Current Fund Terms for Small/Emerging Managers

By Christopher Riccardi, Partner, Seward & Kissel

The capital raising environment for small and emerging managers remains challenging. In order to compete with well-established managers with successful track records, small and emerging managers continue to offer special terms to incentivize investors to invest with them. Some of the more popular terms are:

- *Co-Investment Rights:* Investors are typically given a special right to invest in potential investment opportunities that can't be made within a manager's commingled fund, in situations where it is impractical to offer the opportunity to all investors.
- *Capacity Rights:* Investors are given the right to make additional investments in a manager's co-mingled fund (or in new products the manager may offer in the future), typically for a limited period of time.
- *Bespoke Separately Managed Accounts (SMAs):* Many institutional investors prefer investing in so-called "funds-of-one" or on a separately managed account basis vs. investing in a manager's commingled fund. Typically the separately managed account will trade side-by-side with a manager's commingled fund, although the investor may also impose its own portfolio parameters or risk guidelines based on its internal policies.
- *Aggregate Performance Compensation Across Products:* Managers are agreeing to aggregate the profits and losses of each fund and/or special purpose vehicle in which a particular investor is invested when calculating their performance compensation.
- *Tiered-Management Fees:* Managers may charge a management fee at different rates based on the assets under management (AUM) of a particular fund (e.g., a lower rate based on different levels of AUM), the AUM of the manager as a whole, and, for particular investors, based on the investors' AUM across all of the manager's products, which are then also tiered.
- *Founders Fees:* Investors are typically paying management fees and performance compensation at rates that are discounted 25% - 50% from the manager's standard fee schedule.
- *Hurdles and Multi-Year Performance Compensation:* Managers are more frequently agreeing to take their performance compensation on profits in excess of a hurdle return, and devising structures whereby the performance compensation is allocated over several years and not all paid in a single year.
- *Most Favored Nation Clauses:* It has become fairly standard for emerging managers to grant so-called most-favored nation rights to investors that would ensure the investors are always getting the "best deal" offered by the manager.
- *Gates:* While limitations on the right to make withdrawals from a hedge fund (sometimes referred to

as a "gate") are typically viewed as an impediment to raising capital, in certain strategies investors generally recognize the value of a fund having a gate. However, today those gates are overwhelmingly structured as investor-level gates vs. fund-level gates (this is generally preferred by sophisticated investors so that one panicky investor cannot cause a liquidity crisis for the fund and the remaining investors).

- *Carryover of High-Water Marks:* Managers who launch a new fund are typically incentivizing their existing investors to make an investment in the new fund, and if the investor is in a high-water mark situation (i.e., the investor has been allocated losses that have yet to be offset by subsequent profits), the manager typically will carryover the high-water mark to the new fund (which effectively serves as a "hurdle" in the new fund before the manager can earn its performance compensation).
- *Customer Loyalty Programs:* To incentivize investors to keep their investment with a manager, or to increase the size of their investment with a manager, many managers have been devising policies whereby certain long-time investors are granted various types of special rights if they remain invested with the manager (typically some combination of the terms described in this article).

These are just some of the terms that smaller or emerging managers are offering in order to raise capital. These terms (or some combination thereof) are frequently offered to most if not all investors, but it's also important to note that the vast majority of emerging managers that launch new funds with significant capital (e.g., in excess of $50M) typically have an "anchor" or "seed" investor who, in addition to most of these terms, is given an economic-sharing arrangement whereby the investor participates in the profits or gross revenues of the manager.

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