

## Structure – Private Equity and Venture Capital Funds

Private Equity and Venture Capital funds (abbreviated “PE” and “VC” in this discussion) operate much differently from “normal” hedge funds. Those significant structural differences arise primarily because of the nature of their portfolios, which usually consists of securities of private companies or other illiquid and difficult-to-value investments. Without frequent and accurate valuations, a fund cannot establish a fair valuation to admit new investors; and without liquidity, it cannot permit existing investors to withdraw capital during the term of the fund. Accordingly, PE and VC funds have a single limited offering period, with no new investors admitted after the offering is closed. Typically, the fund then has a lifespan determined by its investments. Often, the legal documents will specify that the fund will terminate at some point, for example, 10 years out, with provisions for extending that timeframe several more years.

In a hedge fund, day-to-day operations and investment activities usually change little over time. On the other hand, there are specific stages in the life of a PE or VC fund. A normal life cycle would include the following:

### The Life Cycle of a PE or VC Fund

|                          | Time (not linear) →                                     |                                  |
|--------------------------|---|----------------------------------|
| <b>Investors</b>         | initial closing   | later investors                  |
| <b>Cash Calls</b>        | initial   | other cash calls                 |
| <b>Investments</b>       | the “Investment Period” - new positions are established | possible “follow-on” investments |
| <b>Proceeds of Sales</b> | documents may permit reinvestment of early gains        | distributions                    |

While the single offering period and extended life offer simplicity from an administrative point of view, there are many details that can lead to complications. This short discussion addresses some of the structural issues and suggests choices that can make life easier for both managers and administrators.

### Commitments and Contributions

Typically, investors will subscribe for fund interests by making a capital commitment – a legal obligation to contribute a certain amount to the fund over time – which is drawn upon in a series of capital calls.

- Fees and certain expense allocations should be defined in terms of commitments (rather than valuations), with an investor’s interest in such items based on “commitment percentage” – his or her commitment divided by the sum of all commitments.
- Normally, an initial cash call is made at the time of subscription. Typically, that first call will be ¼ or so of the commitment, but in some cases, it can be much higher.
- Distributions are typically made based on investors’ pro rata shares of capital contributions. If there are no defaulting partners – all have fulfilled their cash call obligations – these shares will mirror the “commitment percentages.”

### Offering Period

One simplicity of the commitment percentage is that all investors have a fixed percentage interest in all investments made over the entire life of the fund. However, the reality of raising capital for a new fund is that not all subscriptions and initial contributions will occur at the same time. Accordingly, there will normally be a process that ensures fairness between investors coming into the fund at different times.

First, it is important to establish an offering period short enough to remove the risk that material changes in investment values might occur and be known before the last investor commits. Typically, we see offering periods of 6 to 12 months after the initial closing, with possible extensions. During such a limited period, there would typically be a small number of investments and limited time for values to change.

Secondly, there will be an interest charge on late subscriptions. APM has a tool that uses varying prime rates over the offering period to compute an interest charge based on cash calls made prior to the subscription. For example, if the fund had made two cash calls totaling 30% of commitments, a new \$1 million investor would contribute \$300,000 plus interest at the time of subscription. The interest amount would reflect time periods and amounts of the cash calls.

*Drafting note: It is best to connect the interest charge to a published and easily accessible rate. For example, it is simpler administratively if the "Late Commitment Interest Charge" is based on "prime rate as published in the Wall Street Journal or other recognized source" rather than some specific bank where data is not easily verifiable.*

Where does the interest money go? Some offering documents credit existing investors and some credit the fund as a whole. In our opinion, the proper method is the latter, for the following reasons:

- The conceptual purpose of the interest charge is to put the early and late subscribers on the same footing. Since early investors have not had the use of the portion of their capital that has already been called, if interest is charged to the late investors, it removes the benefit of investing late. However, if that interest is then credited only to the early investors, those early investors are now in an improved position relative to the late arrivals. Conceptually, at the moment the late investors are charged, the two groups are equalized; a moment later, if interest is then credited only to the early group, that early group has benefited disproportionately.
- While arbitrarily favoring initial investors might seem attractive, it can lead to unintended results. For example, assume that the initial investors comprise \$50 million in commitments and \$10 million in cash contributions. Six months later, \$150 million is committed. If the interest on the \$30 million catch-up cash call is credited only to the initial group,

they will have effectively received 3X interest rates on their cash contributions. Clearly, the intent of equalization is not to create a wild-card pay-off for the initial investors that is dependent on the size of later subscriptions. On the other hand, if catch-up interest is credited to the fund overall, it keeps all investors on the same footing.

If a late subscription (or group of them) is substantial in size, with the result that cash exceeds the current anticipated needs of the fund, excess cash (and interest) may be paid out pro-rata to all investors. Any such amount is, of course, available to be called at a later time.

Since each commitment is treated as if it were made at the start date of the fund, management fees and other expense allocations incurred during that interim period are also "caught up" or adjusted at the time of later subscriptions.

### Investment Period

In keeping with its limited lifespan, fund documents will usually specify a limited timeframe in which investments may be initiated. This "investment period" should end at a point in time where there is a reasonable assumption that the fund will wrap up on time. After the end of the investment period, the only permitted investments would be additional cash (perhaps with limits) to current portfolio companies (often called "follow-on" investments). Up until the end of the investment period, documents may provide that early sales proceeds be reinvested, but after that point, distributions would be expected to follow sales of portfolio positions.

### Carried Interest

The incentive arrangement to the general partner is best defined in terms of distributions, not income allocations. Following is a normal sequence (sometimes called a "waterfall") for distributions, assuming a 20% carried interest:

*Return of Capital ("ROC").* Investors first get back 100% of their contributions.

*Preferred Return (“PR”).* Investors are allocated a return of X% on contributions until the time that all contributions have been returned. Note that, since investors making late commitments have already been equalized by the interest charge mentioned earlier, this is simplest if calculated on a fund-level basis. Accordingly, all investors are considered to have made contributions at the same times.

*Note that PR can be defined as either a hurdle or a threshold. In APM parlance, a hurdle means that the investor gets back a return of X% on contributions, and then distributions are split 80:20. In a threshold, the GP gets 20% of all profits, provided that the net result to the investor is a return of at least X% on contributions.*

*GP (“General Partner”) Catch-up* (only if PR is defined as a threshold). When the PR is a threshold, a GP Catch-up is used at this point in the sequence so that 100% of the distributions go to the GP until it has received 20% of the distributions in excess of ROC. For example, if the PR was 4%, the next 1% would go solely to the GP, so that the outcome would be that there was an 80:20 split on the first 5% of distributions in excess of ROC.

*80:20 split.* Once beyond the PR and catch-up, all distributions simply follow the stated carried interest split.

*Drafting note: It is often useful to have a catch-all clause in the income allocation section that permits “such other allocations as the GP determines advisable in order to align income allocations with distributions.”*

*Note on “Clawback funds: ” Returning all contributed capital to the investors before making any distributions to the GP eliminates the complexities and stresses of a “clawback.” In some early venture capital funds that we administered, the GP collected 20% of the profit component of each distribution with the requirement that the GP settle up with the fund in the event of overpayment calculated when the fund is wound up – which would occur if some future investments turned out to be losers. Clearly, losers are to be expected and sometimes GPs might have paid some of that incentive to employees or their own partners who are no longer at the firm. Needless to say, the legal descriptions of the segregation of distributions into cost basis and profit components, plus the details of the clawback procedures from the GP and individual employees are also very complex. The majority of funds and documents we now see have eliminated those conflicts and risks and have opted for the relative simplicity of the distribution sequence above.*

### Defaults

What if an investor does not or cannot respond to a cash call? Since the fund itself may have legal obligations for periodic payments to underlying investments, the financial consequences of defaults can be extreme. Accordingly, typical legal documents will have severe penalties such as provisions for the forced sale of the defaulting partner’s interest or a forced disproportionate dilution of the defaulting party’s percentage interest in the fund.

### Valuation

In the model outlined in this discussion, the economic results of a PE or VC fund are determined by its distributions, and the shares of those distributions are set by relative commitments and contributions during the offering period. Plus, management fees are normally determined by commitments, not by net asset value. Accordingly, interim valuations of the fund’s investments do not have the same immediate importance or set of possible conflicts that exist with valuations in a “normal” hedge fund. That said, assets will need to be “fairly valued” for the annual audit.

*Note that accurate valuation would likely be needed at the time of any distribution in a “clawback” type fund, since any positions at a current value of less than cost would likely impact whether a distribution would include a profit component. In such a fund, there will often be an advisory committee of investors charged with monitoring valuations and conflicts of interest.*

### Distributions

Although some circumstances may invite early distributions, normal expectations would be that distributions would commence after the end of the investment period. Note that distributions are, in most cases, subject to future cash calls in the event that the fund requires additional cash, either for legal or operating purposes.

*Drafting note: In some cases, language intended to assure rapid payouts of securities sales proceeds may imply 100% payout. Distribution language should include provisions for maintenance of reserves.*

### Late Stage Issues

At some point, the number and value of investments remaining in the fund will dwindle. Management fees are based on commitments and are thus fixed, so at some point, there may be a reduction in the management fee rate. That reduction can be triggered either by the passage of time (“commencing in the 6th year”), by portfolio liquidations (“commencing the quarter after one-half of the investments have been liquidated”), or by a noted end of the investment period (“commencing the quarter after the end of the Investment Period”). Management fees may be reduced by a stated fraction or redefined to be based upon remaining investments, such as “the cost basis of the current portfolio.”

At some point, it may be advisable to distribute the “lingering” investments to fund participants so that the fund can be wound up. If the fund is at the “80/20 split” point in the waterfall, 20% of those securities would likely be distributed to the general partner. Since there may be legal restrictions on the distribution of securities held by the fund, the fund offering documents will likely contain provisions for a liquidating trust or other wrap-up vehicle.

### Funds of PE or VC Funds

Some funds-of-funds (“FOFs”) invest only in PE or VC funds. In addition to the elements discussed above, such a fund must be especially concerned with its capital calls. It is difficult to administratively “turn around” a capital call from an underlying fund by issuing a similar capital call to the FOF investors and get it all done in the time allowed to pay the capital call amounts. Accordingly, capital calls need to be planned comfortably in advance so that there’s enough cash kept on hand to meet normal calls from underlying funds. If a PE or VC FOF does not keep an adequate cash cushion, it will need to either establish a line of credit or closely monitor its underlying funds with the intent of staying ahead of the game. Because PE and VC FOFs often do not include carried interest and preferred return calculations – so there is no financial motivation to minimize the FOF cash balances – they will usually have just a few large cash calls that will keep them comfortably ahead of the needs of underlying funds.

### Offshore Funds

One notable difference between an offshore PE or VC fund and a “normal” offshore hedge fund is that the offshore PE or VC fund will most often be structured as a partnership or some other structure that elects to pass its tax effects through to investors. Because of the expected long-term holding periods of securities, pass-through taxation will likely be more attractive to the manager, plus, with a single offering period, the complexity of shares and series accounting is unnecessary. Accordingly, reporting to investors will likely be in terms of account values, rather than net asset values per share or unit.

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