Impact Investing Private Equity Fund Industry

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GIIN The Global Impact Investing Network is a not-for-profit organization dedicated to increasing the scale and effectiveness of impact investing. Impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. For more information, please visit **www.thegiin.org**.

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FOREWORD

Dear reader,

The impact investing market is becoming increasingly prominent. Defined as investments made with the intention to generate social and environmental impact alongside a financial return, impact investments account for at least USD 46 billion assets under management, according to the GIIN and J.P. Morgan 2014 Impact Investor Survey.

Impact investing is unique in so far as it brings together investors that (a) pursue various return expectations (from concessionary to market rate), (b) have a range of risk appetites and (c) are of various legal forms (nonprofit and for-profit). Increasingly, these investors come together when investing in a pooled structure – a fund or vehicle managed by a fund manager.

In such an actively developing landscape, investors and their legal counsel would benefit from a better understanding of the various structural, tax, economic, and governance implications specific to this emerging practice. This brief, authored by the legal team at Clifford Chance, and supported by experts at the International Senior Lawyers Project, is a valuable ready reference that outlines legal issues for investors and advisors to consider when investing in impact investing funds.

The document, which focuses particularly on U.S. law and private equity fund regulation, is the culmination of months of meticulous research into existing legislation and real-world fund structures. While not a substitute for legal advice, it includes a range of general points and considerations that will be of value to for-profit and nonprofit investors as they explore making impact investments.

One of the many ways in which the GIIN pursues its mission of enhancing the scale and effectiveness of impact investing is through publishing research that bridges important information gaps in the market. In this spirit, we hope readers find the presented information useful, and thank our research partners at Clifford Chance and ISLP for their generous time and support in putting this document together.

Sincerely,

Amit Bouri
CEO, Global Impact Investing Network

1. INTRODUCTION

This briefing and related content relates to issues for both investors in and **sponsors**[1] of impact investment funds when negotiating the terms of making an investment in an impact investment fund. The impact investing sector is highly varied, incorporating various asset classes and instruments, investors and investment vehicles based in numerous jurisdictions globally, as well as investors of varying types, from foundations to pension funds to **DFIs**. The focus of this brief is on investors in private equity funds. While the issues raised for consideration may be pertinent to many fund investors and fund sponsors throughout the impact investment sector, this brief primarily references concerns for U.S.-based investors and fund sponsors, and focuses specifically on U.S. regulations of private funds.

Impact investments are investments made with the intention of generating social and/or environmental impact, as well as a financial return to their investors. The impact investing sector is growing exponentially, reported at US$10.6 billion in new commitments in 20132 and a total of US$46 billion in impact investments under management in 2013[3] in a 2014 survey by J.P. Morgan and the GIIN of 125 impact investors managing at least US$10 million. One of the keys to such growth is a better understanding of both the tools used to make impact investments, particularly private equity funds (specifically, **closed-end**, **blind-pool investment vehicles**). Over a quarter of the new commitments reported in 2013, US$2.8 billion, was raised through funds.[4] Funds reported managing US$16 billion in impact investments in 2013, over a third of total impact investments under management.[5] Impact investment fundraising continues to be on the rise and provides strong potential for increased commitments from a broad range of investors.

Private equity funds globally have the potential to grow the impact investment industry more than other structures currently available to impact investors. The relative longevity of the private equity fund industry, and the standardization and regulation of such funds and fund managers (see **Appendix C** for an in-depth discussion of U.S. regulatory issues), offer some of the best means for unlocking capital to drive social impact. Moreover, private funds provide the means for impact investors to have the greatest impact, as the pooled capital can expand the financial

1 Bolded terms appear in the Glossary.

2 Yasemin Saltuk et al, "Spotlight on the Market: The Impact Investor Survey," *J.P. Morgan* (02 May 2014): 5, accessed January 12, 2015, URL: http://www.thegiin.org/cgi-bin/iowa/resources/research/594.html.

3 Ibid, p. 21.

4 Ibid, p. 9.

5 Ibid.

resources available to address the issue that the investor wishes to impact far greater than most single investors can on their own. Private impact funds that attract non-impact investors are particularly well-placed to do this, since they are able to further grow the pool of capital by which impact investors can see their goals achieved. Furthermore, private funds allow an investor to allocate its budget across a wide portfolio of impact investments, both within a single fund and by investing in multiple funds.

There is a broad range of investors making impact investments, including high net worth individuals, family offices, foundations, endowments, public and private pension plans, DFIs, other governmental or quasi-governmental organizations (such as the IFC of the World Bank), **funds-of-funds**, insurance companies, and other institutional investors. Not all investors have clarity as to what their fellow investors' goals are in making impact investments. Though investors may meet at the annual meeting typically held by a fund after they have closed on their investment into the fund, at the point of negotiating the terms of a fund, prior to **closing** a fund investment, potential fund investors often operate in a vacuum, communicating only with the fund manager and not the other investors or potential investors.

Investors of all stripes may have both financial and non-financial objectives...

This lack of clarity, combined with the perception of some investors that their fellow investors may have competing goals in making impact investments, may lead to hesitation among certain investors about the impact investing industry or about using private fund vehicles in order to make impact investments. Some industry participants may be concerned that investors have competing aspirations in making impact investments, because they perceive certain investors as being either "impact first" or "finance first" investors. But investors of all stripes may have both financial and non-financial objectives; impact investors and non-impact investors alike may be non-profit or for-profit. Understanding the similarities and differences between various investors' goals and concerns in investing in private funds is key for the growth of the impact investing industry as a whole, and investors and fund managers alike should strive for such understanding. The focus of this briefing will be on providing that understanding, primarily with respect to investors and funds based in the U.S.

Not all investors, even within the same category or classification, have the same goals or needs when investing in private funds...

Of course, not all investors, even within the same category or classification, have the same goals or needs when investing in private funds. This is the nature of private equity funds: they are constantly evolving to grow, leverage, or improve different industries, geographical regions, or financial structures that could be sources of profit to investors, and institutional investors frequently reevaluate their investment policies to seek out different opportunities offered by the wide array of private equity fund managers. But investors are themselves pushing to be considered in the aggregate in fund negotiations and are finding strength in numbers.

For much of the 2000s, private fund investors (or as they are often referred to in the industry, "**LPs**," *i.e.*, **limited partners**, because the structure of their investment is typically as a limited partner in a limited partnership vehicle) operated in a vacuum when investing in private equity funds. Although an institutional investor committing a significant percentage of a fund's target size, anchoring an emerging manager's fund or serving some other strategic purpose of a fund manager would have greater negotiating power, smaller investors found that, other than on the margins, fund terms were often "take it or leave it," especially in the most highly sought after funds.

Following the global financial crisis and the plummeting of investment in private equity funds, certain private fund investors saw an opportunity to press for standards on economic, governance, and information-sharing terms and conditions of funds and established the Institutional Limited Partner Association, a trade organization of institutional investors in private equity funds (**ILPA**). It released the **ILPA Principles**, a description of standards for key terms in private equity funds that are generally desirable from an investor's perspective. Thus, institutional investors became more of a force to be reckoned with and, although the best-performing fund managers continued to attract capital without changing their fund terms, most fund managers increasingly catered to prospective investors.

So in the past decade or more, the pendulum has swung from being somewhat investor-friendly following the tech crash of the early 2000s to being heavily fund sponsor-favorable during the economic boom years to being more investor-friendly again following the global fiscal crisis. The private equity fund industry has benefitted as a result of this evolution, with fund terms becoming increasingly more sophisticated and nuanced with each shift. Moreover, government-imposed regulatory schemes in both the U.S. and the European Union have been on the increase in recent years, ostensibly to provide for greater protection of investors, such as through the provision of better and increased information to investors from fund managers.

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Similar to the effect that greater LP unity has had on the alternative fund industry generally, GIIN believes the industry as a whole can benefit if fund managers and investors alike strive to understand other investors' needs and concerns when investing in private impact investment funds. Public and private pension funds have long dominated the LP universe, but investors such as private foundations and DFIs are a significant presence in private impact investment funds. Appreciating how various investors' investing goals are both similar and different may be one of the keys to keeping the industry developing and thriving as a whole.

All investors typically have a similar basic approach to investing in private investment funds. Initially attracted to a potential investment based on a variety of factors, including the track record of the fund manager and the fund's investment sector, strategy, and geographical focus, all investors will want to ensure that the fund is structured in such a way as to provide for limited liability and optimal tax outcome. All investors will also focus on the fees to be paid by the fund's investors to the fund manager and on the share of the investors' profits to be allocated to the fund's **general partner**. When generally satisfied with the **economic terms**, most institutional investors will then ensure that the fund's **governance terms** and **information rights** provided to investors are satisfactory. An investor may withdraw from its consideration of the investment at any point during this process, but rarely does an investor do so purely as a result of an impasse on governance and transparency issues.

This is not to say that governance and transparency issues are minor elements of a private fund for investors. Even without a particular term, some investors might be able to take a more holistic view and weigh the risks involved, appreciating that it is content with the terms of the investment. But this approach is frequently not possible for other investors, who cannot take such risks and who must ensure that their standards are met with each investment. Certain non-economic parameters may be so fundamental to investors, having been built into the investor's charter or otherwise being part and parcel of the investor's permitted investment thesis, that no balancing of overall terms can satisfy that particular need. For example, non-profit and for-profit investors alike may have adopted the United Nations-backed Principles for Responsible Investments (**UNPRI**), which are voluntary and aspirational actions for incorporating environmental, social, and corporate governance ("**ESG**") issues into investment practices across asset classes. Some investors who have adopted UNPRI may have a "best efforts" standard. Thus, they may be satisfied that the fund investment comports with the investor's investment parameters even without the fund's adoption of UNPRI because the investor used its best efforts to cause the fund to adopt UNPRI. Other investors may not have such flexibility. Fund managers—particularly emerging fund managers—may be unaware (and therefore frustrated) that certain investors cannot trade points the way that others sometimes can. Negotiations between investors and funds can suffer as a result, though outside legal counsel can greatly assist in smoothing the way.

2. FUND STRUCTURING

Having performed the necessary initial due diligence to determine that it may wish to invest in a particular fund, whether an impact investing fund or otherwise, an institutional investor will wish to review the fund structure in order to ensure the jurisdiction of the organization of the fund (or any parallel or feeder investment vehicle being offered for investment by the investor) provides for limited liability and an optimal tax result.

LIMITED LIABILITY

Fund sponsors generally set up their funds with both the investors and the investments in mind. A fund making its investments predominantly in one country may initially consider having its fund vehicles set up in such country, or if not there, then wherever the office of the fund manager is located, in part due to familiarity with such jurisdictions and so as to minimize the legal jurisdictions applicable to deals done by the fund. But some such jurisdictions may not have a developed private fund industry that can provide the fund with clarity on how it would be treated for legal purposes. In particular, investors may not be treated as having the limited liability that they need. Whether located themselves inside or outside of the U.S., fund sponsors particularly catering to U.S. investors might set up a Delaware vehicle (typically a limited partnership) for U.S.-taxable investors and a non-U.S. vehicle for non-U.S. investors and U.S. tax-exempt investors. The non-U.S. vehicle might be set up in the closest possible time zone, such as the Cayman Islands, or if the fund anticipates having a lot of investors in other time zones, in one of multiple jurisdictions in such time zones. Numerous jurisdictions globally provide for limited liability status to passive investors in **privately offered** investment vehicles, but jurisdictions can vary in approach as to how much a passive investor might engage in fund governance before they are deemed to be participating in the management of the fund and thus lose their limited liability status. Delaware is one of the most clear as far as not ascribing general liability to investors, notwithstanding limited partners' veto rights over certain investments or participation on advisory committees that have the power to approve certain investments and conflicts of interest; this is one of the reasons it is a popular choice of investment vehicle for funds with a U.S. nexus.

TAX

Fund sponsors will also seek to set up their fund, or their multiple parallel and feeder vehicles comprising the aggregate fund, with the tax status of their potential investors in mind. While generally investors that are U.S. taxpayers and those that are treated as tax-exempt for U.S. federal income tax purposes will seek a market return on their investment, specific classes of investors are subject to special U.S. tax rules that may impact the type of investments they may make.

a. *U.S. Tax-exempt Investors*

Unrelated Business Taxable Income: Generally, U.S. investors that are exempt from taxation ("**U.S. tax-exempt investors**") under Section 501 of the U.S. Internal Revenue Code of 1986, as amended (the "**Code**"), including private foundations, prefer to invest through investment vehicles that are treated as corporations for U.S. federal income tax purposes to minimize the risk of recognizing "**unrelated business taxable income**" ("**UBTI**"). Some U.S. tax-exempt investors will manage this risk through internal structuring, but many expect that a fund will provide a feeder fund or some other "blocker" entity for the benefit of U.S. tax-exempt investors. Other U.S. tax-exempt investors are willing to recognize UBTI if they determine that investing in a **feeder fund** or "blocker" entity would otherwise result in a lower economic return.

U.S. investors that are exempt from taxation prefer to invest through investment vehicles that are treated as corporations for U.S. federal income tax purposes...

A U.S. tax-exempt investor generally will be exempt from U.S. federal income tax on its income and gains. However, this general exemption from tax does not apply to UBTI of a U.S. tax-exempt investor. Generally, UBTI includes income or gain derived from a trade or business (other than a trade or business of trading in securities) the conduct of which is substantially unrelated to the exercise or performance of the U.S. tax-exempt investor's exempt purpose or function. UBTI also includes (i) income or gain derived by such an unrelated trade or business conducted through an entity treated as fiscally transparent for U.S. federal income tax purposes, (ii) income derived by a U.S. tax-exempt investor from **debt-financed property** and (ii) gains derived by a U.S. tax-exempt investor from the disposition of debt-financed property.

By investing through a corporation, a U.S. tax-exempt investor's income derived from an investment should be limited to dividends and gain and should not be treated as UBTI, except to the extent the U.S. tax-exempt investor incurs indebtedness to acquire or own its interest in the corporation. It should be noted that an investment in a non-U.S. corporation that is treated as a "**passive foreign investment company**" (a "**PFIC**"), however, could result in materially adverse tax consequences to a U.S. investor (as discussed further below). But unless dividends paid by a PFIC that are allocated to a U.S. tax-exempt investor are characterized as UBTI, the PFIC rules will not apply to a U.S. tax-exempt investor's investment in such a PFIC.

b. U.S. Tax-exempt Investors: Private Foundations

Program Related Investments: Private foundations, a special class of tax-exempt organizations under Section 501(c)(3) of the Code ("**501(c)(3) organizations**"), can "invest" in both other 501(c)(3) organizations and for-profit organizations. To avoid the imposition of excise taxes, however, private foundations need to avoid making investments that will jeopardize their ability in both the short and long term to fulfill their charitable purpose, so called "**jeopardizing investments**." If a private foundation makes an investment that is a jeopardizing investment, but it does not qualify as a "**program related investment**" (a "**PRI**," as defined below), the private foundation is subject to a 10% excise tax on the amount of the investment. An additional 10% excise tax may be imposed on the manager of the private foundation if the manager has knowledge that the investment jeopardizes the private foundation's ability to fulfill its charitable purpose. An exception to the jeopardizing rules are investments known as PRIs.

PRIs must meet the following requirements:

- The primary purpose of the investment is to accomplish one or more exempt purposes of the foundation.
- Production of income or appreciation of property is not a significant purpose of the investment.
- No lobbying activity will be supported.

i. *Primary purpose of the investment*

A private foundation must carefully review its organizational documents and investment restrictions to determine the scope of its exempt purposes and whether a PRI is consistent with such purposes. While a private foundation can make a PRI in a for-profit organization, the private foundation must ensure that an investment significantly furthers the accomplishment of its exempt activities (other than through the generation of income to be used by the foundation for its exempt purposes) and that the investment would not have been made but for the relationship between the investment and the accomplishment of the foundation's exempt activities. For example, a private foundation whose goal is to promote a society of economically independent and engaged citizens who contribute to the improvement of their communities through programs that advance education and entrepreneurship should be able to invest in a for-profit fund that is organized for the purpose of investing in businesses in low-income communities owned or controlled by members of a minority or other disadvantaged group. An investment by the same private foundation in a for-profit fund that is organized to conserve ecologically valuable forestland, however, would not qualify as a PRI for that private foundation because the fund would not help the foundation achieve one of its charitable purposes.

While a private foundation can make a PRI in a for-profit organization, the private foundation must ensure that an investment significantly furthers the accomplishment of its exempt activities...

Additionally, if a private foundation has broad exempt purposes, it will have greater flexibility in making PRIs, while a private foundation with a narrow exempt purpose will be subject to greater restrictions in making PRIs. For example, a private foundation that has a broad exempt purpose of scientific research may be able to make a PRI in a program aimed at discovering the cure for a specific disease and a PRI in a program aimed at aiding in the scientific education of college students; but, a private foundation with an exempt purpose of finding the cure for a specific disease generally will only be able to invest in a program aimed at discovering the cure for that specific disease.

ii. ***Production of income or appreciation of property is not a significant purpose***

In order to satisfy the requirement that no significant purpose of the foundation's investment be to generate financial return, private foundations often take the view that their investment must generate little to no return. Guidance from the U.S. Internal Revenue Service (the "**IRS**") suggests that this requirement will be satisfied if, at the time the investment was made, the intent to produce income or to recognize appreciation did not constitute a significant reason for the private foundation making the investment. The fact that an investment subsequently generates market or above-market returns will not, on its own, prevent an investment from being treated as a PRI. There are no clear guidelines on how much return an investment can make yet still qualify to be treated as a PRI, and private foundations must carefully consider each investment. An important factor that is relevant to the determination of whether a significant purpose of an investment is to generate financial return is whether an investor investing solely for profit would make the investment on the same terms as the private foundation.

An important factor that is relevant to the determination of whether a significant purpose of an investment is to generate financial return is whether an investor investing solely for profit would make the investment on the same terms as the private foundation.

To minimize the risk of making a jeopardizing investment, private foundations generally seek to make investments that have returns significantly lower than returns generated by investments made by an investor solely seeking profit, and some funds will structure a private foundation's interest in a manner that will cap or limit a private foundation's return on its investment in some other way. For example, PRIs often take the form of loans bearing interest at below market rates. Private foundations may also consider making investments in hybrid corporations, such as L3Cs, which are organized and operate within the standards for PRIs (discussed further below).

iii. ***Changes in an investment***

Generally, a foundation determines whether an investment qualifies as a PRI based on the facts and circumstances at the time the investment is made and not based on later developments.Once a foundation determines that an investment is a PRI, subject to review by the **IRS**, the investment will continue to be treated as a PRI if changes to the form or terms of an investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. Generally, a change in the form or terms of an investment for the protection of the private foundation's investment will not cause the investment to cease to qualify as a PRI. A PRI may cease to be treated as such because of a "**critical change in circumstances**," such as serving an illegal purpose or a private purpose of the private foundation or its managers. If an investment ceases to be treated as a PRI, a determination would then be made as to whether the investment is a "jeopardizing investment." Private foundations should also consider whether a PRI continues to serve one of its exempt purposes after a change in the mission of the PRI.

Generally, a foundation determines whether an investment qualifies as a PRI based on the facts and circumstances at the time the investment is made and not based on later developments...

iv. ***Proposed Treasury Regulations***

In 2012, proposed Treasury Regulations were published providing additional examples of investments that qualify as PRIs. These new examples clarify that:

(i) An activity conducted in a foreign country furthers a charitable purpose if the same activity would further a charitable purpose if conducted in the United States.

(ii) The charitable purposes served by a PRI are not limited to serving economically disadvantaged individuals and deteriorated urban areas.

(iii) An investment can qualify as a PRI if the investment is made in persons that do not themselves qualify for assistance from the private foundation, but which serve as the instrument by which a private foundation's purpose is accomplished.

(iv) The presence of a potential for a high rate of return should not, by itself, prevent an investment from qualifying as a PRI (*e.g.*, an equity investment in a recycling company that could prevent pollution in a developing country can qualify as a PRI even if there is a high risk associated with the investment and a potential for a high rate of return if the company is successful).

(v) PRIs can take the form of loans with an "equity kicker" (*e.g.*, a loan to a company coupled with stock to induce the private foundation to make the loan), a loan guarantee or a guarantee and reimbursement arrangement.

Excess Business Holdings: Private foundations generally seek to avoid having "**excess business holdings**" because excess business holdings are subject to a 10% excise tax. Generally, an excess business holding is the portion of a private foundation's investment in a corporation or other entity conducting a business that is not substantially related to the exempt purposes of the private foundation and exceeds 20% of the voting power of such a corporation (or 20% of the beneficial or profits interests in such an unincorporated entity).

The excess business holding rules are not applicable to PRIs. Additionally, the excess business holding rules generally are not applicable to investments in entities that derive more than 95% of their gross income from passive sources. For these purposes, passive income generally includes dividends, interest, payments with respect to securities loans, annuities, royalties, certain rents and capital gains, and certain income from the sale of goods (if the seller of such goods does not manufacture, produce, physically receive, or deliver, negotiate the sale of, or maintain inventories in such goods).

c. *U.S. Taxable Investors*

Philanthropic Investments: A U.S. taxpayer looking to "invest" its money in organizations that generate positive social or environmental impact is faced with a threshold question from a U.S. tax perspective: whether to donate its money via a charitable contribution to an organization that qualifies as a 501(c)(3) organization, for which the U.S. taxpayer generally should be able to take a deduction for U.S. federal income tax purposes, or to invest in a fund that allows the taxpayer to receive a return on its investment, for which the U.S. taxpayer cannot take a deduction for U.S. federal income tax purposes.

While several states are creating new hybrid organizations including **L3Cs** (**Low-profit Limited Liability Companies**), **Benefit Corporations**, and **Flexible Purpose Corporations** that allow an organization to both have a philanthropic purpose and to generate a return to investors, the U.S. tax rules do not yet recognize these organizations as tax-exempt. Like an investment in a fund organized solely to generate profit, a U.S. taxpayer is not entitled to a deduction for U.S. federal income tax purposes for amounts invested in such a hybrid organization, even if the investor's expected return from its investment is below market because of the fund's emphasis on a social or environmental mission.

Investments in Fiscally Transparent Entities: Unlike U.S. tax-exempt investors, U.S. taxable investors generally prefer to invest in investment vehicles that are fiscally transparent for U.S. federal income tax purposes. Generally, an entity that is fiscally transparent for U.S. federal income tax purposes is an entity that is not subject to tax itself in the United States and would not be if it earned U.S. source income; rather, the income, losses, credits, and deductions of the entity flow through to, and are included in the income of, the equity investors in the entity. Fiscally transparent entities will also not be classified as PFICs or "**controlled foreign corporations**" ("**CFCs**"), each as described below, with respect to a U.S. taxable investor; however, U.S. investors will be subject to the PFIC and CFC regimes with respect to PFICs or CFCs held indirectly through a fiscally transparent entity.

Passive Foreign Investment Companies: In general, a non-U.S. entity classified for U.S. federal income tax purposes as a corporation will be treated as a PFIC if it meets either of the following tests for any taxable year: (1) 75% or more of its gross income is "passive income," or (2) 50% or more of its assets, based on their average value for the year, are held for the production of passive income. For these purposes, "passive income" generally includes, among other things, dividends, interest, rents and royalties not treated as earned in connection with the active conduct of a trade or business, and gains from the disposition of assets producing passive income. Certain distributions received from, and dispositions of the stock of, a PFIC could be subject to materially greater amounts of tax in the hands of a U.S. taxable investor than a comparable investment in a non-PFIC.

Investors may be able to make certain elections that could result in different tax results; however, these elections generally require either that the PFIC be publicly traded or that the PFIC provides certain information regarding its income and assets in each taxable year. U.S. taxable investors often request assurances from a fund that it will undertake to obtain the relevant information to allow a U.S. taxable investor to make such an election. However, the ability of a fund to obtain the relevant information from a portfolio company often depends on the level of control the fund has over the specific PFIC and the cost of preparing such information.

Regardless of whether any of the foregoing elections are made, an investor in a PFIC will also be required to report additional information regarding the nature of its investment in a PFIC to the IRS and U.S. taxable investors will often request assurances from a fund that it will undertake to provide the relevant information to allow the investor to comply with such reporting requirements.

Controlled Foreign Corporations: Generally, a non-U.S. entity classified as a corporation for U.S. federal income tax purposes will be classified as a CFC if greater than 50% of the total vote or value of the non-U.S. corporation is owned (applying certain attribution rules), in the aggregate, by U.S. shareholders that each own (in each case, applying certain attribution rules) 10% or more of the total combined voting power of all classes of stock of such corporation. Such 10% U.S. shareholders (that are U.S. taxable investors) will be required to include certain items in taxable income prior to the receipt of distributions. Gain from the sale of stock of a CFC will also be treated as ordinary income, and not capital gain.

An investor in a CFC will also be required to report additional information regarding the nature of its investment in a CFC to the IRS, and U.S. taxable investors will often request assurances from a fund that it will undertake to provide the relevant information to allow the investor to comply with such reporting requirements.

Other Sources of Phantom Income: In addition to the rules regarding PFICs and CFCs, certain other investments could cause U.S. taxable investors to recognize **phantom income** (i.e., the recognition of income without the contemporaneous receipt of cash sufficient to pay the corresponding tax liability). Investments directly (or indirectly through a fiscally transparent entity) in certain types of debt instruments (e.g., investments in debt instruments with interest holidays, discount securities, and payment in kind securities) could result in the recognition of phantom income.

3. ECONOMIC TERMS

In addition to considering the jurisdiction of the organization of the fund and the necessary structuring for the best tax result for the investor, all types of investors will review the key economic terms of the fund. The economic terms establish the balance between risk and reward that is perceived to drive the fund towards successful investments and divestments. The following provides a brief overview of the typical terms or ranges of terms that may be found in fund documentation and the concerns investors may have regarding such economic terms. The approach to these terms does not, as a general matter, vary between non-profit and for-profit investors (other than as noted above for private foundations seeking to make program-related investments).

DISTRIBUTIONS

a. ***Distribution Waterfall***: In setting out the agreed-on economic arrangement between the sponsor and the investors in a customary private equity fund, a **distribution waterfall** provides that the income and capital proceeds from investments allocated to each investor are split between the fund sponsor (or more specifically, typically either the general partner of the limited partnership that forms the fund or else an affiliate of the general partner that is a "**special limited partner**," sometimes referred to as the "**carried interest partner**") and the investor in an order of tiered priority. Unlike hedge funds, which pay the sponsor an "**incentive allocation**" (or "**performance fee**") on a periodic basis subject to a "**high water mark**" **test**, private equity funds generally distribute excess cash (net of fund-level expenses, liabilities, and other required reserves) as it is generated, with the lion's share being payable only upon the liquidation of an investment. At each tier of the waterfall, distributions are made in a specific ratio between the investor and the sponsor until either: (a) that tier is satisfied and the next tier is reached, or (b) the fund is wound up and the remaining assets distributed in a manner that reflects the agreed-on economics. Any amount of an investor's allocation distributed to the fund sponsor is referred to as the "**carried interest**" or simply "**carry**."

   There are typically two types of distribution waterfalls, the **whole fund** (or **return of capital**) **waterfall** and the **deal-by-deal** (or **investment-by-investment**) **waterfall**:

"Whole Fund" Waterfall: In a whole fund waterfall, all capital contributions of investors and a **preferred return** thereon are distributed to investors before the fund sponsor begins to participate in any of the carried interest. This is by far the preferred structure of investors.

"Deal-by-Deal" Waterfall: In a deal-by-deal waterfall, only the capital in respect of realized deals is returned to limited partners at each distribution and, after the preferred return thereon is distributed to the limited partners, the general partner receives any carry. Fund sponsors prefer this type of waterfall as it accelerates the receipt of carried interest. Because distribution of carried interest is accelerated, investors must be certain to have "**clawback**" rights through which they can require fund sponsors to return distributions of carried interest if, and to the extent that, when calculating the fund's aggregate profit the sponsor receives a greater proportion of profits to which it would otherwise be entitled (discussed further below).

i. ***Preferred Return/Hurdle Rate***: Whatever the waterfall's structure, the first step of the waterfall is typically the preferred return (although this is sometimes swapped with the "return of capital step"). The preferred return is the minimum return that must be received by an investor before any carry is paid to the fund manager. Preferred returns encourage fund managers to attain higher returns and force them to forgo compensation for returns at or below the threshold. The amount of the preferred return can vary from fund to fund, asset class to asset class, and year to year, but 8% is a figure commonly seen in private equity fund documentation. Preferred returns are a common feature of carried interest calculations in private equity funds; however, a preferred return can be structured in various ways, such as by using multiple hurdles and, after each hurdle, having a "catch-up" (as discussed below) to the general partner until the general partner has received a certain percentage of the profit.

The preferred return is the minimum return that must be received by an investor before any carry is paid to the fund manager...

Perceived gains from a preferred return include that it acts to discourage fund managers from taking excessive risk and motivates fund managers to realize gains in their investments more promptly. These may be counter-balanced, however, by the possible downside to this arrangement, whereby the threat of forgoing compensation may motivate fund managers to make investments that may generate higher returns or faster payouts but that also bear higher risks, which may not be in the best interests of the investors. Also, when the value of a fund declines to such a point that it is unlikely to generate a return in excess of the preferred return, the fund manager may lack incentive to continue managing the fund for the remainder of its term.

ii. ***Return of Capital***: Following (or prior to) the preferred return step is the "return of capital" step, whereby the distributions available are applied against: (i) the capital contributions made in respect of the investment generating the distribution proceeds; (ii) the capital contributions in respect of any previously realized investments (including written-off investments); and (iii) in a whole-fund waterfall only, all capital contributions previously made, including for unrealized and outstanding investments.

iii. ***"Catch-up" to General Partner & "Carry" i.e., profit-split***: In addition to the return on its monies invested togetherwith the other investors in the fund, the general partner is also entitled to a portion of the profits earned by such other investors, which is the general partner's performance-based compensation for running the fund. This "carried interest" or "carry" is typically set at 20% (lower for funds-of-funds) and will be payable to the general partner once the investors have received back their original capital contributions and preferred return thereon. This is typically achieved in two steps: first, the "catch-up" step, when the general partner receives either all or a lion's share of the proceeds until, in effect, carried interest is paid out against the profits received by the LPs as the preferred return; second, profits are divided 80% to the limited partners and 20% to the general partner. Venture capital funds typically do not have a catch-up step to their waterfalls (so the general partner never receives a true 20% of profits, though if the fund is very profitable, it will come close).

b. ***General Partner Clawback***: If earlier carried interest payments to the fund manager in hindsight appear to be overpayments, a "clawback" obligation may be imposed on the fund sponsor. This situation will typically occur when the initial investments of the fund are highly profitable, resulting in carry to the general partner, but subsequent investments are not. Thus looking across all the fund's investments in the aggregate, investors may not have received adequate distributions to satisfy their preferred return while the general partner received carry, or the investors may have received all their preferred return but the general partner may have received carry in excess of the set percentage (e.g., an amount over 20%). The obligation to return excess distributions to investors may be supported by an escrow of some amount of the carried interest or a guarantee from the individual principals or from the fund sponsor (sometimes the latter being referred to as a "keepwell letter").

c. ***Limited Partner* Giveback**: Any ability of a fund to recycle distributable or distributed proceeds aside, many funds also provide for a mechanism whereby the investors may be required to return distributions to the fund to satisfy any liabilities of the fund, sometimes even after the fund vehicle has terminated and been wound up (though more typically liabilities are limited to indemnification obligations only). Limited partners should ensure that the general partner clawback is re-calculated after giving effect to any limited partner giveback. The focus of negotiations frequently centers upon time limits and caps on the amounts to be returned, as investors want to be able to deploy distributions received for other purposes and not hold cash reserves for potential indemnity claims. It is also important for investors to ensure that the giveback provision

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is not used as a money management tool by the general partner, therefore investors prefer the giveback to be required only for indemnification, rather than fund expenses more generally.

d. ***Distributions In-kind & Valuation***: When a fund reserves the right to provide its investors with distributions of securities in lieu of cash, a number of issues arise, most fundamentally surrounding the valuation of such securities. If an investor is allocated freely tradable securities, the general partner may (assuming the return of capital, preferred return, and catch-up steps of the distribution waterfall have been satisfied) distribute the carry in cash to itself. But if the investor liquidates its shares at less than the valuation as of the date of distribution (as the price of the shares is likely to fall with other fund investors similarly attempting to sell their shares), then the general partner will have realized more than 20% of actual profit; however, such excess may not be caught by the clawback. Therefore investors like to ask for a centered trading average, whereby the value of the securities will be determined by reference not only to the value as of the date of distribution, but the five days prior and following as well.

   Valuation for securities that are not marketable is even more problematic. Not only is there no liquid market for setting price, but investors invest in private equity funds precisely to access liquidity from private markets, so if they are left with illiquid securities, the fund manager has not accomplished the endgame. Fund managers may use comparable freely tradable securities for valuation purposes (including for determining carry) and apply discounts to those comps, but how much of a discount to apply is a matter of debate. If a fund is permitted to distribute securities other than readily marketable securities, then, assuming the fund has an **advisory committee** (an "**Advisory Committee**"), the Advisory Committee may be required to approve any valuation done by the general partner or at the general partner's behest.

e. ***Alternative Returns***: The above economic terms generally relate to all closed-end, blind pool investment vehicles where third-party investors receive equity or equity-like interests in the fund. Some investors may make such a fund investment through a different route, such as acting as a lender to a fund (e.g., the U.S.'s development finance institution, the **Overseas Private Investment Corporation** (**OPIC**)), thereby receiving an earlier return on its investment as compared to other third-party investors. Though more rare, other investors may wish to ensure that they receive a portion of the carry and/or the management fee depending on their appetite for risk. Thus, if the fund sponsor so permits, they do not invest directly into the fund; rather, they arrange to invest in the "upper-tier" structure of the fund as a member of the general partner and receive a portion of the general partner's profits (as well as exposure to the general partner's unlimited liability). Other fund structures may have a number of alternative terms, particularly in relation to co-investments or other joint ventures for the acquisition or development of identified portfolio companies or other assets, or smaller club deals, in which the participants are few and well-known to one another. A general overview of the variety of fund types and structures is set forth in Appendix A hereto.

FEES & EXPENSES

a. ***Management Fees***: The fund will pay a periodic management fee to the fund manager, in order to ensure a steady stream of income to the management team and cover various costs incurred by the principals in the operation of their business prior to receipt of the carried interest, which may be several years after the fund launch. Traditionally, this is set as a fixed percentage of total commitments of the fund during the **investment period** (or **commitment period**) and is paid pari passu by each limited partner. Management fees typically are charged at a lower rate and/or on a smaller amount of assets (e.g., aggregate invested capital rather than aggregate **capital commitments**) upon the termination of a fund's investment period, the formation of a **successor fund**, or the extension of the fund's term. The management fee paid typically reduces investors' capital commitments, though some funds require investor contributions for the management fee to be paid in addition to capital contributions applied to the capital commitment.

   Many funds are offering more competitive management fee structures to investors, however, in the current fundraising environment. For example, rather than charging fees on aggregate capital commitments, management fees may be calculated at one rate for invested capital and a slightly lower rate for unused capital commitments, even during the investment period. Another method of computing management fees that has been in use for many years, but is rebounding in popularity, is charging different fee rates depending on the amount of capital committed (with fewer basis points charged for each incremental increase in an investor's capital commitment). Some funds are offering investors management fee discounts or rebates if they subscribe to the fund at the first closing.

   Many funds are offering more competitive management fee structures to investors, however, in the current fundraising environment…

   Investors also like to ensure that any other fees earned by the manager as a result of its role as fund manager offset the amount of management fees payable by the fund. These additional revenue streams may take the form of monitoring fees, director fees, or other fees paid by the portfolio companies. Historically, these fees offsets would range from 50% to 100% of the fee received depending on the type of fee (while the remainder would be kept by the manager or other affiliate), but the current trend is for all such other fees to offset the management fee 100%, dollar-for-dollar (though this may not be the case for certain types of funds, such as real estate funds, with respect to the distinct services that may be provided by affiliates of the fund sponsor). This is less of an issue to the fund manager, which realizes a tax benefit as a result of its management fee basis being lowered and therefore pays less ordinary income tax on such amount.

Management fee waiver programs, which were popular before the credit crunch, have in large measure diminished. These waiver programs allow managers to waive the receipt of management fees and apply the equivalent amount as the general partner's equity into the fund. The waiver programs depend on there being management fees in excess of what the fund sponsor requires in order to pay its operating costs and expenses, *i.e.*, amounts that can be put at risk and invested rather than expended. These waiver programs have fallen out of favor, as investors think that management fees are meant to cover management operating expenses only, and thus there should be no excess that could otherwise be invested. Excess management fees lead investors to believe that management fees that are too high—a fund sponsor's profit should come from well-managed investments that produce carry (and profits for all investors), not management fees.

b. ***Organizational Expenses/Caps***: **Organizational and offering expenses** of the fund are borne by the fund's investors out of their capital commitments, but are typically capped in the fund's operating agreement depending primarily on the size and complexity of the fund. The sponsor is responsible for any organizational expenses in excess of the cap. If a fund utilizes a placement agent, placement fees and expenses are often borne by the fund sponsor and carved out of the organizational expenses that may be borne by the fund.

c. ***Fund Operational Expenses***: In addition to the (capped) organizational expenses, the fund typically bears all other costs and expenses relating to the operation of the fund. In addition to the management fee, these include fees, costs, and expenses relating to the purchase, holding, and disposition of the fund's investments, third-party service providers to the fund (such as the expenses of any administrators, custodians, legal counsel, accountants, and auditors), printing and distributing reports to the investors, insurance, indemnity and litigation expenses, taxes, and any other governmental fees or charges levied against the fund. As with the fund's organizational expenses, the operating expenses of the fund are borne by the fund's investors out of their capital commitments. Unlike organizational expenses, however, operating expenses are typically not capped.

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d. ***Borrowing & Guarantees/Credit Facility***: A fund's ability to borrow money, other than short-term loans to cover partnership expenses or to "bridge" capital contributions, is typically restricted depending on the investment program of the fund. LPs do not want funds to become overly-leveraged.

e. ***Indemnification/Exculpation***: The fund documents will invariably include provisions that require the fund to indemnify the principals, the general partner, the manager, and their respective officers, employees, and agents. This is a promise to hold the indemnified persons harmless from any third-party legal action related to the fund against such persons other than actions related to certain specified bad acts of the indemnified person. If a private fund establishes an Advisory Committee, its members would also be covered by the indemnification provisions. Fund documents will also contain exculpation provisions, which promise not to take legal action against the indemnified persons other than those related to certain bad acts of the indemnified persons. These provisions complement the indemnification provisions by limiting the potential liability of the principals and the other specified persons to the partnership and the partners. Appropriate indemnification and exculpation provisions are regarded as essential because the process of making and disposing of private equity investments involves a certain degree of litigation risk. The specified bad conduct (e.g., fraud, willful misconduct, and gross negligence) for which indemnification and exculpation are not granted is often the subject of protracted negotiation.

f. ***Management Expenses***: The fund's manager is expected to bear the cost of its own ordinary administrative and overhead expenses incurred in managing the fund. These costs typically include the costs and expenses associated with running the business of the manager, such as employee compensation and benefits, rent, and office furnishings, as opposed to specific expenses directly related to the operation of the fund and its investments.

4. GOVERNANCE TERMS

Tax structural differences aside, investors frequently diverge in their approach to negotiating a fund's governance terms. Impact investment funds, being relatively new to the private fund market, often have governance terms somewhat dictated to them by long-standing institutional investors that subscribe only to funds whose standards are aligned with theirs. Even those impact investment funds that had relative success with a first generation of funds and go on to raise successor funds may find that their re-upping investors may take a harder line on governance as their successor funds target larger pools of capital from a greater number of investors.

One of the primary features of an impact investment fund is its investment policy, which codifies the fund's objectives for its impact investments. A fund investment policy will include many elements, such as diversification policies, which restrict a fund sponsor from causing the fund to invest more than a certain percentage of capital commitments in any particular investment, and geographical limits, pursuant to which the fund is restricted from investing in companies operating outside of certain states, countries, or regions. A selection of key governance issues in private impact investment funds generally, including investment restrictions, is set forth in **Appendix B**.

Impact investment funds will also include certain additional investment parameters. For example, the general purpose of an impact investment fund may be to make equity investments in financial services companies that deliver quality products and services to low-income and financially excluded peoplein certain identified developing countries, with a primary focus on insurance and adjacent products. But such investment policy may be restricted (and may not be waived without the consent of the investors) as to:

(a) the amount of capital commitments invested (i) in any single portfolio company or (ii) in any single country;

(b) the amount of commitments invested outside of the fund's target countries (e.g., specifically identified developing nations);

(c) the use of debt (other than with respect to guarantees of an underlying portfolio company's obligations);

(d) the use of **bridge investments**;

(e) the use of hedging instruments to speculate on currency or interest rates;

(f) investments made in other funds (assuming the fund is not a fund-of-funds) or other investment vehicles that generate double fees payable by the investors;

(g) hostile transactions (i.e., takeovers despite the objection of the portfolio company); or

(h) investments in publicly traded securities.

These types of restrictions are also fairly typical in most private equity funds.

While many non-impact investors would be satisfied with the above investment parameters, impact investors may require approval of the fund's more detailed investment policy and compliance manual, covering not only anti-money laundering ("**AML**"), anti-bribery, sanctions, and politically exposed persons policies, but most importantly the monitoring and reporting of social and environmental concerns, including impact measurement and the achievement of target social or environmental metrics and returns, and the fund's specific methods for establishing and monitoring the implementation of all such applicable policies in the underlying portfolio companies. More recently, certain non-impact funds have developed their own ESG policies in order to cater to their impact investors (particularly European pension plans and funds-of-funds that have promised their own impact investors that they will invest in funds with ESG policies).

One key distinction of note among investors is that some non-impact investors may place a premium on getting their full allocation to a particularly well-regarded fund manager (with a potentially over-subscribed fund), sometimes at the expense of preferred, investor-friendly terms regarding some governance issues. Although non-impact and impact investors alike may have certain governance issues embedded in their constitutional mandates, impact investors are more likely to have a longer such list of requirements with respect to governance issues from which they cannot veer and are therefore often less flexible about governance issues than non-impact investors may be. In addition, certain impact investors such as DFIs, often in the position of being the **anchor investors** (particularly with respect to impact funds outside of the U.S.), consider it their moral duty on behalf of all investors to take up the mantle of advocating for strong governance terms and therefore put a greater emphasis on such terms. DFIs make up the plurality of impact investors, holding 42% of total reported impact investments.[6] Also, such investors do not have the same underlying time pressure from their own investors to make their investments that most other institutional investors do. Thus, DFIs have a very strong hand when it comes to negotiating governance terms in an impact investment fund, particularly when the fund is new to the market and keen to get the financial backing and imprimatur of a DFI investor. Because such investors play a significant role in a new impact fund's launch, they typically will be able to win the day on the governance policies of the fund. In addition, some impact investors, having invested in many funds side-by-side, are teaming up and presenting a united front in negotiations with

6 Ibid, p. 6.

impact investment funds. As the impact investment industry grows and the number of investors increases, it may become more difficult for impact investors to present such a united front unless they develop their own set of principles for private impact investment fund terms similar to the ILPA principles, but including the methodology for achieving and measuring impact.

Some of the points negotiated between a fund investor and a fund sponsor may be addressed by revising the fund's operating agreement. But fund sponsors may prefer to handle some points that are very individual to investors outside of the fund agreement for a variety of reasons. Thus, fund operating agreements typically permit the sponsor to enter into **side letter** agreements with investors. A side letter entered into by the fund and an investor alters the terms of that investor's agreement with respect to its investment in the fund and its rights and obligations under the operating agreement. Certain investors require side letters because of their special regulatory or tax needs. Other investors may command additional or special economic, informational, or other benefits as a condition to their investment. Impact investors often have extensive side letters to ensure that the fund follows negotiated policies and procedures if such policies and procedures are not hard-wired into the operative agreement of the fund. Investors may also seek to receive the right to see all such side letters and the right to elect the same terms and conditions as such side letters (referred to in the industry as "most-favored nations" or "MFN" rights, borrowing a term from the World Trade Organization). Fund sponsors may respond to such requests in a variety of ways, including granting them to a limited degree (e.g., only granting the right to see letters with investors of the same or lower commitments as the requesting investor).

Impact investors often have extensive side letters to ensure that the fund follows negotiated policies and procedures...

5. INFORMATIONAL NEEDS OF INVESTORS

Investors will require varying and sometimes customized information about the fund and its investments, often as a result of promises that they have made with their underlying investors or beneficial owners. Fund managers generally try to limit the amount of bespoke information so provided, as providing such additional information adds to the administrative and operational burden of the fund and increases the fund's operating expenses to the objection of the other investors in the fund that do not have customized reporting and other requirements. In addition, fund managers and investors (who are not subject to the U.S. Freedom of Information Act ("**FOIA**") or other so-called "sunshine" laws) are concerned that information about the fund and its investments may become public, thus jeopardizing their profitability in the event that any of the fund's investors are subject to FOIA or the sunshine laws of other jurisdictions. These sunshine laws require certain investors, such as public pension plans, to publicize otherwise confidential information about their investments; thus, fund managers try to limit the information provided to such investors or else provide the information to such investors in a manner that makes it difficult for the information to be published.

a. ***Reporting***: Partnership agreements generally provide that the general partner is required to keep accurate books and records and to furnish the investors with various reports, including unaudited quarterly reports (e.g., within 45 days of the end of the quarter) and audited annual reports (e.g., within 90 days of the end of the fiscal year) describing the fund's investments (including a valuation of the investments). In addition, an investor typically wants the right to obtain any other information about the fund or any of the fund's investments that it reasonably requests and the right to inspect the books and records of the fund. Impact investors that have the expectation of the fund meeting certain social needs or other targets may, in addition, require funds to ascertain whether or not such targets have been met in accordance with pre-defined parameters and to include all such relevant information in its reports. Investors representing a majority of the equity interests in the fund may have the right to cause an audit of the books of the fund by an independent auditor at any time at the expense of the fund.

Impact investors that have the expectation of the fund meeting certain social needs or other targets may, in addition, require funds to ascertain whether or not such targets have been met…

Some investors request additional information from the fund about its operations, portfolio, and other matters. A distinction may be drawn between "above the line" information that a sponsor is willing to provide to investors generally and more sensitive information that will not be provided (or that will be provided only to those investors that can assure that it will be treated confidentially). Impact investors typically require a much deeper and broader scope of disclosure, particularly in respect of oversight measures taken by the fund of each portfolio company's adherence to various policies, summaries of particular events at the portfolio company level, and the fund's own compliance with the various policies and investment directives in place. Most institutional investors require notice of any events that may give rise to potential litigation for the fund; but impact investors may outline for the fund with greater specificity the items that they believe may subject the fund to potential litigation, rather than leaving the decision about notifying the LPs about potential litigation to the reasonable discretion of the general partner.

b. ***Valuation***: Investors want to receive copies of any policies referenced in the fund's operating agreement, which will typically include the fund's valuation policy. Funds must have in place effective policies and procedures for valuing the investments that they hold. As a result of the lack of appropriate knowledge or controls, errors in valuation can arise that materially affect a fund's net asset value. In addition to being in accordance with market practice, valuation policies must be consistently and vigorously applied. Funds usually adopt U.S. GAAP (Generally Accepted Accounting Principles) or IFRS (International Financial Reporting Standards) to determine the fair value of any fund investment or interest in the fund.

c. ***List of other Investors and Advisory Committee Members***: As the Advisory Committee may have the power to influence key decisions of the fund, investors typically want to know its membership, which may not be fully determined until after the fund's final closing. Investors may also require a list of other investors invested in the fund to enable them to contact those investors in the normal course or due to an extraordinary event. A few impact investors may request approval rights over any subsequent investors into the fund.

d. ***Annual Meeting; Consultation Rights***: Even the smaller funds will normally hold an annual meeting for its investors during which investors have the opportunity to ask all manner of questions regarding the fund in person. Investors may also request any documents provided during the meeting and minutes that may be produced following the meeting. Many investors, but particularly impact investors, will require regular consultation rights with the fund manager so as to ensure the ability to speak directly with the fund principals, particularly if they do not anticipate always being able to attend the annual meeting.

e. ***Legal Opinions***: At closing, investors typically request:

    i. an opinion that the fund will be treated for U.S. federal income tax purposes, as applicable, as either (i) a corporation or (ii) a partnership that is not treated as a "publicly traded partnership";

ii. a securities opinion that the issuance of the investor interest does not require the fund to register under the Investment Company Act of 1940 (as amended, the "**Investment Company Act**") or register the fund offering under the Securities Act of 1933 (as amended, the "**Securities Act**");

iii. a partnership opinion that the documents are properly authorized; are duly executed and delivered; and are the legal, valid, and binding obligations of the general partner;

iv. if the fund is relying on status as a **VCOC** (i.e., a venture capital operating company) or an **REOC** (i.e., a real estate operating company), an assurance that the fund is not treated as holding "**plan assets**" for purposes of **ERISA** (the U.S. Employee Retirement Investment Security Act of 1974) and may accept capital from an investor subject to Title I of ERISA (such as a U.S. private pension plan) without being subject to the fiduciary requirements of ERISA, a form of VCOC or REOC opinion; and

v. if the deal contains a side letter and/or guarantee, a legal opinion addressing such agreements.

6. CONCLUSION

Private equity funds are excellent sources of capital for impact investments, particularly during periods of economic instability, when banks limit the risk they are willing and able to take. More recently, banks have become subject to higher capital and liquidity requirements, thus limiting the amount of capital that operating companies can seek from them. Moreover, private equity funds can be important to economic growth, especially when governments face their own deficits and are thus unable to fund public projects or otherwise provide for public goods. But in all of the discussions in recent years of the perceived regulatory risks of private funds, what has become somewhat lost is the diversity of private funds and the opportunities that they present for investors, as well as the institutional strength of investors.

Funds engage in a variety of strategies, including the impact investment sector. As the landscape of private funds has ballooned over the past decade, such strategies have become increasingly competitive and nuanced. Impact investors that cannot compromise on their fundamental investment principles have had enormous influence on the terms and conditions of private funds in recent years as their appetites for favorable private equity returns (and their willingness to bear the risk that is paired with those returns) have increased. Although impact investment funds collectively constitute a small fraction of the private fund industry as a whole, GIIN expects impact investment funds to balloon in the next six to ten years as impact investors better understand that their capital may be well-deployed via a private fund and as non-impact investors increase their impact investments and put their trust in established impact managers.

The competition for investors' commitments is ever increasing, putting greater negotiating strength into investors' hands, which in turn has led to the market-leading principles of ILPA. While the ILPA principles continue to serve as a benchmark for many investors as they negotiate their fund investments, we note an increasing trend in similarly situated investors forming small coalitions to negotiate the terms of their investments. Impact investors have formed many coalitions and associations in recent years and have the opportunity to set certain standards for impact investment funds. While these coalitions can present their own challenges, general partners increasingly appreciate fewer (though longer) negotiations, and investors certainly find strength in numbers.

This trend, for now limited mainly to similarly situated large institutional investors, such as DFIs and non-U.S. pension plans or other private investors, could also be utilized by smaller institutional investors, such as family offices which may not normally engage in fund negotiations. Such investors would likely find value in engaging fund sponsors in such negotiations if their investments were grouped and they sought the assistance of outside counsel who regularly engage with fund sponsors and are well-versed in such negotiations. Somewhat counterintuitively, fund sponsors might additionally encourage greater attention to negotiation and due diligence by family offices and other smaller investors in order to make their funds more transparent and attractive to such investors.

APPENDIX A: GENERAL OVERVIEW OF THE VARIETY OF FUND TYPES AND STRUCTURES

There are many types of funds generally available for investment, and the economic and other expectations of investors in those funds vary according to the fund type. Furthermore, risk tolerance will vary from portfolio category to portfolio category, depending not only on purpose but also time frame. Non-profit and for-profit investors alike must determine how much risk they are willing to assume for each type of investment product, with investment diversification to manage risk a must for most non-profit investment portfolios and public and private pension funds. Diversification by asset class, asset allocation, and within asset classes is considered prudent.

a. ***Growth Equity***: Growth equity funds invest in quickly growing companies with proven ideas/business models to help support further growth. Such funds provide not only financial capital, but also strategic guidance and operational support so as to help the company grow and achieve its full potential. Such funds may make minority equity investments and let the existing management team continue to run the business. The capital injection from such funds may be used for a variety of purposes, such as scaling-up operations, enhancing distribution, expanding geographically, developing a new product, or financing an acquisition.

   The majority of investors in these types of funds are institutional investors. There is typically less opportunity for negotiation in the funds with the highest target capital commitments (*i.e.*, the "mega-funds") because (i) such funds are generally run by the most successful and established fund managers, causing investors to compete with each other to receive their desired allocations to such funds; and (ii) the fund structures of most mega-funds are firmly established in prior funds.

b. ***Leveraged Buyout***: Leveraged buyout funds acquire majority control of portfolio companies (almost always 100% ownership of mature firms) using financial leverage. The acquisitions ar made using both debt and equity, but the proportions can vary depending on the acquisition target, the market conditions, and the ability of the buyout fund to raise debt. The debt portion typically accounts for 50%-85% of the purchase price. The companies targeted by those funds must therefore generate stable operating cash flows which will be used to make interest and principal payments.

c. ***Hedge Fund***: The "hedge fund" definition has come to incorporate any absolute return fund investing within the financial markets (stocks, bonds, commodities, currencies, derivatives, etc.) and/or applying non-traditional portfolio management techniques including, but not restricted to, shorting, leveraging, arbitrage, and swaps. There is often little room for negotiation by investors into hedge funds due to their open-ended structure, generally permitting investors to redeem their interests (subject to certain lock-up periods) if they do not agree with the investment platform. Hedge funds thus generally represent a "take it or leave it" approach for investors.

d. ***Hybrid Funds***: There are various investment vehicles that are referred to as hybrid structures, but generally hybrid funds can be divided into two categories: fixed-term hybrid structures and evergreen hybrid structures. Fixed-term hybrid structures, like private equity funds generally, will have finite subscription periods, closed-end terms, specific investment periods, and distribution waterfall profit allocations. Unlike traditional private equity funds, which generally have a term of 10 years, fixed-term hybrid structures will typically have a term between 18 months and three years and a much shorter investment period. A fixed-term hybrid structure may include illiquid investments (with a short horizon) as well as liquid investments. Evergreen hybrid structures combine rolling lock-ups and rolling subscriptions with limited liquidity. These vehicles will have initial lock-ups ranging from one to three years during which redemptions are prohibited. A soft lock-up period may follow, whereby redemptions are permitted, subject to an early withdrawal fee. Both types of hybrid vehicles will charge lower fees than traditional hedge funds so as to compensate for the longer lock-up periods.

e. ***Fund-of-Funds***: A fund-of-funds is an investment strategy of holding a portfolio of other investment funds rather than investing directly in portfolio companies. Funds-of-funds are a good tool for diversification and often the only route for smaller investors seeking to invest in the most popular funds that have certain minimum commitment requirements. Investors have less control, however, over the underlying fund investments. These types of funds often have longer terms as a result of the types of underlying investments made; therefore, investors have a greater need to negotiate their ability to transfer such investments.

f. ***Real Estate Funds***: Private real estate funds may include private direct real estate investments in multiple property types (such as multifamily housing, commercial, retail, or industrial), "REITs" (real estate investment trusts), debt instruments, and derivatives. They are categorized as "core" funds, which generate steady income, and "opportunity" funds, which seek to generate capital appreciation. There is greater attention paid to leverage in such funds. These types of funds often have longer terms as a result of the types of underlying investments made; therefore, there is a greater need to negotiate the investors' ability to transfer such investments.

g. ***Infrastructure/Real Asset Funds***: Infrastructure funds are traditionally interested in lower risk investments such as roads, rail, grid, and waste facilities, which have a longer term investment horizon and lower returns over the period. More recently, institutional investors are seeking to invest in "real assets," where the fund's underlying assets are a combination of physical assets, such as buildings, and essential infrastructure services.

h. ***Debt/Credit Funds***: Within debt funds, there is a tremendous variety from which to pick depending on the assets to which the debt held by the fund is linked. Broadly speaking, though, in the private funds context, debt funds acquire debt securities and rely on the interest produced by such fixed income investments. The main investing objectives of a debt fund will usually be preservation of capital and generation of income. The fee ratios on debt funds are lower, on average, than equity funds because the overall management costs are lower. Performance against a benchmark is considered to be a secondary consideration to absolute return when investing in a debt fund. Though investors may be investing in a fund at equity level, capital diversification is offered by the variety of debt in which the debt fund might invest (e.g., senior/mezzanine).

Those funds that themselves originate debt, rather than merely purchasing existing debt, are referred to as "credit funds." One of the results of the banking crisis has been the growing role of alternative finance providers who have plugged the gaps that traditional banks can no longer meet. These so-called "**shadow banking**" activities have lately become a focus of various regulators. These regulators acknowledge that shadow banking performs important functions in the financial system, e.g., by creating additional sources of funding and offering investors alternatives to bank deposits, but are concerned that shadow banking may pose potential threats to long-term financial stability.

i. ***Venture Capital Funds***: This type of fund manages money from investors seeking private equity stakes in startup and small- and medium-size enterprises with strong growth potential. These investments are generally characterized as high-risk/high-return opportunities. Theoretically, venture capital funds give investors the ability to get in early at a company's startup stage or in special situations where there is opportunity for explosive growth. While a fund structure diversifies risk, these funds are inherently risky.

j. ***Pledge Fund***:In this structure, each investor enters into a separate but identical agreement with the manager, often called a "participation agreement." Under this agreement, each investor pays a fee to the manager and, in return, the manager undertakes to source and offer all the investment opportunities of a particular type to those investors.

These pledge fund structures have certain perceived advantages for the investor, including greater control for investors over how their commitments are invested, the opportunity to evaluate individual investments to assess their merits and risks and ensure that investments are consistent with the investor's understanding of the fund's investment strategy, and the ability to terminate the commitment to fund investments. Multiple vehicles, a greater volume of documentation, and a more active role, however, may make pledge funds less attractive to many investors. Investor discretion to assess individual investments is only effective if such an investor has sufficient knowledge and experience with relevant assets and sufficient resources to analyze, e.g., reports from the manager and other due diligence documents on each underlying investment.

The manager of a pledge fund retains a guaranteed income from the management fees paid under the participation agreement. This allows the manager to carry on its business in an orderly way (e.g., to rent office premises and hire staff). This type of fund has certain disadvantages for the manager, though: unlike a blind pool fund, the manager has no certainty when identifying and negotiating investment opportunities of the degree to which investors will actually participate in that investment, or indeed if sufficient investors will participate to allow the fund to make the investment at all. This lack of certainty may make it more difficult for the manager to successfully negotiate investments in a short period of time; in particular, it may be more difficult for a pledge fund to obtain exclusivity in a proposed transaction. Confidentiality is also another concern as the manager will have to provide its investors with a considerable amount of information about proposed investments prior to actually making those investments.

k. ***Club deals***: This term describes a private equity buyout or the assumption of a controlling interest in a company that involves several different private equity firms. This group of firms pools its assets together and makes the acquisition collectively. The practice has historically allowed private equity firms to purchase much more expensive companies together than they could alone. Also, with each company taking a smaller position, risk can be reduced.

   These types of funds are not, however, without their disadvantages. Certain practical issues such as the appointment of multiple advisors and extended multi-dimensional negotiations increase the overall cost associated with club investments. Club investors from different geographies may face difficult decisions on the jurisdiction of the club. And domestic tax laws may treat the club as an “association of persons” depending on the nature of the club arrangement, which may severely impact the returns of the investors.

l. ***Co-Investments***: A traditional co-investment is a minority investment made directly into an operating company, alongside a fund, typically in a leveraged buyout, recapitalization, or growth capital transaction.

   Through co-investments, the fund manager may make larger, controlling investments without either dedicating too much of the fund’s capital to a single transaction (and creating exposure issues or violating any investment limitations agreed with the fund’s investors) or sharing the deal with competing private equity firms. Compensation to the fund manager with respect to co-investments varies, but co-investors typically do not pay management fees or carried interest on co-investments.

m. ***Managed Accounts***: Some investors seek their own customized "managed account" arrangements, which provide for greater control (but eliminate the benefit of risk-sharing that pooled investment vehicles provide). These arrangements may be created either in tandem or independently of any blind pool fundraising, with potentially different economics and different investment criteria. These arrangements frequently provide for the investor to have some participation in investment decisions. This can create significant challenges for their fund managers, not least the articulation to their traditional fund investors of the consequences of such managed accounts, particularly as regards the extent of access to deal flow and allocation of investment opportunities.

APPENDIX B: KEY GOVERNANCE TERMS

a. ***Conflicts of Interest***: Often, sponsors of private equity funds manage multiple investment vehicles or otherwise engage in a number of asset management and related services that can potentially give rise to a number of conflicts of interest. The determination of what transactions between related parties may be potential conflicts is of fundamental importance.

Failure to fully address conflicts situations is typically of great concern to investors. In addition, the Investment Advisers Act of 1940 (as amended, the "**Advisers Act**") and the rules promulgated thereunder prohibit agency cross transactions and principal trades without specific authorization from their clients, although investors may agree in the fund agreement how such authorization may be effected (in lieu of obtaining such authorization from each and every investor). For example, it may be agreed that the general partner present potential conflicts of interest to the fund's Advisory Committee, which will consider the terms of the proposed transaction and determine whether or not to provide its consent. Or a fund might utilize an unaffiliated independent representative to make such determinations on behalf of the investors (provided that such independent representative has herself been approved by each investor).

Often, sponsors of private equity funds manage multiple investment vehicles, or otherwise engage in a number of asset management and other related services that can potentially give rise to a number of conflicts of interest.

b. ***Transfer Rights***: Private equity fund interests are illiquid investments that must be held until the fund terminates and is liquidated. Thus, transfers of LP interests are prohibited unless certain qualifications are met: for instance, assuring that the transferor is not trying to create a market in selling unregistered securities or avoiding the application of ERISA's fiduciary requirements. Large institutional investors will typically request, and receive, the right to transfer their interests to bona fide affiliates, subject to the affiliate being able to make the standard representations and warranties required of all investors.

c. ***Advisory Committee***: Advisory Committees provide limited partners with an ability to better oversee the ongoing operation of a fund during the course of its life. Each partnership agreement may vary slightly the particular responsibilities of the Advisory Committee, but most funds do have them. Recurring roles for the committees are to resolve conflicts of interest that may arise and to consent to certain actions that might otherwise constitute a breach of the partnership agreement (e.g., a waiver of investment limitations that would otherwise prohibit a particular investment). By having a representative on the Advisory Committee, an investor is better placed to influence decisions of the fund. Depending on the jurisdiction of the fund, however, the role of the Advisory Committee will have to be carefully constrained so as to ensure the retention of limited liability by each investor represented on the Advisory Committee. An investor who seeks but does not obtain Advisory Committee representation may try instead to obtain non-voting observer status to the Advisory Committee or copies of all information that the fund provides to the Advisory Committee.

Advisory Committees provide limited partners with an ability to better oversee the ongoing operation of a fund...However, the role of the Advisory Committee will have to be carefully constrained so as to ensure the retention of limited liability by each investor represented on the Advisory Committee...

d. ***Term/Termination***: The term of a fund generally consists of an investment period followed by a divestment period. Shorter or longer terms may be required depending on the time it takes to source, acquire, harvest, and exit investments. In addition to a pre-determined termination date where the fund has a fixed life, investors and fund managers must give particular thought to further termination mechanisms, including the early termination of the investment period (preventing the general partner from making further investments, but not shortening the fund's permitted aggregate term length, which allows the general partner to harvest the fund's existing investments). Upon a supermajority-in-interest vote of investors, funds may allow for a "no-fault" termination of the fund's term. The investors' right to vote to terminate the fund or its investment period early may also be triggered by related provisions, such as the change of control of the general partner (discussed further below under "*Change of Control*"), a key person event (discussed further below under "*Time and Attention; Key Person Event*"), the removal of the general partner, and the establishment of a successor fund, each as described below:

   i. ***General Partner Removal***: The fund's operating agreement may provide the ability of a certain percentage of investors to elect to remove the general partner in certain very limited circumstances. For example, a majority-in-interest of investors may have the ability to elect to remove the general partner for "cause," usually with disastrous consequences for the general partner (*e.g.*, by a "haircut" on any carry earned by the general partner). A supermajority-in-interest may have the right to remove the general partner without "cause." General partner removal is often considered the "nuclear option" that investors use only as a rare, last recourse in any dispute with a general partner. Any removal of the general partner typically triggers fund termination unless the investors decide to appoint a new general partner to continue the fund.

   ii. ***Successor Fund***: Though this issue is of less focus for investors who think that if they are happy with a fund manager it will not matter if they are investing via the present fund or a successor fund, investors typically prefer successor funds not to invest until the investment period of the prior fund has terminated or some other protection has been built in (such as the reduction or elimination of management fees paid by the existing fund) to ensure that the fund sponsor's focus remains on the existing fund. Indeed, a successful fund of almost any size is often the foundation for significantly larger successor funds, representing correspondingly larger opportunities for the successful general partner and principals.

e. ***Capital Commitments***: Investors typically contribute their committed capital to the fund over time, upon receipt from the general partner of a **drawdown notice**. Typically, investors have a 10 business day period to provide the fund with the capital contributions requested or be subject to potentially serious **default** consequences (discussed further below).

   i. ***Fundraising Periods***: Private equity funds are structured as closed-ended investment vehicles. A fund's governing documents generally permit the fund to raise capital commitments only during a limited, initial fundraising period (typically 12 to 18 months) after which the fund may not accept additional investor commitments.

   ii. ***Closings***: A first closing of the fund occurs when the sponsor identifies investors who are ready to commit sufficient capital to the fund (based on the sponsor's capital raising target). Sometimes a fund is only permitted to hold an initial closing after a minimum amount of capital has been raised. After the first closing, subsequent closings may be held throughout the fundraising period. At each closing, investors become limited partners of the fund by executing a **subscription agreement**, as well as the fund's limited partnership agreement, and having such documents accepted by the general partner.

   Sometimes a fund is only permitted to hold an initial closing after a minimum amount of capital has been raised...

   iii. ***GP Capital Commitments***: The general partner, together with affiliates of the fund sponsor, traditionally invests a certain amount of money alongside the limited partners in order to ensure that the interests of all partners are adequately aligned. The commitment of the general partner can occur directly through the fund vehicle, which would ensure that it participates *pari passu* with every investment made by the limited partners, or the general partner may participate via a co-investment vehicle, though investors typically require assurance that the general partner participates in each fund investment on the same terms and conditions of the fund.

   The general partner, together with affiliates of the fund sponsor, traditionally invests a certain amount of money alongside the limited partners, in order to ensure that the interests of all partners are adequately aligned...

   iv. ***Change of Control***: It is in the investors' best interest that the general partner remain for the duration of the term of the fund. Thus, the partnership should specify that the general partner may not voluntarily withdraw as general partner, dissolve or liquidate, undergo a change of control, or transfer its interest. The concern here is that the principals will sell their future interests in the fund for immediate cash and withdraw from management of the fund. This is a grave matter for investors whose impetus in making an investment in any given fund is the talent and investment history of the principals who together comprise the general partner. Additionally, such a change of control provision helps to protect the investors from being deserted by the general partner if the portfolio investments that the fund has made have lost value and, hence, the prospects of the general partner ever receiving a carried interest are slim.

v. ***Recycling:*** The fund's operating agreement may permit the fund to "**recycle**" capital that is returned to the investor. Typically a fund may be able to re-deploy: (a) investments yielding a quick return (*e.g.*, bridge investments realized within one year after the investment is made, discussed further below under "*Bridge Investments*"); (b) returns attributable to capital contributions used to satisfy organizational expenses and other fund expenses; and (c) returns on investments during the investment period. The aggregate amount of capital commitments that the general partner may deploy on behalf of each investor may be limited, however, to some percentage slightly higher than 100% of each investor's original fund commitment (but rarely greater than 150%).

vi. ***Excuse***:Some investors may be excused from making a particular investment because of investment restrictions pre-agreed with the general partner, either as described in the fund's operating agreement or in a side letter agreement between the investor and the fund. For example, some religious organizations request excuse in the event of certain types of so-called "sin" investments made by the fund, such as investments involving alcohol, pork, prostitution, or firearms. In the event of excuse, investors' capital commitment may remain unaffected or be reduced by the amount that the fund would have drawn down in the absence of excuse. In other circumstances, there may be regulatory or other reasons why an investor is required to withdraw from a fund completely. Greater attention has been paid to how excuse rights are granted, particularly by impact investors. Impact investors do not necessarily seek excuse rights for themselves; rather, they are concerned that other investors may try to use excuse rights in order to avoid participating in investments that they simply do not want to make, instead of investing blind along with all investors.

Some investors may be excused from making a particular investment because of investment restrictions pre-agreed with the general partner...

Impact investors do not necessarily seek excuse rights for themselves; rather, they are concerned that other investors may try to use excuse rights in order to avoid participating in investments that they simply do not want to make...

vii. ***Default***: Capital commitment default provisions may create severe penalties for a defaulting investor, such as: (a) forced sale of the defaulting investor's capital account to other existing investors at a discount; (b) interest penalties; (c) automatic reduction of the defaulting investor's capital account to cover owed amounts and penalties; or (d) the loss of all or certain rights as an investor, including participation in future investments or voting determinations.

viii. ***Feeder Funds***: Feeder funds are special purpose vehicles formed by a fund to accommodate investment in the fund by one or more investors. Due to the particular jurisdiction of incorporation of the fund, an investor or class of investors may prefer (primarily for tax purposes) to invest in the fund indirectly through an upper-tier entity. One common use of feeder funds is to act as "blockers" for U.S. federal income tax purposes. These types of feeder funds are structured to be treated as corporate taxpayers for U.S. federal income tax purposes so that investors in the feeder funds do not receive direct allocations or distributions of fund income. This ensures that non-U.S. investors are not required to file U.S. federal tax returns and pay U.S. income tax in connection with those allocations and distributions. Many U.S. tax-exempt investors also prefer to invest through feeder funds organized as blockers to reduce the likelihood that their investment generates UBTI.

ix. ***Parallel Funds***: **Parallel funds** are parallel investment vehicles generally formed to invest in and divest from the same investments at the same time as the main fund. They are formed under substantially the same terms as the main fund, with specific differences in terms to the extent required to accommodate the regulatory, tax, or investment requirements applicable to the investors in the parallel fund. Parallel funds are often created in jurisdictions other than that of the main fund. For example, a Delaware-based fund may form a Cayman Islands-based parallel fund to accommodate non-U.S. investors who often prefer to invest through a non-U.S. entity to avoid the U.S. tax compliance obligations that apply to investors in U.S. entities. The parallel fund generally invests directly in each investment alongside and in parallel with the Delaware fund, in fixed proportions determined by their respective capital commitments. Additionally, funds formed to invest in specific countries or regions may have separate funds for local and international investors.

x. ***Alternative Investment Vehicles***: Alternative investment vehicles are special purpose investment vehicles formed to accommodate the structuring needs of the fund (or its investors) in connection with one or more particular investments. Unlike a parallel fund, which is designed as an umbrella entity for investors to participate as an alternative to the main fund, an alternative investment vehicle is formed so that investors who have subscribed to the main fund (or a parallel fund) can take advantage of efficient structures to hold specific assets if the fund is not the optimal investment vehicle for a particular investment, whether for tax, regulatory, or other legal reasons. Operating agreements typically permit the sponsor to form an alternative investment vehicle through which all (or certain) investors may invest in a fund investment, relieving those investors from the obligation to participate in the investment through the fund itself. The fund agreement generally requires alternative investment vehicles to have substantially the same terms as the fund. The general partner or manager typically has a great deal of discretion under the fund agreement whether to form an alternative investment vehicle for a particular investment and, if it does, whether to form the vehicle for a particular investor or group of investors. For example, a Cayman Islands-based fund seeking to invest in a portfolio company located in a country that imposes a withholding tax on distributions to offshore financial centers may form an alternative investment vehicle in another jurisdiction that is not deemed an offshore financial centre for the purpose of making the investment.

f. ***Investment Period; Investment Limitations:***

i. ***Investment Period***: The investment period of a fund will often last between four and six years. At the end of this period, any undrawn capital commitments of a limited partner may no longer be used for new investment and will only be subject to drawdowns for existing commitments, expenses, reserves, to repay existing borrowings, or to fund follow-on investments in companies that are already in the fund's portfolio or that otherwise enhance the fund's existing investments.

ii. ***Time and Attention***; Key Person Event: Investors frequently make investments in a fund primarily in reliance on the skill and expertise of certain individuals to manage the fund and its investments. Often the operation of the fund is tied to the presence of these individuals, who are deemed to be "key persons." Key persons will be required to meet certain minimum time commitment requirements to the fund, e.g., substantially all of a key person's business time and attention must be dedicated to the fund and any prior or successor funds. Failure of a certain number of key persons to meet such requirements may trigger a key person event. Key person events vary from fund to fund, but investors prefer a key person event to trigger an automatic suspension of the fund's investment period. If triggered, the fund is prevented from making new investments until a sufficient number of new key persons are appointed. Often, if the suspension period continues for a long enough period (for example, six months), then the investment period terminates and the fund enters liquidation mode.

Investors frequently make investments in a fund primarily in reliance on the skill and expertise of certain individuals...Key persons will be required to meet certain minimum time commitment requirements to the fund...

iii. ***Diversification Limits***: The general partner is generally not permitted to invest more than a certain percentage of the fund's capital commitments in a single portfolio company, including investments in affiliated entities, bridge investments, and follow-on investments in such portfolio company. Depending on the size of the aggregate capital commitments and the investment focus of the fund, such percentage could be between 10% and 35% for any single portfolio company.

iv. ***Bridge Investments***: Some general partners will seek flexibility to exceed the diversity cap on a short term basis by having the ability to make a "bridge investment". Bridge investments may take the form of short-term debt or equity in an underlying portfolio company, although they are usually debt investments which will be refinanced or converted to equity investments within a year. Since a bridge investment is intended to be temporary, a carried interest will usually not be earned on it and consequently a preferred return will not accrue on capital contributed for a bridge investment. For example, a general partner may intend to sell a portion of a portfolio investment soon after it is made to a co-investor, and thus it may make the most sense to the general partner to structure that part of the investment as a bridge investment so as not to diminish the fund's investment rate of return (IRR). In addition, capital contributed for a bridge investment that is realized quickly (e.g., within the fund's investment period) can usually be "recycled" (see "*Recycling*" above).

v. ***Geographical Limits / Restricted Nation Covenant (Iran, North Korea, etc.)***: If it is contemplated that investments will be made abroad, investors may seek limitations on the amounts that may be invested in any particular jurisdiction. Any foreign investments should be subject to the general partner's receipt of legal advice (possibly in the form of an opinion) that such investment will not subject any investor to liability in excess of its capital contribution.

vi. ***Ethical Investor Limits / ESG Policy Acknowledgement***: Many investors, for environmental, social, or religious reasons/policies require prohibitions on investments in portfolio companies primarily engaged in certain sectors, such as alcohol, gambling, firearms, prostitution, tobacco, and pork products. Moreover, impact investors may require as a pre-condition of their investment that the fund agree to a responsible investment code that imposes obligations on the part of the fund to ensure that the companies in which it invests adopt and maintain rigorous environmental, social, and corporate governance standards.

vii. ***Hostile deals***: Generally, funds are not permitted to engage in any "hostile transaction" (i.e., a transaction that is opposed by a majority of the target company's board of directors and/or shareholders). Investors generally do not want the negative press that can accompany a hostile transaction, and such transactions are usually expensive.

viii. ***Investments generating additional management fees or carry***: A fund is typically prohibited from making a portfolio investment if, as a result, the fund would be obligated to pay any party additional management fees or carried interest, which rules out investments in any other pooled investment vehicles. This addresses concerns that investors will be paying multiple layers of fees.

ix. ***Publicly Traded Securities***: Investors generally request, subject to certain caveats, that the fund not invest in any publicly-traded companies. The general purpose of private equity funds is to make private investments that investors may not otherwise have access to, not to invest in the public markets. Certain exceptions may be made for private equity-like investments, such as taking a controlling stake in a publicly-traded company in a "going private" transaction or purchasing privately offered securities from a public company. The fund may nonetheless provide a cap of 5% to 10% on such investments.

g. ***Amendments***: The partnership agreement may typically be amended only with the written consent of the majority-in-interest of the investors. An amendment to the allocation and distribution sections or an amendment requiring the investors to increase their capital commitments, however, usually requires the unanimous consent of the investors. Notwithstanding the above, the general partner may amend the partnership agreement without investor consent in order to reflect the admission of an additional investor or an increasing investor pursuant to the terms of the partnership agreement, comply with applicable law, or correct a typographical error.

h. ***Voting***: Fund voting (e.g., with respect to amendments) is based on the proportion of the investors' capital commitments held by each investor and not on a "one-partner, one-vote" basis. Any interests held by the general partner and its affiliates are typically excluded from any voting by the investors.

i. ***Governing Law***: Delaware is the most popular jurisdiction for formation of U.S.-domiciled private equity funds sponsored by U.S.-based general partners. In addition to funds formed in Germany, the Netherlands, Luxembourg, France, and the UK, common "offshore" jurisdictions for funds formed outside the United States that are nonetheless marketed to U.S. investors include, among others, the Cayman Islands, Bermuda, the British Virgin Islands, Jersey, Guernsey, Ireland, Gibraltar, Malta, Cyprus, and Mauritius. The best choice for a non-U.S.-domiciled fund will depend on tax and regulatory considerations. Often, the same sponsor will choose to operate a fund strategy using parallel vehicles formed in different jurisdictions (for example, a Delaware limited partnership and a parallel Cayman vehicle) to address the needs of different types of investors. The sponsor will typically seek to cause the documentation for these multiple funds to be as similar as possible; however, due to differences in local law, achievement of identical fund terms may not be possible.

j. ***Disputes***: To address disputes among the principals, arbitration is a dispute resolution method that is often required by the governing documents of general partners and management companies due to its speed and confidentiality. However, it is somewhat less common in fund documents governing the relationship between sponsors and investors. Indeed, some U.S. public pension plans require that disputes be resolved in courts of such plans' jurisdictions.

k. ***Power of Attorney***: The partnership agreement and the subscription agreement typically contain powers of attorney, granted by the investor to the general partner. Some investors require that any grant of a power of attorney be narrow and extend only to ministerial actions such as corporate filings and amendments thereto. Certain institutional investors may be prohibited from granting a power of attorney altogether, but then typically agree with the general partner to expedite delivery of any required signatures.

APPENDIX C: U.S. REGULATORY ISSUES

A private equity fund is at its core a set of corporate transactions to acquire securities. Prior to the Wall Street Crash of 1929, there was little regulation of securities. During the Great Depression, President Franklin D. Roosevelt's New Deal programs included the first piece of legislation to regulate the offer and sale of securities, the Securities Act, followed by the Securities Exchange Act of 1934 (as amended, the "**Exchange Act**"), the Investment Company Act, and the Advisers Act. These four statutes, each as amended, form the core of U.S. federal regulation of the private fund industry to this day. The four aspects of fund investing that U.S. securities laws attempt to address are fund offerings and sales, fund marketing, fund ownership, and fund management.

Historically, the private fund industry in the U.S. has avoided registration under these four statutes (with the exception of the Advisers Act, which regulates fund managers, and which recently has been amended to extend its registration requirements to even more fund managers, as discussed further below). Broadly speaking, the purpose of registration under the U.S. securities laws is to protect average members of the investing public by requiring the funds to provide to the Securities and Exchange Commission ("**SEC**") and/or such investors fulsome disclosures regarding their investments, the sales process surrounding those investments, and those who sell and manage those investments. These disclosures take a substantial amount of time to prepare and are generally very costly, requiring significant legal expenses, which of course limits the returns available to investors. Private funds and those who manage and sell them may be deemed to fall outside the purpose of the regulation for the reasons described further below and thus are exempt from the registration requirements of the U.S. securities laws. Other than with respect to the Advisers Act, most private funds would not be able to bear the burden of the registration requirements. Even the large-scale funds that could administer such registrations would find their expenses relating to registration to be so onerous as to fundamentally change their business model, causing a loss of interested investors and principals and thus a collapse of their business.

a. *Fund offerings and sales*

The foremost concern of the U.S. federal government when they began creating these centralized laws regulating securities was adequate disclosure to investors of the terms and conditions of the securities being offered. Thus, the primary securities law affecting U.S. and non-U.S. offerings alike, the Securities Act, requires all offers and sales of securities to be registered with the SEC , which registration requires a complex (and issuers would say onerous) level of detail of the securities being offered for sale to be submitted to the SEC. Private funds have traditionally been exempt from the Securities Act's registration requirement because private fund interests are not available for sale to the general public and thus their investors do not require the protection of the Securities Act's disclosure requirements. Fund sponsors ensure that their fund offerings are deemed exempt from the registration requirement of the Securities Act and qualify for this so-called "private offering" exemption by utilizing the safe harbors provided by Regulation D and Regulation S promulgated under the Securities Act. Furthermore, recent changes to Regulation D as a result of the Jumpstart Our Business Startups Act of 2012 (the "**JOBS Act**") permit public offerings without registration under the Securities Act under certain circumstances discussed further below.

The primary tenet behind Regulation D has long been that, so long as fund investors are relatively sophisticated, financially astute, and have a substantive relationship with the fund issuer (or its placement agent) that pre-dates the offering of fund interests to those investors, they do not need the protections offered by the Securities Act's registration requirements. Issuers both within and outside of the U.S. may rely upon Regulation D; Regulation D is the primary safe harbor relied upon by fund sponsors globally, wherever their funds may be based, who intend to offer fund interests to U.S. investors and thus fall under the purview of the Securities Act. The Regulation D safe harbor (found in Rules 501 to 508 under the Securities Act, including the Preliminary Notes thereto) allows issuers to offer interests to an unlimited number of "**accredited investors**" and up to 35 non-accredited investors (though in effect, issuers utilizing the Regulation D safe harbor only offer interests to accredited investors due to additional regulatory burdens that would ensue from offering interests to non-accredited investors). "Accredited investors" may be individuals, trusts, corporations, pension plans, and other entities who satisfy stipulated income or net value tests, typically entities with total assets greater than $5 million and individuals with net worth in excess of $1 million.

The "private offering" exemption, however, no longer requires that the offering be private. The JOBS Act uprooted the notion that accredited investors need to have a substantial, pre-existing relationship with fund sponsors (or their placement agents). The regulations promulgated under the JOBS Act that came into effect as of September 23, 2013 have eliminated the requirement that issuers relying on Regulation D must ensure that the interests are not sold by means of "general solicitation or general advertising." Thus interests offered under the Regulation D safe harbor may now technically be offered to the general public, although virtually all investors must still be able to satisfy the "accredited investor" standards and, in addition, other applicable regulations may nonetheless require that such offerings continue to be private. The JOBS

Act has thus provided for increased flexibility—issuers may continue to offer fund interests in the traditional manner without relying on general solicitation, or they may engage in general solicitation.

Regulation D has historically required that a fund offer and sell interests only to persons it "reasonably believes" are accredited investors. Private funds have traditionally relied on investor questionnaires in subscription documents to collect information from prospective investors sufficient to establish this "reasonable belief," and courts have generally accepted this practice. The JOBS Act changed this standard for any fund utilizing general solicitation to offer its interests by requiring not only(i) that an issuer have a reasonable belief that it is selling securities only to accredited investors, but also(ii) that an issuer take "reasonable steps to verify" that it is selling securities only to accredited investors. This second requirement means that private funds engaging in general solicitation must take steps beyond those required to comply with traditional Regulation D private placement. To assist issuers, Regulation D now identifies four safe harbor methods to satisfy the new general solicitation requirements regarding the verification of accredited investors.

The burden of verification, combined with the potential loss of other regulatory exemptions applicable to funds, such as exemption from **CFTC** registration and state fund offering registration, means that traditional fund issuers are, for the time being, not taking advantage of the ability to rely on general solicitation. This trend may continue, with only new fund managers who do not have the advantage of sufficient pre-existing, substantial relationships with accredited investors taking advantage of the increased access to capital that the JOBS Act regulations are meant to provide. Time will tell if the placement agent industry suffers as a result of general solicitation or if instead investors depend more on placement agents and other resources to distinguish the most reputable funds from all other funds offered publicly.

A fund may rely on the safe harbors of Regulation D and Regulation S concurrently to ensure that its offering and sale is exempt from the registration requirements of the Securities Act. The Regulation S safe harbor is for securities that are offered and sold outside the United States. Offers and sales made outside of the U.S. are not deemed to be subject to the registration requirements of the Securities Act, whether or not the purchasers are U.S. persons or foreign investors, as long as the conditions of Regulation S are met, namely that the transaction is offshore and that there are no "directed selling efforts" (effectively, that there be no general solicitation or general advertising, as referenced in Regulation D). It should be noted that while the JOBS Act changed Regulation D to no longer prohibit "general solicitation," the "no directed selling efforts" requirement of Regulation S remains intact.

One final note on "general solicitation" and "directed selling efforts": SEC Rule 135e permits non-U.S. funds to hold non-U.S. press conferences and meetings discussing a proposed offering of unregistered securities (in reliance on Regulation D or Regulation S) if (i) the intent is to make a bona fide offering outside the U.S. (which can be concurrent with a U.S. offering) and (ii) access is given to both U.S. and non-U.S. press. Such press conferences and the like are not considered "general solicitation" or "directed selling efforts."

Exempt private placement offerings of securities are still subject to anti-fraud provisions of U.S. federal securities law under Rule 10b-5 of the Exchange Act. Rule 10b-5 promotes full disclosure in connection with offers and sales of securities and prohibits the making of any untrue statement of a material fact and prohibits the omission of any material fact necessary to make the statements not misleading. These anti-fraud rules need to be considered by a fund sponsor in particular when crafting the fund's **private placement memorandum**, including any risk factors, offering legends, track record disclosure (particularly net v. gross disclosure), and when disclosing new developments in a supplement to the private placement memorandum.

b. Fund management

Investment advisers (or fund managers) are entities that are in the business of, and are compensated for, giving advice—either directly or through publications—regarding securities. The Advisers Act and the rules promulgated thereunder regulate a fund's investment adviser and require certain investment advisers to register with the SEC and others to have "exempt reporting adviser" (or "**ERA**") status. Many investors will only invest with fund managers who are registered under the Advisers Act, as it gives them comfort that their fund managers are being sufficiently regulated. Both full registration and ERA status subject an investment adviser to certain reporting requirements; but full registration status is more onerous and carries numerous other requirements, including SEC examination of books and records (although ERA status still subjects an adviser to SEC examination for cause). Registered advisers are prohibited from charging **performance fees** except to "**qualified clients**" (investors who have at least $1 million in assets under management or a net worth of more than $2 million) and from advertising. All investment advisers, whether registered or not, must comply with the anti-fraud rules of the Advisers Act.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") amended the Advisers Act, most significantly by repealing the private adviser exemption which previously permitted fund managers with fewer than 15 funds under management to claim exemption from registration under the Advisers Act. Now there are two new exemptions: the foreign private adviser exemption (only available to advisers with no place of business in the U.S. and less than $25 million in aggregate assets under management attributable to U.S. investors) and the private fund adviser exemption (a conditional exemption for advisers who act solely for private funds and who have less than $150 million of **AUM** in the U.S.). Investors in funds whose managers qualify for such exemptions are less likely to be concerned about the regulation of such fund managers by the SEC. "Pay-to-play" rules have also targeted the practice of investment advisers making or arranging (or being solicited to make) political contributions while also seeking investment advisory business from a governmental body, which has an effect on investment advisers managing assets for US state and local government bodies. These include public pension plans, state college savings plans, or state and local employee savings plans. Advisers are prohibited from providing services to a government entity for two years after the adviser or any covered associate makes a contribution to an official of the government entity. The pay-to-play prohibition also restricts the use of placement agents, solicitors, and finders.

c. Fund ownership

A separate securities law statute applies to the fund itself, as opposed to the offer of securities in the fund or to the fund manager. The Investment Company Act regulates the ownership of securities. The Investment Company Act generally requires registration for "**investment companies**," *i.e*., issuers (such as private funds or mutual funds) that hold themselves out as being engaged primarily in the business of investing or trading in securities. While mutual funds generally register under the Investment Company Act, certain exceptions from registration as an investment company with the SEC are made for funds being privately offered with limited numbers of beneficial owners (the "**3(c)(1) exemption**") or funds whose owners are all "**qualified purchasers**" (the "**3(c)(7) exemption**").

"Qualified purchaser" status relies on the net value of the individual or entity that is the beneficial owner reaching a certain minimum (a minimum that is much higher than the net value requirements of "accredited investor" status under the Securities Act). "Qualified purchasers" generally refer to natural persons or companies owning $5 million in investments; investment managers investing $25 million in assets; and "knowledgeable employees," i.e., executive officers and directors of a fund or fund manager and non-clerical employees of a fund or fund manager who participate in investment activities.

Smaller private funds that do not anticipate a large number of investors (subject to certain look-through provisions to an investor's beneficial owners) and that do not propose to make a public offering of their securities may utilize the 3(c)(1) exemption, but generally the 3(c)(7) exemption is utilized whenever possible as it does not require the fund to concern itself with the 100-beneficial owner limit of 3(c)(1). A fund may rely on both 3(c)(1) and 3(c)(7) concurrently. Furthermore, a non-U.S. fund may rely on either exemption and needs to concern itself only with its U.S. investors to determine compliance with either exemption.

Finally, the Exchange Act (as modified by the JOBS Act) limits private fund ownership to 2,000 persons in total or 500 persons who are not accredited investors. If either such limit is exceeded, funds must register their interests under the Exchange Act. However, funds are generally in the business of making investments rather than marketing their fund to as many investors as possible—marketing is just a means to the end. Thus, in practice, due to the nature of private funds and their typically limited offering periods, ownership does not come close to reaching such limits.

d. *Fund marketing*

Anyone who sells the interests in a private fund (with certain limited exemptions for a fund selling its own securities without the use of a third-party marketer) is also subject to its own securities regulation. The Exchange Act imposes registration requirements on broker-dealers, including placement agents. Under Section 15(a), it is unlawful for any person meeting the definition of "broker" or "dealer" to effect transactions in any security unless registered, though specific safe harbors from broker-dealer registration are recognized. A private fund not utilizing a registered broker-dealer but instead selling its own securities may rely on the issuer exemption. An issuer may sell its own securities as it is not a "broker" (because the securities are not being sold for the account of others) and it is not a "dealer" (because it is not both buying and selling the securities, but rather distributing them directly to investors). SEC Rule 3a4-1 provides a safe harbor exemption for placement activities by a fund's "associated persons": namely, natural persons who control, are controlled by, or have common control with the issuer and who (i) do not receive transaction-based compensation, (ii) are not an associated person of a broker-dealer, and (iii) are not otherwise subject to statutory disqualification. In addition:

(a) Securities may only be offered and sold to certain financial institutions and intermediaries.

(b) Only "passive sale" activities may take place.

(c) The associated person must have substantial business duties unrelated to securities sales and participate in placement activities no more than once every 12 months.

Although the focus of this brief has been on U.S. funds, it is worthwhile noting that, although the U.S. securities laws on marketing do not distinguish impact investment funds from other fund offerings, the European Union has established a regime, the Regulation on European Social Entrepreneurship Fund (**EuSEF**) for marketing sub-€500 million private investment funds at least 70% of the capital commitments of which is invested, via equity or debt structures, in investments that provide services or goods to vulnerable, marginalized, disadvantaged, or excluded persons; employ a method of production of services that embodies their social objective; and provide financial support exclusively to such social undertaking. EuSEF will permit smaller social-impact fund managers to benefit from the **AIFMD** passport regime and market their funds throughout the **EEA**, thereby making it quicker and easier for such fund managers to raise capital, as well as increasing the confidence of investors that wish to make impact investments.

e. The Volcker Rule

The Volcker Rule is a provision of the Dodd-Frank Act that amended the Bank Holding Company Act to prohibit certain banking entities (and their affiliates and subsidiaries) from acquiring or retaining any ownership interest in, or sponsoring, a hedge fund or a private equity fund. An issuer is deemed to be a "hedge fund" or a "private equity fund" for purposes of the Volcker Rule if it would be an investment company under the Investment Company Act but for the 3(c)(1) or 3(c)(7) exemptions discussed above. Thus, most private funds are caught by the Volcker Rule, though the final rules implementing the Volcker Rule have yet to take effect. Some banks have spun out their private fund businesses in reaction to the Volcker Rule, while others are biding their time until the final rules are implemented.

f. FCPA & Anti-Bribery

The Foreign Corrupt Practices Act is not securities law legislation directed at private funds *per se*, but U.S. fund issuers (and their non-U.S. subsidiaries) need to ensure compliance with the FCPA, particularly when reviewing the qualification of investors subscribing to a fund. The FCPA originated out of the Watergate scandal, following which the government investigated widespread use of improper payments and found that over 400 companies, including about 20% of the Fortune 500, made "questionable" foreign payments to foreign government officials, politicians, and political parties totaling more than $300 million. The FCPA, signed into law in 1977, has two principal provisions: anti-bribery prohibitions, prohibiting bribery of non-U.S. government officials; and books and records requirements, requiring U.S. issuers to maintain accurate books and records and reasonable accounting controls (this latter requirement is actually an amendment to the Exchange Act discussed above). Violations of the FCPA can lead to both criminal and civil penalties, with dual enforcement vested in the U.S. Department of Justice and the SEC.

APPENDIX D: GLOSSARY

3(c)(1) exemption | The private investment company exemption from registration as an investment company under the Investment Company Act for issuers conducting private offerings only with limited number of beneficial owners (not more than 100 persons, which includes both natural persons and companies).

3(c)(7) exemption | The exemption from registration as an investment company under the Investment Company Act for issuers conducting private offerings only with owners who are all "qualified purchasers."

501(c)(3) organizations | Organizations that qualify as tax-exempt under Section 501(c)(3) of the Code.

Accredited investors | Individuals, trusts, corporations, pension plans, and other entities who satisfy stipulated income or net value tests, typically entities with total assets greater than $5 million and individuals with net worth greater than $1 million.

Advisers Act | The Investment Advisers Act of 1940, as amended.

Advisory Committee | A committee to the fund composed of a small number of limited partners, which may have certain consultation and/or approval rights as described in the fund's operating agreement. See also **Appendix B**.

AIFMD | The Alternative Investment Fund Managers Directive of the European Union, which entered into force on July 21, 2011, and was due to be transposed into national law within the EEA by July 22, 2013 (although not all EEA member states have done so). AIFMD aims at establishing common requirements governing the authorization and supervision of alternative investment fund managers in order to provide a coherent approach to the related risks and their impact on investors and markets in the EEA. The issues raised by AIFMD must be addressed by all fund managers globally whenever marketing to investors in the EEA.

Anchor investors | Generally, the first third-party investor(s) committing a significant amount of capital to an investment fund, though such investment may not be made until after the first closing of the fund.

AUM | Assets under management.

Benefit Corporation | Generally, a type of for-profit entity, which, in addition to seeking profit, has a social welfare or environmental purpose.

Bridge investments | Short-term investments by a fund in an underlying portfolio company. See also **Appendix B**.

Capital commitments | The amount of money that an investor agrees to contribute to an investment fund, typically in the investor's subscription agreement with the fund. *See also* **Appendix B**.

Carried interest (or carry) | Any amount of an investor's allocated profit distributed to the fund sponsor, i.e., the amount of profit that the general partner receives (outside of the profit it makes on its own capital commitment) on the fund's realized investments.

CFTC | The U.S. Commodity Futures Trading Commission.

Clawback | The amount of carry that a general partner (or carried interest partner, as applicable) must return to the fund, to be re-distributed to the limited partners, in the event that, when fund distributions to date are calculated on an aggregate basis (typically at liquidation, but a fund may provide for earlier, interim clawback calculations), the general partner has received carry but the limited partners have not received their full return of capital and preferred return, or the general partner has received more than its allotted carry percentage (e.g., over 20%).

Closed-end, blind-pool investment vehicles | Issuers of investment (typically equity) securities to third-party investors, who make their commitment for a fixed term and do not know what the specific investments will be that the issuer makes prior to their commitments to the issuer.

Closing | The time at which a fund issues limited partnership interests to investors who have subscribed for investment in the fund. See also **Appendix B**.

Code | The U.S. Internal Revenue Code of 1986, as amended.

Controlled foreign corporation ("CFCs") | A non-U.S. entity classified as a corporation for U.S. federal income tax purposes, if greater than 50% of the total vote or value of the non-U.S. entity is owned (applying certain attribution rules), in the aggregate, by U.S. shareholders that each own (in each case, applying certain attribution rules) 10% or more of the total combined voting power of all classes of stock of such corporation.

Critical change in circumstances | A condition, such as serving an illegal purpose or a private purpose of the private foundation or its manager, which may result in an investment ceasing to qualify as a PRI.

Deal-by-deal waterfall (or investment-by-investment waterfall) | Distribution waterfall whereby distributable proceeds are allocated and distributed solely with respect to the investment generating the proceeds, rather than across all prior investments, which structure may permit the general partner to receive carry with respect to an individual investment notwithstanding that investors may not have received a return of all of their prior capital contributions. Sometimes referred to in Europe as an "American-style" waterfall.

Debt-financed property | Generally, property held to produce income (including gain from its disposition) for which a portion of acquisition cost is financed by borrowed funds.

Default | When an investor does not fund the capital call issued to it by a fund manager, it is deemed to be in default. See also **Appendix B**.

DFI | Development finance institution.

Distribution waterfall | The fund structure that determines the allocation and distribution as between the investors and the general partner of the distributable proceeds of a fund, including operating income, dividends, and capital proceeds.

Dodd-Frank Act | The Dodd-Frank Wall Street Reform and Consumer Protection Act.

Drawdown notice | Notification from a fund manager to an investor that a capital call to investors is being made, which typically must be funded either directly or by offset of distributable proceeds within 10 business days.

Economic terms | Refers to all of the economic terms and conditions specified in the limited partnership agreement of the fund, in particular the management fee and the distribution waterfall.

EEA | European Economic Area, which consists of the member states of the European Union and three of the four member states of the European Free Trade Association (Iceland, Liechtenstein, and Norway).

ERA | Exempt reporting adviser under the Advisers Act.

ERISA | The U.S. Employee Retirement Investment Security Act of 1974, which is particularly relevant for purposes of fund investments made by U.S. private pension plans. ERISA imposes stringent fiduciary standards of conduct in furtherance of its primary goal of safeguarding the interests of participants and beneficiaries of employee benefit plans.

ESG | Environmental, social and corporate governance.

EuSEF | European Social Entrepreneurship Fund.

Excess business holdings | Generally, a portion of a private foundation's investment in a corporation or other entity conducting a business that is not substantially related to the exempt purposes of the private foundation and exceeds 20% of the voting power of such a corporation (or 20% of the beneficial or profits interests in such an unincorporated entity).

Exchange Act | The Securities Exchange Act of 1934, as amended.

FCPA | The Foreign Corrupt Practices Act.

Feeder funds | Special purpose vehicles through which one or more investors invest in a fund, formed to accommodate those investors' tax or other considerations. See also **Appendix B**.

Fiscally transparent entity | Generally, an entity that is not subject to tax itself, but whose income, losses, credits and deductions flow through to, and are included currently in the income of, the equity investors in the entity as if the items were realized directly by such equity investors.

Flexible Purpose Corporations | Generally, a California corporation that meets certain requirements and specifies in its charter that it has a "special purpose," which can include a charitable or public purpose.

FOIA | The U.S. Freedom of Information Act, requiring certain investors (such as public pension plans) to provide otherwise confidential information about their investments.

Fund vehicles | All of the lower-tier entities comprising the fund through which investors invest in the fund and the fund makes its investments in portfolio companies. A simple fund may have only one vehicle, in which all investors invest and through which it makes all of its investments directly. Larger funds, accommodating investors globally and making investments globally, may have more complicated structures, including parallel funds, feeder funds and alternative investment vehicles.

Fund-of-funds | An investment strategy of holding a portfolio of other investment funds rather than investing directly in portfolio companies. See also **Appendix A**.

Fundraising period | The initial, limited period of time during which a fund offers limited partnership interests to prospective investors. See also **Appendix B**.

General partner (or GP) | Given that U.S. private equity funds are typically formed as limited partnerships, the "general partner" refers to the sponsor entity, usually a newly formed special purpose vehicle in which the exclusive power to manage the fund is vested (which power the general partner may delegate to the investment manager) and which has unlimited liability with respect to the fund's debts and obligations.

Giveback (or limited partner clawback (chiefly British)) | The amount of returned capital or other distributions that a limited partner may be obligated to return in order to assist the fund in satisfying its liabilities, often limited to liabilities incurred as a result of the fund's indemnification obligations. The giveback may be limited as to time (typically anywhere between two years after receipt of a distribution and three years following the fund's termination) and as to amount (set as a percentage of the capital commitment of the limited partner or the distributions received by the limited partner).

Governance terms | Refers to all of the terms and conditions specified in the limited partnership agreement of the fund, which describe in detail the parameters of what the fund can and cannot do. Colloquially, reference to a fund's governance does not include its economic terms. Governance may be described, in a modified manner, in the "term sheet" of a fund's private placement memorandum, but the term sheet may omit many carve-outs and exceptions to the terms and conditions contained in the limited partnership agreement. See also **Appendix B**.

"High water mark" test | Because investors in open-ended funds (which is how hedge funds are typically structured) may acquire and divest themselves of an interest in such funds at different points in time from each other, hedge funds must rely upon the so-called "high water mark" test to determine whether or not any performance fee to the fund manager is applicable to an investor's interest. A performance fee may only be paid to the fund manager in respect of any interest held by the investor if the net value of the investor's interest in the fund has increased since the later of the time of the investor's contribution to the fund and the time the last performance fee was paid to the fund manager with respect to such interest.

ILPA | Institutional Limited Partner Association.

ILPA Principles | A description of standards for key terms in private equity funds that are generally desirable from an institutional investor's perspective.

Impact investments | Investments made to generate social and environmental impact as well as a financial return to their investors.

Information rights | Refers to the investors' rights to all information, particularly financial reports, about the fund and its investments as specified in the limited partnership agreement of the fund.

Investment companies | Issuers, such as private funds or mutual funds, that hold themselves out as being engaged primarily in the business of investing or trading in securities. They are required to register under the Investment Company Act unless an exemption can be utilized.

Investment Company Act | The Investment Company Act of 1940, as amended.

Investment period (or commitment period) | The period of time during which the fund manager may drawdown capital commitments for investment in underlying portfolio companies. See also **Appendix B**.

IRS | The U.S. Internal Revenue Service.

Jeopardizing investments | Investments that will jeopardize a private foundation's ability in both the short and long term to fulfill its charitable purposes. Jeopardizing investments could lead to the imposition of excise taxes.

JOBS Act | The Jumpstart Our Business Startups Act of 2012.

Limited partners ("LPs") | Private equity fund investors, called "limited partners" in reference to the typical structure of their investment in a fund as limited partners in a limited partnership.

Low-profit Limited Liability Companies ("L3Cs") | Generally, a for-profit limited liability company that is specifically organized to further one or more charitable or educational purposes to facilitate PRIs.

Management fee | An annual fee, paid quarterly or semi-annually, either in advance or in arrears, by the fund to the fund manager calculated as a percentage of the fund's assets, to ensure a steady stream of income to the management team and cover various costs incurred by the principals in the operation of their business.

Organizational and offering expenses | Expenses incurred in forming and marketing the fund and any related vehicles, including printing, travel, legal, accounting, and filing fees and costs.

Overseas Private Investment Corporation ("OPIC") | The U.S.'s development finance institution.

Parallel funds | Two or more investment vehicles through which investors subscribe to a private fund, each vehicle being formed to cater to the tax and jurisdiction of the anticipated investors. See also **Appendix B**.

Passive foreign investment company ("PFIC") | Generally, a non-U.S. entity classified for U.S. federal income tax purposes as a corporation that meets either of the following tests for any taxable year: (1) 75% or more of its gross income is "passive income," or (2) 50% or more of its assets, based on their average value for the year, are held for the production of passive income.

Performance fee (or incentive allocation) | Any profit that a hedge fund or other open-ended vehicle pays to its sponsor on a periodic basis, typically subject to a "high water mark" test.

Phantom income | The recognition of income without the contemporaneous receipt of cash sufficient to pay the corresponding tax liability.

Plan assets | The presence or absence of plan assets is crucial in determining whether the fiduciary standards imposed by ERISA apply to a particular fund. Generally, when a U.S. private pension plan invests in another entity, its assets include the investment, but not any of the underlying assets of the entity. In the case of a U.S. private pension plan's investment in an equity interest of a privately-offered fund that is not registered under the Investment Company Act, its assets include both the equity interest (its LP interest in the fund) and an undivided interest in each of the underlying assets of the fund (the fund's portfolio companies), unless it is established that either the fund is an operating company (the so-called VCOC or REOC exemptions) or equity participation in the fund by benefit plan investors is not significant (the so-called 25% test).

Preferred return (or hurdle rate) | The minimum return that must be received by an investor before any performance-based compensation is paid to the fund manager.

Private offering | Generally, non-public offers and sales of securities to a limited number of qualified investors. Specifically, non-public offers and sales of securities that are exempt from the registration requirements of the Securities Act through utilizing the safe harbors provided by the rules set forth in Regulation D and Regulation S promulgated under the Securities Act.

Private placement memorandum | The primary marketing document of a private equity fund describing the business purpose of the fund. Though not a legally binding document, it still must accurately describe the fund in compliance with anti-fraud rules.

Program related investment ("PRI") | An exception to the jeopardizing investment rules. For an investment to qualify as a PRI, it must meet the following requirements: (1) the primary purpose of the investment is to accomplish one or more exempt purposes of the foundation, (2) production of income or appreciation of property is not a significant purpose of the investment, and (3) no lobbying activity will be supported.

Qualified clients | Investors who have at least $1 million in assets under management or a net worth of more than $2 million; defined in the Advisers Act.

Qualified purchasers | Highly sophisticated persons that are able to invest in private investment funds relying on the 3(c)(7) exemption, including: natural persons and family-owned companies with at least $5 million in investments; other companies with at least $25 million in investments; certain trusts in which the trustee and each settler are qualified purchasers; companies owned solely by qualified purchasers; qualified institutional buyers (QIBs), including registered investment companies and similar institutions that own and invest on a discretionary basis at least $100 million of unaffiliated securities; and "knowledgeable employees," such as executive officers and directors of a fund or fund manager and other non-clerical employees of a fund or fund manager who participate in the fund's investment activities.

Recycling | The ability of a fund to re-deploy capital that has been or could be distributed to its investors. See also **Appendix B**.

REOC | Real estate operating company.

SEC | The Securities and Exchange Commission.

Securities Act | The Securities Act of 1933, as amended.

Shadow banking | Non-bank credit activity, which performs many of the same functions but is not regulated in the same way as banking.

Side letters | A separate agreement entered into by a fund and an investor that alters or augments the terms of its investment in the fund.

Special limited partner (or carried interest partner) | A special purpose vehicle through which a fund sponsor will invest in the fund and which, in lieu of the general partner, receives all carry distributions. This structure ensures that any carry received is not subject to the unlimited liability of the general partner.

Sponsor | General term of reference for the investment firm forming a private fund.

Subscription agreement (or subscription deed) | The contract between the investor and the fund pursuant to which the investor commits to contributing a certain amount of money (its capital commitment) to the fund when called; agrees to the terms of the limited partnership agreement or other operative agreement governing the fund; and makes certain representations, warranties, and other undertakings concerning its status in order that the fund may ensure that it complies with various tax, regulatory, and other requirements.

Successor fund | A fund having the same investment purpose as an existing fund of a fund sponsor, but raised because the existing fund's investment period has terminated and it no longer has the ability to raise new capital and seek new investments. See also Appendix B.

U.S. tax-exempt investors | U.S. investors that are generally exempt from taxation under Section 501 of the Code, including private foundations.

United Nations Principles for Responsible Investment ("UNPRI") | Voluntary and aspirational actions for incorporating ESG issues into investment practices across asset classes.

Unrelated business taxable income ("UBTI") | Generally, except with respect to certain categories of exempt trading activity, UBTI for any U.S. tax-exempt investor includes: (i) income or gain derived from a trade or business owned directly or through entities treated as fiscally transparent for U.S. federal income tax purposes, the conduct of which is substantially unrelated to the exercise or performance of such investor's exempt purpose or function; (ii) income derived by such investor from debt-financed property; and (iii) gains derived by a such investor from the disposition of debt-financed property.

VCOC | Venture capital operating company.

Whole fund waterfall (or return of capital waterfall) | Distribution waterfall whereby distributable proceeds are allocated and distributed with respect to all prior investments, irrespective of the investment generating the proceeds, which structure provides that all capital contributions of investors are returned before the general partner begins to receive any of carried interest. Sometimes referred to in Europe as a "European-style" waterfall.