TRENDS IN PRIVATE FUND TERMS

2019 Edition

ADDLESHAW GODDARD

Sam Hadley, A world of complexity.

CONTENTS

WELCOME

Welcome to the 2019 edition of the Addleshaw Goddard, Trends in Fund Terms Report, a publication designed to inform and engage managers, investors and advisers on the latest developments in the global private funds market. Following on from our 2017/2018 trends report, the content of this 2019 edition provides:

- unique and market leading intelligence across all of the key fund terms;
- commentary from leading practitioners on emerging trends in the market;
- an insight into the growing funds finance industry; and
- a summary of recent regulatory developments, combined with a look ahead to further regulatory changes due in 2020.

INTRODUCTION

Our latest trends in fund terms report is published during a period of (1) rapid change for the private funds markets - amongst other things driven by political uncertainty (particularly in the UK), regulatory developments and changing investor preferences; and (2) record levels of "dry powder", combined with increased competition for capital deployment for both investors and managers. In this sort of environment, managers and investors need more than ever to have their finger on the pulse of the economic, political and social developments affecting their strategies, as well as shifts in market practice and sentiment. If the downfall of Abraaj in the last 12 months has done nothing else, it has brought into sharp focus the need to ensure that the detail of fund terms is interrogated fully by managers and investors alike...

Views of current market practice and sentiment can, however, differ from manager to manager, investor to investor, adviser to adviser; it can differ between fund types, size and sectors; and is often framed by a personal and/or subjective view with respect to the position being presented or adopted.

At Addleshaw Goddard, we have invested significantly in our investment management team and the technology and processes it uses and adopts to:

- accurately capture fund term data across a broad spectrum of fund types and sectors;
- facilitate detailed analysis of our fund data, identifying market trends and changes in industry practice from year-to-year; and
- ensure that our clients remain precisely informed when it comes to actual market practice – viewed objectively and not subjectively.

Following on from our 2017/2018 trends report, the content of this 2019 edition provides:

- unique and market leading intelligence across all of the key fund terms;
- commentary from leading practitioners on emerging trends in the market;
- an insight into the growing funds finance industry; and
- a summary of recent regulatory developments, combined with a look ahead to further regulatory changes due in 2020.

We believe that the publication of this report reinforces our team's nomination for the Private Equity Team of the Year (Funds) in the Legal Week British Legal Awards 2019. However, such recognition is only possible as a result of the continuing and fantastic support of our clients and the outstanding efforts and contribution from our team. We would like to take this opportunity to thank you all; and look forward to working with you again in 2020 and beyond.

To find out more about this report and our findings, or to find out how we can support your fund mandates, please get in contact with us:

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PART 1
OUR KEY FINDINGS

OVERVIEW

Against a backdrop of regulatory change, political uncertainty (not least in the UK and the EU) and changing investor preferences, our data shows that:

- fund terms have remained largely static over the last 12 months (perhaps suggesting that new investor preferences are principally being negotiated by way of side letter, rather than being entrenched within the constitutional documentation of the fund); BUT
- wider market forces are beginning to impact at a micro level, with new trends emerging in a number of different areas (highlighted further below).

This section provides a snap-shot of the results of our data and analysis across the key fund terms, and sets out how the most common market position in the last 12 months has moved on (or not) from our findings in 2017/18. For further commentary and analysis in respect of each of our key findings, please see part 2 (Management fees) to part 7 (Fund formation) of this report.

MANAGEMENT FEES

Headline management fee: our data shows a divergence of headline management fees based on fund type, sector and manager – with larger fund managers often able to offer investors discounts to headline rates. While a headline management fee of 1% (calculated by reference to the investor's commitment) was the most common in our fund sample this year, our analysis shows that this was as a result of a greater proportion of co-investment funds, secondaries funds and fund of funds in our sample (as compared to 2017/18) and is not indicative of management fees reducing to this level across the broader market. Our data indicates that a management fee of 2% of the investor's commitment remains the industry benchmark, with 21% of the funds in our sample using this headline rate.

Step-down of management fees at the end of the commitment period: a step down from x% of the investor's commitment, to x% of the 'cost of unrealised investments' has been typical in the last year, reflecting also the position in 2017/18. A commitment period of 5 years has also remained the industry norm over the last 12 months.

Offset of transaction and other fees: a 100% management fee offset of transaction, monitoring, directors, advisory, exit and similar fees has been present in 90% of the funds sampled, mirroring the position in 2017/18.

GP REMUNERATION

Type of carried interest waterfall: in general, global / US private equity funds have in the last 12 months continued to adopt a deal-by-deal carry waterfall, with a whole fund model typically being adopted by UK / EU fund managers. However, whether calculated on a deal-by-deal or whole fund basis, our analysis confirms an emerging trend for more complex waterfall and carry arrangements (for example, tiered or stepped waterfalls with multiple hurdles and different profit sharing arrangements following each hurdle) to be included in fund documentation.

Carried interest rates: 20% remains the industry benchmark for those funds which do not have a tiered or stepped waterfall.

Hurdles: the most common preferred return hurdle rate (i.e. prior to the manager's entitlement to carry) continues to be 8%; but (as highlighted above) a trend to incorporate multiple hurdle rates with different profit sharing arrangements applying following each hurdle has emerged over the last few years.

Carried interest clawback and security for clawback obligations: managers this year have increasingly hard-wired clawback obligations into their fund documents (82% in 2019 vs. less than 75% in 2017/18). However, fewer managers in our sample have provided any form security in order to meet those potential clawback obligations (e.g. by way of a guarantee, undertaking or escrow arrangement etc.), with security arrangements excluded from 61% of the funds surveyed. Guarantee and escrow arrangements have remained the most popular form of security where provided, but interestingly, no funds in our sample provided security by way of undertaking.

Catch-up: now commonly included, an 80/20 catch-up rate (present in 43% of funds sampled) and a 100/0 catch-up rate (present in 38% of funds sampled) have been favoured almost equally, with alternative rates only seen in a smaller proportion of funds.

GOVERNANCE

Key-person: our data from the last two years shows that key person provisions are almost always now included in fund documentation (92% of funds sampled in 2019 included this provision vs. 95% of funds in 2017/18). The consequence has been for key person provisions to be more heavily reviewed and negotiated between GPs and investors, and our analysis shows that investors are increasingly looking for (1) tighter restrictions on the management team, and (2) softer triggers on default, to be included in the fund documents.

Suspension of the commitment period: should a key-person event be triggered, our data shows that in most funds, the commitment period will be suspended automatically. However, it also indicates that there is a trend to (a) provide a longer period during which a GP may cure a key-person event (6 months in 2019, up from 2 months in 2017/18) and (b) make it easier to reinstate the commitment period, with approval of investors representing 50% of commitments being the most common threshold in 2019 (down from 662/3% in 2017/18).

Removal of the GP for cause: our data identifies that the investor consent threshold for removing the GP for cause is reducing (most commonly 50% in the last year vs. 662/3% in 2017/18). This correlates with an increasing number of funds which do not offer investors the ability to remove the GP without cause (see below) – perhaps an acceptable trade for investors and managers alike. However, our data also identifies an increasing number of funds which have sought to more narrowly define “cause”, such that the level of investor consent required to remove the GP has remained secondary to determining the grounds on which the GP may be removed. Whether the downfall of Abraaj will see the definition of “cause” more closely interrogated from the investor community remains to be seen…but our expectation is that this is inevitable.

Haircuts on carried interest: haircuts of 20-25% on carry payable in respect of investments made prior to GP for-cause removal have remained the most common in 2019.

Without-cause events and suspension of the commitment Period: reflecting the data from 2017/18, funds have infrequently provided investors with an ability to suspend or terminate the commitment period without cause. Those that have included this right have required a high threshold of investor consent (e.g. 75%) for the suspension to be triggered.

Removal of the GP without cause: the recent trend has been for funds not to provide investors with the ability to remove the GP without cause. Our data shows that, where this right has been included, approval from a very high percentage of investors (i.e. 80% plus) has been typically required.

INVESTOR PROVISIONS

Investor default: if an investor fails to cure a default, our data indicates that GPs commonly have the ability to forfeit 50%, 80% or 100% of the defaulting investor's interest. This reflects a continuing trend for GPs to place importance on funding certainty – particularly in the context of the competitive capital market which exists currently, where many funds can be over-subscribed.

Limited partner advisory committees: funds now almost universally provide for an advisory committee (92% in this year's fund sample), reflecting the general trend of greater alignment and communication between GPs and investors in recent years. Rights to participate in advisory committees remain, however, a matter for side-letter negotiation and such rights are generally not baked into fund documents.

Investor clawback: amounts which investors may be required to repay in order to enable the fund to meet its obligations, in the majority of funds, has been capped at 25% of the amounts distributed to investors; with the ability of GPs to clawback distributions typically surviving for only 1 to 2 years post-distribution. In each case, our data shows that practice is reflecting industry best-practice guidelines.

Most-favoured nations: our data shows an almost even split between funds which did include an MFN provision and those that didn't, broadly reflecting the position identified in our 2017/18 report.

FUND TERM AND EXTENSIONS

Fund term: the traditional term of 10 years for private equity funds has remained the most common fund term (present in over 35% of funds sampled). Our analysis has identified that the commencement of the term is most commonly first closing, with a 12 month period between first and final closing being typical. This reflects the position we identified in 2017/18.

Extensions: our data indicates that extensions of the fund term have been most commonly permitted by one-year increments, for a maximum of two years. It also shows that the limited partner advisory committee (rather than, for example, a wider investor pool) is increasingly involved in the decision making process and approval for such extensions.

FUND FORMATION

Organisation expense cap: while an increasing number of funds now include a cap on organisational expenses, our data shows that the trend over the last year has been for this cap to be increased; with a typical cap ranging between less than 0.1% to over 0.15% of target commitments. Our data indicates that expenses in excess of the cap are largely offset against management fee (rather than directly paid by the manager), which follows our findings from 2017/18.

GP commitment: in the funds sampled, GPs most commonly provided commitments of 1% of total commitments, or less. However, there is a trend for the largest managers (for example, established managers of private equity buyout funds) to increasingly permit commitments over 2% of total commitments; although in such instances, it is not uncommon to see some form of management fee offset, rather than an upfront commitment in cash.

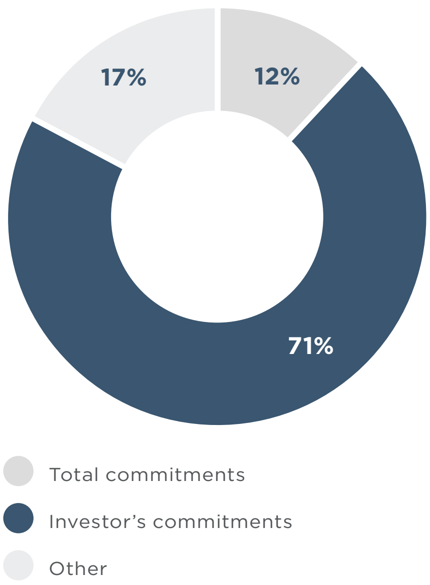
Successor Funds: over the last 12 months and across the funds sampled, the most common position was for GPs to be restricted from raising a successor fund until 662/3% commitments had been invested. This compares to 75% in 2017/2018. In our view, this reflects both the high level of 'dry powder' in the market currently, together with increasing competition in relation to the deployment of capital which would otherwise result in a greater time-period between fund raisings.

PART 2
MANAGEMENT FEES

BASIS OF MANAGEMENT FEE

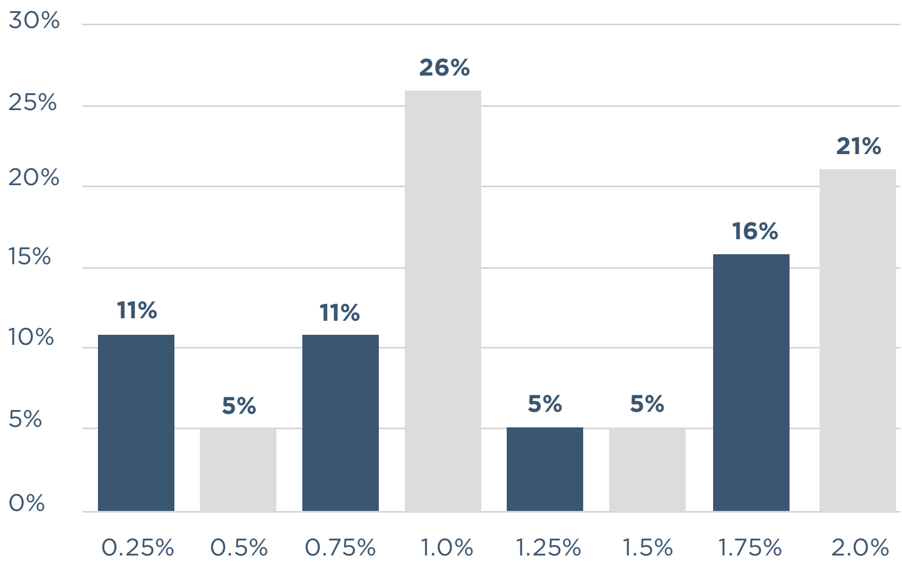
A key aspect of a GP's workload is to seek out new investments. The management fee at the start of the life of a fund is most commonly a percentage of either the investor's commitment or the total commitments to the fund – both end in the same result for the manager. Our data shows that in only 17% of the funds we surveyed, was there a different basis of calculation; for example, a percentage of invested capital. Some would argue that basing management fees upon invested capital incentivises managers to make investments – however managers would usually take the view that having a management fee linked to investor's commitments means that they are more committed to thorough diligence and seeking good investments rather than just investing commitments in order to receive management fees.

BASIS OF MANAGEMENT FEE



HEADLINE MANAGEMENT FEES

MANAGEMENT FEE – INITIAL PERCENTAGE (TO THE NEAREST 0.25%)



While our data showed that the most common overall management fee in 2019 across the funds sampled was 1%, our analysis showed that this was as a result of a greater proportion of co-investment funds, secondaries funds and fund of funds in our sample (as compared to 2017/18) and is not indicative of management fees reducing to this level across the broader market. Our data identified that 1.5% was the most popular headline management fee for larger managers of private equity buyout funds, but a management fee of 2% of the investor's commitment remained the industry benchmark, with 21% of the funds in our sample using this headline rate.

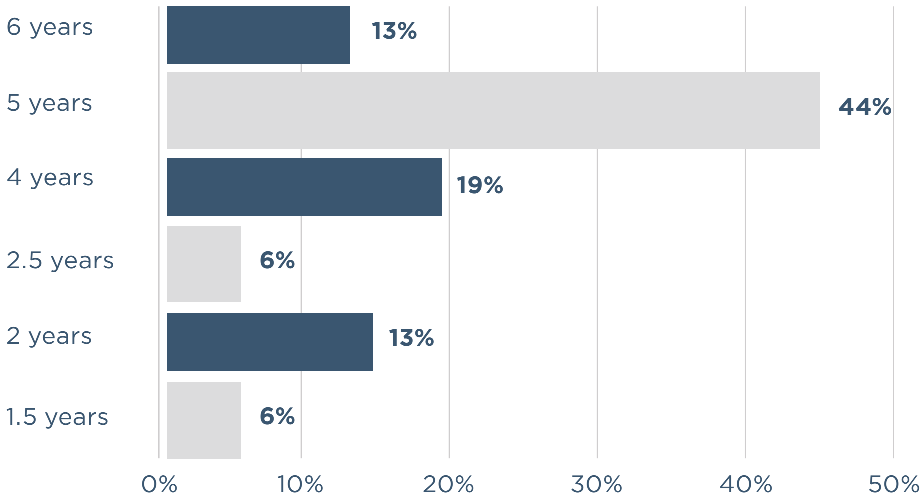
LENGTH OF COMMITMENT PERIOD

GPs of private equity funds typically set a higher rate of management fee during the commitment period in order to take account of the greater workload for GPs in sourcing and making investments compared with ongoing portfolio management and oversight of investments.

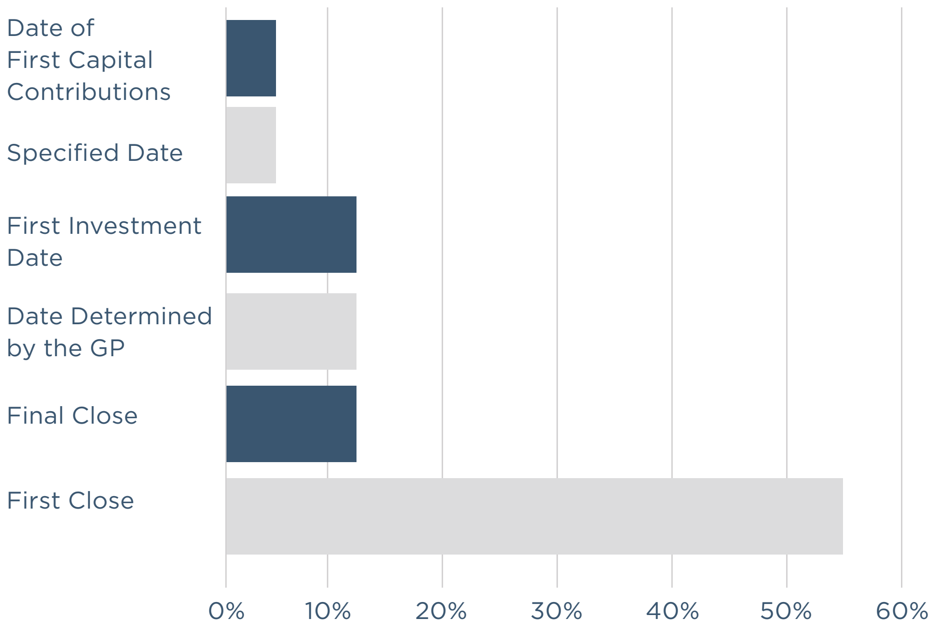
In funds in which the management fees step down following the end of the commitment period, investors will be keen for the length of the commitment period to be appropriate - balancing the need to provide the GP with sufficient time in order to source and make investments, with the desire to see prompt deployment of capital.

Our data shows that commitment periods of 5 years have remained the most common in 2019, reflecting the position in 2017/18. The start of the commitment period is seen as being marked from various points, but first close (rather than, for example, the final closing date) is by far the most common reference point (used in over 50% of the funds sampled).

LENGTH OF THE COMMITMENT PERIOD



WHEN IS THE COMMITMENT PERIOD MEASURED FROM



STEP DOWN RATES

As noted above, it is common in private equity funds for the management fee to decrease following the end of a fund's commitment period. Our data shows that the basis for calculation after the 'step down' of the management fee is most commonly changed to 'cost of unrealised investments' (from investor commitments), and usually excludes reserved amounts.

Alternative methods for the calculation of management fee rates post-step down that we have frequently seen in recent years include: using a basis of 'total commitments minus the cost of realised investments'; or retaining the commitment period basis but fixing a new rate annually by using a percentage discount to the previous year's rate. Our data identifies that where costs of unrealised or realised investments form the basis of the management fee calculation, any investment related fees, tax and expenses have typically been included in such costs.

Beyond private equity and in the wider funds market, the position can be quite different and certain types of funds may not offer a reduction in management fee after the end of the fund's commitment period at all – for example real estate funds, venture capital funds, infrastructure funds and funds of funds. This is often argued to be because the ongoing active management of investments required post-commitment period of these type of funds may justify either a flat management fee being applied during the full term of the fund, or an increase in the management fee payable at the end of the commitment period.

Private equity GPs with significant workloads relating to exits may also be justified in applying a flat management fee during the life of the fund – although this is more relevant for smaller funds where economies of scale are more difficult to achieve or where the management team is small.

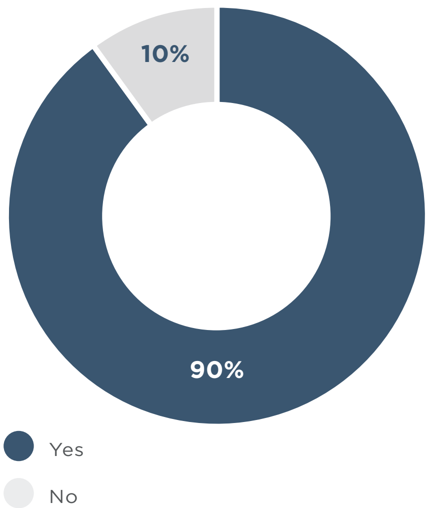
Such arrangements should always be considered in the context of the fund management's carry arrangements.

TRANSACTION AND OTHER FEES

Transaction, monitoring, directors, advisory, exit fees and other similar consideration charged by the GP most commonly accrue to the benefit of the fund. Our findings this year mirror closely our findings from 2017/18, showing that there is a 100% management fee offset of such fees in 90% of the funds sampled.

On this particular point, practice has drastically changed over the last decade - from a position where GPs largely retained the entirety of any transaction fees before the 2008 financial crash to the current position – reflecting the greater alignment of interests between managers and investors during this period.

DO TRANSACTION, MONITORING, DIRECTORY, ADVISORY, EXIT FEES, AND OTHER CONSIDERATION CHARGED BY THE GP ACCRUE TO THE BENEFIT OF THE FUND?



PART 3
GP REMUNERATION

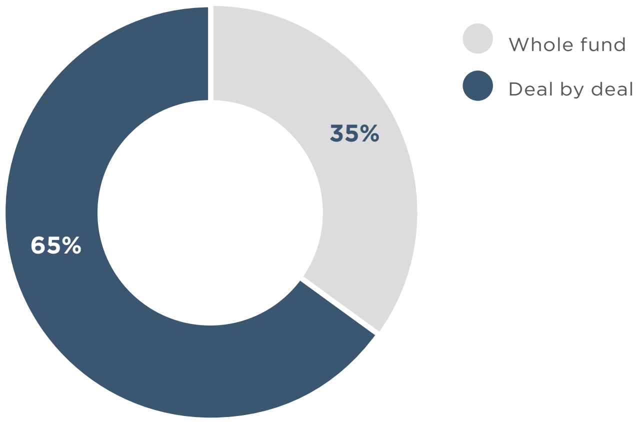
Our research shows that of the global funds in our survey, only 35% operated a whole fund waterfall versus 65% of funds which operated a deal-by-deal waterfall, showing a continued trend across global private equity funds to incentivise investment teams on a deal-by-dealbasis.

TYPE OF WATERFALL

Traditionally, the GP's entitlement to carried interest could be structured on a pure deal-by-deal basis or a pure whole fund basis; the former being traditionally adopted by US funds, and the latter adopted by European funds. Our research shows that of the global funds in our survey, only 35% operated a whole fund waterfall versus 65% of funds which operated a deal-by-deal waterfall, showing a continued trend across global private equity funds to incentivise investment teams on a deal-by-deal basis – with security for investors offered by way of a right to clawback carry from the GP / investment team during and/or at the end of the life of the fund (see further below).

In contrast, our analysis of practice by mid-market funds and managers in the UK highlights a local market in which managers predominantly still operate on a whole fund basis; with no sign that this is going to change any time soon.

HEADLINE MANAGEMENT FEES



A whole fund waterfall reduces the potential for any carried interest clawback liability arising, as investors receive back all drawdowns plus a preferred return before any carry is paid; it also reduces the importance of valuations of the unrealised portfolio. Investors generally prefer a whole fund method of distribution as it defers the payments of carried interest until later in time; but where a deal-by-deal model is adopted, investors may still be protected through clawback and security arrangements (see further below).

CARRIED INTEREST AND PREFERRED RETURN HURDLES

Across our surveyed funds, the predominant carried interest rate has remained 20%; and the predominant preferred return hurdle has remained 8%, in each case reflecting a traditional private equity model. We are, however, seeing a trend for more complex carry arrangements to be included in fund documentation, with tiered or stepped waterfalls (with multiple hurdles and different profit sharing arrangements applying once the initial 8% preferred return has been achieved) becoming increasingly commonplace in the market. Such models frequently operate whereby the carry percentage charged ratchets up as the various performance thresholds are reached. An example of this is set out below.

Stepped / ratcheted distribution waterfall example:

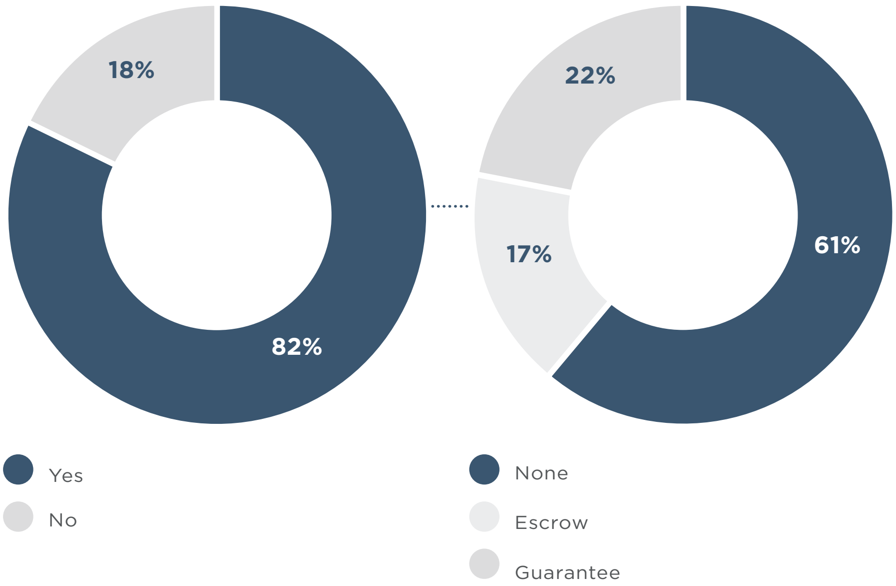
- **Return of capital and costs**;
- **8% preferred return**;
- **1.75x return catch-up:** 80% to the GP and 20% to the investor until the cumulative amount distributed to the GP equals 7.5% of the amounts distributed to the investor and the GP under (b) and (c);
- **GP/investor 1.75x return:** 92.5% to the investor and 7.5% to the GP until: (i) the cumulative amount distributed to the investor equals 175% of its capital contributions; and (ii) the cumulative amount distributed to the investor is sufficient to provide the investor with a 12% preferred return;
- **2x return catch up:** 80% to the GP and 20% to the investor until the cumulative amount distributed to the GP equals 20% of the aggregate amount distributed to the investor and the GP;
- **GP/investor 2.5x return:** 80% to the investor and 20% to the GP until (i) the cumulative amount distributed to the investor equals 200% of its capital contributions; and (ii) the cumulative amount distributed to the investor is sufficient to provide the investor with a 15% preferred return;
- **2.5x return GP catch-up:** 80% to the GP and 20% to the investor until the cumulative amount distributed to the GP equals 25% of the aggregate amount distributed to the investor and the GP;
- **GP/investor 20% preferred return:** 75% to the investor and 25% to the GP until: (i) the cumulative amount distributed to the investor equals 250% of its capital contributions; and (ii) the cumulative amount distributed to the investor is sufficient to provide the investor with a 20% preferred return;
- **20% preferred return GP catchup:** 80% to the GP and 20% to the investor until the cumulative amount distributed to the GP equals 30% of the amount distributed to the investor and the GP;
- **Thereafter:** 70% to the investor and 30% to the GP.

CLAWBACK OF CARRIED INTEREST

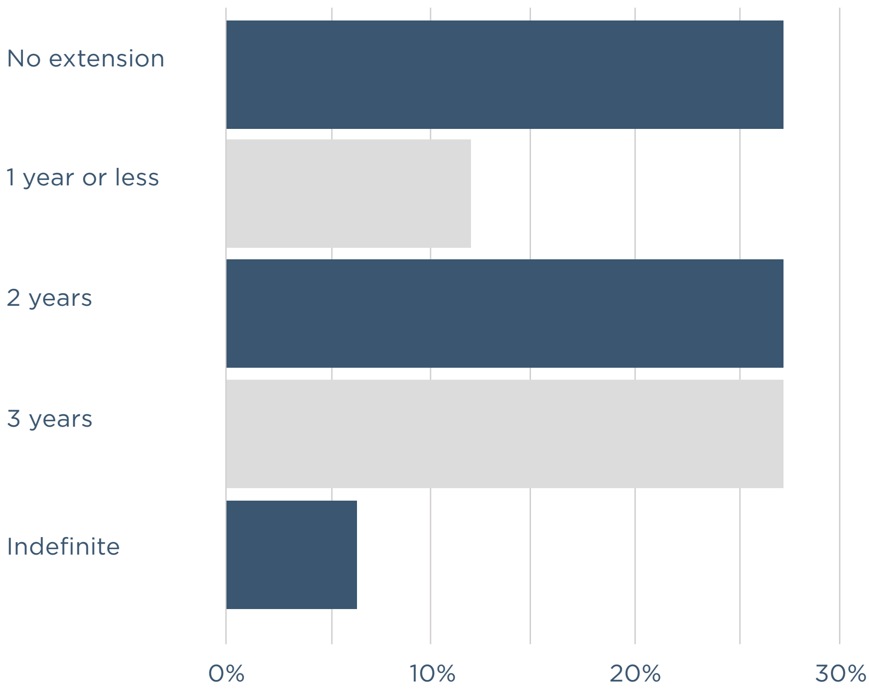
In the funds surveyed this year, an increasing number of managers compared to last year's sample have GP clawback obligations hard wired into their fund documents, with only 18% of our funds surveyed not providing for GP clawback. We have however seen of the funds sampled that the majority of GPs have not provided any security in order to meet potential future clawback obligations. This shows a change from last year whereby the majority of GPs provided some sort of security (whether that is a guarantee, an undertaking or an escrow arrangement). Non-provision of security arguably reduces the comfort given to investors by the presence of a clawback obligation. However, our experience is that often in practice, managers will choose to hold on to all or part of carried interest receipts on behalf of carry recipients, removing or reducing risk of shortfalls in clawback scenarios. Understanding the precise arrangements for both manager and investor is therefore key.

Clawback obligations differ in the length of time for which they continue, some extending to the point of the fund's liquidation and others for two or even three years beyond the term of the fund. In this year's cohort of funds sampled, almost three quarters had clawback obligations continuing beyond the end of the term, and of those, nearly half extended the obligations two to three years post-liquidation.

IS GP CLAWBACK PROVIDED FOR?



HOW FAR DOES THE CLAWBACK PERIOD EXTEND BEYOND THE TERM OF THE FUND?

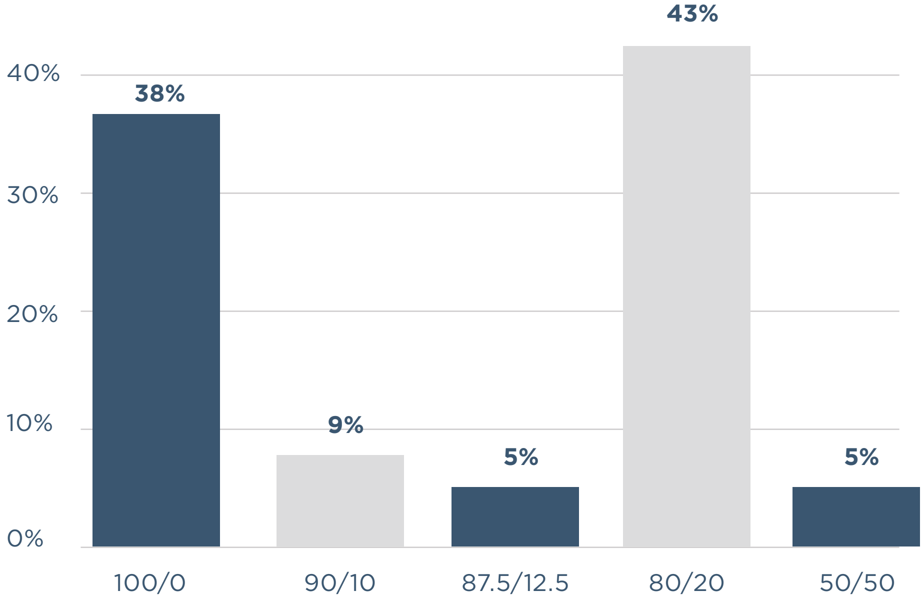


GP CATCH-UP

Catch-up refers to the period which follows a fund achieving the hurdle rate, in which the GP takes a larger portion of subsequent distributions than investors until the time in which its total share of gains has caught up to the rate of carried interest. GPs prefer a catch-up rate of 100/0 in order that they can achieve the carried interest rate more quickly.

Of the funds surveyed, we have seen that, as in the funds surveyed last year, there continues to be a split between the traditional 80/20 catch-up and 100/0, with a marginal preference for a 80/20 split. There are more rarely other formulations, for example, 90/10, 87.5/12.5 and 50/50 catch up rates.

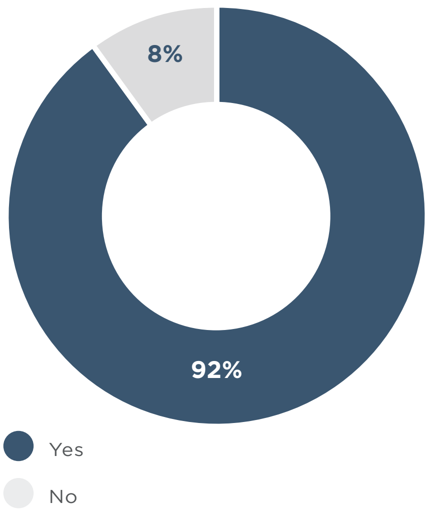
GP CATCH-UP R ATE



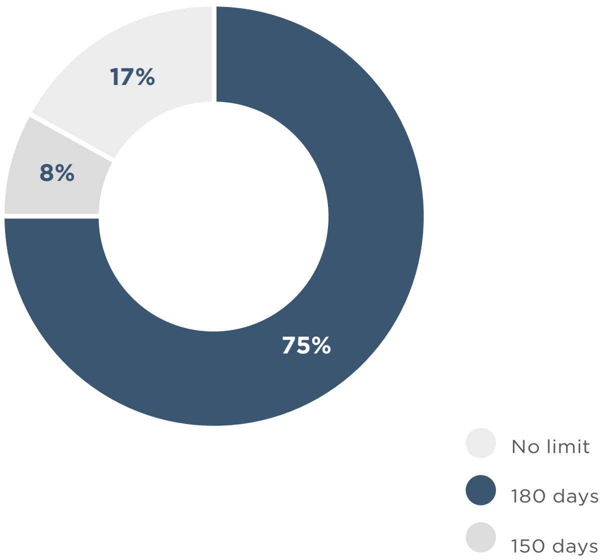
PART 4
GOVERNANCE

KEY-PERSON PROVISIONS

IS THERE A KEY-PERSON CLAUSE?



TIME PERIOD WITHIN WHICH THE INVESTORS ARE ABLE TO REINSTATE THE COMMITMENT PERIOD FOLLOWING SUSPENSION DUE TO OCCURRENCE OF A KEY-PERSON EVENT?



Viewed as industry standard, the precise formulation of a key-person clause is very specific to each individual fund. However, our data evidences continued emphasis and scrutiny of these provisions by investors, with stricter restrictions on the management team, and softer triggers with respect to default being included.

In the funds surveyed this year, we have seen a greater number of funds offer a two-tier key-person test from the outset - that is a test whereby the initial tier is a narrow pool of certain key individuals, and the second tier consists of a wider group of persons. Previously, it was commonplace for tighter provisions such as these to only be included in fund documentation following the negotiation process with investors.

Should a key-person event be triggered, in most funds, the commitment period will be suspended automatically. However, our data indicates a trend to make it easier to reinstate the commitment period, with approval of investors representing 50% of commitments being typical over the last 12 months, down from 662/3% in 2017/18.

Our data also indicates a trend to provide managers with a longer period in which to rectify a key-person breach (6 months, up from 2 months in 2017/18). GPs would argue that the shorter the time, the less time they will have to find a suitable replacement and this position seems to be largely accepted by the investor community. It is not unusual for key person replacements to require approval by either the investor advisory committee or majority of investors.

CAUSE EVENTS AND THEIR CONSEQUENCES

Investors ideally want the concept of 'cause event' to capture a wide range of circumstances which may impact the fund and/or their investment – including material breach of the LPA, or applicable law or regulation; judgment at first (rather than final) instance; and fraud of employees/directors. GPs on the other hand are very conscious of the economic and reputational consequences of a deemed 'cause event' which sometimes results in suspension of a fund's commitment period and ultimately possible removal of the GP/termination of the fund.

Discussion of typical cause events and issues that can occur as a consequence of specific fund terms (including lessions from the Abraaj collapse) will be the subject to separate coverage by our investment management team, and is therefore not captured as part of this report.

In this section, we look instead at the trends flowing from the consequences of a cause event occurring, namely:

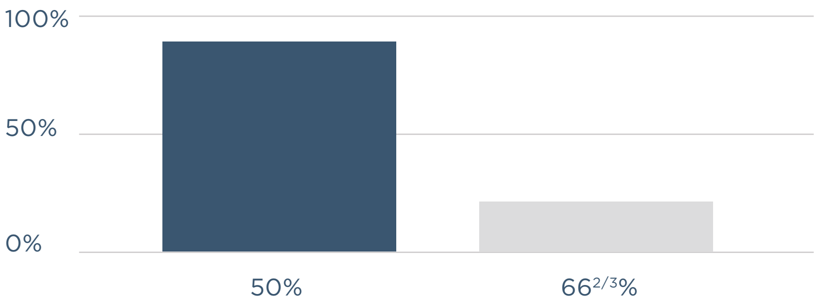
- suspension of the commitment period;
- removal of the GP; and
- haircuts on the carried interest payable to the GP.

SUSPENSION OF THE COMMITMENT PERIOD

A common consequence of the occurrence of a cause event is for the commitment period of the fund to be automatically suspended. However, a trend over the last year (and previous years) has been to make it easier for the commitment period to be reinstated after the relevant default/cause event has been cured and/or with a relevant threshold of investor consent. Our data in this regards indicates that:

- investors are most commonly able to reinstate the commitment period within 180 days of the relevant cause event; and
- the most common voting threshold in order to reinstate the commitment period after a cause event is 50% (falling from 66 $^{2/3}$% in 2017/18).

WHAT THRESHOLD PERCENTAGE OF LIMITED PARTNER VOTES IS REQUIRED TO REINSTATE THE COMMITMENT PERIOD FOLLOWING SUSPENSION?



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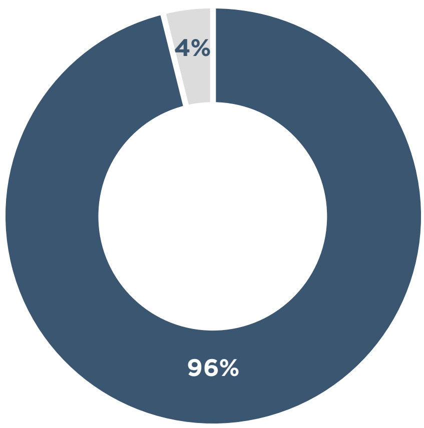
Our analysis has also identified an increasing number of funds which have sought to more narrowly define “cause”, such that the level of investor consent required to remove the GP has remained secondary todetermining the grounds on which the GP may be removed.

REMOVAL OF THE GP

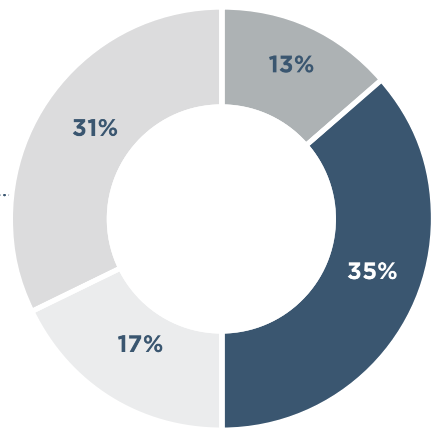
Funds almost wholesale now offer a right to remove the GP for cause (such right being present in 96% of fund documents of the funds sampled); provided that such removal is supported by investors representing at least 50% of fund commitments. This correlates with an increasing number of funds which do not offer investors the ability to remove the GP without cause (see below) – perhaps an acceptable trade for investors and managers alike. However, our analysis has also identified an increasing number of funds which have sought to more narrowly define “cause”, such that the level of investor consent required to remove the GP has remained secondary to determining the grounds on which the GP may be removed. Whether the downfall of Abraaj will see the definition of “cause” more closely interrogated from the investor community remains to be seen... but our expectation is that this is inevitable. Consequently, this topic will be subject to separate coverage and reporting by our investment management team later in the year.

IS REMOVAL OF THE GP FOR CAUSE PROVIDED FOR UNDER THE LPA?



Whole fund
Deal by deal

WHAT PERCENTAGE THRESHOLD OF COMMITMENTS OF LPS ARE REQUIRED TO VOTE TO REMOVE THE GP FOR CAUSE?



60%
50%
75%
35%

HAIRCUTS ON CARRIED INTEREST

Following a for-cause removal of the GP, the fund will often provide for a reduction or 'haircut' in carried interest payable to the GP on investments made prior to its removal. At present, haircut percentages of between 20-25% are common, with fewer examples of 50% or even 100% haircuts.

We have seen a few instances of GPs not providing haircuts but we believe that these are isolated examples based on fund and GP specifics and do not, based on our data, represent a trend.

Although investors do not expect carry to be payable in respect of investments made after removal of the GP for cause; GPs argue that they may have been involved in sourcing investments which had not completed at the point of removal and so should be entitled to receive (a proportion of) carry following removal. With lower haircut percentages being fairly common, GPs may try to offer some other comfort to investors, for example a right of set-off against future carried interest entitlement for damages already awarded to the fund vehicle by a court in relation to the issue giving rise to the cause event.

SUSPENSION AND TERMINATION OF THE COMMITMENT PERIOD WITHOUT CAUSE

Rarely do GPs now offer a right to suspend the commitment period without cause. However, in the small percentage of funds where GPs do permit this, there is a high threshold of consent required – commonly 75%.

GPs similarly limit the possibility of early termination of the commitment period – some GPs do not permit investors to vote in order to terminate the commitment period at all; but those who do require a high percentage of investor votes for termination – in this year's fund sample, investors were able to terminate the commitment period early with a minimum of $66\frac{2}{3}\%$ vote, and most commonly a 75% vote; although 80% was not unusual.

GPs do not want to be in the situation where they are obliged to continue to manage a fund where investors are not prepared to support new investments; and overall would prefer that investors exercise no fault removal rights (where these are present) and appoint a new manager.

NO-FAULT REMOVAL OF THE GP

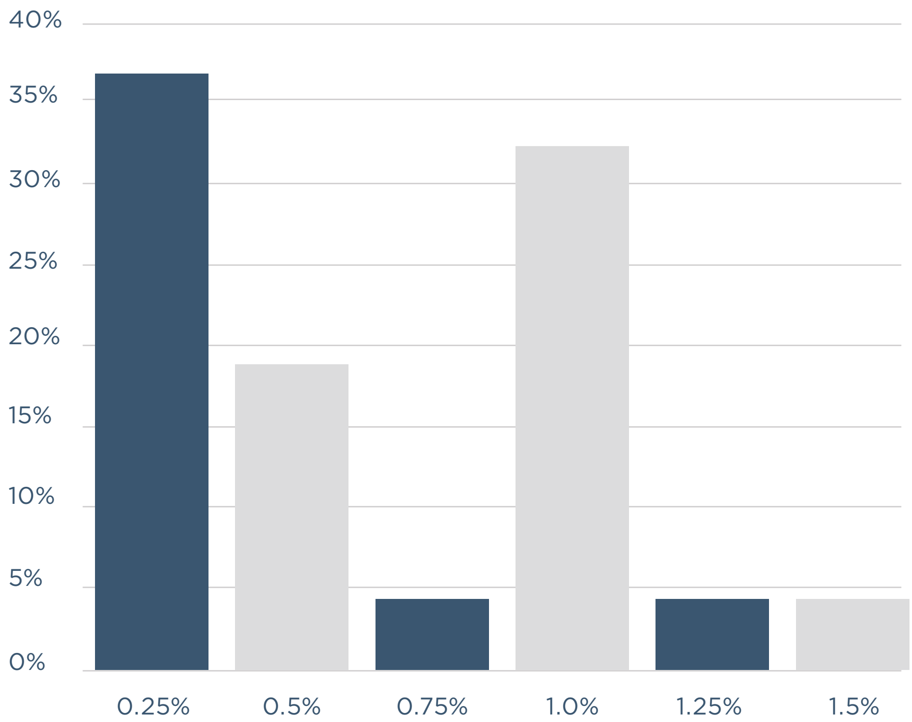
A significant proportion of the surveyed funds did not provide for the ability for investors to vote to remove the GP without cause. Of those who did provide for this, GPs most often required the approval of investors representing 80% of commitments, a similar position to 2017/18.

Some GPs only permitted no fault removal after a certain point in time e.g. two years from initial closing. In circumstances of, for example, a ten year fund term, GPs would argue that they should have a reasonable opportunity to demonstrate their ability to source and complete investments prior to investors having no fault removal rights.

PART 5
INVESTOR PROVISIONS

CONSEQUENCES OF INVESTOR DEFAULT

WHAT PERCENTAGE OF LP INTEREST CAN BE FORFEITED ON LP DEFAULT?



Our data shows that both GPs and investors are taking (and accepting)a firmer approach to investor default, with strong disincentives being included in the fund documentation.

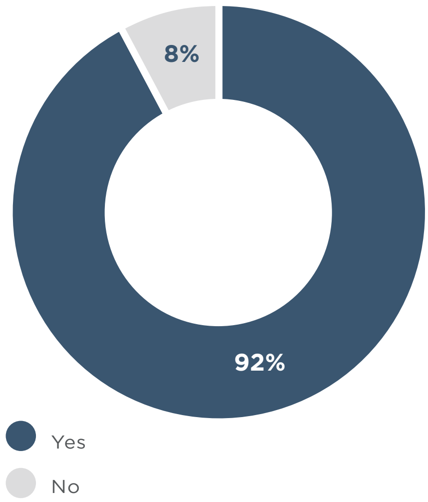
Our data shows that both GPs and investors are taking (and accepting) a firmer approach to investor default, with strong disincentives being included in the fund documentation.

GPs generally argue that defaults can make or break their ability to make a particular investment, and at that point there may be a legally binding obligation on the fund to complete, with the fund potentially incurring penalties and costs should it fail to do so (which would impact the non-defaulting investors).

Should an investor default, it is usual for GPs to notify investors of their failure to meet a drawdown request, usually providing them with 10 days' notice to cure their default, and if the investor fails to do this, our data shows that a GP's ability to forfeit between 50/80/100% of the defaulting investor's fund interest is not unusual; with this right frequently one of a number of options available to the GP in such circumstances.

LIMITED PARTNER ADVISORY COMMITTEES

IS THERE A LIMITED PARTNER ADVISORY COMMITTEE?



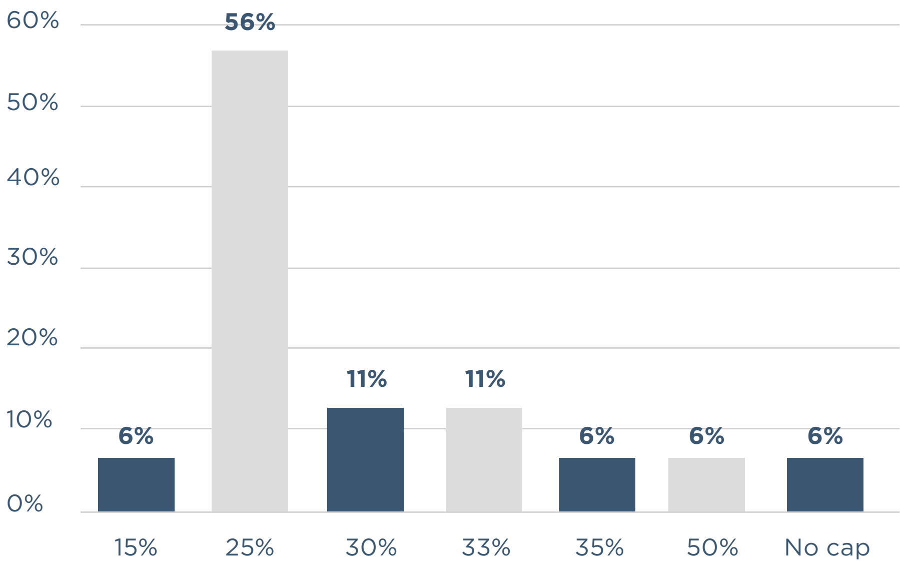
Almost universally, GPs provide for a Limited Partners Advisory Committee or "LPAC", which consists of investors selected by, but independent from, the GP. The small number of funds in our survey where there was no LPAC were predominantly where the fund was a co-invest vehicle and so no LPAC was provided at that level. GPs commonly limit membership to the fund's largest investors or to other investors where the GP views there to be a key relationship. GPs typically favour approval of issues by the LPAC rather than the general investor pool as they see this as a faster way of resolving issues which require approval.

CLAWBACK OF DISTRIBUTIONS

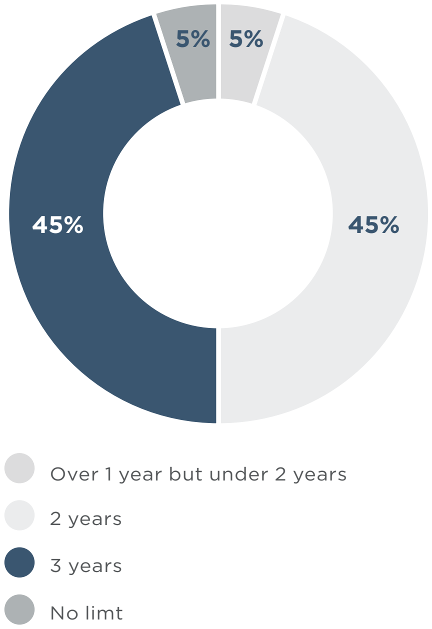
Our data indicates that GPs do commonly provide for the ability to clawback amounts from investors post-distribution in order to meet liabilities of the fund should they arise (including indemnification obligations).

Consistent with our findings in 2017/18, amounts which investors may be required to meet clawback obligations are predominantly capped at 25% of amounts distributed (reflecting industry best practice guidelines); and that 9 out of 10 funds limit clawback to 2 or 3 years after the relevant distribution.

PERCENTAGE LIMIT OF COMMITMENTS OF LPS WHICH THE GP MAY REQUIRE TO FUND CLAWBACK



IS THERE A LIMITED PARTNER ADVISORY COMMITTEE?



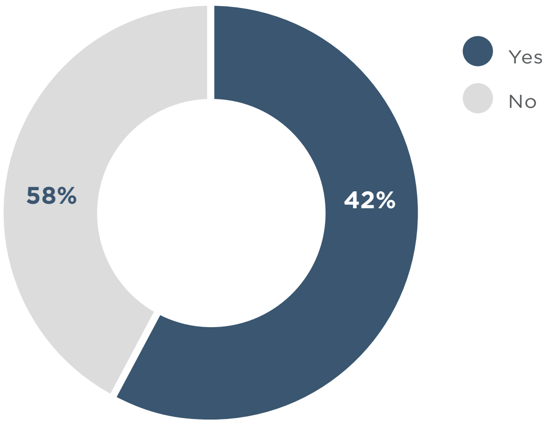
Whereas traditionally, in relation to funds distributing on a whole fund basis, it would be common for a time limit for clawback obligations to be marked from the date of termination of the fund, we have seen that in nearly half of funds sampled this year, the time limit is marked from date of distribution (regardless of whether distribution occurs on a deal-by-deal or whole fund basis). This again shows managers adopting industry best-practice guidance.

MOST FAVOURED NATIONS

Most favoured nations (MFN) is the name given to a provision entitling investors to elect certain benefits negotiated by, and granted to, other limited partners by way of side letter.

There was a split between funds in our survey as to whether they included a MFN provision in their core fund agreement or not, mirroring the results of our 2017/18 survey.

DOES THE FUND ALLOW INVESTORS TO ELECT TO RECIEVE THE SAME RIGHTS GRANTED UNDER OTHER SIDE LETTER?



Inclusion of this provision in the fund agreement removes the need for investors to negotiate that they should be put on an equal footing with certain other investors (e.g. those investors who are committing an equal or lesser amount to the fund); however, for those funds where the provision is not included, it is left to investors to negotiate this in their side letters.

A decade ago, a MFN provision was rarely hard-wired into the fund documentation. While not wholesale, our research does indicate that managers will now more readily accept this investor request.

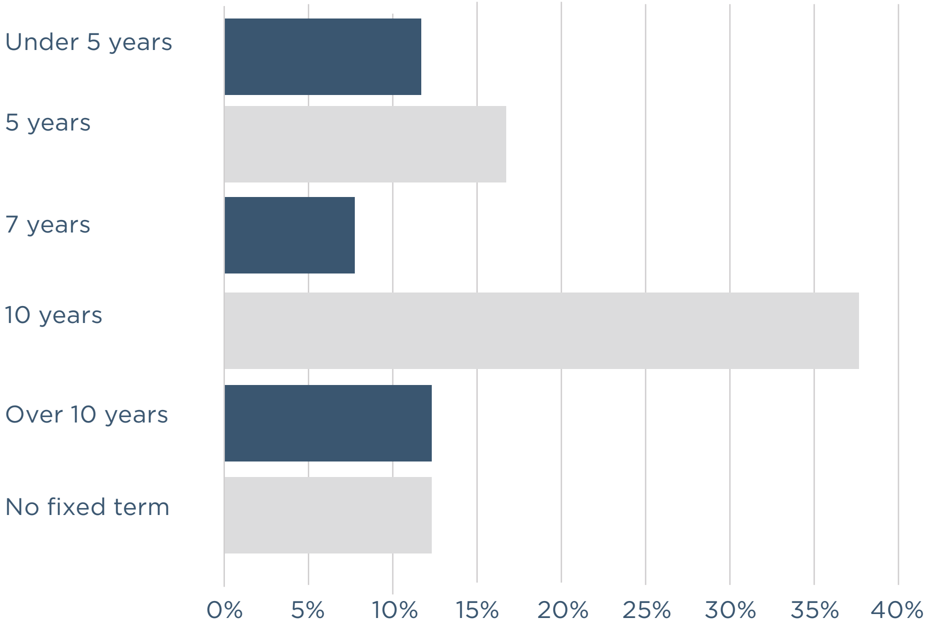
PART 6
FUND TERM AND EXTENSIONS

For private equity funds, a fund term of 10 year remains the most common. In the wider market, debt funds show a trend of slightly shorter fund terms, for example 8 years; and funds formed for the acquisition of a specific asset, significantly shorter terms, for example 5 years.

FUND TERM

For private equity funds, a fund term of 10 years remains the most common fund term. Practically, for private equity in particular, it would be difficult for the necessary steps of fundraising and admission of investors, investment and finally realisation to occur in any drastically shorter period.

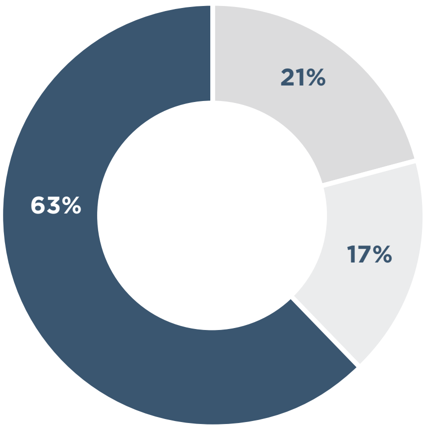
TERM



In the wider market, debt funds show a trend of slightly shorter fund terms, for example 8 years; and funds formed for the acquisition of a specific asset, significantly shorter terms, for example 5 years.

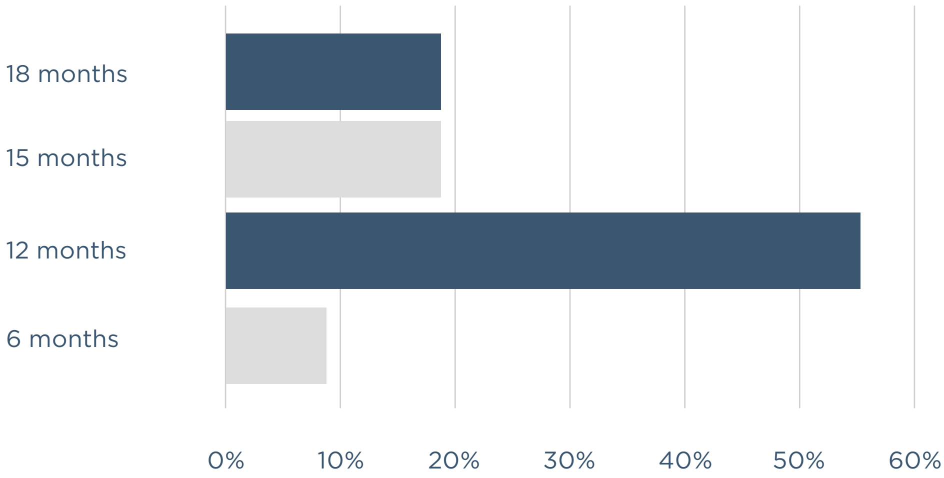
In relation to the period in time from which the term is measured, our data represented a change from 2017/18 (which showed that terms were most often measured from final closing date). This year's data also evidences a greater use of 'other' events as the starting point of the fund term (for example, the date of establishment of the fund, date of the fund agreement or less commonly, the first draw down date or when the fund made a binding commitment to purchase the underlying asset). However, we can attribute this change to having a larger number of co-investment funds within the funds analysed and do not consider this evidence of a new trend. Our view remains that first or final closing is the most common and appropriate reference point for private equity funds, across the wider UK and global market.

WHEN IS THE TERM MEASURED FROM?



Our research shows that the typical period between first and final closing remains 12 months.

TIME PERIOD BETWEEN THE FIRST CLOSING AND THE FINAL CLOSING



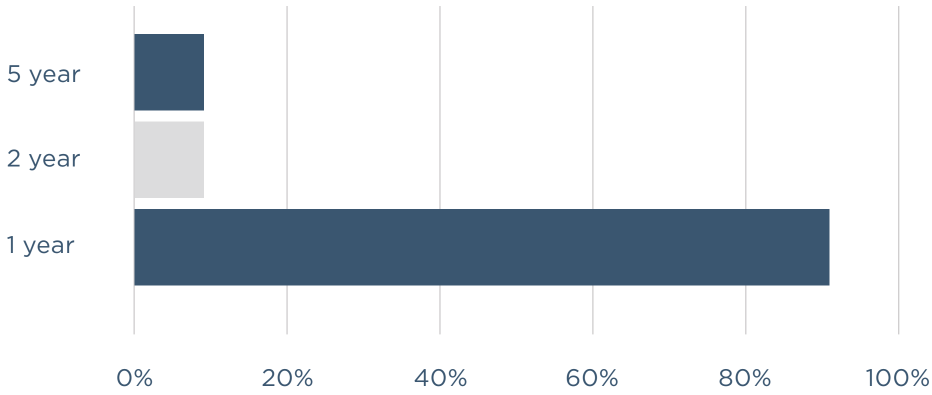
> **First or final closing has remained the most common and appropriate reference for the start of a fund term. The typical period between first andfinal closing has also remained static at 12 months.**

EXTENSIONS

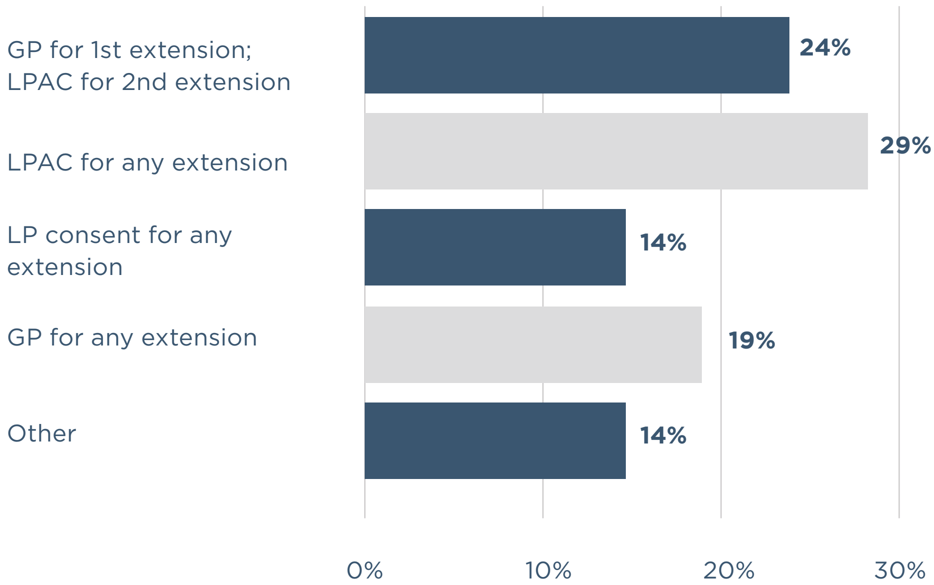
Fund extensions are most commonly permitted by one-year increments; and for a maximum of two years. While our data shows that a minority of funds allowed for greater increments, these were sector of fund specific divergences and, in our view, do not represent a trend.

In respect of the approval mechanism for extensions, traditionally GPs have most commonly approved at least the first of these extensions without the consent of investors or the advisory committee. Data from this year shows an increasing trend towards a variety of formulations, with the advisory committee commonly having a key role in extension decisions – either deciding the first and second extensions or only the second after the GP has decided the first.

IN WHAT INCREMENTS ARE FUND EXTENSIONS PERMITTED?



WHAT IS THE APPROVAL MECHANISM FOR EXTENSION OF THE TERM?



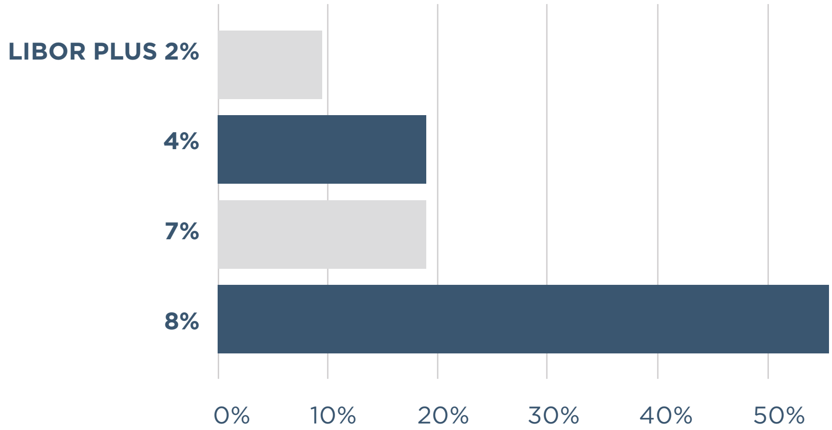
PART 7
FUND FORMATION

FURTHER CLOSINGS

Where investors are admitted to funds after the first closing, such investors are often required to contribute an amount in interest on the amount of capital contribution which would have been drawn down if they had been admitted to the fund at first close (in order to put the investor and the GP in the position they would have been in if the investor was admitted to the fund at first close and to not disadvantage investors admitted to the fund at earlier closings).

There are various rates and bases of interest set by GPs – the most common of which is 8%.

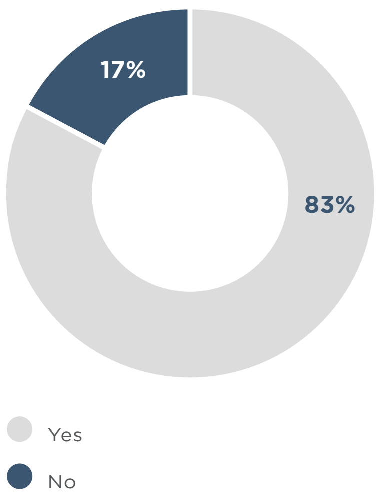
INTEREST RATE PAYABLE BY LIMITED PARTNERS JOINING THE FUND AFTER FIRST CLOSE



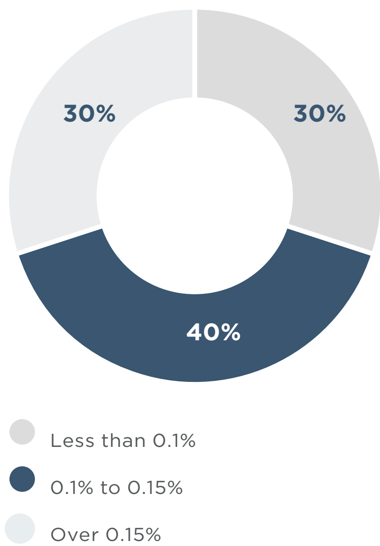
It is also worth noting that there have been fewer examples this year of firms using an interest rate which tracks LIBOR. This is suspected largely to reflect the change in the wider market where there has been a move away from using LIBOR as a reference rate (as LIBOR is being replaced in 2021). Please see part 9 of this report (Funds regulatory developments 2018-19 and outlook for 2020) for further details.

ORGANISATIONAL EXPENSES

IS THERE A CAP ON ORGANISATIONAL EXPENSES?



WHAT PERCENTAGE OF THE TARGET FUND SIZE IS THE CAP ON ORGANISATIONAL EXPENSES?



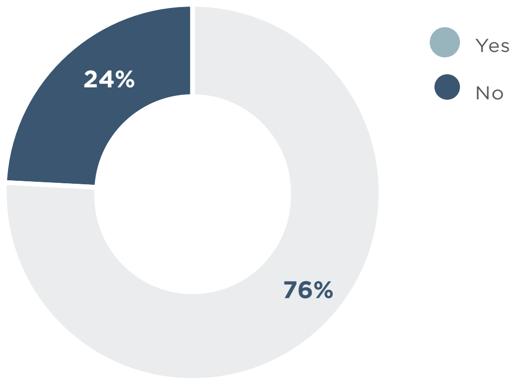
“Our data this year shows that fund documentation reflects the continued trend towards providing a cap upon expenses incurred in order to establish the fund, the general partner, and any fund-related vehicles.

We have seen over the last year that the cap on the level of organisational expenses has increased, with GPs often citing greater regulatory costs and increased investor negotiation as an explanation.

Over recent years, funds have moved from often not providing for a cap on organisational expenses, to this being hard-wired when funds initially go out to market. Such a limit on costs charged to the fund (and therefore investors) gives comfort that unnecessary costs will be kept to a minimum. Our data this year shows that fund documentation reflects the continued trend towards providing a cap upon expenses incurred in order to establish the fund, the general partner, and any fund-related vehicles.

We have however seen over the last year that the cap on the level of organisational expenses has increased, with GPs often citing greater regulatory costs and increased investor negotiation as an explanation. Investors are nonetheless conscious of these increased organisational expenses caps and greater diligence and negotiation on this point may therefore be expected.

ARE THE ORGANISATIONAL EXPENSES SUBJECT TO OFFSET AGAINST MANAGEMENT FEE?



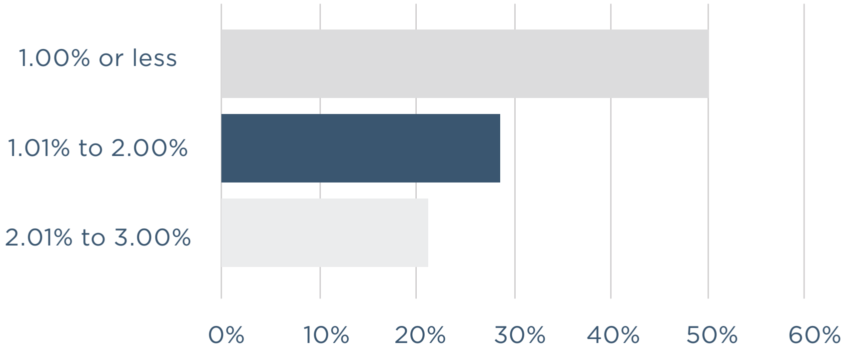
Typically, organisational expenses within the cap will be borne by the fund, and expenses incurred in excess of the cap will either be borne directly by the GP or will offset management fees. Our data shows that, in the last 12 months, nearly three quarters of expenses in excess of the cap went to offset management fees.

GP COMMITMENT

It is standard practice for the GP to make a financial commitment to the fund on the same basis as the investors in order to demonstrate 'skin in the game'. This is seen as an important driver in the alignment of interests between GPs and investors.

GP commitment is most commonly calculated on the basis of commitments. However, in the funds sampled, there was a range of formulations used, reflecting we believe that GP commitments are increasingly subject to individual fund and manager circumstances rather than simply following a calculation based on commitments to the fund.

GP COMMITMENT



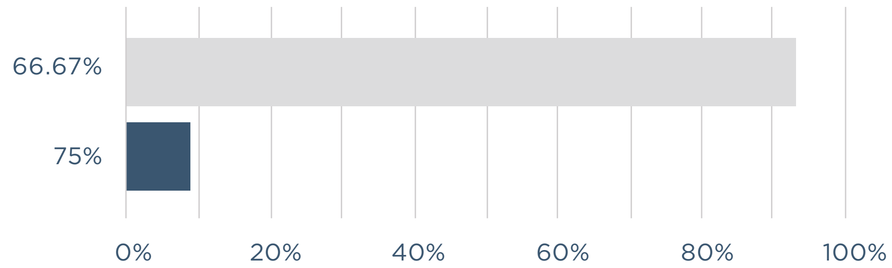
GPs and investors are now largely in agreement that commitments should be funded in cash, rather by way of a waiver of management fees.

Our data indicates that the most common level of GP commitment in funds sampled over the last 12 months is 1% or less. However, we believe this result is predominantly due to a larger number of the sampled funds (as compared to 2017/18) being global 'mega funds' seeking to raise multiple billions of dollars. Our data also indicates that there is an increasing number of funds, where the GP commitment is over the 'traditional' level of 2%; although this is sometimes structured using a management fee offset rather than in cash. However, there is enough evidence to suggest that there is a desire across the manager and investor divide for greater alignment of interests through increased levels of co-investment from management teams.

SUCCESSOR FUNDS

Almost universally, in funds where documentation contained a restriction relating to when the GP could establish a successor fund, GPs were required to have first invested (or committed for investment) 662/3% of capital commitments to the existing fund. This shows a marked change from last year's sample where GPs were most commonly required to have invested 75% of capital commitments to the existing fund. Our view is that this trend reflects both the high level of 'dry powder' in the market currently, together with increasing competition (leading to challenges) in relation to the deployment of capital. However, the effect is to bring to the fore the importance of provisions surrounding allocation of investment opportunities between existing and successor funds in fund agreements; and it will be interesting to see how investors and managers tackle this issue over the coming year.

WHERE THERE IS A SUCCESSOR FUND RESTRICTION, WHAT PERCENTAGE OF COMMITMENTS OF THE FUND MUST BE INVESTED BEFORE THE MANAGER CAN ESTABLISH A SUCCESSOR FUND?



PART 8
FUNDS FINANCE

GROWING FOCUS ON THE MARKET AND LPA TRENDS

The trend in recent years towards greater focus on the use of subscription line (also known as capital call) and other debt facilities at a fund level has continued in 2018-19. This is continuing to have an impact on fund documentation for European investment funds.

On the lender side, the European Fund Finance market has continued to strengthen with further new entrants (both banks and non-bank financial institutions) joining established participants. This has been driven by the attraction of lending into investment funds, which often have diversified institutional investor bases and investment portfolios, in a low interest rate environment. It has also been driven by increasing demand from GPs (and from investors) for the products which the market offers.

Amongst investors, there has been an increasing awareness of the growing Fund Finance market and also the importance of understanding the financing strategies that a GP is intending to use at fund, as well as portfolio company, level.

With this greater visibility and focus on Fund Finance, there has continued to be an impact when it comes to fund documentation: the days when some GPs stayed deliberately silent or opaque on the use of financing have long since gone.

Whilst the details of the provisions in fund documentation vary significantly (depending on the type of fund, the amount of flexibility that a GP is seeking in its mandate and the appetite of investors in relation to the use of financing at fund level), it is standard for LPAs to:

- specify whether the fund can borrow on a short-term or long-term basis (or both) – and in relation to short-term borrowing often to set out what this means (with a range between 6 and 12 months being typical)
- set out the purposes for which borrowing can be used, which can include one or more of: making new and follow-on investments, paying organisational and other fund expenses, covering short-term cash flow issues (e.g. if there is a defaulting investor), paying management fees and providing leverage for the fund
- include limitations on the amount of borrowing which can be incurred or guaranteed at fund level – limitations are usually set by reference to one or more of:
    - a percentage of the total commitments in the fund – with 20-25% being common, though lower or higher levels are seen depending on the nature of the fund
    - a percentage of the total amount of uncalled commitments
    - the value of the fund’s assets

- expressly permit security to be granted over investors uncalled commitments to the fund (and the power of the GP or manager to issue drawdown notices on investors), and sometimes also to be secured by the fund's portfolio investments

- set out whose obligations the fund can guarantee or secure. This can sometimes be extremely wide and encompass portfolio companies, investment holding companies, feeder funds and parallel, alternative investment and co-investment vehicles, but in some funds will be much more restrictive

The trend towards a greater focus on the use of subscription line and other debt facilities at a fund level is expected to continue. GPs will continue wanting to be able to demonstrate they have the right financing strategies in place for their funds, but also that they are being transparent with their investors on what these are: in marketing materials, fund documentation and ongoing reporting. Investors will continue wanting more and clearer information in this area – as evidenced by the use of subscription line facilities being one of the main topics covered in the ILPA Principles 3.0, launched by the Institutional Limited Partners Association in June 2019.

For further details of our funds finance expertise and capability, please speak to:

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PART 9
FUNDS REGULATORY DEVELOPMENTS 2018-19 AND OUTLOOK FOR 2020

Whilst 2019 has not been a year for major new pan-European regulatory change initiatives, it has nevertheless been another busy year for regulatory developments affecting the investment management sector, a trend that easily looks set to continue into 2020 and beyond.

MIFID II IMPLEMENTATION

Many fund managers will have spent significant time and resource in 2018 and part of 2019 to bed down changes brought in by MiFID II[1], in particular around increased transparency vis-à-vis investors on best execution and implementing the strict requirements in relation to payment for market research, with many investment managers now paying for research from their own balance sheet.

AIFMD REVIEW

The beginning of 2019 saw the release by the European Commission of its AIFMD report[2] and marked the start of the Commission's formal review of the AIFMD, a process that will continue into 2020. Significantly, there has been some speculation that the Commission is now likely to drop the implementation of the third country passport. The third country passport would have enabled non-EU fund managers to manage or market alternative investment funds across the EU on the basis of their local authorisation. For now, it looks like non-EU managers wishing to manage EU funds will either have to do so through establishing a physical and locally authorised presence in the EU or, alternatively, through sub-manager models. As for marketing funds, non-EU managers will have to continue to rely on national private placement regimes which differ from country to country. This is a potentially significant development for UK fund managers because following Brexit, and subject to any transitional arrangements, they will become non-EU fund managers.

The Commission is expected to indicate in Q1 of 2020 which other parts of the AIFMD[3] framework will be clarified by either formal guidance or amendments to the AIFMD rulebook.

Hotly tipped for further clarification are the valuation rules in article 19 of the AIFMD and how they apply to "hard to value" asset classes, such as real estate. Particular difficulty has arisen with the concept of unlimited liability for an external valuer in the case of negligence. Negligence has not been defined in the AIFMD and is interpreted differently across member states. This means that many valuation service providers have been reluctant be appointed as external valuer due to the uncertain liability profile.

The Commission may also put forward measures to simplify the notification and disclosure regime for acquisitions in non-listed companies which will be of interest to private equity fund managers.

IMPROVEMENTS TO THE CROSS-BORDER MARKETING REGIME FOR AIFS

The European Parliament and Council recently adopted a directive[4] and a regulation[5] amending the legal framework for the cross-border distribution of investment funds in the EU with the aim to facilitate the cross-border marketing of investment funds. Most of the measures will apply from August 2021.

Of particular note is the introduction of a harmonised definition of "pre-marketing" and an express recognition that pre-marketing may take place in advance of a marketing passport being obtained for particular EU jurisdiction. Significantly, this will allow EU fund managers to distribute draft fund prospectuses in respect of both established and yet to be established funds as part of testing the market. This is currently not possible in some EU countries under local interpretations of the AIFMD regime.

[1] MiFID II Directive (Directive 2014/65/EU) and the Markets in Financial Instruments Regulation (Regulation 600/2014/EU), together with implementing measures. In the UK, the FCA extended the implementation of many MiFID II requirements to alternative investment fund managers.

[2] Report on the operation of the alternative investment fund managers directive (AIFMD), published on 10 January 2018

[3] Alternative Investment Fund Managers Directive (Directive 2011/61/EU) and Commission Delegated Regulation 231/2013/EU together with implementing measures

[4] Cross-Border Distribution of Collective Investment Undertakings Directive (Directive 2019/1160/EU)

[5] Cross-Border Distribution of Collective Investment Undertakings Regulation (Regulation 2019/1156/EU)

ESG

Given wider geo-political and environmental events and trends, it is unsurprising that environmental, social and governance (ESG) compliant investment strategies have become increasingly popular with fund managers and investors. This is a particularly wide and complex field with many regulatory and industry initiatives.

At a European level, three key legislative measures that will impact fund managers are at different stages of finalisation and implementation. These are the Disclosure Regulation[6], Taxonomy Regulation[7] and the Low Carbon Benchmark Regulation[8]. Much of the technical detail on these measures remains to be settled. However, broadly speaking, these measures will have a real impact on how fund managers will present ESG information to investors, the integration of ESG considerations into portfolio management processes and measuring sustainability. This will remain an area of strong regulatory focus in 2020 with several of the measures potentially applying from as early as Q4 2020.

LIBOR – THE LONG FAREWELL

The phasing out of the London Inter-bank Offered Rate (LIBOR) by the end of 2021 will have a significant impact on fund managers and portfolio companies. The use of LIBOR in the investment management world is widespread and includes the use of LIBOR as reference rate for portfolio construction and calculation of returns on investments. Moreover, debt and derivative contracts entered into by funds or held at the level of portfolio companies often use LIBOR as reference rate and in many cases the contractual fall back rates in such contracts will not be a suitable long term replacement. We expect that in 2020 fund managers will need to put significant resource and time into identifying their “LIBOR exposure” and working with counterparties to renegotiate contracts to transition away from LIBOR as well as keeping investors informed.

WOODFORD & RENEWED REGULATORY FOCUS ON ILLIQUID ASSET FUNDS

The suspension of the Woodford Equity Income Fund in the UK during the summer brought renewed attention to funds holding illiquid assets, in particular open-ended funds capable of being sold to retail investors. In September 2019 the UK’s FCA published a first set of measures directed at managers of Non-UCITS Retail Schemes with a particular focus on funds investing in property and dealing with investor disclosure, mandatory suspension and liquidity risk management.

For now, managers of private funds structured as closed-ended funds and solely offered to professional investors are out of scope of these new rules but are well advised to monitor future FCA work. As experience has shown, measures first adopted in a retail fund context can foreshadow future developments in the private funds arena.

The European Securities and Markets Authority (ESMA) has also published a set of detailed guidelines on liquidity stress testing. The scope of the guidelines includes leveraged closed-ended alternative investment funds which could capture a number of real estate, private equity or infrastructure funds that employ leverage. The guidelines will apply from 30 September 2020.

FUND MANAGER GOVERNANCE

Many UK domiciled fund managers will now be in the final stages of implementing the detailed requirements of the FCA’s senior management and certification regime. The regime already applies to banks and insurance firms and regulates individuals in financial services firms. It comes into effect for all FCA authorised firms on 9 December 2019. Whilst UK private fund managers seem to be generally on track to implement by the deadline, many firms are likely to continue optimising their internal governance and HR processes well into 2020 with an emphasis on training staff on their obligations under the new conduct code rules.

[6] Regulation on disclosures relating to sustainable investments and sustainability risks (Regulation 2018/0179(COD)) (draft))

[7] Regulation on Framework to facilitate sustainable investment (Regulation 2018/0178(COD) (draft))

[8] Regulation on low carbon benchmarks and positive carbon impact benchmarks (Regulation 2018/0180 (COD)(draft))

[9] The FCA has agreed the necessary cooperation arrangements with its European counterparts and with ESMA and these will underpin the regulators' supervision of post-Brexit delegation arrangements.

BREXIT

Brexit has continued to pose challenges for fund managers and investors throughout 2019 with uncertainty over the terms of the UK's exit from the EU, the shape of any transitional arrangements and the future long term relationship between the UK and EU.

Several UK fund managers have put in place, or drawn up for future implementation, plans for a partial relocation of functions to EU member states and the establishment of EU regulated entities in order to continue to benefit from management and marketing passporting rights. Dublin and Luxembourg are unsurprisingly emerging as the most popular destinations. Many of these models rely on the continued ability of an EU affiliate to delegate certain functions, in particular portfolio management, back to the UK[9]. Over time local EU regulators are likely to scrutinise closely how these delegation arrangements operate in practice and whether local EU entities meet substance requirements.

A further area of considerable uncertainty is the availability of unilateral local transitional arrangements in case of a "hard"/"no deal" Brexit (i.e. the UK leaving the EU without a deal and without a transitional period). Several EU member states have announced or implemented such contingency arrangements to allow UK firms to continue servicing local investors, however often with considerable uncertainty as to precise scope and steps required to take advantage of such measures.

For further details of any of the issues set out in this section, please speak to:

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