ISLP International Senior Lawyers Project

PRIVATE INVESTMENT FUNDS GOVERNANCE

HANDBOOK

April 2023

International Senior Lawyers Project (ISLP) is a nonprofit 501(c)(3) and nongovernmental organization founded in 2000. Our mission is to provide *pro bono* expert legal assistance on matters that advance the rule of law and just, accountable, and inclusive economic development. Our clients include governments, civil society organizations, and social enterprises in the Global South. Learn more about our work at https://islp.org.

If you have any queries, please direct them to International Senior Lawyers Project, 207 West 25th Street, 6th Floor, New York, NY 10001 or email: info@islp.org.

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GLOSSARY

Note that some terms are defined broadly for the purposes of the Handbook and may be used with more precise definitions in other settings.

AIV	Alternative Investment Vehicle
Carried Interest	Generally, incentive or performance fee amounts received by the General Partner or at times, a special "carried interest partner" in a limited partnership for the Fund Sponsor managing a Fund in a profitable manner; Traditionally set at 20% but amount varies substantially
DFI	Development Finance Institution
ESG	Environment, Social, and Governance
Fund	The vehicle in which an investor invests, whether it be a limited partnership, a company, or other similar vehicle
Fund Manager	The vehicle that will provide investment management services to the Fund, typically in exchange for the Management Fee for such services
Fund Sponsor	Term used generically to describe an asset manager, which may, in a given context be a reference to one or more vehicles within the asset manager's structure, for instance, the General Partner, the Fund Manager, Investment Adviser, and/or any affiliate thereof
General Partner	A person or vehicle that acts as the general partner of a Fund that is structured as a limited partnership
Handbook	This Private Investment Funds Governance Handbook dated April 2023.
IFRS	International Financial Reporting Standards, used broadly outside of the United States (in the U.S. the standard is the U.S. GAAP)
ILPA	Institutional Limited Partners Association, a trade association for institutional limited partners in the private equity asset class that has prepared certain template documents and recommended practices for fund investment; the reporting and notice templates are widely used; see https://ilpa.org/about/

Investment Advisor	The person or vehicle which will provide investment advisory services to the Fund or the Fund Manager, typically in exchange for an advisory fee for such services
IC	Investment Committee
LPA	Limited Partnership Agreement
LPAC	Limited Partner Advisory Committee
Management Fee	Amounts paid by a Fund to a Fund Manager in exchange for the latter's investment management services; typically expressed as a percentage of invested or investable assets
PE	Private Equity
Side Letter	A side agreement between an Investor and a Fund Sponsor that supplements or varies the terms of the Fund documents with respect to that particular Investor
SME	Small and Medium Enterprises
VC	Venture Capital
U.S. GAAP	Generally Accepted Accounting Principles in the United States

FOREWORD

The International Senior Lawyers Project (ISLP) is pleased to make this Private Investment Funds Governance Handbook available to the impact investment community. The Handbook was authored principally by a team of seasoned private equity lawyers from the respected Morgan, Lewis & Bockius international law firm acting *pro bono publico*. The aim of the Handbook is to help impact investment fund promoters and managers gain a greater practical understanding of legal matters that may arise in launching and operating their impact funds.

Impact investment funds are a crucial component of the global effort to promote economic development, eradicate poverty, and address climate change in line with the Sustainable Development Goals (SDGs) and the 2030 Agenda for Sustainable Development. By tapping into the vast pools of private investable capital, impact investing is able to expand by orders of magnitude the resources potentially available in support of achieving the SDGs.[1] The Global Impact Investment Network (GIIN) reports that in 2021 new funds deployed in impact investing exceeded one trillion US dollars for the first time and that these types of investments will continue to grow.[2]

Impact investment funds use legal structures and principles developed in recent years by private equity investors in the United States and Western Europe. But, in some respects, impact investors pour very different wine into the bottles crafted by the private equity industry. Where a traditional private equity fund manager relentlessly seeks to enhance investor financial returns, the impact investor is by definition focused on the societal benefits that can result from their investments as well as on the financial results. Traditional private equity began in the United States and is concentrated today in the US and Western Europe. By contrast, impact investors often operate in the Global South, although significant impact investors work in the US and Europe as well. Development finance institutions have a very important role in impact setting, as they provide financing to the impact investing funds supporting national development objectives aligned to the SDGs. This is critical given that the scale of impact investment funds is typically far smaller than traditional private equity vehicles in terms of both investible funds and earnings, although impact funds are making big strides by both measures.

Notwithstanding the real-world differences between traditional and impact private equity, the legal framework is generally similar. The basic legal framework is contractual and has evolved over the past 50 years. Private equity firms, both traditional and impact, are legally domiciled in many jurisdictions, both in investment centers like the United States (often Delaware), Western Europe, Australia, and Singapore and "off-shore" jurisdictions like the Cayman Islands, Luxembourg, the Channel Islands, and Mauritius. While applicable regulatory regimes differ

[1] Transforming our world: the 2030 Agenda for Sustainable Development. A/RES/70/1, Sep. 25, 2015, https://documents-dds-ny.un.org/doc/UNDOC/GEN/N15/291/89/PDF/N1529189.pdf?OpenElement.

[2] GIINsight: Sizing the Impact Investing Market 2022, https://thegiin.org/research/publication/impact-investing-market-size-2022/.

substantially among these jurisdictions, private equity contractual arrangements generally do not vary a great deal by geography; a useful provision pioneered in Zurich will quickly be adopted from New York to Sydney.

It is with this background in mind that ISLP developed this Handbook: to provide important knowledge on the most frequent legal matters relevant to impact funds, at a moment when supporting impact investing is vital to address the most complex global issues of our time and advance the SDGs.

ISLP has been exceptionally fortunate to be able to draw on the Morgan Lewis team for this important project. Morgan Lewis is a global law firm comprising deeply knowledgeable practitioners on both the formation of investment limited partnerships for private equity and hedge funds as well as the transactions through which those funds are deployed. The Morgan Lewis lawyers have brought to bear not only enormous experience in private equity work, but also exceptional insight into the practical workings of investment vehicles and a sophisticated grasp of the ways in which the impact setting can differ from that of traditional private equity.

The extraordinary Morgan Lewis team has been led by Alisha K. Sullivan, a prominent private equity lawyer admitted to practice in the District of Columbia and based for the last 14 years in the United Arab Emirates. Alisha has been the driving force in creating and refining this Handbook.

We would like to also thank the following contributors from the Investment Management Practice Group of Morgan Lewis: Nabil Abou-Charaf, Carolyn J. D. Abram, Spencer Anderson, Marie-Sophie Bandeira Vieira, Benjamin Beswick, Mark Conrad, Anastasia Dergacheva, Lance C. Dial, Andrea Dougall, Alexios S. Hadji, Ali Houssein, Ayman H. A. Khaleq, Richard Knott, Christopher Lloyd, Matthew J. Leibowitz, Amy C. McDonald, Ryan Nash, William L. Nash III, Tayne Rankine, and Katherine Seager. We owe a great deal to these individuals and to Morgan Lewis overall.

On the ISLP side, Tom Brunner and Florencia Librizzi played significant roles in creating this Handbook. Tom is an ISLP volunteer and a member of the ISLP Board. Drawing on his many years of experience as the general counsel of LeapFrog Investments, an impact investment firm, he prepared the initial outline for the Handbook and brought his experience as an editor to bear. Florencia, ISLP's Director of Civil Society Engagement, provided substantial comments drawing on her expertise in sustainability and the role of the private sector in achieving the SDGs, and acted as an overall project manager for the preparation and publication of the Handbook. Rebecca Landy, ISLP's Program Officer for Civil Society engagement, also helped finalize this publication, and Melissa Eustace, Communications and Operations Director, conducted a final review. Milica Škaro, Legal and Communications Fellow, designed the cover and back page as well as finalized the design of the publication.

The publication of the Handbook is an aspect of ISLP's growing involvement in providing legal support for social finance in the Global South. Most of our work in this sector consists of providing hands-on legal representation to impact fund promoters and their portfolio companies in addressing concrete legal issues. ISLP deploys the *pro bono publico* services of senior legal practitioners, typically current or retired partners in major law firms and often working alongside local lawyers in the relevant jurisdiction. A non-governmental nonprofit organization supported by grants and donations, ISLP was founded in 2000 and is based in New York City. ISLP provides legal assistance to governments, civil society organizations, and social enterprises primarily in Africa, Asia, and Latin America.

We hope this educational resource will benefit the impact investing community by providing useful background and help in spotting relevant issues. We look forward to hearing from potential clients, partners, prospective volunteers, and possible donors and funders that would be interested in continuing to expand this work together with us.

On behalf of the International Senior Lawyers Project

Sara Lulo, Executive Director
Florencia Librizzi, Director of Civil Society Engagement
Tom Brunner, ISLP Volunteer and Board Member
New York
April 2023

INTRODUCTION

A private fund is, broadly, a vehicle or series of vehicles into which two or more investors "commit" an agreed amount of money for investment into assets on a pooled basis, which assets are managed by a separate management team in accordance with agreed investment parameters and in return for an agreed Management Fee and share of profits.

"Private funds" are a subset of a wider category of investment funds or collective investment schemes. Private funds are only open for subscription by investors that meet certain net worth or sophistication requirements (for example, institutional investors such as pension funds, sovereign wealth funds, insurance companies, endowments and certain ultra-high net worth individuals). They are not available for investment by retail investors not meeting these sophistication requirements (as in, the general public), and as a result they have historically been less regulated and not subject to the limitations and restrictions that are imposed on investment funds available to the public (who need greater protection through regulation). In addition, private funds are offered by way of "private placement," which generally means the circulation of confidential documents to limited numbers of sophisticated investors without any form of "general solicitation" such as public advertisements.

Within the foregoing parameters, there is a broad spectrum of private investment funds. These may be closed-ended (for a defined term) or open-ended (with no fixed termination date). Some hedge funds may invest in liquid assets, such as publicly traded debt and equity securities, derivatives and other freely tradable securities. Many invest in illiquid assets, such as privately held companies (private equity), real estate, infrastructure, and private debt. Some invest into other private funds, either at inception (fund of funds) or by acquiring fund interests from existing investors (secondary funds).

Global assets under management of private investment funds (across asset classes) have been estimated by McKinsey to have reached an all-time high of $9.8 trillion as of July 2021, reflecting the increased awareness of this asset class among investors and strong demand for the public market-beating returns of the leading private investment fund managers. The dramatic growth in the industry has resulted in increased complexity and increasingly bespoke solutions for private capital formation.

This Handbook discusses certain key issues to be considered when forming and operating a private investment fund. The information set forth in the following chapters is intended to be generic. This Handbook does not constitute legal advice and is not a substitute for the customized advice needed to address the particular needs of Fund Sponsors or individual investors.

This Handbook aims to provide details on the market positions with regards to key terms of private funds; however, the Handbook has a particular focus on terms of investment funds targeting SMEs in emerging markets, and includes the positions on certain terms that DFI investors may expect.

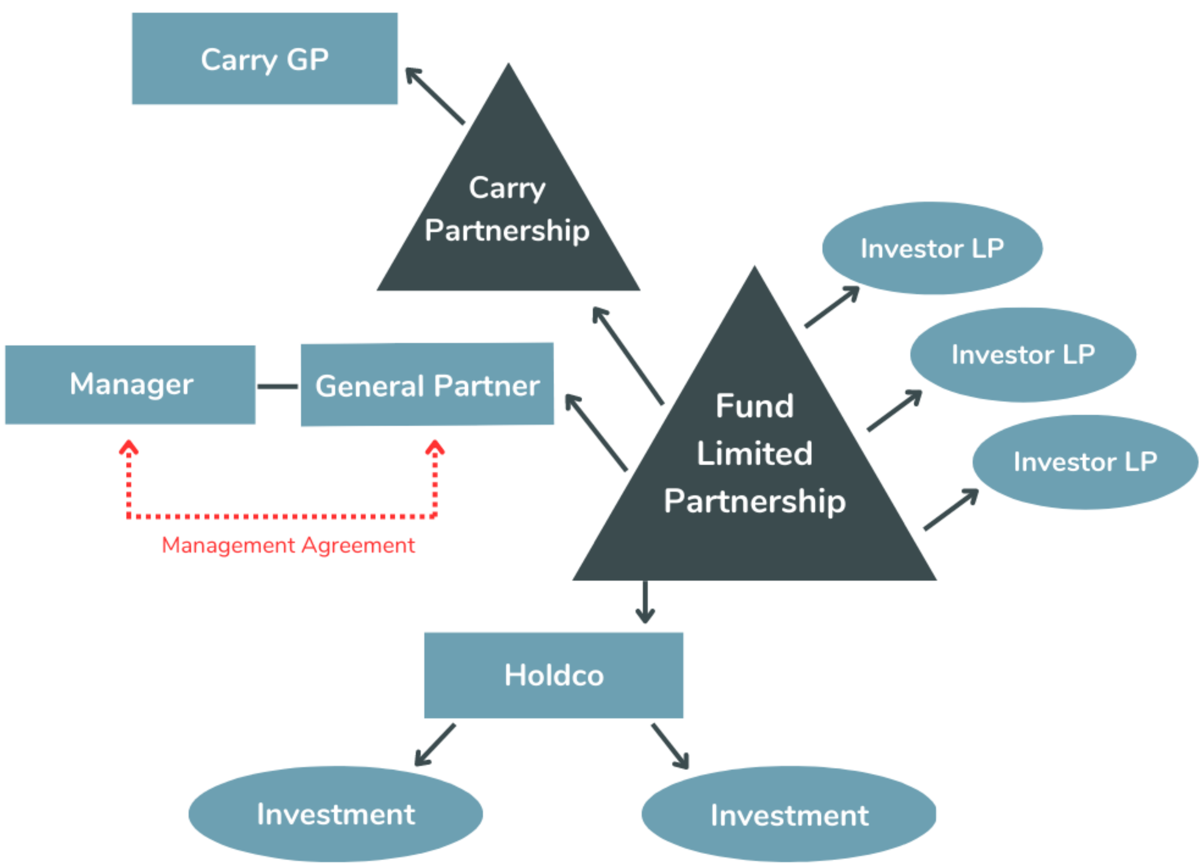
This Handbook provides summary information only and is not intended as legal or tax advice. Readers should seek specific legal or tax advice before taking any action with respect to the matters discussed herein. Importantly, the information contained in this Handbook is intended to serve as a guide for Fund Sponsors and other interested parties in navigating the private fund negotiation landscape. While every effort has been made to provide accurate and up-to-date information, readers should be aware that market positions and practices will shift over time and will vary based on a variety of factors, including (but not limited to) asset class, commitment amount, and investor status. The positions outlined in this Handbook, including those relating to all institutional investors, including commercial investors, DFIs, etc., should be viewed as general guidance rather than prescriptive rules.

SECTION 1: FUND STRUCTURES

I. IN GENERAL

The simplest type of Fund is a single Fund entity structure. Funds may also be set up in other ways, depending on the strategy of the Fund, the types of investors in the Fund, and other factors. These more complex structures are best understood after considering a single fund structure. The discussion below introduces basic fund term concepts in the context of a single entity Fund structure and then briefly explores other more complex structures.

II. SINGLE FUND STRUCTURE



(a) Fund

A Fund that is structured as a limited partnership with a fixed life term is both a common structure and also a helpful paradigm to understand other Fund structures. A limited partnership (as opposed to other types of business organizations) continues to be a common choice of legal form for Funds because it is well known by investors, and it has a well-developed statutory and case law framework in most jurisdictions. Limited partnerships are also available in numerous common fund jurisdictions, including Delaware, the Cayman Islands, and Mauritius. However, Funds also may be formed as a limited liability company, a business trust, a limited company, or other legal entity or as a contractual arrangement. Fund Sponsors, in consultation with their legal and tax advisors, need to decide on the basic structure of a Fund and its legal domicile early in the process of Fund formation.

The final determination of the structure and legal domicile will depend on a number of factors including the location of the Fund's investments, the location and sensitivities of the Fund's investors and the Fund Sponsor, as well as legal, regulatory and tax concerns such as flexibility of the legal structure, level of compliance required by the regulatory regime and tax treatment of the vehicle. Depending on the proposed investor base of the Fund, the Fund Manager may want to consider a particular jurisdiction's classification by the Financial Action Task Force ("FATF"), i.e. a country may be 'black listed' or 'grey listed' by FATF for a lack of or low standards in connection with anti-money laundering and terrorist activities. Certain investors, including DFIs, may have sensitivities and policies against investing in Funds that are domiciled in either black or grey listed countries. The regulatory regime that applies to Funds varies from jurisdiction and depending on the nature of the Fund and its investors, ranging from exemptions from any sort of registration under securities laws, to light-touch notification regimes such as in the Channel Islands, to more burdensome regulatory approval processes.

(b) General Partner

Assuming that a Fund is organized as a limited partnership, the Fund Sponsor will also typically form a separate entity to act as the General Partner, which would often be organized as a limited company. Under partnership law, the General Partner has sole authority to conduct the business of the limited partnership (so, the Fund) and will have unlimited liability with respect to the obligations of the limited partnership. The individual members, or board of directors, of the General Partner manage the investments of the Fund, either in their capacity as members, directors, or owners of the General Partner, or as service providers to affiliated entities. The General Partner (or an affiliate) typically will receive a Management Fee and a "Carried Interest" or share of the profits of the Fund as compensation for its services to the Fund. *See* Section 10 (*Fund Economics*) for additional information. For the purposes of allocation of Carried Interest, among other reasons, certain Fund Sponsors may also select a limited partnership to act as the General Partner (often known as a "GPLP").

(c) Fund Manager

Fund Sponsors frequently form a Fund Manager to administer and advise the Fund, seek out investments, and make recommendations regarding realizing and exiting those investments. The Fund Manager entity is typically regulated by the relevant authorities to perform Fund management, investment/asset management, and/or advising and arranging financial service activities. The main reason the General Partner and Fund Manager are two separate entities is to ring fence the unlimited liability that applies to the General Partner away from the Fund Manager, which is generally the entity of substance in a Fund Sponsor's organization: it will hold regulatory permissions as noted above and likely houses the Fund Sponsor's employees. The Fund Manager typically will be the entity that employs staff, conducts routine operations, and manages cash flows. The Fund Manager and the General Partner may each be directly managed by individual principals of the Fund Sponsor, or the individual principals may manage the Fund Manager, which in turn manages the General Partner. The Fund Manager will typically receive a Management Fee in exchange for its services, either directly from the Fund or from the General Partner, and will cover a broad range of costs including salaries out of that Management Fee. *See* Section 10 (*Fund Economics*), for additional information regarding economics. *See also* Section 2 (*Management/Administrative Entities*) for additional information regarding fund management.

(d) Limited Partners/Shareholders

The limited partners, in the case of a limited partnership, and shareholders, in the case of a Fund structured as a company, are the investors in the Fund and are generally not involved in the management of the Fund. This is a result of both (1) the general commercial arrangements and divisions of duties between Fund Sponsors and investors who are typically passive investors, and (2) because in a limited partnership the limited partners may not participate in management of the limited partnership, as doing so will cause them to risk losing their limited liability. Accordingly, where an investor requests to participate in a Fund's IC or otherwise in the governance of a Fund, care should be taken to avoid prejudicing such investor's limited liability. In a private equity Fund, the Fund's LPA will typically require the limited partners to make capital contributions upon request, up to a total commitment amount, and, in time, the limited partners will receive a return on the capital contribution, after payment of the Management Fee, and other Fund expenses. *See* Section 10 (*Fund Economics*), for additional information.

(e) U.S. Tax Classification of the Fund

Funds are typically classified as, or elect to be classified as, a partnership for U.S. federal income tax purposes. Even if a Fund is not legally domiciled in the U.S., it may well have U.S.-based investors for whom this classification will be important. Common Fund entities such as limited partnerships are typically classified by default as a partnership under U.S. federal income tax rules. Non-U.S. organized entities are generally able to file a "check the box" election to be classified as a partnership for U.S. income tax purposes. If a Fund is classified as a partnership for U.S. federal income tax purposes, the Fund itself will generally not pay U.S. federal income taxes, and each partner will be required to include its share of the Fund's income in its tax return. Such a "pass-through" or "flow-through" structure is typically the most efficient structure for a U.S. taxable investor. However, certain classes of investors, including non-U.S. investors and U.S. tax-exempt organizations, may benefit from different structures. Investors located outside the U.S. may raise concerns derived from their tax situations. The Fund Sponsor may need to make a practical decision about the extent to which it is prepared to incur expense and burden in addressing these concerns.

III. OTHER FUND STRUCTURES AND VEHICLES

(a) Feeder and Parallel Funds

Private equity or other closed-end Funds that raise a substantial amount of their capital from investors across multiple jurisdictions and/or investors with different tax statuses (tax exempt vs taxpayers) may use multiple Fund vehicles structured as parallel Funds (where the vehicles operate side by side) or feeder Funds (where one vehicle (the feeder) invests into another (the master)).

Parallel and feeder Funds are often used to offer Fund vehicles with different tax treatment for investors, who may then select the vehicle most appropriate for their tax status. Alternatively, a parallel or feeder Fund may be used for regulatory purposes, for example to avail Fund marketing regimes only available to Funds domiciled in a certain jurisdiction. For instance, there may be a Luxembourg limited partnership for EU investors and a limited partnership domiciled in the Abu Dhabi Global Market, Mauritius or Singapore for non-EU investors. Establishing multiple vehicles can therefore maximize the ability of a Fund Manager to market the private investment Fund efficiently in multiple jurisdictions to investors with different tax or other sensitivities. However, creating these arrangements can be expensive and may not be cost-effective for small Funds.

(b) Alternative Investment Vehicles

Funds will frequently permit the Fund Sponsor to form AIVs, which are typically used where a particular investment or category of investments if made directly by the Fund would be problematic for regulatory, legal, or tax reasons for some or all of the investors. The AIV is formed to make the investment or investments instead of the main Fund, and the investors who make contributions to the AIV have their capital commitment to the main Fund reduced by an amount equal to such contributions. An AIV differs from a parallel Fund because parallel Funds typically make all investments pro-rata, whereas an AIV only participates in some investments. Where an investor has policy-driven issues for certain investments, this is typically dealt with by simply excusing such investors from the problematic investment and having them invest offsetting amounts in subsequent investments. That approach may be easier for smaller Funds.

(c) Co-Investment Vehicles

Co-investment vehicles are distinct from parallel Funds in that their purpose is to invest alongside the "main Fund" in **some but not all** investments. They are distinct from alternative investment vehicles in that their purpose is to invest **alongside** the main Fund, rather than **in lieu** of the main Fund. Co-investment vehicles can also be established after the expiry of a Fund's closing period, as and when additional capital may be required.

Co-investment vehicles are increasingly popular as private Fund investors seek co-investment rights, as in, the ability to participate in the investments of the private Fund outside of their investment through such a Fund. Market practice has developed such that Fund investors typically pay reduced (or no) Management Fee and Carried Interest in respect of any co-investment, and as such, executing co-investments alongside a Fund will effectively reduce the cost basis of an investor's private Fund investment as they obtain greater exposure to the same assets without any (or without a proportionate) corresponding increase in fees. Large institutional investors such as DFIs often insist on co-investment rights or invest in a particular Fund for the primary purpose of receiving co-investment opportunities. For Fund Sponsors, the availability of co-investment capital allows them to complete deals that they may otherwise be unable to execute due to a lack of funds or by virtue of applicable investment restrictions (including deal size and concentration limitations) in the private fund governing documents. In addition, co-investors may bring sector- or deal-specific expertise to an investment that is useful to a Fund Manager.

Notwithstanding the many benefits, co-investment can significantly complicate the investment process and may lead to delay as individual investors go through their decision-making steps. In addition, Fund Sponsors should be careful if and when agreeing priority co-investment rights, to avoid committing to multiple obligations that, when taken together, form a cumbersome co-investment offer framework. Such co-investment rights are typically agreed via Side Letter. *See* Section 4 (*Limited Partners*), for additional information regarding Side Letters and related "most favoured nation" issues.

IV. MANAGEMENT TEAM ECONOMIC PARTICIPATION

The Fund Manager, whether the management entity itself and/or an affiliate thereof and/or the individuals comprising the management team, typically participates economically in a Fund in two ways: first, they may be obligated to make a cash investment into the Fund, which investment may not be subject to Management Fees and Carried Interest; and second, they are entitled to the Carried Interest if the Fund achieves a stipulated level of financial success. In many cases, this economic participation is structured through the General Partner entity, which itself may have the form of a limited partnership for the tax and liability limiting reasons discussed above. However, parallel and feeder funds are also often used to structure this economic participation so that, for example, all management team members entitled to a share of the Carried Interest are admitted to a feeder fund, which itself receives the Carried Interest from the Fund (a "Carried Interest vehicle"), or that all management team members making an investment into the Fund participate in a parallel fund that is not subject to Management Fees or Carried Interest (a "team co-investment vehicle").

Where a Fund Manager is an emerging (or startup) manager, it may have seed or angel investors that provide financial backing to the Fund Manager, often as well as making an investment in the Fund. In this case, those seed or angel investors may receive shares or other interest in the General Partner and/or Fund Manager in return for their investment in such an entity, which typically results in the seed or angel investor being entitled to a proportion of the Management Fees and Carried Interest generated by the Fund. In addition to these economic entitlements, seed and angel investors in a Fund Manager will likely have certain governance rights, often structured as rights to approve certain fundamental business decisions and/or to appoint members of the board of the Fund Manager.

SECTION 2: MANAGEMENT/ADMINISTRATIVE ENTITIES

I. SECTION INTRODUCTION

One of the first tasks for an emerging Fund Sponsor is to determine how to structure the "upper-tier" (as in, the management structure) of the asset manager's organization. Decisions regarding upper-tier structuring should be given due consideration and made under the advice of legal, tax, and accounting advisors. Notably there are various legal, tax,[3] regulatory, economic, and practical considerations and consequences – and relative permanence – of the chosen structure. For example, it is generally best practice to form (a) a management company entity that will serve as the Fund Manager across Fund vintages, and (b) a General Partner entity that is unique to each Fund launched by the Fund Sponsor structured as limited partnerships. At times, the General Partner or the Fund Manager may serve as the vehicle receiving carried interest; however, separate vehicles are often formed for such purposes.

II. ROLES AND RESPONSIBILITIES OF THE GENERAL PARTNER, THE MANAGEMENT FIRM, AND AN ADVISOR, IF ANY.

As discussed in Section 1 (*Fund Structures*), most private closed-ended Funds are established as a limited partnership with the Fund Sponsor serving as (or managing) the General Partner. With regard to limited partnerships, the General Partner, under the laws of most jurisdictions, is responsible for managing the affairs of the Fund and is liable for all obligations of the partnership. On the basis that investors play a passive role in a Fund, the law of most jurisdictions affords such passive investors limited liability to the extent an investor's role within the Fund remains passive (as in, the investor's liability will be limited to the amount that they commit to invest in the Fund). Where a Fund has an LPAC (as discussed in Section 6 (*Limited Partner Advisory Committee*)), it is important that the rights of the LPAC do not cause investors to be treated as having an active role in the Fund.

Typically, most duties of managing the day-to-day operations of a Fund, particularly investment decisions, are delegated to the Fund Manager. In some scenarios, a Fund or the Fund Manager will engage an Investment Advisor (or a sub-advisor), which is often the case where the individuals comprising the investment team are based in multiple jurisdictions. Managing a Fund and providing investment advice are generally regulated financial service activities. The Fund Sponsor needs to put clear, workable arrangements

[3] Sponsors traditionally focused on tax minimization to provide for greater investor returns; however, certain sponsors recently, particularly given pressures from certain investors, including DFIs, are now putting greater importance on tax transparency and responsible tax practices. Certain investors, particularly DFIs, may scrutinize Funds that use offshore financial centers and/or multiple intermediary jurisdictions within its structure.

in place that reflect the practical realities of the Fund Sponsor's organization (where people are based) and comply with the applicable regulatory regime in such jurisdictions.

III. THE ROLE OF THE FUND ADMINISTRATOR, A THIRD-PARTY FIRM.

While most investment functions are delegated from the General Partner (or, where a Fund is structured as a company, from the company) to the Fund Manager, a Fund Sponsor will often delegate certain administrative duties to a third-party administrator. While the type of work that may be outsourced to an administrator varies from Fund Sponsor to Fund Sponsor, administrators predominately provide an array of "back office" services including accounting, reporting, treasury, and depositary services and corporate secretarial services. However, in some instances, administrators may be appointed for marketing, investor relations services, and as described above, as a third-party management company. For offshore jurisdictions, third-party administrators often provide director services for economic substance purposes.

IV. FIDUCIARY OBLIGATIONS OF EACH PLAYER. POTENTIAL FOR LIABILITY.

Since Fund Sponsors are managing the assets of others, most jurisdictions impose some level of fiduciary responsibility on Fund Sponsors. A Fund Sponsor's fiduciary responsibilities generally require the management of investor assets to be done in a way that is in the investors' best interest (as opposed to the best interest of the Fund Sponsor). Fund Sponsors often attempt to limit their fiduciary responsibilities, especially with respect to the duty of loyalty to the Fund regarding the allocation of investments and conflict of interest transactions with such limits being contractually inserted into the Fund's governing documents. Such limitations are particularly the case for a Fund Sponsor that manages multiple Funds, which will have duties to different Funds that may be in tension with each other, and governing documents and disclosures to investors will need to carefully delineate how the Fund Sponsor is permitted to manage such tension. Examples of such situations include circumstances where multiple Funds managed by the same Fund Sponsor invest in the same company or where an investment opportunity must be allocated between two such Funds. The most acute challenge arises in the circumstance where one affiliated Fund proposes to sell its interest in a particular investment asset to another affiliated fund. Recently, some Fund Sponsors have been aggressively attempting to require investors to waive fiduciary duties to the Fund, which can effectively protect the Fund Sponsor from liability for breaches of such duties. This may be appropriate for governing documents of single purpose vehicles such as a co-investment vehicle, but the extent to which such limitations are effective is highly dependent on a Fund's or a Fund Sponsor's jurisdiction and subject to investor appetite for such fiduciary duty waivers. Many institutional investors are beginning to resist this development, rejecting in particular overly broad modifications or waivers of a Fund Sponsor's fiduciary duties.[4]

The advice of Fund counsel should always be sought with respect to the extent to which fiduciary duties may be waived under applicable law. One commonly applied alternative to seeking outright waivers of fiduciary duties is to make certain actions of the General Partner that would constitute a conflict of interest subject to approval by an independent board of directors, or the LPAC[5] (see Section 6 (*Limited Partner Advisory Committee*), below, for a detailed discussion of the LPAC).

V. KEY PERSON DEVOTION OF TIME REQUIREMENTS, THE PROCESSES TRIGGERED SHOULD A KEY PERSON EVENT ARISE, CURING A KEY PERSON EVENT, IMPLICATIONS FOR UNCURED KEY PERSON EVENT.

Since investors in closed-end Funds have limited ability to withdraw or redeem from a Fund and therefore remain committed to a Fund, investors typically require a Fund's governing documents to designate, by name, individual investment professionals who are important (or key) to such Fund's investment strategy and provide for consequences if such persons are no longer exercising investment discretion with respect to the Fund. Departures of such designated individuals are known in common Fund parlance as "key person events." A key person event can arise if the designated individual shifts to another role within the Fund Sponsor group, leaves the Fund Sponsor entirely as well as when the individual dies or becomes incapacitated, because the trigger is usually the failure to devote a certain specific amount of business time (a 'substantial majority' or 'substantially all') to the Fund Sponsor and the Fund. A key person limitation may constrain the ability of the Fund Sponsor to undertake other business activities even when Successor Fund considerations (see XII below) are not implicated.

The LPA typically requires prompt notice of a key person event to the LPAC or to all of the investors. The Fund Sponsor then may propose a replacement for the departing key person subject to LPAC or overall investor approval. If the situation is not resolved promptly (for example by appointment of a replacement), it can lead to serious consequences: the typical remedy for an unresolved key person event is to suspend the commitment period, and if an agreement is not reached on a replacement within a certain amount of time (often 6 months), the temporary suspension of the commitment period will become permanent, meaning that the Fund Manager will not be permitted to make new investments for the Fund.

[4] Certain DFI investors may, as a matter of Investment Policy, reject any limits to a Fund Sponsor's fiduciary duties and require a representation in the LPA that the General Partner has a fiduciary obligation to the Fund and to always act in the best interests of the Fund.

[5] As noted in the prior footnote, some larger institutional investors, including DFIs, may require a provision in the LPA or their side letter to retain the right for itself to approve any waiver of a fiduciary duty.

The anticipated departure of a key person calls for careful planning and communication by the Fund Sponsor. However, an abrupt departure due, for example, to a fundamental disagreement among the principals or a medical emergency, can present an urgent and critical situation for Fund management. Care should be taken when formulating a key person provision to avoid a formulation that is easily triggered, for example by the departure of a single individual. Where this is the case, the ability of that individual to cause a key person event in the Fund can result in unfavorable dynamics between such individual and the Fund Sponsor organization as a whole.[6]

VI. COMMON PRACTICAL ISSUES, FOR EXAMPLE, ALLOCATION OF EXPENSES BETWEEN FUNDS AND MANAGERS AND ALLOCATION OF BROKEN DEAL EXPENSES.

Investors typically pay the cost of the formation of a Fund[7] (customarily referred to as the "organizational expenses"), subject to a cap, with any amounts over the cap being paid by the Fund Sponsor. The permitted amount of organizational expenses is often in the range of 0.5 - 1.0% Fund Sponsors,[8] of the aggregate investor commitments, with smaller Funds being in the higher range. For emerging Fund Sponsors it may be possible to agree with investors that the Fund (as in, the investors) will initially pay all organizational costs, with any amount in excess of the agreed cap reducing the Management Fee over multiple quarters, in order to assist with a Fund Sponsor's cash flow in the early years of a Fund.

Investors will also typically pay all of the reasonably and properly incurred[9] general expenses of operating the Fund, including (a) administrative costs (for example, auditors, administrators, regulatory and corporate filing fees, etc.), (b) transaction costs (for example, the costs of valuers, legal counsel and due diligence advisors, etc., in connection with structuring, negotiating and consummating an investment) and (c) the Management Fee. The Fund Manager will pay for its own general overhead and operating expenses

[6] While a single individual key person event is not in the Fund Sponsor's interest, certain investors, such as DFIs, may nonetheless still require the key person event be triggered on the departure of a single individual.

[7] Investors will expect these to be suitably evidenced, with some investors requiring exclusions of certain costs such as placement fees, and, in the context of DFIs, limits on travel and entertainment expenses relating to fund marketing.

[8] DFIs typically require a cap on the organizational fees of the Fund set at the lesser of 1% and a specified quantum. In terms of percentages, investors would expect a lower percentage cap for larger funds and for subsequent funds, where set up costs are typically lower, or proportionally lower compared to the size of other Funds.

[9] While Fund Sponsors typically try to steer away from a formulation requiring expenses be 'reasonably and properly incurred,' primarily on the basis that the Fund Sponsor does not want to defend or justify any certain Fund expense, certain investors may follow a strict interpretation of ILPA guidelines and request for the formulation to be included.

(for example, office space, salaries of employees, regulation costs, etc.) out of the Management Fee. Ensuring from the beginning that the allocation of expenses is clear and understood is important to avoid disagreements or even regulatory action down the road. Notably, the US Securities Exchange Commission has penalized fund management firms for improper allocation of expenses.

An expense for Fund Sponsors, investors, and potential co-investors to consider closely is broken deal expenses. These are costs and expenses incurred in developing, investigating, negotiating, or structuring any investment in which the Fund does not ultimately participate. The Fund's governing documents should specifically provide that broken-deal expenses, including those arising with respect to co-investments, will be borne either (i) exclusively by the Fund, or (ii) on some shared basis with potential co-investors and counter-parties.[10] Broken deal expenses have the potential to materially affect Fund Sponsor economics, and they merit the close attention and management (through containment and cost-coverage agreements) from senior figures within a Fund Sponsor.

VII. ALLOCATION OF INVESTMENTS; NO PARTICIPATION BY MANAGER TEAM IN INVESTMENTS OTHER THAN THROUGH FUND, NO INVESTMENTS BY FUNDS IN ENTITIES IN WHICH MANAGER TEAM HAVE PRE-EXISTING INTERESTS.

Most Funds' governing documents provide a detailed description of a Fund Sponsor's policy with respect to the allocation of investment opportunities. A Fund Manager that is managing its first Fund will be expected to offer every investment opportunity made available to the Fund Sponsor and that is within the Fund's investment strategy to the Fund. Fund Sponsors with multiple vintages, or that are involved in sponsoring Funds with overlapping investment strategies, will need to provide a detailed and binding description of how investments will be allocated between the Fund and other various funds the Fund Manager manages. Investors will also require that the Management Team only participate in investments of a Fund by investing in the Fund, to align their interests with those of investors and to avoid the Management Team "cherry picking" additional exposure to investments expected to be successful.

Sometimes a Fund Manager may desire to cause a Fund to invest in an entity in which the Fund Manager or its affiliates may have some interest which predates the establishment of the Fund. This is one of the most common scenarios involving a conflict of duty and interest between a Fund Manager and the Fund it manages. At the very least, the transaction should require the approval of an independent body such as independent

[10] ILPA's guidance provides that in most cases involving parallel investment vehicles and co-investors, broken-deal expenses should be borne on a shared basis. Certain DFI investors may require this obligation for shared broken-deal expenses to feature in the Fund's governing documents.

directors or the LPAC, in each case consisting of and limited to uninterested persons who are not affiliates of the Fund Sponsor.[11] This scenario should not be confused with that involving "warehoused" investments, which occurs where a Fund Sponsor pre-purchases investments prior to the formation of a Fund on the basis and with the intention that, once the Fund is formed, warehoused investments will be transferred from the Fund Sponsor to the Fund. Clear advance disclosures about the existence of the warehoused investments and the proposed valuation methodology should be provided for those investments.

VIII. SUCCESSOR FUNDS.

Given Fund Sponsors are in the business of managing Funds and are remunerated accordingly, they customarily seek to launch multiple Funds over time. Typically, when a first Fund has substantially committed its investable assets, a second Fund will be launched. Such further Funds, if they have the same or substantially similar investment strategy of the existing Fund, are known as "successor Funds." To protect the interests of the investors in the existing Fund, certain milestones are memorialized in a Fund's governing documents that will need to be satisfied before the Fund Sponsor will be permitted to launch a successor Fund. The substance and implications of those terms are of great practical importance to the Fund Sponsor since it does not want to find itself unable to make new investments for a material period of time. At the same time, the investors will be concerned that the investment team remains suitably focused on the first Fund throughout the Fund life.

Typically, the Fund Sponsor will be prohibited from launching a successor Fund until the earlier of either 75% of the prior Fund's committed capital is invested or the conclusion of the prior Fund's commitment period (most commonly five years from first close).[12] The commitment period will often be set for a certain period, but with the option for it to be ended early if the Fund deploys a specified percentage of capital commitments before the end of that period. It may be the case that the Fund Sponsor will be permitted to launch a successor Fund before the requisite deployment threshold is met if a minimum

[11] Investors may prefer a LPAC as opposed to an independent body given the LPAC comprises representatives of certain investors of the Fund who may in fact be, or at least optically considered, better aligned with investors. Additionally, and in line with ILPA guidelines, certain investors, including DFIs, may request that any conflict must be resolved with the consent of the LPAC.

[12] An investor favorable successor fund formulation, and one which DFIs generally seek, limits Fund Sponsors from commencing any fundraising, marketing ,or establishing the successor fund vehicle prior to the relevant threshold agreed in the Fund's governing document being satisfied (e.g., 75% invested capital). A Fund Sponsor, particularly an established Fund Sponsor may formulate the successor fund provision to allow marketing/fundraising and establishment of the Fund vehicle provided that either investors have not been admitted to the successor fund or that no investment activities would occur prior to a relevant threshold (e.g., 75% invested capital).

percentage in interest of the investors or the LPAC approve.[13] The workings of such provisions, particularly in conjunction with key person provisions, are likely to be of great importance to the viability and financial success of the Fund Sponsor and merit considerable attention in negotiating the LPA.

Once a Fund is launched, the Fund Manager will be bound (subject to amendments requiring specified levels of approvals) to its investment allocation policy and should therefore anticipate the eventuality of a successor Fund when crafting it, and address in the Fund's governing documents both the current Fund and the potential successor Fund how it will handle the Fund's follow-on investments with respect to the current Fund's investments. Deal exclusivity will generally apply to a specific Fund during such Fund's commitment period and with respect to follow-on investments, the Fund, and particularly the portfolio company in which the follow-on investment relates, would have priority over such follow-on investment.

IX. CHANGE OF CONTROL / FUND SPONSOR TRANSFER RESTRICTIONS (INCLUDING OWNERSHIP OF CARRIED INTEREST).

Investors desire continuity in the management and control of the General Partner and/or Fund Manager. In addition to the key person and devotion of time provisions, investors will typically require additional assurances that both the ownership and control of the Fund Sponsor (whether it be the General Partner and/or the Fund Manager or otherwise) will not change, either at all or beyond certain levels, during the term of the Fund. From an investor standpoint, it is critical that the right to Carried Interest serves properly as an alignment of interest between the Fund Sponsor and the investors, and therefore they customarily seek to ensure that there is an appropriate correlation between the people making the investment decisions for the Fund and the allocation of the Carried Interest for the Fund to those persons. Accordingly, should a Fund Sponsor breach the change of control/transfer restrictions, a consequence is often that the investors may vote to terminate the Fund and/or the level of Carried Interest is reduced. From the perspective of the Fund Sponsor's owners, however, a prohibition against being able to sell any portion of their interest to achieve liquidity and generate cash for themselves may be unattractive, particularly if it extends for many years. This is a topic that the Fund Sponsor will want to explore candidly with their investors to achieve a fair, workable balance of interests.

Details of the Carried Interest arrangements (at the Fund Sponsor level) are often not provided to investors,[14] so investors will typically insist on the inclusion of provisions in

[13] DFIs may request that in the event the requisite deployment threshold is not met, a minimum percentage in interest of investors (e.g. 50%) must vote in the affirmative for a successor fund, as opposed to the LPAC.

[14] Some investors, including DFIs, may require greater transparency in relation to the allocation of Carried Interest, including particular details of the Carried Interest split amongst the Fund Sponsor's personnel.

the Fund's governing documents requiring at least a certain percentage (at least a majority, but sometimes more) of the management and control of the General Partner and the Fund Manager to be held by certain named persons. This approach incorporates the flexibility for the Fund Sponsor to make strategic allocations of Carried Interest within certain parameters.

These arrangements can remain in effect for the life of a Fund, typically 10-12 years or even longer, and therefore can significantly affect the careers and financial positions of the centrally involved team members. They also can affect the ability to recruit new senior team members and to provide liquidity for affected individuals and potentially for their heirs in the event of death.

X. CIRCUMSTANCES THAT MAY PROMPT THE REMOVAL OF A FUND SPONSOR AND ECONOMIC IMPLICATIONS; CARRIED INTEREST.

Investors will generally insist on the ability to remove the Fund Sponsor, both "for cause" and, at a higher vote threshold, "without cause." The definition of "cause" in a for cause removal provision will typically consist of some combination of an action or omission on the part of the Fund Sponsor consisting of fraud, gross negligence, material breach of the Fund's governing documents, willful misconduct, a violation of securities laws, breach of fiduciary duty or commission of a felony of moral turpitude, criminal conduct, or bankruptcy.[15] Depending on the Fund and negotiations with investors, "cause" may be determinable by court, arbitrator, or regulatory/self-regulatory body of first instance, including any regulatory order or settlement in which the Fund Sponsor is allowed to neither admit nor deny fault or a guilty plea. Fund Sponsors will generally go to market having agreed to some of the above, as qualified by either (i) "and such action caused a material adverse effect to the Fund or any investors in the Fund,"[16] and/or (ii) "as determined by a [final non-appealable] judgment of a court of competent jurisdiction." Subparagraph (ii) is very common for established Fund Sponsors and should always be included when going to market.[17] Subparagraph (i) may be appropriate for some Fund Sponsors.

[15] DFIs may require that an unresolved key person event following the Commitment Period constitute a "cause" event.

[16] A qualifier requiring the cause event to have an adverse effect on the Fund, or its investors may be included for a breach of the Fund's governing documents; however, investors, particularly DFIs, may not permit such qualifies for events constituting willful misconduct, fraud, and gross negligence. In the same scenarios, investors may also not permit the General Partner/Fund Manager to cure the breach and their ability to be removed as a result of simply putting the Fund and its investors back into the position prior to the cause event.

[17] However, DFI investors may require the Fund's governing documentation to provide that a cause event be triggered following any decision by a competent court (not just a final, non-appealable decision).

Generally, any such "for cause" removal must be made by the affirmative vote of some percentage in interest of the investors. Funds vary on this threshold, but in general range from a majority in interest (50%) to two-thirds in interest of the investors (66%).[18] For no-fault removal, the threshold is higher and typically ranges from 66% to 85% in interest of the investors.[19]

Upon the completion of the removal process, as further discussed in Section 6 (*Limited Partner Advisory Committee*), the Fund Sponsor will typically be subject to financial consequences. Typically, in a "for cause scenario" there will be a substantial "haircut" on the amount of Carried Interest to which a Fund Sponsor is entitled on a going forward basis (with respect to existing investments) as well as a loss in entitlement to Management Fee. This haircut can range from 20 - 50% and can also vary depending upon the severity of the "for cause" event. Removal provisions are also further discussed in Section 4 (*Limited Partners*). Where a Fund Sponsor is removed "without cause," the Fund Sponsor may be compensated by receiving Management Fee equal to up to 6 to 12 months' worth of Management Fee that it would have otherwise received if the investors had not removed the Fund Sponsor. Additionally, the Fund Sponsor would continue to be entitled to Carried Interest on investments made during its tenure, which may be based on a straight-line vesting schedule, or, in the case of a Fund Sponsor friendly formulation, at the election of the Fund Sponsor, valued and payable at the time of removal. In either a "for cause" or "without cause" removal, Carried Interest will not be received on investments, if any, be made following the date of removal.

Upon the removal of the General Partner/Fund Manager following a "for cause" or "without cause" event, Fund documentation generally provides that the Fund's term will be terminated and the liquidation and winding up of the Fund will occur. To provide flexibility, investors may require that the Fund documentation include an option, at the election of the investors, for the Fund to instead carry on business, including the commitment period (if it has not already expired), under the leadership of a replacement General Partner (which the investors have selected and appointed). Such a provision is investor-friendly, and most Fund Sponsors would only include it if insisted upon by early anchor investors. Generally, the removal of a General Partner is not completed until a replacement General Partner has been selected. Such selection typically requires the approval of a majority in interest of the limited partners but may also be accomplished by the approval of the LPAC. In such a scenario, the Fund's governing documents should also require that the Fund Sponsor's name be stripped from the Fund and not used by the Fund or the replacement General Partner/Fund Manager on a going forward basis.

[18] DFI investors may require a simple majority.

[19] The threshold will often vary depending on the type and vintage of the fund and the experience of the Fund Sponsor. DFIs typically look to have a maximum no-fault threshold set at 75% of investors; however, for new Fund Sponsors and investment funds targeting SMEs, may look to require a lower threshold, for instance, to require only a 66.6% vote of investors.

SECTION 3: LIFE CYCLE OF THE FUND

I. LENGTH OF TERM.

Unless a Fund is being formed as an open-ended Fund (such as a hedge Fund) or a hybrid "evergreen" style Fund, the Fund Sponsor should carefully consider the appropriate length of the Fund's term (as in, the number of years from Fund inception to the date of liquidation when the Fund Sponsor must wind-up and dispose of any remaining Fund assets). Private closed-ended Funds commonly have a term ranging from 8 to 12 years, although there is generally no set requirement, and a Fund Sponsor should determine the appropriate length of term based on the Fund's specific investment strategy and asset class. Some impact investment Funds have elected to provide for longer terms (for example, 15 years) in recognition of the greater time required for such investments to mature.

Most Funds include a mechanism for the Fund Manager to extend a Fund's term if additional time is required for investments to mature to an optimal state of development for exit or alternatively to avoid unfavorable market conditions. For example, an extension provision commonly seen in private investment Funds allows the Fund Manager a single unilateral one-year extension[20] and an additional one-year extension with the approval of the LPAC or a majority in interest of the investors. Management fees payable during extension periods (save for any extensions which the Fund Manager may unilaterally approve) are usually negotiated and approved by investors or the LPAC, and in some instances waived altogether. It is often the case that fees during the first extension term are stepped down, with no fee payable during a second extension term.

II. LENGTH OF FUNDRAISING PERIOD AND FUND SIZE LIMITS.

The fundraising period is the period during which the Fund Manager is permitted to accept new and additional commitments from investors. For open-ended Funds, there is no set period. The period historically for closed-ended Funds was typically no more than 12 months from the initial closing; however, in recent times due to the COVID-19 pandemic and economic uncertainty, Fund Managers have looked to extend their fundraising periods for up to 18 months. The governing documents of the Fund will typically permit the Fund Sponsor to request the approval of the LPAC or a majority in interest of the investors to approve an extension of the fundraising period, typically for no more than six months. Investors typically like to see limitations on the fundraising period as it can be seen as a distraction from deploying the capital that the Fund has already received. From an investor's perspective, the fundraising period should be short

[20] Although some types of funds may nearly always require a majority LPAC or investor consent for an initial one-year extension, and any further extensions require a supermajority investor consent.

enough to show confidence on the part of the Fund Manager that it will meet its fundraising goals relatively quickly.

Fund Sponsors will typically indicate both the minimum and target total amount of investor commitments for a Fund. A maximum size limit may be specified and is customarily referred to as a "hard cap." As with the fundraising period, investors should assess whether the Fund Sponsor's minimum and target levels for the fund raising as well as any hard cap are appropriate in light of the size and capability of the Fund Sponsor's organization: will the Fund Manager have at least a viable level of capital to support its investment strategy if the minimum level is reached, and will the Fund be able to deploy the capital and have the time and resources to properly manage the Fund's portfolio investments according to the Fund's investment strategy if the target (or hard cap) is reached? The latter consideration is especially prevalent with respect to newer Fund Managers with a limited back office, notably with respect to venture capital Funds.

Additionally, a Fund's governing documents will often provide (i) a minimum raise amount for purposes of reaching an initial closing on investors (particularly for first time Funds), and (ii) the flexibility on the part of the General Partner to end the fundraising period at any time (once the minimum or target amount is raised).

III. LENGTH OF COMMITMENT PERIOD AND TRIGGERS FOR EARLY TERMINATION.

The "commitment period" or "investment period" of a Fund is the period during which the General Partner may draw down commitments. Commitment periods range in length (but often not more than five years from first or final close),[21] and the Fund's governing documents often contain provisions for (a) the suspension of such period, upon a key person event (*see* Section 2 (*Management/Administrative Entities*)) and (b) early termination of the commitment period upon an uncured key person event, or a change in control or removal of the General Partner. Once the commitment period has ended, the Fund may not make further investments; however, the Fund's governing documents usually contain a carveout providing that investments that were committed to be made by the Fund prior to the end of the commitment period and follow-on investments (investments in connection with existing investments), may be made. Caps may be placed on the amount of follow-on investments (expressed as a percentage of total commitments and often capped at c.15-25% of committed capital), and further, investors may additionally request that follow-on investments must be completed within a certain number of years of the end of the commitment period.[22] Fund Sponsors should carefully

[21] One-year extensions to the commitment period are seen on an exceptional basis for some funds; such extensions are usually subject to LPAC or majority investor consent and with negotiated management fees with most investors preferring to pay fees on invested capital during an extension, as opposed to committed capital.

[22] Often 2 years for funds in emerging markets.

consider limitations in the context of their investment strategy – a 'buy and build' investment thesis that relies heavily on bolt on acquisitions will need enhanced flexibility for follow-on investments, for example.

Investors and/or the LPAC will often have rights with respect to determining the permanence of a suspension or termination of the commitment period, including approving a new key person, or in the event of a change in control or removal of the General Partner, approving a replacement General Partner to continue the Fund.

IV. EARLY TERMINATION OF THE FUND.

Investors will look for an array of events in a Fund's governing documents that will trigger the termination of a Fund (meaning that upon any such event, the Fund will be liquidated and wound up). In some instances, particularly with newly established Fund Managers, a Fund may be terminated without cause or fault, upon the approval of a supermajority-plus of the investors (such as 75% or 85% in interest (the lower end for investment funds targeting SMEs)) – investors may look to terminate the Fund early where the Fund has been unsuccessful in making investments, achieving a particular Fund size, and other reasons. Typically, there will be a provision allowing for the termination of a Fund by a majority or two-thirds in interest of the investors upon some "cause" event (*See* Section 2 (*Management/Administrative Entities*) for a description of possible "cause" events). There are also often certain automatic termination triggers, such as bankruptcy of the General Partner/Fund Manager or removal of the General Partner where no replacement General Partner is identified. Some Funds allow the General Partner to terminate a Fund's term early without any further approvals required, although this is sometimes seen by investors as excessively sponsor-friendly and contrary to investor interests.[23] Regardless of any right to terminate a Fund prior to the end of the term, alignment remains because a Fund Sponsor is not incentivized to terminate a Fund early because it would result in the Fund Manager foregoing Management Fee and possibly Carried Interest.

[23] This right of the Fund Sponsor is not typically seen in funds that involve DFI investors.

SECTION 4: LIMITED PARTNERS

I. FUNDRAISING: MARKETING TO POTENTIAL INVESTORS.

Fundraising is the process of raising funds from investors to invest in the Fund (as in, soliciting capital commitments).

The first step in fundraising is marketing the Fund to potential investors. Fundraising can be very quick in the case of an established private equity house with a strong track record. For newer firms or in weaker economic times, the process can take longer and will typically commence well before the formation of the Fund in a period often known as "pre-marketing," during which the market's appetite for and the viability of the Fund is tested by the Fund Sponsor.

The main marketing document for Fund Sponsors in the context of a private placement is the prospectus (sometimes referred to as the information memorandum or private placement memorandum in markets where "prospectus" is a term reserved for a public fundraising), which is the main disclosure document setting out the offering terms of the Fund, providing background on the Fund Sponsor and management team (including demonstrating any track record), and disclosing the key risks, tax, and regulatory implications of an investment in the Fund.

It is very important to ensure compliance with securities laws and other legislation surrounding the marketing (and pre-marketing) of a Fund to investors. Applicable securities laws depend on the specific jurisdiction of the residence of a prospective investor. Accordingly, where a Fund Sponsor intends to market globally or in a number of jurisdictions, compliance with applicable laws can often be an involved process because requirements are jurisdiction specific. Some jurisdictions require notifications and/or registrations prior to any marketing commencing and some jurisdictions even require a person authorized in such jurisdiction to be appointed as the marketing agent.

II. SUBSCRIPTION PROCESS.

Investors wishing to participate in a Fund will subscribe for an interest in, and make a capital commitment to, the Fund in the form of a subscription agreement. The subscription agreement is an investor's application to join the Fund and to become party to and bound by the provisions of the Fund's governing documents. If accepted by the General Partner/Fund Manager (as applicable), the investor will become bound by the terms of the subscription agreement including the obligation to make capital contributions in an amount up to its accepted capital commitment.

Offers to subscribe for interests in the Fund may be accepted at the discretion of the General Partner/Fund Manager and will be subject to the completion of satisfactory "know your client" and related anti-financial crime diligence as well as the provision of satisfactory tax compliance information for applicable tax reporting regimes. To this end, investors are typically asked to make a number of representations in the subscription agreement concerning, among other things, ERISA, tax, securities law, and anti-money laundering matters.

The “first closing” of the Fund is the date that the Fund officially accepts capital commitments from investors and admits investors to the Fund. For closed-ended funds, it is an important date because it starts the fundraising clock for purposes of the LPA (or similar governing document of the Fund), as well as the period in which the Fund may commence investment activities. The final date on which the Fund Sponsor may accept commitments is known as the “final closing.” Fund Sponsors will typically tie key dates of the Fund to the first/final closing date.[24] For example, the investment period for PE/VC Funds would typically commence on the first closing date and last up to five years from the first/final closing date. Additionally, the Fund’s term may continue until the tenth anniversary of the final first/final closing date. The fundraising period ends at the final closing.

III. TRANSFERS.

An investor’s ability to transfer its interest in the Fund is often restricted by the Fund’s governing documents and will typically require the prior written consent of the General Partner/Fund Manager. The main reason for restrictions on transferability is to protect the Fund against any adverse tax, regulatory, credit or other consequences as a result of a changing investor base.

In addition to requiring the consent of the General Partner/Fund Manager, the Fund’s governing documents will also typically stipulate a number of conditions precedent to be satisfied prior to transfer.[25] Those conditions will often include the requirement for: (i) the transferor to provide the General Partner/Fund Manager with advance written notice of the transfer; (ii) the transferor or the proposed transferee to agree to pay the expenses in connection with the transfer; and (iii) the proposed transferee to complete a subscription agreement (providing the representations, warranties and acknowledgements therein) and all satisfactory KYC/AML checks.

The sale of an existing investor’s interest to a third party is known as a “secondary sale.” A secondary sale can offer a valuable mechanism for investors to better manage otherwise illiquid private equity portfolios and many investors see secondaries as a way

[24] Certain investors, particularly DFIs, often tie key dates to the first closing of a fund, which are typically non-negotiable, and are always non-negotiable for some types of funds.
[25] Certain types of investor, such as DFIs, will insist on receiving rights to transfer their interests in a fund without Fund Sponsor consent (which are often subject to reasonable restrictions such as satisfying KYC/AML checks). These rights usually extend to transferring provisions in the investors’ respective side letter (with some exceptions such as specific policy and immunity rights).

to rebalance portfolios or prematurely lock in gains from high-quality private equity investments. On the other end, secondaries offer incoming investors a place to buy private equity assets years into their performance cycle and, normally, at a discounted price. As a result, there has been an ever-increasing demand in recent years for secondary transactions.

IV. KYC/BACKGROUND SCREENING OF INVESTORS.

A Fund will be subject to local anti-money laundering (AML) (among other) laws, which may require the Fund and the Fund Sponsor to conduct certain "know your customer" (KYC) diligence and report on certain suspicious transactions. As described above, the acceptance of an investor's subscription agreement will be subject to completion of satisfactory AML/KYC checks and the obligation to comply with AML laws will be ongoing throughout the life of the Fund.

Legal regimes around the world are increasingly enacting laws requiring strict reporting and compliance regimes, which affect funds' diligence reporting and recordkeeping procedures. Recent legislation in the Cayman Islands, for example, requires the designation of certain money laundering reporting officers, certain training for employees responsible for Funds and ongoing diligence on investors and investments throughout the life of the Fund.

Additionally, all European Union countries are required by a European Directive to implement AML legislation, which may affect Funds and Fund Sponsors operating in European Union countries. Another feature in the European Union is the transparency register. The Directive requires European Union countries to establish a register listing the beneficial owners of, for instance, companies, partnerships and trusts, including Funds established in the European Union. The U.S. regulatory landscape is somewhat different, in that it currently does not explicitly call on Funds and their sponsor to take affirmative anti-money laundering steps; however, Funds and Fund Sponsors that are "willfully blind" to money laundering and related criminal activities (on the part of investors or portfolio companies) could be held criminally liable for money laundering. The regulatory landscape in this area is continually evolving and Fund Sponsors must be aware of anti-money laundering requirements in their relevant jurisdictions, including requirements to carry out "know your customer" and due diligence procedures on potential investors. In addition, it is increasingly common for Fund investors, lenders and others to require funds and their sponsor to adopt anti-money laundering and "know your customer" compliance regimes.

V. LP AND GP COMMUNICATION.

It can take years for private equity Funds to generate returns through exits and distributions and to generate a track record, which is one of the key fields of investor due diligence. Until then, the performance of a Fund is only visible in unrealized valuations, and the main source of communication between the GP and the LPs are quarterly reports, capital account statements, LPAC,[26] and investor meeting presentations as well as update calls.

Quality and transparency of reporting, accuracy of information provided as well as timeliness are key success factors for the LP/GP relationship. Limited Partners need to run their operations and do their own internal reporting, and in order to meet these requirements they will request that Funds deliver reporting on time and up to a high standard.

VI. SIDE LETTERS.

As Fund investors have become increasingly sophisticated, with larger internal resources devoted to Fund investments, it has become increasingly common to address the specific issues of an investor via a Side Letter agreement between the Limited Partner and the General Partner/Fund Manager. Many institutional investors now have a list of personalized "standard" Side Letter requests that they make in respect of all of their Fund investments. Common issues addressed in Side Letters include "most favored nation" undertakings (if not addressed directly in the Fund Agreement) (*see* "VII. MFN Process" below), transfer and/or redemption rights, information and/or disclosure rights, additional investment restrictions (and related excuse rights), investor tax, regulatory, and policy concerns, and other matters particular to the specific investor. Note that a Side Letter cannot amend the Fund's governing documents with respect to other investors not a party to the Side Letter.

VII. MFN PROCESS.

Funds have sought to regularize investors' rights in an even-handed manner by way of a "most favored nation" (MFN) provision, which is now commonplace in Fund documents or Side Letters. In a nutshell, an MFN provision typically entitles an investor to elect the benefit of rights contained in other investors' Side Letters and potentially also the right to view the other investors' Side Letters, with the premise being that individual investors should not be afforded special or additional rights arbitrarily.

Fund Sponsors will often introduce carve-outs to provide for certain exceptions to rights electable under the MFN process to afford first close or repeat investors more favorable rights in a "fair" manner. Additionally, certain types of Side Letter rights are commonly exempted from MFNs. SME common carve-outs include: (i) the right to appoint an LPAC member; (ii) transfer rights; (iii) disclosure rights; and (iv) provisions granted to address legal, regulatory or policy issues (or alternatively, legal, regulatory and policy-related

[26] ILPA guidelines reflect that LPAC meetings should occur at least annually; however, DFI investors may require LPAC meetings be held semi-annually, with one in-person meeting and one virtual.

provision may be available via the MFN election process to similarly situated investors). Fund Sponsors may also tie MFN rights to capital commitments by carving out the ability of investors to elect Side Letter provisions granted to those with greater commitment amounts and coming in to the first close (for example management fee discounts).

While the inclusion of an MFN provision is now commonplace in the private Funds industry, one of the main implications of introducing MFN provisions (which can typically involve significant compliance and reporting burdens) is an increase in the cost and administrative burden on the Fund of ensuring compliance with all of the bespoke rights granted under the MFN provisions, which will impact returns for investors. Investors, on the other hand, view MFNs as creating alignment amongst investors.

VIII. TAX AND REGULATORY CONSIDERATIONS FOR INVESTORS.

While the prospectus of the Fund will often provide a general description of the particular tax and regulatory issues that are relevant to the Fund, investors will be subject to their own specific legal and tax framework and will be strongly advised to consult with their own professional advisers concerning the acquisition, holding or disposal of interests in the Partnership.

Fund Sponsors typically require potential investors to provide information and representations intended to assist the Fund with satisfying regulatory requirements applicable to an investment in a Fund. For example, subscription agreements typically require investors to make representations regarding their status as a “qualified investor” as such terms may be defined in the Fund’s relevant jurisdiction, its beneficial ownership, source of wealth, source of funds, and ability to participate in new issues. An investor subscribing for an interest in a Fund likely will be asked to provide various tax forms to assist the Fund in complying with regulations such as FATCA and CRS. Depending on the nature and location of assets being acquired by the Fund, foreign direct investment restrictions may apply and require certain disclosures regarding the limited partners.

IX. EXCUSE, EXCLUSION, AND MANDATORY WITHDRAWAL.

Excused/Excluded Investors

Fund agreements typically include a mechanism whereby an investor can be excused from participating in particular types of investments (generally due to regulatory or other internal constraints binding upon the investor). This means that such an investor does not contribute capital for, or receive distributions from, such investment. Operating excuse rights in practice can be operationally burdensome and emerging Fund Sponsors should consider carefully before agreeing to this. They may threaten deal execution, as investors typically only exercise an excuse right upon receiving a capital call, which calls are generally issued 10 business days before making an investment. In addition, if one investor is excused, then the relative percentage interests of investors will vary from investment to investment, which will complicate the accounting for and making of distributions and drawing capital for certain investments where this is *pro rata* to such percentage interests.

Often an investor must notify the Fund of any restrictions before it invests and/or require the opinion of external legal counsel to confirm that it is so restricted. A Fund will generally try to limit the amount of investor discretion in determining what an excused investment is as the emphasis should be on using the investor's full commitment rather than allowing it to cherry-pick deals. If the scope of the prohibited investments is stated in the Side Letter itself, it is generally helpful to state why they are prohibited to increase the chance that the provision is taken outside the scope of any relevant MFN right.

In some cases, a General Partner/Fund Manager may exclude a particular investor from participating in an investment, if its participation would have a material adverse effect on the Fund or the investment. As a result of the foregoing, some investors request Side Letter rights such that they must first be consulted if the General Partner/Fund Manager proposes to exclude an investor on such a basis.

Withdrawal

Funds generally do not permit withdrawals by Limited Partners except in limited circumstances (such as, for example, to avoid "plan assets" issues under ERISA or to avoid violations of law). Some governmental plan investors also request that they be permitted to withdraw from the Fund (or be excused from making further investments) if there is a violation of such investor's internal policy. Withdrawals from a Fund can be a burden on the valuation process, liquidity, and non-withdrawing partners and hence, if possible, a transfer of such investor's interest to an affiliate or a third party is more desirable.

X. DEFAULT MECHANICS.

Since Funds draw down capital over time, in installments, it is important to address the possibility of a Limited Partner failing to fund a drawdown. Fund governing documents generally include flexibility for the General Partner to pursue a number of potential actions and remedies in such cases, including causing the total or partial forfeiture of the defaulting limited partner's interest in the Fund. A defaulting limited partner would typically (1) be subject to accruing interest on default amounts, (2) be prohibited from making further contributions, receiving distributions or having a representative serve on the LPAC, and (3) suffer a reduction in its capital account balance, among other potential remedies. Fund governing documents also may permit Fund Managers to provide other limited partners the right to purchase the defaulting limited partner's interest at a specified price and require non-defaulting limited partners to make additional *pro rata* capital contributions or, less commonly, admit additional Limited Partners to fund the capital calls. Certain investors may require the Fund Manager to provide notice and details to investors or the LPAC of defaulting limited partners.

SECTION 5: REPORTING

I. TYPICAL PERIODIC REPORTING SPECIFIED IN FUND GOVERNING DOCUMENTS AND SIDE LETTERS.

Fund governing documents typically set out the requirements for a Fund Sponsor to provide periodic financial, tax, and other information to investors. The timing and content of such reports may be dictated by the laws and regulations that are applicable to the Fund or Fund Sponsor, but often Funds will follow international best practices, such as those set out by the Institutional Limited Partners Association. This international best practice often meets the minimum standards set by applicable regulations and usually exceeds these minimum requirements. DFIs often insist on additional periodic (and exceptional) reporting, particularly regarding ESG concerns.

Investors need reporting on a timely basis to enable them to perform their investment analysis appropriately, and Fund Sponsors typically provide reporting on a quarterly and annual basis. Exact timings/notification periods and content of the reporting, as well as audit requirements and applicable financial reporting frameworks, are usually agreed within the Fund's governing documents. Current market practice is for quarterly reports (which are unaudited) to be issued no later than 45-60 calendar days after the quarter end and annual reports (which are audited) to be issued no later than 90-120 days after the year end. In making investments, Fund Managers will need to ensure that portfolio companies report to them on a schedule consistent with the Fund's reporting obligations. Emerging Fund Sponsors should carefully consider the ability of their portfolio companies and service providers to meet reporting deadlines requested by investors before agreeing to such reporting requirements.

While the exact contents of these reports will vary from Fund Sponsor to Fund Sponsor, typically these reports will contain, among other things: (i) financial statements of the Fund (audited for annual reports and unaudited for quarterly reports); (ii) Management Fees and Carried Interest distributed to the Fund Sponsor and how such amounts have been calculated; (iii) capital account balances; (iv) assets and liabilities of the Fund; (v) value of portfolio investments; (vi) net profit and net loss of the Fund; (vii) amount of any reserves; (viii) summary of investments; (ix) a statement of outstanding borrowings or guarantees; and (x) the amounts of any fee income applied to reduce the Management Fee in accordance with any fee offset. Valuation of portfolio investments will be calculated in accordance with methodologies that are specified as a matter of policy, often with the approval of the LPAC. Valuations for private equity and venture capital funds will usually be prepared in compliance with the International Private Equity and Venture Capital Valuation Guidelines ("IPEV Guidelines"). Certain investors may require quarterly valuations and for such valuations to be made available within 45-60 days of quarter-end. In some Funds, such valuations are performed by outside accounting firms or other advisors (typically annually, with the Fund Sponsor performing interim valuations).

In addition to the reporting requirements set out in the Fund's governing documents, certain investors will require additional reporting due to their internal operational requirements. These requirements are usually memorialized in an investor's Side Letter. These can include, for example, shorter time periods to deliver quarterly and annual reports, additional information to be provided in such reports, or for a Fund Sponsor to provide such reporting in a specific template or format. Additionally, investors may require certain additional reports, as further discussed below. In order for the burden of such reporting to remain manageable, Fund Sponsors will want to seek to standardize and limit the scope of reporting.

II. AUDITED AND UNAUDITED FINANCIAL REPORTING. PORTFOLIO AND OPERATIONAL REQUIREMENTS. STANDARD FOR PREPARATION OF MANAGEMENT ACCOUNTS. OBLIGATIONS TO ASSURE ACCURACY OF PORTFOLIO COMPANY REPORTING INCORPORATED IN FUND REPORTS.

As above, applicable regulations will normally dictate audit requirements for a Fund's reports. However, notwithstanding any such requirements, standard market practice is for annual reports to be audited, while quarterly reports will be provided unaudited. Such audits will usually be performed by an internationally recognized auditor and comply with either U.S. GAAP or IFRS Investors may require the approval by Limited Partners or the LPAC to change the Fund's auditors.

Fund Sponsors will be required to provide investor reporting on portfolio companies/assets, including such portfolio company's or other asset's activities and performance; this is normally provided through a "portfolio summary." A portfolio summary provides information on the individual investments that have occurred over the life of a Fund and typically includes the following details for each investment, as applicable (recognizing that some information may be confidential and may not be able to be provided): (i) portfolio company name; (ii) date of initial investment; (iii) disposal date(s), and, if partial exit, percentage exited; (iv) holding period; (v) geography; (vi) industry/sector; (vii) current percentage ownership; (viii) total return of investment; (ix) valuation methodology at entry and current valuation; and (x) value creation initiatives by the Fund Manager on the asset. It may report on significant developments at the portfolio company and on whether the portfolio company has met key business plan or ESG metrics.

Portfolio reporting is designed to give investors detailed information in both a quantitative and qualitative format on each of a Fund's current portfolio companies/assets. The volume of information may vary depending on the size of the

Fund's investment relative to the whole Fund and the number of investments in the Fund, but the foregoing is the information typically provided in such reporting.

Fund Sponsors are usually obligated to ensure that portfolio company/asset reporting is accurate and not misleading. Fund Sponsors in certain instances can argue that they are not privy to all information in respect of portfolio companies/assets and, accordingly, are not liable for incorrect reporting if information is not presented to them in an accurate manner. However, Fund Sponsors have general duties (including fiduciary duties under certain legal regimes) to, among other things, perform adequate due diligence on the Fund's investments, manage the Fund's investment in the best interest of the Fund, and carefully monitor the Fund's investments throughout the term of the Fund. As such, Fund Sponsors should be well positioned to provide accurate reporting on portfolio companies/assets. Assuring the timely and accurate availability of such information is thus an important part of negotiating portfolio investments.

III. IMPACT REPORTING REQUIRED BY INVESTORS

(a) Additional periodic reports typically required by Development Finance Institutions (DFIs) and other investors.

Certain institutional investors, either due to internal operational requirements or due to their status as an impact or social finance institution in a larger governmental or international organization framework, will require additional reporting to what is required by the Fund's governing documents. This additional reporting can include such things as adhering to ILPA templates, requiring annual certification by the Fund Sponsor that reports fairly present the financial condition of the Fund, or that the relevant Fund Sponsor parties are in compliance with the Fund's governing documents, or to provide on an annual basis an operational due diligence report. If certain of these investors deem that the reporting requirements in the Fund's governing documents are insufficient for their purposes, they may request (through their Side Letter) additional information in annual/quarterly reports; the insertion of the obligation via their Side Letter will result in the request only being applicable to such investors.

Specifically, a more recent trend in reporting relates to ESG and impact reporting. Institutional investors, most often DFIs, are requiring Fund Sponsors to adopt an ESG policy that includes sufficient ESG information to enable an investor to assess the degree to which the Fund Sponsor's investment strategy and operations are aligned with that investor's ESG policies, including how ESG is factored into due diligence as well as incident disclosures and performance reporting. *See* Section 8 (*Environmental and Social*) for additional information on ESG-related issues for Fund Managers.

IV. EXCEPTIONAL REPORTING

(a) Material adverse events and similar developments. Developments affecting portfolio companies/assets, including misconduct or policy lapses. Requirements of prompt reporting from portfolio company to manager.

Investors will typically impose obligations in the Fund's governing documents on Fund Sponsors to proactively and explicitly disclose all material adverse events and similar developments related to the Fund, and in certain instances, the Fund Sponsor and/or portfolio companies. This may include obligations on disclosing all policies, policy changes, and events that may have a significant effect on the Fund or its investors. Such disclosure should include notifying the investors of the following: amendments and breaches of a Fund's governing documents; regulatory examinations and results; changes to regulatory disclosure obligations; co-investments; changes in actual or beneficial ownership of the Fund Sponsor, affiliated entities, or other entities with which the Fund has a contractual relationship; instances where the Fund has exceeded a hurdle rate/preferred return; the occurrence of material contingencies or liabilities; and incidents that may constitute a breach of the Fund's ESG policy or code of conduct.

(b) Environmental, social, and governance issues

As above, institutional investors are more frequently requesting reporting on ESG issues associated with the Fund, its portfolio companies, and the Fund Sponsor.[27] This includes investor requests to provide sufficient reporting on environmental and social issues to enable an investor to assess the degree to which the Fund Sponsor's investment strategy and operations are aligned with an investor's corresponding policies. This type of reporting has been somewhat difficult and onerous for Fund Sponsors. Being a relatively new development, metrics, standards, and formats are not standardized across the market. Accordingly, environmental and social reporting will continue to see an evolution in the near future, driven by investor demand.

(c) Operational developments at Fund Sponsor, for example, key person departure, change of ownership.

Operational developments related to the Fund Sponsor are typically reported both through the standard periodic reports provided to investors (as in, quarterly and annual reports) but also, in certain instances, through specific notifications in

[27] DFIs often require prompt notification (within three days) to such DFI or the LPAC of an ESG issue occurring in respect of a Fund's portfolio company.

relation to such events. For instance, a Fund's governing documents will usually require that upon the occurrence of a key person event, the Fund Sponsor will provide investors prompt notice of such event. Similarly, if there is a change of ownership of the Fund Sponsor, the Fund's governing documents will usually provide that investors be notified of such change of ownership .

(d) Known or suspected misconduct at Fund Sponsor, including integrity and anti-corruption compliance provisions, and conflicts of interest. Misconduct involving important staff outside of the Fund role.

As above, specific events, such as known or suspected misconduct of the Fund Sponsor, including integrity and anti-corruption compliance provisions, if they meet a certain materiality threshold,[28] will require reporting through the standard periodic reports provided to investors (as in, quarterly and annual reports). This may include serious misconduct on the part of senior staff that is not directly related to the Fund. Additionally, the Fund's General Partner may be obligated to report such events to investors, specifically if such events are covered in such Fund's governing documents' "cause" or "removal conduct" definition and whereas as a result of such event, investors have removal rights. If this event does not create a notification obligation under such Fund's governing documents, investors often require reporting and remedial action on such events in Side Letters.

(e) Regulatory and litigation reporting. Are there materiality or exceptionality thresholds? Material developments during the conduct of regulatory proceedings/lawsuits.

Investors are increasingly requesting contemporaneous notice in the event of actual or threatened regulatory investigations or litigation proceedings relating to the Fund and/or the Fund Sponsor.[29] Investigations and litigations relating to the investments of a Fund are generally carved out of these 'prompt notice' obligations but are expected to be disclosed in the Fund's regular reporting. The 'prompt notice' obligations are generally negotiated by institutional investors upon admission to a fund and tend to appear in such investors' Side Letters. These obligations generally exclude routine regulatory investigations (or 'sweeps') and require that investigations or litigation must be disclosed when, if determined adversely to the Fund Sponsor, it would have a material adverse effect on the

[28] DFIs may consider any anti-corruption and AML violation material and therefore not permit any materiality qualifiers.

[29] DFIs may require for certain funds, that at the time of each capital call notice, the Fund Sponsor must either represent that no regulatory investigations or litigation proceedings relating to the Fund exist or otherwise provide details therewith.

Fund or on the Fund Sponsor's ability to perform its obligations under the Fund documents. In addition to notifying investors of the threat or commencement of such proceedings, a Fund Sponsor is often required to report on the outcome of such proceedings. Contractual obligations to report on developments through the course of any proceedings are less typical.

(f) Content and timing of reporting. When does the duty to report arise? Is it permissible to delay reporting until circumstances are clarified? Is there an obligation to be candid and complete in reporting? When should lawyers review a report before GPs submit it to LPs? Role of legal counsel. Potential for LPAC and other involvement post-reporting.

The content and timing of exceptional reporting will necessarily be driven by the nature of the exceptional circumstances or the terms of an investor's additional reporting requests. Fund Sponsors should be careful when agreeing to additional reporting requests on a per investor basis, as these can quickly become cumbersome to monitor and deliver, particularly for an emerging Fund Sponsor with a lean back-office team. Fund Sponsors should endeavor to agree to exceptional reporting 'upon request' of investors, as it is operationally more straightforward to be responsive to a request than to implement processes to create and deliver different reports on different timeframes for different investors.

Fund Sponsors should understand that, especially in smaller Funds with fewer investors, there is often an ongoing dialogue with investors. Accordingly in circumstances where a Fund Sponsor has insufficient information to deliver a report on time, the best approach is likely to inform investors of the delay and the reason therefore, potentially to provide the draft report if appropriate, and to follow up with the report once all required information has been obtained. Investors may have questions or comments about any report or information provided by a Fund Sponsor; willing and transparent engagement with investors is a core element of Fund management.

In certain circumstances a Fund Sponsor may be limited by law or by contract from disclosing certain information to its investors. If in doubt as to whether certain information may be disclosed, a Fund Sponsor should seek the advice of legal counsel.

(g) Tax reporting; assistance in tax filings

Typically, a Fund's governing documents will provide an obligation on the General Partner to provide, within a certain time period (typically 90 days) after the end of each fiscal year, to each investor copies of such information, including copies of U.S. Internal Revenue Service Form 1065, Schedule K-1 or any alternative schedule or form, and such other information that such investor may reasonably request, for tax reporting purposes of such investor arising from the Fund's activities; predominately the requests relate to United States tax, but in the European market, many requests relate to German tax. Additionally, a Fund's governing documents may provide an obligation for the Fund Sponsor to assist an investor, to a reasonable extent and at the cost of such investor, in tax filings.

(h) Potential consequences of deficiencies in reporting

As noted above, the obligations on a General Partner in relation to reporting stem both from applicable regulations and the obligations contained in both a Fund's governing documents and any Side Letter entered into with an investor. As such, any deficiencies in reporting could potentially lead to a breach of such regulations, a Fund's governing documents, and/or Side Letter. The consequences for breach of applicable regulations vary; however, these would likely be monetary fines or suspension/revocation of a Fund Sponsor's license. As both the Fund's governing documents and Side Letter are contracts, the consequence of a breach of a Fund's governing documents or Side Letter would be those that would normally be available under applicable contract law and corporate law (as it relates to misleading and deceptive conduct). In addition to the foregoing, a Fund's governing documents can dictate certain consequences in the event of a breach of such Fund's governing documents, such as the occurrence of a cause event, leading to potential removal of the Fund Sponsor as the General Partner/Fund Manager of the Fund. Apart from the legal consequences associated with deficiencies in reporting, reputational consequences also arise from such deficiencies. Generally, investors consider reporting to be an integral obligation of the General Partner, and if reporting is not up to an investor's standard, this may cause reputational damage to the Fund Sponsor in the market. Thus, assuring timely, accurate reporting needs to be a top priority of the Fund Sponsor and may require the allocation of significant resources.

(i) Responding to requests from investors for additional information

A Fund's governing documents may contain a provision requiring the General Partner to use reasonable efforts to provide to each investor such other information (apart than what is explicitly provided in a Fund's governing documents) as is reasonably requested by such investor for any purpose reasonably related to their interest in the Fund, including access to the Fund's administrators and the auditor and any information they possess with respect to the Fund.

In addition, the General Partner may be obligated, at the request of an investor, to use reasonable efforts to provide the investor with any other information related to the Fund Sponsor or the Fund or its portfolio investments/assets that the investor is required to provide by that investor's governing authorities. Such an obligation is typically memorialized in a Side Letter, which limits its application to that specific investor.

SECTION 6: LIMITED PARTNER ADVISORY COMMITTEE

I. WHY DO LPACS EXIST? CONTRASTS BETWEEN (1) LPACS AND BOARDS OF DIRECTORS AND (2) LPACS AND LIMITED PARTNERS. ABSENCE OF FIDUCIARY DUTY.

Fund Sponsors typically seek to form LPACs to consider requests for approval of transactions involving a conflict of interest and duty for the Fund, as well as to perform an array of oversight functions such as reviewing valuation methodology (and, potentially, the valuations) and considering requests for approval in situations where the approval of the investors more generally would otherwise be required. While the formation of a LPAC is not a statutory or regulatory requirement, it is a standard and nearly uniform market practice. The role and rules governing an LPAC will be stipulated in the Fund's governing documents. LPACs usually consist of between 3 and 10 members, with each member being nominated by those investors granted an LPAC seat by the General Partner. LPACs typically vote on the basis that each member has one vote, rather than a number of votes that reflects the percentage in interest of the investor that nominated them.

LPAC members, unlike members of a board of directors of a corporation, should have no fiduciary responsibility to the Fund and this should be memorialized in the Fund's governing documents. Furthermore, the Fund's governing documents may include an acknowledgement that the LPAC member is permitted to represent solely the interests of the Limited Partner that nominated the member. The Fund's governing documents will also typically provide that any LPAC members will be indemnified for and exculpated from any claims arising out of their activities in their capacity as an LPAC member (*see* Section 9 (*Liability, Indemnification, and Insurance*) regarding indemnification, exculpation and insurance in respect of members of the LPAC).

II. COMPOSITION OF LPACS. WHICH LPS ARE REPRESENTED?

LPAC seats are usually granted to "anchor" investors or other sophisticated investors that the General Partner believes will make a useful or strategic contribution to the Fund (in addition to its capital commitment),[30] as well as be able to nominate a member who will discharge the responsibilities of a member of the LPAC thoughtfully and appropriately. Prospective investors may seek to bargain for the right to appoint an LPAC member.

The size of the LPAC will reflect the size of the Fund and the composition of its investor base – a General Partner will want an LPAC that is large enough to represent a meaningful portion of the total commitments (as it may give approvals on behalf of all

[30] DFI investors will also usually require the right to appoint a member to the LPAC in all emerging funds.

investors), but small enough to function as a more streamlined decision-making body than all investors. ILPA's guidelines provide that the LPAC should comprise a representational cross-section of investors by commitment size, type, tax status, and quality of relationship with the Fund Sponsor.

III. OPERATION OF LPACS. INDIVIDUAL VOTING. ROLE OF CHAIR. PERIODIC AND SPECIAL MEETINGS. EXECUTIVE SESSION. GP PRESENCE AT LPAC MEETINGS. QUORUM.

LPACs generally meet at least annually and more frequently when a meeting of the LPAC is called by the Fund Manager for a special purpose.[31] Since the LPAC primarily exists to advise the Fund Manager, some Fund Managers provide in the governing documentation that they are to attend and chair meetings of the LPAC;[32] however, the Fund Manager should not have voting rights. LPACs could hold "in camera" meetings without the Fund Manager being present. Generally, a majority of the members of the LPAC will constitute a quorum for purposes of the LPAC acting as a body. The expenses of the Annual General Meeting (AGM) and LPAC, including out-of-pocket travel and subsistence expenses for the purposes of attending meetings, will generally be paid by the Fund.

IV. INFORMATION TO SHARE WITH OR SUPPORT REQUESTED OF THE LPAC VS ALL LPS.

The LPAC needs to receive fulsome disclosure of information with respect to the Fund's investments and the Fund Sponsor's operations to advise the Fund Sponsor on and consider conflict of interest and duty transactions involving the Fund. The LPAC therefore may be privy to detailed information with respect to such investments and the Fund Sponsor's operations (for example, key person issues) not generally disclosed to the broader investor base. The Fund's governing documents and offering documents will sometimes disclose this fact to the investors or disclose generally that the Fund Sponsor is not required to share non-public information about the Fund's portfolio investments with the limited partners of the Fund.

V. ROLE OF LPAC (CONSULTATIVE VS DECISION MAKING). TYPICAL AREAS OF OVERSIGHT.

Historically, the role of the LPAC was to advise the General Partner on and consider approval of transactions involving a conflict of interest and duty for the Fund. However, over time, as investors have demanded increased oversight of the affairs of the Funds in

[31] Certain investors, such as DFIs, may require fund terms that provide an LPAC meeting to be called upon the request of Limited Partners representing at least 20% in interest or a majority of LPAC members.
[32] Certain investors, such as DFIs, may require that the LPAC itself have the right to appoint the Chair.

which they invest, the LPAC's remit has expanded significantly. Nevertheless, the role of the LPAC remains primarily consultative in nature rather than determinative, save where the Fund documents give the LPAC rights to make specific decisions, as follows:

(a) Conflicts of interest

The LPAC is to advise the General Partner on, and to consider for approval, transactions between the Fund and the General Partner (or its affiliates), or any other transaction that constitutes a conflict of interest and duty with respect to the General Partner (or its affiliates) on the one hand, and the Fund on the other hand. The LPAC will consider whether the proposed terms of the transaction are in the best interests of the Fund and consistent with "arm's length" terms. It is prudent for a General Partner to seek LPAC approval or waiver of a conflict of interest and duty transaction because approval or waiver sanctions the General Partner's actions and Fund documents will usually release the General Partner from liability for breach of fiduciary duty (or the Fund documents) to the extent the General Partner has acted in accordance with an LPAC approval or waiver.

(b) Key person events; Early termination of commitment period

In certain instances, the judgment and approval of the LPAC may be substituted for that of the limited partners of the Fund with respect to key person events (for example, approving a replacement or additional key person) or terminating or reinstating the commitment period during a suspension for key person event. Occasionally, the Fund's governing documents will provide the flexibility to seek the approval of either a percentage in interest of the limited partners or the LPAC.

(c) Setting standards for periodic portfolio valuation

The Fund's governing documents may provide that certain valuation events are subject to the review and approval of the LPAC. This is by no means the rule, but the LPAC is often involved in valuations with respect to Fund assets in which the General Partner or its affiliate have an interest, and therefore such valuation may give rise to a conflict of interest between the General Partner and the Fund. In order to prudently restrict their activities, the LPAC members may feel more comfortable approving valuation methodology rather than the valuations themselves. Alternatively, LPACs may be given the right to object to certain or any valuations of Fund assets, which typically results in the ability to require an independent valuation.

(d) Allegations of misconduct; replacement of General Partner and/or manager; early termination or extension of Fund life

The Fund's governing documents may give the LPAC rights (in addition to the rights of limited partners acting by a certain threshold) with respect to (i) determining whether a "cause" event has occurred with respect to the Fund Manager, and/or whether to remove the Fund Manager; (ii) replacing the General Partner or approving a replacement management company; (iii) approving Fund extensions; and (iv) terminating the Fund or approving a determination by the Fund Sponsor to terminate the Fund.

(e) Matters concerning tests of investment strategy, geographic, allocation or concentration limitations

The Fund's governing documents may give the LPAC rights to provide the General Partner its view with regards to whether a particular portfolio investment would fall within the Fund's investment strategy. Further, the Fund's governing documents may permit the General Partner to call upon the LPAC to permit the Fund making a proposed investment which may otherwise be restricted by the set investment limitations (including the use of leverage).

(f) Use of external counsel by LPAC and allocation of associated expenses

In connection with its oversight powers with respect to the operation of the Fund, the LPAC is typically permitted to appoint and engage external counsel (including but not limited to legal counsel, forensic auditors, and independent valuers) at the expense of the Fund. While this right is not frequently invoked, it may involve not inconsiderable expense. Some investors may also view such ability as creating a contentious atmosphere between the Fund Sponsor and the LPAC when it is triggered; however, others may view it as being critical to diffuse a problematic situation.

(g) Right to request forensic audit of Fund records

In connection with its oversight powers with respect to the operation of the Fund, the LPAC will often be granted in the Fund's governing documents the right to request outside experts to analyze and audit Fund records and provide an assessment thereof. This is a fairly recent development for LPACs and could be considered a 'gold standard' right.

(h) Reviews of any material ESG incidents and/or risks to the Fund's portfolio

The Fund's governing documents may require the Fund Manager to promptly provide notice (and details) to the LPAC of ESG incidents and/or risks to the Fund and its investments. This generally extends to an information right only; however, the LPAC's role may also be consultative in this regard.

(i) LP defaults; reduction or expansions in fund size

The Fund's governing documents may require the Fund Manager to promptly provide notice (and details) to the LPAC of any investor defaults, withdrawals, or excusals. This generally extends to an information right only; however, the LPAC's role may also be consultative in this regard.

(j) Fees and expenses; reviews of the costs of operational advisors

The Fund's governing documents may require the Fund Manager to promptly provide details to the LPAC of fees and expenses, particularly of operational advisors. This generally extends to an information right only, however, the LPAC's role may also be consultative in this regard.

In connection with its oversight powers with respect to the operation of the Fund, the LPAC is typically permitted, at the cost of the Fund, to appoint and engage external counsel, including but not limited to legal counsel, forensic auditors, and independent valuers.

VI. ALLOCATION OF AUTHORITY AMONG MANAGER, GP, LPAC, AND LPS.

A Fund Sponsor must carefully consider how to balance the authority of the General Partner, the Fund Manager, the LPAC, and the limited partners of the Fund. While it may be tempting for Fund Sponsors to go to market with authority/control purely retained with the Fund Sponsor parties, a more balanced approach may communicate a commitment to fairness and avoid excessive and detailed negotiations. There are however certain matters that will need to be reserved to the Fund Manager (although these may vary from Fund to Fund), such as with respect to Fund economics (Management Fee and Carried Interest), and the ability to manage the portfolio, pay expenses, set aside reserves, remove defaulting members, carry on the Fund Manager's outside activities and obligations, etc. Fund Managers and investors alike should be careful to avoid delegation of management powers, as in addition to fettering a Fund Manager's ability to operate its Fund, this could result in the loss of limited liability to investors in limited partnership structures.

The terms of the Fund's governing documents should be closely analyzed and determined with an eye to the near and distant future, including with respect to successor Funds, because it is very difficult to take back authority relinquished to the LPAC and the limited partners with respect to a prior Fund. By beginning with a balanced approach, it may be easier for a Fund Manager to maintain its position on key issues through the negotiation process.

VII. TYPES OF DOCUMENTATION THAT LPAC MEMBERS NEED TO AGREE UPON AND SIGN; FOR EXAMPLE, RESOLUTIONS.

The charter of an LPAC is usually set out in the Fund documents, so the additional documentation that LPAC members need to sign is generally limited to (i) any letters appointing particular members of the LPAC and (ii) meeting minutes or written resolutions memorializing LPAC discussions. The ability of an investor to appoint a member of the LPAC is also typically confirmed in a Side Letter between the General Partner and such investor.

(a) What kind of minutes and voting records does the LPAC maintain?

The General Partner should maintain minutes of all LPAC meetings for the Fund's records. Minutes should be retained in a permanent file together with any materials presented to the LPAC during the meeting. After an LPAC meeting, it is best practice for the meeting minutes to be compiled by the General Partner before being sent out to the LPAC members for comment and finalization, preferably in good time after the meeting so that thoughts and ideas remain fresh in the LPAC members' minds. This also allows for any discrepancies to be cleared before the next LPAC meeting.

Minutes should have more detail rather than less and include materials that relate to the discussions within the minutes; legal counsel will often attend LPAC meetings and assist with putting drafts of minutes together. Minutes should cover the LPAC's discussions, bearing in mind that the role of the LPAC is primarily consultative rather than decision making (save where the Fund documents give the LPAC rights to make specific decisions).

The minutes may also be used to record how LPAC members have voted. Alternatively, most Fund documents will provide that an LPAC may vote by written resolution.

(b) Insurance

Please *see* Section 9 (*Liability, Indemnification, and Insurance*) with regard to insurance.

SECTION 7: PORTFOLIO VALUATION

I. PURPOSE OF PERIODIC PORTFOLIO VALUATION.

Portfolio valuation is undertaken periodically for the following reasons:

(a) Investor reporting – most Funds investing in illiquid assets require quarterly reporting of portfolio investment valuations, with independent valuations to be undertaken annually;

(b) Where the Management Fee is calculated on invested capital as adjusted for write downs/write offs, in order to calculate the Management Fee;

(c) Where distributions take account of investments that have been written down/written off, or where there are other portfolio valuation linked limitations on distributions (for example, requiring that portfolio value is a certain level prior to any Carried Interest being distributed);

(d) In connection with any distributions in-kind;

(e) In connection with any partner withdrawals, including limited partner withdrawals and removal of the General Partner, each of which typically result in some sort of payout to the withdrawing partner;

(f) If required because the Fund has a credit facility based on the net asset value of some or all of its assets; and

(g) In connection with conflict (or potential conflict) transactions, such as General Partner-led secondaries or continuation vehicles, the acquisition of warehoused investments and other cross transactions involving the sale of an asset between two accounts controlled by the same Fund Manager, or co-investment syndications.

II. RECOGNIZED VALUATION STANDARDS. ROLE OF LPAC IN SELECTING STANDARD.

Most Funds domiciled in the U.S., or managed by U.S. managers, prepare financial statements according to U.S. GAAP. Non-U.S. Funds (and non-U.S. Fund Managers) typically use the IFRS. In addition to these general accounting standards, there are certain industry specific valuation standards which some managers utilize, such as the International Private Equity and Venture Capital Guidelines, or the valuation module of the INREV guidelines (the European Association for Investors in Non-listed Real Estate). The most common approach is that portfolio assets are marked-to-market, which is to say they are valued at fair value, rather than at their cost.

A Fund's valuation standard is typically set by the Fund Manager upon the formation of the Fund, and in some cases investors will require LPAC consent prior to the Fund Manager changing the Fund's valuation standards. As a matter of good governance (and often a contractual obligation pursuant to an LPA or Side Letter), a Fund Manager should notify investors of any material change to the Fund's valuation standards and/or methodology.

III. FREQUENCY AND MANNER OF PERIODIC VALUATIONS. TREATMENT OF GOODWILL.

The frequency of periodic valuations is driven partly by the nature of the Fund's assets and partly by whether any other terms and mechanics of the Fund would require periodic valuation (as noted in the section above). Assets the value of which are not expected to change materially (for example, core real estate) may be subject to less frequent valuations generally and to less frequent independent valuations. Assets the value of which may be expected to change materially in the shorter term (for example, venture capital investments, or liquid assets such as tradable stocks) are likely to be subject to more frequent valuations. Currency shifts are easily quantified and may have material consequences for valuation; therefore, some Funds are required to take currency movement into account frequently.

Investor requirements will also drive the frequency of a Fund's periodic valuation, because many investors incorporate Fund valuation numbers in their own balance sheets. A typical approach is quarterly valuations by the Fund Manager, with an annual independent valuation, all such valuations being reported to the investors.

Investors may also request *ad-hoc* portfolio valuations as market dynamics shift, rather than waiting for quarter-end results. As a consequence, portfolio valuation can become a burdensome process and additional valuation rights granted by Side Letter should be limited unless a manager has the ability as an operational matter to handle such requests.

Valuations by Fund Managers, particularly of privately held portfolio companies, are increasingly under scrutiny by regulators such as the U.S. SEC. Because valuing private illiquid assets is a highly technical and subjective process, and the valuations often directly impact Fund Manager economics, Fund Managers need to ensure that the valuations are realistic and defensible. Valuations should be conducted in accordance with a pre-determined methodology and any associated guidance, and this methodology should be consistent period-to-period. Certain technology solutions exist with a view to streamlining private market valuations, which may be appropriate for managers with small teams.

Any value that can be attributed to the brand of the Fund Manager or the goodwill relating thereto is typically excluded from the value of any portfolio company (and therefore from the value of investors' interests in the related Fund).

IV. WHO DECIDES VALUATION? USE OF OUTSIDE EVALUATORS. NOMINATION OF OUTSIDE EVALUATORS. OBJECTIONS TO OUTSIDE EVALUATORS' VALUATION.

The valuation process is typically undertaken primarily by the Fund Manager in accordance with predetermined guidelines, with less frequent valuations being completed by independent valuers.

Any independent valuers are generally selected by the Fund Manager, save where there has been a valuation dispute or where the requirement for an independent valuer is being driven by specific fund terms and which may therefore give a role to investors in relation to the selection of an independent valuer. This is often the case in conflict transactions.

If an independent valuer is used, their determination of value is typically final and binding on all parties (investors and manager) absent fraud or manifest error. The ability of investors to object to valuations is discussed below.

V. ROLE OF AUDITORS, IF ANY. REQUIREMENTS TO NOTIFY INVESTORS OF CHANGE OF AUDITOR.

Investors invariably require an annual audit of the Fund's financial statements – this is a global standard and, in many jurisdictions, a regulatory requirement. Auditors may also be separately consulted with on complex issues, but in order to provide advice upon which a Fund Manager can rely, auditors must be provided full disclosure of all relevant facts relating to the valuation assumptions and process (this is equally true of the financial statement audit). Some investors will press for the use of a Big 4 accounting firm as the auditor while Fund Managers may prefer local, lower cost accountants.

Investors are increasingly requesting notice of any change in auditor, often accompanied by an explanation of the reasons for the change and perhaps even the ability to discuss with the outgoing auditor. This seems to be driven by the understanding that a change in auditor is inherently negative, whereas recent high-profile failings in audit processes, particularly where there is a deep (and therefore profitable) relationship between auditors and Fund Managers, has highlighted certain conflicts of interest inherent in the audit-Fund Manager relationship and a case can be made that frequent changes in auditor represents good governance (by ensuring the relative independence of the auditor).

VI. HOW TO HANDLE VALUATION DISPUTES.

Investors are increasingly seeking the right to object to valuations, although any such right is generally reserved to the LPAC or certain majority of the investor base, rather than individual investors. Requiring some degree of consensus from investors is important to avoid potential abuse of any such right. There is no set process for handling valuation disputes but a common formulation in the market would be to first have a period of good-faith consultation between the LPAC and the Fund Manager (for example, 30 days) with respect to the disputed valuation. In the event the dispute remains unresolved, the Fund Manager will appoint an independent valuer reasonably acceptable to the LPAC, whose determination of the value will be final and binding. The cost of the independent valuer is typically a Fund expense.

SECTION 8: ENVIRONMENTAL, SOCIAL, AND GOVERNANCE

I. ESG CONSIDERATIONS FOR INVESTMENT MANAGERS.

Investor interest in ESG investing and ESG products continues to grow. Investors are seeking investment strategies that further their ESG goals, capture ESG opportunities and/or mitigate ESG risks. This demand incentivizes Fund Sponsors to address ESG issues in their operations and their investment product offerings.

In the context of investing, reference to "ESG" typically encompasses similar terms such as "sustainable," "responsible," and "impact" investing, among others. Unfortunately, a clear definition of ESG investing remains elusive. The E, S, and G prongs of ESG each capture myriad subject areas impacting environmental considerations, social issues, and governance principles. When investors inquire about ESG practices, it is important to keep in mind that a request might be very client-specific and could be related to any number of ESG-related topics, due to the broad nature of ESG.

II. COMPLIANCE WITH THE ENVIRONMENTAL AND SOCIAL MANAGEMENT SYSTEM, AND WITH ENVIRONMENTAL AND SOCIAL ACTION PLAN.

ESG strategies can vary significantly from one to the next in what approach is taken to incorporate ESG features into the investment process. Some ESG strategies can be classified as "ESG integration" or "ESG-aware." These strategies incorporate ESG factors into the investment decision making process, but often limit consideration of ESG factors to when such factors are viewed as "material." These strategies tend to have the lowest focus on ESG factors and treat ESG factors as a tool to enhance returns and/or mitigate risks in the investment process.

Other ESG strategies have a more central focus on ESG factors. As an example, some ESG strategies seek to promote an ESG goal through limiting the investment universe to specific ESG criteria, either through an inclusionary or exclusionary screen, or through fundamental research. A Fund Manager may offer an ESG product that avoids investing in certain sectors or in issuers with certain negative ESG profiles (an ESG exclusionary screen). Another ESG product could be based on a limited universe of issuers who meet specific ESG characteristics, such as minimum board diversity requirements or the establishment of carbon emissions goals (an ESG inclusionary screen). Other strategies may seek to invest in certain sectors or issuers that the Fund Manager believes are aligned with a certain ESG goal such as solar energy or prevention of climate change.

Lastly, some ESG strategies pursue impact investing goals that seek to generate positive, measurable, and reportable ESG impacts alongside a financial return. These strategies often include participation in activism in the operating companies in which they invest.

III. ESG COMPLIANCE CONSIDERATIONS AND POLICIES AND PROCEDURES.

Owing to the increasing investor demand, many Fund Managers are seeking to offer ESG-related products and strategies. The increasing investor demand coupled with the ambiguity associated with ESG terminology has also given rise to increasing regulatory scrutiny of ESG claims and ESG practices. As a result, Fund Managers should be aware of the regulatory risks associated with ESG investing and enhance existing compliance infrastructure to mitigate those risks.[33]

Regulatory Risks

Fund Managers offering ESG products face a number of regulatory risks. Statements related to ESG investment practices in offering documents and marketing materials are viewed as material to investors, and any such statements expose a Fund Manager to regulatory scrutiny as to the accuracy of the statements. Marketing materials and disclosures that overstate a product's ESG characteristics can lead to claims of "greenwashing" or otherwise misleading potential investors. Fund Managers who are adapting existing investment products to include ESG features face potential conflicts of interest associated with making those changes.

Greenwashing

Increased investor demand for ESG strategies and products runs the risk of incentivizing Fund Managers to emphasize ESG features of products. In certain cases, the Fund Manager may be creating the impression that the products are more ESG focused than they actually are, which is a practice known as "greenwashing." Greenwashing is an area of focus on the regulatory front because many investors are making decisions to invest in certain products based on the products' ESG features, but ESG terminology can be ambiguous and/or misleading. Given the lack of standardization of terms relating to ESG practices, portfolio managers, compliance personnel and marketing professionals may use the same words to describe a particular strategy, while actually meaning different things.

Fiduciary Duties

Another source or regulatory risk arises from the fiduciary duties that Fund Managers owe to clients in existing funds and strategies. The market opportunities available with respect to ESG investing create new potential conflicts of interest that implicate this core fiduciary duty. For example, a Fund Manager has an interest in demonstrating a broad and deep commitment to ESG investing by creating a large menu of ESG products or

[33] *See generally*, ISLP, *ESG Standards, Regulations, and Implementation*, (December 2022), https://islp.org/wp-content/uploads/2022/12/ISLP-ESG-Guide-1.pdf.

having a large collection of ESG-related assets under management. A Fund Manager considering whether to amend existing ESG products to secure their eligibility for such product menus or assets under management figures faces this conflict. Specifically, are the proposed changes in the best interests of the Fund as well as the Fund Manager? Given this potential conflict, Fund Managers who seek to adjust strategies to incorporate ESG practices may face regulatory scrutiny over whether they are putting their clients' interests first when making those adjustments.

Compliance Policy Considerations

Fortunately, regulatory risks can be mitigated with effective compliance policies and procedures that emphasize consistency among (1) portfolio management; (2) product disclosure; and (3) marketing efforts. These three elements create a "ESG Compliance Triangle," with a Fund Manager's legal/compliance function in the middle. The goal is to ensure that the three corners of the triangle are synchronized and operating under the same assumptions. Specifically, Fund Managers should make investment decisions as described in the offering documents, and the offering documents should reflect the investment practices.

Fund Managers vary in their approach to the specific suite of policies and procedures necessary to accomplish this synchronicity, depending on scope and scale of ESG practices. Some Fund Managers will opt to create ESG-dedicated policies and procedures that outline the guidelines and specific steps necessary for the Fund Manager to keep its disclosures, marketing materials and portfolio management all reflecting the same core facts. Other Fund Managers can leverage existing policies and procedures, with targeted enhancements where ESG products and strategies are concerned. For example, an existing marketing compliance policy could be amended to require the validation of ESG claims with designated subject matter experts.

Once the 'ESG Compliance Triangle' is aligned (as in, marketing materials match product disclosures which reflect the portfolio management strategy), Fund Managers should consider implementing monitoring systems based on compliance policies and procedures to ensure that the investments made by the Fund Manager align with disclosures and offering documents. To be effective, these systems should include objective quantitative guidelines than can be clearly tested by systems (for example, "no investment in issuers who derive X% of revenues from fossil fuel production, as identified in XYZ data source") rather than guidelines that are subjective or rely on criteria without available data (for example, "invest a significant portion of assets in issuers who have committed to improving their employee morale").

Develop an Overarching Firm Strategy

In addition, Fund Managers may mitigate regulatory risks through adopting a clear firm ESG strategy. A clear, high-level firm strategy can help to ensure that the entire organization is coordinated in its efforts. Significant regulatory risk is created where, for example, marketing or investor groups embark upon a business strategy that is not endorsed by portfolio managers or compliance officers.

For example, a Fund Manager could focus its resources on developing ESG capabilities through acquisition or through organic growth. Another determination could be whether the Fund Manager intends to create new products or modify and leverage existing ones as well as how the investment manager will incorporate ESG considerations into its products. Finally, a Fund Manager should determine whether it will rely on internal, proprietary research, develop partnerships with third party providers, or a combination of both. Each of these strategic decisions has implications for the compliance policies and procedures an investment manager needs and operational considerations for each of the elements of the ESG Compliance Triangle.

Ensure Product Integrity

Fund Managers should consider establishing processes to ensure that their products are delivering on their ESG commitments. These processes are not necessarily compliance processes (and perhaps should not be), but instead are an extension of existing investment oversight. Fund Managers developing these processes can build upon existing infrastructure. For example, a firm may be able utilize the same processes that it applies to ensure that managers of "value" are actually managing assets consistent with a "value" strategy to confirm that a manager of an ESG integration strategy is appropriately considering ESG factors when making investments, as articulated in disclosures and marketing materials.

IV. PRODUCT DISCLOSURE CONSIDERATIONS.

As noted above, product disclosures are one of the three points of the ESG Compliance Triangle. The content, type, and scale of a product's ESG-related disclosures to investors will depend entirely on the strategy the disclosure is intended to describe and, in certain jurisdictions, applicable regulatory requirements. In order to ensure that disclosures are consistent with portfolio management, Fund Managers should consider developing an internal glossary of ESG-related terms to ensure that the disclosure is drafted consistently with portfolio management's strategies. For example, a firm could establish specific criteria that a strategy must meet to be defined as "sustainable." Similarly, placing clear guidelines on what can be considered an "environmental" or a "social" factor will ensure that the firm does not inadvertently exaggerate the role that ESG factors play in a given investment strategy.

Fund Managers should be prepared to substantiate their ESG claims to both their regulators and their clients. Regulators are increasingly requesting more specific data and information from Fund Managers to substantiate their ESG claims, such as ESG-oriented checklists as well as the specific criteria used to make ESG-assessments. In addition, regulators are reviewing portfolios for overall compliance with ESG disclosures and are inquiring about specific investments that seem not to fit in with the overall ESG program.

Institutional investors are also seeking similar information regarding their investments. Many institutional investors are seeking additional disclosure on a Fund Manager's compliance with and/or progress towards given ESG goals through key performance indicators and other qualitative and quantitative metrics illustrating the implementation of the ESG strategy. This is especially the case for investment products that employ an impact ESG strategy.

V. ESG REPORTING AND COMMUNITY GRIEVANCE PROCEDURES.

Specifically, a more recent trend in reporting relates to ESG reporting. Institutional investors, most often DFIs, are requiring Fund Sponsors to adopt an ESG policy that includes sufficient ESG information to enable an investor to assess the degree to which the Fund Sponsor's investment strategy and operations are aligned with that investor's ESG policies, including how ESG is factored into due diligence as well as incident disclosures and performance reporting. Included in this reporting are community grievance procedures.

A community project grievance involves concerns and/or complaints raised by individuals or groups within communities affected by a portfolio company's operations. Grievance procedures are often an important part of a DFI's ESG policy, particularly with regards to community engagement. DFIs want to ensure that Fund Sponsors have controls in place to ensure that community grievance procedures are observed and monitored at the level of the portfolio companies. The particular grievance mechanism of a portfolio company should be scaled to the risks and adverse impacts of the particular company's operations, address concerns promptly, use an understandable and transparent process that is culturally appropriate and readily accessible to all segments of the affected communities, and do so at no cost to communities and without retribution.

A DFI's ESG requirements (that the Fund Sponsor typically agrees to comply with in the DFI's Side Letter) may provide that in the event a portfolio company fails to comply with certain ESG undertakings/guidelines, the Fund Sponsor will work with the portfolio company to bring it back to compliance; provided, that (i) the non-compliance is capable of cure, (ii) the portfolio company continues diligently to pursue such cure, and (iii) there are no material adverse effects on the Fund or any of its investors. The DFI's requirements may further require that if the foregoing is not possible, the Fund Sponsor will (i) assert and enforce such available remedies as it reasonably determines to be appropriate in the circumstances, in order to ensure compliance; or (ii) use all reasonable efforts to exit the investment or terminate its financing, in each case, consistent with its fiduciary obligation to the Fund and its investors.

VI. CYBERSECURITY RISK MITIGATION.

A Fund Manager's fiduciary obligation to the Fund includes the obligation to take steps to protect client interests from being placed at risk because of the Fund Manager's inability to provide advisory services. Like most businesses, Funds face numerous cybersecurity risks and may fall victim to cybersecurity crimes that can cause failures in the systems and processes used to operate. Fund Managers and Funds rely upon technology for critical business operations. Fund Managers and Funds are exposed to, and rely upon, a variety of interconnected systems and networks, both directly and through service providers including custodians, brokers, dealers, pricing services, and other technology vendors. Cyber criminals may target Fund Managers and Funds, putting them at risk of suffering significant financial, operational, legal, and reputational harm.

Fund Managers should implement cybersecurity policies and procedures tailored to their business operations, including their complexity and attendant cybersecurity risks. At least annually, Fund Managers should review and evaluate the design and effectiveness of their cybersecurity policies and procedures, which would allow them to update them in the face of ever-changing cyber threats and technologies. These policies should address operational and other risks that could harm fund investors or lead to the unauthorized access to or use of adviser or fund information. A Fund Manager should undertake a cybersecurity risk assessment to consider user security and access, information protection (particularly any relevant data privacy regulations), threat and vulnerability management, and cybersecurity incident response and recovery.

SECTION 9: LIABILITY, INDEMNIFICATION, AND INSURANCE

I. HOW ARE PARTICIPANTS IN AN INVESTMENT FUND EXPOSED TO POTENTIAL LIABILITY?

A limited partnership typically has different levels of liability for different participants – namely, limited partners enjoy limited liability (as in, they are not liable for the debts and liabilities of the Fund beyond their committed capital and certain specified amounts they may be required to return to the Fund pursuant to its governing documents) and the General Partner will have unlimited liability, to the extent that the assets of the limited partnership are insufficient to cover the debts and liabilities of the limited partnership.

Limited partners may risk their limited liability status by becoming involved in the day-to-day management of the limited partnership. This concern arises most commonly in connection with participation in and the scope of responsibilities of an LPAC but can also be present where investors are represented on ICs.[34]

Since the General Partner's liability is unlimited, the General Partner is usually a company or other corporate body with limited liability so that, in effect, its liability is limited to its assets.

The Fund Manager's relationship with a Fund is typically contractual (pursuant to a management agreement) rather than one of ownership, which helps a Fund Sponsor avoid exposing their entity of substance (with regulatory permissions and which employs its investment team and other personnel) to the unlimited liability of a general partner entity. However, in addition to the contractual obligations and liability of a Fund Manager to the Fund, many regulatory regimes impose fiduciary duties on a Fund Manager, which broadly require the Fund Manager to act in the best interests of the Fund or its investors (depending on the jurisdiction), and failure to meet these fiduciary standards can expose the Fund Manager to regulatory censure and sanctions.

Finally, the individuals serving as board members of a company (whether the Fund Manager, the General Partner, or any portfolio company) will generally owe fiduciary duties to the company and may incur liability for failing to act in accordance with those fiduciary duties.

II. INDEMNIFICATION OF GP/MANAGER TEAM, IC MEMBERS, LPAC MEMBERS.

While everyone's expectation and hope at the launch of a Fund is for the success of the Fund, the reality is that things can (and do) go wrong. Exculpation and indemnification

[34] Some investors, such as DFIs, may prohibit Limited Partners from participating on the IC.

are part of the toolbox available to Fund Managers to plan for the best, but at the same time, be prepared for the worst.

Exculpation ensures that the General Partner and/or the Fund Manager (and certain other persons) are not liable to the Fund or the limited partners for any conduct unless such conduct is prohibited conduct (see below for a description of prohibited conduct).

Indemnification ensures that the General Partner and/or the Fund Manager (and certain other persons) will be reimbursed by the Fund for any losses or expenses they incur while conducting Fund operations except where the losses or expenses arise as a result of conduct that is prohibited conduct. An important practical benefit of the indemnification is that the Fund (and therefore, indirectly, the investors) will pay the costs of defending claims brought against indemnified persons relating to the operation of the Fund.

The governing documents of most Funds will provide for the exculpation and indemnification of the General Partner and the Fund Manager (and certain other persons, as discussed below) in the course of their conduct of the Fund operations.

Typically, the exculpated and indemnified parties will include:

(a) the General Partner;

(b) the Fund Manager (if separate from the General Partner);

(c) the carried interest partner (if separate from the General Partner);

(d) affiliates of the foregoing;

(e) directors, officers, shareholders, and employees of the foregoing;

(f) persons nominated on behalf of the partnership to sit on the boards of portfolio companies, holding vehicles, special purpose vehicles, and portfolio funds (if applicable); and,

(g) LPAC members.

III. SPECIAL POSITION OF LPAC MEMBERS.

In order to ensure that the LPAC is able to act thoughtfully and independently without the fear of any increased liability, LPAC members and the appointing limited partner are expressly exculpated and indemnified under the Fund's governing documents. In contrast to other categories of indemnified persons, LPAC members are generally exculpated and indemnified more broadly: the notion of prohibited conduct is generally limited to fraud.

IV. CARVEOUTS TO INDEMNIFICATION (INCLUDING FOR CLAIMS BROUGHT BY A MAJORITY OF LPS).

In certain circumstances, the General Partner/Fund Manager (and such other indemnified and/or exculpated parties) may be excluded from relying on the exculpation and indemnification provisions under the Fund's governing documents to the extent there has been certain "prohibited conduct" (commonly referred to as 'indemnification carveouts' or the 'standard of conduct'), such as:

(a) fraud (in most jurisdictions, a party cannot contractually exclude its liability for fraud);

(b) willful misconduct; and,

(c) gross negligence and/or reckless disregard (not all jurisdictions have an agreed definition of "gross negligence" and its distinction from mere negligence (for example, under English law there is no defined threshold, but it has been accepted to mean something more than mere negligence); limited partners may, and often try to, reduce this threshold to mere negligence).

A more negotiated position may reflect a broader scope of prohibited conduct which would render the exculpation and/or indemnification provisions unavailable to the General Partner/Fund Manager;[35] namely:

(a) a breach of the LPA, the management agreement and, less commonly, any Side Letters (this would usually be limited to material breaches (or breaches of material obligations, including fiduciary duties) and/or may be coupled with a requirement that such breach resulted in a "material adverse effect" on, or "material financial disadvantage to," the Fund);[36] and

(b) a violation of any applicable laws and regulations (often with the same materiality qualifiers as discussed in subparagraph (d) above in the context of breach of Fund documents).[37]

Fund Sponsors will typically resist these broader grounds for denying exculpation and indemnity or to qualify them with a materiality standard. A breach of the LPA, for

[35] DFI investors will typically require that an indemnity carve-out mirrors the removal "for cause" grounds for General Partner removal, i.e., such act does not constitute Removal Conduct by or in respect of such indemnified entity, any of its Affiliates or any director, officer, employee or agent of any such person. In addition, some DFI investors will require that the General Partner/ Fund Manager remains liable for third party performance, unless such party is selected and supervised with due care.

[36] Certain investors, including DFI investors, may not permit double materiality qualifiers.

[37] Certain investors, including DFI investors, may not permit materiality qualifiers with respect to violations of any applicable laws and regulations.

example, can be quite nominal and the loss of protection may be disproportionate if there is no materiality requirement. It is worth considering setting a mechanism for determining whether prohibited conduct has occurred. The Fund Sponsor will generally aim for the highest threshold; that there should be indemnification (and/or exculpation, as the case may be) unless and until a court has finally determined, with no further right of appeal, that the relevant prohibited conduct has occurred. Limited partners will generally argue (occasionally successfully, depending on their bargaining power) that a final court determination should not be required at all; the middle ground would be that a court determination is required, perhaps by the court of first instance.

As noted above, investors indirectly bear indemnification payments made by a Fund. As a result, investors generally require additional limitations on the scope of the indemnification provisions as follows:

(a) to preclude indemnification for internal disputes (for example if the General Partner sues the Fund Manager or vice versa);

(b) to preclude advances pursuant to the indemnification provisions to cover expenses associated with an indemnified person defending a legal claim, where such claim is brought against the indemnified person by a majority of the limited partners; and

(c) to require that any advance of indemnification payments to cover legal costs is repayable if it is subsequently determined that the claim is not covered under the indemnification provisions of the Fund documents.

These topics may seem esoteric to the leaders of a Fund Sponsor at the time a Fund is being formed and the circumstances they contemplate may never arise. However, if issues do arise, the details of the relevant provisions will be critically important.[38] As noted, there is considerable variation in these terms and thus it will be advisable to devote the requisite time and attention to developing mutually acceptable arrangements.

V. LP GIVEBACKS.

The Fund's governing documents will also need to address Limited Partners' liability to the Fund in the event of a claim under the indemnification provisions (or other liabilities of the Fund). If there are available capital commitments to draw down, these may be called to satisfy indemnification payments. Fund documents generally also require LPs to return previous distributions to the Fund in the event the Fund has insufficient cash

[38] DFI investors will often require an indemnity cap (except as to LPAC members), including exclusions for punitive and consequential damages, scope being limited to a person involved in the Fund or conduct linked to the Fund and employees, officers, affiliates, etc., of the Fund Manager not having the right to recover directly against investors.

(including available capital commitments to draw down) to satisfy indemnification payments. These “LP Giveback” obligations are important because they give General Partners comfort that assets are available to meet contingent liabilities, so the General Partner can distribute all (or nearly all) of a Fund’s distributable proceeds (as opposed to creating large reserves).

An LP Giveback obligation may vary based on:

(a) the reason for recall (this may be limited to indemnification obligations or could also cover expense obligations and other liabilities of the Fund, which is the more Fund Sponsor friendly formulation);

(b) the length of the time period after which distributions may be recalled (a two-year time period is common and this could be counted either from the date of the distribution or, although less investor friendly, from the date of final dissolution of the Fund); and

(c) the amount of distributions that may be recalled (this is typically the lesser of (i) total distributions received and (ii) 20%-30% of an investor’s capital commitment).[39]

VI. EXPOSURE FOR PORTFOLIO COMPANY ACTIONS: ROLE OF PORTFOLIO COMPANY BOARD MEMBERS ACTING FOR MANAGER/FUND.

Fund Sponsors regularly appoint employees or other designees to the boards of their portfolio companies and, when things are going well, this can be a positive management tool. However, challenges arise when the interests of the portfolio company diverge from those of the Fund Sponsor. Fund Sponsor appointed directors owe fiduciary duties to the relevant portfolio companies on whose board they sit, and they must fulfill those duties notwithstanding any loyalty they may have to the Fund Sponsor. Thus, the director must support actions that are in the best interest of the portfolio company even if they are opposed by the Fund Sponsor. So, for example, a director may be obliged to support a “fire sale” disposition of the portfolio company’s assets even if the Fund Sponsor would prefer to gamble on the ability of the portfolio company to survive without that action. As a result, Fund Sponsor appointed directors should be aware of the high risk for conflicts of interest to arise, giving rise to potential liability for claims made by dissatisfied shareholders and/or portfolio company employees.

[39] DFI investors may request the level of recall be even lower, set at the lesser of 25% of (a) the distributions received by the investor and (b) the investor’s capital commitment.

The risk of liability is further heightened, the larger the stake in the portfolio company, and the more control and influence the Fund Sponsor has over the portfolio company.

In addition, should a portfolio company fail financially and lack the resources to pay any claims (as in, it is "judgment proof"), the Fund and the Fund Sponsor appointed director become realistic targets for such claims.

VII. D&O/E&O INSURANCE. INSURANCE FOR PORTFOLIO COMPANIES. EXPOSURE OF FUND REPRESENTATIVES SITTING ON PORTFOLIO COMPANY BOARDS. DEFENSE COVERAGE.

The Fund's governing documents will commonly provide that the General Partner may or even must obtain insurance and, in many cases, the cost of that insurance is borne by the Fund as a Fund expense.

Fund governing documents may also include provisions to the effect that an indemnified person should first explore and exhaust any other source of recovery (typically, insurance) before using assets of the Fund to satisfy any claims. This insurance usually encompasses Directors & Officers liability insurance and Errors & Omissions/professional liability insurance. The exact scope of coverage (including covered persons under the policy) will depend on the policy terms:

(a) D&O insurance is structured in the first instance to protect a firm's board, management, and employees against personal liability arising from official corporate activities and duties owed to the firm's stakeholders. Most D&O insurance policies also protect the company itself for certain liabilities arising out of its own exposures.

(b) E&O insurance for asset managers and Funds protects the firm, its officers, directors, and employees in the event they are sued by clients or regulators for some failure in the provision of professional services.

A General Partner's insurance policy may extend to portfolio companies and/or portfolio companies will also have their own insurance to cover their own directors. When considering insurance policies, the below may be a helpful list of issues to keep in mind:

(a) Who bears the cost of the insurance policy at Fund level (if it is the Fund this should be expressly stated in the governing documents)?

(b) At the portfolio company level, if the policy belongs to the portfolio company, in the event of insolvency, this will be controlled by the liquidator and may not be available to directors if they are being sued by the liquidator.

(c) Does the Fund Sponsor have a better bargaining position if it obtains the insurance for its portfolio companies, rather than having individual portfolio companies negotiating different terms and coverage, each with reduced bargaining power?

(d) Consider the scope of the policy and the limits; noting that legal costs are a large expense – are these covered?

Procuring appropriate insurance and assuring that it remains in effect is an important aspect of fund management. Although such insurance is widely available in developed countries, its availability in emerging markets and the size of offered policy limits may be seriously limited.

SECTION 10: FUND ECONOMICS

I. COMMITMENTS/CAPITAL CALLS.

For closed-ended Funds investing in illiquid assets, investors typically execute a subscription agreement setting forth the amount of capital that such investor will commit to contribute to the Fund – such amount being referred to as an investor's "capital commitment." Nearly all closed ended Funds will call capital (also referred to as "drawing down" the capital commitments) on an as-needed basis during the term of the Fund, typically on ten business days' notice to investors. Drawdowns will cover both the cost of investments and Management Fee and other expenses of the Fund. When investors pay a portion of their capital commitment to a Fund, this is called a "capital contribution."

An investor's capital commitment may be required to be contributed (in part) to the Fund at the time such investor is admitted to the Fund (the "closing"). Funds may also hold "dry closings," meaning that no capital contribution is required contemporaneously with admission to the Fund, until the Fund reaches its first close.

II. SPONSOR/GENERAL PARTNER COMMITMENT.

The Fund Manager's Carried Interest (described below) will align its interests with those of investors with regard to "upside," because the Fund Manager will share in profits generated. The concern is that a Fund Manager also needs to be aligned with investors with regard to any "downside" (as in, risk of loss), because otherwise the upside alignment/profit sharing may incentivize the Fund Manager to make overly risky investments or approach exit decision-making with a proclivity to hold out for exceptional valuations. As a result, investors usually prefer that a Fund Manager – or more precisely the individuals managing the Fund Manager – make (in aggregate) a large enough capital commitment to the Fund (sometimes referred to as the "GP Commitment") to ensure they have sufficient "skin in the game" to align them in the "downside" such that the Fund Manager's potential profits interest does not result in overly risky investment decision making. As with the allocation of the Carried Interest for a Fund, investors will customarily seek to ensure that there is a strong correlation between the individuals who will be making the investment decisions for the Fund and the contributions to the GP Commitment. Sometimes, investors will seek to ensure that the GP Commitment constitutes a meaningful proportion of the personal net wealth of the key persons or other key decision makers.

Where those individuals do not have significant pre-existing wealth, these arrangements can be challenging. The amount of a Fund Sponsor's commitment to a Fund can be highly customized for first time Fund Sponsors, but it is usually at least 1% of aggregate capital commitments and for established Fund Sponsors, Fund Sponsors commit to a Fund around 1-3% of the Fund size based on the amount of capital commitments.

Some Fund Sponsors prefer not to (or are unable to) put up this much in cash, and so to deal with this, the Fund's governing documents may contain a fee waiver mechanism whereby investors make certain capital contributions (out of their capital commitments) that are deemed to be contributions in respect of the Fund Sponsor's commitment.[40] The Fund Manager then reduces the Management Fee to the extent that investors have made such contributions for the Fund Sponsor's commitment, so investors are not contributing more capital to the Fund than they would have absent such Management Fee waiver. A Management Fee waiver can also result in preferential tax treatment for a Fund Manager, which will receive a profits interest based on its deemed contributions (taxed as capital gains) as opposed to fees (taxed at income rates). However, many investors do not look favorably on Management Fee waivers unless a Fund Sponsor has a genuine need to manage its cash flows with such a mechanic, as a Management Fee waiver is often not considered to demonstrate alignment as well as a cash commitment by the Fund Sponsor. This topic is often the subject of considerable negotiation. If the individuals who manage the Fund Sponsor lack the financial capacity to make significant cash investments, candor may facilitate a suitable resolution in this regard.

III. DISTRIBUTION WATERFALLS.

(a) Generally

As a Fund receives proceeds from its investments, both current income generated by assets (for example, dividends or rent) and return of capital and capital gains received on the realization of assets (for example, from the sale of a portfolio company or the repayment of a debt investment) (collectively, "distributable proceeds"), the General Partner will cause the Fund to make distributions to its investors. Although these arrangements will generally not come into effect until relatively late in the life of the Fund, they are crucially important in determining how the profits of a successful Fund are allocated. They merit careful attention as the Fund is being formed.

Distributable proceeds are initially allocated among all investors based on each investor's percentage share of the investment giving rise to such proceeds. If the General Partner or its related persons have made an investment in the Fund, they will be allocated their *pro rata* share of distributable proceeds. The allocations provisions within the LPA are a bookkeeping exercise; no money is actually paid out of the Fund at this stage.

[40] However, it is noted that DFI investors typically do not permit Management Fee waivers and rather require 100% cash to ensure the Fund Sponsor's genuine commitment to the Fund and 'skin in the game.'

Amounts allocated to investors will be distributed pursuant to a “distribution waterfall” that splits amounts between the investors and the Fund Sponsor, often receiving its share through a Carried Interest partner. This stage of making distributions is where money is paid out of the Fund.

Distribution waterfalls generally come in two styles: (1) the European style “whole of fund” waterfall, and (2) the American style “deal-by-deal” waterfall.

(b) European Waterfall

The European style waterfall requires an investor to receive distributions in an amount equal to all of the capital contributions made by such investor, together with any preferred return on such capital contributions, before the General Partner may receive Carried Interest. This style of waterfall is considered to offer the highest degree of investor protection and alignment of interests as between investors and the General Partner, because it requires the repayment of all capital contributions to investors before the General Partner shares in the profits. As a result, the risk of overpayment of Carried Interest to the General Partner is low, and the General Partner is incentivized to focus on the performance of the portfolio as a whole rather than any singular (or a smaller subset of) investment. Over recent years, a European style waterfall is the most common approach to distribution waterfalls for PE/VC funds globally.

(c) American Waterfall

An American-style waterfall returns capital on an investment-by-investment basis. In other words, an American-style waterfall permits the Fund Sponsor to receive Carried Interest after an investor receives a return of such investor’s capital contributions made with respect to the investment giving rise to such proceeds and any preferred return thereon.

The most aggressive (Fund Sponsor friendly) “pure” deal-by-deal waterfall does not take account of losses, write-downs, and expenses incurred on other deals, so Carried Interest could be payable on a successful realization even if all other deals went bad. However, this model is relatively rare and may feature a lower Carried Interest percentage rate. More often, the American style “deal-by-deal” waterfall will look back to all realized investments, and require return of capital with respect thereto, and possibly also return of capital with respect to unrealized losses (as in, investments still held by the Fund, but which have been written down or written off) and any preferred return thereon, before the Fund Sponsor may receive Carried Interest.

Even this “modified” American style “deal-by-deal” waterfall will result in earlier payment of Carried Interest to a Fund Manager. As a result, investors tend to require that Fund Sponsors employing American style “deal-by-deal” waterfalls are subject to one or more “GP clawbacks” (*see* section IX below) with related protections such as escrows and/or guarantees. Fund Sponsors should carefully consider whether the additional liabilities associated with such Fund Sponsor clawback protections are acceptable. In general, new Fund Sponsors without strong established track records will face considerable resistance from investors in proposing any variant of the American style waterfall.

IV. CARRIED INTEREST.

Most Fund Sponsors receive an incentive or performance fee commonly known as the Carried Interest. The Carried Interest is the Fund Sponsor's share of the profits of the Fund. Structuring the performance fee this way can result in preferential tax treatment for a Fund Sponsor/General Partner, which will receive a profits interest (taxed as capital gains) as opposed to fees (taxed at income rates) under many tax regimes.

The most common Carried Interest percentage is 20%, although this amount is often lower for a fund of funds manager or for certain asset classes (for example, private debt) and can be higher based on premium performance, such as where a higher than usual preferred return threshold has been met. A Fund Sponsor may also waive Carried Interest for certain investors (typically affiliated investors) or, less frequently, offer reduced Carried Interest for certain investors (typically very large investors making an anchor investment in the Fund).

V. PREFERRED RETURN.

Many closed-end Funds include a preferred return (or "hurdle rate") that investors must receive before a Fund Sponsor may receive the Carried Interest. The preferred return is calculated like interest from the time a capital contribution is due until the time an investor receives a distribution representing a return of such capital contribution. The preferred return rate is commonly 8% per annum (compounding), but can be more or less than this amount depending on investor appetite and asset class. Venture funds may be marketed with lower or no preferred returns; however, the rate will be tied to diligence findings.

The reason this interest-like component is called a "preferred" return is because investors receive this amount of the Fund's profits in preference to, as in, on preferential timing as compared to, the Fund Sponsor. In certain limited circumstances, a Fund will use a hard hurdle, which means that a Fund Sponsor will only share in Fund profits over and above the hurdle amount. A preferred return on the other hand involves a "catch-up" step in the waterfall, pursuant to which the Fund Sponsor will receive a higher priority of all subsequent distributions until it receives its Carried Interest percentage with respect to all profits (as in, all distributions in excess of return of capital contributions including amounts previously distributed to investors as preferred return). Fund Sponsors will often try to negotiate a 100% catch-up whereby during the catch-up stage of the distribution waterfall, 100% of distributions will be distributed to the Fund Sponsor.[41] Given the level of challenge faced by many impact investors, setting the preferred return rate for an impact Fund is often the subject of significant negotiation.

VI. DISTRIBUTION TIMING.

Distributions may be made by General Partners at their discretion. Fund governing documents usually permit General Partners to create reserves and pay expenses (including Management Fees) from amounts that would otherwise be distributed. Fund governing documents typically also provide a timeline for which proceeds from the distributions must be made to the investors (for example, 90 days from the Fund's receipt of distributable proceeds),[42] sometimes subject to a set *de minimis* amount (for example, $1 million) being available for distribution, to avoid the administrative burden of making small distributions. However, the nature of the preferred return which, as described above, will accrue unless and until capital contributions are repaid to investors, incentivizes General Partners to make distributions promptly.

VII. FORM OF DISTRIBUTIONS.

Most closed ended Funds investing in illiquid assets will nevertheless seek to make distributions in cash. However, there may be circumstances where a Fund wishes to make distributions *in specie* (or "in kind"), if the Fund has received consideration in kind (for example, securities upon an initial public offering (IPO) of a portfolio company), or where a Fund has been unable to realize an asset and wishes to distribute interests in that asset to investors, typically upon a liquidation of the Fund. In general, Funds are permitted to make distributions in kind prior to liquidation only if the securities are marketable (as in, freely tradeable and liquid). Upon liquidation, the Fund governing documents usually do not restrict in kind distributions, and even private, illiquid securities may be distributed to investors. As a practical matter, many institutional investors will by way of Side Letter request that Fund Managers assist them with liquidating any in kind distributions, so that they will only ever receive cash distributions (including upon liquidation).

VIII. RECYCLING/RECALLS.

Fund governing documents often include provisions permitting the General Partner to reinvest amounts that would otherwise be distributed to investors, or alternatively, to distribute such amounts to investors and recall such amounts to be reinvested. These "recycling" provisions were originally intended to better achieve full investment of an investor's capital commitment, and initially were limited to reinvesting distributions in an

[41] Certain investors, including DFI investors, may try to request 50/50 catch-up.

[42] Certain investors, including DFI investors may require 45 days.

amount previously contributed for fees or expenses (thus permitting the full capital commitment to be deployed into investments).

Recycling is popular because it can reduce the cost basis of an investor's investment (where Management Fees are charged on capital commitments, if more than the capital commitment amount is actually invested) and can increase investors' exposure to a Fund Manager or asset class without having to make another Fund investment (which entails certain up-front costs for diligence and legal fees). Fund Managers like recycling because it increases the amount of capital available for them to make additional investments (and hopefully therefore profits), and recycling will increase invested capital which can benefit a Fund Manager where fees are charged on invested capital. However, some institutional investors strongly dislike recycling because they make investments based on specific allocations to asset classes, and recycling can result in their intended allocation being increased without their specific consent.

Nevertheless, it is now common to see recycling of distributions from investments realized within a certain time (typically around 18 months, or – the broader formulation – within the commitment period). In many cases, only amounts representing a return of capital may be reinvested, although in some Funds both capital and profits may be recycled. Many Funds will include an overall limit on amounts that may be recycled, such as 20–30% of the total capital commitments, so that investors have some comfort as to their maximum level of exposure.[43] Certain asset classes tend to have broader recycling powers, such as private credit (because credit deals are often made and realized relatively quickly).

IX. GENERAL PARTNER CLAWBACKS.

A General Partner may receive too much Carried Interest in some instances, for example, if early investment realizations create large returns and later dispositions do not perform as well. The risk of over-distribution of Carried Interest is particularly prevalent in deal-by-deal American style waterfalls but is possible in whole fund European waterfalls. To address this risk, Fund governing documents usually require the General Partner to return money to the Fund to the extent it receives more Carried Interest than it was entitled to, provided that the maximum amount that a General Partner is required to return is the amount of Carried Interest it actually received net of any tax paid or payable on such Carried Interest. This requirement to return is known as a "GP clawback" or "Carried Interest clawback." The existence of any GP clawback amount is usually determined at the end of the life of a Fund, but investors may require "interim clawbacks"

[43] DFI investors may insist that the total amount invested by the Fund, including reinvestments, is limited to 100% of total commitments.

one or more times prior to that (especially if the Fund has a more aggressive form of deal-by-deal American style waterfall).

A Fund Sponsor typically sets up an entity to receive the Carried Interest, for example, the General Partner or a special "carried interest partner" in a limited partnership, and such entity will likely have made distributions of Carried Interest to the investment professionals entitled to receive it. As a result, investors often require such ultimate recipients of Carried Interest to execute a guarantee requiring such persons to return their share of any such Carried Interest clawback. In addition to, or instead of, any such guarantee, a General Partner may determine or be required by the Fund governing document to hold back or "escrow" all or a portion of the Carried Interest paid by the Fund, to give investors comfort that there is a pool of Carried Interest easily available to satisfy any applicable clawback obligation.

X. MANAGEMENT FEES.

(a) General

Fund Managers charge Management Fees for the services that they provide to the Funds they manage. These fees are payable by the Fund but ultimately borne by the investors by way of capital contribution or payment out of distributable proceeds. Typically, these Management Fees are calculated and set as a percentage of an investor's capital commitment, or the amount of capital contributions made to the Fund. Most private Funds charge a percentage of an investor's capital commitment during the Fund's commitment period, with one or more stepdowns thereafter as described in subparagraph (b) below.

Historically the Management Fee percentage rate has been 2% per annum, and while certain smaller or emerging (as in, startup) Fund Managers can charge at this rate (or even in extreme situations, a bit more), Fund Managers of larger private Funds tend to charge Management Fees at rates of 1.5–1.75% per annum. A Fund Manager may also waive Management Fees for certain investors (typically affiliated investors) or offer reduced Management Fees for certain investors (typically "early birds" who invest in the Fund at its first closing, or investors making the largest capital commitments to the Fund). "Most favored nation" treatment of Management Fee concessions can be tricky for Fund Sponsors.

(b) Management fee stepdown after termination of commitment period. Payment of management fee during term extensions.

After the commitment period, the Management Fee is typically charged based on a percentage of the investor's share of invested capital. However, one alternative formulation is to charge Management Fees based on an investor's capital commitment throughout the life of the Fund except that the actual percentage charged to investors drops for each year after the end of the commitment period until it reaches a certain minimum rate.

Where a Fund Sponsor has established a Successor Fund (as discussed above), the charging of Fees with respect to such Successor Fund can also trigger the end of the commitment period and a "stepdown." A suspension of the commitment period triggered by a key person event may also cause a stepdown in Management Fee, which is calculated based on invested capital rather than total commitments.

Fund Sponsors and investors often negotiate whether the Management Fee should be payable during any extension to the Fund Term, and may insist on the discontinuation of the Management Fee before agreeing to an extension request, on the basis that the Fund Manager will progress the winding up process more promptly if no Management Fee is received during an extended term.

(c) Management Fee Offsets

Fund Sponsors have the opportunity to earn fees from other sources in connection with a Fund's investment activities, such as "transaction fees" where a Fund Sponsor charges portfolio companies for certain services provided to such company, for example, directors' fees, monitoring fees, advisory fees, or commitment, syndication, success, or other fees related to the Fund making an investment in such portfolio company. The Management Fee itself should assist the Fund Sponsor with covering its costs, but not be viewed as a material source of profit for the Fund Sponsor. These additional fees are generally considered by investors to be Management Fee "substitutes" and as such, to the extent that a Fund Sponsor receives such fees, they will reduce (or "offset") the amount of Management Fee that investors would otherwise pay, such reduction usually being on a dollar-for-dollar basis. It should be noted that in circumstances where a Fund Manager controls multiple interests in an underlying investment (for example, where a Fund holds a stake as well as one or more co-investors separately advised by the Fund Manager), only such proportion of the transaction fee that corresponds to the proportion of the investment held by the Fund will be offset against the Management Fee.

SECTION 11: INVESTMENT POLICY & APPROACH

I. FUNCTION AND EFFECT OF AN INVESTMENT POLICY.

Investors in Funds rely on investment policies as guidelines for their investments beyond their potential profitability. Without such policies, Funds would have substantial discretion in terms of the investments made – generally, investors prefer to at least put some limits on such authority. While Fund Sponsors may have firm-wide policies, such as ESG policies, that are applied to all of their Funds, most investment policies will be determined on a Fund-by-Fund basis.

(a) Relationship to LPA

Often, the Investment Policy for a particular Fund is included in the LPA, sometimes under a heading of "investment restrictions." In other cases, the Investment Policy is a freestanding document that is referenced in the LPA. In either case, the restrictions would address most of the items listed below under "*Typical Provisions of an Investment Policy*." Typically, investors will expect the policy to be tied into the governing documents in some form in order to ensure their interests are protected.

Increasingly, potential investors are requesting that managers have ESG policies that will be provided (and often negotiated by large investors for whom ESG is a priority) prior to investment in a Fund. See "*ESG Policies*" (below, XI(a)) for more information on what is typically included in ESG policies.

(b) LPAC's Role and Responsibility

For many Funds, the Fund Manager will have the ability to invest outside of the Investment Policy with the approval of the LPAC. The idea is that Fund Managers should have enough flexibility to make investments where the LPAC, representing the interests of all investors, agrees that the investment would be beneficial to the Fund despite the restriction of the Investment Policy. For example, if an Investment Policy limits investments to southern India, the LPAC might nonetheless allow an investment in Orissa. Or if the Policy restricts investments in microlending to 20% of invested assets, the LPAC might allow the Fund to go to 22% when presented with a particularly compelling opportunity. The goal of the Investment Policy is to protect the interests and policy expectations of the investors; the LPAC's role here is to prioritize that goal over the strict standards of the policy. The Fund Manager will have discretion over investments so long as they are within the parameters of the policy, which is why the Investment Policy is key to protect the interests of investors.

(c) Changes to Investment Policy

Changes to the Investment Policy for closed-ended funds invariably require investor consent (and often super-majority consent, for example 75-80% of total commitments). In some cases, a major investor may regard certain provisions as so fundamental that they will either insist that they can never be changed or at least that the investor may opt not to participate in an investment that departs from a particular restriction. For example, some investors take this approach to businesses that deal in tobacco.

(d) Consequences of Breaching the Investment Policy

As noted above, the Investment Policy usually forms part of the Fund's governing documents so that any investor rights under the LPA, such as removal of the General Partner or termination of the Fund, would be triggered by a breach of the policy. If the goal of the Investment Policy is to protect the expectations and interests of the investors, understandably, the investors want the consequences for breaching such policy to align as well.

II. TYPICAL PROVISIONS OF AN INVESTMENT POLICY.

(a) Typical substantive provisions of an Investment Policy

Type of businesses. Investment Policies for a Fund will often include the kinds of businesses in which the Fund may invest. This is often due to the particular investment strategy of the Fund. The Investment Policy may limit the kind of investment (for example, funds or public or private companies) and the industry (for example, microfinance, alternative energy, fintech). These policies allow for the Fund Sponsor to market the Fund in a particular manner and allow the investors to ensure that their expectations and internal policy and investment allocation requirements are satisfied. Often, these policies will limit investments to a percentage of total capital commitments; for example, the Fund's governing documents may limit the Fund to invest no more than 25% of total capital commitments in investments in medical technology. As noted above, typically the Fund Manager is permitted to invest beyond these parameters with the approval of the LPAC.

Some Funds may include prohibitions against investing in certain industries (for example, tobacco, alcohol, weapons, pornography, etc.) in their Investment Policies. These may be at the request of certain investors, notably DFIs or part of the Fund's values or marketing. To the extent applicable to investors, these kinds of investment restrictions are more frequently found in Side Letters between the Fund and investors (as opposed to the LPA).

ESG Policies. Fund Sponsors should consider preparing an ESG policy prior to raising their first Fund, as it is likely that there will be an investor, particularly a larger institution, that will request it (or even be subject to a requirement prohibiting investment in a Fund without an ESG policy). However, it is also possible that certain investors, notably DFIs, may present a Fund Sponsor with a draft ESG policy. *See* Section 8 (*Environmental, Social, and Governance*) for more details on ESG policies for Funds.

Type of investment. In addition to the type of business, Investment Policies may also limit the type of investment permitted, depending on the strategy of the Fund. Funds may only be permitted to make investments through debt or equity, or a restricted amount of each, or a fund of funds may only invest on a primary or secondary basis. This may be significant to investors who are trying to diversify their portfolio by increasing their exposure to a particular kind of investment. The Investment Policy may also limit investments to public or private companies. Once again, the LPAC may provide flexibility to the manager to invest outside these restrictions.

Geography of investments. The Investment Policy will typically address geographic limitations on the investment. Funds may limit the percentage of total capital commitments that may be invested in a particular country or region or require that investments be made exclusively or predominantly in a particular country or region.

Business Particulars. Alongside the above limits, Funds will often have further restrictions on the businesses in which they may invest. The Investment Policy may:

(1) Restrict the size of the businesses or require a minimum size;

(2) Require a certain proportion of ownership in order to invest (as in, will the Fund be required to have a minority stake in the company in order to invest?);

(3) Require the Fund have membership on a company's board to invest;

(4) Prohibit investments through hostile transactions;

(5) Limit the amount of leverage to be used or prohibit leverage entirely;

(6) Require certain exit requirements (for example, IPOs, sale, merger, etc.);

(7) Limit investments to either start-up or mature businesses; and

(8) Limit investments to revenue-generating or profitable companies.

In some instances, these provisions impose requirements that will need to be reflected in the investment agreements with portfolio companies. For example, if there are mandatory exit arrangements, the cooperation of the portfolio company will clearly be required.

Size of individual investments in absolute amount and percentage. Along with investment-specific restrictions, the Investment Policy may limit the amount or percentage (of total capital commitments) which can be invested into one investment. This is intended to ensure that the Fund Manager adequately spreads out the capital of the Fund across multiple investments to avoid too much reliance on a particular investment for returns.

(b) Typical process provisions of an Investment Policy

Unlike the substantive provisions above, many of the process provisions of an Investment Policy would be found either in internal documents or in the offering memorandum provided to investors when determining whether to participate in the Fund.

Investors will be interested in such provisions to ensure the Fund Manager has clear policies guiding their investment process. These provisions demonstrate that the Fund Manager understands the industry and market which the Fund targets and can appropriately manage, identify, and mitigate any risks when making such investment.

Such policies will address questions such as the below:

(1) *Stages of consideration of target firms.* Who has authority to advance a target from one stage to the next? Who may authorize the expenditure of funds for demands draft (DD), etc.?

(2) *Use of finders and other intermediaries.* Requirements for diligence on intermediaries/finders and contracts with intermediaries/finders and specifying if the Fund can be asked to pay the fees of such intermediaries.

(3) *Co-investments.* When are co-investments appropriate? How are they considered? Who can be considered for a co-investment? Applicable fees payable by investors (or waivers thereof) in co-investment and allocation between Fund and investors.

(4) *Content of investment proposals for IC.*

III. DUE DILIGENCE POLICIES.

In General. As with the process provisions noted above, investors will look to due diligence policies to confirm that the Fund Manager will be able to have all information necessary to make an informed decision. A policy of this nature is intended to guide the Fund Manager but also provide potential investors with the transparency necessary to make their decision with respect to investing in the Fund. Due diligence policies will identify the type of information the Fund will consider when making an investment and how they will use that information in making investment decisions. The Fund may use third parties for due diligence and may be required to disclose this as such to investors.

In addition to diligence for the purpose of making smart investment decisions, the Fund will also conduct due diligence to ensure it is compliant with “Know Your Client”/Anti-Money Laundering laws in its potential investments. This will include diligence on the business or Fund’s key persons, structure, transactions, and other significant information to ensure that the Fund is not investing in a company that is in violation of these laws.

Some investors may seek to have access to diligence information. Most Fund Managers resist such disclosure commitments because they impede the ability to obtain information from target firms and to evaluate it in a candid, open internal dialogue.

IV. OTHER POLICY REQUIREMENTS.

Investment Management Agreements. For most Funds, the actual investment analysis and process will be delegated from the General Partner to a Fund Manager via the investment management agreement. The terms of the LPA and investment management agreement will require the Fund Manager to invest pursuant to the Investment Policy if it is included in the LPA or incorporated by reference. If the Investment Policy is a separate document, the investment management agreement may incorporate the policy to ensure the same result.

Side Letters. The ILPA argues that Fund Managers should accommodate the exclusion policies of investors.[44] Investors may have certain investments they need to avoid, for instance a foundation may be required to avoid investments in weapons or coal. Certain government entities are required to avoid investments in pornography or alcohol. Investors may be subject to their own ESG policies. Investment restrictions in Side Letters may be a strict requirement such as those included in the LPA, or may be a looser

[44] DFI investors typically have policies prohibiting certain activities, for example, investing in businesses which take part in producing or selling: alcoholic beverages, tobacco, gambling products; commercial logging operations; production, trade, storage or transport in significant volumes of hazardous material; construction of coal fired thermal power plants; production or trade in arms/weapons; unsustainable fishing methods; and forced or child labor.

obligation to avoid such investments.[45] For instance, the Fund may agree to use "reasonable efforts" in avoiding investments in a certain industry. The firmness of the obligation will ultimately be determined by the leverage in negotiating the Side Letter between the Fund and the investor.

Where an investor has a strict policy requirement not to invest in a certain type of investment which the Fund is otherwise permitted to make pursuant to its Investment Policy, this investor-specific requirement is usually accommodated by "excusing" the investor from the problematic investment (*See* Section 4.IX *(Limited Partners: Excuse, exclusion, and mandatory withdrawal)* above).

[45] If a Fund is expected to have DFI investors, the Fund Sponsor should be cognizant of and understand ESG categories and the categories which the particular DFI investor requires Funds to invest in. Some DFI investors will have restrictions relating to Category A clients (i.e. clients who carry out or who intend to carry out activities which are likely to have a significant adverse social or environmental impact) and other DFI investors may have slightly different requirements.

SECTION 12: INVESTMENT COMMITTEE

I. WHY DO FUNDS HAVE ICS? AUTHORITY OF IC.

Broadly, Funds have ICs so that the Fund's management team can focus on the day-to-day management of the Fund and its investment portfolio, while the IC handles planning and implementation of the Fund's investment objectives, policies, strategy, and limits. Dividing responsibilities in this manner creates a system of checks and balances on the Fund's investment objectives and allows the management team to dedicate the proper amount of time required to manage the Fund. In addition, the IC's members often include industry experts who can provide valuable insight and assistance with investment decisions. The separation of the staff conducting diligence from the staff exercising investment discretion is also intended to support a robust interrogation of the merits and risks of each investment opportunity and ultimately more thoughtful and dispassionate decision making.

In the process of forming a Fund, the IC serves as the main authority in developing a Fund's investment objectives, policies, and limits. Once a Fund has been launched, the IC's key purpose is to review and approve (or reject) investment opportunities – both acquisitions and disposals of investments for the Fund – all of which must be within the parameters of the Fund's Investment Policy. The specific authorities should be set out in the IC's charter and, ideally, the Fund's Investment Policy.

(a) Composition of IC. Qualifications for membership. Remuneration

An IC will typically include the following key roles:

(1) Investment managers (those responsible for managing client portfolios).

(2) Investment advisers (these can be in-house but often third-party experts are brought in to help review investment activities from a different perspective).

(3) A chairperson (often selected by the Fund's senior management or the board).

(4) Those with significant influence functions/compliance oversight.

(5) Individuals responsible for investment research (these may be non-voting members).

ICs are often built either organically, as in, members are chosen from those already at the Fund based on position/expertise and then those members invite friends/experts with additional expertise to join, or through a more structured approach with defined requirements and processes. A structured methodology will require more initial work, and is also more likely to lead to an effective IC. Selection requirements and methodology can be set out in the IC's charter. Key matters to consider when building the IC include:

(1) optimal size – three to five members is considered the sweet spot, however, larger Fund Sponsors may have larger ICs; and

(2) member diversity – in terms of professional and committee experience, gender, race/ethnicity, and age.

Given IC membership is limited, a holistic approach should be taken in reviewing what each member brings to the IC. Key skill requirements should be considered, and then (for example) a skills-based assessment of potential members can be carried out to assess whether they would be a good fit for the Fund's goals. Key skills for IC members could include sector expertise/qualifications, financial structuring skills, regulatory/legal knowledge, government relations experience, accounting knowledge, fundraising expertise, and economics knowledge.

IC members may, at the Fund's discretion, be remunerated for their services (and indeed IC members may expect remuneration). The level of remuneration should be set out in the IC's charter and will likely include expenses such as travel and accommodation when attending IC meetings. Remuneration levels should be regularly reviewed (for example, annually) by the Fund; a separate remuneration committee can be useful for such reviews. IC members may also be given the opportunity to invest in the Fund.

In addition to the specifics around the composition of the IC itself, Fund Sponsors should consider the level of support required for the efficient functioning of the IC, particularly in terms of support staff. The support staff will be key in ensuring success of the IC through procurement and circulation of relevant investment data and IC meeting materials, reviewing and managing IC member calendars and addressing any IT or similar challenges; any shortfalls in these areas are likely to hinder the effective running of IC meetings and processes generally.

In impact investing, some investors may seek representation on the Fund's IC.[46] Fund Sponsors generally resist such proposals and many investors fear that such involvement might jeopardize their protection from liability as they will be actively participating in running the Fund.

[46] Although this is not allowed by some DFI investors.

II. VOTING. SUPER-MAJORITIES AND OTHER LIMITATIONS.

When reaching a decision on a certain investment or other matter being considered by the IC, the members will be required to vote on the matter. Key considerations for the voting mechanics are:

(1) How is a decision made; as in, how many votes are required to pass a decision? This is the key question, and the mechanics should be considered carefully. Generally, a majority in number should vote in favor of a particular matter for it to be approved/passed. However, for particularly important decisions (for example in relation to key investments or investments over a certain threshold), Fund Sponsors should consider including a "super-majority" mechanic, whereby more than a simple majority of IC members must vote in favor of a matter for it to pass/be approved. A typical super-majority would be at least two-thirds voting in favor and can be anything up to unanimous voting. Such super-majorities can be tied to investments representing certain monetary values, or a percentage of the Fund's assets.

(2) Some Funds (particularly venture capital Funds) may also employ a "champions" rule, whereby a single member's strong positive view to invest will be sufficient to make an investment. This is often employed in the case of seed or very early-stage financings of startups, with the IC shifting back to majority voting for late-stage investments. Champions models can, for example, be useful where only one IC member has access to relevant information for the investment and it would be too time-consuming/financially burdensome to educate the entire IC about the investment relative to the size of such investment.

(3) What happens if there is a tie in votes? In such situations, a mechanic that provides the chairperson with a casting vote could be included in the charter (for example), or a further review of the matter could be required with a subsequent re-vote.

(4) What is the quorum required for a meeting? The IC charter should set a minimum number of IC members required for a valid meeting to take place. The quorum will depend on the size of each IC; however, a general rule of thumb is to ensure that a majority of its members are in attendance.

(5) If a member cannot attend to vote, can another act as proxy? Proxy voting is a common mechanic used across most voting situations.

(6) Manner of voting. Consider requiring IC members to vote at the same time (for example, by show of hands) rather than one at a time. This reduces the chances of groupthink and other decision-making biases from polluting the decision-making.

The IC may also have certain non-voting members. It should be made clear who such members are, and that they are not to vote on the matters discussed at IC meetings.

(a) KYC/AML on IC members

Funds should perform know your customer (KYC) and anti-money laundering (AML) checks on all team members. This includes IC members. Where an IC member is already an investor of the Fund, KYC/AML checks would have been carried out at the time the member joined the Fund; however, best practice requires that KYC/AML checks also be performed on an ongoing basis.

In particular, KYC/AML checks should also be carried out in accordance with the Fund's policies on such matters (and such policies should themselves be continuously reviewed and updated) where an IC member is a third party; given the importance of the roles of such members, the Fund should be comfortable with IC members' backgrounds and suitability to act on behalf of the Fund. Again, these checks should be carried out on an ongoing basis and the information regularly reviewed.

Depending on the jurisdiction that the Fund is registered in, there may be certain reporting obligations of a Fund to show that it is meeting its KYC/AML requirements. Proper due diligence of IC members will assist in demonstrating that a Fund is meeting any such requirements.

(b) Contract with IC members

Funds should enter into contracts with IC members to set out the fiduciary duties of each IC member to the Fund, the general terms of engagement (which should include term and remuneration) and the Fund policies to which the IC member agrees it will adhere (for example, conflicts of interest, confidentiality, AML, etc.). A Fund could also consider imposing the same/similar fiduciary duties on IC members that the board must comply with to ensure that the Fund has recourse against the IC members in the event of a breach of duties. If the terms of engagement between each IC member and the Fund will be the same, then the contract with the IC members can be contained within the IC charter. What is suitable will depend on the circumstances and relationships between the Fund and each IC member.

(c) IC charter

The IC charter states the mission and objectives for the assets and the IC; it also documents the selection process for members as well as their roles and responsibilities.

Given that the Investment Policy/strategy of a Fund can change, the IC charter should be regularly reviewed to ensure that it still meets the requirements of the Fund.

The charter should also include:

(1) The specific authorities granted to the IC, and equally any specific items for which the IC does not have authority.

(2) Meeting procedures and attendance requirements and the frequency of meetings.

(3) Voting mechanics.

(4) Contingency plans to allow special meetings to address urgent business rather than waiting for the next regularly scheduled meeting.

(5) Requirements on record keeping and reporting to the management team.

(6) How conflicts of interest should be addressed and, if necessary, matters that will be deemed a conflict/non-conflict.

As mentioned above, the IC charter can also serve as the contract with IC members, if suitable. Responsibility for drafting the charter will most likely sit with the Fund's board and, if there is one, its chief investment officer.

(d) Types of conflict of interest to be addressed at an IC meeting

Examples of conflicts of interest, and the possible manner in which they can be addressed, include:

(1) An IC member/Fund employee (or a member of their household) has a personal or professional interest in an investment being considered by the IC. This could include investments in other entities where the member serves as a fiduciary or employee.

(A) In such circumstances, the charter should make clear whether the IC member concerned will be able to attend the relevant meeting, whether they can vote, and/or what their role in the relevant meeting will be (for example they may be limited to only providing information on the investment and are not permitted to promote the investment)[47].

[47] This type of issue should also be raised to the LPAC.

(B) The charter, or a separate conflicts of interest policy/the Fund's governing documents, should also address whether the Fund is even permitted to make such "connected" investments.

(2) An IC member/Fund employee (or member of their household) wishes to invest in an opportunity learned about through the IC member's role on the IC. In most circumstances there will be a flat restriction against any such investments by IC members.

(3) Picking investment managers. Certain IC members may have investment manager contacts that the Fund wants to leverage (for example, where a non-executive IC member is affiliated with another investment firm that is a competitor for the potential deal or a possible co-investor). The charter should be clear about the relationship between the relevant IC member and the manager, if such a connected manager is appointed.

Given it is not possible for the Fund to predict every conflict of interest that may arise, Fund Sponsors should consider including a provision in the IC charter that allows the IC to appoint a special committee that will consider conflicts of interest not specifically addressed in the charter (or other Fund documents) itself.[48] Further, the IC should be involved in drafting any conflicts policy of the Fund.

(e) When in the deal process does the IC become involved?

Typically, and depending on the specifics of the IC charter, the IC will become involved after the Fund Manager (or any wider investment team) have learned about the potential investment opportunity and have subsequently carried out some initial due diligence on the target portfolio entity. The Fund Manager may then present the opportunity to the IC for further consideration. Following their review of the presented information, such as the financials of the target entity and any projections for returns of investment, the IC will then make a decision.

(f) Co-investment and other unusual structures

Situations may arise whereby a Fund is presented with co-investment opportunities or the option to invest in other structures that fall outside the "normal" blind pool commingled Fund.

To provide for such situations, the Fund may want to consider setting up a sub-committee of the IC that deals specifically with co-investments and other special situations.

[48] In addition, such conflicts of interests should be raised with the LPAC as and when they arise.

(g) How is the final decision to invest made? What information is provided to IC? What is the role of the IC in negotiation of investment terms?

A final decision to invest will come after resulting information from ongoing due diligence, financial reviews, discussions with the target portfolio entity's management team, and other related items have been reviewed, collated, and presented to the IC. There may be a number of IC meetings before a final decision is made, and during this time the terms of investment will likely be negotiated. Depending on the exact mechanics in the IC charter, IC members will vote on whether or not to make the investment, following which the Fund Managers will organize for the investment to be made; or the IC will review and recommend to Fund Managers the investment opportunities and the Fund Managers will then decide to invest or not (although noting that whether investment decisions are sound would still fall on the IC).

The type of information provided to the IC will often include:

(1) market developments;

(2) the financial history of the target entity;

(3) the expected return on investment;

(4) the quality of management;

(5) the soundness of the business model;

(6) the capital requirements and the impact on the Fund of making the investment;

(7) the relationship between the entity, its management, and stakeholders;

(8) in impact investing, the societal benefits anticipated from the investment; and

(9) regulatory considerations.

During the decision-making process on whether to invest in an opportunity, certain legal documents required for the investment will need to be drafted and negotiated; in particular, the term sheet for the investment. Whether the IC is involved in the negotiation depends on the terms of the charter and the wider processes contained in the Fund documentation; however, in most cases the IC will review any draft terms, and this will assist in their decision on whether or not to make an investment. The IC may (depending on the specific authorities in the charter) be invited to comment on the terms; however, the Fund will liaise with the target portfolio entity to agree the terms.

(h) What kind of minutes and voting record should an IC maintain?

The IC should maintain minutes of all meetings for the Fund's records and, if required, presentation of decisions to the Fund Managers. Minutes should be retained on a permanent file together with any materials presented to the IC during the meeting. After an IC meeting, it is best practice for the meeting minutes to be compiled by a non-voting member before being sent out to the IC for comment and finalization. While this step often happens just before the IC's next meeting, it is best practice to circulate draft minutes for review in good time after the meeting so that thoughts and ideas remain fresh in the IC members' minds. This also allows for any discrepancies to be cleared before the next IC meeting.

Minutes should have more detail than less and include materials that relate to the discussions within the minutes; legal counsel will often attend IC meetings and assist with putting drafts of minutes together. Minutes should cover the IC's process and the rationale that led to key decisions and responsibilities for action items as well as expected completion timelines. It is helpful if the chairperson updates absent IC members on the viewpoints given and decisions made in the previous meeting. This ensures that subsequent meetings are not consumed by updating previously absent IC members.

The minutes may also be used to record how IC members have voted. Provisions on this can be included in the IC charter and will sometimes provide, for ease of recording, that the members that voted against/abstained from voting on a particular matter may have such position recorded; as in, positive votes are not recorded.

Investors in subsequent funds may request copies of example presentations to – and, exceptionally, the minutes of – the IC from earlier Funds in order to assist in their evaluation of a Manager. A thoughtful Manager will maintain high quality records to be prepared for such a request.

(i) Role of IC in exits

One of the functions of the IC is often to review the performance of portfolio entities. The IC will look at, for example, the results of operations, the anticipated additional capital requirements, the return on investment, the level of management support required, budgets, forecasts, and variance reports. If the IC finds that a portfolio entity is underperforming then it might (depending on the specific authorities provided in the charter) either provide final approval for the sale of, or just recommend that the Fund exit, such investment.

The IC charter can also provide that the IC will review offers to purchase portfolio entities and discuss these offers with the management team. Again, the IC can then either recommend the sale of the portfolio entity, or it can be provided with the final authority for approving the sale.

In either case, Funds will sometimes execute a “readiness scan” of the portfolio entity and the exit environment well in advance of the anticipated exit and refresh it as required. To perform the readiness scan and to address ongoing specific exit considerations, the Fund may wish to create an exit committee, which often consists of the Fund’s IC members together with certain other Fund team members.

SECTION 13: FORMS OF INVESTMENT AND PORTFOLIO COMPANY GOVERNANCE CONSIDERATIONS

I. DEBT VS. EQUITY INVESTMENT. MAJORITY VS. MINORITY SHAREHOLDING.

Funds in most asset classes – private equity, venture capital, or real estate, for example – have individual investment strategies that focus on different levels of a portfolio company's capital structure. Equity investments involve private investments in a company's outstanding equity interests, which can vary based on a given company's asset class and corporate structure. Debt investments involve loan originations – making loans to existing portfolio companies that have a need for capital – or syndications of and other exposure to existing debt arrangements. Some investments have both a debt and an equity component, and Fund Sponsors will commonly invest in multiple levels of the same portfolio company's capital structure through one or more Funds. Equity investments and debt investments each have their own unique considerations as they relate to corporate governance.

(a) Equity Investments

Equity investments can take a number of different forms. Private equity "buyout" Funds will often acquire all of a portfolio company's outstanding equity interests (whether public or private), sometimes through the bankruptcy process. These "leveraged buyouts" (or "LBOs") are typically done with capital drawn from the Fund's limited partners combined with a significant debt component usually established with a syndicate of lenders. Once the deal is consummated, the Fund (or group of affiliated or non-affiliated Funds) will have complete or majority control over the company's governance, depending on the transaction. These are known as "control" positions, where the investment carries control over at least 51% of the company's voting interests. Company acquisitions are commonly also done with multiple unaffiliated Funds and other third-party co-investors, in which case governance is divided up going forward as agreed upon by the various investors, usually based on the size of their investment in the company among other factors.

Venture capital Funds, on the other hand, customarily make early-stage investments in private startup companies through Series A and Series B venture financings, which involve a cash investment in exchange for an equity interest in the company which, depending on the size, might involve one or more seats on the company's Board of Directors or comparable control rights. Unlike buyout deals, venture financings typically involve minority interests in the company, meaning that the Fund Sponsor may have a seat at the governance table, but it does not have independent control over the company. These are known as "minority" positions.

Growth equity Funds are a hybrid of the two, where the Fund makes later-stage investments in usually private companies. These investments are often coupled with more robust control rights involving multiple board seats or controlling equity positions in the company. In growth equity investments, the Fund usually seeks to make significant improvements to the company's operations or capabilities with its control position.

(b) Debt Investments

So-called credit Funds and loan origination Funds have an investment strategy that focuses on making loans or otherwise investing in different types of debt incurred by portfolio companies. This debt can range from senior secured debt, to mezzanine (junior) debt, to microfinance. Credit Funds will typically focus on a specific asset class – private equity portfolio companies, early-stage ventures, various types of real estate investments, etc. – and essentially make loans to portfolio companies in exchange for repayment with interest and sometimes equity interests through grants or warrants. Debt investments rarely involve a corporate governance component: in debt strategies, the Fund is often simply acting as a bank to a company that is in need of additional capital. Debt may carry with it a convertible component, as in, if there is a default or at the lender's election, the lender can convert the outstanding debt into an equity interest. These equity interests may have corresponding governance rights, but rarely a control position. As mentioned above, venture debt deals commonly involve a small equity component that may carry some level of governance rights, but this is rarely a significant aspect of the deal.

II. PORTFOLIO COMPANY BOARD MEMBERSHIP. FIDUCIARY OBLIGATIONS OF THE CORPORATE DIRECTOR. INFORMATION RIGHTS OF DIRECTOR. POTENTIAL LIABILITY OF THE DIRECTOR. MANAGER EMPLOYEES AS DIRECTORS. NON-EMPLOYEE NOMINEES AS DIRECTORS. BOARD OBSERVERS. CONTRACT REQUIREMENTS FOR BOARD MEMBERS AND OBSERVERS.

Portfolio companies can have a variety of structures. Most commonly, a portfolio company will either be structured as a corporation or as a limited liability company (or, less commonly, as a partnership). Corporations are governed by Boards of Directors, which are typically appointed by the shareholders based on the size and nature of their equity positions through a process described in the company's Articles of Incorporation. In impact investment, it is not uncommon for a portfolio company to be controlled by an individual or a family. The Board will usually nominate key officers of the company, such as a Chairman or CEO, CFO, COO, etc. LLCs are less structured, and the governance can take whatever form the initial members may agree upon. LLCs are usually managed by a group of Managing Members, Managers, or a Board of Managers nominated by the equity-holders based on relative ownership interests.

While the law governing directors may vary based on the jurisdiction of the company's organization, corporate directors have fiduciary duties of loyalty and care to the company and its stockholders. The duty of loyalty requires the director to put the interests of the company and its shareholders over the director's personal interests in making decisions for the company and evaluating opportunities (as in, the director must be disinterested and free of material conflicts of interest when making a decision). The duty of care requires the director to exercise care in making decisions, based on adequate information and a good-faith belief that the director's decisions are in the best interest of the company and its shareholders (as in, the director must conduct its diligence and inform itself of all information reasonably available to them when making a decision). In this vein, directors generally have the right to examine the company's stock ledger or list of stockholders and its other books and records for purposes reasonably related to the director's position.

Directors are generally not liable for actions taken (or not taken) while in office if the director appropriately performed the duties of their office in line with the applicable statutory standard of conduct and otherwise in compliance with applicable fiduciary duties. Where a director's duties have not been fulfilled – for example, if a director failed to disclose a material conflict that influenced a decision that caused the company harm – the director could be held liable for any resulting damages. Directors may also be held liable for voting for certain transactions that violate the company's articles of incorporation or applicable law. Companies will sometimes alter or limit a director's duties under the articles, and some more mature companies in well developed countries will carry D&O insurance to cover liabilities of directors and officers up to a certain amount.

In impact investing, it is often the case that target companies have conducted their governance far less formally and with less attention to fiduciary notions than this description of applicable concepts suggests. Achieving adherence to international governance norms may be an important part of negotiating an impact investment.

As mentioned above, a Fund's equity position in a portfolio company may entitle the Fund Sponsor to nominate one or more members of the board of directors. In this case, depending on the level of specific focus and control a Sponsor wants to have with respect to a particular portfolio company, the Fund Sponsor may opt to have one of its salaried employees serve on the company's board, or instead look to retain someone from outside to fill its board seat. A Fund Sponsor would want one of its employees to serve on the board if the Fund Sponsor is looking to commit time and attention to the company's governance, thus committing an employee's time to the duties and obligations of the board seat. If the investment is more passive but involves a seat, a Fund Sponsor might leverage someone in its broader network to deal with the board activity on a special retainer arrangement. It is important to note that an employee's salary is an expense of the management company and is not an expense borne by the Fund, so an independent contractor relationship with a director-for-hire with compensation paid out of the Fund's economics is often a logical choice for a Fund Sponsor. Because directors owe a fiduciary duty to the corporation, it may be necessary for a Fund nominated director to resign in certain circumstances where the interests of the Fund and the portfolio company are conflicting or at least not fully aligned.

In lieu of a board seat, a Fund will sometimes receive an observer seat, which entitles the Fund Sponsor to visibility into the board's activities, including sitting in on meetings and receiving the same materials, but observers do not have a vote.

It is customary for a director or observer to enter into a services agreement governing the director's obligations and duties to the company. These agreements are essentially employment contracts that cover important topics like confidentiality, restrictive covenants, compensation, and termination.

III. SHAREHOLDER RIGHTS. RESERVED MATTERS AND SUPERMAJORITY VOTES. NO FIDUCIARY OBLIGATION.

Shareholders and other equity-holders also have governance rights in a company. Unlike directors, shareholders are able to take their own best interests into consideration when making decisions and generally owe no fiduciary or other duties to the other shareholders of the company.

A corporation's shareholder governance rights are set forth in the corporation's constitution (often known as its 'articles') and sometimes in a separate shareholder's agreement. Applicable corporate law also has strong protections on shareholder governance for corporations and requires shareholder consent for certain major decisions. Private companies can have more flexible governance arrangements, where different threshold votes are required for different matters. For instance, minor decisions that come up in the ordinary course of business may only require majority consent or no shareholder vote at all, whereas major decisions, such as a substantial change of control of the company, require supermajority (60%+) or unanimous consent. Corporations also commonly have multiple classes of shares, some of which carry voting rights and some of which do not. As mentioned above, LLCs are much more flexible than corporations, and the governance rights of the equity-holders can take whatever form they agree upon. Certain items, such as amendments to the governing agreement of the LLC that adversely affect the members, will typically require unanimous consent of the equity-holders.

IV. TECHNICAL ASSISTANCE AND OTHER INVOLVEMENT BELOW THE BOARD LEVEL.

Sometimes Funds will seek to make improvements the company or asset it has invested in, in hopes that these active improvements will increase the value of the company and lead to a profitable exit or improve other non-economic metrics (for example, improving the operation of the board of directors, establishing a rigorous accounting function, increasing ESG compliance, eliminating improper related party transactions). For instance, a Fund Sponsor may have a lot of sophistication and expertise in the area of Information Technology, and as part of its strategy, seek to make active improvements to its companies' IT infrastructure. Or, a venture capital Fund Sponsor may have a gift for digital media and help its portfolio companies by revamping their consumer engagement for modern times.

V. PERIODIC AND EXCEPTIONAL REPORTING.

Regardless of the level of control a Fund has over a portfolio company's governance, a Fund should ensure that it has significant reporting and inspection rights (inspection rights are discussed below). The Fund will have reporting obligations to its investors under the governing documents, as described above, so the Fund Sponsor needs to make sure it will have ongoing access to the company's financial information in time to meet those obligations. If financial information is not available, the Fund will need access to *pro formas* and other estimates to satisfy its obligations to investors. In addition, some investors need additional portfolio company information to satisfy requirements under local law or internal policies, so Fund Sponsors need to be mindful of those requirements and make sure to have sufficient access to its companies' information. Fund Sponsors will also want to have any information about material portfolio company developments in time for their annual investor meetings and will be motivated (and sometimes obligated) to inform investors of material developments related to portfolio companies, so the Fund Sponsor should make sure that the company is affirmatively obligated to make it aware of certain significant occurrences. Reporting guidelines developed by the Institutional Limited Partners Association are available here: https://ilpa.org/reporting-template/.

VI. LP AND GENERAL PARTNER INVESTOR INQUIRY RIGHTS.

Similarly, the Fund Sponsor should have sufficient rights to inspect the books and records of the company at reasonable times. Fund investors will have comparable rights with respect to the Fund's books, so the Fund Sponsor should make sure that it has sufficient access to company information to keep its books in order at all times. Some investors also require additional rights to inspect company books, so Fund Sponsors need to make sure there is flexibility to accommodate these requirements.

VII. RESPONSE TO CRISES/EMERGENCIES/MISCONDUCT.

Any Fund Sponsor and each of its portfolio companies should have a strong set of policies and procedures in place, particularly as they relate to certain crises, solvency or liquidity shortfalls, disaster recovery, data breach, major market disruptions, and employee misconduct. Major events are often the ultimate stress test for a firm and the firm's reactions to it might determine its survival and future viability. Fund Sponsors should make sure they are leveraging sufficient third-party corporate, legal, and compliance consultants to develop policies and procedures both at the portfolio company and the management company levels.

SECTION 14: EXITS

I. TYPICAL EXIT EXPECTATIONS IN LPA. DEBT IS USUALLY SELF-LIQUIDATING BUT EQUITY MUST BE SOLD.

As noted in Section 3 (*Life Cycle of the Fund*), a typical Fund has a ten-year term, which can usually be extended by the Fund Manager for a single unilateral one-year extension and an additional one-year extension with the approval of the LPAC or a majority in interest of the investors.[49] Once the Fund goes into liquidation, the Fund's governing documents usually require the General Partner to use reasonable efforts to dispose of the portfolio, but the General Partner typically is able to take three years or more to manage out and dispose of the portfolio. So, while there is customarily no requirement to dispose of a company within a specific period of time, there is a limited amount of time that the Fund Sponsor will have to exit its investments in a typical closed-ended Fund.

Portfolio company exits can take different forms depending on asset class. Private equity Funds typically sell the companies to new buyers in a private transaction, or may sell their stake to the other shareholders, with the sale proceeds paying off existing liabilities, including any debt, and the balance being distributed to investors (and the Fund Sponsor) under the distribution waterfall. The Fund may sell direct equity interests in the company or more commonly interests in a holding company or similar special purpose entity created for tax, regulatory, or administrative reasons. Exits may take the form of an IPO, where the Fund's position turns from a private position to a tranche of liquid public securities (usually subject to lockups or other restrictions), which may be sold or distributed in kind to investors (although it is more typical for the Fund to sell the securities and distribute cash to investors given the complexity involved in distributions in kind to investors and investors often having Side Letter rights limiting distributions in kind).

II. HOW ARE EXITS INITIATED AND EVALUATED? ROLE OF IC.

Exits are a decision of the General Partner and investors rarely have a say in the timing or terms of dispositions. The timing of a disposition will include a range of considerations and depend on the asset class. The Fund's IC will evaluate these considerations in light of circumstances such as the stage of the Fund's life, market conditions, cashflows, debt obligations, industry trends, and other factors. Fund Sponsors do not necessarily like asking the investors to extend the Fund's term, although it is very common, because investors tend to use the opportunity to negotiate Management Fees and expenses, which can be costly and time consuming. The IC needs to carefully weigh extracting value

[49] Although some types of funds always require a majority LPAC or investor consent for an initial one-year extension, and any further extensions require a supermajority investor consent.

versus providing a timely return to investors, which will affect their satisfaction and the Fund's internal rate of return (IRR).

III. SPECIAL ISSUES WITH PUBLICLY HELD OR REGULATED PORTFOLIO COMPANIES. CONFLICTS OF INTEREST POTENTIALLY ARISING IN EXITS.

Portfolio companies, particularly in the venture capital space, will often go public while being held by the Fund. Overnight, the Fund's private equity position is converted into a tranche of shares of a public company. In this case, the shares will likely for a period to be subject to a lockup and/or certain restrictions on re-sale under applicable law. Fund Sponsors should engage legal counsel to advise on all applicable sale restrictions before distributing or disposing of public securities. Because they are liquid, Fund governing documents typically permit public securities to be distributed in kind to investors, and investors are often happy to receive them and have the choice as to whether to sell or hold the shares. Other investors prefer not to receive distributions in kind (or are prohibited from doing so under applicable law), in which case they will have negotiated via Side Letter that the Fund Sponsor will sell any securities proposed to be distributed in kind on the investor's behalf. This is a common arrangement, and some Fund Sponsors offer to do this for their investors in any event (usually at the investor's expense).

Exits can present a number of conflicts. A Fund Sponsor may have multiple Funds invested in the same company, either all co-investing in the same equity or debt components or at different levels of the company's capital structure. A Fund Sponsor may also have additional exposure to the company through co-invest vehicles that have different economics from the Fund Sponsor. These arrangements lead to conflicting fiduciary duties, obligations, and other considerations with respect to different vehicles that may all be affected differently by the same exit. The Fund Sponsor may also have conflicting considerations with the Fund, such as decisions with respect to a Fund that the Fund Sponsor knows will not get into the carry, or with respect to investments that might return investors' capital if managed out but will not be a significant windfall for the Fund Sponsor. As discussed below, conflicts may also arise in connection with sales of assets to affiliated vehicles, such as valuation issues. The Fund's governing documents may require certain conflicts to be cleared with the Fund's LPAC, but the Fund Sponsor may also voluntarily seek the LPAC's input when making exit decisions that involve conflicts, as the LPAC's blessing could avoid litigation or other issues in the future.[50] The Fund Sponsor should also be mindful of any fiduciary duties under applicable law when disposing of investments.

[50] DFI investors may require LPAC clearance.

IV. WHAT HAPPENS IF THE FUND LIFE EXPIRES AND A PORTFOLIO INVESTMENT REMAINS ON THE BOOKS? EXTENDED HOLD INVESTMENTS.

The expiration of a Fund's term is not the end of its life. The term expiration puts the fund into liquidation, during which time the Fund Sponsor can manage out and sell the balance of the portfolio. While the Fund Sponsor does usually need to exercise reasonable efforts to dispose of the portfolio expeditiously, it is given some latitude to extract value and time market conditions.

When the Fund Sponsor wants to hold an investment for a longer period, it has several options. One increasingly popular option is to sell the investment to a new vehicle that the Fund Sponsor manages, or, with the approval of the investors or the LPAC, to convert a closed-ended Fund into an open-ended vehicle to allow for management of certain investments on an indefinite basis, and in each case give the existing investors the opportunity to remain exposed by rolling their commitments over to the new or converted vehicle or be redeemed. New capital is usually brought in at this time as well. These so-called "GP-led structuring" transactions are becoming increasingly prevalent but carry a number of conflicts of interest around valuation, timing, and setting out specific investor consent mechanisms for such potential transactions in the Fund's governing documents. These restructurings are drawing increased scrutiny from investors and regulators, as investors question the conflicts associated with seeking investor consent to a restructuring transaction where certain investors are getting favorable terms for the new Fund. Alternatively, the Fund Sponsor could opt to simply sell the investment to the next successor Fund, which is likely to be operational at the time of the predecessor's dissolution. These transactions still carry conflicts, particularly around valuation, but the Fund Sponsor will typically seek a third-party valuation that it will clear with the LPACs of both Funds, after which the Fund Sponsor can proceed with some comfort.

V. IMPLEMENTATION OF CARRIED INTEREST ARRANGEMENTS.

As early as possible and before any major dispositions, the Fund Sponsor should make sure that any desired Carried Interest arrangements are agreed and documented. Typically, all of the Fund's Carried Interest is paid to the General Partner entity. From there, the ownership is usually set up for the proceeds to be paid to the key principals or to the management company. However, Fund Sponsors typically also want to allocate a portion of the Carried Interest to certain employees, consultants, and other parties. This requires some thought and documentation. All carry recipients are usually grouped together as a special class of members of the General Partner entity or members of a "carry vehicle" for employees that becomes a member of the General Partner and funnels the carry to employees working on the Fund.

When establishing employee carry arrangements, Fund Sponsors should consider (1) which employees will get carry and how much each will get; (2) the structure of how they will get the carry (for example, carry vehicle, etc.); (3) what vesting terms will apply; (4) what associated restrictive covenants will apply and where they will be memorialized; (5) confidentiality issues, and particularly who will manage the project on the Fund Sponsor's side, as they will likely be able to see how much carry all employees are getting; and (6) the tax treatment and making sure the carry is received on a tax-efficient basis.

While not a top priority after a Fund launch, Fund Sponsors should engage counsel to establish and document any Carried Interest arrangements before they start disposing of investments.

PRIVATE INVESTMENT FUNDS GOVERNANCE

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