release from the lockup such that the seed investment rolls into the exact liquidity to which all other investors are subject. However, from the seeder's perspective, this approach could force it to be subject to additional harm following a negative event, and further there also may be features in the fund structure (e.g., lockups applicable to investors in a certain class, redemption gates, etc.) that would have the practical effect of extending the lockup.

Seeder redemption rights during the lockup period are highly negotiated and typically keyed to objective standards. Because a seeder's opportunity to exercise its redemption rights begins only after the trigger event occurs (unlike other investors who would be able to take protective action in anticipation of these events), seeders historically required that their redemption be in priority to all other investors, often on a very short timeframe. This preferential liquidity can become a point of concern for other investors in the fund who worry that the seeder's preferential liquidity can leave these other investors "holding the bag" while waiting for their turn in the redemption cycle (as preferential liquidity can force accelerated sales or unbalanced selling which impacts the overall composition of the portfolio, harming the overall assets of the fund).

To address these concerns, seeders have recently shown a willingness to structure special liquidity rights in a manner that more closely aligns their liquidity with the liquidity of other investors in the fund. The most common ways to achieve this are, in the event of a trigger event, the seeder would be permitted to redeem on the next redemption date (regardless of the fund's redemption notice period), or be redeemed at the end of the next calendar month following a minimum notice period (e.g., with a ten-day notice period, the maximum delay to the seeder is roughly 40 days). While not perfectly aligning seeder and other investor liquidity, these adjustments narrow considerably the historical liquidity variance and have generally been viewed favorably by other investors.

At the expiration of a lock-up, the principal concern of the seeder is whether there are standard terms of the fund that would effectively extend the seeder's lockup. For example, a 25% investor level gate would mean that, at the end of the lockup, a seeder would not be able to fully liquidate its investment for another 12 months – an effective one-year extension of the lockup period.

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To address this issue, seeders will often request some combination of receiving "credit for time served" (e.g., if the standard fund terms include a one-year lockup, a seeder's two-year lockup will be deemed to have satisfied this requirement) or a right to provide notice of a redemption long before the end of the lockup (with effectiveness at the expiration of the lockup), such that notice provided six months prior to the end of the lockup would allow the seeder to redeem its full seed investment notwithstanding a 50% investor level gate.

These approaches are both generally satisfactory from a manager's perspective, though where early notice is provided in a fund that has a gate, managers need to be comfortable that they will be able to achieve the required liquidity all at once at the end of the lockup, as neither the seeder nor the manager would desire an investment program which converts a portion of the seed investment each quarter into cash that would need to be held until the end of the lockup.

Better alignment between seeders and other investors in respect of liquidity is another example of seeders' efforts to structure its investment in a way that supports the overall growth of the manager's business. The benefit of this alignment can be expected to be realized in the manager's fund-raising efforts, thus making the overall relationship more attractive and rewarding to both the manager and the seeder.

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