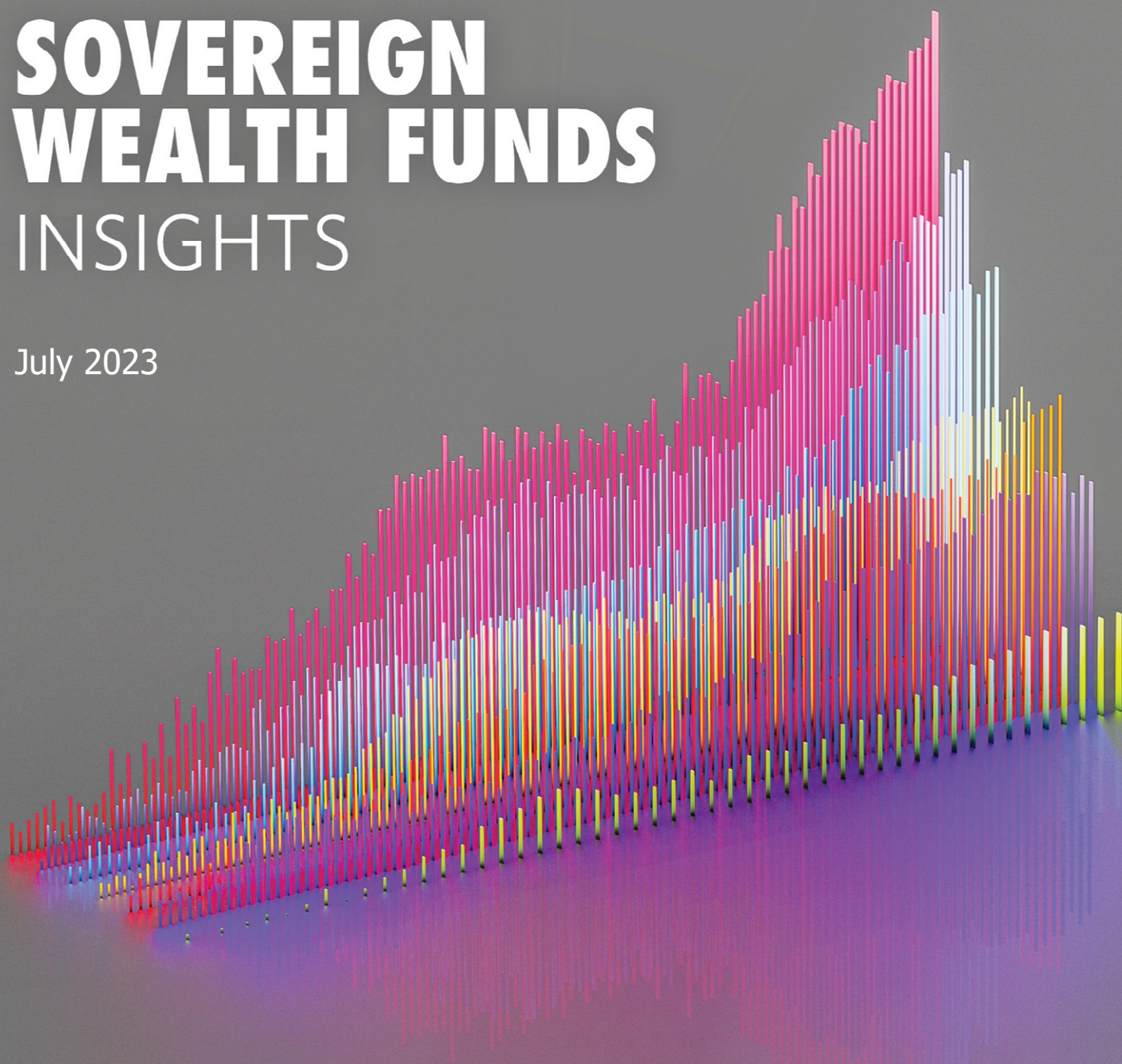


SOVEREIGN WEALTH FUNDS INSIGHTS

July 2023



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EXAMINING INVESTMENT STRATEGIES FOR SOVEREIGN WEALTH FUNDS

With concerns about global economic stability, many sovereign wealth funds (SWFs) are evaluating current market conditions to determine the most effective investment strategies. Diversification is a common theme for many fund managers, with some seeking new opportunities in environmental, social, and governance (ESG) and impact investing, while others are targeting industries that may be buoyed by a financial downturn.

This report breaks down the potential impact of a global recession on the SWF industry, as well as some of the key investment trends SWFs may pursue in the latter half of 2023.

Impact Investing

Increased interest from both fund managers and investors is pushing a continued uptick in impact investing. Compared with 2020, when the GIIN estimated that the impact investing market was worth approximately \$715 billion, in 2022 the GIIN estimated that more than 3,349 organizations currently manage \$1.164 trillion in impact investing AUM worldwide. These investments vary between fund managers using ESG principles to seek the top financial returns for their clients and investors seeking out socially responsible investment opportunities to promote social good.

For more information on impact investing, read [Impact Investing: Doing Well and Doing Good](#).

Economic Downturn

As a higher rate of inflation and continued geopolitical instability has pushed the global economy into the potential for a recession, many fund managers are seeking to diversify their investments, attract new capital, and alter investment terms to be more advantageous. Fundraising is the primary area in which fund managers are likely to feel the effects of a recession, particularly as limited partners take a conservative approach to managing their financial commitments amid the uncertainty. There is likely to be increased allocation to opportunistic areas, with some managers launching funds with investment strategies that target industries more likely to be flooded with opportunities in a financial downturn.

For more information on how managers may change investment strategies in an economic downturn, read [The Current Macroeconomic Climate's Impact on Fund Terms](#).

Seed and Stake Arrangements

SWFs are historic partners of choice for private investment fund managers, and seed and stake arrangements have been growing in recent years. Seed and stake arrangements are expected to continue growing as an attractive opportunity for SWFs looking to take a cornerstone position in a commingled investment fund, as well as a stake in the general partner and manager entities. But these investments raise several legal and structural considerations for both SWFs and private investment fund managers.

For more information on this investment type and opportunities for SWFs, read [Seed and Stake Arrangements: Key Considerations](#).

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**IMPACT INVESTING: DOING WELL
AND DOING GOOD**

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The need to address global challenges is more urgent than ever, and the impact investing market is growing at a significant pace in response to such need. As a result, we are seeing increasing interest from fund managers, the introduction of supportive government policies, and a heightened demand from investors with respect to investments that provide a clear roadmap to a more sustainable and prepared future.

In 2020, the Global Impact Investing Network (GIIN) estimated that the impact investing market was worth approximately \$715 billion. In 2022, the GIIN estimated that more than 3,349 organizations currently manage \$1.164 trillion in impact investing assets under management worldwide.

WHAT IS AN IMPACT INVESTMENT?

An impact investment is an investment that is made with the intention of generating a positive and measurable social and environmental impact in conjunction with a financial return. The focus for these investments is on providing capital to address critical global challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education.

Impact investment is not about an act of charity—investors are still seeking positive returns. The positive social and environmental impact of the proposed investment is an additional factor for impact investors.

According to the GIIN, there are four key elements to an impact investment:

1. **Intentionality.** Impact investments intentionally contribute to social and environmental solutions. This differentiates them from other strategies such as environmental, social, and governance (ESG).
2. **Financial Returns.** A key distinguishing feature between impact investments and philanthropy is that impact investments seek a financial return on capital, ranging from below market rate to risk-adjusted market rate.
3. **Range of Asset Classes.** Impact investments can be made across asset classes.
4. **Impact Measurement.** The investor is committed to measuring and reporting the social and environmental performance of underlying investments.

WHAT IS CAUSING THE IMPACT INVESTING MARKET GROWTH?

COVID-19

The coronavirus (COVID-19) pandemic devastated and disrupted the lives of people around the world. The resulting impact on healthcare systems across the globe has been a key factor in boosting the popularity of impact investments in an attempt to futureproof against pandemics going forward. The aim is to “build back better” by using this opportunity to rebuild economies in a way that attempts to overcome issues such as gender inequality, racial discrimination, and the climate crisis.

Climate Crisis

The climate crisis continues to intensify, and key frameworks and conventions have put a spotlight on the need to take action and invest in climate solutions, including the following:

- United Nations (UN) Framework Convention on Climate Change

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- Kyoto Protocol
- Paris Agreement
- UN Sustainable Development Goals (SDGs)
- UN Climate Change Conference of the Partners (COP27)

As governments shift resources and take on new levels of debt in an ever more challenging economy, it has been increasingly apparent that the public pool of capital is insufficient to tackle the climate crisis, and the private market is under pressure to bridge the funding gap. For example, the UN estimates that we need \$3 trillion to \$5 trillion annually to make the SDGs a reality.

Furthermore, investors are demanding more sustainable products and asking more questions about supply chains. According to the Morgan Stanley Institute for Sustainable Investing, nearly nine in 10 US consumers say that they will purchase a product because of a company's stance on an issue they care about.

Returns

The mindset of many investors and managers alike has shifted. Investors and managers traditionally have believed that market investments should focus exclusively on achieving financial returns and that social and environmental issues should be addressed only by philanthropic donations.

The realization that investing to generate positive environmental and social impact does not mean sacrificing financial gains has been a key driver in the tremendous growth in the impact investing market, enabling investors to advance social and environmental solutions through investments that also produce financial returns.

Diversity, Equity, and Inclusion (DEI)

In the wake of the #MeToo and Black Lives Matter movements, businesses are increasingly considering the commercial implications of their actions with respect to a broader universe of stakeholders rather than just shareholders. These movements have helped encourage investors and corporations to act on racial and gender inequalities by, for example, investing in affordable housing in lower-income areas or in minority-owned banks.

Improved Standards of Measurement and Management

One of the key issues in impact investing has been the lack of a common set of metrics to enable managers to demonstrate quantifiable impact. However, measurement and management standards with respect to impact investing have improved in recent years, helping to elevate the role of impact investments by minimizing concerns over "greenwashing" (i.e., where companies misrepresent or overstate their positive environmental impact).

For example, the International Finance Corporation and GIIN launched the Joint Impact Indicators on March 16, 2021 with the aim of defining a minimum scope for impact measurement and reporting.

WHAT IS THE DIFFERENCE BETWEEN IMPACT INVESTING, ESG, AND SRI?

As sustainable investing grows, so too does the need to define the key concepts within the market.

ESG factors are a set of criteria used to evaluate a company's environmental, social, and governance risks and practices. An ESG evaluation supplements the traditional financial analysis of an investment by identifying a potential target company's ESG risks and opportunities and determining the amount of money the fund could gain from seizing ESG opportunities. Financial returns remain at the forefront of ESG investing.

Socially responsible investing (SRI), on the other hand, focuses on responsible investing. SRI goes further than ESG in that an SRI fund will **actively seek to avoid** investments in companies that have a negative social or environmental impact (e.g., a tobacco or firearms company).

Impact investing goes further again in that the objective is not simply financial returns, but investing in companies that produce a tangible "social good."

DOES IMPACT INVESTING MEAN LOWER RETURNS?

Investment managers active in the impact investment market believe that they can provide more resilient, longer-term outperformance by investing in companies that deliver impact through underlying products and services and actively managing ESG risks.

Impact investors have diverse financial return expectations, many of which will depend on an investor's impact investing strategy. Some investors are focused less on returns and more on the positive impact their investment could have on society. These types of impact investors, i.e., those leaning more toward philanthropy, may therefore receive below-market returns. For others, the positive impact on society is a competing factor with the desire for market-rate returns.

According to the GIIN's 2020 Annual Impact Investor Survey, 68% of respondents reported that in 2019 their investments met their financial expectations, while 20% said their investments outperformed.

MARKET TRENDS

The impact investment market has continued to pick up pace, particularly with respect to green bonds and corporate impact investing.

Institutional investors are beginning to engage with their asset managers to incorporate impact considerations into investment processes. In a [recent survey](#), 79% of investors said they would be more loyal to a financial advisor who actively helps them invest in a way that also has a positive impact on the world. Further, 63% of the surveyed investors said they have taken some sort of action as a result of their climate change concerns.

CONCLUSION

Impact investing has demonstrated that "doing well" and "doing good" is not an "either/or" proposition—investments can achieve both. This change in mindset, coupled with increased awareness of social and environmental challenges—which were so starkly put into the spotlight in the wake of the COVID-19

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pandemic and #MeToo and Black Lives Matter movements—has resulted in an increased demand for sustainable investments that shows no signs of slowing down.

Our ESG and sustainability advisory practice advises public and private companies, asset managers, and their stakeholders across sectors on the opportunities and risks associated with implementing their ESG and impact investing strategies. Given the fluctuating global regulatory market around ESG claims and commitments, it's important for companies to evaluate their overall ESG strategy based on industry and peer practices.

Our team can guide sovereign wealth funds, asset managers, and retirement plan advisors through the landmines of investing through an ESG lens; scrutinize public statements made in support of ESG goals; maximize advantageous tax strategies; and handle enforcement, antitrust actions, and class action litigation swiftly and effectively as they arise.

With a cross-practice global team that has experience in private equity, venture capital, structured and leveraged finance, investment fund formation and management, corporate and securities regulation, international and not-for-profit tax, and international dispute resolution, we help firms make sound decisions and implementations in line with clients' expectations for impact investments to generate both a financial return on capital and a social benefit.

**THE CURRENT MACROECONOMIC
CLIMATE'S IMPACT ON FUND
TERMS**

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The macroeconomic indicators are displaying that a recession could be approaching. Accordingly, fund managers are getting ahead of concerns such as lack of investment opportunities, plummeting valuations, interest rate hikes, and nervous investors by tailoring their investment strategies and approaches to raising capital and investor negotiations.

ATTRACTING AND RETAINING INVESTOR CAPITAL

Fundraising is the primary area in which fund managers are likely to feel the effects of a recession, particularly as limited partners may take a conservative approach to managing their financial commitments amid the uncertainty.

We expect to see fund managers coming back to market within 18 to 24 months rather than the typical three to four years, assuming such fund managers have been able to deploy sufficient capital in their active funds. Managers have historically drafted successor fund provisions loosely such that sponsors are able to return to market sooner, with the standard “75% invested” test actually being “75% invested/committed/reserved,” thus allowing sponsors to interpret the threshold with a degree of flexibility.

In addition to coming to market earlier, we are seeing longer fundraising periods to allow more time to attract capital and more frequent closings stemming from concern about investors renege on their proposed commitment or the manager’s track record being impacted by plunging valuations.

To raise capital as quickly as possible, fund managers are targeting prospective investors with whom they have existing relationships, i.e., managers are looking to raise capital from a smaller number of reliable investors, potentially in the form of club deals or single-investor funds. Other managers are seeking alternative sources of capital; for example, we are seeing an increase in managers targeting the “retail market” via high-net-worth individuals.

We are continuing to see early closer incentives in the form of fee breaks, but are also seeing managers extend these fee breaks to later closers in a bid to attract more capital. In the same vein, we are seeing managers agree to waive the equalization interest payment on management fees.

In addition to attracting capital, retaining capital is also an issue for managers, and one which may be felt even in the closed-ended context where investors do not typically have the ability to exit prior to a fund’s end. Those investors that are not well insulated from an economic downturn may want to renege on their commitments and therefore, particularly if little or no capital has been called, may actively breach their commitment obligations in order to be withdrawn from the fund.

This is the main concern for sponsors in closed-ended funds—unless and until material capital has been called, the default provisions are of little use. We saw in the last financial crisis that some limited partners were willing to risk the reputational impact of default in order to discontinue funding.

As a result of the increased risk of default, sponsors may pay more attention to the default provisions in limited partnership agreements. For example, sponsors may try to give these terms more “teeth” by introducing cross-default provisions—that is, if an investor is invested in multiple products with a single sponsor and defaults in product 1, the sponsor could have recourse to the investor’s returns/commitment to products 2, 3, etc.

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This may be a particularly effective course of action given that in recent years many investors have reduced their asset manager relationships and actively chosen to instead invest in multiple products of a single sponsor.

In reality, managers often acknowledge that default is typically less of a risk with regard to institutional investors who are often well insulated in an economic downturn. As such, for those investors, the need to push back on cross-default provisions may be of less concern. For the majority of institutional investors, the concern is usually whether there is a foot fault with regard to missing a capital call as opposed to a “true” default so, even for cross-default mechanics, the main concern will be ensuring that there is sufficient notice of when funding is due and that there is a “grace” period before an investor is deemed to be in default (consider also a potential pre-notice of default and opportunity to cure before the cross-default mechanism kicks in).

On the other hand, for high-net-worth individuals, there is a greater risk of a true default in an economic downturn, which would negatively impact the entire fund, because they tend to be more sensitive to economic ebbs and flows and the denominator effect in their portfolios. For these clients, pushback on cross-default provisions is, arguably, more critical but, in the same vein, we expect pushback from managers (particularly, as noted earlier, the increased focus on high-net-worth individuals as a means of expanding a manager’s investor base).

STRATEGY ISSUES

We are seeing increased allocation to opportunistic baskets, even in mature vintages of flagship funds (e.g., fund IX, fund X), such as special situations and debt investments. Some managers are taking a light-touch approach and leaving their planned investment strategy unchanged from prior funds while modifying the tone and scope of their marketing materials to address investors’ fears and concerns—e.g., some managers emphasize their conservative approach to valuing portfolio investments and their roles as “stewards of capital.”

Alternatively, other fund managers may take a more heavy-handed approach by launching funds with investment strategies that target industries more likely to be flooded with opportunities in a financial downturn (e.g., special situations, distressed debt, specialty credit, secondaries). Other managers are moving away from niche strategies toward more mainstream or traditional strategies.

In addition to the sectors and types of investments that managers can make, private fund market participants cannot overlook the impact of the interest rate environment on fund-level borrowings. We have seen a huge expansion in the permitted use of fund-level leverage, driven by the last several years of historically low interest rates.

Many closed-ended funds now permit net asset value facilities (secured against fund assets) and subscription line facilities (secured against undrawn capital) with overall limits creeping toward 50% of committed capital, up from a historic average of about 20%, and increasing exceptions to the limits. Given the recent interest rate hikes, we anticipate investors pushing back on a fund manager’s flexibility to incur leverage and ensuring that appropriate restrictions on the use of leverage are in place.

IMPACT ON KEY FUND TERMS

Investment Period. Since a recession can create valuable opportunities for managers to acquire new assets or perform follow-on acquisitions for existing assets at depressed prices, fund managers will want

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to make sure they have time to utilize those advantageous conditions. The result is longer investment periods (three- to five-year period has increased to approximately six years) and increased flexibility of unilateral extensions.

Further, a manager's ability to deploy capital over a longer period of time mitigates exposure to a single-entry point and valuation environment—we have seen this before in the global financial crisis where private equity's 2008 and 2009 vintages delivered solid performances at a time of incredible volatility and uncertainty. Investors will want to see parameters around any rights to increase the investment period (i.e., requiring LPAC consent) and should carefully consider any knock-on effect of an extended investment period on the term of the fund.

Ability to Exit. In an economic downturn, acquisition markets tend to dry up as capital becomes scarce, hindering a manager's ability to exit investments. As such, managers may be prompted to explore options to extend the hold period of their assets for an extra year or two to maximize capital—this may be done by way of increased flexibility to extend the term of the fund or by allowing for the formation of continuation vehicles.

Managers can avoid increasing their leverage by acquiring funding from new investors in a recapitalization transaction. While these transactions were born out of the last financial crisis and the resulting "zombie funds" unable to realize their assets, the transactions have been increasingly used by sponsors in recent times to facilitate continued exposure to high-performing assets.

That said, current Securities and Exchange Commission rule proposals indicate that these transactions will be the focus of increased regulatory scrutiny in the United States (in our experience, the largest market for these vehicles).

From an investor's perspective, the use of continuation vehicles raises a number of key concerns. First, the valuation of assets is often rife with conflict issues given the current owner of an asset is selling the asset to a new vehicle that it will continue to own, and the general partner's (GP's) valuation will be based on its own understanding of the asset's value. Investors will push to require GPs to obtain an independent third-party valuation of the assets being rolled into a new vehicle.

Second, investors will seek consent rights with regard to participation in any such continuation vehicle and upfront agreement on the fees and carry (or a provision that states such economic terms shall be no less favorable than the current fund).

Lastly, investors will also want to ensure that (1) the new carry is correct, (2) the GP has rolled capital and any crystallized carry from the original deal into the new vehicle, and (3) the GP has invested new money in the new vehicle.

Recycling and Follow-Ons. Recycling provisions have historically been heavily negotiated and are often quite restrictive, with typical provisions only permitting invested capital to be reused if an investment is sold within 18 months of its original investment date. That said, some strategies such as private credit have already been doing much greater recycling than the historic illiquid asset classes.

In an economic downturn, where managers may be concerned about the ability to go to market again, increased flexibility as regards the ability to reuse capital is important. Managers are seeking increased

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flexibility for follow-on investments by increasing caps (these were typically set between 15% and 20%, and now we are seeing upward of 30% or, in some cases, no caps at all) and creating flexibility to recycle throughout a fund's term.

Investors will also likely have concerns about "throwing good money after bad" and will seek to keep caps at 15% to 20%. Further, in a turbulent market, investors may desire the ability to allocate money that has been distributed to them to another fund or elsewhere, and as such may resist unlimited recycling.

Governance. We are seeing an increased focus on governance at a time when sponsors need more flexibility. Investors are pushing harder for the right to remove a GP without cause, and GPs are responding to these requests in a time when their negotiating power is weaker. For example, investors are increasingly requesting the ability to remove a GP on a quasi-cause basis—that mechanism enables a minority (e.g., 25% or 30%) of limited partners to assert in writing that the GP should be removed.

The reason for removing a GP on a quasi-cause basis need not meet the high standards required to remove a GP for cause. After written notice is given, the matter goes to the larger pool of limited partners for voting.

With regard to a straight for-cause removal, GPs may try and push for high voting thresholds of 85% and sometimes more. Conversely, GPs may try to push for more moderate remedies, for example, the ability for the limited partners to require the GP to start selling investments and wind up the fund rather than a no-fault GP removal.

INCREASED NEGOTIATION POWER FOR INVESTORS – BESPOKE ARRANGEMENTS

Co-Investments. Offering increased co-investment opportunities to investors is a way to deploy a fund's capital even for investments that may otherwise be too large for the fund to complete. Successful deployment is a key driver for many sponsors. On the other hand, using co-investors can allow a fund to preserve its dry powder if that is more of a concern for the sponsor.

We are seeing managers undertake a dual fundraiser in which a manager simultaneously raises its main fund and blind-pool co-investment vehicle to invest alongside the main fund in any surplus opportunities. Conversely, investors may shy away from binding co-investments given that elective co-investments can be dialed back, whereas an investor would be unable to withdraw its commitment to closed-end funds.

Funds of One. Investor demand for funds of one is high—institutional investors are offering to write large checks but asking for the creation of funds of one so that they can avoid undesirable features of an otherwise attractive strategy. Managers, in a bid to secure additional capital in a difficult fundraising environment, will likely need to be responsive to such demands. Funds of one offer a number of advantages for investors, including

- greater control, transparency, and governance terms (e.g., customized reporting, notice of bad acts, approval of service providers, removal/termination rights),

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- additional rights that may be inapplicable to other investors (e.g., representations or closing opinions, governing law, jurisdiction of choice),
- the ability to leverage the manager's infrastructure (e.g., access to sponsor knowledge), and
- lower management fees.

Conversely, from a managerial perspective, funds of one result in (1) increased responsibilities and duties (tailored reporting and other requirements can require material adaptations to existing processes), (2) the potential for additional regulatory permissions compared with those for operating commingled funds, (3) concerns about managing conflicts of interest between a fund of one and a manager's commingled funds, (4) increased costs, and (5) potential liabilities. However, in a distressed market, the increased negotiation leverage of investors means such investors can push for these types of bespoke arrangements.

CONCLUSION

An economic downturn represents an opportunity for managers to buy low and sell high. Past periods of market distress have taught investors the value of waiting out the storm because the best private equity returns come after a recession.

If you look to the examples of the bursting of the dot-com bubble, the 2008 global financial crisis, and the recent pandemic, a significant slowdown in investment activity from institutional investors is not necessarily a forgone conclusion, provided fund managers are able to nimbly pivot to get ahead of the changes in the market to take full advantage of the recovery to come.

SEED AND STAKE ARRANGEMENTS: KEY CONSIDERATIONS

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“Seed and stake” arrangements are increasingly being seen as an attractive opportunity for sovereign wealth funds (SWFs) looking to take a cornerstone position in a commingled investment fund as well as a stake in the general partner and manager entities. With these investments come several legal and structural factors to be taken into consideration.

KEY CONSIDERATIONS

SWFs have historically been partners of choice for private investment fund managers, being sophisticated investors capable of writing big checks and executing complex deals, as well as bringing the “halo effect” to a manager’s brand. This profile leads to opportunities for SWFs, particularly when SWFs are considering investments with new managers or larger, strategic relationships with existing managers.

One outcome is an increase in so-called “seed and stake” arrangements, where an investor (a Seed Investor) takes a cornerstone position in a commingled investment fund as well as a stake in the general partner and manager entities (collectively, the General Partner) for such fund, which can be structured as either a top-line/revenue-share interest or a bottom-line interest, or sometimes a contractual share of their revenues (management fee or carried interest or both). Where an SWF is considering entering into a seed and stake arrangement, the following are several of the key considerations.

Revenue-Share vs. Bottom-Line Participation

A Seed Investor should consider whether its participation in the General Partner should take the form of bottom-line profit participation (i.e., after reduction for costs such as compensation and other General Partner operating expenses) or a top-line revenue-share interest (i.e., gross management fee and/or carried interest received by the General Partner).

While many fund sponsors may prefer a bottom-line profit participation on the basis that it creates better alignment with the Seed Investor, a Seed Investor should strongly consider the benefits of a top-line revenue-share interest. These benefits include making the General Partner’s operations budget and compensation policies of less importance to the Seed Investor, taking pressure off the ongoing governance arrangements and allowing more autonomy for the General Partner’s spending decisions.

If the Seed Investor receives a top-line revenue-share interest in the General Partner, the Seed Investor should be careful to structure its interest to convert into a bottom-line profit participation, based on a normalized margin of the business, in connection with a sale of the General Partner.

Equity Share Structure

Special consideration should be given to the structure of any revenue share or profit participation for non-US SWFs that rely on US Internal Revenue Code Section 892 (Section 892). A non-US SWF’s ownership of equity in a General Partner or a non-US SWF’s receipt of a share of management fee or certain carried interest revenues derived by a General Partner could cause the non-US SWF’s investing entity to be treated as engaged in “commercial activities” for purposes of Section 892, which could potentially cause the non-US SWF’s investing entity to lose its Section 892 exemption (even in cases where the General Partner does not have US operations).

One option may be to structure the revenue share or profit participation as an offset against amounts the Seed Investor would otherwise bear as management fees and/or carried interest in the commingled fund. Alternatively, the non-US SWF should consider holding the interest in the General Partner through a blocker or special-purpose vehicle not needing the Section 892 exemption.

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Further, if the underlying fund generates income to which the Section 892 exemption would be relevant and is structured to avoid being engaged in “commercial activities,” the non-US SWF should consider separating the ownership of the interest in the underlying fund (which could be held in an investing entity eligible to claim the Section 892 exemption) from the ownership of the interest in the General Partner that could result in a “commercial activities” taint.

Similarly, if the non-US SWF would receive both a share of a management fee stream (which could result in “commercial activities”) and a share of carried interest distributions (which, depending on the structure and operations of the underlying fund, may not result in “commercial activities”), the non-US SWF should consider separating the ownership of those two interests in order to preserve and maximize available Section 892 benefits.

Management Service–Related Commitments

A Seed Investor should ensure that the founders of the General Partner and other key management partners have made significant service-related commitments to the General Partner, with third-party beneficiary rights for the Seed Investor, including long-term employment commitments, restrictions on non–Seed Investor equity holders transferring their interests in the General Partner, advance notice of departure, noncompete and nonsolicitation obligations with post-departure tail periods, confidentiality restrictions, and operating commitments to conduct the business in good faith in compliance with applicable laws, contracts, and policies.

Further Capital Obligations

Oftentimes in seed and stake transactions, the Seed Investor will agree to fund startup capital for the General Partner and make an investment in the relevant commingled fund. The Seed Investor should address at the outset any expectation that it will inject future capital into the General Partner.

This additional capital is typically structured as a debt or preferred equity instrument, with repayment of the Seed Investor’s loan being senior to other equity receiving distributions from the General Partner.

Alternatively, a Seed Investor may provide funding—or working capital assistance—to the General Partner as an advance of future management fees that the Seed Investor would be paying in respect of the commingled fund investment. In this case, care should be taken to clarify repayment obligations of the General Partner in circumstances where the commingled fund is not ultimately established.

Future Capacity Rights

After its initial seed investment in the first fund sponsored by the General Partner, Seed Investors typically obtain the right (which in some instances may be an obligation for a certain number of successor funds, subject to performance and other underwriting criteria) to fund a certain amount or percentage of future private investment funds or other products sponsored by the General Partner (or its affiliates). Any preferential economics or most favored nations (MFN) rights should also apply to such future products.

General Partner Governance

Where Seed Investors acquire an equity stake in the General Partner, they should consider instating minority protection rights in order to ensure appropriate governance of the General Partner, including board representation or observer rights, anti-dilution provisions, rights of first offer and refusal, tag

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rights, information and notification rights, and consent rights in respect of certain material reserved matters.

Seed Investors should also consider including vesting and bad leaver provisions applicable to the founders/sponsors in a General Partner's governance documents to tie the equity stakes of such individuals to certain "bad actor" events at the level of the fund, such as causing a removal of the General Partner for cause and triggering a key person event. These vesting provisions can also apply to the terms of the carry, whether captured through the General Partner or a separate carry vehicle.

Exit Rights

Where Seed Investors acquire an equity stake in the General Partner, they should carefully consider their ability to exit from the General Partner and obtain liquidity. Typically, exit rights would include the ability of the Seed Investor to transfer its interest in the General Partner to a third party after an initial lock-up period, subject to a right of first offer or refusal in favor of the General Partner, which would generally ensure that a sale reflects market value.

In the event the General Partner's founders seek to sell any General Partner interests to a third party, a Seed Investor should have customary tag-along rights and may be subject to a drag-along right of the founders. The Seed Investor should ensure that it receives its pro rata portion of all sale-related proceeds including, going forward, any above-market compensation or other economics payable to the founders that may not be characterized as being part of the purchase price.

Additionally, the General Partner will often have a call right over a Seed Investor's interest in the General Partner after a certain period, typically for fair market value or a fixed multiple. The Seed Investor should also consider a put right in conjunction with a General Partner call right or otherwise in the event of bad acts or regulatory issues involving the General Partner.

Preferred Terms for the Commingled Fund Investment

As Seed Investors often comprise a significant percentage of the initial, if not also the final, commitments of the relevant commingled fund that they anchor, they generally obtain MFN rights and other preferential economics, including reduced management fees and/or carried interest, and terms in the same way large fund investors typically receive.

Commingled Fund Governance

A Seed Investor should take care that it not be treated as an "affiliate" of the General Partner for purposes of the fund documents, which could result in a lack of voting rights or exclusion from the limited partner advisory committee, for example, or other unwanted obligations, such as public reporting requirements. The Seed Investor should enjoy all the same rights as other third-party investors in the fund on an MFN basis.

Warehousing Arrangements

Where a seed and stake arrangement is in respect of a newly formed asset manager seeking to raise its initial commingled investment fund, the Seed Investor's anchor investment may be structured as a warehouse investment commitment as a precursor to the commingled fund commitment.

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The amount of such initial commitment will be available for the General Partner to deploy prior to the formation of its inaugural fund, as a means by which to establish a portion of the portfolio for the fund and therefore make the fund a more attractive investment proposition for other investors.

Any such warehoused investments will then be contributed to the fund, following a first closing with third-party investors (often requiring a minimum level of aggregate commitments from such third-party investors), in satisfaction of all or part of the Seed Investor's anchor commitment. In such case, care should be taken to ensure that the mechanics around valuation and rollover of warehoused investments into the commingled fund are fair and reasonable to both the Seed Investor and future fund investors.

In addition, Seed Investors should consider establishing a framework for managing out any warehoused investments in circumstances where the commingled fund is not ultimately established.

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