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 operaing 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

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;
  - 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.

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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Private Equity Principles

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ILPA Private Equity Principles

The Institutional Limited Partners Association ("ILPA") released the Private Equity Principles (the "Principles") in September 2009 to encourage discussion between Limited Partners ("LPs") and General Partners ("GPs") regarding fund partnerships. These Principles were developed with the goal of improving the private equity industry for the long-term benefit of all its participants by outlining a number of key principles to further partnership between LPs and GPs. Over the past year, ILPA has heard numerous success stories regarding improved communication between LPs and GPs. To that end, the Principles are off to a great start in achieving the goals that were originally envisioned.

In order to make ongoing improvements to the Principles, ILPA committed to solicit additional feedback from both the LP and GP communities throughout 2010. After reflecting on the extensive input from these discussions, the ILPA Best Practices Committee drafted a new version of the Principles. This release retains the key tenets of the first Principles release while increasing their focus, clarity and practicality.

We continue to believe three guiding principles form the essence of an effective private equity partnership:

1. Alignment of Interest

2. Governance

3. Transparency

The three guiding principles are elaborated upon further in the following sections to introduce the revised preferred private equity terms and best practices for Limited Partner Advisory Committees ("LPAC").

These preferred private equity terms and best practices may inform discussions between each GP and its respective LPs in the development of partnership agreements and in the management of funds. ILPA does not seek the commitment of any LP or GP to any specific terms. They should not be applied as a checklist, as each partnership should be considered separately and holistically. We recognize that a single set of terms cannot provide for the broad flexibility of market

circumstance and therefore we emphasize the importance of LPs and GPs working in concert to develop the same set of expectations when entering into any particular partnership. We believe that careful consideration to each of these preferred private equity terms and best practices will result in better investment returns and a more sustainable private equity industry.

In line with the spirit of the Principles, we encourage all LPs to be transparent in their consideration and application of these Principles. A list of organizations that endorse the ILPA Private Equity Principles is posted on the ILPA website (ilpa.org).

The remainder of the document comprises three sections on Alignment of Interest, Governance, and Transparency and three appendices on LPAC Best Practices (Appendix A), Carry Clawback Best Practice Considerations (Appendix B) and Financial Reporting (Appendix C).

Each section starts with a general discussion of the application of the three guiding principles and continues with detail on specific aspects or points of emphasis. The detail should always be seen as subordinate to the more general principles. The appendices are offered as "deeper dives" into specific topics of broad relevance or great complexity. The appendix on LPAC Best Practices is a completely redrafted version of the original Appendix A, reflecting considerable input from GPs. The appendix on Carry Clawback is new, and given the complexity of this subject, it was deemed worthy of outlining suggestions for what we all hope will be a rare contingency. Appendix C covers GP reporting best practices. "Standardized Reporting Templates" are being developed concurrently. Going forward, ILPA will consider issuing further appendices to address similar topics as industry best practices continue to evolve. Suggestions for such consideration should be submitted to the ILPA.

Alignment of Interest

Alignment of interest between LPs and GPs is best achieved when GPs' wealth creation is primarily derived from carried interest and returns generated from a substantial equity commitment to the fund, and when GPs receive a percentage of profits after LP return requirements are met.

GP wealth creation from excessive management, transaction or other fees and income sources, reduces alignment of interest. We continue to believe that a GP's own capital at risk serves as the greatest incentive for alignment of interests. GP equity interests in funds primarily made through cash contributions result in higher alignment of interest with LPs compared to those made through the waiver of management fees.

We continue to believe that an all-contributions-plus-preferred-return-back-first waterfall is best practice. In situations where a deal-by-deal waterfall is used, the accompanying use of significant carry escrow accounts and/or effective clawback mechanisms will help ensure LPs are fully repaid in a timely manner when the GP has received carry it has not earned.

We recognize alignment of interests can be achieved through many different combinations of the elements stated above or indeed, through new approaches. Alignment of interest must be evaluated in giving consideration to each of these elements in totality.

CARRY/WATERFALL

Waterfall Structure

- A standard all-contributions-plus-preferred-return-back-first model must 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 must be valued at lower of cost or fair market value
  - Require carry escrow accounts with significant reserves (30% of carry distributions or more) and require additional reserves to cover potential clawback liabilities
- The preferred return should be calculated from the day capital is contributed to the point of distribution

Calculation of Carried Interest

- Alignment is improved when carried interest is calculated on the basis of net profits (not gross profits) and on an after-tax basis (i.e. foreign or other taxes imposed on the fund are not treated as distributions to the partners)

- No carry should be taken on current income or recapitalizations until the full amount of invested capital is realized on the investment

Clawback

- Clawbacks should be created so that when they are required they are fully and timely repaid

- The clawback period must extend beyond the term of the fund, including liquidation and any provision for LP giveback of distributions

- Appendix B serves as a model given this is an area of considerable complexity

MANAGEMENT FEE AND EXPENSES

Management Fee Structure

- Management fees should be based on reasonable operating expenses and reasonable salaries, as excessive fees create misalignment of interests

- During the formation of a new fund, the GP should provide prospective LPs with a fee model to be used as a guide to analyze and set management fees

- Management fees should take into account the lower levels of expenses generally incident to the formation of a follow-on fund, at the end of the investment period, or if a fund's term is extended

Expenses

- The management fee should encompass all normal operations of a GP to include, at a minimum, overhead, staff compensation, travel, deal sourcing and other general administrative items as well as interactions with LPs

- The economic arrangement of the GP and its placement agents should be fully disclosed as part of the due diligence materials provided to prospective limited partners. Placement agent fees are often required by law to be an expense borne entirely by the GP

TERM OF FUND

- Fund extensions should be permitted in 1 year increments only and be approved by a majority of the LPAC or LPs

- Absent LP consent, the GP must fully liquidate the fund within a one year period following expiration of the fund term

GENERAL PARTNER FEE INCOME OFFSETS

- Transaction, monitoring, directory, advisory, exit fees, and other consideration charged by the GP should accrue to the benefit of the fund

GENERAL PARTNER COMMITMENT

- The GP should have a substantial equity interest in the fund, and it should be contributed in cash as opposed to being contributed through the waiver of management fees
- GPs should be restricted from transferring their real or economic interest in the GP in order to ensure continuing alignment with the LPs
- The GP should not be allowed to co-invest in select underlying deals but rather its whole equity interest shall be via a pooled fund vehicle

STANDARD FOR MULTIPLE PRODUCT FIRMS

- Key-persons should devote substantially all their business time to the fund, its predecessors and successors within a defined strategy, and its parallel vehicles. The GPs must not close or act as a 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 GP 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 GP of a fund should be directed predominantly to the professional staff responsible for the success of that fund
- Any fees generated by an affiliate of the GP, such as an advisory or in-house consultancy, whether charged to the Fund or an underlying portfolio company, should be reviewed and approved by a majority of the LPAC

Governance

The vast majority of private equity funds are based on long-term, illiquid structures where the GP maintains sole investment discretion. LPs agree to such structures based on their confidence in a defined set of investment professionals and an understanding of the strategy and parameters for the investments.

Given that a Limited Partnership Agreement ("LPA") cannot make advance provision for all circumstances and outcomes, LPs need to ensure that the appropriate mechanisms are in place to work through unforeseen conflicts as well as changes to the investment team or other fund parameters. An effective LPAC enables LPs to fulfill their duties defined in the partnership agreement and to provide advice to the GP as appropriate during the life of the partnership. The role of the LPAC is discussed further in Appendix A.

TEAM

The investment team is a critical consideration in making a commitment to a fund. Accordingly, any significant change in that team should allow LPs to reconsider and reaffirm positively their decision to commit, through the operation of the key-man provisions:

- Automatic suspension of investment period, which will become permanent unless a defined super-majority of LPs in interest vote to re-instate within 180 days, when a key-man event is triggered or for cause (e.g. fraud, material breach of fiduciary duties, material breach of agreement, bad faith, gross negligence, etc.)
- Situations impacting a principal's ability to meet the specified "time and attention" standard should be disclosed to all LPs and discussed with, at a minimum, the LPAC
- LPs should be notified of any changes to personnel and immediately notified when key-man provisions are tripped
- Changes to key-man provisions should be approved by a majority of the LPAC or LPs

INVESTMENT STRATEGY

The stated investment strategy is an important dimension that LPs rely on when making a decision to commit to a fund. Most LPs commit to PE funds within the context of a broad portfolio of investments – alternative and otherwise – and select each fund for the specific strategy and value proposition it presents. The fund's strategy must therefore be well defined and consistent:

- The investment purpose clause should clearly and narrowly outline the investment strategy
- Any authority to invest in debt instruments, publicly traded securities, and pooled investment vehicles should be explicitly included in the agreed strategy for the fund
- Funds should have appropriate limitations on investment and industry concentration and may consider investment pace limitations, if appropriate
- The GP should accommodate a LP's exclusions policy, which may proscribe the use of its capital in certain sectors and/or jurisdictions. However, consideration of increased concentration effects on remaining LPs and transparency of process and policies must be requisite in the event of a non-ratable allocation

FIDUCIARY DUTY

Given the GP's high level of discretion regarding operation of the partnership, any provisions that allow the GP to reduce or escape its fiduciary duties in any way must be avoided:

- GPs should present all conflicts to the LPAC for review and seek prior approval for any conflicts and/or non arm's length interactions or transactions. As materiality is a subjective criterion, it is best to consult the LPAC in all instances. No GP should clear its own conflicts
- The high standard of fiduciary duty applicable to the GP should preclude provisions that allow for them to be exculpated in advance or indemnified for conduct constituting a material breach of the partnership agreement, breach of fiduciary duties, or other "for cause" events
- A majority of LPs must be able to remove the GP or terminate the fund for cause
- Conditions precedent and other removal mechanisms should be constructed so that LPs can act before there is irreparable damage to their interests. To the extent that there are mitigating factors, LPs will take these into consideration in evaluating their response to the "for cause" event
- To the extent that an all-partner clawback is appropriate in order for the fund to indemnify the GP, this should be limited to a reasonable proportion of the committed capital but in no case more than 25% and limited to a reasonable period, such as two years following the date of distribution

To assist in monitoring the GP in the performance of its fiduciary and other duties to the fund, LPs rely upon independent auditors and may need, in certain instances, other support from third parties. Independent auditors are engaged on behalf of the fund and should alert the LPAC to any known conflicts of interest in relation to performing such duties.

- The auditor should present their view on valuations and other relevant matters annually to the LPAC and be available to answer questions at the annual meeting of the fund. A list of the members of the LPAC should be provided to the auditors
- LPs should be notified of any change in the independent external auditor of the fund
- The auditors should review the capital accounts with specific attention to management fee, other partnership expenses, and carried interest calculations to provide independent verification of distributions to the GP and LP
- When considering important matters of fund governance or other matters where the GP's interests may not be entirely aligned with the LPs', a reasonable minority of the LPAC may engage independent counsel at the fund's expense

CHANGES TO THE FUND

Given the long-term nature of the PE partnership, the fund's terms and governance must be well defined upfront but also be flexible enough to adapt to changing circumstances. With appropriate protections for the interests of the GP, LPs should have the option to suspend or terminate the fund.

- Any amendment to the LPA should require the approval of a majority in interest of the LPs, and certain amendments should require a super-majority approval. Amendments that negatively affect the economics of a particular LP should require that LP's consent
- No fault rights upon two-thirds in interest vote of LPs for the following:
  - Suspension of commitment period
  - Termination of commitment period
- No fault rights upon three-quarters in interest vote of LPs for the following:
  - Removal of the GP
  - Dissolution of the Fund

RESPONSIBILITIES OF THE LPAC

The role of the LPAC has been evolving in recent years in response to (i) the requirement for increased transparency into the operations of the GP and the fund (driven by increasing emphasis on LPs' fiduciary duties); (ii) the increasing complexity brought by multi-product firms; and (iii) most recently, the strains of the financial crisis. The LPAC has no broad governance role in a PE limited partnership. Its formal responsibilities are defined by the LPA and are generally limited to reviewing and approving:

- Transactions that pose conflicts of interest, such as cross-fund investments and related party transactions
- The methodology used for portfolio company valuations (and in some cases, approving the valuations themselves)
- Certain other consents or approvals pre-defined in the LPA

The LPAC should engage with the GP on discussions of partnership operations, including but not limited to:

- Auditors
- Compliance (including CSR/ESG/PRI)
- Allocation of partnership expenses
- Conflicts
- Team developments
- New business initiatives of the firm

However, as indicated, the LPAC is not intended to serve as a representative or proxy for the broader base of LPs and should not replace frequent, open communications between the GP and all LPs.

Additionally, an effective LPAC depends on a high degree of trust and commitment among the various parties. LPs serving on the LPAC and receiving sensitive information must keep such information confidential. LPAC members should support the GP in taking appropriate sanctions against any LP that breaches this confidentiality.

LPs 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 and should be appropriately indemnified.

Additionally, GPs should disclose the identity of certain LPs which they believe may have conflicts of interest with other LPs in a fund. The GP is in a position to determine if LP-LP conflicts may arise in selected situations, including but not limited to, (i) LPs participating in an investment "related" to the fund, such as a separate managed account which invests alongside the fund or a co-investment in one of the fund's portfolio companies, (ii) if an LP has an ownership in the GP or one of its affiliates, or vice-versa or (iii) if a LP has received preferential economic terms.

Transparency

GPs should provide detailed financial, risk management, operational, portfolio, and transactional information regarding fund investments. This enables LPs to effectively fulfill their fiduciary duties as well as to act on proposed amendments or consents. LPs acknowledge the important responsibility they bear with higher transparency in the form of confidentiality.

MANAGEMENT AND OTHER FEES

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

- All fees charged to the fund or any portfolio company by an affiliate of the GP should also be disclosed and classified in each audited financial report

CAPITAL CALLS AND DISTRIBUTION NOTICES

- Capital calls and distributions should provide information consistent with the ILPA Standardized Reporting Format

- The GP should also provide estimates of quarterly projections on capital calls and distributions

DISCLOSURE RELATED TO THE GENERAL PARTNER

The following should be immediately disclosed to LPs upon occurrence:

- Any inquiries by legal or regulatory bodies in any jurisdiction

- Any material contingency or liability arising during the fund's life

- Any breach of a provision of the LPA or other fund documents

Other activities related to changes in the actual or beneficial economic ownership, voting control of the GP, or changes or transfers to legal entities who are a party to any related document of the fund should be disclosed in writing to LPs. Such activities include but are not limited to:

- Formation of public listed vehicles

- Sale of ownership in the management company to other parties

- Public offering of shares in the management

- Formation of other investment vehicles

RISK MANAGEMENT

GP annual reports should include portfolio company and fund information on material risks and how they are managed. These should include:

- Concentration risk at fund level
- Foreign exchange risk at fund level
- Leverage risk at fund and portfolio company levels
- Realization risk (i.e. change in exit environment) at fund and portfolio company levels
- Strategy risk (i.e. change in, or divergence from, investment strategy) at portfolio company level
- Reputation risk at portfolio company level
- Extra-financial risks, including environmental, social and corporate governance risks, at fund and portfolio company level
- More immediate reporting may be required for material events

FINANCIAL INFORMATION

- **Annual Reports** - Funds should provide information consistent with the ILPA Standardized Reporting[1] for Portfolio Companies and Fund information at the end of each year (within 90 days of year-end) to investors
- **Quarterly Reports** - Funds should provide information consistent with the ILPA Standardized Reporting for portfolio companies and fund information at the end of each quarter (within 45 days of the end of the quarter) to investors

LP INFORMATION

- A list of LPs, including contact information, excluding those LPs that specifically request to be excluded from the list
- Closing documents for the fund, including the final version of the partnership agreement and side letters
- LPs receiving sensitive information as described above must keep such information confidential. Agreements should clearly state that LPs may discuss the fund and its activities amongst themselves. LPs should support the general partner in taking appropriate sanctions against any LP that breaches this confidentiality

1 Appendix C outlines current reporting best practices, however, as standardized reporting templates (available on ilpa.org) continue to evolve, they are intended to encompass all reporting best practices

Appendix A: Limited Partner Advisory Committee

These best practices are offered to provide a model for LPAC duties, its role in the partnership, and meeting protocol. We recognize the differing constituencies of individual partnerships and acknowledge that one standard may not fit every situation. We believe that LPs and GPs should explicitly establish the duties of the LPAC through the LPA and mutually adopt preferred meeting protocol upon establishment of the LPAC. The role of the LPAC is not to directly govern, nor to audit, but to provide a sounding board for guidance to the GP and a voice for LPs when appropriate.

Common objectives in relation to every board should include:

- Facilitating the performance of the responsibilities of the advisory board (as defined in the LPA or by mutual agreement), without undue burden to the general partner
- Creating an open forum for discussion of matters of interest and concern to the partnership while preserving confidentiality and trust
- Providing sufficient information to LPs so that they can fulfill these responsibilities

We note that the role of the advisory board may evolve during the term of the fund, depending on the environment, the specific situation of the fund, and other considerations. The focus should clearly be on substance over form and efficiency over formalistic mechanisms. To this end, there are two points of emphasis in this revised protocol:

- The LPAC should operate as a committee, not as a collection of individual members; to this end, GPs should seek to centralize important discussions within the advisory board context, and not on a bilateral basis
- Regular provisions for an *in camera* session should be made so that LPs can speak, when appropriate, with a unified voice

LPAC Formation

During the formation of the LPAC, the GP should generally adhere to the following protocol:

- The GP should issue a formal invitation to those LPs it has agreed to invite to serve on the LPAC. Such invitations should provide:
  - Information about the meeting schedule
  - Expense reimbursement procedures
  - An outline of the LPAC's responsibilities under the partnership agreement
  - A statement of indemnification
- Simultaneously with each closing, the GP should compile a list of LPAC members and their contact information and circulate this list to all LPs, providing an updated list if and when any information is changed

- The LPAC should be made up of a small number of voting representatives of LPs, with larger funds having as many as a dozen members, representing a diversified group of investors
- Upon initial constitution of the LPAC, any replacements of LPAC members should be determined by the GP with any additional or eliminated seats to be approved by mutual consent of a majority of the LPAC and general partner
- A standing LPAC meeting agenda should be developed and a calendar established as far in advance as possible. The meeting agenda and calendar should be available to all LPs
- Clear voting thresholds and protocols should be established, including requiring a quorum of 50% of LPAC members when votes are taken
- LPAC members should receive no remuneration, but the partnership should reimburse their reasonable expenses in serving on the LPAC

LPAC Meeting Suggested Best Practices

The GP and LPAC members in each fund will determine the best way to conduct the operations of the LPAC. The following best practices are suggested to aid in developing a joint approach in line with the objectives outlined above:

Convening a Meeting:

- LPAC meetings should be held in person at least twice a year with an option to dial-in telephonically
- The GP is encouraged to convene the LPAC more frequently to discuss time-sensitive matters of importance (e.g. conflicts); in these cases, LPAC members should be flexible and responsive. With the consent of the LPAC, certain matters may be handled by written consent
- After initially consulting the GP, a minority of three or more members using reasonable judgment and discretion should have the right to call for a LPAC meeting

Agenda:

- Any member of the LPAC may add an agenda item to the LPAC meeting agenda subject to a reasonable notice requirement to the GP
- With any request for consent or approval by a fund's LPAC, the GP will use best efforts to send each LPAC member background information on the matter at least 10 days in advance of the meeting
- A portion of each LPAC meeting will be set a side for an *in camera* session with only the LPs present. LPs may elect one or more members of the LPAC to lead the discussion and report back to the GP
- The LPAC should have *in camera* access to partnership auditors to discuss valuations. A representative from the audit firm should attend each year-end LPAC meeting or annual meeting

Voting:

- 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 of other related funds may be pooled when general topics are discussed
- The partnership should indemnify members of the LPAC
- Each LPAC member should consider whether they have any potential conflicts of interest prior to voting in all circumstances. LPAC members should disclose actual conflicts to other LPAC members during discussions at LPAC meetings

Records:

- The GP 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. Once approved, LPAC minutes should be available upon request to all LPs within a reasonable time period
- The GP 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 GP to any LPAC member upon request

Appendix B: Carry Clawback Best Practice Considerations

While fortunately rare, carry clawback situations represent one of the greatest challenges to the GP/LP relationship. Appropriate processes and remedies should therefore be defined at the start of the fund, as alignment between GP and LP will usually be at a low point when they occur. The following "building blocks" should be considered with regard to clawbacks:

Seek to Avoid Clawback Situations

- Best approach is all capital back waterfalls ("European style") as this will minimize excess carry distributions
- If deal-by-deal carry, then
  - NAV coverage test (generally at least 125%) to ensure sufficient "margin of error" on valuations
  - Interim clawbacks should apply, triggered both at defined intervals and upon specific events (e.g., key-man, insufficient NAV coverage)

Ensure GPs Backstop Themselves

ILPA strongly recommends joint and several liability of individual GP members as a best practice as LPs contract with the GP as a whole rather than individual members. In cases where joint and several liability is not provided, a potential substitution would be a creditworthy guarantee of the entire clawback repayment by any of:

- a substantial parent company; OR
- an individual GP member; OR
- a subset of GP members

However, in general, repayment obligations should directly track the carry distributions. An escrow account (generally of at least 30%) may also provide an effective mechanism for clawback guarantee.

LPs should have robust enforcement powers, including direct ability to enforce the clawback against individual GPs. Actual and potential GP clawback liabilities should be disclosed to all LPs annually along with a plan to address as additional disclosure in the audited financial statements.

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Ensure Fair Treatment of Tax Burden

GPs receive tax distributions from the fund in order to pay their tax liabilities on carry (capital gains tax treatment). To the extent that the GP either does not receive (or must return) carry, there is a loss of the tax paid since there are limitations on the GP's ability to carry back losses to offset the gains on which tax was previously paid. Historically, LPs have absorbed this loss on behalf of GPs. The initial release of Principles stated that all carry clawbacks should be gross of tax, but after extensive discussions with GPs, we believe that it would be impractical to ask them to bear the cost.

However, current practice in some cases does not take into account the GP's ability to reduce the tax burden through carrying losses forward, offsetting a gain against a loss, or living in a favorable tax jurisdiction. GPs clearly should not make a profit from the LPs' willingness to bear their tax payments in clawback situations. Accordingly, instead of assuming the highest hypothetical marginal tax rate in a designated location, the rate should be based on the actual tax situation of the individual GP member and should take into account:

- Loss carryforwards and carrybacks
- The character of the fund income and deductions attributable to state tax payments
- Any ordinary deduction or loss as a result of any clawback contribution or related capital account shift
- Any change in taxation between the date of the LPA and the clawback

Any tax advances made to the GP should be returned immediately if in excess of the actual tax liability.

Fix the Clawback Formula

In essence, the clawback amount should be the lesser of excess carry or total carry paid, net of actually paid taxes. However, there are often errors in the stipulated formulas which have a material impact on fund cash flows:

- The tax amount should not simply be subtracted from the amount owed under the clawback
- The clawback formula should take the preferred return into account

Appendix C: Financial Reporting

- **Annual Reports** - Funds should provide the following information at the end of each year (within 90 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 an 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;
  - 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;
  - 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;
        - Cash burn rate
- **Capital Call and Distribution Notices –** A standardized reporting template has been developed by ILPA and is available at ilpa.org
    - Under development – standardized reporting templates to cover annual and quarterly reporting as well as supporting financial schedules

About the ILPA

The Institutional Limited Partners Association (ILPA) is a member-led not-for-profit association committed to serving limited partner investors in the global private equity industry. ILPA's mission is to provide a forum for facilitating value-added communication, enhancing education in the asset class and promoting research and standards in the private equity industry.

ILPA has grown substantially since its inception in the early 1990s to include more than 240 member organizations from around the globe. While membership is comprised exclusively of limited partners, the variety of member institutions makes the ILPA a dynamic organization representing a diverse range of interests.

The ILPA membership is united by a common goal: to enhance the professional interests of its affiliates, and ultimately, to enable them to achieve strong portfolio performance. ILPA member organizations collectively manage approximately $1 trillion of private equity assets.

For more information on the ILPA
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