INSIGHTS FROM THE BDO FINANCIAL SERVICES PRACTICE

A CHECKLIST GUIDE: EMERGING FUND MANAGERS

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BDO'S ASSET MANAGEMENT PRACTICE

BDO's Asset Management practice provides assurance, tax and advisory services to asset management entities, comprising hedge, private equity and venture capital funds as well as regulated funds. The practice services over 600 advisors nationwide with funds ranging from start-up funds to those with billions of dollars under management.

Introduction

While emerging managers of new fund launches are initially consumed with fundraising, a careful consideration of basic checklist items can pay important dividends for years to come. This is particularly true since most emerging managers do not launch their fund vehicles with a fully staffed back office, specifically, lacking the appropriate initial finance (e.g. CFO, controller), compliance or IT personnel to run the day-to-day platform functions. This article is intended to serve as a general checklist for emerging managers who have launched or are looking to launch new funds. While we do surface general points regarding jurisdictional considerations, specific regulatory registration questions should be referred to the formation attorney.

In this article, we identify some important checklist items for emerging managers to consider, particularly related to the fund itself, a firm's operational considerations and the selection of appropriate service providers who will ultimately execute these ongoing functions. Addressing these considerations upfront will not only plug the gap until a formal internal team is in place but also help to inform and educate emerging managers on these topics that will mitigate key risks and improve operational efficiency.

LIMITED PARTNERSHIP AGREEMENT REVIEW

The devil is in the details and this is no truer than gaining a thorough understanding of the fund's limited partnership agreement ("LPA"). While emerging managers pay good money to have professional fund formation attorneys draft these documents, it is essential they understand the parameters of the agreement inside and out, particularly regarding those areas that pose the most significant risks to the emerging managers and, also to their investors. One such area of risk is related to advisory fee arrangements (management fees, carry or incentive fees). Since advisory fees are paid directly from the fund and are paid to the emerging managers, they ultimately affect the performance of the fund and, therefore, performance for limited partners. Emerging managers should attempt to map out some of the key parameters and trigger points that they wish to make clear in the LPA in order to safeguard against miscommunication that may result in miscalculation of advisory fee payments.

It is also recommended that the emerging managers share the LPA with their accounting partner (once hired) to perform a formal review. The following are examples of benefits from such a review:

- Specific tax implications related to the structure of the General Partner, Management Company and Fund are typically reviewed by the accounting partners (i.e. both "accounting firm, fund administrator") to determine whether emerging managers' intentions are clearly written and understood. From a tax perspective, emerging managers should involve the tax partner upfront to ensure that the structuring achieves the maximum tax efficiency. Emerging managers and their accounting partners should be in synch to avoid any misunderstanding that could pose real liability for the emerging managers in the future. For example, when fund performance triggers "carry", phantom income must be documented and accounted for and, in some instances, distributed. Emerging managers may face tax consequences without realizing the associated cash flow and should be fully aware of these potential obligations.
- Emerging managers and their tax partner should also carefully discuss and review carry waivers and structuring provisions within the LPA to maximize the opportunity for managers to benefit from reduced capital gains rates. Some upfront time spent on these points will ultimately improve the tax effectiveness and efficiency of the fund structure.
- Besides tax considerations, other important factors come in play. For example, there may be situations where management fees scale down based on certain milestones of the fund. In addition, a deep understanding of any clawback provisions is essential to avoid future surprises. Treatment of related party arrangements to management for positions on a fund's portfolio company board seats, professional services to the fund, etc. should be carefully reviewed by emerging managers to avoid any future conflicts. In addition, management fee waivers/offsets should be thoroughly discussed. Careful consideration of these factors will help to avoid any future misunderstanding, particularly with accounting partners and the limited partners.
- From a cost and flexibility perspective, particularly for an emerging manager with a focus on cost savings, it may be worthwhile to include in the LPA an allowance for a longer time frame (120 days vs. 90 days) to issue the audited financial statements. This is particularly true for private equity or venture capital funds whose audits are issued by or before March. By having the audit issuance requirement to no later than 120 days in the LPA, the audit deadline may land in a period where there is more bandwidth for the accounting partner thus providing for more flexibility with respect to audit pricing discussions.
- Another cost consideration that should be weighed within the LPA is a waiver for an initial year audit (if such initial fiscal period is 3 months or less and provided that the emerging manager is not registered with the SEC as an adviser). This is particularly important if a fund has just commenced investing, has limited activity and does not warrant a full audit for a stub period. By including this specific waiver in the LPA, an extended audit, which rolls into the following year, will cover the initial period and a full year cycle resulting in a more cost-effective engagement for emerging managers.

VALUATION CONSIDERATIONS

As a general rule, emerging managers should be fully committed to the valuation process of the fund's investments in portfolio companies from day 1. From a due diligence and operational perspective, emerging managers' awareness of valuation approach demonstrates a level of management oversight, even after a finance professional is hired to manage this area. This is not to say that emerging managers need to be constantly involved in ongoing valuation discussions with their accounting partners.

- By investing upfront time and consideration in the cursory layout of the valuation policy and by thinking about how valuations will be approached under certain scenarios, emerging managers can ensure that a proper framework is established. In addition, documenting these initial thoughts in a preliminary valuation policy will provide a starting point and framework that can be modified as the fund evolves in its investment complexity and sophistication. This will result in a higher level of consistency and transparency for investors. A good initial reference point for ASC 820 fair value guidance can be found in the AICPA's ***Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies***.

- Emerging managers should also think about valuations in the context of the year-end audit. Upfront, open and ongoing communication with accounting partners can also lessen the learning curve and eliminate surprises at the time of the year end audit. Getting ahead of the curve by having an upfront conversation with their accounting partners will help identify any portfolio company valuations that warrant further scrutiny. These discussions can be held well in advance of the year-end audit.
- Finally, emerging managers and their finance professionals may also opt to consider the use of third party valuation specialists to perform the valuations on the fund's portfolio investments. The decision to use a third party specialist may be due to the complexity of certain Level III investments within a fund portfolio. Furthermore, the decision may entail whether to have that firm perform a review of all or a portion of the portfolio, or at least provide the critical data/assumption for the valuation.

While this specific area of operational expertise may ultimately lie with the hiring of the finance team, emerging managers should invest the time upfront to understand the valuation implications of their investment strategy and help develop protocols and procedures around it.

CYBERSECURITY & DATA PROTECTION

While most funds will hire outside cybersecurity experts, emerging managers should view IT security and investor data integrity and protection in the context of their own reputations and risk to their livelihoods. Breaches in their systems can result in real liability and reputational risk. The integrity of information technology is a critically important operational factor that emerging managers should consider and monitor from the onset of operations.

- Data integrity and security is a vital component of a sound IT strategy. A starting point for data security is to ensure the potential service providers handling sensitive information have tried and tested security infrastructure and procedures such as robust firewalls and secure data rooms or portals. As information flow is fluid, particularly during the audit and tax engagement, it is extremely important for emerging managers to assess the security apparatus of their vendors to ensure limited partner and fund related information is transferred and stored securely.
- To ensure ongoing data security, a formalized and annual vendor assessment may also be a worthwhile best practice. Requiring vendors to demonstrate how they handle sensitive information provides a level of integrity to the process and simultaneously provides larger LPs with an additional level of assurance that their personal information is protected.
- Understanding, mapping and monitoring areas of risk to their own IT infrastructure can prove to be another prudent upfront investment by emerging managers. In fact, increasingly, many larger and sophisticated limited partners are demanding it. It is not sufficient to simply wait for the hiring of back office personnel to monitor internal cybersecurity matters. Some pertinent considerations for emerging managers to consider include breach testing of the firewall, phishing exercises and ongoing training by outside professionals to ensure all personnel are up to speed on the latest threats to their IT infrastructure and operations.

From the onset of operations, identifying potential cybersecurity and data security gaps, both internally and externally, and understanding and implementing the appropriate IT protocols and infrastructure around them can prevent breakdowns and reduce risk.

PERSONNEL/BUSINESS CONSIDERATIONS

In the fervor of fundraising, many emerging managers may lose sight of the fact they are actually running a business with employees, payroll and overhead expenses.

- While most emerging managers will largely outsource specific functions such as payroll and benefits, they must be cognizant of local, state and federal labor laws as well as implementation of a human resource framework to govern hiring and firing, employee promotion and employee incentives and benefits. The lack of a coherent and consistent internal promotion policy and compensation allocation regimen is a simple but relevant example of how a fund's size could grow but how internal infrastructure might not keep pace. A comprehensive write-up governing human resource related decisions would address any future issues by clearly articulating the criterion for promotion and the basis for variable incentive.

- In addition to personnel considerations, other business factors should be fully vetted. For example, from a tax perspective, emerging managers residing outside the state where the fund physically resides could be subjected to specific tax filings. Also, if the fund is involved in international investing it could be subjected to specific IRS compliance and filing requirements.

In short, careful consideration should be given how emerging managers wish to run their business and the documentation related to the rules that govern it.

COMPLIANCE & REGULATORY

One of the most important factors for any emerging manager launching a new fund to consider is the compliance and regulatory aspects of its business. This will have an immediate and lasting impact on their business. Mandatory filings such as Form ADV, Form 13-F (if an RIA) and Form PF are a few examples of required filings.

- For foreign jurisdictions and relevant required foreign filings, emerging managers can rely on their fund formation attorneys but should plan ahead if they intend to launch funds in certain foreign jurisdictions such as the Cayman Islands, British Virgin Islands or Luxembourg. In addition, all compliance related documents also need to be kept up to date in the event of a regulatory audit. As the fund complex evolves, a chief compliance officer may be hired internally or, in some instances, the current CFO or COO often fulfills this role.
- In addition to statutory filing requirements, emerging managers must keep themselves abreast of changes in tax laws as well. Outside third party specialists can provide valuable resources and insights to help guide emerging managers with respect to tax updates that might impact emerging managers' or their fund's overall tax profile, particularly in areas such as carried interest taxation, which is often variable in nature due to the shifting regulatory environment.
- General Partner specific tax issues such as the new carried interest taxation rules as well as issues affecting the LPs (e.g. the choice of legal entity for portfolio company holding purposes and unrelated business income tax) should be thoroughly reviewed and considered.

While a majority of emerging managers will hire outside compliance specialists to help navigate the compliance and regulatory landscape, ultimate responsibility of compliance still lies with emerging managers.

SERVICE PROVIDER SELECTION CRITERIA

Once emerging managers have gained a basic understanding of fundamental business and operational considerations, a careful analysis of key service providers to help manage the ongoing operational areas, such as an audit/tax partner or fund administrator, should come into focus. Several benchmark criteria should be considered by emerging managers that will prevent miscommunication with limited partners and help ensure that the appropriate level of ongoing operational integrity is met.

- **Limited partner considerations –** It is always recommended that emerging managers ask institutional limited partners for their feedback before embarking upon important hiring decisions. Some larger, more institutional limited partners actually maintain formal due diligence procedures they must follow. In addition, certain limited partners may even have standards in terms of service provider size or qualifications that must be met. It is important for emerging managers to understand these constraints and discuss them upfront with their limited partners to avoid miscommunication and ensure all the appropriate boxes are checked.
- **Cost –** Emerging managers must often balance the cost of hiring outside service providers with their immediate needs. It is important to understand the capabilities of the service provider to ensure they provide the right fit to grow with the fund while, simultaneously maintaining a degree of cost discipline. The starting point for emerging managers in service provider selection is truly understanding their own immediate, intermediate and longer-term needs. It is always desirable to have the "best of breed" in terms of service providers, particularly when marketing the fund to outside investors. However, internal cost considerations should be carefully weighed, particularly for a fund starting off with a keen focus on costs. Certain questions should be considered such as whether a full service, national brand is immediately required or whether a more cost-effective initial service solution is more suitable.

  Equally important, emerging managers should realistically assess their fee structure with service providers. For example, an unrealistically low fee arrangement with a service provider that does not reflect the true nature of scope and complexity should be avoided. In addition, emerging managers should also recognize that as their funds' accounting requirements grow, increases in fees to accommodate for higher levels of activity and complexity should be anticipated.

Finally, in order to avoid constantly changing service providers as the fund evolves, it is worthwhile to carefully consider variable fee arrangements with key service providers that provide maximum flexibility so that as assets under management grow, both parties feel invested in the relationship. A true partnership between emerging managers and their service providers should entail a level of investment on both sides of the equation. So, it is recommended that in weighing costs vs. requirements, emerging managers strive to seek a partner that not only checks the box in terms of capabilities but who is also willing to grow as the fund grows, taking a longer term view of the relationship.

- **Scale & Depth** – Fully Integrated Firm vs. Local Solution

In considering service providers, emerging managers should not only focus on their true internal needs but also consider whether they require a national branded firm that provides a certain identity recognition and a holistic service solution, particularly as a fund grows in size and scale. A national firm may have more resources across a broader geographic spectrum than a local or regional firm and, possibly, more experience across a multitude of industries to which these services are provided. Conversely, if there is no requirement for a national brand and an emerging manager is seeking to get to "point B" with the service provider, a local or regional service provider platform may offer a better short term solution.

An internal analysis should be performed as to whether it makes sense to hire a firm that can holistically service other fund level or firmwide needs such as fund international audit or tax requirements or services for portfolio companies such transaction advisory or portfolio company audit and tax. This is particularly true in the case of private equity funds. Understanding one's immediate and future requirements and discussing priorities with limited partners can help emerging managers make the appropriate service provider hiring decisions with the full support of their investors.

After familiarizing themselves with their own priorities and making initial service provider selections, emerging managers should also perform periodic ongoing reviews of their service provider matrix to identify any misalignments based on the current position of the fund and to make any necessary calibrations to fit to one's budget.

- **Service Provider Fit** – Experience, Location & Technology

While COVID-19 has temporarily turned the world upside down in terms of how we think about business and how we interact with one another, over the longer term, emerging managers should ask themselves important questions that will affect how they intend to interact with their third party providers. For example, is it important to have a team that is local, accessible and responsive or is a remote service experience sufficient to get the job done? Delving into the unique qualifications of the service team is critically important to ensure they truly understand the investment strategy, have prerequisite qualifications and will provide the emerging manager with the appropriate level of technical experience.

While all service providers will present strong client references, it is extremely important to consider the actual service team itself that will be handling the account. On the surface, it may be optimal to have a marquee brand name firm on the account. But, if the service team is in a remote location and your firm profile is not aligned with the service provider, emerging managers may not feel they are receiving the appropriate level of service. If, for example, a firm's service team is remotely located in the Cayman Islands but the emerging manager's desire is to have a team they can interact with in person, this should be flushed out before making a hiring decision. Personality fit is also an important consideration to ensure the relationship starts on a solid footing.

Technology is a critical consideration in the service provider selection process. Specifically, the importance of being able to seamlessly connect the administrator and tax provider from a data flow perspective is vital. The partnership tax compliance process, when aided by technology, can provide significant efficiencies to the overall reporting process, including information flow from portfolio companies to the funds, specifically for private equity and venture capital funds. In addition, imbedded performance and investor reporting software technology that fund administration firms utilize is something emerging managers should carefully consider as it will affect many aspects of their own business. In the case of accounting firms, understanding the valuation testing approach, audit and tax technologies utilized and general service approach will help ensure internal goals are aligned with the appropriate service provider(s).

Again, while reference checks can help alleviate some of these concerns a critical ongoing service provider evaluation can ensure emerging managers make the necessary calibration so that the right service team is servicing their account.

Conclusion

Emerging managers launching new funds are often time constrained to address key structural and operational considerations that can pose real risks both in the immediate term and as their fund platform evolves. Since ultimate authority and responsibility resides with emerging managers, it is essential that they keep their fingers on the pulse of key issues that impact their business and continually educate themselves in order to provide an additional buffer to these risks as the fund evolves and grows, even after key personnel are hired to help manage these operational areas.

Also, while cost is always an underlying theme to balance while establishing the highest level of operational integrity, it is important for emerging managers to truly understand their immediate, intermediate and long term growth goals and to ensure the appropriate infrastructure is in place to satisfy their requirements. Maintaining an ongoing dialogue with limited partners will also go a long way to ensuring continued confidence in the emerging managers and to maintain a level of cost discipline aligned with the operational requirements of the fund and firm.

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