Form ADV disclosures: GPs are getting louder about fee allocations ahead of mandatory filing deadlines

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A rush to disclose

SEC saber-rattling on fees is prompting more GPs to file 'other-than-annual amendments' to their Form ADV Part 2As. The new disclosures made prior to the March 31 filing deadline hint at a range of approaches to Form ADV updates taken this year

by KATHERINE BUCACCIO

It's April, which means most private equity firms have just gone through the process of updating their Form ADVs. For registered investment advisers, March 31 generally marks the final deadline to submit annual revisions, as they have 90 days after fiscal year-end to file any amendments to information that is no longer accurate within Part 1A and the Part 2A Brochure.

While this process of filing annual ADV amendments is required of every registered adviser, filing "other-than-annual" amendments has traditionally been a rare practice in the industry. However, prompted by demands for increased disclosure from regulators and investors alike, more firms have been filing interim amendments to the brochure in the past year.

Last November, *The Wall Street Journal* reported that more than a dozen firms had revised their filings after March 31, 2014 to contain more fee information, including such big name firms as KKR, Apollo Global Management and Advent International. The story indicated that those updates were the direct result of pressure from the US Securities and Exchange Commission (SEC) and top inspector Andrew Bowden's "Spreading Sunshine in Private Equity" speech from last May.

The trend has continued. Since November, more top players like Oaktree Capital Management, Bain Capital Partners and Partners Group have filed revised brochures, citing "material changes" to "Item 5" – the fees and compensation section. *pfm* was able to analyze the changes between the old brochures and the new brochures via a freedom of information request to the SEC.

These interim changes are likely not a knee-jerk reaction to a regulatory speech, argue compliance professionals, but rather evidence of the gradual evolution of an industry.

"These interim amendments are a symptom of private equity firms starting to take compliance and operations more seriously," says Todd Cipperman, founding principal of Cipperman Compliance Services. "They're getting used to acting like a regulated business."

No harm, no foul

Traditionally, firms have stuck to filing annual updates.

"When you look at the non-annuals, you know something happened to get a firm to change their ADV. Sometimes it's good, sometimes it's bad, but something happened," says Cipperman. "Someone doesn't just wake up one day and say, 'I've got to update that ADV.'"

With the Office of Compliance Examinations and Inspections' (OCIE) current presence exam initiative, exam feedback or deficiency letters may have been the culprit for many of the recent updates.

"If a firm is receiving a deficiency letter saying the SEC doesn't think they were clear enough with their disclosures in a certain three areas, they're going to go fix those areas right away," notes a second compliance consultant.

Even if a firm has not gone through a presence exam, its compliance team may choose to update the ADV based on hearing about the feedback that other firms have received. "A lot of these people run in the same circles and compare notes and experiences, especially with

regard to SEC reviews," the second consultant adds.

It's also just as likely that the changes have come from the new culture of compliance in the private funds environment. What is now considered "good housekeeping" may be dramatically different from five years ago, says the second consultant. A firm may launch a new fund and include more descriptive language in the Private Placement Memoranda regarding fee and compensation disclosures and update the ADV quickly to reflect those changes whereas before, they may have waited for the annual ADV to make updates.

The increase in other-than-annual amendments might also be due to the fact that more firms are hiring extra compliance help. Updating the brochure is not too time-consuming, as the process is all done online, but deciding what constitutes a "material change" important enough to file an interim amendment to the ADV is difficult, and often driven by the recommendation of compliance consultants, one private equity fund formation lawyer tells *pfm*.

The stakes are high for a firm without adequate fee disclosures. The SEC has charged multiple managers for misallocating expenses when the "disclosures" included in a Form ADV or other documents were too broad to truly prepare investors for the costs they would have to incur.

"Firms are so worried about wanting to be compliant that a 'material change' now has a broader definition," notes Cipperman. "Sometimes we have recommended that people update it out of an abundance of caution, when perhaps it wasn't even material, it was just more of a 'no harm, no foul' situation."

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Material changes

In some recent instances of other-than-annual filings, Partners Group, Bain and Oaktree all took very different approaches to altering their brochures.

Partners Group addresses the brief change to its fee and compensation section noting the "removal of an indication that the adviser does not charge a fee for publications or reports provided to its clients" in Item 2, the material changes section of the brochure. While no such fees are directly charged, the costs of producing those reports may be indirectly incurred by clients, the brochure notes. Partners deemed the change significant enough to warrant an other-than-annual amendment in January, as there are no other significant revisions in the updated filing.

Bain, on the other hand, made more updates in its late November filing. Notably, the firm includes a new section on the allocation of fees for co-investments, an area that the SEC has consistently turned its attention towards in recent years. The new document adds that "fees generated in the course of evaluating potential investments which are not consummated, such as out-of-pocket fees associated with due diligence, attorney fees and the fees of other professionals" will be determined by Bain in "good faith discretion, consistent with the limited partner agreement."

The revision is very much in line with recent trends to include more information on co-investment vehicles in the fees and compensation and conflicts of interest sections of the Part 2A. The second consultant notes his clients have made similar changes.

"I would say at this point if there's no disclosure on the co-investment process, and the firm offers co-investments, that may be seen as a deficient area," he says.

Update overhaul

In contrast, when comparing Oaktree's interim brochure from late November 2014 to the previous version, the fees and compensation section is dramatically different. The structure of the section is reorganized by type of fee charged rather than by type of fund and the length of the section is nearly doubled. Still, the first few lines indicate that the filing "is not intended to depict every scenario" and directs readers to fund documents for specific details.

The revisions in Oaktree's brochure illustrate the many areas of fee disclosure that have been recently targeted by the SEC, including operating partner fees, fee offsets and travel fees and expenses.

Hidden operating partner fees were one of the key fee practices targeted in Bowden's Sunshine Speech. Oaktree dedicates two new paragraphs to the issue, explaining that success fees, travel costs and out-of-pocket expenses incurred by "senior advisors" will be borne by the fund and that "amounts received by senior advisors in connection with their services, including any amounts paid in connection to particular transactions or investments, are not considered deal fees and will consequently not reduce the management fee paid by an account."

Oaktree follows a growing trend in the industry of offering a 100 percent management fee offset on deal and monitoring fees, inserting a new

disclosure detailing that any transaction and monitoring fees (including fees and income paid by portfolio companies), directors' fees or breakup fees received by Oaktree, net of any related expenses paid by Oaktree will "reduce on a dollar-for-dollar" basis the management fee and, to the extent necessary to absorb any excess deal fees, performance-based compensation otherwise payable to Oaktree. However, this does not include the award of a stock option or other non-cash compensation received by an Oaktree employee.

On the expenses side of the equation, Oaktree's amended brochure touches upon another hot topic in the SEC's crackdown of charging "questionable" costs. One example often cited is an executive using a private jet. According to research from ACA Compliance Group, 30 percent of private equity firms charge all costs of private jet travel to the fund, while 35 percent charge a first-class ticket equivalent when jetting around the world.

In a section on costs related to sourcing, monitoring and managing investments, Oaktree includes a few new lines on travel. The brochure notes these costs could include "reasonable travel and related expenses" which may include "business or first class airfare and, in limited circumstances, private air travel (including reimbursement of Oaktree or its employees for use of aircraft owned or leased by them)."

For the second consultant, increased disclosure about private or first class air travel has become a standard practice in amending ADVs. "It was an issue that we consistently discussed with our clients," he says. "The SEC has made it a point during exams that a 'reasonable investor' would not assume that someone is taking a private jet to fly somewhere if it's just under the disclosure of 'travel expenses,' for example."

He adds that he has worked on ADVs with clients to add further enhancements to travel disclosures, explaining "travel costs" could mean meals and entertainment in certain instances to ensure it was more reflective of the expenses incurred by the fund.

The outcome

While more firms are following in Oaktree's footsteps and filing increasingly detailed brochures, questions still remain on how important these amendments will be to the SEC and to investors.

Though providing clients with an accurate and thorough document is important for most managers, the real targets for the altered language and increased disclosures are the SEC examiners who might walk in at any moment.

And there's a flipside to all this extra disclosure, compliance experts warn. On the one hand, GPs are doing what they can to feel safe in the knowledge that investors have been sufficiently debriefed on their policies and procedures. On the other hand, with every additional sentence written, they're opening themselves up to additional SEC scrutiny. These competing interests help explain the different approaches taken by firms, which also may come down to some firms simply playing it extra safe, perhaps at the beckoning of super cautious compliance consultants and lawyers.

The important thing for GPs to remember is that ADV disclosure does not address or improve fee and expense policies in prior funds where the disclosure was not clear, and those older vehicles are typically the targets of the SEC's investigations.

"If you really want to enhance and match all the disclosures you can certainly go back and amend your old fund documents and get all the investors to sign off on them," notes the second consultant. "I've never seen anyone do that."

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From an investor's perspective, the ADV is increasingly important. Many institutional investors have upped the intensity of their due diligence procedures and now parse through the language of the documents. But there's a chance investors do not even realize these brochures are being updated more than once per year.

Most managers send out the ADV to investors annually, despite the fact that technically, they only need to distribute the form to the "client," or the fund itself. When filing an other-than-annual amendment, managers also face the option of distributing the updates to investors or solely filing them. Investors can still access the form on the SEC's website, but some LPs believe delivery of the form without request is a best practice.

"I have not had any of my clients specifically go back and send them out again or make people aware that there have been material changes in the Part 2A throughout the year," says the second consultant.

That practice may change. If these other-than-annual brochure filings continue to rise, both investors and SEC officials will be taking more interest in who is filing them and why.

"It's important for both the SEC side and for institutional investors doing due diligence, and you're going to see more of it," says Cipperman. ■