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ILPA Principles 3.0: Focusing on Enhancing Transparency in Private Equity Funds and Alternative Investments

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The Institutional Limited Partners Association (ILPA) recently published the third edition of the ILPA Principles (Principles 3.0). ILPA originally published the principles in 2009 to encourage discussion between general partners (GPs) and limited partners (LPs) regarding alignment of interests in private equity funds, releasing a second edition in 2011 to incorporate feedback from both GPs and LPs at that time. Principles 3.0 incorporates further feedback from a range of stakeholders across the private equity industry addressing new and emerging issues as well as expanding, clarifying and providing detailed guidance on topics covered in previous editions.

As with prior editions, ILPA continues to contend that alignment of interest, governance and transparency comprise the core principles for the operation of an effective private equity fund. With these principles firmly in mind, Principles 3.0 was drafted to serve as a road map for GPs and LPs to assist them in developing a set of expectations when entering into partnerships, as well as to frame a dialogue between the GP and prospective and current investors in relation to fundraising and the life cycle of a fund. Principles 3.0 is specifically focused on private equity funds, however many of the same concepts could apply to other alternative investments, including real estate, infrastructure and credit funds. Katten believes that Principles 3.0 could encourage a healthy discussion between GPs and LPs regarding how best to achieve alignment in regards to fund terms. The full text of the Principles 3.0 can be accessed here.

Topics for Discussion, Not a Checklist

In Principles 3.0, ILPA acknowledges that a single set of terms and practices cannot provide for the broad range of products, investors, strategies and preferences among GPs and LPs. For this reason, Principles 3.0 is not intended to serve as a checklist of terms to be included in a fund investment. Rather, Principles 3.0 acknowledges that each fund's terms should be considered individually and holistically. Nevertheless, Principles 3.0 is intended to encourage transparency between all stakeholders with respect to the application of the principles set out in it (with respect to GPs) and the extent to which adherence to Principles 3.0 influences their investment policies or approvals (with respect to LPs). It remains to be seen whether this level of transparency will be adhered to by market participants, but it is conceivable that any mis-alignment with Principles 3.0 could be a significant concern for GPs and LPs alike.

Key Points in Principles 3.0

The recommendations in Principles 3.0 are set against a background of unprecedented levels of investment in private equity and an expansion in the means by which investors allocate their capital; factors which ILPA asserts are challenging the alignment of GPs and LPs (as well as among LPs) in an industry which historically has relied on strong alignment. Principles 3.0 seeks to once more instil such alignment via a continuing focus on transparency and governance. A number of key points from Principles 3.0 are summarised below.

- ***Governance: Fiduciary duty of GPs***. ILPA strongly favours safeguarding the principle that GPs owe a fiduciary duty to LPs, notwithstanding the recent trend in some funds to narrow or limit GPs' fiduciary duties. Further to this, Principles 3.0 recommends that fund documentation should reinforce rather than dilute the fiduciary duties of GPs to LPs and that the "gross negligence, fraud, and wilful misconduct" or breach of a partnership agreement (or similar) should be the minimum in terms of the exculpation standard agreed by LPs without any qualifiers with respect to prior knowledge or material and adverse effect. In addition, breach by GPs or behaviour constituting "gross negligence, fraud or wilful misconduct" should be excluded from the protections of indemnification and exculpation clauses, even if permitted by law and any indemnification should be capped at a percentage of the total fund size. This is clearly an area where there has been mis-alignment creep between GPs and LPs. Whether Principles 3.0 will "re-set the dial" in respect of these matters will no doubt be a focus of discussions between GPs and LPs going forward.
- ***Commitment of GPs***. ILPA recommends that GPs should have a substantial equity interest in the fund and that the commitment by GPs should be contributed in cash as opposed to contributed through the waiver of management fees or via specialised financing facilities. Also, ILPA recommends that GPs should not be allowed to co-invest in select underlying deals (i.e., "cherry picking"), but rather the whole equity interest of GPs should be consistent and invested through the pooled fund vehicle to ensure the proper alignment with other investors in the fund. Whether the latter point is feasible given developments in the range of products being offered remains to be seen.
- ***LPAC best practices.*** Principles 3.0 reiterates the important role that the Limited Partner Advisory Committee (LPAC) can play in fund governance by providing a sounding board for GPs and serving as an important source of input on critical governance determinations, including, in particular, conflicts of interest. In Principles 3.0, ILPA gives greater guidance on the operation of the LPAC, including recommending that the roles of the LPAC be formally established and set out in the fund documentation (which aligns with current market practice). Although Principles 3.0 recognises that LPs serving on the LPAC should act in their own interests in good faith, ILPA nonetheless recommends that formal and transparent procedures and processes should apply to the LPAC. In addition, ILPA recommends that the LPAC reflect the diversity of a fund's base (i.e., including by commitment size, type, tax status and quality of relationship with the general partner); a recommendation that does not necessarily reflect current market practice where commitment size plays a significant role in determining LPAC composition. Principles 3.0 also recommends that the LPAC be able to meet in private (without the general partner in attendance) with its own members and the fund auditor. The recommendations set out in Principles 3.0 advocate (arguably) a greater role being played by the LPAC. It will be interesting to see to what extent this is applied by GPs going forward.
- ***Fund economics.*** Principles 3.0 makes specific recommendations in relation to waterfall structure, carried interest calculation, recycling of distributions, clawback and fees and expenses:
  - ***Waterfall structure.*** ILPA notes that a standard all-contributions-plus-preferred-return-back-first, (i.e., a whole of fund model is preferred). For models which are not consistent with the above (e.g., deal-by-deal model of returns), ILPA also includes recommendations regarding how distributions should be assessed, how unrealised investments should be valued for application of waterfall purposes and the holdback of a proportion of accrued carried interest in escrow.
  - ***Calculation of carried interest.*** Together with a number of other proposals which are focused on the preferred return calculation (which separately could impact carried interest calculations), ILPA recommends that carried interest should be calculated based on net profits (not gross profits), factoring in the impact of fund-level expenses and on an after-tax basis. Also, carried interest should only be paid on recapitalisations once the full amount of invested capital is realized on each recapitalised investment.
  - ***Recycling of distributions.*** ILPA suggest that the total distributions that are subject to recycling provisions (and as a consequence can be added back to LPs' undrawn commitments for further drawdown) should have either a mutually agreed cap or a monitoring threshold such that LPs can more accurately project their cash requirements. Furthermore, recycling provisions, including the classification of any unused, recallable distributions, should expire at the end of the fund's investment period (which reflects current market practice).

- ***Clawback.*** Principles 3.0 proposes a number of key recommendations with respect to clawback, including:
  - actual and potential clawback liabilities should be determined and clearly disclosed to the LPs as of the end of every reporting period (as a minimum, annual audited financial statements should include such disclosures along with plan for resolution);
  - all clawback on carried interest amounts should be gross of taxes paid and paid back no later than two years following recognition of the liability; and
  - the clawback period should extend beyond the term of the fund, including liquidation and any provision for LP giveback of distributions.

  In Principles 3.0, ILPA encourages joint and several liability of individual members of GPs as best practice with respect to carried interest clawback in addition to providing guidance as to other potentially acceptable liability models if this is not possible or practicable. Regarding enforcement, ILPA advocates robust (and if necessary, direct) powers being granted to LPs against individual members of GPs. Principles 3.0 also suggests that GPs disclose their ownership and any changes in ownership, which is increasingly relevant given the trend of third parties buying stakes in GPs. Clearly clawback is a sensitive subject as between GPs and LPs and ILPA's recommendations are unlikely to change this.
- ***Fee and expenses.*** Principles 3.0 includes a number of recommendations designed to foster increased transparency in relation to fees and expenses and alignment between GPs and LPs, including:
  - Fund documentation should detail the definition, calculation, assessment and reporting of any fees and expenses allocable to the partnership or to portfolio companies that impact an LP's commitment to the fund and/or the net investment return. Fee and expense policies should be appropriate, reasonable, arm's length and fully disclosed to investors prior to the initiation of the fund.
  - Fund formation costs should be reasonable and capped at an amount appropriate to the size of the fund.
  - Quarterly disclosures should be provided with sufficient detail, including the amount of any fees charged to portfolio companies, so as to enable investors to evaluate and validate the calculation of management fees and fund expenses, offsets to fees and expenses, and accrued and paid carried interest.
  - Overhead costs, salaries of the GP's employees, travel and other costs related to the manager's work on behalf of the fund should come out of the management fee, (i.e., the management fee should pay for office space, research, computer software, entertainment, lodging and consultants).
  - All fees charged to portfolio companies should be fully offset against the management fee and accrue to the benefit of the fund regardless of the application of tax burdens or clawbacks. Any management fees allocated on a pro rata basis to co-invest vehicles should accrue to the fund and be offset.
  - Whenever possible provisions common across a majority of a fund's side letters should be include in the LPA.

While market practice tends to adhere to the recommendations above regarding fees and expenses, Principles 3.0 provides a useful reminder as to expectations in this regard.

- ***Subscription line of credit.*** The use of subscription lines of credit has become more common in light of the low borrowing rates. With this being the case, ILPA now recommends enhanced reporting, including with regards to fund-level leverage, commitments and outstanding balances on subscription financing lines and performance information. ILPA suggests that LPs should be able to opt out of a facility and that GPs should disclose to all LPs the size of facilities, proposed limits on duration, use of proceed restrictions and how commitment-secured facilities or NAV-secured facilities will be treated in the context of overall leverage limitations on the fund. ILPA recommends that facilities should have a short duration (e.g., no more than 180 days) and limited to a maximum percentage of fund commitments, (e.g., 20 percent).
- ***GP-led secondaries.*** Principles 3.0 includes suggestions that are intended to increase the fairness and transparency around the process of considering secondary transactions. These recommendations are consistent with ILPA principles on GP-led fund restructurings, released in April 2019 (available here). ILPA notes that it would be appropriate to involve the LPAC in reviewing secondary transactions and dealing with conflicts. In addition, ILPA recommends that LPs electing to roll their interests rather than sell should be given an opportunity to roll their investment into the new structure with no change in economics.

- ***Co-investment.*** Consistent with the increased desire by LPs to co-invest alongside funds, Principles 3.0, provides detailed recommendations as to co-investment best practices. ILPA advocates a general disclosure obligation on GPs whereby they disclose to all LPs in advance, through both the private placement memorandum and limited partnership agreement, a framework for how co-investment opportunities, interests and expenses will be allocated between the fund and any participating co-investors, including any prioritisation of allocation. Any co-investment policy also will need to mitigate for and/or have a mechanism (using LPAC to resolve) conflicts of interest. Finally, where side letters grant additional rights in relation to co-investments or different economics, this should be disclosed to all LPs. The allocation of co-investment opportunities will continue to be a topic of great interest for GPs and LPs alike and it remains to be seen whether these suggestions will be widely adopted.
- ***ESG reporting.*** Principles 3.0 recommends that GPs should consider maintaining and periodically updating an environmental, social and governance (ESG) policy. LPs should be able to measure a fund's success in complying with its ESG policy. Further to this, an ESG policy should include information sufficient to enable an LP to assess the degree to which the GP's investment strategy and operations are aligned with an individual LP institution's ESG policies, including how ESG is factored into due diligence as well as incident disclosures and performance reporting.
- ***Fund term extensions.*** ILPA recommends that fund term extensions should be permitted only in one-year increments and limited to a maximum of two extensions. Principles 3.0 suggests that an extension would require the favourable endorsement of the LPAC and also require approval of a super majority of LP interests in the fund. After the expiry of a fund's term, unless LP consent is given the GP should fully liquidate the fund within a one-year period. The two extension limit and the super majority approval for an extension are new suggestions.
- ***Future projects.*** ILPA has confirmed that it is working on publishing a model LPA, which will presumably include drafting language that will flesh out the principles recommended in Principles 3.0.

Conclusion

LPs should bear in mind that although Principles 3.0 can serve as a reference point for the negotiations of fund terms, each fund's terms should be considered on its own merits. Although ILPA acknowledges that that the recommendations in Principles 3.0 will not be appropriate for every fund, GPs should be prepared to have discussions with LPs regarding the topics covered in Principles 3.0.

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