The Rise of the Pass-Through Expense Model

While the concept of a pass-through expense model is most often associated with multi-strategy alternative investment funds, this expense structure is beginning to gain wider traction among other managers as well, depending on various considerations.

What is a pass-through expense structure?

In the most common iteration of a pass-through expense structure, the fund will bear not only the fund's expenses (e.g., legal, audit and trading), but also most if not all of the overhead costs that would generally be paid by the manager (e.g., salaries and bonuses of firm personnel, and other overhead costs). This is usually in addition to, but sometimes in lieu of, the management fee charged by the manager.

The following are some variations on the basic pass-through model that managers may wish to consider:

- **Partial Pass-Through**: The fund only pays for certain expenses that would otherwise be borne by the manager, such as certain firm personnel dedicated to a particular fund or strategy.
- **Fixed Cap Pass-Through**: Any manager expenses to be paid by the fund are capped at a certain percentage, and the cap is typically calculated on a quarterly basis.
- **Tiered Pass-Through**: As the fund reaches different AUM thresholds, the percentage of expenses that are passed through changes.
- **Fee Offsets**: In some cases, an expense pass-through may offset either the management fee and/or the incentive allocation payable to management.
- **Bespoke Pass-Through**: In lieu of the traditional fund fee and expense terms, some investors may negotiate a side letter with some form of expense pass-through approach. In this scenario, the manager must ensure that this will not result in higher costs being shifted to the other investors.

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Why are pass-through expense structures becoming more popular?

The increased popularity in pass-through expense structures across the alternative investment fund universe can be attributed to various factors:

- **Pressure on Management Fees / Demand for Greater Transparency**: As managers continue to receive pushback from their investors on management fee rates, they are also being asked to provide greater transparency about their operations. In a pass-through expense model, there will often be a detailed statement available to investors outlining the expenses that the fund is being asked to pay, which will allow the client base to assess the efficiency of the manager's operation from a due diligence standpoint.

- **Better Alignment of Interests**: In an expense pass-through model where there is no management fee (or minimal management fee), the economic success of the manager is aligned with investors. In this model, the manager is only (or primarily) compensated through an incentive allocation that is calculated based off of net profits.

- **Talent Attraction and Retention**: As the competition for elite investment management talent continues to rise, having the ability to "lock up" superstars by passing on compensation costs to the fund may result in better long-term fund performance.

Implementation issues

When deciding whether to implement some form of expense pass-through, the following are the key considerations for the manager:

- **Which Expenses and What Limits**: The manager will need to decide what categories of expenses to pass through and whether there will be any limitations thereon.

- **Impact on Returns**: Since expenses will impact net returns, the manager will need to determine how performance will be impacted, will it affect capital raising and how does this action compare to its peers.

- **Compliance Burden**: In light of the actions of various regulators related to pass-through expenses, management will need to be hyper-vigilant in terms of disclosure and compliance with all appropriate regulations.

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Implementation issues continued

- **Investor Transparency**: The Private Fund Adviser Rules, which would have mandated certain disclosures, have been vacated; however, in order to satisfy its fiduciary duties, a manager must make full and fair disclosure about the types of expenses being passed-through and how they impact fund returns.

- **Expense Scrutiny**: As a fiduciary, a manager must act in the best interest of its clients at all times. This lens must be applied to each expense that is passed through to a fund – i.e., expending the cost must be in the best interest of investors. This scrutiny does not occur when the manager is paying expenses out of its own capital.

- **Tax Implications**: The manager will need to assess whether the pass-through structure may have an adverse impact on the fund or the manager.

- **Operational Factors**: The manager will need to determine whether passing on certain expenses (e.g., rent) may change the liability profile of the fund or otherwise create operational impediments.

While the pass-through expense structure may not work for all managers, it does nonetheless have certain merits that may benefit a wider audience than just multi-strat funds. Managers considering such an approach will need to weigh various considerations when making this decision.

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