REPORTING OBLIGATIONS

The changing face of the LPA

Calls are growing for the standardisation of the limited partnership agreement, but moves towards uniformity are fraught with difficulties, lawyers say. By Claire Coe Smith

If there is one theme that characterises the past decade in the development of private equity's legal terms, it is the way in which the limited partnership agreement, which sets out the legal basis on which investors come into a fund, has grown in both length and complexity. But with negotiations getting ever more unwieldy, might the next 10 years bring more streamlining to the process, and even more standard terms?

The Institutional Limited Partners Association, which represents the interests of investors in private equity funds, has long called for more standardisation, but lawyers see little change on the horizon. "Fund sponsors believe they have unique approaches to investing, and that they know the secret sauce that needs to be reflected in the agreement," says Peter Laybourn, partner in the private funds group at Ropes & Gray in Boston.

"Whether they feel they need different terms to give them flexibility to execute on their strategy, or their returns outperform relative to the market, thereby enhancing bargaining power and, potentially, justifying different compensation arrangements, I don't see a single sponsor wanting a more standardised LPA. The LPs may want that, but I don't see any movement while those interests differ as much as they do today."

But that is not to say there will not be sections of the agreement that become more uniform. Jason Glover, private funds partner in the London office of Simpson Thacher & Bartlett, says: "I certainly see things getting much more prescriptive in terms of reporting obligations, with investors much more focused on standardised reporting templates that sponsors will have to adhere to. I see much more transparency resulting from that, probably done electronically, and much more conformity around the types of things that are reported, so that investors can finally compare like with like."

He also anticipates market practice emerging in areas such as environmental, social and governance criteria. "The significance of ESG is going to be massive," says Glover. "You are going to find investors being very prescriptive as to the ESG standards that need to be adopted. Investors will be more involved in coming up with parameters that go way beyond the UN Principles for Responsible Investment, and those will be hard-lined into the LPA.

"At the moment, investors are asking sponsors to do things in line with the investors' own policies, and the GPs tend only to commit to the UN principles. But I see investors becoming much more focused on coming up with a collective standard that they will expect everyone to operate to."

DIRECTION OF TRAVEL

The degree to which regulators might become more focused on private equity is anyone's guess. Michael Halford, head of Goodwin's private investment funds practice in Europe and Asia, says: "Currently, private equity funds are not regulated, but throughout my career the regulators have taken a growing interest in the industry and that looks likely to continue. I hope that in 20 years' time private equity funds do not look like fully-regulated investment products, but that does appear to be the direction of travel."

One theme that will undoubtedly force regulators to turn a spotlight on the industry is the growing demand from high-net-worth individuals to get access to private equity. Glover says that is a trend that will shape the industry moving forward: "I predict a shift away from pension funds in favour of more products being developed to enable HNWIs to participate more readily in private equity, and that will require a change in the way the LPA works. There is no question that the sheer amount of paperwork required for funds discourages individuals from coming into these funds – we do a lot of schemes for friends and family and they certainly struggle with the documentation."

Laybourn agrees and, like Glover, predicts a two-tier process emerging. "Individual investors are certainly a constituency that private equity sponsors are trying to better access to facilitate investments into private equity funds, because there's a lot of capital there that sponsors are not really able to access today beyond very wealthy individuals. The standardisation of documents for those investors will depend very much on the regulatory environment and whether the US regulators provide better access.

"I can envisage that there will be two categories of offering, with one to access retail channels that will be standardised and regulated, akin to the mutual funds market in the US, and another for institutional capital that functions much like it does today, but we seem to be ways away from that at the moment."

That retail space is the only part of

the market where Laybourn predicts the Securities and Exchange Commission will increase its intervention: "The SEC so far has been attuned to the sophistication of the institutional market participants and the relative bargaining power of investors, recognising that many of the institutional investors in private equity hire large law firms to do this and it really is a negotiation between two sophisticated parties. My guess is that they will continue to take that approach and not intervene in a well-functioning commercial arrangement between sophisticated parties."

One area where the direction of travel seems determinedly against standardisation is around negotiations on carried interest and the management fee. While the two and 20 compensation structure has been ingrained for many years, lawyers predict more flexibility emerging.

Glover says: "You are likely going to see much more flexibility around the percentage amount of carried interest charged, with different carry amounts being agreed for different funds and in particular outperforming managers being able to command much higher amounts of carry. What will become more common will be carry percentage amounts increasing according to performance, so maybe 20 percent up until the sponsor achieves 2x money back to LPs, then 25 percent from 2x to 2.5x, and maybe 30 percent once they go above 3x."

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>
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Laybourn says: "Another area where we have seen a little bit of creativity is around optionality, with some sponsors giving investors a choice between different waterfall options and other bespoke arrangements to address investor concerns."

On the management fee, Glover predicts a move towards drawdowns being varied to mitigate the impact of the J-curve, such that instead of drawdowns being the same year-on-year throughout the investment period of the fund, resulting in a fund showing negative returns in the first few years when investments are in their infancy, larger GPs may be willing to defer management fees in the early years of a fund's life.

Halford predicts that the LPA will adapt over the coming years to allow for more longer-term funds and fund extensions, in recognition of the limitations of the standard 10-year lifespan.

"We are already seeing a major change around the way the industry is dealing with the fact that funds have a fixed term of 10 years and then get extended," he says.

"Solutions for GP-led secondaries, for example, and the transferring of assets into continuation funds, as well as the formation of more longer-term funds, are a recognition that not all assets will get sold within the life of the fund. I see more things being baked into the LPA to do with GP-led secondaries and allowing for assets to be held for longer."

Advisors to both sponsors and investors recognise an opportunity for technology to smooth some elements of the fundraising process, with the potential for anti-money laundering questionnaires and subscription documents – which require investors to fill out lengthy forms documenting their suitability to invest – to be automated, perhaps with the use of barcodes.

Beyond that, few predict the process becoming a whole lot easier. Laybourn says: "These are arrangements that are heavily negotiated, with a lot of time today spent on side letters, which are getting longer and longer. It is not uncommon to get a side letter from an investor that has 40 bespoke provisions, and I don't see that trend reversing any time soon." ■