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Introduction to Fund Formation

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Agenda

- Types of funds
- Structural issues
- Key documents
- Regulatory issues

Types of Funds

- Hedge Funds
 - Typically invest in liquid, publicly-traded securities
 - Investors make capital contributions upon subscription
 - Usually feature a one year lock-up, after which investors may withdraw from the Fund
 - Allocates profits and losses based on realized and unrealized gains

Types of Funds

- Private Equity Funds
 - Make long-term, illiquid investments
 - Investors make “capital commitments” upon subscription
 - Fund manager makes “capital calls” from the investors’ commitments
 - Allocates profits and losses based on realized gains

Types of Funds – Fee Structures

- Hedge Funds:
 - Manager typically collects an annual management fee:
 - Set fee as an annual rate as a percentage of the total amount of the net asset value of the investments owned by the Fund (the “AUM Fee”)
 - Manager also collects an Incentive Allocation:
 - Percentage of the Fund’s net realized and unrealized profits

Types of Funds – Fee Structures

- Private Equity Funds
 - Manager receives an annual Management Fee
 - Early Investment Period: percentage of the Fund's total capital commitments
 - Post-Investment Period: percentage of the Fund's invested capital
 - Manager also receives a Carried Interest
 - Percentage of the Fund's realized profits

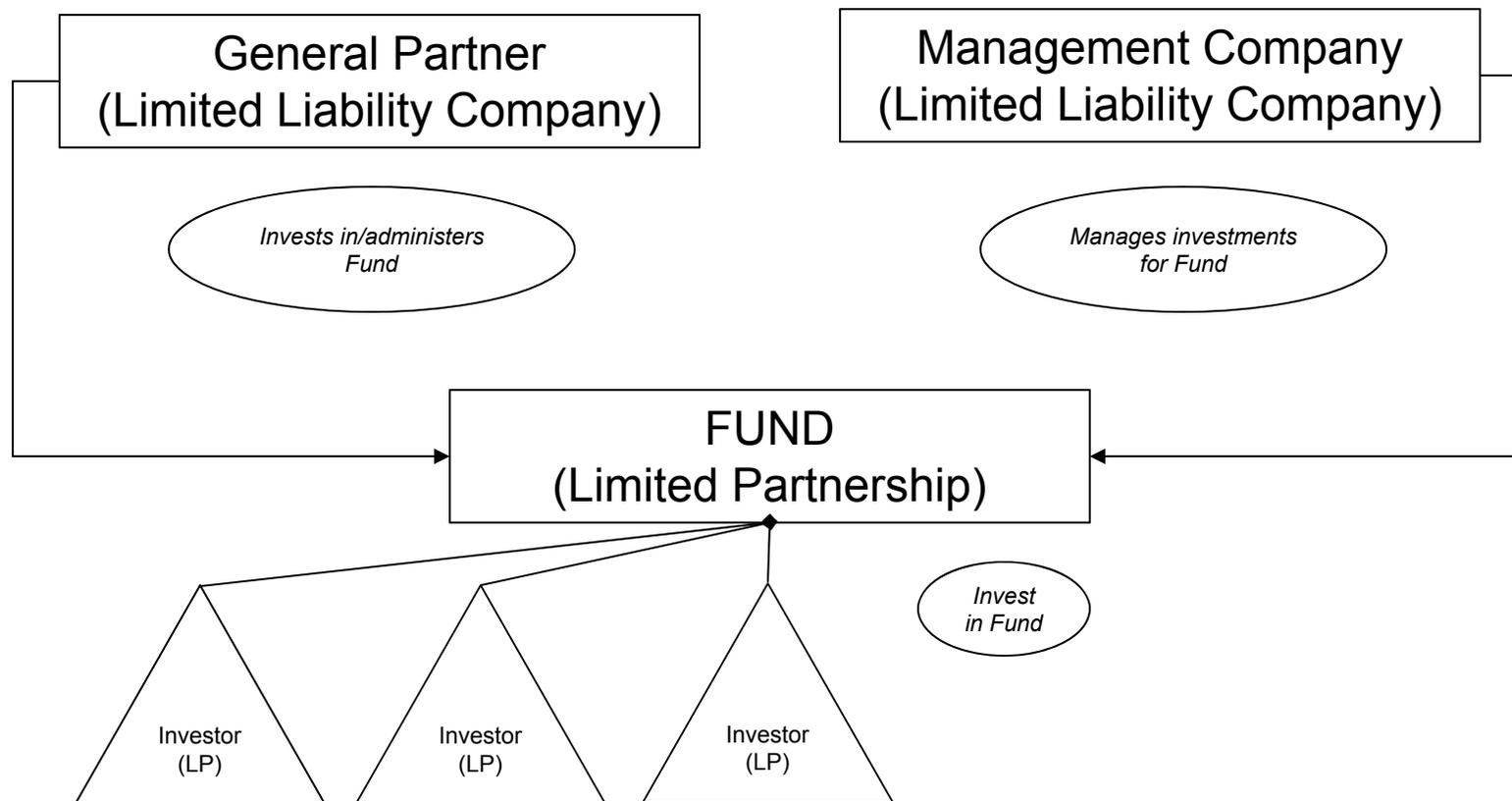
Structure

- Formed as a limited partnership
 - Fund investors are the Limited Partners
- Sponsor forms one or two separate limited liability companies
- Three-party structure vs. two-party structure

The Limited Partnership

- General Partner
 - Often a limited liability company (“GP Entity”)
 - Responsible for overall Fund management
- Limited Partners
 - Passive investors
 - Limited liability
 - Partnership interests are considered “securities”
- Flow-through tax treatment
- Flexibility in management
 - Broad authority for GP Entity

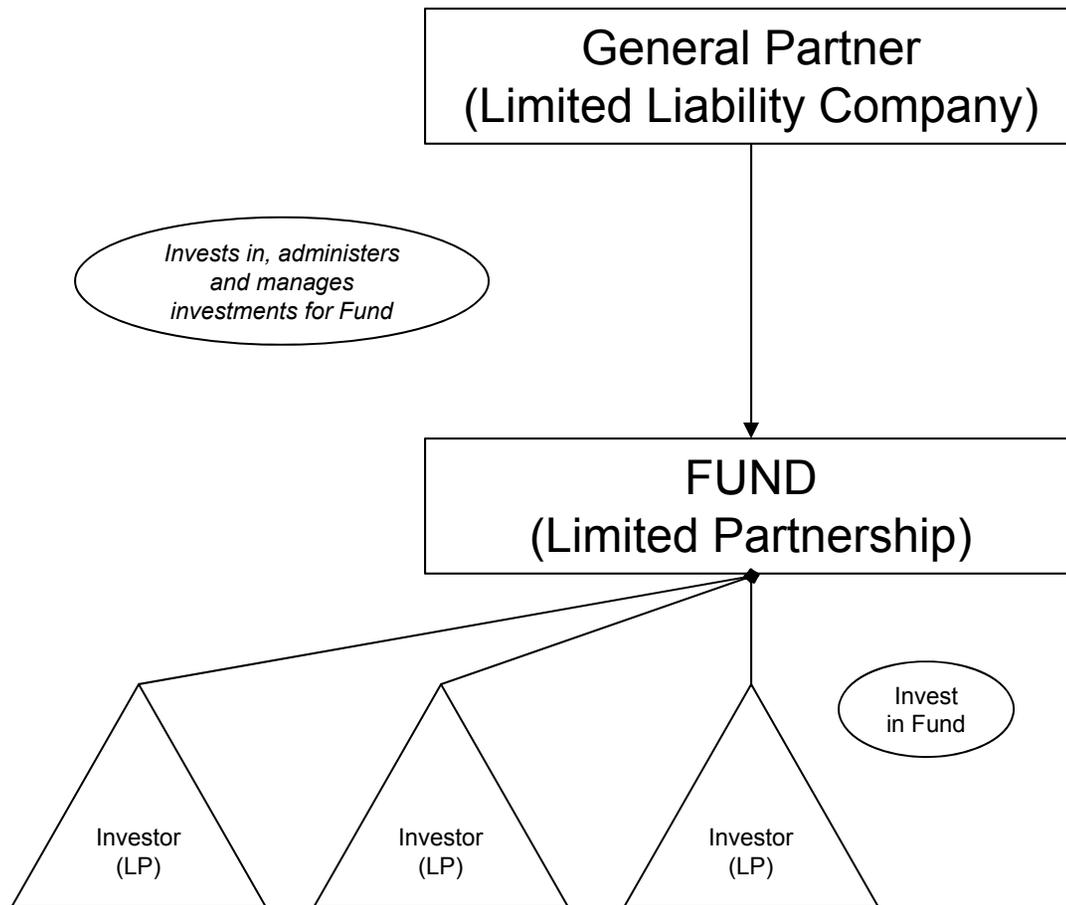
Three-Party Structure



Three Party Structure

- GP Entity receives Incentive Allocation/Carried Interest
- Management Company of a Private Equity Fund:
 - Receives the Management Fee
- Management Company of a Hedge Fund:
 - Receives the AUM Fee

Two-Party Structure



Two-Party Structure

- Hedge Fund:
 - GP Entity collects Incentive Allocation and AUM Fee
- Private Equity Fund:
 - GP Entity collects Incentive Allocation and Management Fee

Key Documents

- Private Placement Memorandum
- Limited Partnership Agreement
- Subscription Booklet
- GP Entity LLC Agreement
- Management Company LLC Agreement
- Investment Management Agreement

Private Placement Memorandum (“PPM”) – Sets forth key information about the Fund

- Investment strategy
- Risk factors
- Information about GP Entity and Management Company
- Management Fee/AUM Fee/Incentive Allocation/Carried Interest
- Other fees/expenses
- Conflicts of Interest
- Tax matters
- Synopsis of Limited Partnership Agreement

Limited Partnership Agreement –

Parties: GP Entity and Limited Partners

- Features:
 - Term
 - Object/purpose
 - Limitation of liability
 - Management
 - Indemnification
 - Fees
 - Fund expenses
 - Tax matters
 - Valuation of Assets
 - Assignment and transfer

Limited Partnership Agreement –

Parties: GP Entity and Limited Partners

- Hedge Funds:
 - Capital accounts
 - Allocations
 - Distributions
- Private Equity Funds:
 - Capital contributions
 - Capital commitments
 - Capital calls
 - Distributions
 - Defaulting Limited Partners
- Hedge Funds: admission/withdraw provisions
- “Key Man” provisions
- GP Entity removal
- Books & records/Periodic reporting

Subscription Documents –

Confirm Investor's obligation to purchase fund interests - Provides important information about an Investor

- Importance of Subscription Documents
 - Exemptions
 - Duty to update
- Investor Information
 - Identifying information
 - Amount of commitment

Subscription Documents –

Confirm Investor's obligation to purchase fund interests - Provides important information about an Investor

- Representations and warranties
 - Type of investor (individual or entity); Net worth
 - NASD New Issues Rule
 - Acknowledgements (receipt of documents, questions answered, etc.)
 - Accredited investor, qualified purchaser and/or qualified eligible person status
 - Acknowledgement of unregistered/restricted status of Fund
 - Indemnification provisions
- Investors that are private funds or “benefit plan investors” – 1940 act and ERISA exemptions
- Confidentiality

Regulatory Issues

- Securities Act of 1933
- Investment Advisers Act of 1940
- Investment Company Act of 1940
- Securities Exchange Act of 1934

Registration of Offer and Sale of Fund Securities Under the 1933 Act

- Interests in a Fund are “securities” under 1933 Act
- Exemptions
 - Section 4(2) of the 1933 Act
 - Private placement exemption
 - Regulation D
 - Safe harbor that qualifies offerings for exemption under Section 4(2)
 - Reduces uncertainty and specifies objective criteria

Regulation D

Accredited Investors

- Rule 506 is most relevant for Funds
- Exemptions for offerings made exclusively to “accredited investors”
- Accredited Investor Criteria Generally:
 - Natural person with net worth in excess of \$1 million. The “net worth” test: (i) excludes the value of the investor’s primary residence; and (ii) provided that such indebtedness was incurred prior to 60 days before the investor’s investment into the fund, excludes the amount of liabilities secured by the investor’s primary residence unless and to the extent that such liabilities exceed the value of the investor’s primary residence.
 - Natural person with an annual income of:
 - Individually: \$200,000; Jointly: \$300,000
 - Trust with assets in excess of \$5,000,000
 - Any entity beneficially owned exclusively by accredited investors

Regulation D

General solicitation or advertising

- Prior to the enactment of the Jumpstart Our Business Startups Act (the “Jobs Act”), general solicitation was prohibited in connection with Regulation D offerings.
- The Jobs Act amended the general solicitation rules and, in July, 2013, the SEC issued final rules allowing for the general solicitation in Regulation D offerings provided that the investors are all accredited investors and the issuer takes reasonable steps to verify each of the investor’s accredited investor status.
- Whether the issuer has taken “reasonable steps” to verify accredited investor status is a facts and circumstances analysis. However, the SEC has issued a non-exclusive and non-mandatory list of ways in which issuers will be deemed to satisfy the verification requirement as long as the issuer does not have knowledge that the investor is not an accredited investor. The list includes the following: (i) review of the investor’s tax return for 2 years and also receive a written statement that the investor expects to reach the income necessary to qualify, (ii) review 3 months’ worth of financial statements and also receive a representation that the investor has disclosed all liabilities necessary to make a net worth determination, (iii) the issuer may receive 3rd party verification from a registered broker-dealer, a registered investment advisor, a licensed attorney, or a licensed accountant; and (iv) the issuer may receive written certification from an existing investor that such investor still qualifies as an accredited investor.
- **Based upon these rules and verification requirements, most funds are well advised NOT to engage in general solicitation.**

Regulation D –

Other considerations

- Investors must not invest with a view to distribute interests to the public
- Form D filing
- Exemption from State Registration/Blue Sky Laws
 - National Securities Markets Improvement Act of 1996
 - Notice filings

Advisers Act

Small Adviser Exemption Before Dodd-Frank Act

- Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (the “Dodd-Frank Act”), the GP Entity and/or Management Company:
 - Was required to register with the SEC if it had \$30 million or more of “assets under management”
 - Was allowed to register with the SEC if it had at least \$25 million or more of “assets under management”
 - Small Adviser Exemption: However, small advisers were not required to register with the SEC even if they had \$30 million or more of assets under management. “Small Advisers” were investment advisers that: (i) had fewer than 15 clients in preceding 12 months, (ii) did not advise registered investment companies or business development companies, and (iii) did not “hold itself out to the public” as an investment adviser. The Management Company typically satisfied this exemption because the Fund qualified as a single client.

Advisers Act

Registration Requirements Post-Dodd-Frank Act

- New Thresholds for SEC Registration: The Dodd-Frank Act significantly changed the landscape for investment advisers. Generally, investment advisers are subject to the new threshold amounts for registration: (i) investment advisers with less than \$25 million of assets under management (“small advisers”) are generally prohibited from registering with the SEC and must register with the state regulators unless an exemption applies, (ii) investment advisers with \$25 million to \$110 million of assets under management (“mid-sized advisers”) are generally prohibited from registering with the SEC and must register with the state regulators unless an exemption applies but there is a buffer for advisers between \$100 million and \$110 million, and (iii) advisers with \$110 million are required to register with the SEC.
- Exemptions from Registration with the SEC:
 - Advisers only to Venture Capital Funds
 - Advisers only to Private Funds with less than \$150 million in assets under management
 - Advisers that are Foreign Private Advisers
 - Advisers only to Small Business Investment Companies (“SBICs”)
 - Advisers only to Family Offices
 - Intrastate Advisers
- Obligations of Investment Advisers that are Exempt from Registering with the SEC: Notwithstanding that an investment adviser may not be required to register with the SEC, such advisers may be subject to certain SEC rules, relating to: (i) the anti-fraud provisions, (ii) the pay-to-play rules, (iii) certain supervisory requirements, and (iv) principal transactions rules. Further, investment advisers relying on the Venture Capital Funds or Private Fund’s exemptions from registration, such advisers will be considered “Exempt Reporting Advisers” and required to a subset of the Advisers Act rules, including, submitting a truncated version of the Form ADV and be subject to SEC examinations.

Advisers Act

Compliance Requirements for SEC Registered Investment Advisers

- Investment advisers that are registered with the SEC, generally, will become subject to the full scope of the Advisers Act. These include:
 - Filing current disclosures on Form ADV
 - Satisfying certain record-keeping requirements
 - Being subject to SEC Office of Compliance examinations
 - Establishing, maintaining, and implementing compliance programs (including written policies and procedures reasonably designed to prevent violations of the Advisers Act or other securities laws, proxy voting policy, insider trading policy, and code of ethics, designating a Chief Compliance Officer tasked for administrating the firm's policies and procedures, performing periodic training on policies and procedures, and performing compliance reviews at least annually)
 - Satisfying the SEC's Custody Requirements
 - Complying with advertising rules
 - Remaining subject to restrictions on performance fees

Investment Company Act

- Most Common Exemptions:
 - Section 3(c)(1) Funds
 - Not making or proposing to make a public offering
 - Beneficial ownership is limited to fewer than 100 persons
 - Section 3(c)(7) Funds
 - Not making or proposing to make a public offering
 - All owners must be “qualified purchasers”

Investment Company Act – 3(c)(1) Funds

- 100 Beneficial Owner Limit
 - Natural persons:
 - Individuals
 - Spouses holding interests jointly
 - Involuntary transfers do not increase the number of beneficial owners
 - Entities:
 - Companies that own 10% or more of the Fund
 - Look-through to beneficial owners
 - Only applies to other Funds and Investment Companies

Investment Company Act – 3(c)(1) Funds

- Prohibition Against Public Offerings
 - Generally satisfied by complying with Regulation D prohibitions

Investment Company Act – 3(c)(7) Funds

- Exclusive ownership by “Qualified Purchasers”
 - Natural persons who own not less than \$5 million in investments
 - Family companies that own not less than \$5 million in investments
 - Trusts with a trustee and settlor who are qualified purchasers
 - Institutional buyers that own and invest on a discretionary basis not less than \$25 million in investments
 - Companies in which each beneficial owner of the company’s securities is a qualified purchaser

Investment Company Act – 3(c)(7) Funds

- Prohibition Against Public Offerings
 - Generally satisfied by complying with Regulation D prohibitions

Exchange Act

- **Broker-Dealer Registration**
 - **Broker:** any person engaged in the business of effecting transactions for the account of others
 - Funds are not brokers because any trading activity is done for their own account
 - **Dealer:** any person engaged in the business of buying or selling securities for such person's own account through a broker or otherwise
 - Funds are not dealers because they are not considered to be "in the business" of buying and selling securities
 - Funds are considered to be "traders" that buy and sell for investments generally

Exchange Act

- Section 12 of the Exchange Act
 - Prior to the enactment of the Jobs Act, Section 12(g) required issuers to register a class of equity securities with the SEC if, on the last day of the issuer's fiscal year, such class of securities was held of record by 500 or more record holders and the issuer had total assets of more than \$10 million.
 - Title V of the Jobs Act amended Section 12(g) of the Exchange Act which now provides that an issuer will become subject to the Exchange Act requirements within 120 days after the last day of its fiscal year on which the issuer has total assets in excess of \$10 million and a class of equity securities (other than exempted securities) held of record by either: (i) 2,000 persons, or (ii) 500 person who are not accredited investors.

Further information

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