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Private Equity Fund Formation

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This Note provides an overview of private equity fund formation. It covers general fund structure, fund economics, fundraising, fund closings and term, managing conflicts and certain US regulatory matters. It also examines the principal documents involved in forming a private equity fund.

Private funds are investment vehicles formed by investment managers, known as sponsors, looking to raise capital to make multiple investments in a specified industry sector or geographic region. Private funds are "blind pools" under which passive investors make a commitment to invest a set amount of capital over time, entrusting the fund's sponsor to source, acquire, manage and divest the fund's investments.

The key economic incentives for sponsors of funds are management fees and a profit participation on the fund's investments. The key economic incentive for investors is the opportunity to earn a high rate of return on their invested capital through access to a portfolio of investments sourced and managed by an investment team that is expert in the target sectors or geographies of the fund.

There are a variety of private funds with different investment types and purposes, such as:

- Venture capital funds that invest in early and development-stage companies (for more on these kinds of investments, see *Practice Note, Minority Investments: Overview (http://us.practicallaw.com/1-422-1158)*).
- Growth equity funds that invest in later-stage, pre-IPO companies or in PIPE transactions with public companies (for more on these kinds of investments, see *Practice Notes, Minority Investments: Overview (http://us.practicallaw.com/1-422-1158)* and *Practice Note, PIPE Transactions (http://us.practicallaw.com/8-502-4501)*).
- Buyout funds that acquire controlling interests in companies with an eye toward later selling those companies or taking them public (for more on these kinds of investments, see *Practice Notes, Buyouts: Overview (http://us.practicallaw.com/4-381-1368)* and *Going Private Transactions: Overview (http://us.practicallaw.com/8-502-2842)*).
- Distressed funds that invest in debt securities of financially distressed companies at a large discount (for more on these kinds of investments, see *Practice Note, Out-of Court Restructurings: Overview (http://us.practicallaw.com/9-502-9447)* and *Article, Distressed Debt Investing: A High Risk Game (http://us.practicallaw.com/9-386-1346)*).

Additionally, funds may be formed to invest in specific geographic regions (such as the US, Asia, Europe or Latin America) or in specific industry sectors (such as technology, real estate, energy, health care or manufacturing).

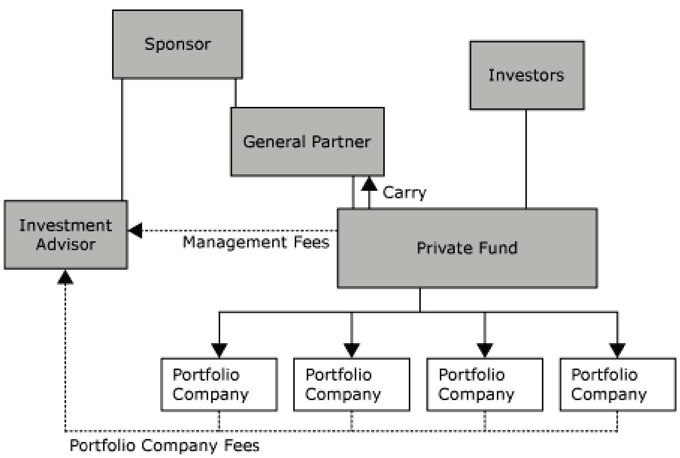
This Note provides an overview of private equity funds formed in the US, discussing the core considerations involved in forming a private equity fund, including:

- Their general structure and the key entities involved.
- Fund economics, including fund fees and expenses.
- Fundraising and fund closings, and the principal legal documents involved.
- Fund term and investment and divestment periods.
- Governance arrangements and managing conflicts.
- Certain US regulatory matters, including federal securities laws and other federal laws affecting fund formation and operation.

This Note does not cover hedge funds, which are considered a distinct asset class from private equity funds. However some of the topics covered are relevant to a review of the core structure and governance arrangements of hedge funds as well (for more on the distinction between hedge funds and private equity funds, see *Box, Distinguishing Hedge Funds From Private Equity Funds*).

GENERAL FUND STRUCTURE

The structure of a private equity fund generally involves several key entities, as follows:



- The investment fund, which is a pure pool of capital with no direct operations. Investors acquire interests in the investment fund, which makes the actual investments for their benefit (see *Investment Fund*).
- A general partner (GP) or other managing entity (manager), which has the legal power to act on behalf of the investment fund (see *General Partner or Manager*).
- A management company or investment adviser, which is often affiliated with the GP or manager and is appointed to provide investment advisory services to the fund (see *Management Company or Investment Adviser*). This is the operating entity that employs the investment professionals, evaluates potential investment opportunities and incurs the expenses associated with day-to-day operations and administration of the fund.
- Other related fund entities, which may be formed to account for certain regulatory, tax and other structuring needs of one or more groups of investors (see *Related Fund Vehicles*).

INVESTMENT FUND

Private equity funds are structured as closed-end investment vehicles. A fund's governing documents generally permit the fund to raise capital commitments only during a limited fundraising period (typically 12 to 18 months), after which the fund may not accept additional investor commitments. During the capital raising period, the sponsor seeks investors to subscribe for capital commitments to the fund. In most cases, the commitment is not funded all at once, but in separate capital contributions called on an as-needed basis to make investments during the investment period (see *Investment Period*) and to pay fees and expenses over the life of the fund (see *Fund Fees* and *Fund Expenses*).

In the US, funds typically raise capital in private placements of interests in accordance with exemptions from the registration requirements of the federal securities laws (see *Securities Act*). For more on fund capital raising and capital commitments, see *Fundraising and Fund Closing* and *Timeline of a Private Equity Fund (http://us.practicallaw.com/9-509-3018)*.

Private equity funds are typically formed as limited partnerships (LPs) or limited liability companies (LLCs). The principal advantages of using an LP or LLC as a fund vehicle include:

- LPs and LLCs are "pass-through" entities for US federal income tax purposes and, therefore, are not subject to corporate income tax. Instead, the entity's income, gains, losses, deductions and credits are passed through to the partners and taxed only once at the investor level (for a discussion of the US federal income tax rules that apply to US pass-through entities, see *Practice Note, Taxation of Pass-through Entities (http://us.practicallaw.com/2-503-9591)*).
- LPs and LLCs are generally very flexible business entities. US state LP and LLC statutes are typically default statutes, which allow many of the statutory provisions that would otherwise apply to be overridden, modified or supplemented by the specific terms of the LP or LLC agreement. This flexibility allows partners in an LP and members of an LLC to structure a wide variety of economic and governing arrangements.
- The investors in the fund, like the stockholders in a corporation, benefit from limited liability. Unlike the partners in a general partnership, as a general matter, the limited partners of an LP and the members of an LLC are not personally liable for the liabilities of the LP or LLC. As result, an investor's obligations and liabilities to contribute capital or make other payments to (or otherwise in respect of) the fund are limited to its capital commitment and its share of the fund's assets, subject to certain exceptions and applicable law.

For a more detailed discussion of the advantages of LPs and LLCs, see *Practice Note, Choice of Entity: Tax Issues (http://us.practicallaw.com/1-382-9949)* and *Choosing an Entity Comparison Chart (http://us.practicallaw.com/7-381-0701)*.

Private equity funds organized in the US are typically formed as Delaware LPs or Delaware LLCs. Sponsors and their counsel choose Delaware law for the following principal reasons:

- LPs and LLCs for large, complex transactions are often formed in Delaware and fund investors consider it a familiar and safe jurisdiction.
- Delaware has specialized courts for business entities, which have a great deal of relevant expertise in economic and governance issues.
- Delaware has a highly developed and rapidly developing common law regime governing LPs and LLCs, which is generally considered the most sophisticated in the US.
- Delaware has a relatively streamlined and inexpensive administrative process, and there are a number of established service providers that can perform many required actions quickly and efficiently.
- Delaware statutory and common law provides for extensive freedom of contract.

Private equity funds formed to invest outside of the US are often formed as LPs or LLCs in offshore jurisdictions with favorable tax regimes and well-established legal systems, such as the Cayman Islands, the Channel Islands and Luxembourg. In cases where these jurisdictions are undesirable, either for reasons of perception or because of "blacklists" kept by countries in which prospective investors or anticipated investments are located, alternatives may include provinces in Canada (typically, Ontario, Quebec or Alberta) or other jurisdictions providing pass through tax treatment.

GENERAL PARTNER OR MANAGER

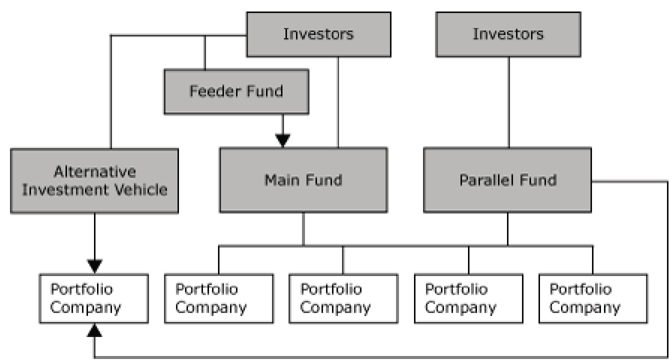
The sponsor of a private equity fund typically creates a special purpose vehicle to control and administer the fund, and take actions on the fund's behalf. The specific type and function of this vehicle depends on the form of the investment fund. For example, in accordance with applicable US state statutes, an LP is controlled by a GP and an LLC is generally controlled by a manager or managing member. For investment funds organized as LPs, the GP is normally a special purpose entity to insulate the sponsor from general liability for claims against the fund because the GP entity is generally subject to this liability in accordance with applicable US state LP statutes (for more on LP entities, see *Choosing an Entity Comparison Chart (http://us.practicallaw.com/7-381-0701)*).

MANAGEMENT COMPANY OR INVESTMENT ADVISER

In addition to the investment fund and GP or manager entities, a sponsor typically establishes an investment advisory entity, which acts as the fund's investment adviser (also called the investment manager or management company). The fund, or its GP or manager, normally enters into an investment advisory agreement (or management agreement or similar services agreement) with the investment adviser (see *Principal Legal Documents*). Under this arrangement, the fund pays management fees to the investment adviser in exchange for the investment adviser's agreement to employ the investment professionals, evaluate potential investment opportunities and undertake the day-to-day activities associated with a variety of investment advisory services and activities (see *Management Fees*). A single management company often serves in this capacity for additional funds raised by the same sponsor, which can result in economies of scale.

RELATED FUND VEHICLES

Structures for private equity funds may involve the formation of other related investment fund vehicles to account for certain regulatory, tax and other structuring needs of one or more groups of investors. In some cases, these entities are formed after the fund itself is established as the need for them arises. These vehicles can include parallel funds, alternative investment funds, feeder funds and co-investment vehicles, and are generally structured as represented in the following chart:



Parallel Funds

Parallel funds are parallel investment vehicles generally formed to invest and divest in the same investments at the same time as the main fund. They are formed under substantially the same terms as the main fund, with specific differences in terms to the extent required to accommodate the regulatory, tax or other investment requirements applicable to the investors in the parallel fund. Parallel funds are often created in jurisdictions other than that of the main fund. For example, a Delaware-based fund may form a Cayman Islands-based parallel fund to accommodate non-US investors who often prefer to invest through a non-US entity to avoid the US tax compliance obligations that apply to investors in US entities.

The parallel fund generally invests directly in each investment alongside and in parallel with the Delaware fund, in fixed proportions determined by their respective capital commitments. Additionally, funds formed to invest in specific countries or regions may have separate funds for local and international investors.

Alternative Investment Vehicles

Alternative investment vehicles are special purpose investment vehicles formed to accommodate the structuring needs of the fund (or its investors) in connection with one or more particular investments. Unlike a parallel fund, which is designed as an umbrella entity for investors to participate as an alternative to the main fund, an alternative investment vehicle is formed so that investors who have subscribed to the main fund (or a parallel fund) can take advantage of efficient structures to hold specific assets if the fund is not the optimal investment vehicle for a particular investment, whether for tax, regulatory or other legal reasons.

Operating agreements typically permit the sponsor to form an alternative investment vehicle through which all (or certain investors) may invest in a fund investment, relieving those investors from the obligation to participate in the investment through the fund itself. The fund agreement generally requires alternative investment vehicles to have substantially the same terms as the fund. The GP or manager typically has a great deal of discretion under the fund agreement whether to form an alternative investment vehicle for a particular investment and, if it does, whether to form the vehicle for a particular investor or group of investors.

For example, a Cayman Islands-based fund seeking to invest in a portfolio company located in a country that imposes a withholding tax on distributions to offshore financial centers may form an alternative investment vehicle in another jurisdiction that is not deemed an offshore financial center for the purpose of making the investment.

Feeder Funds

Feeder funds are special purpose vehicles formed by a fund to accommodate investment in the fund by one or more investors. Due to the particular jurisdiction of incorporation of the fund, an investor or class of investors may prefer (primarily for tax purposes) to invest in the fund indirectly through an upper-tier entity.

One common use of feeder funds is to act as "blockers" for US federal income tax purposes. These type of feeder funds are structured to be treated as corporate taxpayers for US federal income tax purposes so that investors in the feeder funds do not receive direct allocations or distributions of fund income. This ensures that non-US investors are not required to file US federal tax returns and pay US income tax in connection with those allocations and distributions. Many US tax-exempt investors also prefer to invest through feeder funds organized as blockers to reduce the likelihood that their investment generates "unrelated business taxable income."

Co-investment Vehicles

Co-investment vehicles are investment entities formed by the sponsor to co-invest alongside the fund (and its parallel funds) in specific fund investments. They are separate investment vehicles administered and controlled by the sponsor, and unlike parallel funds or alternative investment vehicles, do not necessarily have the same investment terms or fees as the fund. They are typically formed to accommodate investments made by particular investors outside of the fund on a deal-by-deal basis, and may have investors:

- Which are not necessarily investors in the main fund.
- Which are investors in the main fund, but to whom the sponsor wants to allocate an increased share of a particular investment.

For example, a co-investment vehicle may be used by a sponsor when the amount of a particular investment is too large for a fund to consummate alone or when the participation of a particular outside investor (such as a strategic partner) facilitates the investment opportunity.

FUND ECONOMICS

The economic terms of private equity funds differ widely depending on a number of factors, including:

- The expertise and track record of the sponsor.
- The overall fee structure of the fund taking into account factors such as:
  - the structure of the sponsor's profits interest (see *Carried Interest and Catch-up*);
  - the investors' preferred return (see *Return of Capital Contributions and Preferred Return*);
  - the management fee and other fund-level fees, and any offsets (see *Management Fees*); and
  - portfolio company fees paid to the sponsor management company on a deal-by-deal basis (see *Portfolio Company Fees and Management Fee Offset*).
- The investment purpose and structure of the fund.
- General market dynamics.

Although the specific economics vary from fund to fund, there are certain basic elements of fund economics common to all private equity funds, including:

- Investor capital commitments (see *Capital Commitments*).
- Allocations and distributions of profits and losses of the fund (see *Allocations and Distributions*).
- Fees paid to the fund's investment adviser (see *Fund Fees*).
- Expenses of the fund (see *Fund Expenses*).

CAPITAL COMMITMENTS

An investor generally becomes a participant in a fund by subscribing for a capital commitment. In most cases, the commitment is not funded at subscription or even all at once, but in separate installments, which the sponsor designates (by making "capital calls") on an as-needed basis to make investments and to pay fees and expenses over the life of the fund. Investors typically like to see that the sponsor has "skin in the game" as well by making its own commitment to the fund. A substantial commitment by a sponsor and its key executives is an attractive marketing element because fund investors believe it better aligns the interests of the sponsor with those of the investors, since sponsors which make significant commitments share in losses as well as profits. Investors believe this mitigates the incentives for sponsors, which receive a disproportionate share of profits, to take excessive (or unwarranted) risks.

Investors commit to invest an agreed amount in the fund (the investor's capital commitment). The sponsor's ability to call for capital contributions from its investors is limited at any time to the extent of each investor's unfunded commitments (the investor's total commitment less contributions already made). When considering a prospective private equity investment, investors pay close attention to:

- The provisions of the fund agreement governing their obligations to make (and possibly reinvest) capital contributions to the fund.
- Whether (and to what extent) they recoup their invested capital in ongoing investments before the sponsor receives a distribution of profits from investments that are liquidated first (see *Carried Interest and Catch-up* and *Allocations and Distributions*).

Recycling of Capital Commitments

The fund's operating agreement may permit the fund to "recycle" capital that is returned to the investor, often by adding the amount of the capital returns to an investor's remaining commitment. Typical recycling provisions in the fund's operating agreement may cover the following types of capital returns:

- Investments yielding a quick return (typically investments realized within one year after the investment is made).
- Returns attributable to capital contributions used to satisfy the organizational expenses and other fund expenses (see *Fund Expenses*).
- Returns on investments during the investment period (see *Investment Period*).

The fund's operating agreement typically provides that these types of capital returns are available for reinvestment by the fund and increase the remaining unfunded commitments of the investors. However, this increase is typically limited, for each investor, to its original fund commitment.

ALLOCATIONS AND DISTRIBUTIONS

LPs and LLCs are pass-through entities treated as partnerships for US federal income tax purposes. As a result, structuring a fund as an LP or an LLC avoids an entity-level layer of income tax, and causes the partners or members to be treated as the recipients of the entity's income, gains, loses, deductions and credits for US federal tax purposes (for a discussion of the US federal income tax rules that apply to US pass-through entities, see *Practice Note, Taxation of Pass-through Entities (http://us.practicallaw.com/2-503-9591)*). This flow-through tax treatment occurs whether or not any income is currently distributed and requires the fund to establish rules for both:

- Allocations among the partners or members on an annual basis of income, loss and other tax attributes realized by the fund each year. This is necessary because the fund investors must account for their respective shares of these allocations in determining the federal income tax consequences, if any, to them of the fund's investments.
- The proportion in which partners or members share in cash (and, in unusual cases, assets) distributed by the fund. The distribution waterfall implements the sponsor's and the investors' agreed-on economic arrangement. Under provisions in the fund's operating agreement commonly known as the "distribution waterfall", the relative shares of distributions to the investors, on the one hand, and the sponsor, on the other, typically change as the fund makes distributions that cause the total amount distributed to exceed pre-agreed thresholds.

The allocation provisions and the distribution waterfall are typically contained in the operating agreement of the fund, which requires the fund to track allocations and distributions through book entry capital accounts created for each investor. To the extent possible, the allocation provisions (and each investor's share of taxable income and losses) should reflect the economics of the distribution waterfall.

For more on the different approaches to drafting income and loss allocation provisions in operating agreements and the relationship of allocation provisions and distribution waterfalls, see:

- *Article, Understanding Partnership Target Capital Accounts (http://us.practicallaw.com/3-505-3402).*
- *Practice Note, Structuring Waterfall Provisions: Relationship of Partnership Allocations to Distribution Waterfalls (http://us.practicallaw.com/8-506-2772).*
- *Standard Document, LLC Agreement: Multi-member, Manager-managed (http://us.practicallaw.com/3-500-9206).*

Distribution Waterfalls

In setting out the agreed-on economic arrangement between the sponsor and the investors, a fund distribution waterfall provides that the proceeds from investments are paid in an order of tiered priority. This is necessary because private equity funds generally distribute excess cash as it is generated, although the distributions of investment proceeds are made by the fund to its investors net of fund level expenses, liabilities and other required reserves.

At each tier of the waterfall, distributions are made in a specific ratio (which may be 100% to the sponsor, 100% to the investors, or anywhere in between) until either:

- That tier is satisfied and the next tier is reached.
- The fund is wound up and the remaining assets distributed in a manner that reflects the agreed-on economics.

The layering of waterfall tiers, and the apportionment of distributions among them, is a matter of negotiation and has a wide variety of options, although certain approaches prevail for private equity funds. The following describes a common distribution waterfall used for private equity funds, where distributions are made:

- **First,** to the investors until they have received all of their capital contributions in respect of the investment giving rise to the distribution (see *Return of Capital Contributions and Preferred Return*).
- **Second,** to the investors until they have received an allocable percentage (tied to the first tranche) of all of the capital contributions in respect of fund expenses, including management fees (see *Return of Capital Contributions and Preferred Return*).
- **Third,** to the investors until they have received a preferred return on their capital returns in the first and second tranches (see *Return of Capital Contributions and Preferred Return*).
- **Fourth,** a profit participation to the sponsor until the sponsor has received 20% (or other carried interest percentage) of the distributions of profits (meaning, 20% of those amounts distributed under the third tranche and this fourth tranche). This tranche is known as the "catch-up" (see *Carried Interest and Catch-up*).
- **Fifth,** 20% (or other carried interest percentage) to the sponsor as its profit participation, and 80% (or other remaining percentage) to the investors (see *Carried Interest and Catch-up*).

For an example of an actual private equity fund waterfall provision and a discussion of structuring distribution waterfalls for private equity funds and the common material negotiated issues, see *Practice Note, Structuring Waterfall Provisions: Waterfalls in Private Equity Funds (http://us.practicallaw.com/8-506-2772)*.

Return of Capital Contributions and Preferred Return

The first tranche of a private equity fund waterfall generally provides that all capital contributed on account of a particular investment must be returned to the investor who provided it before any other distributions are made from the proceeds of that investment. Sometimes this tranche is expanded to require a return of:

- The portion of unrelated investments that have been permanently written down.
- All unreturned invested capital in previously realized investments.
- All unreturned contributed capital.

Following a return of capital contributions, a private equity fund distribution waterfall next typically provides a preferred return (known as a hurdle) on the capital contributions (see *Distribution Waterfalls*). The hurdle rate:

- Is often a 7% to 9% rate of return, using either a simple interest calculation or, more typically, a cumulative compounded rate of return.
- Accrues from the time those capital contributions are made.

The purpose of the preferred return is to guarantee investors a minimum return on their invested capital before profits are shared with the sponsor. In that manner, the preferred return is merely a priority of return, and is subject to a catch-up by the sponsor if aggregate fund profits on capital contributions exceed the hurdle (see *Carried Interest and Catch-up*).

For more on the priority of capital contributions and the preferred return in distribution waterfalls, see *Practice Note, Structuring Waterfall Provisions: Priority Return of Capital Contributions and Preferred Return (http://us.practicallaw.com/8-506-2772)*.

Carried Interest and Catch-up

The sponsor of a private equity fund is entitled to a profits participation (also known as carried interest, carry or success fee) that is usually a set percentage of profits (typically 20%, but can be higher or lower). The timing and calculation methodology of the carried interest is set out in the distribution waterfall, which typically provides that the carried interest is lower in priority to the return of capital contributions and the preferred return to investors (see *Return of Capital Contributions and Preferred Return*).

After investors receive their capital contributions and a preferred return, the distribution waterfall provides for distributions of carried interest to the sponsor through a "catch-up" tranche. The catch-up distribution:

- Can be made either 100% to the sponsor or allocated between the sponsor and the investors in a fixed proportion (for example, 80%/20% or 50%/50%, although 100% is more common).
- Continues until the carry distributions to the sponsor equal the sponsor's negotiated percentage of profits.

Once this catch-up is fulfilled, the distribution waterfall splits any remaining distribution of profits in accordance with the same agreed-on carried interest split (typically a ratio equal to 80% of profits to the investors and 20% of profits to the sponsor).

Different methodologies for calculating the carried interest exist for private equity funds, including:

- **Deal-by-deal carry (also known as an "American style" carry).** Under a deal-by-deal carry structure, the GP or manager receives carry on profitable deals regardless of losses on unsuccessful deals. This structure is less common today because investors may be concerned that this fee structure requires them to bear a disproportionate share of the fund's risk. Specifically, the sponsor's share of profits on successful investments is not offset by losses on other investments. Deal-by-deal carry is generally used today only in funds where it makes sense to isolate profits and losses on an investment-by-investment basis (for example, where investors can opt out of later investments).
- **Deal-by-deal carry with loss carryforward.** Deal-by-deal carry with a loss carryforward calculates the carry on a deal-by-deal basis, but after accounting for both realized losses on previously divested assets and any "write downs" (permanent

impairments of value) of unliquidated assets. If there are losses on investments liquidated after carry has been distributed to the GP or manager, the GP or manager must return, either at the end of the fund's term, or at other designated times during the life of the fund, the excess amount through a payment known as a "clawback" (see *Clawback*). This modified approach permits the sponsor to receive carry in profitable deals on an interim basis, but unlike a straight deal-by-deal carry, it does not allow the sponsor to retain that benefit permanently if there are subsequent losses or writedowns.

- **Back-end loaded carry (also known as "European style" carry).** With a back-end loaded carry structure, the investors receive a return of their aggregate invested capital, plus their full preferred return on aggregate invested capital, before the GP receives carry. This style of carry typically delays the sponsor's profits participation until near the end of the life of the fund when many of the investments have been liquidated, and generally obviates the need for a clawback because the sponsor does not receive any interim carry on a deal-by-deal basis.

For a more complete discussion of carried interest structures, see *Practice Note, Structuring Waterfall Provisions: Carried Interest Distributions (http://us.practicallaw.com/8-506-2772)*.

Performance Fee Prohibitions for Certain Funds

Sponsors who are registered investment advisers under the Investment Advisers Act of 1940 (Advisers Act) are prohibited from charging carried interest to investors who do not meet certain high net worth tests, subject to certain exceptions (see *Investment Advisers Act*). In particular, subject to certain exceptions, Section 205(a)(1) of the Advisers Act prohibits an investment adviser from entering into an investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (such as performance fees or carried interest). Section 205(b)(4) of the Advisers Act, however, provides an exception to this general rule by allowing an investment adviser to charge performance fees to a private fund that is excepted from the definition of an investment company under Section 3(c)(7) of the Investment Company Act of 1940 (ICA) (see *Investment Company Act*). In addition, Rule 205-3 of the Advisers Act permits an investment adviser to charge performance fees to a fund investor that is a "qualified client", meeting one or more of the following qualifications:

- **Assets-under-management-test.** The client has at least $1,000,000 total assets under management with an investment adviser immediately after entering into the advisory contract.
- **Net worth test.** The adviser reasonably believes either the client:
  - has a net worth of more than $2,000,000 when the advisory contract is entered into; or
  - is a "qualified purchaser" under Section 2(a)(52)(A) of the ICA, generally defined as a natural person owning at least $5 million of investments or an entity with at least $25 million of investments.
- **Knowledgeable employees.** Natural persons who are "knowledgeable employees", including a person who immediately before entering into the advisory contract is either:
  - an executive officer, director, trustee or general partner (or serves in a similar capacity) of the fund manager; or
  - an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions) who, in connection with his or her regular functions, has participated in the investment activities of the investment adviser for at least 12 months.

To comply with Rule 205-3, a registered investment adviser of a fund relying on the 3(c)(1) investment company exception under the Investment Company Act, rather than Section 3(c)(7), requires all of the fund's investors to be qualified clients so that a carried interest can be charged to all of the fund's investors.

Section 205(a)(1) does not apply to investment advisers who are not required to register under the Advisers Act (see *Investment Advisers Act*). Therefore, investment advisers who are exempt from the registration requirements of the Advisers Act may charge carried interest to investors who are not qualified clients.

Also, under Section 205(b)(5), Section 205(a)(1) does not apply to an investment advisory contract with a person who is not a resident of the US. Therefore, a non-US fund managed by a US registered investment adviser may charge a carried interest to all of its non-US investors and to its US investors who are qualified clients.

Clawback

Operating agreements for private equity funds often provide for a "clawback" provision relating to the sponsor's carried interest. A clawback is an adjustment payment that the sponsor must make to the fund at the end of its term when the fund's remaining assets must be liquidated, and in some cases, on an interim basis or at other designated times during the life of the fund.

A clawback payment is triggered if, on calculating the funds aggregate returns, including events occurring after distributions have been made to the sponsor, the sponsor has received more than its "share" of the fund's economics (for example, the return to the investors is less than the hurdle rate or, even if the hurdle rate is exceeded, is less than 80% of the total fund profits). The clawback payment is limited to the amount of carried interest distributions received by the sponsor, net of their associated tax liabilities.

Because the clawback is a mechanism to reverse excess distributions of carry to the GP or manager, it is not generally required in funds with a back-end loaded carry structure. For more on clawbacks, see *Practice Note, Structuring Waterfall Provisions: Clawbacks (http://us.practicallaw.com/8-506-2772)*.

Investor Givebacks

Operating agreements for private equity funds typically require investors to return distributions to meet their share of any fund obligations or liabilities, including:

- Indemnification and other obligations relating to liabilities in connection with the purchase or sale of investments.
- Other fund liabilities.

Often the requirement to return distributions is subject to certain caps, which may be based on the:

- Timing of distributions (for example, no distribution may be required to be returned three years after the date of distribution).
- Aggregate amount of distributions that may be required to be returned (for example, the fund's operating agreement may provide that no more than 50% of an investor's commitment may be required to be returned).

Tax Distributions

Most fund operating agreements provide for periodic tax distributions to the sponsor entity receiving the profits participation (see *Carried Interest and Catch-up*). This is necessary due to the flow-through tax treatment of the main fund and the nature of the carry and the distribution waterfall in the fund operating agreement (see *Allocations and Distributions*).

GPs and managers generally are not entitled to receive distributions of carried interest until the fund has distributed an amount to the investors equal to all, or a portion, of the investors' capital contributions (see *Distribution Waterfalls*). Although these distributions represent a return of capital from an investor's perspective, the cash distributed by the fund to the investors is likely to be derived at least in part from profits earned on one or more investments by the fund. This can give rise to "phantom income" for the owners of the GP or manager, because some of the profits distributed to the investors will generally be allocated (for US tax purposes) on a pass-through basis to the GP or manager in respect of its carried interest even though the cash is distributed to the investors instead (see *Investment Fund* and *Allocations and Distributions*).

Because the owners of the carry recipient are subject to current taxation on phantom income, the fund agreement generally provides for a special tax distribution to the carry recipient each quarter, to the extent that the fund has cash to distribute. This distribution is made in an amount intended to approximate US federal, state and local taxes on the phantom income so that the owners can pay estimated taxes as required each quarter. For an example of this type of quarterly tax distribution provision in the context of an LLC agreement used in a leveraged buyout, see *Standard Document, LLC Agreement: Multi-member, Manager-managed: Section 7.04 (http://us.practicallaw.com/3-500-9206).*

Tax distributions made to the carry recipient are typically considered an advance against (and reduce dollar for dollar) future carried interest distributions under the distribution waterfall. Additionally, tax distributions factor into any clawback payment due from the GP or manager when the fund is liquidated (see *Clawback*).

FUND FEES

In connection with forming an investment fund, a sponsor usually establishes an entity to act as the investment adviser or management company unless it has already done so (see *Management Company or Investment Adviser*). The management company generally enters into an investment advisory agreement (or management agreement) with the fund, or its GP or manager to act as the investment adviser or manager of the fund. Under this arrangement, the fund pays management fees to the investment adviser in exchange for the investment adviser's agreement:

- To employ the investment professionals.
- Evaluate potential investment opportunities.
- Undertake the day-to-day activities associated with a variety of investment advisory services and activities for the fund.

(See *Management Fees.*)

In addition, in connection with each investment transaction, particularly buyout transactions, the management company often enters into a management services agreement with the portfolio company (for a form of management services agreement used in this context, see *Standard Document, Management Services Agreement (http://us.practicallaw.com/1-387-5031)*). Under this arrangement, the management company receives an ongoing management fee directly from the portfolio company in exchange for providing advisory and consulting services to the portfolio company (see *Portfolio Company Fees and Management Fee Offset*).

Management Fees

The sponsor generally receives a management fee for managing the fund. Historically, the management fee has contractually been 2% per annum on the aggregate amount of committed capital. This fee structure is not universal, however, and fees ranging from 1.5% to 2.5% are not uncommon, depending on the aggregate size of the fund and a number of other factors.

Management fees are charged to the fund's investors on a quarterly or semi-annual basis, and typically (though not always) amounts contributed towards management fees reduce an investor's unfunded commitment (see *Capital Commitments*). Typically, after the end of the investment period (see *Investment Period*), the management fee is reduced, often to a percentage of actual invested capital, calculated at the beginning of each fee period, whether quarterly or semi-annually, or a reduced percentage of overall original committed capital.

Certain funds that require a considerable amount of leverage to make investments (for example, real estate investment funds) may calculate their management fee based on a percentage of the gross asset value (or enterprise value) of investments, due to the lower aggregate amount of committed capital relative to the aggregate asset value of investments made. A management fee based solely on enterprise value commonly results in a lower management fee early in the life of the fund (when few investments have been made), with much higher fees later as more and more leveraged investments are made.

In addition to management fees, a limited number of funds may charge fund investors acquisition fees on each investment as well, and perhaps other fund-level fees. However, in the case where a manager charges fund-level fees in addition to the management fees, the investors typically require the manager to demonstrate that the overall fee structure is reasonable in light of the services being provided.

Portfolio Company Fees and Management Fee Offset

Sponsors of funds (and their affiliates) may perform a number of management and other consulting and advisory services for the fund's portfolio companies, depending on the types of investments and the expertise of the sponsor's investment professionals. For more information on these kinds of arrangements, including a form of management services agreement used in the leveraged buyout context to document this relationship, see *Standard Document, Management Services Agreement (http://us.practicallaw.com/1-387-5031)*.

Sponsors may also receive fees related solely to the investment activities of the fund, such as break-up fees and directors' fees (for a discussion of the purpose, advantages and structure of break-up fees in mergers and acquisitions, see *Practice Note, Break-up or Termination Fees (http://us.practicallaw.com/6-382-5500)*).

The operating agreements of funds typically contain an offset mechanism (a management fee offset) requiring a dollar-for-dollar adjustment to the fund management fee against a percentage of management services, transaction and other fees received by the sponsor and its affiliates from the fund's portfolio companies. The percentage of the fee offset may vary depending on the type of fee.

Over the last decade investors have sought to receive a larger share of the sponsor's portfolio company fee income, sometimes requiring that 80% or more of portfolio company fee income received by the sponsor offset fund management fees. This can present tax issues, however, because the investors may be viewed as sharing an income from services performed by the management company (generally taxed at ordinary income rates), rather than investment income (generally taxed at preferential, long-term capital gains rates), to the extent of any of these fee offsets.

Certain types of sponsors and their affiliates operating as service providers (in addition to being fund managers) may seek to provide specialized services to the fund and its portfolio companies for which there is no (or a more limited percentage) management fee offset. The reason for the more limited (or no) offset is that the sponsor is effectively providing "extra" services in a capacity equivalent to that of a third-party service provider, rather than in its capacity as investment manager, and is therefore entitled to be compensated for those extra services independent of its management fee. For example:

- Real estate investment fund sponsors may provide specialized third-party services such as construction, leasing and development services.
- The fund manager may be a small part of a larger alternative asset management platform of a financial institution that provides investment banking, consulting, restructuring or similar financial services.
- The manager of an infrastructure fund may be affiliated with entities that provide services relating to the construction, operation and maintenance of projects.

As with management fee offsets for other portfolio company fees, to the extent that these specialized services fees are set off against management fees, investors are likely to be treated as earning income derived from the manager's business activities (generally taxed at ordinary income rates). This may be problematic for certain non-US investors (for instance, requiring the investor to file US federal tax returns and pay US income tax) and should be taken into account in considering whether non-US investors should be permitted to elect out of receiving the benefit of certain fee offsets.

Regardless of whether there is any management fee offset or its size, the fund's operating agreement typically requires that any specialized service fees charged by the sponsor and its affiliates to portfolio companies or the fund be on arm's length terms and at competitive rates.

FUND EXPENSES

There are a variety of expenses associated with a private equity fund, including expenses relating to:

- Establishing and organizing the fund and its infrastructure (see *Organizational Expenses*).
- The operation of the fund (see *Operating Expenses*).
- The sponsor's management company (see *Manager Expenses*).

Organizational Expenses

The operating agreement of a private equity fund includes provisions requiring the fund, and therefore its investors, to cover the costs of establishing the fund. The organizational expenses of the fund generally include the out-of-pocket expenses of the sponsor incurred in forming the fund and any related vehicles, such as printing, travel, legal, accounting, filing and other organizational expenses.

Organizational expenses are borne by the fund's investors out of their capital commitments, but are typically capped in the fund's operating agreement depending primarily on the size and complexity of the fund. The sponsor is responsible for any organizational expenses in excess of the cap.

Operating Expenses

In additional to the organizational expenses, the fund typically bears all other costs and expenses relating to the operation of the fund. These include fees, costs and expenses relating to:

- Management fees (see *Management Fees*).
- The purchase, holding and disposition of the fund's investments.
- Third-party service providers to the fund (such as the expenses of any administrators, custodians, counsel, accountants and auditors).
- Printing and distributing reports to the investors.
- Insurance, indemnity and litigation expenses.
- Taxes and any other governmental fees or charges levied against the fund.

As with the fund's organizational expenses, the operating expenses of the fund are borne by the fund's investors out of their capital commitments. However, unlike organizational expenses, operating expenses are typically not capped.

Manager Expenses

The fund's manager is expected to bear the cost of its own ordinary administrative and overhead expenses incurred in managing the fund. These costs typically include the costs and expenses associated with running the business of the manager, as opposed to specific expenses directly related to the operation of the fund and its investments, such as employee compensation and benefits, rent and general overhead.

FUNDRAISING AND FUND CLOSING

The success of any fundraising by a private equity sponsor and the time it takes to raise a fund and get to an initial closing depends on a variety of factors, including:

- General economic outlook.
- Economic outlook of the target sectors of the fund and of the geographic region in which the fund will invest.
- Track record of the sponsor.
- Strength of its (or its placement agent's) relationships with prospective investors.

For a detailed timeline of the typical fundraising period of a private equity fund, see *Timeline of a Private Equity Fund (http://us.practicallaw.com/9-509-3018)*.

FUND MARKETING

Fund capital raisings in the US are nearly always made as private placements of securities (in accordance with exemptions from the registration requirements of the federal securities laws) to:

- Institutions, including:
  - government and corporate pension plans;
  - financial institutions;
  - university endowments;
  - foundations;
  - sovereign wealth funds;
  - funds of funds;
  - insurance companies; and
  - family offices.
- In some cases, high-net-worth individuals (see *Securities Act*).

Generally, these private placements are effected by a number of one-on-one presentations to investors with whom the sponsor or its placement agent has a pre-existing relationship. Typically, this presentation involves the distribution of marketing materials and a private placement memorandum (PPM) describing, among other things:

- The fund and its structure (see *Related Fund Vehicles*).
- The sponsor's investment team and track record.
- The fund's investment objectives, strategy and legal terms.

For more, see *Private Placement Memorandum*.

Under the US private offering rules, there should be no general solicitation of investors or general advertising of the fund offering (see *Securities Act*). General advertising or general solicitation can be deemed to include any:

- Advertisement, article, notice or other communication published in any newspaper, magazine or similar media.
- Broadcast over television or radio.
- Seminar or meeting whose attendees have been invited by general solicitation or general advertising.

In general, any activity that might be construed as conditioning the US market for an offering might be seen as violating these restrictions (for more on this topic, see *Practice Note, Section 4(2) and Regulation D Private Placements: No General Solicitation or Advertising of the Offering (http://us.practicallaw.com/8-382-6259)*).

During the fundraising period, the best practice is not to communicate with the press at all regarding the fund or its offering and not to address any of this communication to a general audience. For example, avoid leaving offering documents at an unattended stand at an industry conference or speaking about the fund at an industry conference, the attendees of which have not been pre-screened. These kinds of communications may be regarded as general solicitations even if it is reasonable to believe that all recipients of the communications are all qualified under the federal securities laws (see *Securities Act*). Marketing related communications should include an appropriate legend on any written materials to ensure that it is clear to whom the materials are directed.

Finally, funds conducting capital raisings in non-US jurisdictions should consult with local counsel as appropriate to ensure compliance with applicable local securities laws.

PLACEMENT AGENTS

Many private equity funds use placement agents to market and sell interests in the fund. A placement agent acts as the fund's agent in the marketing process, introducing the sponsor to potential investors who are qualified to invest in the fund under the applicable securities laws of the country in which the offer is being made. A placement agent agreement between the sponsor and the placement agent sets out basic terms relating to the engagement, including:

- The compensation of the placement agent.
- The scope of the engagement, including whether or not the placement agent is retained as the exclusive placement agent or for certain specific jurisdictions or types of investors.

Generally, under the US federal securities laws, entities engaged in brokering the purchase or sale of securities for issuers, such as placement agents, are required to register as broker-dealers under the US Securities Exchange Act of 1934 (Exchange Act) (for an overview of broker-dealer registration requirements in the US, see *Article, US Broker-Dealer Registration: Overview (http://us.practicallaw.com/5-386-0339)*).

FUND CLOSINGS

A first closing of the fund occurs when the sponsor identifies investors who are ready to commit sufficient capital to the fund (based on the sponsor's capital raising target). Often a fund is only permitted to hold an initial closing after a minimum amount of capital has been raised. After the first closing, subsequent closings may be held throughout the fundraising period, which often ends either:

- 12 to 18 months after the fund's initial closing.
- Until the fund has reached its fundraising cap on commitments (as set forth in the fund's operating agreement).

(See *Timeline of a Private Equity Fund (http://us.practicallaw.com/9-509-3018)*.)

At each closing, investors submit their capital commitments by executing a subscription agreement, the fund's operating agreement and any other subscription materials required to be executed by investors (see *Principal Legal Documents*).

FUND TERM: INVESTMENT AND DIVESTMENT PERIODS

Private equity funds have long lives. The term of a fund begins following the first fund closing and typically runs for ten to 12 years, often subject to:

- Limited extensions when necessary to provide the sponsor more time to liquidate the fund's remaining assets.
- Possible early termination based on certain triggering events (see *Early Termination Events*).

Shorter or longer terms may be required depending on the time it takes to source, acquire, harvest and exit investments. The term of a fund generally consists of an investment period and a divestment period (for a timeline of the life of a private equity fund, see *Timeline of a Private Equity Fund (http://us.practicallaw.com/9-509-3018)*).

INVESTMENT PERIOD

An investor's capital commitment is typically not funded all at once, but in separate capital contributions on an as-needed basis. The sponsor sources new investments for the fund during an investment period (or commitment period) and calls capital on a deal-by-deal basis as required to fund new investments or to cover the fund's management fees and other fund related expenses (see *Fund Fees* and *Fund Expenses*).

The provisions of a fund operating agreement generally permit the fund to enter into new investments only during a limited investment period, often four to six years from the end of the fund's fundraising period or the closing of its first investment. After the investment period, the fund typically is permitted to acquire new investments only to the limited extent set out in its operating agreement (see *Divestment Period*).

DIVESTMENT PERIOD

Fund investments are typically not liquidated all at once, but in separate liquidity events as and when directed by the sponsor primarily during a divestment period ending four to six years following the investment period (for an explanation of the main exit strategies for private equity sponsors making control investments in portfolio companies through leveraged buyouts, see *Practice Note, Private Equity Strategies for Exiting a Leveraged Buyout (http://us.practicallaw.com/2-501-0347)*). After the end of the investment period, the terms of the fund typically require investors to contribute capital (subject to the amount of their respective commitments), as and when called, only for:

- Investments under limited circumstances, including:
  - investments for which the fund made a binding commitment before the end of the investment period;
  - follow-on investments in existing investments; or
  - new investments to the extent permitted under its operating agreement.
- Fund fees and expenses, including management fees (see *Fund Fees* and *Fund Expenses*).

At the end of the term of the fund, the fund's remaining investments must be liquidated with the proceeds distributed to investors in accordance with the distribution waterfall (see *Distribution Waterfalls*).

EARLY TERMINATION EVENTS

Funds require investors to contribute capital as and when called by the manager over a long period. Consequently, certain protections are often included in the fund operating agreement that trigger an early termination of the fund or its investment period.

Key Person Events

Investors make investments in a fund primarily in reliance on the skill and expertise of certain individuals to manage the fund and its investments. Often the operation of the fund is tied to the presence of these individuals who are deemed to be "key persons." Key person events vary from fund to fund, but generally when triggered these events cause a suspension of the fund's investment period. If triggered, the fund is prevented from making new investments until a sufficient number of new key persons are appointed to the satisfaction of the investors. Often, if the suspension period continues for a long enough period (for example, six months), then the fund's operating agreement may require that either the investment period be permanently suspended or the fund be liquidated.

Removal for Cause

Fund operating agreements may contain early termination events that allow the investors to remove and replace the sponsor or elect to liquidate the fund for "cause." Cause is often limited to highly material events calling into question the manager's ability to manage the fund, such as fraud or willful misconduct, gross negligence or major securities violations.

Removal Other than for Cause

Fund operating agreements may also contain provisions that permit a supermajority (often requiring 75% or more of total capital commitments) of the investors to remove and replace the sponsor or otherwise dissolve the fund other than for cause. The theory behind this kind of provision is that, even if no adverse event has occurred to call into question the manager's ability to operate the fund, investors should not be required to continue to contribute capital to the fund when an overwhelming proportion of the investors do not wish to continue the fund's operations. An alternative is to permit a supermajority of investors to elect to end the investment period, but not allow an early dissolution of the fund without cause.

MANAGING CONFLICTS

Often, sponsors of private equity funds manage multiple investment vehicles, or otherwise engage in a number of asset management and other related services that can potentially give rise to a number of conflicts of interest. The fund operating agreement often contains terms specifying how the sponsor should address certain conflict situations.

COMPETING FUNDS

Fund operating agreements typically contain provisions requiring the sponsor to offer suitable investment opportunities sourced by it to the fund before offering the opportunity to other managed funds or sponsor accounts. The fund operating agreement typically specifies that, during the investment period, the fund either (or both):

- Has a right of first look on investments within the fund's target objectives.
- May not receive priority in certain instances. For example, the operating agreement may list potentially competing funds managed by the sponsor that will either be given priority over the fund or be permitted to co-invest with the fund.

TRANSACTIONS WITH AFFILIATES

Fund operating agreements typically contain provisions governing affiliated transactions between the sponsor or its affiliates, and the fund or its portfolio investments. Often, certain affiliated transactions described in the operating agreement must be brought to the attention of an investor advisory committee for review or approval, or both (see *Investor Advisory Committee*). The types of transactions requiring approval may include situations where the sponsor (or one of its affiliates) is:

- Engaged to act as a service provider for the fund or one of its portfolio companies.
- Buying an investment from or selling an investment to the fund.
- Acting as a creditor of or lender to the fund or one of its portfolio companies.
- Otherwise buying assets from or selling assets to the fund or one of its portfolio companies.

In addition, Section 206(3) of the Advisers Act specifically prohibits an investment adviser (such as the sponsor) or any of its affiliates from selling any security to its client (such as the fund), or buying any security from its client, without obtaining the prior consent to the specific transaction. So, by law, any purchases or sales of portfolio investments or other fund assets between the sponsor or its affiliates, and the fund or its portfolio investments, often requires the approval of the fund's investor advisory committee (or the fund investors).

EXCLUSIVITY

Often fund operating agreements contain exclusivity terms, preventing the sponsor from forming competing funds with the same investment objective as the fund until the end of the fund's investment period, or until the time as all or substantially all of the fund's commitments have been deployed or reserved for deployment.

INVESTOR ADVISORY COMMITTEE

Fund agreements often establish an investor advisory committee appointed by the sponsor, but comprised of members representing certain of the fund's investors. The fund's operating agreement states the role of the investor advisory committee, which typically involves:

- The resolution of certain conflict of interest situations.
- Waivers under certain provisions of the fund operating agreement.
- Other matters to be presented to the committee (see *Transactions with Affiliates*).

The investor advisory committee is created by contract. It is not a board of directors and, unless otherwise required by law or by contract, its members do not owe fiduciary duties to the fund or its investors when making decisions. For an overview of the fiduciary duties of a board of directors of a corporation, see *Practice Note, Fiduciary Duties of the Board of Directors (http://us.practicallaw.com/6-382-1267)*.

CERTAIN US REGULATORY MATTERS

Private equity funds are regulated by (or require exemptions from the regulation of) a myriad of US federal legislation. As with any investment vehicle, an analysis of the fund's structure and its potential investors should be made with counsel beforehand to ensure proper compliance with US federal regulations.

INVESTMENT COMPANY ACT

The ICA regulates mutual funds and other companies that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public by requiring them to either register with the Securities and Exchange Commission (SEC) as an investment company or qualify for an exemption from registration. Sponsors of private equity funds formed in the US or with US investors typically seek to qualify under certain exemptions of the ICA. Registration would subject them to numerous regulations that would make it impracticable for a sponsor to properly administer a fund (for example, Section 13 of the ICA limits the ability of a registered investment company to borrow money or issue securities). For an overview of the exemptions under the ICA and why it is important for private equity funds to avoid becoming registered investment companies, see *Practice Note, Investment Company Act of 1940 Exceptions: Guide for Transactional Lawyers (http://us.practicallaw.com/1-504-8727)*.

Private equity funds seeking to raise capital from US investors commonly rely on one of two primary exemptions under the ICA for private investment companies:

- Section 3(c)(1) of the ICA exempts from the definition of an investment company any private equity fund that is not making a public offering of its interests and is beneficially owned by not more than 100 persons.
- Section 3(c)(7) of the ICA exempts from the definition of investment company any private equity fund that:
  - does not make a public offering of its interests; and
  - is beneficially owned exclusively by qualified purchasers (generally, a person owning at least $5 million or more of investments, or an entity with at least $25 million or more of investments).

The Section 3(c)(1) and 3(c)(7) exemptions are complex, including a number of rules requiring the fund to look through certain investors to determine their ultimate beneficial owners. For example:

- Each exemption requires a fund to disregard, and look through to the beneficial owners of, any entity formed for the purpose of investing in the fund.
- Section 3(c)(1) requires a fund to look through any investor that is itself an investment company (or would be an investment company but for the Section 3(c)(1) and 3(c)(7) exclusions) and which has more than 10% of the voting securities of the fund.
- Section 3(c)(1) allows non-US issuers to count only US investors for purposes of counting the total number of beneficial owners. Similarly, Section 3(c)(7) allows non-US issuers to require only that their US investors be qualified purchasers.

INVESTMENT ADVISERS ACT

Federal Investment Adviser Registration and Regulation

The Advisers Act regulates investment advisers by requiring them to register as an investment adviser with the SEC unless an exemption from registration is available (see *Article, US Investment Adviser Registration: Overview (http://us.practicallaw.com/7-386-4497)*). Unlike the ICA, which regulates the fund itself, the Advisers Act regulates the sponsors and advisers to the fund.

Historically, many sponsors of private equity funds avoided registration with the SEC under the Advisers Act by relying on an exemption for investment advisers with fewer than 15 clients (with each fund advised counting as only one client) and that do not hold themselves out to the public as investment advisers (often referred to as the private investment adviser exemption) (see *Article, US Investment Adviser Registration: Overview: Advisers Exempt from Registration (http://us.practicallaw.com/7-386-4497)*). However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) amended the Advisers Act to eliminate the private investment adviser exemption, requiring advisers to private equity funds to register with the SEC unless the adviser can rely on an alternative registration exemption (see *Practice Note, Summary of the Dodd-Frank Act: Private Equity and Hedge Funds (http://us.practicallaw.com/1-502-8932)*).

The Dodd-Frank Act broadly expands the group of private equity fund sponsors that must register with the SEC under the Advisers

Act. Essentially, most US managers of private equity funds with assets under management of $150 million or more must register with the SEC as investment advisers. In addition, foreign advisers with US investors or US personnel may be required to register or to make certain basic filings to take advantage of exemptions from registration in light of the act's narrowing of the foreign private adviser exception (see *Practice Note, Summary of the Dodd-Frank Act: Private Equity and Hedge Funds: Foreign Private Advisers (http://us.practicallaw.com/1-502-8932)*). For advisers required to register, the Dodd-Frank Act imposes additional recordkeeping and reporting requirements as well as the new examination and audit obligations (see *Practice Note, Summary of the Dodd-Frank Act: Private Equity and Hedge Funds: Recordkeeping and Reporting Requirements (http://us.practicallaw.com/1-502-8932)*).

US State Investment Adviser Registration and Regulation

In addition to federal regulation under the Advisers Act, investment advisers can be subject to US state registration and conduct regulation requirements. Generally, under the prior Advisers Act rules, investment advisers with less than $25 million in aggregate assets under management were not required to register with the SEC (but were subject to applicable US state regulation).

The Dodd-Frank Act amends the Advisers Act to also require an investment adviser with assets under management between $25 million and $100 million (or a higher amount determined by the SEC) to register with the US state of its principal office and place of business, and not with the SEC, but only if the adviser is subject to registration and examination as an investment adviser with this US state (see *Practice Note, Summary of the Dodd-Frank Act: Private Equity and Hedge Funds: Federal and State Jurisdiction Over Investment Advisers (http://us.practicallaw.com/1-502-8932)*).

As a result, the Dodd-Frank Act expands, generally, the jurisdiction of US state regulators over investment advisers to private equity funds so that US managers of private equity funds with assets under management of $100 million or less may have to register with US state authorities. However, many US states have their own exemptions from state registration, so a private equity fund manager with assets under management of $100 million or less may be exempt under both US federal and state laws.

Other Applicable Investment Adviser Act Regulations

Whether or not an investment adviser must register as an investment adviser with the SEC, it is subject to a number of provisions under the Advisers Act, including:

- A fiduciary duty to the fund, in addition to those fiduciary duties that may exist under US state common law.
- A prohibition under Section 206 from engaging in any act or practice that is fraudulent, deceptive or manipulative with respect to the fund.

SECURITIES ACT

Generally, offers and sales of securities in the US (including private equity fund offerings) may only be made pursuant to a registration statement filed with, and declared effective by, the SEC as required under the Securities Act of 1933 (Securities Act), or in accordance with an exemption from these registration requirements (see *Practice Note, US Securities Laws: Overview: Securities Act (http://us.practicallaw.com/3-383-6798)*). SEC registration is a costly and time-consuming process, so interests in private equity funds are typically offered to US investors by private placements in a manner complying with the private offering exemptions from registration (see *Practice Notes, Unregistered Offerings: Overview (http://us.practicallaw.com/9-382-8837)* and *Section 4(2) and Regulation D Private Placements (http://us.practicallaw.com/8-382-6259)*).

Generally, to meet the private offering exemptions private equity fund interests may only be offered to sophisticated investors who have the knowledge and experience in financial and business matters to evaluate the risks and merits of the proposed offering (see *Practice Note, Unregistered Offerings: Overview: Who Can Buy Unregistered Securities? (http://us.practicallaw.com/9-382-8837)*).

When offering securities within the US, sponsors of private equity funds often seek to rely on the registration exemption provided by Section 4(2) of the Securities Act (see *Practice Note, Section 4(2) and Regulation D Private Placements: Section 4(2) Issuer Private Placements (http://us.practicallaw.com/8-382-6259)*). Section 4(2) is a private placement exemption available to issuers for sales of their securities not involving any public offering to a limited number of sophisticated investors and not to the general public. When relying on Section 4(2), among other things:

- The number of offerees and purchasers should be limited.
- There should be no general solicitation of purchasers or general advertising of the offering (see *Fund Marketing*).
- Offers and sales should only be made to institutions and individuals that qualify as qualified institutional buyers (QIBs) or accredited investors.

In addition to relying on the Section 4(2) private placement exemption, a sponsor may consider utilizing the private placement safe harbor provided by Regulation D (see *Practice Note, Section 4(2) and Regulation D Private Placements: Regulation D Safe Harbor Requirements (http://us.practicallaw.com/8-382-6259)*). Regulation D contains three regulatory safe harbors from the Securities Act registration requirements, each with its own offeree qualifications and limitations. Also, to ensure that a private placement falls within the "black letter" of Regulation D, a fund issuer typically files with the SEC a notice on Form D no later than 15 days after the first sale of securities made under Regulation D (see *Form D*). An issuer should also check that the offering complies with US state securities law offering requirements (known as blue sky laws), which may require a notice filing or other filing with the state.

SECURITIES EXCHANGE ACT

The Exchange Act requires an issuer with total assets exceeding $10 million to register with the SEC any class of equity securities held of record by:

- 500 or more persons, in the case of a US issuer.
- 299 or more US investors, in the case of a non-US issuer (see *Practice Note, Exchange Act Registration: Overview (http://us.practicallaw.com/7-506-3135)*).

As a result, most US private equity funds seek to limit the number of record owners to up to 499 investors so that its securities are not subject to registration under the Exchange Act. If the fund has to register its securities, it becomes subject to onerous reporting and recordkeeping requirements, as well as Sarbanes-Oxley Act of 2002 compliance requirements (see *Practice Notes, Periodic Reporting and Disclosure Obligations: Overview (http://us.practicallaw.com/7-381-0961)* and *Corporate Governance Standards: Overview (http://us.practicallaw.com/7-381-0956)*).

In addition, Rule 10b-5 of the Exchange Act makes it unlawful to make any material misrepresentation or omission in the fund's offering materials (see *Practice Note, Liability Provisions: Securities Offerings: Section 10(b) of the Exchange Act and SEC Rule 10b-5 (http://us.practicallaw.com/6-381-1466)*). Investors (and the SEC itself) have a private right of action against the fund and any sponsor of the fund, as well as any individual who orally may make a misrepresentation or omission to investors (for example, in statements by sponsor personnel at a road show presentation). The party seeking civil liability under Rule 10b-5 must be able to show:

- A misrepresentation of a material fact, or a failure to disclose a material fact that there was a duty to disclose.
- The misrepresentation or omission was committed with intent to deceive or was reckless.
- Reasonable reliance on the misrepresentation or omission.
- In the case of investor claims, resulting damages proximately linked to the misrepresentation or omission.

However, a fund investor may be unable to prove either that a misrepresentation or omission occurred or that it reasonably relied on a misrepresentation or omission, or both, where the potential risks that supposedly led to its loss was fully and adequately disclosed in the PPM (see *Private Placement Memorandum*).

The Exchange Act also requires that anyone engaged in the business of effecting transactions in securities for an issuer must be registered as a broker with the SEC (for an overview of broker-dealer registration requirements in the US, see *Article, US Broker-Dealer Registration: Overview (http://us.practicallaw.com/5-386-0339)*). In general, the SEC has noted that anyone who gets paid on a commission basis for raising capital for an issuer, including for a private equity fund, must be a registered broker. If someone is engaged in raising capital for the fund who should be a registered broker but is not registered, there is a risk that the investor potentially could have a rescission right, to unwind the investment and receive a return of its capital contributions possibly plus interest. For example, if an employee of the sponsor gets compensated on a commission basis for finding investors for the fund, that employee could be deemed to be acting as an unregistered broker, which could subject the employee and the sponsor to sanctions.

ERISA

The Employee Retirement Income Security Act of 1974 (ERISA) may place restrictions on private equity funds if the fund is deemed to hold "plan assets" under ERISA and its regulations (for a description of when a private equity fund is treated as an entity holding plan assets for purposes of ERISA, see *Practice Note, ERISA Plan Asset Rules (http://us.practicallaw.com/0-506-0461)*). In effect, ERISA looks through the fund entity, and the sponsor is treated as directly managing the plan assets of any benefit plan investors, unless the fund meets one of the exceptions from these look-through rules under ERISA and applicable regulations.

Private equity funds typically try to meet one of the following three most well-known exceptions to the ERISA look-through rules:

- Less than 25% of the value of any class of the fund's equity is held by "benefit plan investors" (the 25% test).
- The fund qualifies as a "venture capital operating company" (VCOC).
- The fund qualifies as a "real estate operating company" (REOC).

For an overview of these exceptions, see *Practice Note, ERISA Plan Asset Rules: Exceptions to Look-through Rule (http://us.practicallaw.com/0-506-0461)*. If one of these exceptions applies, the underlying assets of a private equity fund in which a benefit plan investor makes an investment are not considered plan assets under ERISA. Most private equity funds are structured to comply with the 25% test or, for private funds other than hedge funds, to operate as a VCOC or REOC.

If the fund is not exempt from ERISA and is deemed to hold plan assets subject to ERISA, the fund's investment adviser (the sponsor) may be deemed to be a fiduciary with respect to the ERISA plan assets invested by benefit plan investors (those investors' capital commitments to the fund) (see *Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments (http://us.practicallaw.com/0-506-0461)*).

If the sponsor breaches its fiduciary duties under ERISA, it can lead to substantial liabilities and other penalties for the sponsor, including:

- A requirement to restore losses to the investors or to disgorge profits earned by the sponsor as a result of the breach of fiduciary duty.
- Personal liability.
- Equitable remedies, such as removal of the sponsor from the fiduciary position.
- Civil and even criminal penalties.

For a more complete discussion of these potential liabilities and penalties, see *Practice Note, ERISA Fiduciary Duties: Overview: Penalties for Breaching Fiduciary Duties (http://us.practicallaw.com/5-504-0060)*.

In addition, if the fund is subject to ERISA, ERISA and the Internal Revenue Code restrict transactions between the fund and certain parties in interest, or disqualified persons related to the plan, such as the sponsor and its affiliates. They also prohibit self-dealing and conflicts of interest that may adversely affect the ability of the sponsor and its affiliates to engage in affiliated transactions with, or otherwise administer, the fund. As a result, prohibited transaction limits may be imposed on:

- Management and performance fees and investments in illiquid securities (see *Fund Fees*).
- Assets held outside the US, depending on the fund structure and prime brokerage or custody arrangements.
- Administrative and operational expenses that may be borne by the fund (see *Fund Expenses*).

The consequences of a prohibited transaction are onerous. Among other things, the transaction may be required to be unwound and any profits returned, regardless of whether the benefit plan investors benefited economically from the transaction. Also, the IRS may impose excise taxes ranging from 15% to 100% of the amount involved in the prohibited transaction (see *Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments (http://us.practicallaw.com/0-506-0461)*).

If the fund is subject to ERISA, it must also comply with a number of reporting and disclosure, bonding and other requirements under ERISA (see *Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments (http://us.practicallaw.com/0-506-0461)*).

It is important to note that, regardless of whether the fund is subject to ERISA, if benefit plan investors invest in the fund, the fund may be required to disclose service provider compensation and fee disclosure information to benefit plan investors (see *Practice Note, ERISA Plan Asset Rules: Effect of Look-through Rule on Plan Investments (http://us.practicallaw.com/0-506-0461)* and *Legal Update, New fee disclosure rules in effect for certain US benefit plans (http://us.practicallaw.com/1-501-8594)*).

As a practical matter, benefit plan investors in a fund may:

- Require that the fund provide assurances that it will be exempt from ERISA, such as representations, covenants, legal opinions and periodic certifications that the fund is exempt from ERISA.
- Negotiate special withdrawal rights and other remedies in the event that the fund does become subject to ERISA.

Similarly, fund sponsors seeking to ensure that the fund is exempt from ERISA can include provisions in the operating agreement that restrict, or reduce investment by, benefit plan investors to the extent necessary to avoid the application of ERISA (for example, by including in the operating agreement mandatory distribution rights and prohibitions on transfers to benefit plan investors).

PRINCIPAL LEGAL DOCUMENTS

There are certain standard principal investment documents and other ancillary documents typically used in a private equity fund formation.

PRIVATE PLACEMENT MEMORANDUM

The private placement memorandum is the primary marketing document through which the fund markets its interests to prospective investors. The US federal securities laws do not require PPMs to be delivered to sophisticated investors such as QIBs and accredited investors in connection with a private offering of fund securities (see *Securities Act*), although it is generally market practice to provide a PPM to prospective investors. Regulation D of the Securities Act governs the information requirements for nonaccredited investors in connection with a private placement of fund interests. However, because the information requirements are onerous, private equity fund interests are not typically marketed to nonaccredited investors (see *Practice Note, Section 4(2) and Regulation D Private Placements: Information Requirements for Non-Accredited Investors (http://us.practicallaw.com/8-382-6259)*).

Although no formal rules under the Securities Act govern the content of PPMs, generally they contain the following information:

- **Business sections.** From a business and marketing perspective, the sponsor wants the PPM to describe:
  - the target investments of the fund;
  - the background of the sponsor and its investment team, including its performance track record; and
  - the target industries and geographic regions in which the fund will invest.
- **Summary of terms.** Describes the key legal terms to be contained in the operating agreement of the fund.
- **Risk factors and conflicts of interest.** Describes the key risk factors involved in making an investment in the fund to apprise the investors of the primary risks related to, among other things:
  - an investment in the fund;
  - the target industries or geography in which the fund expects to invest;
  - the management team; and
  - other material considerations and risks of which a reasonable investor would expect to be apprised.

  In addition, the PPM often includes a description of the primary conflicts of interest involved in making an investment in the fund, or in the management and operation of the fund by the sponsor and its investment team. For example, sponsor conflicts when managing the fund along with other funds, ventures, projects, or businesses managed by the sponsor.
- **Other key legal and tax considerations.** Often, PPMs targeting a particular investor base include a summary of key tax considerations for an investor making an investment in the

fund (for a discussion of the common form of entity and tax treatment of a private equity fund, see *Investment Fund*). For example, a US fund may include a summary of material US tax consequences that a US or non-US investor would want to take into consideration before making an investment. Other PPMs may include a description of other key regulatory restrictions on investors who might not be otherwise qualified to invest or key regulatory considerations for investors before making an investment (such as filing requirements or potential liability under applicable law).

- **Advisers Act compliance.** The Advisers Act contains numerous rules regarding the content of marketing materials that may be provided by registered investment advisers to investors which are typically reflected in a fund PPM (see *Investment Advisers Act*). Even for unregistered investment advisers, the SEC takes the position that certain information in marketing materials, especially prior performance data, could be misleading to investors if not presented in a certain manner.

FUND PARTNERSHIP OR OTHER OPERATING AGREEMENT

The fund's operating agreement (typically either an LP agreement when the fund is formed as an LP or an LLC agreement when the fund is formed as an LLC) is the primary operating agreement that governs the arrangements among the sponsor (as the GP or managing member) and the investors in the fund. It typically sets out, among other things:

- The investment objectives of, and investment restrictions, on the fund.
- The economic terms, including the allocations of profits and losses, carried interest and management fees, although sometimes the payment of management fees is covered in the investment advisory agreement of the fund (see *Allocations and Distributions*, *Carried Interest and Catch-up* and *Management Fees*).
- The payment of the fund's expenses (see *Fund Expenses*).
- The manner in which conflicts of interests are administered (see *Managing Conflicts*).
- The mechanics surrounding the issuance of capital calls to the investors and any decreases and increases in an investor's capital commitment (to account for, for example, capital calls, returns of capital calls and recycling) (see *Recycling of Capital Commitments*).
- The distribution waterfall, tax distributions and other terms regarding the timing and manner in which the fund may distribute proceeds to its investors (see *Allocations and Distributions*).
- Capital commitment default provisions which create severe penalties for a defaulting investor, such as:
  - forced sale of the defaulting investor's capital account to other existing investors at a discount;
  - interest penalties;
  - automatic reduction of the defaulting investor's capital account to cover owed amounts and penalties; or
  - the loss of all or certain rights as an investor, including participation in future investments or voting determinations.
- The delivery of annual and quarterly financial reports and other informational reports to the investors.
- Provisions for transfers of interests by the investors, which typically only permit transfers according to the provisions of the operating agreement and require GP consent.
- Other standard legal terms, depending on the form of the vehicle and its jurisdiction of incorporation.

SUBSCRIPTION AGREEMENT AND INVESTOR QUESTIONNAIRE

An investor subscribes to a fund as a limited partner, member or other equity holder by executing a subscription agreement, which sets out the investor's capital commitment to the fund. By executing the subscription agreement, the investor also agrees to the rights and obligations of the investors in the fund's operating agreement and makes representations and warranties to the fund, including representations and warranties confirming that is it qualified to invest.

Investors are typically required, including with the subscription of interest, to fill out an investor qualification statement or other investor questionnaire:

- Confirming that the investor is qualified under applicable laws to invest in the fund.
- Providing other supplemental information and appropriate representations required by the sponsor.

For an example of a form of investor questionnaire, see *Standard Document, Investor Questionnaire (http://us.practicallaw.com/9-384-4192)*.

SIDE LETTERS

Often, fund operating agreements allow the sponsor to enter into side letters or other side agreements with investors. A side letter entered into by the fund and an investor alters the terms of that investor's agreement with respect to its investment in the fund, and its rights and obligations under the operating agreement. Certain investors require side letters because of their special regulatory or tax needs. Other investors may command additional or special economic, informational or other benefits as a condition to their investment. The extent to which a fund may be permitted to enter into a side letter, or otherwise alter the terms of an investment in the fund with respect to one of more investors, is typically set out in the operating agreement of the fund.

INVESTMENT MANAGEMENT AGREEMENT

Often, the management company or investment adviser of the fund is retained directly by the fund, or its GP or managing member pursuant to a separate investment management or investment advisory agreement (see *Management Company or Investment Adviser*). The agreement typically contains the general terms under which the investment adviser is authorized to act as the fund's manager or other agent in connection with fund investment in exchange for the fund's management fee (see *Management Fees*).

FORM D

If a sponsor is relying on the specific private placement safeharbor of Regulation D to avoid registration with the SEC when offering interests in the fund (see *Securities Act*), a SEC Form D notice of the sale of fund interests must be filed with the SEC within 15 days of the first sale under Regulation D to ensure that the private placement falls within the black letter of Regulation D. Form D requires certain basic information such as:

- The offering price of the interests.
- The number and location of purchasers.
- Details of offering expenses (including sales commissions).
- A description of the use of proceeds raised from the sale of the interests.

For more on Form D filings for Regulation D private placement exemptions, see *Practice Note, Section 4(2) and Regulation D Private Placements: Form D Filing (http://us.practicallaw.com/8-382-6259).*

Issuers of fund interests (primarily ones conducting institutional offerings) do not always choose to file a Form D to perfect the Regulation D safe harbor, and not making the filing does not make the private placement exemption of Section 4(2) unavailable (see *Securities Act*).

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DISTINGUISHING HEDGE FUNDS FROM PRIVATE EQUITY FUNDS

The distinction between hedge funds and private equity funds is imprecise. There are hybrid funds that exhibit both hedge fund characteristics and private equity characteristics. In general, however, hedge funds are distinguished from private equity funds by the following features:

- New investors can buy into the fund, and existing investors can add to their fund interest, periodically.
- Investors are entitled to have their hedge fund investments redeemed periodically, in whole or in part, although limitations may apply.
- Hedge fund investments are generally funded immediately in cash, whereas private equity fund investors make capital commitments that are drawn by the fund manager as needed (see *Capital Commitments*).
- Hedge fund investors generally participate in all fund investments from the time they acquire an interest in the fund based on the fund's net asset value at that time, whereas private equity fund investors generally participate only in investments made after they join the fund and, in some cases, those made a relatively short period before their investment (but in these cases, subject to an interest charge).
- Hedge funds generally sell assets and reinvest the proceeds on an ongoing basis, whereas private equity funds are generally required to distribute proceeds to investors after an investment is liquidated (see *Recycling of Capital Commitments*). Accordingly, hedge funds tend to be appropriate for investment strategies involving frequent trading in liquid assets with easily ascertainable fair market values (such as the stock of publicly-traded companies), while private equity funds tend to be appropriate for investment strategies involving infrequent trading or investment in illiquid assets whose interim valuations may be difficult to establish (such as a leveraged buyout of a private company or a going private transaction (see *Practice Notes, Buyouts: Overview (http://us.practicallaw.com/4-381-1368)* and *Going Private Transactions: Overview (http://us.practicallaw.com/8-502-2842)*).

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Timeline of a Private Equity Fund

Scott W. Naidech, Chadbourne & Parke LLP

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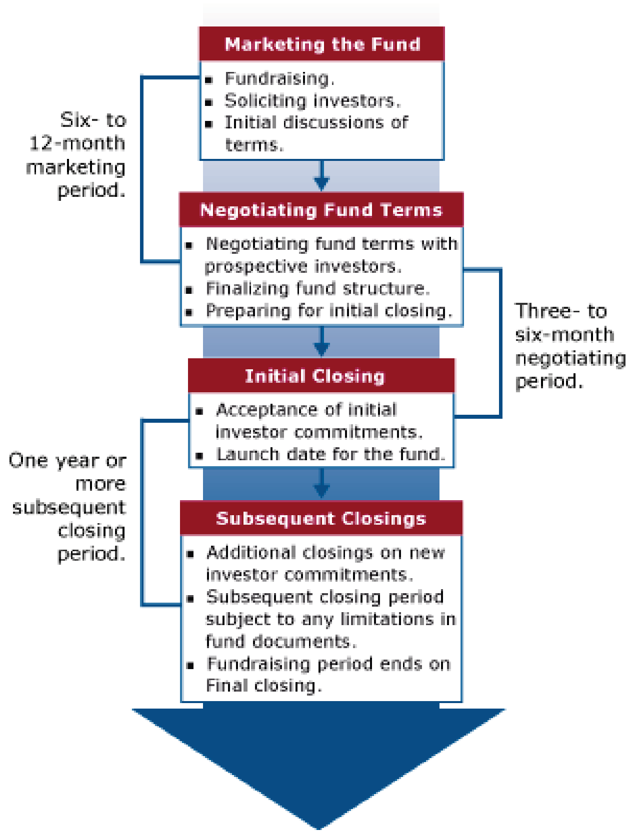
Timelines for a private equity fund, including a timeline showing the typical fundraising period for a private equity fund and a timeline showing the typical term of a private equity fund following the initial fund closing.

Fundraising and Fund Closing Timeline



Fund Term Timeline