Privcap/ Video Briefing

Q3 2016

How Firms Balance SEC and LP Demands

An executive summary of the Privcap thought-leadership video series “PE’s Bold New Era of Transparency”

Featuring Experts from:

Washington State Investment Board, Gen II Fund Services, and EY

Sponsored by Gen II Fund Services, LLC

How Firms Balance SEC and LP Demands

Key Findings

1. The SEC played a key role in creating an "awareness campaign" focused on PE fee allocations
2. PE firms must invest in people and infrastructure to respond to SEC and investor demands
3. Like hedge funds, PE firms are outsourcing key fund-administration functions
4. Timely, useful portfolio-level data is eagerly sought by LPs, but difficult to deliver
5. Creating a policy for sorting out expenses between the fund and the GP entity is critical

CONTINUES ON NEXT PAGE

The Panelists

Ian Cameron
Chief Operating Officer,
Washington State Investment Board

Steven Millner
Managing Principal,
Gen II Fund Services

Scott Zimmerman
Partner,
EY

1 The SEC played a key role in creating an "awareness campaign" focused on PE fee allocations

Who holds the negotiation leverage in private equity? For years, depending on the state of the economy, the pendulum swung regularly back and forth between investors and managers. For example, in the aftermath of the financial crisis, LPs could ask for—and get—a lot of concessions because GPs were struggling. Later, as many funds grew to be oversubscribed, LPs lost leverage.

Then the U.S. Securities and Exchange Commission came along and grabbed the pendulum. A primary thrust of the SEC's PE regulation campaign is to educate investors about the diligence that they are due from firms. "We think about it as an awareness campaign," says Scott Zimmerman, a partner at EY. "Private equity is different than other asset classes in that it has these unusual fees and some unusual expenses. So the transparency is driven…by the awareness campaigns of the regulators, and that's making investors smarter."

And as investors get smarter and more demanding, managers are getting more transparent. GPs tend to be much more attentive to LP needs and concerns. "LPs want this information," says Steven Millner, managing principal at Gen II Fund Services. "They deploy money with managers they feel are going to give them not only good performance on the investment side but also understand their fiduciary responsibility."

A New Sherriff in Town

Ian Cameron
Washington State Investment Board

The fact that most private equity firms now need to register with the SEC may be a burden to the firms, but it has been a boon to their LPs, because the SEC is asking the hard questions that LPs were, in the past, not always getting answered.

"The SEC has a lot of clout. They can get in there and look at these things for us so it's a huge advantage for us and they do a great job," Cameron says. "They uncover a lot of things." For instance, at one of the firms Washington State invested with, the SEC found a problem in the way the firm was allocating expenses. "That resulted in a refund back to us, so there's clearly a benefit here," he says.

2 PE firms must invest in people and infrastructure to respond to SEC and investor demands

Investors now look closely at firms to see if they have the infrastructure needed to support robust compliance and due diligence requirements. Millner has seen private equity firms that have performed well in the market and lined up promising investors for their next fund. But then, suddenly, the LPs start talking about operating due diligence, and the PE firm realizes it's neglected these core functions.

That's when Millner gets an urgent call from a GP who wants to talk—and wants to talk now. "Because we do check a lot of those boxes," he says. "When you talk to our clients, they would tell you that a third-party administrator can bring people, process and technology to the table in a private equity environment. And that we enable a firm to scale."

↓ CONTINUES ON NEXT PAGE

At Whose Expense?

Steven Millner
Gen II Fund Services

Increased LP focus on the way that fees and expenses are allocated is making life at private equity firms more complex. Take, for example, a GP who takes a business trip to visit a portfolio company. Let's say his firm is in New York and the portfolio company is in Hong Kong. That's a relatively expensive trip. So let's say the GP decides to maximize his time in Hong Kong by meeting with a few investment banks about other opportunities in the region.

"So now the question is, how do you charge travel expenses?" Millner asks. "Clearly the portfolio company side is pretty straightforward. That's either going to be billed back to the portfolio company or the fund. But what about the other work that was done away from the portfolio company? Is that research? Generally speaking, research is a management expense as opposed to a fund expense. This is a trip with dual purposes, so how do you expense it?"

That decision could ultimately end up in the hands of an associate at the firm or an executive assistant. "Whoever's filling out the expense report will have to make that call when the report is being completed," Millner says. "You can appreciate how something fairly simple such as filling out an expense report all of a sudden has so much significance."

3 Like hedge funds, PE firms are outsourcing key fund-administration functions

Around the time of the financial crisis, hedge funds moved almost exclusively to outsourced fund-administration tasks. Private equity is now following suit. Research by EY shows around 30 percent of private equity funds outsource; that's projected to increase to 50 percent to 60 percent in the next five years. "We've gone from, 'I don't think it's necessary' to 'OK, let's explore,'" Zimmerman says. "And in another three, four years it should be much more than exploring."

Firms like Blackstone and Carlyle, of course, have sufficient resources to create high-level, high-quality back offices. Smaller- and medium-size firms do not, so they turn to outsourcing to relieve a lot of their administrative burden. "You have a confluence of demands on a sponsor and the sponsor now has to look and say, 'Do I want to build something and think about scalability and attracting talent? Or do I hand this off to somebody who makes it their business?'" Millner says. "We're seeing that process. It's unfolding as we speak."

Three or four years ago, there might have been resistance from firms in the old guard who think, "We've always done this ourselves, so why should we change?" but even they are now realizing that the job is expanding beyond in-house capabilities. "There is a clear recognition by most market participants that, in order to be competitive in the marketplace, you don't have a lot of choice anymore," Millner says.

"Look at LPAs (limited partner agreements) now," adds Ian Cameron, chief operating officer at the Washington State Investment Board. "Where you used to have a paragraph that discussed fees and how those were going to work and what they looked like, now you've got three, four, five pages. So when you sign up for that, you're going to need an infrastructure that's capable of producing that information and delivering it in a way that's intuitively valuable for the LPs."

↓ CONTINUES ON NEXT PAGE

4 Timely, useful portfolio-level data is eagerly sought by LPs, but difficult to deliver

Demand for data about portfolio companies and many other aspects of private equity is exploding. But it is a significant challenge for firms to gather it, process it, and share it with regulators and investors in a form that is useful.

"There is a seismic shift and disruption, which is regulatory," Zimmerman says. "There are transparency and reporting burdens, and firms have a lot of work to do. But there aren't really any solutions out there from a systems or technology standpoint."

Neither are there standards for the data that is collected. "We still don't have universal standards," Millner says. "ILPA and others are starting to think about it but, for large consumers of data, they're actually putting out their own requests and saying, 'Here's what we'd like to see and here's when we'd like to receive it.'"

This demand for data is only going to grow and, when it comes to providing it, GPs have three choices: lead, follow, or get run over. "To those who are resisting transparency, historically transparency tends to win," Zimmerman says. "And those who embrace it early tend to get ahead of the market and figure out how to use that transparency to their own advantage."

LPs will not relax their demands for data anytime soon because they have very good reasons for wanting it. For starters, LPs like Cameron's Washington State Investment Board need data to gain insight into their entire portfolio, all asset classes, and the risks that are spread across it. "Beyond the operational information, we need to get down to portfolio-level data," Cameron said. "That has to be available to us so we can look at our concentration risk, so we can look at liquidity risk, leverage, all those different things. Private equity funds need to be able to provide that data in a timely way and in a common format that can be easily uploaded."

In other words, the data train has not yet reached top speed but it has definitely departed the station. "It's moving," Zimmerman says. "Who's going to jump on and who's going to get there first?"

Waving the White Flag

Scott Zimmerman
EY

Like any growing business, a successful mid-market PE firm will at some point need to scale, especially if it is expanding into new asset classes within private equity. "The tier below the big firms also need to grow their assets and generate additional fees," Zimmerman says. But without significant infrastructure in place, without the proper investments in technology systems, it is very challenging for growing firms to scale.

At this point, it's natural for such firms to consider outsourcing. "These firms know they have demands for transparency, they know they have demands from the regulators," Zimmerman said. "Their business is getting more complex, so they realize it's time to wave the white flag and start asking for outside help if they want to scale effectively."

↓ CONTINUES ON NEXT PAGE

5 Creating a policy for sorting out expenses between the fund and the GP entity is critical

Fee transparency is a very hot topic. ILPA has come out with standards, the SEC is continuing to look into fees—and from the LP perspective, this is a good thing. "There's a confidence and trust-building that's going on," Cameron says. "So the more they can be candid and show us how fees are going to be allocated, the better. What is going to be offset against management fees, what's not going to be, so there aren't any surprises."

From the GP perspective, accurate reporting of expenses is a burdensome process. For example, expenses for a single business trip by a GP to visit a portfolio company in Asia might be sorted any number of ways, depending on where the GP goes and who he or she sees. The GP might take an extra day or two to meet with investment bankers and investigate other opportunities. How should those expenses be billed?

It's complicated. This is why solid guidelines for sorting expenses are critical for PE firms. "You need to have policies," Zimmerman says. "You need to have procedures. You need a road map. You need compliance to make sure that these investment professionals—whoever is out there—are complying with that policy. There needs to be review. It's not just up to the individual to write it down. This is where things are maturing and everybody's getting used to it now." ■

Privcap/

About Privcap Media
Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communications services to market participants.

Contacts

Editorial

David Snow / *dsnow@privcap.com*
Matthew Malone / *mmalone@privcap.com*
Andrea Heisinger / *aheisinger@privcap.com*

Sponsorships & Sales

Gill Torren / *gtorren@privcap.com*

Video Series/ "PE's Bold New Era of Transparency"

Watch the series in its entirety at **www.privcap.com**

Click to follow link

→ **The SEC Drives PE Transparency**

→ **Fund Admin Outsourcing is PE's Future**

→ **What GPs Need to Be 'Cutting Edge'**

→ **Fee Transparency is a Complex New Reality**