Document Stew, Svengali and Buyer's Remorse
By Alan Snyder

We should use skepticism and the lesson of Svengali to heighten the duty of care for our capital. Svengali was a colorful fictional character in George du Maurier's novel *Trilby*, published in 1895. Svengali seduced and exploited an English girl by hypnotizing her to become a famous singer. Far be it for us to suggest all money managers are Svengalis. They are not, but some have been, and thus we must be on guard, ferreting out what information offering and disclosure documents convey. But, there are practical limitations for the scope of these documents, varying degrees of investor sophistication and at some level, marginal benefits from too much scrutiny. As an aside, many managers have told us we err on the side of the last comment. Our defense is that thoroughness is any manager's/sponsor's best friend to avoid buyer's remorse and threats of investor litigation in the future.

Most hedge funds and alternative investments are private placements using either a limited partnership (LP) or a limited liability company (LLC) structure. Some are public interval funds and a very few are public mutual funds, each with a prospectus. LPs are offered with a Private Placement Memorandum (PPM) and a Limited Partnership Agreement (LPA). LLCs are placed with a PPM and an Operating Agreement. Public funds rely on the prospectus for outlining the terms of the offering. Even though these documents are written in dense legalese, they are critical reading material. For private offerings, the PPM is more investor-friendly to read and sets out most of the key ingredients. However, it is the LPA or Operating Agreement which governs in the event there is a conflict in terms with the PPM. The LPA/Operating Agreement outlines who does what to whom with what costs, obligations or liability. The PPM defines the explicit fund provisions chosen by the fund manager under the allowed framework. For example, the LPA may permit multiple share classes, while the PPM defines the number of classes offered and their characteristics. In sum, asset governance is defined. A prospectus undertakes the same mission. Lawyers and the management team of the sponsor carefully craft these legal writings. Unlike public funds, there is no specific Securities and Exchange Commission oversight for private funds, albeit no sponsor wants to be sued for inadequate disclosure. In both cases, Caveat Emptor (buyer beware). As qualified investors, it is our responsibility to understand what is being offered and how we are participating. In the balance of this article, we will examine some aspects of these agreements that demand particular investigation.

In the following paragraphs, we highlight areas for inquiry and attention. Any representation by a fund manager or marketer must be verified by the governing legal documents. For example, what may initially appear to be a hard rule on leverage or investment concentration may in fact be revealed as simply a soft guideline in the documents, an important distinction. Since lawyers use their own ordering structures, these comments may not exactly match the sequence found in the documents of any particular fund under consideration.

1. **Share classes**. Carefully examine the different rights and obligations between share classes and/or manager investment participation. Review voting rights as they pertain to different issues, e.g., terminating the manager. Also, are the classes legally insulated from one another such that a problem in one class would not spill over to another?

2. **Leverage**. Leverage is described but with only wide ranges set forth. Leverage can be great in good times yet deadly when returns fall below the leverage costs. Make a determination as to your own comfort level. If leverage is provided by a third party such as a bank, be sure to find out the terms and covenants, which may not be disclosed in the offering documents.

3. **Investment vehicles**. Multiple funds, separately managed accounts (SMAs) or "funds of one." Many managers offer a smorgasbord of ways to invest in their strategies. This can encompass similar funds with or without leverage, multiple SMAs for particularly large investors that may have unique investment mandates or criteria, and funds-of-one for large investors that seek to have additional control. Such approaches should not kill consideration of the manager, but warrant additional exploration of how investment opportunities are allocated between the different funds or accounts.

4. **Expenses**. Explore the definition of operating expenses, their allocation between manager and fund and ascertain if there is a cap on fund expenses, all of which define the drag from these costs on overall returns.

   Organizational expenses can be substantial and are usually charged against the fund over time. Identify the amounts, what's included and the charge-off period. If the fund has been around for more than five years, this may be a non-issue since costs have usually been recovered by then.

5. **Fees**. As part of any expense analysis, understanding what fees can be paid to the manager comes to the fore. Sometimes, it is anything but obvious. For example, a manager may receive fees from the entities in which the investments are being made, e.g., structuring fees, monitoring fees, fees on the sale of an asset, and more. These may be covered only lightly in the documents, based on the argument that the investor is not paying them, at least not directly. However, they do lower potential returns. They may be justified or not depending on the overall level of the manager fees.

   Incentive fee calculations, preferred returns (if any) and clawbacks can be tricky. What happens during a drawdown? Is there a loss carry forward and for how long? Incentive fees can be determined monthly, quarterly or annually. Longer periods are friendlier to investors. Recently to our amazement, we saw a situation that specified if the manager received too much incentive fee from an accrual in one period being trued up in the final determination, the obligation was to only return the excess on an <u>after-tax</u> basis. Calculation dates and accrual periods should be areas of focus.

6. **Dates and timing.** Of importance are key date triggers and amounts, e.g., notice periods for withdrawals, time to be paid thereon, and audit holdback amounts and limits on withdrawals, whether at the individual account level or as a percent of assets under management for all withdrawals in the fund for a particular time period. Also, if there is a limit on withdrawals, how are held back amounts rolled forward?

   Your investment may be subject to a "lockup," whereby it cannot be redeemed for a specified period of time from the investment date. A "rolling lockup" is even more restrictive, as it imposes the lock-up on subsequent capital additions as well, each with their own lockup period.

   A "soft lockup" does not restrict redemptions but imposes a redemption charge for "early" withdrawals. Carefully evaluate these terms against desired investment flexibility. Generally, the manager is trying to stabilize the pool of assets in order to match their organization's development, or assert that there are costs to unwind positions before they may have ripened for harvest. Thus, an early withdrawing investor would harm investors who are not withdrawing.

   Yet, if the assets are short-term in nature and the fee or lockup period has a longer term than the assets, there is a mismatch. If there are fees charged, to whom are they paid, the manager or the fund? Paying such fees to the fund is more investor-friendly. Lastly, for individuals, is there any hardship provision in the event of death of an investor? If buyer's remorse does set in, understanding the exact mechanisms for a withdrawal shapes how fast or slow money can be redeployed.

   For increasing a position, can capital be added generally when desired or is there a defined period when it can be called at the discretion of the manager, forcing cash to be held in reserve? Managers may use a capital call approach to better match cash inflows to investment opportunities and avoid the return drag of undeployed cash. A capital call method shifts the cash management burden from the manager to the investor.

   Another liquidity provision for review and consideration is the offer made by some managers of periodic or irregular distributions of cash on either a compulsory or voluntary basis. While the former requires advance cash planning, the latter provides additional liquidity and may even be available within the lockup period.

7. **Key personnel**. Even the biggest funds may rely on the skills of a single person. Remember the famed Peter Lynch at Fidelity's Magellan Fund. If death or incapacitation should befall a key person or persons, has provision been made to ease investor exit? Occasionally, there is key man life insurance. Great if in place, but find out to whom the benefit is paid if triggered and how it would be spent.

   A wealth of information is usually displayed in principal biographies. Prior employers and funds managed should be checked out, particularly if no third-party investigatory firm is employed as part of the due diligence process. Ask about family relationships between key management persons because these are not always visible from names alone. Having the brother-in-law of a portfolio manager acting as the chief financial officer is not much separation of power.

8. **Reporting commitments**. All of us want to know how our investments are performing, and the frequency and timing for reporting thereof viz. audits, K-1s if applicable, account statements and manager commentaries.

9. **Accounting**. Most "entity" investors (non-individuals) require accounting to be undertaken under GAAP (Generally Accepted Accounting Principles). Offshore oriented managers may instead report under IFRS (International Financial Reporting Standards). Reconciling between IFRS and GAAP takes work and requires agreement by the manager and their auditor to provide the necessary information. Individual U.S. investors should be wary of investing when a fund blithely indicates they use IFRS and will provide PFIC (Passive Foreign Investment Company) reporting for tax. The ramifications are significant and best addressed by tax advisors.

   Of course, the quality of the accounting and audit firm counts. "Big Four" accounting firms are at the top of the heap, but not perfect as all of us have seen in various headlines. There are many accounting firms that can provide quality services. A useful standard is to find out if they are peer reviewed. Peer reviews under the guidelines of the AICPA (American Institute of Chartered Public Accountants) subject a firm to examination of approved practice-monitoring standards by another independent accounting firm with similar experience.

10. **Service providers**. Delve into the credentials of all the listed service providers, e.g., auditor, lawyers, custodians, trustees, administrator, advisory boards, board of directors, valuation agents and collection agents, etc. Investment committees and compliance and technology functions may have outside personnel or firms participating in the manager operations.

    Governance counts and is reflected in manager in-house committees. Identifying the members delivers worthwhile learnings for initial due diligence and may stimulate further questions.

11. **Plan Assets considerations**. If investing with tax-exempt or tax-deferred funds such as pensions, IRAs (Individual Retirement Accounts) or Keoghs, the investor will disclose this upon subscribing to the investment. In the offering documents, the fund will delineate their approach if limits are set for these types of assets. Most funds limit their acceptance of such funds to 25% of total non-affiliated investments. An investor should find out how their investment might impact this threshold to avoid wasting time if the fund will not accept their funds. Sometimes, investing in an offshore vehicle, as Governor Mitt Romney did, is an alternative. Needless to say, while investing in an offshore vehicle can be attractive, it may raise concerns, as it did with Mitt.

12. **Side letters and other special arrangements**. Offering documents generally describe what has been or may be in the future included in a side letter with a specific investor. Typically, the actual terms of existing side letters are not referenced. Early or large investors may negotiate fee discounts and sometimes additional reporting. In effect, this is a pioneering or quantity discount and does not harm another investor. However, liquidity preferences, if granted, provide more favorable withdrawal rights and could harm any remaining investors,

leaving them "holding the bag." To fund the early exit, the most liquid investments might be sold with the less liquid and riskier ones remaining behind.

When a manager is getting started there may be special incentives offered to entice early investor participation. Most often, it takes the form of a Founder's share class with lower manager fees and enhanced liquidity. Questions may arise and answers merited if not clearly spelled out. How long is the offer period? Is it limited by time, assets raised or something else? Does a participating investor enjoy the especial terms only for the initial investment or for subsequent ones as well?

13. **Offshore fund structure**. There are three basic flavors. A standalone offshore fund, an offshore feeder fund into a U.S. master fund and/or an offshore master fund with an offshore feeder and possibly a U.S. fund feeding into the offshore master. For U.S. investors with tax qualified funds contemplating investing in an offshore fund, any inter-relationships between the various entities should be investigated, e.g., expenses, legal linkage and tax structure and filing stances. Ascertain whether the fund generates effectively connected income (ECI) from being considered a U.S. trade or business, which creates additional tax obligations. Retirement accounts should likewise determine if the fund is expected to generate UBTI (unrelated business taxable income). Unsurprisingly, offshore vehicles have additional sets of documents to review.

In conclusion, Peter Abelard, a French philosopher, sums up this discussion best. "By doubting, we are led to questions, by questioning we arrive at the truth." And, we avoid the Svengalis and buyer's remorse.

Yes, this was a long one. However, we only skimmed the surface to hit the most important considerations. From the talented folks who read this, we welcome hearing all glaring omissions and poignant war stories underscoring the importance of these undertakings.