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Fee Transparency in Private Equity Funds

In May 2014, Andrew J. Bowden, the then-director of the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations, gave a speech addressing various issues in the private equity industry (Sunshine Speech). In the Sunshine Speech, Bowden highlighted several matters of concern related to private equity fees and expenses that the SEC observed in its examinations, including inadequate disclosure of fees and expenses, and collection of hidden fees.[1] Although there have been some positive changes since the Sunshine Speech, such as investors' increased focus on fees and expenses and general partners' detailed discussion of fees and expenses in Part 2A of Form ADV,[2] Limited Partnership Agreements and other offering documents, there is still room for further improvement. This article identifies two common issues with fee transparency in the private equity industry and examines the Institutional Limited Partners Association's (ILPA) Fee Reporting Template as one way to improve fee transparency.

Limited Disclosure of Fees and Expenses.

Since there are no uniform or standardized rules regarding disclosure of fees and expenses in private equity, limited partners ("LPs") in private equity funds are often unable to obtain detailed reports on all fees and expenses regularly. This limited disclosure sometimes creates an imbalance of information between LPs and general partners (GPs), and impairs LPs' ability to exercise strong oversight over fund managers. As stated in the open letter of a coalition of 13 state and city Treasurers and Comptrollers to the SEC Chair, of the four types of private equity firm expenses—management fees, fund expenses, allocated incentive fees, and portfolio-company charges—only directly billed management fees are easily segregated and regularly disclosed.[3] Even when all types of fees are reported, they are often buried in annual financial statements and are not directly reported to LPs on a quarterly basis.[4]

This limited disclosure of fees and expenses has also led to a culture in which institutional investors often do not reflect total management fees accrued by private equity firms.[5] Institutional investors typically disclose how much they pay in base management fees (usually 1% 2%) for private equity managers, but they typically do not disclose how much they pay in profit sharing (*i.e.*, carried interest or performance fees). Contrary to this general practice, some U.S.

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government pension plans have implemented their own systems to provide more complete disclosure of private equity fees and expenses. For example, in September 2016, California enacted a law that obligates California's public investment funds to require alternative investment vehicles to make annual disclosures about the fees and expenses (including carried interest) the public funds pay to alternative investment vehicles and fund managers.[6] Also, unlike most of the other state pension plans, the South Carolina Retirement Systems ("SCRS") reports net management fees, performance fees, and other fund level expenses in the plan's Comprehensive Annual Financial Report (CAFR).[7] The main reason for these developments is to increase the transparency of fees,[8] which resonates with the SEC's position on fees and expense disclosure by private equity funds. While government investors in California, South Carolina and other states have taken steps to require enhanced disclosure of fees and expenses, such disclosure is not yet standard practice in the private equity industry.

Hidden Portfolio Company Fee Income.

Another issue that stems from the limited disclosure of fees and expenses is hidden portfolio company fee income. Private equity firms charge fees such as transaction fees[9] and monitoring fees[10] to portfolio companies, and these fees are often hidden from LPs because they are typically agreed to between private equity firms and managers of their portfolio companies via the Management Services Agreement ("MSA").[11] These MSAs often require portfolio companies to pay these fees for longer than the portfolio companies' holding periods (*e.g.*, ten years or more) and do not describe in detail the scope and scale of services.[12]

If there is an MSA between a private equity firm and its portfolio company that is supposed to last for ten years and the private equity firm sells the portfolio company in less than ten years, the company still has to pay the remaining monitoring fees for services never rendered.[13] Under such MSA, accelerated monitoring fees can easily amount to tens of millions of dollars. The SEC is aware of this issue and has taken enforcement actions. For example, in October 2015, the SEC announced that three private equity fund advisers within The Blackstone Group agreed to pay nearly $39 million to settle charges that they failed to fully inform investors about benefits that the advisers obtained from accelerated monitoring fees and discounts on legal fees.[14] According to the SEC, Blackstone breached its fiduciary duty by failing to disclose the accelerated monitoring fees prior to the portfolio companies' sale or initial public offering and by negotiating a

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legal fee arrangement that provided itself with a much greater discount than the discounts the funds received.[15]

ILPA's Fee Reporting Template.

One way to improve disclosure of fees and expenses in private equity is to require reporting consistent with the Fee Reporting Template ("Template"), finalized by the ILPA in January 2016. The Template proposes to standardize private equity firms' reporting of fees, expenses, and carried interest. According to ILPA, the Template will encourage increased uniformity in the disclosures being provided to LPs and promote transparency and alignment of interests between LPs and GPs.[16]

The Template is split into two sections: (a) Section A— Capital Account Statement for LP and (b) Section B — Schedule of Fees, Incentive Allocation & Reimbursements Received by the GP and Related Parties, with respect to the Fund and Portfolio Companies/Investments Held by the Fund.[17] There are also two levels of data: (i) Level 1 data provides a high-level summary, including management fees and the net asset value of the fund; and (ii) Level 2 data provides additional details, including fees and reimbursements received from portfolio investments.[18] ILPA acknowledges that many LPs may be satisfied with Level 1 data only, but recommends that GPs produce Level 2 data to LPs that require it.[19] The Template is intended to be provided on a quarterly basis, supplementing a private equity fund's standard financial disclosures.[20]

ILPA claims that the Template reflects feedback from nearly 50 LP organizations within its membership and formal comments from numerous GPs, fund administrators, and consultants.[21] As of November 3, 2016, more than 50 LP organizations, including CalPERS, CalSTRS, Chicago Teachers' Pension Fund, and the State of Wisconsin Investment Board, have endorsed the Template.[22] Several GP organizations, including The Carlyle Group, The Blackstone Group, TPG, and Silver Lake, have also endorsed the Template.[23]

Recommendations for Institutional Investors.

Greater fee transparency assists investors with management and negotiation of fees, and it also facilitates holding managers accountable to their investors.

In order to achieve greater fee transparency, institutional investors could ask GPs to provide reporting in the Template form. In our experience, large investors who

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insist on using the Template usually succeed in obtaining the information in the Template. If a GP agrees to provide such information to large investors, small investors are often able to tag along because the GP's burden to provide the information is significantly reduced.

Although many GPs have not adopted the Template, the market appears to be moving towards utilizing the Template and will continue to do so if LPs continue to insist on this transparency.

This article is provided for informational purposes only and is not intended and should not be construed as legal advice.

[1] Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Speech: "Spreading Sunshine in Private Equity," *Private Equity International ("PEI") Private Fund Compliance Forum 2014* (May 6, 2014), *available at* https://www.sec.gov/news/speech/2014--spch05062014ab.html.

[2] Marc Wyatt, Acting Director, Office of Compliance Inspections and Examinations, Speech: "Private Equity: A Look Back and a Glimpse Ahead," *PEI Private Fund Compliance Forum 2015* (May 13, 2015), *available at* https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html.

[3] Letter from State Treasurers and Comptrollers to Mary Jo White, SEC Chair (Jul. 21, 2015), *available at* https://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf. Signatories included District of Columbia Treasurer Jeffrey Barnette; California State Treasurer John Chiang; North Carolina State Treasurer Janet Cowell; New York State Comptroller Thomas P. DiNapoli; Virginia State Treasurer Manju Ganeriwala; Wyoming State Treasurer Mark Gordon; South Carolina State Treasurer Curtis Loftis, Jr.; Rhode Island General Treasurer Seth Magaziner; Vermont State Treasurer Beth Pearce; Nebraska State Treasurer Don Stenberg; New York City Comptroller Scott M. Stringer; Oregon State Treasurer Ted Wheeler; and Missouri State Treasurer Clint Zweifel.

[4] *Id*.

[5] *See id*.

[6] Under section 7514.7 of the California Government Code, California public

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investment funds must disclose such information annually in a report presented at a meeting open to the public. Section 7514.7 applies to new contracts entered into on and after January 1, 2017, and to all existing contracts for which a new capital commitment is made on or after January 1, 2017.

[7] The Schedule of Investment Managers and Fees in the SCRS's 2016 CAFR shows two categories of fees: (1) manager fees directly invoiced and (2) manager fees deducted on a net of fee basis.

[8] The intent of the new California law, which is set forth in the bill, AB 2833, is "to increase the transparency of fees paid by public investment funds to alternative investment vehicles." Also, the SCRS's 2016 CAFR states that "for greater transparency, the RSIC [Retirement System Investment Commission] makes a good faith attempt to account for netted fee amounts that are not necessarily readily separable."

[9] Transaction fees are the fees charged to a portfolio company in connection with activities such as asset sales and buying or selling the portfolio company.

[10] Monitoring fees are the fees charged to a portfolio company for private equity advisers' advisory services during the portfolio company's holding period.

[11] Ludovic Phalippou et al., *Private Equity Portfolio Company Fees*, Saïd Business School WP 2015-22, 1 (2016), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2703354.

[12] Eileen Appelbaum & Rosemary Batt, *Fees, Fees and More Fees: How Private Equity Abuses Its Limited Partners and U.S. Taxpayers*, Center For Economic and Policy Research, 5, 9, 26 (2016), *available at* https://cepr.net/images/stories/reports/private-equity-fees-2016-05.pdf.

[13] *See id*. at 12 13.

[14] Press Release, Securities and Exchange Commission, Blackstone Charged with Disclosure Failures: Private Equity Advisers to Pay Nearly $39 Million Settlement (Oct. 7, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-235.html.

[15] *Id*.

[16] Institutional Limited Partners Ass'n, https://ilpa.org/best-practices/reporting-template/ (last visited February 20, 2017).

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[17] See Template available at https://ilpa.org/best-practices/reporting-template/.

[18] *Id*.

[19] Institutional Limited Partners Ass'n, Fee Reporting Template: Suggested Guidance (2016), *available at* https://ilpa.org/wp-content/uploads/2016/10/ILPA-Reporting-Template-Guidance-Version-1.1.pdf.

[20] *Id*.

[21] *Supra*, note 17.

[22] Press Release, Institutional Limited Partners Ass'n, Leading GPs Endorse the ILPA Reporting Template (Nov. 3, 2016), *available at* https://ilpa.org/wp-content/uploads/2016/11/ILPA-Reporting-Template-Endorsement-Update-2016-November-FINAL-1.pdf.

[23] *Id*.

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