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ACCOUNTANTS AND ADVISORS

Accounting and Legal: Working Together to Avoid Mistakes in the Alternative Asset World

Practical Suggestions for Better Client Service and Mitigating Risk

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Far too often accountants and lawyers begin working together later than they should during the process of a fund launch for a mutual investment manager client. Historically, lawyers have worked directly with the client early in the process on the documents, only involving other service providers at a later stage to provide comments on near-final offering documents and operational agreements. Engagement at such a late stage can result in a rushed review and increases the likelihood of not thinking through complicated fee calculations sufficiently.

The negative consequences of such problems can be severe at worst and embarrassing at best. For example, in a hedge fund structure, if a fee is not calculated properly and capital activity occurs after a bad calculation, it could result in the restatement of Net Asset Value (NAV), with redeeming shareholders being underpaid/overpaid and subscribing shareholders investing at an incorrect price, requiring an adjustment. Even without such a dramatic result, bad calculations or questions as to how something should be calculated could result in both the accounting firm and the law firm being forced to ask the mutual client questions about business intentions following a launch. Such questions create risk of the client accusing both service providers of not thinking through important issues at the appropriate time.

Prior to joining their respective firms, the authors worked together for a large managed account platform, and made the effort to systematically discuss fee and expense calculations and how those calculations are to be reflected in the documents early in the process of a fund launch. In addition to developing good habits which have carried over into private practice, we also came across countless examples of common errors and have learned to spot and fix issues prior to fund launches. While it is true that lawyers and accountants often receive blame when problems arise, it is also true that their ability to foresee issues and ask questions of clients about their business intention will give those clients confidence that both professional service providers are forward-thinking, proactive and experienced.

Best Practices

Lawyers should be proactive about providing accounting and administrative teams with legal documents upon completing the first drafts of documents that contain economic language. Accountants, of course, should read the language produced by the lawyers and perform calculations using a model. To the extent that there is any ambiguity in the language that is discovered while creating these models, the accounting teams should communicate these ambiguities with the lawyers and the two parties should work together to ensure that the words are not vague, can be easily understood and can produce the desired result.

The best test of legal language accurately reflecting the business intention is if two accountants can produce an identical calculation by reading the document independently from one another. If there is a possibility that such a result cannot be achieved, the language should be discussed and re-written. Clients should also have an opportunity to review the language with the model calculations to ensure that their business intention is accurately reflected.

Common Pitfalls and How to Mitigate Them

Management fees, performance fees and expense caps are some of the most important provisions to investors in fund documentation. It is essential that the drafted language matches what investors will see when they review performance reporting and annual financial statements. We will outline some common issues that we have come across while drafting operating agreements, management agreements and disclosure for performance compensation, asset-based fees and expense caps in both hedge fund and private equity fund structures.

Incentive/Performance Fees – Hedge Funds

- **Definition of Performance Period –** It is important to ascertain when a performance period starts and ends. Sometimes, the intent of the fund sponsor is to reset performance calculations on an annual basis, particularly with respect to calculating hurdle rates. Often, standard performance period definitions begin the performance period on the date of investment or as of the last time a performance fee was paid. Without careful review of how that definition ties into other economic calculations, it is easy to make a mistake. The definition of performance period can also be used to reset a loss carryforward, if the intention is not for loss carryforwards to be perpetual.

- **Hurdle Language –** Hurdles in hedge fund structures have become much more common in recent years, particularly in managed accounts. It is key to ensure that there is a specific definition of the rate to be used, as well as the timing and application of the rate. For example, if a benchmark rate is being used, instead of just identifying the benchmark rate, be specific and identify a publication where the rate is printed and the date of the publication that will be used. With respect to timing, we have often seen language that simply states that an annual hurdle rate will apply. This does not take into account additional subscriptions by an investor during a performance period. If an investor subscribes mid-year, a separate hurdle should be applied to the new series at the time of investment, and be pro-rated for the portion of the year that remains. Finally, if a floating rate is being utilized, the fund sponsor or investor may want to have the rate applied monthly to the capital account balance as of the beginning of each month in order to fairly apply the changing rate throughout the performance period.

- **Multiple Rates within a Performance Period –** Some large institutional investors may insist on fee breaks if the investor increases investment size. With management fees, such changes are easy because fees are calculated and paid on a monthly basis, and thus the new rate can be applied on the next calculation. However, if an investor asks for a decreased performance fee rate upon achieving a specific level of investment, it must be structured in a way that the rate will be blended over the performance period, as opposed to attributing the lower rate to performance after the threshold is exceeded. The other option, which an investor will likely not accept, is to crystallize the performance fee once the threshold is met. Either way, if this arrangement is sought from a business perspective, the issues with calculating the fee should be identified and discussed immediately so that the client may think carefully about how to respond to the request.

Incentive/Performance Fees – Private Equity Funds

- **Definition of "Invested Capital" versus "Capital Contributions" –** In the first step of a standard private equity waterfall, the requirement will often be to return the "Invested Capital" to investors and then a preferred return on that amount. However, sometimes capital will be called for reasons other than to make investments. For example, capital can be called to pay management fees or fund expenses. Investors will want a return of all of their "Capital Contributions" and a preferred return on those contributions.

- **Preferred Return or Internal Rate of Return (IRR) –** Private equity waterfalls must be clear on what factors will go into determining the preferred return or internal rate of return. Often, the language will state that a preferred return or IRR will be calculated upon Invested Capital, but in reality it must be calculated on unreturned Capital Contributions in order to take into account that the preferred return stops accruing once the capital is returned. If it is based off a defined term such as Invested Capital, accountants and lawyers should make sure that the definition takes into account that Invested Capital is a net amount (i.e., Capital Contributions less returned capital

pursuant to the first step of the waterfall). Finally, documents should be clear about whether and how the preferred return compounds. Some documents might simply provide for a "compounded" preferred return in the second step of the waterfall. These documents should specify whether the compounding occurs annually or on some other periodic basis and, of course, that the compounding is on unreturned Capital Contributions plus the previously accrued preferred return.

- **Clawbacks –** Clawback provisions, pursuant to which a client may be required to return previously distributed carried interest to the fund, may omit details that a client sought to include. For example, the time over which distributions may be clawed-back is typically important to clients but may not be specified in template documentation. In addition, the client is required to pay taxes on distributed carried interest, of which these taxes are not refundable by the IRS or state taxing authorities. Any clawback provisions should be drafted so that the client is not required to pay back distributions gross of taxes in any circumstance. Net of taxes is the way to go here for the client.

Management Fees – Hedge Funds

- **Timing of Calculation and Payment –** Management fee language often states that an annual management of [X]% of NAV is payable to the investment manager on a monthly basis. The timing of the calculation and payment should be stated more specifically and state the date as of which the calculation is being made, and whether the fee is being paid in advance (at the beginning of the month) or in arrears (at the end of the month). The calculation and payment need not be done at the same time. If the calculation is performed at the end of the period, it should be clear that it is to be calculated on NAV gross of the management fee then being calculated (otherwise, the calculation would be circular). For registered investment advisors, in the event that a fee is paid in advance and covers more than a six-month period, the investment advisor will need to include financial information about itself in its Form ADV that would otherwise not be required.

- **Multiple Rates –** Rate changes with respect to management fees as opposed to incentive/performance fees (described above) are not as troublesome. However, there are certain issues of which to be aware. First, the fund documents should be specific about how performance (as opposed to capital activity) affects the rate change. In the event that performance is taken into account and a redemption is made after positive performance, the language should take into account what portion of the redemption is considered profit to determine whether the management fee rate remains the same or changes. To illustrate this point, consider that a rate may drop from a two-percent (2%) to a one-and-one-half percent (1.5%) management fee for any invested amounts above $300 million. Assume that positive performance increases the value of the investment over the $300 million threshold, which causes the management fee rate to drop. Then, the investor wants to redeem some capital.

  To make it easy, let us say the investor has positive performance of $3 million. If the investor redeems the $3 million, is it $1.5 million of original capital and $1.5 million of profits being redeemed, or rather 1% of the $3 million counts as profit and the remaining 99% is original capital? Going forward, what is the new "basis" of the investor for purposes of determining the fee break? It is much easier to simply use the NAV or capital account balance to determine the fee break, while acknowledging that circumstances unrelated to the contributions from the investor may affect the rate that the investor is charged. It is also much easier to say that the rate is determined based on net subscriptions (i.e., capital contributed less capital redeemed, regardless of profit and loss).

Management Fees – Private Equity Funds

- **Invested Capital –** Management fee language in private equity fund documentation is often very simple. It is based on capital commitments while capital is being deployed during the investment period, and on Invested Capital following the investment period. Similar to the waterfall issues described above, it is important to check that the definition of Invested Capital takes into account returned Capital Contributions, as the management fee should decrease as capital is returned to investors.

Expense Caps

- Fund documents often generally state that an expense cap of [X]% of the fund NAV will apply. This does not take into account when the percentage is applied or what amount it is applied to, particularly for an open-ended hedge fund which will have monthly capital activity. The best way to compute the expense cap correctly is to use the beginning of the month NAV (which takes into account new subscriptions and redemptions from the prior month as the basis) and apply the percentage of the cap divided by twelve. This should be spelled out in the documents. In the event that the cap is not met in a particular month, the manager can receive a credit for the unmet amount in the following month, and vice-versa until the last month of the year, in which case if the aggregate expense cap is exceeded, the excess should be deducted from the final management fee payable to the manager for the year.

Manual Processes

- Using manual processes to calculate fees creates risk, but at times it is necessary. Clients are innovative and may create fee structures for which coding for automated processes is not always possible, making the need to conduct manual calculations a necessity if service providers want to maintain their business. In these circumstances, more than communication is required. Testing of the processes by multiple personnel within accounting, and discussion and modeling with the lawyers drafting the documents, is essential to ascertaining whether the language matches the process that is being developed.

Lessons Learned

Communication with the client by lawyers and accountants, and communication with each other early in the process, is paramount to “getting it right”. Operational risk (human error) inevitably exists, but using the principles discussed in this article, such risk can be mitigated and even avoided with a little communication and hard work, starting at the outset of a relationship with the preparation and review of fund formation documents.

We believe that using appropriately experienced and trusted accountants and lawyers gives investment managers an edge by avoiding severe reputational and financial risk as a result of the type of mistakes that might occur without following this disciplined approach. Requiring the restatement of a NAV for a hedge fund manager, or making errant distributions for a private equity fund manager, could be the difference between success and survival.

From a service provider standpoint, performing incorrect calculations is completely unacceptable and could result in loss of business, liability and a negative reputation throughout the industry.

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