

Fund Fees and Expenses



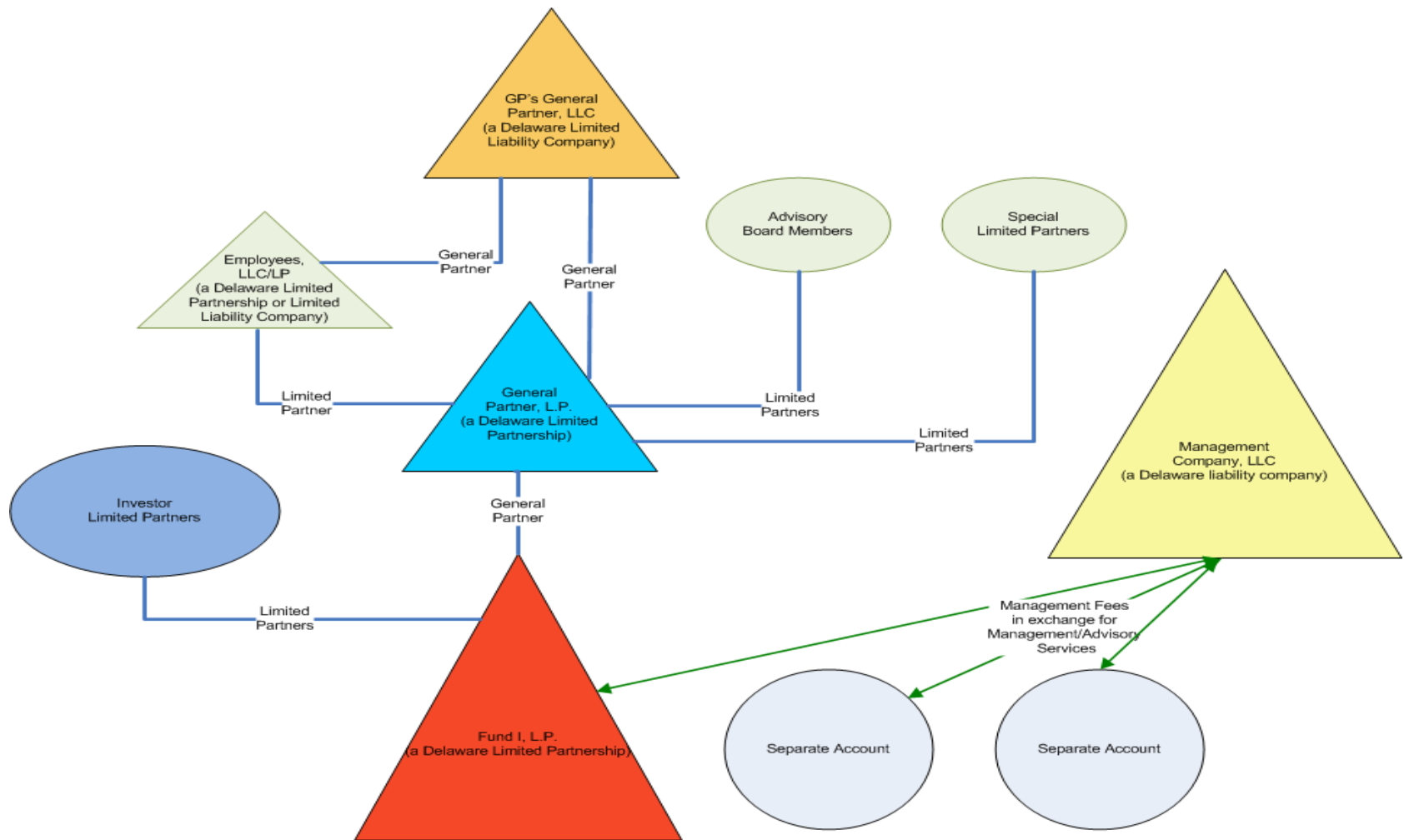
CFA Society – Fund Fees and Expenses

September 24, 2014

Agenda

- Typical fund structure and economics
- The Economics
- LPA Provisions
- Fund Due Diligence
- Legal Landscape
- PEI Survey
- What the SEC is talking about
- What the SEC's been saying
- What's Been the SEC Response
- Hot Topics on Expenses
- What's next

Typical Fund Structure



Typical Fund Waterfall



	Total Fund Size =	\$200,000,000		
			<u>General Partner</u>	<u>Limited Partners</u>
Capital Percentages			2.50%	97.50%
Initial Closing - Commitments	1/1/08		\$5,000,000	\$195,000,000
<u>YEAR 1 - ending 12/31/2014</u>				
Organizational Expense	\$800,000		-\$20,000	-\$780,000
Year 1 Management Fee	2.00%		\$0	-\$3,900,000
Investment A Purchased 1/1/14	\$20,000,000		\$500,000	\$19,500,000
Investment B Purchased 1/1/14	\$30,000,000		\$750,000	\$29,250,000
Other Fund Expenses 2014	\$150,000		-\$3,750	-\$146,250
Total Capital Contributed as of 12/31/14			\$1,273,750	\$53,576,250
Total Invested Capital as of 12/31/14			\$1,250,000	\$48,750,000
Total Contributions for Fees as of 12/31/14			\$23,750	\$4,826,250

Fund Economics- Nuances



- Manager Benefits
 - fee waivers credited to capital contributions
 - fee free/ carry free investing
- Deal by deal economics
 - At the fund or at the GP
- Special Allocations
 - Blocker and AIV structures for particular investors
 - LP triggered expenses
 - claims, books and records requests, special reporting

LPA Provisions

- **Organizational expenses**
- **Management Fees**
- **Deal expenses**
 - consulting, evaluation, T&E , legal accounting, investment banking, IT, brokerage, operating partners
- **Management of investments**
 - research, T&E, trustee, record keeping and other administration fees
- **Operating expenses**
 - fund audit, tax returns and K-1's; insurance; valuation services; taxes, fees, governmental charges; administrators; liquidator
 - parallel vehicles, AIVs, blockers
- **Dealing with Investors**
 - reporting, annual meeting, defaults, LPAC
- **Regulatory**
 - registration, SEC examination
- **Extraordinary**
 - litigation expenses (and damages), amendments, indemnification (advances)



- LP focus on expenses
 - **ILPA 2.0 (Jan 2011) Principle of Expenses -- “Alignment of Interest”**
 - The management fee should encompass all normal operations of a GP to include, at a minimum, overhead, staff compensation, travel, deal sourcing and other general administrative items as well as interactions with LPs
 - The economic arrangement of the GP and its placement agents should be fully disclosed as part of the due diligence materials provided to prospective limited partners. Placement agent fees are often required by law to be an expense borne entirely by the GP

Legal Landscape



Key Securities Laws

- **Securities Act**
(governs offers and sales of securities; exemption for private offerings)
- **Securities Exchange Act**
(regulates secondary trading of securities; reporting; broker/dealers)
- **Investment Company Act**
(regulates mutual funds; two exemptions for private funds)
- **Investment Advisers Act**
(regulates investment advisers; exemptions for \$150MM AUM; venture-only; family office exclusion)

Other Laws & Regulations

- **Employee Retirement Income Security Act**
(governs pension plan investments)
- **Bank Holding Company Act**
(restricts investments by BHCs)
- **USA PATRIOT Act**
(anti-money laundering rules)
- **Freedom of Information Act**
(public disclosure of private equity data)
- **Internal Revenue Code**

- Your firm is visited by the SEC or state regulator for a routine regulatory examination and you enlist a law firm or consultant to help guide you through the process. Who pays the legal or consulting fees?

	Total	AUM			
		Less than \$1bn	\$1bn to \$2bn	\$2bn to \$5bn	More Than \$5bn
Fund	29%	20%	0%	7%	17%
Management firm	61%	67%	100%	93%	83%
Split between both fund and firm	11%	14%	0%	0%	0%

	Strategy				
	Buyout	Growth equity	Debt	Real Asset	Other
Fund	11%	14%	33%	9%	0%
Management firm	83%	68%	67%	82%	100%
Split between both fund and firm	6%	18%	0%	9%	0%

What's the SEC been talking about?



- What's all the fuss about??
 - Obvious
 - Expenses paid by the fund are borne by LPs
 - Expenses paid by the Management Company are paid out of management fee
 - Less Obvious
 - Net cumulative funds return all capital contributions before carry
 - so what's the big deal?
 - Proceeds can be used to pay expenses too
 - 80/20 sharing?
 - Often Overlooked
 - Expense ratios (*cf mutual funds*)
 - Allocation among different vehicles
 - Documentation needs

What's the SEC been saying?

- January 31, 2012- Carlo DiFlorio- OCIE head
 - The role of management and the Board in compliance and ethics
 - Strengthening the SEC's National Exam Program
 - Delivering Mission Objective
 - preventing fraud
 - improve compliance
 - monitor risk
 - inform policy

What's the SEC been saying?

- Andrew Bowden – May 6, 2014 – “Spreading Sunshine in Private Equity”
 - OCIE consists of approximately 900 examiners who go out into the world and directly engage with registrants for the purpose of collecting information for the Commissioners and our colleagues on the staff. We are the “eyes and ears” of the Commission. We are responsible for conducting examinations of more than 25,000 registrants, including approximately 11,000 registered investment advisers, of which at least 10% provide services to at least one private equity fund.
 - At this point, we have initiated examinations of more than 150 newly registered private equity advisers. We are on track to complete our goal of examining 25% of the new private fund registrants by the end of this year.
 - Norm Champ – Sept 22, 2014 – SEC will achieve goal of 400 examinations by end of 2014.
 - By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser’s collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.

Hot Topics re Expenses



- Expense Policies and Procedures
- Allocation among portfolio companies
 - charge back of centralized services
 - offsets
- T& E, but mostly E
- Transaction Expenses
 - brokerage services
 - M&A limited exception

Hot Topics re Expenses



- Operating Partners
 - consultancy fees
 - management company expense
 - fund expense
 - portfolio company expense
 - portfolio company payments
 - portfolio company director fees
 - portfolio company equity
 - management fee offsets
 - disclosure



- LPAs
- SEC Examinations
- SEC Enforcement Actions
- SEC Speeches
 - Drew Bowden – May 6, 2014
- Releases and FAQs
- No-Action Letters
- Anecdotal information

SEC Response – Clear Energy Capital

- 2.25.14 Clean Energy Capital
- Clean Energy Capital, LLC , a RIA, and Scott A. Brittenham CEC's founder, president, and main portfolio manager
- CEC raised and managed 20 private equity funds which all invested in private ethanol production plants through various portfolio companies
 - CEC and Brittenham misappropriated more than \$3 million from the funds by improperly allocating CEC's expenses to the funds without adequate disclosure to investors
 - to enable the funds to pay for these inappropriate expenses, CEC and Brittenham secretly caused the funds to borrow money from CEC at unfavorable rates, pledging the funds' own assets as collateral
 - other charges related to shenanigans regarding dividend distributions, misrepresentations regarding principal investments, and failure to abide by the custody rule

SEC Response – Clear Energy Capital



- All of the expenses incurred by CEC and the Funds were grouped into three broad categories:
 - CEC-only expenses;
 - Fund-only expenses;
 - Split Expenses
- CEC generally allocated 70% of the Split Expenses to all of the Funds based on each Fund's net capital contributions, and 30% to CEC. This 70-30 Split Ratio was used because CEC had determined that roughly two-thirds of its expenses related to the operation of the Funds. As a result, even though the Split Ratio was applied to each fund, the ratio was not derived from expenses actually attributable to a particular Fund.
- The improperly allocated expenses:
 - CEC employee compensation and CEC office expenses included the salaries of the majority of CEC employees, executive bonuses, health benefits, retirement benefits
 - included \$1.1 million of these went to Brittenham, including 70% of a \$100,000 bonus he awarded himself in 2009
 - education and tuition costs for CEC employees, employee hiring costs, gifts, group photos, legal fees for estate planning, maintenance costs on CEC's offices, CEC checks and letterheads, office and mobile telephone, bottled water, office lunches, car washes and insurance, holiday cards,
 - CEC's registration expenses, and business cards, and
 - Charges relating to transporting Brittenham's daughter to and from school.
- Not only not disclosed but it was contrary to what was disclosed

SEC Response – Clear Energy Capital

- Unauthorized loans to cover Fund expenses,
 - 11.8% up to 17.3%
 - secured by Fund assets
- Loans represented a conflict of interest
- Post-loan amendments to the LPAs to permit the loans; made unilaterally only with GP consent

- Case settled in August 2014.

SEC Response – Operational Integration

- Release No. 3858- June 20, 2014,
- SEC concluded that two investment advisers were related entities that essentially comprised a single advisory business and should have registered with the SEC because the integration of the two meant that they each failed to qualify for any exemption.
 - venture-only exemption,
 - the under \$150 million exemption.
- Each had filed as an ERA indicating the common control and ownership between the two reporting advisers.
 - various employees and associated persons of the venture firm adviser held ownership stakes in the venture firm and in the general partner and management company entities of the other adviser: a
 - managing director of the venture firm adviser held, in the aggregate, **majority** ownership interest in the venture firm adviser and indirectly held in the aggregate **more than a 25%**, but less than a majority, ownership interest in the other reporting adviser.
 - two of the three members of the non-venture firm's investment committee, which had **sole and exclusive** authority to approve any investment by that firm's managed fund, also served as managing directors at the venture firm and were significantly involved in providing investment advice to the venture fund.
 - Among the other damaging facts were the following:
 - overlapping employees and associated persons, including individuals who provided investment advice on behalf of both firms,
 - marketing materials indicating the "partnership" of the two firms and references to the non-venture firm's ability to leverage and benefit from its relationship with the venture firm, including through outsourced back office functions"
 - cross-solicitation of investors
 - lack of information security policies and procedures in place to protect investment advisory information from disclosure to the other firm
 - use of one firm's email system to conduct the business of the other firm
 - shared back office functions.
- SHARED EXPENSES AMONG RELATED FIRMS
- SEC concluded that the two investment advisers were "not operationally independent of each other and thus should have been integrated as a single investment adviser " for registration and exemption analysis purposes.
- Fines, disgorgement and penalties totally \$300,000

SEC Response - Lincolnshire

- 9.22.14 Lincolnshire
 - SEC charged a PE firm manager with breaching “its fiduciary duty to a pair of private equity funds by sharing expenses between a company in one’s portfolio and a company in the other’s portfolio in a manner that improperly benefited one fund over the other.”
 - “while Lincolnshire Management integrated the two portfolio companies and managed them as one, the funds were separately advised and had distinct sets of investors.”
 - “Despite developing an expense allocation policy as part of the integration, it was not followed on some occasions, resulting in the portfolio company owned by one fund paying more than its fair share of joint expenses that benefited the companies of both funds.”
 - “Advisers that commingle assets across funds must do so in a manner that satisfies their fiduciary duties to each fund and prevents one fund from benefiting to the detriment of the other.”
 - \$2.3 million

What's Next ----- “Never to Me...”



- Whistleblower System
 - largest ever WB award announced on 9.22.14 -- \$30MM
 - 4th to a non-U.S. person
 - Be careful whom you employ
- Examination System
 - TCRs
 - presence
 - routine
 - “get acquainted” calls
- Referral to enforcement and ever present threat

What's Next – the Winds of Change



- Regulation is not going away
- Disclosure and Policies and Procedures are Key
- Enforcement Actions will proliferate
- All compounded by
 - Challenging deal environment
 - Valuations are high
 - Corporate carve-out transactions
 - Changing technology
 - Changing tax laws

Crystal Ball Store Greatly Needed

Questions & Answers



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Julia D. Corelli

215-981-4325
corellj@pepperlaw.com

Pepper Hamilton LLP
Attorneys at Law