

Institutional Limited Partners Association

Private Equity Principles



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ILPA Private Equity Principles

Historically, the private equity partnership structure has been effective in aligning the interests of investors (the “limited partners”) with those individuals managing the money (the “general partner”). By sharing a substantial portion of profits with the general partner and requiring the general partner to have a meaningful equity interest in their own funds, a business culture was created where most private equity firms were able to maintain a single-minded determination to maximize returns on the underlying investments. The principles contained herein are a means to restore and strengthen the basic “alignment of interests” value proposition in private equity.

Certain terms and conditions that have gradually evolved should receive renewed attention in private equity partnership agreements entered into prospectively in order to (i) correctly align interests between general partners and limited partners, (ii) enhance fund governance and (iii) provide greater transparency to investors. A summary of private equity principles is provided below. Appendix A contains details on preferred private equity terms, and Appendix B contains best practices for Limited Partner Advisory Committees (“LPAC”).

The concepts contained in these documents reflect suggested best practices and are intended to serve as a basis for continued discussion among and between the general partner and limited partner communities with the goal of improving the private equity industry for the long-term benefit of all its participants. These documents were developed through the efforts, contributions and collaboration of many institutional private equity investors and their senior investment officers, the Institutional Limited Partners Association (“ILPA”) and the Private Equity Principles and Best Practices Committee of the ILPA Board of Directors. They reflect the input and feedback from these market leaders and from discussion amongst limited partners at ILPA roundtable events and from a comprehensive survey/questionnaire of the ILPA membership. A list of organizations that endorse the ILPA Private Equity Principles will be posted on the ILPA website (www.ilpa.org).

With the typical limited partnership agreement and related documents numbering well over a 100 pages and containing thousands of clauses it has become increasingly difficult to focus on what aligns the interests of the limited partner with the general partner. These documents will serve as an educational medium. The authors and sponsors of these documents are not seeking the commitment of any private equity investor to any of the outlined terms.

Best Practices in Private Equity Partnerships

Alignment of Interest

- The agreed profit split in commingled funds has typically worked well to align interests, but tighter distribution provisions must become the norm in order to avoid clawback situations.
- Clawbacks must be strengthened so that when they are required they are fully and timely repaid.
- Management fees should cover normal operating costs for the firm and its principals and should not be excessive.
- All transaction and monitoring fees charged by the general partner should accrue to the benefit of the fund, including offsetting management fees and partnership expenses during the life of the fund.
- The general partner should have a substantial equity interest in the fund to maintain a strong alignment of interest with the limited partners, and a high percentage of the amount should be in cash as opposed to being contributed through the waiver of the management fee.
- Changes in tax law that personally impact members of a general partner should not be passed on to limited partners in the fund.
- Fees and carried interest generated by the general partner of a fund should be directed predominantly to the professional staff and expenses related to the success of that fund.

Governance

- General Partners should reinforce their duty of care. The “gross negligence, fraud, and willful misconduct” indemnification and exculpation standard should be the floor in terms of what is agreed to by limited partners. Recent efforts by the general partner to (1) reduce all duties to the fullest extent of the law, (2) demand the waiver of broad categories of conflicts of interests and (3) allow it to act in its sole discretion even where a conflict exists should be avoided.
- Investments made by the general partner should be consistent with the investment strategy that was described when the fund was raised.
- The general partner should recognize the importance of time diversification during the stated investment period as well as industry diversification within the portfolio.
- A supermajority in interest of the limited partners should have the ability to elect to dissolve the fund or remove the general partner without cause. A majority in interest of the limited partners should have the ability to elect to effectuate an early termination or suspension of the investment period without cause.
- A “key-person” or “for cause” event should result in an automatic suspension of the investment period with an affirmative vote required to reinstate it.
- The auditor of a private equity fund should be independent and focused on the best interests of the partnership and its limited partners, rather than the interests of the general partner.
- Limited Partner Advisory Committee meeting processes and procedures should be adopted and standardized across the industry to allow this sub-body of the limited partners to effectively serve its role.

Appendix B serves as a model.

Transparency

- Fee and carried interest calculations should be transparent and subject to limited partner and independent auditor review and certification.
- Detailed valuation and financial information related to the portfolio companies should be made available as requested on a quarterly basis.
- Investors in private equity funds should have greater transparency as requested with respect to relevant information pertaining to the general partner.
- All proprietary information should be protected from public disclosure.

Appendix A

Private Equity Preferred Terms

Alignment of Interest

Carry/Waterfall

- **Waterfall structure**
 - A standard all-contributions -plus-preferred-return-back-first model should be recognized as a best practice.
 - Enhance the deal-by-deal model:
 - Return of all realized cost for given investment with continuous makeup of partial impairments and write-offs, and return of all fees and expenses to date (as opposed to pro rata for the exited deal),
 - For purposes of waterfall, all unrealized investments should be valued at lower of cost or market,
 - Require carry escrow accounts with significant reserves (30% of carry distributions or more) and require additional reserves to cover potential clawback liabilities.
 - Carry should only be paid on recapitalizations once full amount of invested capital is realized on each investment that was recapitalized.
 - The preferred return should be calculated from the day capital is contributed to the point of distribution.
- **Calculation of carried interest**
 - Carried interest should be calculated on the basis of net profits (not gross profits).
 - No carry should be taken on current income.
 - Carried interest should be calculated on an after-tax basis (i.e., foreign or other taxes imposed on the fund should not be treated as distributions to the partners).
- **Clawback**
 - Clawback liabilities, if any, should be determined and clearly disclosed to the limited partners as of the end of every reporting period. The disclosure should be accompanied by a plan by the general partner to resolve the clawback.
 - All clawback amounts should be gross of taxes paid and paid back no later than two years following recognition of the liability.
 - Joint and several clawbacks should exist to encourage effective escrows and other general partner mechanisms to ensure clawback repayment.

Management Fee and Expenses

- **Management Fee Structure**
 - The General Partner should provide prospective limited partners with a fee model for the fund at formation to be used as a guide to set management fees.
 - Management fees should be based on reasonable operating expenses and reasonable salaries, so that fees are not excessive.
 - Management fees should step down significantly upon the formation of a follow-on fund and at the end of the investment period.
- **Expenses**
 - The management fee should encompass all normal operations of a general partner to include, at a minimum, overhead, staff compensation, travel, and other general administrative items as well as interactions with limited partners.
 - The Limited Partner Advisory Committee should review partnership expenses annually.
 - Placement agent fees and general partnership insurance should be an expense borne entirely by the general partner.

Term of Fund

- Fund extensions should be permitted in 1 year increments only.

General Partner Fee Income Offsets

- All transaction, monitoring, directory, advisory, and exit fees charged by the general partner should accrue 100% to the benefit of the fund.

General Partner Commitment

- The general partner should have a substantial equity interest in the fund to maintain a strong alignment of interest with the limited partners, and a high percentage of the amount should be in cash as opposed to being contributed through the waiver of management fees.
- Principals should be restricted from transferring their interest in the general partner in order to ensure alignment with the limited partners.

Standard for Multiple Product Firms

- Key-persons should devote substantially all their business time to the fund and its parallel vehicles. No general partner or any principal may close or act as general partner for a fund with substantially equivalent investment objectives and policies until after the investment period ends, or the fund is invested, expended, committed or reserved for investments and expenses.
- The general partner should not invest in opportunities that are appropriate for the fund through other investment vehicles unless such investment is made on a pro-rata basis under pre-disclosed co-investment agreements established prior to the close of the fund.
- Fees and carried interest generated by the general partner of a fund should be directed predominantly to the professional staff and expenses related to the success of that fund.

Governance

Fiduciary Duty

- Generally, reinforce the fiduciary duties of the general partner.
- Avoid provisions that allow general partner to reduce all fiduciary duties to the fullest extent allowed by law.
- Avoid provisions that allow general partner to use its sole discretion and weigh its own self-interest against the interest of the fund.
- Avoid provisions where limited partners acknowledge and waive broad category of conflicts or affiliated transactions.
- Require general partner to present all conflicts of which it is aware of to the Limited Partner Advisory Committee for review and seek prior approval for any material conflicts and/or non arm's length interactions or transactions.
- Require a review of all affiliated transactions and approval by the Limited Partner Advisory Committee.
- Allow general partner removal for bad acts upon preliminary determination, not by a final court decision not subject to appeal. The termination of the individual responsible for such actions should not be deemed to be a cure or remedy.
- Avoid provisions that allow general partner and its affiliates to be exculpated or indemnified for conduct constituting a material breach of the partnership agreement, breach of fiduciary duties, or other “for cause” events.
- Cap indemnification expenses as a percentage of total fund size.
- Situations impacting a principal’s ability to meet the specified “time and attention” standard should be disclosed to all limited partners and discussed with, at a minimum, the Limited Partner Advisory Committee.
- Any amendment to the limited partnership agreement should require the approval of a supermajority in interest of the limited partners.

Style Drift/Investment Purpose

- The investment purpose clause should clearly and narrowly outline the investment strategy.
- Any changes or modifications to investment strategy should be disclosed and approved by a supermajority in interest of the limited partners.
- The general partner should recognize the importance of time diversification during the stated investment period to avoid over-concentration in short time periods by considering limitations on the amount of capital that can be called on an annual basis from limited partners. Funds should have appropriate limitations on investment and industry concentration (excluding sector-focused funds).
- Explicit limitations or restrictions should be placed on investments in debt instruments, publicly traded securities, and pooled investment vehicles.

Stronger No-Fault Rights and Withdrawal Rights

- No fault rights upon majority in interest vote of limited partners for the following:
 - Suspension of commitment period
 - Termination of commitment period
- No fault rights upon a two-thirds in interest vote of limited partners for the following:
 - Removal of the general partner
 - Dissolution of the Fund

Key-Man, Time & Attention, and For Cause Provisions

- Automatic suspension of investment period, which will become permanent unless two-thirds of limited partners in interest vote to re-instate within 180 days, when a key-man event is triggered or for cause (fraud, material breach of fiduciary duties, material breach of agreement, bad faith, and gross negligence).

Independent Auditor and Independent Fund Counsel

- The external auditor of the fund should not perform other services for the general partner and/or its affiliates whenever practicable.
- Limited partners should ratify any change in the independent external auditor of the fund.
- The external auditor should certify that allocations and distributions have been done pursuant to the partnership agreement and that the capital accounts are correct. Management fee and carried interest calculations should be reviewed and certified by the auditor.
- The external auditor should review the partnership expenses charged to the partnership and certify that any charges were consistent with the partnership agreement.
- Upon request of the Limited Partner Advisory Committee, the fund should make available to the Limited Partner Advisory Committee separate counsel that is independent from the general partner and does not perform work for the general partner or its affiliates.

Limited Partner Advisory Committee Meeting Best Practices

- See Appendix B.

Transparency

Management and Other Fees

- All fees (i.e., transaction, financing, monitoring, management, redemption, etc.) generated by the general partner should be periodically disclosed and classified in each audited financial report and with each capital call and distribution notice.

Capital Calls and Distributions

- With each distribution, the general partner should disclose the exact amount of carry and provide build-up to carry calculation.
- Greater detail on all capital calls should be provided, including percentages for each limited partner and detail in calculation (including offsets) of management fees.

Disclosure Related to the General Partner

- As requested, the economic arrangement of the general partner, the principals and any other third-party investors in the general partner as well as the organizational structure of the general partner and its affiliates shall be fully disclosed to prospective limited partners as part of the due diligence process. Specifically, the following should be disclosed as requested:
 - The capitalization of the fund
 - Profit sharing splits among the principals, including vesting schedules
 - Individual commitment amounts by the principals making up the general partner commitment

- Carried interest and other general partner related cash or stock incentives taken by the general partner as a part of its roles and responsibilities on partnership investments should be disclosed to the limited partners.
- The economic arrangement of the general partner and its placement agents should be fully disclosed as part of the due diligence materials provided to prospective limited partners.
- Any inquiries by the United States Securities and Exchange Commission (SEC) or any other regulatory bodies in other jurisdictions must be immediately disclosed to limited partners.
- Limited partners should be notified of any changes to personnel and immediately notified when “key-man” provisions are violated.

Management Company Activities

- Other activities related to the management company of the general partner should be disclosed in writing to limited partners. Such activities include but are not limited to:
 - Formation of public listed vehicles
 - Sale of ownership of management company to other limited partner(s)
 - Public offering of shares in management company
 - Formation of other funds dedicated to alternative strategies

Financial Information

- **Annual Reports.** Funds should provide the following information at the end of each year (within 75 days of year-end) to investors:
 - Audited financial statements (including a clean opinion letter from auditors and a statement from the auditor detailing other work performed for the fund);
 - Internal Rate of Return (“IRR”) calculations prepared by the fund manager (that clearly set forth the methodology for determining the IRR);
 - Schedule of aggregate carried interest received;
 - Breakdown of fees received by the manager as management fees, from portfolio companies or otherwise;
 - Breakdown of partnership expenses;
 - Certification by auditor that allocations, distributions and fees were effected consistent with the governing documentation of the fund;
 - Summary of all capital calls and distribution notices;
 - Schedule of fund-level leverage, including commitments and outstanding balances on subscription financing lines or any other credit facilities of the fund;
 - Management letter describing the activities of the fund directed to the LPAC but distributed to all investors; and
 - Political contributions made by placement agents, the manager or any associated individuals to trustees or elected officials on investor boards.
- **Quarterly Reports.** Funds should provide the following information at the end of each quarter (within 45 days of the end of the quarter) to investors:
 - Unaudited quarterly profit and loss statements also showing year-to-date results;
 - Schedule showing changes from the prior quarter;
 - Schedule of fund-level leverage, including commitments and outstanding balances on subscription financing lines or any other credit facilities of the fund;
 - Information on material changes in investments and expenses;
 - Management comments about changes during the quarter
 - If valuations have changed quarter-to-quarter, an explanation of such changes; and
 - A schedule of expenses of the general partner

- **Portfolio Company Reports.** A fund should provide quarterly a report on each portfolio company with the following information:
 - Amount initially invested in the portfolio company (including loans and guarantees);
 - Any amounts invested in the portfolio company in follow-on transactions;
 - A discussion by the fund manager of recent key events in respect of the portfolio company;
 - Selected financial information (quarterly and annually) regarding the portfolio company including:
 - Valuation (along with a discussion of the methodology of valuation);
 - Revenue;
 - Debt (terms and maturity);
 - EBITDA;
 - Profit and loss;
 - Cash position; and
 - Cash burn rate
- Performance information for prior funds using both IRR calculation and multiple of invested capital model;
- IRR information for prior funds on both a gross and net basis;
- An explanation of the derivation of IRR;
- Whether the general partner provides performance information to be included in any standard private equity benchmarks;
- Disclosure of agents and sub-agents used; and
- Political contributions made by placement agents, the manager or any associated individuals to trustees or elected officials on investor boards.
- **LP Information.** A fund should provide the following information to all limited partners promptly upon closing, and should update such information when it changes:
 - A list of limited partners, including contact names and contact information, excluding those limited partners that specifically request to be excluded from the list; and
 - Closing documents for the fund, including the final version of the partnership agreement and side letters.

Due Diligence

- **Fund Marketing Materials.** Marketing materials in respect of a fund should include the following information:
 - Values for each unrealized portfolio company in prior funds based on most recent audited financials;
 - Explanation by general partner of those values that deviate from the audited statements;
 - Description of any pending or threatened litigation;

Limited partners receiving sensitive information as described above must keep such information confidential. Agreements should clearly state that limited partners may discuss the fund and its activities amongst themselves. Limited partners should support the general partner in taking appropriate sanctions against any limited partner that breaches this confidentiality.

Appendix B

Limited Partner Advisory Committee

Background

Due to inconsistency in Limited Partner Advisory Committee (“LPAC”) practices including, but not limited to, the lack of uniformity in the size, formation, role, responsibilities and effectiveness of the LPAC, attached is a set of “Best Practices” to improve effectiveness and efficiency both for the LPAC and the overall fund.

LPAC Formation

During the formation of the LPAC, the general partner should adhere to the following protocol:

- 1 The general partner should issue a formal invitation to those limited partners it has agreed to invite. Such invitations should provide
 - Information about the meeting schedule;
 - Expense reimbursement procedures;
 - An outline of the LPAC’s responsibilities under the partnership agreement; and
 - A statement of indemnification.
- 2 Simultaneously with each closing, the general partner should compile a list of LPAC members and their contact information and circulate this list to all limited partners, providing an updated list if and when any information is changed.
- 3 The LPAC generally should be made up of seven to eight voting representatives of limited partners, with larger funds having as many as 12 members, representing a diversified group of investors. A reasonable number of non-voting observer seats should be made available to certain limited partners.
- 4 At any time during the life of the partnership, any additions/substitutions of new LPAC members should be done by mutual consent of the LPAC and general partner with timely notification to all limited partners.
- 5 A standing LPAC meeting agenda should be developed and a calendar established as far in advance as possible.
- 6 Clear voting thresholds and protocols should be established, including requiring a quorum of 50% of LPAC members when votes are taken.
- 7 LPAC members should receive no remuneration, but the partnership should reimburse their reasonable expenses in serving on the LPAC.

LPAC Meeting Protocol

The general partner should use the following protocol during the organization and holding of LPAC meetings:

- 1 LPAC meetings should be held in person at least twice a year with an option to dial-in telephonically.
- 2 There should be separate LPAC meetings for separate funds as opposed to meetings that cover multiple funds. Any meeting requiring a vote of the LPAC should be held with only the members of that specific fund's LPAC in attendance. For convenience, LPAC meetings and/or members may be pooled when general topics are discussed.
- 3 A portion of each LPAC meeting will be set aside for an "in camera" session with only the limited partners present. Limited partners may elect one to three members of the LPAC to lead the discussion and report back to the general partner.
- 4 At any time, any two members of the LPAC should have the right to call for an LPAC meeting. This meeting should be arranged by the general partner if requested.
- 5 At any time, any member of the LPAC may add an agenda item to the LPAC meeting agenda subject to a reasonable notice requirement (10 days) to the general partner.
- 6 With any request for consent or approval by a fund's LPAC, the general partner will send to each LPAC member a memorandum providing background information on the matter at least 10 days in advance of the meeting.
 - i. A conference call should be scheduled by the general partner with the fund's LPAC members to discuss the consent or amendment under consideration and address any questions or comments.
 - ii. The LPAC should reserve the right to request that the general partner send the consent or amendment to the broader limited partner base for vote even if the limited partnership agreement allows the LPAC to make the decision. The LPAC reserves the right to express their opinion on the matter to other limited partners.
- 7 All decisions made by the LPAC shall be provided to all limited partners within a reasonable time period.
- 8 The LPAC should have access to partnership auditors to discuss valuations. A representative from the audit firm should attend each year-end LPAC meeting.
- 9 The LPAC should have access to independent auditors, advisors and legal counsel at the expense of the partnership or of the general partner.
- 10 The partnership should indemnify members of the LPAC.
- 11 The general partner should take minutes at all LPAC meetings. LPAC meeting minutes should be circulated to LPAC members within 30 days and submitted for approval at the next LPAC meeting.
- 12 The general partner should record all votes taken during conference calls or at meetings and maintain a copy of consents obtained in writing, by facsimile, or by email. Detailed voting records should promptly be made available by the general partner to any LPAC member upon request.

LPAC Duties

Limited Partner Advisory Committees should have the core responsibilities of approving transactions that pose conflicts of interest, such as cross-fund investments and approving the methodology used for portfolio company valuations. In addition, the LPAC is ideally suited to engage with the general partner on discussions of partnership operations, including but not limited to:

- **Auditors** – disclosure of conflicts, discussion regarding changes.
- **Operations** – disclosure of general partner’s operating budget, income statement and balance sheet.
- **Compliance** – with the partnership agreement (e.g., investment purpose and restrictions).
- **Partnership expenses** – disclosure of costs expensed to the partnership versus absorbed as part of the management fee.
- Investments by the general partner outside of the fund that create or may create conflicts with their fiduciary duty to the fund.
- **Fees and carried interest calculations** – disclosure to LPAC and subject to independent auditor review and certification.
- **Human resources** – disclosure of material changes in personnel.
- **Strategy** – discussion of changes to the investment strategy.
- **New business initiatives of the firm** – discussion with LPAC in advance.
- **Valuation of portfolio companies** – Valuation policy and practices should be documented by the general partner and reviewed with the LPAC. Changes in policy, practices, or application should be discussed with the LPAC. Valuation of portfolio companies should be reviewed with LPAC no less than quarterly.

Limited partners serving on the advisory committee and receiving sensitive information as described above must keep such information confidential. LPAC members should support the general partner in taking appropriate sanctions against any limited partner that breaches this confidentiality.

LPAC Member Responsibilities

Limited partners that accept a seat on the LPAC should commit the necessary time and attention to the fund. LPAC members should participate in all LPAC meetings, be properly prepared, and responsibly fulfill the duties of their role. LPAC members should be able to take into account their own interest in voting on the LPAC.

The Institutional Limited Partners Association is a not-for-profit association committed to serving limited partner investors in the global private equity industry by facilitating value-added communication, enhancing education in the asset class and promoting research and standards in the private equity industry. ILPA member organizations collectively manage approximately \$1 trillion of private equity assets.





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