Key Considerations for Hedge Fund Managers Working with Outside Consultants (Part One of Two)

Hedge funds increasingly face headwinds in nearly all aspects of their operations—regulatory scrutiny, investment returns, shrinking profit margins, evolving business practices—but fundraising is perhaps the most challenging. With a growing chorus of institutional investors questioning the benefit of their existing hedge fund allocations, new investors, and the fresh capital they bring, are increasingly harder to come by. The difficult environment has also forced many hedge funds to evaluate fixed expenses and, where possible, employ a more flexible cost structure that bends more readily to changes in revenues.

One of the ways managers are adjusting to these challenges is by hiring outside sales consultants—oftentimes referred to as third party marketers, placement agents or finders—to help them raise assets. Whether targeting a specific market in which an in-house sales team has no experience or faces resource constraints, a start-up fund looking to focus on managing assets and outsourcing the sales function to established experts, or an effort to align costs more directly with fundraising, outside sales consultants can present hedge fund managers with more options to access capital than they would otherwise have.

But utilizing outside consultants is not without risks, in part because there exists a sometimes perplexing bevy of rules and regulations to navigate surrounding the use of outside sales consultants at the federal, state and even local levels when soliciting investment dollars. This article, the first in a two-part series, explores why managers hire third party marketers and outlines the regulatory requirements and prohibitions these firms are subject to and that fund managers must also comply with. The second article will discuss how hedge fund managers select the right third party marketer for their needs and the current market for key terms in engagement contracts.

Why do Hedge Fund Managers Hire Outside Sales Consultants?

Hedge fund managers, particularly start-up and smaller fund managers, rely on third party marketers because they may have deep investor contacts and credibility in a specific industry to assist in capital raising and gaining coveted introductions to key investors. The upfront financial and time considerations involved in hiring and training a full-time salesperson can be significant and add up to more than a start-up fund is prepared to bear initially. The flexibility afforded via the cost structure of a placement agent, and the ability to enter a market with an existing list of contacts, provide a viable and cost-effective alternative.

Established hedge fund managers with their own internal marketing teams increasingly hire third party marketers to expand their investor base and solicit investor types, such as state pension plans or insurance companies, with whom the internal marketers may not have been able to establish relationships, either due to resource issues such as time constraints, or general lack of knowledge concerning the investment parameters and needs of a particular investor set.

Ricardo Davidovich, a partner at Haynes and Boone, noted that, “There is probably renewed interest in the use of third party marketers now as assets are harder to raise. On the flip side, when assets are hard to raise, they’re hard to raise for everyone, including third party marketers.”
Added David Frank, CEO and Managing Partner at Stonehaven, “Anecdotally, we are seeing very strong demand for managers seeking placement agents. It’s becoming clear that even when managers have all the right elements in place, they still need to run a very highly choreographed, intensive and organized capital raising process to raise capital.”

Donald Steinbrugge, CEO and founder of Agecroft Partners explained further, “The market is extremely competitive. In order to raise assets, hedge funds have to have a very high quality product that ranks well across multiple factors. It’s not enough anymore to simply have good performance. You do have to have a good track record but you need to have more than that. Investors will look at the quality of the organization, the investment process, the risk controls, the service providers and the overall reputation of the manager. With all of the competition out there, hiring a third party marketer to tell your story to potential investors can help you reach out to more potential investors and articulate what your differential advantages are across the evaluation factors investors use.”

Third party marketers are not only hired to help a fund manager raise capital; they can also help hedge funds develop marketing materials and an investor database, provide some level of media or investor relations, help with requests for proposal responses and development, and assist in planning marketing events, noted Donna DiMaria, chairman of the Third Party Marketers Association.

Akin to third party marketers are so-called “finders,” who are mainly hired specifically to introduce hedge fund managers and potential investors. Federal securities law defines a finder as “someone who finds, interests, introduces and brings parties together for a business transaction that the parties themselves negotiate and consummate.” However

**Regulatory Considerations for Hiring Third Party Marketers**

As with nearly any activity a hedge fund is engaged in, there are regulatory considerations at various levels, and covering a variety of activities, to consider when working with a placement agent. Managers also need to be aware of what the third party marketers are communicating to the market, and who they are approaching, to avoid any violations of private placement regulations—in particular, Regulation D—because ultimately, the manager is responsible for the third party marketer’s actions and descriptions of it and its funds.

“You’re taking some amount of risk with third party marketers because they’re raising money outside of your control, and their incentive is to bring investors to you,” Davidovich cautioned. “You always have to be mindful of the things they are saying and doing on your behalf to raise that money.” Although managers can ask third parties for indemnifications for regulatory violations, they only help the manager monetarily, Davidovich explained, because managers cannot pass on to third parties their own regulatory obligations. Compliance is ultimately the manager’s responsibility. (Indemnifications will be discussed further in Part Two of this series.)

**Federal Pay-to-Play**

Federally, the most important regulation for third party marketers fundraising on behalf of hedge fund managers is the pay-to-play rule, codified in the Advisers Act, which generally prohibits hedge fund managers and other investment advisers from making “payments” to any person for soliciting advisory business from a government entity unless the person is either (1) a “regulated person,” or (2) an executive officer, general partner, managing member, a person with a status similar to any of the foregoing or an employee of the investment adviser. The rule defines “regulated person” as an investment adviser subject to the rule or a broker-dealer subject to a substantially similar rule issued by FINRA.

The pay-to-play rule impacts how third party marketers are compensated since transaction-based pay for soliciting government entities for investment is prohibited.

While the pay-to-play rules generally apply to hedge fund managers, Davidovich noted there is a secondary impact on third party marketers. “The Advisers Act’s pay-to-play rule governs conduct by advisers, [but] it brings in third party marketers indirectly. There is a provision stating that neither an
investment adviser nor any of its covered associates may provide or agree to provide, directly or indirectly, payment to any third party to solicit government clients for the adviser unless such person is a 'regulated person.' A regulated person includes registered broker-dealers. A third party marketer needs to be a registered broker-dealer.”

Broker-Dealer Registration and FINRA Licensing

According to DiMaria, third party marketers should be properly registered. “They need to be registered as broker-dealers or affiliated with a registered broker-dealer. They also have to be aware of the registration requirements in each state, because there are different rules depending on whether you’re marketing to institutional investors or high net worth clients as to what may trigger a third party marketer’s requirement to register.”

As a registered broker-dealer, third party marketers will be subject to FINRA’s regulatory authority. For example, FINRA Rule 03-07 requires five elements for due diligence on hedge funds, balanced disclosure and efforts to ensure that any promotional materials are consistent with disclosures in a private placement memorandum.

Of particular concern to marketers is FINRA Rule 2111, known as the Suitability Rule, which requires that a firm or associated person “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.”

Marketers should conduct due diligence to ascertain whether a particular product is right for a given investor relative to its investment profile, risk profile, and other asset and liquidity needs, and must also conduct a product suitability assessment to determine whether a particular fund is suitable as well.

Finder’s Exemption

Managers should be aware of FINRA obligations, despite the belief by some marketers that they are exempt from registration requirements due to certain exemptions. As Davidovich explained, “The law hasn’t changed, but the focus of the regulators has become more significant. If you hire someone to raise money for your fund, that party must be a registered broker-dealer. While many people refer to a ‘finder’s exemption,’ there are limited situations in which the exemption is applicable. There is a tremendous misunderstanding about how the exemption works.”

According to recent guidance, if an individual simply introduces investors to issuers without any further involvement in the discussions, and without giving advice on the investments’ structure or suitability, he or she can act as a finder and receive compensation for making the introductions, so long as the compensation is not tied to the success of capital raising (i.e. a commission).

In general, managers should exercise caution when using the services of finders because payment of success-based compensation is unlawful to unregistered individuals or entities acting as broker-dealers. Even absent payment of success-based compensation, paying finder’s fees to unregistered individuals is likely to raise compliance issues under both federal and state laws. Certain states prohibit the practice altogether, levying penalties and/or allowing the investor to rescind its investment in the event of a violation.

The SEC has also pursued several enforcement actions against firms for paying transaction-based fees to unregistered consultants. In its case against Ranieri Partners, for example, a sales consultant was found to have: (1) sent private placement memoranda, subscription documents and due diligence materials to potential investors; (2) urged at least one investor to consider adjusting its portfolio allocations to accommodate an investment with Ranieri Partners; (3) provided potential investors with his analysis of Ranieri Partners’ funds’ strategy and performance track record; and (4) provided potential investors with confidential information relating to the identity of other investors and their capital commitments. The SEC concluded that, “by these actions, [the consultant] engaged in the business of effecting transactions in
securities without first being registered as a broker or dealer or associated with a registered broker or dealer," and fined Ranieri Partners $375,000. [1]

Lobbying Regulations

According to Davidovich, California, New York, Kentucky and New Mexico have lobbying regulations that apply to third party marketers. "You have to be careful with the state lobbying laws because not only do they require third party marketers to register as lobbyists, but oftentimes, depending on the state, someone at the investment manager may have to register under those lobbying rules too because they retained the third party marketer or because they are meeting with the covered investor."

"Depending on state jurisdictions, third party marketers may be subject to lobbying rules," explained Andrew Saunders, senior managing director of Castle Hill Capital Partners. "So, you have to be aware of who the marketer is contacting and how they are compensated for any money they bring in from specific investors, namely public pension plans."

New York City’s and California’s lobbying regulations require placement agents and other third party marketers and in-house hedge fund marketers to register as lobbyists. "The lobbying laws that apply to third party marketers, like those in New York and California, are pretty restrictive, so it’s important to understand what is required and what are and are not acceptable activities," DiMaria said.

New York

Under NYC Administrative Code Title 3 §§ 3-211-233, third party marketers (including registered broker-dealers) who earn, receive or expend over $2,000 in compensation and expenses for lobbying in New York City must file a registration statement and periodic reports for each advisory firm that retains them. The Code also stipulates that advisory firms that pay more than $2,000 annually to third party marketers to solicit New York City pension funds must file periodic client reports. A client that lobbies on its own behalf is required to file the various reports required to be filed by lobbyists if it expends over $2,000 annually in reportable compensation and expenses for such activities.

The regulation is important for hedge fund managers since they can be both a client—of a third party marketer—and a lobbyist—stemming from their in-house marketing activities.

The Code also prohibits any compensation to third party marketers that is contingent or dependent, in whole or in part, on the lobbyist’s results in influencing any New York City legislative, executive or administrative action.

If a third party marketer or hedge fund manager is required to register as a lobbyist, the lobbyists and clients must keep, for at least five years, “detailed and exact” accounts of:

- All compensation of any amount or value of any kind;
- Names and addresses of every person paying or promising to pay compensation of $50 or more, and the date of such promises;
- All expenditures made by or on behalf of the client; and
- Names and addresses of every person to whom any expenditure of over $50 is made, and a receipt for each such expenditure.

The Code defines a lobbyist as "every person or organization retained, employed or designated by any client to engage in lobbying." Lobbying, in turn, includes any attempt to influence:

- Any determination made by an elected city official or an officer or employee of the city with respect to the procurement of goods, services or construction, including the preparation of contract specifications, or the solicitation, award or administration of a contract, or with respect to the solicitation, award or administration of a grant, loan, or agreement involving the disbursement of public monies; or
Penalties for violating the lobbying law provisions can be harsh, and include conviction of a Class A misdemeanor; a civil penalty of up to $30,000 to be assessed by the New York City Clerk; an order to cease all lobbying activities for up to 60 days, as determined by the New York City Clerk; or both a civil penalty and an order to cease lobbying activities. Failure to file a required report or the late filing of a required report may result in a Class A Misdemeanor and a civil penalty not to exceed $20,000.

California

California Assembly Bill No. 1743 (AB 1743) regulates lobbyists and their compensation, and expands the definition of a lobbyist to encompass “any individual who receives $2,000 or more in economic consideration in a calendar month, other than reimbursement for reasonable travel expenses, or whose principal duties as an employee are to communicate directly or through his or her agents with any elective state official, agency official, or legislative official for the purpose of influencing legislative or administrative action.” AB 1743 also defines “placement agent” as any person “hired, engaged, or retained by, or serving for the benefit of or on behalf of, an external manager, or on behalf of another placement agent, who acts or has acted for compensation as a finder, solicitor, marketer, consultant, broker, or other intermediary in connection with the offer or sale of the securities, assets, or services of an external manager to a state public retirement system in California or an investment vehicle, either directly or indirectly.”

Firms deemed to be lobbyists are required to register with the Secretary of State and file periodic disclosure reports disclosing campaign contributions, gifts and any payments of $100 or more to certain state candidates or elected officials. Lobbyists are prohibited from accepting or agreeing to accept any payment that is contingent upon the defeat, enactment or outcome of any proposed legislative or administrative action, so-called contingent compensation.

Any violations of the lobbying provisions can result in severe civil penalties or a misdemeanor conviction punishable by a fine up to $10,000 or three times the amount the lobbyist failed to report properly or unlawfully contributed or paid, whichever is greater. Any lobbyist convicted of a misdemeanor for violating California lobbying law is prohibited from acting as a lobbyist for four years following the date of conviction, although a court may reduce that prohibited period.

Other Regulatory Requirements

DiMaria said, “Certain public funds prohibit third party marketers from marketing to them. Others have a list of requirements, including disclosures, for the third party marketer and the manager to adhere to, so there may be some commitments by the manager to back-up the marketing efforts. It’s important to know what the requirements are, because any violation could cause the manager to have rescind the account. So hedge fund managers need to be aware of the regulatory environment that third party marketers operate in, and make sure that anyone they are hiring is aware of them as well.”

Some public pension plans that have an outright ban on placement agents include New York State’s Common Retirement Fund, the Virginia Retirement System, Teachers’ Retirement Systems of Georgia and Illinois and the New Mexico State Investment Council.

For those systems that place restrictions on the use of placement agents, detailed disclosures are typically required. For instance, the Teachers’ Retirement System of Louisiana [2] requires, among other itemized disclosures:

- The name of each placement agent, finder, or third-party intermediary hired or expected to be hired in connection with any fundraising activity related to the investment product. A detailed description of the services to be performed and specific details on how the external investment management firm/partnership was introduced to such person or entity should be included.
• Details on who will bear the cost of any compensation paid to any placement agent, finder, third-party intermediary or other individual or entity. To the extent the bearer of the cost is the external investment management firm/partnership, details explaining exactly how this cost is being borne.

• Details on the amount of compensation of any kind or value paid, or expected to be paid, to any placement agent, finder, third-party intermediary or other individual or entity for any services provided in respect of any client of either TRSL's Public Markets Consultant or Private Markets Manager. The timing of any compensation and the expected compensation should also be included.

• Certification by the external investment management firm/partnership that the investment product and its principals and affiliates are in compliance with all state and local laws and regulations related to the solicitation of, and investment by, governmental agencies and authorities, including but not limited to “pay-to-play” laws and regulations. Certification by the external investment management firm/partnership that the investment product and its principals and affiliates are in compliance with the State of Louisiana Code of Government Ethics.

• A statement whether any placement agent, finder, third-party intermediary or other individual or entity is registered with the SEC, FINRA or any similar regulatory agent in a country other than the United States, and the details of such registration or explanation of why such registration is not required. A statement whether any said placement agent, finder, third-party intermediary or other individual or entity is registered as a lobbyist with any state or national government.

Ensuring Compliance

In light of the various requirements set forth under federal, state and local laws, managers should ensure they fully understand their obligations at every level, that any third party marketers they engage are in compliance with applicable requirements and that internal firm policies and procedures are designed or amended to certify compliance with regulatory obligations. (Other factors included in a manager’s due diligence on a third party marketer will be discussed more fully in Part Two of this series.)

Managers should also obtain representations and warranties from third party marketers that assure they are in compliance with applicable laws and have secured proper licenses. Periodically performing searches in FINRA’s Broker Check database, the New York City Clerk’s office website and any other available database that reports lobbying registrations, enforcement actions and periodic filings can also substantiate that third party marketers contracted with advisers maintain their compliance with applicable laws.
Key Considerations for Hedge Fund Managers Working with Outside Consultants (Part Two of Two)

Fundraising continues to be one of the greatest challenges facing hedge fund managers today. Recent industry reports show that at least one in five North American-based institutional investors intend to decrease their allocations to hedge funds in the coming year, a rate which for the first time in 10 years outpaces more optimistic investors—by a factor of two. Competition for capital is fierce, and hedge fund managers whose core expertise is managing portfolios for investors, not necessarily fundraising, must find new ways to navigate the current environment and engage increasingly sophisticated, and ambivalent, investors. One solution hedge fund managers utilize for approaching and attracting new investors is retaining the services of outside sales consultants, or third party marketers.

Third party marketing firms, or TPMs, are typically seasoned investment marketing and sales experts who raise assets for hedge funds through their relationships within distribution channels, including institutional investors, broker-dealers, investment platforms, financial advisors and high net worth individuals. Retaining their services entails a variety of operational and contractual considerations, including due diligence, fees, indemnifications, representations and warranties, how to handle pre-existing relationships, and possibly coordination between the hedge fund manager’s in-house sales and marketing team and the TPM. This article, the second in a two-part series, explains appropriate due diligence hedge fund managers should conduct to choose the right TPM for their firm, standard fee levels and contract terms to include in engagement agreements, and considerations for terminating the outside sales consultant relationship if a marketing campaign is unsuccessful. The first article explored why managers hire outside sales consultants and detailed the regulatory requirements and prohibitions TPMs are subject to and that fund managers engaging them should know.

Evaluating Third Party Marketers and Conducting Due Diligence

When choosing a TPM, managers should conduct due diligence on the firm’s reputation in the industry and, in particular, evaluate: the backgrounds and reputations of the firm’s key professionals; whether the firm is properly registered or affiliated with a registered broker-dealer, and licensed under the relevant securities laws; and whether any complaints have been lodged against the TPM that could impact its effectiveness in the market.

According to Donna DiMaria, chairman of the Third Party Marketers Association, a manager should also assess its own needs and internal capabilities to find an outside sales consultant that is the right fit for their particular firm. “There is a lot that goes into a hedge fund manager searching for, and ultimately hiring, a third party marketer. Hedge fund managers have a responsibility to make sure they do proper due diligence on the third party marketer and make sure the firm is properly regulated. The manager also needs to make sure they get along culturally and that they can work with someone for a long period of time. Managers need to make sure they have a contract that explicitly states what is expected of both parties. That’s where we see a lot of relationships go awry, when both sides are not in tune with the services that each side is required to provide.”

Background, Experience, Registration and Licensure

David Frank, CEO and managing partner at Stonehaven advised, “Managers should understand the depth of a placement agent’s execution capabilities, including the pedigree of the team, their geographic coverage, their compliance history (including if they own their own broker-dealer or work on another broker-dealer), their technology backbone—which impacts many things including their reporting systems—the firm’s top successes and failures, and critically, their staying power (will they still be in business in three years?).”

Evaluating a TPM’s past successes includes review of former and current clients and the kind of assets the TPM has secured, said Tom Westle, a partner at Blank Rome. “You want to look at what success they have had, who they worked for, the kind of assets they’ve garnered for other clients. You want to know they’ve been successful and that they can do the things they say they will do.”
For his part, Andrew Saunders, senior managing director of Castle Hill Capital Partners said, managers should review the backgrounds of the key professionals who will represent the manager. “You should look at the marketing firm’s track record. You want to check their licenses. They should be registered with a broker-dealer and have a Series 7 and Series 63 license. You can then go on Broker Check and review their backgrounds. You also want to check investors’ and [other] managers’ references.”

DiMaria said a TPM’s industry reputation is key since it will represent the fund manager to the industry and potential investors. “You want to make sure you’re working with a reputable firm. They are going to be your face with new investors, so you want to make sure you’ve hired someone that not only knows the right investors in the industry, but also approaches these investors in a way that does not violate securities law and that the firm overall operates in an ethical and legally compliant manner.” Conferring with other hedge fund managers that have worked with a particular TPM is one of the most effective ways to determine whether the outside sales consultant’s reputation is among the strongest in the industry, added Donald Steinbrugge, CEO and founder of Agecroft Partners.

How successful a TPM has been can also depend on how success is defined, so hedge fund managers should also discuss marketing strategies with TPMs before retaining them and how their efforts on behalf of the manager will be evaluated. “Since so much is outside of a marketer’s control, I measure success by how many investors are coming into the manager’s office. If investors are meeting with the managers in their offices, then you’re making progress,” noted Andrew Saunders, senior managing director of Castle Hill Capital Partners.

Finally, due diligence and evaluation of whether a TPM is the right fit should include an agreed-upon estimate of how much time the firm will dedicate to its marketing efforts on behalf of the manager. “You want to look at how many managers they represent at a time,” Steinbrugge said. “Are other funds competing with you for the same investors with the third party marketers? A lot of the larger third party marketers will not represent more than one hedge fund per person on their marketing team. But if they’re taking on multiple managers at a time, and one or more of those managers are in competition with your firm, then you have to question their dedication to marketing on your behalf.”

**How Third Party Marketers Evaluate Fund Managers as Potential Clients**

Just as hedge fund managers conduct due diligence on TPMs, TPMs conduct due diligence on managers, in large part to assess whether they can be successful on behalf of a potential client. According to Saunders, “When you agree to start working with a manager client, you want to do a background check. We do it because it will help us determine if we will be successful. We want to know about things in a manager’s background that could hinder our success. You should review the PPM and DDQ and you should go on an office visit to confirm the marketability of the manager.”

Added DiMaria “We’re looking at the key professionals, who they are delegating the investment function to, who are members of the general partner. We’ll do background checks on all the key people and do criminal searches and look for anything in their past that could indicate something is amiss. We will also do entity searches to make sure everyone is registered in the right place and there are no regulatory issues with those entities or other bad actions that happened in the past. We do full reviews of the fund itself, the investment process, the offering, the terms, regulatory requirements and whether those obligations are being met.”

Steinbrugge advised managers to “approach a third party marketer like you would an allocator. You want to discuss your differential advantages to give them reasons why they should talk to you. Give them as much information as possible so they can properly evaluate you.”

**Standard Contractual Terms**

Although the terms of each engagement agreement between a hedge fund manager and a placement agent will be unique to the extent they depend on the manager’s investment strategy and size, the TPM’s expertise and network, and the type of investors and amount of capital sought, certain contractual terms appear in and are similar across all industry agreements.
“An agreement should protect both sides and align the interests of the two parties. At the end of the day, the last thing you want is for the hedge fund manager to say he or she doesn’t want to work with the third party marketer anymore and the marketer argues that the manager still has to pay the marketer, and a lawsuit or arbitration follows,” said DiMaria. “So you need a proper contract that explicitly lays out the term, any sunset provisions, and the compensation arrangement,” among other things.

Fees and Duration

TPMs are generally paid a percentage (typically 20%) of the assets invested in the hedge fund that stem from investor relationships the TPM brings to the manager. Many agreements stipulate that the TPM will be compensated for the life of a particular investor’s investment, but some provide that fees will be assessed for a discrete time period and may decline over time, a so-called “sunset provision.” According to Saunders, “Standard fee terms are for the third party marketer to get 20% of the fees collected from the investors they bring on, in perpetuity. Managers often push back on the duration and overall fee number, so sometimes there are sunset provisions or staggering fees. Sometimes there is an agreement for the marketer to get a percentage of fees on any follow-on money from the investor. These are generally deal terms that are a function of the marketability of the strategy, expected return and size of the capital raise.”

Steinbrugge noted that some TPMs also charge a placement fee, which could be as much as a two percent charge on assets placed. Frank added that his firm “charges a retainer as a draw against future commissions, and also is reimbursed for manager roadshows expenses.”

The length of the contract will vary depending on the hedge fund manager’s needs, but most agreements tend to last at least 12 months in order to give the TPM sufficient time to locate potential investors and close a deal. As DiMaria explained, “A lot of times people will want to see a short contract, but a short contract sometimes does not do enough to protect both sides.”

Added Saunders, “The duration of the contract really depends on the agreement with the manager. Generally, a marketer will start with some of their closest relationships to see if there is interest in a particular manager. What happens from there really depends on how marketable the fund is. Timing also depends on if the manager is targeting a hard close or a soft close, because then the marketer may only have a certain window in which to try to raise assets.”

Sunset Provisions

Sunset provisions provide that the fees paid to a TPM for introducing relationships that result in investments with the manager will decline over a period of time until they disappear entirely. Sunset provisions should be negotiated in advance, and are an effective way to account for investors introduced by the TPM who invest with the manager after the contract has lapsed or expired. “The sales process for hedge funds is long,” explained Steinbrugge. “You have to have many meetings with investors, so most third party marketing contracts will include a tail of one to two years where they may continue to call on people on their list and still get paid if the investors invest during that time period.”

According to DiMaria, “Sunset provisions are helpful because not all investors will come in before a contract ends or is terminated for some reason. If an investor comes in at a later day that falls within the terms of the agreement, you want to make sure the marketer is paid for that. Some provisions cover a year for that marketing momentum to continue. I think it’s important that contracts spell out what happens to compensation upon termination. You need to know if the payments continue to the third party marketer even though the services have ended.”

“You need to consider a provision that states how long the investment window for a pre-approved investor stays open post term. If a pre-approved investor invests in a fund six months after termination, does the third party marketer get paid?” Ricardo Davidovich, a partner at Haynes and Boone said. As for how long an appropriate sunset provision lasts, “It can be a year or two, but sometimes it’s up to five years,” Westle advised.
Indemnifications

Standard TPM agreements also provide for indemnifications between the manager and outside sales consultant in the event of contractual breach. Managers typically negotiate indemnification by the TPM for any losses arising out of any breach of any provision of the agreement or any untrue statement of material fact made by the marketer. Managers also negotiate indemnification related to damages stemming from any misrepresentations the TPM makes about having the appropriate licenses and registration in jurisdictions in which it operates.

Third party marketers, in turn, typically negotiate indemnification for losses arising from any breach of any provision of the agreement by the manager or for any untrue statement of material fact or material omissions contained in any offering documentation.

Davidovich explained, “From a legal perspective, there are a few of things we look for when we’re structuring an agreement: indemnifications, representations and warranties about what the third party marketer will and won’t do, that the marketer is properly licensed, and the structure of the agreement. We want to go to great lengths to make sure we’re indemnified for the actions of the third party marketer. It’s important to make sure the manager is protected.”

He added, “We caution our clients that indemnities are not cure-alls. There are lots of things an indemnity will protect you from, but if, for example, a third party marketer engages in activity that violates your Reg D private placement, an indemnity won’t help you with respect to non-monetary penalties.”

Representations and Warranties

While not strictly required, industry best practices advise that third party marketers make standard representations with respect to their current and ongoing registration status and/or licensing in other jurisdictions.

DiMaria said not all agreements will include representations regarding registration status, although that is something more managers ask for, likely because of the enhanced scrutiny on their own registration status. Managers also may ask for representations with respect to compliance with various laws to which TPMs are subject, such as pay-to-play and lobbying laws.

Exclusivity

Mutual exclusivity is a contract term often negotiated between the TPM and manager because how many other clients the TPM works with will affect how much time it has to market on behalf of the manager and whether it’s marketing competing funds to the same pool of potential investors. Accordingly, most larger TPMs do not represent more than one client per person on their marketing team. Likewise, TPMs may negotiate exclusivity so that they are not competing against other marketers when shopping the firm to investors.

“As a third party marketer, you want exclusivity because of the experience and investment opportunities you bring to the market,” DiMaria explained. “You don’t want your efforts hindered by a competing marketing firm. Managers want exclusivity because they don’t want their third party marketer shopping their fund and three other funds just like theirs.”

DiMaria added that when a manager has engaged multiple TPMs, it’s often to approach different jurisdictions or investor types.

Pre-Existing Relationships with Potential Investors

Although managers almost always retain TPMs to find new and non-specific investors, under certain circumstances a manager will engage a TPM to close a deal with an investor the manager has a pre-existing relationship with or a specific potential investor the manager has already been introduced to. “If a hedge fund doesn’t see any momentum at all with a particular investor, they may just give that investor to the marketer,” Steinbrugge said.
For hedge fund managers that have an internal marketing team or who have retained multiple TPMs, it is important to have a list of contacts that each team will be reaching out to in order to prevent arguments or conflicts over who gets paid for which investors ultimately invest.

Westle said creating a call list could help clear up any confusion of who contacted a particular investor. “You want a report showing that marketers are getting paid on the right assets over the right period of time. You need a list of investors so you can cross-reference that and make sure the marketer is paid what is owed.”

Having a call list or a list carving out investors the manager has a pre-existing relationship with who should not be approached can also prevent disputes with any internal marketing personnel who may also have approached a particular investor about allocating to the fund, DiMaria said. “The relationship with the in-house marketing team really depends on the firm, the agreement with the third party marketer and the services to be provided. It’s not unusual to see internal sales and marketing teams co-exist with a third party marketer where they are covering different channels. For example, one may be covering [public pension plans] and the other is targeting [family offices]. Regardless of what channels are being covered, an agreement needs to explicitly spell out who is covering what. In today’s market environment there is a lot of gray space, and there is a lot of opportunity for a good intent to get lost, so the contract needs to be explicit as to what the different types of investors are and which ones are included in the different types.”

Added Davidovich, “Often, the most common source of tension between a hedge fund manager and the third party marketer they hired is about whether the marketer is entitled to payment for a particular investor and, if so, for how long. You need to think about that when drafting your agreements with a third party marketer. With this in mind, you should build into your contracts a pre-approval so that before a third party marketer can approach anyone, they have to come back to the manager and let them know who they plan to reach out to. This gives the manager the chance to see if they have a relationship with the investor the third party marketer wants to approach and to see if any other third party marketers have already reached out to this particular investor.”

He continued, “Even if a manager approves a third party marketer to approach certain investors, there should be a time limit on that marketer’s ability to approach that investor. If they can’t bring the investor in within a certain period of time, they lose the rights to that investor and someone else—whether another third party marketer or someone internally— can approach the investor.”

**What Happens if the Marketing Campaign Fails?**

A hedge fund manager may hire a TPM with the goal of bringing in certain types of investors or to raise a certain amount of capital, but given the current competitive fundraising climate, it is conceivable that a TPM may be unsuccessful in procuring new capital.

According to Saunders, “Very often, a marketing plan will not meet expectations because of the competition for capital. Because of this, there will be a provision within the contract that the agreement can be canceled with a certain amount of notice by either party. In the event that the agreement is canceled, generally the marketer is protected on their investor names for a period of time, maybe a year or two years. So if the agreement is canceled but one of the marketer’s introduced investors ultimately makes an allocation to the manager, the marketer will still get paid for that introduction.”

Both managers and TPMs should consider the terms of termination provisions and what happens if a capital-raising campaign is unsuccessful, advised Davidovich. “Because there is the potential for the marketing effort to not be successful, we advise managers to focus on the termination provisions of these agreements. You want to build in termination rights, perhaps tied to milestones or a general deadline. The longer you keep a relationship in place, the more names the marketer can add to the list, and there is a greater likelihood of problems down the road if the investor does invest.”