Hot Topics in Private Fund Negotiations

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Our private equity team looks at five of the most important issues facing negotiations—for investors and sponsors alike.

Introduction

The recent increase in regulatory scrutiny of the private funds industry has turned investors' attention to their negotiations with sponsors. The wide range of issues at hand here centres around investors ensuring they are treated as long-term partners: they want access to investment opportunities, insight into sponsors' strategies and business plans, and transparency and disclosure that reflects the long-term nature of their relationships with sponsors. The following five issues are key for both investors and sponsors to keep top of mind when negotiating the terms of private funds.

1. Equitable Allocation of Investment Opportunities

When a private fund sponsor's business includes multiple pooled fund platforms, or separately managed accounts tailored to specific investors, allocation of investments across these vehicles becomes a key consideration. In these cases, a sponsor's various investment vehicles will often share at least partially overlapping investment objectives, making a sponsor allocating 100% of all on-strategy investment opportunities to any vehicle during its investment period an unfeasible approach.

Investors are aware of this reality and, while typically supportive of sponsors expanding their businesses, they want to ensure that each sponsor has a robust and transparent allocation policy that both sets out the considerations it weighs when making allocation decisions and that provides for a fair and equitable approach to these decisions. From the sponsor's perspective, flexibility is vital to equitably allocate investments in a manner consistent with both its fiduciary duties owed to investors and the terms of the sponsored vehicles.

Communication is key: sponsors can provide comfort to investors by explaining any practical impediments and stressing that all allocation and investment decisions are made in the context of their fiduciary duties.

In addition to ensuring that a private fund's governing documents do not allow a successor fund to be formed until the end of the fund's investment period, investors might also request additional comfort from sponsors, including in the form of consent, notice and/or consultation rights for investors on the formation of new funds and/or separate

accounts as well as on-strategy investments being allocated entirely away from the relevant sponsored vehicle. Investors may also wish to see positive obligations for the sponsor regarding the required terms of any shared investments (i.e., transactions where two or more sponsored vehicles invest in the same portfolio investment), such as a requirement for all sponsored vehicles participating in shared investments to invest and divest at the same time and on the same terms. In situations where these requirements are not practical for a sponsor, they can provide comfort to investors by explaining their practical impediments and emphasizing that all allocation and investment decisions are made in the context of their fiduciary duties.

2. Consistent Control Dynamics at Sponsors

Investors treat their investments in private funds as long-term relationships, and conduct considerable business, legal and operational due diligence regarding private fund sponsors prior to investing with them. When an initial investment partnership is successful, existing investors are often at the front of the line to re-up their commitments when a sponsor raises a successor fund. Returns are not everything, however, and investors are interested in their long-term relationship being as healthy and sustainable as possible—that means making sure the sponsor's key individuals are fully involved and properly incentivized for the long term, and that sponsors have thoughtful succession plans to ensure the smooth transition of management at their firms.

Investors often require sponsors to commit to relationships for the long term by pushing for protections on consistent ownership and control of sponsors and their subsidiary entities. Once seen as private information, it is now becoming common for investors to request a breakdown of the ownership of the voting and economic interests (including carried interest) among sponsors' principals before making a final investment decision. Investors are also requesting restrictions on the transfer of these interests to third parties to protect against sponsors or individual principals monetizing their interests, leaving investors with their capital being managed by a different team than their initial partners. Sponsors are aware of how important these issues are to investors and have generally begun to accept that certain limitations in this regard are becoming market practice.

Many premier private fund sponsors are nearing or have surpassed their 30th anniversaries, and many of their funds often have 10-plus year terms. It makes sense, then, that succession planning has become more relevant to both new and returning investors, who are having discussions with sponsors during fundraising to better understand their long-term plans. While approaches to succession planning vary and depend on the circumstances of each sponsor, investors want to ensure their sponsors are thinking ahead and that they have a plan in place that considers the full spectrum of the talent pipeline, including more junior talent. While there is no "one size fits all" succession plan, developing one that is the right fit for the firm—and being prepared to discuss it with current and potential investors—is important to investors and reinforces a shared value for a true long-term partnership between both parties.

3. Fees, Expenses and Transparency

How private fund sponsors allocate fees and expenses has become a hot button issue for investors given the increased regulatory focus on such practices. Traditionally, a fund will incur all managing and operating expenses, including management fees, costs associated with acquisitions and dispositions, audit, legal and tax related fees and fees incurred in connection with investor communications. The sponsor will incur all expenses associated with its overhead (including rent, utilities and employee salaries). However, given the propensity for gray areas (e.g., travel, software, etc.), it is important that a fund's marketing materials, constitutional documents and allocation policies outline how expenses will be allocated.

Investors are looking for sponsors that have robust succession planning to make sure that management at the firm is smooth even in transition.

In recent years, the U.S. Securities and Exchange Commission has pursued two primary categories of actions against private fund advisers relating to expense allocation: (a) a lack of, or inadequate, disclosure of fee and expense allocation (e.g., the acceleration of monitoring fee payments from portfolio investments); and (b) the misallocation or

improper shifting of expenses (e.g., disproportionate allocation of expenses among portfolio companies or the allocation of “broken deal” expenses to certain investment entities, but not those entities majority-owned by sponsor affiliates). In each of these enforcement actions, the issue at hand has been inadequate disclosures to investors.

In response to this heightened scrutiny, sponsors are taking efforts to provide accurate and robust disclosure—and as sponsors continue to enhance their disclosures and alter their fees and expenses practices, investors will ultimately look to ensure allocations are reasonable, fair and equitable. The list of fees and expenses that offset a sponsor’s management fee is significant to investors, who want to understand how fees will be allocated among the sponsors various investment vehicles and any carve-outs. To promote transparency and alignment of interests between investors and sponsors, the Institutional Limited Partners Association has published a fee and expense reporting template to serve as a resource for both sponsors and investors.

4. Enhanced Co-Investment Rights

As private equity evolves as an asset class, investors are looking to maximize returns and diversify their portfolios with alternatives to the pooled vehicle investment model. As a result, many investors look to obtain co-investment rights alongside the fund investments in their portfolio. A co-investment right gives the investor the opportunity to make a direct investment on a no (or low) fee and carry basis. For their part, sponsors see the benefits in offering co-investment rights: they build stronger relationships with important investors, gain access to larger pools of capital and improve the chances of successful fundraising and investing.

In negotiating a co-investment, investors will consider, among other things, the structure of the co-investment and seek to ensure that the co-investment has no, or minimal fees and protects against affiliate transactions, that they are aligned with the sponsor with respect to liquidity events, and that any reporting issues have been addressed. Depending on the size of the co-investment, investors may demand additional rights such as board representation, observer rights and veto rights.

Sponsors generally structure co-investments on a deal-by-deal basis, with an investor’s interest in co-investment opportunities recognized in the investor’s side letter and leaving negotiation of the terms of any future co-investment for a later date. In some limited cases, a sponsor and investor may negotiate the percentage of a co-investment that will be offered and the details of a co-investment simultaneously with the investor’s entry into the fund.

5. Amendments

A private fund’s constitutional document (usually a limited partnership agreement) will generally be able to be amended unilaterally or with the consent of a set percentage-in-interest of the investors (typically ranging from a majority to 66 2/3%). The amendment provisions may also include a “negative consent” whereby an investor’s consent to an amendment will be assumed if they have not responded to consent request within a stated number of days, allowing a sponsor to carry out necessary amendments if an investor fails to respond to a consent request. A compromise position for both sponsors and investors often involves sponsors committing to making at least two attempts to obtain consent (a common modification to this middle-ground agreement characterizes an investor’s failure to respond to a request for consent as abstention rather than outright consent).

Transparency is a hot-button issue for investors, and sponsors are taking note, enhancing many aspects of their disclosure to meet rising expectations in this area.

Investors are also setting their sights on sponsors’ unilateral amendment rights, specifically the right of sponsors to amend the agreement to address changes to the tax treatment of a sponsor’s carried interest payments by requiring that sponsors pay the related expenses. While investors generally understand a sponsor’s need to amend the fund’s constitutional agreement over the life of the fund, they want transparency and communication in the process, and want certainty that they will not have to shoulder expenses for amendments that do not benefit them.

Conclusion

Ultimately, careful planning and thoughtful communication are central to ensuring that negotiations meet the goals and expectations of both sponsors and investors. The private funds market is dynamic, with investment strategy and the investor-sponsor relationship changing in concert. We expect negotiations—including the considerations we've outlined here—to continue evolving in step with the broader private funds space in 2017.