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## Seeding Arrangements: Structure, Approach, and the Current Market

*By Ed Dartley*

Private fund growth has exploded over the last several years. While some areas are hotter than others, overall the industry has seen substantial growth. Existing managers have been able to launch larger funds and new managers have been able to successfully enter the market and launch first-time funds, using their reputation and track record from their former firms in order to attract capital.

So if the market demand is healthy, why need a seeder, and why has that segment of the industry experienced such popularity and growth in recent years? As will be discussed in this article, the right seeding arrangement can bring not only significant enhancement to assets under management, but also a competitive advantage in an increasingly crowded field. While there may be strong appetite for private funds, launching a fund in today's environment remains a challenging venture. Competition for investor dollars is higher than ever. SEC adviser registration, now five years old, brings with it added complexity.

A seeding arrangement can provide an array of advantages to a first-time manager, as well as a seasoned manager, seeking additional growth that may not be otherwise attainable on its own. A seed investor's capital can be critical for getting scale sufficient to execute the investment manager's strategy. In addition to seed capital for the manager's fund and for the operation of the business, some seed investors bring additional advantages by virtue of their expertise or

industry contacts. Some seed investors have experience in a particular sector or industry, and can bring operational experience to add to the manager's own expertise. Certain seed investors that are experienced in raising funds can provide a manager with marketing and strategic advice, as well as additional support services. Other seed investors may be well connected within certain investor circles, and can make introductions that can lead to additional early investors in the manager's fund. A seed investor may also be able to make introductions to key service providers for the fund, including administrators, legal counsel, accountants, and custodians.

Having a well-regarded institutional or other investor as a seed investor can also provide a significant benefit to first-time managers who lack experience running their own fund business. While a manager may have a prior track record at another asset manager, running a fund as the "manager" rather than as an "employee" brings different responsibilities. A seed investor's willingness to provide capital and support to a first-time manager can be seen as a significant vote of confidence in the manager's strategy and investing capabilities.

The world of seed investing is a broad and varied one, and this article does not seek to address all aspects. This article focuses on certain key elements of seeding arrangements for closed-end private funds in the current market.

## Seeding Arrangements—What Are They?

A seeding arrangement generally involves the provision of significant capital in one form or another to a private fund and/or to a manager by a third-party investor, in exchange for an interest in the fund being launched, certain other economic benefits such as a reduction in fees paid and sharing of a portion of the fees and carried interest earned by the private fund manager, and certain control and other rights. The specific goals of seed investors are similar but vary in the details and execution. The seed investor may be an experienced provider of capital that engages in seeding arrangements as part of an overall investment strategy. Other seed investors may be seeking to gain entry into a market or asset class in which the investor lacks experience. In those instances, the seeding arrangement can take on more of a joint venture structure. In other instances, the seed investor may itself be a fund manager that wants to provide its own investors with exposure to a specific asset class when that manager does not have relevant in-house experience.

While arrangements vary widely, there are certain hallmark features to most seeding deals. The seed investor invariably provides the fund manager with a significant commitment of capital to the fund, typically early in the fundraising process. In many instances, the amount of capital will be substantial, anywhere from 10 to 33 percent of the overall target fund size. In such instances, the seed investor's capital provides an "anchor" for the manager to complete an initial launch of the fund. The seed investor's capital, along with other investors' and the manager's commitment, become the initial commitments at closing.

### The Seed Capital for the Fund

One of the key features of a seeding arrangement is the provision of commitments to the manager's first fund at its initial closing. As a first-time manager, raising enough commitments to get to an initial closing is a gating item to launching a

new fund business. Over the last several years, competition for investor commitments has intensified because the private funds asset class continues to increase in popularity and new and existing managers continue to launch new funds. The challenges in attracting investing capital are further exacerbated by the increase in investor due diligence and demands for a manager to have sufficient infrastructure to make investors comfortable that operational and regulatory risks are minimized. In addition, institutional and other large investors often have minimum investment size thresholds that are too large for an investment in a smaller first-time fund, where their percentage of the overall commitments to the fund would be higher than is desirable.

Seeders, however, have expectations and investment objectives that take these considerations into account. For instance, seed investors in a first-time manager will make a sizeable commitment to the fund that provides a significant portion of the overall commitments needed to launch an initial closing. In more limited circumstances, a seeder may be willing to provide the entire commitment necessary for the manager to hold an initial closing, with the expectation that other investors will commit to the fund in subsequent closings. Sometimes the seed investor will bring in other anchor investors for the initial closing, with such additional investors also receiving some (but not all) of the same preferential terms as the seeder.

In other instances, the parties' expectation is that the fund will be established with the seeder's funds comprising the sole assets to be managed, and either the parties plan or expect that there will be no other investor commitments for that initial fund. Such funds, sometimes described as a "fund of one" or a "captive fund," allow the manager to fully focus on establishing the strategy and gain experience in running a fund, as well as establishing a track record with the seeder's capital that can be used to attract additional capital in the future. Where the seeding arrangement contemplates other investors joining

the fund, the seeder may provide introductions to other potential investors and may also provide marketing support and advice to the manager.

## Major Aspects of Seeding Deals

Seeding arrangements represent a significant investment by the seeder, and investing in a new and untested manager entails risks that are not present with more seasoned and established managers. In addition, seeders such as pension funds, private funds, and other types of institutional investors may have fiduciary and/or contractual obligations to their own constituents or beneficiaries. For these and other reasons, seeders seek a variety of economic and governance rights and protections that will enhance the chances for a successful investment in the fund, and address potential risks inherent in placing funds with a new manager.

## Economic Rights in Management Fees

Management fees are the key source of revenue for running the management company of an investment manager and are used to pay operating expenses and overhead, including salaries, rent, and other administrative expenses. For a first-time manager, this source of revenue is crucial for the operation of the enterprise.

In seeding arrangements, seed investors, in return for providing critical capital necessary to launch a fund, will typically receive a share of the management fee and other fees (such as monitoring fees, transaction fees, and directors fees) payable to the manager. This arrangement can be effectuated in several ways. In some instances, the seeder will have an ownership interest in the management company, which will include a direct interest in the management fee and other revenue of the management company, as well as an interest in a share of the proceeds of any sale of the enterprise. Alternatively, the seeder may obtain its interest in the economics of the management company contractually, through a revenue sharing agreement between the management company and the seeder to grant the seeder a share

of the management company revenues and proceeds of any future sale of the management company.

The determination of whether to structure the arrangement as an ownership interest or contractual interest is driven by a number of factors. Some seed investors may have concerns about acquiring ownership in a business that provides investment advice, has fiduciary responsibilities, and is subject to regulation by governmental authorities. As discussed further below, an ownership interest in an SEC-regulated investment manager can in some cases present challenges that some seeders would prefer to avoid. Some seed investors may also have concerns about acquiring a minority ownership interest that, even with appropriate governance rights, does not ultimately provide them with control over the entity and that would not provide them with top-line revenue participation (as opposed to receiving distributions after expenses and costs). These concerns can be addressed through the implementation of a revenue sharing agreement between the seeder and the management company. The revenue sharing agreement entitles the seed investor to a percentage of the management fee and other fees received by the manager, as well as proceeds from any future sale of the management company. The percentage can be permanent over the life of the fund, and of successor funds, or it can vary based upon any number of factors—for instance, based upon a period of years, the number of funds, the amount of commitments to future funds, the level of management fees collected by the manager, and other parameters.

There are a number of considerations for seeders and managers when entering into such arrangements. For instance, in cases where the governing documents of a private fund permit the general partner to offset management fees in lieu of making a capital contribution for one or more investments, the seeder may nevertheless require that this offset mechanism have no impact on its share of management fees under the revenue sharing agreement. Similarly, the seeder often will require that the right that a general partner may have to offset the cost of a placement agent through

a reduction in management fees not impact its percentage share in management fees. In addition, fund agreements typically provide that management fees are offset by a variety of other fees that the management company may charge to portfolio companies. In such instances, the revenue sharing agreement will provide that the seeder's rights to a percentage share of management fees is gross of any waivers or offsets allowed under the governing documents.

As noted above, the percentage revenue share of management fees granted to a seed investor is often payable on a gross basis, rather than net of most or all operating expenses of the management company. While the seeder's rights under the revenue sharing agreement may be gross of any amounts needed to run the management company, there will remain a strong interest on the part of the seeder to reasonably ensure that the manager will have cash flow sufficient to pay the seeder its percentage share. In order to address this concern (and, as discussed below, for additional reasons), the revenue sharing arrangement typically will include a number of restrictive provisions and seed investor consent rights on matters such as the amount of debt that may be incurred by the management company, threshold levels for any single expenditure, rights of the seed investor to approve the annual budget for the management company, and seed investor approval rights over certain hiring decisions by the management company, among others.

There are additional protections that are common to revenue sharing arrangements. The seeder typically will require that payment be made within a short number of days after management fee or other fee revenue is received by the management company. In addition, the manager may be required to set up an escrow account to which management fees and other fee income must be paid. The management company may also be asked to enter into a pledge arrangement with the seed investor, providing the seed investor with a security interest in the fee revenues of the management company as well as the proceeds of any disposition of the company.

As noted above, a seeder can also achieve its management company economics through holding a direct interest in the management company rather than through a revenue sharing agreement. This form of arrangement will involve many, if not all, of the same economic rights and control rights for the seeder, and these are incorporated into the governing documents of the management company. For instance, the seed investor's ownership interest will include rights to distributions made by the management company and the governing documents will impose obligations on the management company relating to the timing and priority of such distributions. The governing documents typically also include a series of rights and protections that the seed investor, individually or as a separate class of interests, will have concerning the operation of the management company. As noted above, a key difference with this arrangement is that it provides the seeder with profit participation in the management company rather than top-line revenue participation.

Regardless of whether the arrangement is contractual or through an ownership interest in the management company, the scope of the arrangement in seeding deals is typically broad. The seeder will obtain the right to a share of the management fees of not just the initial fund, but also management fees from any co-investment vehicles or other similar vehicles during the life of the fund, as well as fees payable to the management company or its affiliates by successor funds.

### **Economic Rights to Carried Interest**

Another key component of the economics of seeding deals is the entitlement to a share of the carried interest, or performance fees, earned by the manager. As with management fees, the structure for effectuating these arrangements can vary. Typically, the seeder will obtain the right to a share of the carried interest generated by the private fund through an ownership interest in the vehicle that receives, directly or indirectly, the carried interest from the fund. In some instances, the seed investor may hold

an ownership interest in the general partner of the fund, with a percentage interest in the distributions of carried interest, and in any sale proceeds in the event that the general partner were sold. In other cases, the seed investor participates in the carried interest economics through a “special limited partner” rather than through the general partner. As the name suggests, a special limited partner is a limited partner in the fund, with rights and obligations that are for the most part similar to those of other limited partners. The special limited partner structure has the advantage of being able to segregate the economics of the seed investor from that of the general partner. Because the general partner as an entity is under Delaware law (the overwhelmingly typical choice of jurisdiction for fund limited partnerships) subject to liability for the debts and obligations of the fund partnership, some seed investors prefer to segregate their economics away from the general partner, and will have no ownership interest in that entity.

A seed investor can also choose to receive its share of carried interest through a contractual arrangement rather than through an ownership interest in either the general partner or through a special limited partner. However, an advantage to receiving carried interest distributions through a special limited partner or general partner interest is that distributions received are treated tax favorably as capital gains rather than as ordinary income. By contrast, distributions received through a contractual arrangement would be treated as ordinary income and, therefore, subject to higher tax rates than if those distributions were treated as capital gains. As a third alternative, a seed investor may receive a share of carried interest through a reduction in the amount of carried interest they would otherwise have to pay by virtue of being a limited partner of the fund.

In addition to receiving economic interests in the management fees and carried interest distributions paid by other investors, seeding deals can also include the right to invest in the initial fund and subsequent funds without an obligation to pay management fees to the management company, or

carried interest on distributions to the fund, or alternatively, a reduction in management fees and/or carried interest paid. This right, among others, may be granted through a side letter agreement.

In certain seeding deals, provision of some funding for the manager’s business and operations is an important factor. While the manager will use management fees to pay operating expenses, this source of revenue may not be sufficient to adequately support the launch and initial growth of the business during the initial period of operation. Seeders sometimes will provide additional needed capital to fill that gap. If the seeder has an ownership interest in the management company, the capital can be provided to the manager in the form of a capital commitment to the manager. The manager has the ability to draw on the commitment and the capital will earn a preferred return for the seed investor. If the seed investor does not have an ownership interest in the management company, this funding can be structured as a loan to the management company by the seed investor.

## **Seed Investor Rights on Governance and Business Operations**

As discussed above, the risks involved in committing a substantial amount of capital to a first-time manager can be significant. Seed investors seek to reduce this risk through the acquisition of governance and control rights with respect to the manager’s business and the funds being launched. Seed investors typically have governance rights and control rights in the fund, the general partner, and the manager. At the fund level, this often will include the right to appoint one or more members to the limited partner advisory committee for the fund. Seed investors typically will obtain participation rights on the investment committee of the manager, often in the status of an observer, but sometimes as a voting member of that committee.

As the initial and most significant investor in a new fund, seeders have the ability to shape the terms of the limited partnership agreement and other

governing documents of the fund. While there is to some extent an alignment of interests with respect to the seed investor's interest in the general partner and the management company, seed investors balance that interest against the interest that they have as a limited partner in the initial fund of the manager. There are a number of important terms that seed investors will focus on and try to find the right balance. These include provisions addressing devotion of time and participation of key persons, the ability of the limited partners to remove the general partner both with and without cause, investment restrictions, and the term of the partnership and of the investment period, among others.

While setting the terms of the limited partnership agreement is an important component of a seeding deal, the seed investor and the manager will negotiate additional limited partner rights for the seeder through a side letter agreement. One important right that a seeder will usually receive as a limited partner includes a "most favored nations" provision ensuring that the seeder will get the benefit of any favorable side letter rights granted to other limited partners in future closings of the fund. While typical most favored nations clauses apply where the future investor is making the same or larger sized investment, for seed investors this provision sometimes is not dependent upon the size of future investors' commitments.

There are numerous other side letter provisions that seed investors typically receive, including enhanced reporting and information rights, co-investment opportunity rights, enhanced representations and warranties by the general partner and the fund, appointment rights to the limited partner advisory committee and investment committee, and more advantageous notice and cure rights in the event of a default. There are also certain rights that may be unique to the seed investor and, in those cases, a seed investor's side letter may also require that the general partner limit the ability of future investors to select certain rights granted to the seed investor. In those circumstances, both the seeder

and the manager must assess whether such limitations would create a barrier to bringing in other large investors.

At the level of the investment manager, seed investors will seek to obtain a wide range of rights, some of which may be affirmative rights to consent or approve key business and operational decisions, or may be in the form of negative control rights. For instance, seed investors have an interest in the stability of the manager and the corporate structure that is established at the time that the seeding venture is launched. Accordingly, a seed investor will look to secure rights that will establish the appropriate level of control over changes to the structure. These rights include approval rights over such matters as major corporate transactions of any entities, including restructurings, reorganizations, mergers, and acquisitions. There typically will also be restrictions on the ability to amend the governing documents of the general partner, the special limited partner, the management company, and other corporate entities without the consent of the seed investor.

Seeders also can have rights over significant matters that can impact the day-to-day operations of the business. These rights include the right to approve entering into any contract over a specified dollar amount, taking on debt, and hiring and firing decisions with respect to key personnel. In addition, seeders often will seek rights to approve the annual budget of the manager, as well as any deviations from that budget once approved. Often, the manager will be required to prepare a detailed line-item budget for approval by the seeder; departures over a certain threshold percentage will require the consent of the seed investor.

Given the increase in regulatory oversight and attention to regulatory and operational risk in recent years, a seed investor will also seek to have approval rights over major decisions that relate to risk-related matters for the firm. As an example, managers in seeding deals are often required to receive approval from the seed investor prior to making a change to

the auditor of the fund. The seed investor often will also have rights to approve significant changes to the manager's compliance program.

A seed investment represents a significant investment of capital in the management team personnel. Seed investors typically obtain rights that are designed to protect the personnel component of the seed investment. As noted above, seeding deals will often include approval rights for the seeder over changes in key personnel. In addition, seeders often will have rights over the admission of any additional members to the general partner or the manager. Since incentive compensation is an important component to attracting and keeping investment professional talent, seeders often will seek approval rights with respect to the amounts of carried interest that may be awarded to a particular individual.

There is also a strong interest in ensuring that the key management personnel that the seed investor has backed remain the decision makers for the management entities in which the seed investor has an interest. For this reason, seeders will seek to limit the ability of management team members who own interests in the general partner, the special limited partner, or the management company to transfer their interests to third parties. There may be some flexibility to allow for transfers for estate planning purposes and other types of family-related events that could lead to a transfer of interests, such as a death or a divorce.

## **Rights to Participate in Future Funds**

Part of the investment strategy of a seeder is the creation of a successful franchise and the seed investor will want to participate in the success of that franchise in the manager's future private funds following the initial fund. The seed investor will want to ensure that it has the ability to invest in any future funds that the manager launches on substantially the same terms as their investment in the first fund, or to obtain economic participation rights in such subsequent funds without the need to invest. Seed investors

will typically bargain for and receive the same economic deal for any funds formed by the manager up to a specified threshold of assets under management raised, for a specified period of years, or some combination of these parameters. In some instances, the seeder will be able to bargain for successor rights that continue in perpetuity, although this is less typical.

## **Regulatory Considerations**

In launching a new fund management firm, consideration must be given as to whether the manager will need to register with the Securities and Exchange Commission (SEC) as a registered investment adviser or as an exempt reporting adviser. While the full range of regulatory considerations is beyond the ambit of this article, a seed investor will have an obvious interest in seeking to ensure that the manager complies with applicable regulatory requirements. Accordingly, a manager that enters into a seeding arrangement should expect that the seed investor will pay close attention to both the SEC regulatory status and filings of the manager as well as the manager's compliance program and efforts to minimize regulatory and operational risk. In addition, the seeder and the manager will need to give consideration as to the seeder's role, ownership, and control rights.

## **And Last But Not Least, the Human Dimension to Seeding Arrangements**

While most of this article addresses the key features of seeding deals in today's market, perhaps one of the most important considerations is the human component and relationship factor to seeding deals. Launching or expanding a successful investment management business is an exciting and rewarding endeavor. For a manager, a seeding arrangement is not just an infusion of capital and support, but it is taking on a business partner that will ask for, and receive, significant influence over the manager's current and future business. For both a first-time and a seasoned manager, the perspective adjustment that is necessary can be

significant, in particular where the manager has in the past operated independently with no one to whom the manager needs to answer. By the same token, an experienced seed investor will be sensitive to the need to work with the manager to acclimate the manager to this new type of arrangement and become accustomed to the relative balance of power. The most successful seeding arrangements are those where all parties go in with eyes wide open, with an understanding of the current market with respect to seeding terms, and with the goal of partnering to create a successful fund management business for all constituents—the manager, the seed investor, and of course the investors.

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