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Private Equity

Anatomy of a Private Equity Fund Startup

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A recent Latham & Watkins program provided a soup-to-nuts overview of the steps to establish a private equity fund, covering the initial planning phase; development of fund infrastructure; and offering and closing process. The program, entitled "Starting a Private Equity Fund," featured David J. Greene and Amy R. Rigdon, partner and associate, respectively, at the firm.

This article highlights the key points raised during the presentation, outlining the above three components of forming a private equity fund, along with issues and considerations that may arise during each phase of the process. For another look at the startup process, see "Establishing a Hedge Fund Manager in Seventeen Steps" (Aug. 27, 2015).

Components of Fund Formation

The typical private equity fund is a "blind pool," Greene explained. Investors make capital commitments, which can be drawn down by the fund's general partner, or manager if the fund is organized as a limited liability company (together, GP), for any purpose within the fund's specified objectives.

Fund formation has three main components, parts of which will occur simultaneously. First, initial planning helps define what the sponsor is doing and creates the building blocks for fundraising. Second, the sponsor develops the fund's infrastructure, including governance and back-office operations. The third step is the formal offering of the fund and closing of the offering.

The presentation focused on the securities laws issues relevant to fund offerings, but Greene also noted that launches will also involve considerations of employment, real estate, intellectual property and other areas of law.

Initial Planning

Investment Thesis

The sponsor must crystallize the investment thesis and what the fund will look like, Greene noted. It should prepare an executive summary that addresses what are the characteristics of the target investment market; whether the fund will be generalized, industry-specific or focused on a particular region; how the fund will differ from competitors; and whether any types of investors are particularly well suited for the fund. The executive summary can be recycled later for marketing purposes. See "Capital-Raising Issues Hedge Fund Managers Must Consider" (Jan. 7, 2016).

Business Plan and Budget

The sponsor must develop an initial business plan and budget that identifies how the sponsor will get to the first closing of the fund, Greene added. A key consideration is funding startup operations, because a new fund sponsor will have no revenue until after the first closing. A more formal plan may be required if the sponsor is seeking seed or anchor investors. It is important to consider the possibility that the roll-out of the fund typically takes longer than expected.

Building a Team

Even for a new fund sponsor, institutional investors expect to see a "fully built team" that is consistent with the size and objectives of the fund. Different members of the team serve particular functions, noted Greene:

- The core investment team sources and makes investments and conducts due diligence. These individuals should have references ready from prior employers or counterparties.
- Advisers and operating partners provide guidance and help with investment or investor referrals, but are not involved in day-to-day operations.
- The internal support team must include a chief financial officer and built-out accounting and tax functions to handle cash inflows/outflows, as well as financial and tax reporting. Some functions can be outsourced to an administrator. See "Aite Group Report Maps Outsourcing Landscape for Hedge Fund Managers, Including Outsourced Services Offered, Trends, Goals, Drawbacks and Provider Profiles" (Nov. 15, 2012). A small startup might not need a general counsel.

Track Record

Portability and use of track records and performance information are covered by the Investment Advisers Act of 1940 (Advisers Act), Greene said. It is essential to consider whether the track records of investment personnel can be used without violating that act.

Key concerns are which investment personnel have moved over from other employers, whether there is documentation to support the track record and whether they have permission from their prior employers to use that track record. See "Recent NY Appeals Court Rulings Clarify How Fund Managers May Pursue Former Employees for Breach of Fiduciary Duty and Improper Use of Performance Record" (Dec. 15, 2016); and "Portability and Protection of Hedge Fund Investment Track Records" (Nov. 10, 2011).

Marketing

It is essential to identify the types of investors to which the fund will market, as well as early investors who will be part of the fund's first closing, Greene said. Early investors build critical mass that attracts other investors.

Marketing can be done by internal marketing professionals or placement agents. If outside agents market in the U.S., they must be registered as broker-dealers. If using in-house personnel, compensation policies must be drafted carefully to avoid raising broker-dealer registration issues. See "SEC Settlement Order Reignites Concerns Over Whether Private Fund Managers Must Register As Brokers" (Jun. 16, 2016); and "The Transformation of Third-Party Hedge Fund Marketer Contracts and Compensation" (May 3, 2012).

In addition to the Advisers Act, other regulations to consider include the Securities Act of 1933 (Securities Act), the Investment Company Act of 1940 (Investment Company Act) and state and foreign laws, Greene continued. Virtually all funds rely on exemptions from registration. State law requirements are relatively modest compared with those of the SEC. Foreign laws, such as the Alternative Investment Fund Managers Directive, may also apply.

The most common exemption under the Securities Act is the private placement exemption set forth in Rule 506(b) of Regulation D, which prohibits general solicitations and advertising. To comply with this requirement, marketing must be conducted on a "one-to-one" basis with investors with which the sponsor or placement agent has a pre-existing relationship. All investors must meet the "accredited investor" threshold. Fund personnel, placement agents and certain investors may not be "bad actors." See "SEC Staff Discuss 'General Solicitation' and Other Regulation D Issues" (Jun. 9, 2016); and "Implications for Hedge Fund Managers of the SEC's Recent Guidance on the Rule 506 Bad Actor Disqualification Provisions" (Dec. 12, 2013).

It is "practically impossible" for a private equity fund to register under the Investment Company Act, Greene cautioned. Most funds rely on the Section 3(c)(7) exemption, which requires all investors to be "qualified purchasers" or "knowledgeable employees." Under Section 3(c)7, there is generally no limit on the number of investors as long as there is no general solicitation. The exemption under Section 3(c)(1) offers an alternative to the investor qualification requirements of Section 3(c)(7), but the offering must be limited to 99 investors. See "SEC Clarifies Scope of the 'Knowledgeable Employee' Exception for Section 3(c)(1) and 3(c)(7) Funds" (Feb. 28, 2014).

Fund Structure

Fund structure is driven by the types of investors the fund will have and the types of investments it will make, Rigdon explained. It is largely tax-driven. If all investors will be U.S. taxpayers, the fund will usually be structured as a standalone Delaware limited partnership. The investors become limited partners of the partnership, which in turn will directly make all investments. In those circumstances, the fund documents should disclose that the fund will not undertake to mitigate any tax impacts of this structure on its investors.

Effectively connected income (ECI) and unrelated business taxable income are key considerations for both U.S. tax-exempt and foreign investors, Rigdon continued. Sovereign wealth funds may have other tax concerns. Some investors are more sensitive to tax issues than others. It is not possible to eliminate those taxes, but appropriate fund structuring can mitigate their impact.

If the fund will have U.S. tax-exempt or foreign investors, it will often set up a feeder fund for those investors in a no- or low-tax jurisdiction. The feeder fund will typically invest in a master fund, but it may elect to make certain investments through a wholly owned blocker corporation, which will in turn invest in an alternative investment vehicle. Having a fund structure that is flexible enough to accommodate investors with a variety of tax needs can facilitate growth, but that flexibility must be balanced with the complexity of such structures.

For more on tax structuring, see "How Managers Can Structure Direct Lending Funds to Minimize U.S. Tax Consequences to Foreign and U.S. Tax-Exempt Investors: 'Season and Sell' and Blocker Structures (Part One of Two)" (May 18, 2017); "Key Tax Issues Facing Offshore Hedge Funds: FDAPI, ECI, FIRPTA, the Portfolio Interest Exemption and 'Season and Sell' Techniques"

(Jan. 22, 2015); and "Tax Experts Discuss Provisions Impacting Foreign Investors in Foreign Hedge Funds During FRA/HFBOA Seminar (Part Two of Four)" (Jan. 23, 2014).

Infrastructure

Registration and Compliance

Generally, if a manager has $100 million in assets under management (AUM), it must register as an investment adviser with the SEC, Rigdon explained. Managers with less than $100 million in AUM may have to register at the state level. Advisers to venture capital funds, small business investment companies and family offices, as well as certain foreign advisers, do not have to register, regardless of AUM. All advisers are subject to the anti-fraud provisions of the Advisers Act, regardless of whether they are registered.

Registered advisers must comply with the panoply of regulations under the Advisers Act, including those pertaining to advisory contracts; advertising; books and records; custody; and disclosures to clients. SEC compliance expectations have increased dramatically in recent years, as have those of institutional investors, Rigdon added. The "compliance rule" (Rule 206(4)-7) requires registered advisers to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser and its supervised persons; to conduct an annual review of the adequacy of those policies and procedures; and to appoint a chief compliance officer. See "Top Five Compliance Deficiencies in OCIE Risk Alert Include Annual Compliance Reviews, Accurate Regulatory Filings and Custody Issues" (Feb. 23, 2017).

Economics and Governance

Fund economics and governance vary from sponsor to sponsor, Greene explained. Control of operations and investment decisions may be CEO-based, team-based or somewhere in between. The two key players in the fund structure are its GP and the fund management company. The fund GP is typically a standalone special purpose vehicle that controls the fund, receives carried interest and makes the sponsor's capital commitment to the fund. The sponsor must decide who participates in that carried interest and under what terms, as well as who participates in investment decisions.

The fund's management company or investment adviser is the "hub entity for [the sponsor's] asset management business," Greene continued. Each of the sponsor's funds typically appoints this entity as its investment manager and pays management fees to the entity. The investment adviser employs investment professionals, leases office space and carries on the sponsor's day-to-day investment management business. The sponsor must decide who shares in excess management fee revenues, as well as under what terms and how business and operational decisions are made.

Back Office

Back-office functions, which can be performed internally or outsourced, must include fund accounting; independent auditing; cash management (including the process for capital calls and distributions); periodic reporting to investors; and obtaining errors and omissions and director and officer liability insurance coverage, according to Greene. Institutional investors expect a strong back office from day one, Rigdon added.

Fund Offering

Pre-marketing Materials and Roadshows

A sponsor's executive summary can be adapted into a marketing "teaser" and then into a "flip book," which can be used to gauge investor interest, Rigdon said. The flip book is a short, high-level overview of the investment strategy and team. The book, as well as any responses to investor due diligence questions, must be consistent with the fund's private placement memorandum (PPM). Some investors may want to see a pipeline of potential deals or to do a co-investment with the manager before committing to invest in the new fund.

Private Placement Memorandum

The PPM is the main offering and disclosure document of a private fund and the "official" means for offering interests in the fund, Rigdon explained. It must not contain any material misstatements or omissions. "The more accurate and thorough, the better protection it provides against later claims by regulators or investors," she added. See "Contractual Provisions That Matter in Litigation Between a Fund Manager and an Investor" (Oct. 2, 2014).

It may be necessary to supplement the PPM if the offering takes place over a long period of time to ensure that all investors get the same information. The sponsor typically drafts the investment strategy, market opportunity and track record sections of the PPM. Fund counsel draft risk factors, fee provisions, disclosures of conflicts of interest and a summary of the limited partnership agreement or limited liability company operating agreement (together, LPA); they also ensure that the sponsor's disclosures satisfy SEC requirements. The SEC will closely scrutinize any performance forecasts set out in the PPM, so "avoid those whenever you can," Greene said.

Fund Documents and Negotiations

Prospective investors are typically provided with a PPM, as well as a subscription agreement and LPA for the fund, Rigdon continued. The subscription agreement contains investor representations and warranties that confirm compliance with private placement rules and anti-money laundering laws. The LPA describes investors' rights and responsibilities, provides for control by the GP (or managing member) and shields investors from liability. It is the "rule book for how the fund will operate," she said. See "OCIE Director Andrew Bowden Describes the Primary Compliance Failings of Private Equity Managers With Respect to Fees, Expenses, Limited Partnership Agreements, Valuation and Marketing" (May 16, 2014).

After the initial fund documents are presented to investors, there may be negotiations over various terms. Fund documents may have to be modified, and larger investors may request legal opinions. Some investors also ask for preferential terms, which are set out in side letters that modify the LPA or subscription agreement, Rigdon added. They typically cover fees, accounting, reporting, transparency, confidentiality and "most favored nations" terms.

Before entering into side letters, the sponsor should consider its ability to monitor and comply with their terms and not breach duties to other investors. If some requests affect all investors, or occur frequently enough, the sponsor may decide to amend the LPA to offer the rights to all investors, rather than enter into side letters. See "HFLR and Seward & Kissel Webinar Explores Common Issues in Negotiating and Monitoring Side Letters" (Nov. 10, 2016).

Closing

Once fund documents are done, the sponsor can proceed to closing, Rigdon explained. Some offerings have a single, "one-and-done" closing, but there are typically multiple closings over a 12-18 month fundraising period. When there are multiple closings, later investors make the requisite capital contribution, plus interest to compensate the earlier investors. At so-called "dry" closings, investors commit capital but do not fund their investments until the sponsor makes a capital call.

Private equity funds typically have a duration of 8-10 years after the end of the fundraising period, during which investors are locked in, Rigdon continued. Investors in new managers often ask for a shorter fund term or a shorter investment period.

In the event that a fund holds an asset that is difficult to liquidate, the PPM may permit extension of the fund term, either with or without the limited partners' consent. Moreover, Delaware law permits a fund to wind down over time after the end of its term; it does not require a "fire sale" of fund assets. Thus, many funds continue beyond their stated terms. In-kind distributions may be permissible, but most investors do not want that. Some secondary market players will work with fund sponsors to provide liquidity to investors in funds that have "just gone on too long," Greene added. See "Key Structuring and Negotiating Points in Secondary Sales of Private Fund Interests" (Mar. 21, 2014).

Alternatives to Traditional "Blind Pool" Funds

If a sponsor is not ready to launch a traditional private equity fund, or does not have a sufficient track record, there are other options, Greene explained:

1. *Co-Investment in a Single Company*. The sponsor may have a particular deal in mind that it markets to prospective investors. See "Private Equity in 2017: How to Seize Upon Rising Opportunity While Minimizing Compliance and Market Risk" (Jun. 8, 2017); and "Sadis & Goldberg Seminar Highlights the Ample Fundraising and Co-Investment Opportunities in the Private Equity Industry, Along With Attendant Deal Flow and Fee Structure Issues" (Dec. 8, 2016).
2. *Separate Account*. The sponsor may enter into a customized arrangement with a single investor that gives the investor enhanced rights in the investment process.
3. *Pledge Fund.* In a pledge fund, investors decide whether to participate in each investment on an investment-by-investment basis.

These alternatives do not have committed capital, as in a typical blind pool.

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