FUND GOVERNANCE OF PRIVATE EQUITY FUNDS – THE NEW ILPA-PRINCIPLES

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ISSUES relating to corporate governance of public companies have received great attention. Fund governance applies the corporate governance concept to investment vehicles (funds). The purpose of this article is to highlight current developments in fund governance relating to private equity funds. It is imperative for institutional investors and fund managers alike to be aware of best market practices when negotiating fund investments.

APPLYING CORPORATE GOVERNANCE TO FUNDS

When management and ownership of a company rest in separate hands, the parties involved generally have differing interests and information. This conflict is known as principal agent problem. The situation is similar with funds: investors provide capital while the fund management alone is responsible for investment decisions and fund operations. A legal framework is required which reconciles conflicting interests and provides incentives for success-oriented corporate leadership. Regarding public corporations, these rules are referred to as corporate governance and regarding funds as fund governance. Such rules can originate from statutory laws, court decisions, expert recommendations, market standards or individual negotiations.

In some areas, a strict legal framework exists which only allows for very limited aberrations. In the case of public companies, corporate and capital market laws often provide a number of guidelines for corporate governance (U.S. Sarbanes-Oxley Act). This is true for most jurisdictions. These rules are supported by "soft law", such as expert recommendations (German Corporate Governance Codex, OECD Principles of Corporate Governance, U.S. COSO/Treadway Commission). In the case of German open-end mutual funds, similar guidelines exist (Investment Act). In the German closed-end retail fund segment, court decisions provide a detailed legal framework.

SPECIAL FEATURES OF PRIVATE EQUITY FUNDS

The situation is different for closed-end funds which are primarily geared towards institutional investors (banks, insurance companies, pension funds, fund-of-funds), such as buyout, venture capital, mezzanine, infrastructure, real estate and hedge funds. According to international standards, these funds are generally established as limited partnerships providing tax transparency and limited liability for investors. Limited partnership law contains fewer binding rules than corporate law. This is true for most fund jurisdictions. Thus, individual negotiations between parties are paramount. In addition, investors in closed-end funds are not allowed to redeem their interests during the entire fund term. A secondary market for fund interests only exists informally. An exit through a sale of interests is the exemption. Thus, knowledge of the best market practice is important before investing in a fund.

ILPA-PRINCIPLES 1.0 AND 2.0

The Institutional Limited Partners Association (ILPA) is a non-profit association of institutional investors of private equity funds. Its goal is to achieve transparency and to promote discussion with fund managers. With 240 members holding US $1 trillion in private equity assets under management, ILPA's opinion carries a lot of weight in the sector.

In September 2009, ILPA published a set of rules for fund governance called "ILPA Private Equity Principles" (Principles 1.0) with three key principles for the governance structure of private equity funds: alignment of interest, governance and transparency. This publication occurred during a time of the financial crisis already weakening the negotiation position of fund managers. It evoked a strong response in the industry. Investors welcomed it as an important contribution to negotiating fund agreements. Managers considered it an "investor wish list" and departure from market standards. In January 2011, ILPA published a revised version ("Principles 2.0"). While leaving key principles unchanged, it aimed at clarifying certain issues, incorporate market reactions and responding to criticism by fund managers. Some of nearly 100 points covered are described below.

ALIGNMENT OF INTEREST

The most important principle is the demand for alignment of interest between investors and managers. Remuneration structures should be designed to create positive incentives, while avoiding disincentives. The remuneration of fund managers consists of various components. ILPA emphasizes that a variable, performance-based remuneration is the most important part and that a fixed, non-performance related fee should only reimburse costs incurred, in order to create a performance-based incentive. Moreover, managers shall have "skin in the game" by personally investing their own money (usually 1%-3% of entire fund capital). By having their capital at risk, incentives are created so that managers avoid risky investments. The former demand to disclose the remuneration split and vesting schedules among managers was dropped.

Managers receive a disproportional profit participation (carried interest; carry), typically 20% of the profits, while owning a smaller stake of the fund's capital. ILPA has a clear preference for European whole-of-fund carry structures whereby investors receive a full return of

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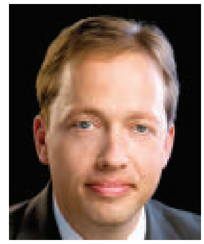
contributions plus a preferred return ("hurdle"; often 6-8% p.a.) prior to any payment of carry to the managers. Now, ILPA recognizes that many U.S. funds provide for deal-by-deal carry which allows early carry payment based on realized investments to date. If managers were overpaid at the end of the term, they must repay the clawback amount. ILPA wants to avoid overpayment scenarios by imposing certain conditions on carry payouts (inclusion of all, not only pro rata deal-related costs, fees, taxes, write-offs). Any required clawback payment should occur promptly and be secured in advance through robust escrow mechanisms: at least 30% of carry distributions, prudent valuations, NAV coverage tests and joint and several guarantees by the management or affiliates. Initially, ILPA had demanded clawback amounts to be returned gross of taxes. Now ILPA modified its view to demand that the clawback amount should be the lesser of excess carry or the total carry paid net of taxes. Instead of applying a uniform (highest bracket) tax rate to all managers as is usually done, ILPA recommends applying individual tax rates to each manager taking individual set-offs into account. ILPA has dedicated Appendix B to carry clawback.

The management fee should only cover actual costs and expenses as excessive fees would create a misalignment of interests. Fees should be lowered at the end of the investment period. Further income and fees (e.g. transaction fees) which the fund management receives from portfolio companies or third parties should be completely credited against the management fee for the benefit of the fund (fee offset). Should the management decide to participate through co-investments with the fund, it should not be able to do so selectively, but be required to invest in all of the portfolio companies pro rata at equal terms.

GOVERNANCE AND INVESTOR PROTECTION

The fund management is solely responsible for operating the fund. Therefore, personnel changes should be reported to investors. The exit of certain managers (key person event) should automatically suspend the fund's investment activities. The investment strategy should be maintained (no style drift) and investment limits observed.

In the case of managerial misconduct (cause), investors may remove the management, terminate/suspend the investment activities or end the fund term through a simple majority vote. Even without cause, the fund agreement should provide for similar investor rights exercisable through an investors' resolution with a qualified majority (no fault rights). With a 2/3 majority (Principles 1.0: simple majority), investors should be able to terminate the investment period and with a 3/4 majority (Principles 1.0: 2/3-majority) decide to remove the fund management or end the fund term prematurely.



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In addition to (annual) meetings of investors, ILPA emphasizes the role of the investors' advisory board (Appendix A). Potential conflicts of interests within the management should be presented to the advisory board, and certain transactions should require its approval.

TRANSPARENCY

The Principles 2.0 contain an Appendix C providing guidelines for standardized reporting, capital call and distribution notices. Also, the management shall disclose all fees and income. A section on risk management at the fund and portfolio company level shall be included in the annual financial statement. Additional guidelines are provided for quarterly and annual financial statements.

SUMMARY

The ILPA-Principles are not meant to be a strict checklist; rather the specific situation of each fund must be accounted for and balanced with general principals. The ILPA-Principles are a development of existing market standards: evolution rather than revolution. Many funds have expressly recognized the key objectives of ILPA (alignment of interest, governance, transparency). Nevertheless, investors and managers will continue to negotiate hard on individual points. Changes to the regulatory framework for funds (European AIFM Directive, U.S. Dodd-Frank-Act) will influence fund governance. Institutional investors and fund managers alike should engage experienced legal advisors with in-depth knowledge of the best practice, especially if one wants to take advantage of the tightening room for negotiation. ■

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