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The 4 Rules of Legal Document Reviews

SwissAnalytics

Introduction

Most alternative investment allocators are well-aware of the potential traps of investment strategies and have even become increasingly aware of operational risks over the past years. However, our experience has shown that many have not taken care of covering the details contained in the legal documentation of a fund before investing. Whether a hedge fund, fund of funds, private equity fund, CTA, or managed account… the devil is always in the details.

Within the primary legal documentation exist provisions, rights, obligations and terms that must be fully comprehended in order to avoid any surprises at the worst possible moment for the investor. Key factors which must be examined in relation to investor rights, corporate governance, fees, delegated functions, and liquidity, among others.

In this month's paper, we provide some basic rules for investors with regard to the funds' legal documentation. Although reviewing 100+ pages of funds' documentation can be a tedious task for investment professionals more keen on discussing fund strategies, quantitative profiles, or even managers' operations, it is a crucial aspect of risk management and due diligence for alternative investment allocators.

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1: Review ALL Docs of ALL Entities

Investors all too often assume that if they read the Offering Memorandum (OM), then they have understood their legal relationship with the fund. Of course, the OM is the actual contract between the investor and the fund, containing the legal and economic terms of the fund-investor relationship. Any changes to the terms of the OM must be accepted by all investors.

Although the OM is often understood to be the core binding agreement, ***we have seen many investors overlook the Articles of Association***, which are of particular importance and can contain key provisions that trump terms of the OM. The Articles define how the business of the company (i.e. the fund) is actually to be run, including key provisions on directors' responsibilities, NAV calculation, liquidity management, general meetings of the fund , procedures for winding up the fund and more. When examining the articles, one must ask questions such as "What sorts of duties are assigned to directors? Have they delegated any essential duties?

Furthermore, in a Master-Feeder structure, one must ***request, review and thoroughly examine the legal documents of the Master fund as well***. One simple, yet common mistake is to assume that because there are independent directors assigned to the feeder fund, that the Master fund is subject to the same degree of corporate governance and accords investors the same protections, where this may not be the case. For example, in the case that the Master fund is a Limited Partnership, these controls will be specifically lacking.

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2: Compare the Documents for Inconsistencies

When inconsistencies are discovered, these may not necessarily represent any mal intent on the part of the manager, however these must be rectified in order for an investor to have confidence in their legal relationship with the fund going forward.

For instance, in the case that a feeder fund's documentation guarantees a wide range of investor protections, corporate governance, voting rights, etc., one must ensure that the master fund's documentation contain similar rights. It may be the case that the conditions under which redemptions or NAV calculations can be suspended are much more restrictive according to the legal documentation of the feeder fund than they are in the articles of the master fund.

By relying wholly on the conditions and terms contained in the feeder documents only without comparing them and reconciling any differences between that and those of the master fund, ***investors can drastically mis-estimate the conditions of their investment with regards to several core risk factors***. Inconsistencies can arise from the documents having been approved at different time periods, use of a different law firm, or other less harmless reasons, however they can also be signs of further hidden risks that need to be investigated.

It is often the case that a fund's OM allows the manager the ability to charge a broad range of fees to the fund. This typically includes costs one may expect, such as the audit, directorship and administration fees, etc., however, fees such as marketing costs or legal fees of the investment manager regardless of cause may fall into the category of abnormal or unacceptable. Moving beyond the legal documents, it may be important in such cases to cross check whether the right to charge abnormal fees has been exercised by the manager in the past. If the investment manager is also a director of the fund, which is often the case, one may also be able to trace down in the audit whether they have been receiving fees for this directorship above and beyond their investment management fees, for example.

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3: Review The Docs *Before* the Fund has Encountered an Issue

Too often investors wait until the fund runs into an issue before they fully understand their rights. As an alternative investment due diligence specialist, we have received numerous calls over the past years with investors asking questions such as: "The manager isn't communicating with us, what do I do?", "How can the manager just suspend calculating their NAV, I need a statement!" or "I have a letter from the fund, but don't know what it means for my investment". Most often it is the case that the investor has not understood their rights in the first instance, is not in contact with the proper parties (e.g. Directors), and has likely already missed some key opportunities to advocate their own rights before they have contacted us to take a forensic look at what happened with the fund.

For example, it can be the case that the manager is ***only obliged to inform redeeming investors of a suspension of redemptions*** or the imposition of a gate for redeeming investors. If an investor assumes that they will be informed of the use of liquidity management tools, they may be invested in a fund which is much more stressed than they believe. Should the fund's legal documentation restrict the requirement to notify only those investors of a suspension who have posted redemptions and concurrently contain extremely broad and wholly discretionary conditions under which such suspension can occur, than investors may be left with an investment in a fund where the manager has significantly misaligned interest to those of their investors. If a manager is suspending redemptions "in the interest of remaining investors", those remaining investors should advocate their own right to know that the manager is apparently protecting them from the evil redeemers.

Rule 3 (cont'd)

Advanced knowledge of your rights as an investor can be particularly valuable when a fund is faced with a situation related to a fund's liquidity or voting rights of investors. Furthermore, prudent investors who maintain standards for the types of conditions they need in funds which are in their portfolio are much more prudent investors, who are capable of advocating their own rights if a fund encounters difficulties.

If investors remain passive and assume to be notified of their rights when they need to be notified, ***they may miss out on crucial opportunities***. For instance, knowing the procedures for the notification of investor meetings along with the required quorum is essential. We recently had a case where the fund is required to notify investors of meetings where investors may vote to replace the investment manager, however that the location may change on short notice. If a quorum of investors were still met, the results of the vote would remain valid and investors who were unable to attend would simply have missed out on their opportunity to participate in the vote.

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4: Seek Additional, Supporting Information

As with all aspects of due diligence, it is often difficult to draw a clear line in where to stop investigating or where to divide one portion of due diligence from others. When charged with the assignment of fully interpreting and understanding the rights and obligations between yourself as an investor and the fund also requires digging beyond the primary documentation.

For example, if, according to the Articles of Association, the directors maintain full discretion to suspend redemptions, but they may delegate those rights, it is important to request and review the corresponding resolutions. It may be the case that a director opts to pass on the responsibility to suspend redemptions to another director who is not independent or directly to the investment manager, which reverses the investor protections which were built into the Articles. ***Funds' articles tend to be vague, while OM's tend to be all-encompassing disclaimers.***

Resolutions can be an extremely important source for a complete legal document review, however they may also be confidential. For diligent investors, ***this may be circumvented by interviewing the fund's directors directly***. If one is not provided with satisfactory transparency to become comfortable in such key risk areas such as the fund's governance, it may be advisable to err on the side of caution.

As a part of the legal document review, a review of the directors registry may also be included. Therein, one can gain further insights into some practical considerations which are crucial in taking the next step forward with a fund. If the fund's directors have a high turnover, this can signify that there were past disputes with the fund's directors, which must be considered to be a red flag until one becomes comfortable with the reasons offered which explain their departures.

It is often difficult to separate legal document reviews from the big picture of comprehensive due diligence, however, focussing in upon the primary pitfalls and key weaknesses, a trained professional is able to avoid some headaches down the road.

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Conclusion – Be Your Own Advocate

Taking the time to carefully navigate the legal documentation of an investment and fully understanding the implications on your investment is crucial in the alternative investment space. All too often, investors still take on uncompensated risks which are buried in the details of these documents, and are incapable of advocating their rights until its too late.

Inadequate corporate governance, hidden fees, and broad, discretionary liquidity management practices can and should all be addressed by investors before making any investment in alternative funds. We have seen all too often that these details are not properly examined by professionals, particularly by those who are less accustomed with the unique structures and requirements of alternative investment funds.

Although it takes much time and expertise in order to navigate every possible detail which can have a future effect on your investment, prudence can pay off, and if you find your teams time too valuable to do so or want to ensure that you haven't missed crucial factors, ***there are experienced professionals at SwissAnalytics who provide the additional support and transparency you need.***

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