



# Private Equity Funds

Key Business, Legal and Tax Issues



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## **GLOSSARY**

# Private Equity Funds:

## Key Business, Legal and Tax Issues

### INTRODUCTION<sup>1</sup>

This outline discusses key business, legal and tax issues to be considered in the formation of a private equity fund (a “Fund”).<sup>2</sup> The private equity business has a global reach, with Fund sponsors and investors active around the world. Private equity firms and the Funds that they manage invest in virtually every geographic region, pursue a wide range of investment strategies in almost every arena of commercial endeavor, and account for a significant percentage of M&A activity in the United States and Europe.

The private equity industry has grown dramatically in the 30 years that Debevoise & Plimpton LLP has been representing Fund sponsors. Private equity investing is now considered a mainstream asset class, with nearly \$3.8 trillion under management globally at July 2014 as compared to \$2.2 trillion in 2008 and \$716 billion in 2000.<sup>3</sup> Growth in the size and number of private equity firms and Funds has been fueled on the *demand* (limited partner) side by: increased awareness of the

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<sup>1</sup> See the “Glossary” at the end of this outline for definitions of all capitalized terms used herein and not otherwise defined.

<sup>2</sup> As of the date of printing, a number of changes in U.S. tax law have been proposed by Congress and the Obama administration that could materially affect the discussions of U.S. tax consequences herein.

<sup>3</sup> Source: *Preqin*.

asset class and of the extraordinary investment returns of the leading firms; demand for higher performing investments to supplement the performance of large investment portfolios, which typically rely primarily on index strategies; and demand for strategic alliances with sponsors who serve as a source of transaction flow to pension plans, banks and other institutions. On the *supply* (sponsor) side, growth has been fueled by: new generations of private equity professionals entering the market; the development of new Fund products; and the extension of private equity skills to new industries and types of transactions. This dramatic growth has been accompanied, not surprisingly, by increased complexity in the structuring of Funds.

Debevoise & Plimpton LLP has, we believe, the world's leading Fund formation practice. We advise private equity firms on the formation of, and represent investors in, Funds pursuing all major investment strategies. Debevoise has a dedicated Investment Management Group with teams in its New York, London and Hong Kong offices, and additional capacity in its Washington, D.C., Paris, Frankfurt, Moscow and Shanghai offices. Experienced lawyers working in our offices worldwide contribute to the Investment Management Group's practice, supported by an extensive library of flexible model forms, memoranda and precedents, as well as a proprietary database containing detailed data on over 2,000 Funds. Since 1995, we have acted as counsel for sponsors of, or investors in, over 1,700 Funds worldwide, representing committed capital of over \$1 trillion.

This outline is based on Debevoise's experience over many years as counsel to sponsors of, and investors in, Funds worldwide; however, this outline does not constitute legal advice and cannot substitute for the customized advice needed to address the particular needs of individual investors and Fund sponsors.

**Debevoise & Plimpton LLP**  
**Investment Management Group**

## **A. OVERVIEW OF PRIVATE EQUITY FUNDS**

Funds are private pools of capital formed to make privately negotiated investments, including investments in leveraged buyouts, venture capital, real estate, infrastructure, mezzanine, workouts, distressed debt and other private equity funds. Some Funds focus on investments in one or more developed countries, others in one or more emerging economies. Some Funds pursue a generalist strategy, while others focus on investment in one or more particular industries or business sectors, such as telecom, media and communications, healthcare, energy, infrastructure, technology, life sciences or financial services. Typical investors in Funds include corporate pension plans, state and other governmental pension retirement plans, sovereign wealth funds, university endowments, charitable foundations, bank holding companies, insurance companies, family offices, funds of funds and high net worth individuals, all of which invest in Funds out of assets allocated to alternative or non-traditional investments.

### **1. *What is a Fund?*<sup>4</sup>**

- a. A typical Fund is structured as a fixed-life limited partnership (or series of parallel limited partnerships and/or feeder partnerships) whose partners (the investors) have agreed contractually to contribute capital to the Fund as and when needed by the Fund to make investments in portfolio companies. The outside investors (the “Limited Partners”) generally are not involved in the Fund’s investment decisions or other day-to-day activities. Instead, the Fund is controlled by its general partner (the

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<sup>4</sup> Although this discussion focuses on U.S. and European funds, the discussion below on fund structures and terms for the most part applies equally to Funds investing in Asia.

## A. OVERVIEW OF PRIVATE EQUITY FUNDS

“General Partner”) which, subject to regulatory considerations, issues calls for capital from the Limited Partners and makes all final decisions concerning the purchase and sale of the Fund’s investments. Unlike hedge funds, a Fund is generally structured as a closed-end vehicle, with very limited redemption rights. A typical Fund is managed and advised by the private equity firm or a subsidiary of the firm (the “Manager”); the General Partner and the Manager usually are separate but affiliated entities.

- b. In most cases, the Manager receives a management fee paid by the Fund (or, occasionally, directly by its investors), although in the case of U.K. and European Funds, the management fee is typically structured as a special profits allocation to the General Partner (such management fee or special profits allocation is referred to herein as the “Management Fee”). See Figures 1 and 2, below. The Manager, directly or through affiliates, employs and pays the salaries of the key individual investment professionals (the “Investment Professionals”) and other investment personnel. The Manager administers the Fund, seeks out and structures investments to be made by the Fund and recommends strategies for realizing and exiting those investments. Frequently these arrangements are set forth in a management agreement or investment advisory agreement between the Manager (or the General Partner) and the Fund. Where the Fund invests in multiple jurisdictions, the Manager (or the General Partner) may have subadvisory contracts with subadvisors in the various jurisdictions where the firm’s investment teams are based.
- c. The General Partner controls the Fund and, subject to regulatory considerations, generally makes final decisions concerning the purchase and sale of the Fund’s

## A. OVERVIEW OF PRIVATE EQUITY FUNDS

investments. The General Partner or, in some cases, a special purpose vehicle admitted as a special Limited Partner of the Fund, is the entity through which the sponsor and the Investment Professionals share in the Fund's investment profits, with such share being frequently referred to as the "incentive fee," "override," "promote," "carry" or, most often, the "carried interest" (the "Carried Interest"). The General Partner (or such special purpose vehicle) is also usually the entity through which the sponsor and the Investment Professionals make all or a portion of their capital investment in the Fund. As investors, the Investment Professionals are typically entitled to returns on their invested capital on the same basis as the Limited Partners, but without paying Management Fees or bearing Carried Interest.

2. ***U.S. Tax Structuring Considerations.*** Sponsors typically desire to use a structure that will not result in any U.S. federal income tax being incurred at the Fund level. A number of structures generally will accomplish this result; the most common approach is to structure the Fund as a partnership for U.S. federal income tax purposes.
  - a. *Structure the Fund as a partnership.* The Fund can be organized as an entity classified as a partnership by default for U.S. federal income tax purposes, such as a Delaware limited partnership or a Delaware limited liability company. See Topic A.3, below. In addition, under the U.S. entity classification rules, many types of non-U.S. entities can elect to be classified as partnerships for U.S. federal income tax purposes by filing a "check-the-box" election form with the U.S. Internal Revenue Service.

## A. OVERVIEW OF PRIVATE EQUITY FUNDS

- b. *Structure the Fund as a non-U.S. corporation.* Where a Fund consists of a series of parallel funds, sometimes one or more of the parallel funds organized as a partnership under non-U.S. laws will elect to be classified as a corporation for U.S. federal income tax purposes. For Funds that invest exclusively outside of the United States, such an election should not result in any U.S. federal income tax at the Fund level, but would change the U.S. federal income tax consequences to investors and, therefore, may be desirable for certain categories of investors (e.g., U.S. tax-exempt investors).
  - c. *Avoid the use of a Fund entirely.* Some sponsors choose to enter into separate investment management agreements with each investor. This approach achieves fiscal transparency at the Fund level by eliminating the Fund, but at the cost of losing the potential for capital gains treatment (and raising deferred compensation issues) for U.S. taxpayers in respect of the Carried Interest.
  - d. *Organize the Fund as a private Real Estate Investment Trust.* A Fund that qualifies as a REIT under section 856 of the Code may eliminate the U.S. federal income tax liability at the Fund level to the extent it satisfies certain organizational, asset and income tests and distributes its income and gains within applicable time periods.
  - e. *State and local taxes.* In addition to U.S. federal income tax aspects, U.S. state and local tax aspects should be considered in structuring the Fund.
3. ***Partnership or Other Form?*** Assuming that the sponsor wants a Fund that is classified as a partnership for U.S. federal income tax purposes, the sponsor may choose among the forms

## A. OVERVIEW OF PRIVATE EQUITY FUNDS

described below. Generally, the choice among them will depend ultimately on specific tax or business goals of the sponsor.

- a. *Limited partnerships.* This is the traditional and still by far the most common vehicle for establishing a Fund. Limited partnerships have the most developed statutory and case law, and investors are most familiar with them. Limited partnerships can be more flexible in some jurisdictions than, for example, companies in terms of their ability to alter profit sharing ratios, return capital to investors and distribute profits.
- b. *Limited liability companies.* Limited liability company statutes have the advantages of being available in all U.S. states, permitting great flexibility in structuring the Fund, offering familiar “corporate governance” forms (e.g., board of directors) and allowing “managing members” to manage the Fund (i.e., functioning like a General Partner) but without unlimited liability for investors in respect of the Fund’s losses. Limited liability companies, however, may present issues for Funds operating outside of the United States because it is unclear the extent to which some non-U.S. jurisdictions will recognize their limited liability status, treat them as flow-through entities for tax purposes or allow their members to claim treaty benefits. In addition, the limited liability company statutes remain relatively new compared to limited partnership statutes, and there is still relatively little case law under them.
- c. *Business trusts.* U.S. business trust laws are extremely flexible; investors can tailor the entity precisely to the terms of their deal. In particular, there is no requirement that any party function as a General Partner with agency

## A. OVERVIEW OF PRIVATE EQUITY FUNDS

powers. Despite a long history of investment companies organized as trusts, most business trust statutes are relatively new and there is not extensive case law on business trusts structured to function like private partnerships.

- d. *Qualifying non-U.S. entities.* Under the U.S. entity classification rules, many kinds of non-U.S. vehicles can “check the box” to be classified as partnerships for U.S. federal income tax purposes, including English limited partnerships, Cayman Islands exempted limited partnerships and Channel Islands limited partnerships. Use of such a non-U.S. vehicle is sometimes dictated by specific tax or business objectives.

### 4. *Jurisdiction of Organization.*

- a. The Delaware limited partnership is the fund vehicle of choice among U.S.-based Fund sponsors where the Fund will principally invest in the United States. Of the more than 1,000 U.S. Funds listed in Debevoise’s proprietary database, 80% are Delaware limited partnerships. Investors and their counsel are comfortable with, and are used to seeing, Funds organized in Delaware. Furthermore, Delaware’s Revised Uniform Limited Partnership Act (“RULPA”) contains strong protection of limited partner liability (e.g., limited statutory clawbacks of distributions and safe harbor activities in which a Limited Partner may engage without jeopardizing its limited liability) and significant flexibility to modify many core partnership terms by contract. Delaware also has good limited liability company and business trust statutes, as well as a sophisticated bar, well-developed case law and an efficient Secretary of State’s office.

## A. OVERVIEW OF PRIVATE EQUITY FUNDS

- b. If the Fund is investing outside of the United States, consider structuring it as a Cayman Islands, Guernsey, British Virgin Islands or English limited partnership or other non-U.S. entity. The Cayman Islands exempted limited partnership is a popular investment fund vehicle among U.S.-based sponsors, but is less commonly used than the Delaware limited partnership. The English limited partnership is a commonly-chosen fund vehicle in the United Kingdom's (and to some extent Europe's) private equity industry; nearly one-third of the Funds in the Debevoise database that focus on European investments take the form of English limited partnerships. The choice of jurisdiction is generally driven by an analysis of tax, corporate and partnership laws, as well as operating factors.
- c. Certain classes of potential investors in certain countries may require special structuring considerations, including listing interests in the Fund or a feeder fund on an exchange. Where a listing is desired, one of the Dublin, London, Amsterdam, Luxembourg or Hong Kong exchanges is typically used.
- d. Figure 1 below presents a typical but simplified U.S. Fund structure based on a Delaware limited partnership. Figure 2 below presents a typical but simplified European Fund structure based on an English limited partnership.

A. OVERVIEW OF PRIVATE EQUITY FUNDS

Figure 1: Simplified U.S. Fund Structure

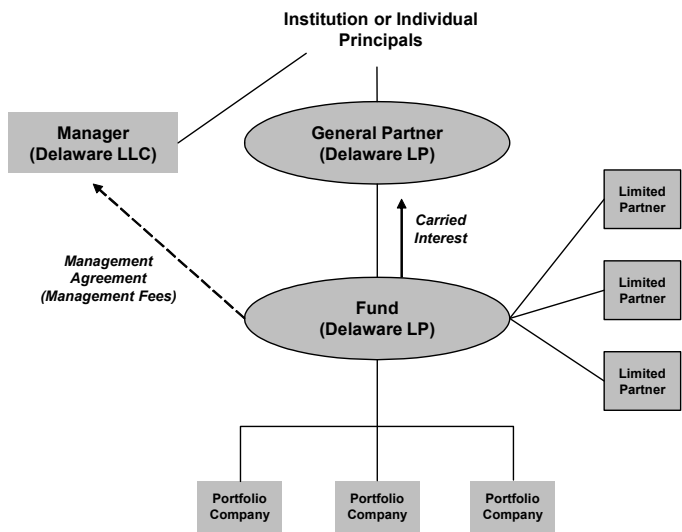
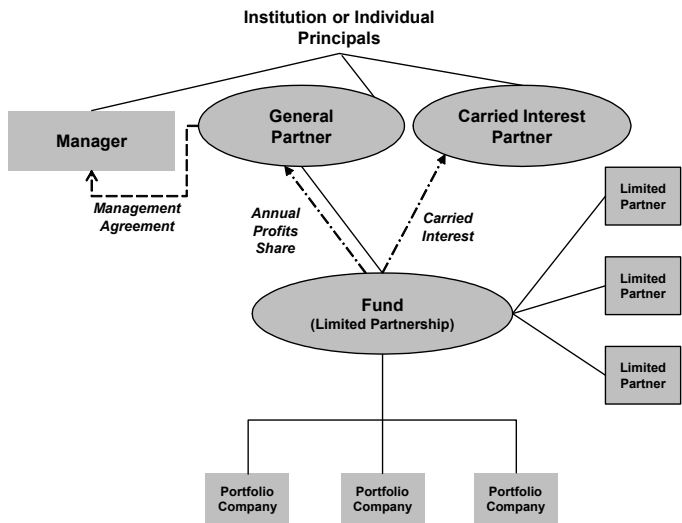


Figure 2: Simplified European Fund Structure



**5. Multi-Product and Multi-Jurisdictional Offerings.**

- a. *Parallel funds.* In some cases it may be advisable to respond to the concerns of different types of investors by structuring a fund program using one or more parallel funds that would be co-managed by the sponsor. For example, a Fund program might consist of a Delaware-organized main Fund and a Cayman Islands-organized parallel Fund. Generally, parallel funds co-invest and divest alongside the main Fund at the same time and on the same terms, *pro rata* based on their respective committed capital. Typically, the Fund Agreement of a parallel fund will also be substantially the same as the Fund Agreement for the main Fund, subject to modifications for regulatory, tax, structuring or other reasons. In most cases, the size of the Fund and any parallel funds will be aggregated for purposes of any overall Fund size cap, and investors in the Fund and any parallel funds generally will be aggregated for purposes of voting under the Fund Agreements.
- b. *Feeder funds.* In some cases, a sponsor may form a “feeder” fund that would aggregate the commitments of certain investors. For example, sometimes feeder funds are structured as “blocker” vehicles, taxed as corporations for U.S. federal income tax purposes. The feeder fund would then invest directly in the Fund as a Limited Partner.
- c. *Tax issues.* Careful tax analysis at both the investor and Fund levels is always critical to structuring and offering interests in a Fund successfully. This can be especially complex when interests in the Fund are being offered in multiple jurisdictions. See Topic J, below.

## A. OVERVIEW OF PRIVATE EQUITY FUNDS

- d. *Securities law issues.* See Topics L.1 and L.2, below, for a discussion of Securities Act and Investment Company Act issues relating to marketing to U.S. and non-U.S. persons.

**6. *Alternative Investment Vehicles.*** In some cases, a Fund Agreement may give the General Partner flexibility to form an alternative investment vehicle (“AIV”) if a direct investment by the main Fund might not be the optimal vehicle for purposes of structuring a particular investment (e.g., for tax, regulatory, legal or other reasons). Unlike a parallel fund, which generally would co-invest side-by-side with the main Fund in all investments, an AIV is formed as an alternative vehicle for the Limited Partners themselves. In such a case, the investment made through the AIV would reduce the Limited Partners’ remaining capital commitments to the main Fund and, typically, the investment results of the AIV are aggregated with those of the main Fund for purposes of the economic “waterfall” (see Topic D, below).

## **B. FUND PRODUCTS AND STRATEGIES**

There are many types of Funds, and business and legal considerations may vary considerably depending on the strategy being pursued. Debevoise has extensive experience representing both sponsors of and investors in all of the major types of Fund strategies and products, including:

### **1. *Private Equity Funds.***

- a. *Buyout Funds.* Buyout Funds make investments (often controlling investments) in established companies, with deals that often involve a debt financing component. Buyout Funds could also include growth equity funds that provide “expansion capital” so that more mature businesses can scale their business operations and enter new markets. Funds focused on buyout transactions are frequently the largest and best known Funds. Accordingly, the discussion in this outline focuses heavily on buyout Funds, although this outline is broadly relevant to all Funds.
- b. *Venture capital Funds.* Venture capital Funds invest primarily in early- or later-stage ventures. These funds typically make a significant number of high-risk, minority investments.
- c. *Real estate Funds.* Real estate Funds primarily make equity or debt investments in commercial and residential property, often utilizing leverage and generating current income. Strategies include “core,” “core-plus,” “value added” and “opportunistic,” with core strategies being the most low-risk (and lower target return), focusing on traditional property investments with stable cash flows, and opportunistic strategies being the most high-risk (and

## B. FUND PRODUCTS AND STRATEGIES

high potential return) and often involving niche sectors and development projects.

- d. *Infrastructure Funds.* These funds invest in projects in infrastructure sectors such as transport (e.g., toll roads, bridges, tunnels, airports, ports), water and waste, energy and other public sector services, often utilizing leverage. As with real estate Funds, the risk-return profiles within infrastructure Funds can be quite diverse, and strategies range from “brownfield” projects (mature assets with stable current cash flows) to “greenfield” projects (early-stage/opportunistic projects, typically with higher risk profiles).
  - e. *Debt and special situations Funds.* These Funds, which may include distressed debt, mezzanine and credit opportunities Funds, focus on “later stage” investments in distressed, mezzanine, senior or subordinate debt at a large discount. Debt strategies can include the purchase of existing debt and/or making direct loans.
  - f. *Funds of Funds.* These Funds invest primarily or exclusively in other Funds (or hedge funds), providing investors with a diversified portfolio and access to funds where they otherwise might not be permitted to invest. Funds of funds may make primary investments in other Funds, “secondary” investments (by purchasing and selling commitments made by other investors to existing Funds) and/or co-investments.
2. **Other Types of Fund Products.** A detailed description of private investment funds outside the private equity Fund “realm” is beyond the scope of this outline; however, some of these products include those listed below. We can provide our clients

## B. FUND PRODUCTS AND STRATEGIES

with separate, detailed materials on these and other private investment fund products.

- a. *Hedge Funds.* Hedge funds pursue a wide variety of complex strategies, but generally focus on investments in listed equities. Unlike most Funds, hedge funds typically draw down 100% of investor capital at the time of subscription rather than only when needed, invest in marketable securities or derivative instruments, provide for periodic redemptions after an initial lockup period, pay a Management Fee based on net asset value and pay a Carried Interest (or annual incentive allocation) calculated on increases in net asset value and often using a “high water mark” methodology.
- b. *Pledge Funds.* In contrast to a typical Fund, which is normally a “blind pool” and in which investors are generally not permitted to opt in or out of specific investments (subject to certain excuse rights), pledge funds are pools of “soft” commitments from investors, and participants are able to choose whether to participate in investments on a deal-by-deal basis. Often these pools of capital are structured as contractual arrangements, with a separate Fund formed for each portfolio investment. Generally, Management Fees are charged on invested capital only, and Carried Interest is calculated on a deal-by-deal basis. (See Topic D, below.) This approach may be appropriate if the sponsor does not yet have a sufficient track record to raise a blind-pool Fund.
- c. *Evergreen Funds and other permanent capital Funds.* Like hedge funds, evergreen fund products do not have a fixed life. Structuring varies from product to product, but generally the vehicle is structured so that the sponsor can

## B. FUND PRODUCTS AND STRATEGIES

raise additional capital from time to time, e.g., by issuing further classes of interests during fixed buy-in periods or by having investors “roll over” their capital commitments (either in tranches or on a staggered/individualized basis). Other products may be structured as open-ended vehicles that continually reinvest investment returns, rather than distributing proceeds from each investment to Limited Partners. Evergreen and other permanent capital vehicles may be publicly-listed or private.

- d. *Registered investment companies.* RICs are traditional investment companies, registered under the Investment Company Act. These products may be closed-end or open-end, and often focus on credit investments. RICs are subject to significant investment/economic structuring restrictions and regulatory oversight. See also Topic L.2.f below.
- e. *Business development companies.* BDCs are typically publicly-traded, closed-end funds that, upon election, are subject to a special set of regulations (and regulatory oversight) under the Investment Company Act, which are designed to be more flexible than those applicable to RICs. The relevant act governing BDCs was passed by Congress primarily to increase the capital available to small- and medium-sized businesses, and sets forth a number of investment restrictions. Like RICs, BDCs typically do not have set term limits and therefore offer another source of permanent capital.
- f. *Small business investment companies.* SBICs are licensed by the U.S. Small Business Administration and regulated under the U.S. Small Business Investment Act of 1958. SBICs primarily provide equity capital, long-term loans and

management assistance to qualifying small businesses and are eligible for relatively inexpensive government loans (which can allow for both a larger fund size and the ability to make less frequent calls for capital). Among other restrictions, SBICs are generally prohibited from numerous types of investments and are subject to diversification requirements.

3. **Separate Accounts.** Separate accounts have received increasing attention in recent years, and involve a custom management or advisory arrangement for a specific investor. Separate accounts can be documented using a Fund structure (with the investor as the sole Limited Partner), or in some cases via an investment management agreement, which is a purely contractual arrangement. The determination is often heavily driven by tax and economic considerations, particularly where Carried Interest will be paid. Separate accounts are appealing to certain institutional investors (such as, for example, government pension plans and sovereign wealth funds) in that they facilitate bespoke structuring, an investment strategy addressing particular investment limitations and goals, tailor-made economics and reporting, and other individualized terms fitted for such particular specifications. Separate account arrangements can be heavily negotiated and require careful consideration of a sponsor's obligations with respect to its other Fund products.

## C. THE OFFERING

### 1. *The Fundraising Process.*

- a. *Generally.* The process of structuring, organizing, marketing and closing a Fund can take a year or longer, particularly in the current difficult fund raising environment. A typical offering process begins with preliminary meetings and indications of interest. The sponsor then prepares an offering memorandum and “goes on the road” to market the Fund. A fundraising period then begins, which can last for several months leading up to the Fund’s initial closing. In many cases, one or more subsequent closings are held for a total fundraising period of, in many cases, 12-18 months.
- b. *Securities law compliance.* The marketing of interests in a Fund almost always constitutes an offering of securities (e.g., in the case of a Fund structured as a limited partnership, the securities are the limited partner interests), and therefore the offering must comply with the securities laws of the jurisdictions where the sponsor and the potential investors are located. The marketing of, and offering of interests in, a U.S. Fund is typically conducted as a private placement under the Securities Act. Note also that most European jurisdictions require marketing notifications, approvals or permissions before marketing of Fund interests begins in the relevant jurisdiction. See Topics L.1 and L.10, below.

## C. THE OFFERING

2. **The Private Placement Memorandum.** The offering memorandum (or Private Placement Memorandum) is generally the primary disclosure document when raising a Fund.
  - a. *Contents.* Matters typically covered in the Private Placement Memorandum include:
    - (i) *Business description.* These sections typically include a discussion of the Fund's investment strategy and process, market commentary, and a description of the sponsor (including relevant team biographies).
    - (ii) *Legal description.* These sections typically include a summary of the Fund's principal governing terms, a description of relevant conflict of interest considerations, risk factors and other legal (including, as applicable, regulatory, tax and ERISA) disclosures, and relevant U.S. and non-U.S. securities legends.
    - (iii) *Track record.* It is common (and often essential if an offering is to succeed) to illustrate investment policies with a track record. Issues to be considered when preparing track records and other performance information include:
      - (A) *Methodology.* Performance disclosure must be balanced, including a description of valuation methods used. The valuation methods that are used should be documented, consistently applied and designed to ensure that any performance presentation on which the valuation is based is not misleading. Among other things, RIAs are prohibited from publishing or distributing an advertisement that uses testimonials, "cherry picks" prior investment recommendations

without disclosure of the entire track record for the relevant period and, more generally, contains any untrue statement of material fact or is otherwise false or misleading. A number of important no action letters issued by the SEC staff interpret this rule, including letters that generally prohibit the use of gross performance data if unaccompanied by net performance data. While this rule does not technically apply to unregistered investment advisers, compliance with its guidance is recommended given the applicability of the general anti-fraud provisions of the Advisers Act to unregistered advisers.

(B) *Attribution of track record.* The sponsor should clearly disclose the role and responsibilities of the individuals who are now employed by the sponsor and any other relevant information to make the disclosure of the performance not misleading. If the General Partner or Manager is an RIA, the portability of a track record achieved at a previous employer is subject to a number of conditions. The RIA must also have the books and records necessary to substantiate the prior performance.

(C) *GIPS Standards.* Various trade groups have promulgated standards for their members to follow when including performance data in offering materials. One such set of standards is the Global Investment Performance Standards, which is administered by the CFA Institute.

- b. *Securities law compliance.* As the primary document describing the offering of interests in a Fund, the Private

### C. THE OFFERING

Placement Memorandum must be drafted carefully to ensure compliance with relevant securities laws, including:

- (i) *Exchange Act*. Rule 10b-5, promulgated by the SEC under section 10(b) of the Exchange Act, prohibits fraudulent conduct (including material misstatements and omissions of any material facts, and acts and practices that operate as a fraud or deceit) in connection with the sale and purchase of securities, including interests in a Fund. Each offering participant, including the sponsor, its officers and directors, the General Partner, and any placement agent, is potentially liable under this provision.
  - (ii) *Advisers Act*. All investment advisers (including RIAs and unregistered investment advisers) are prohibited under the Advisers Act from making any untrue statement of material fact or omitting to state a material fact necessary to make the statement made not misleading to any investor or prospective investor in a pooled investment vehicle (e.g., a Fund). In addition, the Advisers Act prohibits investment advisers from using false or misleading advertisements (broadly defined). See also Topic C.2.a.iii, above, and Topic L.3, below.
- c. *Supplements*. The Private Placement Memorandum is typically supplemented (e.g., prior to each closing of the Fund) to reflect material developments during the course of the offering.

### 3. **Other Primary Fund Documentation.**

- a. *Pitchbooks*. In many cases a sponsor may wish to “premarket” a Fund or conduct a roadshow on the basis of a very brief description of terms and the sponsor’s track

record. Even if a pitchbook is to be followed by a full Private Placement Memorandum, it is important that it include appropriate legal disclaimers and disclosures.

- b. *Fund Agreement.* The Fund Agreement is typically the most comprehensive (and most negotiated) governing Fund document, as it contains the majority of the structuring and other terms discussed in Topics D through H, below.
- c. *Subscription agreement.* This is the document whereby an investor subscribes for its interest in, and makes its capital commitment to, the Fund. Investors typically make representations concerning, among other things, ERISA, tax, securities law and anti-money laundering matters. For Funds without a separate Private Placement Memorandum, additional risk factors and other disclosures may be included in the subscription agreement.
- d. *Side letters.* As Fund investors have become increasingly sophisticated, with larger internal resources devoted to Fund investments, it has become increasingly common to address the specific issues of an investor via a side letter agreement between the Limited Partner and the General Partner (or the Fund). Many institutional investors now have a list of personalized “standard” side letter requests that they make in respect of each Fund investment. Common issues addressed in side letters include “most favored nations” undertakings (if not addressed directly in the Fund Agreement), transfer and/or redemption rights, information and/or disclosure rights, investor tax and regulatory concerns and other matters particular to the investors. Note that a side letter cannot amend the Fund Agreement with respect to the other investors.

## C. THE OFFERING

4. **Placement Agents.** Some sponsors may engage a private placement agent to assist them in raising capital from investors. Some placement agents are engaged to target a specific kind of investor (for example, the private placement regulations of certain countries require a local distributor or placement agent to be used); in other cases, global placement agents are engaged to provide more “full service” advisory and marketing services to the sponsor.
  - a. *Engagement letter.* If a placement agent is being used, then the Fund or the sponsor will enter into an engagement letter with the placement agent. Typical issues when negotiating a placement agent engagement letter may include:
    - (i) Scope of the arrangement (e.g., exclusive, limited, etc.);
    - (ii) Responsibility for disclosure;
    - (iii) Fees (including the amount of fee, what investors the fee is charged on, who ultimately bears the fee, and the time period over which the fees are paid);
    - (iv) Representations and warranties (see below); and
    - (v) Rights of the placement agent in respect of any subsequent Funds.
  - b. *Representations and warranties; compliance with law.* Because the placement agent is conducting business as agent of, or on behalf of, the sponsor, the sponsor could become exposed to liability due to the actions (or omissions) of the placement agent. Thus, compliance with applicable law (including securities laws and anti-money

laundering/anti-terrorism laws) by the placement agent in the course of its services is of great importance to the sponsor, and the placement agent agreement often contains detailed representations, warranties and covenants by the placement agent in this regard.

- c. *Broker-dealer registration.* Placement agents are considered to be engaged in the business of effecting transactions in securities for the account of the Fund and therefore are subject to regulation in the United States under applicable broker-dealer laws. See Topic L.5, below.
- d. *Solicitation of government investors.* If a local or state government entity (including a pension plan) is being solicited for investment, then the placement agent must be a registered broker-dealer. The Fund's sponsor must ensure that any compensation paid to a placement agent is in compliance with the SEC's "pay-to-play" rule. See Topic L.3.b.xv, below.
- e. *Regulation D "covered person."* The placement agent will also need to give sufficient representations to permit the Fund's counsel to give its private placement opinion, including additional diligence regarding the placement agent's "covered persons," if the Fund is relying on Regulation D for an exemption from registration under the Securities Act. See Topic L.1.b, below.
- f. *High net worth feeders.* Concerns similar to those that arise when negotiating a placement agent arrangement also arise when a bank or similar institution raises a "high net worth feeder" in connection with a Fund investment. See Topic I.9, below.

## D. FUND TERMS: CARRIED INTEREST AND DISTRIBUTIONS

In the United States, the Carried Interest is an incentive payment to the General Partner. It is typically structured as a partnership allocation of profits rather than as a fee to preserve the underlying tax characteristics of the Fund's income and gain. This benefits U.S. Investment Professionals, as currently they can generally use the lower U.S. long-term capital gains tax rate on their share of the Fund's long-term capital gain rather than the higher ordinary income tax rate applicable to a fee. Where a vehicle other than a limited partnership is used, or in certain types of non-U.S. Funds, the sponsor may choose to form a special class of investor (such as a "special limited partner") to receive the Carried Interest.

1. **Basic Deal.** In a typical deal, over the life of a Fund, (a) the General Partner receives a Carried Interest equal to a specified percentage (typically, for a buyout Fund, 20%) of the cumulative net profits from the Fund's investment program and (b) the Partners as a group (including the Limited Partners) receive the balance (thus, typically 80%) of the profits *pro rata* in accordance with their respective invested capital, plus the return of their invested capital. When computing the Carried Interest, the netting of a Fund's gains and losses across all investments is almost universal.
2. **Distribution Timing.** Unlike in a hedge fund (which generally computes a General Partner's incentive allocation as a percentage of net gains over a particular period), in a typical Fund the General Partner only receives its Carried Interest when cash is distributed, with the two main approaches being to pay Carried Interest on a "deal-by-deal" basis or on an "all-capital-first" basis.

#### D. FUND TERMS: CARRIED INTEREST AND DISTRIBUTIONS

- a. *Deal-by-deal.* In the United States (and particularly in the case of buyout Funds), a Fund's economic provisions often, but not always, provide for payment of the Carried Interest on a "deal-by-deal" basis. In this approach, the General Partner is not required to wait until the Limited Partners have received a return of all contributed capital to receive Carried Interest. Rather, the General Partner receives Carried Interest out of the proceeds from the sale of an investment once the capital invested in the deal disposed of (plus any deals previously disposed of at a loss and often write-downs and apportioned expenses) is returned.
- b. *All capital first.* A Fund's economic provisions may instead provide for payment of the Carried Interest only after all contributed capital is returned. This is the most common approach in Europe and Asia, and is becoming more common in the United States.
- c. *Expenses.* Carried Interest typically is computed net of expenses, including Management Fees.
- d. *Current Income.* In strategies that produce current income (for example, real estate or mezzanine funds), a Fund Agreement may provide for a separate "waterfall" for distributions of current income. For example, such provisions may be drafted to assume return of principal (other than in the case of writedowns), which could permit the General Partner to realize Carried Interest based on the current income of portfolio investments.

## D. FUND TERMS: CARRIED INTEREST AND DISTRIBUTIONS

3. ***Preferred Returns and Cushions.*** It is very common to require a specified return or yield to be achieved on invested capital before the General Partner is permitted to take Carried Interest.
- a. *Hurdle rate.* A hurdle rate is a preferred return in a distribution formula that includes a “catch-up” provision. Hurdle rates are almost universal in buyout Funds and most other types of Funds (but relatively uncommon in venture capital Funds). The most common hurdle rate is 8% per annum, compounded; however, certain types of Fund strategies may provide for higher hurdle rates, hurdle rates that may be subject to adjustment for inflation, or floating rates.
  - b. *“True” preferred return.* A “true” preferred return is a specified yield that comes off the top and is retained by Limited Partners before calculation of Carried Interest. In Funds with true preferred returns, Carried Interest is calculated as a percentage of profits remaining after the preferred return is deducted. True preferred returns are less common than hurdle rates.
  - c. *Cushion.* In venture capital Funds, rather than providing for a preferred return, a “cushion” is typically required, e.g., that the value of the Fund’s portfolio be equal to, for example, 120% of cost, before Carried Interest distributions may be made.

#### *D. FUND TERMS: CARRIED INTEREST AND DISTRIBUTIONS*

4. ***Distributions in Kind.*** Generally, investors will prefer to have distributions made in cash, rather than in kind. Some Fund Agreements explicitly provide that in-kind distributions (at least prior to the Fund's dissolution) be limited to "marketable" securities only.
5. ***Tax Distributions.*** Under U.S. tax principles, the partners in a partnership generally are taxed on the partnership's income or loss in accordance with their economic interests therein, regardless of whether and in what proportion current distributions are made to the partners. As a result, if the General Partner is entitled to a 20% Carried Interest, the U.S. members of the General Partner may be currently taxable on 20% of the Fund's net investment profits (after any applicable hurdle rate is achieved), even if the Fund's distribution provisions provide that all capital contributions are returned to the Limited Partners prior to the distribution to the General Partner of any of its Carried Interest. Tax distributions may be necessary to ensure that the Investment Professionals have sufficient funds to pay their taxes in circumstances where they are allocated income from the Fund for tax purposes but are not otherwise entitled to a cash distribution from the Fund.
6. ***General Partner Clawback.*** To protect the basic deal on Carried Interest (the so-called "80/20 deal"), Fund Agreements typically provide that an overdistribution to the General Partner is "clawed back" to the Fund from the General Partner, and then distributed to the Limited Partners. An overdistribution would typically also include a situation where the General Partner has received Carried Interest but the Limited Partners have not achieved their preferred return/hurdle.
  - a. ***Clawback timing.*** Traditionally, the most common approach has been to have a single clawback calculation at

#### D. FUND TERMS: CARRIED INTEREST AND DISTRIBUTIONS

the time of the Fund's liquidation. However, some Fund Agreements provide for the General Partner to make clawback payments at one or more specific times over the life of the Fund (e.g., at the end of the Fund's investment period, or even more often) if there has been an overdistribution. This is sometimes called a "true-up" or an "interim clawback." Interim clawbacks occurring at least once during a Fund's term have become increasingly common in recent years.

- b. *Netting of taxes.* The General Partner typically provides a clawback that is "net of taxes," that is, the amount of the clawback obligation never exceeds (i) total Carried Interest distributions received by the General Partner less (ii) total taxes (including state and local, usually at an assumed rate of tax) paid or payable thereon.
- c. *Securing the clawback obligation.*
  - (i) *Guarantee by the Investment Professionals.* Where the General Partner is a special purpose vehicle, the "owners" of the General Partner (i.e., the ultimate recipients of Carried Interest distributions) often guarantee the General Partner's clawback obligation (typically on a several, not joint, basis). In some cases, the sponsor itself may guarantee the clawback, or the "key" principals may jointly guarantee the clawback obligations of all carry recipients.
  - (ii) *Segregated reserve account or "holdbacks."* A Fund Agreement might provide for a holdback of all or some specified portion of Carried Interest distributions (e.g., 20-30%, net of taxes) in a segregated reserve account. Holdbacks are more common in European Funds than in U.S. Funds.

## **E. FUND TERMS: MANAGEMENT FEES, FEE INCOME AND FUND EXPENSES**

1. **Management Fees.** As noted at Topic A.1.b, above, in most cases, the Manager receives a Management Fee paid by the Fund (or, occasionally, directly by its investors), although in the case of U.K. Funds, the Management Fee is typically structured as a special profits allocation to the General Partner. The Management Fee is used to, among other things, pay for overhead, salaries and other “manager” expenses that are not charged to the Fund.
  - a. *Management Fee rates.* The spectrum of “market” Management Fee rates can vary depending on a Fund’s size and strategy. A flat Management Fee rate is still the most common; however, some sponsors might offer different Management Fee options, such as different rates depending on the size of an investor’s commitment, or lower rates for early closers. Some Funds may also have a Management Fee that ratchets down once the Fund reaches certain size thresholds.
  - b. *Management Fee base.* In most cases, during a Fund’s investment period the Management Fees are based on a percentage of committed capital, whether or not paid in. However, occasionally (depending on the strategy of the Fund) the Management Fee, even during the investment period, may be based on invested capital. In the majority of today’s Funds, post-investment period Management Fees are based on remaining invested capital (*i.e.*, paid-in capital less the cost of investments that have been disposed of). Some Funds, however, may continue to use committed capital as a base (for example some venture capital Funds)

## ***E. FUND TERMS: MANAGEMENT FEES, FEE INCOME AND FUND EXPENSES***

and others may use a net asset value calculation for the base.

(i) Whether *all* paid-in capital (including Management Fees and other expenses) counts or *only* capital paid for portfolio investments (but not for Management Fees and other expenses) is a negotiation point.

(ii) Realized losses and write-offs are often deducted from the Management Fee base.

(iii) Write-downs (*i.e.*, unrealized losses) may also be deducted, but many sponsors argue that this should not be the case since the Manager needs resources to manage troubled investments.

- c. *Early step-downs.* For many Funds, Management Fees step down (either the percentage or the base, or both) at the end of the investment period (or earlier, if the sponsor begins raising, or receiving Management Fees for, a successor Fund). The Management Fee may be paid through the end of the Fund's stated "term" (including extensions), or may continue through the final liquidation; however, the existence of so-called "zombie" funds has raised concerns regarding whether a Fund should continue to charge Management Fees post-term.
- d. *Timing of payments.* Management Fees may be paid semi-annually, quarterly or on another timeframe, and may be paid in advance or in arrears. Quarterly advance payments are most common.

*E. FUND TERMS: MANAGEMENT FEES, FEE INCOME AND FUND EXPENSES*

**2. *Sharing the Benefit of Directors' Fees and Transaction, Break-Up, Monitoring and Other Similar Fees.***

- a. *Types of Fee Income.* “Transaction fees” are received by the sponsor for playing a role in structuring a portfolio company transaction. “Monitoring fees” are earned by the sponsor for monitoring portfolio companies. “Break-up fees” are paid if the proposed acquisition of a portfolio company is not consummated. “Directors’ fees” are earned by Investment Professionals or other employees of the sponsor for service on a portfolio company board.
- b. *Sharing of Fee Income.* The disclosure documents of a Fund should clearly disclose how fee income will be shared between the sponsor and the investors. For many years, the offset percentages for these fees were clustered at 0%, 50%, 80% and 100%. In recent years, however, the market has moved toward 80-100% sharing of fee income.
  - (i) If the Fund (and thus investors) is to receive a portion of transaction fees or other fee income, the economics are typically structured as an offset against the Management Fee (i.e., fees received by the sponsor are passed on to the Fund in the form of Management Fee reductions).
  - (ii) If fees are credited against the Management Fee, some Fund Agreements provide for carryforwards of unused credits and possible rebate of past Management Fees if there are unused credits remaining at the end of the term of the Fund.
  - (iii) In structures where more than one Fund is co-investing in a particular transaction that has given rise to

## **E. FUND TERMS: MANAGEMENT FEES, FEE INCOME AND FUND EXPENSES**

fee income, the sponsor should clearly address how the corresponding offset will be shared among the various participating vehicles.

3. **Fund Expenses.** The disclosure documents of a Fund should clearly disclose how all expenses are allocated (both as between the Fund and the Manager, and as between the Fund and any co-investment vehicles). Types of expenses arising in connection with a Fund's activities are:
  - a. *Salaries and other similar overhead expenses.* These are typically borne by the Manager, as are general expenses relating to a Manager's Advisers Act registration.
  - b. *Out-of-pocket expenses of completed portfolio transactions.* These are typically capitalized into transaction costs and accordingly borne by the Fund.
  - c. *Broken deal out-of-pocket expenses.* Many different structures have been used on this point, such as having the Fund bear all, having the sponsor bear all, a pre-arranged split (e.g., 80/20) or some other agreed sharing arrangement. Often, if 100% of fee income (including break-up fees) is shared with the Fund, then the Fund will pay out-of-pocket broken deal expenses.
  - d. *Organizational expenses.* These are often borne by the Fund with a cap, which may be a fixed dollar amount or percentage of the Fund's size. In such cases, the excess above the cap is borne by the sponsor, typically through a corresponding reduction of the Management Fee.

*E. FUND TERMS: MANAGEMENT FEES, FEE INCOME AND FUND  
EXPENSES*

- e. *Placement fees.* These are typically borne by the sponsor through a corresponding reduction of the Management Fee.
- f. *Allocation of deal expenses to multiple vehicles.* A co-investment or parallel vehicle generally only bears its *pro rata* share of deal expenses. Note that in recent years a sponsor's allocation of expenses (and in particular broken-deal expenses) and related conflict of interest issues have become a focus of increased regulatory scrutiny. See Topic G, below.

## **F. FUND TERMS: CLOSING THE FUND AND MAKING INVESTMENTS**

1. ***Size of the Fund.*** Some sponsors set forth a target size when marketing a Fund; often investors will seek a specific cap in the Fund Agreement.
2. ***Sponsor Investment in the Fund.*** Many General Partners and Fund sponsors invest between 1% and 3% (or more) of a Fund's capital for business or marketing reasons. The sponsor investment may be made in, or in some cases alongside, the Fund.
3. ***Investment Period and Fund Term.***
  - a. For a buyout Fund, a five- or six-year investment period is typical, followed by a four- or five-year harvest period, for a total basic term of around ten years.
  - b. A Fund's initial term may be extendable for two or three one-year periods at the option of the General Partner (often with the consent of the Fund's Advisory Committee or some percentage in interest of the Limited Partners) if necessary to allow for an orderly liquidation of the Fund's portfolio.
  - c. Many investors request the option to suspend or terminate the investment period early (or dissolve the Fund early) upon a supermajority vote of Limited Partners (i) without cause or (ii) under specified circumstances (e.g., termination of services of specified Investment Professionals). See Topic H, below.

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- d. Funds of funds will often have a somewhat longer term because the Funds in which they will invest may have terms of up to 12 or 13 years. Infrastructure Funds tend also to have longer terms because of the nature of the asset class. Some real estate, emerging markets, debt and venture capital Funds have shorter terms.
- 4. **Closings.** It is typical to hold the first closing of the sale of interests in a Fund once a critical mass of capital commitments has been obtained, and then to admit additional Limited Partners at one or more subsequent closings. A typical window period for subsequent closings is 12 to 18 months after the first closing. If the Fund makes one or more portfolio investments before the final closing, subsequent closing investors typically buy in at acquisition cost of the previously-acquired portfolio securities plus accrued interest (for example, at the prime rate plus 2%); some sponsors may adjust these “true-up” amounts to take into account interim distributions and/or material changes in value of portfolio investments.
- 5. **Drawdowns of Capital.** In contrast to hedge funds (which generally provide for an up-front contribution of an investor’s entire capital commitment), Funds typically draw down capital on an “as needed” basis – often, with 10 business days’ notice.
- 6. **Subscription Credit Facilities.** Many Funds use subscription credit facilities for short-term financing needs in connection with the making of investments (for example to fund an investment pending receipt of drawdowns from Limited Partners), or in anticipation of syndicating a portion of an investment to third parties or Limited Partner co-investors. In the case of real estate Funds or infrastructure Funds, a longer term facility may be used to provide or backstop construction

## *F. FUND TERMS: CLOSING THE FUND AND MAKING INVESTMENTS*

financing or letters of credit during the development phase of a project before capital is called from Limited Partners or to purchase an asset outright pending permanent take-out financing.

7. ***Recycling of Capital Commitments.*** Some Funds are permitted to “recycle” capital that is returned to Partners during the investment period, typically by adding the amount of recyclable capital to an investor’s remaining (callable) capital commitment. Some Fund Agreements permit full recycling of proceeds during the investment period, while others may not permit recycling at all, or may permit only the recycling of capital contributions in respect of investments and/or capital contributions used for expenses. Investors may also seek to negotiate timing or percentage limitations on recycling, or to allow recycling only if proceeds are in respect of a “quick flip” of an investment.
8. ***Investment Limitations.*** The Fund Agreement will spell out (in varying degrees of detail) not only what the Fund is permitted to do, but also what the Fund is *not* permitted to do. A Fund Agreement might provide that certain (or all) of the stated investment restrictions are waivable by the Limited Partners or the Advisory Committee. Typical limitations will, of course, vary depending upon the Fund’s investment strategy, but may include the following:
  - a. ***Diversification and “single issuer” limitations.*** A limit of 20% or 25% of total commitments in one portfolio company is common in buyout Funds. Lower percentages are common in venture capital Funds. In some cases, a higher threshold may be used for “bridge” investments and/or if portfolio company guarantees are to be included in the cap.

**F. FUND TERMS: CLOSING THE FUND AND MAKING INVESTMENTS**

- b. *Geographical limitations.* Some Funds have a global strategy, while others limit investments to a certain region or country.
  - c. *Industry limitations.* Some Funds restrict, or provide for only a small “basket” for, investments outside of the Fund’s primary industry or strategy.
  - d. *Pacing.* Some Funds have limitations on the amount of capital that can be drawn down in any given year or other time period.
  - e. *Hostile acquisitions.* Hostile acquisitions are most frequently defined as transactions opposed by the target’s board of directors.
  - f. *Publicly-traded securities.* Some Fund Agreements may exclude going-private transactions, PIPEs and similar transactions from this limitation.
  - g. *Derivatives and similar products.* Note Commodity Exchange Act requirements (see Topic L.4, below) in addition to investor concerns.
  - h. *Limitations on investments in other Funds.* Some investors may be concerned about pyramiding of fees and Carried Interest, and/or the General Partner ceding investment control to another sponsor.
  - i. *Other restrictions (e.g., real estate, oil and gas).*
9. ***Excused/Excluded Investors.*** Many Fund Agreements permit investors to be excused from funding capital calls to make

## *F. FUND TERMS: CLOSING THE FUND AND MAKING INVESTMENTS*

portfolio investments if such funding would violate applicable law or ethical investor policies (e.g., tobacco, alcohol or firearms). See also Topics I.2.d.ii and I.3.a, below. In some cases, a General Partner may exclude a particular investor from participating in an investment if that participation would have a material adverse effect on the Fund or the investment.

- 10. *Defaulting Limited Partners.*** Since Funds draw down capital over time, in installments, it is important to address the possibility of a Limited Partner failing to fund a drawdown. Fund Agreements generally include a number of potential actions and remedies in such cases, including total or partial forfeiture of the defaulting Limited Partner's interest in the Fund.
- 11. *Withdrawal.*** In contrast to hedge funds, which typically allow for periodic redemptions of interests, Funds generally do not permit withdrawals by Limited Partners except in very limited circumstances (such as, for example, to avoid "plan assets" issues under ERISA or to avoid violations of law). Some governmental plans also request that they be permitted to withdraw from the Fund (or be excused from making further investments) if there is a violation of their placement agent policy. Withdrawals from a Fund can be a burden on the valuation process, liquidity and non-withdrawing partners. Often, it is far preferable (if feasible) for a Limited Partner to assign its interest in the Fund rather than withdraw.
- 12. *Amendments.*** Majority in interest is typical for general amendments to a Fund Agreement. Certain provisions (such as those pertaining to the core economic deal) will often require a supermajority to amend. The vote of a particular class of investors may be required to amend provisions specific to that

*F.FUND TERMS: CLOSING THE FUND AND MAKING  
INVESTMENTS*

class (such as ERISA provisions). Finally, the General Partner may have a unilateral right to amend the Fund Agreement in limited circumstances (such as to make ministerial or technical changes, or to implement amendments required by law).

## **G. FUND TERMS: CONFLICTS OF INTEREST AND RELATED ISSUES**

1. ***Conflicts of Interest.*** Conflicts of interest provisions, including deal flow allocation, expense sharing, co-investment and affiliate transactions, are receiving close scrutiny from investors and, increasingly, from regulators. Issues include:
  - a. *Formation of successor funds.* Many investors will seek to limit the ability of the sponsor (and/or the Investment Professionals) to form other funds or accounts during the investment period of the Fund, particularly funds or accounts with an investment strategy that is substantially similar to that of the Fund.
  - b. *Deal flow allocation.* Many investors will seek explicit disclosure of how investment opportunities will be allocated between the Fund and other funds or separately managed accounts sponsored by the Manager.
    - (i) Some investors may request that, during the Fund's investment period, the Fund have a right of first refusal on investment opportunities within its strategy. Where a sponsor has multiple Funds with overlapping investment strategies, or where a separately managed account or successor fund has been formed, investments might be allocated on a *pro rata* basis, or in the General Partner's discretion.

## G. FUND TERMS: CONFLICTS OF INTEREST AND RELATED ISSUES

- (ii) Investments by other Funds, separately managed accounts or other clients sponsored or advised by the Manager may create a different set of conflicts of interests if the strategies of different Funds could result in the investment by those Funds in different classes of an issuer's securities.
  - (iii) If the Manager or the General Partner is an RIA, it should develop compliance policies and procedures setting forth its investment allocation policy and should disclose this policy to investors.
- c. *Co-investments by the Manager, its affiliates or its employees.* In order to alleviate potential investor concerns over "cherry-picking," co-investments by Manager affiliates are often permitted only on a lock-step basis, or subject to a specified annual (or overall) cap.
  - (i) Some sponsors may restrict key individual personnel from making investments in companies that are suitable for investment by the Fund (or limit such investments to pre-existing investments).
  - (ii) A Manager or a General Partner that is a RIA is required to adopt a Code of Ethics that, among other things, will require the pre-clearance and disclosure of certain personal securities transactions. Note that during the due diligence process of evaluating potential investments, employees of the sponsor may have access to material non-public information, which they must not use for personal gain.

## G. FUND TERMS: CONFLICTS OF INTEREST AND RELATED ISSUES

### d. *Affiliate transactions.*

(i) Cross transactions between the Fund and other funds, separately managed accounts or clients sponsored or advised by the Manager and its affiliates can raise a number of conflicts of interest, including with respect to disclosure, valuations and receipt of transaction fees. Often, the consent of the Advisory Committee may be sought prior to such transactions.

(ii) Occasionally, a sponsor may want to warehouse deals or commit pipeline deals to the Fund during the fundraising process. The Fund Agreement might contain specific provisions regarding how such warehoused deals are to be transferred to the Fund.

(iii) The Fund and its portfolio companies may engage the Manager, its affiliates or its employees to provide certain services (e.g., transaction services, administrative services, asset management services, consulting services, etc.). Some investors may request that such transactions be on an arms' length basis and/or be disclosed periodically to the Advisory Committee.

## 2. ***Co-investment Opportunities for Limited Partners?***

- a. *Generally.* Many Limited Partners are interested in participating in co-investment opportunities, to the extent available. Some General Partners offer co-investment opportunities only at the General Partner's discretion; other Fund Agreements provide that opportunities will be offered to all Limited Partners on a *pro rata* basis, offered only to investors that committed capital at an early closing, or

## G. FUND TERMS: CONFLICTS OF INTEREST AND RELATED ISSUES

offered only to investors that have made a capital commitment above a certain threshold.

- b. *Co-investment Funds.* Some co-investments may be made directly by the co-investor; in other cases the sponsor may create a special co-investment fund to pool the commitments of the participating co-investors.
- c. *Other considerations.* Careful disclosure should be made with respect to how the General Partner intends to allocate co-investment opportunities, as well as how expenses (in particular broken deal expenses) will be shared among the Fund and any co-investors. Other considerations in connection with co-investments may include coordination of timing of exits by the Fund and co-investors, and whether a Management Fee or Carried Interest will be charged.

### 3. ***Indemnification; Exculpation; Standard of Care.***

Indemnification of the General Partner, the Manager and their affiliates by the Fund, subject to certain limited exceptions, is nearly universal.

- a. *Exceptions.* The scope of any exceptions to indemnification is a point of negotiation, but typically, no indemnification is available if liability is due to fraud, gross negligence, willful malfeasance or reckless disregard of duties. Other potential carveouts to indemnification may include material violation of the Fund Agreement (which may be subject to a cure right), a conviction of a felony or a willful violation of law having a material adverse effect on the Fund.
  - (i) Gross negligence under Delaware law, in the Fund context, implies a level of care similar to the business

## G. FUND TERMS: CONFLICTS OF INTEREST AND RELATED ISSUES

judgment rule applicable to a corporate board of directors' decisions. For U.S. funds, "simple" negligence suggests a standard more analogous to the prudent investor standard applicable to true fiduciaries, and is not market. Many non-U.S. jurisdictions, however, do not have a concept of "gross negligence" *per se*; in such cases, one solution may be to define "gross negligence" by reference to the Delaware law standard.

(ii) The exceptions to indemnification in the case of Advisory Committee members are often narrower than the exceptions for the General Partner, Manager and their affiliates (*e.g.*, exceptions may be limited only to fraud or gross negligence).

(iii) Often, indemnification is also not available for claims relating to internal disputes within the Manager.

- b. *All-Partner Givebacks*. The General Partner is generally permitted to "claw back" from all of the partners amounts distributed to them to the extent needed to satisfy the Fund's indemnification obligations. This type of provision is often referred to as an "LP clawback" or "all-partner giveback" to contrast it with the General Partner clawback that protects against overdistributions of Carried Interest (discussed at Topic D.6, above). The intention of the all-partner giveback is to ensure that the fundamental economic deal (*e.g.*, the 80/20 deal) on sharing of gains is protected; however, returnable distributions under an all-partner giveback provision are often subject to limitations as to timing and/or amount.

4. **Advisory Committee.** Most Funds have an Advisory Committee comprising representatives of certain Limited

## G. FUND TERMS: CONFLICTS OF INTEREST AND RELATED ISSUES

Partners (often, Limited Partners with significant commitments to the Fund). Unlike a corporation's board of directors, an Advisory Committee is a contractually created body, and its members generally do not owe fiduciary duties to the Fund or the Limited Partners. Common functions of Advisory Committees include approving conflicts of interest (including providing consent for transactions that require the Fund's consent under the Advisers Act, including principal transactions and "assignments"), passing on matters waivable by the Advisory Committee under the Fund Agreement (such as investment limitations) and, in certain circumstances, approving (or objecting to) the General Partner's valuations or valuation methodology.

- a. *Limited liability.* An Advisory Committee's functions should be limited to ensure that Limited Partners that have Advisory Committee representation do not lose their limited liability.
- b. *Indemnification.* Members of Advisory Committees are typically indemnified against any liability arising from their service. See Topic G.3.a.ii, above.

### 5. **Valuations.**

- a. *GAAP vs. tax-basis accounting.* U.S. GAAP for Funds requires portfolio securities to be marked to market. Tax accounting generally requires investments to be carried at cost. Many investors insist that the Fund prepare financial statements according to U.S. GAAP or, for non-U.S. Funds, the International Financial Reporting Standards.
- b. *Responsibility.* Many Funds require periodic valuations because their distribution provisions or Management Fee

## G. FUND TERMS: CONFLICTS OF INTEREST AND RELATED ISSUES

calculations take account of investments that have been written-down, or the distribution provisions include a value “cushion.” Valuations may also be required in connection with distributions in kind or upon the early withdrawal of a Limited Partner (see Topic F.11, above).

- c. *Third-party valuations.* Some investors request Advisory Committee approval of (or objection right with respect to) valuations or third-party valuations, particularly in connection with distributions in kind of non-marketable securities.
- d. *Regulatory concerns.* Valuation issues (particularly in respect of disclosure of the valuation process) are important from an AIFMD perspective. See Topic L.1.d, below.

## **H. FUND TERMS: LP REMEDIES AND OTHER COMMON PROVISIONS**

Unlike hedge funds, which typically allow Limited Partners to redeem their interests periodically, Funds generally do not permit withdrawals by Limited Partners except in very limited circumstances. Thus, many investors will seek to ensure that the Fund Agreement includes protections allowing the Limited Partners to suspend the Fund's investment period (or terminate the Fund) early in certain circumstances. A Fund Agreement's "basket" of Limited Partner rights and remedies may include some (or many) of the following:

### **1. *For-Cause Termination.***

- a. *Key person events.* A "key person" provision is a mechanic allowing for suspension or termination of the Fund's investment period (or term) if specified key individuals leave the Manager (or cease to devote a specified portion of their time to the Fund or the Manager).
  - (i) The details of the key person trigger (or triggers), and in particular whether the "key persons" are the top principals of the sponsor, a larger group of Investment Professionals, or some combination of the foregoing, are often highly negotiated. Another highly negotiated point is the result of a "key person" event, *i.e.*, whether the event results in an automatic suspension, or whether a vote of the Limited Partners is required.
  - (ii) Many Fund Agreements include a right to designate qualified replacement Investment Professionals with Advisory Committee or Limited Partner approval, and/or the right of Limited Partners to vote to terminate the suspension mode once triggered.

## H. FUND TERMS: LP REMEDIES AND OTHER COMMON PROVISIONS

### b. *Other for-cause termination events.*

(i) Some Fund Agreements give the Limited Partners the right to terminate the Fund's investment period (or term) if there is a change of control of the Manager, or if the General Partner violates the applicable standard of care, breaches the Fund Agreement or engages in other "disabling" conduct. Less commonly, Limited Partners may have the right to terminate if certain fundraising targets are not reached.

(ii) Sometimes the General Partner is given the right to cause an early termination of the Fund's investment period (or term) if adverse regulatory or tax changes substantially impair its ability to carry out the Fund's investment objective.

## 2. **No-Fault Divorce.**

- a. *No-fault termination.* A "no-fault" divorce is the right of Limited Partners to terminate the investment period or liquidate the Fund at any time, with or without cause. No-fault termination rights typically require investor votes spanning 75-90% interest. Note that it is important to have the percentage vote large enough to avoid a minority of investors forcing a decision on the majority, or to give a single large investor a unilateral termination right.
- b. *Termination by the General Partner.* Some Fund Agreements also give the General Partner the right to terminate the investment period or liquidate the Fund at any time in its sole discretion; however, this right is somewhat uncommon, because Limited Partners generally expect a

## H. FUND TERMS: LP REMEDIES AND OTHER COMMON PROVISIONS

long-term commitment (and typically do not want an early liquidation of the Fund that could result in distributions in kind).

- c. *What happens to the Management Fee?* In connection with an early termination of the investment period (either with or without cause), the Management Fee generally steps down to its post-investment period base. See Topic E.1, above.

3. ***Removal of the General Partner.*** As an alternative to (or in some cases, in addition to) a for-cause termination right, some Fund Agreements give the Limited Partners the right to remove the General Partner and replace it with another sponsor's General Partner if the General Partner violates the applicable standard of care, breaches the Fund Agreement or engages in other "disabling" conduct. In some cases (but subject to certain regulatory and/or accounting considerations), the General Partner may also be removed on a no-fault basis.

- a. *Voting.* The "cause" triggers for a GP removal, as well as the voting thresholds required to remove, are often heavily negotiated.
- b. *What happens to the Carried Interest?* Often, the Fund interest of the removed General Partner is converted into a special Limited Partner interest; in this way, the removed General Partner remains entitled to retain Carried Interest with respect to investments made prior to removal (in some cases, subject to a "haircut"). In other Funds, the removed General Partner is bought out, with its interest valued to take into account the agreed Carried Interest entitlement.

## *H. FUND TERMS: LP REMEDIES AND OTHER COMMON PROVISIONS*

- c. *What happens to the Management Fee?* Generally, the Management Fee will terminate upon a removal. Note that some Funds (especially in Europe) provide for a Management Fee “tail” as severance, particularly in the case of a no-fault removal.

## I. COMMON PRIVATE EQUITY FUND INVESTORS

Below is a discussion of the major categories of investors in Funds and some of the key legal and tax considerations and business concerns specific to those types of investors. For a further discussion of regulatory and tax concerns of investors generally, see Topics J and L, below.

1. ***U.S. Corporate Pension Plans.*** U.S. corporate pension plans (i.e., private pension plans subject to ERISA, as opposed to governmental plans) have a number of unique issues, including the following:
  - a. *Exemption from “Plan Assets” status.* Most Funds operate under an exemption from ERISA, which avoids compliance with burdensome ERISA regulatory requirements. These exemptions include:
    - (i) *“25% exception.”* One exemption under ERISA is for Funds in which benefit plan investors as a group constitute less than 25% of each class of interests in the Fund (excluding for these purposes any investment held by the General Partner, the Manager and their affiliates). For this purpose, “benefit plan investors” include U.S. private pension plans or other investors subject to ERISA or section 4975 of the Code (including funds of funds that hold plan assets), but do not include U.S. governmental plans or non-U.S. corporate plans.
    - (ii) *VCOC exemption.* Another exemption under ERISA is for Funds that qualify as “venture capital operating companies.” The DOL regulations on this subject are complex, but in general they require that the Fund obtain “management rights” with respect to at least 50% or more

## I. COMMON PRIVATE EQUITY FUND INVESTORS

of its portfolio investments (based on cost) and exercise those rights in the ordinary course of its business with respect to at least one portfolio company at the times specified in the regulations. In order to qualify, the Fund *must* obtain management rights with respect to its first long-term investment.

(A) Generally, “management rights” are direct contractual rights between the Fund and the portfolio company that provide for the Fund to “participate substantially in, or influence substantially the conduct of the management” of the portfolio company, which may include contractual rights to appoint one or more directors, to consult with management, to receive financial statements, to inspect books and records, etc.

(iii) *REOC Exemption*. The REOC exemption is similar to the VCOC exemption described above, and is sometimes used by real estate Funds.

(iv) *Registering the Fund as an RIC*. See Topic L.2.f, below.

- b. *Operating a Fund as “Plan Assets” under ERISA*. The consequences of plan asset status for a Fund are significant. In effect, the Fund’s investments (and not just the plan investor’s investment in the Fund) are treated as the assets of the plan investor, thereby subjecting the Fund and its Manager and the General Partner to extensive DOL regulations and compliance requirements concerning ERISA-regulated plans, including with respect to (i) constraints on incentive fee arrangements (which may impact payments of Carried Interest), (ii) fiduciary duties, (iii) prohibited transactions, (iv) retention of transaction fees, (v) other fee arrangements, including placement fees

## I. COMMON PRIVATE EQUITY FUND INVESTORS

and other fees payable to any affiliated service providers, (vi) sponsor co-investments and (vii) ERISA's fidelity and bonding requirements.

- c. *Unrelated business taxable income.* Many U.S. corporate pension plans (as well as other U.S. tax-exempt entities such as charities and colleges and universities) are sensitive to the receipt of "unrelated business taxable income" or UBTI. For some plan investors, avoiding UBTI is of great concern; for other tax-exempt investors, it is simply one factor in considering whether (or how) to invest in a Fund. See also Topic J.2, below.

2. **U.S. Governmental Plans.** If governmental plans (including U.S. private pension plans sponsored by states or municipalities) invest in a Fund, the issues to be considered include the following:

- a. *ERISA.* Governmental plans and non-U.S. corporate plans are not directly subject to ERISA; however, a number of states have legislation or regulations that is similar to ERISA or that make ERISA provisions applicable to state plans. In addition, some government plans may demand as a contractual matter to be treated as plans subject to ERISA.
- b. *Placement fees and political contributions.* Sponsors of Funds with governmental plan investors are often subject to gift policies, as well as anti-"pay-to-play" restrictions under the Advisers Act and applicable state law. These restrictions include limitations on political contributions and other political fundraising activities by the sponsor, its affiliates and certain of its employees, as well as limitations on the use of placement agents to solicit governmental plan investors. Some placement agent policies require the

## I. COMMON PRIVATE EQUITY FUND INVESTORS

ability of the governmental plan investor to withdraw from the Fund in certain circumstances. In addition, a number of governmental plans require completion of detailed disclosures regarding payment of placement fees and political contributions.

- c. *FOIA.* Many governmental pension plans are subject to “freedom of information” (“FOIA”) or “sunshine” laws, which may require that they disclose confidential information regarding the Fund (publicly or pursuant to request under an applicable FOIA statute).
- d. *Registration as a municipal advisor.* An ERA should confirm that the capital being committed to the Fund will not include the proceeds of municipal securities in order to assure that the ERA will not be required to register with the SEC as a “municipal advisor.” Registration as a municipal advisor would impose certain fiduciary standards on the Manager. Fund sponsors that are RIAs are generally exempt from registration as a municipal advisor.
- e. *Other common concerns.*
  - (i) A number of governmental plans have questioned whether they are authorized under applicable law to make indemnity payments. Certain governmental plans are not permitted to directly indemnify (but they can honor their obligation to contribute capital to the Fund so it can honor its indemnification obligations). See Topic G.3, above. In addition, certain governmental plans and instrumentalities refuse to waive sovereign immunity.
  - (ii) Many governmental plans have ethical investor policy restrictions. The effect of these constraints (such as

## I. COMMON PRIVATE EQUITY FUND INVESTORS

limitations on investing in businesses producing alcohol, tobacco products or firearms) can be mitigated by excusing the relevant Limited Partners from participation in the investments in question.

3. ***Sovereign Wealth Funds.*** Investment funds owned and managed by government agencies on behalf of a nation or sovereign state, known as “SWFs,” have in recent years become an increasingly large source of capital for Funds. In many cases SWFs seek to negotiate their own separately managed account, but they also invest directly in pooled multi-investor Funds. SWFs often make very large commitments to Funds, and in return often seek to negotiate fee breaks and/or an increased level of involvement with the Fund’s investment team (such as periodic meetings and increased reporting rights).
  - a. *Investment restrictions.* Like many U.S. governmental pension plans, some SWFs, in particular those from Middle Eastern and Asian states, are prohibited from making certain types of investments (such as investments in businesses producing alcohol, tobacco products or firearms).
  - b. *Confidentiality.* In addition, like many U.S. governmental pension plans, many SWFs are subject to “sunshine” laws, which may require that they disclose confidential information regarding the Fund (publicly or pursuant to request under an applicable statute).
  - c. *Disclosure.* Some SWFs are sensitive to disclosure of their identities on Schedule 13D, Hart-Scott-Rodino report forms, other similar filings and, in some cases, the Fund’s tax return. In addition, anti-money laundering rules may require additional disclosure. “Use of name” and other

## I. COMMON PRIVATE EQUITY FUND INVESTORS

confidentiality provisions for SWFs are often heavily negotiated.

- d. *Tax considerations.* See Topic J.4, below, for an overview of special tax considerations applicable to non-U.S. governments subject to special exemptions under section 892 of the Code.

4. ***Life Insurance Companies.*** U.S. life insurers can make an investment in a Fund as either a general account investment or a separate account investment. General account assets typically support guaranteed insurance policy obligations of the insurer, while separate account assets generally support variable insurance policy obligations of the insurer. Note that some investors (e.g., certain German insurance companies) may want to structure investments (or the Fund's investment policies) to allow them to treat their investment in the Fund as falling within certain appropriate regulatory "baskets."

5. ***U.S. Insured Depository Institutions, Bank Holding Companies, Non-U.S. Banks with U.S. Banking Presence and their Affiliates.***

- a. *General.* U.S. insured depository institutions, non-U.S. banks with a U.S. banking presence and any affiliate thereof (each, a "banking entity") are generally prohibited from sponsoring or investing in Funds under section 13 of the BHC Act (also known as the "Volcker Rule"), subject to certain exemptions.
- b. *Non-U.S. banking entities.* A non-U.S. banking entity may invest in certain "covered" funds if, among other requirements, (i) the banking entity satisfies certain criteria to ensure that its business is principally located outside of

## I. COMMON PRIVATE EQUITY FUND INVESTORS

the United States, (ii) the banking entity satisfies certain “risk” criteria to ensure that the decision making, the accounting treatment and the financing of the investment is outside of the United States and (iii) the ownership interests of the fund are not sold in an offering that targets U.S. residents. In addition to this so-called “SOTUS Fund” exemption, a non-U.S. banking entity may invest in foreign “non-covered funds” (i.e., funds that are domiciled outside of the United States and that have not made any offering of securities into the United States).

- c. *Bank holding companies.* A BHC and its affiliates that invest in a Fund are subject to restrictions under the BHC Act (in addition to restrictions under the Volcker Rule discussed above). A BHC that has not elected to be regulated as a financial holding company is generally restricted from engaging in non-banking activities and from acquiring or controlling “voting securities” or assets of a non-banking company, subject to certain exemptions. To accommodate ownership limitations applicable to BHC investors, a Fund Agreement may provide that BHC investors hold non-voting equity interests as necessary.

- 6. ***Non-U.S. Regulated Entities.*** The regulatory position of non-U.S. investors may impact their investment in Funds. For example, the European Solvency II is due to be implemented in the European Union in January 2016. Following implementation, the rules determining the risk weightings that European insurers must apply to the different categories of assets they hold (including interests in Funds), for the purpose of calculating their prudential capital, will apply. Further, as of the date of printing, a number of changes in German insurance and pension fund regulation have been proposed and could

## I. COMMON PRIVATE EQUITY FUND INVESTORS

materially affect the capacity of insurers and pension funds to invest in Funds managed by non-European Managers.

7. **Funds of Funds.** A “fund of funds” investor in a Fund may have particular concerns with respect to the ability to disclose Fund information to its investors. In addition, depending on the makeup and needs of the investors in the fund of funds, a fund of funds investor could have any number of the concerns and requirements described above.
8. **Private Foundations and Endowments.** These types of investors have special tax concerns in addition to concerns about UBTI (discussed at Topic J.2, below). For example, a U.S. “private foundation” may become liable for an excise tax if its holdings in a “business enterprise” – measured by aggregating its interest and the interests of its “disqualified persons” (such as officers, trustees, “substantial contributors” and their families and affiliates) – exceeds a specified threshold.
9. **Individual Investors and Family Offices.** High net worth individuals and family offices are also frequent investors in Funds.
  - a. *High net worth feeders.* Some large Funds restrict investors to those making large, multi-million investments. In order to gain access to such Funds, some high net worth individuals and family offices may invest in a “feeder fund” formed by a bank or other financial institution to aggregate the commitments of smaller investors. The feeder fund then invests as a Limited Partner of a Fund. Careful consideration must be given to regulatory restrictions applicable to such “high net worth feeders.”

## I. COMMON PRIVATE EQUITY FUND INVESTORS

- b. *Personal holding companies.* If even a single individual invests directly in a Fund, potential “personal holding company” tax issues could arise in relation to investments in U.S. corporations. One solution is to have the individual invest in the Fund indirectly through an entity that is not treated as an individual for tax purposes such as a partnership, a limited liability company with at least two members or a trust (other than a grantor trust). Another solution is to obtain a covenant from the individual to the effect that he or she will transfer his or her interest in the Fund, at the General Partner’s request, if the Fund acquires an interest in a personal holding company.
- c. *Privacy and identity theft issues.* Funds with natural persons as investors will face issues under certain laws and regulations designed to protect investor privacy and detect, prevent and mitigate identity theft. See Topic L.8, below.
- d. *Other regulatory matters.* There may be regulatory constraints in certain jurisdictions on the offering of interests in a Fund to individuals and family offices (e.g., this is the position in a number of European jurisdictions following the implementation of AIFMD).

## **J. INVESTOR LEVEL TAX ISSUES**

### **1. *Taxation of U.S. Taxable Investors.***

- a. *Flow-through tax treatment.* In a Fund that is treated as a partnership for U.S. federal income tax purposes, each investor subject to U.S. tax will be required to take into account its distributive share of all items of the Fund's income, gain, loss, deduction and credit, whether or not distributed to such investor.
- b. *Restrictions on deductibility of expenses for individual and other non-corporate investors.* It is generally anticipated that a Fund's expenses (e.g., the Management Fee) will be investment expenses treated as miscellaneous itemized deductions rather than trade or business expenses for U.S. tax purposes, with the result that any individual that is a partner (directly or through a partnership or other pass-through entity) will be subject to limitations on the deductibility of his or her *pro rata* share of such expenses.
- c. *Syndication costs.* Syndication costs (e.g., placement fees) are non-deductible expenses.
- d. *Phantom income, etc.* Investments in certain types of securities such as original issue discount instruments and preferred stock with redemption or repayment premiums could result in partners realizing income for U.S. tax purposes even though the Fund realizes no current cash income.
- e. *PFICs and CFCs.* Investments in non-U.S. corporations treated as passive foreign investment companies ("PFICs")

## J. INVESTOR LEVEL TAX ISSUES

or controlled foreign corporations (“CFCs”) are subject to special U.S. tax rules.

- f. *State and local taxes.* Investors may be subject to state and local taxation on their income from the Fund in jurisdictions in which the Fund and its portfolio companies are located or do business, especially in the case of portfolio companies treated as partnerships for U.S. federal income tax purposes.
- g. *Non-U.S. taxes.* The Fund (and, perhaps, the partners directly) may be subject to withholding and other taxes (and reporting requirements) imposed by countries in which the Fund makes investments. Tax conventions between such countries and the United States may reduce or eliminate certain such taxes, and taxable partners may be entitled to claim U.S. foreign tax credits or deductions with respect to such taxes, subject to applicable limitations.

### 2. ***Taxation of U.S. Tax-Exempt Investors.***

- a. *UBTI.* Organizations that are generally exempt from U.S. federal income tax under the Code such as corporate pension plans, charities and universities are nonetheless subject to U.S. federal income tax on their “unrelated business taxable income,” or UBTI. UBTI is defined as the gross income derived by the organization from any unrelated trade or business, less the deductions directly connected with carrying on the trade or business, both computed with certain modifications and subject to certain exclusions.
  - (i) *Sources of UBTI.* In Funds, the principal areas of concern are investments in operating partnerships,

unrelated debt-financed income, fees and certain insurance income. Special UBTI rules apply to real estate funds.

(A) *Operating partnerships.* If a Fund invests in a portfolio company that is a flow-through entity (a partnership, an LLC or other entity treated as a partnership for U.S. federal income tax purposes) that is engaged in a trade or business (whether within or without the United States), a U.S. tax-exempt partner's share of the entity's income would (subject to certain exceptions) be UBTI. In addition, a portion of the gain from the sale of the Fund's interest in the entity would be UBTI based on the amount of the entity's debt.

(B) *Unrelated debt-financed income.* UBTI includes a percentage of the income derived from property as to which there is "acquisition indebtedness" during an applicable period. Accordingly, if a Fund borrows money to make an investment, a portion of the income from the investment (both current income and any gain on the disposition of the investment) may be treated as UBTI for U.S. tax-exempt investors.

(C) *Fees.* If a Fund were to regularly render services for fees, it would likely be engaged in a trade or business and the fees would likely be UBTI. Typically, a Fund does not perform any services; it merely invests. It is possible, however, that reductions in the Management Fee resulting from transaction, monitoring, directors' and similar fees may be treated as UBTI to U.S. tax-exempt investors.

## J. INVESTOR LEVEL TAX ISSUES

(D) *Certain insurance income.* Certain insurance income received from or attributable to CFCs is includable as UBTI.

(ii) *State and local government pension plans.* In our experience, most state and local government pension plans take the position that their income is exempt from U.S. federal income tax as income derived from an essential governmental function accruing to a state or a political subdivision or otherwise as a result of sovereign immunity. In that case, they would not be subject to UBTI. However, there is no clear authority that so holds.

(iii) *Rate of tax.* Tax-exempt corporations are subject to tax on UBTI at regular corporate income tax rates. Trusts such as pension plans are subject to tax on UBTI at rates applicable to trusts.

- b. *Private foundations.* In addition to the tax on UBTI, private foundations are subject to a number of complex excise tax provisions, a few of which could conceivably be triggered by an investment in a Fund.

### 3. ***Taxation of Non-U.S. Investors Investing in the United States.***

- a. *U.S. trade or business income.* Non-U.S. persons are subject to U.S. federal income tax on their “ECI,” defined as income effectively connected with the conduct of a trade or business within the United States. A non-U.S. person that is a partner in a partnership is considered as being engaged in a trade or business within the United States if the partnership is so engaged.

(i) *Sources of ECI.* In Funds, the principal areas of concern are investments in operating partnerships, investments in “United States real property interests” and fees.

(A) *Operating partnerships.* If a Fund invests in a flow-through entity (a partnership, an LLC or a non-U.S. entity treated as a partnership for U.S. tax purposes) that is engaged in a trade or business within the United States, a non-U.S. partner’s share of the Fund’s income from the entity would be ECI. In addition, the IRS takes the position that gain from the sale of the Fund’s interest in the entity, and the applicable portion of any gain realized by the investor upon the sale of its interest in the Fund, would be ECI.

(B) *United States real property interests.* Gain or loss realized by a non-U.S. person from the disposition of a “United States real property interest” is generally taken into account as if it were effectively connected with a trade or business within the United States. “United States real property interests” include not only direct interests in real property but interests in certain U.S. corporations (“USRPHCs”) where the value of the corporation’s U.S. real property interests is at least 50% of the value of the corporation’s business assets.

Because of these rules, Funds investing in U.S. real estate that wish to market to non-U.S. investors will generally engage in structuring that is specifically designed to mitigate U.S. tax and filing requirements for such investors. For example, a U.S. real estate fund may structure its investments through “blocker” corporations that can avoid U.S. tax filing obligations for non-U.S. investors, and can also reduce the overall

## J. INVESTOR LEVEL TAX ISSUES

tax burden by eliminating branch profits taxes (discussed below in (v)). Sometimes, these blockers are capitalized partially with shareholder loans from the Fund, with the result that the interest on the loans reduces the amount of income taxable at the blocker level. Funds may also utilize REIT structures to mitigate the impact of these rules on non-U.S. investors.

(C) *Fees.* Typically, a Fund does not perform any services; it merely invests. It is possible, however, that reductions in the Management Fee resulting from transaction, monitoring, directors' and similar fees may be treated as ECI to non-U.S. investors.

(ii) *United States real property interests.* Under FIRPTA, gain or loss realized by a non-U.S. person from the disposition of a "United States real property interest" is generally taken into account as if it were effectively connected with a trade or business of the non-U.S. person within the United States. While the conventional wisdom is that Funds investing in U.S. real estate are not suitable for non-U.S. investors, under certain circumstances it may be possible to avoid FIRPTA treatment by holding suitable real property investments through a privately offered REIT, more than half of which is directly and indirectly owned by U.S. persons. Sale of shares in such a "domestically controlled" REIT will not be subject to tax under FIRPTA.

(iii) *Permanent establishment.* Many U.S. income tax treaties provide that the United States may not tax the income of a resident of the other treaty country unless the income is attributable to a permanent establishment of the

resident in the United States. The office of a partnership in the United States would likely be considered a permanent establishment of the non-U.S. partner for this purpose.

(iv) *Filing requirements.* A non-U.S. person engaged in a U.S. trade or business within the taxable year is required to file a U.S. federal income tax return, regardless of whether it has any ECI, has any income from sources within the United States or its income is exempt from income tax by reason of the Code or a treaty. Many non-U.S. investors that do not already file tax returns are reluctant to become subject to U.S. tax filing obligations as a result of their investment in the Fund.

(v) *Rate of tax.* A non-U.S. person is subject to U.S. federal income tax on its ECI at the regular graduated rates applicable to U.S. individuals or corporations. In addition, a non-U.S. corporation may be subject to the “branch profits tax” at the rate of 30% on its earnings and profits attributable to income effectively connected with the conduct of a trade or business within the United States and not reinvested in the United States. However, gain from the disposition of a USRPHC is not subject to the branch profits tax.

(vi) *Withholding.* A U.S. Fund is generally required to withhold tax at the highest applicable marginal rate on the ECI allocable to each non-U.S. partner. The amount withheld is available as a credit against the tax shown on the partner’s return.

- b. *Interest, dividends and certain other income.* The United States imposes a 30% tax on the gross amount of interest, dividends, rents, royalties and certain other income from

## J. INVESTOR LEVEL TAX ISSUES

U.S. sources paid to non-U.S. persons, subject to exemption or reduction by statute or treaty. A U.S. Fund is generally required to withhold tax on these items of income includable in the distributable share (including amounts that are not actually distributed) of a non-U.S. partner.

### 4. ***Taxation of Non-U.S. Governments.***

- a. *Section 892 exemption.* Non-U.S. governments, although generally subject to the same rules as any non-U.S. investor, enjoy a special exemption under section 892 of the Code, under which income received from investments in the United States in stocks (including income derived from a USRPHC) and bonds and certain other income is generally exempt from tax.
- b. *Commercial activities.* The exemption applies to both an integral part of a non-U.S. sovereign and controlled entities wholly owned by a non-U.S. sovereign. However, the exemption does not apply to income derived by or from the conduct of a “commercial activity” or derived from a “controlled commercial entity,” defined as an entity that is 50% or more controlled by the government and that is engaged in commercial activities (whether inside or outside the United States). Accordingly, if an entity wholly owned by a non-U.S. government engages in any commercial activities within or without the United States, it loses its exemption for all of its income.
- c. *Proposed regulations.* Under proposed U.S. Treasury regulations, an entity that is not otherwise engaged in commercial activity will generally not be considered to be so engaged solely because it holds an interest as a limited partner (with no participation right) in a Fund that is itself

engaged in commercial activities. Nonetheless, many non-U.S. governments elect to invest in Funds (or their operating partnership investments) through a “blocker corporation” to mitigate any risk of “tainting” and being treated as engaged in commercial activities. See Topic J.5, below.

5. **Structuring Mechanisms.** In recent years, many Funds have abandoned the traditional approach to protecting investors from UBTI, ECI and sometimes “commercial activities” by simply covenanting to avoid such income. Instead, Funds are moving more and more towards an “elective blocker” approach, whereby those investors desiring to avoid UBTI or ECI can choose to invest in a Fund (or in the investments that produce such income) through an entity taxed as a corporation for U.S. tax purposes, often called a “blocker” or “blocker corporation.” Other types of investors typically invest in the Fund or in the “offending” investments directly. Depending on the structure, blocker corporations can be used to shield U.S. tax-exempt investors from UBTI from both operating partnerships and debt-financed income, to shield non-U.S. investors from ECI (and the resulting filing requirements) from both operating partnerships and USRPHCs (an investment that produces either UBTI or ECI (or both)) and to shield non-U.S. governments from commercial activities.
  - a. *Blocker corporations.* We can provide clients with detailed guidance as to the various ways the blocker corporation can be structured.
  - b. *Opt-out provisions.* Some Funds allow an investor not to participate economically in a specific portfolio investment under certain circumstances.

## K. STRUCTURING THE MANAGER AND THE GENERAL PARTNER

1. **General.** The Manager is typically a separate entity from the General Partner, although it is usually affiliated with the General Partner. Separation allows for continuity of the management entity from fund to fund (while still having a different special purpose General Partner for each fund) as well as the buildup of goodwill, and may simplify estate planning for the Investment Professionals.

Optimizing the structure of the Manager and the General Partner may involve significant effort and expense. Issues to be considered include the following:

- a. Compensating individual Investment Professionals and other employees.
  - b. U.S. federal, state and local taxation and, where personnel are located outside the United States, taxation in non-U.S. jurisdictions.
  - c. Regulatory and business constraints applicable to institutional sponsors.
  - d. Governance.
  - e. Liability issues.
  - f. Subadvisor and satellite office arrangements.
2. **General Partner Arrangements.** Because (subject to regulatory considerations) the General Partner makes all investment decisions for the Fund and (at least in the case of U.S. Funds) typically receives the Carried Interest, governance issues are

## K. STRUCTURING THE MANAGER AND THE GENERAL PARTNER

critically important in structuring the General Partner. Each sponsor will have unique concerns with respect to governance, Carried Interest sharing, admission of new Investment Professionals and departure planning.

### 3. *Economics.*

- a. Economic sharing and vesting arrangements are highly idiosyncratic and often complex. Issues to consider include:
  - (i) Fund-wide vs. deal-by-deal sharing.
  - (ii) Dilution of existing Investment Professionals in connection with the admission of a new Investment Professional.
  - (iii) Vesting (timeline, adjustments due to manner of departure, etc.).
  - (iv) Reallocation of unvested Carried Interest in connection with a departure.
  - (v) Removal provisions.
  - (vi) Funding obligations post-departure.
- b. Subject to regulatory considerations, a variety of structures can be used so that Investment Professionals and other employees of the sponsor can participate in a Fund's investment program.
  - (i) Most commonly, Investment Professionals invest capital in the Fund wholly or partly through the General Partner.

## K. STRUCTURING THE MANAGER AND THE GENERAL PARTNER

(ii) Investment Professionals (and, in some cases, “friends and families” of a sponsor’s Investment Professionals and other employees) may also invest a significant portion of their commitments through an affiliated co-investment vehicle, which may or may not pay Management Fees or bear Carried Interest.

(iii) It may also be possible to offer to numerous individuals employed by the sponsor of the Fund participation in an “employees’ securities company” under the applicable provisions of the Investment Company Act or in other employee vehicles. Such vehicles require an application to the SEC.

- c. Similar considerations apply where the Fund utilizes a “special limited partner” to receive the Carried Interest.

- 4. **Restrictive Covenants.** A General Partner’s governing documents may include restrictive covenants in the event of an Investment Professional’s departure, including covenants not to compete, non-solicitation (of employees and investors), non-disparagement covenants, ongoing confidentiality requirements and restrictions on use of the Fund’s track record. Such covenants are particularly important when the Investment Professional does not have a separate employment agreement with the sponsor.

## K. STRUCTURING THE MANAGER AND THE GENERAL PARTNER

5. **Insurance.** General Partners should consider obtaining general partnership liability insurance that comprises both management liability and “errors and omissions” insurance coverage. While the costs of such insurance policies are typically high, the potential advantage of these policies is that they cover risks that may not be recognized or be covered by indemnities (and investors may want assurance that such policies have been obtained).
6. **Estate Planning.** Careful, early structuring of the General Partner is important, particularly in the case of U.S. Funds, for individual Investment Professionals wishing to optimize their estate planning. This area involves the interaction of gift tax, estate tax, income tax and securities laws.

We can provide our clients with separate detailed materials summarizing issues to consider in structuring the General Partner, the Manager and any “special limited partner.”

## **L. CERTAIN KEY REGULATORY ISSUES**

### **1. U.S. Securities Act and Other Private Placement Regulations.**

- a. *U.S. private placement.* In general, section 5 of the Securities Act requires that every offer and sale of a security, including an interest in a Fund, be registered by the filing of a registration statement with the SEC, unless an exemption from registration is available. Interests in a Fund typically are offered and sold in the United States in a private placement in reliance on the exemption from registration in Rule 506 of Regulation D of the Securities Act, and, under certain circumstances, section 4(a)(2) of the Securities Act. Interests in a Fund may also be offered and sold outside the United States in reliance on Regulation S under the Securities Act.

- b. *Rule 506 of Regulation D.*

(i) *Rule 506(b).* Traditionally, most interests in Funds have been offered in reliance on Rule 506(b) of Regulation D which, among other things, permits an offering of interests to an unlimited number of “accredited investors” (as defined in Rule 501(a) of Regulation D) and up to 35 non-accredited sophisticated investors but prohibits the use of a “general solicitation” (such as, for example, an advertisement, speaking to the press or at seminars or conferences, communications on a publicly accessible website, cold-calling, etc.). If there has been a general solicitation, the Fund may be required to cease the offering for a “cooling off” period.

(ii) *Rule 506(c).* An offering of interests under Rule 506 of Regulation D may also be made in reliance on Rule 506(c),

## L. CERTAIN KEY REGULATORY ISSUES

which permits the use of a “general solicitation” under certain circumstances. The Fund must have a reasonable belief that all of its investors satisfy the definition of “accredited investor” in Rule 501(a) of Regulation D. The Fund is required to take “reasonable steps” (based on the facts and circumstances) to verify that all purchasers of interests are “accredited investors.”

(iii) *Form D*. A Fund relying on either Rule 506(b) or Rule 506(c) is required to file a Form D no later than 15 days after the first sale of interests and must amend the Form D in certain circumstances.

(iv) *Disqualification under Rule 506(d)*. A Fund is prohibited from making an offering under Rule 506 if certain persons affiliated with the issuer (“covered persons”) are subject to certain disqualifying events.

- c. *Regulation S*. Regulation S provides that an offering will be deemed to occur outside of the United States if, among other things, (i) the offer or sale is made in an offshore transaction and (ii) there are no “directed selling efforts” in the United States by the issuer, a distributor, any of their respective affiliates, or any person acting on behalf of any of the foregoing.

(i) *Sales to non-U.S. persons*. Offerings under Regulation S are generally limited to non-U.S. persons. As a general matter, the definition of U.S. person under Regulation S focuses on whether the person is a U.S. resident or whether the investing vehicle is organized under the laws of the United States.

(ii) *Directed selling efforts*. “Directed selling efforts” under Regulation S means any activity for the purpose of (or that could reasonably be expected to have the effect of) conditioning the U.S. market for the Fund interests, including actions to encourage “flow-back” of the interests into the United States.

- d. *Other private placement rules*. A sponsor should carefully consider the securities offering requirements of each non-U.S. jurisdiction where Fund interests are to be marketed. In some cases, the Fund will need to engage a locally licensed agent. Many jurisdictions have local filing, registration or ongoing reporting requirements, for one or more of the General Partner, the Manager or the Fund itself. In particular, the recent implementation of the AIFMD requires careful analysis of marketing, filing and reporting requirements in the countries comprising the European Economic Area. See Topic L.10, below. Debevoise maintains an international survey that tracks securities laws requirements in over 50 jurisdictions.

2. ***U.S. Investment Company Act***. In general, any issuer of securities which is engaged or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities, must register under the Investment Company Act, unless otherwise excluded from the definition of “investment company.”

- a. *Section 3(c)(7) “Qualified Purchaser.”*

(i) Under section 3(c)(7) of the Investment Company Act, a Fund is exempt from registration under the Investment Company Act if (A) its outstanding securities are owned solely by any number of “qualified purchasers” and (B) it is

## *L. CERTAIN KEY REGULATORY ISSUES*

not making and does not propose to make a public offering of its securities. Note, however, that if the section 3(c)(7) Fund has 2,000 or more investors, it will become subject to filing public periodic reports with the SEC under section 12(g) of the Exchange Act.

(ii) “Qualified purchasers” include (A) natural persons, or companies owned by persons related as siblings or spouses, or the descendants, estates or trusts of such persons, owning not less than \$5 million in investments and (B) any person or entity, acting for its own account or the account of other qualified purchasers, that in the aggregate owns and invests on a discretionary basis not less than \$25 million in net investments.

### *b. Section 3(c)(1) Funds.*

(i) Under section 3(c)(1) of the Investment Company Act, a Fund is exempt from registration under the Investment Company Act if (A) its securities are beneficially owned by not more than 100 persons and (B) it is not making or proposing to make a public offering.

(ii) Special “look-through” counting rules apply to certain investors.

(iii) The SEC staff has said that similar Funds with the same sponsor may be “integrated” (*i.e.*, viewed as a single fund) for purposes of the 100 beneficial owner limit of section 3(c)(1) unless a reasonable investor would consider interests in the two funds to be materially different. A Fund relying on section 3(c)(1) will not be integrated with a Fund relying on section 3(c)(7).

## L. CERTAIN KEY REGULATORY ISSUES

- c. *Joint marketing to U.S. persons and non-U.S. persons (Touche Remnant/Goodwin Proctor doctrine).*

(i) A Fund organized in a non-U.S. jurisdiction may make a private offering into the United States if either (A) fewer than 100 U.S. persons beneficially own the Fund's securities (section 3(c)(1) of the Investment Company Act) or (B) all U.S. persons who own securities of the Fund are "qualified purchasers" (section 3(c)(7) of the Investment Company Act). For these purposes, only investors resident in the United States are counted. Thus, an offshore Fund could be offered widely to non-U.S. investors and at the same time placed privately either with up to 100 beneficial owners in the United States or with (in theory) an unlimited number of U.S. qualified purchasers. Generally, however, additional steps will have to be taken to ensure that a U.S. trading market is not likely to develop for the Fund interests offered to non-U.S. persons. The SEC has said that generally an offshore Fund may look to Regulation S to determine who is a non-U.S. investor.

(ii) By contrast, a Fund organized under U.S. law counts all investors world-wide.

- d. *Ongoing requirements.* The 100 beneficial owner limit of section 3(c)(1) and the qualified purchaser requirement of section 3(c)(7) are ongoing requirements that must be monitored. This means, among other things, that (A) investors must be restricted in their ability to transfer or subdivide interests and (B) the sponsor will have to monitor who the actual beneficial owners of the Fund's investors are.

## L. CERTAIN KEY REGULATORY ISSUES

- e. *Knowledgeable employees.* Under Rule 3c-5, a “knowledgeable employee” is not required to be counted toward either the 100 beneficial owner limit in section 3(c)(1) or the qualified purchaser requirement in section 3(c)(7). A “knowledgeable employee” of a Fund is (i) any “executive officer” of the Fund or an “affiliated management person” of the Fund and (ii) certain “participating employees” of the Fund or an affiliated management person.
  - f. *What if a Fund decides to register?* While this is highly unusual and burdensome, certain Funds have registered under the Investment Company Act in special cases. This could be desirable to obtain the benefit of the plan asset exemption for investment companies under ERISA, to obtain the favorable regulated investment company tax status or to permit retail distribution of a Fund. A Fund registered as an RIC is required to comply with the many substantive regulatory provisions contained in the Investment Company Act, including restrictions on incentive fee arrangements. We can provide our clients with further detailed materials regarding RICs (and BDCs).
3. **U.S. Advisers Act.** In general, investment advisers (persons who, for compensation, are in the business of providing investment advice), must register as such with the SEC, unless an exemption is available.
- a. *Investment Adviser Registration.*
    - (i) Most U.S. Managers (and their related General Partners) of Funds are now required to register with the SEC under the Advisers Act.

## L. CERTAIN KEY REGULATORY ISSUES

(ii) Most non-U.S. Managers (and their related General Partners) of Funds and U.S. Managers subject to certain exemptions are not required to register with the SEC under the Advisers Act; however, they may be required to make certain filings as “exempt reporting advisers” (“ERAs”).

(iii) The following exemptions from registration are available to Managers of Funds:

(A) *Foreign private adviser exemption.* A non-U.S. investment adviser is exempt from registration under the Advisers Act if it (1) has no place of business in the United States, (2) has, in total, fewer than 15 U.S. clients and U.S. investors in private funds advised by the investment adviser, (3) has aggregate assets under management attributable to those U.S. clients and U.S. investors of less than \$25 million, (4) does not hold itself generally to the U.S. public as an investment adviser and (5) does not act as an investment adviser to any RIC or BDC.

(B) *Private fund adviser exemption.*

(1) An investment adviser whose principal place of business is in the United States may be exempt from registration under the Advisers Act if the investment adviser (x) provides investment advice only to private funds and (y) has less than \$150 million in assets under management.

(2) An investment adviser whose principal place of business is outside the United States may be exempt from registration under the Advisers Act if the investment adviser (x) has no advisory clients who

## L. CERTAIN KEY REGULATORY ISSUES

are U.S. persons other than private funds and  
(y) manages less than \$150 million in assets at a U.S.  
place of business.

(C) *Other applicable exemptions.* An investment adviser will be exempt from registration under the Advisors Act if:

(1) The investment adviser provides advice solely to venture capital Funds (an investment adviser that relies on the venture capital fund adviser exemption is an ERA); or

(2) The investment adviser provides advice solely to SBICs.

b. *Advisers Act regulation of RIAs.* If Advisers Act registration is required, the Manager and General Partner will be subject to substantive requirements as well as oversight by the SEC through its inspection program. The substantive provisions of the Advisers Act include the following.

(i) *Form ADV.* In order to register, an RIA must file a Form ADV with the SEC as well as amend the Form ADV at least annually. Parts 1A and 2A of Form ADV are publicly available on the SEC website. Parts 2A and 2B of Form ADV are required to be delivered to the “clients” of the RIA. With respect to a Fund, the Fund is the client; however, a Manager will generally deliver copies of Part 2A and 2B to its investors along with the offering materials of the Fund (and on an annual basis).

(ii) *Form PF.* An RIA with more than \$150 million in assets under management attributable to private funds is

## L. CERTAIN KEY REGULATORY ISSUES

required to file Form PF, a report that is designed to allow the SEC and other financial regulators to assess the systemic risks related to private funds. The frequency and level of detail required by Form PF depend on the RIA's assets under management relating to private funds and the types of private funds the adviser manages.

(iii) *Compliance policies and procedures.* An RIA is required to adopt, implement, maintain and continually review written policies and procedures reasonably designed to prevent violation of the Advisers Act by the RIA or any of its supervised persons. An RIA must also establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information by the RIA and any person associated with the RIA.

(iv) *Code of ethics and personal securities trading.* An RIA must adopt a code of ethics that sets forth, among other things, a standard of conduct for its employees and that requires compliance with U.S. federal securities laws.

(v) *Books and records.* An RIA is subject to extensive books and records requirements.

(vi) *SEC examination.* All of the books and records of an RIA are subject to examination by the SEC. An SEC inspection often occurs within a year after initial registration; the frequency of examinations thereafter depends upon the SEC's assessment of the firm's risk profile.

(vii) *Incentive compensation limits.* The Advisers Act prohibits certain types of performance fees, including

## L. CERTAIN KEY REGULATORY ISSUES

Carried Interest, unless (A) the Fund relies on section 3(c)(1) of the Investment Company Act (see Topic L.2.b, above) and all of the Limited Partners meet a “qualified client” test, (B) the Fund relies on section 3(c)(7) of the Investment Company Act (see Topic L.2.a, above), (C) the Fund is not a U.S. resident (for example, if it is not a U.S. person for purposes of Regulation S under the Securities Act (see Topic L.1.c, above)) or (D) the Fund is a BDC and the compensation does not exceed 20% of realized capital gains.

(viii) *Restrictions on “assignments” of advisory contracts.* The investment management agreement between a Fund and an RIA must contain a provision requiring the client’s (i.e., the Fund’s) consent to an “assignment” of the agreement. For purposes of the Advisers Act, an “assignment” is a technical term that includes certain transactions that involve a transfer of a controlling interest in the RIA (e.g., an acquisition of the RIA or the entrance or departure of a control person of the RIA).

(ix) *Disclosure requirements.* An investment adviser is a fiduciary and must make full disclosure to clients of all material facts relating to the advisory relationship, including full disclosure of all material conflicts of interest that could affect the advisory relationship.

(x) *Notice provision.* If the RIA is organized as a partnership, the investment advisory contract must provide for the notification of the client (i.e., the Fund) of any change in the membership of the RIA within a reasonable time of such change.

## L. CERTAIN KEY REGULATORY ISSUES

(xi) *Advertising restrictions.* Generally, the Advisers Act prohibits RIAs from distributing any advertisement that, among other things, contains untrue statements of material fact or that is otherwise false or misleading. These advertising restrictions have been the subject of numerous enforcement actions by the SEC. The rules also set forth conditions for disclosing prior recommendations of the RIA (i.e., past investment performance).

(xii) *Anti-fraud provisions.* Generally, the Advisers Act's anti-fraud provisions are interpreted broadly to impose on an investment adviser an affirmative duty of utmost good faith to act solely in the best interests of its clients and to make full and fair disclosure of all material facts, particularly with respect to conflicts of interest. The general anti-fraud provisions of the Advisers Act apply to all advisers, whether registered or exempt.

(xiii) *Limits on principal and agency cross transactions.* The Advisers Act prohibits an investment adviser (whether or not registered) from entering into certain transactions with the Fund where the adviser, or a person controlling, controlled by or under common control with the adviser, acts as principal for its own account, or the adviser or one of its control persons acts as broker for the other party to the transaction, without prior disclosure to and consent from the Fund.

(xiv) *Custody.* The SEC has adopted an anti-fraud rule that imposes additional requirements if the RIA has "custody" of client assets. In general, a sponsor that is an RIA is required to maintain the Fund's securities and other assets with a "qualified custodian" (e.g., a bank or registered broker-dealer).

## L. CERTAIN KEY REGULATORY ISSUES

(xv) *Pay-to-play*. The SEC has adopted a rule designed to prohibit certain practices relating to the solicitation of business from state and local governments (generally characterized as “pay-to-play” practices), including significant restrictions on the political contributions and certain other fundraising activities by an RIA and its affiliates, officers and employees, and restrictions on using a third-party solicitor or placement agent to solicit business or investments from state or local governments unless the solicitor or placement agent is either an RIA, registered municipal advisor or a registered broker-dealer (as applicable). The rule is applicable to RIAs, to ERAs and to investment advisers relying on the Foreign Private Adviser Exemption (see Topic L.3.a.iii.A, above).

- c. *Advisers Act requirements for ERAs*. As noted above, an investment adviser that relies on either the Private Fund Adviser Exemption or the Venture Capital Fund Adviser Exemption is an ERA and is subject to certain regulatory requirements under the Advisers Act. As a practical matter, most non-U.S. Managers that are not RIAs are ERAs if they have 15 or more U.S. investors or have \$25 million or more in assets under management attributable to U.S. investors.

(i) *Form ADV*. An ERA is required to file Part 1A of Form ADV within 60 days of becoming an ERA and is required to update its Form ADV at least annually. An ERA is not required to provide all of the information required by Part 1A; rather, it is only required to provide certain identifying information concerning the ERA and the private funds that it manages.

(ii) *Examination*. The SEC has specifically stated that it has the statutory authority to examine ERAs.

## L. CERTAIN KEY REGULATORY ISSUES

(iii) *Books and records.* ERAs are not subject to the recordkeeping requirements for RIAs set forth in Rule 204-2 under the Advisers Act; however, the SEC has the authority to impose recordkeeping requirements on ERAs in the future.

(iv) *Anti-fraud.* ERAs, like all registered and unregistered investment advisers, are subject to the anti-fraud provisions of the Advisers Act (see Topic L.3.b.xii, above). Similarly, ERAs are subject to the “pay-to-play” restrictions (see Topic L.3.b.xv, above).

(v) *Municipal advisor.* An ERA should confirm that its activities do not require it to register with the SEC as a “municipal advisor.” See Topic I.2.d, above.

### 4. **U.S. Commodity Exchange Act.**

- a. The Manager or General Partner of a Fund that trades commodity interests must either (i) register with the CFTC as a commodity pool operator (“CPO”) or (ii) limit its commodity interest trading such that it may rely on the exemption from registration with the CFTC that is available under the “*de minimis* exemption” of the CFTC Regulations (which, in addition to certain other requirements, requires the Fund to meet certain criteria each time a commodity interest position is established).
- b. Additionally, the Manager or General Partner of a Fund that trades commodity interests will generally be required to either register as a commodity trading advisor (“CTA”) or qualify for an exemption from registration under the CFTC Regulations.

## L. CERTAIN KEY REGULATORY ISSUES

- c. “Commodity interests” for these purposes include (A) futures and options on futures traded on exchanges, including security futures products that are based on a single security or narrow-based securities index, (B) options on commodities, (C) retail forex transactions and (D) swaps, including swaps that are traded on a designated contract market or on a swap execution facility and swaps that are traded on a bilateral basis.
- d. A Manager or General Partner that cannot satisfy the *de minimis* test may have to register with the CFTC as a CPO or CTA, which will result in additional disclosure, recordkeeping and reporting requirements.

### 5. **Broker-Dealer Issues.**

- a. *Who is a broker?* Generally speaking, a broker is a person engaged in the business of effecting transactions in securities for the account of others. In the private equity context, a Manager (and its employees) may be considered to be acting as a broker with respect to (i) the offering of limited partnership interests in the Fund or (ii) the transactions engaged in by the Fund or by the portfolio companies controlled by the Fund.
- b. *Offering of interests to investors.*
  - (i) *Issuer exemption.* Associated persons of a Fund (e.g., employees of the Manager) will often rely on a nonexclusive safe harbor from broker-dealer registration in Rule 3a4-1 under the Exchange Act that requires that the persons (A) do not receive commissions or other transaction-based compensation, (B) perform substantial duties other than sales activities and (C) do not participate

## L. CERTAIN KEY REGULATORY ISSUES

in selling an offering of securities for any Fund more than once every 12 months. In addition, since Rule 3a4-1 is a nonexclusive safe harbor, Fund sponsors may follow most (but not all) of the requirements of Rule 3a4-1 but still maintain that they do not fall within the definition of “broker,” particularly if the sponsor has more than one Fund in the market at the same time.

(ii) *Registration as a broker-dealer.* Many larger Fund sponsors have affiliated registered broker-dealers, who participate in the offering of interests in the Fund. Registered broker-dealers are generally members of FINRA and are subject to regulation (and examination) by FINRA and the SEC.

- c. *Transactions by Funds and portfolio companies.* Private equity sponsors often engage in a variety of activities on behalf of Funds and portfolio companies including identifying, providing advice on, structuring, negotiating and executing transactions involving securities and receive fees relating to such transactions. The SEC staff has stated that it is currently considering whether and under what circumstances these activities could require registration of a Fund sponsor as a broker-dealer under the Exchange Act. As an initial matter, the SEC staff has indicated that a Fund sponsor whose transaction fees are subject to a 100% offset against its Management Fees would not be required to register as a broker-dealer. See Topic E.2, above.

### 6. ***Anti-Money Laundering and Anti-Terrorism Regulations.***

- a. *Generally.* A Fund organized or managed outside of the United States will be subject to local anti-money laundering (among other) regulations. For example, the Cayman

## L. CERTAIN KEY REGULATORY ISSUES

Islands, Guernsey and Jersey, jurisdictions often used to organize Funds, have enacted legislation on money laundering that affects Funds' reporting and recordkeeping procedures. Additionally, all European Union countries are required by a European Directive to implement anti-money laundering legislation. While not specifically related to money laundering, if a Fund holds assets belonging to persons or entities controlled by or associated with identified terrorist groups, those assets are blocked under U.S. Executive Order 13224. The regulatory landscape in this area is continually evolving and Fund sponsors must be aware of anti-money laundering requirements in their relevant jurisdictions, including requirements to carry out "know your customer" and due diligence procedures on potential investors.

- b. *Special regulations applicable to broker-dealers.* Generally speaking, broker-dealers (including broker-dealers affiliated with Funds) must comply with the recordkeeping and reporting requirements of the Bank Secrecy Act and may be subject to criminal penalties if they assist in money laundering by their customers. Broker-dealers and certain other types of financial institutions must establish anti-money laundering compliance programs (including customer identification programs) and submit suspicious activity reports (SARs). Funds are currently not subject to these requirements, although financial counterparties and investors will often require the Fund sponsor to implement an anti-money laundering program.

- 7. **Merchant Banking Rule.** Fund sponsors that are regulated as FHCs will need to comply with the merchant banking rule issued under the BHC Act. This rule governs an FHC's investments in non-financial companies, including the extent to

which the FHC may be involved in the management or operation of such companies. The merchant banking rule also comes into play if a non-FHC Fund sponsor seeks FHC investors for its Funds.

8. ***Consumer Privacy Regulations.*** U.S. Funds whose investors include natural persons are subject to regulations (of both the SEC and the FTC) restricting the ability of financial institutions to disclose an individual's non-public personal financial information to non-affiliated third parties. The two U.S. privacy schemes also generally require that a sponsor and Fund notify their "consumers" and "customers" (as defined in the regulations) of their policies and practices regarding non-public personal information, and if the sponsor or Fund intends to share non-public personal information about consumers and customers with certain non-affiliated third parties, these individuals must be permitted to opt out of such information sharing. These requirements apply only to individual investors (as opposed to entities such as trusts or pension plans). Non-U.S. Funds are not subject to these U.S. privacy regulations specifically, but may be subject to privacy rules of non-U.S. jurisdictions.
9. ***Investments in Regulated Industries.*** In some cases, a Fund's investment strategy (for example, Funds that intend to invest in insured depository institutions, defense industry businesses, public utilities or "critical infrastructure") will impose additional regulatory burdens on the Fund, its investors or the sponsor. For example, a Fund that invests or may invest in media companies will need to include certain FCC-specified insulation provisions in its Fund Agreement (or in the governing documents of an alternative investment vehicle) to ensure compliance by the Fund, as well as its media companies and investors, with FCC rules.

## *L. CERTAIN KEY REGULATORY ISSUES*

- 10. AIFMD.** The AIFMD is concerned with regulating Managers who manage and/or market Funds in Europe. Unless an exemption applies, a European Manager is required to become authorized by its local regulator as an “alternative investment fund manager” in order to manage Funds. Authorization necessitates, in addition to other matters, the Manager appointing a depositary that meets specified standards (per Fund), meeting regulatory capital requirements, complying with disclosure and transparency obligations, ensuring that the “no asset stripping” requirements in respect of controlled European portfolio companies are adhered to and implementing certain systems and controls (including with respect to remuneration of the Manager’s staff).
- a. In general, for a non-European Manager to market a Fund to professional investors in Europe, it must comply with
    - (i) the AIFMD disclosure and transparency obligations,
    - (ii) the AIFMD ‘no asset stripping’ requirements in respect of controlled European portfolio companies and
    - (iii) national private placement regimes then effective in the relevant European jurisdictions (which involves, for a number of jurisdictions, making a marketing notification or obtaining a marketing license or approval). Cooperation agreements, which are intended to help regulators oversee potential systemic risk, must be in place between the regulator in each European jurisdiction where the Manager is marketing and the regulators in the jurisdiction(s) in which the Fund and the Manager are established.
  - b. We can provide our clients with separate detailed materials summarizing issues to consider when marketing a Fund to prospective European investors.

11. **FATCA.** The U.S. Foreign Account Tax Compliance Act, or “FATCA,” was enacted in the United States to combat tax evasion by U.S. persons holding assets offshore by requiring the disclosure of their direct and indirect ownership interests in certain non-U.S. accounts and non-U.S. entities to the IRS. A withholding tax of 30% will apply to certain non-U.S. persons unless they comply with the FATCA reporting regime; thus, Funds (whether organized in the United States or offshore) will need to consider FATCA and its impact on their investors, operations and investments.
12. **Blue Sky and Other U.S. State-Level Matters.** Many U.S. states require filings to be made in connection with the sale of securities within that jurisdiction. Many U.S. states also have requirements in respect of investment adviser registration. An investment adviser relying on the Private Fund Adviser exemption under the Advisers Act (see Topic L.3.a.iii.B, above) must still evaluate whether it is required to register under applicable U.S. state laws. In addition, Fund sponsors must take care to ensure compliance with state broker-dealer regulations.

## **GLOSSARY**

<b>Advisers Act:</b>	U.S. Investment Advisers Act of 1940, as amended
<b>AIFMD:</b>	European Alternative Investment Fund Managers Directive
<b>BDC:</b>	regulated business development company
<b>BHC:</b>	bank holding company
<b>BHC Act:</b>	U.S. Bank Holding Company Act of 1956, as amended
<b>CFC:</b>	controlled foreign corporation
<b>CFTC:</b>	U.S. Commodities Futures Trading Commission
<b>CFTC Regulations:</b>	regulations of the CFTC under the U.S. Commodity Exchange Act
<b>Code:</b>	U.S. Internal Revenue Code of 1986, as amended
<b>Dodd-Frank Act:</b>	U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act
<b>DOL:</b>	U.S. Department of Labor
<b>ECI:</b>	income effectively connected with the conduct of a trade or business within the United States

## GLOSSARY

<b>ERA:</b>	exempt reporting adviser
<b>ERISA:</b>	U.S. Employee Retirement Income Security Act of 1974, as amended
<b>Exchange Act:</b>	U.S. Securities Exchange Act of 1934, as amended
<b>FATCA:</b>	U.S. Foreign Account Tax Compliance Act provisions of the Code and related U.S. Treasury guidance
<b>FCC:</b>	U.S. Federal Communications Commission
<b>FHC:</b>	financial holding company
<b>FINRA:</b>	U.S. Financial Industry Regulatory Authority
<b>FIRPTA:</b>	U.S. Foreign Investment in Real Property Tax Act, as amended
<b>FTC:</b>	U.S. Federal Trade Commission
<b>Investment Company Act:</b>	U.S. Investment Company Act of 1940, as amended
<b>IRR:</b>	internal rate of return
<b>IRS:</b>	U.S. Internal Revenue Service
<b>LIBOR:</b>	London InterBank Offered Rate
<b>PFIC:</b>	passive foreign investment company

## GLOSSARY

<b>REIT:</b>	real estate investment trust
<b>REOC:</b>	real estate operating company
<b>RIA:</b>	registered investment adviser
<b>RIC:</b>	registered investment company
<b>RULPA:</b>	Delaware Revised Uniform Limited Partnership Act
<b>SBIC:</b>	small business investment company
<b>SEC:</b>	U.S. Securities and Exchange Commission
<b>Securities Act:</b>	U.S. Securities Act of 1933, as amended
<b>UBTI:</b>	unrelated business taxable income
<b>U.S. GAAP:</b>	U.S. generally accepted accounting principles
<b>USRPHC:</b>	United States real property holding corporation
<b>Volcker Rule:</b>	Section 13 of the BHC Act
<b>VCOC:</b>	venture capital operating company