

Morgan Lewis

Fundamentals of Private Equity Fund Formation

Private Investment Funds Practice



Forming the Fund

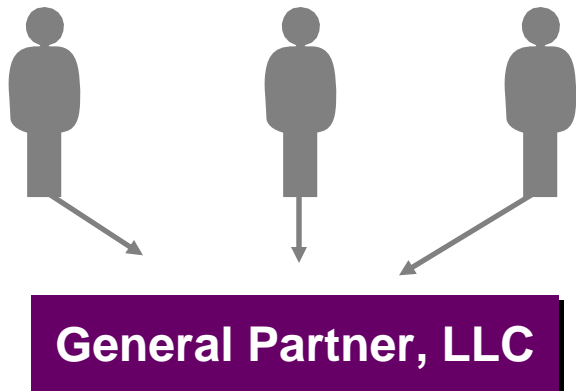
Step 1:
The Venture
Capitalists



● Individuals

Forming the Fund

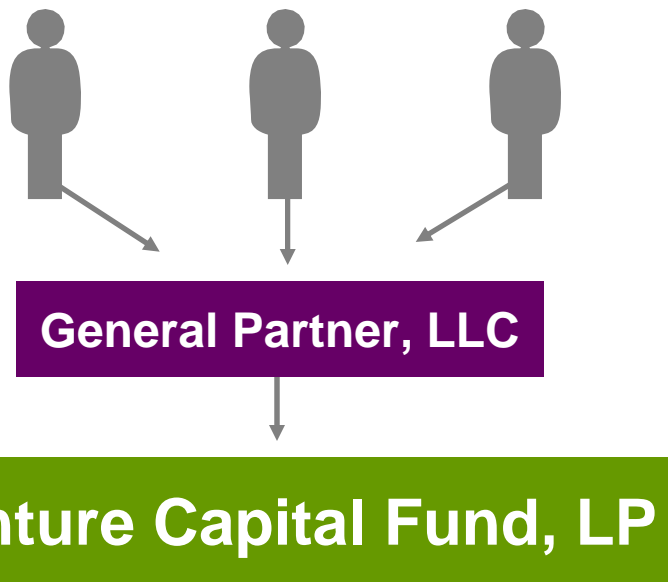
Step 2:
The General
Partner



- Delaware Limited Liability Company
- Limits Liability for Members
- Tax Advantages
 - Pass-through
 - Capital gains
 - Tack holding periods

Forming the Fund

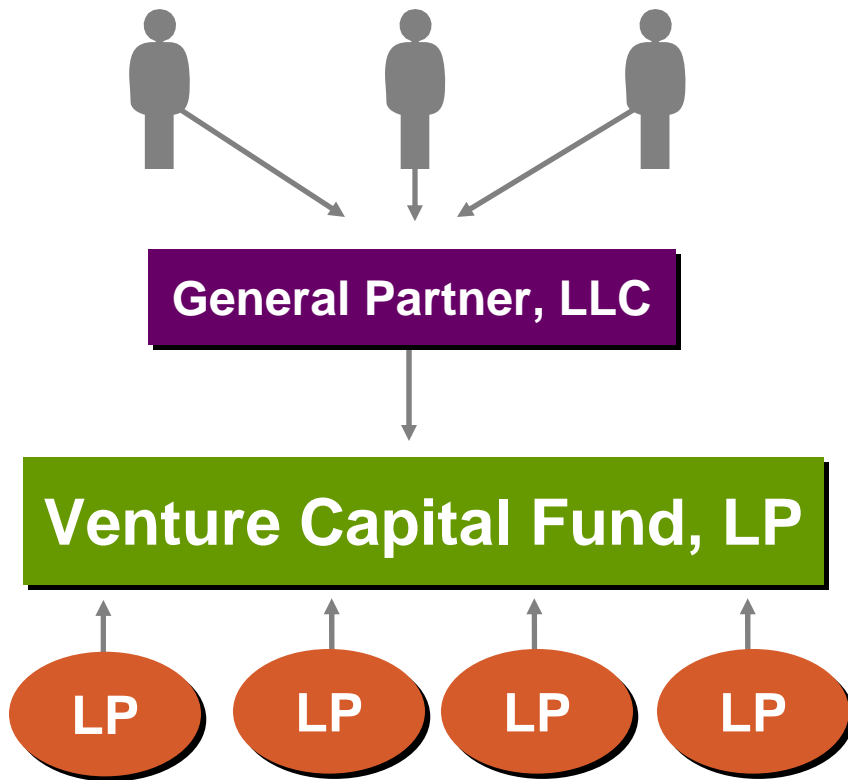
Step 3:
The Fund



- Delaware Limited Partnership or Delaware LLC
- Tax Advantages
 - Pass-through
 - Capital gains
 - Tack holding periods

Forming the Fund

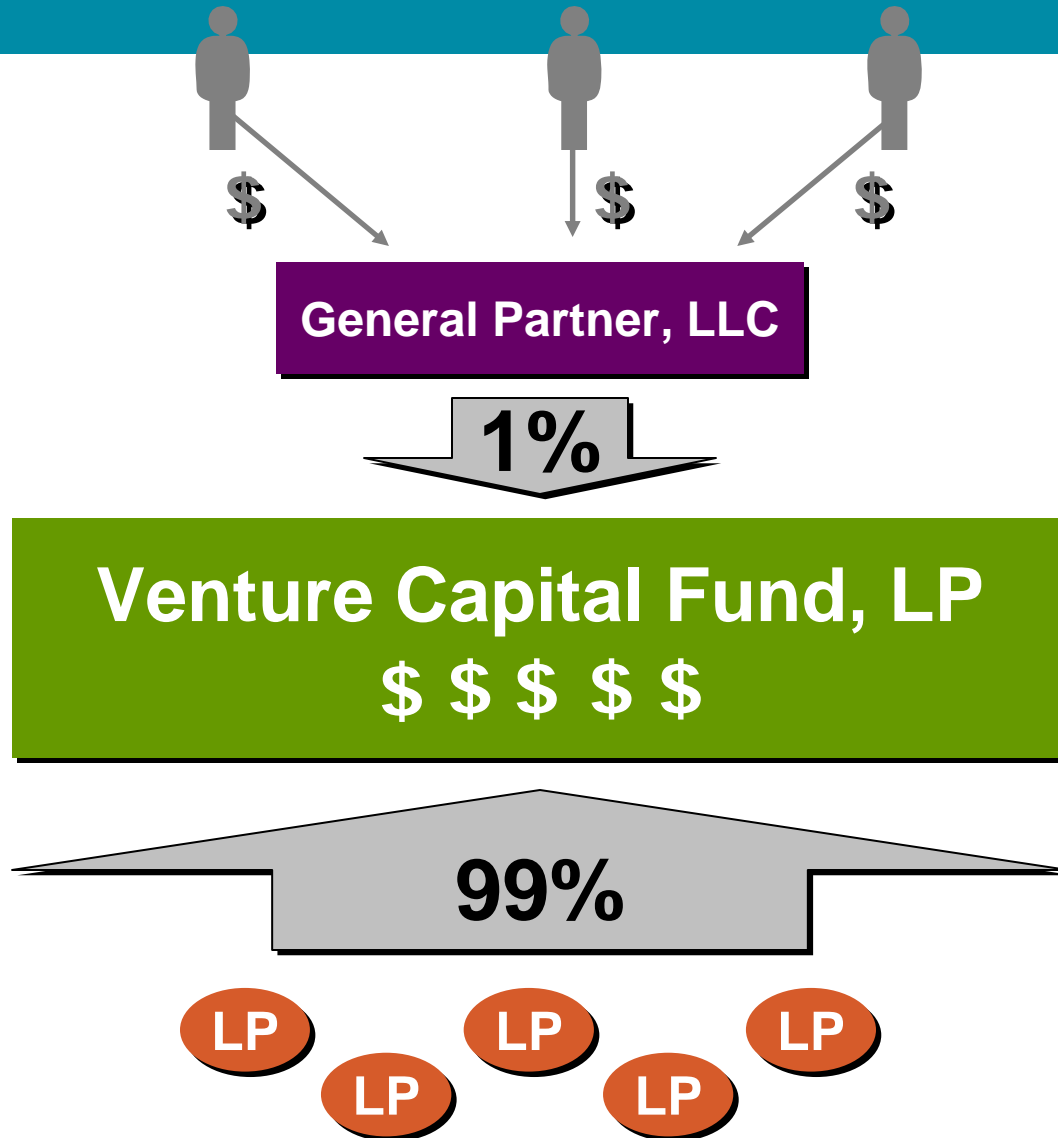
Step 4:
The Limited
Partners



- High-net-worth individuals, estate planning vehicles
- Pension plans
- Insurance companies
- University endowments
- Foundations
- Funds of funds

Following the Money

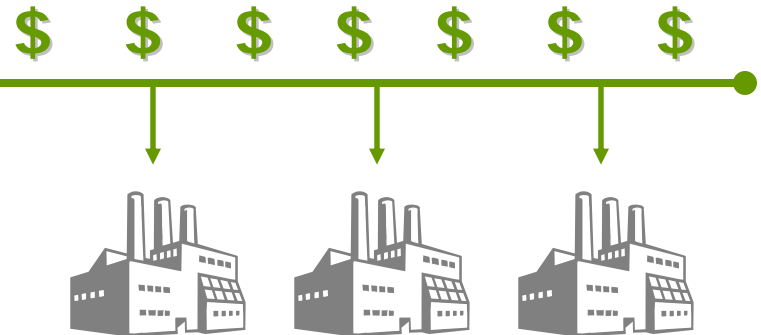
Step 1:
Capital
Contributions



Following the Money

Step 2:
Making
Investments

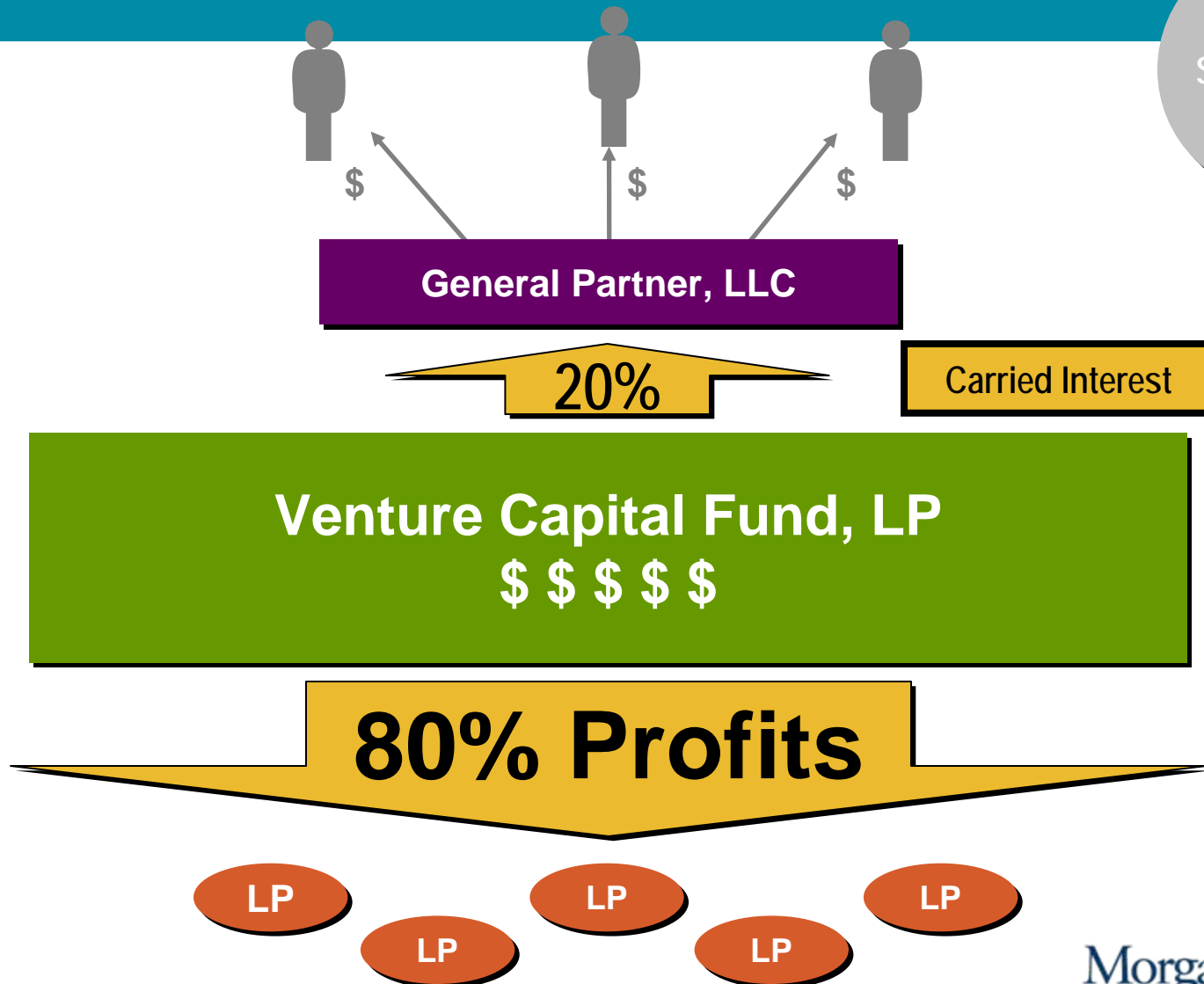
Venture Capital Fund, LP
\$ \$ \$ \$ \$



Portfolio Companies

Following the Money

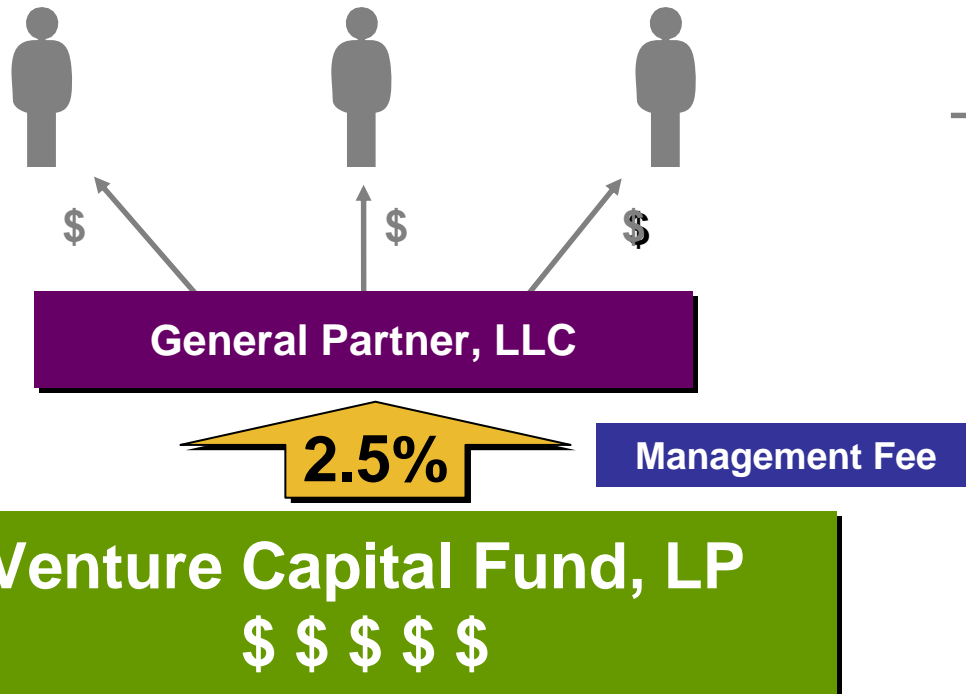
Step 3:
Splitting the
Profits



Following the Money

Step 4:
Paying the
Management
Fee

Alternative
#1



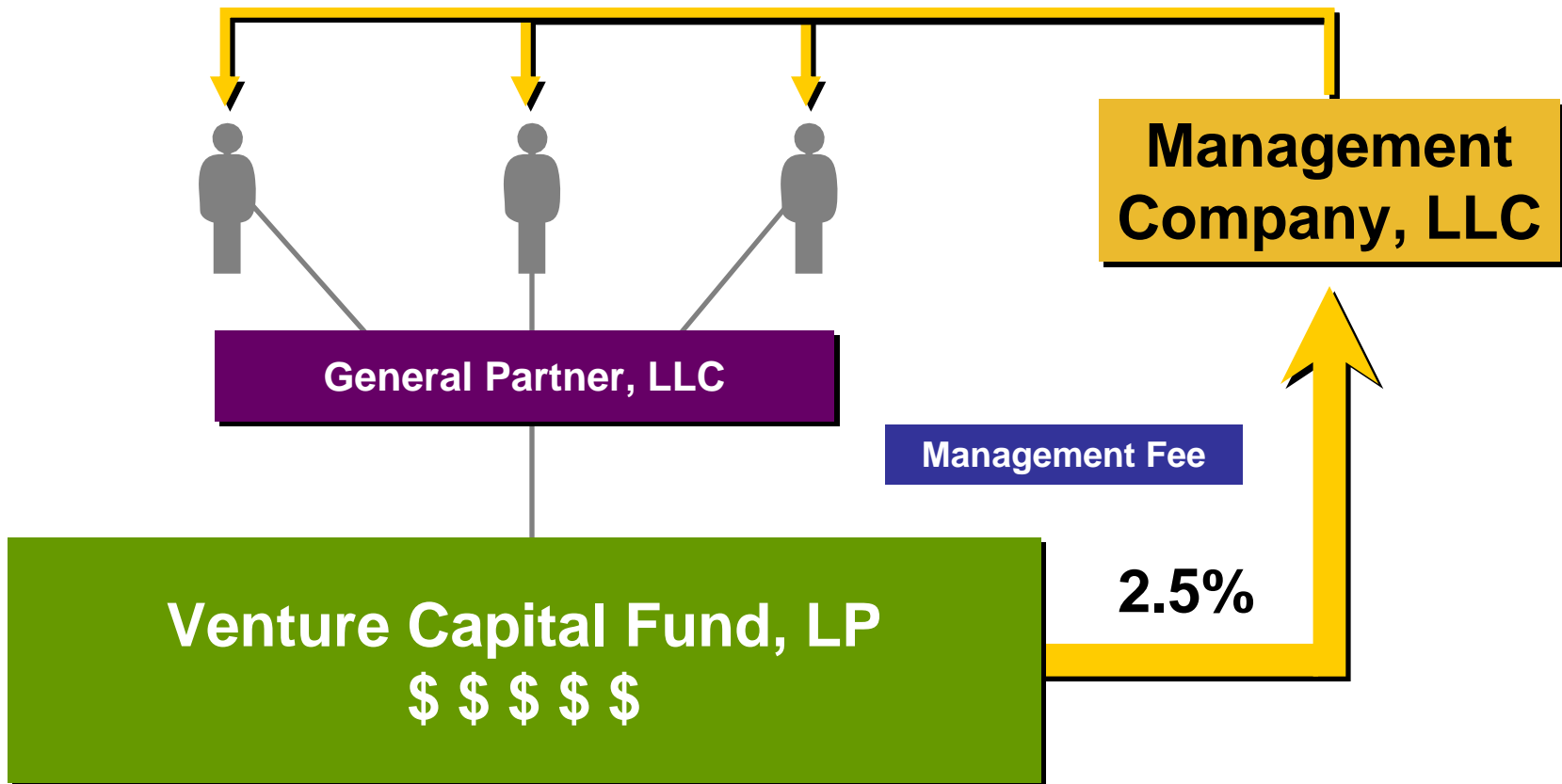
Typical Terms:

- Annual fee
- Percentage of committed capital
- Paid quarterly
- Funds the operations
- Declines after investment period ends

Following the Money

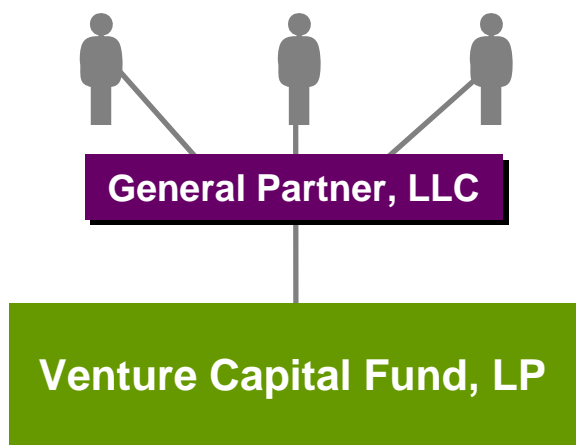
Step 4:
Paying the
Management
Fee

Alternative
#2



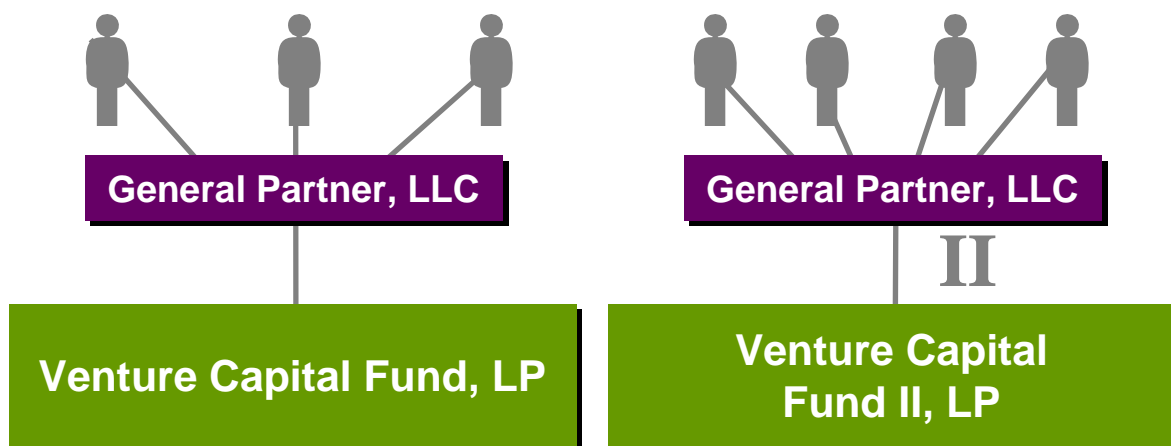
Building the Franchise

Step 1:
First Fund



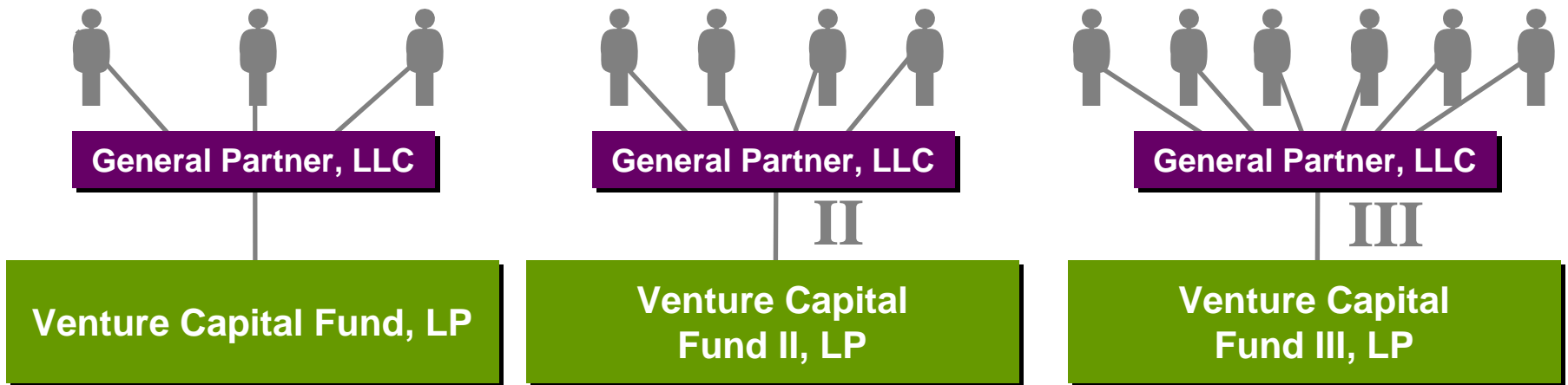
Building the Franchise

Step 2:
Expand



Building the Franchise

Step 3:
Success:
Multiple
Funds



Building the Franchise

Step 4:
A Management
Company

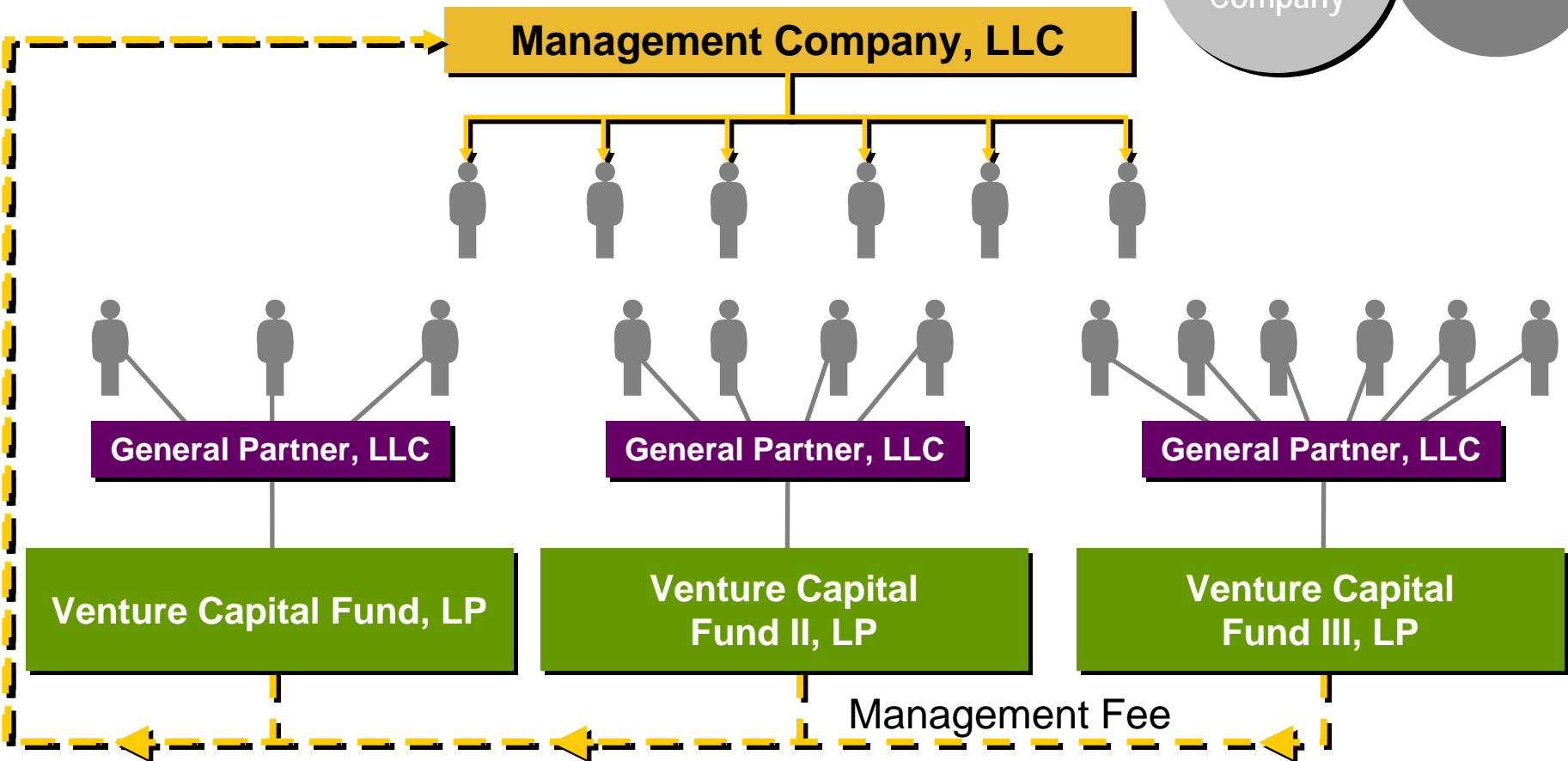
The Management Company

- Permanent entity
 - Office lease
 - Employees and benefits
 - Trademarks (i.e., fund names)
 - Insulates liability from any one fund
- Consolidation
 - Can pool all excess management fees
 - May have fewer managers with more power
 - Controls formation of successor fund

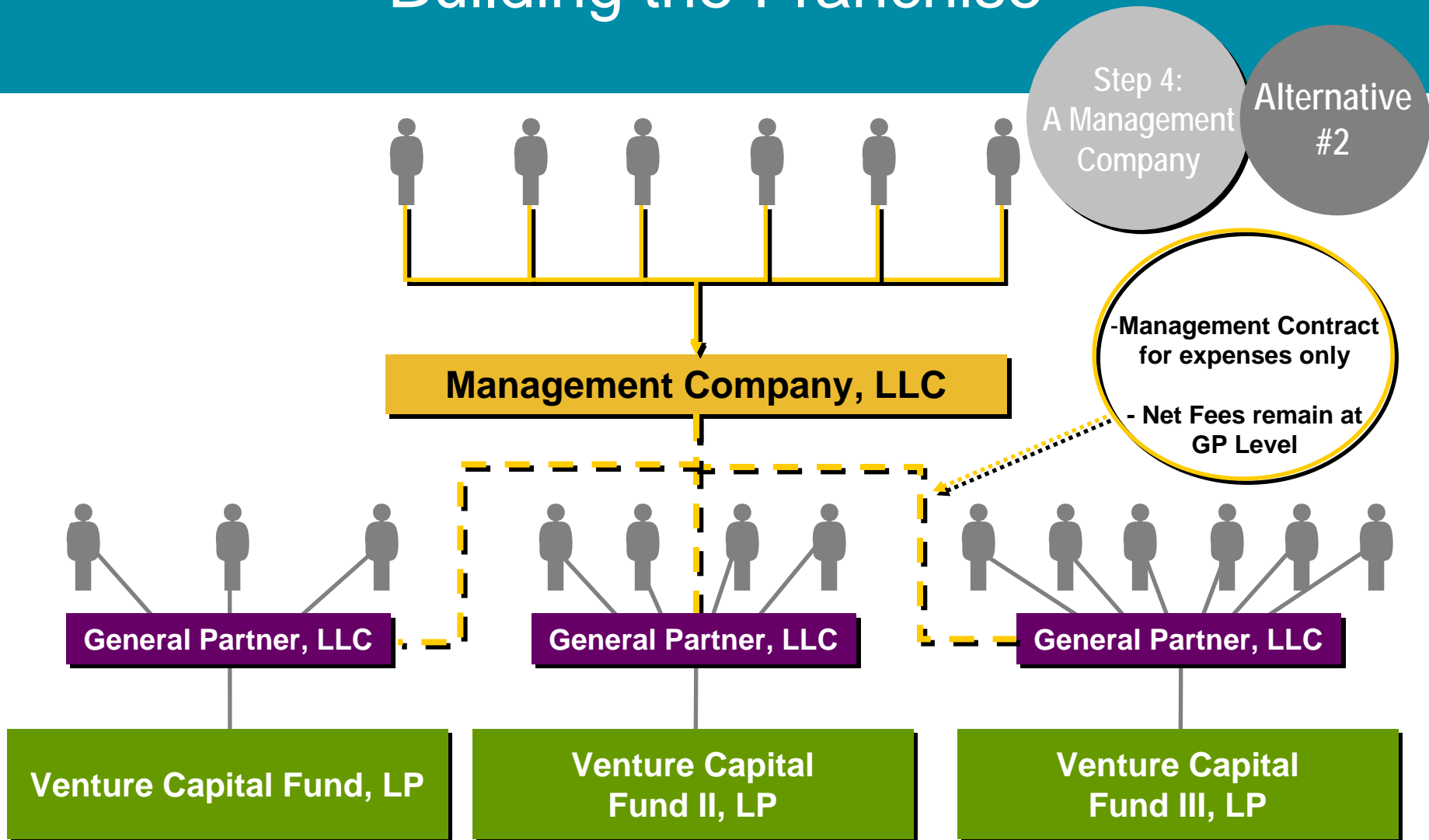
Building the Franchise

Step 4:
A Management
Company

Alternative
#1



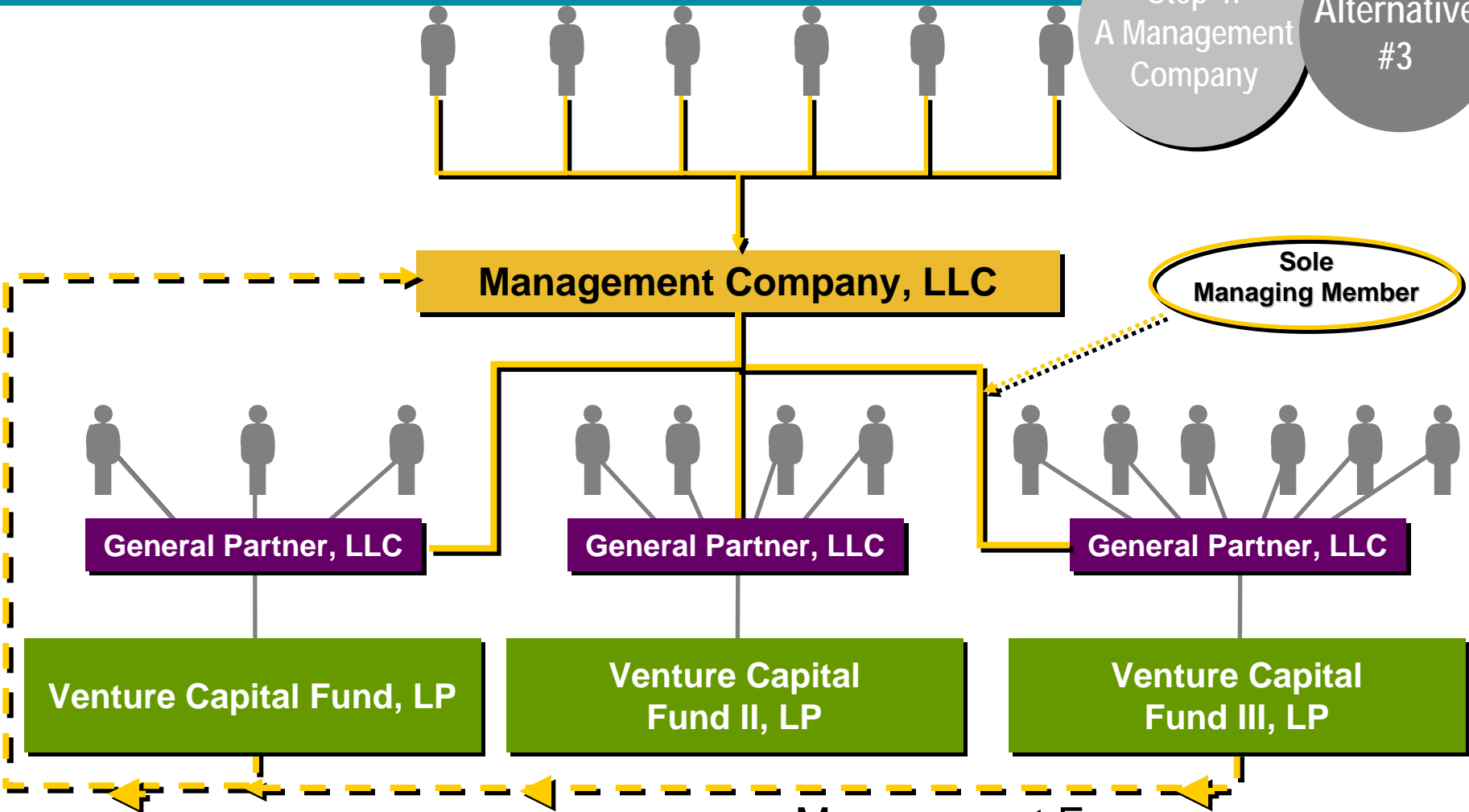
Building the Franchise



Building the Franchise

Step 4:
A Management
Company

Alternative
#3



Management Fee

What Are the Mechanisms of Investments?

- Offering Memorandum
- Limited Partnership Agreement
- Subscription Agreement
- Investor Questionnaire

What Are the Mechanisms of Investments?

- Offering Memorandum
 - General disclosure document
 - Terms
 - Risk factors
 - Marketing document
 - Management bios
 - Track record
 - Investment focus
 - Not always used by established funds

What Are the Mechanisms of Investments?

- Limited Partnership Agreement
 - Sets forth relationships, rights and duties of General Partner and Limited Partners
 - Major provisions emphasize:
 - Economic deal (allocations, distributions, clawbacks)
 - Investment restrictions (diversity)
 - Governance issues (no-fault divorce, key man)
 - Alignment of interests
 - Side Letters
 - Special rights, most favored nations (MFNs)
 - Can alter terms after first closing
 - Specific regulatory issues

What Are the Mechanisms of Investments?

- Subscription Agreement
 - Investor commitment
 - GP may accept less if oversubscribed
 - Capital called over time
 - LP has maximum utility of \$ for as long as possible
 - VC maximizes IRRs
 - Closing Conditions
 - Opinions
 - Minimum fund size
 - Representations
 - Power of Attorney
 - Allows LP favorable changes to agreement

What Are the Mechanisms of Investments?

- Investor Questionnaire
 - Information-gathering document
 - Accredited investor
 - Qualified purchaser
 - ERISA status
 - Look-through issues
 - NASD restricted persons
 - PATRIOT Act compliance
 - Contact information
 - Use information for exemptions, legal opinions, and general management purposes

What Is the Regulatory Framework?

- Securities Act of 1933
- Investment Company Act of 1940
- Investment Advisers Act of 1940
- Securities Exchange Act of 1934
- Employee Retirement Income Security Act (ERISA)

What Is the Regulatory Framework?

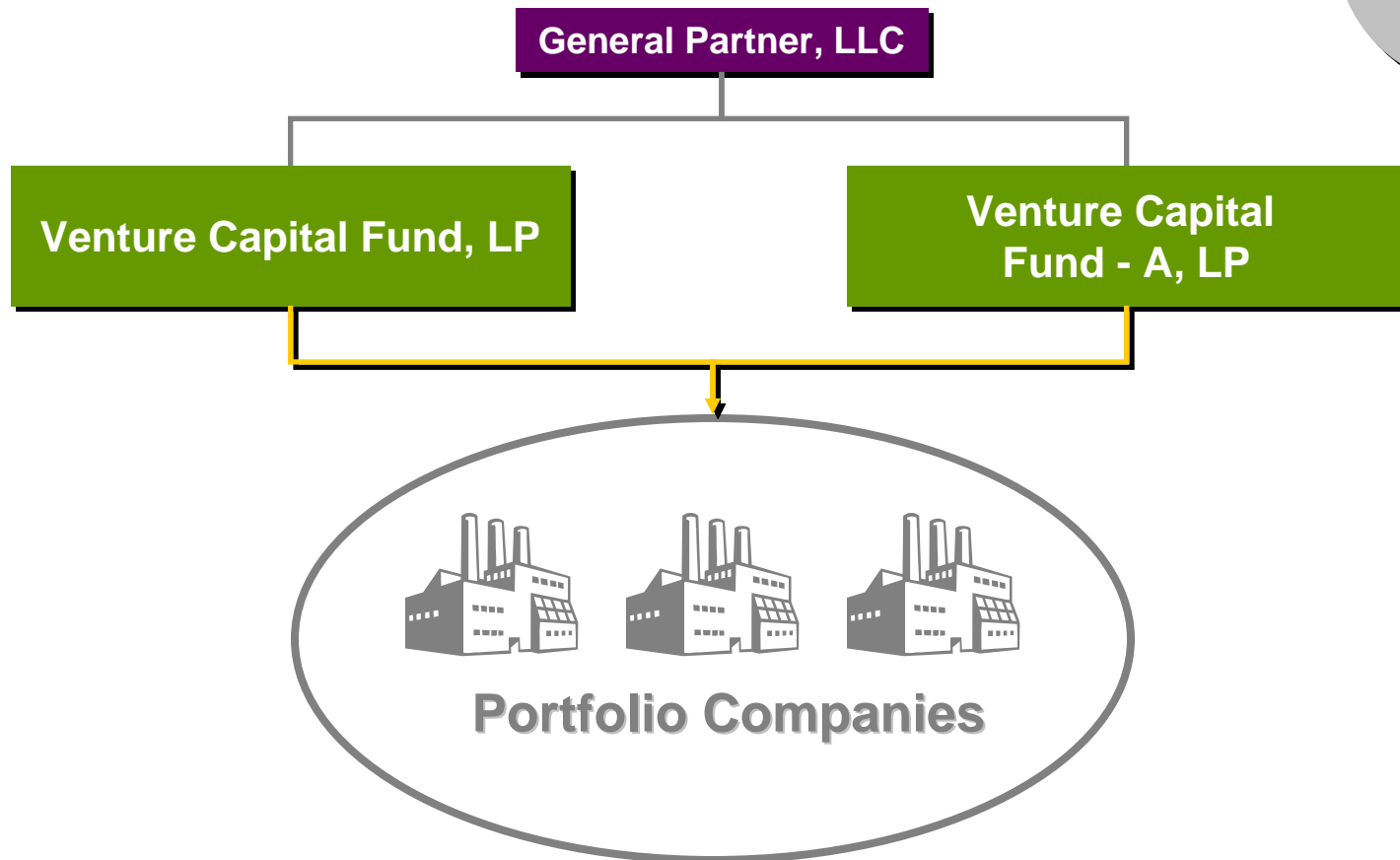
- Securities Act of 1933
 - Section 4(2), private placement exemption
 - Regulation D, Rule 506 (safe harbor in Securities Act Rules)
 - Unlimited offering amount
 - No general solicitation
 - Accredited investors
 - Information requirements for nonaccredited investors (therefore don't admit)
 - Federal preemption of state securities laws

What Is the Regulatory Framework?

- Investment Company Act of 1940
 - Section 3(c)(1), exclusion from definition of “investment company”
 - Less than 100 investors; and
 - Securities not offered in a public offering
 - Qualified Purchaser Pools (Section 3(c)(7))
 - Unlimited number of investors if all are Qualified Purchasers (generally, individuals with \$5 million and entities with \$25 million in “investments”)
 - “Look-through” issues
 - 10% Rule for other Investment Companies in 3(c)(1) entities
 - “Formed for the Purpose” criteria in Handy Place

What Is the Regulatory Framework?

Parallel Funds



What Is the Regulatory Framework?

- Investment Advisers Act of 1940
 - Must register if:
 - The general partners are considered to have more than 14 “clients”; each partnership under management is considered to constitute one “client”
 - Discretion is afforded investors on choosing individual investments (e.g., pledge funds), therefore seen as individual clients
 - Acting as ERISA fiduciary or a QPAM
 - Review state laws

What Is the Regulatory Framework?

- Securities Exchange Act of 1934
 - Section 12(g)(1) registration requirements (cannot exceed 499 investors)
 - Broker/Dealer exemption under Rule 3a4-1:
The General Partner
 - Is an “associated person” of the partnership;
 - Is not now nor was in the past 12 months an “associated person of a broker or dealer”;
 - Does not receive a commission for the sale of the limited partnership interests;
 - Will perform substantial duties for the partnership; and
 - Does not participate in an offering more than once every 12 months.

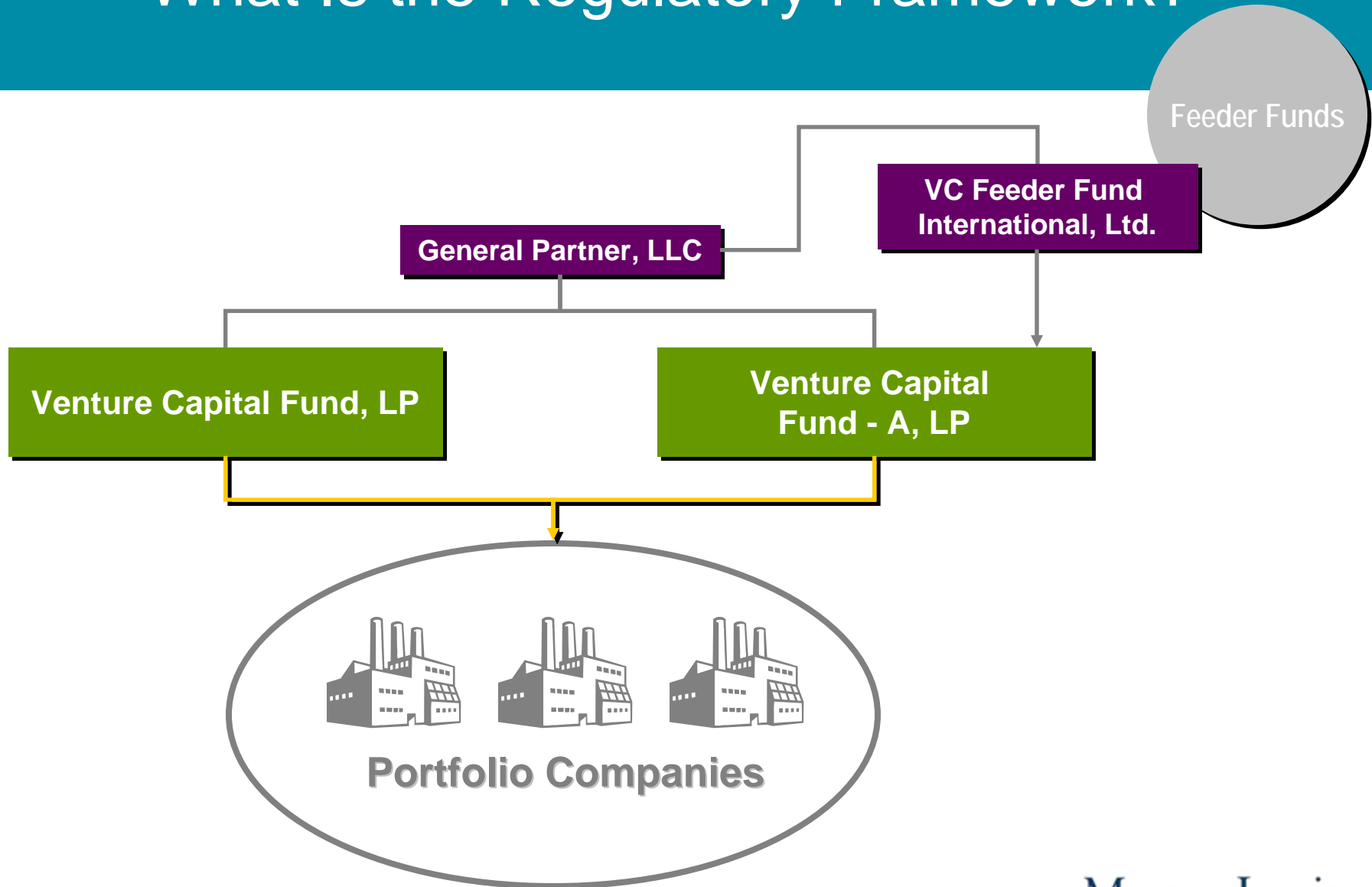
What Is the Regulatory Framework?

- Employee Retirement Income Security Act (ERISA)
 - Plan asset regulations
 - 25% test (“significant participation”)
 - Venture capital operating company (VCOC) exemption
 - Management rights letter
 - QPAM exemption

Other LP Issues Affecting Terms

- Bank Holding Company Act
 - 25% Ownership
 - 5% Voting
- Tax-Exempt Investors
 - Unrelated Business Taxable Income (UBTI)
 - Borrowing to fund investments
 - Investing in pass-through entities
 - Receiving fees for service (fee offset provisions)
- Foreign Investors
 - Effectively Connected Income (ECI)
 - Investing in pass-through entities
 - Receiving fees for service
 - Withholding on Distributions

What Is the Regulatory Framework?



Other LP Issues Affecting Terms

- Foundation Investors
 - Limited to 20% ownership of portfolio company
 - Subject to excise tax on profits
- FCC Regulations
 - Limitation on media company ownership
- Investment Restrictions
 - Political
 - South Africa, Cuba, Northern Ireland, etc.
 - Religious, Moral
 - Tobacco
 - Sharia (Islamic laws)

Other Regulatory Issues

- **PATRIOT Act**
 - Know your client
- **Privacy Act**
 - Regulated under FTC Rules regarding disclosure of consumer financial information
 - Annual notice, in-house procedures
- **Public Disclosure**
 - Primarily affects government pension funds
 - State Sunshine Laws