Private Equity Fund Governance

Establishing Best Practices 2017

The Manager & Investor Perspective

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IFI Global and Vistra would like to thank the many GPs and LPs who kindly gave up their time to participate in this industry best practice study. This report identifies the critical issues underlying private equity fund governance, using their expert insight to determine what CFOs and COOs need to know.

Executive Summary

The influence of investors in the private equity industry is growing significantly and has never been as strong as it is today. Vistra, in partnership with IFI Global, conducted a worldwide research study investigating the current state of play in private equity fund governance. Our survey of LPs and GPs examines the significant trends, concerns and developments in private equity fund governance from both a manager and investor perspective.

Governance Absorbs an Increasing Amount of Time

Almost all of the GPs surveyed said they spend more time on governance than they used to do. Some respondents noted it is as much as 50% more than it was three years ago, whilst others estimated it to be in the 10% to 30% range. More importantly, the majority of interviewees – both LPs and GPs – expect that there will be more investor involvement in the governance structures of the private equity industry in the future.

The shift appears to be global in nature. The views expressed by GPs in Asia, Europe and the US were, on the whole, very similar on most governance matters. Equally, there were little to no geographical differences in the responses from LPs and their advisors.

Key Trends in Governance

The LPs and GPs interviewed provide a window into key industry trends around transparency, LPAC development, co-investing, outsourcing, and fund structures, offering a deep dive into these challenges and opportunities to help establish best practices for fund governance.

1. **Transparency:** An overarching theme from the research was that investors are demanding, and managers are providing, an increased level of transparency on the structure and operation of funds. Almost every GP said that they are required to introduce greater transparency around fees and performance calculations to satisfy investors. Many have also been asked for more transparency on their fund structures, their LPAC role and membership, and in some cases, their co-investing agreements.

2. **Limited Partner Advisory Committees (LPACs):** The evolving development and authority of LPACs is a clear example of the increasing involvement of investors in fund governance and the influence of their oversight of GPs. The wide variety of responses to questions on LPACs infers that the industry is a long way from establishing any standardisation of LPAC practices with a significant degree of disparity in LPAC oversight. Many of the LPs surveyed are dissatisfied with the overall governance structures employed by the private equity industry.

3. **Co-Investment:** The growth in the trend for co-investing is anticipated to continue. Both LPs and GPs highlighted challenges that are a direct result of the steep upward curve in co-investing, especially around remuneration and governance. As part of a larger trend across the asset management business toward disintermediation, co-investing is particularly popular with LPs that would like to see more transparency and lower costs in the private equity industry.

4. **Outsourcing:** The majority of GPs interviewed outsource at least some administration functions to third party providers. They say it helps them access specialist skills and is more efficient, especially for those with a global footprint. Added to which investors and regulators like funds that outsource their administration functions to third party providers.

5. **Fund Structure & Domiciles:** Offshore funds and fund partnerships, common in the US, were the most popular structures used by the GPs surveyed. There were no major shifts in domicile selection and most participants seem satisfied with the regulatory options currently available.

Oversight & Transparency in the Industry

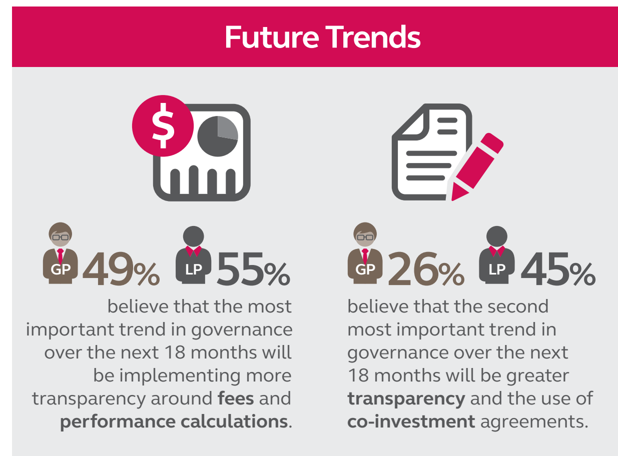
The growth in investor demand for more information and the GPs' challenges on providing appropriate and timely data is a backdrop for many of the specific issues highlighted from this research. Transparency is a contentious issue within the industry. LPs and GPs surveyed were often on different sides of the debate on what is the appropriate level of transparency for managers to employ. LPs' desire for more transparency, in part, helps explain why so many of them are enthusiastic about co-investments and are keen to be on LPACs.

Many of the LPs interviewed would like to see greater levels of transparency:

- 55% of LPs surveyed said that they want more transparency around fees and performance calculations.
- 45% want greater general transparency, including in the use of co-investment agreements.

GPs were more ambivalent on this topic. Some see the trend to greater levels of transparency as being unavoidable, whilst others believe it is becoming, as one interviewee commented, **"intrusive"**.

- Implementing more transparency around fees and performance calculations is seen as the most important trend in fund governance by 49% of GPs.
- Greater transparency in co-investing agreements is seen as the most important trend by a further 26%.



Investor Demand for Transparency Driven by Responsibility

The most enthusiastic drivers for more transparency are the LPs in the public pension fund sector. External managers that are hired by pension funds, private equity and others are seen, in effect, as their sub-contractors. One advisor to institutional investors commented, the pension fund is still **"entirely, utterly and unavoidably"** responsible for all activities that are outsourced to an external manager.

Regulation a Driving Force

Several US-based participants said the SEC, which set up a Private Funds unit recently, has played a major part in increasing investors' interest in more rigorous oversight of GPs and greater levels of transparency. Many respondents felt that the industry was unjustly tarnished by comments the SEC made publicly when taking many private fund managers to task. Nonetheless, it has pushed transparency up the agenda in the US.

> Investors are demanding, and managers are providing, an increased level of transparency on the structure and operation of funds.

The Evolution of LPACs

Results from this study suggest that LPAC development is in transition. Most survey respondents – LPs and GPs – expect that the role played by LPACs in the industry will grow further. A GP at a European buyout firm indicated that the movement in LPAC development suggests that these entities could eventually be performing the same functions as a corporate board.

LPAC Membership Variety

There was a lack of consensus on how GPs determine the use of the LPAC and who should ultimately join them. Some of the LPs surveyed would like the selection process to be more transparent. Decisions on who joins the LPAC break down into the following four broad categories:

1. **Size:** This was the most popular criterion for selection. Most GPs surveyed select LPs by the size of their allocation. If an LP's allocation constitutes at least 10% of the fund, it is generally thought that they have a right to be on the LPAC.

2. **Contribution:** Approximately one-fifth of GPs surveyed say that they select LPAC members by whether they are **"sensible, professional and user-friendly".** GPs in this category often made the point that they want intelligent and experienced people on their LPAC, so that they can use the meetings as a sounding board and for guidance. **"We don't want them just to sit there and nod; they should challenge,"** said a lower to mid-market UK manager.

3. **First in:** A number of GPs stated that who is on their LPAC is determined by the first to commit capital over a certain size. One GP commented, **"LPACs should be for the cornerstone investors."**

4. **Proportionality:** Proportional selection was mentioned less often than the other reasons given. But as a criterion for LPAC selection, it is growing. Proportional selection aims to represent all of the LPs in the fund, including selection by investor size, sector, country and region. This study came across GPs that take proportional selection very seriously and do it on a quasi-scientific basis. For example, one of the GP respondents noted how selection is made is based on the total assets of each LP, and other details. This GP also said that the intention is to make the process entirely transparent. However, the majority of GPs in this proportional selection category do it more randomly. The larger group stated **"we try to get a mix of LPs"** or **"we like to have a variety."**

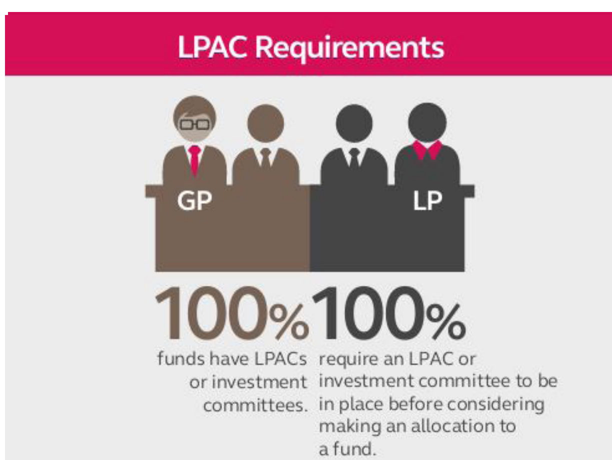
The Scope of LPACs

There is some confusion in the industry as to what exactly the role and responsibility of LPACs are. Regarding LPACs, one advisor to a UK-based LP said that they are **"extended due diligence sessions. They have no power. They can't veto something. They have no legal role or sanction."**

The following are aggregate responses from the GPs surveyed regarding what LPACs are used for (listed in descending order of mentions):

- Conflicts of interest issues
- Going beyond allocation limits
- Fund term changes/fund extensions
- Advisory for doing something new or different
- Investment strategy reviews
- Updating mechanism for progress with the fund
- Any matter that LPs need to take to Counsel

Many GPs surveyed stated that LPs are getting more actively involved in the details at LPAC meetings. Typically, they ask questions that focus on whether the structure of the operation is ideal for the fund size and their stake in it.



LP Focus on LPACs is Growing

One of the largest LPs surveyed said his organisation allocates to 87 private equity funds and is on the LPAC for 86 out of 87 of these funds. No LP interviewed for this study said that they would consider making an allocation to a private equity fund unless there is an LPAC in place. And a number of these admitted to agitating for a place on the committee.

Some of the LPs surveyed use consultants to do due diligence on the LPAC members, particularly those that would like to join the committee. Some also ask to see minutes of previous meetings to get a sense of how professional they are.

Another advisor to a pension fund said that they tell their clients that the scope of reference for LPACs is critically important. The type of questions asked include whether the minutes of the meetings are available to all LPs and how conflicts are resolved between the LPAC and the board of the fund (if there is a board). One LP said that having a professional and serious LPAC is the best response from GPs to the issues raised by the SEC and in the media regarding fund governance practices.

Investors are finding LPACs to be increasingly useful oversight vehicles – even without formal governance responsibility. Some LPs want to know that there is someone on the LPAC in the same investor category as them—someone who is allocating a similar amount and who can act as their de facto representative. A number of smaller LPs commented there is a growing trend for **“observer status”** roles.

LPACs Are Evolving

The CEO of a major due diligence firm, which acts on behalf of many LPs, said that his impression of LPACs has changed recently. He believes that quite a few of them were used as much for client entertainment purposes as anything else. But these days, those types of LPAC meetings are the exception rather than the rule.

A New York-based advisor believes there is still some resistance to LPAC development in the US. He noted that if LPACs acquire real power, developing into something beyond an advisory committee, it could create legal problems. The LPs on the committee might end up having legal liability for the decisions that they make. This advisor had first-hand knowledge of investors who would not serve on LPACs for fear of incurring any form of liability by doing so. Family offices and Sovereign Wealth Funds are sometimes reluctant to be on the committee because of this.

A leading US private equity lawyer said that the driver of LPAC development in the US is the SEC. The SEC has made clear to the private equity industry that investors should be consulted on fund changes. The choice is either a vote of all LPs or an LPAC, viewed as a representative committee of investors.

80% of LPs surveyed are in favour of further professionalisation of LPACs. If they are not on it themselves, they like to know who is. A number of LPs and their representatives made the point that how well the LPAC is run tells them a considerable amount about the fund manager.

> 100% of the LPs surveyed are dissatisfied with the overall governance structures employed by the private equity industry.

Co-investment: A Growing Trend

The PE sector is witnessing a major shift towards co-investing. One GP commented that around 70% of LPs now want it. **“There is huge interest from LPs,”** said a mid-market technology manager. Another GP forecasts that the size of co-investing deals will get smaller as the market for these arrangements grows bigger.

Almost all of the GPs and LPs interviewed expect that there will be further sizeable growth of co-investing in the future. The results of this research suggest that this is coming from all investment areas, not just the largest LPs surveyed. For example, platforms are being built for smaller investors, like family offices, so they can get in on the co-investing boom. But the fee model is different for these platforms than traditional co-investments. The parties participating in co-investment deals via this arrangement are agreeing to the kind of fees that they would expect to pay in a normal fund.

One of the largest GPs surveyed said that almost all of the deals that they do now have a co-investing element to them. The challenge his firm faces is in determining what LPs to do co-investments with at any given point, since there are so many that want them.

There are two different co-investing models that were referred to: the deal specific arrangement, which usually do not have governance problems, and the more common ‘programmatic’ arrangement, which can have governance problems.

Mixed Opinions

Responses to questions on co-investment show that there are a wide variety of views, some of which are passionately held, especially by GPs who are antagonistic to its growth.

Growth in Co-investment

73%

welcome the growth in co-investment that has taken place over the last 5 years.

A global US-based mid-market buyout firm believes that the growth in co-investing is necessary, but, overall, an unwelcome development. A UK-based special situations manager thinks the trend to more co-investment is unhealthy for the industry. Another GP commented that the growth in co-investment is a result of the industry giving in to it. **“Our arms are twisted behind our backs by LPs,”** he said. **“Weaker members of the community have caved in and it means we have to follow.”**

The greatest antagonism expressed to the co-investing trend came from GPs with a large cost base; they are more invested in preserving the traditional structure of the private equity industry.

Co-Investment Offers Benefits All Around

The vast majority of LPs interviewed like co-investing arrangements. Reasons given were as follows (in order of mentions):

- Fee arrangements
- Alignment of interests
- Transparency
- Liquidity
- Understanding the investment process better

The main reasons GPs gave for the growth in co-investing are:

- It allows deals to be done that are too big for the fund (either from a risk or portfolio management perspective)
- It gets GPs closer to LPs

Co-Investment is Not Without Challenges

A number of institutions made the point that whilst co-investing improves deal transparency and reduces fees, it can add to risk. Others said the opposite, noting that doing homework on the deal reduced the risk in the co-investment. Either way, it helps LPs understand more about the GP's investment process. One UK based LP said, **"It lowers our fees but doubles our exposure."**

Investors are seeking to develop their in-house expertise, so co-investing is a helpful first step. But one advisor to LPs said that this is a dangerous trend. He fears investors in this category think that they are capable of doing the deals themselves.

The majority of GPs interviewed, including those that embrace the growth of co-investing, accept that it presents a number of governance challenges, such as:

- Scale vs. profitability: It requires GPs to pursue the largest deals available, rather than the best ones
- Difficulty in ensuring viable long-term flow of fees for GPs as the industry becomes more dominated by co-investing arrangements
- Should GPs be charging more? Should a 10% carry be standard? **"We can't survive on no fees,"** said one GP
- Cutting corners because of fee reductions. A number of respondents suggested that there is a temptation for GPs not to do everything that they would do in a normal fund arrangement because of the fee reductions
- How GPs determine who to co-invest with at any given time
- How to deal with complaints from smaller investors who do not have the internal teams to turn around due diligence quickly and are, therefore, cut out of co-investing arrangements
- The lack of independent research that is often carried out on co-investments' preferential rights on deals to favoured (large or cornerstone) investors

The Industry Should Accept and Adapt

The results of this research suggest there is a need to establish some common governance guidelines for the growth of co-investing, so it can successfully exist alongside traditional private equity fund structures. Co-investing is currently seen by some smaller LPs and GPs as creating conflicts alongside traditional funds.

The remuneration models employed in co-investing arrangements are another prominent issue. Several GPs said they cannot survive without fees and the more sophisticated LPs interviewed understand this. They are looking at various ways that GPs could be given working capital in co-investing arrangements, along with a share of the profits. This is a combined income and capital appreciation model.

The growth of co-investing, and other direct investing arrangements with GPs by institutional investors, especially UK pension funds, is changing the structure of this business more quickly than many people realise.

Traditional third party funds appear to be falling out of favour with a number of the institutions interviewed but they still want the expertise of GPs. Some pension funds surveyed are looking to make direct stakes in companies, particularly those with sustainable asset streams. This gives them a long-term stake in the business along with a seat on the board.

> The growth in the trend for co-investing is anticipated to continue, and threaten the traditional fund model.

Outsourcing: the Pros & Cons

Amongst the GPs and LPs interviewed, there is wide consensus on the trend to outsourcing – both in terms of why it is done and the benefits that it brings.

All LPs surveyed prefer the administration function to be outsourced to a third-party provider of this service. They appreciate getting reports directly from the administrator as it shows independence from the GP.

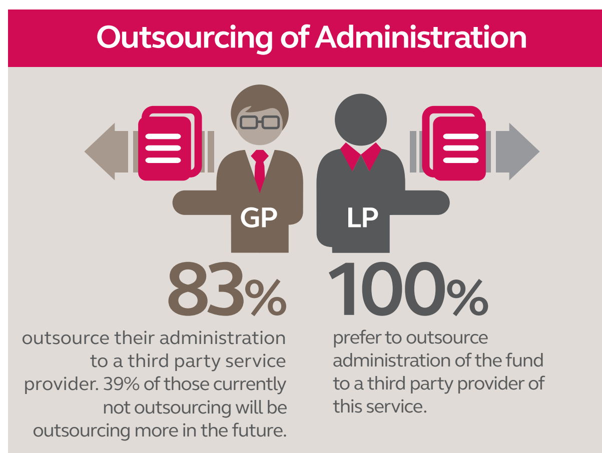
83% of GPs interviewed outsource some of their administration to third-party providers and 39% say that they expect to outsource more functions in future. For GPs, outsourcing is the preferred option for the overwhelming majority because it is liked by both investors and regulators. It also helps to access specialist skill sets that private equity managers do not have in-house.

Among the GPs surveyed, there were just a handful of dissenters to outsourcing. And those that did not outsource their administration say that they developed full transparency of this process to field due diligence enquiries from LPs.

Outsourcing is also considered by the majority of GP interviewees to be more efficient. For larger managers, they may have multiple offices and various fund structures, frequently across different jurisdictions. In those cases, it makes sense to have an outsourced specialist service provider who can provide the needed local knowledge. Third party administrators are seen as useful allies in managing local relationships for global businesses.

Here are the reasons given for outsourcing (ranked by frequency of mentions):

- Investor demand
- Fees/cost-benefit
- Expertise/Skill set ('Outsourcers are the experts')
- More efficient
- Regulators prefer it
- Scalability–Benefits of outsourcing grow with increases in size and complexity



Of the 15% of GPs that don't outsource, these are the reasons given for not outsourcing functions in the foreseeable future (ranked by frequency of mentions):

- Cybersecurity concerns
- Lack of flexibility
- Increases in fees by administrators in some jurisdictions
- Staff turnover
- Fear of trusting an external provider

The Impact of Cybersecurity on Outsourcing

Cybersecurity is a critical issue for all GPs – whether they outsource or not. Those that are considering outsourcing state that they have to be satisfied with their service providers' cybersecurity in order to proceed. And cybersecurity was the second most popular reason given by those that are opposed to doing more outsourcing. A European buy-out firm commented, **"It is about weighing up the many benefits vs. the cybersecurity issues."**

Despite some concerns over cybersecurity, flexibility and trust, the benefits of outsourcing are seen as being overwhelming by the majority of GP respondents – and all LPs – surveyed.

> The majority of GPs interviewed outsource, they say it helps them access specialist skills and is more efficient.

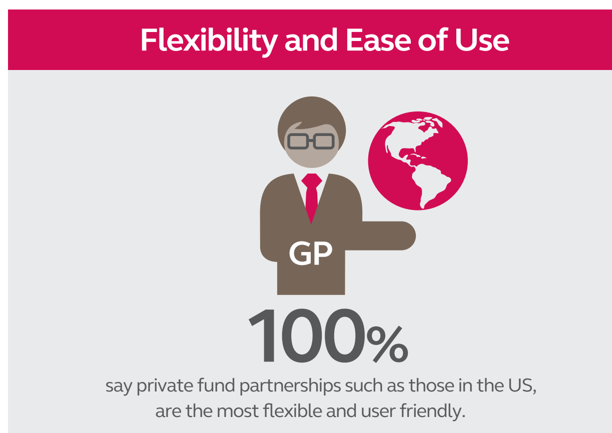
Fund Structure Preference

Questions asked about fund structures and domiciles provided some of the more variable responses. This study includes GPs that use private fund partnerships, offshore funds and regulated AIFs under AIFMD.

Some interviewees rely on just one of these structures, a number use two of them and a handful of GPs are familiar with all three. Those with views on this topic were generally GPs who operate different fund structures across multiple domiciles.

Fund Structuring Variability

Fund structuring decisions are driven by regulatory requirements, tax issues and investor preference. As this is such a geographically diverse set of survey respondents, the variability in fund structuring preferences is to be expected. For example, GPs surveyed that are only interested in the US will not be familiar with any fund structures other than private fund partnerships.



Flexibility & Ease of Use Still Important

Almost all of those with knowledge of the three different fund structures stated that private fund partnerships, such as those used in the US, are the most flexible and, as one interviewee said, **"user friendly"**. GPs said that private fund partnerships are adaptable, and investors are familiar with them. Cayman funds were also praised by GPs for their flexibility and for being relatively **"un-bureaucratic"**. A US-based mid-market buyout firm said, **"Cayman does the job that it is intended to do."**

Independent Oversight is Desirable

A number of LPs and their advisors noted the absence of independent oversight in US private partnership structures. Private fund partnerships have also fallen foul of the SEC's Private Funds Unit. The complaint from some investors and their advisors is that the absence of a board means that too many decisions are made at the GP's discretion. And it is generally the GP who determines what information is given to any oversight group, such as an LPAC.

Some LPs interviewed said that they would like to see the boards of offshore funds provide more rigorous independent oversight. There was a concern that boards can rubber stamp decisions made by the GP. But many GPs surveyed have a different perspective, especially those in the US. Their view is that current board oversight, including in Cayman, is demanding enough.

Domicile Options

GPs said that the governance standards of offshore funds vary by domicile. Many of those that use offshore fund structures made the point that Guernsey and Jersey funds have higher governance oversight standards offshore. Cayman was cited as coming under increasing scrutiny from investors as their due diligence becomes more active.

Despite the comments, no one surveyed said that they were aware of a situation where an investor had declined to allocate to a fund because of where it was domiciled.

Regulation: Benefit or Burden?

A number of GPs surveyed suggested that regulations in some jurisdictions have become unnecessarily rigorous in ways that are of no help to investors. One commented that the regulatory burden falls heavily on their offshore administrator. The extra compliance work they are required to undertake has forced them to increase their fees.

AIFMD: Necessary but Unpopular

The most critical comments received on regulatory structures were reserved for regulated AIFs. One GP said regulated AIFs, in some respects, are the **"antitheses"** of private partnership structures in the US. Another called AIFMD's depositary requirements, at least for private equity funds, **"ridiculous"**.

Several GPs with Luxembourg-domiciled AIFs were surveyed. None of them said that these structures provide investors with sufficient additional benefits to justify the extra costs that these structures incur, particularly in comparison with Channel Island-domiciled funds.

GPs surveyed that use regulated AIF structures do so to meet investors' requirements in EU countries by complying with AIFMD. Regulated AIFs are viewed as being costly and cumbersome, but compliance with the Directive is necessary to raise capital with continental European investors. In terms of fund domiciliation, Luxembourg is the main beneficiary of this development.

> There were no major shifts in domicile selection and most participants seem satisfied with the regulatory options currently available.

A Look Ahead

Governance of private equity funds and the industry is evolving more rapidly than many realise. Pressure from regulators and demands from investors are leading to significant shifts in fund governance practices.

The push for transparency continues to be one of the main factors affecting LPACs, fund structures, co-investing, outsourcing, choice of domicile, and related items.

Limited Partner Advisory Committees & Independent Oversight

One of the major findings from this research study is that LPACs will continue to evolve. However, there isn't yet a consensus on where that evolution will lead. Should there be more standardisation in the scope and the terms of reference for LPACs? LPACs could evolve into something more akin to a corporate board. Given this scenario, the legal ramifications for LPAC members remain unclear.

Private equity funds with boards might want to explore how the relationship between their LPAC and board should develop into the future. The selection of LPAC members might require a much more transparent process. This change could necessitate that boards and LPACs work more closely together than they do today.

Co-Investing Development

Transparency is also driving the growth of co-investing. However, co-investing is challenging the industry's traditional remuneration model as part of a larger trend across the investment industry towards disintermediation. Simply put, investors are looking for new and more innovative ways to work with asset managers without being in their funds. Industry players are also wondering whether or not there should be more of a consensus on the charging of carried interest in co-investments and other remuneration issues.

It's also unclear as to whether or not private equity should establish governance guidelines to address issues of concern expressed by smaller LPs about the growth of co-investing. Co-investing platforms are being built for smaller investors, such as family offices, but concern exists about possible conflicts with investors who are only in traditional third-party funds.

Outsourcing: Independence and Efficiency

The majority of LPs surveyed prefer the administration function to be outsourced, with the move certainly driven by a desire for cost-savings, as well as transparency. The trend towards outsourcing is now well established in the private equity world and, if current trends continue, it is likely that the outsourcing of administration to third party providers will eventually become universal.

Fund Structures & Domiciles

Fund structures will continue to play a role in transparency development. Regulated AIFs are generally seen as expensive and cumbersome and often ill-suited for the private equity industry, however a requirement for EU investors. While European GPs and LPs surveyed are much more familiar with Luxembourg than Ireland, Cayman remains the preferred offshore choice for US managers raising capital from tax-exempt investors.

The UK may become a more popular jurisdiction for private equity funds when the UK leaves the EU. For example, survey respondents wonder whether or not the FCA will relax depositary and other requirements under AIFMD once the UK is out of the EU. Fund structures will continue to evolve and be impacted by global economic and regulatory changes.

Transparency, Fees & Investor Involvement

Not surprisingly, transparency and cost-savings are closely linked. There are two key areas that dominate the demand for greater levels of transparency: fees and performance calculations.

Of the GPs surveyed, transparency around fees and performance calculations was seen as the most important trend in fund governance. But, what exactly is an appropriate level of transparency for fees and performance calculations? The jury is still out. This probing and questioning has led to concern by many GPs. However, the positive aspect of this is closer collaboration with investors. The direct involvement in institutional investors in LPAC's and through co-investment can be seen as an opportunity by GPs to be closer to their clients, get a more detailed understanding of their goals, gain from the investor's expertise and insight and align the understanding of value and results.

> The majority of interviewees – both LPs and GPs – expect that there will be more investor involvement in the governance structures of the private equity industry in the future.

Look to the Future: Plan Today

Depending on the issue, geography and manager, it is clear that industry trends are happening at different speeds. The consistent factor is that the scale of change is only going to become larger and the rate of change quicker. Many managers are gaining an understanding from these changes, making a plan and reacting as the future becomes clearer.

The majority of the results of this study are opinion-based and therefore qualitative.

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About the authors

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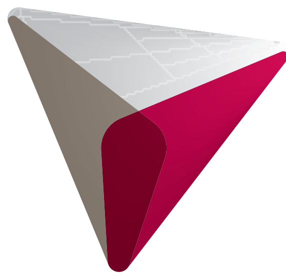

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