

# Hedge Fund Management and Performance Fees

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**Greater Reward for Hedge Fund Managers.** Everyone who compares a hedge fund's offering documents with those of a mutual fund cannot ignore the enormous difference in rewards for the managers of hedge funds versus those of mutual funds.

**Mutual Funds.** As mutual funds (and closed-end funds) may offer their securities to the greater investing public, their managers are severely restricted in their rewards, as the fees for investment advisers are limited to a percentage of assets under management (AUM). Rewards based on the fund's actual performance for its investors are prohibited. On the other hand, the mutual fund manager is still entitled to his fee, even if the fund's performance has been subpar.

**Hedge Funds.** By contrast, the hedge fund world is very different. The nature and tax implications of the rewards received by a hedge fund manager are intertwined with the fund's domicile and organizational structure. An investment adviser to a domestic hedge fund generally receives compensation composed of an investment management fee and an incentive (performance-based) reallocation of profits. The investment management fee is an asset-based fee, similar to the advisory fee charged to registered investment companies and is designed to provide the investment manager with current cash flow to maintain operations. The investment management fee is generally 1% to 2% of AUM. Although the typical fund offering provides for a management fee paid to the manager periodically (e.g., monthly or quarterly, usually in advance but sometimes in arrears), it is the rare hedge fund manager who can survive even on a fee of 2% of AUM. Rather, it is in the "performance reallocation of profits" (for domestic funds with an entrepreneurial manager that is fiscally transparent) or "performance fee" (for a corporate adviser or an offshore fund) that financial rewards are realized.

**Charging Fees and Federal Law.** Section 205 of the Investment Advisers Act and Rule 205-3 thereunder address the assessment of fees (and incentive allocations) based on a share of capital gains and capital appreciation. These provisions generally prohibit registered investment advisers from charging performance-based fees (or incentive allocations) to most clients that are not qualified clients, as defined in Rule 205-3. Consequently, the manager can take performance fees only from an investor that satisfies one of two tests under Rule 205-3 or that is a "knowledgeable employee" of the fund's adviser (such as senior management and persons participating in the fund's investment activities). This article does not further discuss "knowledgeable employees" as it is rare when a hedge fund adviser charges performance against its own personnel's investment in the fund. Rule 205-3 generally defines a "qualified client" as one of the following:

1. A natural person or company that has \$750,000 under management of the adviser.
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).

Rule 205-3(b) thus requires a registered investment adviser intending to charge a hedge fund fee 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). 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)).

These fees can also be charged against persons who are not U.S. residents and business development companies. As a practical matter, this means that, if the fund is a section 3(c)(7) fund, a performance 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.

**State Law Impact on Funds and Fees.** Even if the manager is not an SEC-registered investment adviser, most states have rules similar to the SEC with respect to taking performance allocations. The rules of each affected state must be reviewed separately. Exemption from registration as an investment company has two routes: section 3(c)(1) (no more than 99 beneficial owners on the investor side, of whom up to 35 can be non-accredited investors) or section 3(c)(7) (no more than 499 investors, all of whom must be qualified purchasers). In both instances, solicitation of the investing public is forbidden.

Accredited investors generally must 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 two past 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.

When conducting a compliance examination, the SEC audit team may review the procedures that an adviser uses to ensure that any clients charged performance meet the applicable criteria. Evidence of satisfaction of these tests should be on hand.

**Drafted Correctly, Performance Allocations Benefit Managers and Investors Alike.** In its Hedge Fund Audit Manual, the IRS contends that the performance allocation is not an allocation of partnership income, but rather a disguised fee arrangement. This is true even if the adviser hyperactively trades the client’s account; the client is always an investor. This is an absolutely vital point for investors and managers. First, fees paid to investment managers are Section 212 expenses, subject to many limitations. Every

taxable investor will have some benefit taken away; many investors will get no benefit at all (e.g., because of limitations under the alternative minimum tax). For the entrepreneurial manager, the net fees are income from self-employment subject to Social Security taxes and ordinary income for income tax purposes. Those manager s fortunate enough to carry on business in New York City are also subject to the 4% Unincorporated Business Tax for the privilege of carrying on business in a non-corporate form within NYC. For these reasons, the managed (“discretionary”) account whereby an investment adviser (or commodity trading adviser) manages other people’s money is highly tax-disadvantaged. 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 Subchapter K of the Code (partnerships and partners) and its (voluminous and confusing) regulations, 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 Q, LP has a general partner Q, LLC (whose two members are John Doe and Richard Roe) with 48 limited partners. On January 1, 2007, new limited partner Rogelio Lorenzo 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, 2007, \$200,000 of capital account value is re-allocated from RL’s account to Q, LLC’s. RL’s ending book capital account is \$1.8 million.

**Components of the Performance Allocation.** This section illustrates some principles with examples.

**High-Water Mark.** It is common for the performance allocation to be subject to a “highwater mark” provision. The highwater 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.

**Example 2.** Same as Example 1, except that in 2008 RL’s capital account is now \$900,000 because the fund lost 50% (economic loss). No incentive is chargeable. In 2009, RL’s capital account increases to \$1.35 million because the fund was up 50%. If there is a high-water mark provision, Q, LLC gets no performance. If there is no high-water mark provision, Q, LLC gets a performance of \$90,000 even though RL is still in the hole.

**Example 3.** Same as Example 2, except that in 2009, the fund makes 100% (economic) return and RL’s (tentative) book capital account is \$2.7 million. Q, LLC is entitled to a re-allocation of \$180,000 (\$2.7 million – high-water mark of \$1.8 million x 0.20). If there is no high-water mark, Q, LLC’s re-allocation is \$270,000 (\$1.35 million x 0.20); RL would have been subject to a re-allocation twice on the same amount (\$1.8 million

high-water – \$1.35 million x 0.20, twice). 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.** Many funds also have a “hurdle rate” provision. Hurdle rates are also used to guarantee that the hedge fund achieves a minimum investment performance before the fund’s adviser may receive any incentive allocation. Hurdle rates establish a floor that the investment adviser must exceed to obtain the incentive allocation or performance-based fee. 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.** Of course, a high-water mark and a hurdle rate can be combined in the same computation.

**Example 4.** Same as Example 1, except that 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 2007, the incentive reallocation of profit is \$155,000 (\$1 million x [0.2 – 0.045]).

**Example 5.** Same as Example 4, except that 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 (these calculations must be checked by fund 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, 2007. 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, Q, LLC at least has a fighting chance of making good and earning performance.

Again, proration is the standard practice.

**Keep it Simple!** Pity is in order for the poor accountants preparing the fund's interim accounts, annual audited financial statements, and fund's tax returns. Moreover, 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, in hedge fund practices, 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.

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