WHAT'S THE FUSS ABOUT PRIVATE EQUITY FEES?

Public Pension Financial Forum
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North Charleston, SC

Moderator:
Todd Boudreau, Chair
Private Funds|Buyouts
Foley & Lardner LLP

Panelist:
Andrew Kurzon, Partner
Private Funds
Foley & Lardner LLP

Panelist:
Jennifer Choi, Managing Director
Industry Affairs
ILPA
I. Federal Legislation, SEC Guidance and ILPA Revisions
The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) eliminated certain exemptions under the Investment Advisers Act of 1940, requiring many previously unregistered asset managers to register with the SEC and subjecting them to SEC oversight. Affected investment advisers included hedge fund managers, private equity fund managers, real estate fund managers, collateral managers and other alternative asset managers.
In 2012, the SEC’s National Exam Program announced its “Presence Exam” initiative – focused, risk-based examinations of newly registered investment advisers.
In April of 2014, SEC Chair Mary Joe White testified before the House of Representatives that through the “Presence Exams” in 2013 and 2014, the SEC had identified common deficiencies that included misallocating fees and expenses; charging improper fees to portfolio companies or the funds they manage; disclosing fee monitoring inadequately; and using bogus service providers to charge false fees in order to kick back part of the fee to the adviser.
In May 2014, based on the results of those exams, then-OCIE director Andrew J. Bowden stated that OCIE had identified widespread violations of law or material weaknesses in control in more than 150 private equity advisers. Of particular concern, according to Bowden, were shifting of expenses, insufficiently disclosed fees and questionable marketing and valuation practices.
On May 13, 2015, Marc Wyatt, acting director of the Securities and Exchange Commission’s OCIE addressed the Private Equity International Private Fund Compliance Forum. In his first speech as acting director, Wyatt summarized focus areas and findings from OCIE examinations and discussed what to expect from OCIE and the Division of Enforcement going forward. According to Wyatt, the pillars of OCIE’s mission are fourfold: to promote compliance, monitor risk, detect fraud and inform policy.

Wyatt discussed the role of OCIE’s Private Funds Unit (PFU), which targets and selects exam candidates, identifies risk areas, executes exams and analyzes data.
Examples of positive change noted by Wyatt include:

- More robust disclosure of fee arrangements, expenses and other practices, including collection of revenues from portfolio companies’ use of group purchasing organizations
- Enhanced disclosure on private equity websites and to advisory committees
- Retention of third-party consultants to evaluate fee practices
- Increased attention to resources devoted to compliance programs, including better integration of chief compliance officers into the adviser’s business and management
- Decrease in the practice of accelerating monitoring fees upon disposition of a portfolio company and a decline in “evergreen” provisions in monitoring agreements that enable advisers to take large termination payments
Wyatt emphasized that expense shifting from parallel funds – created for insiders, friends and family and/or preferred investors – to the main comingled, flagship vehicles is often difficult for investors to detect but susceptible to testing by OCIE. Wyatt noted that many managers “still seem to take the position that if investors have not yet discovered and objected to their expense allocation methodology, then it must be legitimate and consistent with their fiduciary duty.”

Wyatt also said it is reasonable to expect additional Enforcement recommendations in the private equity space, focused on, among other things, undisclosed and misallocated fees and expenses as well as conflicts of interest.
Institutional Limited Partners Association ("ILPA") releases Draft PE Fees Disclosure Template (Sept. 2015)

■ The template itemizes fees charged to funds’ underlying portfolio companies in a uniform template in an effort to make it less difficult for investors to determine how the fees may affect the companies.

■ Specific fees and costs detailed in the ILPA template include advisory fees, broken-deal fees, transaction and deal fees, directors’ fees, monitoring fees, organizational costs, placement fees and capital markets fees.

■ The template also tracks management fee offsets and the amount of the GP’s carried interest for each reporting period.
II. SOME STATE INITIATIVES
STATE INITIATIVES

CALIFORNIA:

- CalPERS begins developing PEAR (Private Equity Accounting and Reporting Solutions) (2011)
- State Treasurers Letter to SEC Chair (July 2015)
- LACERA RFP for Fee Consultant (Sept. 2015)
- CA Treasurer Chiang’s Letter to CalPERS and CalSTERS (Oct. 12, 2015)
- State Treasurers Resolution (Oct. 19, 2015)
- CalPERS “Carried Interest Report” (Nov. 2015)
III. ENFORCEMENT ACTIONS
Williamson, a former portfolio manager at Oppenheimer & Co., disseminated quarterly reports and marketing materials to prospective investors, in which he marked up the valuation of Oppenheimer’s fund and reported an IRR that failed to deduct fees and expenses.

Both Williamson and Oppenheimer were charged with violating Section 17(a) of the Securities Act for conduct which operates as a fraud; and 206(4)-8 of the Advisors Act for making materially false statements to investors/prospective investors. Additionally, Williamson was charged with violating Section 10(b) of the Exchange Act for employment of manipulative and deceptive devices. Oppenheimer was also found to have violated 206(4)-7 for having deficient policies and procedures.

Oppenheimer agreed to pay $2.8 million. Williamson agreed to pay $100,000 and to be barred from the securities industry for at least two years.
LMI integrated two portfolio companies owned by different LMI-advised funds (with distinct sets of investors and separate fiduciary duties owed to each fund) and managed them as one company. As part of the integration, the companies utilized a joint management team and allocated a certain percentage of the resulting expenses to each company. In certain instances, the expense policy was not followed, which resulted in one portfolio company paying more than its share of expenses relating to services that benefitted both companies. This constituted a breach of LMI's fiduciary duties to the funds and violated Section 206(2) of the U.S. Investment Advisers Act of 1940 ("Advisers Act"), particularly in light of the fact that in the case of both companies, no disclosures were made to investors that the fund may bear more than its proportionate share of portfolio company expenses. In addition, LMI violated Section 206(4) of the Advisers Act by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act arising from integrating two portfolio companies owned by separately advised LMI funds.
Clean Energy Capital (“CEC”) and founder/president/portfolio manager, Scott Brittenham, breached their fiduciary duty to 20 PE funds sold and managed by CEC. CEC and Brittenham allocated CEC expenses (including Brittenham’s salary) to the funds without disclosure to investors. When the funds ran out of cash to pay expenses, CEC and Brittenham loaned the funds money at unfavorable interest rates and pledged the funds assets as collateral, without notice to investors. CEC further profited at the expense of investors by changing the calculation of dividend distributions, adversely affecting dividends in order to pay out less money. CEC also accepted an investment in a new fund after Brittenham misrepresented to the investor the amount he and his co-founder had invested in the new fund.

The SEC found that CEC and Brittenham willfully violated the antifraud provisions of the federal securities laws. The Commission also found custody, compliance and disclosure violations for failing to use a qualified custodian and failing to segregate the funds’ assets, maintaining an inadequate compliance policy, and in certain fund documents, failing to disclose CEC’s co-founder’s SEC disciplinary history.

CEC and Brittenham paid almost $2.5 million in disgorgement and fines.

Monitoring Fees
- PE funds commonly enter into monitoring agreements with portfolio companies with a ten year duration, with some including “evergreen” provisions that automatically extend the life of the agreement for an additional term. Blackstone routinely entered into monitoring agreements with its portfolio companies, under which it would receive annual fees in exchange for services provided (certain consulting and advisory services concerning such portfolio company’s financial and business affairs). Blackstone’s pre-investment commitment partnership documents, including private placement memoranda, limited partnership agreements and investment advisory agreements, disclosed and authorized such monitoring agreements and the payments related thereto. Blackstone would apply 50% of such payments to offset a portion of the partnership investors’ management fees that would otherwise be paid to Blackstone. Upon the sale or IPO of a portfolio company, the monitoring agreements allowed Blackstone to terminate such agreement and accelerate the payments scheduled to be made throughout the life of the agreement, in some cases including the evergreen period, and receive a lump sum termination payment. A portion of these payments were applied to offset the management fees, but they also reduced the value of the portfolio companies that formed part of each fund’s assets and thus negatively impacted the amount of proceeds available for distribution to the limited partners. While Blackstone had disclosed its ability to collect monitoring fees to the investors prior to their commitment of capital, and, after the fact, it disclosed the receipt of accelerated termination payments, it failed to disclose, to the limited partners or the advisory committee, its practice of accelerating payments under the monitoring agreements until after Blackstone had taken such fees.

Disparate Legal Services Fees
- Blackstone negotiated a single legal services agreement with its outside counsel for all fund work and received a substantially greater discount on its legal services than any of the funds it advised, e.g. it did allocate any of such discounts to its funds. Blackstone breached its fiduciary duty to investors by failing to adequately disclose to investors prior to their commitment of capital the nature of the disparate nature of legal fee apportionment.
IV. ISSUES TO MONITOR GOING FORWARD
Areas of Concern

- Improper Allocation of Expenses and Fees
  - Expense shifting from parallel funds (or co-investment SPV entities) to main fund
  - Expense shifting from Manager to Fund
  - Misallocation of “broken deal expenses”
  - Acceleration of monitoring fees
  - Payments to consultants
  - Misallocated consultant/legal fee discounts

- Conflicts of Interest (Adequate Disclosure)
Appendix

Additional Enforcement Actions

Additional Enforcement Action cases:

- Cox v ING Global RE Fund
- Westend Capital Management LLC
- Alpha Titans LLC
- KKR Settles SEC Charges for $30M
- Summit Asset Strategies
- Fenway Partners agree to $10.2M settlement with SEC
- Cherokee Investment Partners and Cherokee Advisers settlement
In an ongoing case, ING Investments is the defendant in a derivative suit filed by shareholders who allege the asset manager is charging exorbitant fees to the ING Global Real Estate fund, which receives most of its investment management services from a subadviser. The suit also accuses the Fund’s board of breaching its fiduciary duties for agreeing to the management fee structure, which the plaintiffs allege has little bearing to the actual services being provided to the Fund. The plaintiffs argue that the subadviser is receiving a fee for the work performed for the Fund, but the overall fee is quite larger because the adviser is still receiving a fee at the adviser level.

This suit is one of several where courts are trying to determine what fees bear a “reasonable relationship” to the work being done for a fund when a third-party subadviser is carrying out the majority of the work.
WestEnd Capital Management LLC  (Sept. 2014)

- A former hedge fund manager for WestEnd Capital Management LLC improperly withdrew more than $320,000 from the fund he managed. WestEnd disclosed the withdrawal of annual management fees of 1.5%, however, the manager withdrew much larger amounts, recorded the amounts as management fees in the fund’s books, and transferred the funds to his personal bank account to spend freely. WestEnd expelled the manager and reimbursed the fund once it became aware of the managers actions, but was charged by the SEC for failing to effectively supervise him. The manager had sole authority to transfer money out of the fund, and there were no controls in place at the firm to prevent him from making improper withdrawals. WestEnd paid a penalty of $150,000 to settle the charges with the SEC.
Alpha Titans LLC
(April 29, 2015)

- Alpha Titans, and its principal and general counsel, were charged by the SEC for improper allocations of fund assets to pay for undisclosed operating expenses. Alpha Titans used assets of two affiliated private funds to pay more than $450,000 in office rent, employee salaries and benefits, and similar expenses without clear authorization from fund clients and without accurate and complete disclosure that fund assets were being used for these purposes. Alpha Titans also violated the custody rule by distributing financial statements that were not GAAP compliant, as they failed to disclose almost $3 million in expenses tied to transactions involving other entities controlled by the principal. To settle with the SEC, Alpha Titans and the principal paid almost $700,000. The fund’s principal and the general counsel were each barred from the securities industry for a year and the general counsel was barred from practicing as an attorney on behalf of any entity regulated by the SEC for one year.
Across several vintages of funds, KKR established a main fund along with several co-invest funds, including a KKR Partners Co-Invest Funds, which was established to allow KKR executives, affiliates and certain consultants to co-invest alongside the main fund. Certain of the co-invest funds were intended to co-invest in each investment made by the main funds on a pro rata basis, whereas other KKR funds, including the KKR Partners Co-Invest Funds, would only invest in certain investments. Typically, PE funds recoup broken deal expenses (expenses incurred in sourcing investments deals that ultimately aren't completed, e.g. research costs, travel costs, professional fees, diligence costs and other expenses, etc.) by charging them to the fund. A certain percentage of these fees/expenses are then applied to offset the management fee. In the case of KKR, the broken deal expenses where overwhelmingly charged to the main fund, in fact, only one partial allocation was charged to a co-invest fund. According to the SEC order, KKR breached its fiduciary duty to investors though such broken deal fee allocations because there was no express disclosure in the fund documents or otherwise that no broken deal fees or expenses would be charged to the co-invest funds.
Summit and its CEO were charged by the SEC with fraudulently inflating the values of investments in the portfolio of a private fund they advised so they could attain unearned management fees. The CEO directed the firm to withdraw fees that were based on fraudulently inflated investment values or were otherwise disproportionate from the fund’s actual profits. As part of the scheme, the CEO falsely claimed that the fund owned a specific asset that had appreciated to approximately $2 million in value, when in reality the fund owned a different asset that was worth less than $200,000. As a result, the fund’s financial statements materially overstated the fund’s investment values. In total the fund and CEO withdrew nearly $900,000 in excess fees, which they were not entitled to. Summit and its CEO agreed to pay over $1 million to settle the fraud charges.
An affiliate of Fenway Partners had entered into a Master Services Agreement with several portfolio companies pursuant to which it received periodic fees for providing management consulting and other services. A portion of the fees received by the affiliate would be applied to offset a portion of investors’ management fees that would otherwise be payable to Fenway Partners. Beginning in December 2011, Fenway Partners caused certain portfolio companies to terminate the Master Services Agreements with the affiliate and enter into a new Consulting Agreement with Fenway Consulting, another affiliate. Under the Consulting Agreements, similar services would be provided by the same individuals; provided, however, that the fees received by Fenway Consulting would not be applied to offset the management fee.

In addition, Fenway Partners failed to disclose the conflict in a June 2012 transaction in which one of its funds sold its equity interest in a portfolio company, and certain former Fenway Partners were included in the portfolio company’s cash incentive plan. As part of the sales transaction the individuals were paid $15 million under the cash incentive plan from the sale proceeds, reducing the amount received by the relevant fund. That amount was paid almost entirely for services performed while the men were employees of Fenway Partners. Fenway Partners and the relevant individuals also made, or caused to be made, material omissions to investors concerning the cash incentive plan payment during subsequent advisory committee meetings (to say the least no waiver of such conflicts was solicited of the fund advisory committees) and in the financial statements provided to investors, as the payments made to Fenway Consulting were not listed as Related Party payments. According to the SEC Order, Fenway Partners and the individuals involved willfully violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 promulgated thereunder.
Cherokee Investment Partners and
Cherokee Advisers settlement (Nov. 5, 2015)

Cherokee Investment Partners, LLC (“CIP”) is a private equity adviser that served as manager of Cherokee Investment Partners II, L.P. (“Fund II”), and Cherokee Investment Partners III, L.P. and Cherokee Investment Partners III Parallel Fund, L.P. (together, “Fund III”). Cherokee Advisers, LLC (“CA”) is a private equity adviser that served as manager of Cherokee Investment Partners IV, L.P. (“Fund IV” and, together with Fund II and Fund III, the “Funds”). CIP and CA incurred consulting, legal and compliance-related expenses in the course of either preparing for registration as an investment adviser under the Advisers Act, complying with legal obligations arising from registration or preparing for / responding to an investigation from OCIE or the Division of Enforcement, respectively. A portion of these expenses were allocated to the Funds. Although the Funds’ partnership agreements disclosed the fact that the Funds would be charged for expenses that in the General Partner’s good faith judgment arose from the operations and activities of the Funds, including legal and consulting expenses, that the Funds would be charged for CIP’s and CA’s legal and compliance expenses was not disclosed, which the SEC alleged constituted a breach of fiduciary duty in violation of Section 206(2) of the Advisers Act and violated Section 206(4) and Rule 206(4)-7 thereunder. In addition, the SEC found that CIP and CA failed to adopt written policies or procedures reasonably designed to prevent violations of the Advisers Act. CIP and CA failed to review, no less frequently than annually, the adequacy of their internal procedures to prevent such violations.
The ILPA

Dedicated to advancing the interests of private equity limited partners through...

Research & Benchmarking
Content & tools to help LPs manage their PE portfolios

Member Events
Exclusive opportunities for peer-to-peer networking

Advocacy & Standards
The voice of LPs, driving quality & transparency

Professional Development & Member Education
Best-in-class private equity education. By LPs for LPs
ILPA Membership Demographics

- United States: 64%
- Europe: 15%
- Canada: 10%
- Asia: 4%
- Middle East: 2%
- Oceania: 3%
- Other: 1%

- Public Pension: 35%
- Corporate Pension: 13%
- Insurance: 11%
- Family Office: 11%
- Endowment: 10%
- Other: 7%

380+ Organizations
41 Countries
2,800+ Professionals
Transparency Initiative: Broad Interest in Consistent Reporting on Fees, Expenses

Organizational Attitudes

“The lack of reporting consistency among GPs hinders our ability to adequately monitor our PE plan costs.”

<table>
<thead>
<tr>
<th>Change in Concern Levels (Past 2 Years)</th>
<th>Pubic Pensions</th>
<th>All Other LPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>kehragri</td>
<td>62%</td>
<td>60%</td>
</tr>
</tbody>
</table>

Change in Concern Levels (Past 2 Years)

Concern increased **significantly** for **of large plans (>5bn)**

....and **moderately** for **of midsized plans**

and **of small plans**

52% of LPs have requested that GPs provide additional detail on a one-off basis, and /

or have begun issuing customized templates.

Source: 2016 ILPA Members Survey on Fee & Expense Practices
Inconsistent GP Reporting Led to Proliferating LP Templates...

40% of LPs believe cost monitoring procedures are inadequate to identify material discrepancies within GP disclosures.

52% have requested additional data on a one-off basis, or have begun issuing customized templates.

*LP requests varied significantly: from headline fees to waterfall validation to details of fees broken down by portfolio company*

Source: 2016 ILPA Members Survey on Fee & Expense Practices
...For a Range of Reasons

Drivers of Organizational Interest in Reporting

Current Cost Monitoring Policies are Capable of Finding Material Discrepancies

Source: 2016 ILPA Members Survey on Fee & Expense Practices
ILPA Transparency Initiative

**Goal:** Promote enhanced, more uniform practices related to fee disclosures

1. Enhanced fee and expense reporting template (expanded Partners Capital Account Statement with definitions, guidance)
2. ILPA Principles addenda around fee/expense reporting, disclosures
3. Recommendation on role of third parties in providing for enhanced assurances of LPA compliance, i.e., fund audits and third party reviews
The ILPA Reporting Template
Seeking standardization of GP Disclosures

**Analyzes and Aggregates:**
- LP investment costs
- Economics paid to the management company (including non-arms-length transactions)

**Establishes Standards for Disclosing:**
- Management fees
- Fund expenses
- Carried interest
- Fees charged to portfolio companies

**Developed in Consultation With:**
- 50+ LP organizations
- 25+ GP organizations
- 10+ trade associations
- 20+ sample templates
**Final Reporting Template**

- **Detailed NAV Reconciliation**
- **Multiple Time Horizons**
- **Two Tiers Of Reporting: Headline and Detail**
- **XML Format For Incorporation Into Current Reporting Packages**
- **Reconciliation for Carry Roll-Forwards and Accrued Carry**
- **Definitional Clarity For Common Industry Fees And Expenses**
- **Commitment Reconciliation**
### Final Reporting Template (cont.)

#### Table: Expenses

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incentive Allocation - Earned (period-end balance)</td>
<td>$250,000</td>
</tr>
<tr>
<td>Incentive Allocation - Amount Held in Escrow (period-end balance)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Capital Paid in for Series A</td>
<td>$90,000</td>
</tr>
<tr>
<td>Distribution Related to Fees</td>
<td>$1,000</td>
</tr>
<tr>
<td>Fund of Funds Gross Fees, Exp. &amp; Incentive Allocation paid to the Underlying Funds</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Fund Of Funds Expenses**

**Paid to the GP, Fees, Carry & Expenses from LPs**

**Paid to the GP, Fees & Reimbursements from Portfolio Companies**

**Portfolio Company Fees Attributed to Affiliated Positions**

**Comment Box For Additional Detail on “Other” Fees**
Reporting Template: “How To” Guide

**How**

- Supplemental to fund’s standard financial disclosures, provided quarterly
- Intended be produced in Is and Os (Excel, reporting software), not PDF

**When**

- Up to a year or more for implementation; GP systems and personnel changes necessary
- Disclosure recommendation: QTD & YTD only for older vintages

**The Template Is...**

- ...a disclosure framework: when in doubt, the LPA “wins”
- ...a tool to establish reporting parameters

**The Template Is NOT...**

- ...a substitute for dialogue
- ...a verification tool (validating fee/carry calculations)
- ...one-size-fits-all, e.g., VC and small funds with simpler economics
- ...all data can be calculated at LP level – estimates are acceptable
Implementation Outlook

Prospects for Template Integration into Reporting Processes are Strong

- We will request/complete the ILPA template as is (43%)
- We will amend our existing template or format in use (44%)
- We will incorporate these fields into our reporting software (5%)
- We will not likely use the template (1%)
- Not sure yet (6%)

N=179
Source: ILPA Webcast: Unpacking the Reporting Template – February 23

More than 150 GPs are producing, or have agreed to produce, the data in the template for select LPs - several of these have committed to providing for all of their GPs beginning in 2017.
Endorsing Organizations

CONSULTANTS
- Cambridge Associates
- Capital Analytics
- CEM Benchmarking
- Conifer Financial Services
- eFront Financial Services
- Federation of the Dutch Pension Funds (Pensioenfederatie)
- National Association of State Treasurers
- PEA Accounting Insights
- SEI Investment Manager Services
- TorreyCove Capital Partners
- Upwelling Capital

FUNDS OF FUNDS
- Pathway Capital Management
- Albourne

GENERAL PARTNERS
- Carlyle
- TPG
- Silver Lake

LIMITED PARTNERS
- AP2
- APG
- Alberta Teachers’ Retirement Fund
- BBC Pension Scheme
- Bonanza Oil Company
- CalPERS
- CalSTRS
- Canada Pension Plan Investment Board (CPPIB)
- Canadian Medical Protective Association (CMPA)
- Chicago Teachers’ Pension Fund
- Colorado PERA
- Commonwealth of Pennsylvania, Public School Employees’ Retirement System (PSERS)
- The Connecticut Retirement Plans and Trust Funds
- District of Columbia Retirement Board
- Florida SBA
- Guardian Life Insurance Company of America
- Halifax Regional Municipality Master Trust
- Illinois State Treasurer’s Office
- Iowa Public Employees’ Retirement System
- Kentucky Retirement System
- Maryland State Retirement and Pension System
- MetLife
- Minnesota State Board of Investment
- Missouri State Employee’s Retirement System (MOSERS)
- Montana Board of Investments
- Municipal Employees Retirement System of Michigan
- New Mexico Educational Retirement Board (NMERB)
- New York State Common Retirement Fund
- New York State Teachers’ Retirement System
- Ohio PERS
- Ohio SERS
- Ontario Teachers’ Pension Plan
- Oregon State Treasury
- Pensionskassernes Administration (PKA)
- PGGM Investments
- Sampension KP Livsforsikring a/s
- San Diego County Employees Retirement Association (SDCERA)
- South Carolina Retirement System Investment Commission
- SPF Beheer
- State of Rhode Island
- State of Wisconsin Investment Board
- State Teachers Retirement System of Ohio
- Teacher Retirement System of Texas (TRS)
- Texas Permanent School Fund
- USS Investment Management Limited
- Utah Retirement Systems
- Virginia 529
- Washington State Investment Board

Note: List current as of 9/21/2016;

If you have questions or are ready to endorse the ILPA Fee Reporting Template, please email ilpaprinciples@ilpa.org
Regulated Disclosure: State of Play

California AB 2833
- More granular fund-level fee and expense disclosures by public plans
- Bill passed August 24, signed into law September 14
- Applies to all new fund commitments from Jan. 2017

Dodd-Frank/Investment Advisers Act
- Form PF – portfolio-level leverage, assessment of systemic risks
- Form ADV “Brochure” – plain English summary of risks, fees, conflicts, publicly available
- Mandated registration for advisers with >$150m capital, at least 15 US investors

Level of LP concern varies – depends on internal legal opinion and PE strategy – big/small, venture, emerging

Focus is at the adviser level: consistency between LPA, LP-facing disclosures and submissions to the SEC
Precedent Risk: tangle of jurisdiction-specific requirements or regulatory “contagion”

Partnership Risk: Proliferation of requirements, negotiations, and templates

Headline Risk: Increased scrutiny of the asset class and the professionals who work in it
### SEC Enforcement Actions Relating to Private Equity Fund Advisors

<table>
<thead>
<tr>
<th>Date</th>
<th>Firm</th>
<th>Penalty Paid</th>
<th>Disgorged to LPs</th>
<th>Key Findings</th>
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</thead>
<tbody>
<tr>
<td>September 2014</td>
<td>Lincolnshire Management</td>
<td>$800,000</td>
<td>$1.5 million</td>
<td>Expense shifting</td>
</tr>
<tr>
<td>June 2015</td>
<td>KKR</td>
<td>$10 million</td>
<td>$18.7 million</td>
<td>Expense shifting</td>
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<tr>
<td>October 2015</td>
<td>Blackstone</td>
<td>$10 million</td>
<td>$28.9 million</td>
<td>Undisclosed fees &amp; expenses</td>
</tr>
<tr>
<td>November 2015</td>
<td>Fenway Partners</td>
<td>$1.5 million</td>
<td>$8.7 million</td>
<td>Failure to disclose conflict of interest</td>
</tr>
<tr>
<td>June 2016</td>
<td>Blackstreet</td>
<td>$500,000</td>
<td>$504,000</td>
<td>Acting as an unregistered broker-dealer</td>
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<tr>
<td>August 2016</td>
<td>Apollo</td>
<td>$12.5 million</td>
<td>$40.3 million</td>
<td>Disclosure of accelerated monitoring fees</td>
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<tr>
<td>August 2016</td>
<td>W.L. Ross</td>
<td>$2.3 million</td>
<td>$11.9 million</td>
<td>Disclosure of transaction fees</td>
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## PE in the Legislative Crosshairs

### US State-Level Transparency Legislative Attempts

<table>
<thead>
<tr>
<th>State</th>
<th>Status</th>
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</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Failed</td>
</tr>
<tr>
<td>California</td>
<td>Passed</td>
</tr>
<tr>
<td>Illinois</td>
<td>Pending</td>
</tr>
<tr>
<td>Kentucky</td>
<td>Failed</td>
</tr>
<tr>
<td>Louisiana</td>
<td>Pending</td>
</tr>
<tr>
<td>New Jersey</td>
<td>Failed</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Pending</td>
</tr>
<tr>
<td>Washington</td>
<td>Enacted</td>
</tr>
</tbody>
</table>

*Source: National Conference of State Legislatures, Bloomberg BusinessWeek.*
Beyond the Template
Additional Recommendations on Disclosure

White Paper recommending...
- Access to and Explanation of Regulatory Examinations
- Expanded scope of fund audits and Enhanced LP Access findings
- Discretion to conduct 3rd Party LPA Compliance reviews if/when Necessary

ILPA Principles Appendices: New best practices in...
- Level of disclosure on fees, offsets, carried interest, portfolio company fees
- Compliance and other disclosures to LPs: SEC exams and findings, co-investment policy and secondaries transactions, books and records and information rights

LPA Compliance and Role of Third Parties

Additional Guidance on Disclosures in ILPA Principles
Capital Call & Distribution Notices

**CC& DN Template and Best Practices**

Provides a Clear Transactional Breakdown of:
- Investment activity
- Accounting treatment of flows
- Recycled capital

Other Features
- Available to entire industry
- Since inception balances can be checked against internal records to ensure quality control
- Side-calculation workspace supports fee verification; reconciliation of revisions to prior period balances
- Supplemental best practices document includes sample notices & other guidelines
Financial Reporting Best Practices

Standardized Quarterly Financial Reporting

Features
- Derived from “best-in-class” fund reporting packages
- Sample balance sheet, income statement & schedule of investments
- Reporting checklist
- Portfolio company update template

Quantitative Disclosures
- Management fee calculations & offsets
- Carry accrued, escrowed & paid
- Related party transactions

Supplemental Schedule: Portfolio Executive Summary
Best Practices Fund II, L.P.
Executive Summary – Firm and Fund Level Data
($ Unaudited)

<table>
<thead>
<tr>
<th></th>
<th>12/31/2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Capital</strong></td>
<td>$289.5m</td>
</tr>
<tr>
<td><strong>% of total drawdown</strong></td>
<td>32%</td>
</tr>
<tr>
<td><strong>% of committed capital</strong></td>
<td>29%</td>
</tr>
</tbody>
</table>

Key Fund Valuation Metrics
- DPI (Distributions to paid-in-capital)
- RVPI (Residual value to paid-in-capital)
- TVPI (Total value to paid-in-capital)

Historical Fund Performance (TVPI)
Due Diligence Questionnaire Tool

Questionnaire covers 13 topics of interest, including:

- Investment Process
- Alignment
- Terms
- Governance

Uses

- Creates efficiencies for LPs & GPs by proactively addressing questions from diverse LP base
- Increases awareness of diligence best practices

DDQ has 3 Sections:

1. Basic Questions
   - Yes/no questions can be used to quickly identify red flags
   - "Reference" column directs readers to more expanded answers

2. Detailed Questions
   - Expanded answers to common questions
   - Provides circumstances for any answers in the Basic Questions sections

3. Appendix
   - Outlines best practices in document & data disclosures

Basic Questions

<table>
<thead>
<tr>
<th>ID</th>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1</td>
<td>Does the Firm have any existing business lines that are unrelated to the Fund’s investment strategy?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2</td>
<td>Has the Firm or any affiliated entity ever failed to make payments under any secured or unsecured indebtedness?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.3</td>
<td>Has the Firm or any affiliated entity ever filed for bankruptcy?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.4</td>
<td>Has any of the Firm’s current or former Team Members (as defined in Appendix B) ever filed for bankruptcy?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.5</td>
<td>Will the Firm or any of its Principals (as defined in Appendix B) conduct outside business or investment management activities during the investment period of the Fund?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.6</td>
<td>Will the Firm or any of the Principals (as defined in Appendix B) conduct outside activities (non-profit, academic, etc.) that are expected to take up a significant (approx. ≥ 20%) amount of time during the investment period of the Fund?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.7</td>
<td>Is the Firm a publicly-held company?</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2.1 | Will the Fund offer co-investments? | | | |

2.2 | Outside of the General Partner, will non-limited partners affiliated with the Fund be prohibited from investing or holding an ownership interest in the Fund’s investments? | | | |

2.3 | Will Placement Agents be used during the fundraising process? | | | |

2.4 | Will unregistered Placement Agents (i.e., (i) not affiliated with a FINRA member broker-dealer, (ii) not registered as a municipal advisor with the SEC and the MSRB and (iii) not registered as a lobbyist in the State of California) be prohibited from assisting in the fundraising process? | | | |

2.5 | Will there be an annual investor meeting throughout the life of the Fund? | | | |

2.6 | Will the Fund facilitate an in-camera session for each of the Fund’s LP Advisory Board meetings? | | | |

2.7 | Is the Fund prohibited from holding leverage on its balance sheet? | | | |

3.1 | Is the Fund’s strategy materially different from the previous fund? | | | |

3.2 | Will the Fund actively pursue investments in public securities and/or Private Investments in Public Equity (PIPE) investments? | | | |

3.3 | Will the Fund engage in hedge transactions? | | | |