

## Private Equity Update: SEC Continues to Scrutinize “Accelerated” Monitoring Fees

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The U.S. Securities and Exchange Commission (SEC) recently settled its latest enforcement action around the practice of private equity fund managers receiving so-called “accelerated” monitoring fees from their funds’ portfolio companies without adequate disclosure to the funds’ limited partners.

The SEC has brought a number of these actions in the past few years. The focus on this issue has been part of the SEC’s overall focus on private equity fund managers’ disclosure practices generally, in an effort to ensure fairness to their investors. The actual practice of earning accelerated monitoring fees – that is, charging portfolio companies fees for performing consulting, advisory, or similar services, and then upon “early” exit (i.e., before the end of the term of the management agreement between the fund and the portfolio company), earning a lump sum of all the fees the fund manager would have received if the companies had not been exited early – has not been the focus of enforcement by itself. Rather, the SEC has brought actions where this practice was not adequately disclosed to a fund’s limited partners in its offering materials (i.e., its private placement memorandum and/or its limited partnership agreement) prior to the limited partners’ commitment to the fund. As management services agreements often have long terms, an accelerated fee provision can result in a significant payment to the fund manager that the SEC has indicated requires adequate disclosure. The SEC has made it clear that such disclosure should be made pre-commitment, and that including disclosure in fund performance reporting to investors after the fact is insufficient.

There are some nuances on this issue around whether the fund in question has a management fee “offset” provision. The practice of charging accelerated fees clearly reduces the value of the applicable portfolio company upon exit. However, many private equity funds provide for a management fee “offset,” where the fund-level management fee is reduced by any portfolio company fees earned by the fund manager and its partners and employees. To the extent that accelerated monitoring fees are fully offset against fund-level management fees, limited partner investment returns would not be affected. However, all management fee offsets are not equal. While there has been a trend in the industry recently to move towards more 100% offset provisions, many private equity funds still have management fee offsets in the 75%-80% range, and some top-tier firms still apply even lower management offset percentages. Furthermore, even funds with a 100% offset provision do not necessarily insulate themselves from scrutiny. Where portfolio company fees exceed fund-level management fees available to offset against in a given fee period, they typically carry over until the next fee payment periods until the final liquidation of the fund, when they are then sometimes kept by the fund manager. This can come into play in the case of a large accelerated fee payment, particularly towards the end of a fund’s life when fund-level management fee amounts are

often significantly reduced. The SEC has cited this scenario in at least one settlement release relating to accelerated monitoring fees.

The recent flurry of enforcement actions around accelerated management fees has also put the issue into more focus from a commercial perspective, and a number of firms are changing their approach and are no longer charging these fees in order to avoid being perceived in the marketplace as earning fees for services they did not ultimately provide. However, there can be circumstances where the facts and circumstances around charging an accelerated monitoring fee can be justified. A portfolio company going up for sale earlier than originally anticipated could mean that the fund manager was required to spend more time advising management through a sale process earlier in the term of a management agreement than originally planned. At least one high-profile fund manager recently established an accelerated management fee policy that provides that the firm will only charge an accelerated management fee where its limited partners will benefit from the fee, or at the very least not be worse off based on the availability of a fund-level management offset.

In any case, with regulators zeroing in on this issue and others around adequate fee disclosure, transparency with investors will continue to be key. Prior to entering into a management services, consulting, or similar portfolio company management agreement that will include a provision for accelerated monitoring fees, it is best practice to consider whether the possibility of a fund manager earning accelerated fees was adequately disclosed in the fund's private placement memorandum and other offering documents.

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