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FEES AND EXPENSES 2016

A PFM BENCHMARKING SURVEY

Published in association with: PEF Services, Pepper Hamilton LLP, WithumSmith+Brown

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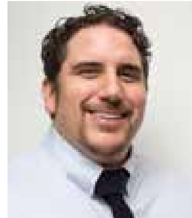

Bringing clarity to a murky matter

The devil is always in the detail and nowhere is this truer than in private equity. For the Securities and Exchange Commission, the demons of late have been fee and expenses violations. Over the past two years, the regulator has focused on weeding out as many as possible. The sweep has already yielded $150 million in fines and disgorgements, and in the past couple of months we saw giant Apollo Global Management fork out $52.7 million to resolve SEC charges over inadequate disclosures, while Silicon Valley-based SilverLake has had to defend itself against similar accusations. Neither has admitted to any wrongdoing.

It is against this backdrop LPs have been putting additional pressure on GPs to be clear about what fees they are charging and where. One vehicle for this push towards transparency is the Institutional Limited Partners Association's fee-reporting template. Our report on ILPA on p. 6, and accompanying interview with ILPA managing director of industrial affairs Jennifer Choi, helps clarify the issue and the message conveyed by LPs seems clear: it can no longer be business as usual.

For this reason, the release of our second fees and expenses benchmarking survey – conducted in partnership with PEF Services, Pepper Hamilton, and WithumSmith+Brown – could not be more timely. To conduct this survey we contacted CFOs and industry professionals across the US and asked about their current fees and expenses policies. The responses included in this special supplement provides a valuable insight into how far the industry has moved in the two years since our last survey, but equally valuable are the accompanying commentaries that complete the picture.

On p. 10, PEF Services' Anne Anquillare offers fund managers pragmatic advice on how managers can keep ahead of the myriad demands regulators and investors have put on them. Meanwhile, on p. 20, Pepper Hamilton's Julia Corelli explores why these same demands are squeezing mid-market fund managers. In his commentary on p. 28, Thomas Angell of WithumSmith+Brown explains how the survey data point to a new normal on fees and expenses allocation for investment managers.

These insights – combined with a series of analyses looking at attitudes toward things such as SEC examination, operating partners, deal expenses, and co-investment – shed much-needed light on an issue that can cause equal amounts of anxiety and frustration among GPs and their investors. We hope this survey will help you put your fees and expenses practices into a broader context so you can ensure your business is better equipped to cope with any unwelcome surprises along the road.

Enjoy the supplement

Andrew Woodman
Special Projects Editor

FEES AND EXPENSES BENCHMARKING SURVEY

4. EVOLUTION NOT REVOLUTION
Two years on from our last survey and there are signs that the industry is getting to grips with the demands of regulators and investors, but change will not happen overnight

6. ELUSIVE STANDARDS
The SEC and ILPA have put fees firmly in the spotlight, but is the industry any closer establishing a standard that all investors can agree on?

8. CULTIVATING CONSENSUS
Jennifer Choi, ILPA managing director of industry affairs, explains the association's recently released fee-reporting template and its role in the industry's push for transparency

10. EXPERT COMMENTARY
THE PROACTIVE APPROACH
The ongoing stream of new regulatory requirements covering expenses can be overwhelming, but PEF Services' Anne Anquillare offers a proactive strategy that can keep managers ahead of the game

14. SMOOTH OPERATORS?
Some GPs still charge operating partner fees to their portfolio companies, despite greater SEC scrutiny, but attitudes are changing

17. WEAPON OF CHOICE
As the rocky relationship between private equity and unions grows tense, some labor groups have found recent sensitivity over fees a useful tool for putting the heat on GPs

18. WHAT LIES BENEATH?
Management fees and carried interest make up most of a GP's income, but numerous other 'hidden expenses' lie in wait for LPs and portfolio companies

19. CRACKDOWN ROUNDUP
The SEC is making good on its promise to get tough on fund managers over fees and expenses – some have been hit harder than others

20. EXPERT COMMENTARY
SQUEEZED IN THE MIDDLE
As pressure from both regulators and investors builds, Julia Corelli, a partner with law firm Pepper Hamilton, asks whether fees and expenses are burying the PE model for smaller funds

23. TUG OF WAR
Agreeing on who foots the bill for SEC examination costs is becoming a constant battle for GPs and LPs and the situation is unlikely to improve anytime soon

26. WHO PICKS UP THE TAB?
GPs are feeling more comfortable with charging the cost of schmoozing to the fund, raising questions about the alignment of interests between GPs and investors

28. EXPERT COMMENTARY
SHIFTING SANDS
As fees become a priority for both LPs and the SEC, fund managers are having to rethink expenses. Thomas Angell, a partner with audit tax advisory WithumSmith+Brown, explains the change in mindset

31. DATA ROOM
Additional industry fees insight relating to co-investment, deal expenses, and ESG

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Evolution not revolution

Two years on from our last survey and there are signs that the industry is getting to grips with the demands of regulators and investors, but change will not happen overnight, writes **Andrew Woodman**

Fees and expenses has always been a sensitive discussion point between LPs and GPs. The biggest problem is transparency. LPs craving clarity push for more information, while GPs, obsessed with privacy, have been reluctant to change. It is a battle that has defined the asset class.

In late 2014 – when *pfm* first measured industry sentiment on fees – that status quo had come under threat. Months earlier Drew Bowden, then head of the Securities and Exchange Commission's National Exam Program, had fired a warning shot across the bow of the industry. His speech, "Spreading Sunshine in Private Equity," delivered at the PEI Private Fund Compliance Forum in New York, warned that change was coming and that the SEC would shed an uncomfortable light on how GPs share information on fees and expenses. Many in the industry were rightfully alarmed.

The original survey offered valuable insight into the fees and expenses debate in light of that speech. In many areas, there was a consensus. The majority agreed that management firms should bear the cost of things like SEC examinations. In other areas, it was more complex, with respondents split on the issue of fee offsets for operating partner expenses.

Fast forward two years and opinions are evolving. Fund managers have been able to get a better idea of where they stand with fees and expenses. SEC enforcement actions have made it clearer what regulators are looking for. Meanwhile, the Institutional Limited Partners Association has pushed the industry toward standardization with the release of its guidelines on fees disclosures.

Our latest survey bears this out, but not in ways one would expect. While there is an indication that some fund managers are abandoning certain fee practices and embracing better disclosures, there are also signs of pushback on fee allocation where it is clear that is the LP who benefits. The industry is still far from an established standard for fees and expenses.

Methodology

What is the pfm 2016 Fees and Expenses Benchmarking Survey?

The survey was launched in response to fund managers' questions about who should pay for various fees and expenses. The resulting report 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 101 US alternatives fund managers on their fee practices in June and July 2016. 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.

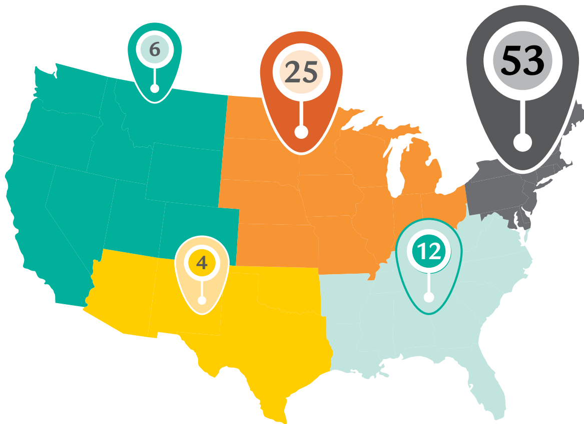
What about confidentiality?

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

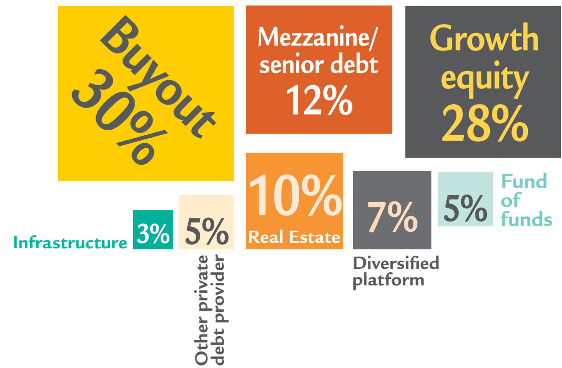
Why alternatives and not just private equity?

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 of several of these private equity firms manage as a diversified platform, and, more importantly, much of the scrutiny facing private equity firms is equally placed on other alternative asset classes that we cover.

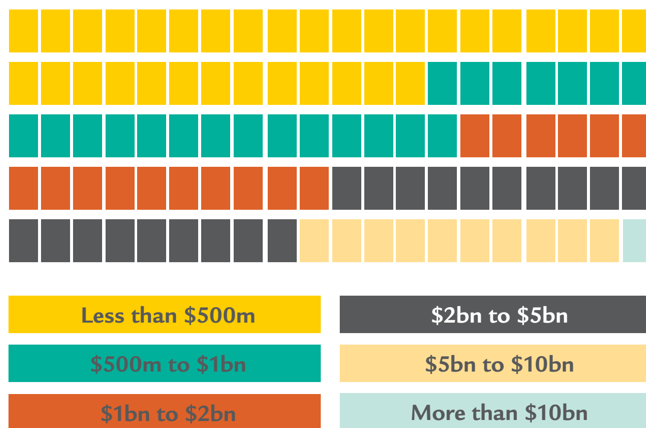
Where is your firm headquartered? (%)



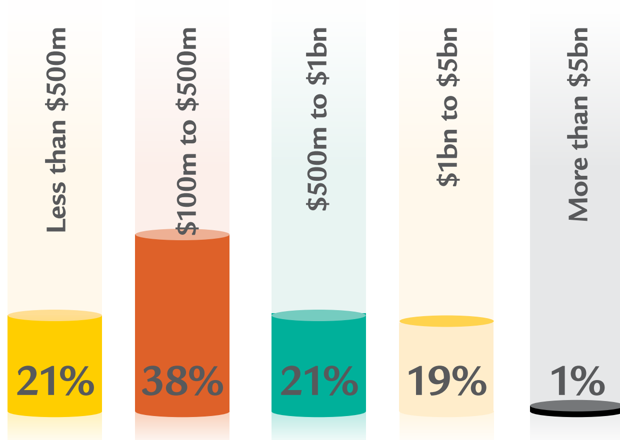
Which of these definitions best describes your firm?



What is the total value of the firm's AUM? (%)



What is the size of your most recently closed fund?



What is your primary job title?

Elusive standards

The SEC and ILPA have put fees firmly in the spotlight, but is the industry any closer establishing a standard that all investors can agree on, asks **Andrew Woodman**

When the Private Equity International CFO and COO conference kicked off in New York last February the new fee reporting template issued by the Institutional Limited Partners Association was one of the first items up for discussion. The new guidelines, released weeks earlier, are the latest attempt by ILPA to bring standardization to the industry and transparency on fees. Only a handful of those present were impressed with the idea.

A brief poll of the audience revealed that just 23 percent saw the template as a positive development compared with 43 percent who saw it as negative. The rest were indifferent. In a subsequent poll, 79 percent said their organization was yet to provide feedback on the template to ILPA.

The conference poll was small, so should be taken with a grain of salt, but it wasn't far off the mark. Thomas Angell, a partner with accounting firm WithumSmith+Brown, was present at the event and says that the dearth of enthusiasm regarding the new ILPA templates was partly because of the number of smaller funds present.

"ILPA has around 300 members, and they are all the largest funds," he says. "A lot of the smaller funds don't pay attention to ILPA; they may go have a look and see what is included, but I think it will take a while for the smaller funds to adapt."

The *pfm Fees and Expenses Benchmarking Survey* echoes this lukewarm response. Overall, just 17 percent of respondents said they have plans to implement the new fee reporting template, while 38 percent said there would be no implementation – 30 percent said that they would only look at using a modified format.

The sampling is too small to give a reliable measure of sentiment across GPs of all sizes. However, it does show a significant proportion of small to medium-sized GPs (those with less than $1 billion in assets under management) have no plans to use the templates, while larger GPs are more likely to use a modified format.

Shay Caufield, executive vice-president and fund administrator for PEF Services, echoes Angell's sentiment, adding that the drive for standardization will initially be limited to the largest LPs and GPs. Meanwhile, she adds that it is the smallest GPs – those with less than $50 million in AUM – that are likely to be the most resistant to the ILPA templates, citing their relative lack of sophistication.

"They are struggling to bring about this type of reporting because they are just not using these types of sophisticated systems to slice and dice information, and get down to a granular level to report on it," she says.

But there is perhaps a bigger issue surrounding standardization. Caufield adds that while some GPs are making use of the new reporting guidelines, they are not all using the ILPA format. Another issue is that the impetus for adopting ILPA's fee reporting template does not lie solely with the GPs.

According to our survey, nearly 22 percent of respondents said they only made fee disclosures when asked, while just over 60 percent said they reported fees using an internally developed form or via annual financial statements. Angell notes that many GPs have to deal with the fact that their LPs may not want a one-size-fits-all approach to disclosures. "Everybody each has their own sort of disclosure they want," he says. "The GPs in some of these funds are preparing 25 different pieces of information to comply with what the LPs want from them."

He adds that the new template may only serve to add an extra layer of burden to the GPs who already have to respond to each LP's specific disclosure demands.

Meanwhile, Caufield notes that ILPA best practice template, released in 2011, is also struggling to see widespread adoption.

"The ILPA best practices template includes the capital calls, the distributions, the quarterly reporting, and they all grasp at this standardization that nobody has been able to achieve until this point," she says. "Historically, it has been a painful and selective process."

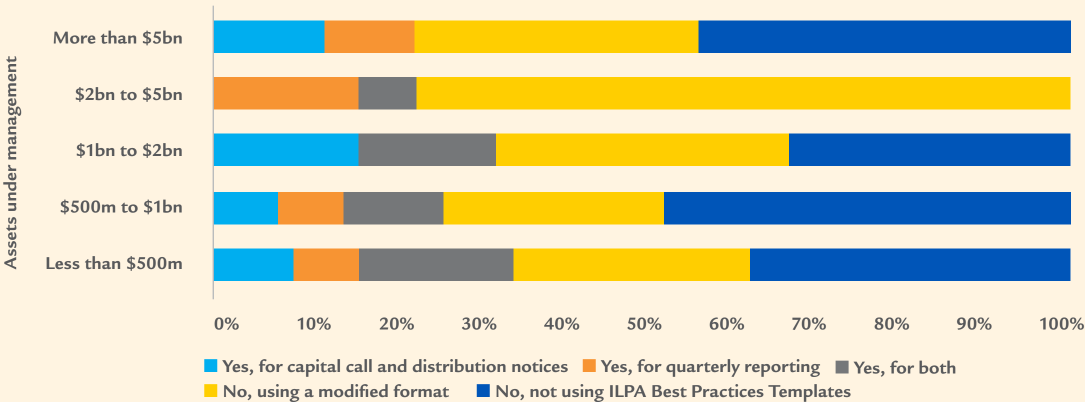
17%

Respondents who have plans to implement ILPA's fee reporting template…

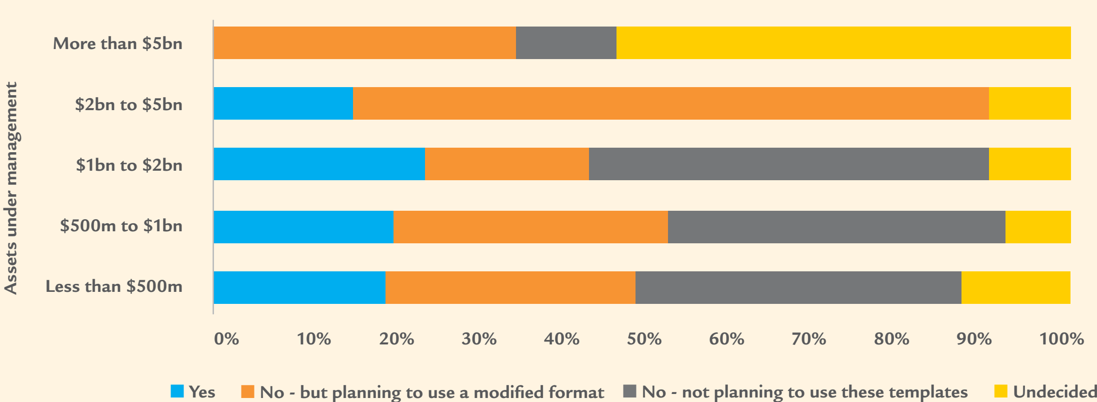
38%

… respondents who have no plans to do so

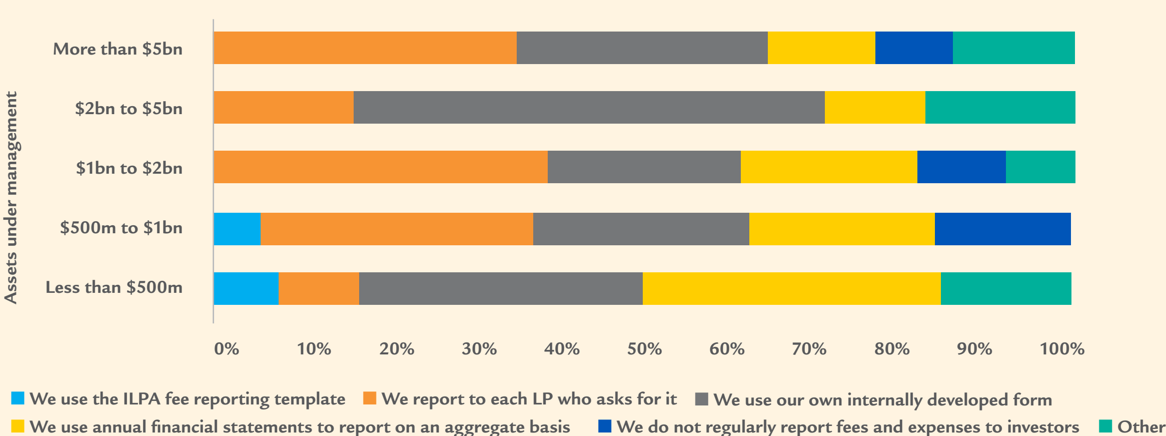
Are you currently using the ILPA Best Practice templates?



Are you planning to implement the ILPA fee reporting template?



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



Source: pfm

Cultivating consensus

The Institutional Limited Partners Association launched the industry's first attempt to unify and codify the disclosure of fees and expenses to LPs this year when it published the final version of its fee-reporting template. **Jennifer Choi**, ILPA managing director of industry affairs, explains more about the template and its role in the industry's push for transparency

Choi: Addressing the need for transparency

"Given how many ILPA members were seeking to answer questions about fees and expenses with bespoke solutions, the template was a natural next step"

What are the factors behind ILPA's decision to issue the new reporting template now?

The initiative emerged from a confluence of factors, but I believe the genesis was a meeting we hosted in March 2015 among some GPs and our members, exploring the question of transparency in our industry. The message from that conversation was clear: GPs want more precise guidance on the information required by LPs on fees and expenses, and a more consistent process for providing those disclosures.

Given how many ILPA members were seeking to answer questions about fees and expenses with bespoke solutions, the template was a natural next step.

Where were the biggest pain points for LPs looking for consistent disclosure from GPs?

Early in the template development process, it was clear that many LPs, particularly pension funds, operated on different fiscal cycles, and yet the bulk of reporting coming from GPs was being provided on a calendar-year basis. Also, LPs quickly pointed out that things like offsets can appear in a multitude of places depending on the GP – in a footnote or the financial report or as a line item in a capital call. Beyond that, we discovered inconsistencies due to differences in labeling, timing, and methodology among GPs.

How did you ensure that the template would be able to address the needs of investors across various sizes, strategies, interests, and jurisdictions?

We approached the exercise with the understanding that no standard – in any industry – will satisfy 100 percent of all needs for 100 percent of organizations. We solicited feedback from a broad range of LPs, as well as LP advisors such as consultants and fund administrators on the level of detail and the categories that made the most sense.

We then market-tested those suggestions on nomenclature and level of itemization with the GP community, in particular with CFOs at several GP organizations. We continue to take feedback from GPs who are in the process of reviewing and amending their internal accounting and reporting processes against the template. We are very pleased to see that many organizations are getting close to implementing the template guidance for at least some of their LPs.

Financial reporting in private equity reflects the range of circumstances behind each fund, including how fees and offsets are charged, and how expenses are tracked, allocated, aggregated, and reported back to the LPs. But regardless of these differences, it's abundantly clear to us that most GPs are genuinely trying to be responsive to the information needs of their LPs.

At the same time, LPs' back offices are not necessarily specialized or singularly focused on PE, which means they are trying to marry information provided in different format by

"We can probably all agree on the benefits of standardization, particularly around something like reporting. But adoption is another matter, and it really comes down to supply and demand"

different managers. We're making great progress, and the template is a step change, but we are still a long way from GPs and LPs being able to manage all this data on a fully automated basis. The data and compliance challenges are very real.

What do you think will be the long-term benefits for GPs using this template?

We believe that efficiency gains will be the greatest benefit, but that's a function of the extent to which LPs adopt the template as the sole format for requesting fee and expense information from GPs. The full realization of the efficiencies of a standard template will require a consistent effort from all parties. Beyond efficiency gains, providing data in a format that has the blessing of an industry body like ILPA should provide GPs with a competitive edge.

Do you anticipate any resistance from GPs and LPs who might be unwilling or unable to implement the new template?

We can probably all agree on the benefits of standardization, particularly around something like reporting. But adoption is another matter, and it really comes down to supply and demand. If LPs elect to accept sub-par reporting rather than lose allocation, or if only a minority of LPs in a given fund ask for the ILPA standards, there won't be sufficient motivation for that GP to build the infrastructure and automated process to deliver the data.

Further, if LPs who request the ILPA standard also insist on receiving data in their own bespoke formats, some GPs will be deterred from complying with the ILPA template.

On the other hand, there will always be certain GPs that aspire to be considered best-in-class who will be the first to embrace what the LP community has put forward.

Too, there's the aspect of providing guidance for the next generation of GPs. An emerging manager keen to have state of the art reporting may look to the template guidance as a way to start out on the best foot possible. System readiness and infrastructure also plays a role for LPs, who may be cautious about asking for the new standards until they have the right vessel to receive and analyze that information. LPs recognize that by asking for the data, they incur a responsibility for using it to inform their decisions.

Outside of ILPA's direct influence, are there any other factors you hope will encourage broader adoption of fee reporting standards?

An increasing number of state-level legislative initiatives are focused on transparency and mandating a minimum level of reporting on costs by public plans. This may raise the bar regarding the quality of reporting needed to access public capital over the longer term in certain states. The SEC's focus on disclosures and their consistency with the LPA sets a very favorable backdrop for standardized reporting.

The SEC's remit, however, does not extend to the reporting specifically to an individual LP in a single fund – they are looking at processes for an advisor and across fund families. It will always be incumbent upon LPs to assert their particular reporting needs.

Beyond legislation, market forces will certainly factor into adoption. Should the market shift and capital become scarcer, we may see greater momentum from GPs towards standardization.

Looking ahead, what will be the next step for ILPA in this drive for more transparency?

Today we have 68 endorsing organizations, including GPs and LPs, with more coming forward nearly every day. It will take time for LPs and GPs to fully integrate the template into their processes, perhaps a year or two, and we will be keeping a close eye on how the ILPA can best support this evolution.

This can be done by clarifying the guidance, encouraging service providers to build solutions to facilitate standardization, or celebrating the efforts of the pioneers who have taken steps towards automation, such as the AltExchange initiative. There is a tremendous market opportunity here for third parties that can cost-effectively simplify the process of exchanging data between GPs and LPs. ■

The proactive approach

The ongoing stream of new regulatory requirements covering expenses can be overwhelming but PEF Services' **Anne Anquillare** says a proactive strategy can keep managers ahead of the game

How often have you thought: "We never seem to get ahead"? There are always new issues or challenges facing our back office. Whether it comes from investors, regulators or internal requests, more often than not, it creates a fire-drill mentality. Are there better ways? Of course there are. Remember the *Seven Habits of Highly Effective People* by Stephen Covey? Habit one was "be proactive."

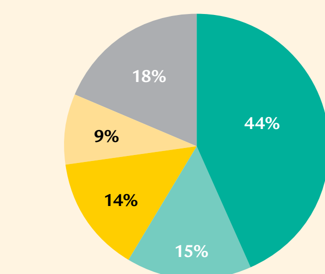
Think of all the new expenses you had to allocate over the last five years. Some of these expenses weren't even contemplated when you formed your last fund. You now need to decide how your firm allocates these expenses, and based on the results of this survey, there doesn't seem to be a standard approach.

A practical and helpful tool that fund managers have employed is an expense allocation policy. Under the Investment Advisors Act of 1940, registered investment advisors (RIAs) have a fiduciary duty to act in the investors' best interests. RIAs need to ensure that they do not breach this duty by improperly allocating expenses to funds and investors. Having an expense allocation policy that has been approved by the LPAC helps in this effort. The policy should be tailored to your firm, disclosed to investors, and consistently followed. Even if you are not an RIA today, most investors would like you to run the firm with that same fiduciary approach.

The expense allocation policy is more principles-based than rules-based and can streamline how a company handles new expenses, avoids unnecessary legal costs and internal distractions and helps with efficiently running the firm. A policy also avoids the trap of "case by case" decisions which could lead to hindsight scrutiny by investors and regulators. Here is some step-by-step advice on how to be proactive and not let expenses overwhelm the resources of the firm, or become a potential weak spot for future fundraising efforts:

Anquillare: Offering a proactive approach to fee allocation

How do you answer expense-related queries that are not addressed in the PPM, LPA or policy documents?



- The management team decides
- The CFO decides
- We consult with the LPAC
- We decide informally with a few LPs
- Other

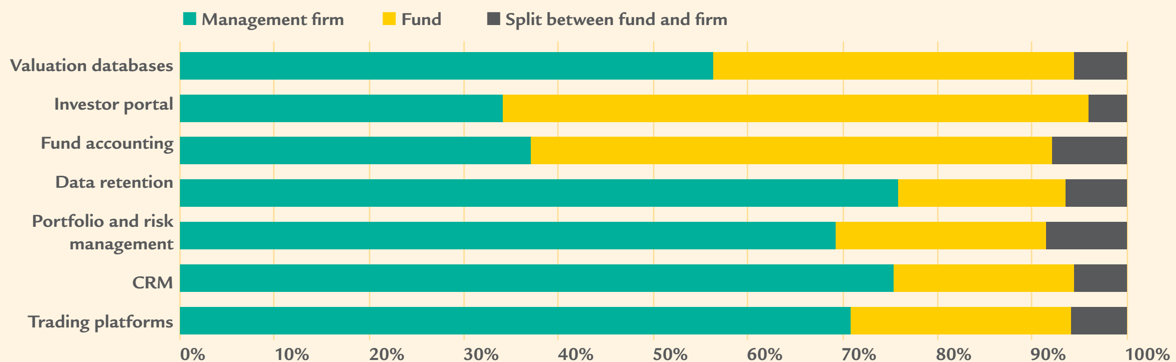
Step one

Develop policy to address allocation of expenses that are not contemplated by, or are not clear, in your existing funds' LPAs, and communicate this policy and procedures to all investors in all funds.

Older funds' LPAs are not as thoroughly documented as regulators or investors expect today.

Use this opportunity to clarify a consistent position for all funds and include new industry issues (eg, allocation of vendor discounts). To the extent that the new policy and procedures are in conflict with specific sections of any existing fund's LPA, highlight and carve out those expenses in the exhibit to the policy for each fund. Involve LPAC members, investment managers, and the CFO and CCO in the decision-making process.

The general rule for most expenses is that they are allocated to the entities benefiting from them. For example, most agree that accounting and investor communications are beneficial to the fund, so many managers are allocating those costs accordingly.



Source: pfm

Step two

Look at anything that has come up recently in the industry even if it doesn't apply to you today. For example:

- New insurance policies (eg, cybersecurity)
- New technology applications
- Specialized service providers and consultants
- Regulatory and compliance costs (if recently registered, or planning to register, or for keeping up with the constantly changing regulatory landscape)

The use of specialized service providers or consultants is increasing as our industry matures. For example, we have started to see more environmental, social, and corporate governance service providers since the UN issued its Principles for Responsible Investment. Having a proactive ESG strategy and reporting can help both the firm and its investors. When the decision to use an ESG consultant was the firm's, 70 percent of the respondents in the survey said it was a management company expense. But, if an investor required the ESG consultant, 50 percent of the respondents said that would change the allocation, making it either a fund expense or an expense charged to a specific investor.

Step three

For any new funds, add a provision to the LPA for the allocation of expenses not contemplated at the time of the agreement. The expense policy and procedures of the firm will determine the allocation of these expenses. Also, establish procedures for addressing expense allocations that do not clearly fit within the policy. Review and update the expense policy at least annually.

Step four

Ensure that you have proper documentation in place for expense allocations. Document the calculation of the allocation of expenses in accordance with your policy and the required approvals. If it is a new type of expense, ensure that the documentation includes the rationale for the allocation methodology as well as the required approvals. There are a variety of applications available that can assist in the allocation and documentation for record keeping purposes.

Step five

Make certain that you are in compliance with your expense allocation policy and procedures. Educate members of your firm and service providers, such as your fund administrator, to ensure that they understand how expenses should be allocated. On a test basis, periodically conduct a review of the allocation of expenses for historical transactions to ensure that you are in compliance with your policy and procedures.

So, yes, there are better ways. Having an expense allocation policy and procedure will save you a lot of time and money in the long run. Think of how relieved your auditors and regulators will be if they can follow a consistent policy across all funds. You might hear that some fund managers like the flexibility of not having to go through and create or clarify the firm's expense policies. This flexibility comes at a great cost, one that might not be apparent until it's too late (eg, SEC fines or a failed fundraise). Call us if you need any encouragement. We'd be happy to share some motivational success stories as well as best practices that we see at firms that have robust policies and procedures in place.

Anne Anquillare is co-founder and chief executive of PEF Services. Launched in 2002, PEF provides high touch fund administration solutions for alternative investments. Anne has been an active member in the private equity industry since 1993 and has served as general partner of Walden Capital Partners, a growth capital fund licensed in 1996.

Profile

Founded in 2002 by experienced managers of private capital funds, PEF Services helps private capital firms transform their back office into a Center of Excellence by seamlessly upgrading the quality, breadth and depth, and timeliness of investor information. Our Center of Excellence approach means we build a plan that is unique to each firm and fund's needs. We have an exceptional, track record spanning 15 years of delivering cost effective solutions to private capital funds of all types and sizes, including buyout, venture, real estate, debt, distressed, special purpose vehicles and fund of funds.

And, our designated LPAS Group focuses solely on meeting the unique administration and data needs of limited partners investing in illiquid alternative assets.

Our Differentiators

Everything we do from technology development through service delivery is designed to reward the trust our client's place in us.

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The justification for our business simple – we must exceed the capabilities of our competitors and the expectations of our customers.

Our Technology

PEF Services has consistently invested in technology since day one. The result is an outstanding IT team of developers and quality assurance professionals who have extensive alternative investment experience.

We have developed Proprietary web-based applications customized for private fund financial reporting, investor communications and data management. These applications facilitate the collection of data, simplify compliance and streamline the financial reporting function. These applications, PEFOnline and Investor Library, are continuously updated and improved upon based on feedback from our clients and the demands of the market.

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Smooth operators?

Some GPs still charge operating partner fees to their portfolio companies, despite greater SEC scrutiny, but attitudes are changing, writes **Marine Cole**

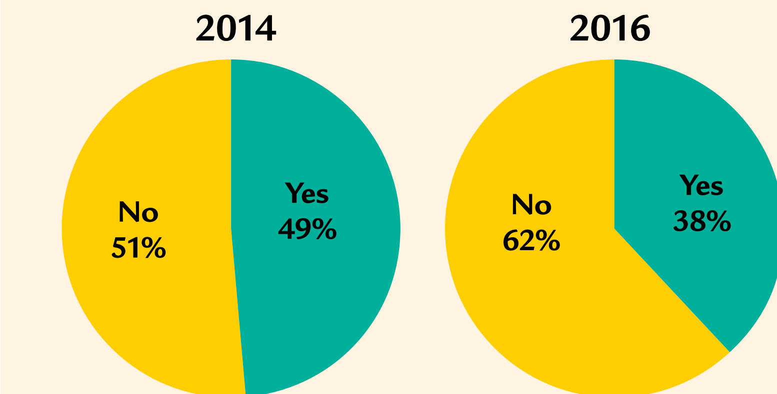
Value creation has become a favorite buzz term among private equity managers under ever-growing pressure to boost returns for investors. The days of simple multiple arbitrage are fading, and general partners now have to roll up their sleeves and drive growth in their portfolio companies, or at least hire people who can.

Operating partners – industry consultants often plucked from Fortune 500 companies and high-profile multinationals – are now an essential part of the average fund manager's tool box. Their importance is such that general partners now routinely use the pedigree of these professionals as a major selling point when on the fundraising trail. At the same time, the increasing use of operating partners has attracted the attention of the Securities and Exchange Commission.

Andrew Bowden, a director in the SEC's office of compliance, inspections and examinations, highlighted the practice when he spoke at the PEI's Private Fund Compliance Forum in 2014. He zeroed in on consultants who were effectively double-dipping – being paid on a retainer by the GP while at the same time sitting on the board of a portfolio company and collecting a director's fee.

Broadly speaking, general partners should not let portfolio companies pay the operating partners. If they do, the private equity firm should offset remuneration from the management fee. In many instances, this hasn't been the

If an operating partner on retainer joins a portfolio company as an independent director. Do you offset the cash director fee against the management fee?

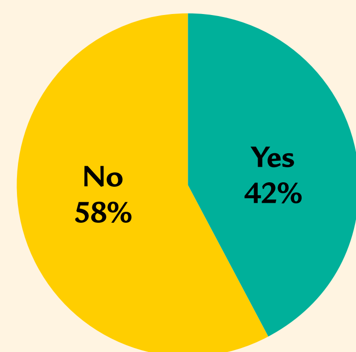


Source: pfm

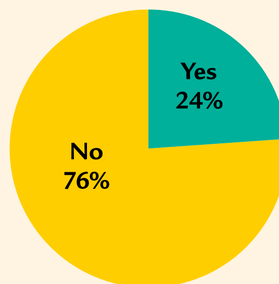
"Many operating partners are paid directly by portfolio companies without sufficient disclosure to investors. This effectively creates a 'back door' fee that many investors do not expect"

Andrew Bowden

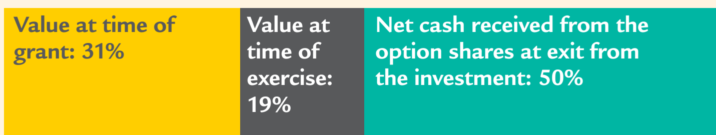
If the firm stops paying the OP's retainer, would you offset the partner's director fee against the fund's management fee?



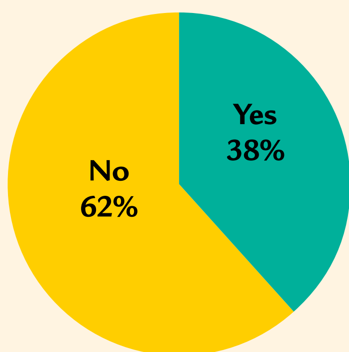
Would you offset any equity options the portfolio company grants to the OP?



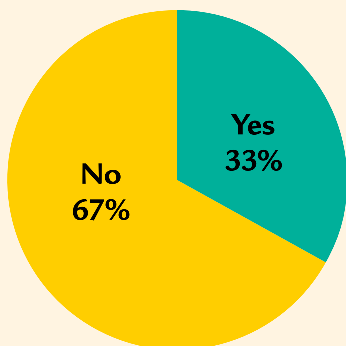
What is the amount of the offset?



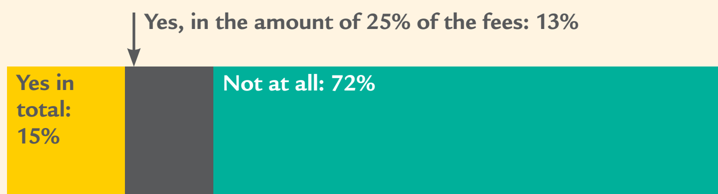
When OPs sit on a portfolio company board, does it pay them director fees?



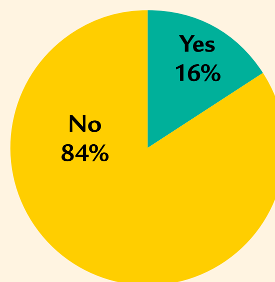
If you answered yes to the above question, if the firm ceases to pay them the retainer would you offset the operating partner's cash director's fee against the fund's management fee?



If the portfolio company pays consulting fees to the OP's company and OP owns 25% of the consulting firm, would you offset the fees paid to the business against the management fee?



Would knowing what the consulting firm actually pays the OP make any difference to your answer?



case, and the SEC is now taking action. "Many of these operating partners are paid directly by portfolio companies of the funds without sufficient disclosure to investors," Bowden said at the forum. "This effectively creates an additional 'back door' fee that many investors do not expect, especially since operating partners often look and act just like other advisor employees."

If operating partners are being paid by the fund or the portfolio company they advise, investors are unknowingly footing the bill for these resources in addition to paying a management fee to GPs.

Meanwhile, in the eyes of limited partners, the operating partner may just look like any other part of the management. As Bowden said, they work exclusively for the GP, in the offices of the GP, they have the title of partner and they appear on the GP's website and marketing materials as full members of the team.

Thomas Angell, a partner at consulting firm WithumSmith+Brown, says the pressure from the SEC on fees and expenses in the past two years has forced many GPs to be more conservative in their allocation of various expenses, including those related to operating partners.

"Nowadays, limited partners are placing extreme pressure on GPs to offset any types of fees charged at the portfolio company level that are perceived to benefit the general partner, in this case, director's fees, which otherwise would have to have somehow been taken from the pockets of the general partners," he says.

Yet, contrary to expectations, our survey shows that fewer firms are offsetting the operating partner cash director fee against the fund management fee when the partner is on retainer with the GP. About 38 percent of respondents who answered the questions said they offset director fees, down from nearly 49 percent two years ago.

On the other hand, Angell notes that more operating partners are being paid directly by the general partner, thus alleviating any issues related to portfolio companies paying compensation, fee offsets and ultimately SEC scrutiny.

"The operating partners who are typically marketed to the limited partners as being 'the expertise of the GP' would then appropriately be compensated by the GP, in more of an employer/employee type relationship," adds Angell.

Indeed, this year's survey shows that just 38 percent of respondents said that they still charged operating partner's director fees to the portfolio company, indicating that direct compensation of operating partners by the GP is becoming the norm.

In future, Angell anticipates that private equity firms will continue to look at all the fees being paid and offset those fees if portfolio companies are paying operating partners a director's fee. As investors continue to focus on the issue, it's likely that limited partnership agreements will become more detailed regarding various fees and expenses incurred by the fund and its portfolio companies.

Despite the SEC's focus on operating partners as a part of its push for more transparency on fees, the use of these industry specialists is likely to remain a core strategy for many private equity firms.

"GPs will continue to use operating partners in order to build the profitability of the portfolio companies," Angell says. "The operating partners are brought in to help increase productivity, reduce costs from suppliers and build out the management team." ■

> **"LPs are placing extreme pressure on GPs to offset any types of fees charged at the portfolio company level that are perceived to benefit the general partners"**
>
> Thomas Angell

Clearing the air: Unite Here puts the spotlight on GP expenses

Weapon of choice

As the rocky relationship between private equity and unions grows tense, some labor groups have found recent sensitivity over fees a useful tool for putting the heat on GPs

When details of almost 1,900 flights taken on its company jets were published online in February, Leonard Green became the latest target in an elaborate struggle between unions and private equity that has now spilled over into the industry's fees and expenses debate.

The report by Unite Here, a US union representing workers in the hospitality industry, suggested Leonard Green had been less than transparent with investors about expenses associated with its use of private jets.

Leonard Green denied the claims but is far from the only firm to come under fire from the union. Unite Here is infamous in the private equity and real estate industries for its fund manager list, which labels 17 managers as "irresponsible" and 11 as "responsible."

PE Closer Look, the union's private equity-focused website, defines irresponsible managers as those "that have refused multiple requests to meet, have refused to identify places to work together, or have had a longstanding, unresolved dispute at a hospitality-related property or portfolio company."

Responsible managers, meanwhile, have reached an agreement "ensuring labor peace" at hospitality-related properties or companies that create "a basis for co-operation."

As of August this year, The Carlyle Group, TPG Capital and Ares Management were labeled "irresponsible," while The Blackstone Group and Apollo Global Management were regarded as "responsible."

Unite Here has been posting reports on "irresponsible" managers since 2013, but the Leonard Green report stood out because of the lengths to which the union was willing to go to dig up dirt.

It used Freedom of Information Act requests to access old filings of Leonard Green's Form ADV Part 2A and researched the firm's three private jets registered with the Federal Aviation Administration, analyzing its 1,898 flights over the past three years. It then appealed to all Leonard Green LPs, urging them to request more transparency on private jet travel from their manager while citing similar calls from both the Securities and Exchange Commission and the Institutional Limited Partners Association.

"I didn't know they were going to those levels, but I'm not terribly surprised," said one source.

The goal of Unite Here's report, according to its author Michael Pineschi, was to increase transparency for defined benefit plans. But some industry sources take a more cynical view, suggesting it was part of Unite Here's broader campaign to persuade Leonard Green to unionize the Palms Casino Resort in Las Vegas, which the firm owns alongside TPG. When Unite Here released its report, the union had been trying unsuccessfully for eight months to meet the fund manager regarding unionization of the Palms.

"We, Leonard Green & Partners, pay virtually all [98 percent last year] of the costs associated with private air travel. Our investors were charged nothing," the firm said. It declined to comment further on the matter.

For institutional LPs, the union attention is more of a nuisance than anything else, said a source familiar with the matter. When Unite Here shows up at public pension meeting with flyers or publishes scathing reports, it makes more work for the LPs who have to answer questions from trustees and other stakeholders.

"It makes life miserable for investment staff," said one GP whose firm received negative attention from Unite Here in the past. "We haven't lost a single investor because of it, but for firms that don't have the same returns, it may impact them." ■

What lies beneath?

Management fees and carried interest make up most of a GP's income, but numerous other 'hidden expenses' lie in wait for LPs and portfolio companies

Two and 20

The two-and-20 fee structure – typically a 2 percent flat rate on the total asset value of the fund and an additional 20 percent of any profits earned – is the traditional model, but times are changing. Sophisticated LPs have been pushing for concessions and GPs – eager to secure large commitments – have been willing to concede ground. The upshot is that many GPs have turned to other streams of revenue.

Monitoring fees

Justified by fund managers who point to the resources that go into adding value to investments. These fees are ongoing and unrelated to performance. Accelerated monitoring fees, charged when a GP exits a portfolio investment ahead of schedule, are even more contentious.

Closing fees

Following an acquisition, a private equity firm will pay itself a fee after the deal closes using the proceeds. This is for raising the capital needed to close the deal with the justification that the PE firm is saving investors the expense of using outside advisors.

Exit fees

Paid to GPs once they sell a company. Some portfolio companies are charged twice: first when the private equity firm comes in, and then when it exits. Even if a bank is involved, the GP will often justify an exit fee by their close involvement in the process.

Recap fees

Occur whenever there is a liquidity event or additional transaction within a portfolio investment, such as a dividend recapitalisation or bolt-on acquisition. These are often charged whether the GP deploys additional equity from the fund or not.

Broken deal expenses

Typically charged by a seller if the buyer wants to enter exclusive negotiations. These will normally only occur at late stages of competitive deals. Their definition can be so broad that GPs stretch it to include costs associated with routine deal-sourcing.

Director fees

PE firms will often bring outside directors to sit on the boards of their portfolio companies. The problem is when these directors collect a fee from the company while also being paid by the fund manager.

Crackdown roundup

The SEC is making good on its promise to get tough over fees and expenses – some have been hit harder than others

Apollo $53m

In August 2016, Apollo Global Management agreed to pay $52.7 million after the SEC alleged that four fund advisors had misled investors about fees and a loan agreement. They were also accused of failing to supervise a senior partner who charged personal expenses to the funds, and inadequately disclosing benefits received from accelerating monitoring fees.

Blackstone $39m

Three fund advisors fell afoul of the SEC in October 2015 after they were accused of failing to fully inform investors about benefits that the advisors gained from accelerated monitoring fees and discounts on legal fees. The SEC said the fees reduced the value of portfolio companies to the detriment of investors.

KKR $30m

In June 2015, KKR paid $30 million after it was accused of misallocating more than £17 million in broken deal fees to its funds. The SEC alleged that over six years to 2011, the firm incurred $338 million in broken deal or diligence expenses related to unsuccessful deals. The regulator also alleged that KKR did not allocate any portion of these broken-deal to co-investors for years. KKR neither admitted nor denied the SEC's findings.

WL Ross $14m

An alleged failure to disclose fees landed Wilbur Ross's WL Ross & Co a $2.3 million fine in August. The SEC said the firm was not clear on how transaction fees were charged to funds. WL Ross neither confirmed nor denied the agency's finding and also paid $11.9 million in reimbursements.

Fenway $10m

Four executives got into hot water with the SEC in November 2015 after they were accused of rerouting portfolio company fees to an affiliate. Fenway agreed to pay penalties and disgorgements totalling $10.2 million without admitting or denying the charges.

Blackstreet $3m

The Maryland-based private equity firm and its owner was fined in June 2016, after being found to have in engaged in brokerage activity – and charged fees – without having a broker-dealer license.

Lincolnshire $2.3m

New-York based Lincolnshire Management paid $2.3 million to settle SEC charges in 2014 after it was accused of sharing expenses between two portfolio companies in a way that benefitted one fund over the other. Lincolnshire agreed to the penalty without admitting or denying the SEC's findings.

Squeezed in the middle

As pressure from both regulators and investors builds, **Julia Corelli**, a partner with law firm Pepper Hamilton, asks whether fees and expenses are burying the PE model for smaller funds

Corelli: Mid-market managers are facing a trifecta of pressures

Fund managers are getting squeezed from all directions. Absent raising a larger fund next time, GPs cannot realistically expect to grow top line revenue. At the same time, they bear variable and often unpredictable expenses. The only true lifeline for the middle market manager is a positive track record that can sustain the firm over several funds until carry kicks in. As a result, new managers have a precarious business path for the first 10 years or more.

As in 2014, over 80 percent of participants in the 2016 *pfm Fees and Expenses Benchmarking Survey* are managers with less than $1 billion under management. Around 20 percent have AUM of less than $100 million. The group comprises the lower, middle and maybe some of the upper end of the middle market. The survey shows how difficult the current private equity business model has become for smaller funds.

Internally, GPs often need to manage a talent pool where compensation is a constant source of pressure. Junior professionals are expecting more, sooner. Limited partners are pushing to reduce their fee burden. Completing the trifecta, regulators are triggering unforeseeable – and at times uncontrollable – examination costs. Technology, space and utility costs look predictable by comparison. Combine that with the ever-growing interest in patient capital and one wonders why any new manager would willingly enter the fray.

Predictably, the survey shows that managers have not been shifting expenses to their funds and continue to bear variable costs – like marketing, travel, research, accounting and communication. Two exceptions seem to be broken deal expenses and co-investment costs. Meanwhile, fee offsets are more often 100 percent, so other forms of fee income are less available to bolster top line revenue.

When asked who pays the legal, accounting or consulting costs during diligence before a letter of intent is signed, 57 percent of respondents agreed that the fund should pay if the deal ultimately closes. If the deal doesn't close, close to 80 percent said the fund pays. By contrast, the figure was 29 percent and 53 percent, respectively, in 2014. The number of responses indicating the portfolio company pays pre-LOI costs in a deal that closes dropped from 61 percent to 38 percent between the two surveys.

There has been a similar shift when it comes to attributing post-LOI deal expenses. If the deal is closed, 42 percent agreed in 2016 that post-LOI expenses should be reimbursed by portfolio companies, compared with 65 percent in 2014.

The net result: the fund is picking up more. Perhaps there are more minority or co-investment transactions occurring where it is more common that the portfolio company does not bear all of the fund's transaction costs. The more likely driver is competition for deals.

Catch 22

How co-investors should share in deal costs remains controversial. When the co-investment entity is expense-free, the best practice is to have a pre-disclosed policy making fund investors aware of

this. Without this, regulators complain. But pre-set policies are by their nature inflexible, and managers usually prefer an approach based on fairness. As the legal structuring necessary to accommodate co-investments has grown more complex, the debate over who bears the cost of the co-investment vehicles has escalated. Costs include not only organizational expenses but the ongoing costs of tax returns, audits, bookkeeping, LP transfers, etc. Co-investment vehicles are increasingly management fee and carry free, especially when populated by existing LPs, leaving many wondering whether separate co-investment investment vehicles are worth it.

In the 2016 survey, over 83 percent of respondents said that the organizational costs of co-investment vehicles were borne by the co-investors, while only 9 percent treated them as transaction expenses. While the GP could try to negotiate for the portfolio company to cover them (which means the fund is effectively bearing its percentage ownership share of those costs), that is not always successful. Yet, having the portfolio company pay them would seem to be a fair outcome as the deal would not happen without the co-investment entity being organized and funded and all participants in the deal benefit from the co-investment.

If a fund manager cannot negotiate a management fee from the co-investment entity; or does not have a policy making it a fund expense; or is unable to negotiate for the entity's costs to be covered by its investors or the portfolio company, it has to absorb those costs within the firm's budget. It is one of those unpredictable expenses – the fund manager cannot know in advance what kind of deals will present themselves during the fund's life which will require co-investment capital.

"In the 2016 survey, over 83 percent of respondents said that the organizational costs of co-investment vehicles were borne by the co-investors, while only 9 percent treated them as transaction expenses"

At the risk of increasing operating costs, fund managers are succumbing to LP pressure to deploy their capital through co-investments. By doing larger deals, the manager may hope to raise a larger fund next time, facilitating revenue growth and supporting a bigger team. The danger is they may wander from their original investment mandate: the lower end of the middle market PE deals. It's a catch-22.

The cost of compliance

A third large variable cost for mid-market managers is regulatory costs. These come in many shapes and sizes: registration costs, the cost of having a chief compliance officer, ongoing compliance maintenance costs, examination costs and investigation costs, ie, the costs of interactions with regulators beyond the routine examination. The 2014 and 2016 surveys were fairly consistent in their treatment of examination costs – the majority are manager-borne. In 2014, about 67 percent of survey respondents said managers should bear the legal costs incurred in connection with a routine examination, while 20 percent said the fund pays that expense.

Both surveys asked whether the GP or fund should bear the costs associated with the restatement of financials should an examination show valuation deficiencies. In both, about 57 percent said the management company paid the costs of the restatement and just under 30 percent said the fund would pay it. The sample size may not be significant enough to call this an industry practice, but this may indicate that, in some cases, fund managers can require the one who benefits from the regulator's remedial action to bear the associated costs. It will depend on the circumstances.

Broken deal expenses, co-investment costs, regulatory examination costs are three areas where mid-market fund managers have been able to advance a bit against the trifecta of cost pressures. Their solutions are often creative and heavily scrutinized by investors, resulting in longer, more negotiated LPAs and side letters, which increases organizational costs. It is only by industry surveys such as the *pfm Fees and Expenses Survey* that we can see, at a macro level, some of the pressures that middle market managers face and understand how much it takes a special kind of manager to maneuver their way through the first 10 years necessary for a sustainable business model. ■

Julia Corelli is a partner with Pepper Hamilton LLP's Corporate and Securities Practice Group and co-chairs its Funds Services Group, a constituent of Pepper's Investment Funds Industry Group (IFIG).

Pepper Hamilton LLP
Attorneys at Law

Founded in 1890, Pepper Hamilton LLP is a multi-practice law firm with more than 500 lawyers nationally.

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 and are well versed in the dynamic and ever-evolving arena of investment industry regulation. We work with our clients to help them not only understand the new regime of transparency, accountability and enforcement but to successfully adapt to it.

Our Fund 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, corporate, securities and regulatory matters. 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.

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Alternative investment funds, particularly hedge and private equity funds, have been subject to heightened scrutiny from legislators and government agencies in recent years. With increased regulation under the Dodd-Frank Act, new actions from Congress and the SEC and changing requirements in international jurisdictions, this trend is likely to continue in the future. We work with our clients to ensure they both stay on top of these developments and prepare for future change.

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Tug of war

Agreeing on who foots the bill for SEC examination costs is becoming a constant battle between GPs and LPs, and the situation is unlikely to improve anytime soon, writes **Nicole Miskelly**

When the Securities and Exchange Commission revealed in 2012 that it would embark on a large-scale sweep of the private equity industry, GPs were unprepared for the cost of examinations.

Fast-forward four years and GPs are not only prepared but are trying to shift the costs to the fund.

"We have started to see, from a practical standpoint, that GPs and LPs have become savvier in determining who pays for what," says Anne Anquillare, co-founder of fund administrator, PEF Services.

"There has been a tug-of-war between the two sides with the GPs trying to convince the LPs, saying, 'Look, the SEC came in to protect you, so you have got to bear a least some portion of the expenses.'"

This correlates with the results of our latest survey, which shows that there has been a 11 percent increase in the number of GPs that concede that regulatory exams are a fund expense, compared with the same survey in 2014.

"There is a shift towards the fund taking these expenses," says Anquillare. "When the regulations first came out, and the exams first started to hit, nobody had contemplated it in the partnership agreement, so the management companies had to eat it. But now people are getting more sophisticated, more knowledgeable, and they are starting to make distinctions between what should be a fund expense versus a management expense."

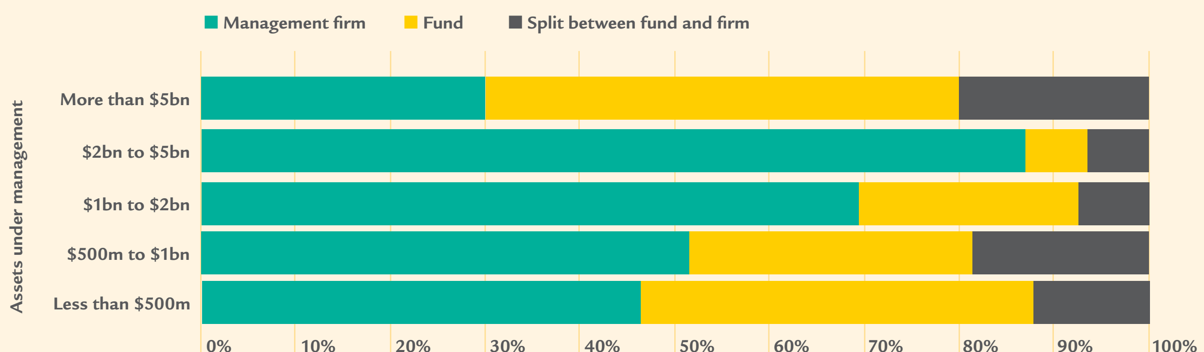
With the SEC ramping up its scrutiny of the private equity industry in recent years, more private equity firms have been charged with fees-related offenses as a result of discrepancies found during examinations.

In August, Apollo Global Management agreed to pay $52.7 million to settle SEC charges, relating to accelerated monitoring fees and allegations of misleading LPs in four funds about fees and a loan agreement. It was also accused of failing to supervise a senior partner who had charged personal expenses to several funds.

The same week, distressed-focused firm WL Ross & Co agreed to pay a $2.3 million civil penalty issued by the SEC for allegedly failing to properly disclose the method used to allocate certain fees it charges investors.

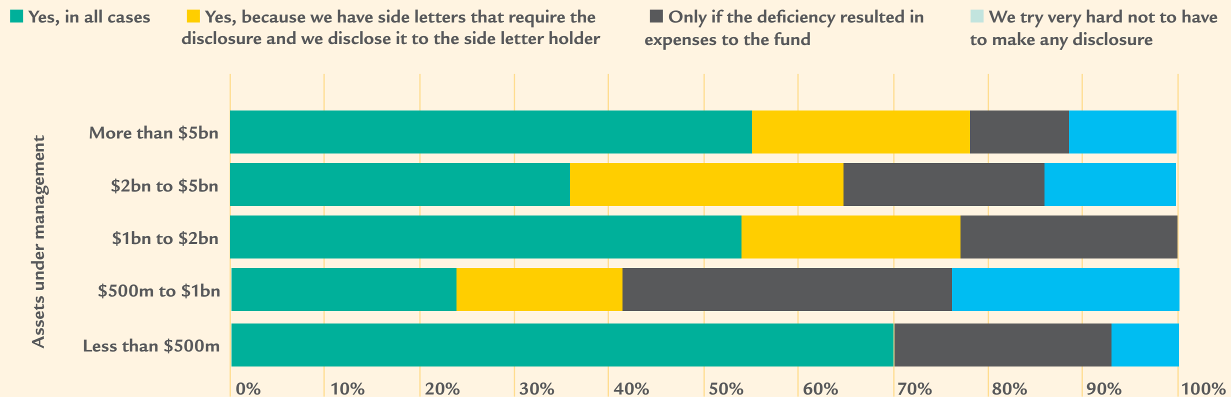
Managers should expect this trend to continue. "The message should be clear: we have the expertise and will continue to aggressively bring impactful cases in this space," SEC Division of Enforcement director Andrew Ceresney warned in a speech at the Securities Enforcement Forum in San

Following a routine examination, regulators find a deficiency around valuations. You redo the last two quarters' reports and deliver them along with an explanatory letter to your LPs. Who pays the accounting and legal costs?

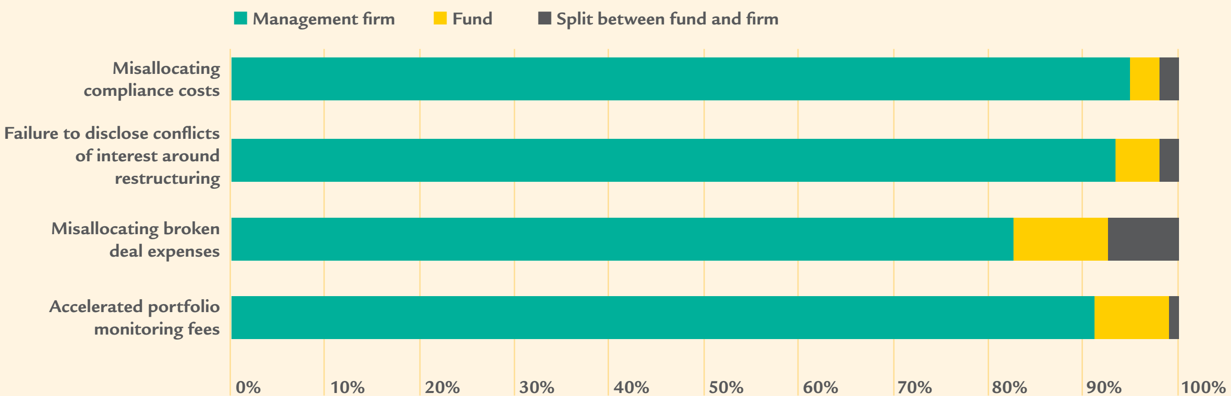


Source: pfm

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



The SEC determines you had a problem with the below item. Who pays the financial penalty?



Francisco in May. During examinations, the SEC reviews all of a firm's internal documents, including all policies and procedures, such as valuation, fee and expense allocations. The regulator also reviews fund documentation, such as the Limited Partner Agreement and Private Placement Memorandum.

Now that GPs know what to expect from an examination, many are taking the time to review their fund documentation.

"GP's are more prepared now than before the SEC came out with its findings regarding fees and expenses," says Thomas Angell, a partner at accounting firm WithumSmith+Brown. "They have had some time to review how fees and expenses were allocated and to make sure they have documented all necessary policies and procedures. Some funds have even gone through mock SEC audits by an outside compliance firm."

However, many GPs are still of the opinion that the fund should bear the cost of examinations because, as Angell says, "an SEC examination is part of the cost of doing business and therefore it is a fund expense. If not for having the fund, there would be no reason for the SEC to review them."

Post-exam expenses

If the SEC finds mistakes during an examination, they will usually tell the firm if they need to take corrective action within six months of the exam taking place. Allocating the cost for

this, however, depends on what the SEC has found as an issue and each fund may handle it in a different way, says Angell. "One would think that going forward GPs would bear these costs to avoid uncomfortable conversations with investors and to placate the SEC," he adds.

We asked respondents about four possible scenarios stemming from an examination to gain a feel for how GPs allocate these expenses: accelerated portfolio monitoring fees; misallocating broken deal expenses; failure to disclose conflicts of interest around restructuring; and misallocating compliance costs.

Although many GPs reiterated these scenarios are usually a cost for the firm, smaller GPs are more willing to shift these costs to the fund. However, according to Anquillare, smaller GPs get a smaller management fee, so they are less willing to concede the issue – and they are more affected by the burdensome cost of a full-blown inspection.

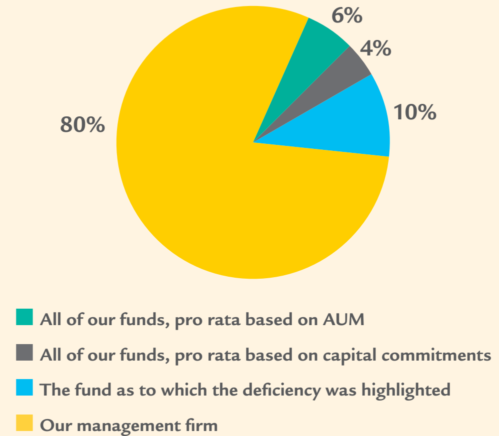
"The point of SEC supervision is to protect investors, so it wouldn't be surprising to see smaller GPs use that argument to negotiate around exams being a fund expense. It's partly the case that some GPs simply can't afford these new regulatory costs," says Anquillare.

Issues often arise during the inception of a fund if examination expenses to be allocated to the fund – and to any co-investor – are not adequately disclosed in the Limited Partnership Agreement.

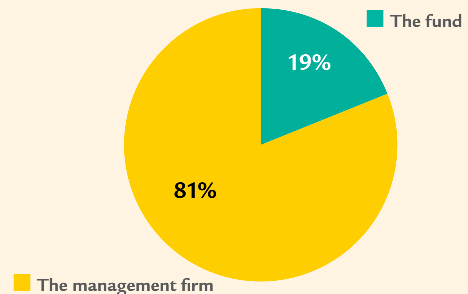
However, in the future, LPA's are likely to become more involved, says Angell. "With all fees and expenses, LPAs will be more detailed in their description of what will be charged to the fund and what will be charged to the investment manager."

The SEC's spotlight will remain firmly fixed on the issue of fees for the foreseeable future. Negotiating terms for the allocation of exam costs will be difficult, but managers and investors need to agree on who foots the bill because the burden will not be getting any lighter. ■

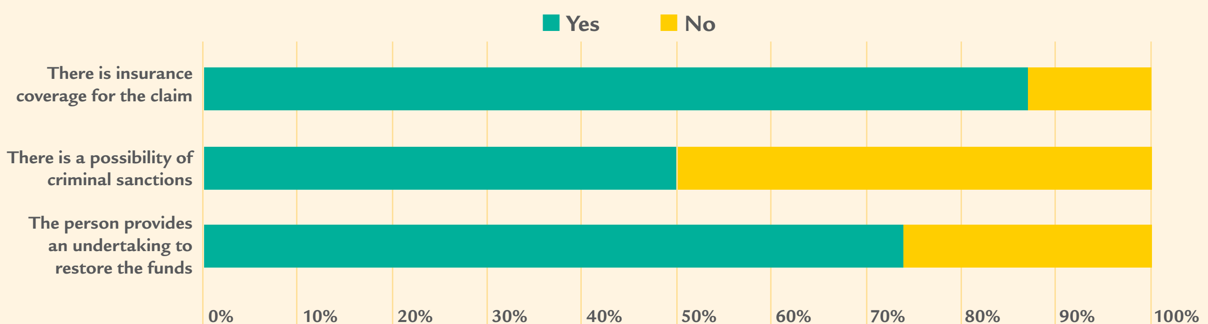
The SEC requires that you engage a compliance consultant to review your CCO's activities. Who pays the consultant?



If you advance funds, who pays the amount advanced?



A principal with your firm is subject to an SEC inquiry involving the activities of the firm and the funds you manage. Do you advance expenses for the principal's defense if:



Who picks up the tab?

GPs are feeling more comfortable with charging the cost of schmoozing to the fund, raising questions about the alignment of interests between GPs and investors, writes **Annabelle Ju**

Private equity is a relationships-based business. Fund managers enter a partnership with investors and a multi-year collaboration with the portfolio companies they purchase. Several general partners have likened it to finding a good match for marriage.

It is inevitable, then, that a lot of schmoozing and networking goes on behind all the capital-raising, legal filings, and deal-making. But who picks up the tab when it comes to the entertainment, the travel, and all the sundry expenses that come with running an annual general meeting? It is a question that frequently comes up when trying to align interests between GPs and LPs.

"I think the biggest concern for LPs is the potential for conflicts of interest," says fund administrator PEF Services co-founder and chief executive Anne Anquillare. "If the LP feels the GP is aggressive with regards to their expenses, and there is any hint of a conflict of interest, then that undermines trust."

The degree of faith an LP can place in their GP will inevitably depend on the manner in which they disclose their fees and charges, and whether the investors feel the fund manager is sufficiently transparent. That's easier said than done.

The *pfm Fees and Expenses Survey* found 23 percent of GPs still don't disclose their AGM budget to the LP advisory committee, whereas only 3.7 percent do. Just 11 percent said they disclosed the budget to all LPs, but over half said they don't have a set budget.

Also, it is no longer a blanket assumption that the GP pays for everything when it comes to AGM expenses.

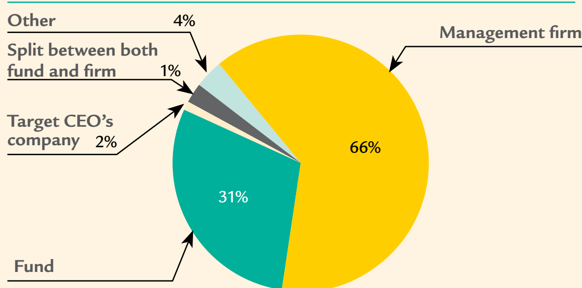
The survey indicates a trend towards charging such expenses to the funds rather than the GP. This year, 68 percent of GPs said their funds absorbed the costs for meals and entertainment provided to the existing LPs. By comparison, just 53 percent of GPs said so in 2014. Similarly, 41 percent of GPs said the fund would be expected to pick up the tab when it comes to wining and dining the chief executives of their current portfolio companies, up from 33 percent two years ago.

"This is because the purpose of the annual meeting is to give the investors an opportunity to meet, talk, and rub shoulders with CEOs of the portfolio companies," Anquillare says. "It gives them access to that one layer down to the actual people responsible for the performance of the fund."

The bottom line is that it depends on who benefits from these activities. In the above case, it is the fund's LPs who are considered to be the winners and hence they are paying the bill. But that decision doesn't happen naturally. Angell emphasizes it's about making investors comfortable with the allocations. To improve communication, GPs should be more detailed when outlining the fees and expenses in the LPA.

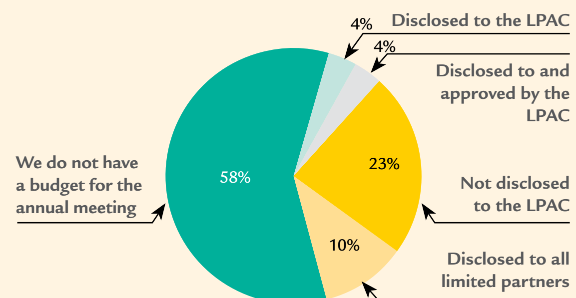
"It comes down to [the GPs] marketing to the LPs and whether they are comfortable with the allocations, and are willing to pay them because they want to be invested with that particular GP," says Tom Angell, partner at accounting and consulting firm WithumSmith+Brown. "It becomes a marketing issue in fundraising – how is your competition handling these items compared to how you are handling them?" ■

A partner takes a target company CEO out to lunch but there is no letter of intent or pre-existing deal discussion. Who pays the tab?



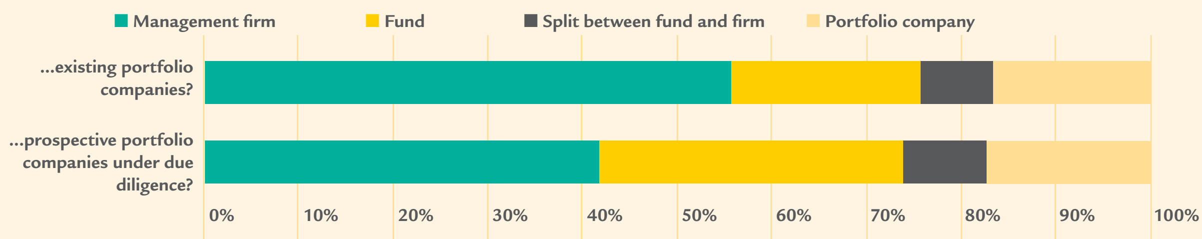
Source: pfm

If you have a budget for the annual meeting of limited partners, is it:

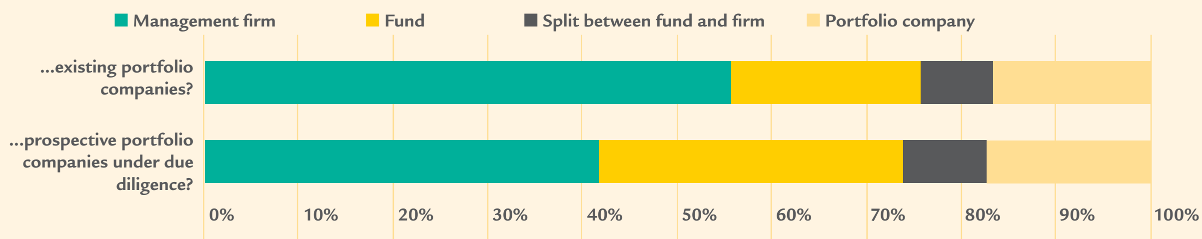


At the annual meeting, who pays for the meals and entertainment of the CEOs of...

2014

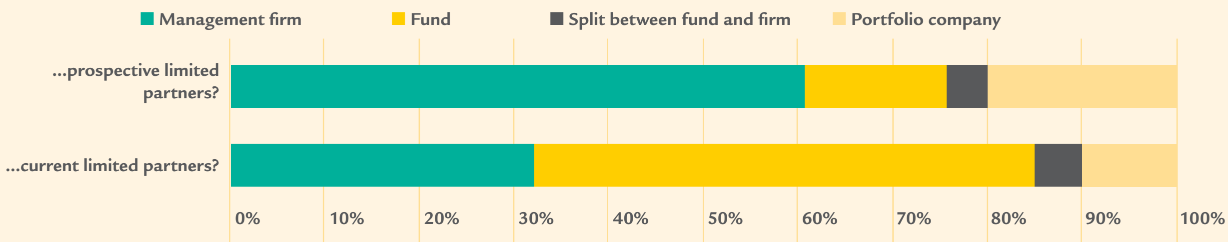


2016

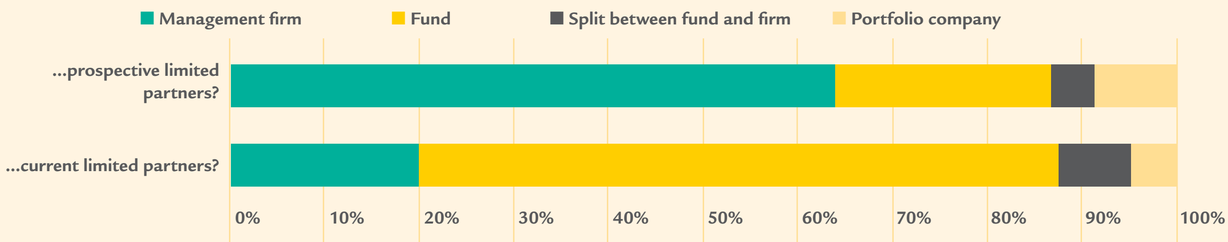


At the annual meeting, who pays for the meals and entertainment of the...

2014



2016



Shifting sands

As fees become a priority for both LPs and the SEC, fund managers are having to rethink expenses when handling investments. **Thomas Angell**, partner with audit tax advisory WithumSmith+Brown, explains the change in mindset around portfolio fees

Angell: Regulators and investors are aputting the spotlight on deal fees

> "In today's environment, clarity and equitable allocation of fees and expenses are the new normal for investment managers"

Since 2010, the Securities and Exchange Commission has been moving toward a more entrenched presence within the private equity industry. As a result, the SEC's focus has advanced beyond valuations and marketing to fees and expenses, operating partners, co-investments and separate accounts – all of which have an effect on current funds as well as those emerging managers coming to market.

The SEC's most recent enforcement efforts have concentrated on fees and expenses, specifically the shifting or misallocation of expenses, and failure to disclose conflicts of interest. The latter, in particular, pertains to consulting agreements and fees and payments from portfolio companies to affiliates of the advisor.

When comparing the results of the pfm 2016 fees and expenses survey to those from 2014, the SEC's focus on fees has clearly started to alter the behavior of managers. As expected, over 80 percent of respondents said they look to the LPA for guidance on how fees and expenses should be allocated. Consequently, the LPA has become more detailed.

Even so, in many instances, the LPA may not necessarily address all fees and expenses in its initial draft as the document will often only include basic and broad language. This can pose a significant challenge. When this situation occurs, 43.5 percent of the survey respondents say they will leave it to the management team to decide how to allocate those items which are not in the LPA. This also extends to cases where they are consulted on the allocation. Despite this effective twofold remedy, all of the LPs may not always be satisfied.

Shifting liabilities

Pressures from both the LPs and the SEC have had a significant impact on management fee offsets. As the current environment demands complete transparency on fees, there has been pressure from LPs who want to benefit from payments made to the management firm. After trending higher in the past several years, 100 percent offset on management fees is becoming the norm, though around a quarter of respondents say they still only offset management fees by 80 percent or less.

When it comes to broken deal expenses, 83 percent of respondents said they charge these to the fund while just 50 percent said that all resulting proceeds go to the fund. As reported in the survey, expenses are charged to the funds while as many as half of respondents deposit broken deal proceeds to the management company. The assumption would be that 100 percent of the proceeds would be used to offset management fees. In short, broken deal expenses and proceeds are treated differently by the funds.

Of particular interest is when a manager starts charging management fees and when it stops. For example, over half of the responding managers indicated – quite logically – that management fees are charged upon the first closing of the fund. However, a fund can often extend its life via extension periods as permitted by its LPA and in some cases continue to operate past

permissible extension periods to liquidate remaining investments in an orderly manner. Approximately 71 percent continue to charge management fees during these extension periods. In such instances, managers need to be cognizant of conflicts of interest related to any GP-led restructurings or fund recapitalizations related to end-of-life scenarios.

Monitoring fees also become a big focus for the SEC, particularly since funds often have portfolio companies sign a fee agreement for a 10-year period. Upon a termination event, such as an IPO or sale, the remaining life of the agreement would be accelerated. Although 28 percent of respondents do not charge monitoring fees, nearly 63 percent of those charging such fees have a 100 percent offset. Since the SEC has frowned upon 10-year agreements, Blackstone, as well as others in the industry, has dropped the acceleration provision.

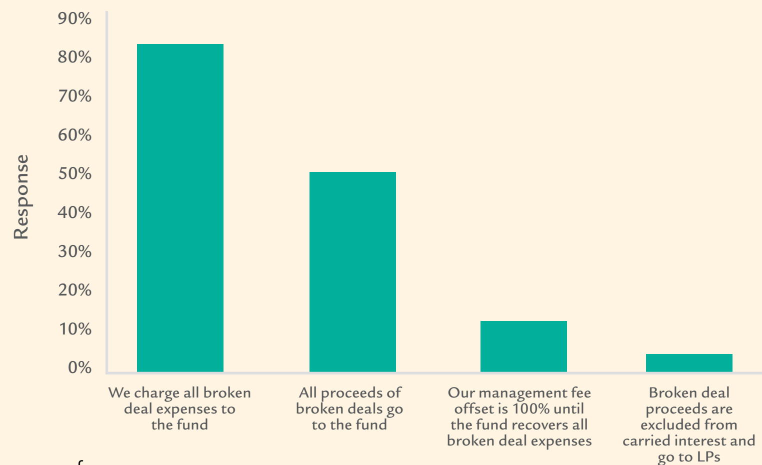
Another fee and expense area to come under SEC review concerns activities and practices surrounding co-investment. Traditionally used by fund managers to close larger deals than they would have been able to do with a standalone fund, only certain LPs and other outside investors are invited to participate. Many co-investment vehicles are charged a reduced management fee or carry, or no fee or carry at all. This way LPs can enhance their returns by making additional investment in deals that have reduced or no expenses.

The SEC is concerned that fund managers were cherry-picking deals for the co-investments. It is also a concern that not all LPs were allowed to participate or were unaware that the practice was going on in the fund. Currently, a little more than 50 percent of the survey respondents said they charged co-investment vehicles management fees equal to, or less than, those charge to the commingled fund. Meanwhile, approximately 61 percent charged carry equal to, or less than, than that charge to the main fund.

In today's environment, clarity and equitable allocation of fees and expenses are the new normal for investment managers. From reviewing current fee and expense allocations to potential conflicts of interest and their disclosure to LPs, 100 percent of respondents and industry thought leaders agree: this is just the beginning of the SEC's efforts to enhance and sustain transparency industry-wide. ■

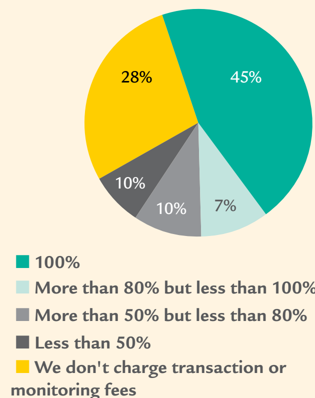
Tom Angell, CPA, is the leader of WithumSmith+Brown, PC's Private Equity Practice. He serves a diverse roster of private equity clients including domestic funds, funds of funds, private equity and commodity pools. From start-ups to long-established organizations, Angell spearheads a team of auditors, tax professionals and internal quality-control specialists who advance each entity's strategies and objectives while ensuring reporting standards and tax compliance. His expertise also extends to raising financing, deal organizational structure.

In terms of broken deal expenses, which applies to you?



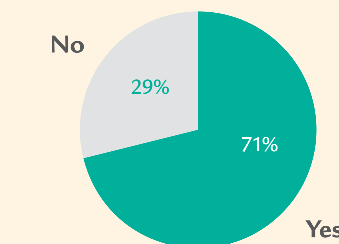
Source: pfm

What percentage of your transaction or monitoring fee is offset against your management fees?



- 100%
- More than 80% but less than 100%
- More than 50% but less than 80%
- Less than 50%
- We don't charge transaction or monitoring fees

Do you charge management fees during extension periods?



Source: pfm

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Among the topics discussed are:

- Organizational structure
- Management fee and incentive allocation structure
- Investor liquidity requirements
- 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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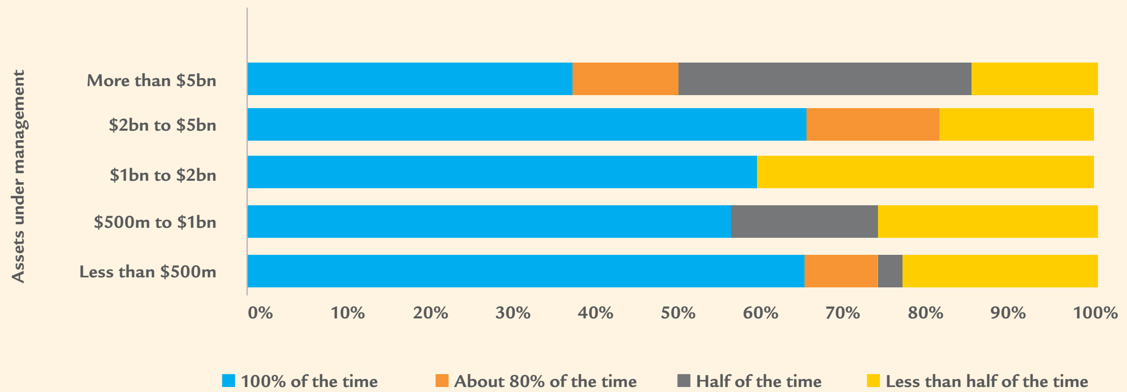
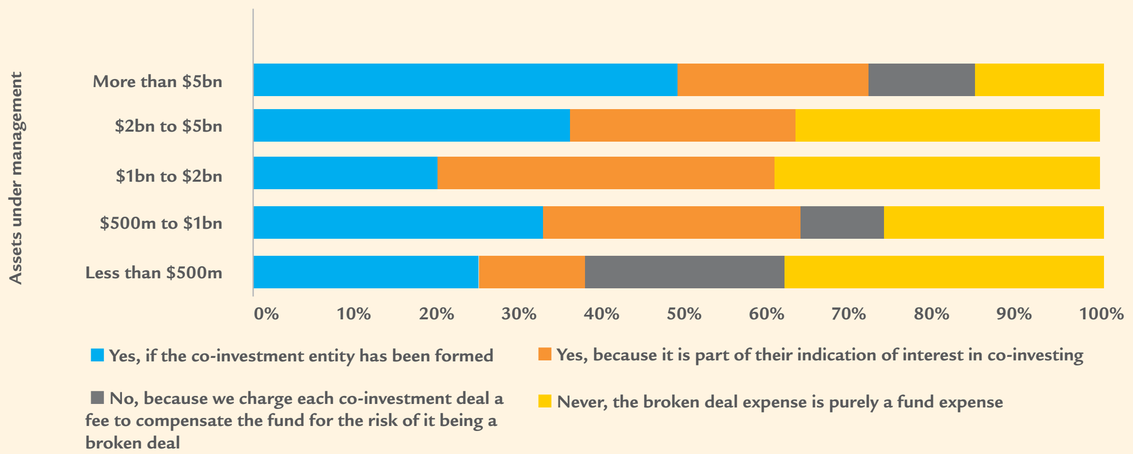
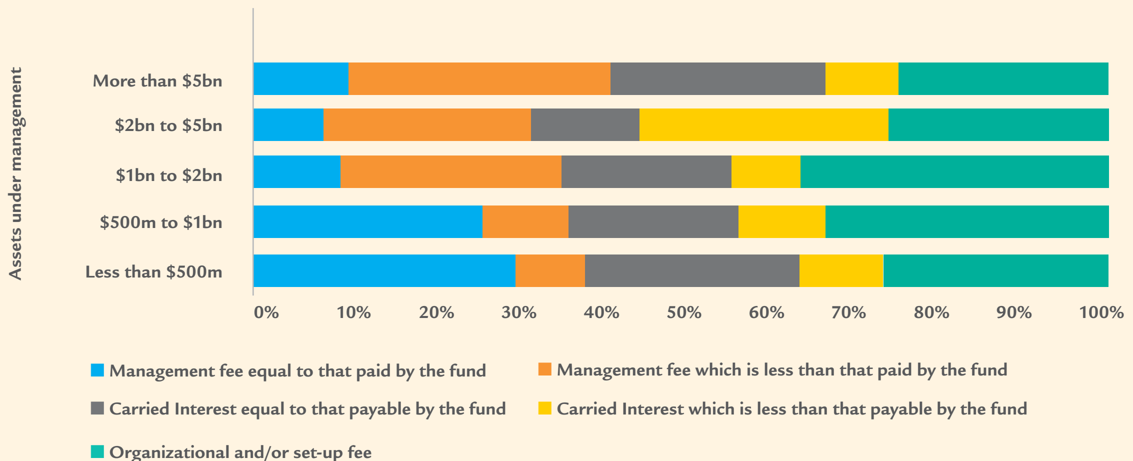
If you offer co-investments, are your co-investments structured as separate entities?



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



Which of the following do you charge to your co-investment vehicles?



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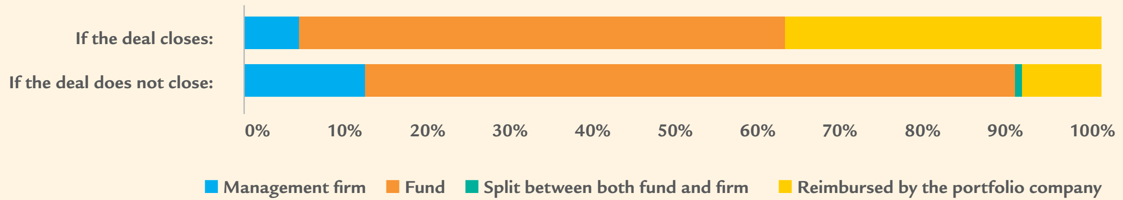
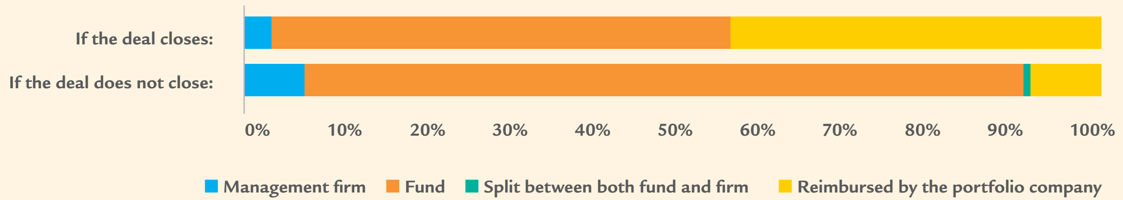
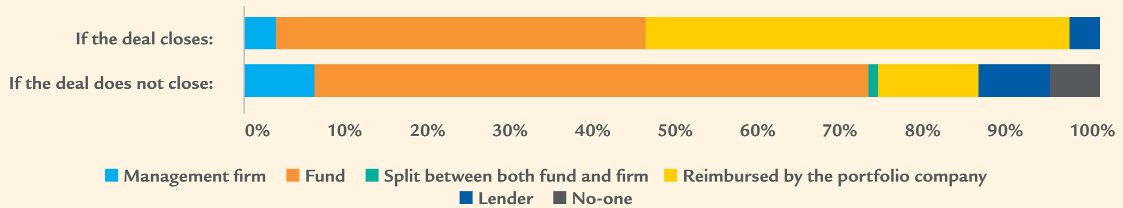
During due diligence and before any letter of intent is signed, the firm hires lawyers and other service providers to begin working on the transaction. Who pays these expenses?



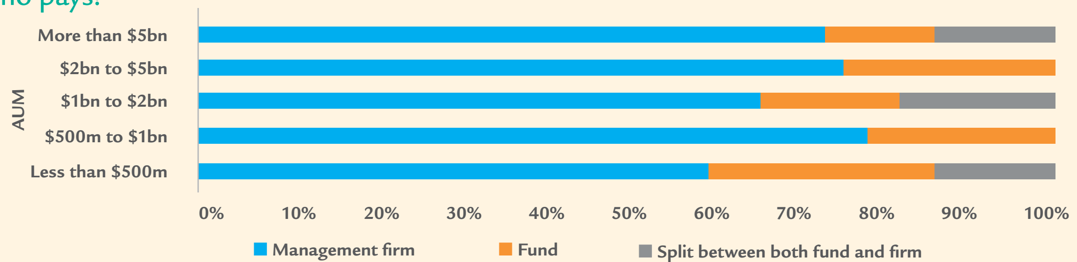
After a letter of intent is signed, the firm hires lawyers and other service providers to begin working on the transaction. Who pays these expenses?



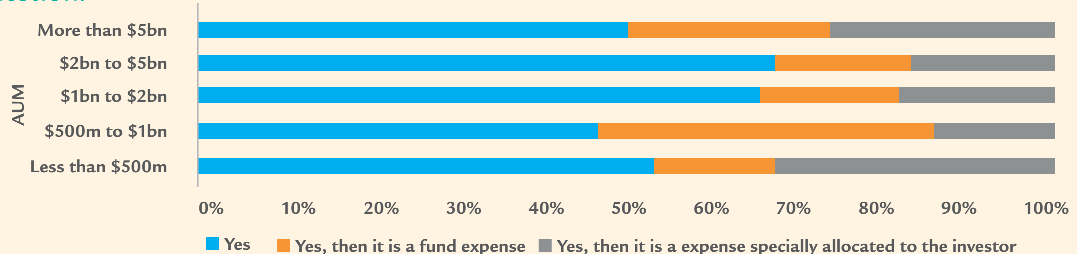
After a definitive agreement is signed, the firm's financing team agree a lending package for the deal. Who pays legal fees incurred by the lender?



Your firm employs an ESG consultant to advise on a new 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?



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Edited by Arnold May, Proskauer Rose LLP

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