

Hedge Fund Performance Fees

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Paying Hedge Fund Management *There are two ways Hedge fund managers can profit. Charging a management fee (typically 1%-2% annually) plus receiving a percentage of the fund's performance (often set at 20%).* Performance is typically calculated on a cumulative basis with incentive fees calculated against a ceiling or “high-water mark”. Losses experienced by a hedge fund in one or more prior years must first be recouped (in whole or in part) by compensating gains before further (or full) incentive fees are paid. For example, a \$15 million loss in one year followed by a \$20 million gain in the next year, the incentive fee would be assessed only on the net \$5 million gain. Expenses are also allocated by hedge fund managers to their funds and the investors in those funds.

Best Practices *The fund's offering materials and legal documents must clearly spell out the manager's approach to charging fees.* Include a description of the fee schedule; the exact formula used to calculate fees owed and example calculations where appropriate; the time period for fee calculations and the source of information used to calculate the fee payments. Hedge fund fees should be calculated based on audited portfolio valuations. Investors should be aware of any discrepancies and familiarize themselves with the hedge fund manager's portfolio valuation methodologies and the processes used to prepare the fee calculation. Once audited financials become available, the fee calculations should be reviewed and adjusted for any valuation differences. Calculate performance fees based on dollars of value added, not percentage returns or average capital invested for the period. Performance fees computed as carried interest should be calculated on net value added as opposed to gross value added. Offering documents should adequately define "net value added" upon which performance fees are calculated (gross value added less expenses charged to the hedge fund). All possible expenses and charges potentially deducted from fund assets should be adequately delineated in the offering documents. Expenses may include, but are not limited to: legal, accounting, trustee, administrative, marketing and sales, custodial, and general investment management charges. Performance fees should be calculated over a period of time that is appropriate given the volatility of the hedge fund strategy's returns and any lock-up period required by the hedge fund manager. Funds with a more volatile investment strategy, generally calculate performance fees over a longer period.

Charging Fees *The Investment Advisers Act of 1940 prohibits a registered fund manager (including a state registered manager) from entering into an advisory contract that provides for a performance fee.* Section 205(a)(1) provides that "no investment advisor...shall...enter into, extend or renew any investment advisory contract...if such contract provides for compensation to the Investment Advisor on the basis of a share of capital gains or capital appreciation of the funds or any portion of the funds of the client." The point behind this law is to prevent fund managers from being compensated based on appreciation of the fund's assets.

Management Fees *The management fee is paid whether the fund loses money or makes money.* Section 205(b)(1) provides that the prohibition on performance fees shall not be construed to prevent an investment adviser from receiving compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date. This provision allows for management fees based on a percentage of assets under management.

Performance Fees (Incentive/Performance Allocations) Section 205-3 of the Investment Advisers Act allows for performance-based fees (or incentive allocations) to be charged to qualified clients. This law allows sophisticated investors who are capable of evaluating and understanding investment risks to enter into performance based fee contracts. Rule 205-3(d) defines a "qualified client" as 1. A natural person or company that has \$750,000 under management of the adviser; or 2. A natural person or company whom the adviser believes (a) has a net worth of \$1.5 million or (b) is a qualified purchaser as defined in section 2(a)(51) of the Investment Company Act (ICA). The SEC has specific requirements to insure non-qualified clients do not pool their assets and form a company or hedge fund to become qualified for this exemption. To avoid this, *the SEC requires each equity owner of the company or fund qualify on their own as qualified clients*. More detailed rules apply to multiple tiers of hedge funds where again each equity owner of each fund needs to be a qualified client. Rule 205-3(b) thus requires a registered investment adviser intending to charge a hedge fund relying on ICA section 3(c)(1) to look through the hedge fund to ascertain that an investor has at least \$750,000 of AUM with the adviser or a net worth of more than \$1.5 million when the investment is made (this test applies to individuals and companies).

Qualified Purchasers The net worth test is also met if the investor is a qualified client under ICA Section 2(a)(51)(A) (this is the test for qualifying as an investor under ICA section 3(c)(7)). As a practical matter, this means that, if the fund is a section 3(c)(7) fund, a performance fee can always be taken against each investor. However, in a section 3(c)(1) fund, this is not necessarily true. A purpose of the subscriber questionnaire is to provide written guidance from each investor on its status on many vital issues including whether it is a qualified purchaser. When conducting a compliance examination, the SEC audit team may review the procedures that a fund manager uses to ensure that any clients charged performance meet the applicable criteria and evidence of satisfaction of these tests should be on hand. *Keep good records*.

State Law Impact on Fees Many investment advisers are confused when they read their home state securities statutes. Most states have law similar to federal law with respect to taking performance allocations. In fact, state statutes read almost verbatim to the federal statutes. Most states, with a few twists, have followed the federal exemption for performance fees and have either incorporated them into their state securities statutes or in their state securities regulations. The end result is that state *securities laws often provide the same exemptions offered at the federal level*. However, sometimes the actual drafted provisions of the performance fee (and calculations thereunder) are subject to intense review by and negotiation with the state regulators.

Some states use the older federal law definition of "qualified client" with the result that in some states, a registered investment adviser can charge the performance fee to what is in today's currency, an "accredited investor." *Accredited investors must generally have a net worth of at least \$1 million* (\$5 million for certain entities); the test for qualified purchasers is \$5 million/\$25 million. There is an alternative test for an accredited investor: over \$200,000 of income in each of the past two years (over \$300,000 with spouse) and a "reasonable expectation" of reaching the same income level in the year in which the hedge fund investment is made.

An investor that falls below any of the aforementioned levels of income/net worth after the investment in the hedge fund is made does not retroactively disqualify the investment. However, further investments by the now "unqualified" investor would appear to be unallowable.

Well Drafted Performance Allocations Benefit All First, fees paid to investment managers are deductible expenses, subject to limitations. For the fund manager, the net fees are income from self-employment subject to Social Security taxes and ordinary income for income tax purposes. The performance allocation of profits is not a fee, but rather an allocation of profits (separated into all of its components) from a tentative allocation to an investor's capital account to the manager's capital account. From the standpoint of partnership tax law, it is as though the investor never saw the re-allocated amount.

Example 1 *All taxpayers are domestic persons subject to the highest income tax rates.* Hedge Fund, LP, has a General Partner LLC. On January 1, 2008, new limited partner RL makes his only capital contribution of the year of \$1 million. His ending book capital account prior to reallocation is \$2 million. He is subject to a 20% performance re-allocation. As of December 31, 2008, \$200,000 of capital account value is re-allocated from RL's account to LLC's. RL's ending book capital account is \$1.8 million.

High-Water Mark *When investing in a fund, investors should determine whether performance fees are subject to a high-water mark.* It is common for the performance allocation to be subject to a "high-water mark" provision. The high-water mark's function is to ensure that a manager who has made money for an investor and then loses part of that capital cannot take a performance allocation (or fee) until the loss has been made up. Thus, performance can be taken only on the profits *above* the high-water mark. Investors must recall that performance is always calculated on the fund's economic performance, which will include the net of the yield (e.g., dividends, interest) less fees and expenses chargeable to the investor, and both realized and unrealized profits and losses. Investors should determine the period of time to which the high-water mark limitations apply, and confirm that it is consistent with their redemption rights and investment objectives. High water marks are widely used and are considered a market standard best practice. Further, since investors may join a hedge fund investment at different times, investors should confirm that high water marks are specific for each investor and separately tracked.

Example 2 Same as Example 1, except in 2009 RL's capital account is now \$900,000 because the fund lost 50%. No incentive fee is chargeable. In 2010, RL's capital account increases to \$1.35 million because the fund was up 50%. If there is a high-water mark provision, LLC gets no performance allocation. If there is no high-water mark provision, LLC gets a performance allocation of \$90,000 even though RL is still in the hole.

Example 3 Same as Example 2, except in 2020, the fund makes 100% (economic) return and RL's (tentative) book capital account is \$2.7 million. LLC is entitled to a re-allocation of \$180,000 (\$2.7 million less the high-water mark of \$1.8 million x 0.20). If there is no high-water mark, LLC's re-allocation is \$270,000 (\$1.35 million x 0.20) and RL would have been subject to a re-allocation twice on the same amount. If the investor is a fiduciary account (trust account, pension plan, endowment, etc.) the prudential concerns of the fiduciary may well require that the fiduciary invest in a fund that has a high-water mark. *In any event, the absence of a high-water mark provision may be viewed as indicative of a fund manager not overly concerned with issues of fairness to investors.*

Hurdle Rate *Hurdle rates establish a floor that the investment adviser must exceed to obtain the incentive allocation or performance-based fee.* Many funds have a "hurdle rate" provision. Hurdle rates are used to guarantee that the hedge fund achieves a minimum investment

performance before the fund's adviser may receive any incentive allocation. The underlying concept is that an investor could keep its funds in tax-exempt bonds and earn a safe, tax-free return (assume 3.5%). The investor demands that the incentive allocation be calculated only if the manager makes at least that rate -- a hurdle rate. There are two basic types: 1. The incentive allocation is charged only on economic profits made above the hurdle rate. 2. Once the hurdle rate is achieved, the performance is based on the entire economic profit.

Combining a Hurdle Rate and a High Water Mark A high-water mark and a hurdle rate can be combined.

Example 4 Same as Example 1, except the incentive allocation is chargeable only after RL's book capital account earns a rate exceeding the federal funds rate plus 200 basis points, determined each year based on the rate in effect on the first business day of that year, and that the performance is chargeable only to profits exceeding that hurdle rate. With a hurdle rate of 4.5% for 2008, the incentive reallocation of profit is \$155,000 (\$1 million x [0.2 - 0.045]).

Example 5 Same as Example 4, except the incentive allocation is chargeable in full to the profits, provided that the hurdle rate is met for that year. The incentive allocation is \$200,000 (same as Example 1). The hurdle rate is optional; it provides an additional layer of computational complexity to whichever of the two alternatives is chosen, although the first alternative is clearly more complex. *In some funds, the hurdle rate is quarterly, or even monthly, which is certainly an additional complexity and administrative expense as these calculations must be checked by the fund's accountants.* Further, in some funds, the hurdle rate is cumulative; thus in Example 3 above, RL's hurdle rate would have to be calculated separately to determine what the performance allocation is when profitable years kick in.

Withdrawals Many issues go into the performance's calculation. For example, how is performance calculated when an investor withdraws, in whole or in part, prior to the end of the tax year; if there is a hurdle rate, should it be annualized or applied in full?

Example 6 Same as Example 4, except that RL withdraws June 30, 2008. Should the hurdle rate be 4.5% or 2.25%? Proration is the standard practice.

What about the high-water mark when an investor withdraws only part of their capital?

Example 7 Same as Example 2, except that RL withdraws half his (much depleted) capital account of \$900,000 on December 31. Should his high-water mark be \$1.8 million or prorated to \$900,000? If \$1.8 million, the manager is unlikely to realize a penny of performance from RL for a very long time, if ever. If prorated to \$900,000, LLC at least has a fighting chance of making good and earning performance. Again, proration is the standard practice.

Keep Fund Accounting Simple The manager who has a highly complex performance allocation and expects the financials and tax returns by March 1 is tempting fate. *The manager must recall that once the investor is promised something, less cannot be given.* At the very least, no manager wants to go back to investors and ask them to sign amended fund documents about how the manager's own cut of the profits is determined.

The preceding article discussed critical points to be considered in drafting the performance/incentive provisions, both from the manager's and the investor's standpoint. *This*

article does not discuss the rules for commodity pool operators (CPOs) under the jurisdiction of the CFTC. The CFTC (and the industry self-regulatory organization, National Futures Association) have no comparable restrictions on a CPO's entitlement to performance, provided that the investor receives appropriate disclosure and consents in writing to a performance-based compensation (or allocation of profits). Because many funds trade both securities and commodities, the SEC rules on performance typically govern the outcome.

Written By: Hannah Terhune, Esquire. Portions of this article were originally published in part "Derivatives: Financial Products Report" an RIA publication, September 2005, as 'Hedge Funds - Do's and Don'ts for Crafting Hedge Fund Performance Allocations' by Hannah Terhune, Esq. and Roger Lorence, Esq. (Reprinted with Permission). Ms. Terhune is an attorney with Capital Management Services Group and specializes in setting up hedge funds, incubator funds, master/feeder funds, forex funds, commodity pools and other financial products of interest to the alternative investment community. Ms. Terhune and her legal team can be reached at (307) 213-4732 or legal@capitalmanagementservicesgroup.com.