Private Funds CFO

Fees & Expenses Survey

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Fees & Expenses

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Insight

Seven charts that matter **Our biennial survey shines a light on fees and expenses as the SEC seeks to tighten its grip**

The founding laws of the Securities and Exchange Commission all share the assumption that the best way to protect investors is to ensure transparency, ***writes Amy Carroll***. Private fund managers were originally excluded from these disclosure requirements, but that changed with the global financial crisis. Under Dodd-Frank, enacted in 2010, private capital firms were forced to follow the provisions in the SEC's founding charters and the issue of fees and expenses came firmly onto the regulator's radar.

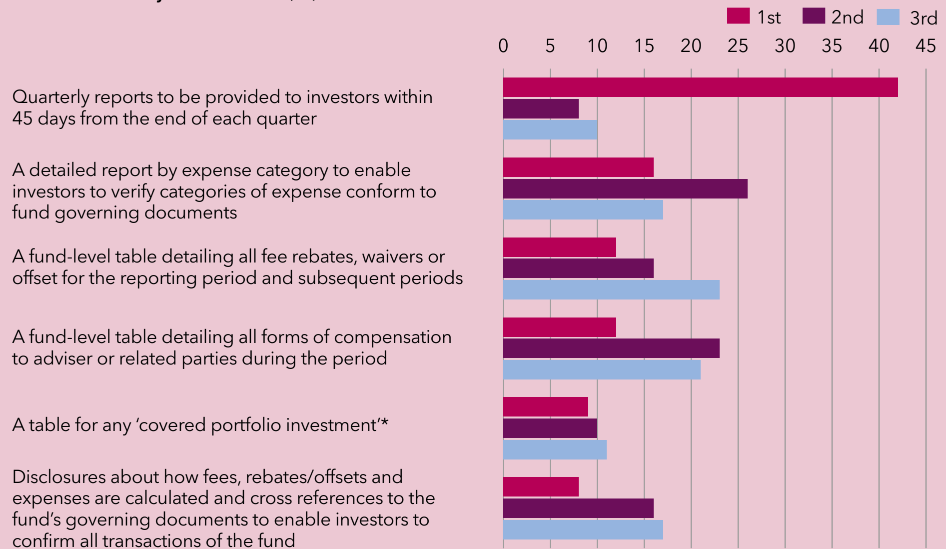
Now, the SEC is tightening its grip on fees and expenses once more, with an array of new proposals currently under review. At the same time, investors themselves continue to build negotiating power, under the auspices of the Institutional Limited Partners Association.

Conducted biennially since 2014, the *Private Funds CFO Fees & Expenses Survey* has captured the latest evolutions in the balancing act that is the GP/LP relationship. As the industry again finds itself at a turning point, here are the most important developments identified this year.

A bad report?

New proposals issued by the SEC could force an overhaul of private markets reporting requirements for fees and expenses. Among those causing concern is the need to disclose how fees, rebates and expenses are calculated, including cross references to the fund's governing documents. Expedited reporting within 45 days of the end of the quarter would also put pressure on back-office functions and could drive an increase in outsourcing.

Which three requirements involving quarterly reporting of fees and expenses proposed by the SEC will be most valuable to your investors? (%)

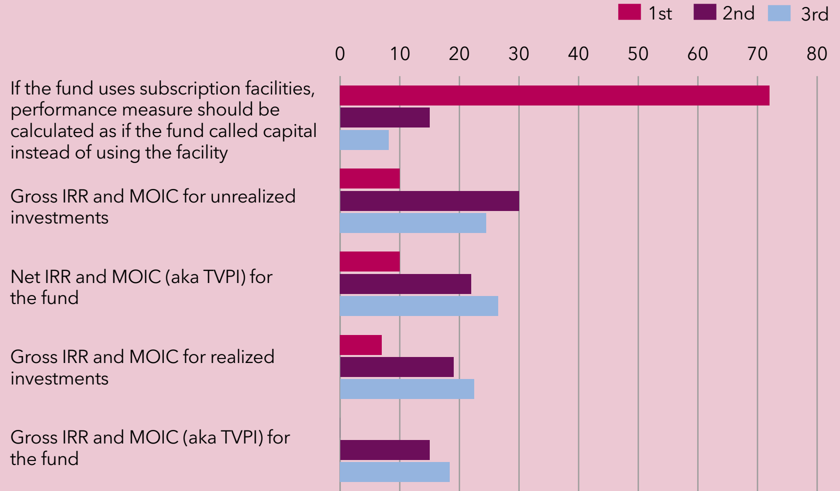


*detailing: 1 – all forms of compensation to adviser or related parties not already included in report; 2 – fund's ownership percentage; 3 – dollar amount of each type of compensation

Performance anxiety

The SEC has also tabled proposals relating to the presentation of performance metrics. These include the requirement to calculate performance as if a fund called capital rather than using a fund finance facility. According to some CFOs, reporting unlevered returns is not the same as reporting a return that would be generated by a fund without leverage, given that, without a line of credit, firms would have to call capital in advance and return that capital if a deal failed to complete.

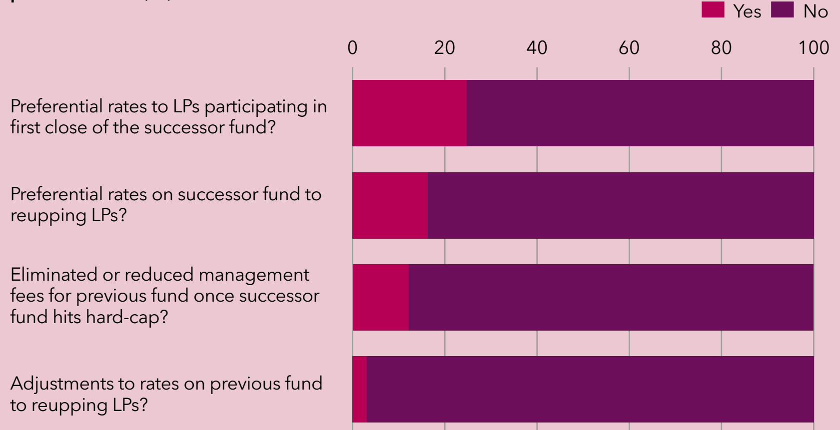
Which three requirements involving quarterly reporting of performance metrics for illiquid funds proposed by the SEC will be hardest to implement? (%)



Crossing the starting line

The point at which the management fee should kick in has long been a subject of debate. And yet in 2022, 47 percent of respondents still begin charging management fees at first close, regardless of when they start investing. Investors would prefer not to pay up until capital is called, of course. The issue is likely to become more pertinent as fundraising timelines extend in a downturn.

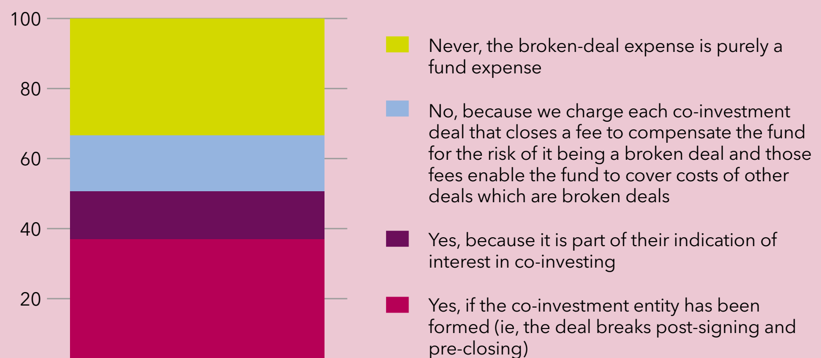
How do management fees on successor funds relate to management fees in the previous fund? (%)



Sharing failure

The issue of how broken-deal expenses are shared between the fund and potential co-investors is a hot topic in the industry, right now, not least because the SEC is threatening to get involved. A third of investors still deem that the fund should always pick up the cost, even if additional capital was slated from third parties, while only 14 percent routinely expect co-investors to pick up part of the bill, as part of their indication of co-investment interest.

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

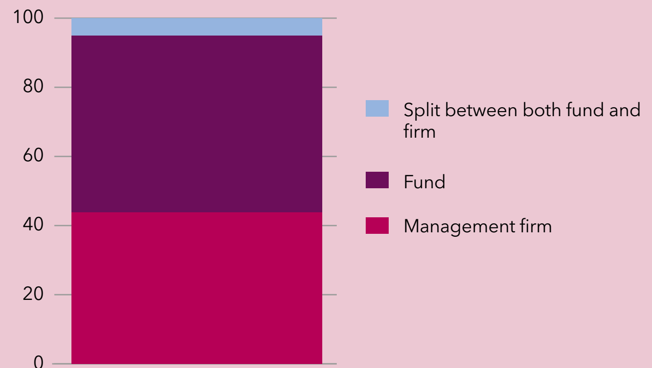


Source: Private Funds CFO Fees & Expenses Survey 2022

Travel costs

The issue of who pays for what when it comes to marketing costs has always been controversial, but LPs are increasingly resistant to picking up the tab for travel expenses, in particular. The spiralling cost of flights and growing environmental awareness, has combined with a realisation – demonstrated through the pandemic – that much of the business of private equity can be conducted remotely. As one expert says, LPs are questioning what is really necessary and what is just a matter of convenience.

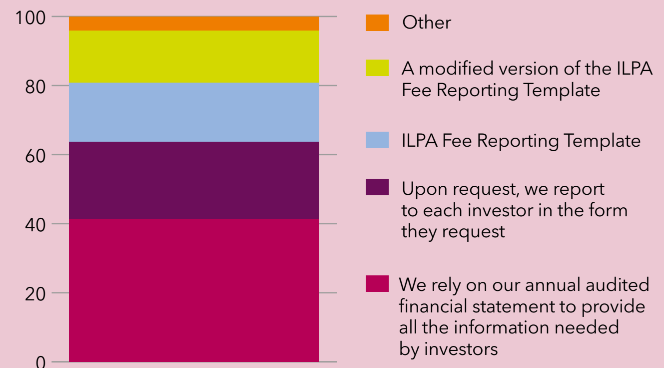
Who pays for travel and expenses for in-house staff marketing funds? (%)



The ILPA effect

Only 17 percent of survey respondents use ILPA's template for the reporting of fees and expenses. However, this is an increase on just 9 percent in 2020. According to one expert, the ILPA template represents a road map, which firms are adopting at a sustainable pace. From slow beginnings, therefore, this year's findings represent a positive direction of travel. And as the SEC closes in on inconsistencies in fees and expenses reporting, uniformity of disclosure can only be a good thing.

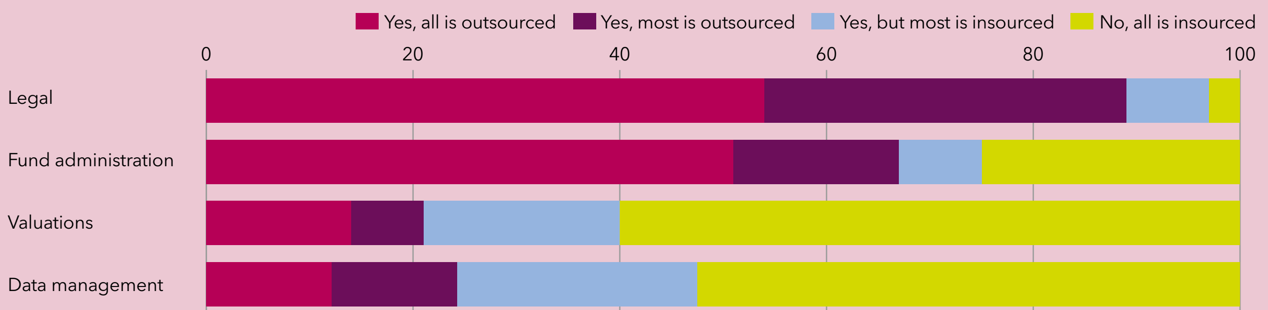
How do you currently report your fees and expenses to investors? (%)



Outsourcing soars

There has been a marked uptick in the proportion of managers now exclusively outsourcing their fund administration. In 2020, just 29 percent of respondents relied entirely on third parties. In 2022, that figure has leapt to 51 percent. This shift has been driven, in part, by tight labor markets, as well as regulation. Should the SEC's latest proposals come into force, the outsourcing of fund administration is likely to become more prevalent.

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



Source: Private Funds CFO Fees & Expenses Survey 2022

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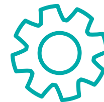

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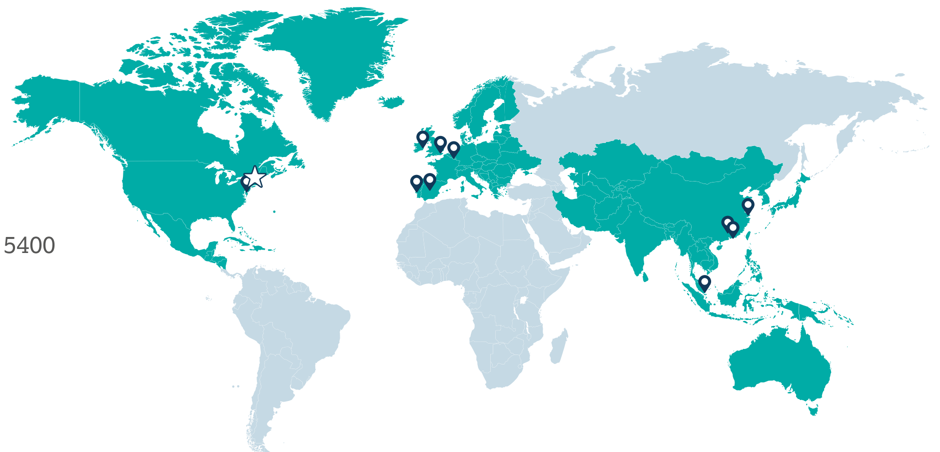

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Editor's letter

All eyes on the SEC

Graeme Kerr
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There is added spice to this year's *Private Funds CFO Fees & Expenses Survey*, with the news that the Securities and Exchange Commission has the private funds industry in its sights with a set of proposals that could rebalance the burden of fees between investors and managers, and fundamentally change reporting standards.

We've been surveying this area since 2014, but it's fair to say that the stakes have never been higher in the opaque world of who exactly should pay what in terms of fund expenses. At the heart of the SEC's proposals are a quest for transparency. Disclosure has been a growing imperative for asset managers ever since the financial crisis. Private fund managers have, until now, been able to sidestep the most stringent rules – but that could all change.

"At the heart of the SEC's proposals are a quest for transparency"

With the SEC tightening its grip, and investors continuing to flex their muscles, there's a real sense that the balance of power between LPs and GPs – and between regulators and fund managers – is shifting.

Our survey takes the pulse of the private funds industry at this historic juncture, and we are fortunate to welcome back three of *Private Funds CFO*'s most seasoned sets of commentators to provide expert analysis on this important topic.

Anne Anquillare, CSC's head of fund services, North America, tells us how the SEC's proposed regulations will force the funds industry to adopt new reporting standards – something that is already causing "no small measure of apprehension for the private capital industry" (p. 16); Troutman Pepper's Stephanie Pindyck-Costantino, Julia Corelli and Patrick Bianchi fear the proposals add an additional layer of complexity to compliance (p. 22); and Withum's Tom Angell examines just what the inflationary pressures and recessionary headwinds mean for the traditional 2 percent management fee (p. 30).

Taken together, this wealth of in-depth analysis comes from the some of the most knowledgeable people in the funds industry.

Enjoy the issue,

Graeme Kerr

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How we reached our results

Our Fees & Expenses Survey is one of the most comprehensive in the private markets industry

The *Private Funds CFO Fees & Expenses Survey* – formerly known as the *PFM Fees & Expenses 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 as a benchmark to compare and review fee-related practices across the private markets industry.

Creating the benchmark

PEI Media's Research & Analytics team surveyed 186 US alternatives fund managers on their fee and expenses practices in May and June 2022. 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, COOs and IR professionals, provided they were aware of the firms' practices. The sample covers each region in the US with the largest proportion of respondents coming from the Northeast, reflecting the private equity hubs of New York, Washington, DC and Boston. We also received responses from across the AUM spectrum, from firms managing assets in excess of $10 billion to smaller GPs with AUMs under $500 million.

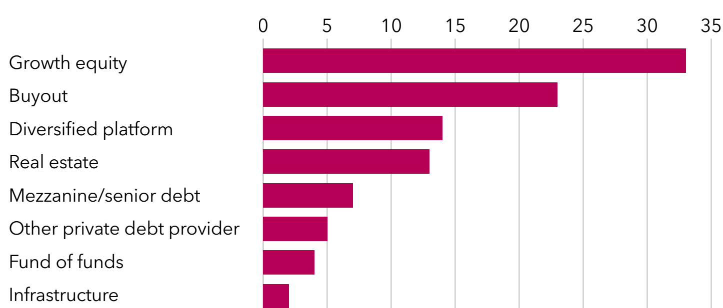
What about confidentiality?

To encourage wide participation, the survey is entirely confidential.

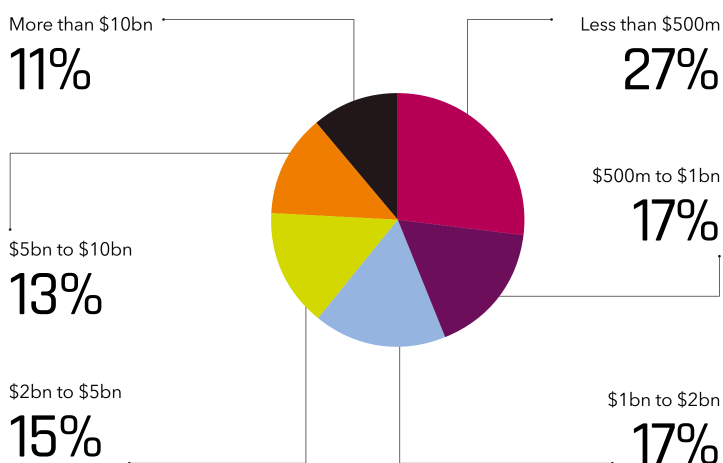
Why alternatives and not just private equity?

The survey's emphasis is on private equity firms – 56 percent of respondents manage buyout or growth funds – but we included fund managers in other illiquid alternative asset classes such as private debt, venture capital and real estate. Much of the scrutiny facing private equity firms is equally placed on other alternative classes that we cover.

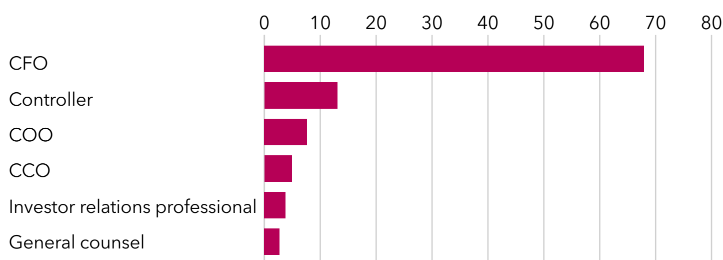
What type of investment firm best describes your firm? (%)



What is the total value of your firm's assets under management? (%)



What is your primary job title? (%)



Source: Private Funds CFO Fees & Expenses Survey 2022

Coming, ready or not

The SEC is ramping up its scrutiny of fees and expenses. Amy Carroll asks whether the private markets industry is prepared for what may come next

In June 2020, the Securities and Exchange Commission issued its first-ever risk alert directed at the private funds industry. Among the issues highlighted were conflicts of interest, insider trading and – crucially – disclosures around fees and expenses.

A year that will primarily be remembered for the unleashing of a global pandemic also saw the Democrats win the White House, with the Biden administration becoming the first in history to declare corruption a threat to national security.

Months later, the former CFO for Hillary Clinton's presidential campaign, Gary Gensler, was appointed chairman of the SEC and the scene was set for a clamp down on the perceived liberties being taken by private markets firms.

Indeed, Gensler has made no secret of his plans to bring 'enhanced disclosures' to a private capital industry that he believes is now too big to fail, with an estimated $18 trillion in gross assets, including $9 trillion in private equity.

And there can be no doubt that fees and expenses are in his crosshairs. In one of the first speeches he made, at an ILPA conference late in 2021, Gensler claimed that LPs are paying an eyewatering $250 billion a year under private equity's two and 20 model. But he reserved his real ire for the myriad additional expenses that have crept onto private equity P&Ls. "Hundreds of billions of dollars in fees and expenses are standing between investors and businesses," he declared.

There have been nine fees and expenses enforcement actions taken since the risk alert was issued and six since Gensler took up his post. Notwithstanding the fact that some of these would already have been in motion, this represents a marked ramp up in activity, given that only enforcement actions have taken place in total since 2015.

And now, of course, Gensler has proposed an extensive sweep of reforms that would represent the biggest regulatory shake-up of the industry since the Dodd-Frank era began over a decade ago. Changes relating to fees and expenses range from expedited reporting and increased transparency to outright prohibition in the case of accelerated monitoring fees and the act of seeking indemnification with investors for enforcement investigations, litigations and actions.

Regulatory creep

Anne Anquillare, head of US fund services for financial services firm CSC, is sanguine about the growing intensity of regulatory scrutiny, likening the escalation to the origins of the Food and Drugs Act back in 1906. "Our industry got its first taste of regulation in 2010 with the Dodd-Frank Act. And as regulators get more educated, their view is going to evolve based on that knowledge, leading to further rounds of regulation. That is not unique to private equity, it is just that we are a relatively young industry."

But Anquillare is wary about the sheer breadth of the proposals. "You don't want a situation where regulators are stifling an industry, especially one as crucial as private equity. At the end of the day, institutional investors

$250bn

Amount that Gary Gensler claims LPs are paying a year in fees and expenses under private equity's two and 20 model

cannot meet their long-term return objectives without the use of a robust private capital allocation," she says.

"Investing in municipal bonds is not going to produce the returns that a pension manager, for example, needs in order to keep up with its obligations to pensioners. The key is for global regulators to provide a source of fairness and clarity on what is right and wrong, without hindering the growth of the asset class."

Because there is no doubt that, while mega-managers will continue to pour funds into their compliance functions, including implementing technology to ease this rising regulatory burden, these reforms, if enacted, are going to hit smaller firms hardest, and may severely hinder the emergence of new managers as well.

"Mid-market funds that have above $150 million AUM and therefore need to be registered will be the most heavily impacted," says Tom Angell, financial services practice leader at advisory firm Withum. "They simply don't have the infrastructure to deal with these demands."

Anquillare fears this could lead to a desert in the lower mid-market, as firms seek to either stay below the SEC's radar by keeping funds small or raise their fundraising ambitions substantially to ensure management fees cover spiralling compliance costs. Angell, meanwhile, believes the changes would lead to an increase in outsourcing.

Patrick Bianchi, a private investment funds associate at law firm Troutman Pepper, agrees. "If you don't have the reporting teams and expertise to meet these requirements then you are going to look for a third party to support you," he says. "Crucially, however, I think we will see larger management fees in order to accommodate these changes. That would be an undesirable

"Hundreds of billions of dollars in fees and expenses are standing between investors and businesses"

GARY GENSLER
SEC

and unintended consequence of these rules."

The vexatious question of who should bear the cost of broken-deal expenses in the context of co-investment is among those the industry has failed to reconcile internally, to point to just one example. And it is still far from normal to stipulate details in LPAs around restructuring costs, or provisions for fees in fund extensions – something that may prove particularly pertinent in a more challenging economic environment.

> *"[Mid-market funds] simply don't have the infrastructure to deal with these demands"*
>
> **TOM ANGELL**
> **Withum**

Meanwhile, documentation has also yet to catch up with the proliferation of continuation vehicles, something else the SEC has set its sights on. Elsewhere, it is not unusual for funds to bear the costs of SEC investigations and resulting actions, indemnification is common and disclosure around investment-related fees is not yet universal.

Furthermore, while the emergence of the ILPA template has started to create a semblance of standardisation, the majority of firms continue to rely on financial statements and bespoke reporting to individual investors.

That is not to say significant progress has not been made with regards to driving opacity out of the asset class in the 12 years since Dodd-Frank was enacted in the aftermath of the global financial crisis. Far from it. But the private markets industry has grown dramatically in both size and sophistication since 2010 – and so too, crucially, has the SEC.

And while, taken individually, the proposals made by Gensler may be palatable, taken collectively, the task becomes onerous for some, and potentially prohibitive for others.

"My biggest concern is the sheer volume of proposals," says Anquillare. "The SEC has said it will give the industry a year to comply, but they have really thrown the kitchen sink at this. There is an awful lot to absorb. I would prefer a more staged approach that would allow the industry to digest the changes over time. There is not one proposal that would necessarily crush us. But trying to implement them all at the same time would be extremely challenging."

Certainly, the perennial issue of fees and expenses has rarely been more pertinent than it is today. ■

Preparing for the worst

Are private equity firms ready for the regulatory storm bristling on the horizon?

The latest *Private Funds CFO Fees & Expenses Survey*, which has been conducted biennially since 2014, suggests the industry is playing a wait-and-see game. Movement in many areas has been limited – it takes time for change to filter into the industry's 10-year plus static documents, of course – and current practices suggest that significant adaptation would be required to adhere to the proposals as they currently stand.

The cost of compliance

If new SEC proposals come into force, it could create a punishing SME funding gap. By Amy Carroll

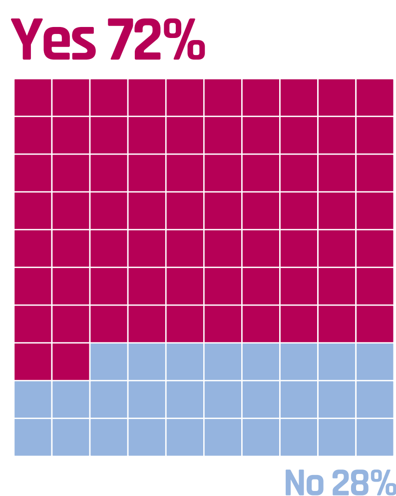
The Securities and Exchange Commission is pursuing perceived private markets fees and expenses mishandling with dogged determination. Firms to have fallen foul of enforcement actions in the past 12 months include international giants such as Global Infrastructure Partners, which paid $4.5 million to settle claims that it had failed to offset fees in three of its funds despite documented promises to do so.

Alumni Ventures, meanwhile, was censured for misleading statements about its management fees and engaging in interfund transactions that violated operating agreements. Tellingly, the SEC named and shamed, charging the firm's CEO, Michael Collins, specifically.

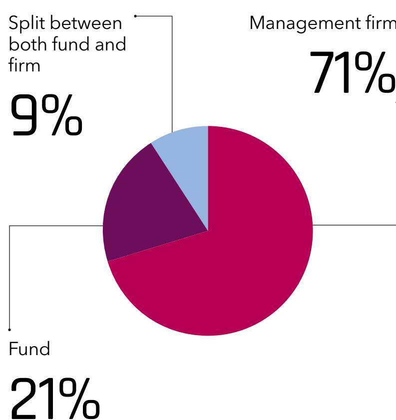
These enforcement actions come as the SEC lays out proposals for a radical overhaul of reporting and transparency rules. These changes have yet to be adopted but it is clear the regulator is not letting the industry out of its sights.

Against this backdrop, private markets firms' approach to SEC intervention remains mixed, however. Less than 40 percent of respondents to the *Private Funds CFO Fees & Expenses Survey 2022* disclose deficiencies found during routine examinations as standard practice. A further 23 percent only do so if required by individual side letters, and 22 percent only if the deficiency results in expenses to the fund. Critically, 17 percent will avoid disclosure at any cost – the antithesis of the SEC's transparency mantra. And while the management company will typically share the cost of any remediation following an exam, that is not universally the case. Just under 30 percent of respondents would charge the cost of fixing inadequately disclosed portfolio monitoring fees to the fund, for example.

Is your firm registered with the Securities and Exchange Commission? (%)



Your firm is visited by the SEC or state regulator for a routine regulatory examination that 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? (%)



Figures have been rounded
Source: Private Funds CFO Fees & Expenses Survey 2022

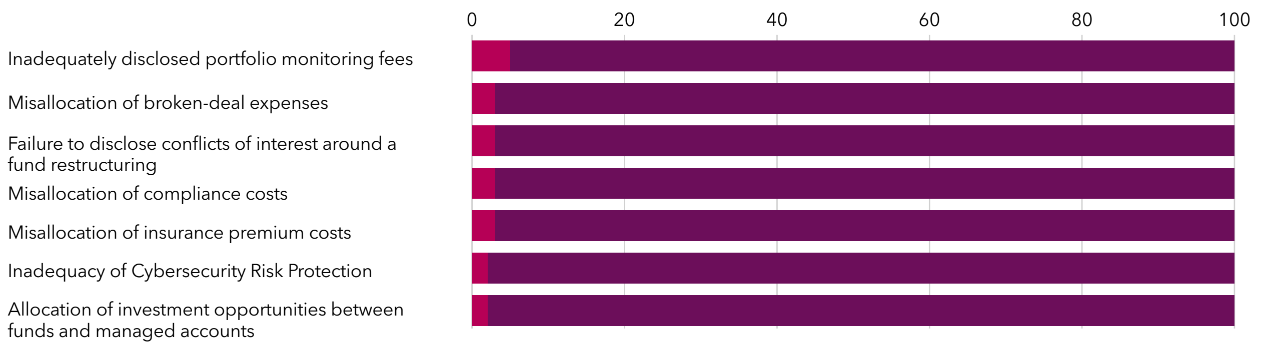
Meanwhile, in many cases, managers would also expect the fund to pick up the penalty – something that the SEC looks set to take a dim view of under the new rules. A third of respondents would pass on the penalty for a misallocation of investment opportunities between funds and managed accounts and 14 percent would pass on penalties for the misallocation of broken-deal expenses.

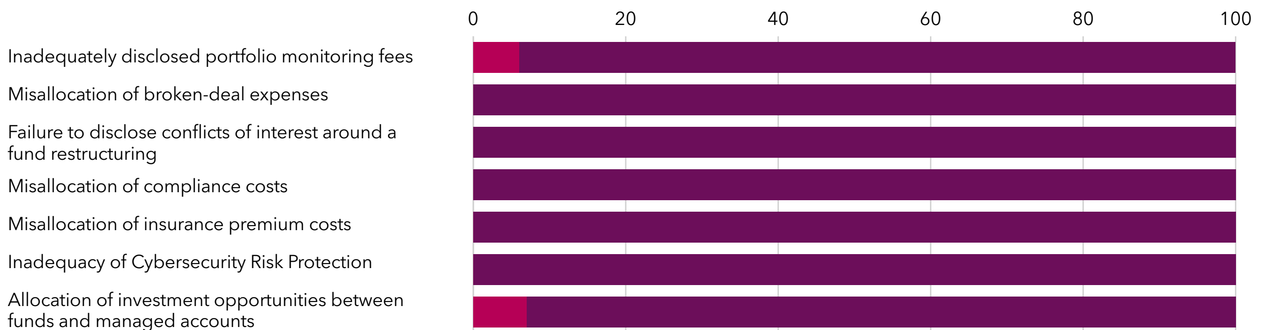
"One of the biggest changes in the proposals relating to fees and expenses, is the fact that firms will not be able to pass on examination and compliance costs to the fund, even if specified in the documentation," says Patrick Bianchi, a private investment funds associate at law firm Troutman Pepper. "I think that will result in higher management fees being charged to cover that potential cost."

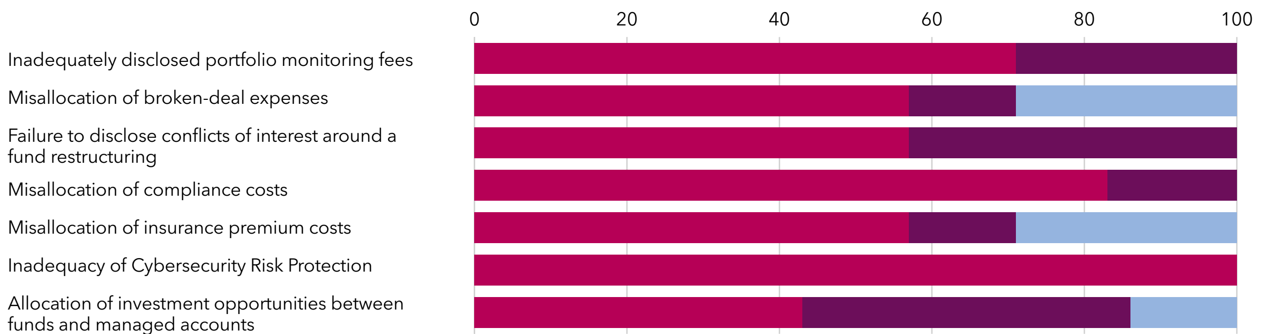
Indemnification

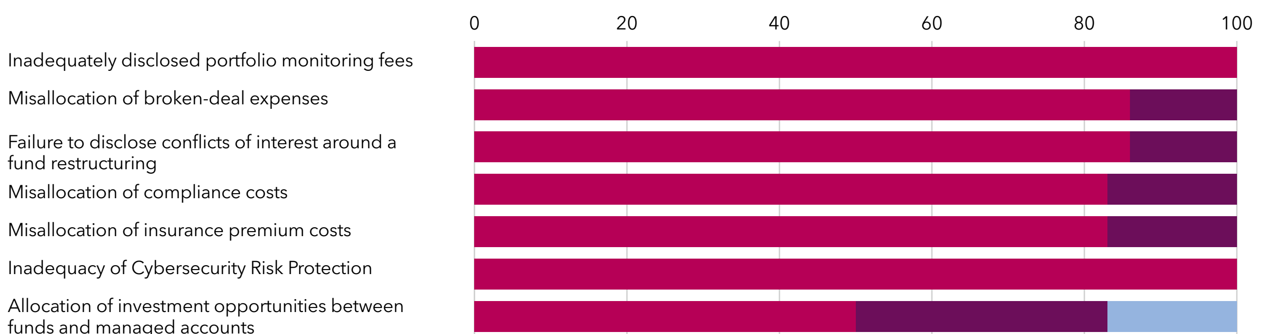
It is also clear that firms continue to seek indemnification of principals, something else that the SEC is seeking to crack down on. For 30 percent of respondents, this indemnity provides the advancement of expenses in all cases – admittedly a slight fall on recent years. Instead, firms are increasingly seeking

Has the SEC raised the below issues with your firm? If they concluded you had a problem and you incurred costs to correct it, who bore the costs? (%)









LPAC approval, or limiting the circumstances in which an advance would be considered. If the SEC proposals are adopted, however, these nuances will be irrelevant – all indemnification will be banned.

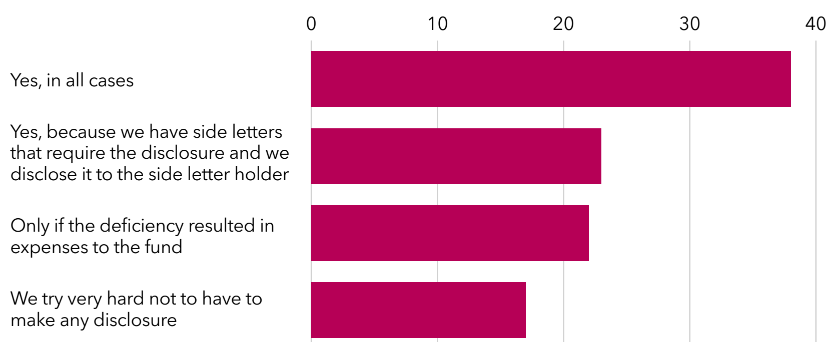
Indeed, the scope of the new proposals is breathtakingly broad, covering the expedition of quarterly reporting, the detailing of expense categories and all compensation, fee rebates, waiters and offsets, including clarification around how these are calculated and cross references to governing documents.

The SEC is also proposing that firms tighten up the reporting of performance metrics, in order to ensure greater standardisation and comparability. And according to Tom Angell, financial services practice leader at Withum, one of the most challenging and contentious aspects of this reporting involves the need to present

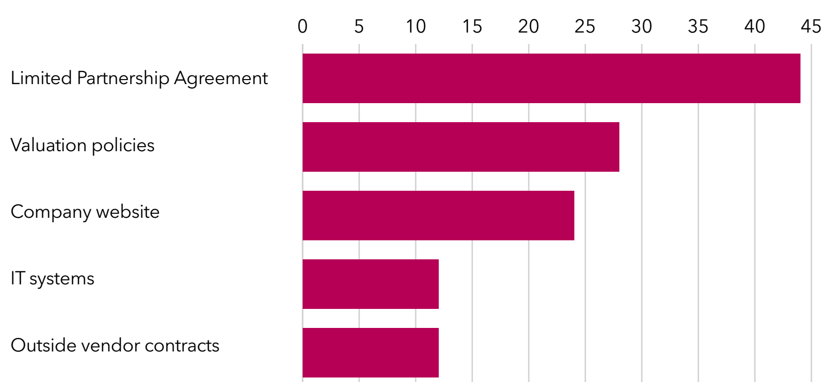
"Reporting unlevered returns may sound like a straightforward and reasonable request but it is not"

JOSHUA CHERRY-SETO
StartUp Health

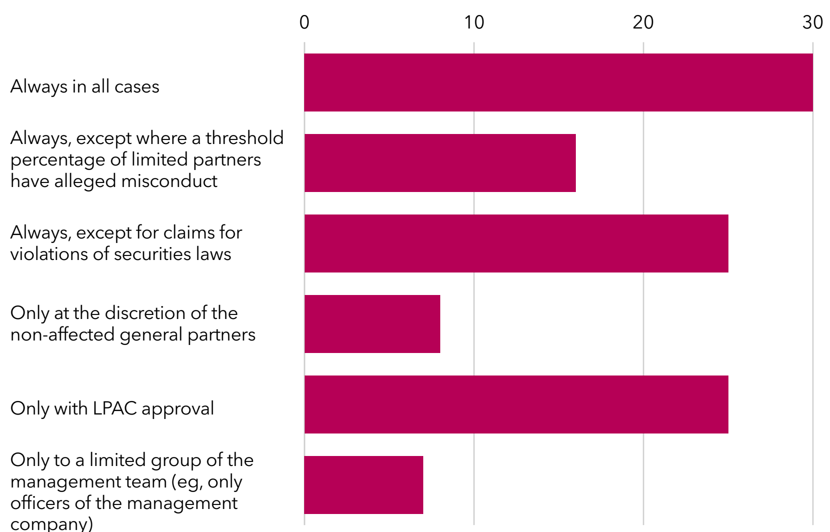
As a result of a routine examination, the SEC highlights deficiencies in the examination report. Do you disclose these deficiencies to your LPs? (%)



If you have made changes to any documentation following an SEC visit, what documentation was updated? (Multiple answers allowed, %)

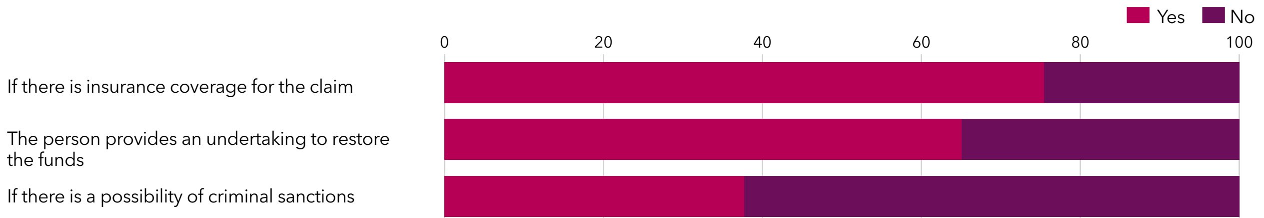


If your LPA provides indemnification of principals serving on the management team, does that indemnity provide for advancement of expenses? (Multiple answers allowed, %)

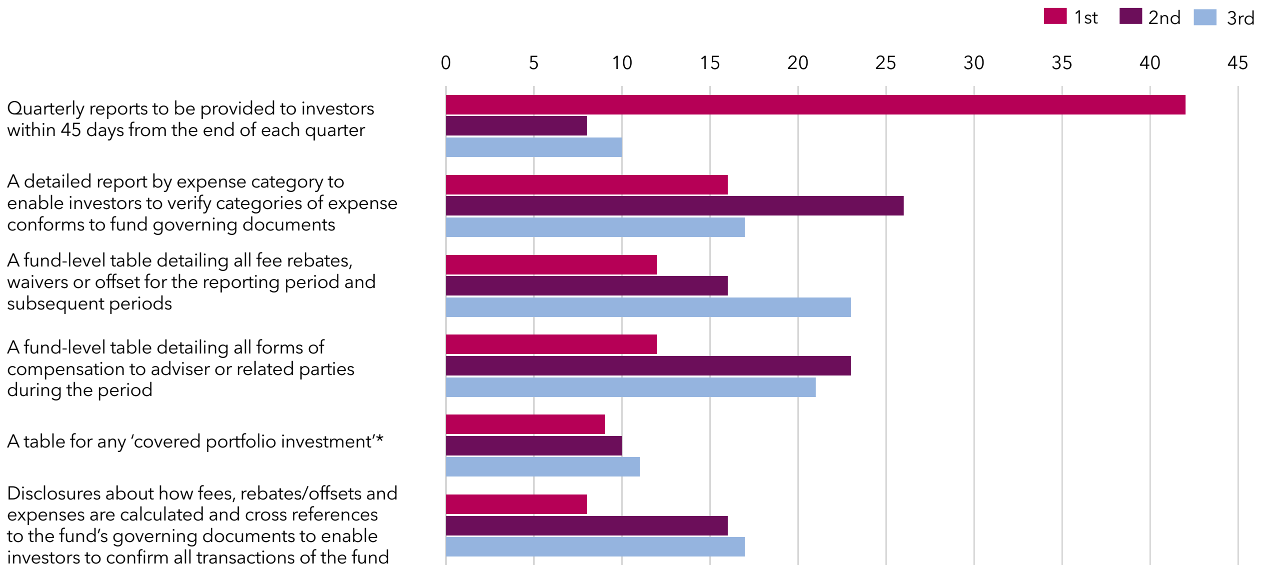


Source: Private Funds CFO Fees & Expenses Survey 2022

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… (%)

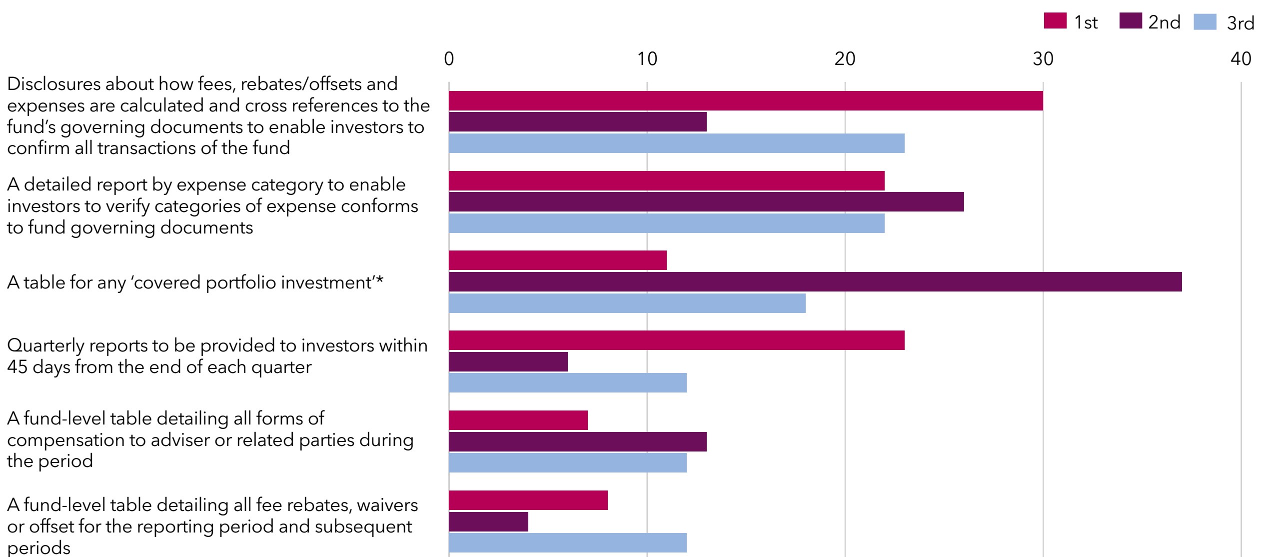


Which three requirements involving quarterly reporting of fees and expenses proposed by the SEC will be most valuable to your investors? (%)



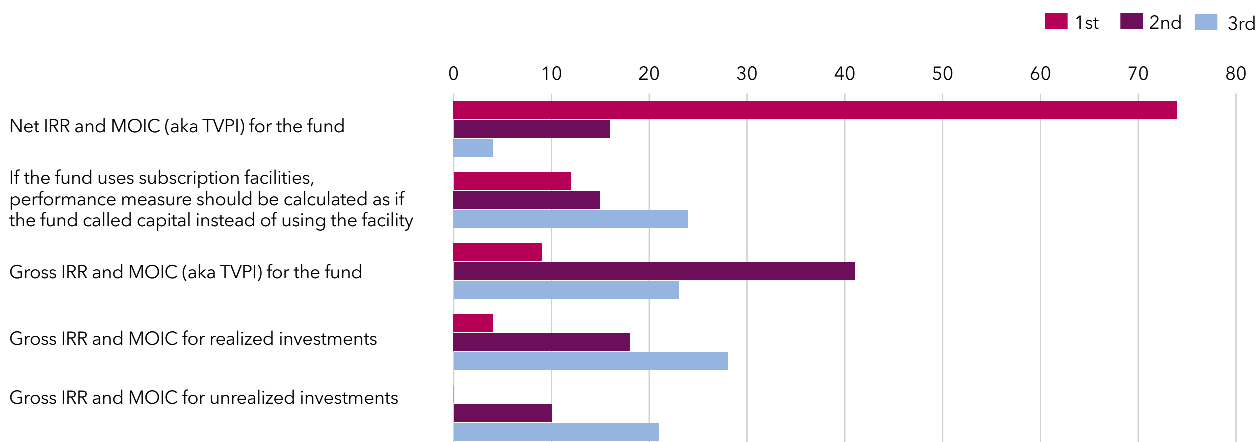
* detailing: 1 – all forms of compensation to adviser or related parties not already included in report; 2 - fund's ownership percentage; 3 - dollar amount of each type of compensation

Which three requirements involving quarterly reporting of fees and expenses proposed by the SEC will be hardest to implement? (%)

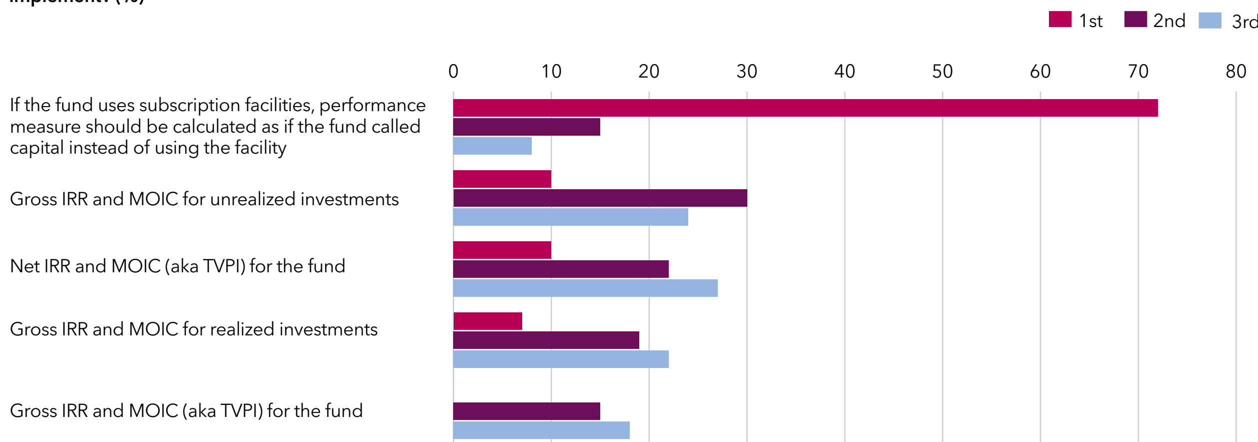


*detailing: 1 – all forms of compensation to adviser or related parties not already included in report; 2 - fund's ownership percentage; 3 - dollar amount of each type of compensation

Which three requirements involving quarterly reporting of performance metrics for illiquid funds proposed by the SEC will be most valuable to your investors? (%)



Which three requirements involving quarterly reporting of performance metrics for illiquid funds proposed by the SEC will be hardest to implement? (%)



Source: Private Funds CFO Fees & Expenses Survey 2022

performance metrics both with and without the impact of funding facilities.

Joshua Cherry-Seto, CFO of venture capital firm StartUp Health and until recently of Blue Wolf Capital, agrees. "Reporting unlevered returns may sound like a straightforward and reasonable request but it is not. If we didn't have access to a line of credit, we would have to call capital in advance," he explains.

"We would also have to return that capital if the deal didn't complete. The reporting of an unlevered return is not the same as the return that would be generated by a fund without leverage."

Of course, the impact of all these additional compliance costs would hit smaller firms, particularly hard. In many cases the chief compliance officer in these organizations is already stretched, wearing multiple hats – often that of the CFO.

And the SEC has indicated it would frown on the complete outsourcing of the compliance function. "I have always held more than one title. Even having raised $1 billion for our latest fund, we were never quite big enough to separate the functions," says Cherry-Seto.

There is also a fear that heightened compliance costs could prevent smaller managers crossing the SEC registration threshold, or else propel them over the lower mid-market to a size where the management fee could cover these increased costs, leaving a funding gap in the SME economy.

It may also curb enthusiasm for new entrants, in what is already an extremely challenging fundraising environment for emerging managers.

As Anne Anquillare, head of US fund services for CSC, says: "Adding more compliance to the act of registration is only going to exacerbate pressures on those firms at the lower end of the mid-market and my concern is that over time it may also stifle the next generation of fund managers." ■

EXPERT COMMENTARY

The private capital industry has reached a crucial juncture, says Anne Anquillare, CFA, CSC's head of fund services, North America

The future of private fund regulation

Earlier this year, I wrote a blog series exploring the implications of the SEC's proposed regulations on private funds. Given that the rules had yet to be finalized, some of my peers wondered whether I had jumped the gun. When the other shoe dropped on August 10, 2022 bringing more proposed rules, it became clear that addressing these issues quickly is the only way forward.

Much more might change by the time this article is published, but we, as an industry, need to work toward solutions. These solutions will require four things: data, conversations, planning, and action.

The private capital industry is at an inflection point. While regulators, investors and fund managers may all have different priorities, we share two overriding goals. The first is to grow capital (both inflows and fund value). The second is to protect investors and markets with the rules and data required to make proactive, accurate decisions.

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Investor reporting

Let's start with the data. The proposed rules, which referenced exam findings, reports, articles, and letters from investors, highlighted a lack of data as an industry shortcoming. This resulted in several proposed rules that relate to investor reporting. These requirements are listed in Chart 1, which ranks the perceived degree of value to investors and degree of effort required based on survey data.

This data points us in the direction of proposals 1, 3, and 4 – those that deliver higher value to investors while being easier to implement.

The best place to start the conversation around industry solutions is proposal 1: providing reports to investors within 45 days from quarter's end. Having prompt access to this information would be very helpful to investors. Q&A sessions with managers would happen on a timelier basis and be more thoughtful and focused. Reporting to investors' management and

Chart 1: Proposed new requirements for quarterly reports, ordered by weighted average

Value to investors

1. Quarterly reports to be provided to investors within 45 days from the end of each quarter
2. A detailed report by expense category to enable investors to verify categories of expense conforms to fund governing documents
3. A fund-level table detailing all forms of compensation to adviser or related parties during the period
4. A fund-level table detailing all fee rebates, waivers or offset for the reporting period and subsequent periods
5. Disclosures about how fees, rebates/offsets and expenses are calculated and cross references to the fund's governing documents to enable investors to confirm all transactions of the fund
6. A table for any "covered portfolio investment" detailing: 1) all forms of compensation to adviser or related parties not already included in report 2) fund's ownership percentage 3) dollar amount of each type of compensation

Difficulty to implement

1. Disclosures about how fees, rebates/offsets and expenses are calculated and cross references to the fund's governing documents to enable investors to confirm all transactions of the fund
2. A detailed report by expense category to enable investors to verify categories of expense conforms to fund governing documents
3. A table for any "covered portfolio investment" detailing: 1) all forms of compensation to adviser or related parties not already included in report 2) fund's ownership percentage 3) dollar amount of each type of compensation
4. Quarterly reports to be provided to investors within 45 days from the end of each quarter
5. A fund-level table detailing all forms of compensation to adviser or related parties during the period
6. A fund-level table detailing all fee rebates, waivers or offset for the reporting period and subsequent periods

Chart 2: Proposed new requirements that require all illiquid funds to present the following performance metrics since inception as part of the quarterly reports, ordered by weighted average

Value to investors

1. Net IRR and MOIC (aka TVPI) for the fund
2. Gross IRR and MOIC (aka TVPI) for the fund
3. If the fund uses subscription facilities, performance measure should be calculated as if the fund called capital instead of using the facility
4. Gross IRR and MOIC for realized investments
5. Gross IRR and MOIC for unrealized investments

Difficulty to implement

1. If the fund uses subscription facilities, performance measure should be calculated as if the fund called capital instead of using the facility
2. Gross IRR and MOIC for unrealized investments
3. Net IRR and MOIC (aka TVPI) for the fund
4. Gross IRR and MOIC for realized investments
5. Gross IRR and MOIC (aka TVPI) for the fund

Source: Private Funds CFO Fees & Expenses Survey 2022

constituents would also be timelier. And our asset class wouldn't be seen as such an outlier by investors and wealth managers. (No mutual funds report on a 60-day lag.)

While specific situations, such as emerging manager funds with limited resources or the need for timely information for valuations from underlying investments, will require more conversations and planning, this is a good target for all. Fortunately, the required investments in technology and adoption of reporting standards are already well underway, which reduces the level of difficulty in achieving this target.

Similarly, proposals 3 and 4 expand the range of reporting data and the speed with which it is delivered, thereby adding to the need for better technology and standards. I'm confident our industry is already moving through planning and action on these items. I know we are, as a company, on behalf of our clients.

Performance metrics

Performance is also attracting regulatory scrutiny. The lack of consistency in the way performance is calculated means that virtually every fund can be classed in the top quartile. This is one of the reasons investors and regulators don't trust the numbers and spend a lot of time recalculating and asking for more data. The proposed rules include performance metrics as part of the quarterly reports, as are listed in Chart 2.

"The private capital industry is at an inflection point"

Survey data suggests that proposals 1 and 2 (both fund-level metrics) will deliver higher value to investors while being easier to implement.

Here, the conversation can begin with proposal 1: providing net internal rate of return and multiple on invested capital (MOIC) – also known as total value to paid-in (TVPI).

Most investors are already receiving net IRR as part of their annual audited financials. Shifting to a quarterly reporting of this metric would not be difficult, and if you have the data for IRR, you have the data for TVPI/MOIC. Investors need both IRR and TVPI to assess the performance of the fund, and when distribution to paid-in (DPI) and residual value to paid-in (RVPI) are also included, investors can appreciate how much of the performance is realized vs. unrealized.

Providing access to the data used in these calculations would go a long way toward building the trust in our industry's numbers. Adopting the Global Investment Performance Standards (GIPS®), a global standard for all major asset classes, would also be a great step forward in building trust.

Proposal 2 – gross IRR and TVPI/MOIC – is reported less frequently. Usually, gross returns are a focus when a manager is fundraising. Reporting both the net and the gross performance metrics on a quarterly basis tends to elicit questions from investors (and regulators) about the spread between the two. There are two ways to calculate gross returns: bottom up (all investor-level cashflows, with fees and expenses added back in) and top down (all investment-level cashflows). The main difference between the two is how the investment manager handles cash and lines of credit, which wraps in proposal 4. (You see where this is going.)

Once we tackle performance metrics for fund-level net and gross and details on the spread, we will be doing the same at the investor level. (These metrics were not in the SEC's proposal but were included as a question for the comments.) Bottom line: the best way to provide standard performance reporting across all levels is still in the conversation stage. I strongly recommend including the GIPS in this conversation.

"The SEC's proposed regulations have created no small measure of apprehension"

From data to action

The SEC's proposed regulations have created no small measure of apprehension in the private capital industry, but there is good news here. As a fund manager, you have the data you need to prioritize your efforts and kick off conversations with your team and investors. You have access to a robust network of service providers to help transition your firm to the next level for your investors. And the industry is, albeit gradually, moving toward standards and – mostly through service providers – adopting technology solutions that can help them align with other asset classes.

Everyone, including the SEC, wants our industry to survive and thrive, and that means ensuring capital growth and investor and market protections. As we work together to achieve these goals, let's keep the data, conversations, and planning going. And bring on the action. ■

Breakdown costs

The debate around who pays dead deal fees has entered a new phase, writes Amy Carroll

Broken-deal expenses were one of the first anomalies to pique the interest of the SEC in the years after the regulator brought private markets into its fold. In 2015, KKR was charged with misallocating more than $17 million in broken-deal expenses to its funds, in breach of its fiduciary duty – it was the first case of its kind. A rush to specify details surrounding the treatment of broken-deal fees in LPAs ensued and, as a result, many now see this as an issue that has been resolved.

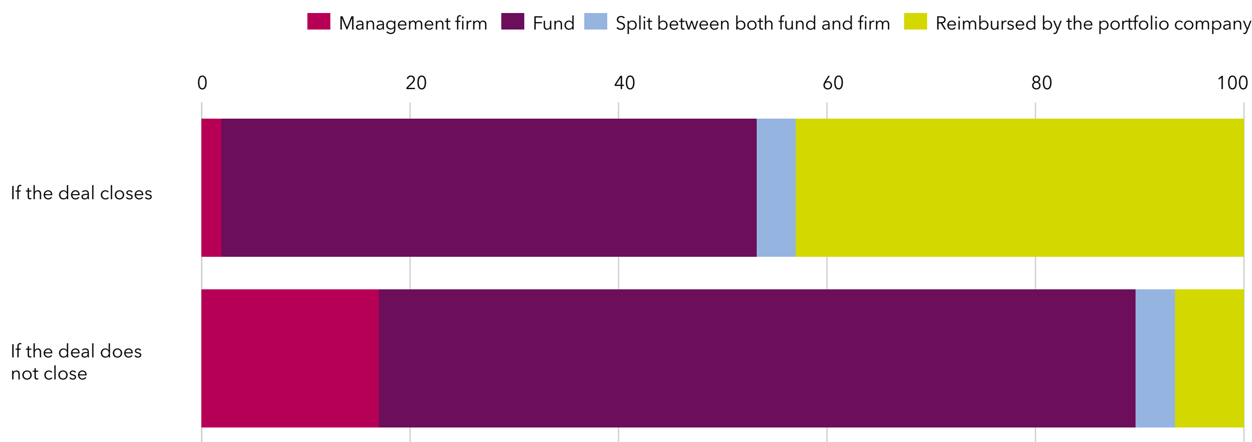
Two-thirds of respondents to the *Private Funds CFO Fees & Expenses Survey 2022* said they charge all broken-deal expenses to the fund, equal to the 2020 findings, adding weight to the idea that the market has found an equilibrium. "Broken-deal fees make up an area where there has been increased specificity in fund documentation," says Patrick Bianchi, a private investment funds associate at law firm Troutman Pepper. "It used to be vague, but now everything has been spelled out."

Joshua Cherry-Seto, CFO of venture capital firm StartUp Health and until recently of Blue Wolf Capital, adds: "The issue of broken-deal fees comes down to your take on who should be responsible for the deal-sourcing function, and how that should therefore be paid for. But fundamentally, it is something that is negotiated directly in the LPA, so in that sense, it should be a non-issue."

If anything, Tom Angell, financial services practice leader at Withum, says managers that erred on the side of caution in the wake of initial SEC scrutiny have now been able to relax their broken-deal stance.

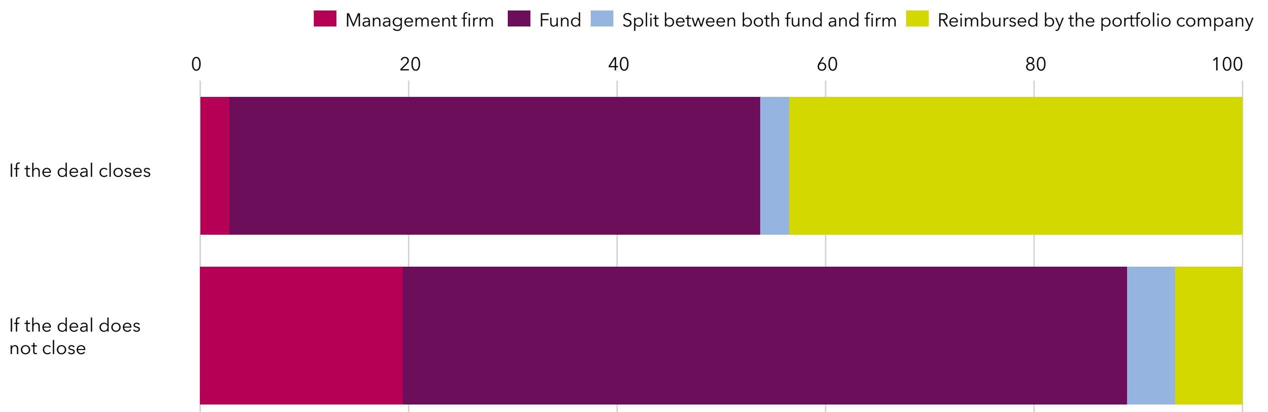
"Andrew Bowden's 'Spreading sunshine in private equity' speech at [affiliate title] *PEI*'s Private Funds Compliance Forum in 2014, put broken-deal

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? (%)

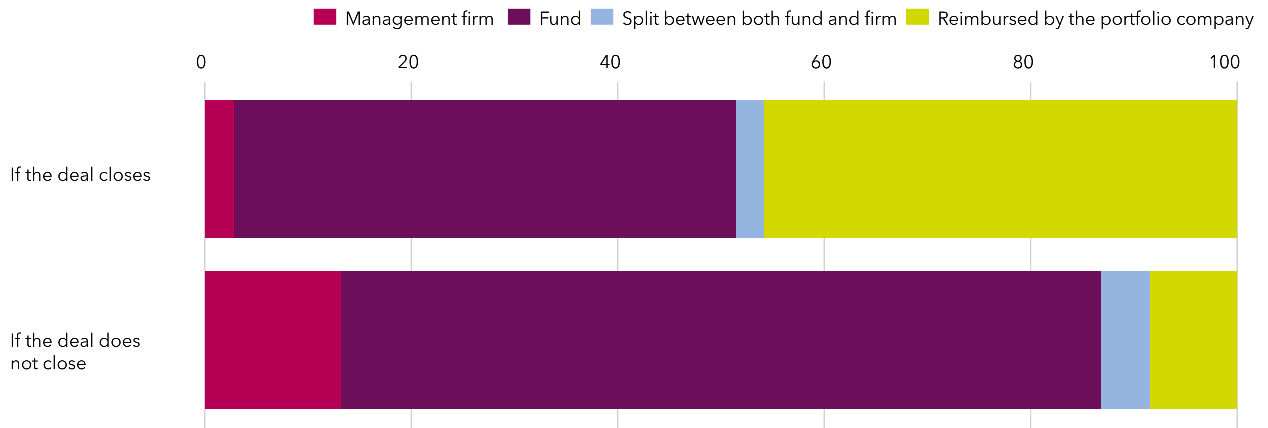


Source: Private Funds CFO Fees & Expenses Survey 2022

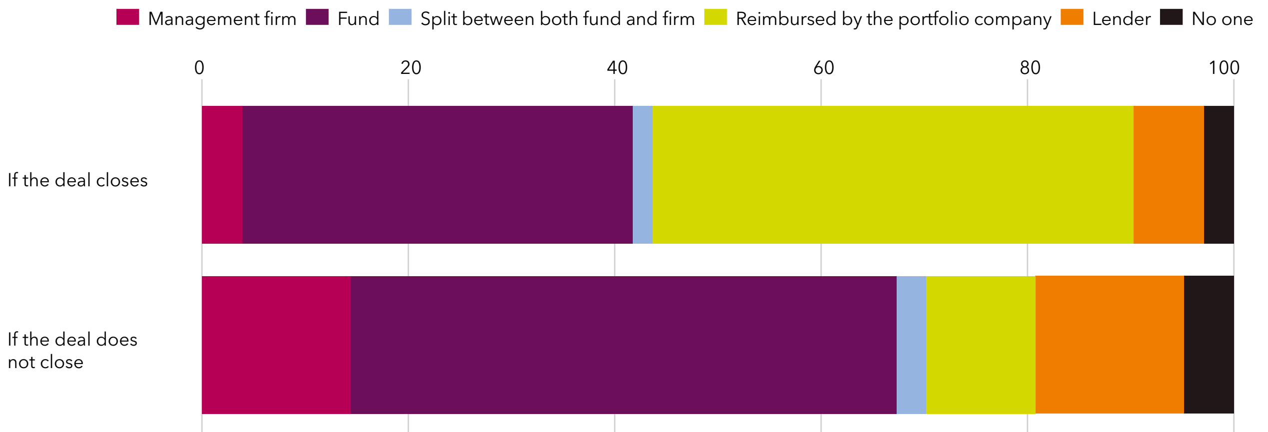
During due diligence and before a formal letter of intent is signed (binding or non-binding), the firm hires lawyers, consultants, accountants and other service providers to work on the transaction. Who pays for these expenses? (%)



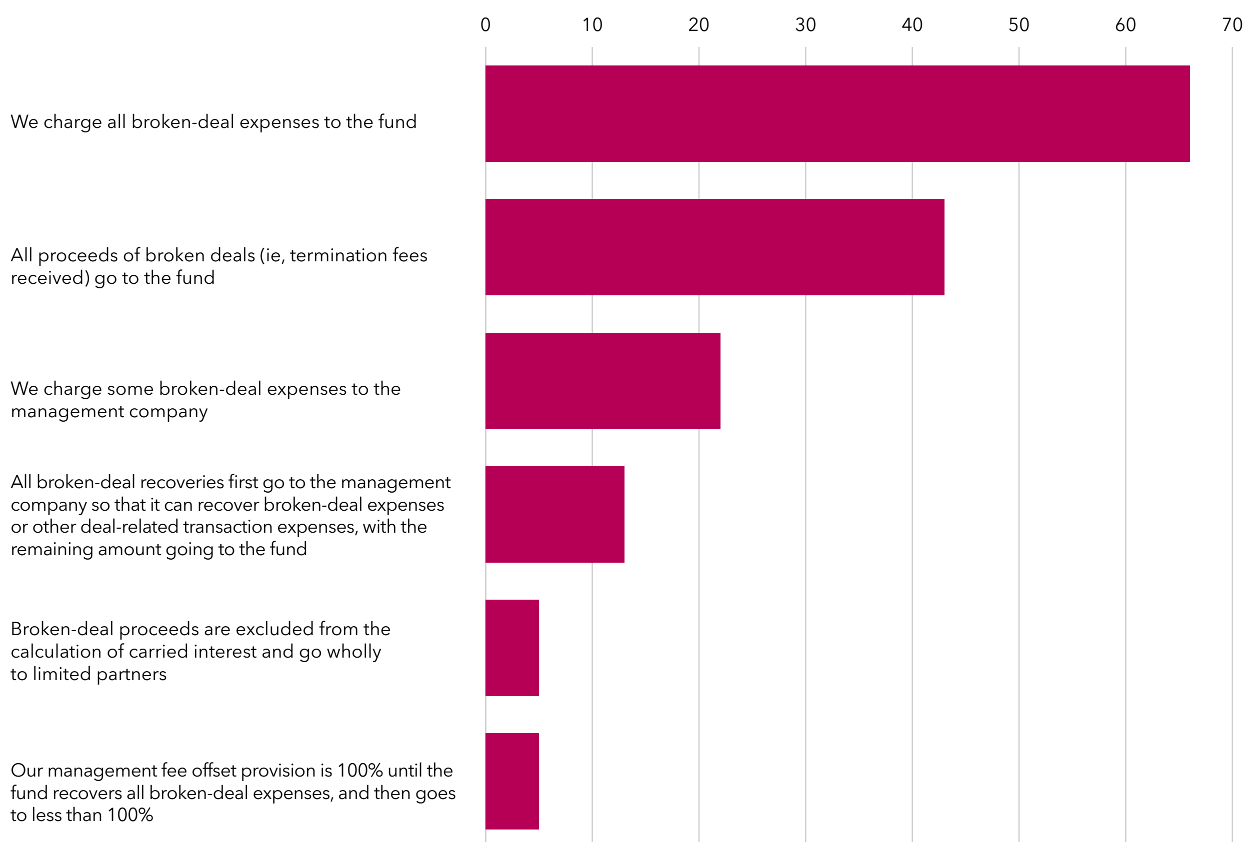
After a formal letter of intent is signed, the firm hires lawyers, consultants, accountants and other service providers to begin working on the transaction. Who pays for these expenses? (%)



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? (%)



Source: Private Funds CFO Fees & Expenses Survey 2022



fees and other expenses in the spotlight. General partners responded by taking on costs that may have been properly allocated to the fund in their LPAs because they were concerned it would attract the wrath of the SEC," Angell explains.

"The pendulum now appears to be swinging in the other direction, with expenses that would have previously been absorbed by the management fee as a precaution now reverting as firms get comfortable from a compliance perspective, based on prior SEC rulings and enforcement actions."

Indeed, there are rational reasons why it does not make sense to charge broken-deal fees to the management company, including potential incentivization to curb due diligence spending or even to shy away from pulling out of a dubious deal. The problem, as Blinn Cirella, CFO of Saw Mill Capital, says, is that broken-deal fees can add up.

"We've not had many truly broken deals – meaning a deal that gets within weeks of transacting before it is pulled – but on one of the bigger deals, we spent around $700,000 on fees and expenses. Those expenses were 100 percent paid for by the fund," Blinn says. "We've not made any significant changes in how we manage potential deal costs, but we are careful to not start running up costs until we are fairly deep into our diligence process."

Co-investment confusion

Where broken deals do remain a subject of considerable controversy, however, is when it comes to the responsibilities of co-investors – which, of course, includes any co-investment made by the general partners themselves. While LPAs typically now explicitly state the division of broken-deal costs between the management company and fund, allocation issues persist when it comes to deals a manager intended to strike alongside third parties.

"The treatment of broken-deal expenses with respect to co-investment continues to be the topic of much discussion," says Stephanie Pindyck-Costantino, partner at Troutman Pepper. "Should those fees be charged exclusively to the fund, or should they also be borne by the co-investors? In many cases, the fund continues to bear the cost, and this remains a topic of discussion."

It is an issue the SEC is pursuing with determination, but the industry is resisting with equal force. "To lessen the burden on the fund LPs, the SEC wants private equity firms to require the co-investors to share in broken-deal costs," says Cirella. "As you can imagine, co-investors are not agreeable to this. One co-investor even told me that if this ever really came to pass there would be no more co-investments." ■

EXPERT COMMENTARY

SEC proposals represent a significant change in approach, say Troutman Pepper partners Stephanie Pindyck-Costantino, Julia Corelli and associate Patrick Bianchi

SEC has fees and expenses in its sights

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The comment period has closed for the 9 February 2022 proposed new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act). The US Securities and Exchange Commission received multiple comments raising concerns that the proposed new rules and regulations would significantly impact terms that have historically been negotiated between managers and investors and would ultimately lead to increased fees and expenses for private funds and private funds advisers and ultimately for investors.

One of the most notable proposed new regulations is the proposed Rule 211(h)(2)-1, which prohibits certain activities by private fund advisers (Prohibited Activities Proposal). The proposed rules, in particular the Prohibited Activities Proposal, represent a sea change in the SEC's historical approach under the Advisers Act from full and fair disclosure with informed consent, especially with respect to fees and expenses, to prohibitions on certain practices and requirements on reporting, policies and procedures. We expect two components of the Prohibited Activities Proposal to significantly impact the established arrangements for management fees and transactions fees.

Prohibiting compliance costs

The Prohibited Activities Proposal would, among other things, prohibit private fund advisers from charging to a fund (1) fees and expenses associated with examinations or investigations by any governmental or regulatory authority of the private fund adviser or its related persons and (2) regulatory and compliance fees and expenses of the private fund adviser or its related persons, even where such fees and expenses are otherwise disclosed.

The SEC stated that these types of expenses are a cost of being an investment adviser and should not be passed on to private fund investors. The SEC expressed the view that allocating such

expenses to a private fund is contrary to the public interest and is potentially harmful to investors because doing so creates an inherent conflict and potentially incentivizes a private fund adviser to unfairly allocate expenses to the fund. The Prohibited Activities Proposal removes the notion that disclosure alone is the recommended course of action.

In its proposal, the SEC stated that many private fund advisers do not currently charge their funds for such fees and expenses, and as a result, the proposed prohibitions would not cause a dramatic change in industry practice. However, approximately 30 percent of the respondents to the *Private Funds CFO Fees and Expenses Survey 2022* reported that the fund is charged at least some portion of costs associated with a correction process following a routine regulatory examination by the SEC or a state regulator. These underscore the nuances of the types of fees and expenses potentially charged to the private fund.

In addition, several survey respondents reported sharing costs and expenses for corrections for inadequate disclosure or misallocation of fees and allocation of investment opportunities between funds and managed accounts.

Imposing a blanket prohibition on a private fund adviser from charging a fund or sharing these fees and expenses with a fund would alter existing fee and expense arrangements for many funds. Such fee and expense provisions are often subject to negotiation among the private fund adviser and the investors.

As a consequence of the proposed rule, other components of the fee and expense arrangement may be negotiated to preserve a comparable arrangement as the prohibitions would likely increase operating costs for private fund advisers.

Private fund advisers may seek higher management fees to cover those increased operating costs. We would expect changes to fee rates, discounts, stepdowns, the timing of charging the management fee, and/or the composition of the management fee base to cover these operating expenses.

Even the SEC questioned if private fund advisers would increase management fees to offset such an increase in operating costs. An increased management fee may ultimately not decrease the overall fee and expense arrangement for investors and, in such event, would reduce returns for investors.

Increased operating costs for private fund advisers may also disproportionately impact small or mid-size private fund advisers. These advisers, who often provide creative and innovative fee and expense arrangements, may not have the resources to support the fees and expenses associated with examinations, investigations or regulatory requirements without increasing their management fee.

Fees for unperformed services

The Prohibited Activities Proposal would also prohibit a private fund adviser from charging a portfolio investment for monitoring, servicing, consulting, or other fees in respect of any services the private fund adviser has not yet and does not reasonably expect to provide to the portfolio investment. Most of the respondents to this year's survey charge these types of fees.

When these fees are charged with respect to unperformed services due to acceleration clauses, they are commonly referred to as "accelerated payments." The SEC has expressed concern that accelerated payments reduce the value of the portfolio investment upon the private fund's exit and thus reduce returns to investors. The SEC also expressed that the potential for the private fund adviser to receive these economic benefits creates an incentive for the private fund adviser to seek portfolio investments for its own benefit rather than for the benefit of the fund's investors.

"There are many nuances to the types of fees and expenses charged to private funds"

Many commentators have noted, however, that permitting the charging of accelerated payments actually aligns the interests of the private fund adviser with those of the investors in the fund because such payments are commonly accelerated upon a sale or other triggering event, while prohibiting the private fund adviser from accelerating such fees could incentivize avoiding a triggering event.

Although an exception was provided for the prohibition on charging accelerated payments when 100 percent of the accelerated payment would offset the management fee, approximately 30 percent of this year's respondents who charge such fees do not provide for a 100 percent offset. In addition, as proposed, the exception would not apply if there were excess fees retained by the private fund adviser.

Additional layer of complexity

Overall, as reflected in our survey, there are many nuances to the types of fees and expenses charged to private funds. The new proposed rules and regulations, in whatever form ultimately adopted, would add an additional layer of complexity and, ultimately, compliance. With that additional compliance comes cost, both in terms of the time and attention of personnel and actual dollars spent.

For many private fund advisers, the additional costs and complexities layered onto an already complex system may lead them to re-evaluate their current fee structure and ensure the current fee structure can support the additional changes being proposed with this latest set of new proposed rules and regulations. ■

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Private Fund Services

Our Private Fund Services practice helps U.S. and international funds and their sponsors, managers, advisers, and investors define and achieve their business goals.

Our attorneys have represented hundreds of pooled investment vehicles, including committed capital funds, permanent capital/evergreen funds, independent sponsors, and others — experience that we bring to bear in the dynamic and ever-evolving arena of investment structuring and regulation. We deliver focused insights and advice based on regulatory, industry, and private practice experience. Our team includes veterans of the asset management industry, the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the Department of Justice (DOJ), and other regulatory agencies. Renowned for our full-service practice that addresses all issues that arise in a fund's life cycle, individuals and organizations often call on our fund attorneys for comprehensive guidance on achieving their business goals and strategies, or to provide insights or second opinions.

In addition, our representation of institutional investors investing in mega and large funds, coupled with representing fund managers in high-profile examinations, investigations, and enforcement actions, gives us unparalleled insights into the evolution that is constant in the asset management industry. Fund managers rely on us for the strength of our industry insights, and members of our team are regularly called upon to present at industry conferences and are quoted in the press on a range of industry issues.

Our clients include a wide range of funds and their sponsors, managers, advisers, placement agents, and investors, including:

- Traditional private equity, growth equity, and venture capital funds
- Permanent Capital Vehicles for both liquid and illiquid strategies, and long-term PE model funds
- Hybrid fund and programmatic co-investment platforms
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The complex world of management fees

Private equity's two and 20 fee structure belies a host of idiosyncrasies, especially how management fees should be handled at the other end of a fund's life, writes Amy Carroll

When Securities and Exchange Commission chairman Gary Gensler spoke to the Institutional Limited Partners Association in November last year, it was clear that private capital management fees were troubling him. In particular, he was perturbed that the two and 20 fee model has persisted, largely unchanged, despite a meteoric growth in assets under management. But these are headline figures only. In reality, the management fee calculation is a great deal more complex.

First, there is the question of how monitoring, financing and transaction fees are offset against the management fee itself. The treatment of these fees has proved contentious in the past and the SEC is particularly resistant to the use of so-called accelerated monitoring fees, where managers earn a lump sum in the event of a portfolio company being exited early.

Firms to have fallen foul of inadequate disclosure around accelerated monitoring fees include TPG Capital and more recently Alumni Ventures. Under the SEC's latest proposals, meanwhile, accelerated management fees would be banned altogether.

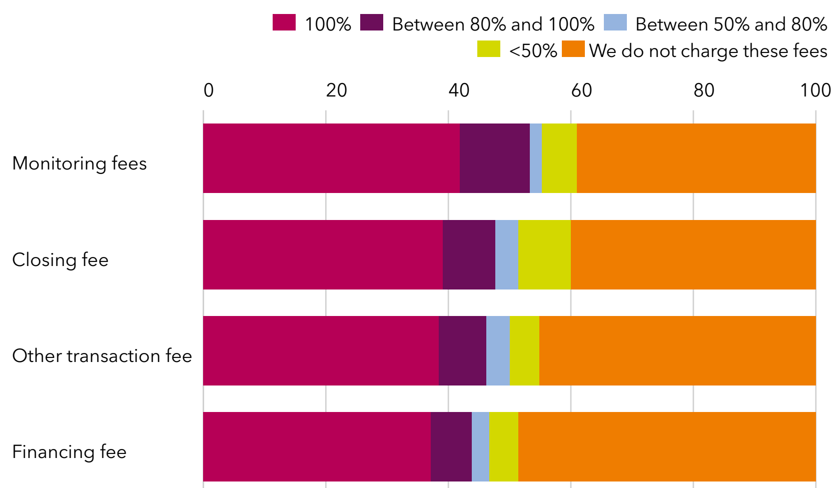
The impact of this particular rule change would be minimal, however. The majority of firms have not only moved away from accelerating monitoring fees, but effectively from charging them altogether. In the latest *Private Funds CFO Fees and Expenses Survey*, 39 percent of firms no longer charge monitoring fees, while 42 percent offset them completely against the management fee – essentially negating their existence. A similar story plays out against all other forms of transaction and financing fees.

"Several years ago, the management fee was offset by 50 percent. And if at the end of the life of the fund there were still unapplied offsets, that money was distributed to the LPs," says Saw Mill Capital CFO Blinn Cirella.

"That percentage started to increase from 50 to 75 to 80 and is currently 100 percent for most funds. So, there is no real benefit to charging those fees if you are just going to reduce the management fee collected accordingly."

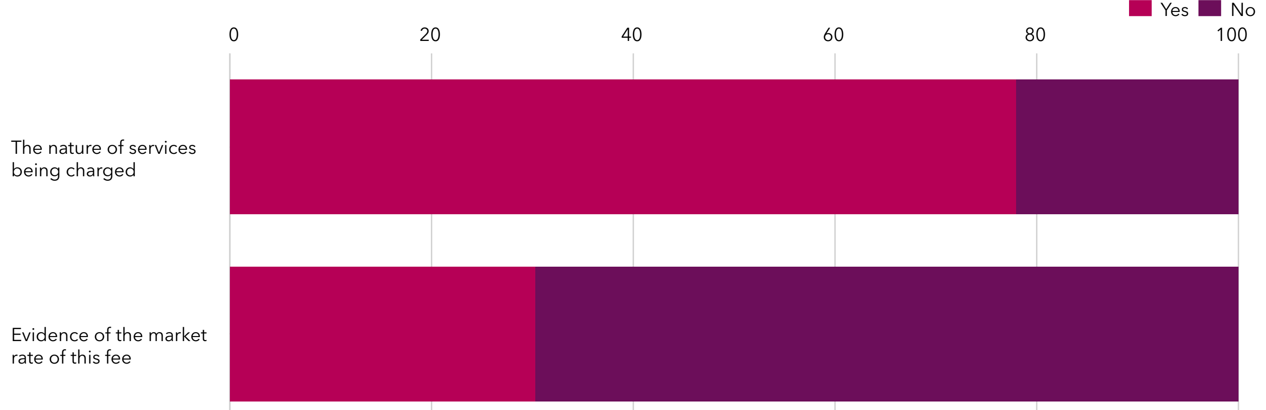
The management fee charged to investors is also impacted by the point at which it first comes into force, and the point at which it is terminated. Almost half of respondents to the 2022 survey

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

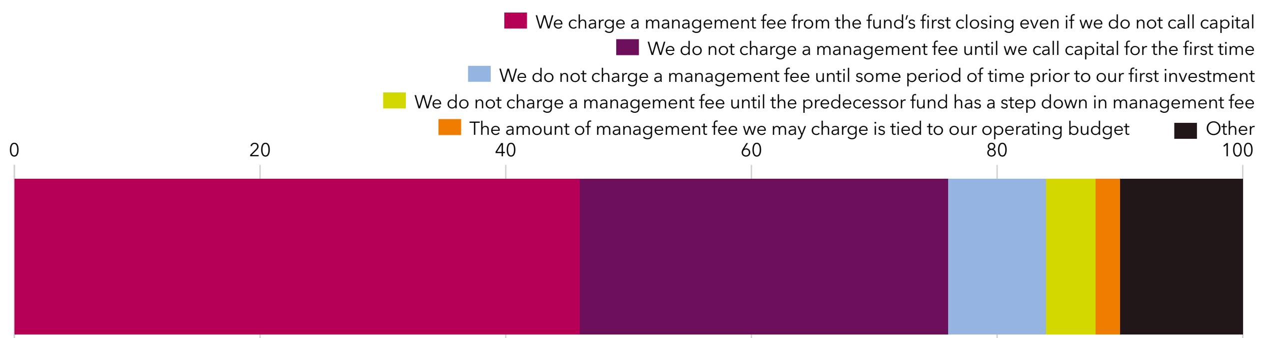


Source: Private Funds CFO Fees & Expenses Survey 2022

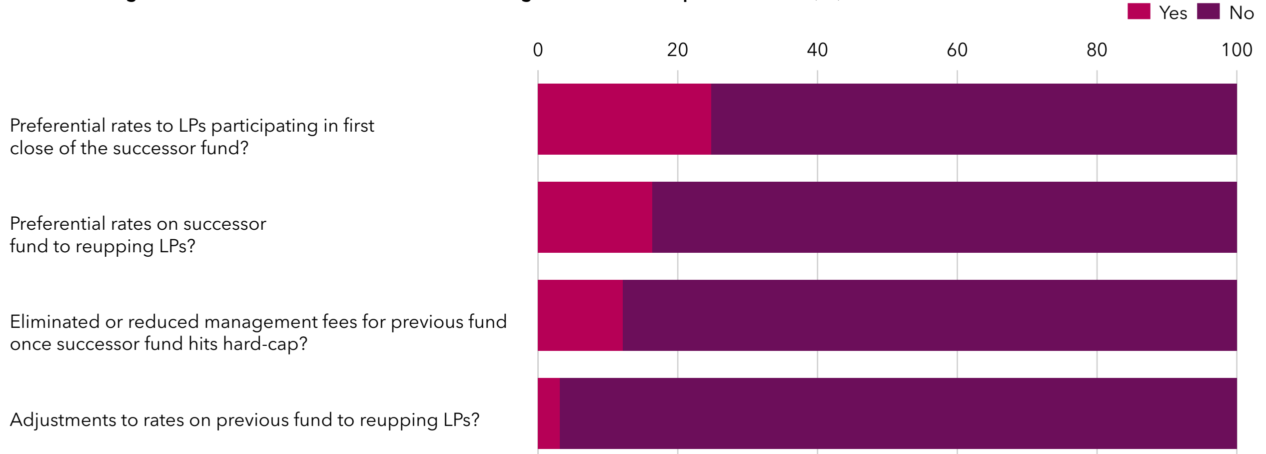
If your firm charges investment-related fees, do you disclose to investors… (%)



Which is true of your most recent fund? (%)



How do management fees on successor funds relate to management fees in the previous fund? (%)



Source for all charts: Private Funds CFO Fees & Expenses Survey 2022

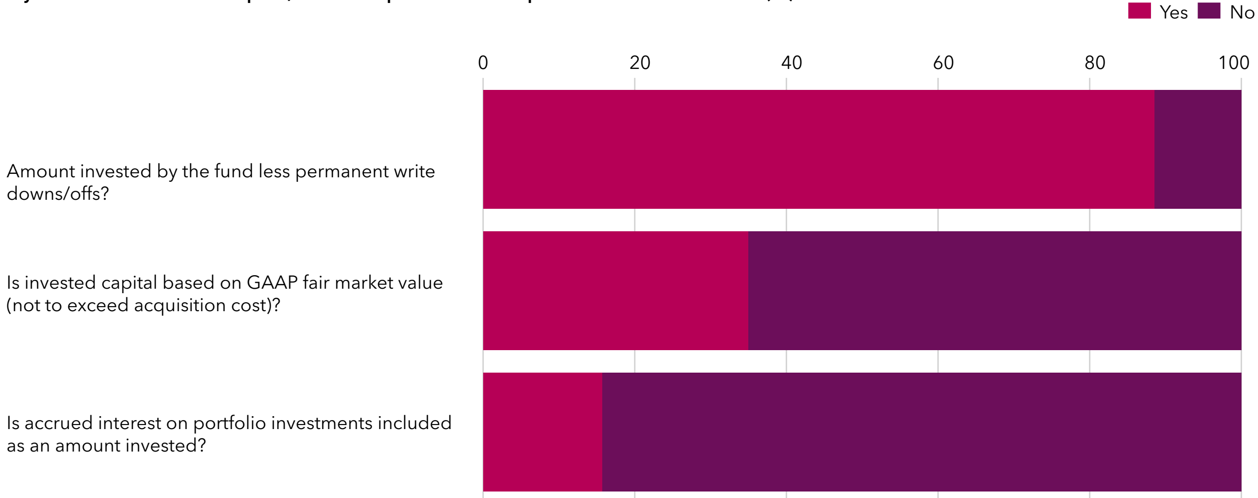
begin charging the management fee at first close, while only 30 percent wait for the first capital call. This is controversial.

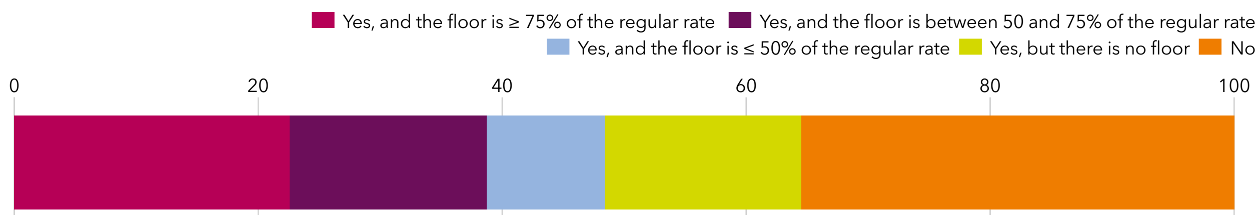
"LPs don't really want to be paying management fees until they actually make an investment," says Cirella. "It can also have a negative impact on performance if the fund calls capital for management fees early in its life, while accruing the fees would create a drag on NAV."

Furthermore, Cirella adds, the period between first and final close can sometimes be as long as two years. "LPs can feel like they are paying for nothing."

Then there is the question of how management fees should be handled at the other end of a fund's life. The survey found that 82 percent of respondents switch from a fee based on commitments to a fee based on invested capital, while the remainder employ a step down on the committed capital rate.

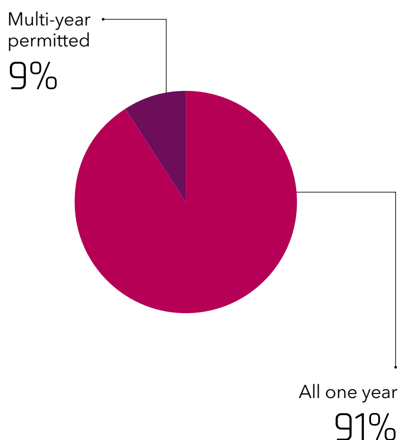
"Many investors look for the management fee to start with the first





"LPs don't really want to be paying management fees until they actually make an investment"

BLINN CIRELLA
Saw Mill Capital

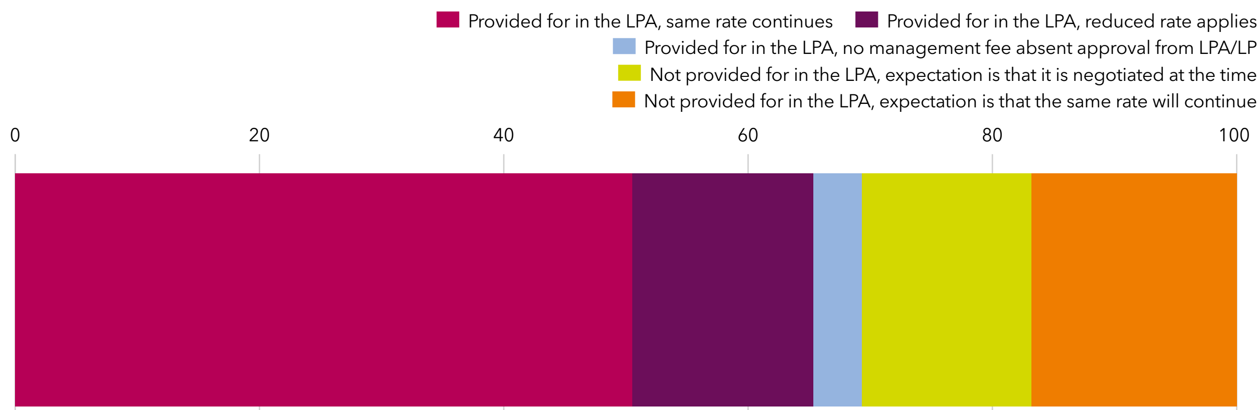


investment and they look for it to terminate at the end of term. In short, investors do not want what seems to be a never-ending fee," says Stephanie Pindyck-Costantino, a partner at law firm Troutman Pepper.

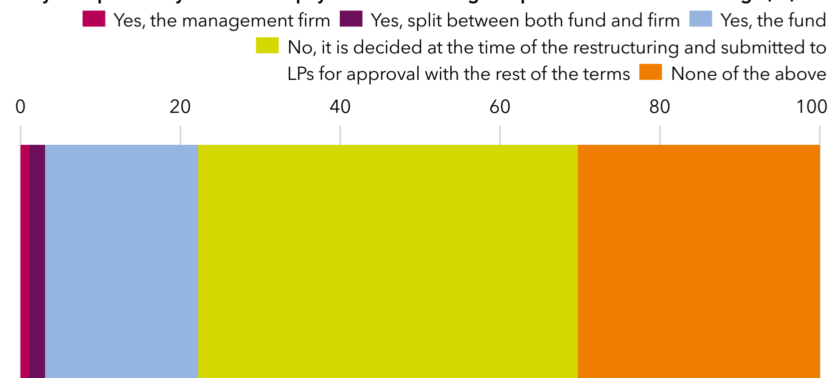
"Some of the larger houses continue to run the management fee through wind up, under the premise that that is when some of the hardest work occurs. Others argue that that is what liquidation fees are for. Crucially, the language around the mechanics is getting tighter and tighter."

Cirella adds: "I think reducing the management fee from commitments to invested capital after the end of the

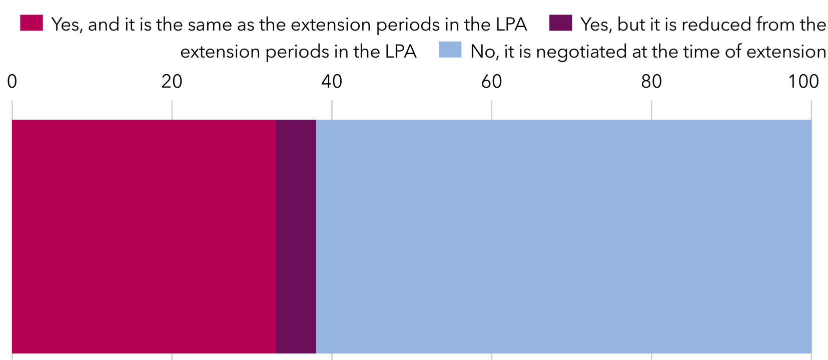
What does your LPA provide about the management fee charged in an extension period? (%)



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



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



Source for all charts: Private Funds CFO Fees & Expenses Survey 2022

investment period makes sense. As deals are sold the management fee continues to be reduced and I think this is fair as the amount of work required to manage the fund lessens with each sale. I also think that once a fund exceeds its extension periods the fee should be reduced to zero."

Provisions around fund extensions, as well as fund restructurings, are often still overlooked in documentation, however. Over three-quarters of respondents do not stipulate who pays costs relating to a potential fund restructuring, while 62 percent do not stipulate fees and expenses arrangements in the event of an extension. This is important, because given the current economic maelstrom, both of these eventualities are only likely to increase in prevalence.

"I think you'll see more restructurings and extensions as a result of this new environment," says Dan Rochkind, CFO at Lerer Hippeau. "For one, exit markets have slowed. As for restructurings, the industry has experienced a proliferation of first-time funds or new managers.

"As the environment becomes more challenged, I think you can expect some of these new managers to exit the industry and/or attempt to close down their funds through strategic secondary sales. Indeed, at Lerer Hippeau, we're currently managing a few portfolios that were the result of these types of events."

Rochkind believes it is important for GPs to be clear with investors regarding expectations on the timing of liquidity and fund wind-downs in an extension period.

"Management fees and expenses also need to be clearly and precisely agreed upon as part of this discussion to ensure that interests are aligned between the GP and LP," he says. "In my experience, LPs are pretty understanding of the work that needs to be done during an extension and recognize that GPs need the resources to complete the fund wind-down properly." ■

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EXPERT COMMENTARY

Private equity remains squarely on the minds of legislators, writes Tom Angell, a partner at Withum

(Sort of) breaking news

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The private equity industry seems to have dodged yet another bullet aimed at the carried interest deduction. As has been well reported, the language in the Biden administration's Inflation Reduction Act of 2022 to extend the holding period on private equity investments from three to five years was stripped out of the bill at the insistence of Arizona Senator Kyrsten Sinema. Not willing to lose much-needed election year momentum if the Act was defeated, the Democratic leadership sacrificed the carried interest restriction in favor of a 1 percent excise tax on stock buybacks.

If the failure of the latest attempt to rein in the carried interest deduction was not much of a surprise, it is worth noting that private equity remains squarely on the minds of legislators, and so the seemingly magical lifespan of carried interest continues, but it is just a matter of time before it comes under renewed attack.

Management fees

For the overall picture of private equity fund management, let's look more closely at a few of the management fee findings that arise from the biennial *Private Funds CFO Fees and Expenses Survey*. Concerning fees, the survey asked: "What percentage of your transaction, monitoring or any type of investment-related fee received by an affiliated entity is offset against your management fee?" Analyzing those results, I note that fees such as monitoring, closing, financing and others are not being charged back by funds in a range from between 39 and 49 percent of the time. If the fees are charged in a range between 37 and 42 percent of the time, they receive a 100 percent offset.

When looking back at the results of the 2020 survey there does seem to be a shift in the 2022 results. Most funds in 2020 were not charging these fees, but if they did, most were doing 100 percent offsets.

There seems to me to be two reasons that these fees were not charged to funds in 2020. One was the concern over SEC enforcement actions against funds for overcharging on fees, and the second was a market shift back then from general partners calling all the shots to limited partners having the upper hand in the marketplace. Yet much can happen in two years' time, and it would appear from this year's survey results that the

GPs seem to be in their regular position to dictate terms.

A shift from 2020 to 2022 is further revealed by the survey results regarding fee disclosure. When asked: "If your firm charges investment-related fees, do you disclose to investors?" The 2020 answer was 38 percent 'yes' on disclosure with that figure dropping in 2022 to just 30 percent. It is my belief that the higher level of disclosure in 2020 was a result of funds paying stricter attention to SEC oversight, and that it might be that the scrutiny is less of an issue in 2022. This will be a trend worth watching in subsequent surveys.

Some additional observations from the 2022 results: the percentage of funds charging management fees from the fund's first closing almost doubled in 2022, from 24 percent in 2020 to 47 percent in 2022. It seems plain that this was also due to the market being in favor of the GP. Further, all fees on 2022 successor funds showed little or no preference to the limited partners as compared with the 2020 survey.

There is a slight uptick in management fees (82 percent compared with 76 percent) being charged on invested capital for the post-investment period in the 2022 survey. Committed capital is another basis for management fees with the survey showing these fees decreasing in 2022 to 18 percent from 24 percent in 2020. Committed capital is used by the mid- and lower-mid-market funds to help them generate enough management fees to run their operations.

Finally, I notice that most management fee arrangements for funds that extend their life beyond the extension periods allowed are being negotiated at the time of the extension. I would have assumed this would have lessened over time, but it has increased since 2018. Why wait until the fund is past its life to negotiate these fees instead of doing it at the time of the fund launch? Apparently, it isn't high on the priority list of either party.

For now, the tried-and-true private equity fee structure of two and 20 remains in force with little on the horizon to impede it. Indeed, the pendulum may have switched back from the last survey in 2020 when there was some pressure on the GPs to offset more of the funds' charges.

However, the strong economic recovery, as evidenced by the remarkable level of dealflow recently, has empowered general partners to hold the line against charge backs. The numbers are staggering – according to Dealogic for the 18 months from January 2021 through mid-year 2022, dealflow was $1.7 trillion, by far the most in industry history. With this level of activity there is little incentive on the part of GPs to reduce charges in the immediate future.

But now there is a new and more troubling cloud on the horizon that may start to affect the strategy around management fees – the specters of inflation and recession. Rising inflation and the damage that it can cause to the fortunes of portfolio companies is very real and mitigation strategies are being instituted by every deal shop as we speak.

"There is little or no incentive on the part of GPs to reduce charges"

The private equity deals that are already underway will have to confront inflationary pressures on pricing, inventory and labor costs in traditional ways, such as price increases and layoffs. However, for deals in the pipeline it may be that we will see language in deal documents that reflect increases in fees because of higher expenses around the structure of new deals.

Limited partners may be on the lookout for ammunition to use to argue against higher fees. You can be sure that management is aware of this push back, in addition to the feeling that there may be the potential for lower levels of fund raising.

Certainly, through the rest of this year and into 2023 fund management is looking straight into the eye of rapid inflationary pressure and, according to many economic forecasters, a recession in the third and fourth quarters of this year. Given these headwinds it appears likely the general partners will be looking to protect their margins by keeping fees at current levels.

Of course, not all recessions are the same and if a recession appears to be severe or of a longer term than the short sharp one that is being talked about, there may indeed be significant pressure on general partners to eliminate certain charge backs, such as board of director fees, that could affect their rate of return. This is well within the realm of speculation but is worth considering.

Indeed, there has been some suggestion by limited partners at mid-market funds (those in the $250 million-$750 million range) to replace the 2 percent fee that funds charge with a formula that caps all fees up to a set dollar amount with that cap being set by the fund's seed limited partners. At the multi-billion-dollar fund levels there is also some activity around limited partner groups seeking to negotiate fee levels, but there is no new normal yet, and the very large funds do not appear to be in any hurry to adjust fees.

The 2 percent management fee has been a standard almost since the inception of the private equity structure. Although there have been adjustments for offsets to certain fee revenue generated by the portfolio companies, based on this survey over the years, it doesn't appear that there will be a change to the management fee anytime soon. ■

The co-investment controversy

Disagreement over broken-deal fees could spell the end for co-investment if the regulator intervenes, says Amy Carroll

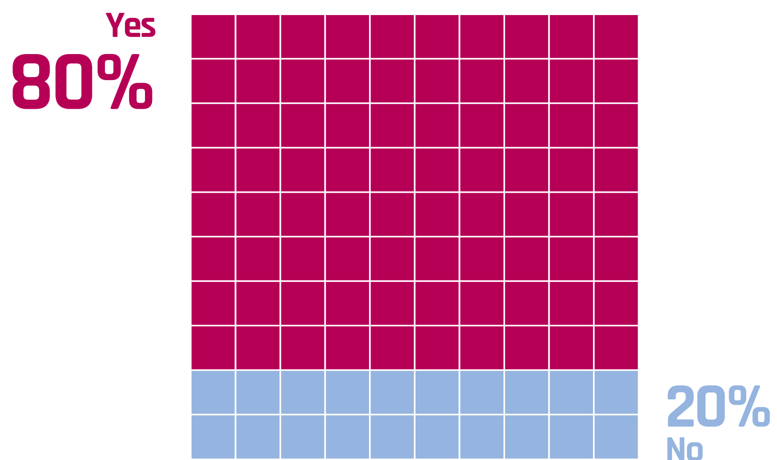
Co-investment has become a ubiquitous and powerful tool for GPs, in both the world of fundraising and investment – employed by 80 percent of respondents to *Private Funds CFO Fees & Expenses Survey 2022*.

"We are seeing more co-investment supply than ever before," says Andrew Bernstein, head of private equity at Capital Dynamics. "This is partly due to slower fundraising processes caused by the residual effect of travel restrictions and a logjam in the market. Uncertainty around ultimate fund sizes leads to conservatism in the size of the check some LPs are willing to write mid-fundraise."

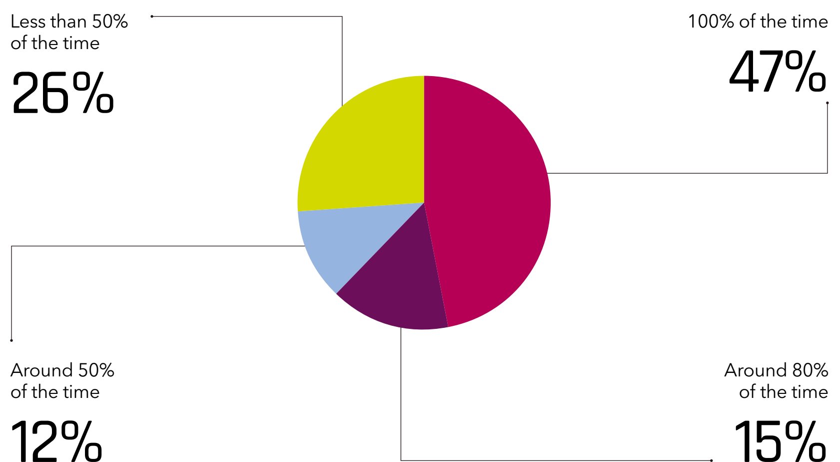
Appetite from investors is also increasing. "More and more investors are looking to build out their own direct investment portfolio," says Dan Rochkind, CFO of Lerer Hippeau. "It makes complete sense that LPs would want to invest alongside a top-tier VC fund partner that has already sourced a deal, done most of the due diligence and negotiations, and will likely have a key role in monitoring and supporting the company post-investment."

"Many LPs that did not historically co-invest have grown tired of effectively subsidising those that do," adds

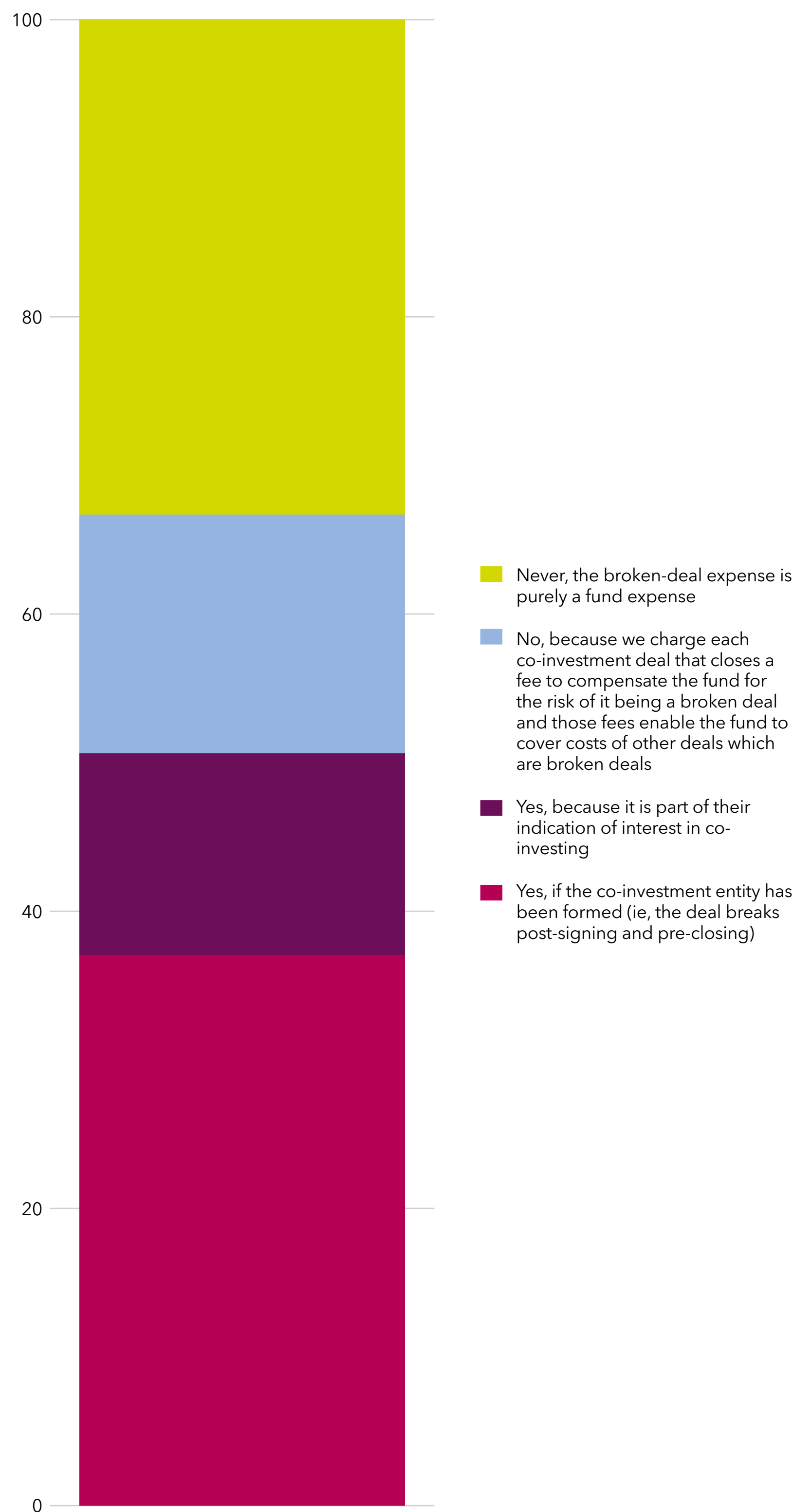
Does your firm offer co-investments?



How often are your co-investments structured as separate entities (as opposed to direct investments in portfolio companies)?



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



Source: Private Funds CFO Fees & Expenses Survey 2022

Bernstein. "They have now built out their own teams or partnered with specialists in an effort to blend down fees as well as deepen their relationships with GPs. LPs can use co-investment to see how the sausage is made in order to better inform their decisions on the primary side."

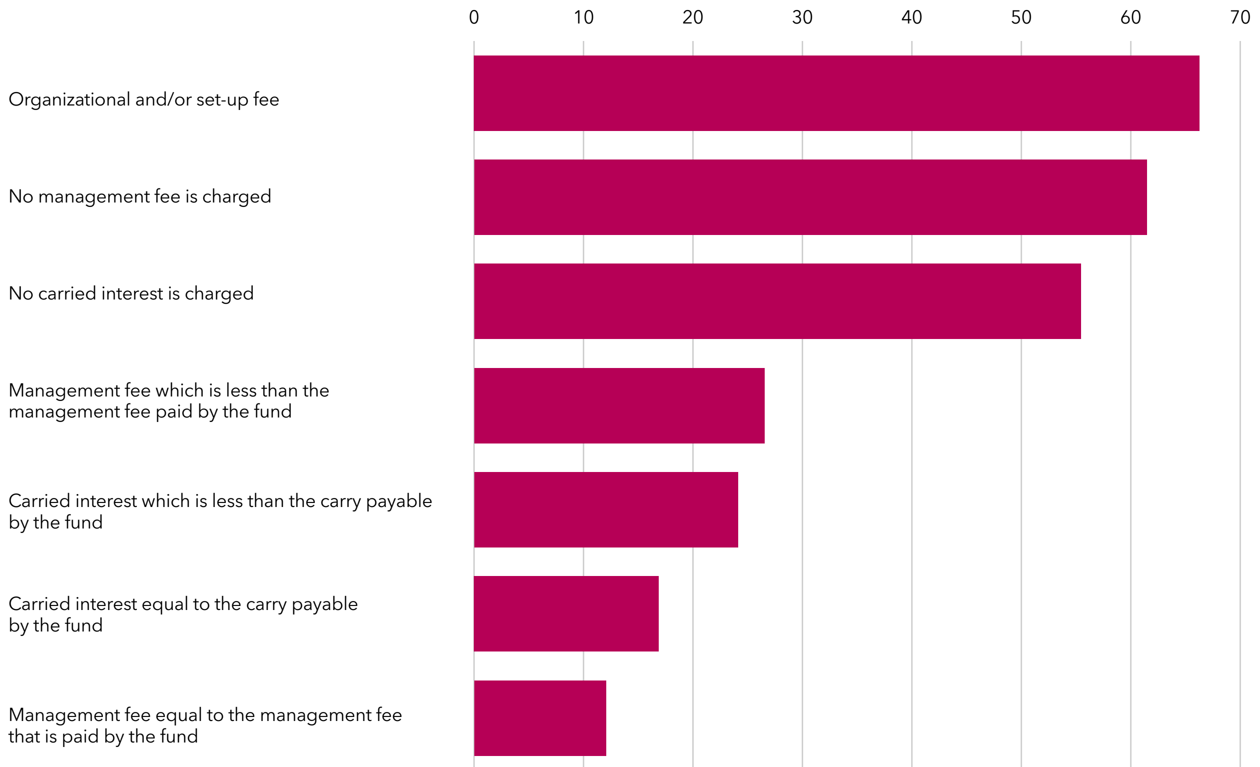
Indeed, the idea that co-investment can be used to lure new investors into funds is something that has courted controversy.

"Co-investment is a route through which LPs get to know GPs and potentially make the decision to invest in future funds," says Joshua Cherry-Seto, CFO of venture capital firm Start-Up Health and until recently of Blue Wolf Capital. "That could mean a GP is incentivized to offer co-investment to those investors in order to support future fundraising. There are typically policies in place governing how co-investment is awarded but those policies, and the extent to which they are adhered to, are going to come under increasing scrutiny."

Meanwhile, co-investment allocation is not the only area where there is a lack of consistency. Some firms charge a management fee and carry equal to that charged by the fund – although the survey reveals a steady decline in this practice over time. Others charge reduced fees and some no fees at all.

"Fees chargeable are very much opportunity dependent," says Neda Vakilian, managing director of global relationships at Actis. "In infrastructure, co-investment is traditionally half fees and half carry. However, fees may well be charged for third-party investors who are not in the relevant fund. It is not inconceivable that deal introduction fees might also be charged. How high these fees are will very much depend on whether the GP is in a strong bargaining position."

Bernstein agrees: "Fees are all over the map. Some GPs charge upfront fees, management fees and/or transaction fees for M&A. Others don't charge



Source: Private Funds CFO Fees & Expenses Survey 2022

> *"I hope the use of co-investment isn't regulated out of the market"*
>
> **ANNE ANQUILLARE**
> **CSC**

fees at all. LPs should demand transparency. As long as fee expectations are disclosed upfront, co-investors have an opportunity to negotiate, and in the end, they can decide if the impact on returns is such that they want to walk away."

Where the real controversy lies, however, is in the treatment of broken-deal expenses when it comes to transactions slated to include co-investment capital. A third of respondents charge broken-deal expenses exclusively to the fund. A further 16 percent also charge these expenses to the fund, with the rationale that they charge co-investment deals that do close a fee payable to the fund, which compensates for broken deals elsewhere.

"The issue of how dead deal fees are shared continues to be debated in the market," says Cherry-Seto. "The fund typically bears the cost, but if a proportion of the capital earmarked for the deal was never going to come from the fund, should that expense not be shared? It is a timely and important topic and one that the SEC may well take issue with."

Anne Anquillare, head of US fund services for CSC, adds: "The industry doesn't seem to be reaching any consensus as to how fees and expenses should be dealt with in these situations. And when the industry is unable to reach a consensus on a sensitive topic, that is typically when the regulator intervenes."

But SEC intervention could ultimately prove fatal for co-investment. "I hope the use of co-investment isn't regulated out of the market because it is an important tool," Anquillare says. "But it is a tool that must be used and communicated appropriately, if it is to continue to have a role in this industry." ■

Picking up the tab

With funds keen to farm out non-core functions, the issue of whether the management company or the fund should be paying outsourcing costs is rising up the agenda. By Amy Carroll

The trend toward outsourcing continues unabated as firms increasingly farm out non-core functions, so that they can focus on their field of expertise –investing and divesting.

The shift is most notable when it comes to fund administration. Just over half of respondents to the *Private Funds CFO Fees & Expenses Survey 2022* outsource their fund administration entirely, compared with just 29 percent two years earlier. This has been driven, in part, by a proliferation of regulation over the past decade. The additional burden represented by the SEC's latest proposals are only likely to exacerbate the situation.

"Outsourcing is being driven by the need to increase efficiency and reduce cost, as well as the need to stay abreast of, and keep pace with, evolving regulatory requirements," says Stephanie Pindyck-Costantino, partner at law firm Troutman Pepper.

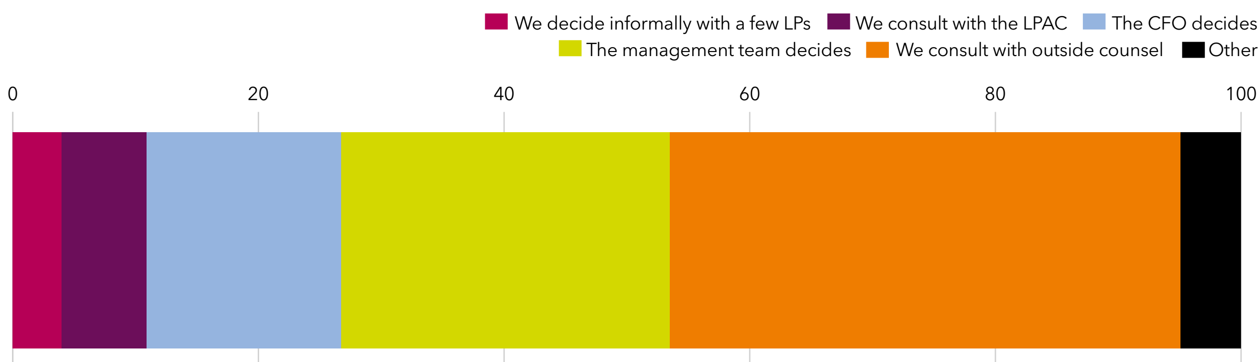
> *"The new SEC proposals would require faster reporting times and more disclosures to LPs"*
>
> **PATRICK BIANCHI**
> **Troutman Pepper**

"This is particularly true for small and mid-market managers. Outsourcing provides those firms with a breadth of knowledge and depth of resource that is becoming necessary, in many cases where the firm's team is already at capacity, to meet the growing regulatory requirements."

Patrick Bianchi, a private investment funds associate at Troutman Pepper, agrees, adding: "The new SEC proposals would require faster reporting times and more disclosures to LPs, all of which would increase demand for outsourcing."

A difficult environment for recruiting is also heightening demand for third-party service providers. "The

How do you decide questions about fee and expense allocations that are not addressed in the PPM, LPA or policy documents? (%)



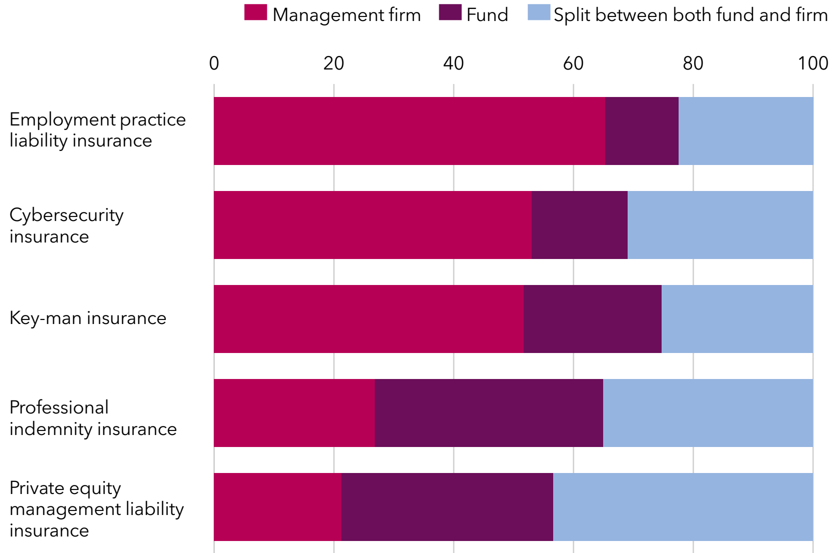
tight labor market is definitely driving outsourcing," says Anne Anquillare, head of US fund services for CSC.

"Fund accounting and investor reporting are back-office functions in a private equity firm and it can be difficult to get those teams properly resourced. But for a third-party service provider, they represent the front office.

"And, as front office revenue generators, we can be focused on training and career progression, making it far easier for us to attract, retain and develop talent in these roles."

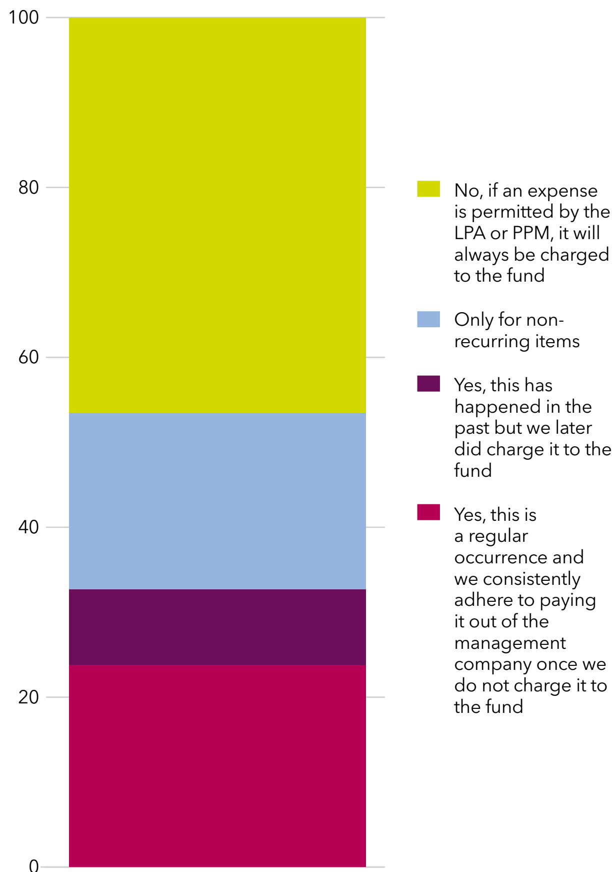
Joshua Cherry-Seto, CFO of venture capital firm StartUp Health and until recently of Blue Wolf Capital, agrees. "It is challenging to hire internally at the moment, which means we have increased our outsourcing,"

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

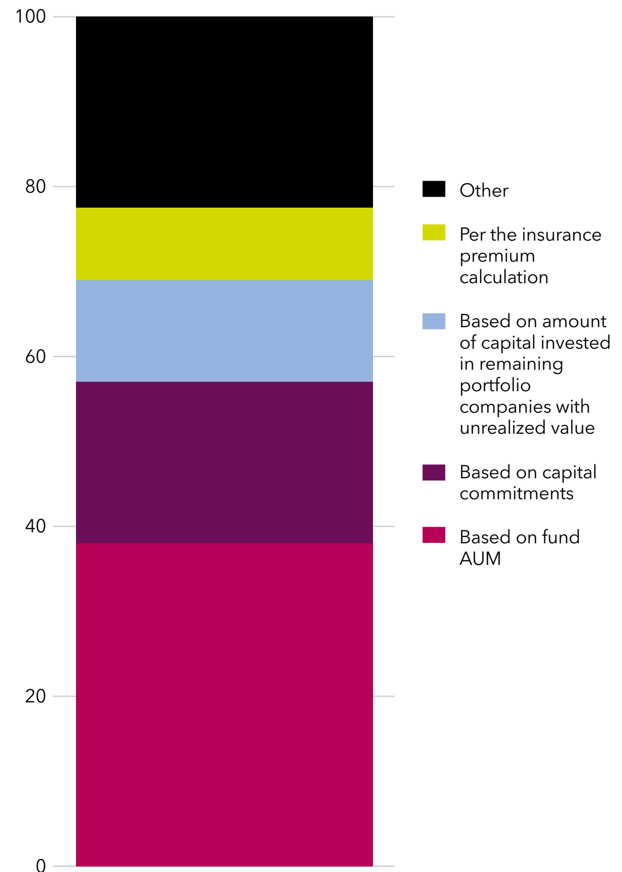


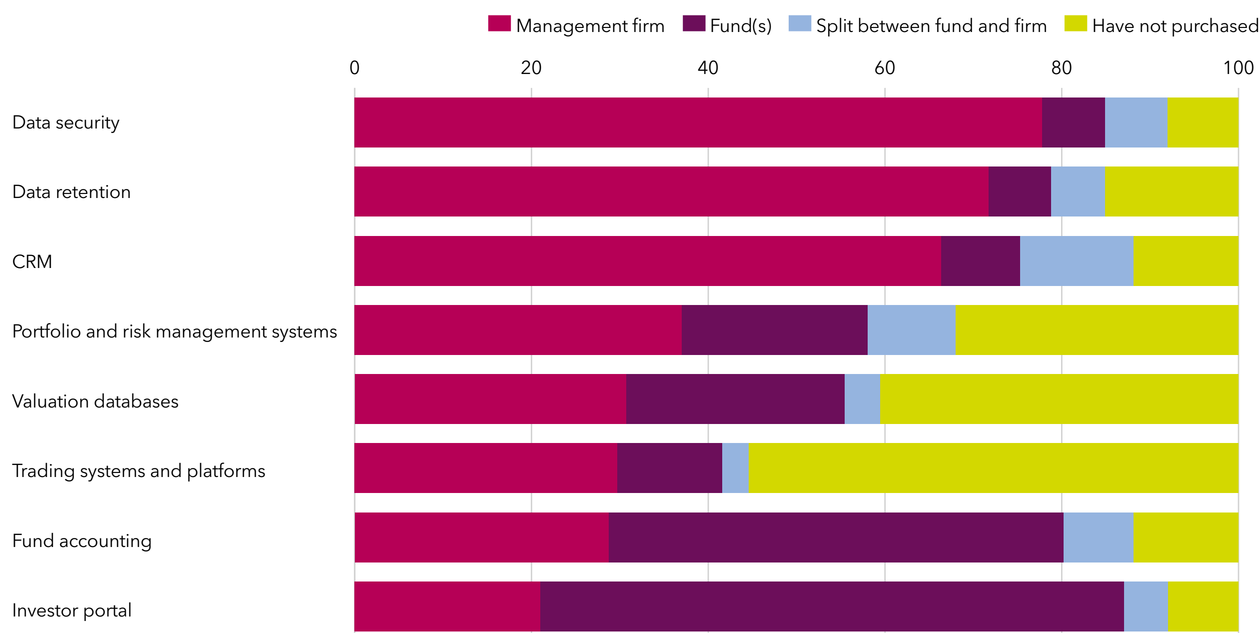
Source: Private Funds CFO Fees & Expenses Survey 2022

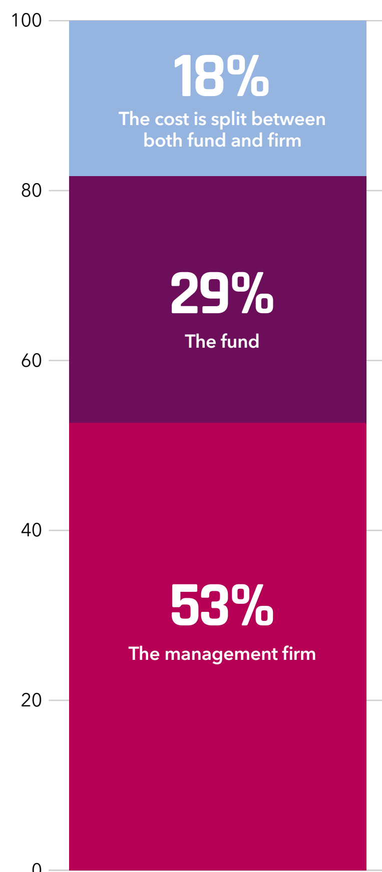
Have you ever decided not to charge to the fund an expense that was expressly permitted in the LPA or PPM? (%)

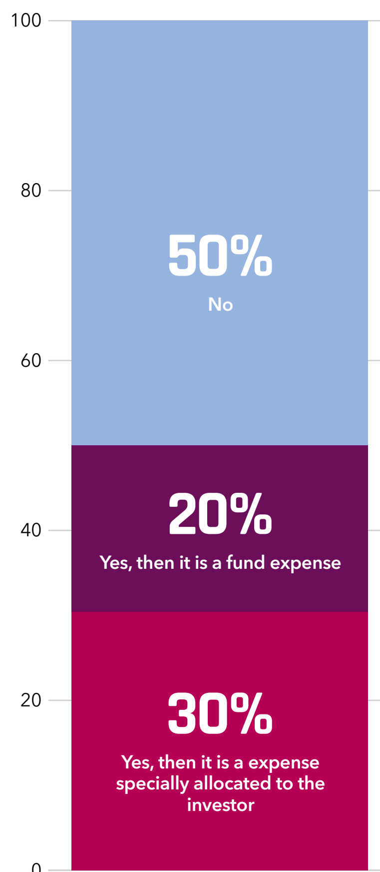


If you allocate these costs across funds, how is this allocation calculated? (%)









he says, adding that having a team of people familiar with a firm's operations is preferable to having that knowledge reside with a single individual.

However, Cherry-Seto adds that outsourcing has been stressed by short-staffing at vendors too.

Splitting the bill

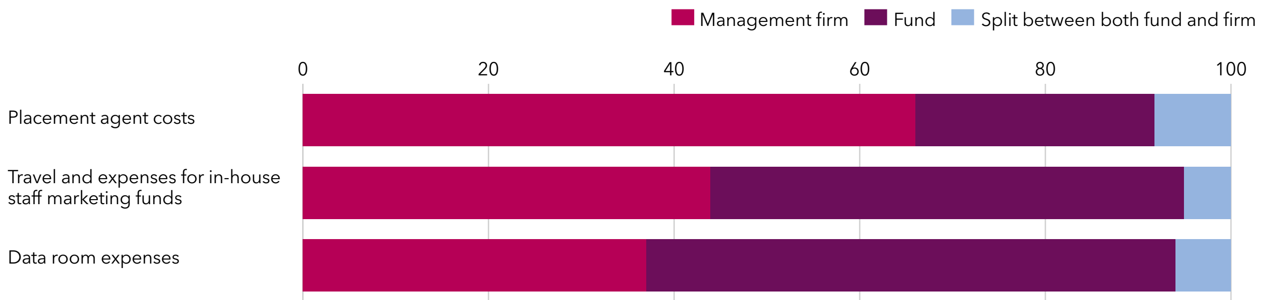
The question then becomes who should be paying for these outsourced services – should it be the management company or should it be the fund? The answer varies depending on the firm, of course, as well as the situation.

"Many of the most contentious costs are those where it is harder to determine how much the management company benefits from the service and what benefit there is to the fund," says Pindyck-Costantino. "With some expenses like insurance or certain security expenses, for example, LPs have pushed hard to understand the allocation mechanics."

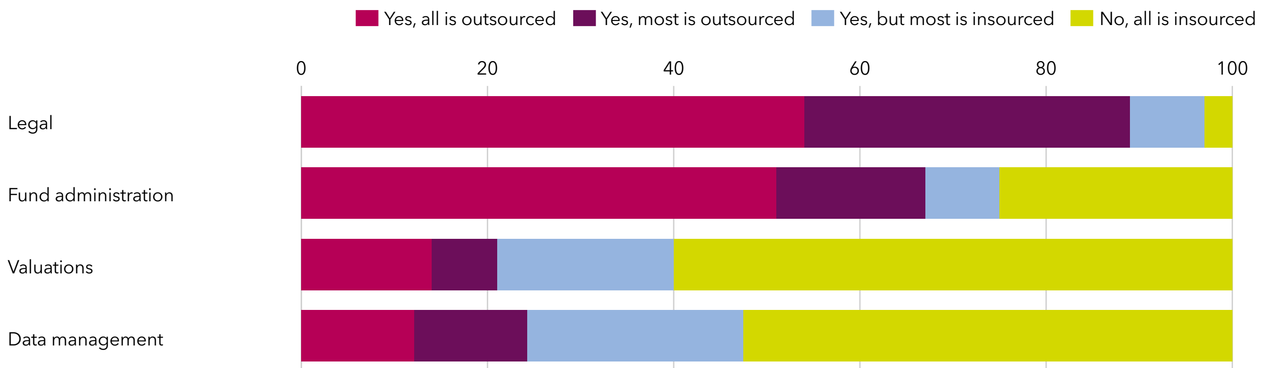
Tom Angell, financial services practice leader at Withum, suggests that the issue is partly determined by the AUM of the manager. "I am sure you would find that multi-billion-dollar

Analysis

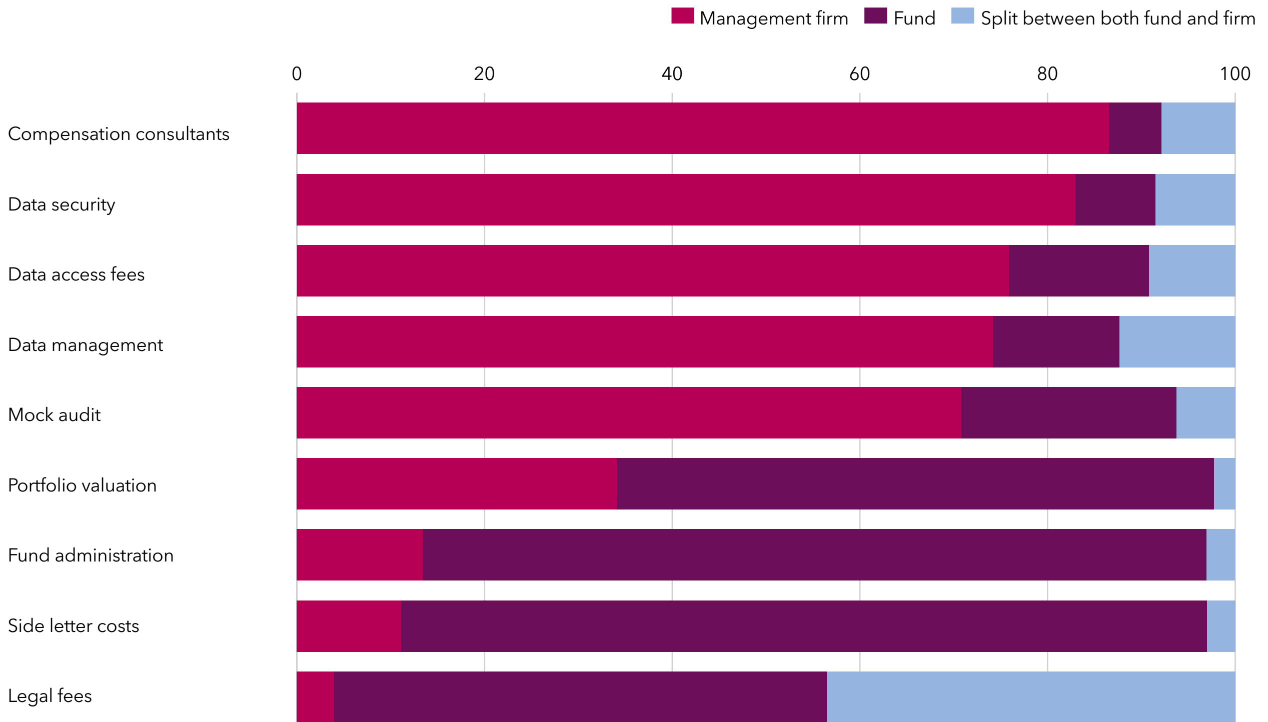
Who pays for the following fund marketing costs? (%)



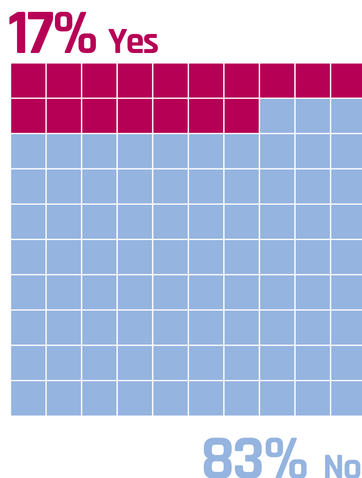
For the following services, do you outsource to third parties? (%)



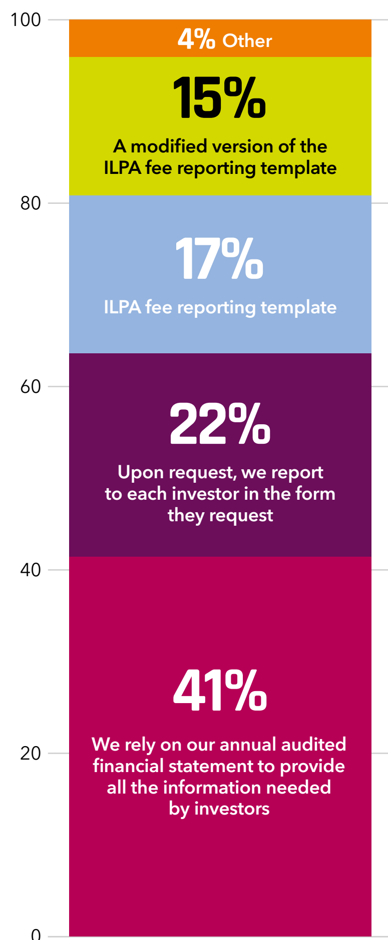
Who bears the cost of the following outsourced services? (%)



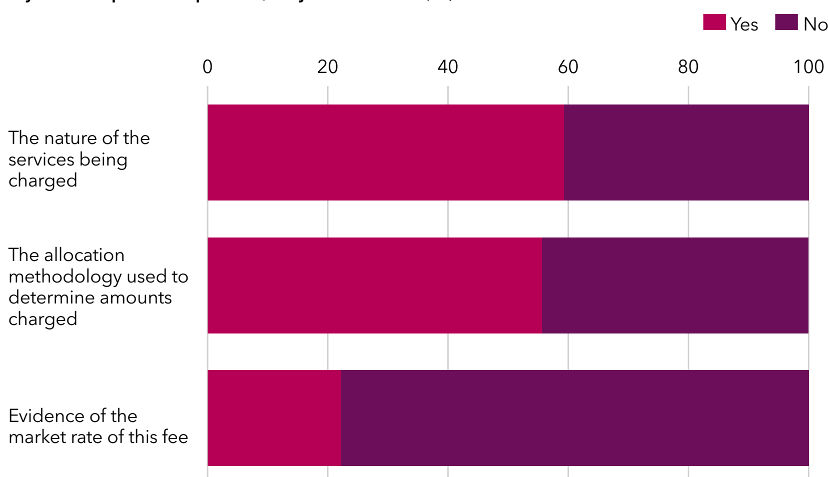
If you are insourcing any services such as fund administration, portfolio valuation, data management, data access fees, data security, legal fees, side letter costs, mock audit, compensation consultants, do you charge any of these services to the fund in addition to the management fee? (%)



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



If yes to the previous question, do you disclose… (%)



Source for all charts: Private Funds CFO Fees & Expenses Survey 2022

funds have a different take on what they are willing to absorb when compared to a $250 million AUM firm, that would be less able to take on those expenses," he says.

One area that always proves contentious, however, is travel expenses. This has only intensified as LPs have prioritized sustainability, and as covid revealed just how much business could, in fact, be carried out remotely. The latest fees and expenses survey shows that 51 percent of respondents expect the fund to pick up the travel expenses of inhouse marketing staff.

"There has been increased focus on the cost of doing business across the board," says Anquillare.

"LPs are questioning what is really necessary and what is just a matter of convenience.

"Additional expenses creeping onto funds' P&Ls is one reason for the SEC's proposed rules for enhanced disclosure. Investors need to understand the benefit that using specialist service providers brings to a fund. We are starting to see that dialogue take place during the negotiation of partnership agreements and with the LPAC as part of the governance of existing funds. It is an important evolution."

The ILPA effect

Meanwhile, the standardization of fees and expenses reporting continues to make slow progress. Over 40 percent of respondents still rely on financial statements, and 22 percent deal with fees and expenses disclosure requests from LPs on an ad hoc basis. Only 17 percent use the ILPA fee reporting template, while 15 percent use a modified version.

"The ILPA template has been a great starting point for conversation, and firms are moving increasingly in that direction," says Anquillare. "They may adopt 50 percent of the template for one fund, for example, and then 60 or 70 percent for the next. In that sense, ILPA is providing a road map, and adoption is happening at a pace that is sustainable."

And that direction of travel is likely to continue as managers and investors seek more efficient reporting solutions, and as regulators continue to exert pressure.

"At the end of the day, disclosure is always going to be the manager's friend," says Pindyck-Costantino. "Firms will gravitate towards any attempt to streamline disclosures and bring formulaic transparency." ■

"The SEC has said it will give the industry a year to comply, but they have really thrown the kitchen sink at this"

ANNE ANQUILLARE, head of US fund services for financial services firm CSC, is concerned by the sheer volume of the SEC proposals

"I think we will see larger management fees in order to accommodate these changes"

PATRICK BIANCHI, an associate at law firm Troutman Pepper, believes the SEC proposals will require substantial third-party support

"Mid-market funds that have above $150 million AUM and therefore need to be registered will be the most heavily impacted"

TOM ANGELL, financial services practice leader at advisory firm Withum, says the demands for increased disclosure will hit the smaller firms

Reflections on fees and expenses

The SEC proposals are proving very controversial

"Reporting unlevered returns may sound like a straightforward and reasonable request, but it is not"

JOSHUA CHERRY-SETO, CFO of StartUp Health and until recently of Blue Wolf Capital, says the proposals could have unforeseen consequences

"We are seeing more co-investment supply than ever before"

ANDREW BERNSTEIN, head of PE at Capital Dynamics, says LPs are building their own teams in an effort to blend down fees as well as deepen their relationships with GPs

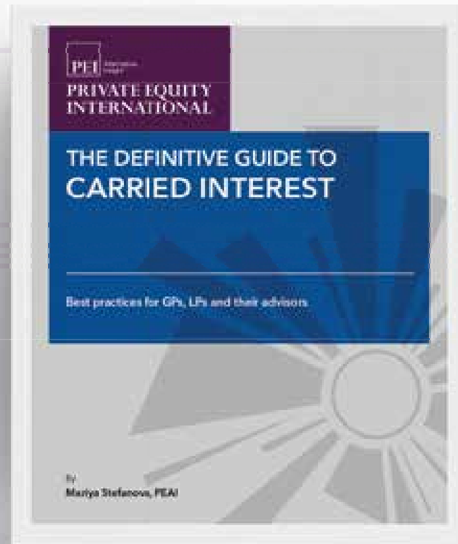
"I think you'll see more restructurings and extensions as a result of this new environment"

DAN ROCHKIND, CFO at Lerer Hippeau, believes GPs must be clear with investors regarding the timing of liquidity and fund wind-downs in an extension period

"One co-investor even told me that if this ever really came to pass there would be no more co-investments"

BLINN CIRELLA, CFO of Saw Mill Capital, says co-investors are opposed to SEC proposals for PE firms to require co-investors to share in broken-deal costs

Private Equity International



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