# Creative Ways to Raise Capital

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# Creative Ways to Raise Capital

- Emerging Hedge Fund Managers and Registered Investment Advisers Face Significant Obstacles to Raising Capital, including the following issues:
  - Insufficient Track Record (time and performance)
  - Compliance Restrictions (i.e. cannot accept separately managed accounts, not SEC-registered, can only accept "qualified clients")
  - Low assets under management
  - Insufficient internal resources (operations, compliance, etc.)
  - Too risky for many institutional investors

# Creative Ways to Raise Capital

- As a result, emerging managers must be creative and flexible in their approaches to raising capital.
- May be required to call numerous audibles and pivot to satisfy demands of investors.
- Thus, it is highly recommended to keep initial company structure and fund structure as simple as possible.
- Simplicity provides managers with ability to pivot and accommodate demands of investors without incurring significant time, resources, and legal expenses.

# Creative Ways to Raise Capital

- Creative ways and structures have been implemented by many emerging managers to become more attractive to investors and inspire allocations.
- Most important concepts are simplicity and flexibility.  More complexity in entity structure and agreements make a manager's ability to pivot far more difficult.
- No guarantee that any particular method will work.  Thus, need to limited restrictions and obtain as much flexibility in any arrangement.

# Side Letters

- Side letter is an agreement between hedge fund manager that outlines different terms that apply to an investor’s investment in the fund.
- Fund documents must include provisions that allow a manager to enter into side letters.
- Investors typically ask for reduced fees, reduced lock-ups and greater liquidity, more transparency and most favored nation clause (MFN).

# Side Letters

- Some side letter provisions raise issues with SEC and state regulators.
- Ability to make additional investments, MFNs and any reduction in fees are generally not issues for regulators.
- Other terms such as preferred liquidity or more portfolio transparency create material conflicts of interest. Should generally avoid such arrangements or disclose such arrangements and relevant conflicts.
- Contrast to founders' shares.

# Founders’ Shares

- Founders’ shares are fund interests offered to investors with disclosed lower fees for either a certain period of time or until a particular amount of capital contributions have been made to the fund.
- Terms apply to investors for the entire investment in the fund.
- Manager needs to determine whether lower fees apply to additional capital contributions of investor outside of founders’ share period of time or asset period.

# 0 and 30 Funds

- 0 and 30 Fund is a fund that charges its investors no management fee but manager receives a performance fee/allocation of 30%.
- Some investors prefer this fee structure, only paying if a manager performs.
- Potential moral hazard with this fee structure.
- If registered with the SEC or a particular state regulator, need to make sure that any performance-based compensation is in compliance with state or federal law.

# Feeder Funds

- Feeder funds have 2 distinct meanings in hedge fund space:
- Could be an offshore fund taxed as a corporation into which U.S. tax-exempt investors concerned about unrelated business taxable income (“UBTI”) invest.
- Could also be an entity set up by a registered investment adviser or other investment adviser that is formed for the purpose of investing into a hedge fund.

# Feeder Funds

- Offshore feeder funds are typically set up in Cayman Islands or BVI. The fund becomes a member/limited partner of Delaware fund in mini-master feeder structure.
- Difference between mini-master feeder and master feeder structure.
- Many companies that are unaffiliated with managers have developed feeder fund products allowing investors to invest with managers with higher minimums.
- Potential broker-dealer registration issue.

# Seed Deals

- Seed deals are arrangements in which emerging managers sell equity in the general partner and/or investment manager of a fund in consideration for a fund investment.
- Difference between professional and non-professional seeders.
- Could be heavily-negotiated transaction as seeder typically want strong control rights.
- Seed deals can be structured as revenue shares as well.
- Be wary of seeders' marketing promises.

# Sub-Advisory Agreements

- A subadvisory agreement is an agreement in which a fund manager enters into an agreement with another unaffiliated manager to manage a portion of the fund's assets.
- Very popular in the registered fund world (mutual funds).
- Allows an emerging manager to gain assets but not have the operational costs of sponsoring a fund
- This structure also helps managers who are exempt reporting advisers or not registered.

# Separately Managed Accounts

- A separately managed account is typically a discretionary account managed by an investment adviser pursuant to an investment advisory agreement.
- SMAs have been much more popular among institutional investors who want full transparency, ownership of the account, greater liquidity rights and lower expenses.
- Exempt reporting advisers in many states cannot accept separately managed accounts without registering as an investment adviser.

# First Loss Programs

- First loss program is a program in which the capital provider generally allocates capital for manager to trade.
- Manager is required to contribute capital equal to a fixed percentage of the total amount of capital allocated by provider.
- Manager receives a higher than normal performance fee but manager’s capital sits in the first position with respect to losses.
- Any gains after losses are reallocated to manager until manager is back to even.

# Placement Agents and Solicitors

- What is a Placement Agent?
- Difference between Placement Agents and Solicitors
- FINRA Broker-Dealer Must be Paid Compensation based on Sale of Securities
- Employees who are Broker-Dealer Registered Representatives Must be Monitored
- Licensing Requirements (Series 7 and 63)
- www.finra.org
- Must amend Form D if paying broker-dealer

# QUESTIONS?

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- The gross amount of IBG’s portfolio of debt securities, with the exception of U.S. government securities, is less than 10% of our equity capital.
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