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THE LPA ANATOMISED

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

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7 ILPA and other influences on LPA terms

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The Institutional Limited Partners Association (ILPA) Private Equity Principles first appeared in 2009 when the global financial crisis was taking its toll on all financial markets (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 also 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 partner (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 LPs post-financial crisis.

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 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 (LPAs). 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), covers various standardisation initiatives (such as reporting and fee templates), and offers an outlook on industry developments and regulatory factors that are likely to shape the negotiation of fund terms in the coming years — at a time when the power pendulum is swinging back in the fund managers' court (at least for the most successful ones).

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 GPs and LPs, to gain more oversight 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 renegotiation 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 originally based in Toronto, Canada and since 2015 headquartered in Washington, DC, USA. 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 members meet semi-annually in a LP-only forum – besides a number of other industry events and training workshops.

Its member base currently consists of around 450 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 Invest Europe's [formerly known as 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.

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1 https://ilpa.org/who-we-are/ (as of January 2018).

The Principles focused on three key areas:

1. Strengthening alignment of interest.
2. Enhancing fund governance and investor protection.
3. 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 (AlpInvest Partners, Blackstone Group, KKR, Carlyle Group, CVC, Oaktree, Apollo Management, Coller Capital, Apax, Permira, 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 chapter 1, 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, at least historically, there have been significant differences between US funds on the one hand, and European and Asian fund agreements on the other (see chapter 3, LPAs: A regional comparison).

In European and Asian fund agreements, whole-of-fund carry waterfalls are predominantly 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 percent 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 its 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 LP distribution giveback obligations).

Principles 1.0 proposed that carry 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 executive receiving carried interest 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 Principles left their mark on the negotiation of LPAs — in line with the general trend of convergence of fund terms. Since the publication of the Principles 1.0, deal-by-deal carry structures are under pressure worldwide and on the decline (although in buyout funds and certain debt funds less so than in other fund types). Even in the US, whole-of-fund structures are now becoming more common than deal-by-deal structures in new funds raised. At the time of publication of the Principles 2.0 (vintage year 2011), a slight majority (52 percent) of all US private equity funds still used the deal-by-deal carry model.[2] In just five years, this number dropped significantly. Now (vintage period 2016–17), the whole-of-fund model is also clearly prevalent with US funds (in 78 percent of US funds), which is comparable to the numbers for European funds (93 percent) and Asian funds (86 percent) with respect to the whole-of-funds model.[3] Of course, the percentage of deal-by-deal structures can still vary widely depending on fund strategy (for example, with direct lending funds using the whole-of-fund model in only 40 percent of cases).[4] This development is one of the largest changes in fund economics (besides the 100 percent fee offset and the general pressure on management fees) in the years since the financial crisis.

In recent years, investors have also been focusing on escrows and carry clawbacks, and are demanding creditworthy guarantees from the ultimate carry recipients (or, alternatively in cases of larger fund groups, by an affiliated entity with substantial economic substance). 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 on this point — even with respect to the most successful fund managers.

An issue that has emerged in the last two years, and thus the ILPA Principles are silent on this point, is that some managers are offering investors a choice between two or three options on carried interest and management fee which deviate from the classical (and still clearly dominating) '2 and 20' model. Typically, such options include a lower management fee in exchange for a higher carried interest (sometimes combined with a lower hurdle rate). Others are offering a choice between whole-of-fund and deal-by-deal carried interest models, often the latter combined with a lower management fee. The number of funds offering such options is still very small, so they can only be seen as a kind of experiment for the time being. Also, there is no clear picture yet on how investors are using their election rights in such circumstances. A new economic model is not yet established and offering economic election rights will not be a solution for all managers. That said, this could be an area where investors may be looking for further guidance from ILPA in the future.

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[2] The 2016 Preqin Private Equity Fund Terms Advisor, p. 50.

[3] The 2017 Preqin Private Equity Fund Terms Advisor, p. 49.

[4] The 2017 Preqin Private Equity Fund Terms Advisor, p. 49.

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 stipulates 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 in the following circumstances:

- At the end of the investment period (as generally seen in practice).
- Where a successor fund is formed (though ILPA is silent on whether a step-down is recommended if only a 'dry closing' of a successor fund occurred).
- In the event of the extension of the fund's term (a new requirement not previously covered).

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[5], but this continues to be an area of negotiation and continuous pressure from investors (both in terms of actual percentage of management fee as well as the mechanics of the step-down and reference to invested capital instead of committed capital). 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 often not willing to provide (though it is quite common that investors ask for budgetary information as part of their due diligence, and managers are now better prepared for such requests compared to a few years ago).

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 over time increased to 80 percent and nowadays a 100 percent fee offset is typically seen, though sometimes using different offset percentages depending on the type of fee (see chapter 1, 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.

[5] The 2017 Preqin Private Equity Fund Terms Advisor, p.33-47 (regarding a detailed breakdown of the typical range of management fees for the various sub-categories of private equity funds and differences in reducing management fees after the end of the investment period for those subcategories).

According to ILPA, placement agent fees 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.

A major development since the publication of the Principles 2.0 has been the SEC's enforcement practice, and, to some extent, also similar practices of European regulators, with respect to disclosure of fees and expenses. The SEC's intention to "spread sunshine" is intended to force fund managers to greater disclosure so that investors can make an informed decision about fees and expenses and the allocation thereof between fund management and investors. It is important to note that the regulators' focus is on disclosure only, as regulators are rather hesitant to be involved in the power struggle of allocating expenses between fund managers and investors. Consequently, the disclosure sections in fund documents on fees and expenses have come under greater scrutiny from investors in their due diligence and negotiations. Fund managers have to pro-actively address this and reflect the regulators' requirements in their LPAs and PPMs (and other marketing materials) resulting in longer, rather exhaustive provisions on fees and expenses extending for several pages. This development fits well into the bigger trend of recent years for greater transparency pushed by ILPA, and an updated future version of the Principles will likely expand on this. While it is widely expected that the Trump administration in the US will lead to changes in regulatory enforcement practice in general, it remains to be seen whether this will also be true for fees and expenses. Irrespective of that, now that certain former practices of fund managers have come into the spotlight, it is hard to imagine that investors will ease their scrutiny of fees, expenses and their allocation. Rather, it is likely that this point will remain a fixture in the investors' due diligence process in the future. (See also page 69 on financial disclosure templates.)

GP 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 has been questioned by several investigations into fee waivers by different tax and regulatory authorities).

In recent years, GP commitments have increased from the traditional 1 percent of total fund commitments to between 2 percent and 5 percent, and sometimes higher.[6] Although this trend started before the ILPA Principles were issued, it is nevertheless supported by them.

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 Principles).

[6] The 2017 Preqin Private Equity Fund Terms Advisor, p. 57 to 59.

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 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 LPs and a sounding board for managers in governance matters. This is considered in more detail below.

Key persons

In the private equity fund 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 15, 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. ILPA also does not provide guidance on the practically important issue of the economic effect (in particular the fate of the carried interest, whether held in escrow or otherwise) of the cause remedies as opposed to the no-fault remedies.

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 supermajority requirements).

Due to the practical inefficiencies of fault remedies, the most effective tool that LPs possess are no-fault remedies. ILPA recommends that LPAs should provide for investors' rights that are exercisable through an investors' resolution with a supermajority, 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 chapter 3, 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, supermajority thresholds have been reduced in many LPAs (although not always to ILPA levels as, for example, 80 percent is still sometimes 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 does not specifically address the issue of 'grace periods' (that is, a period of 18 to 24 months after the first or final closing in which no such no-fault removal would be possible). A limited number of LPAs provide for such grace period with respect to the no-fault removal of the GP. On the other hand, ILPA's recommendation that LPAs should include a super-majority threshold for a no-fault removal is not conditional on a certain time period during the fund's term (whether banning a removal during such time at all or whether increasing the relevant threshold during such a time period). This implicitly suggests that ILPA would be rather critical of such grace periods.

ILPA is also 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. This is an area that has gained importance since the publication of the Principles. Nowadays, a significant number of investors request excuse rights in relation to environmental, social and governance (ESG) issues (see below) and other internal investment policies. This may give reason for ILPA to revisit this issue in greater detail in the future.

Fiduciary duty and conflict of interests

One of ILPA's main concerns 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 a number of other jurisdictions, this is not possible by law.

Consequently, ILPA requires that all conflict of interests (such as crossover 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 chapter 16, The Advisory Committee).

The Principles provide a detailed list of LPAC responsibilities, 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 is typically seen in LPAs, but the general trend in recent years is to provide the LPAC with greater responsibilities. Further, GPs usually appreciate the LPAC's role as a sounding board.

While ILPA specifically calls for a stronger role for LPACs (as a more efficient governance body as compared to meetings/votes of all investors), ILPA does not specifically address the remaining dichotomy of fund governance and the practical functionality of investor meetings. Basically, all LPAs provide for a split between certain fund governance functions being the responsibility of the LPAC, while others (including votes on no-fault and fault remedies) remain in the hands of investors meetings. In particular, ILPA does not specifically address whether investors should have the right, with a certain kind of voting threshold (20 percent of commitments, for example), to call for an extraordinary investors meeting.

A further potential issue to be addressed by ILPA in the future could be the use of independent investor representatives (in addition to, or as a replacement for, the LPAC), which are used in certain (though very limited in number) hybrid fund structures with a historic background either as retail mutual funds or ERISA fiduciary funds.

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 (in comparison to Principles 1.0) to adapt the LPA to changing circumstances when requiring a supermajority for approval.

ILPA now limits supermajority 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).
- 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). In practice, this is an area where investors may disagree among themselves as some investors expect a qualified majority in order to modify the 'basic deal' agreed in the initial LPA when investors joined the fund.

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.

Later, ILPA launched a transparency initiative in 2015, which culminated in the January 2016 publication of the ILPA Reporting Template for fees, expenses and carried interest.

The purpose of all 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 and reduce the compliance burden.
- Reduce individual LP requests for additional information.
- Reduce monitoring costs for LPs.
- Improve communication among all partners.
- Minimise inefficiencies resulting from varying reporting standards.

In particular, ILPA believes that a template, rather than reporting guidelines, will facilitate technology and third-party solutions, eventually accelerating the implementation and delivering economies of scale.

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 to, for instance, 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.

Reactions from GPs regarding the above templates 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 Invest Europe (formerly 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.
- Smaller GPs may lack the back office capacity to adjust to various reporting templates as standardisation initiatives may not stop investors asking for additional customised reporting formats.

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

Even after some years have passed since the publication of the various templates, there is no clear-cut picture when assessing the full impact of the standardised reporting templates. The standard reporting templates have definitely made both GPs and investors review and look for ways to improve the status quo. However, the number of investors and GPs officially endorsing the reporting templates is relatively low based on numbers provided on the ILPA website.[7] On the particularly important Fee Reporting Template, ILPA disclosed that, as of mid-January 2018, more than 140 organisations have endorsed the template,

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[7] While the number of endorsers has grown over time, the initially adoption of the fee reporting template was rather slow and is still far from being universally adopted. As of October 2016, only three GPs (Carlyle Group, Silver Lake and TPG) and only 57 investors (out of the 450 ILPA members) had officially endorse the ILPA Reporting Template (information on ILPA website is dated 18 October 2016: https://ilpa.org/wp-content/uploads/2016/10/Template-Endorsement-List-Current-1.pdf). This is a much lower number compared to the number of investors and GPs endorsing the Principles itself. On November 3, 2016, ILPA announced that some more well-known GPs (Advent International, Apollo, Blackstone, CCMP, Hellman & Friedman, KKR) also endorsed the ILPA Reporting Template (https://ilpa.org/wp-content/uploads/2016/12/Template-Endorsement-List-Current.pdf). As of mid-January 2018, the fee reporting template is now endorsed by 23 GPs and 101 LPs (https://ilpa.org/best-practices/reporting-template/template-endorsers/).

including more than 20 GPs.[8] Further, ILPA's members report that, as of Q3 2017, more than 200 GPs are completing the Fee Reporting Template "when asked".

In any event, ILPA has indicated that it is open to revising the above templates based on future feedback received. It may well be that any future breakthrough in the standardisation of reporting templates, if any, may come from technology (for example, reporting software providers) rather than from industry negotiations, as the clear benefits of standardisation can eventually be only achieved if GPs, independent of the size of their back office operations, are able to implement such standard in practice.

In March 2017, ILPA announced the launch of 'Phase II' of the Fee Reporting Template initiative, which focuses on supporting further global implementation.

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 enquiries 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 the Alternative Investment Fund Managers Directive (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.

Further standardisation initiatives/ standardisation of fund documents

In addition to the existing ILPA templates and recommendations, further standardised guidance by ILPA can be expected in the years to come. These templates will not be limited to reporting issues.

[8] As of mid-January 2018 (https://ilpa.org/best-practices/reporting-template/).

In June 2016, for instance, ILPA launched a new standardisation initiative called the 'LPA Simplification Initiative' by setting up a working group. This ambitious project, which is still in an early phase, intends to 'examine ways to improve and simplify the limited partnership agreement and the process surrounding it'. The goal is a 'streamlined, cost-effective fund documentation process'. A motivation for this initiative is that ILPA acknowledges that the Principles have not been adopted as widely as hoped. ILPA hopes to provide best practices example(s) of drafting language (including annotations regarding rationale, implications for alternative drafting, and recommended approaches to resolving sub-optimal drafting language in a particular provision). ILPA intends, in particular, to cover the following issues: distribution waterfall, carried interest clawback, management fee (including limitations and offsets), removal (cause and no-fault), key person, exculpation and indemnification, limited partner giveback obligations and the standard of care. This initiative may seem, at first, a natural step for ILPA to take the Principles to a higher level and translate them into specific provisions in the fund documentation. However, switching from a 'principles-based' recommendations to 'detailed rule-based' recommendations could be viewed as a fundamental shift in ILPA's approach.

In any event, it is a very ambitious project, both in terms of scope as well as in the potential impact on the industry. Yet, it should not be belittled because it may seem overambitious at the moment. Similar standard contracts exist in other industries, such as the model documents of the Loan Market Association for the syndicated loan market, the sample documents of the US National Venture Capital Association (NVCA) for venture financings, and the templates of the International Swaps and Derivatives Association (ISDA) for certain derivative transactions.

In the private equity world, however, there are good reasons why a one-size-fits-all model LPA does not (yet) exist, although certain convergence has occurred over the years. As is often the case in similar circumstances, once these recommendations are actually published they will likely create their own dynamic and may shift the discussion in a new direction.

Realising the herculean task of creating a model LPA, ILPA decided to aim for different standardisation milestones. On December 12, 2017, ILPA published a 'Model Subscription Agreement' (MSA) based on input from internal and external counsels working with LPs and GPs. By its nature, the subscription agreement is a less controversial document and, therefore, is a wise choice for an initial milestone of the standardisation initiative.

The MSA is designed to be balanced, streamlined and modular document. ILPA acknowledges that the MSA will need to be customised (significantly) to reflect the specific and unique situations of fund structures and the jurisdictions of the fund, the GP and the LPs. Therefore, the MSA includes various bracketed provisions, explanations in footnotes and removable schedules. With 25 pages (including schedules), the MSA is a rather slim document compared to current market standard subscription agreements, which can reach some 40 to 60 pages. That said, a number of schedules are still left blank to allow for up-to-date provisions on anti-money laundering, tax, securities and other regulated requirements of the various jurisdictions. Thus, in practice, a final subscription agreement based on the MSA would likely still end up 35 to 50 pages. Therefore, the

MSA's greatest achievement is to reduce some of the lengthy sections on representations and warranties (in particular, those to be provided by LPs that became unbalanced over time) to a balanced and core minimum. The legal, tax and regulatory requirements of the various jurisdictions involved in international fundraisings will continue to result in a lengthy document. Ultimately, filling out subscription agreements will continue to be a little bit of painful exercise for LPs and their counsels. However, ILPA has tried hard to reduce the pain. It remains to be seen whether GPs will adopt the MSA, given that many of their counsels have expanded provisions relating to representations and warranties and power-of-attorneys over the years without facing much pushback from LPs.

The MSA is only ILPA's overture to the intended development of a model LPA. In the fall of 2017, ILPA started working on this ambitious project in accordance with the Principles. It hopes to publish the result in 2018. The focus will be on provisions regarding the waterfall, indemnification, fees and expense allocations, removal of the GP, treatment of co-investments and the functions and role of LPACs. The shifting from a principles-based to a detailed provisions-based approach is an ambitious and likely more controversial approach. Surprisingly, it may potentially lead to greater acceptance of the ILPA Principles as it translates them into specific wording that can easily be adopted or adjusted. (See also chapter 6.)

It is likely that the model LPA (as well as Version 3.0 of the Principles, likely to be released in 2018) will include ILPA's recommendations on the use of subscription lines of credit facilities used by funds. In June 2017, ILPA published guidelines that consist of both considerations and a set of suggested rules in reaction to the increased use of subscription credit lines by GPs in recent years due to the low interest rate environment. Some market observers have accused GPs of artificially inflating IRR numbers and warned that the use of subscription lines by funds may have negative implications on money multiples, create clawback issues and tax implications, and add extra costs as well as substantial risks for GPs and their investors (including potentially the default on fund commitments).

ILPA reacted quickly to this development and emphasised the need for alignment of interest between GPs and LPs, as well as for transparency and disclosure. While recognising that subscription lines can be beneficial to the cash flows of the fund, ILPA provided a set of questions to be addressed by GPs in the fundraising process and in quarterly reports. Further, ILPA suggests a number of points to be included in the LPA to limit the use of subscription facilities to a "reasonable" level. These proposals include limiting the maximum percentage of all uncalled capital (ILPA suggests to 15 to 25 percent) and the maximum maturity of up to 180 days outstanding, avoiding cross-collateralisation between subscription lines, securing subscription lines only by LP commitments (rather than assets of LPs or underlying assets of the fund), disclosing additional burdens on LPs (transfer restrictions, for example), and limiting disclosure to publicly available information only. Some proposals will be more controversial, such as specifying that the date used to calculate the GP's preferred return hurdle aligns to when the credit facility is drawn, rather than when capital is ultimately called from the LPs. Initial reactions by GPs have been rather non-committal, but a bit of a pushback by LPs, based on the ILPA recommendations, can be expected in future fundraisings.

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, albeit in an evolutionary rather than revolutionary manner. They provide an important resource and basis for discussions. To a certain extent, the Principles have made investor comments to the fund documentation more uniform, and from a GP's perspective, easier to predict and pre-empt.

Partly driven by the financial crisis, and partly a natural evolution of a maturing asset class, the new negotiation environment emerging from the financial crises reflected a rather fundamental shift in the approach of investors towards investments in private equity funds. Since then, LPs 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 from time to time occur in the future as markets improve, such shifts are unlikely to rollback fund terms to the manager-friendly pre-crisis levels. In fact, recent fundraisings (in the vintage years 2015–16 and 2016–17) have seen the most successful fund managers gaining the upper hand again in the fundraising power dynamic in general, with limited concessions to investors and sometimes receiving 'premium terms' such as 'super carry' or 6 percent hurdle rates while pushing for a 'one-and-done' closing process, which puts additional pressure on investors. However, even there, investors generally have been able to defend their position on fee offsets, no-fault rights, transparency and continuous pressure on management fees, reflecting a general shift from the pre-crisis years independent of the current status of the balance of power.

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 were black and white, future fund term variations will likely resemble many shades of grey (see chapter 3, LPAs: A regional comparison). It will be interesting to see whether ILPA efforts (see above, 'LPA Simplification Initiative') will also one day (maybe as early as 2018) result in an industry 'model fund agreement', which will be widely adopted. However, this seems to be rather ambitious in the near future given the current variation in market standards. ILPA deserves kudos for at least trying.

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 AIFMD, European Venture Capital Funds Regulation (EuVECA) and the US Dodd-Frank Act, even though mainly focused on regulation of managers rather than funds, have influence on fund structures and their governance (in particular, with regulatory requirements for risk management, outsourcing of management functions, compensation, and use of depositary/custodians). So far, the impact has been smaller on fund terms and structures in general than initially anticipated (aside from increased complexity, higher establishment costs and time delays due to stricter marketing requirements). Similar regulatory changes have been taking place in recent years at the investor level, such as Solvency II for insurance companies, Basel III and IV (CRD IV and V) and the 'Volcker rule' for banks, and IORP II for certain pension funds. It remains to be seen whether the global trend of increased regulation in the aftermath of the financial crisis will slow down or even be reversed by possible deregulation under the new Trump administration in the US and Brexit in Europe. In any event, balancing the interests of managers and investors in a world where one-size-fits-all regulation may overrule calibrated individually negotiated agreements will be more required than ever. As a result, fund structures tend to get more complex (nowadays often comprising of a master fund with one or more feeder funds, and sometimes parallel fund structures).

Similarly, it remains 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 and backed by strong political pressure in many main fund jurisdictions (for example, USA, UK, 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. For the time being, ILPA has emphasised in press statements that carried interest is "critical" in aligning interests of fund managers with investors.

Industry trends will also impact existing fund terms and 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. Ultimately, this could affect how investors think about key-person clauses (including 'time and attention' wording) and conflicts of interest provisions (including allocating investment opportunities among fund products with overlapping investment strategies). 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 large appetite of investors for co-investments (and the SEC's recent scrutiny of co-investment practices of fund managers).
- The increasing use of corporate fund structures (as opposed to partnership structures).
- Listed private equity funds.
- 'Core' private equity funds with longer fund terms and lower return expectations.
- 'Early bird' discounts/benefits for first closing investors.
- Succession issues.
- Zombie funds (see chapter 1, Aligning GP and LP interests in the LPA: New cycle, new challenges).
- Election rights with respect to fund economics (lower management fees in exchange for higher carried interest and/or reduced hurdle rate).
- Increasing volume of secondary fund interest transactions and fund restructurings (including stapled transactions and other GP-led secondary transactions).

The so-called Panama Papers (leaked in April 2016) and Paradise Papers (leaked in November 2017) have brought the use of offshore structures to the general public's attention. There are legitimate concerns that some of these structures could be used for illegal purposes (anti-money laundering, terrorism financing or illegitimate tax avoidance schemes). However, offshore fund structures have often been used (both as master funds and feeder funds) by the private equity fund industry (mainly in Cayman Islands for US-focused funds as well as in Guernsey and Jersey for European-focused funds — but not in Panama) for perfectly legitimate and legal purposes (for example, due to marketing restrictions applicable to 'sub-threshold' fund managers under AIFMD and domestic regulators laws, or for using offshore feeder structures as 'tax filing blockers'). Most funds — whether onshore or offshore — are structured as limited partnerships that are typically tax transparent in most jurisdictions, thus taxable income is directly allocated to the underlying investors. In other words, these structures only make sure that there is not an additional layer of taxes at the fund level while not interfering with taxation of investors at their own level in their countries of residence. While this is perfectly legitimate, legal and in line with general fund structuring principles, the Panama Papers and Paradise Papers have alerted a substantial number of investors to the potential reputational risk involved when investing in offshore structures, and some investors are considering moving onshore for future investments. It remains to be seen whether ILPA will offer guidance on this point in the future.

Responsible investing (or ESG) is another issue not (yet) addressed in the Principles, but that has gained a lot of attention in the last few years since the publication of the Principles, and has become a standard investor request. LPs and GPs now largely agree that responsible investment is not only good policy, but that it can often be a value driver for investments. Here, the challenge faced by GPs is that, although there are some industry standards such as the United Nations Principles of Responsible Investment (UNPRI), the issue is still evolving. In practice, agreeing on a set of investment restrictions in the LPA can often not be achieved as some LPs have deviating or more extensive catalogues of restricted investments than other investors, and are often not willing to compromise on the exact wording of such lists unless it fully mirrors their internal investment policies. As a result of such negotiations, GPs often agree to side letter provisions instead, which often lead to individual excuse rights of certain investors as opposed to investment restrictions applicable to the fund as a whole. This is not ideal from a fund governance perspective (including for those investors not receiving such excuse rights), and is only mitigated by the fact that some requested investment restrictions are relatively obscure (for example, no investments in companies trading with drift nets over 2.5 kilometres in length) meaning that the likelihood of such excuse rights being triggered in practice is remote.

Many GPs (at least the smaller operations) also struggle with ESG reporting requests from LPs as many LPs have their own templates (for example, ESG annual questionnaires). This is another area where future standardisation, while not yet on the horizon, may ease administrative burdens. So far, LPs and GPs alike cannot yet look to ILPA for guidance on this point (although there are five high-level questions included in ILPA's Due Diligence Questionnaire, Version 1.1, originally published in October 2013 and revised in September 2016). However, there are several other publications that provide guidance:

- UNPRI ESG DDQ (Limited Partners' Responsible Investment Due Diligence Questionnaire, 30 November 2015).
- UNPRI, Guide on Climate Change for Private Equity Investors (1 June 2016).

- UNPRI, Engaging on Anti-Bribery and Corruption – a guide for investors and companies (20 June 2016).
- Invest Europe Professional Standards Handbook (November 2015).
- Invest Europe ESG Due Diligence Questionnaire for Private Equity Investors and their Portfolio Companies (November 2016).

The ESG issue highlights the trend of the ever increasing number of side letter requests from investors. Nowadays, negotiating side letters can sometimes be more time consuming than negotiating the actual LPA. The results of this customisation trend (though less customised than a managed account, of course) are potential severe delays in fundraisings and increasing organisational costs, and the potential special treatment of investors contrary to the general concept of equal treatment of investors (a development often criticised by the very same investors with a long list of side letter requests compared to requests from other fellow investors). ILPA has not yet published a position on this phenomenon and it is rather unlikely that it will provide detailed guidance on this point in the future, given that each side letter request is unique and that any guidance, therefore, can only be of a very general nature.

The year 2018 will be an important year for ILPA with the rumoured Version 3.0 of the Principles as well as the model LPA scheduled for publication in this year. 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, if fund managers decide to deviate from individual ILPA proposals, they should expect to proactively communicate and explain this to investors that are increasingly sensitive to terms and conditions. In a competitive 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 ('middle of the road') is in the long-term best interests of both GPs and their LPs.

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