Forming the Fund

Step 1: The Venture Capitalists

- Individuals

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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

General Partner, LLC
Forming 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

Venture Capital Fund, LP

General Partner, LLC

LP  LP  LP  LP
Step 1: Capital Contributions

General Partner, LLC

1%

Venture Capital Fund, LP

$ $$ $$ $$ $$

99%

LP LP LP LP LP

Following the Money

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Following the Money

Step 2: Making Investments

Venture Capital Fund, LP

Portfolio Companies

$ $ $ $ $
Following the Money

Step 3: Splitting the Profits

General Partner, LLC

$ 20%

Carried Interest

Venture Capital Fund, LP

$80% Profits

LP

LP

LP

LP

LP

LP

LP

LP

LP

LP
Step 4: Paying the Management Fee

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

General Partner, LLC

Venture Capital Fund, LP

Management Company, LLC

Management Fee

2.5%
Building the Franchise

Step 1: First Fund

General Partner, LLC

Venture Capital Fund, LP

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Building the Franchise

General Partner, LLC

Venture Capital Fund, LP

General Partner, LLC

Venture Capital Fund II, LP
Building the Franchise

Step 3: Success: Multiple Funds

General Partner, LLC

Venture Capital Fund, LP

General Partner, LLC

Venture Capital Fund II, LP

General Partner, LLC

Venture Capital Fund III, LP

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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
Step 4: A Management Company

Alternative #1

Management Company, LLC

General Partner, LLC
Venture Capital Fund, LP
General Partner, LLC
Venture Capital Fund II, LP
General Partner, LLC
Venture Capital Fund III, LP

Management Fee

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Step 4: A Management Company

- Management Contract for expenses only
- Net Fees remain at GP Level

Alternative #2

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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?

- General Partner, LLC
  - Venture Capital Fund, LP
  - Venture Capital Fund - A, LP
    - Portfolio Companies

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

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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?

Feeder Funds

General Partner, LLC

Venture Capital Fund, LP

VC Feeder Fund International, Ltd.

Venture Capital Fund - A, LP

Portfolio Companies

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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
For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

About Morgan Lewis’s Private Investment Funds Practice
Morgan Lewis has one of the nation’s largest private investment fund practices and is consistently ranked as the “#1 Most Active Law Firm” globally based on the number of funds worked on for limited partners by Dow Jones Private Equity Analyst.

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