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THE LPA ANATOMISED

A practical guide to negotiating private fund terms to create GP/LP alignment

The ILPA influence is written by Tarek Mardini and Amos Veith and was first published in *The LPA Anatomised* by PEI.

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The ILPA influence

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Introduction

The Institutional Limited Partners Association (ILPA) Principles first appeared in 2009 when the global financial crisis was taking its toll on all financial markets (both public and private, equity and debt). After a moment of virtual standstill following the Lehman Brothers' bankruptcy and AIG bailout, market participants began to assess not only the damage caused, but to reassess the opportunities and risks of making any new investments as well as the existing rules governing such investments.

Contrary to certain doomsday predictions, the private equity limited partnership structure (the established governing model of private equity funds in the US, UK, Germany and many other jurisdictions), unlike some other asset classes (asset-backed securities, for example) proved to be robust and generally the industry emerged from the crisis with limited damage. Nevertheless, there remained a deep sentiment in the limited partners (LP) community that some of the fund terms of the pre-financial crisis years significantly favoured general partners (GP) as a result of a GP-friendly fundraising environment, and, therefore, had to be scaled back to fulfil the industry's objective that funds should be long-term partnerships aligning the interests of both fund managers and investors to deliver superior returns. The power pendulum in the negotiation of fund terms had begun to swing from GPs to investors in the post-financial crisis world.

Particular areas of examination included whether existing fee structures were providing the right incentives and alignment of interests between GPs and LPs, whether common investor protection rules were able to deal sufficiently with market downturns and crisis scenarios, and whether the level of transparency provided in the past would be sufficient to make LPs comfortable with investing in private equity funds in a post-crisis world.

The arrival of the ILPA Principles was not coincidental to this. Rather they were a direct consequence of changing LP attitudes towards certain fund terms. This chapter assesses the impact of the Principles on the negotiation of fund terms among fund managers and investors and the part they have played in influencing and shaping limited partnership agreements (LPA). It summarises the reassessment of the GP/LP relationship following the global financial crisis, the appearance and evolution of the Principles from version 1.0 to version 2.0 (analysing the latter in more detail) and offers an outlook on industry developments and regulatory factors that are likely to shape the negotiation of fund terms in the coming years.

Evolution of the ILPA Principles

It did not come as a surprise that LPs were looking for ways to exchange their ideas on improving fund terms for the investor community. Before the ILPA Principles were published, investor cooperation was largely informal and not coordinated. Negotiations of fund terms with GPs were mainly conducted on a one-to-one basis by cornerstone and larger investors, such as pension funds. Smaller investors, on the other hand, often only negotiated the investor issues specific to their needs (such as special regulatory or tax requirements, affiliate transfer or special reporting needs), which were usually addressed in a side letter to the fund agreement. Generally, they were content to receive an allocation to a fund with a good track record and, effectively, left the 'heavy lifting' of securing acceptable fund terms in negotiations with GPs to the larger investors.

The financial crisis and the emergence of the ILPA Principles changed this relationship dynamic. Investors, both large and small, realised the need to strengthen the alignment of interests between fund managers and investors, to gain more control over their investments and to demand better downside protection. Investor cooperation – whether in new fundraisings or in selected cases of investor activism in existing (troubled) funds, leading to re-negotiation of terms (such as capping fund sizes or reducing management fees) – became the new imperative. ILPA, which had already existed for some years, provided the long sought-after platform to achieve this.

What is ILPA?

ILPA is an international non-profit organisation based in Toronto, Canada. It was founded by institutional investors in the private equity asset class in the early 1990s to provide a forum for investors to exchange information, build networks and relationships among the investor community and to educate investors about the private equity asset class.

Its member base currently consists of more than 250 institutional investors that collectively manage more than $1 trillion of private equity assets.[1] Around three-quarters of its members are based in North America (US and Canada), but it also has members from all continents and all major investor regions around the world. Its membership is also diverse representing all major investor groups in the private equity asset class (including corporate and public pension funds, insurance companies, foundations and endowments, family offices and sovereign wealth funds). Funds of funds, however, are not ILPA members due to their dual role of being both GPs and LPs.

ILPA Principles 1.0

In September 2009, ILPA published the first version of its Private Equity Principles – ILPA Principles 1.0, the culmination of ongoing discussions and consultations among investors. Although industry standardisation projects had occurred before (an example is the European Venture Capital Association's (EVCA) valuation and reporting standards), they had largely been driven by GPs rather than investors. ILPA 1.0 was, therefore, the first major coordinated attempt by investors to set out guidelines for the structuring, and terms, of private equity funds and to propose best practices from an investor perspective.

1. http://ilpa.org/about/

The principles focused on three key areas:

- strengthening alignment of interest;
- enhancing fund governance and investor protection, and
- improving transparency and investor reporting.

The Principles were intended not only to educate the LP community about best practices from an investor perspective, but also critically to facilitate discussions between GPs and LPs about good fund governance and investment value creation through alignment of interests. They generated a strong reaction from the private equity community.

The industry had already seen a weakening of the negotiation position of GPs due to the reduced flow of institutional money into new funds in the aftermath of the financial crisis. While investors welcomed the Principles and immediately began to use them when negotiating fund agreements, GPs – although generally in agreement with the three core principles – saw in many of the detailed proposals a clear departure from established market standards. Overall, they regarded the ILPA Principles as an 'investors' wish list'.

In particular, GPs considered the following ILPA proposals to be departures from the market norm:

- Clear preference for a whole-of-fund carry model over the US style deal-by-deal carry structures.
- Significant carry escrow requirements (in particular in the case of US style deal-by-deal carry structures).
- Requirement that management fees would merely cover a fund manager's reasonable operating costs and expenses.
- Cash funding of a GP's commitment rather than funding through a tax-efficient waiver of the management fee.
- In cases of a 'for-cause' removal of a GP, changing the review process from a final and non-appealable court decision to a preliminary determination and, in general, reducing the suggested thresholds for simple or special investor consents in cases of no-fault divorce, no-fault dissolution and no-fault termination.

Investors, in contrast, considered many of the standard market terms established in the pre-financial crisis years to be too GP friendly and believed they had to be recalibrated to create a better alignment of interests between GPs and LPs.

ILPA Principles 2.0

ILPA recognised that version 1.0 of the Principles would have to be amended over time to reflect feedback from the private equity industry and to improve best practices. Therefore, in January 2011, ILPA issued revised Principles – ILPA Principles 2.0 – which included an updated appendix on the Limited Partner Advisory Committee (LPAC) and two new appendices relating to clawbacks and financial reporting.

This second version adhered to the three core principles of alignment of interest, fund governance and transparency set out in Principles 1.0. However, ILPA indirectly acknowledged in version 2.0 that some of the detailed proposals in Principles 1.0 had gone too far in departing from established market standards. Principles 2.0, therefore, incorporated feedback about Principles 1.0 received from both LPs and GPs.

Generally, Principles 2.0 are an evolution rather than a revolution of the original ILPA Principles and are considered by the private equity community to be more balanced. As a result, their influence in LPA negotiations has had a greater impact. LPs and GPs nevertheless continue to disagree in negotiations about whether individual proposals are reasonable or not. Many well-respected GPs (KKR, Oaktree, Apollo Management, Coller, Apax, Pantheon, among others) have, however, endorsed Principles 2.0, at least with respect to the three guiding principles, although this does not necessarily mean adopting or adhering to all of the roughly 100 detailed individual proposals of the Principles 2.0.

ILPA 2.0: impact on negotiating fund agreements

This section discusses the fund terms where ILPA Principles 2.0 has had most influence and analyses the points that are often subject to heated negotiations between investors and fund managers.

It is worth noting at this point that ILPA recognises that the Principles should not be applied as a checklist and that the specific circumstances of a fund must also be taken into account during negotiations.

Alignment of interests

The alignment of interest between fund managers and investors is often regarded as the most important of the three ILPA Principles. The economics and remuneration structures of a fund should create positive incentives and avoid a misalignment of interests (see also 'Aligning GP and LP interests in the LPA: New cycle, new challenges'). In the private equity fund context, remuneration structures consist of different components, which are discussed in this section.

As a general rule, ILPA strongly prefers variable, performance-based remuneration (carried interest) over fixed, non-performance related fees (such as management fees), which should be limited to covering the costs and expenses necessary to provide performance-oriented incentives. In addition, ILPA expects fund managers to invest a significant amount of their own capital in the fund in order to better align interests. Both the performance-based incentives as well as the downside protection incentives are designed to fully align the interests of fund managers with their investors.

Carried interest waterfall and clawbacks

This is one of the few remaining areas where there are significant differences between US funds on the one hand, and European and Asian fund agreements on the other (see also 'LPAs: A regional comparison').

In European and Asian fund agreements, so-called whole-of-fund carry waterfalls are used. Here, the carry is only paid out if investors have first received a full return of their contributed capital (including unrealised investments, management fees and expenses) plus a preferred return (often called a hurdle rate, which is typically between 6 and 8 percent per year). As a result, carry payments are deferred often until the end of the fund's investment period and thereafter. ILPA has a clear preference for such carry arrangements to reduce the likelihood that any carry paid out has to be returned due to excess profits being distributed as carry or insufficient profits being distributed to LPs (a so-called carry clawback).

ILPA Principles 2.0 acknowledge, to a greater extent than their predecessor, that a different carry model – the deal-by-deal carry scheme – is historically used in most US funds. With this model, the GP already receives carry after a return of costs of realised investments and write-downs and write-offs to date, plus expenses and fees attributable to realised investments. This waterfall is GP friendly and can accelerate carry payments by many years compared to the European model. If early deals are profitable and later deals are not, any excess carry received by fund managers would have to be returned to the investors.

ILPA proposes that the risk of overpayment be dealt with by imposing the following conditions on carry payouts:

- Inclusion of all (not only pro rata) deal-related costs, fees, taxes and write-offs.
- A robust escrow mechanism of at least 30 percent of carry distributions, prudent valuations and a 125 percent net asset value (NAV) coverage test.
- Interim clawbacks tested at intervals (rather than at the term's end) and on specific events, such as key-person events or insufficient NAV coverage.
- Joint and several guarantees by the GP and the individual members of the management team and/or associates (although Principles 2.0 are more flexible than Principles 1.0 and provide alternatives, if only several liability is provided, such as a creditworthy guaranty of a substantial parent company).
- Certification of carry calculations by the fund's independent auditors.

In terms of timing, ILPA requires that carry clawbacks should be repaid fully and in a timely manner (rather than within two years as proposed by Principles 1.0) and that clawback obligations should extend beyond the fund's term (mirroring any limited partner distribution giveback obligations).

Principles 1.0 proposed that management clawbacks should be returned gross of tax. The revised Principles 2.0 softened this position and conceded that clawbacks should be net of tax. This effectively requires investors to absorb the tax burden.

This is one example where ILPA reversed its position based on extensive feedback from fund managers. However, ILPA recommends reducing the resulting tax burden by applying individual tax rates to each manager rather than applying the highest marginal tax rate as a hypothetical tax rate (as often used in fund agreements in the past), as well as taking into account loss carry-forwards and carry-backs, and any tax changes between the formation of the fund and clawback date. ILPA considers this issue to be so important that Principles 2.0 contain a newly added Appendix B dedicated to carry clawbacks.

ILPA mentions that any carried interest generated by the fund manager should be directed 'predominantly' to the professionals active in achieving the success of the fund, but stops short of offering detailed guidance on this point. In practice, other constituent parties may participate in the carry, such as inactive founding partners, parent companies or passive minority shareholders of a management company, whether private or publicly listed.

The allocation of carry is of increasing importance for many reasons, including the succession issues faced by many funds, and the increasing number of publicly listed management companies of private equity funds as well as pension funds or sovereign wealth funds acquiring minority positions in management companies. Further guidance can be expected in future ILPA publications.

In the field of carry structures and clawbacks, the ILPA principles left their mark on the negotiation of LPAs. Deal-by-deal carry structures are now on the decline, or at least under pressure worldwide. Even in the US, whole-of-fund structures are now slightly more common than deal-by-deal structures in new funds raised.[2] Investors are also now focusing on escrows and carry clawbacks, and are demanding creditworthy guarantees. While they may not often get pure ILPA terms and negotiations may focus on technical details, the pendulum has clearly shifted in favour of LPs.

Management fees and fee offsets

As management fees are not performance-related, an excessive level would create a misalignment of interests between a fund manager and its LPs. For this reason, ILPA demands that the level of management fees should be limited to covering reasonable salaries, operating costs and overhead expenses (such as rents, travel and deal sourcing) actually incurred by a fund manager, rather than providing material upside compensation to managers.

A reduction of management fees (known as a step down) is typically recommended by ILPA (i) at the end of the investment period (as generally seen in practice), (ii) in case of the formation of a successor fund (though ILPA is silent on whether a step-down is recommended if only a 'dry closing' of a successor fund occurred) and (iii) in the event of the extension of the fund's term (a new requirement not previously covered).

2. The 2012 Preqin Private Equity Fund Terms Advisor, p. 45-46 (regarding fundraisings and funds closed in vintage year 2011/12 in North American funds: 48 percent whole-of-fund structures versus 46 percent deal-by-deal structures).

The vast majority of funds provide for a step down of the management fee. ILPA, therefore, only describes a common practice, but the mechanics of fee reductions often vary substantially. Some funds only switch the base from committed capital to invested capital, while others may also reduce the percentage fee rate. Management fees have come down over the last few years, typically within the range of 1.5 percent to 2.5 percent, and often 2 percent or lower,[3] but this continues to be an area of negotiation. Common investor sentiment is that fees are still too high and create a misalignment between managers and investors. Attempting to set management fees at a level equal to actual costs would require a level of transparency, in terms of detailed information, that most managers are not willing to provide (though it is quite common that investors ask for budgetary information as part of their due diligence).

The fund manager may also receive additional fees (such as transaction, director, monitoring, advisory and break-up fees) from portfolio companies or third parties. ILPA recommends that such fees should be credited in full against the management fee for the benefit of the fund. While there was either no, or only, a 50 percent fee offset in pre-financial crisis years, fee offsets increased over time to 80 percent and nowadays a 100 percent fee offset is often seen, though sometimes using different offset percentages depending on the type of fee (see chapter 'Aligning GP and LP interests in the LPA: New cycle, new challenges). This is the area of fund economics where investors have probably made the greatest progress in negotiations in the last few years.

The ILPA Principles stress that any fees generated by an affiliate of the fund manager (for example, an advisory firm or in-house consultancy), whether borne by the fund or a portfolio company, should be reviewed and approved by the majority of the LPAC.

Placement agent fees according to ILPA should be borne by the GP and not the fund. The Principles 1.0 had recommended that insurance expenses should also be borne by the GP, but Principles 2.0 are silent on this point.

General partner commitment

ILPA emphasises that fund managers should have 'skin in the game'. This means that they should make a substantial equity commitment to the fund in the form of cash, as opposed to contributions by way of a management fee waiver. Managers often consider such waivers a preferable route due to tax advantages and it can be hard to persuade them otherwise (though this practice was recently further questioned by an investigation into fee waivers by the New York attorney general. [4]

In recent years, GP commitments have increased from the traditional 1 percent of total fund commitments to between 2 percent and 5 percent, sometimes higher. Although this trend started before the ILPA Principles were issued, it is nevertheless supported by them.

3. The 2012 Preqin Private Equity Fund Terms Advisor, p.30-40 (regarding a detailed breakdown of the typical range of management fees for the various sub-categories of private equity funds).

4. New York Times. 'Financial Firms Face Subpoenas On Tax Strategy'. September 2, 2012.

According to ILPA, fund managers should not be allowed to selectively participate through co-investments with the fund. Instead, the GP's entire commitment should be invested in all of the portfolio companies pro rata at equal terms through the fund in order to avoid cherry-picking of investments by the GP (again already an investors' complaint before the arrival of the ILPA Principles).

Governance

In practice, many investors focus on the fund economics as the main area of the ILPA principles because, ultimately, all investors are eager to receive an above-market performance from their private equity investments in order to justify the main inherent drawback – long-term illiquidity – of the private equity asset class. Sometimes lost in all the number crunching, however, is that investors and fund managers should care equally about fund governance.

At the heart of the fund governance issue is a principal-agent dilemma – management of the fund and ownership of the fund's capital are in separate hands. The LPA, therefore, serves as the legal framework to reconcile conflicting interests and to create incentives for success-oriented fund leadership.

Good fund governance not only serves as an instrument of pursuing joint goals and achieving success for the fund as a whole, but more importantly it must provide clear and thoughtful rules for unforeseen events in times of market crisis or fund crisis.

Governance is an investor's insurance policy and an integral part of an investor's risk management. Fund managers also have an interest in operating their fund according to an agreement that steers them through good and bad times by providing clear rules, but that also provides the flexibility to adapt to changes. In many jurisdictions, limited partnership structures provide the flexibility needed by both fund managers and investors in addition to limited liability of investors and tax transparent treatment.

ILPA considers the LPAC to be an effective voice of the limited partners and a sounding board for managers in governance matters. This is considered in more detail below.

Key persons

In a fund's world where small is beautiful and running a fund is still a people's business, ILPA emphasises that the management team is a key factor when an LP considers an investment in a fund. Changes in personnel should be promptly reported to investors to give them a chance to reconsider or positively affirm their decision to invest in the fund.

The exit of certain managers (key-person event) or a cause event (fraud, wilful misconduct, gross negligence and material breach of the fund agreement or fiduciary duties) should, therefore, trigger an automatic suspension of the investment period (or, in the case of a cause event, even trigger an automatic termination of the investment period). While an automatic suspension is to be found in the vast majority of fund agreements, some US fund agreements still require a positive vote from LPs to suspend the investment period (though this minority of funds is declining). ILPA recommends that a suspension of the investment period should be permanent unless a super majority of investors positively reinstates the investment period within 180 days. This is contrary to some more manager-friendly fund agreements that provide for an automatic re-enactment of the investment period after a certain time period, unless the investors vote to make the suspension permanent.

Key-person clauses continue to be heavily negotiated in practice with an emphasis on time and attention requirements (including carve-outs for related predecessor and successor funds) as well as on the identity of key persons (and in general more complex/tiered key person clauses).

Fault and no-fault remedies

In addition to key-person provisions, cause (fault) and, in particular, no-fault remedies are the main investor protection rights (see chapter 'Investor protection provisions'). In case of managerial misconduct (cause event), investors should be able to remove the GP, terminate/suspend the investment period or end the term of the fund through a vote of a simple majority of investors' commitments.

ILPA does not define 'cause', although in practice the devil is in the detail when defining cause events. In addition, many LPA negotiations focus on whether any court determination of a cause event must be final and non-appealable (which GPs prefer) or whether an early court determination is sufficient (which LPs prefer). ILPA is silent on this point.

In any event, it would usually take too long to enforce fault remedies in courts. Investor rights for cause/fault are, therefore, universally regarded as practically inefficient. However, they may be used by investors in disputes with managers as a threat to a GP's reputation or in cases where the LPA does not provide for no-fault remedies (or only with extremely high super-majority requirements).

Due to the practical inefficiencies of fault remedies, the most effective tool that LPs possess are no-fault remedies. ILPA recommends that the LPA should provide for investors' rights that are exercisable through an investors' resolution with a super majority, even in situations without managerial misconduct (no-fault). Unlike in cases of cause/fault, an additional court determination is not required. This makes these remedies very attractive to investors.

ILPA recommends that with a qualified majority of two-thirds (Principles 1.0 recommended 50 percent), investors should be allowed to suspend or terminate the investment period at their discretion on a non-fault basis (no-fault termination). With a qualified majority of three-quarters (Principles 1.0 recommended two-thirds) investors should be able to remove the GP (no-fault divorce) or end the fund's term prematurely (no-fault dissolution) – (see also 'LPAs: A regional comparison').

Principles 2.0 increased the super-majority thresholds from the prior ILPA recommendations because the general market perception was that the earlier proposals did not reflect the market standard. In addition, managers rightly argued that once investors signed up for a fund, they should not be able to change their minds (for example, due to changing market conditions) and walk away with a simple majority vote at the cost of other investors (and the managers). Over the years, super-majority thresholds have been reduced in many LPAs (although not always to ILPA levels as, for example, 80 percent is often seen for no-fault manager removal) due to ILPA's efforts and investors' increased awareness of the need to include such investor protection rights.

ILPA is silent on whether LPAs should contain all no-fault remedies, which would be the investors' preference. Fund managers generally concede that having at least one no-fault remedy included in the LPA is market standard, but many managers are reluctant to include them all. Usually, this point is subject to intense negotiations. Investors try to persuade managers to include many, if not all, no-fault remedies by pointing out that having a choice between remedies can be advantageous to both investors and managers.

In many practical instances, investors would prefer to use a less intrusive remedy (for example, a suspension of the investment period rather than terminating the fund) to address a perceived problem. However, conceptually this would require offering investors a choice of appropriate remedies. If the LPA only provides for one remedy (such as no-fault divorce), then triggering that remedy could be overkill in some instances. Managers are, therefore, usually well advised to consider including a choice of remedies in the LPA.

Investment strategy

ILPA emphasises the importance of a fund's investment strategy to an investor's decision to commit to the fund. Investors allocate their resources according to specific strategies and track records of management teams. Any changes to the investment strategy (the so-called style or strategy drift) should, therefore, be avoided. This requires a fund to lay out a clear and well defined strategy in the LPA with meaningful limitations on investments (including the use of debt instruments, publicly traded securities and pooled investment vehicles) and diversification restrictions such as industry concentrations.

ILPA encourages funds to consider investment timing restrictions ('pace limitations') as it stresses the importance of time diversification during the investment period.

While ILPA is generally open to allowing fund managers to accommodate investors' exclusion policies (for example, regarding certain industry sectors and/or jurisdictions), it highlights that fund managers must consider that such exclusions may have negative concentration effects on the remaining investors. ILPA recommends transparency of process and policies of a fund manager regarding excused investment requests from investors.

Fiduciary duty and conflict of interests

One of the main concerns of ILPA regarding fund governance is that GPs have reduced or eliminated their fiduciary duties to the LPs, effectively replacing their obligation to act in the best interest of the fund by acting in the manager's interest.

ILPA's guidance is that such practices, while possible under certain jurisdictions such as Delaware law, should not be permitted. The duty of care requires GPs to act on behalf of the partnership as a prudent person would act on its behalf. The duty of loyalty requires acting in the best interest of the partnership where a conflict of interests is present. In other jurisdictions, this is not possible.

Consequently, ILPA requires that all conflict of interests (such as cross-over investments and related-party transactions) should be presented to the LPAC for review and approval rather than 'self-clearing' of conflicts by managers.

Role of LPAC

In addition to open communications between the GP and its LPs, ILPA emphasises the increased role of the LPAC in fund governance, listing specifics in a separate Appendix A (see also the chapter 'The Advisory Committee').

The Principles provide for a detailed list of responsibilities of the LPAC, including review and approval of conflict of interests as well as setting out a methodology of portfolio company valuations and valuations themselves, other pre-defined consent requirements in the LPA (such as deviations from investment restrictions) and engaging with the GP in discussions relating to fund operations (such as auditors, compliance, allocation of partnership expenses, team developments and new business initiatives).

Some of these suggested LPAC responsibilities go beyond what can typically be seen in LPAs, but the trend is to provide the LPAC with greater responsibilities and GPs usually appreciate its role as a sounding board.

Changes to the fund

ILPA has refined its stance on LPA amendments. As a general rule, it now only requires a simple majority-in-interest of the investors (in addition to the consent of the GP) to amend the LPA. This provides managers with more flexibility to adapt the LPA to changing circumstances than Principles 1.0 when requiring a super majority for approval.

ILPA now limits super-majority approval to certain amendments without specifying them, though this would typically include provisions that:

- were specifically negotiated or investor-specific, such as tax or regulatory clauses;
- relate to the investment strategy (as proposed in Principles 1.0), and
- concern economics or limited liability.

If an amendment would negatively affect/discriminate certain investors, it is common to require the unanimous consent of these affected investors. ILPA suggests that changes to key- person clauses should be approved by a simple majority of the investors or the LPAC (whereas the Principles 1.0 had suggested a two-thirds vote).

Other governance issues

Other governance issues, which are not discussed in detail here, relate to ILPA recommendations regarding independent auditors, the engagement of independent legal counsel by the LPAC at the fund's expense, limitations regarding all partner givebacks to indemnify the fund manager and extension of the fund's term.

Transparency

Transparency, which is the third key area of the ILPA principles, is important as it is the foundation on which the other two principles relating to strengthening alignment and governance operate.

Financial disclosure/ additional standardisation templates

ILPA requires that managers should, periodically and individually, disclose and classify all fees in each audited financial report, and in each capital call and distribution notice.

In addition to further financial disclosure rules in the Principles and Appendix C on financial reporting (which extends some of the proposed reporting deadlines for annual and quarterly reports suggested in Principles 1.0), ILPA has developed a set of standardised reporting templates based on consultations with GPs and LPs.

In January 2011, ILPA published, together with the ILPA Principles 2.0, the first set of these templates: the 'Capital Call and Distribution Notice Template'. This was followed by a 'Quarterly Reporting Standards' template in October 2011. It is intended that ILPA will provide additional standardised reporting templates in the future.

The purpose of these templates is to establish industry standards which improve transparency, accountability and fosters greater uniformity in reporting. ILPA hopes that this will:

- generate industry efficiencies;
- spare the GPs time and money in processing and reporting information;
- reduce individual LP requests for additional information;
- reduce monitoring costs for LPs;
- improve communication among all partners, and
- minimise inefficiencies resulting from varying reporting standards.

As is the case with the overall ILPA Principles, ILPA does not suggest that GPs adhere to every aspect of these standardised reporting templates. ILPA also recognises that a one-size-fits-all approach cannot do justice to a very diverse GP base from different jurisdictions adhering, for instance, to different accounting standards (US/UK GAAP, IFRS). Rather, these templates serve as an indication of best practices and identify the type of information and the degree of disclosure reasonably required by investors as guidance to all market participants.

Initial reactions from GPs have been mixed with objections such as:

- The templates are not limited to information requirements but also require certain reporting formats that deviate from the GP's current practice.

- Some of the information required is too detailed compared to existing reporting standards such as the European Private Equity and Venture Capital Association (EVCA) Reporting Guidelines or the International Private Equity and Venture Capital (IPEV) Reporting Guidelines.

- Templates create an undue administrative burden on GPs.

Other GPs have recognised the positive effect that the templates reduce the amount of individual requests from LPs and the increasing efficiencies this brings.

It is currently too early to give a fuller assessment on the standardised reporting templates as many GPs will only fully implement them in the reports covering the end of 2012. In any event, ILPA has indicated that it is open to revising the templates based on future feedback received.

Disclosures

The Principles also require immediate disclosure to investors of sensitive information relating to the GP (for example, any changes in actual or beneficial ownership, voting control of the GP, formation of publicly listed vehicles, sale of ownership of the management company, public offerings of shares in the management, or formation of other investment vehicles) and the fund's operations (for example, any inquiries by legal or regulatory bodies, any material contingency or liability arising during the fund's term, and any breach of the LPA or other fund documents).

Some of these items go beyond what was initially suggested by ILPA, but ILPA also dropped requests to disclose the profit-sharing split among a GP's principals (including vesting schedules) or individual commitment amounts of each principal as part of the manager's commitment. That said, these points remain a very common request from investors as part of their commercial due diligence.

ILPA added new risk management disclosure requirements to be included in the annual reports, which should cover certain risks at the fund and/or portfolio-company level (for example, concentration, foreign exchange, leverage, realisation, strategy, reputation, environmental, social and corporate governance as well as material events). In practice, GPs have traditionally been sceptical about detailed portfolio-company level information. Risk management and risk disclosure is a major area covered by AIFMD and the industry will have to make certain changes to current practice to adapt to such a new framework.

Additional disclosure requirements are set up for contact information of investors and closing documents. ILPA underlines that enhanced disclosure of sensitive information goes hand in hand with a corresponding need for confidential treatment by investors.

Assessment and future outlook

The days when European fund managers, initially confronted with the ILPA Principles, responded by saying "it's an 'American thing', we have nothing to do with that" are long over. The ILPA Principles have certainly altered the relationship dynamic between GPs and LPs worldwide, though in an evolutionary rather than revolutionary manner. They provide an important resource and basis for discussions.

Partly driven by the financial crisis, partly a natural evolution of a maturing asset class, the new negotiation environment reflects a rather fundamental shift in the approach of investors towards investments in private equity funds. Investors now focus more on alignment of interests and risk management. An increased professionalism on the investors' side is supported by greater market transparency through database providers and specialised advisers (placement agents, financial advisers and lawyers). For that reason, although temporary swings in the balance of power will occur in the future as markets improve, such shifts are unlikely to roll back fund terms to the manager-friendly pre-crisis levels.

While the industry is far away from having one uniform fund agreement as a market standard, the room for negotiation has certainly tightened. Differences in US and European funds (and Asia and other emerging markets) will continue to shrink as can be seen with respect to carry structures. Unlike in the past, where the differences in fund terms was black and white, future fund term variations will likely resemble many shades of grey (see chapter 'LPAs: A regional comparison').

ILPA has not been the only influencing force in the past and it will not be the only influencing power that will shape fund terms in the future. New challenges for negotiating fund agreements will appear. For instance, changes to the regulatory framework, such as the EU Alternative Investment Fund Managers' Directive (AIFMD) or the US Dodd-Frank Act, even though mainly focused on regulation of managers rather than funds, will influence fund structures and their governance (in particular with regulatory requirements for risk management, outsourcing of management functions and compensation). Balancing the interests of managers and investors alike in a regulated world where one-size-fits-all regulation may overrule calibrated individually negotiated agreements will be required.

Similarly, it will remain to be seen if significant changes to the taxation of carried interest (such as treating carry as ordinary income rather than capital gains or applying special tax rates) will occur and how this will influence fund remuneration structures. Such tax changes are on the political agenda in many main fund jurisdictions (for example, USA, Germany and France). LPs will resist (for example, in side letters) the higher taxes of fund managers being passed on to investors. Future ILPA publications are likely to have to deal with the negative economic impact of changes in taxation.

Industry trends will also impact existing fund terms and will influence the evolution of ILPA. For example, the growth of private equity firms to larger multi-asset management institutions comparable to investment banks could mean that the asset class will become less of a people's business and ultimately this could affect how investors think about key-person clauses. Future Principles issued by ILPA might have to address this and other challenges raised by new trends, such as the emergence of separate managed accounts, the increasing use of corporate fund structures (as opposed to partnership structures), listed private equity funds, succession issues of private equity firms, dealing with 'zombie funds' (see 'Aligning GP and LP interests in the LPA: New cycle, new challenges' at page 23) or the increasing volume of secondary fund interest transactions.

For the moment, and more important than ever, both GPs and LPs have to be aware of market standards and best practices when negotiating fund terms, whether by building up their own know-how or by using experienced advisers.

Each investor has its own experience and position regarding compliance with the ILPA Principles. However, it is true that only a minority of investors would dismiss outright the opportunity of investing in a fund solely on the grounds that the GP does not adhere to most of the ILPA Principles. Yet, the general opinion is that a majority of investors would at least consider this as a reason not to invest.

Therefore, to the extent fund managers decide to deviate from individual ILPA proposals, they should expect to proactively communicate and explain deviations to investors that are increasingly sensitive to terms and conditions. In a tough fundraising environment, adhering to the ILPA Principles can be a marketing tool for managers.
At the end of the day, a well-balanced fund agreement is in the long-term best interests of both GPs and their LPs. ■

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