In the movie *Jerry Maguire*, Rod Tidwell is not sure he can trust the title character, his agent, to represent his interests fairly. He screams, “Show me the money, Jerry!” to emphasize Maguire’s obligations to his client. Over the past five years, LPs and regulators have been having similar conversations with Private Equity GPs. In this context, “show me the money” means full transparency about what LPs pay for and the revenue GPs actually receive.

Fees and expenses continue to garner significant scrutiny in the Private Equity industry—receiving an almost constant glare from the press, regulators, institutional investors, pension beneficiaries and federal and state governments. In Part 1, *Uncovering the Costs and Benefits of Private Equity*, we investigated the amount of fees charged in Private Markets, and whether the returns justify these costs. Here, in Part 2, we explore trends in fees and expenses and how the energy and attention given the subject have changed the behavior of market participants.

Based on our review of regulatory actions, as well as our interactions with GPs and LPs, we conclude that behaviors with respect to fees and expenses have improved: offsets are higher and there is more disclosure across the board. Notwithstanding these improvements, a number of barriers remain. To continue moving the industry in this positive direction, there are a number of steps that LPs large and small can and should take.

1 Fees are high but worth it—on a net basis and when adjusted for risk and correlation.
Spreading Sunshine

The focus on fees and expenses has been a healthy exercise for a maturing industry. LP and GP interests are more aligned, and LPs can monitor GPs more easily. Due to increased regulatory scrutiny, GPs are institutionalizing their policies, procedures and back office infrastructure. It has also led to initiatives from the LP community to clarify what level of disclosure would represent best practice.

Until passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") Private Equity firms in the United States were largely unsupervised. Dodd-Frank amended the Investment Advisers Act of 1940 to require most US private fund advisers with at least US$150 million in assets under management to register with the Securities and Exchange Commission ("SEC"). It also instructed the SEC to examine newly registered advisers through focused, risk-based reviews.

This trend toward greater supervision is global. Although more regulated than their American counterparts, Private Equity firms in Europe have not necessarily been more transparent; hence the passage of the Alternative Investment Fund Managers Directive in June 2011. Through both sets of regulations, Private Markets are under an unprecedented level of scrutiny.

In October 2012, the SEC’s Office of Compliance Inspections and Examinations ("OCIE") announced that its National Exam Program Initiative would conduct “Presence Exams” of approximately 1,100 Private Equity advisers newly registered under Dodd-Frank. In May 2014, in what has come to be known as the “Spreading Sunshine in Private Equity” speech, Andrew Bowden, OCIE’s Director, relayed initial findings from the first batch of Presence Exams, which consisted of more than 150 Private Equity advisers. Mr. Bowden highlighted deficiencies found across 50% of examinations, including:

1. Passing operating partners off as members of the full team;
2. Not disclosing accelerated monitoring fees when monitoring agreements are first signed;
3. Hiring related-party service providers that deliver services of questionable value; and
4. Using different valuation methodologies when raising funds or preparing marketing materials.

The SEC had determined that, despite LPs’ best efforts, investors are often unable to detect violations of law or material weaknesses of controls in the handling of fees and expenses.

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The Details Matter

The majority of Limited Partner Agreements ("LPAs") in today’s marketplace provide for a 100% fee offset. These provisions, however, should be examined carefully: they often carve out certain fees or revenue streams from the offset and disclosure provisions, including fees paid to affiliates, or fees received as compensation for the services of employees of the fund manager working full time at a portfolio company or entrepreneurs in residence.

The fees that are neither carved out nor disclosed are the most problematic; LPs are unable to obtain a clear picture of the entirety of fees received by a GP and therefore unable to determine if their interests are aligned with the GP. Even a sophisticated investor with a robust diligence process may fail to account for all of the fees a fund manager receives.

Fund managers who segregate service providers from their corporate structure present additional problems. Because they are segregated, they are not subject to the fee offset provisions—often they are not subject to the disclosure provisions either. In Fenway, the termination of services provided by Fenway Partners and the re-engagement for these same services with an affiliated entity was done, according to the SEC, so that any fee revenue received by the new entity would not offset the management fee—an arrangement that was not disclosed to investors.5

In some instances, the SEC found expenses that were allocated solely to the main fund vehicle and kept separate from parallel funds created for friends, family or preferred investors—a practice that was not disclosed to investors. GPs can also misallocate expenses often both horizontally across funds (e.g., Lincolnshire) and vertically between the adviser and the funds it manages, as exhibited in Cherokee.

These cases highlight the need for GPs to implement their own agreements diligently. They also underscore the risks in more complex legal documentation. Greater scrutiny on the treatment of these fees and expenses, from both regulatory bodies and LPs, has resulted in these situations becoming less frequent.

5 Refer to the Appendix for more details on this and other cases.
Although it took the SEC four years to come to a realization that seemed obvious to many investors, the LP community has generally welcomed the SEC as an ally in the fight to improve disclosure and alignment around fees and expenses. Nevertheless, some LPs have criticized the SEC for a dearth of enforcement actions—eight in the past four years—most of which did not require admissions of guilt.

**It’s Getting Better**

The SEC’s increased oversight has definitely had a positive effect on the behavior of GPs and LPs alike. Ten years ago, 50% fee offset provisions were commonplace. Today the “market” term is 100%. Figure 1 illustrates the trend towards greater offsets. GPs have also become more informative: Form ADV filings include more detail regarding fees and expenses, and their marketing materials define Operating Partners’ roles more clearly. GPs are also using Limited Partner Advisory Committees more often to disclose sensitive fee and expense information. The SEC has noted accelerated monitoring fees are on the decline. This practice has become rare enough that, when used, GPs often request an LP vote for approval to avoid the appearance of any impropriety.

During due diligence, prospective investors look closely at the portfolio company fee revenue generated from prior funds, discuss what fees GPs anticipate receiving in future funds and how the GP will allocate expenses. Fee, expense and disclosure provisions are now negotiated vigorously to provide not only more favorable terms and information but much more precision. The amount of information that LPs possess today, although not always complete, is the highest it has ever been, and continues to increase.

Standard reporting guidelines were first widely adopted by Private Equity firms in continental Europe and adopted by the European Private Equity and Venture Capital Association (“EVCA”) in 2005. EVCA’s successor, Invest Europe, updated these guidelines in 2015 to emphasize the importance of fully disclosing fees. Similarly, the desire for a standardized reporting template is surfacing in the United Kingdom. In July 2016, the Investment Association, which represents British managers that collectively manage more than £5.5 trillion for clients around the world, appointed an independent advisory board that is tasked with creating a standardized template.

Earlier this year, the Institutional Limited Partners Association (“ILPA”) developed a reporting template designed to increase uniformity in disclosure, promote transparency and align interests between investors and fund managers. ILPA worked closely with its members, industry trade groups and fund managers to ensure that the template would neither lead to undue costs nor create unnecessary administrative burdens. The template provides for reporting on fees, expenses, carried interest and all capital collected from investors and portfolio companies in an effort to disclose the source of all revenue received by a GP generated in connection with its activities on behalf of the fund.

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**FIGURE 1 | AVERAGE MANAGEMENT FEE OFFSET**

![Average Management Fee Offset](source: StepStone SPI database.)

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6 StepStone has noticed a trend toward the elimination of this practice in the co-investments in which we participate.
The template delineates these revenues by type of fee and source, including management fees, portfolio company fees—especially those that are not offset—and fees received in connection with co-investments. The template also includes unapplied fee offsets, a key piece of information that, along with fees received in connection with co-investments, was not typically disclosed to LPs. The template also itemizes expenses in greater detail and is more consistent with traditional profit and loss statements. Thus, LPs can make cross-fund comparisons more readily. ILPA focused significant attention on the defined terms in this section and worked closely with external stakeholders to define these terms precisely.

ILPA's template also provides a baseline for the information that investors should expect to receive; however, some question whether it can be applied across all fund types. Critics argue that the template is most suited for large buyout funds and largely irrelevant to venture funds. While many state pension plans have endorsed the template, the number of stakeholders that actually adopt it remains to be seen. Regardless, the ILPA reporting template is a valuable tool that informs the negotiation of fee, expense, reporting and disclosure provisions.

The LP community, which sees the value in the standardization of disclosure that a template would give, has driven the development of a standard reporting template. Now faced with more requests for customized investment reports, GPs are starting to come around; however, few have the resources to provide customized reports to LPs and many are concerned about how these data will be used. Global adoption of a standardized reporting template would add value to investors with international portfolios and to GPs with funds that reside in jurisdictions around the world.

More Light than Heat

Much of the progress made on fees, expenses and transparency affects incremental fees and expenses.\(^7\) Management fees and carried interest, on the other hand, have remained relatively unaffected by regulatory scrutiny. Critics say the SEC’s sunshine has provided light, but little heat for investors who are feeling left in the cold by Private Equity’s fee burden.

Reducing fees or conceding other economic terms has concentrated costs for the GP and diffuse benefits to LPs. This dynamic strengthens the GPs’ negotiating leverage, counter-intuitively, because the cost of concessions to the GP is much higher than the benefits to any individual LP negotiating those terms.

The negotiation process also presents unique challenges to LPs. When LPs can drive terms, such as when they are anchor investors or invest with first time managers, the favorable terms often benefit only their investment, and not the investor base as a whole. Unless represented by experienced advisers, LPs have little, if any, knowledge about what similarly situated investors are negotiating with GPs. Even if they did, they often cannot use this information due to fiduciary issues and anti-collusion laws.

Many LPs hesitate to challenge GPs for fear of getting their allocations cut, or worse, kept out of a fund altogether. Others face internal pressure to endorse the status quo by not objecting to terms that are consistent with prior funds in which LPs invest currently. For some LPs, it is simply inertia: investing with existing funds on the same terms or investing in a named fund with a proven track record but less favorable terms is easier and less risky. For others, because they are not paid for excess performance, they perceive only downside career risk for investing outside of accepted, brand name funds. This stagnation creates substantial barriers to entry and reduces competition, thus diminishing the likelihood that fees will be lowered. As a result, some believe that government intervention, either through legislative or regulatory action, is the only way to address fee disclosure.

\(^7\) In *Uncovering the Costs and Benefits of Private Equity*, we found that these incremental fees and expenses represent about 10-15% of the management fees that GPs charge.
The Australian government and the California state legislature have proposed actions that would impose greater disclosure requirements on GPs and LPs. LPs are concerned about the unintended consequences of these measures.

The progress of these regulations in Australia is a source of consternation among LPs. Australia’s equivalent to the SEC, the Australian Prudential Regulation Authority, has proposed regulations that would require the superannuation industry to disclose all investments down to the portfolio company level. In theory, this will help their members make better decisions when selecting pension fund providers.

Implementing this well-meaning rule has been fraught with delays and is now in its third year of review. GPs are reluctant to have information about their holdings made public. A number of GPs with strong track records and consistent demand from LPs have refused commitments by Australian LPs because this rule could be promulgated. The protracted consultation could result in disclosure requirements that are limited to fund level information, which should mollify GPs and end this period of uncertainty.

California’s legislation would require a full accounting of fees and expenses paid by portfolio companies. Assembly Bill 2833 would penalize GPs that refuse to disclose this information by barring them from entering into contracts with California’s public funds. Although less controversial than Australia’s proposed regulations, some Californian public pension plan partnerships have expressed concern that GPs will choose instead to accept commitments from investors without the same disclosure requirements.

In other Private Markets such as Infrastructure, Real Estate and Agriculture, where the weight of money has been invested in core style strategies that deliver a risk/return below that of Private Equity, the fee structures have been lowered accordingly. Base fees tend to be lower (e.g., 1.75% and below) and performance fees are often below 20%, albeit with lower hurdles. As returns continue to compress, there is sustained pressure on fee structures. GPs most successful at resisting this pressure are those that are heavily in demand and employ strategies that require a constrained fund size. Another important trend is that LPs, particularly those with large amounts of capital to deploy, who have become increasingly experienced at investing in these sectors have a desire to have direct exposures. Often such LPs are looking to hold such assets for extended periods. With this has come a shift towards splitting fees between transactional and asset management functions. The combined effect of these trends has led to more competitive fee structures.

"Help Me Help You"

Ultimately, the title character in Jerry Maguire has his client’s best interests aligned with his own. In one of the more memorable scenes, Jerry implores Rod to help him achieve Tidwell’s goals. Jerry has changed his approach to their relationship, and now needs Rod to change his own behavior to get the best deal.

It is an imperfect metaphor: not every GP is Jerry Maguire, and not every LP can be Rod Tidwell. For example, tools such as co-investment programs and anchor commitments help some LPs reduce their overall fee burdens. Some investors can leverage their size and influence to gain better transparency through side letter provisions or Advisory Committee participation. These “behaviors” require resources and scale that is beyond the capacity of many LPs.

Many GPs, however, are looking for ways to recognize their best LPs; we believe that the number of potential "Rod Tidwells" is higher than the LP community might think. We believe this because we help our clients navigate these waters regularly. They benefit from our information advantages—our SPI database garners detailed summaries on thousands of LPAs—the volume of capital we represent and our ability to source, diligence and execute fee-friendly transactions such as co-investments, secondaries and anchor commitments. Private Equity will remain a fee-rich asset class, mainly because the returns are worth it. But, LPs must make sure that they are paying for performance, that interests are aligned and that they have the information to hold GPs accountable.

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Appendix

LINCOLNSHIRE MANAGEMENT, SEPTEMBER 2014
Lincolnshire Management was charged with breaching its fiduciary duty to Lincolnshire Equity Fund, a US$119 million fund (“Fund I”), and Lincolnshire Equity Fund II, a US$315 million fund (“Fund II”), by sharing expenses between a company in one fund’s portfolio and a company in the other’s portfolio despite the two funds being separately advised and having distinct sets of investors in a manner that improperly benefited one fund over the other. Although an expense allocation policy was formulated 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. Lincolnshire agreed to pay more than US$2.3 million to settle the SEC’s charges—US$1.5 million in disgorgement, plus US$358,112 in prejudgment interest and a US$450,000 penalty.

ALPHA TITANS, APRIL 2015
Alpha Titans LLC and two of its executives were charged with using the assets of two affiliated private funds to pay US$350,000 of the firm’s operational expenses without accurate and complete disclosure to LPs. The SEC also charged an accountant who conducted the outside audit of preparing misleading financial statements that the firm sent to investors. To settle the SEC’s charges, Alpha Titans agreed to pay disgorgement of US$469,522, prejudgment interest of US$28,928, and a penalty of US$200,000. The firm and the three individuals settled the charges without admitting or denying the SEC’s findings.

KOHLBERG KRAVIS ROBERTS & CO. L.P., JUNE 2015
Kohlberg Kravis Roberts & Co. L.P. (“KKR”) was charged with misallocating more than US$17 million in “broken deal” expenses in a breach of its fiduciary duty. KKR agreed to pay nearly US$30 million to settle the charges—US$14 million in disgorgement, US$4.5 million in prejudgment interest and a US$10 million penalty. An SEC investigation found that during a six-year period ending in 2011, where KKR invested US$30.2 billion in 95 transactions, KKR incurred US$338 million in broken deal or diligence expenses related to unsuccessful buyout opportunities and similar expenses, but did not allocate any of these expenses to KKR’s co-investors, including KKR executives. KKR did not expressly disclose in its fund LPAs or related offering materials that it did not allocate broken deal expenses to the co-investors.

THE BLACKSTONE GROUP, OCTOBER 2015
Three Private Equity fund advisers within The Blackstone Group agreed to pay nearly US$39 million to settle charges in connection with their failure to disclose accelerated monitoring fees and discounts on legal fees in connection with the activities of three funds whose aggregate capital commitments total approximately US$30 billion. Nearly US$29 million of the settlement was distributed back to affected fund investors. Blackstone typically charged a monitoring fee to each portfolio company which covered advisory and consulting services for a period of ten years. Before the private sale or initial public offering of certain portfolio companies, Blackstone terminated monitoring agreements and accelerated the payment of future monitoring fees, including in some instances, when monitoring services would no longer be provided. Some of the accelerated fee payments were used to offset management fees. While Blackstone disclosed its ability to collect monitoring fees, the SEC found that Blackstone failed to adequately disclose the acceleration of these fees until after they had already been taken the accelerated and that such payments effectively reduced the value of the portfolio company prior to the sale to the detriment of the funds and their investors. The SEC investigation also found that fund investors were not informed about a separate fee arrangement by an outside law firm that provided Blackstone with a much greater discount on services than the discount that the law firm provided to the funds.
**FENWAY PARTNERS LLC, NOVEMBER 2015**

Fenway Partners LLC and four executives were charged with failure to disclose conflicts of interests to a fund client and investors when fund and portfolio company assets were used for payments to former firm employees and an affiliated entity. Fenway Partners entered into contracts with certain portfolio companies held by Fenway Capital Partners Fund III L.P., a US$680 million fund under which the companies paid fees to Fenway Partners that were offset against management fees. Fenway caused certain portfolio companies to terminate their payment obligations to Fenway Partners and enter into consulting agreements with an affiliated entity named Fenway Consulting Partners LLC, which provided similar services and often through the same employees. Fenway failed to disclose these payments to investors and fees totaling US$5.74 million were not offset against the management fee. Fenway Partners and the four executives, agreed to jointly and severally pay disgorgement of almost US$8 million and prejudgment interest of over US$800,000. They also agreed to pay penalties totaling US$1.5 million.

**CHEROKEE INVESTMENT PARTNERS, LLC, NOVEMBER 2015**

Cherokee Investment Partners, LLC and Cherokee Advisers, LLC were charged with causing their funds, whose aggregate capital commitments total US$1.75 billion, to pay for expenses related to the firm’s registration as an investment adviser under the Advisers Act, expenses related to a third-party compliance consultant and expenses related to responses to the SEC exam and SEC enforcement staff totaling US$455,698.

According to the SEC, while the funds’ organizational documents disclosed that the funds would bear expenses arising out of the operation and activities of the funds, the documents did not indicate that the funds would be charged for the advisers’ legal and compliance expenses. The advisers had already voluntarily reimbursed the funds in the amount of US$455,698, the full amount of the expenses, and were assessed a US$100,000 fine.

**JH PARTNERS, LLC, NOVEMBER 2015**

The SEC charged JH Partners, LLC (“JHP”) with failure to disclose conflicts of interest created by loans of US$62 million made by principals to the funds’ portfolio companies, which, in certain cases, created positions senior to those of the funds. JHP also caused more than one fund to invest in the same portfolio company at differing priority levels and/or valuations, potentially favoring one fund client over another. JHP failed to disclose these conflicts of interest and when certain investments exceeded limitations set forth in the funds’ LPAs to the advisory boards of the funds. JHP agreed to subordinate the direct loans to the funds’ investment interests, forego any rights to pursue repayment under the security agreements on certain loans and waive US$24 million in management fees and carried interest. JHP also agreed to pay a civil money penalty in the amount of US$225,000.

**BLACKSTREET CAPITAL MANAGEMENT, JUNE 2016**

An SEC investigation found that Blackstreet Capital Management and Murry N. Gunty performed in-house brokerage services rather than using investment banks or broker-dealers to handle the acquisition and disposition of portfolio companies for a pair of private equity funds they advised. The investigation also found that the firm engaged in conflicted transactions and inadequately disclosed fees and expenses. Blackstreet fully disclosed to its funds and their investors that it would provide brokerage services in exchange for a fee, yet the firm failed to comply with the registration requirements to operate as a broker-dealer. Blackstreet charged fees to portfolio companies in one fund for providing operating partner oversight, but the fund’s LPA failed to disclose that Blackstreet received such fees. Blackstreet used fund assets to pay for political and charitable contributions as well as entertainment expenses without authorization under the fund documents or LP consent. Without admitting or denying the findings, Blackstreet agreed to be censured and Blackstreet and Gunty must cease and desist from further violations while paying a combined disgorgement of US$2.3 million, including US$504,588 that will be distributed back to affected clients. They also agreed to pay US$283,737 in interest and a US$500,000 penalty.
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