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Fund Expenses from the Dealmaker's Perspective



Attention to fund fees and expenses is important for both GP-LP relations and regulatory assessment.

Perhaps it's a natural outcome of a maturing and cyclical industry, or maybe the over-exuberant swing of the regulatory pendulum, but today's private equity world is about as challenging as any. The combination of competition for deals, external pressure from investors, internal pressure for talent and succession, and the mentality of regulators all contribute to this onerous climate. While ongoing regulatory scrutiny may normalize in the coming years, the shift may merely mark a calcification of changes in the PE industry precipitated in 2010 by Dodd-Frank. One of those changes is the accountability and transparency now required for a fund's fees and expenses.

Why do fund managers need to be concerned about the SEC's current focus on fund fees and expenses? Not because of the dollars, though those may be substantial, but because it is fundamental to the trust between the GP and LP and to the regulator's assessment of your firm's culture.

Transparency means full disclosure, either when requested or through regular reporting. It's generally easy to achieve, but the proverbial gray areas are what trip up people. PE managers should not take comfort in the fact that there are few SEC enforcement cases about fees and expenses, or that only the most egregious cases are brought—the ones any person with a modicum of common sense would have recognized as involving wrongdoing. It is a long and often expensive process to

separate these situations from those where a regulator or investor simply questions an expense. That questioning, as well as your answer, may have a dramatic impact on your firm.

At fundraising time, the dealmaker needs to help the firm understand how the deal process has changed, or may change. Will more expenses be incurred earlier in the process than before? Will auctions have more participants? Will the auction process change? Will you need to spend more to gain exclusivity for a deal? When interviewed by the SEC, the dealmaker may need to demonstrate an understanding of the firm's stance on expenses, including its interplay with indemnification protections in fund documents. When sitting face to face with investors, dealmakers

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need to understand investors' focus on the cost of their investment and their view of the fairness of the PE firm's stance on costs. The dealmaker can help an investor understand the full economic picture of managing the fund—that no manager has a crystal ball, that costs may go up in unexpected ways, and that the manager cannot shoulder all of it. The dealmaker is critical to striking the right balance between imposing costs on the fund and making the management firm sustainable.

Little formal guidance is available from the SEC or industry experts about which kinds of expenses should be fund expenses, so fund managers inquire of their friends and advisers: "What do you do about X?" or "How would you treat Y?" Answers vary immensely. While the industry is starting to deliver some benchmark guidance, the dealmaker can help by understanding and influencing the firm's position regarding fees and expenses to align closely with the deal process.

Understanding the effect of deal management on the fund generates investor trust and demonstrates a culture of compliance to regulators. //

This is a modified version of an article that first appeared in the November 2014 issue of *pfm*, which unveiled the results of the Pepper Hamilton, PEF Services and PEI benchmarking survey on fees and expenses. Visit www.pepperlaw.com for the full survey results.

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