

SEC Has Fees and Expenses in Its Sights

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

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.

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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