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private funds management

# FEES & EXPENSES SURVEY 2018



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IS BECOMING  
MORE GRANULAR'**

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## Towards transparency

Talk to anyone concerned in drawing up fund documents and the issue of fees and expenses quickly emerges as a key battleground. Julie Corelli, partner at Pepper Hamilton, recalls an afternoon spent recently trying to convince a limited partner's counsel that it was the fund's responsibility to pay the travel costs as part of the deal origination costs. "I said 'So you want the portfolio manager to be incentivized to assess management over the phone? I could never recommend that the fund manager bear travel expenses incurred in the course of evaluating a specific opportunity. That's nonsensical.'"

It's a scene played out in legal offices from New York to Nairobi as limited partners start to question fees routinely charged by private equity funds. It's a trend that *pfm* has kept a close eye on since we began the Fees and Expenses Benchmarking Survey in 2014. Conducted every two years in partnership with PEF Services, Pepper Hamilton and WithumSmith+Brown, we contact CFOs and industry professionals across the US and ask about their fees and expenses policies.

The responses detailed in this special supplement provide a valuable insight into how far the industry has moved towards taking a more transparent approach to this contentious area.

This year's survey gives clear indications that GPs are becoming more selective in exactly what they charge to the fund. That's partly the result of a crackdown by the Securities and Exchange Commission which has resulted in millions of dollars

in fines for inadequate disclosures. It's also a reaction to the success of the drive by Institutional Limited Partners Association for greater transparency.

Issues do, of course, still remain. The survey details a worrying 'wait-and-see approach' to whether fees will be renegotiated at the time of a fund restructuring, says Tom Angell of WithumSmith+Brown (p. 22). There are question marks, too, about who picks up the tab for outsourcing, as Anne Anquillare of PEF Services details on p. 16, and the issue of who should pay for broken deal expenses remains a hot topic, Corelli says (p. 10).

While ILPA welcomes greater disclosure, there are fears that the increased expense provisions are coming at the cost of clarity at what exactly investors will have to pay, argues ILPA managing director of industry affairs Jennifer Choi (p. 28).

So while there's no doubt that LPs are pushing for – and getting – greater disclosure, bones of contention remain, especially over the treatment of co-investors (p. 25).

The consensus is that the pendulum still remains very much in the GP's favor in fee negotiations, but that could all change if there's a correction. "LPs will be understandably selective in how they place their bets if there is another turn of the cycle," says Choi.

Enjoy the supplement.

Graeme Kerr  
Special Projects Editor



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Co-investments have become standard in private equity, but arrangements between LPs and GPs don't all fit the same mold

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More expense provisions in LPAs come at the cost of clarity over what investors have to pay, says Jennifer Choi, managing director of industry affairs of the Institutional Limited Partners Association

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# LPs demand more granularity

Investors are forcing funds to take disclosure to a whole new level of detail, with broken deal expenses one of the most contentious areas, writes *Graeme Kerr*

To say that the issue of fees and expenses has risen up the agenda of private equity over the last decade would be something of an understatement. Bolstered by a crack-down that has seen the Securities and Exchange Commission get tough on violations, limited partners have pushed for greater transparency. This has forced general partners to change their limited partnership agreements to provide more details of fees and expenses.

That's something that comes through clearly in the 2018 *pfm* Fees and Expenses Benchmarking Survey. According to the survey, 38 percent of general partners revise their limited partnership agreements following a visit by the SEC and 40 percent change their valuation policies.

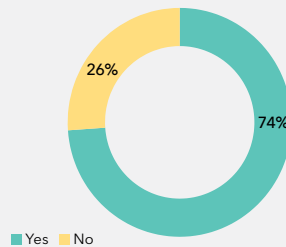
"A lot more funds are altering their LPAs and creating a more detailed procedure for fee and expense allocations," says Tom Angell, a partner at WithumSmith+Brown. "They've become a lot more transparent and detailed."

There is more clarity on operating partners, board and directors fees and some fees – monitoring fees, for example – have "disappeared altogether" says Angell, following action by the SEC.

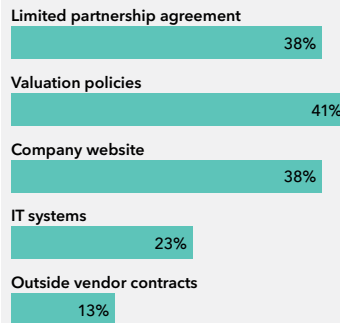
*pfm* has conducted the Fees and Expenses Benchmarking Survey every two years since 2014. The 2018 version is the most comprehensive ever: "LPAs are getting longer and so is the survey," says Julie Corelli, a partner at law firm Pepper Hamilton, who has been involved with the research since its inception. "Everything is becoming more granular."

## Securities and Exchange Commission

Is your firm registered with the Securities and Exchange Commission?

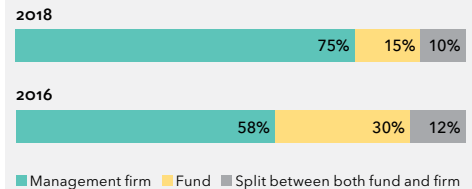


Have you made changes to the following documentation following the SEC visit? (Check all that apply)

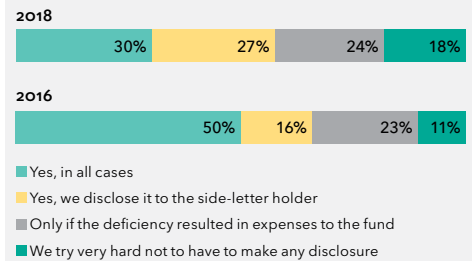


Your firm is visited by the SEC or state regulator for a routine regulatory examination which leads to a deficiency finding around valuations. You decide to redo the last two quarters' reports and deliver the new ones along with an explanatory letter to your LPs.

Who pays for the accounting and legal costs in getting through this correction process?

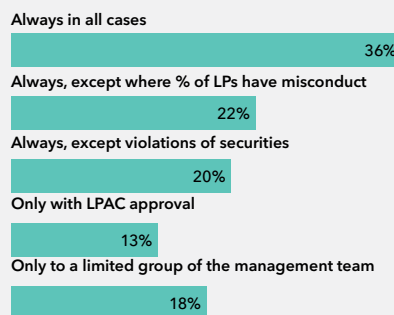


As a result of a routine examination, the SEC highlights deficiencies in the examination report. Do you disclose these deficiencies to your LPs?

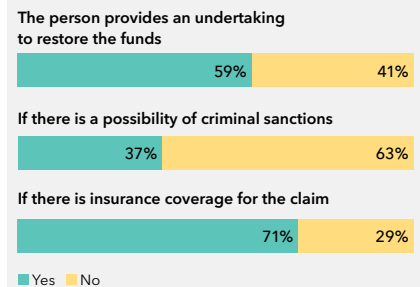


## Expenses

If your LPA provides indemnification of principals serving on the management team, does that indemnity provide for advancement of expenses? (Check all that apply)



An individual principal within your firm is the subject of an inquiry from the SEC that involves the firm's activities and the activities of the funds you manage. Do you advance expenses for the principal's defense if:



To conduct the survey, we contacted chief financial officers and industry professionals across the US and asked about their fees and expenses policies. The poll comes against the backdrop of a push by the SEC for increased disclosure of fees and expenses over the last four years, with enforcement actions against some of the largest private equity firms.

Apollo Global Management had to fork out \$52.8 million to resolve charges over inadequate disclosures, and other matters. Blackstone had similar issues over monitoring fees and had to pay \$32.9 million. Both firms paid the fines, but neither admitted any wrongdoing. “The enforcement actions forced firms to create fees and expenses policies that are transparent and detailed to LPs,” says Angell.

### Investor paranoia

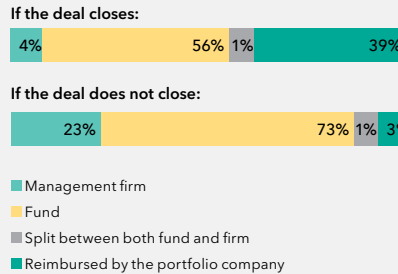
The result has been something of a sea change in the way the private equity industry deals with the issue of fees and expenses: “It wasn’t well documented, it wasn’t well executed and it opened everyone up to regulatory scrutiny and investor paranoia,” says Anne Anquillare, the CEO of fund administration firm PEF Services, who has also been involved with the survey since the start. “The industry really has shifted towards transparency.”

One of the biggest areas of controversy is whether the fund should pay the expenses when a deal doesn’t complete. This year’s survey took a deeper dive into the issue than in previous years and found a 5 percent drop in the percentage of firms that charge all broken deal expenses to the fund, and a 5 percent increase in cases where all the broken deal proceeds go to the fund: a result that is “clearly favorable to LPs”, says Corelli.

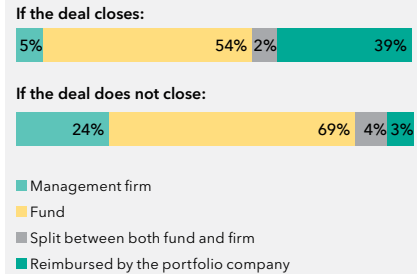
Another new topic for the 2018 survey was fund restructuring. More than half the funds were found to adopt what

## Deals

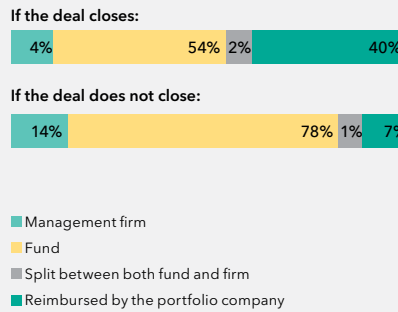
*After data room review in an auction deal, a non-binding indication of interest is executed in connection with which you incur legal and accounting expenses. Who pays for these expenses?*



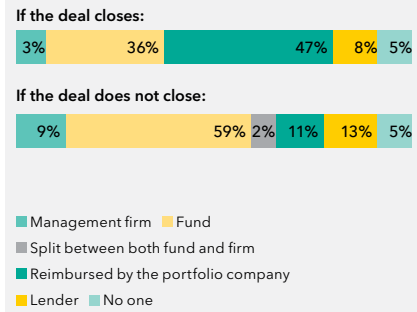
*During due diligence and before a formal letter of intent is signed (binding or non-binding), the firm hires lawyers, consultants, accountants and other service providers to work on the transaction. Who pays for these expenses?*



*After a formal letter of intent is signed, the firm hires lawyers, consultants, accountants and other service providers to begin working on the transaction. Who pays for these expenses?*

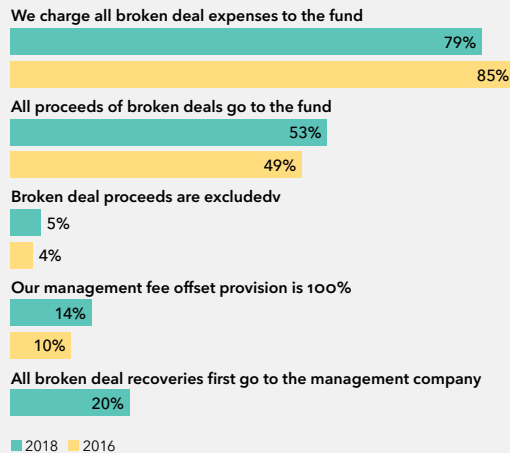


*After a definitive agreement is signed, the firm's financing team agree a lending package for the deal. Who pays legal fees incurred by the lender?*

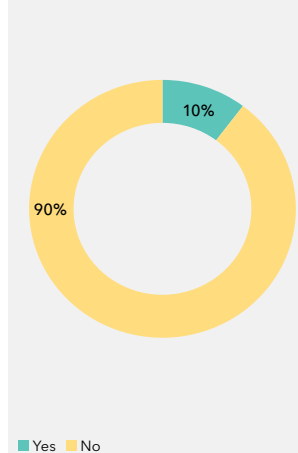


## Broken deals

*In terms of broken deal expenses, which of the following applies to you? (check all that apply)*

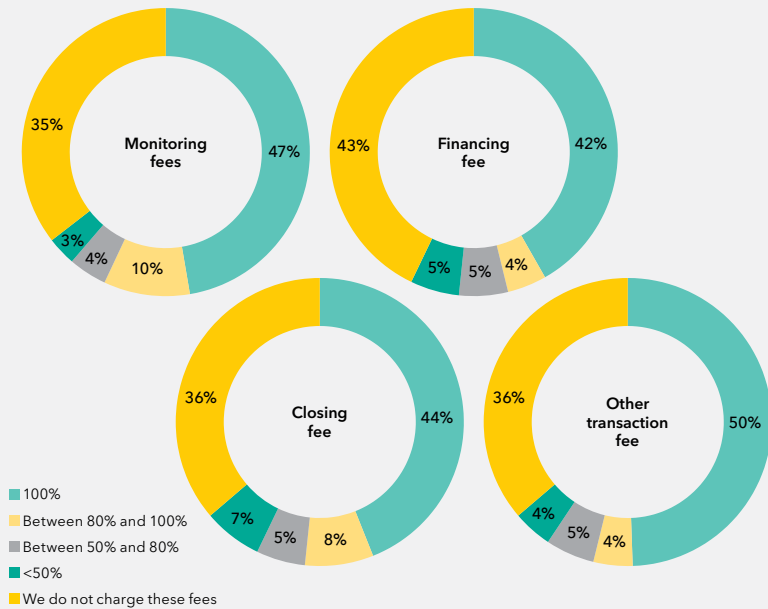


*Are broken deal fees capped if charged to the fund?*

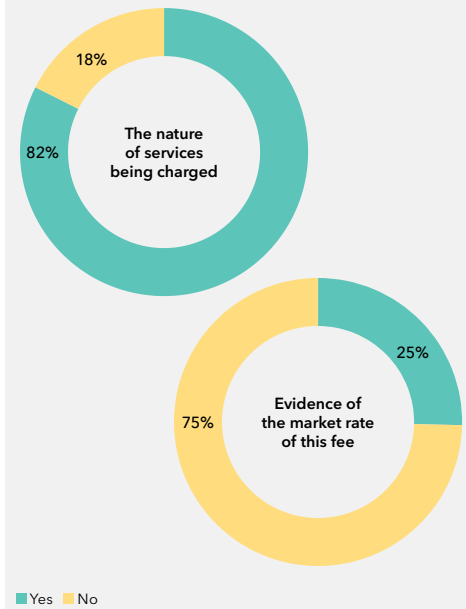


Deal fees

What percentage of your transaction, monitoring or any type of investment related fee received by an affiliated entity is offset against your management fees?

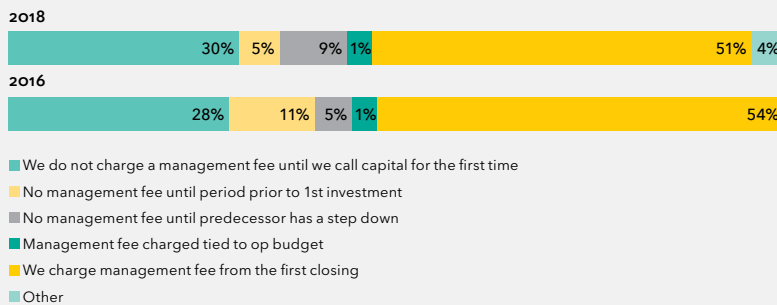


If your firm charges investment-related fees, do you disclose to investors:

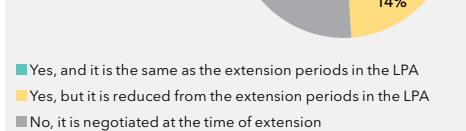


Management fees

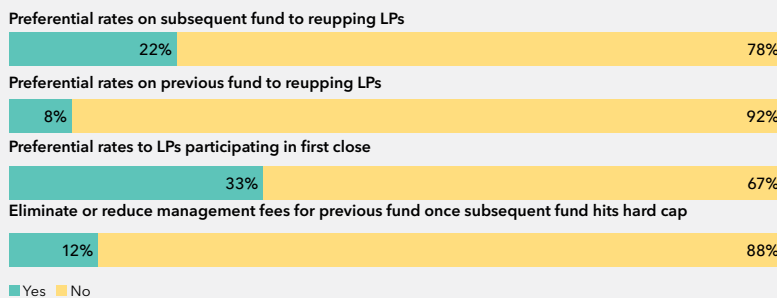
Please state which is true of your most recent fund:



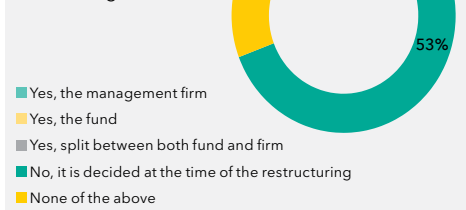
Did you stipulate in your LPA the fee and expense arrangements if your fund life is extended beyond the extensions periods allowed in the LPA?



How do management fees on successor funds relate to a previous fund?



Did you stipulate in your LPA who pays for costs relating to a potential fund restructuring?



Angell terms a “we’ll-cross-that-bridge-when-we-get-to-it approach” by saying they plan to negotiate the handling of fees and expenses at the time of the extension: a “wait-and-see approach” that “can be dangerous,” he says.

### Contentious charges

Co-investments are another area where broken deal expenses are contentious. Here there are clear signs that co-investors are being expected to pick up a growing share of the fees and expenses burden, with 9 percent more funds (40 percent in 2018 versus 31 percent in 2016) reporting that they will require a co-investment entity to bear a portion of broken deal expenses.

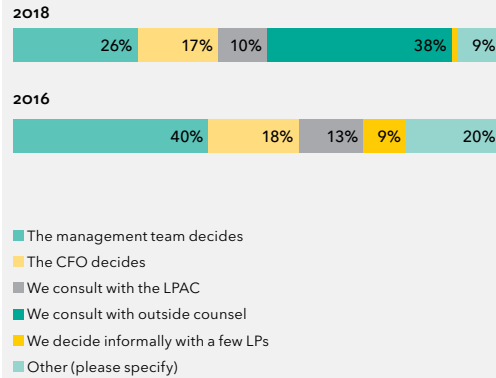
There is widespread agreement among everyone that *pfm* interviewed for the 2018 survey that there has been a fundamental shift in the fees and expenses dynamic between LPs and GPs over the last decade. “LPs expecting transparency want to know exactly what is to be charged to them so they’ve insisted on everything being detailed in the LPA,” says Corelli. “That is fundamentally not an issue and it’s a better practice to list even more than the manager expects to charge – leaves room for judgment, which is necessary to be able to do the right thing.”

Fund documents have become more “expansive,” says Jennifer Choi, managing director of industry affairs at The Institutional Limited Partners Association. But while it is encouraged by the greater disclosure, the group voices concern that “burying investors in pre-emptive disclosures” can leave investors scratching their heads as to which fees they will actually end up paying. This is particularly the case when the documents give the fund manager the discretion to choose whether to levy those charges.

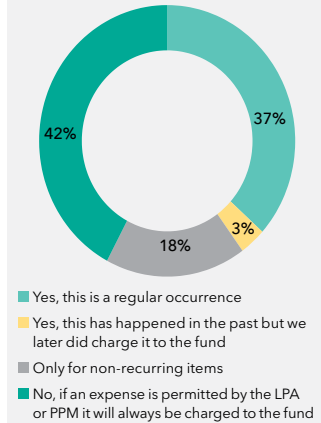
And the result can be heated discussions

### LPAs/PPMs

How do you decide questions about fee and expense allocation which are not addressed in the PPM, LPA or policy documents?

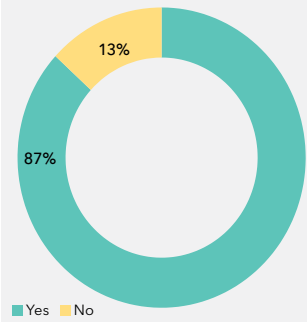


Have you ever decided not to charge to the fund an expense that was expressly permitted in the LPA or PPM?

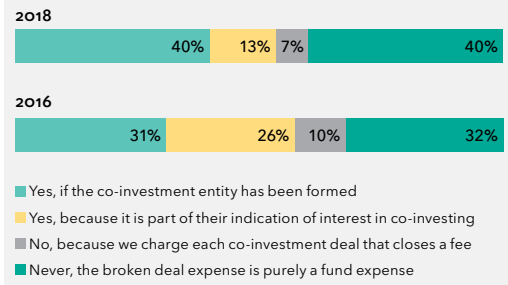


### Co-investment

Does your firm offer co-investments?

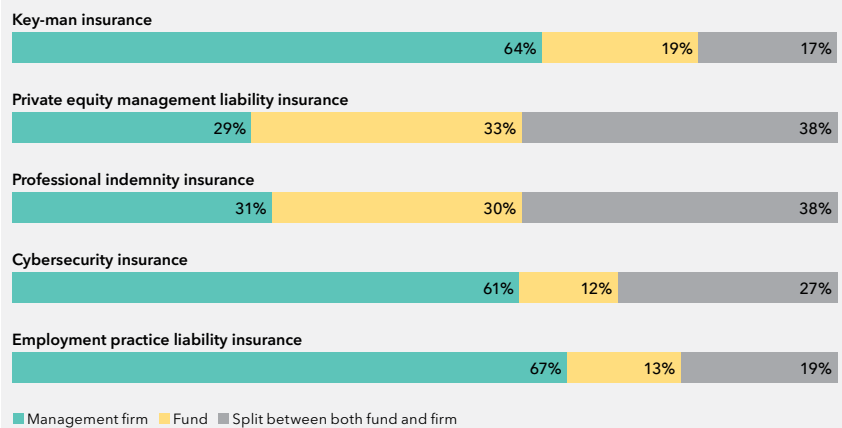


Do the co-investors have any responsibility for broken deal expenses if the deal does not go forward?



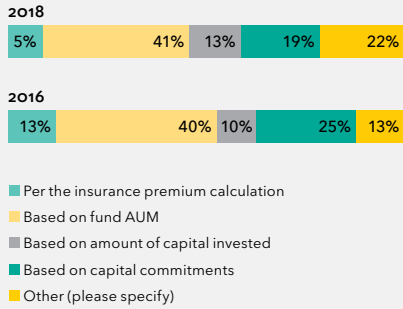
### Insurance premiums

When your firm takes out new insurance policies covering the below, who bears the premium?



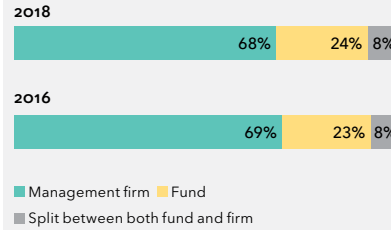


If you allocate these costs across funds, how is this allocation calculated?

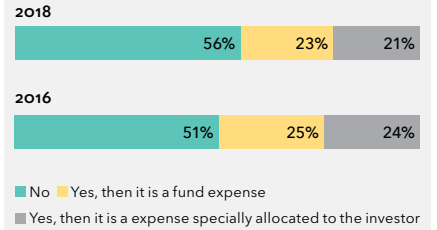


ESG

Your firm employs an ESG consultant to advise on a responsible investment policy across your portfolio. Who pays?

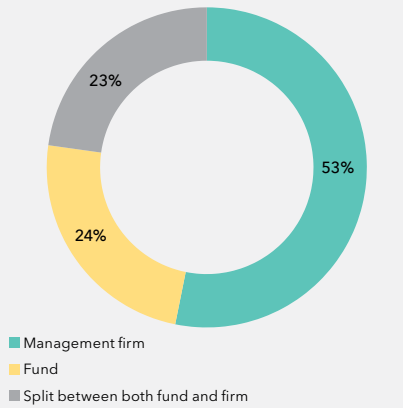


If an ESG consultant is a requirement of a particular limited partner, does this change your answer to the above question?



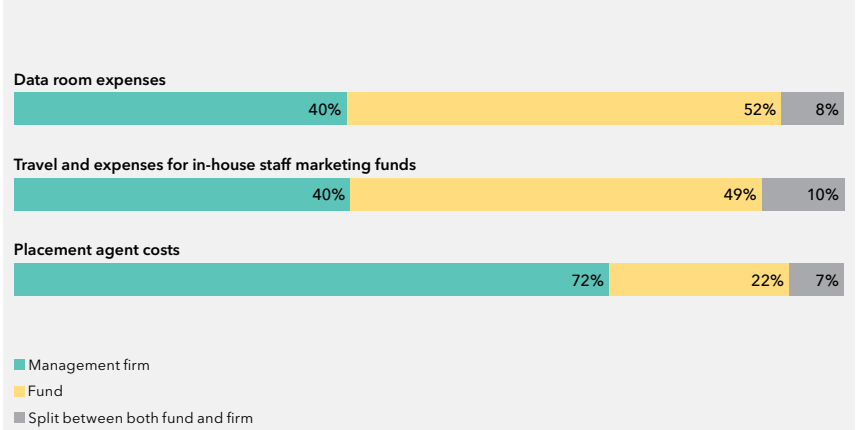
Tax advisors

If you have hired external advisors to address the 2017 Tax Reform Act, who pays the bill?



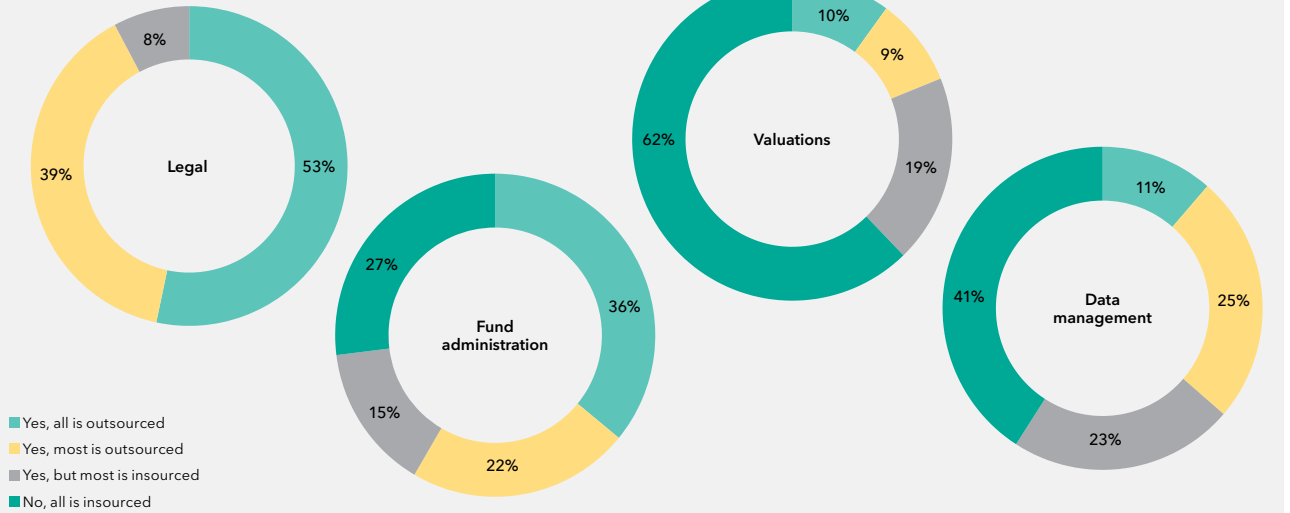
Marketing costs

Who pays for the following fund marketing costs?



Outsourcing costs

For the following services, do you outsource to third parties?



during fund negotiations over fees and expenses. “I think that counsel who represent LPs are taking a harder line,” says Corelli, who recounts an LP objecting to travel expenses as part of deal origination costs: “I said ‘So you want the portfolio manager to be incentivized to assess management over the phone? I could never recommend that the fund manager bear travel expenses incurred in the course of evaluating a specific opportunity. That’s nonsensical.’”

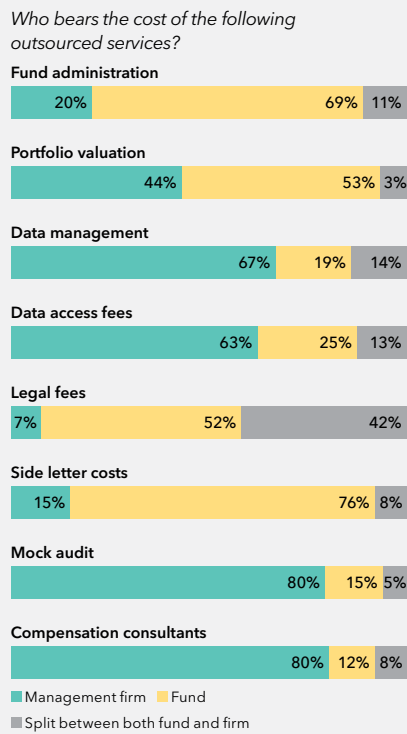
### Swinging pendulum

The other big change since our first survey in 2014 is the introduction of the Institutional Limited Partners Association fee-reporting template. The 2018 survey found that 76 percent of LPs either use it or are moving closer to an ILPA-standardized template, up from 68 percent in 2016.

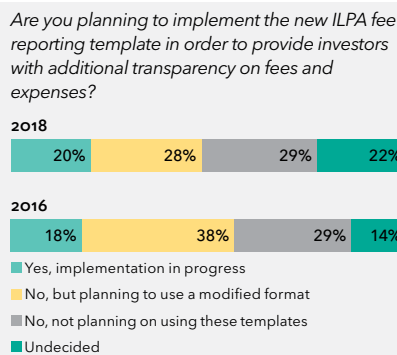
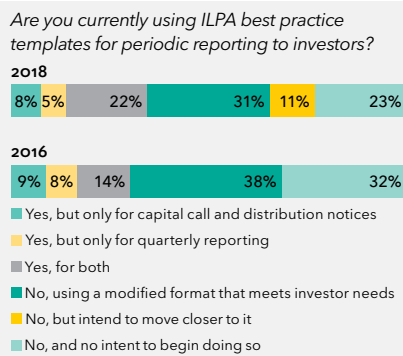
That’s not quite as much movement as the group was expecting, says Choi, but that may be because smaller GPs with less than \$500 million in assets made up more than 40 percent of the sample, she says. Larger GPs are more likely to use the ILPA template.

So what does the survey say about the state of the GP-LP dynamic? Despite the increase in disclosure, “the pendulum is still so much in the GP’s favor,” says Anquillare. “I think it’s because we haven’t had a correction in the overall marketplace for so long. There are so many institutional dollars looking for a home in private equity they just need to find yield somehow.”

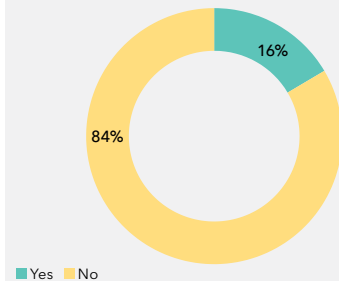
But that could all change: “If they are not today positioned to be seen as balanced, fair and reasonably LP-friendly in the next cycle, it could really pose a significant challenge to raising their next fund because LPs will be understandably selective in how they place their bets if there is another turn of the cycle,” says Choi. ■



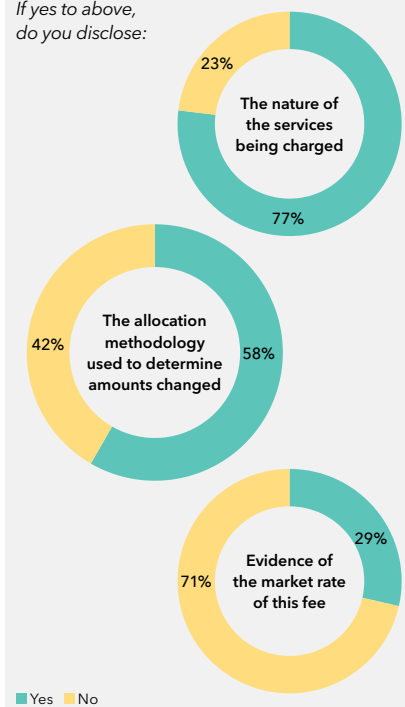
### ILPA template



If you are insourcing any of the above services, do you charge any of these services to the fund in addition to the management fee?

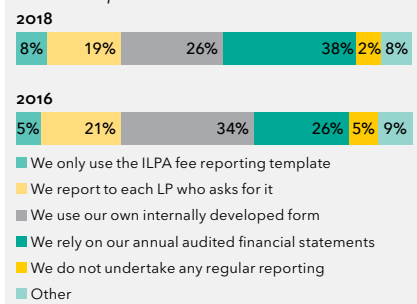


If yes to above, do you disclose:



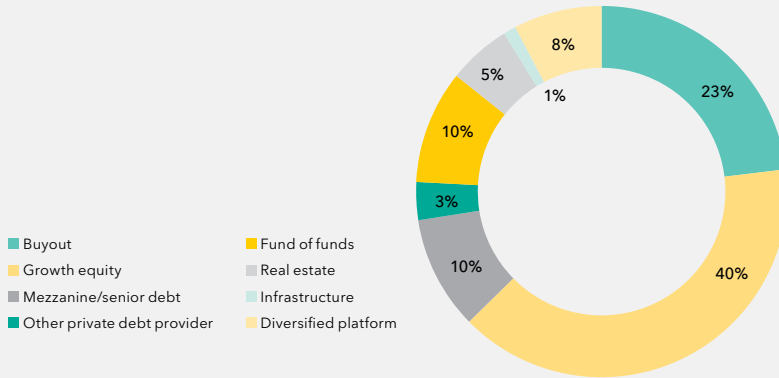
### Reporting

How do you currently report your actual fees and expenses to investors?

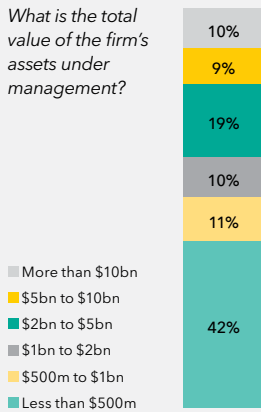


Survey respondents

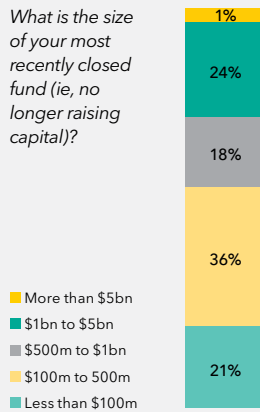
What type of investment firm best describes your firm?



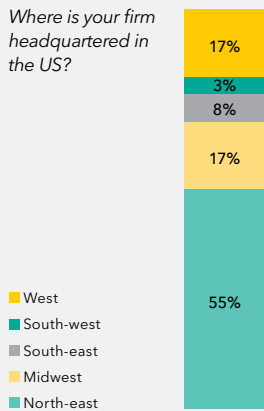
What is the total value of the firm's assets under management?



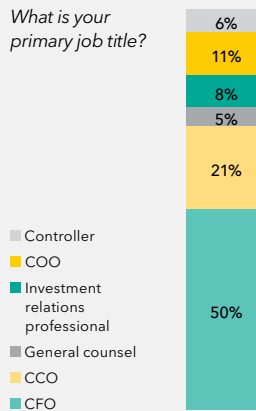
What is the size of your most recently closed fund (ie, no longer raising capital)?



Where is your firm headquartered in the US?



What is your primary job title?



Methodology

WHAT IS THE PFM 2018 FEES AND EXPENSES BENCHMARKING SURVEY?

The survey was launched in 2014 in response to fund managers' questions about who should pay for various fees and expenses. The resulting report, which we produce every two years, is intended to be used as a benchmark to compare and review fee-related practices across the industry.

HOW WAS THE BENCHMARK CREATED?

PEI's Research & Analytics team surveyed 157 US alternatives fund managers on their fee practices in June and July 2018. We targeted CFOs because they are the most informed of these practices. However, if the CFOs were unavailable, we asked responses from other professionals, including CCOs, IR professionals, and COOs, provided they were aware of the firms' practices. Next, this is a benchmark covering the US, so we surveyed firms from every region across the country.

More than half of all responses came from the north-east; this is reflective of the market due to the private equity hubs of New York, Washington DC, and Boston.

WHAT ABOUT CONFIDENTIALITY?

The survey is entirely confidential. No names of the individuals or the firms that responded are revealed.

WHY ALTERNATIVES AND NOT JUST PRIVATE EQUITY?

The emphasis is on private equity firms, but other alternatives, such as mezzanine debt, real estate and infrastructure, have been included. In the case of mezzanine, one can argue that the strategy qualifies as private equity due to the equity options of its investments. Meanwhile, we included real estate and infrastructure because several of these private equity firms manage diversified platforms, and, more importantly, much of the scrutiny facing private equity firms is equally placed on other alternative classes that we cover.

## ‘If it’s not disclosed, it can’t be charged’

Expense provisions in fund documents are getting longer and longer, amid pressure on GPs to be more transparent, says *Julie Corelli*, a partner at Pepper Hamilton

From fund design, through regulatory review and enforcement, the fees and expenses borne by an investment fund are a point of intense focus. The 2018 *pfm* Fees and Expenses Benchmarking Survey covered some of the same territory as the 2016 survey, but added a new level of granularity. And that’s exactly how funds have had to deal with fees and expenses over the two-year period: with a new level of granularity. “If it’s not disclosed, it can’t be charged” is a frequent refrain.

Routinely, we see investors asking for fulsome disclosure of fees and expenses on an annual basis and regulators parsing books and records and examining (in excruciating or heavenly detail, depending on whether you are a manager or an investor) expense records and comparing them to the disclosures in the fund’s offering documents. To avoid being caught with an unauthorized expense, expense provisions in fund documents are growing longer and longer.

### Broken deal expenses

The 2018 survey took a deeper dive into broken deal expenses than in past years. Paying expenses when there is no investment to show for it is anathema to a healthy investor. However, a comparison with the 2016 survey showed a 5 percent drop in funds that charge all broken deal expenses to the fund and a 5 percent increase in funds that have all broken deal proceeds going to the fund.

The result is clearly favorable to LPs in funds with broken deals (ie, most funds): less expense and more income to the fund. In 2018, we added a new component to this question: how many



Corelli: everything is becoming more granular

“Managers are being required to bear more and more expenses that used to always be fund expenses”

funds provide for broken deal recoveries to go to the management company first so that it can recoup broken deal expenses or other deal-related transaction expenses, with the remaining amount going to the fund. The response was a surprising 19.8 percent.

As more costs are pushed to the fund manager, it would make sense to let them recover those costs out of broken deal proceeds. Is the timing important? Should the manager have to incur costs from one broken deal and recover proceeds subsequently for this to work? Or is it really just math and fungible dollars so that timing should not matter?

### Capping fund fees

Regardless of the netting of proceeds and expenses of broken deals, is it a good idea to cap the amount of broken deal fees that the fund can bear? An overwhelming number of funds (89.7 percent) responded that they do not cap such costs – not surprising.

What is surprising is that more than 10 percent said they did. A cap on costs incentivizes managers to control costs, but isn’t the manager already incentivized to do that by the very nature of the fund business? After all, if the fund gets to carry territory, the manager is paying 20 percent of the costs (assuming a 20 percent carry percentage).

A cap on fees has an intangible cost as well. It incentivizes a manager to defer engaging consultants and legal help until later in the process after points have already been negotiated and the deal trajectory has already been established. (Readers beware: this author is in the legal business and no doubt biased against caps.)

## The co-investment dilemma

Should co-investors be required to bear broken deal expenses? Most fund managers would answer this in the affirmative but find the mechanisms for sharing such costs to be challenging to implement.

The 2018 and 2016 survey both asked how many funds used certain mechanics about charging fees. Nine percent more funds (40 percent in 2018 vs 31 percent in 2016) reported that they will require a co-investment entity that has been formed to bear a portion of broken deal expenses.

So if a deal busts after the co-investment entity has been established but before closing, investors who will be funding the co-investment agree to pick up the tab for a portion of the deal costs if closing does not happen.

Half as many funds (13 percent in 2018 vs 26 percent in 2016) said the sharing obligation is set forth in the indication of interest from the co-investor.

And almost 8 percent more (40 percent in 2018 vs 32 percent in 2016) said that the broken deal expense is purely a fund expense. Lastly, fewer funds (6.7 percent in 2018 vs 10.3 percent in 2016) said they charge a fee on closed co-investment deals in order to mitigate the fund's obligation to bear broken deal costs.

## Fee income

When one looks at the answers to the transaction and monitoring fees question in the 2018 survey, one can see that the trend is definitively against growth in fee income for managers. In the survey, 82.7 percent of funds responded that they either did not charge transaction-type fees or they offset such fees 100 percent against the management fee (as compared with 73 percent in 2016).

## Lengthening LPAs

In response to the investors' desire for greater transparency and the regulatory push for more upfront disclosure, fund expense provisions in fund governing documents are getting longer and longer. But do fund managers view the list of expense types that are chargeable to the fund as an authorization or a mandate? We asked this question in the 2018 survey and not surprisingly a large group, 36.7 percent, said that as a regular occurrence they choose not to charge the fund for something that could be charged to the fund. On the other hand, 42 percent said they would charge to the fund whatever they are authorized to.

So how can investors know which camp their manager falls into? By requesting detailed reporting on fund fees and expenses year over year. Twenty percent of funds reported in the 2018

survey that they intended to use the ILPA fee reporting template, as compared to 18 percent in 2016. That is not a big shift, but the downward step in those intending to use a modified form (28.09 percent in 2018 vs 38.06 percent in 2016) and the increase in those who were undecided on what reporting format to use (22.47 percent in 2018 vs 14.10 percent in 2016) clearly demonstrates the depth of the challenge facing managers today.

## Favoring investors

In conclusion, one more point on broken deals is illustrative of the issues funds face today on fees and expenses. In 2018, almost 4 percent more funds (13.5 percent vs 10.26 percent in 2016) said they offset their management fee 100 percent until the fund has recovered all broken deal expenses and then the offset goes to less than 100 percent. That means that the management company effectively bears all broken deal expenses and in return is allowed a lower offset provision on transaction fees.

This would only make sense for managers with significant fee income. Given the 2016 to 2018 data points on monitoring and transaction fees, the trend is clearly away from charging transaction-based fees – which is not surprising in light of regulatory developments over the years – and away from keeping fees that are charged. The result is that managers are being required to bear more and more expenses that used to always be fund expenses. Less fee revenue, more costs put management team budgets under a lot of stress, particularly for smaller funds. What are they doing about it? The survey suggests they are giving careful consideration to which service to outsource, and which should be taken in-house, presumably in a bid to reduce costs. ■

*In terms of broken deal expenses, which of the following applies to you? (check all that apply)*

**We charge all broken deal expenses to the fund**



**All proceeds of broken deals go to the fund**



**Broken deal proceeds are excluded**



**Our management fee offset provision is 100%**



**All broken deal recoveries first go to the management company**



■ 2018 ■ 2016

Source: pfm

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Attorneys at Law

Pepper Hamilton LLP is a multipractice law firm with more than 425 lawyers in 13 offices across the United States. We use the unique skills and talents of our people, the breadth of our practices, and the depth of our experience to deliver powerful solutions to clients' legal and business issues. The firm was founded in 1890.

Pepper's Funds Services Group — a core component of the firm's Investment Funds Industry Group — partners with U.S. and international funds and their sponsors, managers, advisers and investors to define and achieve their goals. The more than 50 lawyers in the Funds Services Group have represented hundreds of pooled investment vehicles, including independent sponsors and committed funds, and are well-versed in the dynamic and ever-evolving arena of investment structuring and regulation. We work with our clients to help them not only understand the regime of transparency, accountability and enforcement but to successfully adapt to it.

Our Funds Services team — which includes veterans of the asset management industry, the SEC, FINRA, the Department of Justice and other agencies — has

experience in investment management, structuring, securities offerings, portfolio investment transactions and regulatory matters affecting investors, investment vehicles, family offices and portfolio companies. We regularly counsel on the various issues that may arise from different fund structures, fund strategies and investor bases. We are also able to call on our colleagues throughout the firm to assist with other issues arising during a fund's life cycle, including technology, litigation and litigation-risk mitigation, government investigations and white collar defense, FCPA issues, FATCA compliance, CFTC matters, energy and environmental regulation, information management, privacy, governance, shareholder activism and public securities regulation.

We counsel funds and their sponsors, managers, placement agents, administrators and registered and unregistered advisers, as well as exempt reporting advisers, in all matters arising throughout the fund's life cycle, including fund formation and structuring (domestic and offshore); general partner and management structuring, compensation and succession; and regulatory compliance and investor negotiations and relations.



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**Bone of contention:** monitoring fees have proved highly controversial

## Managers playing a ‘game of cat and mouse’

GPs are finding ways to get round investors’ reluctance to pay fees for running portfolio companies, writes *Alex Lynn*

“We are playing a game of cat and mouse with regards to what general partners are narrowly defining as monitoring fees.”

This is the view of Eamon Devlin, managing partner at fund lawyer MJ Hudson, who notes that while monitoring fees have improved for limited partners – many now being offset by management fees or scrapped altogether – some private equity houses are still taking value from portfolio companies, and therefore the LPs, by other means.

Monitoring fees were historically a point of contention in the asset class. Portfolio companies were expected to cover the costs incurred in managing an asset, such as expenses for consultants and travel costs for board directors.

Seventy-three percent of GPs now

either offset 100 percent of the costs against a fund’s management fees, or have ceased to charge them, according to the *pfm* Fees and Expenses Benchmarking Survey.

“Since the global financial crisis it’s really become the norm that portfolio companies shouldn’t really be seen as cash cows for the management company,” Jean-François Le Ruyet, partner at fund of funds Quilvest, tells *pfm*. “On the other hand we’re also aware that not

“The onus is also on the LPs to be more precise and discuss with the GP what is acceptable and what is less so”

Jean-François Le Ruyet

all GPs are alike, and while some things could be understandable coming from a manager which has smaller revenues, it’s less so when there is room to pay from the profit and loss of the GP.”

Part of this shift at the upper end of the market can be attributed to a heady fundraising environment, Devlin says. As assets under management continue to soar, so too does income from management fees, meaning GPs are more at liberty to offer attractive concessions, such as offset monitoring fees, to their investors.

Another reason for the improvement is heightened regulatory attention in the US. Thomas H Lee Partners had agreed to pay out \$6.5 million in July over the way it had charged portfolio companies with accelerated monitoring fees – essentially the lump sum fee paid to cover the remaining term of the consulting agreement when a company was exited early. Blackstone and TPG Partners also fell foul of the Securities and Exchange Commission over accelerated fees in 2015 and 2016 respectively.

These advances bely a dark trend. Monitoring fees are subject to a precise legal definition that is outlined at the start of a fund’s life within the limited partnership agreement, meaning other income that falls outside of this bracket is not subject to any potential offset, Devlin says. For example, a GP may own a business that needs to hire more staff and therefore appoints a recruitment agent from its existing portfolio.

“The onus is also on the LPs to be more precise and discuss with the GP what is acceptable and what is less so,” Le Ruyet adds. “We need to apply a bit of pragmatism; at the end of the journey, what is important is what we believe is going to be net to the investor, which is why LPs sometimes accept funds which have economics which are not the classic cookie-cutter.” ■



**Room for improvement:** the SEC is forcing firms to change their fees and expenses procedures

## How the SEC gets into the guts of GPs

Fund managers are faring better in SEC exams, but many still revise documents after a visit from the regulator, says *Rob Kotecki*

**B**y now, a lot of private equity firms have resigned themselves to the requirements of being registered with the Securities and Exchange Commission, but that doesn't mean the regulator can't find room for improvement during an exam. Although currently, such critiques are more specific, and in many ways, easier to address.

Often that means clarifying language in valuation policies and the limited partnership agreement, or ensuring the website doesn't contradict more formal governing documents. Rarely does this mean amending the LPA, but GPs will update their ADV filing, and ensure the next fund's agreements include that "upgraded" language. GPs and their counsel will push back on certain criticisms, but in most cases, they will make real changes

to stay in the regulator's good graces.

That's easier to do, as many firms have improved their documents to meet the requirements of being registered. "After the initial wave of registrations, from 2012 to 2015, PE advisors didn't know what the issues were," says Alpa Patel of the law firm Kirkland & Ellis. "But thanks to the exams, enforcement actions and speeches from the SEC, documents for funds launching today are more substantial, more detailed, than ever before."

### To the letter

This doesn't mean every firm gets an 'A.' According to the *pfm* Fee and Expenses Benchmarking Survey, plenty of GPs revise their documents after a SEC visit. Forty percent of survey respondents

changed their valuation policies, while 37.5 percent changed the language of the next fund's LPA, and the same percentage revised their website. Just 21.8 percent changed documents concerning IT systems, and only 12.5 percent changed outside vendor contracts. So what kinds of changes are GPs making to these documents to keep regulators happy?

"Common deficiencies tend to be granular," says Julie Riewe of Debevoise & Plimpton. "For better or worse, the SEC is getting into the guts of what a GP has actually been doing." According to several law firms, the changes tend to be centered around three main categories: compliance policies and procedures, internal controls, and oversight procedures for third-party administrators and service providers.

More often than not, the deficiencies will be addressed with everything short of amending an existing LPA. "A huge focus for the SEC is fees and expenses," says Greg Merz of Gibson Dunn.



“So what often happens when a deficiency is identified is that the firm will put into place enhanced internal controls and disclosure policies, update the next ADV filing, and then ensure those changes are reflected in the next fund’s governing docs. If need be, they will repay the fund any relevant fees.”

One lawyer recalls a client that received a terse letter from the regulator over the allocation of some fees related to an annual meeting, and, as a result, the firm settled on changing the policy and paying a portion of those fees back.

### A matter of clarity

Most of the time, changes in documentation are far less serious, and often merely a matter of clarifying the process, especially when it comes to valuation policies. “The SEC isn’t about validating a particular valuation methodology,” says Patel. “They’re going to want to ensure that a firm is actually following the valuation policies that are spelled out in black and white and whether those policies are generally reasonable in the applicable context.”

Other common changes include aligning the language on the firm’s website with its governing documents. “Sites will sometimes have to be edited to comply with the Advisers Act rules, especially if specific internal rates of return are cited,” says Nabil Sabki of Latham & Watkins. GPs may scoff at this, but lawyers warn that the SEC visits a firm’s website right after they review the ADV filing.

But some of the time, GPs and counsel will argue that their policies and procedures are adequate and adequately documented. “The staff is reasonable, and often once we cite the relevant text, that’s sufficient,” says Sabki. Given how savvy the regulator is these days, GPs better be able to cite text that’s relevant and substantial. ■

## Regulatory scrutiny

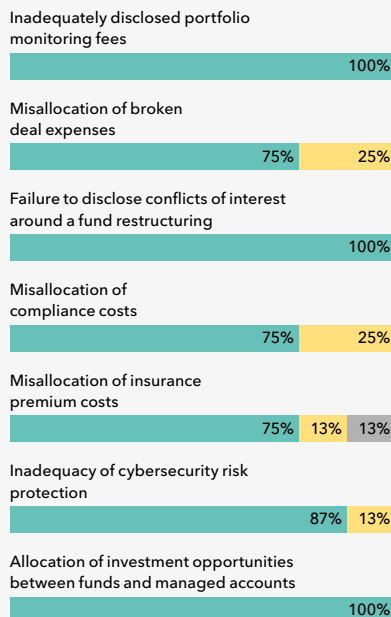
You are examined by the SEC. Did they raise the issues below? If they concluded you had a problem and you incurred costs to correct it, who bore the costs?

### Was this raised?



■ Yes ■ No

### Who pays cost of correction?

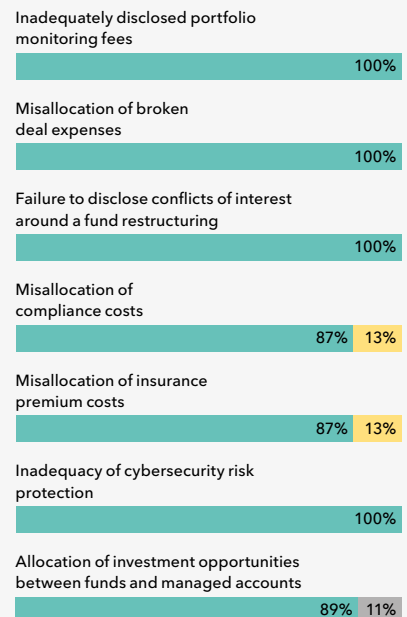


■ Management firm ■ Fund ■ Split between fund and firm

### Was penalty assessed?



### Who pays penalty?



# Aligning all the interests: GPs, LPs and service providers

General partners are engaging a whole host of specialized service providers, and funds are increasingly picking up the tab. Are all parties aligned enough to ensure that investors can reap the benefits as well, asks *Anne Anquillare*, CEO and president of PEF Services

As the private funds industry matures, the complexities increase. That is reflected in the growing trend towards outsourcing specialized services. But can the greater use of third-party valuation and fund administration firms benefit both limited partners and general partners? The 2018 *pfm* Fees and Expenses Benchmarking Survey offers some telling insights. Here we consider how to achieve alignment among all interested parties.

The rapid development of the private funds industry over the last two decades has brought increased demands from regulators and investors. That has encouraged the growth of third-party valuation and fund administration services to support the back office.

This has picked up speed since the 2008 financial crisis. GPs have adjusted to the more mature landscape by improving the way they select external services to take advantage of the growing number of specialized services.

Investors are helping drive the change. Mindful of the long-term nature of their commitments, they are looking for GPs that are savvy in their approach to managing private funds. And that requires both sides to agree about who pays what for a variety of specialized services ranging from data management to legal counsel so that LPs can be sure they are getting the right support and value for these services, whether they are provided in-house or by a third party.

That's something that comes through

loud and clear in the *pfm* 2018 Fees and Expenses Benchmarking Survey. The use of external service providers appears to be a growing trend, with 59



**Anquillare:** more disclosure is needed on who picks up the outsourcing costs

“Expect most of the costs of outsourcing to be picked up by the fund”

percent of GPs outsourcing all or most of their fund administration work.

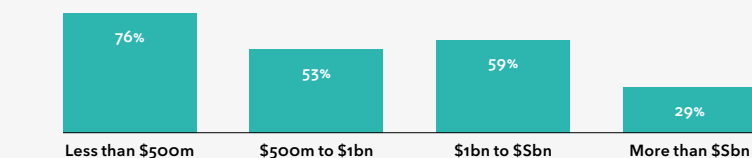
Debt funds led the way with 67 percent using third-party fund administrators. Size is a factor: small and mid-sized firms with less than \$500 million in assets were the main users of fund administrators, with the largest firms – those with more than \$5 billion in assets – the least likely to outsource.

This should benefit investors as smaller fund managers are the most at risk of not having enough resources to cope with the changing demands of the private fund industry. They lack the management fees to attract human capital in the current hot job market. Leveraging a third-party fund administrator allows them to stretch their resources to obtain the industry expertise and scale needed for the expanded role the back office now assumes – with an eye to an improved service level for investors.

Using a third party allows internal resources to focus on the higher level tasks that are better suited to in-house teams with knowledge of the deal team and

## The size differential

The percentage of respondents that outsource all or most of their fund administration by AUM size



Source: *pfm*

investor requirements. These include data analysis to ensure investors and the deal team are kept fully informed, as well as the oversight of third-party valuation and technology providers. A fund administrator's scale and industry expertise really comes into its own on the more standardized services such as accounting, record keeping and delivering reports and documents through a best in class portal.

### Work still needed

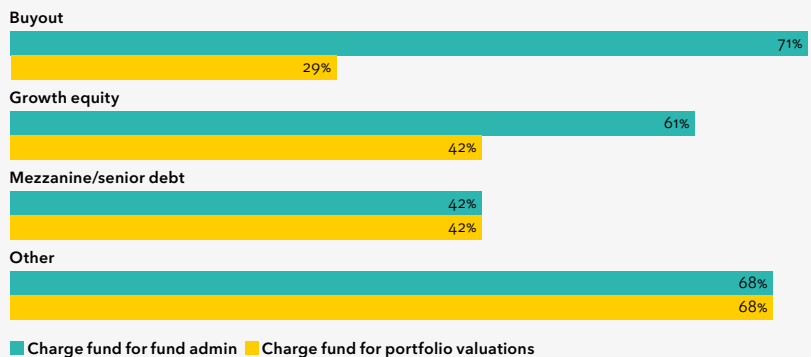
Now for the unsettling news. There is still a lot of work to do to ensure that fund managers and investors are getting the support and value from specialized services. There also needs to be better disclosure on who picks up the tab for their services.

Choosing a fund administration firm or valuation consultant can be a challenging task, especially if you are doing it for the first time. Here are some tips to ensure that GPs and LPs are getting support and value.

- Avoid selecting a service provider solely on price and assets under administration. The quality and capabilities depend primarily on a service firm's ability to attract, develop and retain top talent. While price and asset levels may be the easiest comparison point, it is the experience and credentials of the staff that is most relevant to success.
- If your first selection doesn't work out, then consider switching. Investors are not just seeking great returns. They also want fund managers that can operate their funds efficiently – and that requires careful selection and management of service providers. Things to look for in a fund administrator include ensuring that they have expertise in your fund strategy and that they are able to offer a customized service specific

### Fund strategy variation

Funds that outsource and charge fund admin and portfolio fees to the fund, by strategy



Source: *pfm*

to your needs. If they don't offer this, be prepared to look elsewhere.

- Expect most of the costs of outsourcing to be picked up by the fund. The 2018 *pfm* Fees and Expenses Benchmarking Survey shows that investor-facing services such as side letter costs, fund administration, portfolio valuations and legal fees are typically picked up by the fund. This can be regarded as an alignment of interest between GPs and LPs because the fund's back office is primarily servicing the investors.

As seen in the above chart, the economics does, however, differ between fund types. For example, funds with buyout strategies are more likely to charge the fund for fund administration services than other types of strategy but less likely to expect the fund to pay portfolio valuations costs.

But the situation is changing. We anticipate that, as the private funds industry continues to mature, expense allocations and disclosures will change, reflecting the alignment of interests between GPs and LPs. Recently, disclosing the use of a fund administrator has become the norm. GPs now tend to highlight their use during fundraising,

with fund administrators often asked to participate in due diligence calls.

Coincidentally, as LPs see the benefit from the addition of fund administrators, fund administration and the associated investor portal technology are specifically identified as partnership expenses in the limited partnership agreement. The same trend is developing for portfolio valuations as investors push to ensure that third parties are involved in marking the investments to market.

What is emerging is a strategic use of specialized services that benefits both GPs and LPs and provides for alignments among all parties. While fund managers have an incentive to keep fund expenses low to maximize net IRR, it is clear that investors don't want GPs to sacrifice client services.

If anything, they are demanding more from the funds in terms of disclosure. The fact is that the fund's back office is also the investor's back office, even if it is provided by external administrators. That's why this ability to add value to both GPs and LPs is so crucial. Get the balance between the use of internal and external resources right and it can benefit the firm, the fund and its investors. That is true strategic alignment. ■



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**Cyber protection:** GPs are expected to pick up the tab

## Splitting the IT bill

GPs should think twice before allocating too much of the IT budget to the fund, because LPs aren't inclined to pick up the tab, writes *Rob Kotecki*

While the data revolution may promise great things for the alternative assets industry, it never promised to do anything cheaply. Managing and securing that data can cost a pretty penny. But with the Securities and Exchange Commission making cybersecurity a priority, and limited partners demanding more information than ever before, few general partners are planning to cut their IT budgets anytime soon.

And GPs can't offload those expenses to the fund, at least without clear language disclosing what IT costs end up charged to investors. Cybersecurity is considered a cost of doing business, and most management companies pay for such programs. The consensus among LPs is that all IT costs are

part of the overhead, but, in practice, there are elements of the IT program that the fund does end up paying. If the GP outsources its fund administration, the cost is passed on to the fund, which includes the fund accounting systems.

But if the GP brings fund administration in-house, it will have to spell out

“In essence, LPs deem technology investments to be a benefit to the GP”

Jennifer Choi

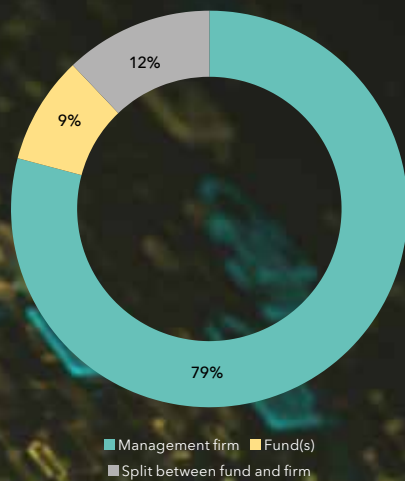
what part of the tech solution is billed to the fund, and what is billed to the firm, as part of its overall infrastructure. But GPs should step lightly here. LPs might agree to certain terms to access top-tier funds, but these are not costs they're happy to cover.

### Careful with that IT bill

And the regulator tends to agree. “The SEC is extremely skeptical of any attempt by the investment advisor to charge its own overhead costs back to a fund or any other client,” says Greg Merz of Gibson Dunn. “In theory, if properly disclosed, the firm can bill its in-house administrative costs to the fund, but the regulator hates the practice.” And lawyers stress that costs related to cybersecurity and technology fall into the category of administrative expenses that the SEC, and many LPs, expect GPs to pay.

And in terms of cybersecurity, most GPs are paying for those initiatives. According to the *pfm* Fees and Expenses

You implement a new cybersecurity policy who pays the consultancy and implementation fees?



“It’s generally not controversial to charge the costs of an outsourced administrator to the fund”

Greg Merz

Benchmarking Survey, 79 percent of survey respondents pay for the implementation of cybersecurity initiatives. Only 9 percent charge the fund. “It’s a management cost,” says Nabil Sabki of Latham & Watkins. “Some advisors may negotiate to lay off some of the expenses, but LPs push back on that.”

Jennifer Choi of ILPA conducted an informal poll of members to see if any investors were willing to pay for cybersecurity programs or other technology costs. “In essence, LPs deem technology investments to be a benefit to the GP,” says Choi. “It’s an intrinsic aspect of operating as a best-in-class GP, and therefore, those costs should be covered by the management fee.”

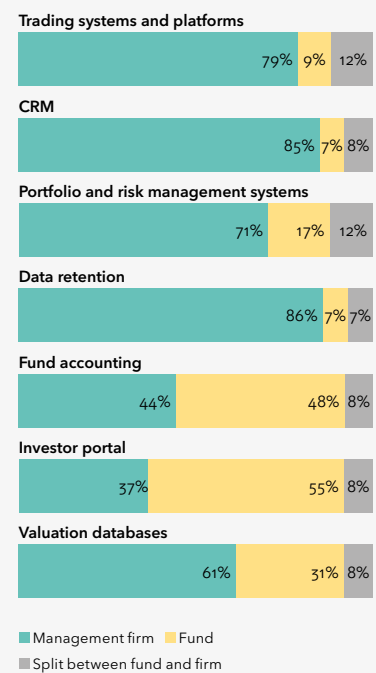
Although the survey did find that GPs charged other technology costs to the fund: 55 percent billed investor portals; 48 percent billed fund accounting systems; and 31 percent billed valuation databases. But there’s a catch to those numbers. If the GP outsources its fund administration, the service

provider has their own fund accounting and reporting software. “It’s generally not controversial to charge the costs of an outsourced administrator to the fund,” says Merz. But when GPs begin bringing administration in-house, the costs need to be itemized and clarified before being billed back to the fund.

“GPs need to be very specific in their disclosures around allocating the costs of in-house fund administration to their clients,” says Merz. “And the SEC is more likely to question those costs. They’ll test GPs on whether these costs are equal to the market rate for these types of services. Are they overcharging? Did they consider other alternatives?”

That doesn’t mean that some GPs won’t be able to negotiate attractive terms around technology costs with their LPs, even if regulators frown on the practice. But GPs headed to the negotiating table for their next fund should be wary of adding too much in tech costs to the investors’ tab. ■

When your firm implements technology-driven systems covering the below, who pays the initial acquisition and ongoing costs?



# The cost of restructuring

More than half of funds plan to renegotiate fees if they extend the life of the fund. This could create a whole new set of problems, says *Tom Angell*, partner at WithumSmith+Brown

**T**rending in a fund near you: Restructuring. As one of the most viable end-of-fund-term solutions today, more and more LPs are being presented with GP-led proposals in the quest for more liquidity by extending the potential upside of a portfolio. While fund restructuring is becoming widely accepted, it does not lend itself to a “one-size-fits-all” approach. Extending its life is not as simple as it sounds, particularly when it comes to fees and expenses.

With the steady rise in the number of funds now extending beyond their original lifecycle, market practices are still developing. In this year’s *pfm* Fees & Expenses Benchmarking Survey, respondents shed some interesting light into how they plan for and implement the restructuring process, which seems to be more of a “we’ll cross that bridge when we get to it” approach than a consideration at inception.

When properly conceived and implemented, and in the right situation, a restructuring can solve many end-of-term concerns or create a whole new set of problems. Here are some of the key findings from the survey in two of the most contested areas: fund extensions and co-investments.

## Fund extensions

There was a clear split in the LPA stipulations for fees and expense arrangements for fund life beyond the extension periods. Almost half of the 90 respondents to the stipulation-related question indicated they planned to continue with the same or an amended extension period in the LPA, but that was outnumbered by the 51 percent



**Angell:** In essence, ‘the plan is no plan at all’

“Those funds without clear-cut stipulations are living dangerously, given the mounting velocity for restructurings”

who said they would negotiate the handling of fees and expenses at the time of the extension. While the former lays the groundwork for success, the latter “wait-and-see” approach can be dangerous. When the fund reaches the end of its term and still holds a significant portfolio, opinions among all interested parties will no doubt vary regarding management. While this practice was not assessed in the 2016 survey, it is safe to say that a lack of vision early in the process could yield negative outcomes – from a failed transaction and significant expenses to angry investors and regulatory scrutiny – if fee and expense arrangements are left open for negotiation at the time of the extension.

## Fund restructuring

The survey also asked about LPA stipulations for costs relating to potential fund restructurings. Once again, a majority – 52.75 percent or 48 of the 91 respondents to this question – indicated “no,” this would be decided at the time of restructuring and submitted to LPs for approval with the rest of the terms. Even more interesting, almost one-third of the respondents stated they have not indicated whether these costs would be handled by the management firm, the fund, split between the two or decided at the time of restructuring. In essence, the plan is no plan at all. Once again, while we lack comparative survey data from 2016, those funds without clear-cut stipulations are living dangerously, given the mounting velocity for restructurings.

## The rise of co-investments

About three years ago, this practice



gained tremendous traction and has not demonstrated any signs of slowing down. With almost 87 percent of the respondents replying affirmatively to co-investments, it is expected that these transactions will continue to grow in popularity among both private equity investors and private equity fund sponsors. Not only will this trend continue, it will most certainly accelerate in the foreseeable future.

### Structural issues

Of 81 respondents who answered the question of how they structure their co-investments, more than half (55.56 percent) indicated they structure them as separate entities 100 percent of the time, which falls slightly below the 2016 survey results (58.82 percent). While those saying they did this 80 percent of the time recorded a bump from 7.35 percent in 2016 to 9.88 percent in 2018, the “50 percent” and “less than 50 percent” categories dipped from 8.82 percent and 25 percent two years ago to 7.41 percent and 17.28 percent today, respectively. So what does all this mean for future trends? One cannot overlook a common theme mentioned by the 10 percent that answered “other”: direct investments.

### Contentious charges

Broken deal expenses are a hot, contentious topic for co-investments. There was a straight divide here between the 40 percent that answered co-investors had responsibility “if the co-investment entity has been formed” and “No, the broken deal expense is a fund expense.” Despite this “standoff,” the numbers also indicate an abandonment of two previously held overriding philosophies: co-investors are responsible because it is part of their interest in co-investing and they are not responsible

because each co-investment deal that closes is charged a fee. The former is down 13.14 percent from 2016 while the latter declined by 3.62 percent. Since restructurings are a firm management tool for the GP, it is critical to establish the parameters for these expenses, including those related to broker deals.

### Downward trend

There’s an undeniable reduction in the levying of management fees for co-investment vehicles. The following responses all declined between 2016 and 2018:

- The respondents charging a fee that is equal to the management fee that is paid by the fund fell 4.56 percent.
- The respondents charging a management fee which is less than the management fee that is paid by the fund declined 6.97 percent.
- There were 7.21 percent fewer respondents charging carried interest equal to the carry payable by the fund

In contrast, there was a 17.55 percent surge in organizational and/or set-up fees and a 6.61 percent bump in charging carried interest which is less than the carry payable by the fund. One important note: 93 respondents skipped this survey question

– prompting analysts like myself to wonder why and what this could mean.

### Creative thinking to the fore

For fund restructurings, creativity, consideration and careful analysis are essential elements. These form the foundation for optimal results as this practice becomes even more entrenched in private equity.

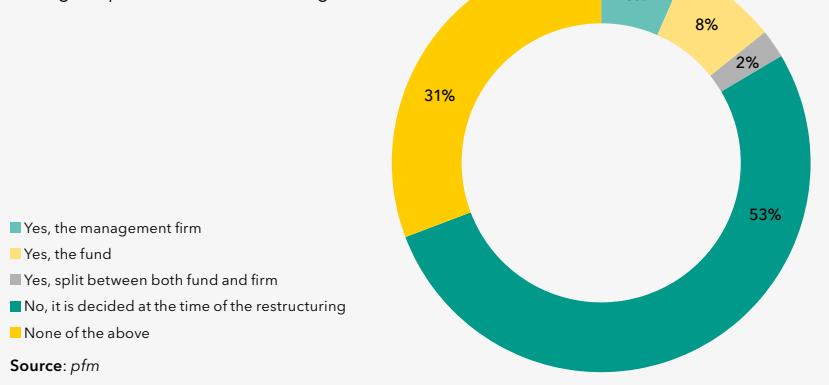
Industry-wide, fund restructurings are being driven by these key factors:

- Soon-to-be 10-year-old funds with portfolios valued at billions of dollars
- Sophisticated secondary investors with abundant capital
- Fundraising challenges among some sponsors

In 2018, it is more the rule rather than the exception for fees and expenses and costs of restructuring to be negotiated when the event occurs. As post-recession funds come to their end of life, perhaps we will see a new wave of stipulations incorporated into LPAs to address these very conditions.

Not all end-of-term funds are suited for restructuring. And not all end-of-term funds signal the end of a fund’s life. When properly conceived, planned and implemented, restructurings offer a more favorable solution than the once traditional routes. ■

Did you stipulate in your LPA who pays for costs relating to a potential fund restructuring?



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- Projections of the Management company's operating cash requirements
- Professional reporting standards
- Tax compliance issues
- Evaluations of performance of existing portfolios and strategies
- Review of organizational/operational documents

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## The co-investment conundrum

Co-investments have become standard in private equity, but arrangements between LPs and GPs vary, writes *Marine Cole*

In an environment where limited partners are trying to maximize returns and lower their fees, co-investments have become an ordinary component of the private equity landscape and of relationships between limited partners and general partners.

Nearly 87 percent of fund managers offer co-investments to their LPs, according to *pfm*'s Fees and Expenses Benchmarking Survey.

"In the last five years, co-investments went from being pretty common to ubiquitous," says Brian Gallagher, a partner and co-founder at Twin Bridge Capital Partners, which often co-invests alongside its GPs. "It's gone from a topic at most fundraising meetings, to a topic at every fundraising meeting."

But no two co-investment situations

**“It's gone from a topic at most fundraising meetings, to a topic at every fundraising meeting”**

**Brian Gallagher**

are the same and specific arrangements between managers and co-investors in the same deal often vary greatly.

Initially, GPs offer co-investment opportunities to their LPs in different ways.

"I'm seeing some sponsors forming specific co-invest funds ahead of time, anticipating that they're going to need additional capital for specific investments that their main fund will make," says Babak Nikraves, a partner with Hogan Lovells and the co-head of the firm's sovereign investor practice.

"But most people actually do it on an à la carte basis. They realize they need more money for a particular investment, maybe because they're up against their percentage cap on how much they can invest per company and they have to go out and raise money from other institutional investors. Typically they will reach out to the people in their main fund, often preferred LPs who they hope will re-up in another fund and which they believe can provide capital promptly. Or they may reach out to other potential partners outside their main fund."

Co-investments also differ in terms of the structure GPs adopt once they are about to make a specific investment.

While the majority of general partners offering co-investments structure these transactions as a separate entity as opposed to direct investments in a portfolio company, this is a small majority. Only 55 percent of respondents say they do so 100 percent of the time, down from 59 percent when *pfm* last surveyed fund managers in 2016. Meanwhile, 17 percent of respondents say they do so less than 50 percent of the time, down from 25 percent two years ago.

Gallagher believes it's always better to be in the same vehicle as the sponsor



## Who pays when the deal breaks?

*Broken deal expenses have become a more contentious topic between LPs and GPs*

"We have felt some pressure in recent years and we've got a little bit more push back on these broken deal fees," says Guinee. "But in our case it's strictly if the deal doesn't work for us as a group of co-investors, then we have to pay a penalty."

Asked whether co-investors have any responsibility for broken deal expenses if a deal doesn't go forward, 40 percent of respondents said that they do if the co-investment entity has been formed, up from 31 percent two years ago. At the same time, another 40 percent said they never do because the broken deal expense is purely a fund expense,

up from 32 percent two years ago.

Meanwhile, less than 14 percent said they do because it is part of co-investors' indication of interest in co-investing, down from nearly 27 percent two years ago.

"Who bears broken deal expenses is an important issue, and one which sponsors like to address up front," says Nikraves. "If co-investors will not agree to absorb broken deal expenses, the concern is that those expenses become a fund expense that the fund will have to absorb – and if that's the case, you have to make sure that's disclosed to the investors in the main fund."

of the deal, but adds that "as long as we have the right protection and rights, it's form over substance".

John Guinee, managing partner and co-founder of Constitution Capital Partners, also a frequent co-investor, thinks the type of structure varies depending on the size of the GP and that the creation of a limited partnership with co-investors is typically indicative of a bigger group of co-investors and often of a larger GP.

"The sponsor needs to create a mechanism so it doesn't have to deal with each co-investor at a time," he says. "The bigger the sponsor is, the less they want to deal with co-investors anymore."

Co-investment arrangements also differ based on the types of fees and expenses being charged. One of the main drivers behind institutional investors wanting more co-investments is the ability to avoid paying management fees and carried interest on such deals.

According to the survey, only 28 percent of co-investment vehicles pay a management fee equal to the fee paid by the fund, a reduction from the 2016 survey when the figure was 32 percent.

The fee structure depends on how close are the links between the LP and the GP.

"If it's a true co-investment that you're offering to LPs in an existing fund, a no fee, no carry arrangement is pretty typical, but there's a lot of variation," says Nikraves.

Gallagher notes that overall, a

co-investor pays a management fee and carried interest depend on whether it is also an LP in the main fund. As co-investment transactions become larger, if interest among LPs from the main fund is not sufficient, GPs tend to reach out to investors who have not invested in the main vehicle.

“If you are not an LP in the fund, I think it’s totally reasonable to be charged a management fee and carry,” he says, adding that Twin Bridge only co-invests with existing managers.

Guinee agrees that co-investments for existing LPs should be no fee/no carry.

“organizational and set up fee is all we ever see and that’s the only one we pay,” says Guinee, echoing the survey, which shows that more than 65 percent of respondents charge LPs organizational and set-up costs, up from 48 percent in the survey two years ago.

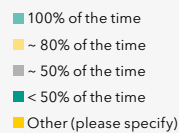
“All the other fees – management fees and carried interest, that’s more indicative of bigger funds,” he adds.

With so much money flowing into private equity funds and such a great interest among LPs for co-investments, the negotiating power has tended to swing into the hands of fund managers recently as opposed to co-investors.

“For savvier GPs, they’re recognizing that co-invests are a hot commodity, and they may have the ability to command some alternative fee arrangement involving some form of management fee and/or carry depending upon the deal and LPs in question,” says Nikravesh.

## How fees are structured

If you offer co-investments, are your co-investments structured as separate entities (as opposed to direct investments in portfolio companies):



Source: pfm

Which of the following do you charge to your co-investment vehicles? (select all that apply)

Management fee equal to the management fee that is paid by the fund

28%

Management fee which is less than the management fee that is paid by the fund

22%

Carried interest equal to the carry payable by the fund

31%

Carried interest which is less than the carry payable by the fund

30%

Organizational and/or set-up fee

66%

Source: pfm

This is especially true for strong performing money managers. But for first-time funds or managers starting a co-investment program, co-investors can still have the upper hand.

It remains to be seen whether a downturn in the economy will modify co-investment appetite among LPs and as a result will impact LPs’ and GPs’ negotiating power. ■

## What is the real meaning of transparency?

More expense provisions in LPAs come at the cost of clarity over what investors have to pay, says *Jennifer Choi*, managing director of industry affairs of the Institutional Limited Partners Association

ILPA continues to believe that disclosures related to fees and expenses can and should be clearer and more uniform. We are encouraged to see continuing migration towards transparency generally and the ILPA standards specifically in regular reporting to LPs. Investors are receiving more granular information on costs, as well as portfolio level data, and on a more consistent basis than ever before. The survey at the focus of this supplement indicates that 76 percent of respondents are now using some version of ILPA reporting standards or moving their reporting closer to an ILPA-standardized format.

Worryingly, however, the drive toward transparency on fees and expenses has tipped over to burying investors in pre-emptive disclosures in fund documents. While expansive expense provisions in limited partnership agreements – extending to a page or more in many cases – may insulate against some compliance risks, it comes at the cost of clarity for investors into what actual and specific charges they should expect to pay over a fund’s life. Over-reliance on pre-emptive disclosure also brings to the fore questions about the reasonability of certain expenses borne by the fund.

As a result, and in light of “sole discretion” clauses appearing in more and more partnership agreements, many LPs are finding themselves drawn into discussions during fund negotiations on the rationale for certain allocable expenses, or how offsets are applied to management fees, no matter how likely or unlikely such charges may be.

Many such questions are a matter of nuance. What’s the market rate basis for the fees assessed for in-sourced



**Choi:** the allocation of costs can be a nuanced issue

“The drive toward transparency on fees and expenses has tipped over to burying investors in pre-emptive disclosures in fund documents”

legal and accounting support for the fund? Should fees paid by the portfolio company to members of the GP serving as interim portfolio company management be offset against the management fee? Under what circumstances is private air travel more cost-effective than commercial travel? Should the fund bear the cost for the GP being a registered investment advisor? When is it rational to allocate broken deal expenses to co-investors, eg, distinguishing between syndication and co-underwriting? For LPs seeking co-investment as a way to achieve more favorable

economics, when is it reasonable for GPs to charge organizational costs and fees on that incremental capital?

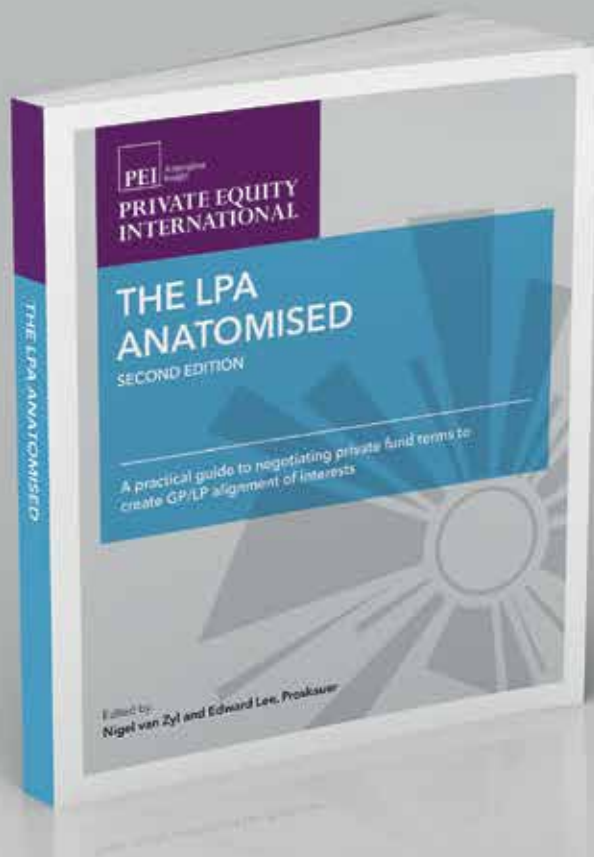
One point in particular eliciting more focus during fund negotiations is the treatment of management fees upon the raising of a successor fund and at the end of the investment period. The time to raise a fund has shrunk from 20 months on average in 2013 to only 12 months in 2017, and intervals between fund numerals are their lowest on record, raising concerns about “stacking” management fees, ie, collecting management fees at full rates on two funds at the same time. It’s encouraging to see that LPs invested in the successor funds often get a fee break, but unfortunate that this break isn’t uniformly being extended to LPs in the previous fund.

The allocation of costs can be a nuanced issue, and expansive expense provisions in LPAs that do not precisely reflect what LPs will actually be charged should not be the sole determinant for such decisions. Where management teams elect to exercise their discretion or defer to outside counsel’s reading of the contract rather than bringing nuanced questions to LPACs, GPs risk erosion of trust in the partnership.

If expenses must be paid back to LPs before the GP can take carry, there is a natural disincentive curbing aggressive practices, but given increased complexity of fund structures and fund economics, LPs will remain vigilant for business models predicated on LPs bearing a disproportionate share of a firm’s overall operating costs or fund structures favoring fee income over carried interest. ■

# THE LPA ANATOMISED, SECOND EDITION

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