Pepper Hamilton LLP
Attorneys at Law

CLIENT ALERT

July 28, 2015

Trends for Early-Stage Investing in Emerging Managers

Irwin M. Latner | latneri@pepperlaw.com

The current environment for early-stage investing with emerging managers reflects an increasing number and variety of early-stage investments firms, an increasing pool of talented emerging managers, and a growing number and variety of investment structures and terms.

This article was published as a guest post on Hedge Connection on July 24, 2015. It is reprinted here with permission.

Ten years ago, "seeders" were few in number. Emerging hedge fund managers had few structural options and a limited group of institutional seeding firms to approach and with whom to negotiate. In the current market, however, surveys indicate that there is an increasing pool of talented emerging managers and an increasing number of new firms entering the early-stage investing arena, including funds of funds, dedicated seeding vehicles, endowments, foreign financial firms, family offices and even high-net-worth individuals.[1] Indeed, recent data indicates that, for the first time in years, capital flows to smaller funds are starting to exceed those to larger funds.[2] Though early-stage investing often refers to investing within the first six months after a fund's launch, many early-stage investors are willing to invest on day one, which is typically referred to as "seeding."

So we are clear, we are speaking of seed investment in the private fund that the emerging manager will manage, and not working capital seed investment in the manager itself. In that regard, all of the fiduciary and securities law protections associated with the management of "third party" money attach to the seed investments.

From the investor's perspective, there are a number of investment structures now available to invest with emerging managers on preferential economic terms, thereby taking advantage of the increased returns and alpha often associated with such managers. Though the traditional industry nomenclature of early-stage investing can sometimes be confusing and overlapping, most early-stage investment structures involve a variation of one or more of the following features: discounted management fees and performance fees/allocations; customized investment terms; revenue sharing; and/or joint venture or partnership arrangements.

From the manager's perspective, these new entrants to early-stage investing and broader structural options afford the manager with more flexibility in sourcing capital and growing the assets needed to build the requisite operational infrastructure to cope with an increased regulatory environment and the expanding due diligence requirements of pension plans, sovereign wealth funds and other larger institutional or later-stage investors.

Background and Increasing Pool of Emerging Managers

With the passage of the Dodd-Frank Act in 2010 and the subsequent adoption of enhanced Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission registration and reporting requirements, expanded regulatory examination efforts, new Foreign Account Tax Compliance Act regulations, and the implementation of the Alternative Investment Fund Managers Directive in Europe, among other things, the regulatory barriers to entry for new private fund managers have increased significantly. In addition, the Madoff fraud, together with the demise of Lehman Brothers and other notable asset management and brokerage firms, have ushered in a new era of investor due diligence. Many investors now perform extensive operational as well as investment due diligence on private fund managers, which often involves lengthy questionnaires, meetings, background investigations, compliance and risk management reviews, on-site visits and other transparency requests. Many managers need more resources and infrastructure and a larger asset base (and correspondingly higher management fee revenues) to operate effectively in this environment.

Despite these obstacles, there appears to be an increasing pool of emerging managers seeking to launch new hedge funds and managed account products employing a variety of equity, fixed-income and commodity-based strategies. Some of this influx may be attributable to the Volcker Rule, which required banks to close down their proprietary trading desks, resulting in the spin-out of many high-caliber traders. In addition, many quality portfolio managers are leaving larger asset management firms to launch their own firms due to a perceived lack of growth opportunities at their existing firms and/or an entrepreneurial desire to build their own firms.

Types of Early-Stage Investing

The industry nomenclature for early-stage investing typically refers to various structure types, such as seeding, anchor investing, incubation platforms, acceleration capital and founders' share classes; timing benchmarks, such as day-one seed investing versus post-launch acceleration capital; product benchmarks, such as managed account platforms versus commingled funds; and whether the revenue sharing is contractual or via an equity stake in the management company. While such descriptions may have been useful when the universe of early-stage investors was small, they may not be as useful nowadays to investors and managers looking to cut through the morass to develop an effective early-stage investing or capital-raising strategy that is mutually beneficial. A goal-oriented view of early-stage investing, however, may be a more rational and clearer way to understand the universe of possible early-stage investment structures.

Discounted Fees

Many investors, typically smaller investors, such as high-net-worth individuals and single family offices, are content to invest early with managers they believe in (and perform varying levels of due diligence on) in exchange for a lower management fee and/or a lower incentive fee, normally between 1 percent and 1.5 percent for the management fee and 10 percent and 15 percent for the incentive fee.[3] In the past, these arrangements were reflected in one-off side letter agreements. Now, these arrangements are typically reflected in founders' share classes, which are built into the fund's governing documents and provide for lower fee terms for all investors who come into the fund either before a certain date or before a certain asset threshold is reached. Indeed, recent surveys indicate that the majority of early-stage investors in funds invest through founders' share classes, which have been incorporated into the majority of new hedge fund launches.[4] In certain cases, the reduced fee terms of founders' shares may also be tied to longer lock-up periods.

Most of these investors are passive and do not have any control over or input into the management company. In fact, even modest control rights by an investor raise compliance and liability concerns. Initially, the manager must determine if the person exercising the rights needs to be listed on the manager's Form ADV regulatory filing with the SEC and/or registered with state securities authorities. Such status may also trigger increased disclosure in the fund's offering documents and potential liability concerns vis-à-vis other fund investors. Needless to say, most passive investors have no such interest in assuming these obligations and risks and, as a result, temper their demands for such control rights.

One drawback for managers of the discounted fee approach is that, despite the founders' economic incentive to invest early, the desired capital ramp-up may still take a substantial amount of time. Some managers may desire increased working capital for the management company at an earlier point in time in order to hire personnel and build infrastructure. To bridge this gap, some managers may entice some of these passive early investors to invest a small amount of working capital into the management company in return for a small equity stake, normally in the range of 1 percent to 10 percent (either in incentive fee revenues only or in both management and incentive fee revenues) for a working capital infusion, typically in the range of a few hundred thousand dollars to $1 million.

Customized Investment Terms

Certain strategic investors, most often family offices and endowments, but sometimes funds of funds and pensions as well, will seek to obtain a customized account or vehicle that is tailored to their institutional needs. For example, some of these investors seek a managed account or single investor fund relationship (*i.e.*, a "fund of one") in order to obtain a greater degree of transparency and control over their assets. A managed account arrangement may also be appropriate where the investor seeks to pursue a different strategy or variation of the strategy the manager utilizes to manage the commingled fund. Due to the added administrative and compliance costs on the manager side, a managed account arrangement will often be extended only to larger investors (but not necessarily limited to day-one or seed investors) and will typically involve larger account sizes. The larger the managed account investment, the more likely the manager is to grant fee concessions, especially on the management fee side as the compensatory nature of such fees (as opposed to their status as a profit center) tends to decline as the account size increases. A first loss platform (*i.e.*, where the manager co-invests with the platform provider to leverage its own capital and earn a higher incentive fee on the platform provider's capital) is another example of a customized managed account structure.

Certain strategic investors may be willing to invest in a commingled fund with the right strategy fit but may want to make the fund terms more aligned with their interests. For example, certain early-stage investors have requested a number of modifications to many of the traditional terms and provisions contained in a fund's governing documents, including, but not limited to, the following types of customized arrangements:

Lower management fees (or tiered management fee structures) to remove or reduce the profit component from management fee revenues. Some managers have agreed to forego an asset-based management fee altogether in favor of an expense reimbursement formula intended to reimburse the manager for its operating and overhead costs and other management company expenses, subject to an agreed-upon budget and/or expense cap.

Certain categories of expenses shifted to the manager. Many early-stage fund investors have requested that certain research, marketing, consulting, insurance, travel, regulatory and/or similar categories of noninvestment-related expenses or expenses not directly tied to the fund's activities be paid by the manager rather than the fund. This is consistent with trends we have seen in the private equity space as well.

Extended incentive fee measurement periods intended to address investor concerns that they might pay significant incentive fees for short-term returns that could be offset by losses in subsequent periods. Such structures often involve a rolling two-to-three-year measurement period (sometimes combined with a hurdle rate) with partial vesting and a performance clawback for unvested portions to account for subsequent losses over the extended measurement period. Similarly, certain managers have adopted back-ended incentive fee structures whereby a portion of the incentive fee (typically one-half or greater) is taken on redemption with performance measured from the date of investment through the date of redemption in order to create a more long-term alignment of interests with investors.

More negotiated limited partnership agreements, which may include, in addition to the above terms, more explicit time commitment undertakings from the principals, more extensive reporting to investors (including more detailed monthly and quarterly reports and notices of certain material events) and more limited manager indemnification rights. However, given the periodic liquidity offered by most open-end hedge funds, once the terms are set with the lead/founders investors, the terms tend to be set for all other investors in the fund.

Revenue-Sharing Arrangements

Certain early-stage investors will make a larger investment into a newly launched hedge fund in return for a percentage share of the manager's fee revenues (this can be structured as a gross or net revenue interest and may involve incentive fee revenues only or a combination of incentive and management fee revenues). Ticket sizes for these "seed capital" deals typically range from $50 million to $200 million for some of the larger fund launches and from $10 million to $50 million for some of the smaller deals.[5] The revenue-sharing percentage associated with such deals normally ranges from 10 percent to 30 percent and may be structured as either a contractual relationship or a direct equity interest in the management company.

Though revenue-sharing arrangements are frequently passive in nature with respect to the investor's involvement in day-to-day manager operations and investment decisions, an early-stage investor entering into such an arrangement in connection with a large early-stage or seed investment will typically demand a number of additional terms, including, but not limited to, some or all of the following: capacity rights for additional investment; veto rights over major fund management or operational decisions; enhanced reporting and liquidity terms; certain operating covenants and indemnities; restrictions on the manager's ability to retire or launch new products; and/or many of the customized investment terms described above.[6] As noted above, the more control exercised by the investor, the greater the risk of compliance entanglements for that investor.

In return for granting an investor a revenue share, a manager will often negotiate the above terms as well as other manager-friendly provisions, including lock-up periods (generally two–three years); sunset provisions (where the revenue-sharing interest gradually decreases to zero over time); buyout rights (where the manager has the option to buyout the investor's revenue-sharing interest, typically at a multiple of three percent to six percent of trailing net revenues); and/or working capital investments into the management company. Though not always a part of early-stage revenue-sharing investment structures, many investors will contribute ancillary services or support to the manager in order to facilitate building infrastructure and growing assets. Such services may include office space or other facilities, technology and/or distribution support, as well as compliance consulting and other advisory services intended to enhance the manager's operational infrastructure. Though the early-stage investing market has traditionally been a buyer's market, the increased number of early-stage investment firms currently willing to provide early-stage capital in return for a revenue share has bred competition, thereby enabling some elite managers to negotiate more favorable investment terms and larger ticket sizes.

Joint Venture and Partnership Arrangements

Some early-stage investors seek to partner with emerging managers to jointly launch a new fund or investment platform. Family offices and funds of funds, in particular, are increasingly willing to undertake such ventures. These joint venture arrangements often involve a partnership, whereby the investor firm receives a larger revenue share (normally around 50 percent) and provides the manager with most of the operations, technology and infrastructure support noted above. The investor may also seek to customize the fund terms along the lines noted above or otherwise to suit the firm's own investor base.

In addition to the higher revenue-sharing participation normally associated with a joint venture relationship (which is typically embodied in a negotiated operating agreement for a jointly owned management company), the key differences between a joint venture relationship and a revenue-sharing/seed relationship are control and branding. Though these differences may be one of degree, a manager normally enters into a joint venture with an early-stage investment partner in return for a broader package of operational and marketing support, which often includes branding the fund under the partner's name and access to the partner's network of investors and distribution capabilities. Whereas these relationships may or may not involve a committed amount of capital to be invested in the fund, they often focus on the joint management, infrastructure support and capital-raising features. Accordingly, the investor partner will typically demand a much greater degree of transparency and control alongside the manager than would be found in a typical revenue-sharing or seed investment transaction.

Takeaways

The current environment for early-stage investing with emerging managers reflects an increasing number and variety of early-stage investments firms, an increasing pool of talented emerging managers, and a growing number and variety of investment structures and terms available to accommodate early-stage investment relationships. To the extent that these trends result in the increased availability of strategic capital for emerging managers, they should foster the growth of dynamic new asset management firms that provide more diverse investment options for all types of investors and a welcome alternative to larger established asset managers.

Endnotes

1 *See* Deutsche Bank Global Prime Finance 13th Annual Alternative Investment Survey [DB Survey]; InfoVest 21 Special Research Report: The Outlook for Start-Up Hedge Funds Including Seeding and Platforms [Invest21 Report].

2 The Hedge Fund Law Report, *Report Offers Insights in Seeding Landscape, Available Talent, Seeding Terms and Players*, Vol. 8, No. 1, January 8, 2015.

3 *See* DB Survey, *supra*, note 1.

4 *See* DB Survey, *supra*, note 1.

5 *See* Invest21 Report, *supra*, note 1.

6 Some forms of revenue-sharing arrangements may take the form of a multimanager platform or incubation model, whereby the firm (typically a larger asset management firm itself) provides the manager with a complete investment and operational infrastructure, including the management vehicle and investment capital. The manager is thereby enabled to focus its attention on trading and typically is compensated based on a share of the fund's revenues attributable to the manager's trading (in essence, a reverse revenue-sharing relationship), though the manager is often relegated to employee status and can be terminated upon short notice.