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Fund Governance

Aspects and Fiduciaries to be Considered by Fund Directors

July 2015

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1. Introduction

The crucial decision-makers of a fund[1] are generally the investment manager, investment committee, advisory board and directors. While these decision-makers may play intrinsically different roles in the governance of a fund, they all have a common fiduciary duty towards the investors.

The objective of this paper is to highlight the roles and responsibilities of fund directors and managers generally. The objective parameters may very well also be considered by members of the investment committee in the context of the India based funds that are primarily set up in the form of a trust.

Good governance of funds is important not only for investor protection but also for better investment returns and preventing early or untimely investor exits.

This paper summarizes the emerging jurisprudence which suggests that the threshold of fiduciaries to be met by directors is shifting from *"sustained or systematic failure to exercise oversight"* to *"making reasonable and proportionate efforts commensurate with the situations".*

A failure to perform their supervisory role could raise issues as to the liabilities on independent directors for resultant business losses as would be seen in the recent Cayman Islands Court of Appeals' judgment in the case of *Weavering Macro Fixed Income Fund* (summarized later in this paper). The paper also discusses duties of directors at different stages during the cycle of a fund, concepts such as investor activism and 'managerialism of hedge funds' and the regulation of fund governance in different jurisdictions.

1. The usage of the term 'fund' throughout this paper, unless specified otherwise, refers to several forms of pooling vehicles under discretionary management. The pooling or raising of private capital could be from institutional or High Net Worth Investors (HNIs) with a view to investing it in accordance with a defined investment policy for benefit of those investors.

2. General Fiduciaries Expected from Fund Directors

The fund directors are often described as being subject to certain 'fiduciary' duties which refer to the general guiding principles under which they are required to act. These duties and guidance thereon are derived from the various statutes, fund organizational documents and case laws.

I. The Duty to Act with Reasonable Care, Skill and Diligence

Generally the directors of a fund are required to perform their duties with that diligence, care and skill which would be exercised by ordinarily prudent persons in similar circumstances. The dereliction of such duty so as to give rise to the liability of directors involves a 'gross' or sustained abdication of responsibility on the part of the directors, or a serious deficiency in the board's decision-making process when a particularly important decision is involved.[2]

In Frances vs. United Jersey Bank,[3] the court observed that "a director is not an ornament, but an essential component of corporate governance." Further the court also laid down that directors as a basic rule should acquire a rudimentary understanding of the business; engage in general monitoring of corporate affairs and activities; regularly attend board meetings; regularly review financial statements; and make inquiries into doubtful matters, raise objections on what appear to be illegal, and consult counsel and/or resign if corrections are not made.[4]

In a recent case, the US Securities and Exchange Commission (the "**SEC**") charged an investment firm with misallocating diligence expenses up to $17.4 million related to unconsummated deals to its private equity funds, resulting in a breach of its fiduciary duty as an investment adviser. It was alleged that the firm failed to provide justifiable grounds for the misallocation.

II. The Duty to Act in Good Faith and in a Bona Fide Manner in the Best Interests of the Fund

Directors are not liable for the decisions of the Board that cause harm to the fund or its shareholders if such decisions are made in good faith, in the best interests of the fund and have been carried out in a well-informed manner. Often termed as the 'Business Judgment Rule', which was first used the case of *Charitable Corp v. Sutton*[5] directors are presumed to have met the standards of care as long as no fraud, illegality, or conflict of interests is established, thereby protecting them from the constant fear of prosecution if a business decision goes awry.

However, this standard of protection offered by the rule does not provide unlimited scope to the directors for instance if it is discovered that the decision-making process was 'grossly negligent', the director would be liable for breach of fiduciary duty.

A sound 'business judgment' by a director should be taken in good faith in the best interests of the fund by participating in an informed decision-making process bearing in mind reports and opinions of committees, employees and experts on a rational basis in compliance with applicable laws.[6]

III. The Duty to Act Loyally in the Interest of the Fund

Fund directors owe to the fund a duty of loyalty that requires them to put the best interests of the fund and its shareholders before their personal interests.[7] The conflict of interest of the 'interested' directors with that of the fund does away with the business judgment rule in making an informed decision. The interested director has the burden of proving that in the process of taking the decision, he has not

2. Fund Governance: Legal duties of Investment Company Directors, Part I, 2-25.
3. 432 A.2d 814 (N.J. 1981)
4. Ibid.
5. 2 Atk. 400, 26 Eng. Rep. 642 (Ch. 1742).
6. Fund Governance: Legal duties of Investment Company Directors, Part I, 2-38.
7. Ibid. at 2-45.

breached the duty of loyalty when such conflict of interest is involved.

A director may be considered an 'interested' party when the transactions relate to the purchase or sale of property, loans and other financial arrangements between the fund and the director. The involvement of family members in such transactions may also give rise to concerns

The Institutional Limited Partner's Association ("**ILPA**") released the Private Equity Principles ("**Principles**") to encourage discussions between the fund managers (general partners or "**GPs**"), directors and the investors to the fund (limited partners or "**LPs**") or the shareholders regarding key issues including *governance.*[8]

The Limited Partner Advisory Committees ("**LPACs**") play a crucial role in the governance of a fund. LPAC's are of various types and not constant through all funds, they could be in the form advisory boards, investment committees, valuation committees, etc. The primary functions performed by an LPAC generally include resolving conflicts of interests of the GPs, waivers of partnership restrictions and general oversight of the governance of the fund. LPACs are comprised of the LP representatives who often are the significant LPs appointed by the GPs.[9]

Operation of the fund involves a high level of discretion assigned to the GPs. This often results in provisions being included in the partnership agreement which reduce the GPs fiduciary duties or in some cases, the GPs even avoid certain duties. The Principles provide for mechanisms via which such provisions could be avoided:

- The GPs should present all conflicts of interest to the LPAC for review and seek prior approval for such conflicts and/or non-arm's length interactions or transactions. The GPs should not clear their own conflicts.
- The GPs should preclude provisions that allow them to be exonerated or indemnified for acts constituting a material breach of the partnership agreement, the fiduciary duties or other "for cause" events.
- Majority of the LPs should be given the authority to remove a GP or terminate the fund for cause.
- To prevent irreparable damage to the interests of the LPs, conditions precedent and other such removal mechanisms should be included in the partnership agreement.

The Principles also suggest on-boarding independent auditors and other such third party mechanisms for monitoring the performance of fiduciary and other such duties by the GPs. The independent auditors are tasked with informing the LPAC of the conflict of interests the GPs might have in relation to the performance of their duties.

Among other things the auditors are expected to review the capital accounts with specific attention to management fee, partnership expenses, and carried interest calculations to provide independent verification of distributions to the GP and LP.

As regard other third parties, a reasonable minority of the LPAC may engage independent counsel at the fund's expense when considering matters where the GPs interests may not be entirely aligned with those of the LPs.

However, recently the expenses of third party services going up, is not just to do with supply and demand. The securities' regulators now require that service providers who don't do enough to catch clients' bad behavior can be held liable, which has led to these specialist service providers taking a more compliance-minded approach themselves.

Apart from independent auditors and third parties, the Principles outline the functions of LPACs which are generally limited to reviewing and resolving conflict of interest transactions such as cross-fund investments and related party transactions, methodology used for valuations of portfolio companies, etc. The formal responsibilities of LPACs are provided in the private placement memorandum, the LP agreements and fund's constitutional documents (depending on the format in which the fund has been set up).

8. See Annexure-1: ILPA Private Equity Principles, Version 2.0, January, 2011.
9. ILPA PE Principles version 1.0

3. Duties of Directors at Different Stages During Life-Cycle of a Fund

The Directors perform wide-ranging duties during different stages of the fund. These duties should guide everything that a director does during the following phases in the life of a fund.

I. At the Fund Formation Stage

The Directors must satisfy themselves that the offering documents comply with applicable laws, that the terms of the service providers' contracts are reasonable and consistent with industry standards, and that the overall structure of the fund will ensure a proper division of responsibility among service providers. Directors must act in the best interests of the fund which, in this context, means its future investors.

In this respect, we believe 'verification notes' can be generated. The notes would record the steps which have been taken to verify the facts, the statements of opinion and expectation, contained in the fund's offering document(s). The notes also serve the further purpose of protecting the directors who may incur civil and criminal liability for any untrue and misleading statements therein or material or misleading omissions therefrom. Alternatively, a 'closing opinion' may also be relied upon.

Following closely on the footsteps of the SEC's recent observations[10] by U.S. Securities and Exchange Commission (SEC) that there are several disconnects between "what [general partners] think their [limited partners] know and what LPs actually know", the Indian Securities Exchange Board of India ("**SEBI**") has issued a circular[11] ("**Circular**") that consolidates guidelines on disclosures and reporting that alternative investment funds ("**AIFs**") have to make. The Circular also provides certain clarifications on the interpretation of the provisions of the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**").

The AIF Regulations were notified on May 21, 2012. Subject to certain exceptions, the ambit of the AIF Regulations is to regulate all forms of vehicles set up in India for pooling of funds on a private placement basis. To that extent, the AIF Regulations provide the bulwark within which the privately pooled discretionary fund management industry operates in India.

The Circular inter alia requires detailed tabular example of how fee and other charges are calculated and how the distribution waterfall is structured.

II. During the Fund's Tenure

A. Appointment of Service Providers

The Directors should consider carefully which service providers are selected for appointment. They should understand the nature of the services to be provided by the service providers to the fund.

B. Agenda

The formalities of conducting proper board meetings should be observed. An agenda for such meetings should list the matters up for discussion, materials to be inspected, and inputs from the manager, the service providers and directors themselves. It should be circulated in advance.

C. Actions Outside Board Meetings

The Directors should review reports and information that they receive from the administrator and auditors from time to time to independently assess the functioning of the fund and whether it is adhering to with the fund's investment strategy.

10. On May 6, 2014, Andrew Bowden, Director of the U.S. Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE), stated that the OCIE has found widespread instances of insufficiently disclosed fees in the private equity industry. Also see http://blogs.wsj.com/privateequity/2014/06/10/sec-official-points-to-disclosure-shortcomings-by-private-equity-firms/11. July 08, 2014 – Reuters, http://www.reuters.com/article/2014/07/08/financial-regulations-sec-alternatives-idUSL2N0PJ0XB20140708

11. CIR/IMD/DF/14/2014

D. Decision Making Process

The Directors should exhibit that there was an application of mind when considering different proposals before it. For example, in case of investor 'side letters' that may restrict the fund's investments into a restricted asset class, etc., it could raise management issues.

While execution of such 'side letters' may not be harmful to the fund, but an approval at 'short notice' may be taken up to reflect on the manner in which the directors perform their duties. The director of the SEC's Division of Investment Management recently stated that the SEC will launch examinations of fund companies targeting, among other issues, quality of fund governance. For example, a fund's board of directors is expected to review and approve the fund's compliance program, ensure that the fund does not have misleading names which suggest protection from losses and other such promises.[12]

E. Minutes

Board meetings should be followed by accurately recorded minutes. They should be able to demonstrate to a reader that how the decision was arrived at and resolution thereon passed. The minutes should reflect that the directors were alive to the issues that were being discussed. Clearly, a 'boilerplate' approach would not work.

F. Remuneration

The remuneration for independent directors should be commensurate to the role and functions expected to be discharged by them. While a more-than-adequate remuneration does not establish anything, an inadequate recompense can be taken as a ground to question whether the concerned director intends to perform his/her duties to the fund.

G. Conflict of interest

If related party transactions or transactions that may raise conflict of interest cannot be avoided, a policy should be outlined where events and mechanisms to identify and resolve events which could lead to potential conflicts, should be recorded. Suitable measures that demonstrate governance and that the interest of the investors would not be impaired, should be adopted.

The rulings discussed above and the responsibilities enlisted thereafter confirm that a fund's board has duties cast on it and the 'business judgment rule' may not shield them from liability in all cases. There are certain non-delegable functions for the directors to discharge on an on-going basis and none more paramount than reviewing of the fund's performance, portfolio composition and ensuring that an effective compliance program is in place. These functions require action 'between' board meetings and not 'during' board meetings only.

12. July 08, 2014 – Reuters, http://www.reuters.com/article/2014/07/08/financial-regulations-sec-alternatives-idUSL2N0PJ0XB20140708.

4. Aspects Concerning Governance of Hedge Funds

The governance dynamics of different types of funds differ due to their structures. For example, it has been argued (as explained later) that the governance of hedge funds varies greatly from other types of funds because of the exit options available to its investors.

Governance in the hedge fund context is conceptually different from other forms of corporate governance.[13] Investors generally have a right to short term redemption, managers have high pay performance sensitivity and there is presence of sophisticated investors who are expected to have taken into account the risk-return profile of the asset class.

In most public corporations, ultimate control (or management) rests with directors who have authority over managers and other constituencies. In the hedge fund context however, managers have complete discretion and authority over the structure and operation of the funds they manage. This is so because, hedge funds are organized as functional equivalents of privately held limited partnerships, which restrict the otherwise typical rights held by 'equity' holders. Equity investors are issued shares that neither have voting rights nor any forthwith mechanism to replace manager or directors leaving the hedge fund manager with more control and authority.[14]

Hedge fund governance also has to be uniquely responsive i.e. even though investors have limited role on management, responsiveness to their preferences is essential to retain and to obtain capital. The failure to be responsive can lead the investors to seek redemption and cash out of the fund thereby disrupting its operations.

I. Transparency

Transparency continues to remain the number one concern regarding the working of hedge funds. Greater disclosures will also likely lower a hedge fund's cost of capital and increase the liquidity of the shares in the secondary markets by giving investors more information about the fund and the manger's activity. However, complete transparency may not necessarily be the way forward. Complete transparency into a fund's specific investments may be overwhelming for an investor. This can be true even in the case of sophisticated investors. This would also probably not provide a sufficient basis for the investor to make meaningful comparisons between managers. Additionally, in the case of hedge funds that hold illiquid securities or complex instruments, disclosure would provide significant insight into the fund's investment strategy, which might erode the manager's competitive advantage and thereby reduce returns. Therefore, the best form of transparency is not greater disclosure but rather disclosure focused on providing right level and frequency of meaningful information about strategy and risks.

From an onshore (India based) funds perspective, under the AIF Regulations introduced different categories of AIFs to cater to different investment strategies. Category III AIF is a fund which employs diverse or complex trading strategies and may involve leverage including through investments in listed or unlisted derivatives.

The AIF Regulations provide that Category III AIFs may engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit specified by SEBI. On July 29, 2013, SEBI issued a circular which laid down certain important rules relating to redemption restrictions and leverage.

II. Redemption Restrictions

A Category – III AIF cannot impose redemption restrictions unless the possibility of suspension of redemptions has been disclosed in the placement memorandum and such suspension can be justified as being under exceptional circumstances and in the best interest of investors. This could mean that the practice of using 'gates' to limit the frequency and quantum of redemption may be impacted. Further,

13. Houman B. Shadab, Associate Professor of Law, New York Law School. B.A. 1998, University of California Berkley J.D. 2002, University of Southern California.

14. Shabad at page 147

in the event of a suspension of redemption, a fund manager cannot accept new subscription and will have to meet the following additional obligations:

i. Document reasons for suspension of redemption and communicate the same to SEBI;
ii. Build operational capability to suspend redemptions in an orderly and efficient manner;
iii. Keep investors informed about actions taken throughout the period of suspension;
iv. Regularly review the suspension and take necessary steps to resume normal operations; and communicate the decision to resume normal operations to SEBI.

III. Reporting Leverage

On July 29, 2013, SEBI issued a circular specifying the extent to which leverage can be employed by Category III AIFs and also prescribing a formula for computing leverage. SEBI had also indicated that those Category III AIFs which employ leverage are required to report the amount of leverage to the custodian on a daily basis. SEBI has now formally taken cognizance of the fact that the calculation of leverage by a Category III AIF requires information from various parties who provide such information at varied time periods which has consequently made it difficult for Category III AIFs to report the amount of end-of-day leverage to the custodian on the same day. The Circular provides that Category III AIFs shall report the amount of end-of-day leverage to the custodian by the end of the next working day.

IV. Requirement of Maintaining Minimum Corpus

Regulation 10(b) of the AIF Regulations provides that each scheme of an AIF should have a corpus of at least INR 20 crores (approx. USD 3.3 million) ("**Minimum Corpus**"). Further, Regulation 2(1)(h) of the AIF Regulations defines "corpus" as the total amount of funds committed by investors to the AIF by way of a written contract or any such document as on a particular date. An AIF cannot commence operations until it has secured the Minimum Corpus. SEBI now proposes to extend regulatory oversight to a post-commencement scenario where an open-ended scheme (post redemption(s) by investors or exits) is not able to sustain the Minimum Corpus. The Circular provides that where the corpus of an open-ended scheme falls below the Minimum Corpus, the AIF shall intimate SEBI within 2 days of receiving request of redemption from the client. Further, the fund manager is given a period of 3 months to restore the Minimum Corpus, failing which, all the interests of the investors will need to be mandatorily redeemed. The Circular also provides that SEBI may take appropriate action where the Minimum Corpus is breached repeatedly.

5. Emerging Jurisprudence on Duties of Fund Directors

In the context of emerging jurisprudence, we examine some of the recent cases and events that directors would do well to take note of.

I. Puda Coal, Inc. Stockholders Litigation

In Puda Coal, Inc. Stockholders Litigation,[15] Chancellor Strine of the Delaware Chancery Court issued a bench ruling addressing the duty of independent directors. The court reasoned that outside directors are selected, not "for their industry experience," but "because of their independence and their ability to monitor the people who are managing the company."

As a matter of brief background, Puda was a publicly-held Delaware corporation with its operations in China. The audit committee determined that the company's chairman had inappropriately transferred the company's primary operating subsidiary to himself.

The Court held that the complaint sufficiently alleged that the former outside directors breached their fiduciary duty of loyalty by failing to discharge their oversight function. Interestingly, the court observed that independent directors have a duty not to be dummy directors.

II. Paige Capital Management, LLC v. Lerner Master Fund, LLC

In *Paige Capital Management, LLC v. Lerner Master Fund, LLC.,*[16] the Delaware Chancery Court inter alia investigated who owes 'fiduciary' obligations to the fund and its investors. The seed investor had a specifically negotiated 'Seeder Agreement' which allowed withdrawal from the fund within 3 years only upon a liquidated penalty being levied. The investor also had a typical fund limited partnership agreement ("**LP Agreement**") that had a usual 'gates' clause. Such clause enabled the hedge fund manager to restrict a withdrawal of capital if it results in more than a defined threshold of the total assets of the fund being withdrawn in a period. It so also happened that the fund manager could not secure any other outside investor in the fund, and the fund's contributed capital significantly comprised of the seed investment.

Controversy arose when the 'gates' were raised after the 3rd year (under the LP Agreement) to prevent the exit of the investor (as was understood under the Seeder Agreement) for preserving the management fee for the manager.

If wide powers are granted to a person pursuant to the terms of their appointment, the same may make such party a fiduciary. In the concerned matter, the court observed that acting in self-interest does not absolve a governing fiduciary. Accordingly, preventing the exit of an investor for preserving its management fee is in violation of fiduciary obligation of the investment manager. The case also provides the limits of discretion that fund managers can validly exercise.

III. Weavering Macro Fixed Income Fund Limited v. Stefan Peterson and Hans Ekstrom

It is also interesting to note the learnings from a ruling by the Cayman Islands Court of Appeals ("**CICA**"), in the case of Weavering Macro Fixed Income Fund Limited (In Liquidation) v. Stefan Peterson and Hans Ekstrom [17] ("**Judgment**") dated February 12, 2015, which set-aside the Cayman Islands' Grand Court's ruling in the case dated August 26, 2011. The objective is to lay down the 'standard' for directors' role in a funds context.

As a matter of brief background, Weavering Macro Fixed Income Fund ("**Fund**") was a Cayman Islands based hedge fund. The Fund appointed an investment manager to *'manage the affairs of the Fund subject to the overall supervision of the Directors'.* The Fund went into liquidation when it was discovered that

15. C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013)
16. 5502-CS, Delaware Chancery Court
17. CICA 10 of 2011, delivered on 12th February 2015.

certain assets shown on the Fund's balance sheet were fictitious, at which point in time, action for damages was initiated by the official liquidators against the former "independent" directors.

In the instant case, the Grand Court found evidence that while board meetings were held timely, the meetings largely recorded information that was also present in the communication to fund investors and that the directors were performing 'administrative functions' in so far as that they merely signed the documents that were placed before them.

Based on such factual matrix, the Grand Court held against the directors for wilful neglect in carrying out their duties. It was also observed that based on their inactions, the defendant directors "did nothing and carried on doing nothing". The measure of loss was determined on the difference between the Fund's actual financial position with that of the hypothetical financial position had the relevant duties been performed by the directors.

The Grand Court had ruled against each of the directors in the amount of $111 million. It was also observed, that the comfort from indemnity clauses are for reasonably diligent independent directors to protect those who make an attempt to perform their duties but fail, not those who made no serious attempt to perform their duties at all.

The Grand Court observed that the directors are bound by a number of common law and fiduciary duties including those to (1) act in good faith in the best interests of the fund and (2) to exercise independent judgment, reasonable care, skill and diligence when acting in the fund's interests.

However, the CICA, while affirming the original findings of breach of duty by the directors held that there was no element of 'wilful' negligence or default on their part; therefore, the indemnity provisions in the Fund documents relieved the directors from liability arising out of breach of their duties.

The CICA held that the evidence available to the Grand Court was insufficient to support the finding that the directors' conduct amounted to "wilful neglect or default".

The Court of Appeal accordingly set aside the earlier judgments against each of the directors for $111 million.

IV. In Re Bear Stearns High Grade Structured Credit Strategies (Overseas) Ltd. (In Voluntary Liquidation)

In this case, director misconduct was alleged but not established in the court proceedings. The allegation was that the directors and trustees put up the fund for liquidation voluntarily because they were apprehending their removal through shareholders' votes. Even though the court could not reach a conclusion that directors were acting ultra vires their fiduciary duties, it denied the directors and trustees of the convenience of getting the liquidation done by liquidators appointed by them. The court appointed liquidators as per the shareholders' preferences.

6. Regulatory Frameworks on Fund Governance

I. Mauritius

The Financial Services Commission , Mauritius ("**FSC**") recently revised the Guide to Global Business ("**Guide**")[18] to enhance the level of substance required to be demonstrated by Mauritius based entities for holding a Category 1 Global Business Licence ("**GBL-1**").[19]

This development is important since it is necessary for a company to obtain a GBL-1 to be eligible to apply for a Tax Residence Certificate ("**TRC**") which itself is a necessary pre-condition for a company to qualify for treaty benefits under the India-Mauritius Double Taxation Avoidance Agreement ("**Treaty**").

The revised rules of substance as introduced also require the resident directors to meet certain standards of governance including committing required levels of time, attention and independent exercise of mind. This seems to be in line with the emerging jurisprudence which suggests that the threshold of fiduciaries to be met by the directors is shifting from "*sustained or systematic failure to exercise oversight"* to *"making reasonable and proportionate efforts commensurate with the situations*".

FSC's approach seems to be in line with other jurisdictions like Singapore and Luxembourg that expect a level of substance from a resident company beyond being just the jurisdiction of its incorporation.

II. What has the FSC Prescribed?

The FSC has revised the list of guidelines that it considers relevant while determining whether a company is being managed and controlled from Mauritius for the purpose of issuing / renewing a GBL-1 through amendments to Section 3 of Chapter 4 of the Guide. These revisions are:

A. Resident Director Qualifications

Before the amendment, a company holding GBL-1 was required to have at least two resident directors of sufficient caliber to exercise independence of mind and judgment. While these requirements have been retained, there is now an additional requirement for the Mauritius resident directors to be "appropriately qualified".

B. Administration of Closed-end Funds and Collective Investment Schemes

The FSC has introduced a fresh requirement that a company seeking GBL-1 which is a collective investment scheme or a closed-end fund or an external pension scheme must be administered from Mauritius.

C. Mandatory Parameters

In addition to these, a GBL-1 will have to continue to fulfill the other criteria, being: (i) maintaining its principal bank account in Mauritius at all times; (ii) keeping and maintaining its accounting records at its registered office in Mauritius at all times; (iii) preparing its statutory financial statements having them audited in Mauritius; and (iv) providing for meetings' of directors to include at least two Mauritius resident directors.

D. Mauritius Resident Director Requirements

The amended Guide also mentions that the Mauritius resident directors will have to comply with the requirements of Circular Letter (CL280313) issued by the FSC ("**Circular**").[20] The Circular summarizes duties and obligations of directors of Mauritius companies. In this regard, the FSC will consider 'Qualification and experience'[21], 'Independence of

18. The Guide to Global Business has been issued by the Board of the FSC under section 7(1)(a) of the Financial Services Act, 2007.

19. Section 71(4) of the Financial Services Act, 2007 provides that the FSC may consider any such matters when determining whether a company holding GBL-1 is managed and controlled in Mauritius.

20. Circular Letter dated March 28, 2013 issued by the FSC.

21. The Mauritius resident director must have relevant qualification and experience to exercise sufficient care, diligence and skills for good conduct of the business.

mind'[22], 'Judgment'[23] and 'Time Commitment'[24] of the Mauritius resident directors of a company holding GBL-1.

III. European Economic Area

In the European Economic Area ("**EEA**"), the undertakings for collective investment in transferable securities directive ("**UCITS Directive**") makes it important for each fund to have a depositary independent from the fund and its manager to monitor cash flows, custody and safekeeping of assets. It also oversees whether the fund is in due compliance with legal and regulatory requirements as well as its own policies. The UCITS Directive mandates that the directors of the depositary have to be sufficiently experienced and of good repute.[25]

It is important to note that alternative investment funds in the EEA are not regulated by the UCITS Directive but by the Alternative Investment Fund Managers Directive ("**AIFMD**") which also requires AIFs to have an independent depositary with similar responsibilities and duties as under the UCITS Directive.

IV. Cayman Islands

In the Cayman Islands, the Cayman Islands Monetary Authority ("**CIMA**") has recently adopted CIMA Guidance, registration and licensing requirements for directors. In pursuance of this step, a Statement of Guidance ("**SoG-MF**") was issued to be effective from January, 2014. It basically covers all regulated mutual funds that are defined by Mutual Funds Law and details corporate governance principles applying to operators as well as governing body. Rules cover oversight function, conflicts of interest, meetings and documentation, operator's duty of skill and care, risk management, and disclosures to the CIMA.

The key areas which the new abovementioned code covers are as follows :[26]

i. Degree Of Delegation: SoG-MF describes the fund's governing body as "the directing will and mind" of the fund with 'ultimate responsibility' for directing and supervising the fund's activities. How easily this can be extended to the fund's investment activities will depend on the complexity of the manager's investment strategy, the extent of the manager's responsibilities as defined in the investment management agreement and the sophistication of the investors in the fund.

ii. Expertise: The board collectively must have sufficient knowledge and expertise, not just to understand the manager's investment strategy and the risk profile it creates for the fund, but also to monitor compliance with investment strategy and evaluate performance. Having a person affiliated to the manager on the board is a necessary component of maintaining sufficient oversight of the fund, i.e. directors being able to monitor and supervise the manager's strategy and performance.

iii. Independece: All corporate governance codes insist that directors, as a minimum, exercise independent judgement, and most corporate governance codes recommend that boards have at least one independent director. These essentially restate existing legal principles that are found in most major financial jurisdictions.

iv. Directors: The SoG-MF, mindful that the number of directorships an individual can competently discharge is contingent on a number of factors, states that the board should "consider carefully" the number of directorships a potential director holds. In its Corporate Governance Survey, CIMA found that respondents were more or less split evenly over the issue of limiting the number of directorships that can be held by an individual.

Additionally, CIMA prepared a bill which was made public on March 21, 2014. The bill mainly establishes the registration and licensing requirements for fund directors (for all funds regulated or licensed in the Cayman Islands). There are three types of directors mentioned in the bill, i.e. , registered directors, professional directors and corporate directors whereby the latter category is subject to a compulsory licensing regime. The license will be granted based upon capacity in terms of qualification, "fit and proper" test (including the honesty, integrity and reputation confirmation, competence and

22. The Mauritius resident director must act with integrity, freedom of mind, without any influence, interest or relationship that might impair his professional judgment or objectivity.
23. The Mauritius resident director must provide impartial and good judgment.
24. A Mauritius resident director serving on multiple boards must ensure that sufficient time is given to the affairs of each company in which he/she is a director.
25. ILPA
26. http://www.aima.org/en/education/aimajournal/past-articles/index.cfm/jid/4898EC23-66AA-4065-8EAD6137DEBC8126

capability and financial soundness).

Corporate directors, on the other hand, have to make certain filings to CIMA on a specified form but they also have to satisfy the fit and proper persons' requirement. There is a compulsory requirement for keeping minimum insurance coverage. Violations of these regulations may lead to criminal penalties.

7. Investor Activism: Role of Investors in Good Governance

Investor activism is the practice of active supervisory participation of investors in the management affairs of the fund by way of exercising their voting rights effectively, scrutinizing the decisions taken by the managers or directors and generally exhibiting keen interest in the way affairs of the fund are being handled.

The trend is for investors to assume that managers and directors know the best about management of the fund and their job is not to interfere. However, as we observed earlier, there are cases of mismanagement and unethical conduct due to which investors have to question the trust they placed on the managers and directors. Research and data suggest that investor activism in hedge funds has resulted in abnormally high returns for investors.[27]

It is understood that the directors of a hedge fund will automatically increase standards of good governance if the investors emphasize on the importance of these standards as being factored into their investment decisions.[28] In the latter quarter of 2013 to early 2014, activist hedge funds were the best-performing hedge fund strategy.[29]

At the time of formation of a fund, a feature that is quasi-set in stone is the establishment of the advisory board which performs a crucial role in fund governance. The advisory board comprises of several representative investors tasked with providing advice to the GP regarding management of the fund. The monitoring of the adherence of GPs to the provisions of the partnership agreement usually with regard to basic fees and other terms which are activated or triggered on the occurrence of certain events or upon the decision of the LPs is a paramount function that the advisory board performs. Some of the aforementioned provisions may include:

I. No-fault Clauses

The inclusion of a 'no-fault divorce' clause gives the ability to the LPs to end the acquisition of new assets by the fund and enforcing the liquidation of existing assets. Similarly, a related provision may prescribe the removal of an existing GP and installing a new GP in his/her stead

II. Key Person Provisions

A key person provision (also referred to as a key-man provision) casts a duty on the GPs to inform the LPs of the departure of a key person involved with the fund's operations such as the portfolio manager. In certain cases the departure may also trigger the provision of offering a redemption window to the LPs with no penalty fees being charged. In other cases the GPs ability to acquire new assets may be frozen for a specified period of time, subject to the consent of a majority of investors. In case of private equity funds, the commitment period (i.e. the period during which capital is drawn down) may be suspended as a consequence of a key person event.

27. http://www.hbs.edu/faculty/Publication%20Files/08-004.pdf.
28. www.treas.gov/press/releases/reports investors committeereportapril152008.pdf.
29. http://americasmarkets.usatoday.com/2014/07/09/activist-hedge-funds-agitate-their-way-to-gains.

8. Conclusion

The quality of governance of a fund highly depends on observance of the basic fiduciary duties by its directors and managers. However, as additional measures, the structure or form of a fund can be such that maximum governance standards are met at the formation stage itself. These measures may include appointment of independent directors, better incentives for directors such as encouraging the directors to invest in the funds they are overseeing as directors, giving retirement benefits to the directors, provisions for frequent evaluation of their performance and increase general awareness and circulate important industry related advancements to the directors.[30]

Also, in some cases, where the administrators fill in for the post of directors in a fund, such administrators will have to be mindful of their fiduciaries and be vigilant and supervise the actions of the outsourced entities such as accountants, etc. more diligently.

The fund documents generally provide for indemnity of its directors with a carve-out for directors acting in 'willful negligence or default'. Since the element of 'willfulness' is the determining factor, the directors should be extremely cautious about their acts and omissions with respect to the fund.

30. http://www.ici.org/pdf/rpt_best_practices.pdf.

ANNEXURE-I

Institutional Limited Partners Association

Private Equity Principles

VERSION 2.0 ● JANUARY 2011

INSTITUTIONAL LIMITED PARTNERS ASSOCIATION

Contents

ILPA Private Equity Principles

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

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

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

1. Alignment of Interest

2. Governance

3. Transparency

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

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

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

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

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

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

Alignment of Interest

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

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

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

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

CARRY/WATERFALL

Waterfall Structure

- A standard all-contributions-plus-preferred-return-back-first model must be recognized as a best practice

- Enhance the deal-by-deal model:

  - Return of all realized cost for given investment with continuous makeup of partial impairments and write-offs, and return of all fees and expenses to date (as opposed to pro rata for the exited deal)

  - For purposes of waterfall, all unrealized investments must be valued at lower of cost or fair market value

  - Require carry escrow accounts with significant reserves (30% of carry distributions or more) and require additional reserves to cover potential clawback liabilities

- The preferred return should be calculated from the day capital is contributed to the point of distribution

Calculation of Carried Interest

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

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

Clawback

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

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

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

MANAGEMENT FEE AND EXPENSES

Management Fee Structure

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

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

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

Expenses

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

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

TERM OF FUND

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

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

GENERAL PARTNER FEE INCOME OFFSETS

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

GENERAL PARTNER COMMITMENT

- The GP should have a substantial equity interest in the fund, and it should be contributed in cash as opposed to being contributed through the waiver of management fees

- GPs should be restricted from transferring their real or economic interest in the GP in order to ensure continuing alignment with the LPs

- The GP should not be allowed to co-invest in select underlying deals but rather its whole equity interest shall be via a pooled fund vehicle

STANDARD FOR MULTIPLE PRODUCT FIRMS

- Key-persons should devote substantially all their business time to the fund, its predecessors and successors within a defined strategy, and its parallel vehicles. The GPs must not close or act as a general partner for a fund with substantially equivalent investment objectives and policies until after the investment period ends, or the fund is invested, expended, committed, or reserved for investments and expenses

- The GP should not invest in opportunities that are appropriate for the fund through other investment vehicles unless such investment is made on a pro-rata basis under pre-disclosed co-investment agreements established prior to the close of the fund

- Fees and carried interest generated by the GP of a fund should be directed predominantly to the professional staff responsible for the success of that fund

- Any fees generated by an affiliate of the GP, such as an advisory or in-house consultancy, whether charged to the Fund or an underlying portfolio company, should be reviewed and approved by a majority of the LPAC

Governance

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

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

TEAM

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

- Automatic suspension of investment period, which will become permanent unless a defined super-majority of LPs in interest vote to re-instate within 180 days, when a key-man event is triggered or for cause (e.g. fraud, material breach of fiduciary duties, material breach of agreement, bad faith, gross negligence, etc.)

- Situations impacting a principal's ability to meet the specified "time and attention" standard should be disclosed to all LPs and discussed with, at a minimum, the LPAC

- LPs should be notified of any changes to personnel and immediately notified when key-man provisions are tripped

- Changes to key-man provisions should be approved by a majority of the LPAC or LPs

INVESTMENT STRATEGY

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

- The investment purpose clause should clearly and narrowly outline the investment strategy

- Any authority to invest in debt instruments, publicly traded securities, and pooled investment vehicles should be explicitly included in the agreed strategy for the fund

- Funds should have appropriate limitations on investment and industry concentration and may consider investment pace limitations, if appropriate

- The GP should accommodate a LP's exclusions policy, which may proscribe the use of its capital in certain sectors and/or jurisdictions. However, consideration of increased concentration effects on remaining LPs and transparency of process and policies must be requisite in the event of a non-ratable allocation

FIDUCIARY DUTY

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

- GPs should present all conflicts to the LPAC for review and seek prior approval for any conflicts and/or non arm's length interactions or transactions. As materiality is a subjective criterion, it is best to consult the LPAC in all instances. No GP should clear its own conflicts

- The high standard of fiduciary duty applicable to the GP should preclude provisions that allow for them to be exculpated in advance or indemnified for conduct constituting a material breach of the partnership agreement, breach of fiduciary duties, or other "for cause" events

- A majority of LPs must be able to remove the GP or terminate the fund for cause

- Conditions precedent and other removal mechanisms should be constructed so that LPs can act before there is irreparable damage to their interests. To the extent that there are mitigating factors, LPs will take these into consideration in evaluating their response to the "for cause" event

- To the extent that an all-partner clawback is appropriate in order for the fund to indemnify the GP, this should be limited to a reasonable proportion of the committed capital but in no case more than 25% and limited to a reasonable period, such as two years following the date of distribution

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

- The auditor should present their view on valuations and other relevant matters annually to the LPAC and be available to answer questions at the annual meeting of the fund. A list of the members of the LPAC should be provided to the auditors

- LPs should be notified of any change in the independent external auditor of the fund

- The auditors should review the capital accounts with specific attention to management fee, other partnership expenses, and carried interest calculations to provide independent verification of distributions to the GP and LP

- When considering important matters of fund governance or other matters where the GP's interests may not be entirely aligned with the LPs', a reasonable minority of the LPAC may engage independent counsel at the fund's expense

CHANGES TO THE FUND

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

- Any amendment to the LPA should require the approval of a majority in interest of the LPs, and certain amendments should require a super-majority approval. Amendments that negatively affect the economics of a particular LP should require that LP's consent

- No fault rights upon two-thirds in interest vote of LPs for the following:

  - Suspension of commitment period

  - Termination of commitment period

- No fault rights upon three-quarters in interest vote of LPs for the following:

  - Removal of the GP

  - Dissolution of the Fund

RESPONSIBILITIES OF THE LPAC

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

- Transactions that pose conflicts of interest, such as cross-fund investments and related party transactions

- The methodology used for portfolio company valuations (and in some cases, approving the valuations themselves)

- Certain other consents or approvals pre-defined in the LPA

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

- Auditors

- Compliance (including CSR/ESG/PRI)

- Allocation of partnership expenses

- Conflicts

- Team developments

- New business initiatives of the firm

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

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

LPs that accept a seat on the LPAC should commit the necessary time and attention to the fund. LPAC members should participate in all LPAC meetings, be properly prepared, and responsibly fulfill the duties of their role. LPAC members should be able to take into account their own interest in voting on the LPAC and should be appropriately indemnified.

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

Transparency

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

MANAGEMENT AND OTHER FEES

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

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

CAPITAL CALLS AND DISTRIBUTION NOTICES

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

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

DISCLOSURE RELATED TO THE GENERAL PARTNER

The following should be immediately disclosed to LPs upon occurrence:

- Any inquiries by legal or regulatory bodies in any jurisdiction

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

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

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

- Formation of public listed vehicles

- Sale of ownership in the management company to other parties

- Public offering of shares in the management

- Formation of other investment vehicles

RISK MANAGEMENT

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

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

FINANCIAL INFORMATION

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

LP INFORMATION

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

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

Appendix A: Limited Partner Advisory Committee

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

Common objectives in relation to every board should include:

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

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

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

LPAC Formation

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

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

- The LPAC should be made up of a small number of voting representatives of LPs, with larger funds having as many as a dozen members, representing a diversified group of investors

- Upon initial constitution of the LPAC, any replacements of LPAC members should be determined by the GP with any additional or eliminated seats to be approved by mutual consent of a majority of the LPAC and general partner

- A standing LPAC meeting agenda should be developed and a calendar established as far in advance as possible. The meeting agenda and calendar should be available to all LPs

- Clear voting thresholds and protocols should be established, including requiring a quorum of 50% of LPAC members when votes are taken

- LPAC members should receive no remuneration, but the partnership should reimburse their reasonable expenses in serving on the LPAC

LPAC Meeting Suggested Best Practices

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

Convening a Meeting:

- LPAC meetings should be held in person at least twice a year with an option to dial-in telephonically

- The GP is encouraged to convene the LPAC more frequently to discuss time-sensitive matters of importance (e.g. conflicts); in these cases, LPAC members should be flexible and responsive. With the consent of the LPAC, certain matters may be handled by written consent

- After initially consulting the GP, a minority of three or more members using reasonable judgment and discretion should have the right to call for a LPAC meeting

Agenda:

- Any member of the LPAC may add an agenda item to the LPAC meeting agenda subject to a reasonable notice requirement to the GP

- With any request for consent or approval by a fund's LPAC, the GP will use best efforts to send each LPAC member background information on the matter at least 10 days in advance of the meeting

- A portion of each LPAC meeting will be set a side for an *in camera* session with only the LPs present. LPs may elect one or more members of the LPAC to lead the discussion and report back to the GP

- The LPAC should have *in camera* access to partnership auditors to discuss valuations. A representative from the audit firm should attend each year-end LPAC meeting or annual meeting

Voting:

- Any meeting requiring a vote of the LPAC should be held with only the members of that specific fund's LPAC in attendance.

For convenience, LPAC meetings and/or members of other related funds may be pooled when general topics are discussed

- The partnership should indemnify members of the LPAC

- Each LPAC member should consider whether they have any potential conflicts of interest prior to voting in all circumstances. LPAC members should disclose actual conflicts to other LPAC members during discussions at LPAC meetings

Records:

- The GP should take minutes at all LPAC meetings. LPAC meeting minutes should be circulated to LPAC members within 30 days and submitted for approval at the next LPAC meeting. Once approved, LPAC minutes should be available upon request to all LPs within a reasonable time period

- The GP should record all votes taken during conference calls or at meetings and maintain a copy of consents obtained in writing, by facsimile, or by email. Detailed voting records should promptly be made available by the GP to any LPAC member upon request

Appendix B: Carry Clawback Best Practice Considerations

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

Seek to Avoid Clawback Situations

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

Ensure GPs Backstop Themselves

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

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

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

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

Ensure Fair Treatment of Tax Burden

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

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

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

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

Fix the Clawback Formula

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

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

Appendix C: Financial Reporting

- **Annual Reports -** Funds should provide the following information at the end of each year (within 90 days of year-end) to investors:

  - Audited financial statements (including a clean opinion letter from auditors and a statement from the auditor detailing other work performed for the fund);
  - Internal Rate of Return ("IRR") calculations prepared by the fund manager (that clearly set forth the methodology for determining the IRR);
  - Schedule of aggregate carried interest received;
  - Breakdown of fees received by the manager as management fees, from portfolio companies or otherwise;
  - Breakdown of partnership expenses;
  - Certification by an auditor that allocations, distributions and fees were effected consistent with the governing documentation of the fund;
  - Summary of all capital calls and distribution notices;
  - Schedule of fund-level leverage, including commitments and outstanding balances on subscription financing lines or any other credit facilities of the fund;
  - Management letter describing the activities of the fund directed to the LPAC but distributed to all investors;
  - Political contributions made by placement agents, the manager or any associated individuals to trustees or elected officials on investor boards.

- **Quarterly Reports -** Funds should provide the following information at the end of each quarter (within 45 days of the end of the quarter) to investors:

  - Unaudited quarterly profit and loss statements also showing year-to-date results;
  - Schedule showing changes from the prior quarter;
  - Schedule of fund-level leverage, including commitments and outstanding balances on subscription financing lines or any other credit facilities of the fund;
  - Information on material changes in investments and expenses;
  - Management comments about changes during the quarter;
  - If valuations have changed quarter-to-quarter, an explanation of such changes;
  - A schedule of expenses of the general partner

- **Portfolio Company Reports -** A fund should provide quarterly a report on each portfolio company with the following information:

  - Amount initially invested in the portfolio company (including loans and guarantees);

  - Any amounts invested in the portfolio company in follow-on transactions;

  - A discussion by the fund manager of recent key events in respect of the portfolio company;

  - Selected financial information (quarterly and annually) regarding the portfolio company including:

    - Valuation (along with a discussion of the methodology of valuation;
    - Revenue (Debt terms and maturity);
    - EBITDA;
    - Profit and loss;
    - Cash position;
    - Cash burn rate

- **Capital Call and Distribution Notices –** A standardized reporting template has been developed by ILPA and is available at ilpa.org

  - Under development – standardized reporting templates to cover annual and quarterly reporting as well as supporting financial schedules

About the ILPA

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

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

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

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(416) 941-9393

INSTITUTIONAL LIMITED PARTNERS ASSOCIATION

55 YONGE STREET, SUITE 1201 ● TORONTO, ONTARIO M5E 1J4 ● (416) 941-9393 ● ILPA.ORG

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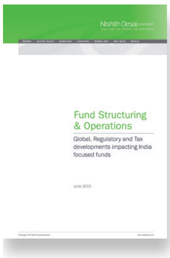

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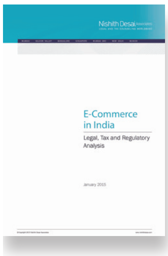

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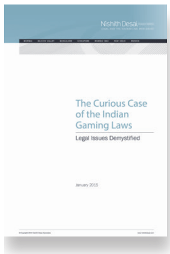

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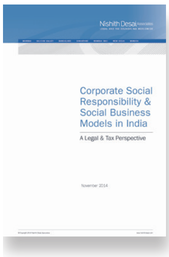

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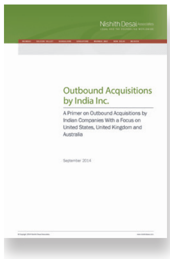

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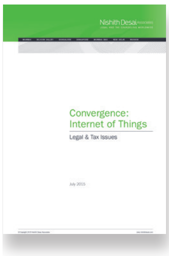

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TITLE	TYPE	DATE
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Research @ NDA

Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Research has offered us the way to create thought leadership in various areas of law and public policy. Through research, we discover new thinking, approaches, skills, reflections on jurisprudence, and ultimately deliver superior value to our clients.

Over the years, we have produced some outstanding research papers, reports and articles. Almost on a daily basis, we analyze and offer our perspective on latest legal developments through our *"Hotlines".* These *Hotlines* provide immediate awareness and quick reference, and have been eagerly received. We also provide expanded commentary on issues through detailed articles for publication in newspapers and periodicals for dissemination to wider audience. Our *NDA Insights* dissect and analyze a published, distinctive legal transaction using multiple lenses and offer various perspectives, including some even overlooked by the executors of the transaction. We regularly write extensive research papers and disseminate them through our website. Although we invest heavily in terms of associates' time and expenses in our research activities, we are happy to provide unlimited access to our research to our clients and the community for greater good.

Our research has also contributed to public policy discourse, helped state and central governments in drafting statutes, and provided regulators with a much needed comparative base for rule making. Our *ThinkTank* discourses on Taxation of eCommerce, Arbitration, and Direct Tax Code have been widely acknowledged.

As we continue to grow through our research-based approach, we are now in the second phase of establishing a four-acre, state-of-the-art research center, just a 45-minute ferry ride from Mumbai but in the middle of verdant hills of reclusive Alibaug-Raigadh district. The center will become the hub for research activities involving our own associates as well as legal and tax researchers from world over. It will also provide the platform to internationally renowned professionals to share their expertise and experience with our associates and select clients.

We would love to hear from you about any suggestions you may have on our research reports. Please feel free to contact us at
research@nishithdesai.com

Nishith Desai Associates

LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI

93 B, Mittal Court,Nariman Point,
Mumbai 400 021 India
Tel: +91 - 22 - 6669 5000
Fax: +91 - 22 - 6669 5001

SILICON VALLEY

220 S California Ave., Suite 201,
Palo Alto, CA 94306, USA
Tel: +1 - 650 - 325 7100
Fax: +1 - 650 - 325 7300

BANGALORE

Prestige Loka, G01, 7/1 Brunton Rd,
Bangalore 560 025, India
Tel: +91 - 80 - 6693 5000
Fax: +91 - 80 - 6693 5001

SINGAPORE

Level 30,Six Battery Road,
Singapore 049909
Tel: +65 - 6550 9855
Fax: +65 - 6550 9856

MUMBAI BKC

3, North Avenue, Maker Maxity
Bandra – Kurla Complex,
Mumbai 400 051, India
Tel: +91 - 22 - 6159 5000
Fax: +91 - 22 - 6159 5001

NEW DELHI

C-5, Defence Colony
New Delhi - 110024, India
Tel: +91 - 11 - 4906 5000
Fax: +91 - 11- 4906 5001

MUNICH

Maximilianstraße 13
80539 Munich, Germany
Tel: +49 - 89 - 203006 - 268
Fax: +49 - 89 - 203006 - 450