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PRIVATE EQUITY FUND INVESTMENT DUE DILIGENCE

Strategies for evaluating and selecting top performing fund managers

Edited by

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Legal due diligence panel discussion

A thorough review of the terms and conditions of the limited partnership agreement (LPA) is a vital part of the due diligence that any investor considering investing in a private equity or venture capital fund should undertake. In the wake of the 2007–08 Global Financial Crisis, the due diligence process has become more important and focused as investors re-evaluate relationships and reconsider their approach to fees, carry and disclosure. Examining the details of the partnership agreement, and negotiating items of concern with the GP, is as much a step in the due diligence process as analysing the GP's track record or taking references.

To examine the area of legal due diligence in depth, PEI asked a panel of distinguished fund formation experts to comment on a number of issues, including whether investors are paying more attention to legal due diligence, whether there are substantial differences between different classes of investors, and which areas are causing concern to LPs.

The panel

Our panel consists of leading legal private equity and venture capital fund formation experts from the US, the UK, Germany and Asia. Between them, they have many years of experience in structuring funds and drafting terms and conditions globally. Their experience relates to all types of private equity and venture capital funds and all types of investors in such vehicles. The panel members are:

Craig Dauchy, Cooley
Dean Collins and **Albert Tse,** Dechert
Uwe Bärenz and **Tarek Mardini,** P+P Pöllath + Partners
Duncan Woollard, Paul Hastings
Robin A. Painter, Proskauer

PEI: *The fundraising market between 2014 and 2016 has been strong overall, but it has also been described as a 'have and have not' market, with a small number of haves quickly racing to 'one and done' closes while many other funds spend 15 months to 18 months or more in the market. Does this reflect what you are seeing? Are 'hot' funds able to achieve much more GP-friendly terms or is some of their momentum due to being LP friendly?*

Paul Hastings: The fundraising market has undoubtedly picked up for many GPs but with huge variation in success rates across the market. Only a minority are achieving 'one and done' closings that reach the headlines. These often feature a number of pre or rolling closings, albeit over a fairly short time frame, rather than a single closing in the strict, technical sense. The majority of GPs are taking around a full 12 months to reach their target fund size, and often suffering from an element of uncertainty along the way. There is also a distinct third group of GPs that need to extend the closing period by up to a further six months, that fail to achieve their target size or that need to change their structure on the fundraising trail in order to achieve their goal, for example, by negotiating discretionary mandates rather than bringing further LPs into the fund or by offering other sweeteners to potential larger LPs.

The hot funds are, as always, those that tick all the boxes for LPs. They almost always have a stable team, good track record, strong deal flow and focus on sectors the LP community views as capable of delivering their target returns. For these funds, the market terms have shifted in the GP's favour. Almost all the hottest fundraises have had a high GP commitment and an increase from their prior funds. This has generally not been driven by LPs, but by the teams themselves wanting to deploy more of their own capital into the opportunities they source. Some hot funds have chosen to retain the LP-friendly terms they have negotiated in prior funds as a quid pro quo for an abbreviated negotiation process, but the majority have sought to renegotiate the terms in their favour. The hot funds are often those with *less* LP-friendly terms, rather than more LP friendly. This has not been an aggressive process, but more of a rebalancing of terms away from what were perceived as over-restrictive terms negotiated in a poorer fundraising market. For example, many of these GPs have focused on revisiting overly wide key-person clauses, which they felt often did not benefit GPs or LPs, inflexible investment restrictions and limitations on the fund's ability to structure and finance transactions in certain ways. Some have sought to renegotiate the economics of their funds but again, largely to amend terms conceded at the bottom of the market. This has generally meant returning to more 'textbook' provisions; for example, for fees to run in full from closing and simple, full catch-up over the hurdle return. But there has been some movement for GPs on transaction fee sharing, if the GP is able to demonstrate an economic need and alignment of interest in such arrangements.

Proskauer: I have found this bifurcated market to be a trend across multiple strategies and fund sizes. As a caveat, though, sometimes it is not as dramatic a gap as may first appear. For example, when one reads about a 'one and done' fund that closed within three months from launch, the press coverage may not take into account the fund's pre-marketing phase, which may have been substantial. In these circumstances, the closing timeline may appear deceptively short and may not accurately reflect the amount of legwork being done.

With respect to the relationship between momentum and terms, we have found that terms tend to reflect the perceived market response to a fund rather than market reception being influenced by the proffered terms. In other words, LP-friendly terms will not, in and of themselves, drive momentum. Established industry participants tend to drive one another to normalise terms to some degree; as a result, the largest bifurcation in terms is often seen in the context of first time or emerging funds. Here, hot funds are able to achieve GP-favourable terms, whereas others that are having trouble herding the cats are more likely to offer incentives that ultimately adversely impact the whole economic package for the GP.

Dechert: This is consistent with our experience. We are certainly seeing that the funds being raised by some of the more established GPs in Asia with good track records can quickly become oversubscribed, allowing them to carry over substantially all of the key terms from their predecessor funds without a great deal of resistance from LPs, despite the market generally moving towards a more LP-friendly environment. One particular issue for investors into some Asian funds is that many of the local GPs are unwilling to agree to some of the more onerous tax, regulatory or reporting issues that LPs are used to achieving in more developed markets, and LPs often have to take a view as to whether they can live with a suboptimal position if the fund is oversubscribed. Conversely, new GP entrants are without a doubt spending considerably longer in the market and the recent wave of global regulatory reforms is definitely not making fundraising any easier.

P+P: There is definitely a gap between the top-quartile fund managers (the 'haves') and the rest (the 'have nots'). GPs with an excellent track record, a compelling and proven investment strategy, an experienced and stable management team (including transparent succession plans), and a reliable and happy investor base from prior funds are able to complete fundraising in three to six months, achieve better, more manager-friendly terms (for example, super carry) and are oversubscribed. In contrast, GPs with mixed performance, succession issues or a less compelling strategy (either relating to industry or geography) are struggling with their fundraising (sometimes 18 months or longer), may not reach their target volume (not to speak of reaching the hard cap) and have less GP-friendly terms. Whether fund terms are more GP friendly or more LP friendly reflects the respective GP's position in the market, not the other way around. Successful managers will always be able to have better, more GP-friendly terms than less successful ones as investors prefer good performance over good terms.

Cooley: We are absolutely seeing a 'have' and 'have not' market. The strongest funds, particularly in venture capital, have been well oversubscribed. Those funds have not only been able to close in a single closing, but some have also been able to improve their economic and governance terms. Strong funds without changes in terms have had an even easier time, although most of the strong funds have at least tweaked their terms to make them more GP friendly.

PEI: *Are there general differences between classes of investors (such as sovereign wealth funds, pension plans and endowments) in how they approach legal reviews? Is adherence to the ILPA Private Equity Principles important to a large number of investors, even as a starting point for negotiations?*

Proskauer: It is not uncommon for investors that account for a substantial portion of the fund's capital (often the larger sovereign wealth funds and public plans) to seek economic packages that are more favourable than 'retail economics'. Larger investors are more likely to seek a 'fund of one' or a separately managed account arrangement to address their discomfort with the corporate governance implications of a commingled vehicle. Certain investors prefer the ability to unilaterally impact the investment arrangement as opposed to engaging in an LP consent process, which they perceive as time-consuming and burdensome. Investors with multiple stakeholders may be more concerned than others with second-guessing with hindsight by the press or with policy-driven agendas affecting their stakeholders, which are not necessarily economic or return driven.

The ILPA Principles in large part were constructed with larger private equity firms in mind, so not all of the principles necessarily apply to smaller sponsor firms or venture capital funds. However, the overall mission of the ILPA Principles is to promote alignment of interest and transparency, which are important objectives of all LPs, regardless of size or strategy and whether or not they are specifically looking to the ILPA Principles for suggested terms.

Cooley: We generally see little difference among classes of investors; differences in due diligence are far more likely to be related to the amount of capital being committed by the investor. Overseas investors, funds of funds, banks, insurance companies, foundations and ERISA investors each focus on their own issues, of course, and negotiate changes to the LPA or their side letter that are appropriate for their particular needs. Geographic location of the investor generally does not affect diligence, since overseas investors typically use the same sets of lawyers as US investors. However, certain overseas investors negotiate very aggressively, particularly if they are investing large amounts of capital or are particularly sensitive to certain tax issues.

Dechert: We would say the general approach is the same, but different types of investors have different 'hot button' issues that they concentrate on in negotiations. For instance, sovereign wealth funds tend to be concerned about the confidentiality of their identities and are usually bound by policies regarding the geography, nature and/or industry of their investments. On the other hand, public pension plans and endowments, especially ones from the US, are typically obligated to publicly disclose details of their investments and are often required to comply with strict rules on solicitation by placement agents following the pay-to-play scandals in the US. One interesting class of LP that has emerged recently is Chinese insurance companies. They were only given the ability to invest into private equity funds as recently as 2010 (and into non-Chinese funds in 2012); however, liberalisation of their investment policies has not necessarily been accompanied by an easing of exchange control restrictions. Therefore, while making a commitment is relatively straightforward, drawdowns can be subject to delays. Accordingly, we regularly find ourselves dealing with amendments to the excuse rights and default provisions in order to accommodate possible delays in drawdowns as a result. More generally, we rarely see specific references to the ILPA Principles, although we do find that fund terms are generally moving towards that direction and are becoming more LP friendly.

P+P: Overall, LPs have become more sophisticated in recent years in their legal reviews. Before the Global Financial Crisis of 2007–08, LPs predominately focused on economics while governance or transparency issues were mostly ignored. A combination of factors has changed this. First of all, the financial crisis was a wake-up call for investors to focus on overall acceptable terms and to strengthen fund governance and transparency. In other words, to 'waterproof' terms if the sun is not shining. Of course, it helped that the power pendulum swung and allowed for more LP-friendly terms in the aftermath of the financial crisis. But this development was not only triggered by a change in the power game. It was a result of investors opening up to see the 'big picture' and understanding that a fund agreement is a bit like a marriage – it must work in both good and bad times.

Second, the ILPA Principles, first established in September 2009, were both a result of this paradigm shift by LPs as well as a significant factor in educating investors and accelerating this change. Examples of changes due to ILPA are the preference for whole-fund carried interest structures over deal-by-deal carry schemes (which have been significantly reduced in US funds) and an increase of no-fault rights.

Nowadays, we hardly see LPs explicitly referring to the ILPA Principles by name in fundraising negotiations. This is why some suggest that their influence is fading. However, many investors have internalised the ILPA Principles and simply demand certain governance or transparency points covered in the Principles, without specific reference thereto. In other words, have the ILPA Principles become a checklist? For most investors, the answer is no (unlike at the very beginning of their existence). Are they still relevant in negotiations, even implicitly? Definitely. This is true for most investor groups. Of course, larger investors, such as insurance companies, pension funds and sovereign wealth funds, use their stronger bargaining power and focus on achieving better economic terms like reduced management fees or preferred co-investment rights. They also focus on transparency (for example, requests for management budgets, fees and expenses) as well as governance issues (key-person clauses, no-fault rights, cause removal). Smaller investors, such as family offices or smaller funds of funds, tend to focus on their specific requirements (for example, reporting, disclosure, tax or regulatory issues) and understand that their bargaining power to change economics or governance issues is limited. They often use the same fund lawyers as larger investors, so their legal due diligence is not less sophisticated but more focused as a result of their weaker position and bargaining power. In fact, some of the most sophisticated investors are funds of funds as they do many fund investments, have specialised in-house teams and a unique investor perspective, as they are not only investors but also fund managers with respect to their own fund products.

Paul Hastings: There can be a significant difference in approach between different classes of investors. Sovereign wealth funds often feel a lot less constrained by market norms, and often write the largest tickets. Therefore, they can craft terms which they feel fit their requirements better than a more standard model. Occasionally, this means that the GP establishes a bespoke structure for sovereign wealth funds, rather than admitting them to the main fund vehicle. Sovereign wealth funds also often have privileged tax and legal status, which they are keen to maintain, and often focus strongly on reputational issues.

Family offices tend to focus on the core economic terms and rarely wish to negotiate the detailed legal terms and conditions of the funds, especially if they are part of a broader investor base. Pension funds, endowments and other more conventional institutional investors, still the backbone of most fundraisings, tend to follow market standards for fund terms and have negotiated the legal terms of funds in increasing detail over the years. This leads to longer closing processes, but a lot more detail in the operation of key investor protections. Development finance institutions tend to operate as an amalgam of sovereign wealth funds and institutional LPs, in that they broadly follow the range of market standard terms for fund economics, but expect to push them strongly in the LPs' favour. They often negotiate highly restrictive investor protections and investment limitations, coupled with extensive reporting requirements and a strong emphasis on reputational concerns.

ILPA Principles compliance is not a direct concern for many LPs. However, it has provided a great deal of inspiration and education to the LP community as to the issues they should be concerned about and how governance should operate for a typical fund. It has also benefitted GPs because it has made LP requests more uniform and therefore easier to predict and pre-empt.

Cooley: Some investors do start with the full set of ILPA Principles, in essence asking fund counsel to explain how the LPA differs from the ILPA Principles, and why. But the ILPA Principles generally have not driven fund managers' approach to fund terms. Our general practice is to advise our GPs to offer middle-of-the-road terms. Nonetheless, fund managers should be prepared to respond to comments from investors that are in line with the ILPA Principles and should expect the negotiation of fund partnership agreements around these issues to generally take longer and to perhaps be more difficult. The ILPA Principles are unlikely to have a major impact on fund terms for established managers with impressive track records, but could have more impact on fund terms for emerging managers or established managers that have not performed as well.

PEI: *Are there still significant differences in 'market' terms of funds being launched on a geographic basis or are most institutional funds pegged to an international standard? Is it different for small funds whose investors are totally local or for emerging market funds?*

Dechert: The international nature of most institutional funds, with various types of LPs coming from a wide spectrum of geographies and sectors, means that funds are increasingly pegged to an international common standard. This is best illustrated by Asia-focused funds that have been launched by global private equity managers, where the fund terms are very similar to the terms they achieve for their US and/or European products. Of course, smaller funds which have no more than a handful of LPs can often have terms that are more bespoke and that can be considerably 'off-market' depending on how negotiations play out between the GP and LPs.

Proskauer: Geographical differences among funds have become less stark over time. As investors have increasingly built global portfolios, their exposure to a variety of structures and terms across jurisdictions has led more sophisticated investors to seek to combine favourable terms. A good example of this phenomenon is GP removal clauses, which historically have been less common in US funds and ubiquitous in European funds. We are now seeing these clauses becoming more universally requested. An exception to this general trend is in certain emerging markets. Emerging market fund terms tend to be more variable and often more favourable to GPs than fund terms in developed markets that have a larger concentration of specialised market participants.

P+P: The general trend in recent years has been a convergence of fund terms on a geographic basis. A good example is the development of carry structures. Here, traditional proponents are the deal-by-deal model (the classic US model) on the one hand, and whole-fund carry structures (often described as the European model, but historically also prevalent in Asian funds) on the other. When looking back to 2011 vintage year funds, a slight majority (52 percent according to Preqin) of all US funds still used the deal-by-deal model. In mid-2016, some 83 percent of US funds employ the whole-fund model. This matches the trend for European funds (86 percent) and Asian funds (81 percent) with respect to the whole-funds model – and show a clear convergence of fund terms. In fact, this is one of the largest shifts on fund terms in recent years. Of course, the percentage of deal-by-deal structures can still vary widely depending on fund strategy (with buyout funds using the whole-fund model in only 67 percent of cases). So the overall trend is a convergence of fund terms, especially for mid-size and larger funds with an international investor base. The same investors that invest in an Asian growth fund may also invest in a US venture capital fund and a European mid-market buyout fund. Therefore, LPs may insist on the same terms.

Differences can sometimes be seen in certain specialised sub-asset classes. The best known example is US venture capital funds, which often do not use a hurdle rate. Here, the convergence has been slow as some of these funds belong to the most successful fund managers with a very loyal investor base. The greatest differences can be seen among smaller funds with a more local LP base and sometimes in smaller emerging markets, often due to less common fund structures.

Cooley: Generally, terms for US venture capital funds continue to differ from the terms applicable to European funds. In contrast to US venture capital funds, the distribution waterfall for European venture capital funds typically includes a preferred return, which must be paid to investors before a manager can take carry distributions and may require a return of investor commitments (as opposed to capital contributions) before carry distributions are paid. Terms for small funds with only local investors may differ, unless investors in those funds include institutional investors. For example, many of our smaller funds with primarily individual investors have premium carry and/or premium management fees and relaxed governance standards. These favourable terms typically become more standard as a firm takes on institutional investors in later funds, but the strongest managers are often able to maintain them.

Paul Hastings: The fundraising market is becoming more global and fund terms are becoming more standardised across regions. The differences tend to be driven by asset class and the strength of the GP's marketing position, rather than by geography.

Having said this, there are some variations, which arise based on the geographic focus of the fund. In the US, deal-by-deal carried interest structures are still more common than elsewhere. In Europe, they are the exception to the rule but not unheard of. In emerging markets, whole-fund carry is almost always required by investors given the perception of higher risks involved.

In the past, GPs often had to make a higher GP commitment to an emerging market fund than to a fund focused on a more established market. This difference has now largely fallen away as commitment levels across all funds have increased. Other key terms, such a management fees, preferred return, key person and diversification requirements tend to be similar across regions.

Small regional funds consisting predominantly of local investors can sometimes be outliers to the above principles. Local investors may be backing a particular management team for a variety of reasons other than a pure investment return; for example, to support local investment, for co-investment opportunities or because of prior connections with the investment team. It is also sometimes the case that a small country-specific fund can have a uniquely strong track record compared to its local peers, thus enabling it to require off-market terms from local LPs, which might not be available if it were to approach international investors. All of these factors combine to mean that a small number of funds with a country-specific investor base can have very different terms than the international standard.

PEI: *There has been a fair amount of discussion by GPs that the 8 percent hurdle rate is anachronistic, and reflects a period of time when interest rates were significantly higher than they are now. Are you seeing this in terms negotiations?*

Proskauer: Universally, GPs are flummoxed as to why the industry is holding fast at 8 percent. We conducted a survey in Q1 of 2016 on this issue and found that only a minority of funds have moved to lower hurdle rates. In terms of negotiations, GPs often conclude not to fight the request for an 8 percent hurdle because it is so common – but it is always a point of discussion. A hurdle's function and overall impact differs depending on the waterfall type. In a US style, deal-by-deal waterfall, a hurdle arguably serves a useful function by delaying distributions and slowing cash flows to the GP. However, when the hurdle mechanic is applied in a European style, 'return-of-contributions' waterfall, the potential effect is much more significant and can arguably distort the intended economics and incentives.

Cooley: Yes, we are definitely seeing pressure from GPs in private equity funds to lower, or even eliminate, the preferred return. These GPs argue that preferred returns are rare in venture capital (at least in the US), and should not be required in private equity. LPs argue that in private equity, where companies are profitable, there is an ability to model, and strive to obtain in every deal, some baseline return over the risk-free rate of capital. If that baseline return cannot be obtained, LPs argue, the GP is not doing its job and the investor would be better off in safer investments yielding a risk-free rate. LPs suggest that venture capital is different, where a number of bets are made on companies without earnings, with the hope that a few will pay out significantly. Once again, and not surprisingly, the strongest private equity managers have been able to lower the 8 percent hurdle.

Dechert: As anachronistic as it may be, the 8 percent hurdle rate is still very much the norm for Asian blind-pool private equity funds. It is uncommon to see negotiations over this, as compared to management fee or carried interest rates, which have a much greater impact on overall economics, although there are sometimes negotiations on the catch-up mechanism within the hurdle. In other markets, however, we do see that the terms for Asia-focused venture capital funds are increasingly moving away from the 8 percent hurdle and adopting, for example, a hurdle rate equivalent to a multiple of the LP's capital contributions (which is more representative of the expected returns generated by this particular asset class). Sometimes we see no preferred return at all. For funds set up to acquire a portfolio of secondaries investments in Asia and other jurisdictions, where investments are in existing portfolios of investments, we find that multi-tiered hurdle rates are fairly common where the payment of carried interest is subject to tests on both IRR and money-back multiples.

P+P: Similar to the 20 percent carried interest rate, which was established by KKR in 1976 to become the market standard, being a somewhat arbitrary number (as admitted by Henry Kravis in a speech in 2007), the 8 percent hurdle has also always been an arbitrary number – giving both sides arguments for either reducing or sticking with it. Some GPs (though still a minority) have recently tried to reduce the hurdle rate to 6 percent or 7 percent. They argue that interest rates, as well as performance of other assets classes, are at historical lows and substantially lower than at the time when the hurdle rate of 8 percent was established as market standard for buyout funds. Investors, on the other hand, have not really been willing to change this standard. They argue that the hurdle was never structured to relate to interest rates (for example, X percent above a reference interest rate such as LIBOR). Therefore, a change in such interest rate should not affect the fixed rate market standard.

Second, the hurdle rate's function has always been to ensure that LPs receive a preferred return (above market performance) before a 20 percent carried interest for the manager is justified. Third, all GPs have raised expectations that they will perform above this hurdle rate and have generally not reduced expectations for the overall fund performance. Therefore, it is only fair that investors hold them to their word and demand that GPs stick to the traditional 8 percent hurdle rate. As is often the case in fund term negotiations, both sides have good arguments and often the better position, rather than the better argument, prevails.

Although the recent general fundraising climate has seen the power pendulum swing to fund managers, statistically only a very small number of fund managers have eventually succeeded in reducing the hurdle rate. That said, a greater number of fund managers have at least tried. So far, on the face of it, it looks like investors are successfully fighting back on this point, but it is not a complete defeat of managers. If a GP is able to deliver returns in the target range, the hurdle rate does not affect the amount of carried interest received by the manager; only timing is affected. Therefore, the concession by fund managers is of a limited nature.

More importantly, in a give and take bargaining scenario (to which fund term negotiations can sometimes come down to), some GPs have been able to 'trade' this point in negotiations with concessions by investors in other areas, such as governance. In effect, some GPs have been able to make LPs concede on areas that they may otherwise have not without the manager giving in on the hurdle rate. So what looks like, at first glance, a defeat by managers sometimes turns into a victory. Therefore, we predict more GPs will continue to try to reduce the hurdle rate, at least as long as interest rates remain low.

Paul Hastings: The hurdle, or preferred return, has become a very odd feature of the private funds sector. Historically, it was there to represent the best approximation for a risk-free rate of return, below which the GP should not be receiving any carried interest. The 8 percent industry standard was settled a long time ago when the returns available on US government bonds delivered a comparable return. That logic has completely changed now, and both GPs and LPs readily acknowledge that there is no rational argument for a hurdle at this level.

However, the 8 percent figure has remained, defiantly, the market standard over time despite the shift in the macroeconomic environment. If anything, it has become more typical; in the past the most successful fund managers often had a 6 percent hurdle rate in their funds, but even they have generally moved to 8 percent on the basis that their LPs push for it and their track records easily exceed this figure, so it feels like an easy give.

Why has this figure remained? Most importantly, when GPs are marketing a new fund they are usually confident of achieving a double-digit return for their investors. GPs may also be reluctant to raise the issue of hurdle rates as it may seem a sign of weakness. Similarly, investors argue that if there are double-digit returns expected, then GPs should have no concerns about offering an 8 percent hurdle before any carried interest is paid. This perhaps misses the point – although the GP may be confident of a high return, if the economic situation changes and those returns cannot be achieved, but the fund still achieves a net return of, say, 7 percent for its investors as compared to a negligible return on a US treasury bond, it would seem reasonable that the GP should get some reward for its effort. Second, and very simply, if a lower hurdle rate is proposed investors will resist it simply on the basis that 8 percent is the market norm and they are uncomfortable departing from that.

It has been interesting to compare this with the direct lending market. Clearly, the return expectations in that sector are lower, but GPs have also not felt the need to be bound by the private equity precedent and have crafted a series of differing hurdle, catch-up and carry rates each tailored to the specific product in question.

PEI: *In the aftermath of the 2007–08 Global Financial Crisis, certain GPs began to offer inducements such as fee breaks to participants in a first close in order to develop fundraising momentum. Has this become a widespread feature in the market or has interest faded?*

Paul Hastings: It is interesting how often this discussion arises, even now in mid-2016. The use of such inducements has become a lot less common and most LPs admit that such arrangements do not affect their investment decision either way. There can also be concerns raised by other LPs that such arrangements can create misalignment between investors, and that certain LPs are de facto subsidising the larger LPs. It is now the exception to the rule to offer any investor a special fee arrangement. However, there are occasional circumstances where it arises, almost always at the instigation of the relevant LPs themselves. The situations in which inducements are currently being offered generally fall into two distinct categories.

First, there are the smaller, often first-time, funds that are working hard to generate momentum for a first closing. They may face a number of LPs that are interested but reluctant to meet the first closing schedule and to which a small fee discount may move them from being a second closer to being in the all-important first closing.

Second, there are cornerstone investors in larger, more established funds. These LPs know that the fund can close without them, but often, as one of the larger investors in the fund, coming in at the first closing and often with a pre-existing relationship with the GP from prior funds, they know they have a lot of negotiating power and actively use this to negotiate a better deal.

Proskauer: In my experience, first closing economic inducements, such as fee or carry breaks, are talked about more than they are actually done. Generally speaking, they are more prevalent in younger franchises or firms that need help with momentum, such as those that have lost a large investor or have had disruptions in their teams or strategies. As a practical matter, a problem with economic inducements is that it can be difficult to refuse a large investor's request for a first closing benefit, even if that investor commits at a later closing. Other types of incentives, such as preferential co-investment rights or participation in 'overage' or 'top-up' funds with favourable economics, can be offered subject to the appropriate disclosures. With respect to first-time funds, we are seeing a larger emphasis on assuring continued loyalty to early investors. To achieve this, some of these GPs are granting investors contractual rights to participate proportionately in successor funds, with or without the ability to cap the subsequent fund sizes.

Cooley: We see fee breaks to early closers less often than we did in the years immediately following the financial crisis. Weaker funds that adopted the practice have often continued it; stronger funds either never adopted it or discontinued it. New fund managers often use the practice today, and sometimes offer other inducements to early closers, including lower carried interest, preferred co-investment rights, and the like.

P+P: Fund managers often used early bird or loyalty discounts to create fundraising momentum, but this has faded since 2015. One factor for special early bird discounts was that the historic main economic incentive – that is, the 'late coming fee' or 'equalisation payment' for investors joining at a later closing – proved not to be in itself sufficient to create such momentum, as falling interest rates also lead to lower late coming fees and momentum was generally weak in the aftermath of the financial crisis. In the years following the financial crisis, some investors took a calculated risk by waiting on the sidelines to see whether a fund was able to have a meaningful first closing. Also, the number of funds with 'dry closings' increased, making the equalisation payment ineffective as an incentive for participating in a first closing. GPs turned to other instruments to create momentum, such as reduced management fee rates for first-close investors. They also offered preferred co-investment rights as well as board seats or special thresholds for 'most favoured nations' clause applicability. These additional incentives have proven to be effective instruments in past fundraisings.

In today's fundraising market (mid-2016), the power pendulum has swung back to managers after a streak of successful exits by private equity GPs. Low returns in other asset classes helped. Nowadays, GPs generally do not have to give special first-close incentives. If they do concede on reduced fees (and many do not), then this is usually based on special commitment size or as a loyalty rebate. More often, managers are willing to give special co-investment rights to first-close investors – but even that is less common than in 2013 or 2014. The reason is the death of the second closing: GPs (and their placement agents!) often aim to have only one closing. In practice, this usually means that the first closing is a meaningful one with 70 percent to 80 percent of total commitments being raised, often followed by smaller closings in a relatively short period of time, which allows some investors, with slower investment processes, to join and bring the fund to its target volume (often dubbed 'closing 1B' instead of second closing). Therefore, in the current fundraising environment, the greatest first-closing incentive is investors' fear that waiting too long may result in them not being admitted at all or their allocation being significantly scaled down if the fund is oversubscribed.

Dechert: Until a few years ago, some of the more established managers in Asia were offering early bird discounts to investors to gain momentum in the fundraising market. These were made explicitly on the back of the success that US- and European-based managers were achieving through this strategy. This trend has certainly subsided, save perhaps for some new entrants and some managers with less healthy track records. It is more common for any first closer fee breaks to be a consequence of negotiations, rather than anything that was explicitly offered to generate momentum. In a similar vein, LPs are increasingly acquiring stakes in the GP, which is a different way of improving economics, and this is increasingly popular in the Asia context.

PEI: *Have you seen evidence of investors walking away from funds they would have otherwise invested in because they perceived the terms and conditions to be unfavourable? Are there specific clauses more likely to generate this response?*

Cooley: Walk aways have become less common in today's robust market. We saw a number of prospective LPs choose not to invest in funds with so-called 'premium' terms in the years following the financial crisis. But now that the balance of power has shifted back to fund managers, there is less resistance to premium terms. Having said that, there are still LPs that won't invest in funds with premium terms, whether it be premium carry, above market management fees, or relaxed conflict rules. In light of the shift in the balance of power, fund managers generally may be less willing to compromise to accommodate these investors.

Deal-by-deal carry is a common deal killer. Also, premium carry is not accepted by some investors. But if the key economic terms are in the middle of the pack, the most general common walk aways are the absence of a strong key-person clause and the absence of strong enough conflict of interest rules. Of course, each investor may have its own particular must haves in addition to the foregoing.

Proskauer: We do see this occasionally. In the early stages of marketing a fund, if a major economic term, such as the management fee or carry percentage, or a major corporate governance term, such as the key-person clause, is substantially different than the investor's expectations, the investor may drop out at this early stage and not continue to the next phase of due diligence. Once an investor has progressed to a point in the process where a favourable recommendation is made to an investment committee, however, it is rare that an investor would walk away over legal terms. An exception to this general rule is in the case of an investor that has very specific, stringent requirements, which cannot be waived, and the prospective fund is unwilling or unable to grant such terms due to fiduciary concerns or otherwise.

Paul Hastings: It is very rare for investors to actually walk away from a fund due to the terms, but it does happen. This most often happens with funds that are oversubscribed where they come up against an LP with a fixed internal policy they will not derogate from, for example, around ownership issues, governance or key-person protections, and sometimes issues you might not expect to be deal-breakers. These LPs may even ask for provisions they know to be off-market, but may have gotten used to them being conceded over the last few years. If the GP is in a position where it must cut back allocations or turn some LPs away from the fundraising, it simply becomes the logical course of action to resist such requests and let the LP decide whether to walk away.

There are also some LPs that have requirements on commercial matters, such as management fees or GP commitment levels, which may be financially unachievable for some GPs. In these situations, discussions can draw to a halt relatively early in the process.

Apart from these situations, GPs and LPs generally manage to work out a set of terms that compromise and balance their respective requirements and enable the fund to close successfully. The key issue to bear in mind is that, provided their interests are broadly aligned, there should be a suitable compromise solution to any issues raised. An area where this approach comes under the most strain are key-person provisions. Some LPs can take a view that the weaker the GP's position on key-person provisions, the better the LP's position must be. While there is a superficial logic to this, and it can end up with GPs conceding arrangements they are not comfortable with, in many cases it results in the LPs being frequently required to approve amendments to the key-person provisions as the investment team evolves over time. In a worst case scenario, the clauses are triggered and the fund is suspended when a majority of LPs are happy to continue investing.

P+P: Generally, as the tide has turned, LPs learn again to accept less favourable terms as long as they are able to invest with the most successful fund managers. That said, even though GPs are again in a better position compared to the aftermath of the financial crisis, investors are generally not willing to compromise on certain terms.

There has been continuous pressure on fees, in particular management fees and fee offsets and limitations for other fees. GPs face this reality and both sides usually come to an agreement on economics. If the pressure from all investors is too great, fund managers adjust. Therefore, these points generally do not become deal-breakers. In practice, it is seldom the case that an LP walks away from fund terms that other reputable investors have accepted. In those few cases, this most likely happens because of special governance issues, particularly relating to key-person clauses and succession issues. Private equity is still very much a people business. If an investor is not happy with the GP's dedication, spread of responsibility among team members and long-term succession plan, it may walk away, even if other investors have accepted the terms.

Special investor groups, particularly those state or supranational investors backed by public funds, may have special requirements in relation to no-fault or cause rights that are stricter than general market standards. For example, these may apply to full forfeiture of carried interest in a cause removal case, even with respect to those parts of the carried interest held in escrow. Those investors are very much concerned with reputational risks and are often not willing to compromise on those points while other investors can accept them. Such government investors may be able to implement strict standards when they are the anchor investor in a fund (for example, in smaller venture capital or growth funds), but may have to face reality with established buyout funds where they are in a weaker bargaining position. If the GP is not willing to bend on terms, some of these government investors have to walk away as they are not allowed to compromise due to internal policies. That said, these cases rarely happen.

Dechert: We occasionally see that some GPs, particularly ones with oversubscribed funds, are very aggressive regarding their fund terms to the extent that LPs have walked away. Often LP feedback is not so much that any particular term was a deal-breaker, but rather they are uncomfortable with the aggressive approach that the GP takes to negotiations and do not see the GP as a good long-term partner. While the short-term effect may be negligible for the GP of an oversubscribed fund, the GP does risk alienating investors in a manner that could have an adverse effect on future fundraises, if the track record is less stellar or if fundraising conditions are less favourable.

PEI: *When reviewing partnership agreements, what areas do LPs tend to focus on? Are they more concerned with the economics (such as management fee, carry rates and distribution waterfall), with governance issues (such as key person and clawback) or with alignment of interests issues (such as the GP's capital contribution)?*

Proskauer: All of the above. We can look at these items as wholly separate categories or we can view them as having the same underlying fundamental concerns of alignment of interests and transparency. What LPs tend to emphasise in their risk analysis depends on the specific circumstance of the particular investment in question. For instance, if the investment is a spin out, an investor may be more focused on corporate governance; if the investment is in a larger fund complex with a large fee or carry history, an LP may be more concerned with the GP having sufficient 'skin in the game'. If a fund sponsor intends to propose a term that is dramatically off-market in any of these categories, it is advisable that they do so for a well-conceived, articulable reason, and address this item early. For example, a fund manager with a very large imbedded team may seek a higher management fee or use third-party fees to help defray operating costs – if articulated early in the process they are more likely to prevail.

P+P: Economics are still the main focus of investors' due diligence as this will have a direct impact on performance. Within economics, the focus shifted in the last few years to greater scrutiny of management fees (including the request for detailed budgets), fee offsets as well as review of fees and expenses in general. Regarding carried interest, whole-fund structures are on the rise in all jurisdictions. What we have seen recently in some funds is that managers are offering investors a choice between two or three options that deviate from the classic two-and-twenty model. Typically, such options include a lower management fee in exchange for a higher carried interest (sometimes combined with a lower hurdle rate). The funds offering such options are still a small minority, so they can be seen as a kind of experiment. Also, there is no clear picture on how investors are using their election rights in such circumstances. A new economic model has not yet been established and offering economic election rights is not a solution for all managers.

Another area closely related to economics is the alignment of interest. Here, the traditional 1 percent commitment by fund managers has often been increased to 2 percent, although 3 percent to 5 percent can be seen in some cases. A greater capital commitment by GPs ensures an alignment of interest with LPs. That said, investors do understand that, depending on fund size, a relatively young management team often cannot offer more than the traditional 1 percent commitment.

Regarding governance, the focus of investors has always been on the key-person clause and this is still the case today. Funds are a people business. Nowadays, key-person clauses are more differentiated in terms of who is covered (sometime distinguishing between two or three levels of fund managers) and what is covered (investment period only or whole-fund term). These clauses are very much tailored to each specific investment team. As a result of the financial crisis, LPs are also paying greater attention to no fault and cause rights with respect to the removal of the fund manager, the suspension or termination of the investment period, and the termination of the fund.

Cooley: LPs tend to focus, in order, on economics (distribution waterfall and carry rates, management fee, clawback and GP commitment), key person and GP removal provisions, and conflicts of interest. The most sophisticated LPs put substantial weight on each of those areas. The allocation of deals among fund vehicles – and LPs – has been a particular hot button of late.

Dechert: Fund economics remain a primary focus area for LPs, even if they are gradually becoming more standardised across Asia, with a number of GPs that previously had a US-style deal-by-deal waterfall having to change to the European whole-fund model on their most recent fundraises. One universal area of interest relates to the GP commitment. As the market in Asia matures and fund executives become wealthier, we often see LPs pushing the GP to increase the amount they contribute beyond the minimum 1 percent of commitment threshold.

Managers in Asia are also increasingly branching out to other asset classes, causing potential conflicts and resource allocation issues. We are seeing LPs spend more time on these provisions. One other trend in Asia arising from the maturity of the market relates to key executives where there is now less emphasis on the founder and more recognition that a broader group of executives contribute to the success of the firm. Accordingly, we see a broader group of individuals being named as key executives, and a larger number of executives needed to depart to trigger a fund suspension.

Paul Hastings: More LPs than ever before are reviewing the fund terms as a whole, including economic, governance and alignment issues. In our experience, it is now the exception to the rule for investors to limit themselves to, say, only the economic terms. This can lead to a very extensive set of legal comments being received from a broad range of investors in the run up to each closing.

The better approach for both the LP in question and the GP is to raise their headline concerns – for example, on fees, GP commitment and who the key-person clause should cover – at an early stage with the GP, and follow this with legal comments on the operation of those provisions and more generally on the fund documents. Unfortunately, there are still some investors whose internal processes mean that many of their headline issues are not raised with the GP until the partnership negotiations are already well advanced and closing is imminent.

PEI: *Do LPs have different concerns when considering the terms and conditions of buyout vehicles as opposed to venture capital funds or mezzanine? Do they approach the legal due diligence differently depending on the type of fund in question?*

Paul Hastings: Over the years, the LPs' concerns have become more unified across buyout, venture capital and mezzanine, and they are accepting fewer differences than ever before. Clearly, there are some differences that are necessary given the investment approaches of the three types of fund and there are some differences driven by these factors. For example, the likelihood of venture capital to invest in minority positions and require extensive reserves for follow-ons, and the requirement for mezzanine and other credit funds to recycle capital, are exceptions. However, the majority of terms have become unified across the asset classes. There is still some investor reluctance to accept differences between asset classes on such matters as new fundraising restrictions and diversification requirements where, for example, the buyout model does not really fit with venture capital.

P+P: Nowadays, most LPs are sophisticated and use sophisticated legal counsel. They know that there are different market terms for different sub-asset classes and fund sizes, and they adjust their expectations accordingly. Other than that, generally the approach to legal due diligence is not different. In practice, an LP's smaller commitment to a small venture capital fund may also result in a more focused and leaner due diligence process, compared to due diligence by the same investor in relation to a considerably larger commitment in a mega-buyout fund. On the other hand, an investor does not typically compromise on certain regulatory or tax requirements or certain internal policy issues; for example, a side letter clause on special reporting.

Cooley: Terms and conditions for buyout funds are somewhat different than venture capital funds. For example, preferred returns are standard for buyout funds but are not pervasive in venture capital funds. Also, there is much more negotiation of fee sharing and fee offsets with buyout funds than venture capital funds. Moreover, the distribution waterfall typically differs between buyout and venture capital funds.

Dechert: Investors' concerns when considering the terms of any closed-ended fund (whether it be buyout, venture capital or mezzanine) are generally the same and, accordingly, the approach they take on legal due diligence is similar. Of course, there are often differences in the key economic terms regarding management fee, carry rates and distribution waterfall, which are expected to reflect anticipated returns generated by the type of fund in question.

Proskauer: The range of market terms differs depending on the asset class. For example, transaction fees have never been a robust issue in the venture capital space, but obviously are a significant concern in the private equity community. One due diligence protocol that has changed is in connection with re-ups. It used to be the case that re-ups were given a lighter hand in terms of diligence across the board. LPs are now much more likely to do a full diligence review for re-ups, especially if the senior management team is transitioning or where a firm is expanding into a new product focus. Further, certain areas of diligence, such as cyber-security protocols, were not front of mind in prior cycles, but are key considerations in the current market.

PEI: *The SEC, in its reviews of US fund managers, has focused a lot of attention on fees and expenses charged by managers and the justification of these fees detailed in the private placement memoranda. Has this become a larger issue in drafting documents and in negotiations?*

Proskauer: This is absolutely the case with respect to drafting disclosure documents. The SEC has done an impressive job of identifying certain market practices that, in hindsight, could have benefited from a more fulsome disclosure in the marketing documents, as opposed to the long-form agreements. The legal community and sponsors alike are taking great care to think through all of the practices and policies of the industry, and ensuring that they are fully articulated and explained. This renewed focus on disclosure does not necessarily translate to additional terms negotiations on the long-form agreements. However, sponsors are taking the guidance of the regulatory community to heart and are more intensively and proactively ensuring that their disclosures are fulsome and appropriate.

Paul Hastings: The publicity the SEC has brought to this topic has caused a lot of LPs to delve a lot deeper into fee and expense issues than was previously the case, and to consider more closely the merits of certain cost allocation amounts. In drafting terms, the provisions have extended from clauses that are very brief, focusing principally on headline items, to clauses that are now intended to be exhaustive, with the list of expense items sometimes extending for multiple pages.

However, the market has also developed since 2011 or so, and some areas of reasonable practice by GPs have become harder to clearly define and justify. For example, the practice of GPs retaining experienced business managers between placements with portfolio companies is now typical and valuable to the funds in question. However, it has become harder to clearly differentiate this within the legal documentation of the fund from the less straightforward practice of re-charging what are de facto GP employees to those companies.

The SEC's highlighting of this issue has also caused a number of LPs to start to thinking a great deal more about the expenses being allocated to them and to start challenging what had previously been accepted market norms. For example, in areas such as broken deal costs, compliance costs and indemnity payments, LPs are starting to push for greater restrictions on when such costs can be charged to the fund or when they should be borne by the GP. The logic of the dividing line is not always clear, but compromise positions are being reached on each of these issues.

Cooley: Portfolio fees, attending management fee offsets and fund expenses have long been staples of the dialogue between fund managers and their investors, particularly for private equity where the economic stakes in portfolio fees and deal expenses are high compared to venture capital. The SEC's policy of 'spreading sunshine'[1] has resulted in more disclosure to investors of how the GP intends to conduct its business. In addition, institutional LPs are now asking for detailed reporting regarding portfolio fee generation, management fee charges and expense items. What we are seeing are fund managers, wary of the risk of regulatory scrutiny, choosing to be more conservative in their application of their own portfolio fee and expense allocation practices. This has impacted fund managers' margins, and their incentives, in a very real way.

P+P: The SEC's enforcement practice and, to some extent, similar practices of European regulators, is one of the major developments in the funds industry, irrespective of fund jurisdiction if the fund has an international investor base. Therefore, GPs have to proactively address this and reflect the regulators' requirements in their limited partnership agreements and PPMs. This results in greater disclosure.

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1 Speech by Andrew Boden, director, Office of Compliance, Inspections and Examinations, at Private Equity International's Private Fund Compliance Forum on 6 May 2014 in New York.

This development fits well into the bigger trend of recent years for greater transparency. LPs focus more on these points in their due diligence and resulting fund term negotiations. They increasingly ask for disclosure of budgets and expenses. Besides increased disclosure and transparency, which is nowadays routinely reflected in the fund documents as a result of this enforcement practice, LPA provisions on expenses, which were seldom a focus of negotiations in the past, now receive stricter investor scrutiny. Resulting negotiations often focus on whether certain expenses have to be borne by the fund or the manager. In this context, it is important to understand that the regulators' focus is on disclosure only, as regulators are rather hesitant to be involved in the power struggle of allocating expenses between fund managers and investors. The rationale is that full disclosure enables investors to make an informed decision.

As with budgets for management fees, the best advice for GPs is to be prepared for such discussions. Some fund managers are still living in the 'old times' and may be caught by surprise, which may end badly in negotiations. On the other hand, if a manager has done its homework and has compelling arguments why a certain expense should be paid by the fund, investors typically can accept this.

Dechert: Transaction fees and expenses are certainly a hot topic for the SEC, with the first enforcement action being brought recently against a manager for its failure to register as a broker-dealer due to its receipt of transaction fees. These actions are directly relevant only for transaction fees with a US nexus, but this is nonetheless a hot topic for Asia-focused funds. Interestingly, this recent concern over fees comes at a time when the Asia market is maturing; there are more highly structured transactions, more control deals, more emphasis on sponsors building up internal operational teams and, accordingly, more scope to generate transaction fees. Because transaction fees have not been a major part of the Asian market historically, GPs have generally been willing to offset them against the management fee (the debate was largely theoretical as there were no fees to offset), but they may seek to take a different approach as the scope to generate such fees increases. As is the case in many other areas, however, US regulatory or tax issues often have knock-on effects on commercial terms in other geographies and we would therefore expect this to have an impact on the terms that Asia-based GPs can achieve. □

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