



Private Equity Funds

Key Business, Legal and Tax Issues

Debevoise
& Plimpton



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ABOUT DEBEVOISE & PLIMPTON'S INVESTMENT MANAGEMENT GROUP

Debevoise's leading private equity funds practice is one of the largest and most broadly diversified in the world. Since 1995 we have acted as counsel for sponsors of, or investors in, over 2,800 private equity funds worldwide, with committed capital of over \$3 trillion. Our firm, having focused on the private equity industry since the late 1970s, has deep knowledge of the industry and has worked closely with pre-eminent private equity sponsors to develop much of the fund "technology" that is now industry standard.

Over the past 35 years, we have advised private equity firms and investors on the formation of and investment in private equity funds across every major investment strategy, including buyout, venture capital, funds of funds, credit, real estate, infrastructure and energy. We represent the full range of private equity firms, from first-time funds to the longest established and most pre-eminent firms and from independent boutiques to institutional sponsors and multi-strategy alternative asset firms.

Our fund formation practice is an important element in the comprehensive range of services that Debevoise provides to private equity firms. With over 100 lawyers dedicated to private equity fund formation worldwide, we have one of the largest and most experienced groups of lawyers in the world focusing exclusively on fund formation. In addition, Debevoise's world class tax, ERISA, employment and regulatory specialists devote a substantial portion of their time to our private equity clients. Debevoise is among a handful of firms with a truly global private equity practice, with over 200 fund formation, M&A, finance, securities, tax and other deal lawyers serving private equity firms in the United States, Europe, Asia, Latin America and Africa.

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GLOSSARY OF KEY TERMS

Private Equity Funds: Key Business, Legal and Tax Issues

INTRODUCTION¹

Private equity is a broad and global industry that has seen remarkable growth over the past several decades. Today, private equity firms and the funds that they manage invest in virtually every geographic region, pursuing investment strategies in almost every arena of commercial endeavor and accounting for a significant percentage of M&A activity across the globe. As private equity firms become larger and more global, investors are committing more capital than ever. Global assets under management for the private equity industry now exceed \$3 trillion, and the majority of fund managers predict that this number will continue to increase.²

Growth in the private equity industry has been fueled on the *demand* (limited partner) side by: increased awareness of the 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; and demand for strategic alliances with sponsors who serve as a source of transaction

¹ See the Glossary of Key Terms at the end of this guide for definitions of all capitalized terms used herein and not otherwise defined.

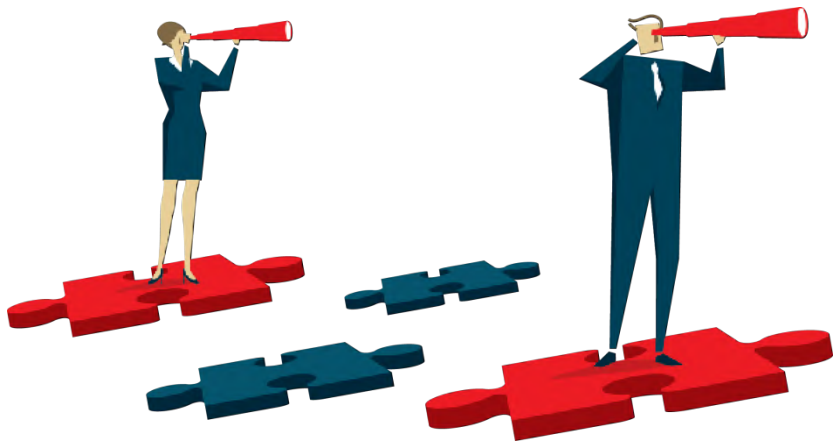
² Source: *Preqin*.

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. The dramatic growth on both the supply and demand side has been accompanied by an increased complexity in the structuring of funds.

This guide discusses the key business, legal and tax issues to be considered when forming a private equity fund. The information set forth in the following chapters is based on our experience over many years as counsel to sponsors of, and investors in, funds worldwide; however, this guide does not constitute legal advice and cannot substitute for the customized advice needed to address the particular needs of fund sponsors or individual investors.

Debevoise & Plimpton LLP
Investment Management Group

A. Overview of Private Equity Funds



A private equity fund is a private pool of capital (a “Fund”) formed to make privately negotiated investments, which may include investments in leveraged buyouts, venture capital, real estate, infrastructure, mezzanine, workouts, distressed debt or other private equity funds.

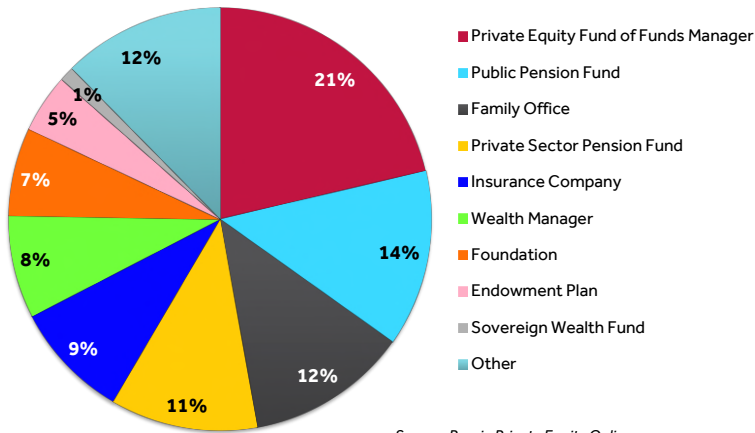
Some Funds pursue a broader generalist strategy, while others focus on investments in one or more particular industries or business sectors, such as telecom, media and communications, healthcare, energy, infrastructure, technology, life sciences or financial services. Certain Funds also focus their investments in particular geographic regions or specific markets (such as emerging economies). In contrast to hedge funds, investments made by private equity funds are generally illiquid in nature. Typical investors in Funds include corporate pension plans, state and other governmental pension

A. Overview of Private Equity Funds

1. What Is a Fund?

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 nontraditional investments.

**Proportion of Aggregate Capital Currently Invested in Private Equity
by Investor Type (at January 2019)**



Source: Preqin Private Equity Online

1. What Is a Fund?³

- a. A typical Fund is structured as a fixed-life limited partnership (or series of parallel limited partnerships and/or feeder partnerships) whose partners have agreed

³ 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

1. What Is a Fund?

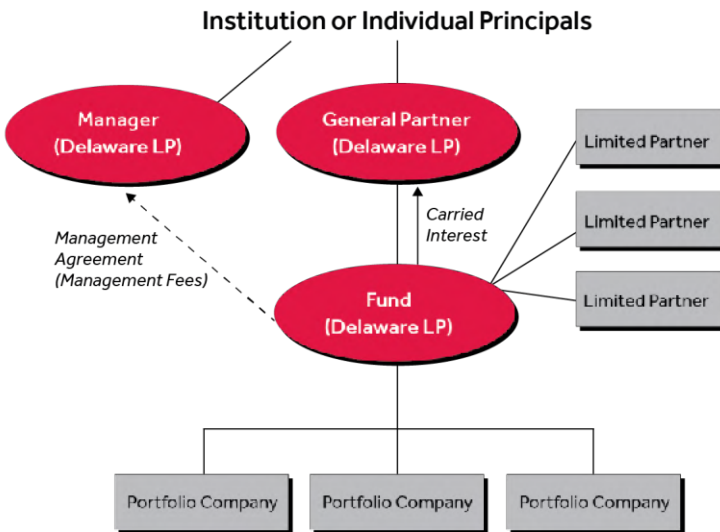
contractually to contribute capital to the Fund as and when needed in order for the Fund to make investments in portfolio companies. The investors (the “Limited Partners”) generally are not involved in the Fund’s investment decisions or other day-to-day activities. Instead, the Fund is controlled by its general partner (the “General Partner”), which generally makes all final decisions concerning the Fund’s operations and the purchase and sale of the Fund’s investments. Unlike hedge funds, a private equity fund is generally structured as a closed-end vehicle, with very limited redemption rights. A typical Fund is managed and advised by a private equity firm or a subsidiary of the firm (the “Manager”); the General Partner and the Manager usually are separate but affiliated entities run by the same people.

- b. The Manager administers and advises the Fund, seeks out and structures investments to be made by the Fund and recommends strategies for realizing and exiting those investments. Frequently the arrangements between the Manager and the Fund are set forth in a management agreement or investment advisory agreement between the Manager and the Fund. Where the Fund invests in multiple jurisdictions, the Manager may have subadvisory contracts with subadvisors in the various jurisdictions where the firm’s investment teams are based. The Manager, directly or through affiliates, typically employs and pays the salaries of its investment personnel, including those of the key individual investment professionals (the “Investment Professionals”). In most cases, the Manager receives a management fee paid by the Fund (or, occasionally, directly

A. Overview of Private Equity Funds
1. What Is a Fund?

by its investors), although in the case of UK and EU 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 Figure 1 below, which presents a typical but simplified U.S. fund structure utilizing a Delaware limited partnership.

Figure 1: Simplified U.S. Fund Structure



- 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 investments. The General Partner or, in some cases, a special purpose vehicle admitted as a special Limited Partner of the Fund, is

A. Overview of Private Equity Funds
2. U.S. Tax Structuring Considerations

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," "performance fee," "promote," "carry" or, most often, "carried interest" (the "Carried Interest"). As investors, the Investment Professionals typically invest their own capital on the same basis as the Limited Partners (but without paying Management Fees or bearing Carried Interest), usually through the General Partner and often through co-investment vehicles as well.

2. U.S. Tax Structuring Considerations

Sponsors typically want structures that will not result in any U.S. federal income tax being incurred at the Fund level. A number of structures can 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. 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. See Topic A.3, below. Classification as a partnership allows the Fund to generally not be subject to U.S. federal income tax, and instead each Partner that is

A. Overview of Private Equity Funds
2. U.S. Tax Structuring Considerations

subject to U.S. tax will be required to include its share of the Fund's income in its own tax return.

- b. *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 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.
- c. *Organize the Fund as a Private Real Estate Investment Trust ("REIT").* A Fund that qualifies as a REIT under section 856 of the Internal Revenue Code (the "Code") may eliminate U.S. federal income tax liability at the Fund level to the extent it satisfies certain organizational, asset and income tests and distributes its taxable income within applicable time periods.
- d. *Alternative Structures.* Certain investors (e.g., non-U.S. and certain tax-exempt investors) may prefer to avoid investing directly in entities treated as partnerships for U.S. tax purposes. To accommodate such investors, the Fund may organize one or more feeder or parallel vehicles treated as partnerships under non-U.S. laws that will elect to be classified as corporations for U.S. federal income tax purposes. These structures may be particularly useful for tax-exempt investors investing in Funds that invest primarily outside of the United States to avoid "unrelated business taxable income" from debt-financing. These alternative structures may also be useful for investors

A. Overview of Private Equity Funds
3. Partnership or Other Form?

concerned with U.S. tax filing obligations arising from the Fund's "effectively connected income" because qualifying non-U.S. investors could continue to apply their treaties to U.S. dividends and other U.S.-sourced income.

- e. *State and Local Taxes.* In addition to U.S. federal income tax considerations, U.S. state and local tax aspects should be considered in structuring a 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 described below. Generally, the choice among them will depend on the specific tax and/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 in the jurisdictions where Funds usually are organized, and investors are most familiar with them. Limited partnerships can be more flexible in some jurisdictions than other forms (e.g., companies) in terms of their ability to alter profit-sharing ratios, return capital to investors and distribute profits. Limited partnerships are most commonly formed in Delaware, the Cayman Islands, and most recently Luxembourg.
- b. *Limited Liability Companies.* Limited liability company statutes have the advantages of being available in all U.S.

A. *Overview of Private Equity Funds*
3. *Partnership or Other Form?*

states and, recently, the Cayman Islands, 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, investing and/or marketing 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 comparatively 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 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 Cayman Islands exempted limited partnerships, Cayman Islands limited liability companies, Luxembourg limited partnerships,

Channel Islands limited partnerships and UK 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 1,270 U.S. funds listed in Debevoise's proprietary database, 70% 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") strongly supports limited liability for Limited Partners (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 favorable 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.
- b. If the Fund is investing outside of the United States, many sponsors choose to form non-U.S. entities as their Fund vehicles, usually limited partnerships organized in the Cayman Islands, Luxembourg or Guernsey. 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 was historically a

A. Overview of Private Equity Funds

5. Multiproduct and Multijurisdictional Offerings

commonly chosen fund vehicle in the United Kingdom's (and to some extent Europe's) private equity industry. The choice of jurisdiction is generally driven by an analysis of tax, corporate and partnership laws, as well as operating factors.

- c. A primary reason sponsors that invest outside of the United States choose non-US entities for the Fund vehicles is to avoid the adverse tax consequences that would otherwise apply with a US entity to the US team members of the sponsor and US taxable investors under the CFC rules. See Topic J.1.e, below. Recent IRS regulations may allow more sponsors to use US entities for non-US investments without triggering many of the adverse tax consequences of the CFC rules.
- d. 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.

5. *Multiproduct and Multijurisdictional 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

A. Overview of Private Equity Funds
5. Multiproduct and Multijurisdictional Offerings

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.* As discussed above, a sponsor may in some cases form a Feeder Fund for certain investors. For example, sometimes Feeder Funds are created for certain investors or to accommodate tax preferences. The Feeder Fund would then invest in the Fund as a Limited Partner, and investors in the Feeder Fund would hold an indirect interest in the Main Fund. The Feeder Fund and Main Fund partnership agreements would include provisions addressing the indirect nature of the feeder Limited Partner's investment, including look-through voting, default, excuse and reporting rights, among others.

- 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 complex when interests in the Fund are being offered in multiple jurisdictions. See Topic J, below.

A. Overview of Private Equity Funds

6. Alternative Investment Vehicles.

- 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 Fund might not be the optimal structure for the 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 typically formed as an alternative vehicle for the Limited Partners to make a particular investment or subset of investments. In such cases, any investment made through the AIV reduces 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 investors, 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 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 usually 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.

B. Fund Products and Strategies

1. Private Equity Funds

Funds focused on buyout transactions are frequently the largest and best known Funds. Accordingly, the discussion in this guide focuses on buyout funds, although this guide is broadly relevant to all funds.

- b. *Venture Capital Funds.* Venture capital funds invest primarily in early and growth-stage companies, usually in rounds of funding called “series” with alphabetical labels that correspond to how early in the company’s existence the investment is made. The first round is called a seed round, and subsequent rounds are called Series A, Series B, etc. These funds typically make a significant number of smaller high-risk, minority investments compared to buyout Funds. Many venture capital sponsors offer more than one Fund product, e.g., a Fund that makes seed and/or early stage investments and another Fund that makes investments in later rounds in companies considered to be more mature. Venture funds also tend to be smaller (in terms of aggregate investment commitments), and thus are less accessible to investors (other than known active venture fund investors).
- 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 (with a corresponding lower target return) focusing on traditional property investments with stable cash flows, and opportunistic strategies being the most high-risk (with a corresponding higher target return) and often involving niche sectors and development projects.

B. Fund Products and Strategies
2. Other Types of Fund Products

- 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/return 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 private equity funds (which may include venture or hedge funds), providing investors with a diversified portfolio and access to Funds to which they otherwise might not have had access. 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 in companies.

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 guide;

B. Fund Products and Strategies
2. Other Types of Fund Products

however, some of these products include those listed below. We can provide our clients 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 private equity funds, hedge funds are usually open-ended and typically draw down 100% of investor capital at the time of subscription instead of on an “as needed” basis, 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, often using a “high water mark” methodology.

- b. *Pledge Funds.* In contrast to a typical private equity 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 limited excuse rights), pledge funds are pools of “soft” commitments from investors, and participants are able to choose whether to participate in investments on a transaction-by-transaction 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 separately for each investment. 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.

B. Fund Products and Strategies
2. Other Types of Fund Products

- c. *Permanent Capital Vehicles.* 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 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 includes a number of investment restrictions with which BDCs must comply. Like RICs, BDCs typically do not have set term limits and therefore may offer permanent capital available for investment and reinvestment.

B. Fund Products and Strategies

3. Separate Accounts

- 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). SBICs are subject to a number of investment restrictions and requirements including prohibitions on certain types of investments and 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 via an investment management agreement, which tends to be a more simple contractual arrangement. The determination is often 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) because they facilitate bespoke structuring, pursuit of an investment strategy addressing particular limitations and goals, tailor-made economics and reporting, and other individualized terms. Separate account arrangements can require extensive negotiations and require careful consideration of a sponsor's obligations with respect to its other fund products.

4. Co-Investment Vehicles

- a. *Single Investment.* While blind-pool funds are the most common type of Fund, sponsors are increasingly offering investors the opportunity to “co-invest” side-by-side with their “Main Funds” in specific investment opportunities, often as they arise. Participation is often by invitation only and may be on a reduced or no Management Fee/Carried Interest basis. Conflicts may arise between co-investors’ interests and the interests of the Limited Partners in the Main Fund. For example, in recent years, the SEC has focused on the allocation of expenses (particularly broken deal expenses) between the Main Fund and co-investors in a specific transaction.

- b. *Overflow.* Some sponsors form a multi-investment co-investment vehicle that participates alongside a Main Fund in investments that are too large for the Main Fund to make alone.

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. 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 a number of 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 12-18 months.

C. The Offering
 1. The Fundraising Process

The Fundraising Process – an Overview	
Pre-Marketing	<ul style="list-style-type: none"> • Pitch book • Marketing plan • Placement agent
Structure and Terms	<ul style="list-style-type: none"> • Structure • Detailed term sheet • Legal and tax advisors
Launch	<ul style="list-style-type: none"> • Private placement memorandum • Diligence materials • Fund documents • Regulatory marketing filings
Investor Negotiations	<ul style="list-style-type: none"> • Fund documents • Side letters
Initial Closing	<ul style="list-style-type: none"> • "Dry" signing • Disclosure update
Subsequent Closings	
Post-Final Closing	<ul style="list-style-type: none"> • Side letter elections

- b. *Securities Law Compliance.* The marketing of interests in a Fund almost always constitutes an offering of securities under applicable securities laws (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, any placement agents 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 many non-U.S. jurisdictions and most European jurisdictions also have regulations applicable to the offering of securities, which often include marketing notifications requirements as well as government approvals or permissions before

C. The Offering
1. The Fundraising Process

marketing of Fund interests may begin in the relevant jurisdiction. See Topics L.1 and L.12, below.

C. The Offering

2. The Private Placement Memorandum

2. **The Private Placement Memorandum**

The offering memorandum (or Private Placement Memorandum) is generally the primary information and disclosure document that is made available to prospective investors when raising a Fund.

a. *Contents.* Matters typically covered in the Private Placement Memorandum include:

- (i) *Business Description.* These sections typically discuss 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 summarize the terms in the Fund’s principal governing documents and include a description of relevant conflict of interest considerations, risk factors and other legal disclosures (including, as applicable, regulatory, tax and ERISA) as well as 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 the sponsor’s investment policies and strategy 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 the valuation methods applied. The valuation methods that are

C. The Offering
2. The Private Placement Memorandum

used should be documented, consistently applied and designed to ensure that all performance information on which any valuation is based is not misleading. Among other things, Registered Investment Advisors (“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 and the related no-action letters do not technically apply to unregistered investment advisers, compliance with its guidance is generally recommended given the applicability of the general anti-fraud provisions of the Advisers Act to unregistered advisers.

- (B) *Attribution of Track Record.* Under certain circumstances, a sponsor may wish to present the performance information of investment recommendations made by one or more of its employees while they were employed by a different firm. The sponsor should clearly disclose the role and responsibilities of such individuals while at their previous firms and any other relevant information to ensure the disclosure of

C. The Offering

2. The Private Placement Memorandum

the performance is not misleading. If the General Partner or Manager is an RIA and wishes to integrate that performance information into its track record, the portability of a track record achieved at a previous employer is subject to a number of conditions, including that the persons or persons were primarily responsible for the investment recommendations at the prior firm. 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 (“GIPS”), which is administered by the CFA Institute. An investment adviser should not advertise or make representations about GIPS compliance unless the materials have been reviewed by someone trained in GIPS compliance.

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

C. The Offering
2. The Private Placement Memorandum

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 both 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 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.

- (iii) *AIFMD.* Under more recent legislation in place in the European Union since 2013, the so-called Alternative Investment Fund Managers Directive (“AIFMD”), Fund managers (i.e., the person making investment decisions for the Fund and/or assuming risk management (the “AIFM”)) are subject to certain filing and authorization requirements which vary depending on whether the Fund and/or the AIFM has its seat in the European Union or outside the European Union, and/or the Fund is marketed to investors in the European Union or not. To market the Fund in the European Union, certain disclosures to investors are

C. The Offering

2. The Private Placement Memorandum

required before the investors commit to the Fund. These disclosures are typically included in the Private Placement Memorandum or a supplement thereto.

- 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.
- d. *Other Marketing Materials*
 - (i) *Pitch Books.* 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 in advance of preparing and/or distributing a Fund’s Private Placement Memorandum. Even if a pitch book is to be followed by a full Private Placement Memorandum, it is important that the pitch book include appropriate legal disclaimers and disclosures.
 - (ii) *Key Information Document (“KID”).* Starting January 2018, the Packaged Retail and Insurance-based Investment Products (“PRIIPs”) Regulation requires the issuance of a highly standardized short-form information leaflet when marketing to non-professional investors in the European Union. It must thereafter be regularly updated. Although Funds generally target professional investors, a KID may be required if a Fund approaches certain types of sophisticated retail investors that exist in some

3. Other Primary Fund Documentation

jurisdictions in the European Union (see Topic L.10, below), including marketing to so called “friends and families” and even high net worth individuals and semi-professional investors.

3. Other Primary Fund Documentation

- a. *Fund Agreement.* The Fund Agreement (generally a partnership agreement) is typically the most comprehensive (and most negotiated) governing Fund document, as it contains the majority of the governance and contractual terms to which the parties agree, discussed in Topics D through H, below.
- b. *Subscription Agreement.* This is the document pursuant to which each investor subscribes for its interest in, and makes its capital commitment to, the Fund. It is the document that memorializes each investor’s interest in the securities they are purchasing in the Fund. Investors also typically make representations concerning, among other things, ERISA, tax, securities law and anti-money laundering matters in the Subscription Agreement. For Funds without a separate Private Placement Memorandum, additional risk factors and other disclosures may be included in the Subscription Agreement and it often includes a power of attorney granting the General Partner the authority to execute the Fund Agreement on behalf of the investor.
- c. *Side Letters.* As Fund investors have become increasingly sophisticated, with larger internal resources devoted to Fund investments, it has become increasingly common to address

C. The Offering

3. Other Primary Fund Documentation

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 all of their Fund investments. 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, additional investment restrictions (and related excuse rights), investor tax and regulatory concerns and other matters particular to the specific investor. Note that a side letter cannot amend the Fund Agreement with respect to the other investors not a party to the side letter.

- d. *Management Agreement.* The Management Agreement is typically a separate agreement between the Fund and the Manager (most often an affiliate of the General Partner). The level of information contained in a Management Agreement differs depending on each sponsor, and can either be a short form document setting forth the legal relationship between the parties or a detailed agreement specifying, among other things, the Management Fee structure, any fee offsets, the use of any Management Fee waiver mechanism.
- e. *Guarantee.* Most U.S. funds have a General Partner clawback guarantee, which is a document in which some (or all) of the carry recipients (usually, individual members or partners of the General Partner) agree to be directly liable to the Fund or Limited Partners for their several and *pro rata* portion of any

distributed Carried Interest that is required to be returned to the Fund.

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 type of investor (for example, the private placement regulations of certain countries require a local distributor or placement agent to be used to market to prospective investors in such countries); 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 that are the subject of negotiation between sponsors and placement agents include:
 - (i) Scope of the arrangement (*e.g.*, will a particular placement agent’s services be exclusive, limited, etc.);
 - (ii) Responsibility for accuracy of the Fund’s marketing materials;
 - (iii) Fees payable to the placement agent (including the amount of fee, which investors’ commitments will generate such fees, and the time period over which the fees are paid to the placement agent);

C. The Offering

4. Placement Agents

- (iv) Representations and warranties to be made by the placement agent and the Fund; 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 an 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 engagement letter 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/or investors. To the extent that these activities take place within the jurisdiction of the United States or target U.S. investors, placement agents are generally subject to regulation in the United States under applicable broker-dealer laws, including SEC registration requirements. See Topic L.5, below.
- d. *MiFID Authorization.* When using a placement agent to market fund interest in the EU, registration is typically

required under the European Directive on markets in financial instruments, also called the “MiFID”.⁴ Historically, this authorization could only be obtained by entities with a registered office in the EU. As of January 2018, however, the MiFID 2 rules were amended to permit registration of non-EU firms (i.e., “third-country firms”) without a branch in an EU-member state in order to provide investment services to EU *per se* professional clients. Registration requires that third-country firms be subject to and comply with prudential rules deemed to be just as stringent as those laid down in the MiFID. This registration of third-country firms is currently not available as the European Commission has not yet made any of the necessary equivalence decision.

In addition, as of January 2018, under the amended MiFID 2 rules, placement agents are required to disclose additional information on the products they offer, including details about the cost structure and the appropriate “target market.” The obligation to disclose a Fund’s “target market” will apply to AIFMs with registered offices in the UK and may indirectly impact AIFMs in other EU member states and AIFMs outside the EU if they use EU placement agents who are required to comply with MiFID 2 rules.

⁴ Note that the MiFID rules do not apply to an AIFM when it is placing the interests of a Fund that the AIFM itself manages (as opposed to when the AIFM engages a placement agent or other third party to assist in the fundraising process).

C. The Offering

4. Placement Agents

- e. *Solicitation of Government Investors.* If a U.S. local or state government entity (including a pension plan) is being solicited for investment, then the placement agent generally 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 and any relevant local or state rules. See Topic L.3.b.xv, below.

- f. *Regulation D "Covered Person."* The placement agent will also need to give sufficient representations to permit the Fund's legal counsel to give its private placement opinion, including additional information 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.c, below.

- g. *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 a payment to the General Partner out of the profits earned by the Fund. 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 on its behalf.

1. Carried Interest Rate

Typically, the General Partner receives a Carried Interest equal to a specified percentage of a Fund’s cumulative net profits (for a buyout fund, typically 20%). The Fund’s partners receive the balance of such profits *pro rata* in accordance with their respective invested capital (including the General Partner with respect to its invested capital), in addition to the return of their invested capital. In venture capital Funds, Carried Interest can

D. Fund Terms: Carried Interest and Distributions

2. Distribution Timing

be anywhere from 20% to 30%; in some other types of Funds, 10% to 15%.

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 or securities are distributed to the partners, with the two main approaches being to pay Carried Interest on a "deal-by-deal" basis or on an "all-capital-first" basis.

Types of Carried Interest Distribution Waterfalls		
Waterfall Type	Description	Region
Deal-by-Deal	Return of capital for disposed of investments	U.S. funds
All Capital First	Return of all contributed capital	Europe, Asia
Venture Style	Distributions based on allocated gain	Global

- 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 Partners have received a return of all the capital they have contributed to the Fund before receiving any Carried Interest (which may increase the likelihood of a General Partner clawback obligation). Rather, the General Partner receives Carried Interest out of the proceeds from the sale of each

D. Fund Terms: Carried Interest and Distributions
2. Distribution Timing

investment once the capital invested in such disposed of investment is returned (plus, typically, any (i) capital not yet returned from investments previously disposed of at a loss, (ii) additional capital equal to the amount of any investments and (iii) apportioned expenses).

Deal-by-Deal Waterfall Mechanics	
Return of Capital	LPs get back their capital contributions for "Realized Investments"
Preferred Return	LPs receive 8% preferred return
Catch-up	GP catches up to the 8% preferred return
Carried Interest Split	80% to LPs and 20% to GPs

- 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 more common in the United States for first time Funds, Funds with limited track records or where large investors have the power to require it.
- c. *Expenses.* Carried Interest typically is computed net of expenses, including Management Fees. In venture capital funds, Carried Interest is sometimes computed gross of expenses.
- d. *Current Income.* In strategies that produce current income (for example, real estate or mezzanine funds), a Fund Agreement may provide for adjustments to the waterfall for distributions of current income. For example, such provisions may be drafted to require a return of capital from disposition proceeds and not current income, which could

D. Fund Terms: Carried Interest and Distributions

3. Preferred Returns and Cushions

permit the General Partner to realize Carried Interest based on the current income from portfolio investments.

3. Preferred Returns and Cushions

It is very common to require a specified return or yield to be achieved on the Limited Partners' capital contributions before the General Partner is permitted to take Carried Interest.

- a. *Preferred Return.* A hurdle rate is a preferred return to the Limited Partners in a distribution formula that includes a “catch-up” provision for the General Partner unless it is a “hard hurdle” as explained in b. below. 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 (often expressed as an internal rate of return (“IRR”) of 8%) with 100% “catch-up” thereafter. However, certain types of fund strategies may provide for higher hurdle rates, hurdle rates that may be subject to adjustment for inflation or floating hurdle rates, or may provide for lower “catch-up” rates.

If the hurdle rate is met and the “catch-up” is fully made up, the Preferred Return and “catch-up” do not ultimately impact the overall sharing of profits between the Limited Partners and the General Partner.

- b. *“True” Preferred Return.* A “true” preferred return or “hard hurdle” is a specified yield that comes off the top and is

D. Fund Terms: Carried Interest and Distributions
4. Distributions in Kind

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 with no “catch-up” for the General Partner. True preferred returns are far less common than hurdle rates.

- c. *Cushion.* In venture capital Funds, rather than providing for a preferred return or hurdle rate, a “cushion” is typically required, *e.g.*, that the value of the Fund’s portfolio be equal to, for example, 120% of unreturned capital, before Carried Interest distributions may be made.

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 those made prior to the Fund’s dissolution) be limited to “marketable” securities only. For now, most investors are requesting, and most General Partners agree, that distributions of digital assets, whether or not “marketable,” be prohibited. A notable exception is venture capital funds, which frequently distribute securities in kind following IPOs of portfolio companies.

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.

D. Fund Terms: Carried Interest and Distributions

6. General Partner Clawback

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 profits, even if current distributions would otherwise be made entirely to the Limited Partners (e.g., because the Fund has a return-all-capital waterfall or has not met the preferred return). This is often referred to as "phantom income." Tax distributions to the General Partner help to ensure that the Investment Professionals have sufficient funds to pay their taxes in circumstances where they are allocated phantom income and are not otherwise entitled to a cash distribution from the Fund. Amounts distributed to the General Partner as tax distributions are treated as an advance against subsequent Carried Interest distributions to the General Partner and are not intended to alter the ultimate economic arrangement between the General Partner and the Limited Partners.

6. General Partner Clawback

To protect the basic deal on Carried Interest, Fund Agreements typically provide that any overdistribution to the General Partner is "clawed back" to the Fund from the General Partner, and then distributed to the Limited Partners. An overdistribution may occur, for example, where the General Partner has received Carried Interest, but the Limited Partners ultimately do not achieve their preferred return/hurdle.

- a. *Clawback Timing.* Traditionally, the most common approach has been to have a single clawback calculation at the time of the Fund's liquidation. However, interim clawbacks occurring at least once during a Fund's term have

D. Fund Terms: Carried Interest and Distributions
6. General Partner Clawback

become increasingly common in recent years (e.g., at the end of the Fund's investment period or 10-year term, or even more often).

- 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.* As most General Partners are special purpose vehicles, the “owners” of the General Partner (i.e., the ultimate recipients of Carried Interest distributions) often personally guarantee the General Partner's clawback obligation (typically on a several, not joint, basis). Without this “guarantee,” Limited Partners could only make claims against the General Partner, which has no capital because it was all distributed out to its members.

 - (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 or “escrow” account. Such escrowed amounts can then be used to satisfy any clawback obligation of the General Partner. Holdbacks are more common in European funds than in U.S. funds.

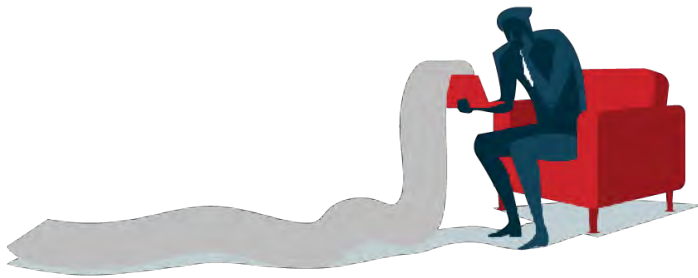
D. Fund Terms: Carried Interest and Distributions

7. Tax Treatment of Carried Interest

7. Tax Treatment of Carried Interest

The General Partner's entitlement to Carried Interest is typically structured as a partnership allocation of profits rather than as a fee, in order to preserve the underlying tax characteristics of the Fund's income and gain. This benefits U.S. Investment Professionals, as they can generally use the lower U.S. long-term capital gains tax rate on their share of certain of the Fund's long-term capital gain, rather than the higher ordinary income tax rate that would be applicable to a fee. In order for U.S. Investment Professionals to be entitled to such lower long-term capital gain tax rates on gain from the sale of portfolio investments, the Fund must generally hold the portfolio investment for at least three years.

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, or in some cases the General Partner, receives a Management Fee paid by the Fund (or, occasionally, directly by its investors). In the case of U.K. funds, the Management Fee is typically structured as a special profits allocation to the General Partner (although in Guernsey and Luxembourg funds, a Management Fee is common). The Management Fee is used to, among other things, pay for overhead, salaries and other Manager expenses that are not charged to the Fund.

E. Fund Terms: Management Fees, Fee Income and Fund Expenses

1. Management Fees

- 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 alternative Management Fee options, such as differing 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, or, in the case of venture capital funds, after a certain amount of time has elapsed.

- b. *Management Fee Base During Investment Period.* In most cases, during a Fund’s investment period (the time frame during which the Fund is making new investments, usually three to seven years), the Management Fee is based on a percentage of committed capital, whether or not contributed. However, for some Funds (for example, debt funds), the Management Fee during the investment period may be calculated on invested capital.

- c. *Management Fee After Investment Period.* In the majority of today’s Funds, the post-investment period (the time during which the Fund is only making follow-on investments in portfolio companies it already owns and disposing of its investments) Management Fees are based on contributed capital for investments, less the cost of investments that have been disposed of. The majority of venture funds, however, may continue to calculate the Management Fee on committed capital and certain other types of Funds may calculate the Management Fee on the net asset value of the Fund’s investments (for example, funds focusing on public

E. Fund Terms: Management Fees, Fee Income and Fund Expenses

1. Management Fees

securities or debt). When the post-investment period rate switches to remaining invested capital, realized losses and fully written off investments are typically deducted from the Management Fee “base.” 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.

- d. *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.
- e. *Duration of Management Fee.* The Management Fee may be paid through the end of the Fund’s stated “term” (including extensions), or may continue through the Fund’s final liquidation; however, there has been increasing pressure for Funds recently to stop Management Fees from accruing after the end of the Fund’s term (usually 10-13 years, including possible extensions).
- f. *Timing of Payments.* Management Fees may be paid semi-annually, quarterly or on another time frame, 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 Fee Income: Directors’, Transaction, Break-Up, Monitoring and Other Similar Fees

Management Fee Trends		
	Buyout	Venture
Fee During IP	Based on committed capital	Based on committed capital but higher percentages given smaller fund sizes
Fee After IP	Based on invested capital	Continues on committed capital, but percentages step down
Negotiation Points	Increasingly removing successor fund step-down Including more in post-IP fee base (e.g., write downs, expenses and fees, borrowings)	Increasingly shifting fee base to invested capital after 5-6 years

2. Sharing the Benefit of Fee Income: Directors’, Transaction, Break-Up, Monitoring and Other Similar Fees

- a. *Types of Fee Income.* “Directors’ fees” are earned by Investment Professionals or other employees of the sponsor for service on a portfolio company board. “Transaction fees” are received by the sponsor for playing a role in structuring a portfolio company transaction (buying and selling). “Break-up fees” are paid if the proposed acquisition of a portfolio company is not consummated. “Monitoring fees” and “advisory fees” are earned by the sponsor for monitoring and/or advising portfolio companies.
- b. *Sharing of Fee Income.* The Fund documents should clearly disclose how fee income will be shared between the sponsor, the investors and any third parties (e.g., co-investors). Typically, any fee income earned by the Manager is offset

E. Fund Terms: Management Fees, Fee Income and Fund Expenses
2. Sharing the Benefit of Fee Income: Directors', Transaction, Break-Up, Monitoring and Other Similar Fees

against the Management Fee. Sharing of fee income has become the subject of SEC scrutiny in recent years, see Topic L.3.b.vii.

- c. *Broker-Dealer Considerations.* The SEC has historically advised that acting for others to market a securities transaction, identify buyers or sellers, negotiate the terms of a transaction or otherwise participate in key stages of execution are hallmarks of acting as a “broker” for purposes of the Exchange Act, and may necessitate registration as a broker-dealer if compensated. In particular, taking compensation in connection with such activities (dependent on the size and/or success of a transaction) is generally viewed by the SEC as acting as a broker. In a 2003 speech by David Blass, the Chief Counsel of the SEC Division of Trading and Markets at the time, he cautioned that advisers to private equity funds were seemingly acting as brokers if they take commissions for putting together investment banking transactions involving the securities of portfolio companies. Mr. Blass also noted that backing commissions out of advisory fees otherwise charged to a Fund could be a way to sanitize the activity.

E. Fund Terms: Management Fees, Fee Income and Fund Expenses
3. Fund Expenses

3. Fund Expenses

The Fund documents should clearly disclose how all expenses are allocated (between the Fund and the Manager, and between the Fund and any co-investors). The SEC has focused on expense sharing between the Fund and other Sponsor vehicles and co-investors in recent years. See Topic L.3.b.vii below. Types of expenses arising in connection with a Fund's activities are:

Fund Expenses Trends

- GPs overhauling disclosure of expenses and charging more to the fund
- Increased SEC scrutiny
- Strategic Response: LPAC disclosure, annual caps and targeted comments

- Salaries and Other Similar Overhead Expenses.* Salaries of the Manager's employees, rent and other expenses incurred in maintaining the Manager's place of business are typically borne by the Manager.
- Regulatory Costs.* While Sponsors differ in their treatment of regulatory costs, many initial expenses relating to a Manager's Advisers Act registration are borne by the Manager, with certain reporting expenses relating to a Fund (including Form PF and AIFMD) are apportioned to each of the Sponsor's Fund platforms.
- Organizational Expenses.* These are often borne by the Fund but subject to 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
3. Fund Expenses

- d. *Placement Fees.* As with excess organizational expenses, these are typically borne by the sponsor through a corresponding reduction of the Management Fee.
- e. *Out-of-Pocket Expenses of Completed Portfolio Transactions.* These are typically capitalized into transaction costs and accordingly borne by the Fund.
- f. *Allocation of Deal Expenses to Multiple Vehicles.* A co-investment or parallel vehicle generally only bears its *pro rata* share of deal expenses, but only if the deal is consummated. 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 immediately below and Topic G further below.
- g. *Broken-Deal Out-of-Pocket Expenses.* Funds take a variety of approaches to the issue of how to allocate broken-deal expenses. These days the Fund often bears all broken-deal expenses. In the past, the Sponsor sometimes bore 100% of broken-deal expenses or there may have been a pre-arranged split (e.g., 80/20) or some other agreed sharing arrangement. Often, if 100% of all fee income (including break-up fees) is turned over to the Fund, then the Fund will pay all broken-deal expenses.
- h. *Expenses of Senior Advisers and Similar Third-Party Consultants.* The expenses of senior advisers or other similar third-party consultants may be paid by the Fund or a portfolio company of the Fund for a variety of different

E. Fund Terms: Management Fees, Fee Income and Fund Expenses
3. Fund Expenses

services. To the extent they are paid by the Fund, they should be properly disclosed in the Fund Agreement.

Examples of Fund Expenses

- In-house employees (e.g., accountants, administrators, legal, tax, compliance, etc.)
- 3rd party consulting services provided at sponsor's office
- Broken deal expenses (not shared with co-investors)
- Co-investment expenses (not shared with co-investors)
- Expenses related to facilities, support/back office services, including finance, IR, reporting, legal and IT
- Memberships and participation in industry/conferences
- Subscription and data services

F. Fund Terms: Closing the Fund and Making Investments



1. *Size of the Fund*

Most sponsors include a target Fund size (total aggregate commitments that the Fund can accept) in their offering documents when marketing a Fund; often investors will seek an explicit cap on the Fund size in the Fund Agreement.

2. *Sponsor Investment in the Fund*

Many General Partners and Fund sponsors invest between 1% and 5% (or more) of a Fund's committed capital. The sponsor

F. Fund Terms: Closing the Fund and Making Investments

3. Investment Period and Fund Term

investment may be made through the General Partner's commitment to the Fund, or in some cases alongside, the Fund.

3. *Investment Period and Fund Term*

- a. For a buyout fund and most venture funds, 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 10 years.
- b. Funds of funds will often have somewhat longer terms because the Funds in which they will invest may have terms of up to 12 or 13 years. Infrastructure funds also tend to have longer terms because of the nature of the asset class. Some real estate, emerging markets, debt and venture capital funds have shorter investment periods and/or terms.
- c. A Fund's initial term usually may be extended for two or three one-year periods at the option of the General Partner (such extensions often require the consent of the Fund's Limited Partner Advisory Committee or some percentage in interest of the Limited Partners) to allow for an orderly liquidation of the Fund's portfolio.
- d. 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 in the event certain Key Investment professionals cease to provide services to the Fund. See Topic H, below.

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 time frame 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 the acquisition cost of the previously acquired portfolio securities plus 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 the 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 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

Credit Facility Considerations

- May reduce preferred return hurdle
- Interest expense is borne by Fund
- Lenders requesting more information from LPs
- Administrative convenience
- Strategic investment tool (more nimble for GPs)
- Misleading performance data (can artificially boost Fund IRRs)
- Systemic risk in event of financial crisis
- Surplus of cash for LPs to manage

F. Fund Terms: Closing the Fund and Making Investments

7. Recycling of Capital Commitments

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 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. The use of credit facilities has increased in popularity and complexity. The practice has been used more aggressively recently, as credit facilities are structured to look more like a profit-generating tool, rather than an administrative tool to cover gaps in commitments. The use of subscription credit facilities (or other Fund-level borrowings) may impact the tax consequences to certain U.S. tax-exempt investors subject to tax on UBTI. See Topic J.2 below.

7. *Recycling of Capital Commitments*

Many 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 for “quick-flip” investments (investments purchased and disposed of within 12-18 months) and/or capital contributions used for fees and expenses.

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

F. Fund Terms: Closing the Fund and Making Investments
8. Investment Limitations

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 Limited Partner Advisory Committee. Typical limitations will, of course, vary depending upon the Fund's investment strategy, but usually include the following:

- a. *Diversification and "Single Issuer" Limitations.* A limit of 20% or 25% of total capital commitments in one portfolio company is common in buyout funds. Slightly 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.
- b. *Geographical Limitations.* Some Funds have a global strategy, while others limit investments to a certain region or country or include percentage limitations with respect to the percentage of capital commitments the Fund may deploy in investments outside a specified region (e.g., North America, Western Europe or "Greater China").
- c. *Industry Limitations.* Some Funds restrict, or provide for only a small percentage "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 over some specified time period.

F. Fund Terms: Closing the Fund and Making Investments

9. Excused/Excluded Investors

- e. *Hostile Acquisitions.* Hostile acquisitions are most frequently defined as transactions opposed by the target’s board of directors. Many buyout funds are not permitted to engage in such transactions.
- f. *Publicly Traded Securities.* Most Funds have a limitation on the amount of capital commitments that may be invested in publicly traded securities. Some Fund Agreements may exclude going-private transactions, PIPEs and similar transactions from this limitation.
- g. *Derivatives and Similar Products.* Some Funds include prohibitions on the use of derivatives and similar products for speculative purposes. Funds that make use of these products should be mindful of Commodity Exchange Act requirements (see Topic L.4, below).
- h. *Limitations on Investments in Other Funds.* Most Funds include these limitations because many investors are concerned about pyramiding of fees and Carried Interest (*i.e.*, the Fund’s bearing “double fee” and “double carry”) and/or the General Partner ceding investment control to another sponsor.
- i. *Other restrictions.* Some Funds also include prohibitions or baskets on investments in real estate, oil and gas.

9. Excused/Excluded Investors

Many Fund Agreements permit investors to be excused from funding capital calls to make portfolio investments if such

funding would violate laws applicable to such investors or ethical investor policies (e.g., tobacco, alcohol or firearms). See also Topics I.2.e.ii and I.3.a, below. In some cases, a General Partner may exclude a particular investor from participating in an investment, if its 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 great deal of latitude for the General Partner to pursue a number of potential actions and remedies in such cases, including causing the total or partial forfeiture of the defaulting Limited Partner's interest in the Fund.

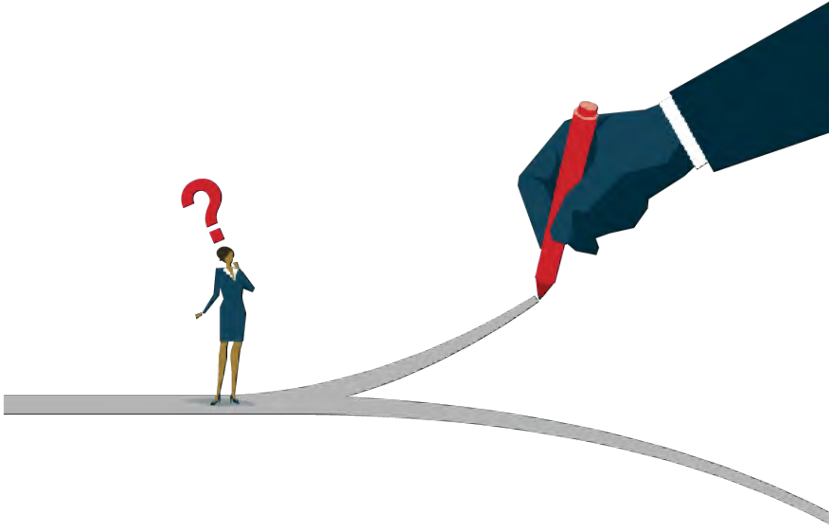
11. *Withdrawal*

In contrast to hedge funds, which typically allow for periodic redemptions of interests, Funds generally do not permit withdrawals by Limited Partners except in 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 to withdraw.

12. Amendments

A 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 the consent of a supermajority to amend or the consent of all investors who would be materially adversely affected. The vote of a particular class of investors may be required to amend provisions specific to that 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, including the SEC. The disclosure and mitigation of conflicts of interests is a primary area of focus for SEC examinations with respect to private Fund sponsors and has been the basis for a number of SEC enforcement actions (see Topic L.3.b.i.A, below). Issues include:

G. Fund Terms: Conflicts of Interest and Related Issues

1. Conflicts of Interest

- 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 investment strategies 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) 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.
 - (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 interest if the strategies of different Funds could result in the investment by those Funds in different classes of an issuer's securities.
 - (iii) Managers or General Partners who are RIAs should develop compliance policies and procedures setting forth investment allocation policies and disclose this policy to investors.

G. Fund Terms: Conflicts of Interest and Related Issues

1. Conflicts of Interest

- 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.

- 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 Limited Partner 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 once it is up and running.

 - (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 arm’s-length basis and/or be approved or disclosed periodically to the Limited Partner Advisory Committee.

G. Fund Terms: Conflicts of Interest and Related Issues

2. Co-Investment Opportunities for Limited Partners

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 have committed capital at an early closing, or offered only to investors that have made a capital commitment above a certain threshold amount.
- 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 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. This area has become the subject of SEC scrutiny in recent years. See Topic L.3.b.vii, below.

3. Indemnification; Exculpation; Standard of Care

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

The scope of any exceptions to indemnification is a point of negotiation. Typically, no indemnification is available if the claim or liability is due to fraud, gross negligence, willful malfeasance or reckless disregard of duties. Gross negligence under Delaware law, in the Fund context, implies a level of care similar to the business judgment rule applicable to a corporate board of directors' decisions. Other potential exceptions to the right 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. Often, indemnification is also not available for claims relating to internal disputes within the Manager or derivative claims brought by a majority-in-interest of the Limited Partners.

4. All-Partner Givebacks.

- a. The General Partner is often 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 referred to as an “LP payback” or “all-partner giveback” to contrast it with the General Partner clawback that protects against over distributions of Carried Interest (discussed at Topic D.6, above). Similar to the General Partner clawback, the intention of the all-partner

G. Fund Terms: Conflicts of Interest and Related Issues

5. Limited Partner Advisory Committee

giveback is to ensure that the fundamental economic deal (e.g., the 80/20 deal) on sharing of gains is protected. Returnable distributions under an all-partner giveback provision are often subject to limitations as to timing and/or amount.

All-Partner Givebacks	
Limitations	Economics
<ul style="list-style-type: none">• Amount: Most commonly, 15-30% of commitments• Timing: Most commonly, 2 years after the relevant distribution• Purpose: To cover indemnification obligations	<ul style="list-style-type: none">• An LP payback can alter the economic arrangement between the Partners if not properly implemented

5. Limited Partner Advisory Committee

Most funds have a Limited Partner Advisory Committee comprising representatives of certain Limited 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 (such as providing consent for transactions that require the Fund's consent under the Advisers Act, including principal transactions and "assignments"), voting 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 most liability that might arise from their service. See Topic G.3.a.ii, above.

6. Valuations

- a. *GAAP.* U.S. GAAP for Funds requires portfolio securities to be marked to market. Most Funds 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 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). Further, if the Management Fee base is reduced by write downs, this, too, would require quarterly valuations.
- c. *Third-Party Valuations.* Some investors request Limited Partner 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.

G. Fund Terms: Conflicts of Interest and Related Issues

6. Valuations

- d. *Regulatory Concerns.* Valuation issues (particularly in respect of disclosure of the valuation process) are important from an SEC perspective (see Topic L.3.b.vii below) and an AIFMD perspective.

H. Fund Terms: LP Remedies



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, terminate the Fund early or remove the General Partner and Manager.

A Fund Agreement's "package" of Limited Partner rights and remedies may include some (or many) of the following:

H. Fund Terms: LP Remedies

1. For-Cause Remedies

Remedies At a Glance
• Key Person Suspension
• GP Removal
• Dissolution
• Suspension of Investment Period

1. For-Cause Remedies

- a. **Key Person Events.** A “key person” provision causes a suspension of the Fund’s investment period (or, less commonly, the term) if specified key individuals leave the Manager, or cease to devote a specified portion of their time to the Fund, the General Partner 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, is often highly negotiated. If there is a “key person” event, many Funds go into an automatic suspension period during which no new investments may be made. Some Funds require a vote of the Limited Partners to cause such suspension.
 - (ii) Many Fund Agreements include a right to designate qualified replacement Investment Professionals with Limited Partner Advisory Committee or Limited Partner approval, and/or the right of Limited Partners to vote to terminate the suspension mode and reinstate the investment period.

H. Fund Terms: LP Remedies
2. No-Fault Remedies

- b. *Change in Control.* Some Fund Agreements give the Limited Partners the right to terminate the Fund’s investment period (or term) if there is a change in control of the Manager or General Partner. In other Fund Agreements, the sponsor provides a covenant that lasts through the term of the Fund in respect of the ownership of the General Partner and the Manager. Where the General Partner and/or the Manager is an investment adviser registered with the SEC, then the Fund Agreements will include a provision that prohibits the “assignment” of the Agreement without consent of the client (which includes a change of control of the General Partner and/or the Manager). In order to receive this consent from the Fund, the General Partner and/or the Manager may need to seek the consent of the Limited Partners or a Limited Partner Advisory Committee.

- c. *Other For-Cause Remedies.* Some Fund Agreements give the Limited Partners the right to either suspend the investment period or dissolve the Fund if either the General Partner, Manager or “key persons” violates the applicable standard of care, breaches the Fund Agreement or engages in other “disabling” conduct.

2. No-Fault Remedies

- a. *No-Fault Divorce.* A “no-fault” divorce is the right of Limited Partners to terminate the investment period or the term of the Fund at any time without cause. No-fault termination rights typically require investor votes of between 75% and 90% in interest. From a sponsor’s perspective, it is important to have the percentage vote high enough to avoid a minority of

H. Fund Terms: LP Remedies

3. What Happens to the Management Fee?

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 long-term commitment, and typically do not want an early liquidation of the Fund that could result in distributions in kind of non-marketable securities.

3. *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.

4. *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. Fund Agreements may also include (subject to certain regulatory and/or accounting considerations) that the General Partner may be removed by a Limited Partner vote on a no-fault basis.

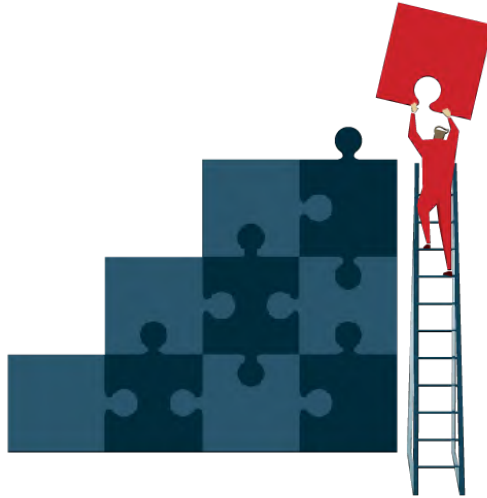
H. Fund Terms: LP Remedies
4. Removal of the General Partner

- a. *Voting.* The “cause” triggers for a General Partner removal, as well as the voting thresholds required to cause such removal, are often heavily negotiated. The “cause” triggers for General Partner removal often mirror the “for-cause” triggers described in the Fund Termination and early suspension of investment period remedies above.

- 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 many cases, subject to a “haircut”; *i.e.*, the General Partner only receives 75% of the Carried Interest that it would have received as of the removal date had it not been removed). In other Funds, the removed General Partner is bought out, with its interest valued to take into account the agreed Carried Interest entitlement.

- 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 (usually 12-18 months’ worth of Management Fee to which it would have been entitled had it not been removed), 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 tax and regulatory concerns of investors generally, see Topics J and L, below.

I. Common Private Equity Fund Investors
4. Removal of the General Partner

Common Private Equity Fund Investors



- U.S. Corporate Pension Plans



- Sovereign Wealth Funds



- U.S. Insured Depository Institutions and Bank Holding Companies



- Funds of Funds



- Individual Investors and Family Offices



- U.S. Governmental Plans



- Life Insurance Companies



- Non-U.S. Regulated Entities



- Private Foundations and Endowments



- Other

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% Exemption.* 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 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 and individual retirement accounts (“IRAs”)), but do not include U.S. governmental plans or non-U.S. corporate plans.
 - (ii) *VCOE Exemption.* Another exemption under ERISA is for Funds that qualify as “venture capital operating companies.” The Department of Labor regulations on this subject are complex, but in general they require that the Fund obtain “management rights” with respect to at least 50% of its portfolio investments (based on cost basis) and exercise those rights in the ordinary course of its business with respect to at least

I. Common Private Equity Fund Investors
1. U.S. Corporate Pension Plans

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.

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 “real estate operating company” exemption is similar to the VCOC exemption described above, and is sometimes used by real estate funds.
 - (iv) *Registering the Fund as an RIC.* A Fund that is registered as an RIC will be exempt from ERISA. 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, all of the Fund’s investments 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

I. Common Private Equity Fund Investors
1. U.S. Corporate Pension Plans

impact payments of Carried Interest), (ii) fiduciary duties, (iii) prohibited transactions, (iv) retention of transaction fees, (v) other fee arrangements, including placement fees 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," on which even tax-exempt entities pay taxes. 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.

I. Common Private Equity Fund Investors

2. U.S. Governmental Plans

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 are similar to ERISA or that make ERISA provisions applicable to state plans. As a result, 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 laws. 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 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 Act (“FOIA”) or other “sunshine” laws, which may require that they disclose confidential

I. Common Private Equity Fund Investors
3. Sovereign Wealth Funds

information received in connection with their investment in the Fund (publicly or pursuant to a request under an applicable FOIA statute).

- d. *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 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 entities owned and managed by government agencies on behalf of a nation or sovereign state, known as “SWFs,” have become an increasingly large source of capital for Funds. In many cases SWFs seek to negotiate their own separately managed accounts (see Topic B.3, above), but they also invest directly in pooled multi-investor Funds. SWFs often

I. Common Private Equity Fund Investors

3. Sovereign Wealth Funds

make very large commitments to Funds, and in return often seek to negotiate fee breaks, priority co-investment opportunities and/or increased levels 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.* 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 in marketing materials, 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 confidentiality provisions for SWFs are often heavily negotiated in their side letters.
- 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 U.S. and non-U.S. insurance company investors may want to structure their investments in the Fund (or shape 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. *Generally.* 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 various exemptions.
- b. *Non-U.S. Banking Entities.* Non-U.S. banking entities enjoy several exemptions from the Volcker Rule's general prohibition. 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 the United States, (ii) the banking entity satisfies certain "risk" criteria to ensure that the decision making, the accounting treatment

I. Common Private Equity Fund Investors
6. Non-U.S. Regulated Entities

and the financing of the investment is outside of the United States and (iii) the banking entity does not participate in marketing the ownership interests of the Fund to U.S. residents. In addition to this so-called “SOTUS Fund” (“Solely Outside the United States”) 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 in the United States). See Topic L.7, below.

- 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 (including one for *de minimis* ownership stakes). 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 regime came into effect in January 2016. Solvency II introduces solvency requirements for EU insurance companies on a risk-based approach. EU insurance companies are subject to rules determining the risk weightings applicable to the different

I. Common Private Equity Fund Investors
7. Funds of Funds

categories of assets they hold (including interests in Funds), for the purpose of calculating their prudential capital. They also have to ensure that their investments meet certain “prudent person” quality standards and make regular reports to the national regulator. To calculate the prudential capital and meet reporting requirements, EU insurance companies need regular and detailed information on the Fund and the Fund’s investments (so-called Solvency II reporting). Investments in private equity Funds are generally subject to high capital requirements for such insurance companies. However, closed-ended Funds established in the European Union not using leverage will benefit from a special beneficial treatment for Solvency II purposes.

While EU insurance companies are afforded considerable flexibility to ensure the quality standards for their investments, German pension funds and other pension schemes are subject to very detailed and very formalistic guidelines to be met by the Fund, the Manager and the structure in order to qualify as an eligible investment. These guidelines have produced over time relatively standardized side letter provisions every German pension fund or scheme will request before subscribing to a Fund. These guidelines in some cases materially affect the capacity of these regulated investors to invest in Funds managed by non-EU Managers and investing in Funds organized in the Cayman and Channel Islands is difficult and in some cases (depending on the investment strategy of the fund) not possible.

I. Common Private Equity Fund Investors

7. Funds of Funds

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 own 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. (See 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 dollar 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

I. Common Private Equity Fund Investors
9. Individual Investors and Family Offices

consideration must be given to regulatory restrictions applicable to such “high-net-worth feeders”.

- 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 disregarded 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.

10. 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 jurisdictions in the European Union following the implementation of AIFMD). Offerings to investors not qualifying as so-called “professional investors” (as defined under AIFMD by reference to MiFID) are subject to burdensome rules and in some countries are even impossible. Under AIFMD, professional investors are mainly institutional investors such as credit institutions, investment firms, insurance companies, pension funds, collective investment schemes and management companies of such schemes and larger companies. Individuals and family offices may be treated as professionals on request if they meet a test regarding the size of their portfolio, their expertise, experience and knowledge, which gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the investor is capable of making investment decisions and understanding the risks involved.

The Manager and/or placement agent will also assess whether the investor is sufficiently qualified and experienced. Some jurisdictions in the European Union may permit offerings to certain high-net-worth investors that would not meet the professional investor test (often referred to as so-called “semi-professional” investors). But marketing to any such semi-professional investors means complying with KID requirements. Similarly, in non-EU jurisdictions, offerings of interests to individuals and family offices are often subject to more

I. Common Private Equity Fund Investors
10. Other Regulatory Matters

regulatory restrictions and enforcement than offerings to institutional investors. See Topic C.2, above.

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, deductions and credits, whether or not such investor receives a distribution.

- 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.

J. Investor Level Tax Issues
1. Taxation of U.S. Taxable Investors

tax purposes, with the result that any individual that is a partner (directly or through a partnership or other pass-through entity) will not be able to claim a deduction for his or her *pro rata* share of such expenses prior to 2026 and thereafter will be subject to limitations on the deductibility of such expenses.

- c. *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.
- d. *Operating Partnerships.* Certain income from investments in certain U.S. operating partnerships may be eligible for a 20% deduction until 2026 (the so-called “qualified business income deduction”). However, certain losses from such investments may be limited or disallowed.
- e. *PFICs and CFCs.* Investments in non-U.S. corporations treated as passive foreign investment companies (“PFICs”) or controlled foreign corporations (“CFCs”) are subject to special U.S. tax rules. The CFC rules generally require certain U.S. shareholders to (i) include their share of the CFC’s passive income and certain other income above a specified threshold on a current basis and (ii) treat some of their gain from the sale of the CFC into ordinary or dividend income.

J. Investor Level Tax Issues
2. Taxation of U.S. Tax-Exempt Investors

- f. *State and Local Taxes.* Investors may be subject to state and local taxation (and reporting requirements) 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 operates or makes investments. Tax conventions between such countries and the United States may reduce or eliminate certain of 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 and

J. Investor Level Tax Issues

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

unrelated debt-financed 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.

- (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. In addition, if a Fund sells its interest in a flow-through entity that has acquisition indebtedness outstanding on the date of the sale or during the 12-month period prior to sale, the portion of the gain attributable to the debt would be UBTI.

- (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

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

merely invests. It is possible, however, that reductions in the Management Fee resulting from transaction, monitoring, directors' and other similar fees may be treated as UBTI to U.S. tax-exempt investors.

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

- (ii) *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. *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 tax on UBTI. However, there is no clear authority that so holds.
- c. *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 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 fees and investments in operating partnerships.
 - (A) *Operating Partnerships.* If a Fund invests in a flow-through entity (e.g., 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, 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) *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.

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

- (ii) *United States Real Property Interests.* Under the Foreign Investment in Real Property Tax Act (“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. “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 and real property interests. 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. See Topic J.5, below for an overview of certain structuring mechanisms. Real estate funds may also utilize REIT structures to mitigate the impact of FIRPTA rules on 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.
- (A) Qualified foreign pension plans (and non-U.S. entities wholly owned by qualified foreign pension plans) are not subject to tax under FIRPTA upon

J. Investor Level Tax Issues

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

the disposition of a “United States real property interest” and on certain distributions from REITs attributable to the disposition of a “United States real property interest.”

- (B) Sovereign wealth funds (or “Section 892 investors”) have a more limited exception on FIRPTA from the sale of USRPHCs.

- (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 whether 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. Qualified foreign pension plans, however, are not required to file US tax returns on gain from sale of USRPHCs.

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

- (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 is subject to the “branch profits tax” at the rate of 30% (or a lower treaty rate) 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. In addition, if any portion of a non-U.S. investor’s gain on the disposition of an interest in the Fund would be treated as ECI, such sale may be subject to 10% withholding tax on the gross amount received for such interest.

- 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 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), bonds and certain other income is generally exempt from tax. The exemption also applies to an integral part of a non-U.S. government (e.g., an agency or instrumentality such as a governmental pension plan) and controlled entities organized under the laws of such non-U.S. government and wholly owned by such non-U.S. government.
- b. *Commercial Activities.* The above-referenced exemption does not apply to income derived by or from the conduct of a “commercial activity” or received from a “controlled commercial entity,” which is 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 a “controlled entity” engages in any commercial activities within or without the United States in a year, it loses its exemption for all of its income in such year.
- 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 management 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

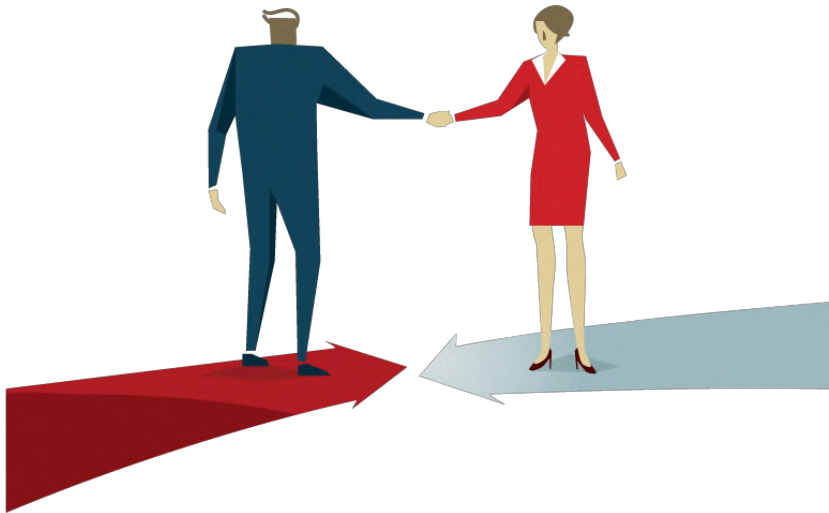
In recent years, many Funds have abandoned the traditional approach to protecting investors from UBTI, ECI and sometimes “commercial activities” by simply covenanting to avoid such income. Instead, Funds are moving more and more towards an “elective blocker” approach, whereby those investors desiring 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 such 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 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.

J. Investor Level Tax Issues
5. Structuring Mechanisms

- 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 and Certain Strategic Transactions



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.

K. Structuring the Manager and the General Partner and Certain Strategic Transactions

2. General Partner Arrangements

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, to the extent 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 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) Dilution and allocation of Carried Interest in connection with the sale of a portion of the General Partner or Manager to a third party.
 - (vi) General Partner removal provisions.
 - (vii) Funding obligations post-departure (including in respect of existing investments, expenses and any ongoing clawback obligations).

- 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.

K. Structuring the Manager and the General Partner and Certain Strategic Transactions

4. Restrictive Covenants

- (i) Most commonly, Investment Professionals invest capital in the Fund wholly or partly through 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.

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.

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.

7. Advisers

If an AIFM (either Manager or General Partner) has its seat in the European Union and is advised regarding the investment decisions by an adviser, the adviser may be subject to authorization requirements for rendering investment advice and brokerage services in the European Union under MiFID. (See

K. Structuring the Manager and the General Partner and Certain Strategic Transactions

8. European Outsourcing Restrictions

Topic C.4.d, above).⁵ The same authorization requirements may apply to Advisers operating from the European Union.

8. *European Outsourcing Restrictions*

AIFMs in the European Union can delegate management functions only when complying with regulatory restrictions. The AIFM must notify the competent regulator. The central tasks of portfolio and risk management can only be delegated to regulated entities. The AIFM may enter into a “non-discretionary advisory agreement” which is not considered a delegation for such purposes; provided that the ultimate decision making remains with the AIFM and substance requirements are met at the level of the AIFM. Management is deemed to have been delegated if AIFMs base their investment decision on advice without carrying out their own qualified analysis before concluding a transaction. The delegation to non-EU delegates is currently under review by the European Securities and Market Authority (“ESMA”) and further requirements might be introduced, for example, substance requirements and/or approval requirements by the competent regulator authority.

9. *AIFM for Hire*

- a. It is possible to use an external AIFM which has the required authorization as Manager of the Fund. The option is often used by sponsors who cannot meet the regulatory

⁵ In certain cases, an exemption under the so-called “group privilege” may be available.

K. Structuring the Manager and the General Partner and Certain Strategic Transactions

10. GP and Manager Minority Stake Sales

requirements themselves in order to get an authorization as AIFM or a non-EU sponsor looking to establish a feeder or Parallel Fund in the European Union.

- b. Such external AIFMs could either delegate portfolio management to the sponsor or hire the sponsor as its adviser. Delegating portfolio management to the sponsor is subject to the strict rules described above. The sponsor can alternatively provide non-discretionary investment advice to the AIFM. The adviser will not make final investment decisions but only provides advice. If the adviser assumes certain investor relation functions and renders marketing assistance with respect to the Fund (*e.g.*, identifying, introducing and meeting prospective investors) attention is required to determine whether the adviser's activity could also be subject to regulation and license or authorization requirements under MiFID or the laws of its home state. See Topic C.4.d, above.

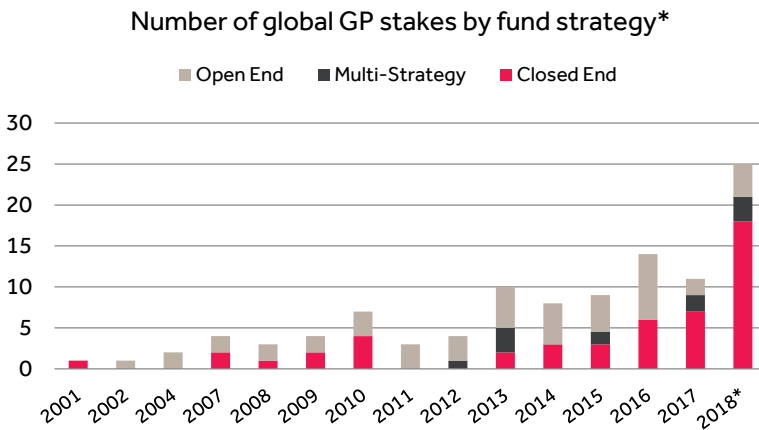
10. GP and Manager Minority Stake Sales

Fund sponsors are increasingly participating in minority stake sales, whereby the sponsor agrees to sell a portion of its fee income, Carried Interest and/or capital interest in the underlying funds to one or more third parties. Buyers in this market were historically large institutional investors seeking to solidify relationships with investment managers or to diversify their capabilities or portfolios. In recent years, however, a growing number of alternative asset managers have established investment platforms focusing specifically on these types of transactions, which has led to an increase in the number of these

K. Structuring the Manager and the General Partner and Certain Strategic Transactions

11. Strategic Fund Transactions

transactions and participation in such transactions by a broader variety of sponsors. Proceeds of such transactions are often used to grow a sponsor's business or to provide liquidity to its founding members.



* Source: PitchBook

11. Strategic Fund Transactions

- a. Fund restructurings are strategic transactions that provide liquidity to existing investors and offer incentives to sponsors. The market has seen a significant increase in Fund restructurings, which can take the form of interest tender offers, Fund recapitalizations or stapled secondary transactions.

K. Structuring the Manager and the General Partner and Certain Strategic Transactions

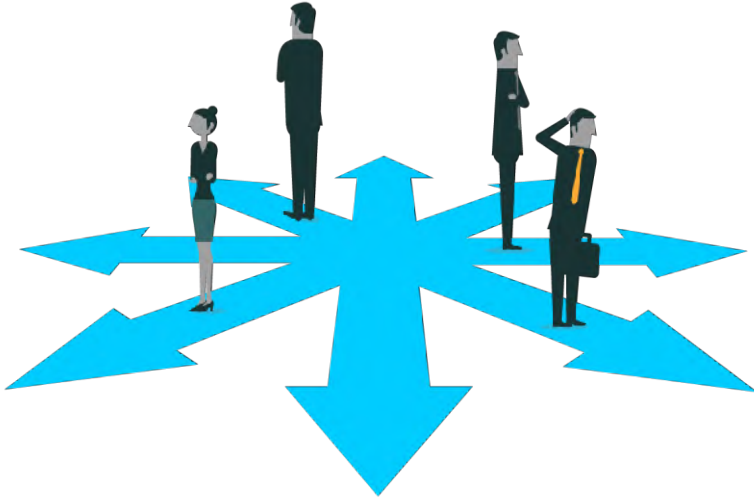
11. Strategic Fund Transactions

- (i) *LP Tender Offers.* An LP tender offer is a Fund-wide secondary transaction in which the General Partner presents an offer from a secondary buyer (or a consortium of buyers) to its existing investors who have the option to sell their interests to the buyer or stay in the Fund.

- (ii) *Fund Recapitalizations.* In a Fund recapitalization, new investors provide capital to a new vehicle to acquire all or substantially all of the portfolio investments from a Fund nearing the end of its term. The sponsor continues to manage the portfolio through the new vehicle, and investors in the existing Fund are generally provided the option to either cash out or roll their interests into the new Fund.

- (iii) *Stapled Secondary Transactions.* Interest tender offers or Fund recapitalizations may also include a stapled secondary component in which the buyer commits additional capital for future investments, either through the existing Fund or as a stapled commitment to a new Fund.

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

L. Certain Key Regulatory Issues

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

United States in reliance on Regulation S under the Securities Act.

- b. *Section 4(a)(2) of the Securities Act.* Section 4(a)(2) of the Securities Act (formerly known as Section 4(2) prior to the Dodd-Frank Act) exempts from registration a transaction by an issuer “not involving any public offering.” Whether an offering qualifies as a private placement under Section 4(a)(2) is a fact-specific analysis based on multiple factors, including: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of securities offered; (3) the size of the offering; (4) the manner of the offering; (5) the sophistication and experience of the offerees; (6) the nature and kind of information provided to offerees or to which offerees have ready access and (7) actions taken by the issuer to prevent the resale of securities. Offerings under Section 4(a)(2) do not preempt applicable state blue sky laws.

- c. *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

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

has been a general solicitation, the Fund may be required to cease the offering for a “cooling off” period.

- (ii) *Rule 506(c)*. A smaller group of offerings have been made under the relatively new Rule 506(c) of Regulation D, 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 annually if the offering of interests is continuing. An interim amendment is also required to be filed when a material change in the information previously filed occurs (e.g., if, among other things, any of the following takes place—a change in the principal place of business, the addition of an executive officer, director or placement agent, or if the amount of sales commissions will be more than 10% greater than was estimated in the Form D that was originally filed).

- (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

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

(e.g., certain criminal convictions, court judgments and regulatory orders generally involving fraud or violations of the securities laws).

- d. *Regulation S.* Regulation S provides that an offering will be deemed to occur outside of the United States (and thus outside the registration requirements of the Securities Act) 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) *Offshore Transaction.* 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 (i.e., the resale of the securities back into the United States).
- e. *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

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2. U.S. Investment Company Act

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 implementation of the AIFMD requires careful analysis of marketing, filing and reporting requirements in the countries comprising the European Economic Area. See Topic L.12, below. Debevoise maintains an international survey that tracks securities laws requirements in over 60 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.”

Key Comparisons between 3(c)(1) and 3(c)(7) Exemptions		
	Section 3(c)(1)	Section 3(c)(7)
Public offering	No	No
Investor qualification	None (<i>but see '33 Act, AIs</i>)	Qualified purchasers (excluding knowledgeable employees)
Investor limit	100 (excluding knowledgeable employees)	None (<i>but see '34 Act, <2000</i>)
Statutory look-through	10% beneficial owners who are “private funds” (<i>i.e.</i> , 3(c)(1) or 3(c)(7))	None (<i>but see ICA Rule 2a51-3</i>)
Non-statutory look-through	Yes	Yes

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2. U.S. Investment Company Act

- a. *Section 3(c)(7) Funds for “Qualified Purchasers.”*
 - (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” (see further description in L.2.a(ii), immediately below) and (B) it is 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 for 100 Beneficial Owners or Less.*
 - (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, including if any investor that itself relies on either section 3(c)(1) or 3(c)(7) of the Investment Company Act (e.g., a fund of funds) owns 10% or more of the outstanding voting securities of any Fund.
 - (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).
 - (iv) In May 2018, section 3(c)(1) of the Investment Company Act was amended to include an additional exemption for venture capital funds (as defined in the Advisers Act) that offer securities to no more than 250 people and have no more than \$10 million in aggregate contributions and uncalled capital.
- 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

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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 (e.g., requiring transfer to U.S. persons to occur under a private placement exemption). 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 worldwide.
- 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 (i) investors must be restricted in their ability to transfer or subdivide interests and (ii) the sponsor will have to monitor who the actual beneficial owners of the Fund's investors are.
- 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). “Knowledgeable Employees” of a Fund are (i) any “executive officer” of the Fund or “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 as a “RIC” in special cases. This could be desirable to obtain the benefit of the plan asset exemption for investment companies under ERISA, to obtain 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.

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 if they have more than \$150 million in assets under management.

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- (ii) Most non-U.S. Managers (and their related General Partners) of funds with no place of business in the United States 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 and related General Partners 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 (e.g., private funds or managed accounts) 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

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3. U.S. Advisers Act

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 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 Advisers Act if:

- (1) The investment adviser provides advice solely to venture capital funds (*i.e.*, an investment adviser that relies on the venture capital fund adviser exemption is an ERA); or
- (2) The investment adviser provides advice solely to small business investment companies.

- 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:

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3. U.S. Advisers Act

- (i) *Anti-Fraud Provisions.* The anti-fraud provisions are at the heart of the Advisers Act and are the basis for many SEC enforcement proceedings. The general anti-fraud provisions of the Advisers Act apply to all advisers, whether registered or exempt. Generally, the Advisers Act's anti-fraud provisions are interpreted broadly to impose on an investment adviser a number of duties, including 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 (*i.e.*, a fiduciary duty), particularly with respect to conflicts of interest. The SEC has issued a number of rules under the anti-fraud provisions that are discussed further below. In addition, the SEC recently published an interpretation of the standard of conduct for investment advisers under the Advisers Act that, addresses, among other things, an adviser's duties of care and loyalty and disclosures of conflicts of interest. This interpretation is available on the SEC website at <https://www.sec.gov/rules/interp/2019/ia-5248.pdf>.

- (A) *Conflicts of Interest.* An investment adviser should identify and mitigate and/or disclose any conflicts of interest that it, its affiliates or its employees have with its clients. In many cases, the limited partnership agreements of a private Fund will require an investment adviser to receive consent of a limited partnership advisory committee with respect to certain transactions involving conflicts of interest, including certain affiliated transactions. The SEC's recent interpretation also notes that

certain types of exculpation or “hedge” clauses may present conflicts of interest that should be disclosed.

- (B) *Allocation of Investment Opportunities and Portfolio Management.* An investment adviser should adopt policies and procedures to address (and disclose) the conflicts of interests between different clients, including the allocation of investment opportunities, investments in different classes of securities of the same portfolio company and the allocation of co-investment opportunities to Limited Partners of the Main Fund, strategic partners and other third parties. In many circumstances, the organizational documents of a private fund client will include specific requirements regarding these issues.
- (C) *Allocation of Fees and Expenses.* An investment adviser has a duty to disclose all fees and expenses that may be charged to its clients, all fees that the investment adviser earns from managing investments and the allocation of all such fees and expenses among its clients (including separate accounts and co-investment vehicles), the adviser and its affiliates. In the Fund context, the fees and expenses that Fund investors may pay (directly or indirectly, through the Fund or portfolio companies) should be addressed with an appropriate level of specificity in the Fund’s limited partnership agreement and Private Placement

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3. U.S. Advisers Act

Memorandum as well as in the investment adviser's Form ADV Part 2A (see below).

- (D) *Duty of Best Execution.* Where an investment adviser is responsible for directing client brokerage, it must seek best execution of its clients' securities transactions (*i.e.*, the investment adviser must seek to ensure that the client's total cost or proceeds in each transaction is the most favorable under the circumstances). In assessing whether this standard is met, an investment adviser should consider the full range and quality of a broker's services.
- (ii) *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. As explained above, with respect to a Fund, the Fund is the client; however, a Manager will generally deliver copies of Part 2A to its investors along with the offering materials of the Fund (and on an annual basis).
- (iii) *Form PF.* An RIA with more than \$150 million in assets under management attributable to private funds is 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.

- (iv) *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.
- (v) *Code of Ethics and Personal Securities Trading.* An RIA must adopt a code of ethics that, among other things, sets forth a standard of conduct for its employees, requires compliance with U.S. federal securities laws and requires the adviser’s “access persons” (employees with access to certain types of information) to periodically report their personal securities transactions and holdings to the adviser’s chief compliance officer or other designated persons.
- (vi) *Books and Records.* An RIA is subject to extensive books and records requirements covering both the RIA’s books and records and the books and records of any of its funds. A sponsor should develop document retention policies that are designed to facilitate compliance with the books and records rules, including with respect to the retention of e-mails.

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- (vii) *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 sponsor's risk profile. Violations of the Advisers Act may result in the imposition of civil or administrative sanctions by the SEC, as well as substantial monetary penalties. SEC staff examinations of private fund managers and related SEC enforcement actions have focused on, among other things, issues relating to the allocation of fees and expenses (including broken-deal expenses), the allocation of investment and co-investment opportunities, the valuation of Fund assets, performance presentations and other marketing materials, disclosure relating to the portfolio companies' or Funds' payments for the use of "consultants" that are otherwise employed by the adviser and the use and adequate disclosure of accelerated monitoring fees or monitoring fees that last longer than the Fund's holding of the portfolio company.
- (viii) *Incentive Compensation Limits.* The Advisers Act prohibits certain types of performance fees, including 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.d, above)) or (D) the Fund is a BDC and the compensation does not exceed 20% of realized capital gains.

- (ix) *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 equity interest in the RIA (e.g., an acquisition of the RIA or the entrance or departure of a control person of the RIA).
- (x) *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.
- (xi) *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.
- (xii) *Advertising Restrictions.* Generally, the Advisers Act prohibits RIAs from distributing any advertisement

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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).

- (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). In addition, the Fund generally will be audited annually by an independent accountant registered and inspected by the Public Company Accounting Oversight Board and its audited financial statements are distributed to fund investors within 120 days (180 days, in the case of a fund of funds) after the end of its fiscal year.

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- (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) that is also subject to “pay-to-play” restrictions. The rule is applicable to RIAs, to Exempt Registered Advisers 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 (see Topic L.3.a.iii.B, above) 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

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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 stated that it has the statutory authority to examine ERAs.
- (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.i, above). Similarly, ERAs are subject to the “pay-to-play” restrictions (see Topic L.3.b.xv, above).
- (v) *Insider Trading.* ERAs are also required to adopt written policies and procedures relating to the misuse of material, non-public information (e.g., insider trading). In addition, ERAs, like all persons, are subject to liability under the U.S. insider trading laws to the extent that they apply.
- (vi) *Business Continuity Plans.* While not yet required by a formal rule, the SEC expects an RIA to develop a business continuity plan identifying procedures relating to an emergency or significant business disruption. A proposed rule requiring specific

components of a business continuity plan is under consideration but has not been adopted.

- (vii) *Municipal Advisor*. An ERA should consider whether or not its activities require it to register with the SEC as a “municipal advisor.” See Topic I.2.d, above.

4. U.S. Commodity Exchange Act

- a. In general, where a Fund (or any other “commodity pool” in the Fund structure) trades “commodity interests” (as defined below), the Manager, General Partner, board of directors (in the case of certain Cayman feeder structures) or other entity or body that has ultimate investment authority and/or is responsible for marketing the Fund must either (i) register with the CFTC as a commodity pool operator (“CPO”) or (ii) ensure that the Fund (and all other commodity pools in the structure) limits its commodity interest trading such that the CPO may rely on the “*de minimis* exemption” from CPO registration with respect to the Fund (and any other commodity pool) under the CFTC Regulations (which, in addition to certain other requirements, require the Fund and any other commodity pool to meet certain criteria each time a commodity interest position is established).
- b. Additionally, the Manager, General Partner, board of directors (to the extent applicable) or other entity providing commodity interest trading advice to the Fund may be required to either register as a commodity trading advisor (“CTA”) or qualify for an exemption from registration under the CFTC Regulations.

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5. Broker-Dealer Issues

- c. “Commodity interests” for these purposes include (i) futures and options on futures traded on exchanges, including security futures products that are based on a single security or narrow-based securities index, (ii) options on commodities, (iii) retail forex transactions and (iv) 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 CPO that cannot satisfy the “*de minimis* exemption” or other applicable exemption may have to register with the CFTC as a CPO, 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. For these purposes, being “engaged in the business” means taking compensation from others (particularly compensation tied to the size or success of a securities transaction) and does not necessarily require activity over an extended period of time or multiple transactions. In the private equity context, a stakeholder in a Fund (including a sponsor, Manager and/or its employees) may potentially be considered to be acting as a broker with respect to (i) the offering of ownership 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 one of the non-exclusive safe harbors from broker registration described in Rule 3a4-1 of the Exchange Act, the most commonly used of which 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 in selling an offering of securities for any Fund more than once every 12 months. In addition, since Rule 3a4-1 is a non-exclusive safe harbor that does not preclude direct reliance on the statutory text, some Fund sponsors take the position that they (and their associated persons) fall outside of the statutory definition of “broker,” while also following most (but not always all) of the requirements of Rule 3a4-1 as a prudential matter.
 - (ii) *Registration as a Broker-Dealer.* Many larger Fund sponsors have affiliated registered broker-dealers, who participate in the offering of interests in funds and portfolio transactions of the funds. Registered broker-dealers are generally members of FINRA and are subject to regulation (and examination) by FINRA and the SEC. The registration process can be quite involved.
- c. *Transactions by Funds and Portfolio Companies.* Private equity sponsors may wish to engage in a variety of activities

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6. Anti-Money Laundering, Anti-Terrorism and Sanctions Regulations

on behalf of funds and portfolio companies, including identifying, providing advice on, structuring, negotiating and executing transactions involving securities, and receiving fees relating to such transactions. While such activities are not uncommon (and enforcement has been rare), sponsors should bear in mind that the SEC staff takes the general view that soliciting or structuring securities transactions for compensation (particularly transaction-based compensation) is a brokerage activity requiring registration as a broker-dealer. Informally, 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, Anti-Terrorism and Sanctions Regulations*

- a. *Generally.* A Fund organized or managed outside of the United States will be subject to local anti-money laundering (among other) regulations, which may require the Fund and its sponsor to conduct certain “know your customer” diligence and report on certain suspicious transactions. For example, the Cayman Islands, Guernsey and Jersey jurisdictions, often used to organize funds, have enacted legislation on money laundering that affects funds’ diligence, reporting and recordkeeping procedures. The Cayman Islands recently enacted more burdensome anti-money laundering regulations that require stricter reporting requirements and compliance regimes. The new Cayman legal regime requires, for example, the designation of certain money laundering reporting officers; certain training for all

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responsible for Cayman funds; ongoing diligence on investors and investments; and formal delegation by Cayman funds of AML functions to those performing AML responsibilities. Additionally, all European Union countries are required by a European Directive to implement anti-money laundering legislation, which may affect funds and sponsors operating in European Union countries. Another feature in the European Union is the transparency register. The Directive requires European Union countries to establish a register listing the beneficial owners of, for instance, companies, partnerships and trusts, including funds established in the European Union. The U.S. regulatory landscape is somewhat different, in that it currently does not explicitly call on funds and their sponsors to take on affirmative anti-money laundering steps; however, funds and their sponsors that are “willfully blind” to money laundering and related criminal activity (on the part of investors or portfolio companies) could be held criminally liable for money laundering. 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. In addition, it is increasingly common for Fund investors, lenders and others to require funds and their sponsors to adopt anti-money laundering and “know your customer” compliance regimes.

- b. *Sanctions.* A related set of issues involves economic and trade sanctions. For example, the United States and European Union maintain (similar but not identical)

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6. Anti-Money Laundering, Anti-Terrorism and Sanctions Regulations

sanctions that prohibit citizens of their jurisdictions from doing business with certain sanctioned countries, persons and entities. Often these sanctioned parties are alleged to be engaged in terrorism and other criminal activities. Although not specifically related to money laundering, if a Fund holds assets belonging to persons or entities controlled by or associated with sanctioned persons or entities, the Fund must “block” such assets and report this to the relevant government.

- c. *Special Regulations Applicable to Broker-Dealers.* Generally speaking, broker-dealers (including broker-dealers affiliated with funds) are subject to affirmative anti-money laundering requirements. They must comply with the recordkeeping and reporting requirements of the Bank Secrecy Act. Broker-dealers and certain other types of financial institutions must establish anti-money laundering compliance programs (including customer identification programs), conduct ongoing customer due diligence and submit suspicious activity reports (“SARs”), among other requirements. Recently, broker-dealers have also become subject to the so-called “customer due diligence rule,” which requires them to identify and verify beneficial owners of certain legal entity customers. Fund sponsors that are affiliated with a broker-dealer may need to implement these programs (because the Fund investors may be considered “customers” of the broker-dealer).

7. Merchant Banking and Volcker Rule

Fund sponsors that are regulated as Financing Holding Companies will need to comply with the merchant banking rule and Volcker Rule issued under the BHC Act. The former 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 and how long investments may be held. The merchant banking rule also comes into play if a non-FHC Fund sponsor seeks FHC investors for its funds; in this case, Fund sponsors may need to account for the investment restrictions applicable to FHCs. The Volcker Rule generally restricts banking organizations from sponsoring private funds and making private fund investments, subject to an array of exceptions. For example, under the Volcker Rule, a non-U.S. banking institution may be able to invest in a Fund under the SOTUS Fund exemption, which may apply if the bank is investing from one of its foreign offices without impermissible involvement of its U.S. branches, operations and personnel. See also Topic I.5.b, above.

8. Internal Accounting Control Systems and Cybersecurity

- a. *SEC Rules and Regulations.* Federal law requires all broker-dealers, investment companies, and investment advisers registered with the SEC to adopt written policies and procedures on safeguarding customer information. These policies and procedures must be reasonably designed to ensure the security and confidentiality of customer records and information, protect against any anticipated threats to the security or integrity of customer records and

L. *Certain Key Regulatory Issues*

8. *Internal Accounting Control Systems and Cybersecurity*

information and protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

In addition, certain financial institutions, creditors, broker-dealers, and investment advisers are required to develop and implement an “Identity Theft Prevention Program” designed to detect, prevent, and mitigate identity theft in connection with covered accounts. Such a program must delineate reasonable policies and procedures to achieve that objective.

- b. *Developing Policies and Procedures.* The SEC has stated that, in its examinations, it focuses on the following major areas: governance and risk assessment processes, access rights and controls, data loss prevention, vendor management training and incident response policies.

When designing policies and procedures to protect against cybersecurity risks, sponsors should, among other things, appoint a member of senior management to oversee cybersecurity policies and practices, regularly review and update procedures to respond to changing risks and ensure its employees communicate regularly to investors about ongoing threats.

- c. *Cybersecurity.* Finally, a fund sponsor may wish to comply with the guidance in the SEC’s October 2018 report, in which the SEC warned companies to ensure their internal accounting control systems effectively protect them from cyber-related threats and frauds. Though the SEC’s report involved publicly traded companies, it provides important

insights into the agency's thinking on these issues and may inform the obligations imposed on registered investment advisors to secure their investors' assets.

9. Consumer Privacy Regulations

U.S. Funds whose investors include natural persons are subject to regulations (of the SEC and/or the FTC) restricting the ability of financial institutions to disclose an individual's non-public personal financial information to non-affiliated third parties. These two federal privacy schemes also generally require that a sponsor and Fund notify their "consumers" and "customers" of their policies and practices regarding non-public personal information, and provide an opt-out if the sponsor or Fund intends to share non-public personal information about consumers and customers with certain non-affiliated third parties. These requirements apply only to individual investors (not 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.

10. GDPR

The EU's General Data Protection Regulation ("GDPR") became effective on May 25, 2018, greatly increasing the geographic reach of EU privacy laws to potentially include U.S. companies to the extent they target or monitor EU data subjects, including many PE firms that actively fundraise in the EU. The GDPR allows companies to process personal information only on certain limited bases, and requires them not to over-collect or misuse data subjects' personal data. Companies must consider

L. Certain Key Regulatory Issues

11. Investments in Regulated Industries

when and how they collect and use information of EU data subjects. Covered entities also must inform consumers when their data is collected and respond to consumers' requests about their data. The GDPR also strictly controls when and how information can be moved out from the EU to the United States.

Starting in 2020, companies conducting business in California or holding the data of California residents will be subject to the recently passed California Consumer Privacy Act ("CCPA"), which contains provisions similar to the GDPR, including substantive cybersecurity requirements.

11. 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.

12. AIFMD

- a. *AIFM*. The AIFMD is concerned with regulating Managers who manage and/or market Funds in the European Union. See also Topic C.2.b.iii, above. Unless an exemption applies, an EU Manager is required to become authorized by its local

regulator as an “alternative investment fund manager” in order to manage Funds. The AIFM can be the Manager or the General Partner depending on who assumes the portfolio management and/or risk management function in the structure. The AIFMD is relevant if (i) the Fund is marketed to investors in the European Union, irrespective of whether the Fund or its AIFM is established in the European Union or not, and/or (ii) the AIFM has its seat in the European Union, and/or (iii) the AIFM not having its seat in the European Union manages a Fund which is established in the European Union. It is not relevant for funds which are outside the European Union, managed by an AIFM outside the European Union and not marketed to investors in the European Union.⁶

- b. *Authorization for EU Managers.* Authorization necessitates, in addition to other matters, the Manager appointing a depositary (for each Fund) that meets specified standards, meeting regulatory capital requirements, complying with disclosure and transparency obligations, ensuring that the post-transaction notification and “no asset stripping” requirements in respect of controlled portfolio companies in the European Union are adhered to and implementing

⁶ The AIFMD is implemented in most member states of the European Union and the European Economic Area. Although we refer to the European Union in this discussion, readers should be aware that European Directives are also implemented in the other member states of the European Economic Area (Norway, Liechtenstein and Iceland).

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12. AIFMD

certain systems and controls (including with respect to remuneration of the Manager's staff).

- c. *Marketing Notification for Non-EU Managers.* In general, for a non-EU Manager to market a Fund to professional investors in the European Union, it must comply with (i) the AIFMD disclosure and transparency obligations, (ii) the AIFMD “no asset stripping” requirements in respect of controlled portfolio companies in the European Union and (iii) national private placement regimes applicable in the relevant EU jurisdictions (which involves, for a number of jurisdictions, making a marketing notification or obtaining a marketing license or approval or the appointment of a depositary for Danish and German marketing purposes). Cooperation agreements, which are intended to help regulators oversee potential systemic risk, must be in place between the regulator in each EU jurisdiction where the Manager is marketing and the regulators in the jurisdiction(s) in which the Fund and the Manager are established.

- d. *Passporting.* An EU Manager benefits from a “passport” enabling it to market its EU funds throughout the European Union without requiring registration or licensing by authorities other than its home state regulator. Although there is a regime in the legislation of the European Union to allow non-EU managers to market funds in the European Union using a passport, this regime has not yet been activated and therefore is not currently available to non-EU Managers.

13. 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. Under FATCA, a withholding tax of 30% will apply to certain payments made to non-U.S. persons, subject to exceptions, unless they comply with the FATCA reporting regime. In order to facilitate the implementation of FATCA, the United States has entered into intergovernmental agreements (“IGAs”) with many foreign countries, which simplify the due diligence and disclosure requirements and eliminate certain withholding obligations otherwise imposed under FATCA. Funds (whether organized in the United States or offshore) need to consider the compliance and reporting aspects of FATCA and any applicable IGA.

14. CRS

The Common Reporting Standard, or “CRS,” is another exchange of tax information regime, developed by the Organization of Economic Co-operation and Development (“OECD”) to combat tax evasion by requiring the disclosure of certain direct and indirect owners of interests in financial accounts (and certain other persons that control such owners). Around 100 countries participate in CRS, including the Cayman Islands, Jersey, Guernsey and the United Kingdom. The United States is not participating in CRS. Funds organized in participating countries need to consider the compliance and reporting aspects of CRS.

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15. Blue Sky and Other U.S. State-Level Matters.

15. 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. A state securities law review must be undertaken in connection with each transaction. 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.

16. CFIUS

President Trump's signing of the Foreign Investment Risk Review Modernization Act ("FIRRMA") on August 13, 2018 meaningfully broadened the scope of review of foreign equity investment into the United States by the Committee of Foreign Investment in the United States ("CFIUS"). CFIUS review now extends beyond controlling investments that may raise national security concerns. Under FIRRMA, CFIUS may review transactions by which non-U.S. persons make non-passive minority investments in U.S. critical technology and critical infrastructure businesses, and businesses that maintain and collective sensitive personal information of U.S. citizens. In addition, CFIUS will promulgate regulations that will require mandatory declarations for non-passive substantial investments by foreign government entities. Moreover, as part of FIRRMA's implementation, on November 10, CFIUS launched a Pilot Program that requires mandatory declarations for non-passive

foreign investment in U.S. businesses that design or use “critical technologies” for a set of specified key industry sectors. Also as required by FIRRMA, the Department of Commerce has initiated a proceeding to specify a list of “emerging technologies” that will themselves be deemed to be “critical.” In light of foreign investments in U.S. portfolio companies, whether made directly or indirectly through a general fund, separate account or co-invest vehicle, sponsors may wish to take these developments into account, both in drafting Fund documents and in considering whether they should or must make a CFIUS filing at the time the Fund makes an investment in a U.S. business.

A piece of good news for Fund sponsors in the context of a fundraising is that FIRRMA provides an “investment fund safe harbor,” which excludes from the definition of a “covered transaction” (*i.e.*, a transaction over which CFIUS has jurisdiction) a passive investment made by a foreign investor through a qualifying investment fund. To qualify for this safe harbor:

- (i) The fund must be under the control of a General Partner who is not a foreign person.
- (ii) If the foreign investor sits on the fund’s advisory committee, the committee must not have the ability to approve, disapprove or control the fund’s investment decisions, decisions made by the General Partner regarding the fund’s portfolio companies, or the hiring, firing, selection or compensation of the General Partner. The committee may, however, opine on a waiver of conflict of interest or allocation limitations.

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- (iii) The investor may not have access to material nonpublic technical information (*i.e.*, that relates to critical technologies or critical infrastructure).

If the fund's General Partner is itself a non-U.S. person, or is controlled by a foreign person or if foreign investors will have certain rights of access to nonpublic technical information or governance or will have decision-making rights with respect to the portfolio company, CFIUS implications should be considered. In those cases, understanding the ownership of the foreign investors as well as the nature of the U.S. business becomes important. If the Fund proposes to invest in a business that develops or uses critical technologies in an industry included on the Pilot Program list or is, more broadly, involved in "emerging" or other "critical" technologies, or if other national security considerations are present, the sponsor may want to consider whether a CFIUS filing should or, in the case of mandatory declarations, must be made.

17. Cryptocurrencies

The rapid growth of cryptocurrencies and the underlying blockchain technology presents a number of new challenges and opportunities for investment managers. Managers considering investments in or holding cryptocurrencies will want to carefully consider the legal, financial and reputational risks that could present themselves. For cryptocurrency creators, the key area of regulatory risk is around whether or not the specific cryptocurrency is a security and thus subject to the securities laws, including the rules and regulations of the SEC. For investment managers considering investing in the

cryptocurrency space, however, there are a host of additional issues that should be carefully considered prior to investment, including:

- a. Tax implications (the IRS views virtual currencies as property);
- b. Custody rules;
- c. AML and similar compliance;
- d. Valuation concerns;
- e. “Marketable security” definition; and
- f. Cyber security risks (The blockchain may be secure but the networks which provide access to it are frequently not).

Given the attention on cryptocurrencies and the staggering amount of money being raised in this new area, a host of U.S. regulators (and many of their state and foreign counterparts) have expanded their oversight and enforcement of cryptocurrency-related participants, including the SEC, CFTC, FINRA, FinCen, OFAC and IRS, among others. In light of this regulatory scrutiny, we encourage investment managers to consult with counsel in advance of making an investment in this area.

GLOSSARY OF KEY TERMS

Advisers Act:	U.S. Investment Advisers Act of 1940, as amended
AIFMD:	European Alternative Investment Fund Managers Directive
BDC:	regulated business development company
BHC:	bank holding company
BHC Act:	U.S. Bank Holding Company Act of 1956, as amended
CFC:	controlled foreign corporation
CFIUS	Committee of Foreign Investment in the United States
CFTC:	U.S. Commodity Futures Trading Commission
CFTC Regulations:	regulations of the CFTC under the U.S. Commodity Exchange Act
Code:	U.S. Internal Revenue Code of 1986, as amended
CRS:	The Common Reporting Standard
DOL:	U.S. Department of Labor

GLOSSARY OF KEY TERMS

ECI:	income effectively connected with the conduct of a trade or business within the United States
ERA:	exempt reporting adviser
ERISA:	U.S. Employee Retirement Income Security Act of 1974, as amended
Exchange Act:	U.S. Securities Exchange Act of 1934, as amended
FATCA:	U.S. Foreign Account Tax Compliance Act provisions of the Code and related U.S. Treasury guidance
FCC:	U.S. Federal Communications Commission
FHC:	financial holding company
FINRA:	U.S. Financial Industry Regulatory Authority
FIRPTA:	U.S. Foreign Investment in Real Property Tax Act, as amended
FIRRMA	Foreign Investment Risk Review Modernization Act
FOIA	Freedom of Information Act
FTC:	U.S. Federal Trade Commission

GLOSSARY OF KEY TERMS

GDPR	The EU's General Data Protection Regulation
IGAs:	Intergovernmental agreements
Investment Company Act:	U.S. Investment Company Act of 1940, as amended
IRR:	internal rate of return
IRS:	U.S. Internal Revenue Service
KID	Key Information Document
MiFID:	Markets in Financial Instruments Directive
OECD:	Organization of Economic Co-operation and Development
PFIC:	passive foreign investment company
REIT:	real estate investment trust
REOC:	real estate operating company
RIA:	registered investment adviser
RIC:	registered investment company
RULPA:	Delaware Revised Uniform Limited Partnership Act
SBIC:	small business investment company

GLOSSARY OF KEY TERMS

SEC:	U.S. Securities and Exchange Commission
Securities Act:	U.S. Securities Act of 1933, as amended
UBTI:	unrelated business taxable income
U.S. GAAP:	U.S. generally accepted accounting principles
USRPHC:	United States real property holding corporation
VCOC:	venture capital operating company
Volcker Rule:	Section 13 of the BHC Act

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