November 15, 2021

Fund Finance: Impact of ILPA's DDQ 2.0 and Diversity Metrics Template

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ILPA's Publication of DDQ 2.0 and Diversity Metrics Template

Last week the Institutional Limited Partners Association[1] ("***ILPA***") published an updated version of its Due Diligence Questionnaire (such updated version, "***DDQ 2.0***") and Diversity Metrics Template (such updated version, the "***Metrics 2.0***" which along with DDQ 2.0 can be accessed here). The revised versions, updated throughout 2021, are intended to standardize the key areas of inquiry posed by ILPA's investor constituents ("***LPs***") during their diligence process with respect to managers and to provide a framework for ongoing monitoring of progress related to diversity, equity and inclusion ("***DEI***") and environmental, social and governance ("***ESG***"). ILPA indicates that DDQ 2.0 benefitted from input that ILPA sourced from a public comment period and discussions with LPs, general partners of private investment vehicles ("***GPs***"), as well as other industry bodies via working groups and roundtables.

ILPA's Prior Subscription Facility Guidance

As this iteration of the DDQ includes changes relating to subscription credit facilities and the fund finance market more broadly, by way of background, in June 2017, ILPA published *Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners* (the "***2017 Best Practices***"), which can be found here. The 2017 Best Practices sought to highlight a number of considerations for ILPA's constituents related to expanded use of subscription facilities by PE funds, including comparability of performance, clawback issues, expenses, tax considerations and liquidity and legal risks. The 2017 Best Practices made specific recommendations and suggestions with respect to (1) terms of the partnership agreement governing the PE vehicle relevant to the credit facility (*e.g.*, clean-down requirements, loan limits based on maximum percentage of uncalled capital and caps on total interest expense), (2) manager disclosures regarding subscription facilities (*e.g.*, net IRR with and without use of the credit facility and amount of fees), and disclosures of investment details and timing, (3) terms of the subscription line itself, (4) LP due diligence inquiries and (5) recommendations on the PE manager's use of subscription facilities (*e.g.*, subscription facilities should not be used to cover fund distributions in anticipation of, but prior to, a portfolio company exit). The 2017 Best Practices concluded with a series of questions that ILPA recommended LPs should ask of GPs regarding the introduction or enhanced use of subscription facilities.

Then, in June 2020, ILPA published *Enhancing Transparency Around Subscription Lines of Credit: Recommended Disclosures Regarding Exposure, Capital Calls and Performance Impacts* (found here) (the "***2020 Recommended Disclosures***" and together with the 2017 Best Practices, the "***ILPA Subscription Facility***

[1] A global trade association, ILPA states that its mission is dedicated to advancing the interests of LPs and their beneficiaries with regard to private equity ("PE") investments. According to its website as of the date of this publication, its membership consists of more than 5000 professionals across 50+ countries managing 50% of the global institutional private equity assets under management and including membership from public pensions, corporate pensions, endowments, foundations, family offices, insurance, investment companies, development financial institutions and sovereign wealth funds. ILPA advances its members' interests via events, industry affairs, education and research and content.

Guidance”), noting that while transparency around use of subscription facilities had generally improved since ILPA published the 2017 Best Practices, inconsistencies remained in the quality and consistency of disclosures to LPs. Thus, the 2020 Recommended Disclosures focused on specific recommended quarterly and annual disclosures, characterized as “incremental reporting”, to make explicit metrics that are “implicit in quarterly and annual reporting today,” with the aim of providing LPs visibility to better monitor the impact of subscription lines on exposure and performance, as well as key terms and associated costs. Notably, ILPA acknowledged the utility of subscription lines, which provide benefits to both GPs and LPs. Some of the recommended disclosures were:

- Quarterly reporting of facility size, balance, amount (and percentage) of unfunded commitments financed through the facility, days outstanding of each borrowing, net IRR with and without facility, and schedule of cash flows;
- Annually, the same information, plus maturity, renewal options, interest rates and fee amounts, and use of proceeds;
- Increased transparency on capital call timing; and
- Analytics to better understand the fund’s liability under existing subscription facilities.

ILPA’s Due Diligence Questionnaire

While the ILPA Subscription Facility Guidance applies on a fund-specific basis once an LP is already invested in a fund, the DDQ 2.0 and Metrics 2.0 would be requested by an LP to a GP before an LP has actually committed capital to a fund. ILPA first introduced its DDQ in 2013 with subsequent updates made in 2016 (focused on reporting in concert with the ILPA Reporting Template and reflecting the Principles for Responsible Investment’s LP Responsible Investment DDQ as the ESG section). Then, in 2018, ILPA updated the DDQ with the introduction of a section dedicated to questions and requested documents on DEI. The ILPA Diversity Metrics Template was first published by ILPA in 2018.

The release of the updates made to DDQ 2.0 are intended to incorporate the diligence items discussed in the ILPA Subscription Facility Guidance and reflect additional changes to practices, norms and conventions in the PE industry. In publishing DDQ 2.0, in addition to the input from working groups and roundtables, ILPA leveraged insight gained from many other efforts, including the ILPA Subscription Facility Guidance.

Summary of Changes Included in DDQ 2.0 and Diversity Metrics Template

Below is a summary of some of the revisions contained in DDQ 2.0 that are of interest to the fund finance industry:

Credit Facilities

A new section, *Section 7.0 (Credit Facilities)* (the “***Credit Facility Section***”) has been added, as well as new focus questions in *Section 14.0 (Track Record)* related to returns with and without the use of a credit facility and a new *Appendix H*: *Credit Facilities*.

The Credit Facility Section requests the GP answer a host of questions relating to credit facilities, including historic use of facilities (including non-subscription lines and with regard to the sponsor’s predecessor funds), benefits to the funds, and impacts on LPs (such as documentation required from LPs or limitations on transfers and similar restrictions on LPs). All of the information that the ILPA Credit Facility Guidance recommends should be periodically reported is also included in the questionnaire (facility size, lead lender, *etc.*), as well as questions about net IRR calculations, LPs' opt-out rights with respect to the facilities and alignment of reporting to ILPA recommendations.

Other Financings

In addition to the questions relating to non-subscription financings in the Credit Facility Section, *Section 10.0* (*Alignment of Interests)* was revised to include a question about whether and how GP and principal commitments are financed.

Further, in addition to the existing questions related to prior bankruptcies, defaults, modified audit opinions and excluded and underperforming investments, *Section 14.0 (Track Record)* was updated to include a comparison of LP returns, both with and without the use of a credit facility.

Appendix H (Templates: Credit Facilities)

The Due Diligence Questionnaire template also includes Appendixes, which provide lists of requested documents and information that can be reported to supplement the answers to the questionnaire. DDQ 2.0 adds a new *Appendix H* (*Templates: Credit Facilities*) which requests summary tables with details for every credit facility used by the fund and the fund's predecessor funds over the last five years. The information to be included in the summary tables broadly follows the questions included in the questionnaire, with the inclusion of facility specific information such as type of facility, lead bank, size, tenor, borrowing base composition and information on specific fee rates including upfront fees and unused fees.

ESG and DEI

Section 19.0 of the DDQ 2.0 relates to questions around the fund's ESG policies, progress, and key ESG risks and liabilities, and Section 20.0 of DDQ 2.0 addresses diversity, equity and inclusion. The scope and detail of the questions in Sections 19.0 and 20.0 aim to determine whether the firm is making a real investment in DEI and ESG, and whether it has set substantive goals and thoughtfully considered fundamental issues that are often impediments to better representation of diversity in an organization or attainment of ESG progress. The questions ask not only whether a fund has ESG or DEI policies, but also if and how its progress is tracked, how DEI and ESG concerns are incorporated into decision-making, if and how the fund is holding itself accountable, and whether it has examined processes to de-bias them in order to achieve better outcomes. For funds that have not yet incorporated such policies, DDQ 2.0 includes provoking questions and guidance that may be useful to organizations as they continue to develop DEI and ESG policies and practices.

ESG

In updating the ESG Section for DDQ 2.0, ILPA sought to synchronize ESG reporting with an updated version of the Principles for Responsible Investment ("***PRI***") *Limited Partners Private Equity Responsible Investment DDQ*. Additionally, new *Section 7.0 (Credit Facilities)* and *Appendix H (Templates: Credit Facilities)* include questions as to whether the fund's predecessor funds have used different forms of credit facilities, such as an ESG-linked facility, and benefits derived therefrom, including the key performance indicators required and the corresponding impact on the facility (such as a lower interest rate).

DEI

Expanding from eight to 21 subsections, revised Section 20.0 of DDQ 2.0 asks for far more granular information and has broader coverage than the prior DDQ. ILPA notes that both for the DEI components of the DDQ 2.0 and with regard to the Metrics 2.0, ILPA included updates based on information increasingly requested by LPs of GPs, as informed by signatories to the Diversity in Action initiative and aligned with ILPA's recently released ESG Assessment Framework found here. ILPA additionally noted that it worked closely with FCLTGlobal to align Metrics 2.0 with FCLTGlobal's template used to track diversity for boards of private companies.

Section 20.0 begins by asking whether the fund is a signatory to ILPA's *Diversity in Action* initiative, and covers:

- Tracking metrics on ownership, control, investment committee, and professional staff both qualitative and quantitative and at sponsor and portfolio company levels;
- Creation and implementation of policies on DEI (including recruitment and retention), codes of conduct (including addressing harassment, discrimination and workplace violence), equitable pay, family leave and specific recruiting policy for underrepresented groups;
    - Specific questions about any family leave policy, including whether it covers "Family Violence Leave";
- Programs at sponsor and portfolio company levels relating to employee engagement, performance review, and advancement of employees in underrepresented groups;
- Questions about specific processes for diversity in recruiting (targets, goals and practices that demonstrably result in improved diversity);
- Addressing bias in hiring;
- Training related to unconscious bias, inclusive leadership, systemic racism, and harassment;
- Governance structure and accountability with respect to DEI;
- Formal commitments to diversity; and
- Contributions to improving DEI beyond the fund, within the PE industry.

Metrics 2.0 (the template report) includes more globally relevant designations for race and ethnicity, more inclusive information on gender/diversity by adding a nonbinary designation and additional diversity designations, simplified structure for role designations across ownership and professionals as well as insight into staff movement and select portfolio company-level data. It tracks, in detail, diversity at all levels, promotions, and includes detailed definitions and guidance about the information requested.

Implications for Subscription Facilities and Fund Finance Market

The use of ILPA's DDQ 2.0 is not mandatory for any LP, GP or fund and is offered primarily as a tool to promote efficiency and standardization in the diligence process. While some LPs may request that GPs complete the

DDQ 2.0 in the exact form provided by ILPA, it is also common for LPs to have their own form due diligence questionnaire. However, the updates made in DDQ 2.0 are intended to reflect the changing priorities and considerations evidenced by LPs in the private equity market. It is therefore likely that individual LPs will seek additional information of the kind included in DDQ 2.0, including further and more specific data on ESG and DEI policies.

Requested disclosure around DEI and ESG will serve to bring these trends top of mind for funds who have not previously had formal ESG or DEI policies. As more and more funds incorporate formal policies it will continue to put pressure on funds that have not taken similar actions and may over time result in significant advancement of these initiatives in the fund finance industry.

Additionally, funds that develop formal ESG or DEI policies will be better positioned to incorporate ESG or DEI elements into a fund finance facility in the form of a sustainability-linked loan. While lenders are often keen to offer sustainability-linked loans, presently many funds do not have sophisticated enough DEI or ESG policies to identify a key performance indicator or meet a suitably ambitious sustainability performance target necessary to support a sustainability-linked loan. As funds integrate DEI and ESG more fully, the availability and prevalence of these facilities is likely to continue to increase.

ILPA's Subscription Facility Guidance has historically raised questions as to the impact and benefits of subscription credit facilities to LPs. While many LPs recognize the potential benefits of subscription credit facilities (such as increased IRR, reduced capital calls and liquidity management), LPs may also be hesitant to provide additional documentation or information to subscription facility lenders. It is not yet known whether DDQ 2.0 will inspire additional scrutiny or require expanded diligence on subscription credit facilities. However, to the extent LPs are increasingly focused on subscription credit facilities, this could have several implications in the market including expanded side letter provisions relating to credit facilities, or potential changes in the way funds structure subscription credit facilities.

Finally, we should note that ILPA itself stated that DDQ 2.0 and the new Diversity Metrics are most suited to established private equity managers, and that ILPA intends to produce modules for the DDQ in coordination with other industry bodies in an effort to tailor the DDQ to different asset classes (*e.g.*, real estate, private credit, infrastructure, emerging markets). Haynes and Boone will be on the lookout for such modules, as well as other expected future updates published by ILPA.

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