

## **Negotiating the New Normal: How Fee Compression and Custom Capital Structures Are Reshaping Private Funds**

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*In today's fundraising environment, fee compression and bespoke fund structures are no longer episodic negotiating points; they are permanent features of private fund formation. Sponsors that approach these demands strategically, rather than reactively, are better positioned to protect economics, manage risk, and deepen investor relationships.*

### **The Shift in Negotiating Leverage**

For much of the modern history of private investment funds, fund terms were largely dictated by the sponsors that managed those funds. Fund investors, commonly known as limited partners, accepted management fees, carried interest rates, and governance structures that sponsors set at the outset of each fundraise. Today, that dynamic has shifted materially. The current fundraising environment is defined by limited partner overallocation, concentration of capital among established managers, and growing scrutiny of net returns, which increasingly has placed negotiating leverage in the hands of sophisticated limited partners. The result is a new normal in which fee compression and bespoke economic structures have moved from the exception to a standard part of fund formation practice. Against the backdrop of an already challenging fundraising environment, sustained downward pressure on economic terms and the rapid proliferation of bespoke capital structures are converging to further reshape the negotiating leverage between sponsors and institutional limited partners.

### **Co-Investments and Customized Vehicles Drive Economic Pressure**

Increasingly, sophisticated institutional investors are using co-investment structures to put continued downward pressure on management fees and carried interest to achieve better limited partner economics on a blended basis. Co-investment allocations, or the right to invest alongside a fund in individual portfolio investments, typically on a fee-and-carry-free basis, have become one of the most frequently negotiated side letter provisions. The largest allocators (e.g., sovereign wealth funds, pension funds, insurance companies, and similar institutions) are leveraging enhanced negotiating power to secure separately managed accounts ("SMAs"), expanded co-investment platforms, single investor funds, and multi-vintage strategic alliances. For large institutional investors, co-investment rights can represent a meaningful component of the overall economic package. These arrangements provide the investor with greater transparency, customization and, in some cases, more favorable tax treatment, but impose significant operational and legal complexity on the fund's general partner.

The critical insight for sponsors is that fee compression and structural customization are not separate negotiating fronts. Investors are exchanging headline fee concessions for structural flexibility, greater control over economics, deal exposure, governance, and liquidity. Several structural forces have driven this shift. First, many institutional investors entered the post-2021

period significantly overallocated to private equity relative to their policy targets. Constrained by the denominator effect and slow distributions from existing funds, these investors became more selective about new commitments and more assertive about the terms on which they would participate. Second, capital in this environment has become concentrated among the largest and most established managers, giving those sponsors more pricing power, but also making cornerstone investor relationships more valuable and, therefore, worth accommodating. Third, the performance metrics that limited partner investment committees emphasize have shifted from internal rate of return, which can be managed through fund mechanics, toward Distributions to Paid-In Capital (or DPI), which cannot. Investors focused on realized cash returns are scrutinizing fee loads more carefully than in prior cycles, demanding deeper, more strategic arrangements.

Where investors once committed to a flagship fund and then negotiated a sidecar, many now approach a sponsor seeking an SMA as the primary vehicle, with a smaller flagship allocation as a secondary component. These SMAs span multiple vintage years and strategies, feature invested-capital fee bases, and include deal-flow covenants and enhanced governance rights. Relatedly, a growing number of large institutional investors are seeking minority stakes in the sponsor's management company or general partner entity as an alternative or supplement to fee concessions. These arrangements provide the investor with exposure to the general partner's management fee income and carried interest economics, rather than merely to the underlying fund's returns. The result is a multi-layered capital formation architecture in which headline fund terms represent only one element of the total economic relationship.

### **The Compounding Effect on Sponsor Economics**

For general partners, this convergence produces a compounding effect. This multi-layered stack results in compressed headline fees — early-bird and loyalty concessions, compounded by fee-free co-investment capital, and further diluted by SMA-level arrangements. Each concession may appear manageable when viewed in isolation. However, in the aggregate, the cumulative impact on effective fee yield and management company economics can be material. Sponsors should model the cost of these concessions carefully. For example, offering fee-free co-investment of \$0.33 per \$1.00 of commingled fund commitment translates to an approximate 25% reduction in effective fee revenue per dollar managed.<sup>1</sup>

### **Practical Legal and Governance Considerations**

Fee concessions are the most visible form of investor accommodation, but sophisticated investors increasingly seek structural arrangements that go beyond the economics of the fund itself. These bespoke structures require more complex drafting, raise additional legal considerations, and create structural tension that can be difficult to manage within the commingled fund model. The proliferation of parallel vehicles alongside flagship funds creates additional complexity around

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<sup>1</sup> Brenda Rainey, Hugh MacArthur, Lindsay Creedon & Aiyu Nicholson, *Private Equity's Reality Check: The GP Outlook for 2026*, Bain & Company and StepStone Group (March 2026).

deal-flow allocation, transaction fee sharing, and exit coordination, each carrying fiduciary and disclosure dimensions that require careful drafting, risk and conflict disclosures, and potential engagement by a fund's limited partner advisory committee.

Sponsors should approach fund formation with the understanding that drafting the limited partnership agreement, side letter management, and upper-tier documentation and structural design are now interdependent workstreams. Allocation and conflict-of-interest provisions deserve particular attention where a sponsor operates a flagship fund alongside SMAs and co-investment vehicles. Governing documents and allocation policies should specify allocation parameters such as percentage caps, first-look protocols, and conflict guardrails. Furthermore, the disclosure framework should address how investment opportunities, deal costs, broken-deal expenses, and transaction fees are shared across vehicles. Side letter management has evolved into a core governance function. Sponsors should develop a standardized framework, incorporating frequently requested provisions and constraining the proliferation of conflicting terms. Critically, sponsors should understand the most-favored-nations ("MFN") exposure created by each incremental concession, recognizing that, without the proper MFN protections, a single bespoke accommodation may ultimately be elected by a meaningful percentage of the fund's limited partner base.

The grant of differentiated economic or other arrangements to select limited partners, particularly where such limited partners hold an ownership interest in the general partner or the management company, is a significant source of conflict-of-interest risk in fund formation. Sponsors and their counsel must approach this dimension of fund structuring with rigor. A fund's confidential private placement memorandum (the "PPM") is the primary disclosure document through which sponsors describe the terms, risks, and conflicts associated with the fund to prospective investors. Where a sponsor has granted, or intends to grant, bespoke economic arrangements to certain investors, the PPM should disclose: (i) the existence and general nature of side letter arrangements, even if individual side letters are kept confidential; (ii) the potential for fee structures to vary among investors; (iii) the existence of co-investment rights and the sponsor's allocation methodology; (iv) the potential for conflicts of interest arising from parallel vehicles, SMAs, or GP-stakes arrangements; and (v) the existence of enhanced information rights and the potential for information asymmetries among limited partners.

Inadequate disclosure or documentation can give rise to investor complaints, SEC examination findings and enforcement actions, and reputational damage. SEC examination and enforcement activity continues to focus on fee calculation accuracy, expense allocation, and conflict-of-interest disclosures across fund vehicles.

### **Operational Readiness Is Now a Competitive Issue**

Approached reactively, fee concessions and bespoke structural accommodations can erode fund economics without meaningfully strengthening investor relationships. Approached strategically, they can be tools through which a sponsor deepens relationships with cornerstone investors,

differentiates its offerings in a competitive fundraising market, and positions the firm for long-term capital stability. Sponsors should stress-test fund economics under scenarios accounting for varying co-investment ratios, layered discounts, and SMA-level arrangements, as the headline management fee is no longer a reliable proxy for effective fee yield. Where a sponsor administers different fee arrangements, the compliance burden is amplified.

Operational readiness, in this context, is not merely an administrative function; it is a competitive capability that directly affects a sponsor's ability to accommodate large investors without introducing legal or governance risk. Sponsors must ensure their operational infrastructure can track investor-specific obligations throughout a fund's life. The rising complexity of bespoke arrangements demands centralized data platforms and technology-enabled workflows that provide real-time visibility into investor-specific obligations across legal, finance, compliance, and reporting functions. Fund formation counsel plays a central role in this calculus. Early engagement between the sponsor and its counsel allows the parties to establish a coherent framework. The objective is not to eliminate customization, but to make it operationally sustainable at scale, ensuring that personalization does not introduce conflicting obligations or compliance gaps.

### **The Road Ahead**

Although new capital sources, such as family offices and private wealth platforms, may moderate investor leverage at the margins and improved exit activity could ease fundraising pressure, the shift toward structural customization generally is not viewed as a cyclical phenomenon that will reverse when fundraising conditions improve. It reflects an evolution of the private equity market — one in which institutional investors are more sophisticated, more cost-conscious, and more willing to walk away from fund terms that they do not believe reflect the value of their capital. Fee compression and bespoke economic structures are the operational expression of that shift, and they are now a permanent feature of fund formation practice.

For fund managers and their counsel, the appropriate response is not to resist this shift but to manage it deliberately, converting investor demands into durable, value-creating relationships. Fund managers are no longer competing solely on strategy and track record; they are competing on the terms of the relationship itself. Managers that embed operational readiness and structural flexibility into their platforms from the outset, treating customization as a competitive differentiator rather than an administrative burden, will be best positioned to raise capital efficiently and sustain investor confidence in the cycles ahead.