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PRIVATE MARKETS FEE DILIGENCE: A COO's CHECKLIST ON FEES AND EXPENSES

A PRACTICAL GUIDE FOR ASSET-OWNER COOs TO HELP VALIDATE PRIVATE MARKET FEES AND EXPENSES

Private market fund agreements can contain highly complex fee, expense, and carried interest provisions. While a complete validation of these calculations often requires specialist review, COOs and senior finance executives can perform several high-level checks to identify potential inconsistencies and determine whether further investigation is warranted.

The following checklist highlights key areas that LPs should periodically review to help ensure that management fees, partnership expenses, and carried interest allocations are being applied in accordance with the governing agreements.

1. CONFIRM ALL KEY FUND DATES

Management fee calculations often change throughout a fund's lifecycle. As a result, inaccurate or delayed transitions between fee stages are among the most common sources of calculation errors.

Review and document:

- Initial closing date
- Subsequent closing dates
- End of the investment period
- Extension periods (if applicable)
- Fund termination date and extensions
- Any dates that trigger management fee step-downs or basis changes

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The check
Confirm that management fee calculations transition on the correct dates and that any fee reductions or basis changes occur precisely when required under the LPA.

Why it matters
Delayed implementation of fee step-downs can result in LPs being overcharged for extended periods without obvious visibility.

2. MONITOR THE INVESTMENT-LEVEL IRR AGAINST THE PREFERRED RETURN

Even though preferred return calculations are often governed by detailed waterfall provisions and may not be calculated strictly as an IRR, the individual investment IRR can serve as a useful reference point.

Review:

- Cash inflows and outflows since inception
- The calculated investment IRR
- The preferred return or hurdle rate specified in the LPA

The check
Compare the investment's IRR with the hurdle rate that must typically be achieved before carried interest is allocated.

Why it matters
While the relationship will not always be exact, a significant divergence between the calculated IRR and the GP's reported preferred return achievement may warrant further review of carried interest calculations.

3. EVALUATE THE AMOUNT OF CARRIED INTEREST BEING ALLOCATED

When the GP starts allocating carried interest, LPs should assess whether the magnitude of the allocation appears consistent with the waterfall provisions.

Review:

- Reported accrued or realized carried interest
- Pre-carry gains for the relevant period
- Stated carried interest percentage
- GP catch-up provisions

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The check
Calculate the carried interest allocation as a percentage of pre-carry gains.

For example:

- Pre-carry gains: $1,000,000
- Reported carry allocation: $200,000
- Effective carry rate: 20%

If the implied percentage differs materially from the stated carry rate, assess whether the variance can be explained by catch-up provisions.

Why it matters
An effective carry rate significantly above the headline carry percentage may be entirely appropriate during catch-up periods. However, understanding whether the allocation aligns with LPA provisions can quickly identify situations that merit further investigation.

4. VERIFY SIDE LETTER FEE ARRANGEMENTS

LPs with negotiated fee discounts should periodically confirm that preferential terms are being correctly applied.

Review:

- Side letter provisions
- Applicable management fee rate
- Management fee basis as defined in the LPA
- Fee calculations reported by the GP

DURING THE INVESTMENT PERIOD

The following applies if fees are calculated based on commitments.

The check
Multiply the commitment amount by the negotiated fee rate, then compare the result to the gross management fee allocation reported to the account.

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AFTER THE INVESTMENT PERIOD

The following applies if fees are based on invested capital, net invested capital, or remaining cost.

The check
Apply the negotiated fee rate to the applicable balance from the previous reporting period. In many fund structures, the remaining cost reported in the balance sheet provides a useful reference point.

Why it matters
Operational errors can occur even when preferential terms are properly documented, making periodic verification essential.

5. ASSESS PARTNERSHIP EXPENSE ALLOCATIONS

Fund expenses are generally allocated based on ownership percentages, although the specific methodology depends on the governing documents.

Review:

- Expense allocation provisions within the LPA
- Fund ownership percentage
- Feeder vehicle ownership percentage (if applicable)
- Reported partnership expenses

The check
Select a relatively stable expense category, such as:

- Fund administration
- Accounting services
- Audit expenses
- Regulatory filing expenses

Multiply the fund-level expense by the applicable ownership percentage and compare the result to the amount allocated to the account.

Why it matters
Stable expense categories provide an efficient way to confirm that allocation methodologies are operating as expected. While not a substitute for detailed testing, this approach can quickly identify potential allocation issues.

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6. EXAMINE THE STRUCTURE OF THE CARRIED INTEREST WATERFALL

Understanding the economics of the waterfall is essential to understanding the resulting carry allocations.

Review:

- Distribution priority provisions
- Income and loss allocation provisions
- GP catch-up mechanics
- Carried interest allocation percentages

Does the waterfall contain the following standard components?

1. **Return of capital:** all contributed capital is returned to LPs.
2. **Preferred return:** LPs receive a specified preferred return, also called a hurdle rate.
3. **GP catch-up:** once the preferred return is achieved, a higher percentage of allocations may be directed to the GP until the agreed economic sharing ratio is reached. Common catch-up rates include 100%, 80%, or 50%.
4. **Residual profit split:** remaining profits are allocated according to the standard carried interest split, such as 80% LP/20% GP.

The check

If your waterfall contains unusual provisions, such as a preferred return without a catch-up mechanism, or non-standard allocation sequencing, request a sample calculation from the GP showing how the most recent carry allocation was derived.

Why it matters

Many allocation issues originate from misunderstandings of the waterfall mechanics rather than arithmetic errors. A clear understanding of the waterfall structure provides a critical foundation for evaluating reported carried interest.

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7. RECONCILE CAPITAL ACCOUNT MOVEMENTS TO OVERALL FUND ECONOMICS

While individual fee and carry calculations are important, COOs should periodically assess whether the overall movement of their capital account aligns with the economics reported by the fund.

Review:

- Beginning and ending capital account balances
- Contributions and distributions made during the period
- Allocated income and losses
- Management fees and partnership expenses
- Carried interest allocations
- Changes in reported NAV

The check
At a high level, capital account movements should be explainable by the combination of contributions, distributions, income allocations, expenses, and carried interest reported during the period.

For example, if the fund reports significant investment gains during a quarter but the capital account growth appears disproportionately low after accounting for distributions and fees, further review may be warranted.

Why it matters
Many reporting inconsistencies are identified through simple reconciliation exercises before they are discovered through detailed recalculations. A periodic review of capital account movements helps confirm that fees, expenses, gains, losses, and carried interest allocations are collectively producing results that are economically reasonable.

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8. REQUEST AND REVIEW SAMPLE CALCULATIONS PERIODICALLY

Even where reported amounts appear reasonable, LPs should periodically request supporting calculations to confirm that key provisions of the LPA are being applied as intended.

Review:

- Management fee calculations
- Preferred return calculations
- Waterfall allocation examples
- Partnership expense allocation methodologies
- Side letter adjustments, if applicable

The check
Request a sample calculation for a recent reporting period and compare the methodology used by the GP against the relevant provisions in the LPA and any side letter agreements.

The objective is not necessarily to independently recalculate every figure, but rather to confirm that the calculation approach appears consistent with the governing documents.

Why it matters
Many fund terms involve judgment, interpretation, and complex allocation mechanics. Reviewing sample calculations provides transparency into the GP's methodology and can identify misunderstandings or operational errors before they become material over the life of the fund.

LOOKING TO IMPROVE OVERSIGHT OF PRIVATE MARKET FEES, EXPENSES, AND CARRIED INTEREST?

eFront FAIR provides fee validation, fee tracking, benchmarking and board-ready reporting to help investors strengthen oversight of private market fees, expenses and carried interest.

Supported by experienced legal and accounting professionals, FAIR combines independent fee validation, standardised ILPA-aligned data, fee variance identification and ongoing review of fees against governing agreements.

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