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ADVANCED TOPICS IN  
**HEDGE FUND PRACTICES**  
**CONFERENCE**

Manager and Investor Perspectives

**WEBINAR SERIES**

**SESSION 8** | Thursday, June 4

**Succession Planning**

**Hot Topics for Quant Managers**

**Issues to Consider in Structuring and Making Co-investments**

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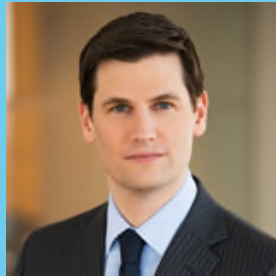
# SUCCESSION PLANNING

## SPEAKERS



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# Introduction

- The franchise value of an asset or wealth manager can be protected and enhanced through a series of steps taken to “institutionalize” its business
- An institutionalized firm is more sustainable with greater projected longevity, which helps founders and next-generation partners by enhancing:
  - Valuation of the firm by outside investors or acquirers through improved long-term financial projections and reduced discount rate
  - “Tail” value following a partner’s departure from the business
  - A lasting independent legacy for the founders

# Overview



**Institutionalized boutique investment managers have many of the following attributes in common:**

- Multiple generations of talent with succession planning
- Governance structures designed to endure beyond the founders
- Broad equity ownership with aligning terms
- Service-related commitments from partners and key professionals
- Complimentary product mix and distribution channels
- Optimized middle- and back-office functions
- Independent Directors or Advisory Board members
- Credible/branded outside vendors and investors

# Multiple Generations of Talent with Succession Planning



Succession planning at any boutique firm is an ongoing process that begins at the hiring stage and continues through ongoing training, annual reviews, and promotions of next-generation leadership



Aligning equity terms helps facilitate transparency and cooperation among founders and next-generation professionals in planning succession



Once anticipated career horizons are known for senior professionals, the resulting time “runways” can be used to identify, cultivate, and elevate successors and effect messaging and the transition of key relationships

# Governance Designed to Endure Beyond the Founders

- Formation of operating and investment committees can provide valuable forums for next-generation participation and grooming for leadership
- Establishing firm leadership succession well in advance of anticipated founder departures helps ensure adequate runway for communications with clients and employees, and the transition of management functions and relationships
- Restructuring founder equity arrangements and creating distinctions between “founder equity” and “sweat equity” can often improve alignment around the timing and sequencing of next-generation management transitions



# “Trading” Equity Ownership for Service-Related Commitments

- Elevating key individuals to partnership presents a unique opportunity to change their mindsets from those of employees to those of owners while also receiving back service-related commitments that protect franchise value
- By equitizing next-generation professionals, it is often possible to recapture EBITDA by converting a portion of annual cash compensation into “below-the-line” equity distributions that also participate in the firm’s terminal value
- Professional partners have a greater tendency to remain with a firm through tough times and to take longer-term views on operations and strategy



# Service-Related Commitments

- When spreading equity ownership to key next-generation professionals, it is important to receive from them individual service-related commitments to the firm, including:
  - Operating commitments
  - Departure and transition commitments
  - Restrictive covenants
- It is typically easier to obtain these types of service-related commitments from next-generation professionals if a firm's founders simultaneously make the same franchise-protective commitments to the firm
- Once all key professionals are properly equitized and integrated into governance, and have "locked arms" through service-related commitments, the firm is institutionalized from an ownership, structure, and governance perspective





# HOT TOPICS FOR QUANT MANAGERS

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# The Future of Quantitative Investing



- Quantitative approaches—meaning those grounded in advanced data science and systematic techniques—will play a growing role in private market investing.
- As more financial services firms embrace artificial intelligence techniques like machine learning, it will become apparent that human talent and effective teaming are key to unlocking their promise.
- Systems talent and a systematic approach will be required to develop the complex infrastructure that enables data aggregation, analysis, and computation reliably and at scale.
- Investors' desire to incorporate ESG will be served well by systematic approaches.
- Will systematic bond strategies overtake the Bond Kings?

# Use of Alternative Data & Alternative Data Set Attributes

Asset Class	Investment Style	Alpha (Net of Cost)	Known	Stage of Processing	Quality	Technical Aspects
Equity	Macro	Viable Stand-alone	Public Free of Cost	Raw	History	Frequency
Commodity	Sector Specific	Viable in a Portfolio	Well Known	Semi-Processed	Outliers	Latency
Credit	Stock Specific	Not Viable	Lesser Known	Processed	Missing Values	Format
Rates	Risk Indicator	Capacity	Proprietary Not Known	Trading Signal	Methodology Transparency	Robust API
FX	Quant Signal	Orthogonality	Limited Sales Deals	Research Piece or Alert	Support Structure	Conflicts and Legal Risk



# Immigration – Issues in Securing Talent



- Those with the most desirable educational backgrounds to fill quantitative analyst and data scientist roles are often foreign nationals who require sponsorship to work in the United States.
- The work-authorized sponsorship category most widely used by fund managers for foreign nationals applying for quant and data scientist roles is the H-1B.
- Recent announcements from the US Chamber of Commerce have indicated that the White House will be looking at proposals to institute a complete ban on the H2B, H1B and L1 programs.
- In the past, firms have been able to sponsor foreign nationals for H-1B status without significant trouble.
  - Recently, however, 60 percent of H-1B cases are being questioned and subjected to lengthy requests by the U.S. Citizenship and Immigration Services (USCIS)—and one-third of all H-1B cases are ultimately denied.
- Specialty Occupation Requirement & Evidence of Specialized Knowledge

# Model Integrity

- **“Quantamentals”**
  - Trying to help advisers understand when they have a quant strategy; it is becoming harder to determine when you have a quant strategy and when you don’t
- **Convergence**
- **Model integrity under stressed market conditions**



# Quantative Model Integrity



## Policies and Procedures

- Identification and mitigation of model risks

## Disclosure

- Accurate description of model and associated risks

## Model Errors

- Preventing errors
- Implementation of reporting infrastructure
- Error disclosure
- Self-reporting

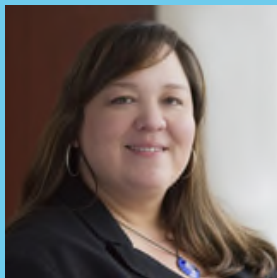
# ISSUES TO CONSIDER IN STRUCTURING AND MAKING CO-INVESTMENTS

## SPEAKERS



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# What is a Co-Investment?

## What is a co-investment?

- A minority equity investment in a portfolio company made directly by a private fund investor together with, but not through, the private equity fund
- The investment is often in addition to the investment in the private equity fund sponsor.

## Why do investors like co-investment transactions?

- Reduced or eliminated fees on co-investments
- Ability to select investments
- Increased exposure to certain investments
- Higher and quicker returns on investments
- Investor access to restricted opportunities
- Better understanding of sponsor's deal process



# Co-Investment Structures

## Portfolio Company Direct Investment

Co-investor contributes capital directly to the portfolio company in exchange for equity of the portfolio company.

## Fund Investment Vehicle

Co-investor contributes capital to, and receives equity of, the entity used by the private equity fund to acquire and hold its portfolio company equity.

## Co-Investment Aggregation Vehicle

Co-investor contributes capital to, and receives equity of, an investment vehicle managed by the fund sponsor into which all co-investment funds are pooled to acquire and hold portfolio company equity.

## Single-Investor SPV

Co-investor contributes capital to, and receives equity of, a fund sponsor-managed special purpose vehicle (SPV) that acquires and holds portfolio company equity. If there is more than one co-investor, each co-investor comprises its own SPV.

# Structuring Tax Considerations

- Taxable US investors are likely to prefer a pass-through vehicle, such as a limited partnership or limited liability company.

- Certain tax-exempt US investors may want to block “unrelated business taxable income (UBTI)” by using a corporation or other blocker structure. Blocker structures typically insert an entity (either a corporation or a limited liability company that makes an election to be taxed as a corporation) between the investor and the investment. They are often used by funds that have foreign investors.

# Key Investor Objectives in Negotiating Co-Investments: Due Diligence

## Sponsor's Due Diligence

- Legal due diligence summary
- Financial due diligence summary

## Transaction Documents

- Underlying Purchase Agreement
- Disclosure Schedules
- Ancillary documents (e.g., management agreement, shareholders' agreement)

## Other Due Diligence

- Regulatory
- Tax
- ERISA

# Key Investor Objectives in Negotiating Co-Investments: Alignment of Co-Investor and Sponsor Interests

**Co-investor negotiates with fund sponsor and has limited or no contact with portfolio company**

**Maintain as much alignment as possible with sponsor to provide protection of the co-investors' interests such as:**

- Price
- Type of security
- Terms of investment
- Simultaneous exit
- Expenses

**Require sponsor to take same actions on behalf of co-investor as on behalf of sponsor**

**Investments in separate investment vehicles make it more difficult to ensure alignment of interests, and ensure lead sponsor will govern co-investment vehicle in lock-step with its own fund vehicles**

# Key Investor Objectives in Negotiating Co-Investments: Limited Minority Protections

**Minority protections depend on the structure of the co-investment and get increasing pushback from sponsors**

## **Types of minority protections:**

- MFN – ensure no other investor receives superior investment rights, but becoming very rare
- Preemptive rights
- Board observer/Board seat
- Information rights
- Consent rights

**Side letters are common when the co-investor is a large public pension plan or investment authority and are becoming more common with other investors, especially in the context of a co-investment aggregation vehicle**

# Transfer/Exit Rights

- The general goal is to be tied at the hip with the Sponsor and to exit at the same time and on the same terms as the Sponsor.
- Transfer of investors equity
- Types of exit rights:
  - Drag-along right
  - Tag-along/Co-sale right
  - Registration rights



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Laura E. Flores' practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. She counsels both well-established clients and clients that are new to the industry on a variety of regulatory, transactional, compliance and operational issues, including the development of new financial products and services, federal and state registration issues, the preparation and implementation of compliance programs, business combinations involving investment companies and investment advisers, interpretive and "no-action" letter requests, requests for Securities and Exchange Commission exemptive relief, and regulatory examinations. Laura also counsels investment advisory clients on matters, including advertising and communications with the public, investment adviser registration, and separately managed account (or wrap fee) programs. Laura also has significant experience representing "liquid alt" funds, funds that invest through offshore subsidiaries, and funds that utilize QFII/RQFII quotas to invest directly in securities issued and traded in China.

Prior to joining Morgan Lewis, Laura was a partner in the financial services practice of another international law firm, where she also served on the firm's diversity committee. Before that, Laura was assistant general counsel in the asset management division of a global bank and an associate in the Washington D.C. office of Morgan Lewis.



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Robert D. Goldbaum serves as co-leader of Morgan Lewis’s investment management transactions practice and as a consultant with Morgan Lewis Consulting. Rob regularly advises a wide variety of industry leaders in the full range of asset and wealth management transactions, including mergers and acquisitions, strategic minority investments, sales, spin-outs and lift-outs, capital markets transactions, and “seed & stake” arrangements.

Rob also provides strategic advice as a consultant to established and emerging financial services firms in connection with a range of business initiatives, including institutionalization of their businesses to enhance franchise value, governance and succession matters, product and channel diversification, and similar initiatives.

Prior to returning to private practice, Rob co-founded HighView Investment Group with Ralph Schlosstein (co-founder and former president of BlackRock), a platform targeting acquisitions of minority interests in alternative asset managers. Previously, he was senior vice president for new investments at Affiliated Managers Group, which he joined after more than 14 years in private legal practice.

Rob is a former member of the Visiting Committee of The University of Chicago Law School, a former member of the Professional and Judicial Ethics Committee of the NYC Bar, and a frequent speaker on industry panels.

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Brendan R. Kalb utilizes his in-house asset management and corporate legal experience to counsel clients on issues relating to the establishment and ongoing operation of global hedge funds, private equity funds, commodity pools, UCITS funds, hybrid customized vehicles, and separately managed accounts, along with providing regulatory, compliance, and trading advice to managers investing in various asset classes in the United States and abroad. He also has deep experience advising on the structuring and operation of various registered fund products, including liquid alternative funds.

Prior to joining Morgan Lewis, Brendan was the managing director and general counsel at AQR Capital Management, LLC, a systematic global asset management firm based in Greenwich, CT, where he was responsible for managing the full spectrum of the firm's legal affairs, including involvement in all aspects of US and overseas regulatory exams, product structuring, derivatives and operational risk management, quantitative investment practices, drafting of investment guidelines and restrictions, creation and update of compliance policies and procedures, as well as implementation and interpretation of international rules and regulations regarding trading and marketing. Prior to joining AQR in 2004, he worked as an investment management associate in the New York office of an international law firm, where he regularly represented registered investment companies, investment advisers, commodity pool operators, commodity trading advisors, and broker-dealers.

Brendan has spoken at a number of industry conferences on regulatory matters affecting the financial services industry and previously served as chairman of the Managed Funds Association's CTA, CPO, and Futures Committee and as a member of MFA's Investment Adviser, International and Government Affairs Committees. In addition, he has served on the National Futures Association's board of directors and is an active member of the Investment Company Institute's Equity Markets, CPO Advisory and Derivatives Markets Advisory Committees. Brendan also serves on the board of advisors of the Institute for Law and Economics, a joint research center between the Law School, the Wharton School, and the Department of Economics at the University of Pennsylvania.

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Christina Melendi's corporate and securities practice focuses on representing public and private corporations and private equity sponsors and their portfolio companies in mergers and acquisitions, asset purchases, joint ventures, private and public equity and debt financings, securities offerings, and other general corporate matters. Christina also assists companies to raise capital in the public markets, including initial public offerings and secondary offerings. Christina counsels clients on SEC reporting and securities law disclosure, annual meeting and proxy related issues, corporate governance matters, and stock exchange listing requirements. Additionally, she currently serves as Morgan Lewis's firmwide hiring partner and co-leader of the firm's retail and eCommerce industry initiative.

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Sheryl counsels clients in the structuring and negotiation of US and cross-border mergers, acquisitions, dispositions, carve-out transactions, joint ventures, complex internal reorganizations, and other strategic business transactions. Sheryl's extensive experience representing both strategic and financial buyers and sellers in the financial services and life sciences industries enables her to help her clients successfully achieve their business goals while navigating and solving structuring issues, any regulatory approval landscape and potential customer, employee and third party consents.

Her clients include broker-dealers, investment advisers, asset managers, trust companies, and other financial institutions, as well as both branded and generic pharmaceutical companies and private equity firms. Sheryl co-chairs the firm's Fintech Initiative and the ML Women New York steering committee.

# Nathan R. Pusey



Nathan R. Pusey advises public and private clients, primarily in the financial services industry, in mergers and acquisitions, joint ventures, and restructuring transactions. He regularly represents a variety of industry leaders in transactions involving traditional and alternative asset management firms, including acquisitions and sales of majority and minority investments, spin-outs, joint ventures, seed investments, and strategic relationships.

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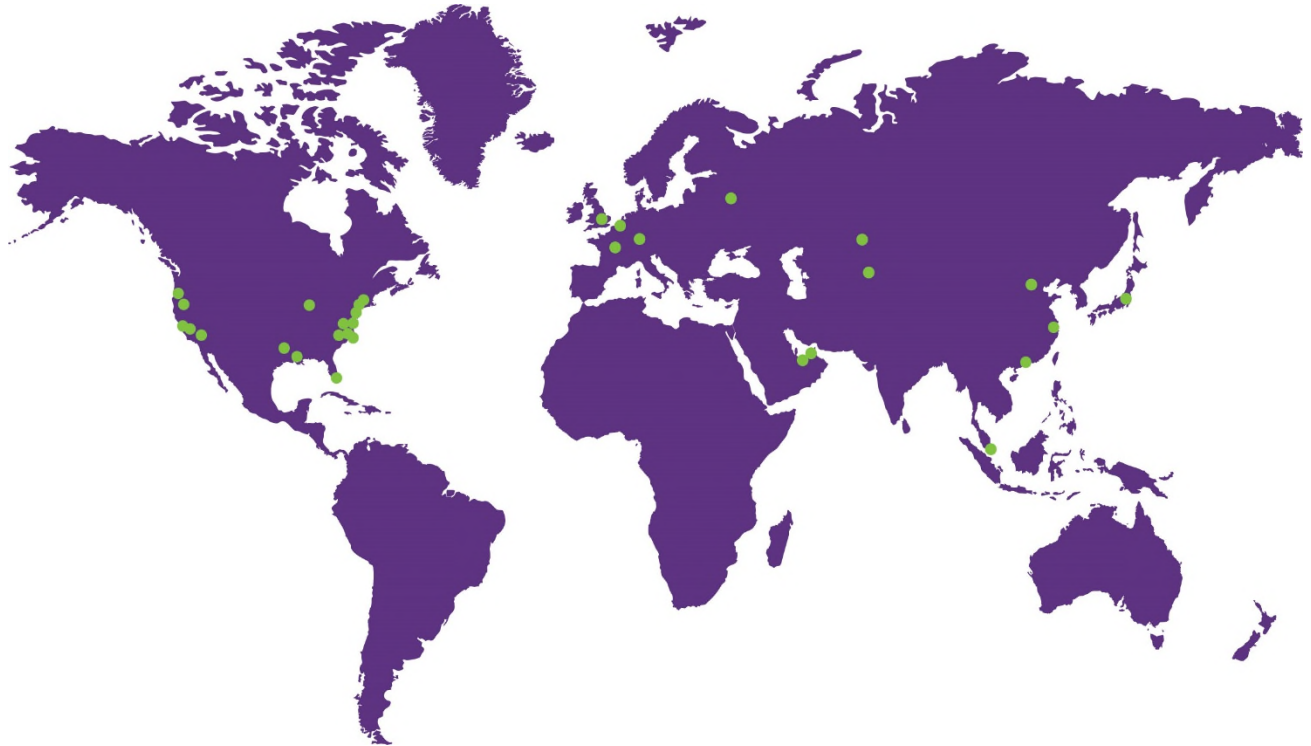
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