Securities Regulation Daily Wrap Up, PRIVATE EQUITY NEWS—State treasurers and comptrollers urge better disclosure of private equity expenses, (Jul. 24, 2015)

Securities Regulation Daily Wrap Up

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By John Filar Atwood

Ten state treasurers and two comptrollers have written to SEC Chair Mary Jo White urging the Commission to require better disclosure by general partners of their private equity expenses to limited partners. Increased disclosure transparency will provide limited partners with a stronger negotiating position, resulting in more efficient investment options, they believe.

Role of private equity. The authors of the petition pointed out that private equity as an asset class plays a central role in public pension fund investment. According to the Private Equity Growth Capital Council, U.S. public pension funds invest 9.4 percent of their portfolios in private equity on a dollar-weighted basis.

The authors noted that a comparison of 10-year annualized returns shows that pension fund investments in private equity have outperformed other asset classes. Given the funding challenges facing public pension plans, they added, strong returns continue to make private equity investments an attractive option for public pension systems.

Complicated cost structure. Problems arise, however, because the cost structures of private equity are complicated compared to public asset classes, the authors stated. In their view, this complexity, combined with a lack of industry disclosure best practices, has led to an uneven playing field for state fiduciaries seeking to report private equity fees.

The four types of private equity firm expenses are management fees, fund expenses, allocated incentive fees, and portfolio-company charges. Of these, only directly billed management fees are regularly disclosed, according to the authors. They acknowledged that private equity firms disclose information on all types of fees, but said that it is often reported deep in annual financial statements and is not reported directly to limited partners on a quarterly basis. The lack of clear and frequent reporting has resulted in an uneven approach to fee disclosure from private equity general partners to limited partners, the authors said.

To further illustrate their point, they provided the example of portfolio company monitoring fees. Limited partners, such as state pension portfolios, are typically eligible for an allocation of fees that private equity managers collect from their portfolio companies, they noted. However, the limited partner share is usually not transferred to the limited partner, but is maintained by the manager and used as an offset against payment of management fees. The calculation behind the offset is often opaque to the limited partner, making consistent disclosure of private equity expenses to the public challenging, the authors wrote.

States at a disadvantage. They believe that opaque disclosure has led to a culture in which management fees reported by state pension funds often do not reflect total management fees accrued by private equity firms. In the absence of a clearly defined standard, they argued, states that voluntarily disclose more comprehensive accounts of total fees and expenses are put at a disadvantage in state-to-state comparisons.

The treasurers and comptrollers asked the SEC to take steps to require better disclosure, and offered to assist the Commission in its consideration of the matter.

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