Risk Management Spotlight

Private Equity Firms – A New Dawn Coming In Fee Transparency

*By **Corwin Chen**, principal, **C&A Consulting***

Much can be said regarding the recent U.S. **Securities and Exchange Commission** (SEC) inquiry into the fees that private-equity firms charge. While many investors have previously wondered about the fees that firms charge, fee disclosures haven't been all that transparent; but now that all seems to be changing. The SEC, through the Office of Compliance Inspections and Examination (OCIE), has been conducting presence examinations of certain private-equity firms, with a focus on fees charged to investors. The regulator identified potential problems with fees in approximately 400 of the 2,700 private-equity firms examined. The regulator's review confirmed what many believed that certain fees charged were questionable and potentially outside the realm of what would be permitted as detailed under the limited partnership agreement. In some cases, it was alleged that some fees were not properly calculated or charged consistently. On the flip side, there are appropriate and legitimate fees that private-equity firms do charge investors, and the SEC has not questioned them.

For those private-equity firms where the OCIE found deficiencies in charging fees, those situations will have to be individually addressed to satisfy the regulator and their investors. Depending on the individual situation, this may entail a long process and it might get uglier, from a legal perspective, before there is a final resolution. While the regulator's examinations found an unacceptably high percentage of fee-related discrepancies from the firms that they examined, there were also those firms that passed the examination.

Private Equity is an Important Investment Asset Class

Private equity is a multi-trillion dollar industry and is an important asset class to all investors. Experts can debate over the performance and merits of the industry, but private equity is not going anywhere, and it does have a legitimate place in the investment community in a diversified investment portfolio. It is important, and also prudent, that the private equity industry address the findings of the SEC examinations related to fee allocations and expenses to investors. It will be incumbent upon each private-equity firm to ensure that they can address with investors on how fees are charged. Firms can expect this topic to be raised in the investor's due diligence process. If not handled properly, firms may find themselves in a difficult investor situation trying to raise capital and possibly losing out to other private-equity competitors that do a better job of providing fee transparency.

Private Equity Fees

Private equity firms' fee structures are fairly complicated. Firms typically charge an annual management fee of 1.5-2% of investors' committed capital, while keeping profits from investments of typically from 15-20%. To add to its complexity, there are several ways to calculate management fees, such as a percentage of committed capital, called capital or total costs of assets acquired. There are also several ways to calculate incentive fees, such as being paid out from the first dollar of profit, after some sort of hurdle rate (specified return), or preferred return. Each will result in a very different amount in the management or incentive fee.

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This is in addition to other ancillary fees that are charged related to the acquisition and management of portfolio companies. Ancillary fees and expenses related to acquisitions, divestitures and management of the portfolio companies are usually charged directly to the portfolio companies or fund. These charges are not offset against the management fee. In structuring the partnership for these types of investments, the general partner is typically the private-equity firm and limited partners are typically the investor. They work together for the common goal of maximizing investment returns.

A fund management fee is paid to a private-equity firm for them to think of investment strategies and to manage the investment portfolio. Sounds simple, but there is a tremendous amount of work that goes into synthesizing those ideas, formulating a plan to acquire a company and properly executing. Incentive fees are intended to compensate private-equity firms to invest profitably, and ultimately, for their investors.

How to Achieve Fee Transparency with Investors

Achieving full fee transparency starts with the firm having robust policies and procedures related to fee allocations and direct charges to the portfolio companies. Policies will define how fees and expenses are calculated, allocated and ultimately charged. Procedures will describe the process and controls (supervisory oversight) in place to ensure the accuracy of the fee calculation, proper allocation and portfolio company charges.

While this may sound simple, fee structures are usually fairly complicated and wide ranging, covering various types of expenses. The firm should identify all fees and expenses related to the investment from inception, acquisition, maintenance and disposal of the investment. Fees and expenses should be categorized by type of expense along with a detailed description and the allocation of these expenses to the management fee or directly to the portfolio of companies or fund. Once all fees and expenses have been identified, they should be compared to the limited partnership agreement to determine whether the fees and expenses have been appropriately handled and disclosed according to the agreement. If not, then the firm should notify the investor to discuss, and come to an agreement. Going forward, limited partnership agreements that have been a little vague on details of handling of fees and expenses will have to provide sufficient details so investors can understand and accept the handling of fees and expenses. In the end, greater transparency will be good for the private-equity industry and all parties involved.

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