

VII. *Private Fund Fees*

A. Introduction and Background

A private fund refers to investment funds that fall outside of the typical definition of an investment company as defined under Investment Company Act of 1940.¹ Private funds are typically pooled investments and the most common types are hedge funds and private equity funds.² Private equity funds typically invest directly in companies, whereas hedge funds function as alternative investments and employ a wide range of investment strategies to earn returns.³ Both private equity and hedge funds tend to employ similar fee structures, using what is known as the two and twenty rule.⁴ This refers to the managers taking two percent of the capital investment in the fund and an additional performance fee which is typically twenty percent of the profits generated by the fund.⁵ These fees paid to the managers recently came under scrutiny from the SEC for lack of transparency.⁶

In April 2021, Gary Gensler (Gensler) was confirmed by the United States Senate as the Chair of the Securities and Exchange

¹ *Private Fund Adviser Overview*, U.S. SEC. AND EXCH. COMM'N, 2016, (Oct. 21, 2016) <https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm> [<https://perma.cc/9MNA-9SU4>].

² *Id.*

³ J.B. Maverick, *Hedge Fund vs. Private Equity Fund: What's the Difference?*, INVESTOPEDIA (Jan. 31, 2021) <https://www.investopedia.com/ask/answers/121614/what-difference-between-hedge-fund-and-private-equity-fund.asp> [<https://perma.cc/27L3-G4J6>].

⁴ James Garrett Baldwin, *What Is the Structure of a Private Equity Fund?*, INVESTOPEDIA (Dec. 03, 2021) <https://www.investopedia.com/articles/investing/093015/understanding-private-equity-funds-structure.asp> [<https://perma.cc/WS6T-5435>].

⁵ *Id.*

⁶ Gary Gensler, Chairman, *Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs*, U.S. SEC. AND EXCH. COMM'N (Sep. 14, 2021) <https://www.sec.gov/news/testimony/gensler-2021-09-14> [<https://perma.cc/8M92-GGZ4>] [[hereinafter Gensler's Testimony](#)].

Commission (SEC).⁷ In September 2021, Gensler appeared before the United States Senate Committee on Banking, Housing, and Urban Affairs to discuss what he believed should be the SEC's agenda under his tenure.⁸ He outlined a number of areas he wished to address, one of which was Funds and Investment Management.⁹ Gensler stated that he wished to address private funds "in particular the conflicts of interest their managers may have and the information they are providing investors about the fees they charge."¹⁰ Gensler intends to make this an area of focus in his role as SEC chair.¹¹ In November 2021, Gensler appeared before the Institutional Limited Partners Association Summit and outlined in greater depth his belief in the need for additional regulation and transparency among private funds.¹² This article will discuss the focus areas of Gensler and the SEC, followed by a discussion of the SEC actions taken thus far under Gensler, and then will discuss the potential future outlook for private fund fees and conclude with a discussion of potential issues with the SEC suggestions. Further regulation of private funds is undoubtedly a necessary and noble pursuit, and the SEC has begun to take some strong steps towards private fund fees. However, the SEC must be careful to not attempt overreach and too much at once.

B. SEC Focus Areas

In Gensler's November 2021 appearance, he highlighted what the SEC believed should be the focus areas in providing greater transparency to the private funds industry.¹³ These focus areas were: (1) "efficiency, competition and transparency", (2) "market integrity",

⁷ *Biography: Chair Gary Gensler*, U.S. SEC. AND EXCH. COMM'N, 2021 (last visited Feb 18, 2022) <https://www.sec.gov/biography/gary-gensler> [<https://perma.cc/Q9BJ-PRGW>].

⁸ Gensler's Testimony, *supra* note 6.

⁹ *Id.*

¹⁰ *Id.*

¹¹ Lauren Berg, *SEC Chair Wants Transparency In Private Fund Investor Fees*, LAW360 (Nov. 10, 2021) <https://www-law360-com.ezproxy.bu.edu/articles/1439778/sec-chair-wants-transparency-in-private-fund-investor-fees>.

¹² Gary Gensler, Chairman, *Prepared Remarks At the Institutional Limited Partners Association Summit*, U.S. SEC. AND EXCH. COMM'N, 2021 (Nov. 10, 2021) <https://www.sec.gov/news/speech/gensler-ilpa-20211110> [<https://perma.cc/94RT-YFZS>] (hereinafter Gensler's Prepared Remarks).

¹³ *Id.*

(3) “resiliency.”¹⁴ This article focuses primarily on the first two . Gensler highlighted three subcategories under “efficiency, competition and transparency.”¹⁵ These areas were: (1) fees and expenses, (2) side letters, and (3) performance metrics.¹⁶ Fees and expenses in particular are an important focus for private funds.¹⁷

Private funds oftentimes charge several levels of fees, constituting a performance fee, a management fee and sometimes additional fees depending on the fund.¹⁸ As outlined above, typical management fees are 2% of the capital committed to a fund and another 20% fee for performance.¹⁹ Although the 2-20 rule may seem transparent given the clear percentage numbers, it is often difficult to tell how the fees are actually computed because of the lack of transparency in calibrating the performance of the fund. Furthermore, the use of side letters as outlined below often make the fees uneven across different investors.²⁰ As a result, the SEC is focusing on these fees in order to ensure that investors are protected.²¹ This is especially important to Gensler and the SEC because the investors in these private funds are oftentimes pensions and retirement funds, made up of “teachers, firefighters and municipal workers.”²²

Side letters are a tool used by private fund managers to negotiate “special rights and privileges” which oftentimes include a reduction of fees.²³ “Important investors” typically agree to side letters in order to receive preferential treatment.²⁴ These investors may be deemed important because they are investing above a dollar threshold or simply because they are friends or family of the fund managers.²⁵ Side letters have come under scrutiny because they give advantages to certain investors, while many other investors do not receive the same

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ Baldwin, *supra* note 4.

¹⁹ Baldwin, *supra* note 4.

²⁰ Berg, *supra* note 11.

²¹ *Id.*

²² *Id.*

²³ *Venture Capital & Private Equity Funds*, MORGAN LEWIS, https://www.morganlewis.com/-/media/files/special-topics/vcpefdeskbook/fundformation/vcpefdeskbook_sidelettersandmostfavorednations.pdf

²⁴ *Id.*

²⁵ *Id.*

benefits.²⁶ Side letters have a number of disadvantages as well. Negotiating side letters oftentimes can lead to a delay in fund closing if the parties are unable agree on terms.²⁷ Furthermore, they increase administrative costs because side letters are not uniform.²⁸ Therefore, each side letter must be tracked and accounted for individually and applied to each specific investor, which can be difficult especially for funds with longer lifespan and more investors.²⁹ These side letters seem to be trending towards heavily regulatory scrutiny.³⁰ Thus, the funds may face additional costs and compliance concerns to either more fully disclose or completely do away with these letters.³¹

Private Fund performance is typically measured in a number of ways, but the two most common are the Internal Rate of Return (IRR) and the Multiple of Money (MoM).³² IRR calculates a funds time-adjusted return and MoM is used to show a return on invested capital.³³ Both these metrics have disadvantages and are oftentimes not clear indicators of the actual return of the funds.³⁴ Furthermore, private funds' investments in illiquid assets render these metrics even less reliable.³⁵ While an advantage of investing in private funds is outperforming the market,³⁶ it is unclear if the investors themselves actually beat the market after factoring in the high fees and unclear performance metrics.³⁷ A study performed by the American Investment Council showed that private funds "had produced a 14.2 percent median annualized return, net of fees, over the previous 10 years, compared with 13.7 percent for the S&P 500".³⁸ However, when

²⁶ Gensler's Prepared Remarks, *supra* note 12.

²⁷ Venture Capital and Private Equity Fund, *supra* note 23, at 1.

²⁸ *Id.*

²⁹ *Id.* at 1-2.

³⁰ *Id.*

³¹ *Id.* at 1.

³² Alexandra Albers-Schoenberg, *Measuring Private Equity Fund Performance*, INSEAD, 1 (2019)

https://www.insead.edu/sites/default/files/assets/dept/centres/gpei/docs/Measuring_PE_Fund-Performance-2019.pdf

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.* at 5.

³⁶ Michelle Celarier, *Is Private Equity Overrated?*, THE NEW YORK TIMES (Dec. 4, 2021) <https://www.nytimes.com/2021/12/04/business/is-private-equity-overrated.html>

³⁷ *Id.*

³⁸ *Id.*

accounting for fees paid by pension funds in private funds over the same time period, they returned 12.8 percent.³⁹ The SEC would like to push for more transparency in how these fees and returns are calculated so that investors may make informed decisions into what may be the best investments.⁴⁰

Another main focus of Gensler and the SEC will be whether to allow the waiver of fiduciary duties by fund managers.⁴¹ Since many private funds are structured as Limited Partnerships, Delaware law allows “negotiated contract language modifying, restricting or even eliminating fiduciary duties.”⁴² Although the waiver is allowed under Delaware state corporate law, but it is not permitted under the Investment Advisers Act which is at the federal level.⁴³ Delaware courts believe that LPs are “creatures of contracts” and thus should be afforded the opportunity to “negotiate the terms of their respective governing documents.”⁴⁴ Accordingly, Delaware allows limited partnerships—the most common type of structure for private funds—to restrict or eliminate fiduciary duties through the structuring their partnership agreements.⁴⁵ The Institutional Limited Partner Association estimates that nearly 48% of funds may be using this waiver.⁴⁶ Gensler mentioned that private funds need to “act... consistent with those fiduciary duties.”⁴⁷ There is an inherent conflict between the waiver of this fiduciary duty and the implied fiduciary duty between an investment advisor and an investor.⁴⁸ Furthermore, what incentive is there for an investor to agree to such a waiver? At

³⁹ *Id.*

⁴⁰ Gensler’s Prepared Remarks, *supra* note 12.

⁴¹ *Id.*

⁴² Courtney Nowell, et al., *A Call to Duty: Waivers of Fiduciary Duty under Delaware Law* (July 2015) https://www.squirepattonboggs.com/-/media/files/insights/publications/2015/07/a-call-to-duty-waivers-of-fiduciary-duty-under-delaware-law/a_call_to_duty_waivers_of_fiduciary_duty_under_delaware_law.pdf.

⁴³ Andrew Lom & Gary Padrta, *Compliance Lessons For PE Sponsors Amid SEC Scrutiny*, LAW360 (Dec. 2, 2021) <https://www-law360-com.ezproxy.bu.edu/articles/1443614?scroll=1&related=1>.

⁴⁴ Nowell et al., *supra* note 42, at 1.

⁴⁵ *Id.*

⁴⁶ Chris Flood, *Investors take aim at private equity’s use of private jets*, FIN. TIMES (Nov. 18, 2021) <https://www.ft.com/content/1212b266-8760-4766-a03e-9e7db203b5d2>.

⁴⁷ *Id.*

⁴⁸ Nowell et al., *supra* note 42.

least at the surface level there seems to be very little incentive for investors to waive these duties and all the benefit is bestowed on the fund managers. These sorts of waivers are not an issue with non-private fund investments because they are not usually structured as LPs.

C. SEC Actions

The SEC has several actions currently in the works with more seemingly coming sometime in the near future. On January 26, 2022, the SEC voted on proposed amendments to the Form PF.⁴⁹ Form PF is a form for private funds, used to confidentially report information to regulators.⁵⁰ The Form PF was created as part of the passing of Dodd-Frank and is used by registered investment advisers with at least \$150 million in assets under management.⁵¹ The proposed amendment would require certain funds to provide “current reporting of events that could be relevant to financial stability and investor protection, such as extraordinary investment losses or significant margin and counterparty default event.”⁵² These funds would need to report an event within one day if the events “indicate significant stress at a fund.”⁵³ This would allow the SEC and the Financial Stability Oversight Council (“FSOC”) to more accurately and adequately analyze investor risk.⁵⁴ This could be incredibly useful to provide more information to investors and allow them to know when their investments may be facing serious risks. Furthermore, in addition to the notification of significant stress to a fund, the updates would also lower the reporting

⁴⁹ Press release, SEC Proposes Amendments to Enhance Private Fund Reporting, U.S. Securities and Exchange Commission (Jan. 26, 2022), <https://www.sec.gov/news/press-release/2022-9> [<https://perma.cc/CW4J-RVWD>].

⁵⁰ *Regulatory & Compliance: Form PF*, MAPLES GROUP, <https://maples.com/en/services/regulatory-and-compliance/form-pf#:~:text=Form%20PF%20is%20a%20US,to%20the%20US%20financial%20system> (last visited Apr. 5, 2022).

⁵¹ Nabil Sabki & Nadia Sager, *Five Lessons for Form PF* 35, 35 (Aug. 2013) <https://www.lw.com/thoughtLeadership/lessons-for-form-PF>.

⁵² Press Release, SEC Proposes Amendments to Enhance Private Fund Reporting, *supra* note 49.

⁵³ *Id.*

⁵⁴ *Id.*

threshold and require additional information intended to assist with risk assessment.⁵⁵

On February 9, 2022, the SEC proposed additional amendments under the Investment Advisers Act of 1940.⁵⁶ These rules are intended to protect private fund investors and increase regulations on private fund advisers.⁵⁷ The proposed rules aim to accomplish many things. One of main items proposed would require private funds to produce quarterly statements to provide to investors.⁵⁸ These statements would provide investors with “information regarding fees, expenses, and performance.”⁵⁹ The SEC believes these statements “would allow investors to understand and monitor their private fund investments better.”⁶⁰ Another proposed rule would require private funds to undergo an “annual audit of the financial statements of the private funds.”⁶¹ This proposed rule is intended to prevent “misappropriation of fund assets” and provide an oversight of private fund valuations.⁶² Oversight of the valuations is important because a large amount of fund fees are tied to these valuations.⁶³ The audit would be conducted by an “independent public accountant.”⁶⁴ The proposed rules will also require funds “to distribute to investors a fairness opinion.”⁶⁵ Furthermore, the SEC would work to prevent certain forms of preferential treatment.⁶⁶ The SEC is also going to require “all registered advisers, including those that do not advise private funds, to document the annual review of their compliance

⁵⁵ *Id.*

⁵⁶ Press release, SEC, SEC Proposes to Enhance Private Fund Investor Protection (Feb. 9, 2022) <https://www.sec.gov/news/press-release/2022-19> [<https://perma.cc/8KF3-7C6M>].

⁵⁷ *Private Fund Proposed Reforms*, U.S. SEC. AND EXCH. COMM’N (last visited Feb 18, 2022) <https://www.sec.gov/files/ia-5955-fact-sheet.pdf>.

⁵⁸ Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews, (proposed Feb. 9, 2022) (to be codified at 17 C.F.R. pt. 275), at 17. <https://www.sec.gov/rules/proposed/2022/ia-5955.pdf>.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.* at 99.

⁶⁵ *Private Fund Proposed Reforms*, *supra* note 57.

⁶⁶ Press release, SEC, SEC Proposes to Enhance Private Fund Investor Protection *supra* note 56.

policies and procedures in writing.”⁶⁷ These proposals are a huge first step towards the SEC regulating private funds and address many of the areas Gensler targeted as points of interest for the SEC. The following section discusses the expectation of whether these rules will pass and possible implications of such.

D. Potential Future Outlook

The SEC rulemaking process usually proceeds through three steps before a rule becomes official.⁶⁸ The first step is the concept release, which is issued by the SEC and it discusses the “the area of interest and the Commission's concerns.”⁶⁹ The concept release is a step that is not always used, but can be used in unique situations to gauge public view on a subject matter.⁷⁰ The concept release is followed by a rule proposal, which in this situation was outlined in detail above.⁷¹ The proposed rule is published and then the SEC allows between thirty and sixty days after a proposal to gather reviews and comments.⁷² If the proposed rule becomes a final rule, it is adopted by the SEC and becomes part of the official rules used by the SEC to regulate the finance industry.⁷³ If the above proposed rule is adopted, a large amount of issues that Gensler wished to address with private funds will have begun to be addressed.⁷⁴ As outlined in the proposal, there will of course be a transition period before funds are expected to begin implementing all the rules.⁷⁵

Although the above-mentioned proposal did address preferential treatment with some items, it did not directly address side

⁶⁷ *Id.*

⁶⁸ *Investor Bulletin: An Introduction to The U.S. Securities and Exchange Commission – Rulemaking and Laws*, U.S. SEC. AND EXCH. COMM’N (Aug. 20, 2015) https://www.sec.gov/oiea/investor-alerts-bulletins/ib_rulemaking.html [<https://perma.cc/Q5X3-QS62>].

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ SEC, *Rulemaking Process* (Jul. 12, 2002) <https://www.sec.gov/oig/reportspubs/aboutoigaudit347finhtm.html> [<https://perma.cc/4HSE-A9ET>].

⁷⁵ SEC Proposes to Enhance Private Fund Investor Protection, *supra* note 56.

letters.⁷⁶ One option would be to remove the use of side letters all together, but this would likely lead to heavy pushback. The other option would be to more seriously limit the scope with which these letters can be applied. Although Gensler mentioned side letters as a focus point in his November remarks, the SEC has yet to pursue further regulation of side letters.⁷⁷

The other item discussed but not addressed was waiver of fiduciary duty.⁷⁸ Although the above proposal mentions fiduciary duty, it does not explicitly address the waiver of such duty.⁷⁹ This will likely be a strong point of emphasis for the SEC in the coming months because Delaware's allowance of waivers seems to contradict the fiduciary duty imposed by the Investment Advisers Act of 1940.⁸⁰ Although the act does not explicitly prevent such waivers, the waivers could be determined to be void if an investor is believed to have waived a nonwaivable right.⁸¹ The SEC could take a firm stance and amend the act to either explicitly prevent these waivers or at least further regulate and limit when and how they are used.

Any regulation also raises questions in regards to the SEC's ability to impose regulation. The above proposal was done under the Investment Advisers Act of 1940, which is the primary way the SEC imposes regulations.⁸² This act is primarily responsible for mandating how investment advisers are to act.⁸³ This act gives the SEC pretty broad power to regulate investment advisers and has been amended several times since its passage to help with the everchanging environment of investment advisers.⁸⁴

⁷⁶ *Id.*

⁷⁷ Gensler's Prepared Remarks, *supra* note 12.

⁷⁸ Press Release, SEC Proposes to Enhance Private Fund Investor Protection, *supra*, note 56.

⁷⁹ *Id.*

⁸⁰ Gensler's Prepared Remarks, *supra* note 12.

⁸¹ Michael Hong, *Fiduciary Duties Under The Advisers Act Vs. Delaware Law*, LAW360 (Apr. 7, 2017) <https://www.law360.com/articles/896627/fiduciary-duties-under-the-advisers-act-vs-delaware-law>.

⁸² *Id.*

⁸³ Investment Advisers Act of 1940, 15 U.S.C. § 80b-1-80b-21.

⁸⁴ Julia Kagan, *Investment Advisers Act of 1940*, INVESTOPEDIA (Oct. 28, 2021) <https://www.investopedia.com/terms/i/investadvact.asp>.

E. Potential Issues

Although it is understandable why the SEC is choosing to target private funds, particularly when considering who many of the investors in these funds are, but it is important that the SEC does not go overboard with their regulations. Many of the items discussed would likely prove to be a good thing for investors, such as the removal of the fiduciary waivers and the more heavily regulating side letters. These items would provide smaller investors more protections and most likely be beneficial to the broader investing community. Regulation of side letters would help smaller investors maintain even footing with much larger investors, which would be a definite positive. Additionally, further transparency with certain aspects of the fund, such as how performance is calculated or a more in-depth fee breakdown may also help investors. Some regulations are necessary and should definitely be addressed by the SEC. More transparency by funds is something that would be highly beneficial to investors and should definitely remain one of the main target areas of the SEC.

However, the SEC should be careful to not attempt to overreach in their regulation of private funds. Private funds are inherently different investments than a mutual fund or a publicly traded security. There is a different strategy and mentality that goes into investing in them and managing them. There is most likely a middle ground between the complete overhaul of the private fund industry as outlined by the SEC and the current state of things. It seems unlikely that all the rules proposed will be adopted, since it could have a potentially harmful effect on private funds and, as a result, the money of their investors, who are exactly who the SEC is attempting to protect. The proposed regulations and reports and audits could prove very costly to the funds both in time and dollars, which ultimately will be passed along to investors.

It is however important to reiterate that transparency is an integral aspect of any investment, so a push for further transparency by the SEC would likely prove to be a good thing. There are ways to provide transparency without completely overhauling the industry. One way would be instead of requiring quarterly in-depth reports, perhaps something like a bi-annual report could be provided. These reports could offer similar information to the quarterly reports suggested by the SEC but would prove less intrusive if they were twice a year instead of every quarter. Furthermore, the SEC currently publishes “investor bulletins” for things such as private places, or

mutual funds.⁸⁵ These reports are intended to aid and educate investors, such as one aimed to teach investors to read a mutual fund shareholder report,⁸⁶ or explaining how mutual fund fees and expenses work.⁸⁷ Although they do not appear to produce any such documents currently, the SEC could work with private funds to produce similar articles specifically for private funds. These reports could work to further educate investors on how funds and performance are calculated to make more conscious informed investors into private funds. Regardless of what the SEC chooses to proceed with, they will likely receive push-back from private funds. It remains to be seen how they proceed, but it is definitely an area of the regulatory landscape to pay close attention to.

F. Conclusion

It is clear that with Gensler as the head of the SEC, private funds will be under even greater scrutiny than they have been in the past years. There are already several proposals in the pipeline to change reporting standards and transparency among funds. Although some of the focus areas that Gensler mentioned have not yet been addressed, it seems as though they will be in the future. It is clear that Gensler wishes to protect investors, particularly those who invest in private funds and is proposing a large private fund industry overhaul to do so. The SEC is undertaking an important task, but they must be careful and thoughtful how they proceed.

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⁸⁵ *Investor Alerts and Bulletins*, U.S. SEC. AND EXCH. COMM'N
<https://www.sec.gov/investor/alerts/investment%20management>.

⁸⁶ See generally, *How to read A Mutual Fund shareholder report*, U.S. SEC. AND EXCH. COMM'N
https://www.sec.gov/investor/alerts/ib_readmfreport.pdf.

⁸⁷ *Mutual Fund Fees and Expenses*, U.S. SEC. AND EXCH. COMM'N
https://www.sec.gov/files/ib_mutualfundfees.pdf.

⁸⁸ Student, Boston University School of Law (J.D. 2023).