PCA | PENSION CONSULTING ALLIANCE

MEMORANDUM

Date: July 22, 2015

To: Clients

From: Pension Consulting Alliance, LLC ("PCA")

RE: **Private Equity and Carried Interest**

Carried interest is an issue that has recently received and will continue to receive significant attention in the press and at client meetings in the near term. The discussion has centered on what information is available to private equity investors, how it is being used, and how it should be used. PCA believes that these issues warrant significant attention from both limited partners and general partners. This discussion also deserves some context, as well as a historical perspective that can shed light on how private equity disclosures have operated since the industry's inception.

Most domestic private equity partnership agreements are structured under Delaware law, which provides wide berth as to the terms of those agreements, subject to certain limited statutory requirements. The proverbial "2 and 20" describes the general partner's compensation under these agreements, i.e., management fee of 2% of committed capital and 20% share of the partnership's profits (carried interest). Those terms of the partnership agreements dictate the disclosure requirements of fees and expenses and the accounting thereof. The accounting profession and most investors consider carried interest to be an allocation of profits between/among partners in a fund, not as an expense as it has been characterized in recent reports and articles. This has caused confusion and added to the lack of clarity in the discussion.

Almost all investors verify the profit allocation when distributions from general partners to limited partners occur (after realization of the proceeds from the sale of a portfolio company). This point has been lost in the recent media reports. Almost all general partners have their funds' financial statements audited by one of the largest certified public accounting firms in the world. This is intended to provide external assurance to the limited partners that the general partner is properly accounting for its share of realized profits. Unrealized profits during the time an investment (usually a company or a security) is in the fund's portfolio include the changes in market valuations reduced by the general partner's allocation of unearned profits. There is wide variation in the ways in which this is reported to investors, resulting in a lack of uniformity of reporting on an interim basis. This is another reason for the industry-wide lack of consistency and clarity.

Most investors have historically concluded that the aggregation and reporting of a manager's share of profits was unnecessary for those with plan sponsor fiduciary responsibility. Historically there has been almost no public reporting of a general partner's profit allocation by its investors. The focus has been on returns on a gross and net basis and on multiples of invested capital. Until recently, this was considered to be the best practice by most investors, their advisors (including PCA) and independent certified public accountants.

PCA has been a longstanding proponent of increased transparency in private equity. While regulatory scrutiny and media attention can be helpful at the margins, at its core, private equity relationships are governed by contracts. Meaningful changes will only be achieved through an evolution in the parties' willingness to accept different terms and conditions. We strongly

encourage our clients and industry groups to collaborate and apply collective pressure on general partners to achieve greater transparency.

Lastly, it is worth mentioning private equity's role as a return enhancing asset class in an institutional investor's portfolio. In almost all projections of capital market rates of return, private equity (net of fees) is assumed to generate the highest return with commensurate risk. For many large investors, private equity has been the best performing asset class over the long-term. As of March 31, 2015, the portfolios comprising the peer-based State Street Private Equity Index reported annual returns of 11.5% over the last ten years, compared with 8.4% generated by the Russell 3000. A continuation of private equity's outperformance relative to the public markets is necessary for many investors to continue meeting their objectives.