Finding your way on fees

EisnerAmper compliance consultants Gary Swiman and Carmine Angone share a few thoughts on how to feel confident about the thought of SEC inspectors showing up at your door

It seems as though not a day goes by without some mention of the US Securities and Exchange Commission's (SEC) focus on private capital funds and their investment advisers. After reading many of these articles and comments being made by Andrew Bowden, Director, Office of Compliance Inspections and Examinations, one may wonder whether private funds' methods of conducting business are rife with regulatory inflection points. While the SEC is not in the business of telling advisers how to run their businesses, they do identify when an operating model presents certain risks and what those risks may be.

So how exactly are many private equity advisers addressing these heightened regulatory concerns?

One option that's experienced a recent surge in popularity is an independent inspection style review of the firm's operations. These reviews can assess practices around the allocation of fund expenses among client accounts (for purposes of this section client means private fund) and the corresponding issuing of an expense certification as to the appropriateness of allocations. This type of review involves both seasoned compliance professionals working side-by-side with experienced accountants with auditing experience, operating as one unified team.

The purpose of the review is to simulate what the SEC would scrutinize when performing an SEC examination, by looking at all the documents, contracts and disclosures, outside business interests, processes flows, internal controls, and the breadth and depth of the adviser's compliance program. It also includes an audit-like review of all payments (including invoices) made by funds, portfolio companies, parties involved in vendor selection and revenue inflows, among other areas.

What to watch for

One of the key tasks in these reviews is understanding the adviser's interpretation of disclosures found in the limited partnership agreements (LPA), which is the primary document used to allocate expenses and fee-sharing. As an example, LPA's general disclosure that the adviser can do all acts and perform all deeds necessary to carry out the business operations of the fund can be open to interpretation. The LPA language is designed for the specific fund and not for management to independently do all acts and perform all deeds relating to sharing of an invoice among other funds with separate LPAs (that may or may not have the same language). This occurs when an invoice is addressed to one fund and management decides to allocate the expense to other funds that are the beneficiary of either, for example, the service provided or legal decision rendered.

Trickier still are instances when an invoice is provided to management with a lump sum amount and management allocates the entire expense over a number of funds, but not all, that are named on the invoice without identifying a breakdown of the expense among the funds. The best way to handle these situations is to either have the vendor resend revised separate invoices or to allocate the expenses over all the funds you believe have benefited from the service provided, subject to confirming the authority to do so from outside counsel. As a final step here, best practice is to coordinate with your compliance department to collectively craft a carefully worded memo to file whenever these or similar situations occur.

Swiman: reading the tea leaves on compliance

In addition to the above, there have been instances of management making decisions to allocate expenses pro-rata based on total capital commitments, or even split over all funds regardless of size, without any disclosures in governing documents such as "the GP may equitably allocate expenses in any manner it deems appropriate in its sole and absolute discretion among funds under management."

There have also been other instances where management changed its customary expense allocation methodology because the cost being charged for services rendered to a specific fund would have a material impact to those specific investors – which prompts the manager to instead allocate the expense across other funds under management. The rationale here is to share the expense among related funds who may have also been a beneficiary, as determined by management, of the service performed by a third-party vendor. On the face of it, and with appropriate authorization to do so, this can be appropriate. However, this decision may raise eyebrows if it's discovered that investors in other funds managed by the adviser end up sharing an expense for a service performed for another fund specific purpose that is based on the request or requirement of an anchor investor. At the least, the adviser would need to document its rationale for changing its customary allocation process in a memo to file and obtain compliance and advisory board approval.

On the disclosure front, some advisers do not specifically disclose how expenses are allocated but do disclose the types of expenses clients may incur, in Part 2A of their Form ADV. Although not required, this may be a good control and compliance practice, as the SEC looks at consistency of disclosure in all externally disseminated information from the adviser during a routine inspection and not just a sweep examination. It also provides a prospective investor with information that may be important in making a decision to invest in one of the funds managed by the registered investment adviser.

Angone: be inspection-ready

One of the last items of mention relates to consultant arrangements and the agreements that impact portfolio companies. The termination provisions of many of these arrangements are extremely vague and at times missing from the agreement. But if provided in the agreement, for example, it will indicate that either party may terminate the agreement upon notification of either party. To avoid any doubt, managers are clarifying this language by linking the fee section to the termination provision, such as, fees will terminate upon the termination of the agreement, and revising the contract termination provision to immediately terminate upon the occurrence of an event, such as when a portfolio company is sold or is subject to an IPO.

Looking down the road

In reaction to this changing regulatory environment, private capital advisers are bolstering their compliance efforts through the onboarding of additional resources and enhancements to their compliance program. In essence, where we are seeing changes is largely around how advisers configure their staffing and modifications to their policies and procedures.

It is not uncommon for the Chief Compliance Officer role to be a dual responsibility of the Chief Financial Officer, the Chief Operations Officer or General Counsel. However, this practice is starting to change as the compliance responsibilities of these advisers are expanding and as issues come to light, they are realizing that compliance requires the attention of a seasoned professional with the requisite experience to identify and deal with matters such as those described above. When the CCO is a key person to the investment process, this can put that person at risk and even potentially jeopardize the adviser's reputation and years spent to build a successful advisory business. In fact, a client wisely stated during a review of findings that, "if you are finding these issues related to just expenses, I am wondering what else we are doing that could hurt us."

Private fund advisers, based on our observations, are rethinking their entire compliance program in a number of ways. First, they are adopting industry practice to reasonably ensure that there is a strong tone of compliance from the top down. This message is being sent directly by senior management and being demonstrated by ensuring that the CCO is included in virtually every aspect of senior management decisions and activities. Also compliance policies, procedures, risk metrics, periodic forensic testing and the annual review required under Rule 206(4)-7 is including in more depth other areas of the firm, including for instance the CFO's team, advisory board and decision-makers. In the end, that will help SEC firms feel confident should inspectors, intent on finding any wrongdoing, come knocking on their door. ■

Gary Swiman is an audit partner with EisnerAmper's newly constructed "Compliance and Regulatory Services" unit. Carmine Angone is a director within that same unit.