

# Katten

Financial Markets Litigation and Enforcement

## From A(lgorithm)–Q(uantitative): What You Need to Know About Creating a Quantitative Asset Manager

Webinar Series Episode 3: Seed Capital and Fund Launch



April 15, 2021

# From A(Algorithm)–Q(uantitative): What You Need to Know About Creating a Quantitative Asset Manager

## Introduction

---

One of the first issues you'll address when creating your quant management firm is raising the capital to launch. Part Three of Katten's webinar series, "Seed Capital and Fund Launch," explored the incredibly important (and incredibly complex) relationship between quant managers and their seed funders.

The session was moderated by **Lance Zinman**, Partner and Global Chair of Katten's Financial Markets and Funds Department, and **Allison Yacker**, Partner and Co-Chair of Katten's Investment Management and Funds group. Lance and Allison were joined by **Mark Peckman**, General Counsel at Schonfeld Strategic Advisors LLC, and **Eric Tavel**, Chief Investment Officer and Founder of Masa Capital.

## Finding the right seed funder

---

The best seed relationships are strategic partnerships. Most seeders are looking for good risk-adjusted returns on their investment, but the more aligned your firm and your seed funder are and the more committed your seed funder is to your success, the more likely that success will become a reality. When you find the right match, a seeder can give you the runway you need to get your business off the ground, build a track record, and develop your alpha.

### What type of seeder is right for you?

- Strategic, supportive partnership - This is the match that leads to long-term success.
- "Just manage my money" - Low maintenance, but do they offer anything beyond the cash?
- Adversarial: "What am I getting out of this?" - This relationship can push you to make your firm better, but how will this seeder react if you don't meet your targets?

## Seed relationships in the quant space

---

There are two types of seeders: those who get quant, and those who don't (yet). Understanding your seeder's level of knowledge and comfort in the quant space, identifying and addressing knowledge gaps on the fundamentals of what you do, and being clear-eyed about other benefits the seeder offers can help build a strong relationship whether or not your seeder has quant in its DNA.

- **Beyond the cash.** It takes a lot of runway to get a quant fund off the ground: collecting data, hiring talent, building infrastructure, establishing managerial processes. Your seeder's cash is important, but a seeder can also provide other benefits: managerial support, infrastructure, and marketing chops. Maybe they offer name recognition that benefits you by association. When the going gets tough, a good seeder will also work with you to turn things around.
- **Germination time.** Is your seeder comfortable with quant launch timing? Our panelists estimated a good two to two and a half years from the start of negotiations with a seeder to trading: a year to put together the

agreement and get it signed, another year to build out the firm. Only then does trading (and building that track record) begin.

- **Funding mechanisms.** Like most quant managers, you will likely find yourself in need of startup capital to develop your systems for launch. Those funds can come in the form of loans, a payment, or preferred equity. Then, you need to determine how you are going to fund your operations. You could take a straightforward management fees model: the seeder invests a chunk of money, and the management fees you charge fund the growth of your business. But you could also consider other funding models such as incentives like 30% performance fees or expense pass-throughs. You'll need to figure out what arrangement works for you and your seeder; for example, some seeders will raise an eyebrow at pass-throughs of bonuses or similar compensation.
- **Think about the taxes.** As you consider how to take in the startup capital, look at ways that minimize the tax burden for both parties. You have options: loans, a payment, preferred equity. Each of these will have a different impact on your tax obligations. As you consider the approach that's right for you, consult with an experienced legal advisor to develop the most tax-advantageous approach and help communicate with the IRS.
- **Contracts won't anticipate everything.** The relationship is everything. Locking in a budget is important and negotiating and signing the contracts is important. But you should understand that unexpected hurdles will pop up as soon as the ink has dried. Targets may be missed. Talent may be poached. A downturn in the economy or trading volume and volatility could drag down your performance. The best seed relationships include regular check-ins, the flexibility to make adjustments as needed, and open communication about progress and concerns. That way, when the unexpected happens, your seed funder can be a problem-solving partner.

## Key terms in quant fund seed agreements

---

As you consider terms for your seed agreement, be sure to keep your short- and long-term goals in mind and watch for alignment concerns during the negotiation process. But this bears repeating: the contract terms will be important, but the relationship you build—and your seed funder's commitment to your success—will be the most valuable asset to come out of this process.

- **Investment capacity.** Seeders may want to include terms that limit the size of your portfolio to avoid performance degradation while at the same time reserving additional capacity.
- **Revenue share.** Structured like royalties, seeders will receive a share of your revenue right off the top. One thing to watch: are they receiving a share of gross revenue or net revenue?
- **Equity.** This gives the seeder more control, but it can increase their costs and have tax implications. Oftentimes there are ways to give your seeder a bigger voice at the table without giving them equity in the company.
- **Other key terms to navigate.** Right of first refusal on additional seed capital. Control of day-to-day business management. Reporting and transparency. Liquidity rights. Non-competes or trailers that follow key employees in the event the firm shuts down.

## What can threaten my relationship with my seed funder?

---

Our panelists were unanimous about one thing: any break in a relationship between a manager and a seeder will be preceded by a good bit of conversation and negotiation. Typically, performance-related triggers will be built into the contract that allow the seeder (but typically not the manager) to withdraw. Even with these performance triggers, expect a good deal of communication and discussion with your seeder before any decision to terminate the relationship takes place.

The exception may be a “bad boy” clause in which a seed funder will immediately end the relationship if the fund manager engages in illegal activity or activity that strays far from their original mandate.



**Allison C. Yacker**  
*Partner and Co-Chair,  
Investment Management and  
Funds*

---

New York | +1.212.940.6328  
allison.yacker@katten.com



**Lance A. Zinman**  
*Partner and Global Chair,  
Financial Markets and Funds  
Department*

---

Chicago | +1.312.902.5212  
New York | +1.212.940.6544  
lance.zinman@katten.com

## USA Offices

---

### Charlotte

---

550 South Tryon Street  
Suite 2900  
Charlotte, NC 28202-4213

### Chicago

---

525 West Monroe Street  
Chicago, IL 60661-3693

### Dallas

---

2121 North Pearl Street  
Suite 1100  
Dallas, TX 75201

### Los Angeles – Century City

---

2029 Century Park East  
Suite 2600  
Los Angeles, CA 90067-3012

### Los Angeles – Downtown

---

515 South Flower Street  
Suite 4150  
Los Angeles, CA 90071-2212

### New York

---

575 Madison Avenue  
New York, NY 10022-2585

### Orange County

---

100 Spectrum Center Drive  
Suite 1050  
Irvine, CA 92618-4960

### Washington, DC

---

2900 K Street NW  
North Tower - Suite 200  
Washington, DC 20007-5118

## International Offices

---

### London

---

Paternoster House  
65 St Paul's Churchyard  
London, EC4M 8AB  
United Kingdom

### Shanghai

---

Suite 4906 Wheelock Square  
1717 Nanjing Road West  
Shanghai, 200040  
P.R. China

©2021 Katten Muchin Rosenman LLP. All rights reserved.

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at [katten.com/disclaimer](https://www.katten.com/disclaimer)

Attorney advertising. Published as a source of information only.