

ILPA RELEASES CONTINUATION FUND GUIDANCE

On 15 May 2023 the Institutional Limited Partner Association (ILPA) published a new guidance paper relating to continuation funds, directed at the private funds industry across asset classes. This follows ILPA's broader paper on GP-led secondary transactions published in April 2019. ILPA is a global organisation dedicated to advancing the interests of investors in private funds.

ILPA's continuation funds guidance paper is available online¹. It comes less than two weeks after the United States Securities and Exchange Commission adopted new rules in respect of SEC-registered investment advisers which, among other things, seek to expand the regulatory reporting requirements with respect to GP-led transactions such as the establishment of continuation funds.

Introduction

ILPA begins its paper by ascribing a number of key concerns to the limited partner community which can be summarised as follows:

- Continuation funds can be complex and can require significant time and attention from limited partners.
- Limited partners may dislike being asked to make decisions about one or more specific assets - some see this as being beyond the traditional remit of an investor in a blind pool multi-asset fund.
- Some of the decision-making around continuation funds can require short timeframes, which may or may not be consistent with investors' own practical requirements and limits (such as investment committee schedules). In turn this can result in a forced exit for an investor if its reinvestment decision cannot be made in time.
- GPs having interests on both the sell side and the buy side leads to conflicts of interest which need to be carefully managed.

In this brief overview, we outline the headline takeaways from ILPA's paper and submit a few related observations.

¹ See <https://ilpa.org/continuation-funds/>

Conflicts and the Role of the Limited Partner Advisory Committee

The ILPA paper recommends that GPs should consult with the fund's LP Advisory Committee ("LPAC"), including as to the rationale for pursuing a continuation fund in light of alternative transactions explored. It goes on to recommend that the LPAC should vote on whether to waive any conflicts of interest associated with the process of the transaction, irrespective of whether the waiver is a contractual requirement under the fund documents. It encourages GPs to avoid including provisions which pre-clear these transactions in their fund documents or, if included, not to rely on such provisions in respect of continuation funds.

The paper acknowledges scenarios in which the interests of individual LPAC members may differ from one another depending on their own respective priorities and intentions in relation to the asset in question. The overarching ILPA recommendation is that the LPAC should seek to optimise value for all investors in the selling fund. However, achieving this can be a delicate exercise in circumstances where there are conflicts of interest as between multiple LPAC members and/or as between LPAC members and the non-LPAC investor base (for example, if a sell-side LPAC member also wishes to anchor the new fund). Often GPs seek to afford particular weight to independent 'safeguards' such as external fairness opinions or market pricing processes in order to counter this. The ILPA paper also contemplates LPAC recusals, which are typically catered for in LPAs but which tend to be exercised relatively rarely in practice.

The paper suggests that if effectuating a GP-led secondary sale transaction requires amendments to the existing fund documents, the LPAC should not be asked to provide a recommendation to approve the amendments. In some older fund vintages, LPA amendments may be unavoidable in this context. Quite often the amendment process will move ahead without any formal commentary or 'blessing' from the LPAC in any case, requiring a straightforward LP-wide vote. There may be circumstances in which the LPAC might wish to express a positive view of the transaction, and we would expect this to be approached on a case-by-case basis.

Pricing

ILPA notes that a competitive process should be run with a view to ensuring a fair price, and that this process "*should include third party price validation*". From a legal perspective, being able to demonstrate that conflicts of interest have been handled in a transparent and fair manner is critical, and independent market-based stress-testing is a highly effective way of doing this. Occasionally there may be situations in which true external price validation may be difficult (or impossible) to achieve, such as in the context of partial disposals / hybrid co-invest arrangements where the transaction is by its nature not one that would be made available to external buyers, or in respect of fund-of-funds where valuations can be 'passed through' with minimal input from the GP.

Information

The ILPA guidance states that GPs should disclose "*the necessary information about the selected assets, the process, the rationale and the bids in a timely fashion to the LPAC when considering conflict waivers and to all existing LPs to facilitate roll or sell decisions*". In general we have found that providing an early

and comprehensive pack of information to existing investors is helpful to ensure a smooth and a fair transaction. We agree with ILPA that parity of information as between existing investors and potential incoming investors represents best practice in this area.

Notably, the paper is granular regarding the type of information that a GP is recommended to disclose. This includes performance information in respect of any continuation funds it has previously managed. This recommendation does not appear to be limited by timing, asset class or otherwise. Accordingly, it will need to be treated with care in the context of SEC and ESMA rules regarding the use and pertinence of track record from dissimilar products. (It is not clear why the performance of a continuation fund that holds a certain type of investments is considered more relevant here than, for example, a co-investment vehicle holding similar assets.)

Process and Timing

ILPA's preference is for the GP to appoint advisors to facilitate the transaction, and to disclose its arrangement with such advisor(s) including any associated conflicts of interest. The paper notes that the advisor's engagement should be specified as being for the benefit of the fund and not just the GP. It will be interesting to see whether/how this plays out in practice, in terms of the market position, cost and any knock-on impact on fund indemnification clauses to expressly cover advisors in this field.

Timing-wise, the paper suggests at least 30 calendar days or 20 business days for existing investors to confirm decisions as to whether to roll into the continuation fund or to exit. This is broadly consistent with how most processes are run and with what the U.S. tender offer rules (sometimes used as best practice parameters for GP-led secondaries) generally require - albeit sometimes GPs will divide the process into an initial non-binding phase and a subsequent binding election phase, which when combined will typically last longer than one month but with each individual phase being shorter.

Terms

The paper suggests that existing investors who roll into a continuation fund should continue to receive the benefit of their original side letters - at a minimum as to risk and governance. Often the original side letters are used as a base where appropriate, accepting however that there will be various provisions in the original side letter which might not apply based on the facts of the transaction and/or the passage of time.

The ILPA guidance is quite firm about commercial terms, recommending that:

- there should be no increase to the management fee rate or base for rolling LPs
- there should be no increase to the carry (or decrease in the hurdle)
- there should be no crystallisation of carry with respect to rolling LPs' interests
- any carry crystallised from selling LPs should be reinvested into the new continuation fund

Whilst ultimately these are commercial rather than legal matters, these points can be quite difficult to prescribe in the abstract. There is merit in considering the commercial features of a continuation proposition on a case-by-case basis, taking into account all relevant facts. For example, the comments around carry crystallisation do not address the incentivisation challenges which may be faced by managers operating longer term products within certain asset classes. They also do not distinguish between transactions that happen at an early stage of a fund's life (e.g. during the investment period) versus transactions that happen at the end of a fixed term. In principle they could also result, inadvertently, in GPs preferring as many investors as possible to sell given that the economics of accommodating existing investors may be less attractive.

Contacts

London



ALEXANDRA DAVIDSON
Partner, Global Head of Funds &
Investment Management
alexandra.davidson
@cliffordchance.com



GERARD SAVIOLA
Partner
gerard.saviola
@cliffordchance.com



ALEXANDER CHESTER
Partner
alexander.che-
ster@cliffordchance.com



JONATHAN BRAY
Partner
jonathan.bray
@cliffordchance.com



LILY MARCEL
Partner
lily.marcel
@cliffordchance.com



VISHAL MASHRU
Partner
vishal.mashru
@cliffordchance.com

New York



MICHAEL SABIN
Partner
michael.sabin
@cliffordchance.com



SUSAN BURKHARDT
Partner
susan.burkhardt
@cliffordchance.com



KELLY LABRITZ
Partner
Kelly.Labritz
@cliffordchance.com



BILL STURMAN
Partner
William.Sturman
@cliffordchance.com



DANIEL DRABKIN
Partner
daniel.drabkin
@cliffordchance.com

Europe



XAVIER COMAILLS
Partner, Paris
xavier.comaills
@cliffordchance.com



MARIE PREAT
Partner, Paris
marie.preat
@cliffordchance.com



SONYA PAULS
Partner, Munich
sonya.pauls
@cliffordchance.com



PAUL VAN DEN ABEELE
Partner, Luxembourg
paul.vandenabeele
@cliffordchance.com



MAREN STADLER-TJAN
Partner, Luxembourg
maren.Stadlertjan
@cliffordchance.com



KRISTOF MEYNAERTS
Partner
kristof.meynaerts
@cliffordchance.com



EMMANUEL HENRION
Partner, Luxembourg
emmanuelfrederic.henrion
@cliffordchance.com



ILDEFONSO ALIER
Partner, Madrid
ildelfonso.alier
@cliffordchance.com

Asia



KAI SCHNEIDER
Partner, Singapore
kai.schneider
@cliffordchance.com



DARYL LIU
Partner, Singapore
daryl.liu@cliffordchance.com



YING WHITE
Partner, Beijing
ying.white
@cliffordchance.com



MATTHIAS FELDMANN
Partner, Hong Kong
matthias.feldmann
@cliffordchance.com



LIYONG XING
Partner, Hong Kong
liyong.xing@
cliffordchance.com



VIOLA LUI
Partner, Hong Kong
viola.liu@cliffordchance.com