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When Should a Fund Sponsor Make its Capital Commitment?

Investors in private equity and real estate funds typically expect sponsors to invest in the funds they manage. A typical commitment by a sponsor group is to provide 1-5% of the total investor commitments to the fund and its parallel vehicles. This commitment is usually made by a combination of the general partner, the key investment professionals that control the general partner, and their related entities, family members and trusts. This investment commitment is frequently set forth in the fund's offering and/or governing documents. When those documents are silent, investors often seek this commitment through a side letter assurance.

Fund governing documents and side letters often go into more nuanced concerns regarding the sponsor commitment: for example, if there is a maximum commitment amount, or if a portion of the commitment can be satisfied on a "cashless" basis through management fee waivers. However, one aspect that is often overlooked is the date by which the sponsor must make its commitment when the fund has multiple investor closings.

Most private equity and real estate funds conduct two or more investor closings. In these situations, is it fair for the sponsor to delay funding its commitment until the last closing? The question is not as easy to answer as it may first appear. If the sponsor's commitment is being fulfilled by multiple individuals and investment vehicles, then having each of those individuals and entities make incremental capital contributions at each investor closing in order to keep the sponsor's capital contributions proportional to the rising investor commitment level can be challenging . This approach becomes even more complex if additional closings are coupled with investor defaults or adjustments to the size of one or more investor commitments.

To avoid this situation, a fund sponsor may be inclined to wait until the final closing to make its commitment (and its share of contributions made since the first closing) based on the final, total investor commitments. However, this choice can present its own challenges. For example, assuming the fund charges a "catch-up" or "cost-of-funds" charge on investors admitted to the fund at later closings, should the fund sponsor pay this charge as well? Most investors would say the sponsor should be treated exactly like an investor in this situation. However, the fund sponsor may have—even before the first closing—reserved cash yielding little or no return in anticipation of meeting its sponsor commitment at an upcoming closing. Is it fair in this situation for the sponsor to pay a cost-of-funds charge that is typically much higher than the return earned by the sponsor on liquid reserve amounts?

Sponsors that chose to "keep it simple" and catch-up on their sponsor commitment at the final investor closing may be at risk of generating negative perceptions among their investor base. Most fund investors want as much alignment as possible of the sponsor's capital with investor capital.   That alignment includes the timing of capital inflows and outflows with respect to the fund. Some investors may conclude that a sponsor that delays putting "skin in the game" while investor capital is at risk does not have the proper mindset regarding sponsor-investor alignment.

An additional consideration for fund sponsors is how the timing of its capital contributions to a fund may impact regulatory reporting. For example, for managers making a Form ADV filing on the IARD website[1], one of the required disclosures is the approximate percentage of each private fund managed by the sponsor that is beneficially owned by the sponsor and its affiliates. If a fund has held its first investor closing, but the sponsor has not yet actually contributed capital to the fund, the sponsor may find itself in a questionable regulatory posture (or worse) if it were to answer that it owned more than a 0% beneficial interest in the fund at the time of the filing.

While the general principles surrounding the sponsor commitment are simple, the details surrounding how and when the sponsor commitment is fulfilled can create complexity and investor relations challenges for sponsors. Fund managers who do not clearly communicate on these topics may being taking more business and regulatory risk than they recognize.

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[1] This would include sponsors registered as investment advisers as well as sponsors exempt from registration under the private fund adviser exemption available federally and in certain states.   The public can view Form ADVs filed through the IARD website at https://adviserinfo.sec.gov/IAPD/Default.aspx.