

Hedge Fund Marketing: Pros, Cons and Structuring Agreements with Third-party Marketers

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As more hedge funds seek the services of third-party marketers to source investors, this article looks at how the agreement with the marketers should be structured and the critical issues which need to be addressed to lay the foundations for a successful partnership.

With the continued growth in demand for hedge funds, hedge fund marketing has evolved into an industry of its own. Third-party marketers (TPMs) — unaffiliated firms which enter into agreements with managers to find investors for their hedge funds — are increasingly offering more sophisticated and specialised marketing services as they face not only increasing demand for their services, but increasing competition from new firms as well as prime brokerage departments and internal marketing staffs. These services include working with managers on strategy and market positioning, developing market intelligence and identifying prospective investors, arranging meetings to pre-qualify prospective investors in terms of overall suitability, accompanying managers to investor presentations, preparation of marketing materials, follow up with prospective investors, and acting as client liaison throughout the investment period.

For these services a TPM will often demand an exclusive arrangement with the manager and approximately 20% of all fees. Why, therefore, would a manager be interested in engaging a TPM commanding high fees and demanding exclusivity, when the often gratuitous services of a prime broker are on offer, or they could hire internal marketing staff?

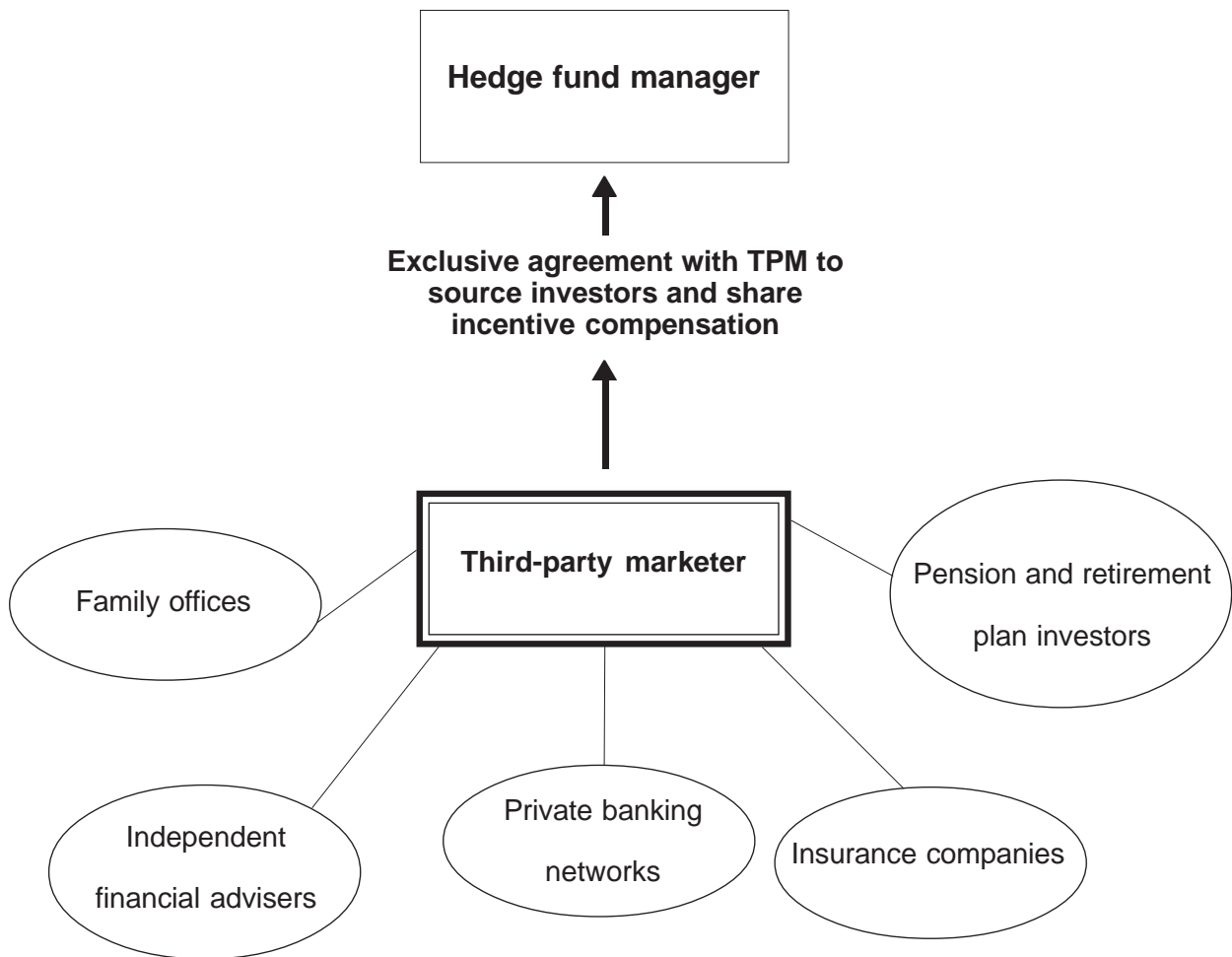
Well, there are a number of reasons why a TPM may be the right choice to market a manager's fund. First, the increasingly global nature of the hedge fund business may require a manager to hire a specialist to reach potential investors residing in countries around the world. Many hedge funds trading in the US markets may not be able to reach investors in Europe and Asia through an internal marketing staff or even through introductions provided by their prime broker. In these cases, a TPM which has an office or established relationships in Europe or Asia may be the best choice. Often, a TPM will have an understanding of investor needs in these continents as well and will be able to advise on structuring the fund to appeal to an investor's concerns in such areas as tax and reporting.

A TPM may also have a focus in particular fund strategies and therefore may more easily direct a fund to investors who it knows would have an interest in the particular strategy employed by the fund. A TPM will essentially act as an independent consultant to the manager and will provide a variety of services over and above what a prime broker may offer which may assist a manager in attracting investors. The TPM will regularly assess strategy, execution, risk management processes, reconciliation and reporting processes of the manager which in the end may help make the fund more attractive for investment.

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The TPM industry is still relatively concentrated. The number of dedicated firms consists of approximately three US-based and seven UK-based firms that have established themselves as a presence in the industry. The US-based marketing firms are Far Hills, based in New York, Coronado Investments in Boston and California, and Boomerang Capital Management, based in Connecticut, which has plans for a London expansion. UK-focused marketers include Altus Hedge Partners in the BVI and London, Dexion Capital plc, Hodges Associates, Liability Solutions, Nomos Capital, RAB Capital, and Strategic Capital Services Ltd, all in the UK.

Any and all of these firms will want to perform serious due diligence on a manager prior to taking the manager on as a client. Not only does this due diligence assist in developing the relationship between the TPM and the manager, but it is ultimately essential for the TPM in establishing and maintaining credibility with its investor clients. The firms all have different strengths and focus and the difference is probably most noticeable with the firms focused on UK, as opposed to US, investors. Investors in the UK, particularly institutional investors, are probably much more interested in investing opportunities with funds of funds and are less likely to be interested in single managers.



Likewise, each of these TPMs may have strengths in dealing with a certain investor base. Some have particularly strong relationships with the private banking network while others may prefer family offices or independent financial advisers. Still others have come from a background in the insurance industry and therefore may be most suitable for marketing products which would be attractive for investors seeking to invest in insurance-related products.

Structuring an Agreement with a TPM

If your fund is considering negotiating an agreement with a TPM there are a variety of issues to consider. First, among them, especially if the TPM intends to approach investors in the US, is whether the TPM is licensed as a broker dealer with the Securities and Exchange Commission, the National Association of Securities Dealers and the various states in which it intends to solicit investors. This issue arises since the TPM through its solicitation efforts and the fact that it is compensated by a share of fees derived from the investors, will be considered to have 'effected transactions in securities' which is the essence of broker-dealer activity. The definition of a broker-dealer will not usually encompass the internal marketing departments of the hedge funds themselves since they are usually able to take advantage of an issuer exemption as long as the employees are not separately compensated for their sales efforts.

Negotiating an agreement which carefully considers the duties and obligations for both the manager and the TPM is vitally important to a long-term successful relationship. The following are some of the issues to be considered.

Who is the manager?

The TPM will want to make sure that it really has an exclusive arrangement with the manager and that the agreement compensates the TPM with respect to any investment in which the TPM's investors participate with the manager, whether it is the intended hedge fund or a separately managed account. Therefore, the 'manager' should be defined to include affiliates which would include any person or entity managed or controlled, controlling or under common control with the manager or its principals. The proposed form of investment might be defined as a 'manager-related entity or account' which would include not only the proposed or existing fund, but any other entity

or form of investment which is directly or indirectly managed or controlled by, controlling or under common control with the manager.

Who is the investor?

The agreement with the TPM, since it is often mutually exclusive (ie, the manager cannot work with another TPM during the term and the TPM will not be able to market a fund within the same investment class) will seek to compensate the TPM for any investors entering the fund during the term of the agreement, whether or not they were introduced by the TPM. Thus 'investor' will often be defined as any investor, other than an excluded investor identified at the outset, who invests in any manager-related entity or account during the term of the agreement, and if introduced during the term by the TPM, for at least one year after the term. In this fashion the TPM will ensure it is compensated with respect to investors who may postpone their investment decision until after completion of the term for whatever reason, but subsequently invest in a manager-related entity or account.

What constitutes compensation subject to sharing between the manager and the TPM?

The TPM will want to ensure that it shares in any fees paid to the manager as a result of the performance of the investor's account. The compensation paid to the TPM may or may not include a share of the management fees and may or may not include retainer-based fees. Some TPMs do not charge retainers and do not seek to share in the management fees so it is all the more important to the TPM to ensure that all other compensation is shared. Thus 'incentive compensation' will be defined to include any fee or other allocation paid to the manager, based upon the performance of the investments made by the investor in a manager-related entity or account pursuant to an investment management agreement, subscription agreement or other similar arrangements. This way the TPM will be paid regardless of whether the investor places all of his money in the manager's fund or instead chooses to allocate some to a separately managed account. The typical arrangement is for the TPM to receive 20% of all fees received by the manager.

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Exclusivity

Exclusivity is usually a focus of both parties to the agreement. The TPM obviously would wish to have an exclusive relationship whereby the manager cannot engage any other individual or entity to perform the services during the term of the agreement. In consideration for receiving a promise of exclusivity the TPM will usually reciprocate with a promise of exclusivity in the strategy or asset class of the fund. There are also several other benefits to the manager in entering into an exclusive relationship with a TPM which may not be so apparent. It may be far preferable for the manager to refer investors' enquiries to one marketer rather than several. In this way, investors will be referred to one firm with an in-depth knowledge of the manager's business who has also been highly incentivised to promote the manager's fund.

Often the exclusivity provisions will be muted somewhat by a list of 'excluded accounts'. These may be pre-existing relationships, or investors which the manager already has in his fund, or serious prospects which have met with the manager and are contemplating an investment.

The TPM will usually attempt to negotiate an arrangement whereby it will continue to receive its participation in the incentive compensation post-termination so long as, and until, total withdrawal of the investor from any manager-related entity or account. Some agreements with marketers who are more in the nature of finders and do not provide all the services of a TPM may limit the incentive compensation to some period of time or attempt to scale it downwards the longer the investor remains in the fund.

The TPM will likewise participate in a share of compensation with respect to all future investments or additional increments of investments made by an investor in any manager-related entity or account either during the term of the agreement, or within five years, or some similar period thereafter.

Changes affecting the manager

The agreement will also address the issue of what happens in the event that the manager ceases operation or management or control of its fund or any manager-related entity or account or an investor subsequently invests in a new entity owned, controlled or managed by the manager. The agreement will typically provide therefore that if within

six months of the manager ceasing operation, management or control of the fund the investor transfers investments already made into a 'successor entity', that manager's obligations to pay the share of incentive compensation shall continue and survive termination of the agreement.

Manager services

The services which the manager will provide to the TPM also need to be appropriately defined. The TPM will be making necessary promises to the investors regarding the quality and frequency of reports which the investor will be receiving from the manager. It is therefore incumbent on the TPM to make sure in the agreement that the manager understands and agrees to furnish such reports and to thereby provide the transparency that is required in today's marketplace. The manager will usually represent that no less frequently than monthly it will provide status reports summarising the portfolio composition and recent performance of all manager-related entities or accounts. For the TPM's benefit, the manager will also be required to provide data on all contributions and withdrawals from such entities and/or accounts including all contributions and withdrawals by investors.

The manager should also be under an obligation to immediately notify the TPM of any change in circumstances or anticipated change which would materially affect the manager, its personnel or its activities. This provision is important since the TPM may be in the process of distributing offering documentation which could become materially misleading if not amended.

Termination

The term of a typical agreement between a manager and a TPM would be on average two to three years, but could of course be terminated earlier upon mutual consent or material breach. Such a term gives the TPM a long enough period to be able to work closely with the manager to formulate the marketing strategy and not be forced to rush the manager's product to market for fear that the TPM must successfully attract investment quickly prior to expiration of an otherwise too short term. Even after the expiration of the term, however, the TPM will be entitled to participate in the incentive compensation earned from the investors. The longer the term sought by the TPM, the more likely it is that the manager will seek to include a provision setting

forth some milestones in terms of investment dollars which the TPM must raise by certain intervals or face the possibility of an early termination by the manager.

Indemnification

The indemnification provisions will usually be similar to those seen in an underwriter's agreement. The manager will therefore indemnify and hold harmless the TPM from any breach by the manager of the agreement, any untrue statement of material fact or material omissions contained in any offering documentation or other written statements of the manager and any claims brought by investors which are subsequently determined against the manager.

The TPM will indemnify and hold harmless the manager from any losses arising out of any breach by the TPM of any provision of the agreement, any untrue statement of material fact made by the TPM and any claim brought by any investor which is subsequently determined against the TPM.

Books and records

The books and records provisions in the agreement are most important to ensure that the TPM has an opportunity to inspect the manager's records to determine if the TPM has received the proper percentage of the incentive compensation. The agreement will usually provide therefore that the manager is required to keep certain records for the term of the agreement and for up to five years thereafter covering all transactions relating to investment by investors and calculation and payment of all incentive compensation participation to the TPM.

For the TPM's benefit the agreement should contain a provision that during the term of the agreement and for five years thereafter, the TPM, either through itself or through authorised agents, shall have the right, upon ten days prior written notice to the manager, to examine such books and records and all documents and materials in the possession or under the control of the manager with respect to any manager-related entity or account. In this way, the TPM can obtain necessary accountability from the manager with respect to the TPM's participation in the incentive compensation.

Conclusion

Choosing the right TPM and structuring an agreement with the TPM are critical to the success of any manager who has made the decision to use a TPM. With the exclusive nature of the relationship and a significant share of the incentive compensation the TPM will be a major partner in the manager's business. Not only must the manager's fund match up well with the focus and talents of the TPM, but the chemistry between each entity's principals should be right as well since the relationship is going to be one requiring significant interaction between them. The TPM will be meeting with the manager during the due diligence phase and will be closely involved in discussing strategy, all marketing decisions, and attending investor presentations. The good news for managers is that with the importance of the role served by a TPM we will probably continue to see high quality individuals and firms enter the business and provide attractive choices and a more specialised focus to managers who are attempting to reach a targeted investor base.

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Mr. Zimmermann's practice is concentrated in the areas of investment management and regulatory proceedings. Stephanie Fisch, a summer associate with the firm, assisted in the preparation of this article.

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