Before They Come Knocking: Addressing Issues Uncovered During a Review of Fee and Expense Allocations (Part Two of Two)

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During examinations, the Securities and Exchange Commission increasingly is scrutinizing how hedge fund managers are charging expenses—in particular, whether the costs assessed are outside the purview of the fees, expenses and liabilities agreed to by investors in the fund's offering documents. In light of this regulatory focus, in part one of this two-part series, we examined why and how hedge fund managers should conduct an internal review of fee and expense allocation practices. Part one addressed recent SEC enforcement actions against private funds for misallocating fees and expenses; explored business considerations necessitating an internal review of costs, including investor demands and the potential for uncovering inconsistencies and inadequate disclosures; and explained how to coordinate an internal review across legal, compliance and finance business units. An internal review of this range is designed to determine how best to allocate costs between the fund and the manager, and ensure that existing policies and procedures are reviewed, expressly and equitably distribute fees and expenses and are strictly adhered to. The process can help to avoid the spectre of improper allocation of fees and expenses to the investment fund, and any possible violation of fund documents or breaches of fiduciary duties owed to investors.

But if any allocation issues are uncovered during the course of an internal review, hedge fund managers need to move immediately to address and correct them, as well as ensure they do not occur again. This second article in our two-part series outlines best practices for remediating problems that arise during a fees and expenses audit, and whether and how to update policies and procedures, restate financials and/or reimburse the fund and/or investors in light of the issues uncovered.

Remediating Issues Uncovered During an Internal Expense Audit

In order to avoid increased scrutiny during SEC examinations, burdensome regulatory requests, and the potential refund of expenses to fund investors, fund managers should review and test their expense allocation practices. Where problems are discovered, how to remediate them depends on the issue uncovered and why it was part of prior allocation practice.

Managers should also want to make sure the remediation addresses whatever the perceived harm was. As Dov Braun, a Financial Services Assurance Practice partner at EisnerAmper, cautioned, "You do not want to leave your investors worse off for an error that you committed."

When rectifying any issues uncovered, Richard Marshall, a partner at Katten Muchin and a former examiner with the Securities and Exchange Commission, advised senior management, counsel, compliance and operations to handle any problems found. "You want to have it escalated so that you make informed, careful decisions on the issues and remediations."

Even if no errors or inconsistencies are identified during the audit, vagueness or ambiguity in the fund's disclosures might require additional clarification in the adviser's Form ADV, as well as require managers to provide fund investors with additional written disclosures clarifying ambiguities.

Stephanie Monaco, a partner at Mayer Brown, recommended managers "figure out what happened, if there is a defense in the fund's governing documents for having allocated the expenses the way you did and, if not, how much money you owe and to whom. You then have to determine what is the best course of corrective action, and take it expeditiously, to make sure the problem doesn't happen again."

Additionally, managers may need to change their disclosures and policies and procedures, Monaco said, particularly if the manager feels justified in charging to the fund certain expenses that weren't previously disclosed. "You also need to evaluate whether investor consent is necessary to charge expenses not previously disclosed."

Remediation likely could include updating expense policies and procedures, noted Braun. Managers may also have to train employees on how expenses should be allocated according to the firm's policies and procedures. Training is a possibility, especially for the people that are directly involved in the expense allocation process, noted Richard Heller, a partner at Thompson Hine.

In dealing with issues, Monaco said many funds have advisory committees that consist of an odd number of the largest unaffiliated investors to look at issues and make a judgment call on what is best for the fund. "The manager can convene the advisory committee to tell them what the governing documents currently say, what expenses the manager is incurring that the manager thinks are solely for the benefit of the fund and should be charged to the fund, and get agreement from the advisory committee on how to best resolve an issue."

Carmine Angone, a Director in EisnerAmper's Compliance and Regulatory Services recommends managers create expense allocation policies and procedures that form a part of the manager's risk-based compliance program. "Regulators are actually looking for this, as demonstrated through their actions, by citing managers for inappropriate allocation of expenses during exams," Angone said. "It should be an integral part of the compliance program that's reviewed and tested, the frequency of which is based on its risk ranking." Concomitantly, policies and disclosures should be updated to reflect the changes made to the firm's written procedures based on the results of its testing and as the practices and strategies within the fund and firm change.

Restating Financial Information and Financial Restitution

When an error is uncovered, managers need to determine immediately the scope of the issue and any potential harm caused to investors. Once the problem has been assessed, managers should determine which investors, if any, should be made whole and how much restitution should be made. According to Monaco, "Where you uncover issues, it is best practice to pay the funds back with interest, depending on how long ago the fund paid an expense for which disclosure was inadequate."

In outlining an issue that could come up and how managers should deal with it, Marshall said where a manager has been charging a fee that is inconsistent with the disclosures, "you have a whole laundry list of issues that immediately raises. Namely, should you pay investors back? Under law, where a fiduciary determines they have damaged the client economically, they're supposed to make the client whole."

As an example of a situation that may require restitution, and potentially a restatement of financial information, Laurie Shen, a principal at UHY Advisors, explained, "If you get a data bill, which is legitimate, and one month it is $10,000 and the next month it is $400,000, you will need to look into why the bill is so much higher, how the bill got approved and whether it is a legitimate cost that should be charged to the fund. If it was an error, the manager should bear those costs and issue a refund to the fund. When there are discrepancies like this, you have to look at how big the problem was and discuss options with the financial auditor and the management company to determine whether they need to reissue a corrected financial restatement."

Shen said such problems often arise when a firm receives a bill from a broker or other third-party service provider, and the finance employee reviewing the bill assumes the charges are correct and legitimate. To avoid discovering errors later, "You have to look at the actual amount and the services provided to make sure you're paying for services that were actually provided," Shen advised. "You have to look for discrepancies and analyze the expenses to make sure they fit into what is expected."

Marshall noted that because most hedge funds are subject to a gross negligence standard for inadvertent errors, that benchmark may determine whether managers have to pay back the fund and its investors during the remediation stage of an internal review of fees and expenses.

Venkat Rao, a director of Compliance and Regulatory Consulting Services at EisnerAmper, said materiality of issues uncovered during an internal review determines whether a manager should restate financials. "If it is something that would impact an investor's decision to invest in or stay with the fund, it is material. Also, as a registered investment adviser you have a fiduciary duty to your investors to act in their best interests. So, deciding whether you need to restate your financials is going to be a fact and circumstances-based test."

Managers should know the restitution process is complicated, Monaco cautioned. "Once you determine how much investors have been charged incorrectly—and this often happens innocently or unintentionally—and how much you owe investors, you then have to look at how long you had been applying the expense you shouldn't have, to calculate how that inappropriate expense charge affected the fund's NAV. You then have to determine the materiality of the NAV change on a per investor basis. Once you've made those calculations, you have to pay the money back to the fund and sometimes investors—both past and present. This can be a very arduous task when the error started a long time ago because you have to change the capital base going forward to see how it would have affected the NAV, depending on how big a problem it is. You need to look at the investor base to see which ones withdrew or bought based on that inaccurate NAV."

Rao agreed that restating financials can be a challenging process. "Where the error is that significant, there is notification to the limited partners describing the error, what the manager intends to do about it and how they intend to remediate the issue. The auditor is involved because you have to redo the audit. The manager should take up those expenses because it is their error that led to the audit having to be redone. Having such a problem could lead to redemptions, that's why communication is so important. If you fail to communicate, that puts investors on edge and could harm the manager going forward."

When to Self-Report Issues Uncovered During an Internal Expense Audit

After remediation, managers should consider whether to report to regulators issues uncovered during an expense audit. Though not technically required to self-report the findings of an expense audit, Marshall said, managers may decide to self-report to gain good favor with regulators later. “You may be given credit if you do. With the whistleblower rules, if you don’t self-report you could end up with a problem if an employee or investor goes to the government. So, depending on the issue, you may want to self-report.”

Monaco said managers should first address the problem to make sure it doesn’t happen again. Considering the whistleblower rule, Monaco said, “Managers have to do a risk calculation on whether an employee or investor will report an issue to the SEC. So while there is no obligation to self-report issues, managers need to consider whether someone else may report the issue first to the SEC.”

Generally, self-reporting depends on the materiality of the error and whether it conflicts with governing documents, noted Angone. Managers could self-report issues to the SEC for defensive purposes, but Angone advised that managers have a plan in place if they choose to do so. “If you approach the SEC, you need to let them know what the problem was, what you’ve done to correct the issue and what steps you’ve taken or are taking to make sure it doesn’t happen again,” Angone said.

Angone also pointed out that errors always happen. “That’s what your policies and procedures are for; that’s what the testing is for. When errors occur, it doesn’t make sense to go to the SEC for every one. The decision to self-report depends on each case and the impact and how material it is.”

Braun said that potential whistleblowers are, however, a significant consideration in the decision to self-report. “Managers will self-report to eliminate the risk of an irate investor running to the SEC with a complaint. If you ultimately don’t self-report, when the SEC comes for an exam, you want to have the documentation that you’ve corrected an error and taken remedial measures. That’s important because you don’t want to create the impression that you’re not taking this stuff seriously.”

Notifying Investors

Managers also have to consider when investors should be notified of errors uncovered during an internal expense review. Rao said this decision is also based on the materiality of the issue uncovered. “If it’s something that would impact investors’ decision making, they have to be notified. You don’t have to notify investors of all errors. Again, it comes down to a materiality threshold. If you do notify your investors of an error, you have to also include information about what remedial steps you are taking—whether changing your policies and procedures or implementing additional controls—to ensure the issue doesn’t come up again. You have to give enough information so they can make an investment decision with full and fair disclosures.”

What is material is often debatable among hedge fund managers. Managers should, in all events, determine whether an issue uncovered is the result of a serious violation or internal control problem. In such instances, investors should be notified.

Finally, the decision to notify investors of issues uncovered during an expense audit will also depend on the fund’s governing documents and the investment agreements with each investor, noted Shen. The test of materiality is whether a reasonable investor would consider the error important to know, and, if so, it should be disclosed. If the error relates to a manager’s ability to manage the fund as outlined to investors or his integrity in the management of funds, investors will want to know, and they should be notified promptly.

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