Private Funds: Analyzing Management Fee Provisions

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The sponsor of a closed-ended fund, such as a private equity fund, typically receives a management fee to cover the basic overhead expenses of operating the fund and managing its investment activities, including salaries of the investment professionals and administrative staff, rent, utilities and travel. In the course of conducting due diligence on a prospective investment in a fund, investors should pay attention to the fund documentation and reporting by sponsors, and carefully review the provisions relating to the calculation of the management fee and allocation of expenses to the fund and its investors. Regulatory agencies, such as the US Securities and Exchange Commission, have reviewed the business practices of many private equity firms and found that they pass on fees and expenses that should be covered by the management fee to clients without their knowledge. For example, Andrew Bowden, the former director of the SEC's Office of Compliance Inspections and Examinations, said at a private equity conference in 2014 that "[b]y far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time." Prospective investors may wish to consider the following questions when evaluating an investment in a closed-ended fund and the determination of the management fee:

- ***What is the applicable rate of the management fee?*** Generally, the rate of the management fee is in the range of 1% to 2% per annum, though we have seen instances where the applicable rate has been higher or lower than this range.

- ***Are there any discounts available on the rate?*** With increased competition to attract capital commitments and an escalating pressure to raise larger funds, it is becoming more commonplace for sponsors to offer discounts on the stated rate. Discounts may be offered in circumstances where (i) an investor's commitment exceeds a stated minimum threshold (a size-based discount), (ii) an investor has invested in prior funds raised by the sponsor (a loyalty discount), or (iii) an investor participates at the first closing (an early closing discount).

- ***What is the base on which the management fee is calculated?*** During a fund's investment period, the management fee should be expressed as a percentage of capital committed to the fund by investors unaffiliated with the sponsor. It would be unusual for the sponsor to charge a management fee for managing its own committed capital (or the committed capital of its affiliates). To the extent it does, however, the investor should ensure that the management fee is also being charged to the sponsor and its affiliates such that they bear their proportionate share of the management fee.

- ***Is the management fee subject to any offsets?*** Generally, sponsors agree to offset or reduce the management fee by amounts of any placement fees or organizational expenses incurred by the fund as well as certain transactions fees that may be received by the sponsor, its affiliates and their respective members and employees in respect of any portfolio investment. These transaction fees may include monitoring fees, director fees, commitment fees, break-up fees, investment banking or similar services and topping fees. The management fee will typically be offset and reduced by a specified percentage of these transactions fees. Normally, the percentage is in the range of 50% to 100%, and it is now viewed as market for the management fee to be offset by 100% of these transactions fees.

- ***When does the management fee start to accrue?*** Historically, the management fee started to accrue from the fund's first closing date as the sponsor effectively begins to manage the committed capital from that date. As sponsors tend to focus the first twelve to eighteen months on raising additional capital and having subsequent closings, it is becoming more commonplace to see the management fee start to accrue from a later date, such as the fund's final closing date, a "commencement date" or "effective date" which is a date determined by the sponsor, or the date on which the fund makes its first investment.

- ***Who is responsible for paying the management fee?*** It is important to determine whether the management fee is paid by the fund rather than by the investors directly. In other words, is the management fee included within an investor's capital commitment or is it expected to be paid on top of the investor's capital commitment? An investor typically expects that its capital commitment represents its entire obligation to contribute capital to the fund and that it will not be expected to make further contributions in addition to its capital commitments to fund the management fee.

- ***When does the management fee "step down"?*** Generally, the management fee should "step down" when the sponsor is no longer actively managing committed capital and/or devoting all of its time to the fund. This "step down" usually occurs at the end of the investment period where investors are, subject to certain limited exceptions, released from their obligations to make further contributions to the fund or once a successor fund starts to accrue fees.

- ***When the management fee steps down, what adjustments are made to the base on which the management fee is calculated?*** Following the expiration of a fund's investment period (or other event that gives rise to the stepping down of the management fee), the management fee should be expressed as a percentage of invested capital. Sponsors may, however, seek to have other amounts included in this calculation, such as amounts reserved and committed for investments or follow-in investments and outstanding indebtedness and borrowings. Further, to the extent that the fund makes acquisitions or dispositions of investments, or otherwise undertakes a write-down or write-up of an investment, such events may affect the base on which the management fee is calculated.

- ***When does the sponsor stop earning the management fee?*** Generally, the management fee will continue to accrue during the fund's term for so long as their remains invested capital. Where the sponsor seeks to extend the fund's term or the investors elect for an early termination of the fund's term, the investors (or the limited partner advisory committee) may be faced with negotiating an appropriate management fee for the sponsor to continue to manage the fund for the duration of the extended term and/or through its winding up and dissolution.

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