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## The Battle Between Efficient Asset Allocation and Sound Governance

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**A**lthough the current fundraising climate for private equity (PE) is under pressure<sup>1</sup> it cannot be denied that the PE industry has seen exuberant growth over the past decades on the back of historic outperformance of traditional asset classes such as listed equities and real estate.<sup>2</sup>

In view of the large sums required for PE investments and the relatively high-risk profile, PE investments since the early days have been made through collective vehicles in which several investors participate.<sup>3</sup> As the PE industry grew and matured, so did the features and structures of the collective vehicles through which such investments are made.

In order to permit investments in illiquid assets, traditional PE funds provide for long, but finite, hold periods without the possibility to redeem. More than once the rigid framework of a typical PE fund proved to be incompatible with the economic reality of the underlying assets. For instance, this is the case if a portfolio company unexpectedly requires additional capital, but the fund lacks the flexibility to provide such capital without breaching its mandate or exhausting its reserves, or when the hold period of the fund does not align with the optimal growth and exit path of the portfolio company. Over the years new fund structures emerged to allow fund managers to address such portfolio needs, often triggering new governance challenges. The opening up of PE

to the masses (a/k/a/ the democratization of PE) in recent years exacerbated the governance dilemma,<sup>4</sup> both for the retail investors in such funds (often semi open-ended), as well as for the investors in the underlying PE funds into which such retail funds typically participate.<sup>5</sup>

In this article we take a look at various fund vehicles that are being used in the fund industry to achieve efficient asset allocation and marry the economic reality of the PE assets with the structure of closed-ended PE funds. We discuss the key benefits as well as the challenges in respect of governance and oversight that investors in such vehicles are facing and suggest ways to overcome these. The article begins by looking at the emergence of PE funds to better understand the current governance model by putting it in historical perspective.

### Contractual Governance in Evolving PE Structures

PE funds first emerged in the United States, with their origins dating back to the 1940s and 1950s. Early PE deals often were structured as single investment vehicles for identified deals, meaning that a separate legal entity was created for each investment. Single investment vehicles allowed for a clear segregation of assets and liabilities and simplified governance for each deal whereby the investment returns

of each such deal were allocated to the investors with a performance allocation (carried interest) to the manager.

As the industry grew in the 1980s and 1990s, especially with the rise of leveraged buyouts (LBOs), PE firms began using multi-asset blind pool investment vehicles to manage larger and more complex deals.<sup>6</sup> It is at this time that PE funds also started to emerge in Europe. Because these funds were attracting capital from a wide range of investors and often had an international investment universe, the complexity of these structures grew to address tax and regulatory requirements both at investor and portfolio company level.

Over time, the PE industry diversified into various strategies beyond buyouts and venture capital, including growth equity, distressed investing, mezzanine financing, and secondaries. The rise of megafunds and global expansion has made PE a more sophisticated asset class and the complexity of the vehicles and fund terms have evolved commensurately, giving rise to a suite of different PE fund structures. While investor protection in retail-oriented funds such as an Undertaking for Collective Investment in Transferable Securities (UCITS) is largely a function of regulatory safeguards, the governance architecture in private investment funds is shaped primarily through contractual design. Investors in PE funds are expected to be sophisticated enough to be able to negotiate the terms of their investment and make an informed decision as to whether such investment is suitable given their desired risk return profile.<sup>7</sup>

A non-exhaustive set of governance mechanisms employed in closed-ended structures includes investor voting rights on fund continuation or liquidation, the establishment of limited partner advisory committees (LPACs), alignment through team co-investment and performance related incentive models (waterfalls) and individualized protections via side letters. These mechanisms aim to mitigate information asymmetries and managerial discretion within illiquid and opaque funds. However, the structural evolution of the private markets—which is driven by

the rise of specialty fund structures, such as continuation vehicles, increasingly complex co-investment arrangements, and the growth of customized fund and retail platforms—has outpaced the development of corresponding governance tools.<sup>8</sup> As fund structures grow in complexity and scale, traditional governance rights risk becoming diluted, fragmented, or inaccessible to many investors, particularly those outside the circle of large institutional investors (who often have side letters rights).<sup>9</sup> This growing mismatch between fund innovation and investor governance demonstrates a significant governance gap in the modern private capital markets: contractual flexibility may enable financial engineering and capital formation, but it may exceed the ability of current governance instruments to safeguard investors consistently and fairly.

## PE Specialty Fund Structures

Due to the limitations inherent in closed-ended fund structures, achieving efficient asset allocation can be challenging. In response, a range of alternative fund structures has emerged. While these alternatives often facilitate more effective asset allocation, they also introduce governance challenges that investors must navigate. Outlined below are several of these alternative structures and the associated governance considerations.

### Co-Investment Funds

#### *Characteristics*

Co-investment funds have been around for ages and are widely used by PE managers. A co-investment vehicle is a separate investment entity created to allow investors to invest alongside a main fund in a specific transaction/portfolio company. Typically, the purpose of a co-investment fund is to take up a slice of an investment that is too large for the main fund as a whole (for example, in view of its concentration limits). As such a co-investment fund enables the main fund to seize investment opportunities that it otherwise would need to forego or allows the fund

manager to maintain or gain control over a portfolio investment that it would not have in case only the main fund would invest.

Co-investment funds typically are offered on a low or no fee/carry basis. From an investor's standpoint, the opportunity to participate in a co-investment fund is attractive as it helps to reduce fees of an investor's overall portfolio.<sup>10</sup> Moreover the decision to participate in a co-investment can be made on a deal-by-deal basis, enabling investors to invest in an identified asset without the need to commit capital to an entire fund strategy.

### **Governance**

Because of the benefits, co-investment rights typically are offered to "cornerstone" or other strategically important investors. Where things start to get murky is in situations where strategic investors have a "gentlemen's agreement" or informal understanding with the fund manager that, in return for their commitment to the main fund, they will receive access to a certain volume of co-investment opportunities. This pushes the fund manager into deliberately seeking deals that exceed the typical bite-size of the fund in order to generate sufficient co-investment volume, which may cause style-drift for the fund.

Another aspect that is problematic is the fact that co-investments often are warehoused by the main fund (by way of bridge investment) and then syndicated to the co-investment fund. A reason for warehousing is that a transaction may need to complete at short notice whereas forming the co-investment fund and aligning the co-investors may take some time. Syndication by a main fund typically occurs at acquisition cost plus a carrying rate which seldomly exceeds the hurdle. In other words, for investors in the main fund the warehousing does not yield an attractive return whereas, if an issue would arise in respect of the underlying asset and syndication does not occur, the fund will be disproportionately exposed.<sup>11</sup>

Other complications may arise if investors in a co-investment fund have governance rights relating

to the underlying investment or if the term and exit horizon of the co-investment fund and the main fund are not aligned. Normally co-investment funds are fully accessory to the main fund, but if not, the fund manager may end up with conflicting interests in view of its fiduciary obligations *vis-à-vis* the investors in the main fund and in the co-investment fund.<sup>12</sup>

## **Opportunity Funds**

### **Characteristics**

Opportunity funds are commonplace in the venture capital (VC) landscape. These funds are typically set up by VC-managers to make follow-on investments in high-performing portfolio companies of other VC funds that they manage. VC funds focus on early-stage investments. As portfolio companies grow and raise more money at higher valuations a VC fund may not have enough capital for follow-on rounds and may be forced to give up its right to invest and be diluted. Since dilution pre-exit generally is unattractive, opportunity funds have been created to capture this value. Opportunity funds provide managers a separate pool of capital to continue backing their top-performing companies, without straying from the original fund's term, strategy or concentration limits.

### **Governance**

Opportunity funds offer clear benefits. For investors, opportunity funds provide a chance to enhance returns by increasing exposure to portfolio companies that perform well. Since these funds invest in more mature companies, investment in such funds also reduces the risk profile compared to an original VC-fund. At the same time opportunity funds allow the VC firm to retain or increase ownership in companies that are raising large rounds, preserving influence and upside potential. Such sustained influence on the underlying company also benefits the investors in the earlier VC fund.<sup>13</sup>

Opportunity funds, however, may give rise to governance concerns. First, since opportunity funds invest in the “winners” in the portfolio of earlier stage VC funds, the investors in such earlier funds may feel short-changed if they are deprived of the opportunity to participate in such later rounds. For this reason, it is good practice to offer all investors in such earlier funds the possibility to invest in the opportunity fund before offering access to third-party investors. Secondly, because opportunity funds typically invest in follow-on of a main fund (as opposed to co-investment funds that typically invest parallel with a main fund) this may give rise to valuation issues. If such follow-on investment is part of a larger funding round in which third-party investors participate this may not be problematic.

However, in absence of a clear market valuation significant attention should be given to a proper valuation methodology (see in this context our remarks under Continuation funds below). Finally, consideration should be given to the term and exit strategy of the opportunity fund in an attempt to align those with the hold period of the earlier VC fund. This may not always be easy, given the later vintage and the unpredictable exit runway of the underlying portfolio companies.

## Continuation Funds

### *Characteristics*

Continuation funds have become a widely adopted tool in PE. Continuation fund transactions offer an exit strategy for portfolio assets of a fund managed by a manager, by selling such assets to a newly created continuation fund that is managed by the same manager. Continuation funds create flexibility by extending the hold period of an asset beyond the life of the original fund and by raising fresh capital for high-performing assets.<sup>14</sup> The primary rationale is to avoid a premature sale and instead pursue further value creation under a new structure while creating an exit opportunity for investors in the selling fund.

Structurally, continuation funds often have a lifespan of five to seven years and offer existing investors the option to either cash out at a pre-agreed valuation or roll over their interest into the new vehicle. Rollovers may occur on a “reset” basis, where the fund manager realizes carried interest and resets economic terms, or on a “status quo” basis, preserving the original terms.<sup>15</sup> In most cases, rolling investors will be asked to commit additional capital to support follow-on investments or operational improvements.<sup>16</sup>

Continuation funds generally fall into two categories: (1) single-asset continuation funds, and (2) whole-fund continuation funds. The former is used to retain a high performing “trophy” asset that the fund manager believes has further upside potential. The latter involves transferring multiple assets from the original fund into a new vehicle, often to avoid a forced sale or to extend the investment horizon across a broader portfolio. Each structure presents distinct governance challenges, particularly around valuation, conflict of interests, and investor alignment.

### **Governance**

Governance in continuation fund transactions is particularly sensitive due to the inherent conflict between exiting and incoming investors. Exiting investors seek the highest possible valuation, while incoming investors aim to buy in at the lowest price. These tensions are compounded by the manager’s economic incentives, such as the opportunity to realize carried interest and earn additional management fees.<sup>17</sup> Without proper safeguards, these incentives may influence the manager’s judgment in structuring and pricing the transaction.<sup>18</sup>

To achieve arm’s length pricing typically a competitive auction is organized in which one or more “lead investors” in the continuation fund make a bid for the underlying assets and as such, price the deal. Such a pricing process may however not fully extinguish the risks inherent to conflict situations. To further mitigate those, best practices have

emerged. These include appointing an independent financial advisor to oversee the valuation process, obtaining fairness opinions, and ensuring active involvement of the LPAC.<sup>19</sup> Full transparency is essential: Investors should be informed of the rationale behind the continuation fund, the identity of both rollover and incoming investors, and the terms of the transaction.

## Partnership Funds

### *Characteristics*

Partnership funds are funds that invest in portfolio companies in partnership with third-party managers. A partnership fund is designed to extend the management and ownership of select high-performing portfolio companies beyond their initial hold period. This is achieved by taking a minority stake in such portfolio company through a secondary transaction initiated by the fund manager (a GP-led secondary), at the point of its exit by an earlier vintage fund that is also managed by the manager of the partnership fund. In doing so partnership funds enable further growth, value creation, and attractive returns whilst extending the hold period and resetting the terms on which such investment is made.

### *Governance*

Just as a continuation fund, a partnership fund allows the manager to better align the fund term and capital need with the growth curve of the portfolio company and its (ultimate) exit. In this sense a partnership fund shows great resemblance with the features of a continuation fund. Therefore, many of the governance concerns that are prevalent for continuation funds also are relevant for partnership funds albeit the valuation issue, one of the key challenges for continuation funds, is absent in these structures in view of the majority sale to a third party. To further mitigate investors' concerns it is good practice that investors in the selling fund are offered to participate in a partnership fund (like a roll option in a continuation fund context).

A partnership fund offers clear benefits for investors in the selling fund as it may facilitate exits. The fact that the fund manager will continue to sponsor the portfolio company, through the minority investment by the partnership fund, underscores that the fund manager believes in further growth. Moreover, the ongoing involvement of the fund manager of the selling fund may help continue the growth strategy at the portfolio company level. Finally, a partial sale may be easier to finance for an acquiring fund. All these factors may enhance the exit value, which benefits all investors in the selling fund.<sup>20</sup>

## The Rise of Permanent Capital Vehicles

The democratization of PE has given rise to a great influx of retail capital in the PE space. Whereas historically, banks, wealth managers and multi-family offices established feeder vehicles or fund of funds for their clients, nowadays large PE firms have their own proprietary semi open-ended fund of funds through which retail investors may invest in their fund products. These vehicles are often set up in the form of Luxembourg UCI Part II Funds<sup>21</sup> or Business Development Companies (BDCs).

Permanent capital fund vehicles are the holy grail for fund managers as they provide flexibility for future capital increases, a time-horizon appropriate for harvesting growth from investments where current income flows and/or disposition opportunities continue and ripen beyond traditional closed-end fund long-stop dates. Furthermore, such vehicles limit fund establishment costs by avoiding the need for repeated successor funds as well as the need for fund managers to devote their time on fund-raising.<sup>22</sup> Because the retail investors in such funds are less sophisticated and have no bargaining power the terms of such funds are generally designed by the manager.

While traditional fund models generally have traded off liquidity for governance, recent innovations have begun to challenge this. In traditional closed-ended structures, investor capital is subject

to long-term lock-up, with governance rights serving as the primary mechanism of investor discipline. Open-ended retail funds, by contrast, substitute individualized governance for standardized investor protections grounded in regulatory liquidity, offering frequent redemption rights backed by legislation.

A growing number of hybrid structures now attempt to combine elements of both models, trying to retain long-term investment horizons while offering the appearance of liquidity, for example, semi-open-ended PE vehicles, such as open-ended feeder funds into illiquid master portfolios. These designs often restrict redemptions to fixed intervals or impose gating mechanisms, thereby simulating liquidity without providing the full investor autonomy of traditional open-ended funds. Yet these hybrid forms lack the regulatory strictness of UCITS and the negotiated safeguards typical to closed-ended funds, resulting in a blurred governance framework. In theory, investors are protected either by the ability to exit or by meaningful voice. In practice, however, such innovations risk eroding both dimensions. This leaves investors exposed to long-duration risk without corresponding control or protection.

At the same time also at the level of the underlying funds governance is easily impaired. As mentioned, much of the investor protection in PE funds still relies on a privately negotiated governance model. With the rise of the mega funds, the balance of power, which is at the grassroots of any negotiation, has eroded for a significant portion of the PE market. In the past years, when fundraising was hard, we have seen a trend of capital concentration among the largest funds. Therefore, even when markets are down, those large PE firms are less dependent on the capital of individual investors and it is exactly those firms that have now mobilized permanent retail capital to supplement their investor base. This has further diminished investor's individual bargaining power leaving only the largest strategic investors that often have a broader relationship with the firm. However, those investors often choose to pursue more global objectives, such as securing preferential

co-investment rights (*see* above), rather than focusing on the governance of an individual fund.

Finally, it is noteworthy that the retail (feeder) funds that invest in the underlying PE funds usually are not designated as being "affiliated" to the fund manager and therefore not excluded from voting in the underlying fund. Although the retail (feeder) funds usually are managed by a different arm of the PE firm, it is questionable whether they will vote on matters such as fund extensions and fund manager removals as independently as any other investors would. It is fair to say that the influx of retail capital has a significant bearing on the governance model for PE funds. A trend that is far from over.

## The Response to Increasing Structural Complexity

The evolution of fund structures offers managers and investors great flexibility in asset allocation, enabling managers to optimize value across diverse time horizons and liquidity profiles. However, this evolution is testing the limits of the traditional governance framework found in closed-ended funds.<sup>23</sup> Regulators have responded with a growing set of reforms aimed at strengthening investor protections and recalibrating governance standards, but regulatory oversight can only do so much. Given that the conventional closed-ended fund model is being stretched, sometimes beyond its limits, a fundamental shift in governance structures is needed to effectively address these emerging conflicts. In this context, we describe recent regulatory developments and offer suggestions for structural reform.

## Regulatory Developments

Recent regulatory efforts in the United States and European Union have targeted governance vulnerabilities in PE fund structures, particularly those arising from conflicts of interest, valuation practices, and diminished investor bargaining power. In April 2025, the European Union adopted the revised Alternative Investment Fund Managers Directive (AIFMD II), which reinforces disclosure obligations,

such as the mandatory reporting by managers on all fees, charges, and expenses allocated to their funds, including periodic breakdowns, prohibitions on hidden charges and the disclosure of any preferential treatment granted to specific investors, such as fee rebates or enhanced liquidity rights.<sup>24</sup> AIFMD II further introduces formal liquidity management tools for semi-open-ended funds to prevent redemption imbalances and recommends appointing independent board members in retail funds to counterbalance manager control. The European Securities and Markets Authority (ESMA) is tasked with reviewing the effectiveness of this latter recommendation and may propose mandatory independent governance by 2026.<sup>25</sup>

Meanwhile, the SEC's 2023 reforms, though vacated in mid-2024, have reshaped market expectations. These included mandatory fairness opinions for GP-led secondary transactions and disclosure of prior relationships between managers and opinion providers, aimed at mitigating valuation conflicts.<sup>26</sup> Despite the court setback, many managers continue to follow these standards voluntarily. Beyond investor-facing disclosures, regulators have also strengthened reporting obligations to supervisory authorities. In the United States, the SEC expanded Form PF to include event-driven reports for extraordinary fund events, enhancing systemic risk monitoring and enabling earlier regulatory intervention. Finally, industry bodies such as The Institutional Limited Partners Association (ILPA) have complemented regulatory efforts by issuing best-practice guidance for continuation funds, emphasizing LPAC oversight, equal access to deal information, and standardized reporting templates. These measures aim to embed investor protection directly into the fund governance, rather than relying solely on negotiated safeguards.<sup>27</sup>

### Structural Governance Reform

In the governance framework of funds third parties such as accountants, valuers, depositaries and even fund administrators play an important

oversight role. To assure proper functioning, such parties often are subject to professional standards, as is the case for accountants, or mandatory obligations or liability, as is the case for depositaries under the AIFMD framework in the European Union. In practice however such market parties face a commercial dilemma when performing their function. Because these service providers are selected and effectively appointed by the fund manager, not the investors, their commercial incentives tend to align more closely with the manager's interests than with those of the funds they are meant to serve. This structural misalignment is exacerbated when they maintain broader business relationships across multiple mandates.

Conflicts of interest and valuation issues are recurring themes in the governance of PE fund structures. In many cases, investors are required to form a view or grant approval via (or in their capacity as a member of) the LPAC, yet in their decision making they need to rely on information often provided by third-party service providers through the fund manager. This indirect flow of information places investors at a structural disadvantage, as they are not only dependent on the manager's framing but also lack direct access to the underlying data or advisors. This asymmetry risks distorting the governance process and may result in underexposure of material risks or alternative viewpoints.<sup>28</sup>

Rather than relying solely on regulatory developments to address this imbalance, a more effective solution may lie in reconfiguring the fund architecture to bring investors closer to the service providers and sources of information. This could be achieved by ensuring that the fund's key service providers may be effectively appointed and replaced by the investors (for example, acting through an LPAC) and by granting LPACs direct access to such third-party service providers. In doing so, the governance model would shift from a manager-centric framework to a more balanced structure in which investors are empowered to interrogate and validate the inputs that shape their oversight responsibilities.

To institutionalize this shift, certain investor rights should be embedded in the fund documentation. For example, every fund should be required to establish an LPAC from the initial closing, and such LPAC should be granted specific rights, including the authority to select (and confirm the manager's initial selection) and replace the fund's service providers at the fund's expense. This reflects the economic reality that investors are the ultimate beneficiaries of the fund and should be equipped with tools to safeguard their interests. Such rights also would enhance accountability among service providers, who would be incentivized to maintain independence and quality in their work, knowing that their appointment is subject to investor oversight.

A key challenge in operationalizing investor-led governance reforms is the ambiguity surrounding the fiduciary duties and liability regime applicable to LPAC members. Unlike fund managers, whose fiduciary obligations are well-established under both the US Investment Advisers Act of 1940 and the EU's AIFMD framework, LPAC members operate in a more ambiguous legal space. This uncertainty can deter qualified individuals from serving, particularly when the scope of their responsibilities is unclear or perceived as overly burdensome.

In the United States, LPAC members generally are not considered fiduciaries under Delaware law unless explicitly designated as such in the fund documentation. Their role is typically advisory, limited to specific consents outlined in the limited partnership agreement.<sup>29</sup> However, when LPAC members exercise discretion that materially affects other investors, courts have occasionally inferred fiduciary-like obligations.<sup>30</sup> To mitigate liability, fund agreements generally include indemnification clauses that protect LPAC members from personal liability, provided they act in good faith and avoid gross negligence or willful misconduct. These provisions typically mirror those applicable to the general partner and cover legal costs and liabilities incurred in connection with LPAC duties, provided the member has acted in good faith and not engaged in gross negligence or

willful misconduct.<sup>31</sup> In the European Union, LPAC duties are not regulated under the AIFMD and are instead governed by national law and contract. For example, under Dutch law, LPAC members may be treated as third-party beneficiaries entitled to indemnification if such rights are explicitly granted in the fund documentation. These indemnities typically exclude coverage in cases of disabling conduct, such as gross negligence or a breach of law.

Ultimately, alignment between investors and managers is best achieved through well-functioning investor bodies. In closed-ended funds, this means a robust LPAC with clearly defined rights and responsibilities. Because an LPAC normally is composed of investor representatives it is an ad-hoc body by nature and there can be no assurance that it will be formed. To counter this structural challenge we would advocate that, on the basis of proportionality as to the size of a fund, funds investors should have the right to appoint a third party as a permanent member of the LPAC as a representative of all investors (just as the proposed appointment of independent directors for open-ended retail funds). Such independent member could assure the proper function of this important investor body, which could make better informed decisions thanks to the right to directly appoint, and consult with, third-party service providers. By embedding these mechanisms into the fund structure, the industry can move toward a governance model that is both resilient and responsive to the evolving dynamics of private capital markets while limiting the need for further detailed regulatory requirements and external regulatory oversight.

## Concluding Remarks

Governance in PE funds is based on the theory of a freely negotiated contract between sophisticated market parties with the goal to establish a structure where the fund manager and the investors are aligned. In recent years fund structures have grown more diverse and complex and retail investors entered the PE fund market to efficiently allocate assets and address the economic realities

of underlying portfolios. These developments are a natural evolution of the market and are likely to continue. Due to the increased size and complexity, investor's individual bargaining power has been eroded, putting the governance model of PE funds under pressure.

In response regulators increased oversight introducing additional mandatory disclosures, structural requirements, and prohibitions, raising the cost of regulatory oversight. Such regulatory requirements often are implemented through the involvement of market parties such as accountants, valuers, depositories, or advisors. As such parties are effectively appointed by the fund manager, they face a commercial conflict when performing their services for the fund that may affect the quality of their services.

In order to improve the PE governance model in an ever-complex environment we would advocate seeking more alignment between the third-party service providers of funds and the investors in such funds. If accountants, administrators, depositories, and advisors to the fund would be effectively appointed by (representatives of) the investors rather than the fund manager their commercial interests would be more aligned with their oversight duties. This could be achieved by having clear rules on the authority for the investors, acting through the LPAC, to appoint such parties and have direct consultation and information rights. This also requires clear rules about the functioning, (information) rights and liability position of the LPAC and its members including, subject to the concept of proportionality, the possibility for investors to appoint an independent LPAC member at the fund's expense.

Such alignment between investors and service providers could balance the governance model and compensate the sometimes-fading alignment between the investors and the managers.

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## NOTES

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