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Redemptions

Implementation of Hedge Fund Audit Holdbacks (Part Two of Two)

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By Jennifer Banzaca, *Hedge Fund Law Report*

Audit holdback provisions allow a fund to retain a portion of a withdrawing investor's redemption proceeds for a period of time – typically until the fund's annual audit is completed – to guard against adjustments to the fund's net asset value (NAV) after the investor has redeemed. However, when establishing an audit holdback, a hedge fund manager must carefully balance the overall liquidity of the underlying investments and the likelihood of subsequent adjustments to the NAV against the interests of investors and market practice.

This article, the second in a two-part series, discusses the prevalence of holdbacks in the hedge fund industry; investor response to these provisions; and considerations for hedge fund managers in crafting audit holdback terms. The first article analyzed the mechanics of audit holdbacks; considered common variables found in such provisions; and evaluated potential alternatives to audit holdback structures. For more on holdbacks, see "The Evolution of Offshore Investment Funds (Part One of Three): In Interview with Hedge Fund Law Report, Ogier Partner Colin MacKay Discusses Drafting of Offshore Fund Documents; NAV Adjustments; Clawbacks; Managed Accounts; and Payment-in-Kind Provisions," Hedge Fund Law Report, Vol. 2, No. 30 (Jul. 29, 2009).

Prevalence of the Use of Holdbacks in the Hedge Fund Industry

Rationale for Holdbacks

As discussed previously, audit holdbacks are intended to protect the fund and its remaining investors from overpayment to a redeeming investor in the event that the fund's NAV later undergoes an adjustment. EisnerAmper partner Dov Braun explained the reasoning for this practice, noting that once the fund has paid a redeeming investor, it is difficult to recoup any potential overpayments to that investor. "However, if a portion of the redemption proceeds is still held by the manager," he argued, "in the event of any corrections to the prevailing NAV at the redemption date, the manager can take corrective action and remit the adjusted balance to the investor." Thus, the holdback provisions are set in place to protect the other investors in the fund from one redeeming investor receiving an improper windfall.

"Inclusion of a holdback provision can be both reasonable and appropriate," agreed Bill Thomas, a partner at Gibson Dunn. "A holdback provision can protect the fund and its remaining investors from the overpayment of redemption proceeds to a redeeming investor."

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In addition to protecting the manager and remaining investors against errors in computing the NAV, Paul Hastings partner Arthur Zwickel noted that audit holdbacks can also insulate against a situation where "some liability arises that was not fully identified at the time the fund struck the NAV." Echoing the concern regarding the potential difficulty for a fund that has overpaid a redeeming investor to retrieve the amount of overpayment, Zwickel commented, "A holdback allows you to settle the NAV with certainty before the releasing the final amount, while taking comfort in knowing you won't have to chase down an investor who was overpaid."

Prevalence of Holdbacks

Holdbacks are common terms found in a majority of funds. "Holdbacks are in almost every deal," noted Michael Gray, a partner at Neal, Gerber & Eisenberg, although "we have seen very liquid funds that have no holdbacks."

"What you will see typically, regardless of fund structure and assets traded, is that most funds have holdback provisions," noted Braun. "Even in a long/short equity fund that is relatively liquid, there is still some level of holdback."

Thomas agreed that many funds have holdback provisions, noting, "There are a number of different subcomponents of these provisions that vary across funds. One is the amount held back. Typically, a fund with a holdback may retain up 5% to 10% of the redemption amount. The fund usually has discretion to hold back less."

"It used to be the case that fund documents almost always provided for a holdback of up to 10%," added Allison Yacker, a partner at Katten Muchin Rosenman. "Now, more frequently, I see holdbacks of 5% when the strategy is more liquid and there is less likely to be any deviation in the NAV. Investors are more likely to push back now if they think the amount being held back is artificially high. You generally see a 10% holdback for more illiquid strategies."

Braun echoed Yacker's distinction between funds with liquid strategies and those with illiquid strategies. "For funds with more liquid strategies and easily priced assets, the holdback provisions may be a lower percentage," he said, "while funds with more illiquid strategies typically have a holdback provision for a larger percentage of the investor redemption."

If a fund invests in illiquid assets, however, it may use a side pocket or other mechanism as opposed to holdbacks. "In many cases the managers effectively wait until the disposition of the illiquid position to pay back the redeeming investor," Braun argued.

Finally, Sheryl Mejia, a partner at Decagon Advisors, said all types of funds are likely to include holdback provisions, regardless of the age and related bargaining power of the manager. However, what may differ with a newer fund versus a more established fund is the amount held back or the length of time the funds are held. According to Mejia, "Fund terms are starting to favor the managers again, and they can set the terms that they like more frequently now. However, newer funds are setting terms that are a little more investor-friendly."

Investor Response to Holdbacks

Investors largely accept holdback provisions, although they may try to negotiate the terms of such provisions where they feel appropriate. The portfolio manager at a startup hedge fund told Hedge Fund Law Report that investors in his fund have not argued with the inclusion or terms of a holdback in his fund's offering. "I think it's really just an accepted term," he said. "There are

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other terms that investors are pushing back on, and they're just not all that focused on the holdback."

"I have not seen pushback on any holdback provision itself because these terms have become quite standard, simply in case there is a restatement of valuation following the annual audit," concurred Mejia. "Where we have seen pushback is on the specific amount being held back, particularly with more liquid managers who are holding back higher amounts. There is a huge difference in liquidity terms between event driven managers and long/short equity managers, so the amount to be held back should reflect that."

Investor resistance to holdback provisions has been limited, Gray agreed. "Investors have pushed back a little on the holdbacks, but generally there are other areas of greater concern where investors are more likely to focus their negotiations with a manager."

"Overall, I think investors understand the need for the holdback and the annual audit to make sure everything is correct," he continued. "However, the holdback needs to be reasonable and appropriate to the fund strategy. Investors expect that the manager should not be off by more than 5% of the fund's NAV." Arguing that investors are more likely to be concerned with how the fund manager is calculating the NAV and how well it is done, Gray noted, "Some managers have lowered their holdbacks down to 2% because they don't expect that adjustments to their NAV will be greater than that. So, overall it's more about practice and the valuation policy than it is about the legal provisions of a holdback."

Thomas agreed that investors are more likely to resist higher holdback amounts in funds with liquid strategies. "If it's a fairly liquid strategy and the fund documents call for a holdback of 10%, it may strike some investors as being an overly large holdback. This can be a pressure point in investor negotiations."

Investors in a liquid fund "want to see lower holdback provisions, for shorter periods of time," Braun concurred. "They're pushing back on managers who seek to hold 10% of their money for six months. Investors now want to have a better understanding of the holdback requirements and how significant they are to the overall investment. That's where we've seen a lot of communications and where many funds have changed their provisions to match the vehicles' liquidity to the investment strategy and underlying assets."

"There has been pushback from investors where the holdback amount is too high," echoed Yacker. "For example, if you're running a very straightforward, liquid product where there is not a lot of risk that the NAV will deviate from the net asset value set forth in the fund's audited financial statements, then a smaller holdback amount of 5% or less would be appropriate."

Determining Terms of Holdback Provisions

Establishing the Holdback Parameters

In light of the foregoing, when a hedge fund manager is considering establishing an audit holdback for its fund, while the fund's strategy generally will not determine whether the fund will have a holdback, the strategy may dictate the general terms of the holdback provision. If a fund has illiquid holdings or investments that are otherwise difficult to value, the possibility of an adjustment to NAV subsequent to the redemption date may be greater than if the fund were to hold only liquid securities that are easily priced in the market. Accordingly, an illiquid fund is more likely to have a higher holdback than a liquid fund.

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The hedge fund portfolio manager told Hedge Fund Law Report that there was no discussion at his fund as to whether or not to include a holdback as, "these are general provisions that a significant majority of funds have. It's rare that you see a fund that doesn't have some holdback. I would say the bigger discussion is what the general terms of your holdback will be, since this varies from fund to fund."

More liquid funds may have less restrictive holdback provisions. "Some funds with very liquid strategies either do not have a holdback or have a lower percentage of the total redeemed amount being held back," explained Thomas. "On the opposite end of the spectrum, funds that have more illiquid strategies, or funds that may invest in assets that are more difficult to value, are more likely to have more protective holdbacks."

Zwickel agreed and added, "The more liquid the strategy, the smaller the holdback. The fund documents may provide the manager with the right to hold back up to 5% of the redemption proceeds, but, in practice, the manager may only hold back 1% or 2% because it is highly confident that the NAV will be accurate." Zwickel noted that funds trading pursuant to strategies with difficult to value securities, derivatives or fixed income securities, tend to have higher holdbacks to account for the increased risk that an auditor will challenge valuations, thus altering the final NAV of the fund.

"The most important things to consider when determining the terms of a holdback mechanic are the liquidity of the underlying instruments and how often the manager's NAV has historically deviated from the audited financials," advised Yacker.

Competing funds can also help determine the parameters of a fund's audit holdback. "If you're a new manager setting up a fund and you are trying to create a fair holdback provision, look at your strategy and the anticipated liquidity of the fund's assets," advised Braun. "Then, try to understand what similar funds are doing. You want a provision that's appropriate for your fund but also matches what your competitors are doing. If your terms are non-standard, investors are going to push back."

Determining Treatment of Held Back Assets

Managers also need to determine whether interest will be paid on the withheld funds. As Thomas noted, "Practice also varies with respect to whether interest on the holdback accrues to the benefit of the investor. Fund managers need to make clear in the offering documents whether interest is paid or not."

"Some managers will pay interest on the held back amounts," agreed Gray. "However, that is not a majority position; it is not market practice to pay interest."

When drafting a holdback provision, managers also need to determine where the withheld funds will be held until they are distributed to the redeeming investor (or returned to the fund). As Thomas noted, "Fund documents often do not specify whether the funds held back are maintained in a segregated account. This can be worrisome for an investor because, after a redemption, the investor becomes a general creditor of the fund and the holdback amount is potentially at risk. The investors concerned about this may seek to reduce the size of the holdback in order to mitigate that risk. A prudent manager needs to make sure that capital is available to pay when the amount is due. Investors also need to be comfortable with the manager's practice before agreeing to holdback terms."

"Best practice is to keep the held back amount in a separate account not subject to additional fees or the profits and losses of the fund," stated Gray, noting that investors generally prefer to

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have the money held outside the general fund and free of additional risk.

"The held back amounts generally are not subject to additional fees, but are subject to adjustment following the final NAV through the audit process," Thomas said. "The principle is that, if an investor redeems on Dec. 31, the money should be available for future payment regardless of the performance of the fund. The holdback amount is not being invested with the rest of the fund, so it is not subject to additional fees."

Braun concurred, stating, "It is important to note that the held back amount of the redemption proceeds are no longer an investment in the fund and are thus not subject to profits and losses of the fund or fees subsequent to the redemption. The holdback is only subject to any corrections or adjustments that would have occurred prior to the redemption date."

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