Debevoise & Plimpton

Private Funds

Key Business, Legal and Tax Issues

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ABOUT THE DEBEVOISE & PLIMPTON TEAM

For more than 40 years, Debevoise has been at the forefront of the private capital industry. Our unique close-knit partnership brings a breadth of resources to solve complex problems, enabling us to be a seamless presence globally at every stage of the private fund life cycle.

Comprised of approximately 500 lawyers (including 100+ partners), our interdisciplinary team is able to seamlessly deliver to our clients, collaborating across global offices and practice groups, benefitting clients with collective experience and insights in everything from fund formation to M&A and leveraged finance, to tax, as well as cybersecurity, litigation and regulatory enforcement matters. Our clients also rely on Debevoise's wealth of industry-specific experience to successfully navigate the high regulatory risk inherent in areas such as healthcare and insurance and other active and emerging industries for private equity including (clean)tech, financial services, consumer, and (green) industrials.

Debevoise's leading private 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 3,400 private funds worldwide, with committed capital of over $5.5 trillion. Our firm, having focused on the private funds industry since the late 1970s, has deep knowledge of the industry and has worked closely with pre-eminent private fund sponsors to develop much of the fund "technology" that is now industry standard.

We advise sponsors and investors on the formation of and investment in private funds across every major investment strategy, including buyout, venture capital, growth equity, funds of funds, credit, real estate, infrastructure and energy. We represent the full range of funds, from first-time funds to the longest established and most pre-

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eminent firms and from independent boutiques to institutional sponsors and multi-strategy alternative asset firms.

Debevoise's strong track record, leading-edge insights, deep bench and commitment to unified, agile teams are why, year after year, clients quoted in *Chambers Global*, *Chambers USA*, *The Legal 500* and *PEI* cite Debevoise for our close-knit partnership, breadth of resources and relentless focus on results.

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Private Funds:

Key Business, Legal and Tax Issues

INTRODUCTION[1]

The private funds industry has matured over the past several decades into a broad, global industry with well-established practices. Today, private funds 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 fund advisers become larger and more global investors are committing more capital than ever, and global assets under management for the private funds industry now exceed $16 trillion.[2]

On the demand (investor) side, the private funds industry has been fueled by increased awareness (including by retail/high-net-worth investors) of the asset class and attractive track records 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 flow to repeat investors such as pension plans, sovereigns, banks and other institutions. On the supply (sponsor) side, growth has been fueled by

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[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] Preqin, *Future of Alternatives 2029* (Sept. 17, 2024).

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new generations of investment professionals entering the market; the development of new fund products; and the extension of private fund portfolio management skills to new industries and types of transactions. The dramatic growth on both the supply and demand side has been accompanied by increased complexity in the structuring and negotiation of funds, new rules/regulations and intensified regulatory scrutiny.

This guide is intended to serve as a primer with respect to the key business, legal and tax issues to be considered when forming a private 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, private 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 investors. For information on the latest regulatory and market developments, reach out to your Debevoise funds counsel or visit https://www.debevoise.com/capabilities/practice-areas/funds-investment-management.

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Investment Management Group

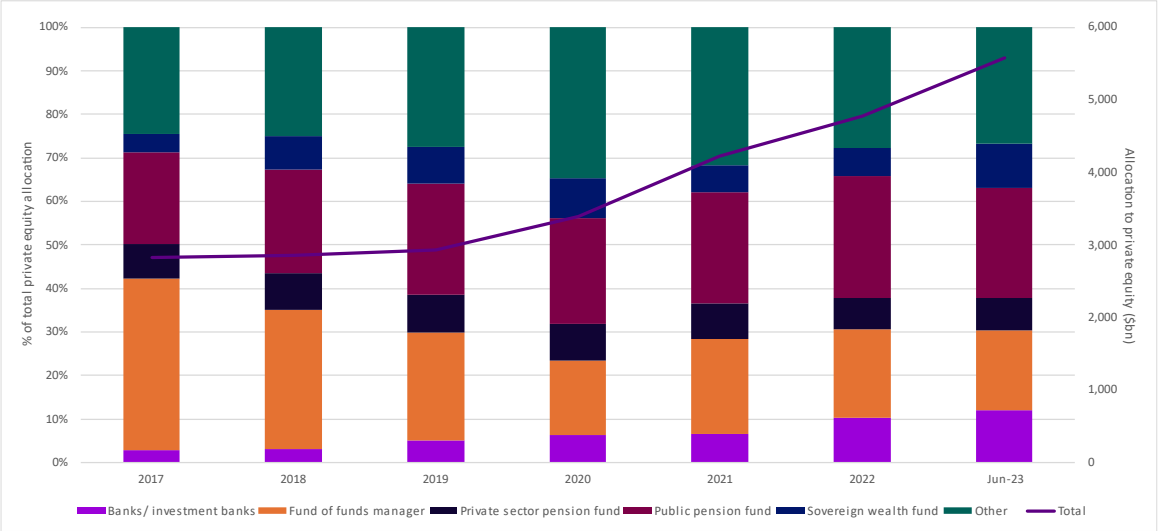
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1. Overview of Private Funds

> A private fund is an investment vehicle created and managed by an investment adviser that pools the capital of investors. In order to invest in a private fund, investors must meet the applicable sophistication requirements. Private funds invest in a broad range of asset classes, including growth equity, private equity, credit, leveraged buyouts, venture capital, real estate, infrastructure, energy, funds of funds and secondaries, among others.

Some funds pursue a broader generalist strategy, while others focus on investments in one or more specific industries or business sectors, such as energy, infrastructure, real estate, technology, healthcare, life sciences, sports, media and entertainment, insurance or other financial services. Certain funds also focus their investments in particular geographic regions or specific markets (such as emerging markets). Buyout, growth equity and venture capital funds tend to be illiquid, closed-ended funds. Hedge and other funds that largely invest in publicly traded securities tend to be liquid, open-ended funds. Funds with current income generating assets, such as certain debt and real estate funds can be open-ended, closed-ended or a range of hybrids between the two, depending on the strategy. Typical investors in funds include corporate pension plans, state and other government pension plans, sovereign wealth funds, insurance companies, university endowments, charitable foundations, 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.

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A. *What Is a Fund?*

a. *The Fund.* A typical closed-ended fund is structured as a fixed-life limited partnership (or series of parallel limited partnerships and/or feeder partnerships) whose partners have agreed contractually to contribute capital to the fund as and when needed in order for the fund to make investments and to be locked into the fund for the duration of its lifecycle with limited or no opportunity to withdraw from the fund. A typical open-ended fund is also structured as a limited partnership, with potential parallel funds or a master-feeder structure, but with a perpetual life. Partners generally contribute their capital at the time of subscription and have some periodic right to withdraw from the fund. In either case, investors are not involved in the fund's investment decisions or other day-to-day activities. Instead, the fund is controlled by its general partner, which generally makes all final

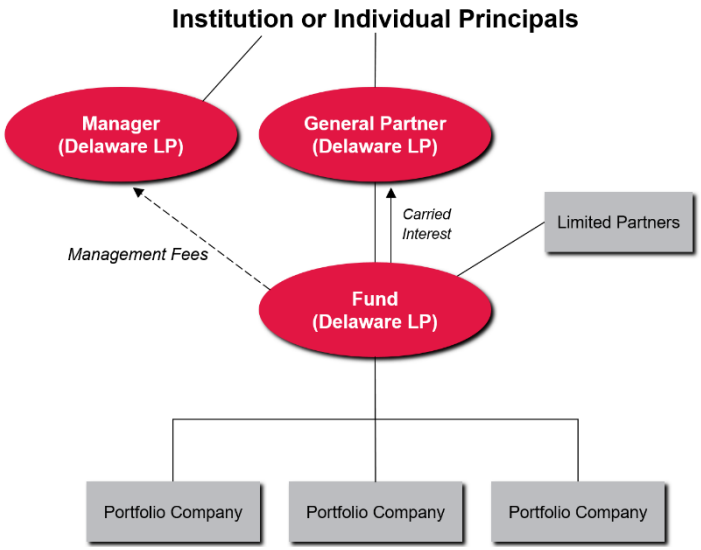
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decisions concerning the fund's operations and the purchase and sale of the fund's investments. A typical fund is managed and advised by an investment adviser firm or a subsidiary of the firm; the general partner and the manager usually are separate but affiliated entities run by the same professionals.

b. *The Manager*. 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. 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 (the "investment professionals"), together with the finance, tax, legal, investor relations and other functions that support the firm's activities. In most cases, the manager receives a management or advisory fee paid by the fund (or, occasionally, directly by its investors). See Figure 1 below, which presents a typical but simplified U.S. fund structure utilizing a Delaware limited partnership.

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Figure 1: Simplified U.S. Fund Structure



c. *The General Partner*. The general partner controls the fund and makes 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 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 "carried interest," "carry," "promote," "incentive" or "performance allocation." 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 in or alongside the fund).

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B. *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. *Partnership Classification*. 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 default into partnership status or 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 1.C, 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 subject to U.S. tax will be required to include its share of the fund's income in its own tax return.

b. *Qualifying Non-U.S. Entities*. Under the U.S. entity classification rules, non-U.S. vehicles where at least one member has unlimited liability default into partnership status for U.S. federal income purposes. Moreover, many kinds of non-U.S. vehicles, including most entities that are established as a company, can "check the box" to be classified as partnerships for U.S. federal income tax purposes. While Cayman Islands exempted limited partnerships, Luxembourg limited partnerships, Channel Islands limited partnerships

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and UK limited partnerships likely default into partnership status, many sponsors will make a precautionary "check-the-box" election to avoid all doubt. Use of such a non-U.S. vehicle is sometimes dictated by specific tax or business objectives.

c. *Separately Managed Accounts*. 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 carried interest.

d. *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 "U.S. 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.

e. *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 concerned with U.S. tax filing obligations

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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. Different fund products or strategies (*e.g.*, funds investing in U.S. real estate or credit funds) often merit special tax structuring for certain investors. See Topic 10 below for an overview of more of these considerations and certain structuring mechanisms.

f. *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.

C. *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 by far the most common) vehicle for establishing a fund. Limited partnerships have the well-developed statutory and case law in the jurisdictions where funds usually are organized, and investors are most familiar with them. Limited partnerships are creatures of contract and are therefore generally more flexible than other forms (*e.g.*, companies) in terms of their ability to define customized governance and economic arrangements. Limited partnerships are most commonly formed in Delaware, the Cayman Islands and Luxembourg.

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b. *Limited Liability Companies*. Limited liability company statutes have the advantages of being available in all U.S. states and 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) without unlimited liability for investors in respect of the fund's debts and obligations. Limited liability companies, however, may present issues for funds operating, investing and/or marketing outside of the United States because 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 is unclear.

D. *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 1,670 U.S. funds listed in Debevoise's proprietary database, approximately 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 core partnership terms by contract. Delaware also has favorable limited liability company statutes,

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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 or is targeting investors outside the U.S., many sponsors choose to form non-U.S. entities as their fund vehicles, usually limited partnerships organized in the Cayman Islands or Luxembourg. The Cayman Islands exempted limited partnership is a popular investment fund vehicle among U.S. and Asia-based sponsors, but it is less commonly used in Europe (both for sponsors investing in Europe and funds marketing to investors in Europe). Luxembourg partnerships, such as the *société en commandite spéciale* (SCSp) are frequently used as the sole fund vehicle or as parallel vehicle due to their general flexibility, their contractual freedom, their ability to mimic non-European parallel funds, their marketability under a pan-European passport as well as their general alignment with international standards. The choice of jurisdiction is generally driven by an analysis of tax, corporate and partnership laws, as well as operating factors, such as marketability.

E. *Multiproduct and Multijurisdictional Offerings*

a. *Parallel Funds*. In many cases, funds are structured to address the concerns of different types of investors by using one or more parallel funds. For example, a fund program might consist of a Delaware main fund and a Cayman Islands and/or Luxembourg parallel fund. Generally, parallel funds co-invest and divest alongside the main fund at the same time and on the same terms, *pro rata* based on their respective committed capital. Typically, the fund agreement of a parallel fund will

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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*. A sponsor may in some cases form a feeder fund for certain investors. For example, sometimes feeder funds are created for high-net-worth individual investors, for certain insurance company investors for whom it can be advantageous to invest in certain types of funds through "rated note" feeders (see Topic 1.E.c, below) or to serve as "above the fund" tax blockers for certain electing investors. 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 fund limited partner's investment, including look-through voting, default, excuse and reporting rights, among others.

c. *Rated Note Feeders*. Private equity sponsors often look to insurance companies as a source of perpetual capital but need to be mindful of unique regulatory and capital requirements that apply to insurance company investors. Insurance companies with long duration liabilities and lower liquidity risks generally are willing to invest in less liquid assets in exchange for higher yields. Sponsors that can source higher-yielding assets can succeed in attracting insurer capital if they

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address potential risk-based capital ("RBC") friction from high capital charges on direct investments in private funds. Properly structured rated feeders address RBC considerations and provide an attractive entry point for insurance company investment into private credit strategies.

Investors that participate through rated feeder structures typically hold rated debt and equity in a fund vehicle that invests as a limited partner in a private credit fund. Rated feeders can also be set up as a co-investment fund vehicle. Typical rated feeder capital structures include Class A and Class B rated notes with residual equity limited partner interests (insurance company investors have higher RBC charges on the residual equity). If underlying investments made by the fund sitting underneath the rated feeder are debt investments, it will be easier to secure favorable ratings on the notes. These types of investment structures also involve bespoke waterfall approaches to repayment of notes and equity.

d. *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 10, below.

F. *Alternative Investment Vehicles*

Typically, a fund agreement provides the general partner flexibility to form an alternative investment vehicle ("AIV") if a direct investment by the fund might not be the optimal structure

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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 investors to make a particular investment or subset of investments. In such cases, any investment made through the AIV reduces the investors' remaining capital commitments to the main fund and, typically, the investment results of the AIV are generally aggregated with those of the main fund for purposes of the economic "waterfall." See Topic 4, below.

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2. Fund Products and Strategies

> Private funds today cover a broad range of asset classes and investment strategies, 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:

A. *Buyout Funds*

Buyout funds make investments (typically controlling investments) in established private companies or public companies that are later taken private. A buyout fund's investment strategy may focus on one or more geographical areas or specific industries (such as healthcare, information technology or energy) or take a broader, generalist approach to investment opportunities. Buyout fund investments usually involve a debt financing component (a leveraged buyout). Funds focused on buyout transactions are frequently the largest and best-known 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

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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 round 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.

C. *Growth Equity Funds*

Growth equity funds (also called growth capital or expansion capital funds) make minority investments in companies that are predicted to grow or otherwise change in a way that will result in future growth. Those businesses (which typically have low leverage) then use such investment capital to further their expansion goals, thereby increasing the likelihood of positive returns. Growth equity investments typically have a shorter holding period than venture capital investments and are generally lower risk because companies targeted for growth equity investments typically operate in more established and mature markets.

D. *Real Estate Funds*

Real estate funds invest in real assets, or debt or securities backed by real assets. Many real estate funds focus on a particular property type (*e.g.*, multifamily, industrial, life science, office, affordable housing, self-storage). Others have the flexibility to invest in any property type or are required to diversify their investments among several property types.

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Real estate funds are further classified based on their risk-return profile:

- Core funds have relatively low-risk and low target returns—they invest in cash-flowing stabilized assets with long weighted average lease terms and minimal projected near-term renovation costs. Core funds tend to employ modest leverage in the range of 20–40% LTV. Core-plus funds are similar but have a slightly elevated risk-return profile.

- Value-added funds involve more risk and seek higher returns—they invest in assets that have significant vacancy or business plans that involve significant capital requirements for tenant improvements or repositioning. Value-added funds are typically levered in the range of 50%–70% LTV.

- Opportunistic funds have the highest risk and highest target returns—they invest in distressed or vacant assets, distressed debt, speculative ground-up developments, or assets that require major redevelopment. Opportunistic funds tend to employ leverage in excess of 60% LTV.

E. *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. Although infrastructure funds can focus on specific

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geographic areas, typically they focus on the stage of development of the acquired investment. Strategies range from investment in "brownfield" projects (mature assets with stable current cash flows) to "greenfield" projects (early-stage/opportunistic projects, typically with higher risk/return profiles). As with real estate funds, the risk-return profiles of infrastructure funds can be quite diverse, especially as the energy and technology sectors continue to develop. Despite this, funds investing in long-term infrastructure projects and projects that provide necessary public resources commonly produce more predictable returns, especially given their ongoing relationship with the government and their public visibility.

(i) *Climate and Energy Transition Funds*. Climate and energy transition funds are types of infrastructure funds that invest in the environmental sector. Climate funds target businesses, infrastructure and real estate projects focused on climate initiatives (*e.g.*, carbon offsets and solar power), while energy transition funds focus on projects that relate to decarbonization efforts (*e.g.*, the development of electric vehicles). Investment in these two types of infrastructure funds has steadily increased in recent years.

F. *Credit Funds*

Credit funds can be structured as either closed- or open-ended and engage in private, non-bank direct lending or invest in loans and other debt instruments. Private credit strategies have experienced rapid growth in recent years, including by

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number of funds and total capital raised, and have captured significant market share from bank lenders. Some common strategies include the following:

(i) *Loan Origination/Direct Lending*. Loan origination funds (also called direct lending funds) lend capital to small- and medium-sized businesses in exchange for a security interest in the company. Common investments include businesses that may have otherwise struggled to obtain financing from traditional lenders. Returns (typically predominately in the form of interest coupons on the debt) are lower but more consistent than returns from other credit funds. Loan origination funds also have shorter investment periods and terms, resulting in increased liquidity.

(ii) *Mezzanine*. Mezzanine funds invest in subordinated loans. To further diversify their risk, mezzanine funds make multiple mezzanine loans to different issuers. Like other private credit funds, these funds target companies that are having difficulty obtaining financing (usually mid-market companies).

(iii) *Opportunistic/Special Situations*. Opportunistic and special situations funds seek value creation by investing in companies impacted by credit market dislocations or other events. These funds may invest across the capital stack in debt, equity and structured capital that falls somewhere in between. Although some may invest in distressed companies, companies in restructuring or bankruptcy scenarios are typically not the predominant

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focus. Given the nature of their investments, opportunistic and special situations funds present a greater risk-return profile than funds with direct lending and mezzanine strategies.

(iv) *Distressed Debt*. Distressed debt funds aim to generate returns by purchasing or refinancing distressed senior or subordinated debt at a large discount or originating loans to distressed borrowers, in some cases with the intent of taking control of the borrower. Distressed debt funds typically focus on companies that are in or close to default, bankruptcy or restructuring. These funds are at the high end of the risk-return spectrum for private credit and often have shorter investment and holding periods.

(v) *Specialty Finance*. Specialty finance funds focus on asset-backed finance, often with a niche sub-strategy such as NAV lending, royalty financing, aircraft leasing or litigation finance. The risk and return profiles of specialty finance funds vary widely depending on the particular strategy and may be more difficult to assess for highly bespoke products. Specialty finance funds are growing in popularity as investors look to diversify their private credit portfolios while still capitalizing on the expansion of private funds into traditional lending markets.

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G. *Impact Funds*

Impact funds seek to achieve social and/or environmental impact or sustainability with their investment activities in addition to financial returns. The target returns for these funds depends upon the types of investments it will make (such as buyout, venture capital, infrastructure, etc.) and typically tracks the target return of a non-impact fund that invests in the same kind of assets. How an impact fund adviser incorporates impact considerations into its investment decisions, how the adviser measures the impact of the fund's investments, and to what extent, if any, the adviser's compensation is linked to the fund achieving its impact goals may vary substantially depending on the fund sponsor and the impact fund's investment objectives.

H. *Funds of Funds*

Funds of funds may invest on a primary basis or secondary basis in other private funds (including venture or hedge funds). Many funds of funds have co-investment rights with the funds in which they invest, giving the sponsor of the fund the opportunity to invest additional capital on generally more favorable terms. Even though some funds of funds focus on particular strategies (*e.g.*, investment in infrastructure funds), they generally offer increased diversification relative to an investment in a single private fund. Given the relatively high minimum investment thresholds for certain private funds, funds of funds can provide a useful entry point for smaller investors.

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As the private equity secondaries market continues to mature, funds of funds pursuing secondaries strategies have proliferated. Whereas traditional secondaries funds of funds historically focused on purchasing limited partner stakes directly from investors, the development of the General Partner led ("GP-led") secondaries market has precipitated a new product offering focused on buying into GP-led secondaries transactions (predominantly continuation vehicles). These GP-led focused funds of funds are more akin to a co-investment fund from a diversification perspective (*i.e.*, more concentrated than typical secondaries funds of funds), and have been formed by established secondaries funds of funds sponsors, as well as established private equity sponsors entering the secondaries market for the first time. The proliferation of secondaries funds of funds has also led to increased specialization, such as funds focused on single-asset GP-led deals and funds focused on acquiring credit secondaries.

I. *GP Stake Funds*

GP stake funds are specialized investment vehicles that provide capital to alternative investment managers, typically in exchange for a minority equity ownership in some combination of the management fees and carried interest generated by that investment manager's funds, as well as indirectly participating in the manager's commitments to its underlying funds. GP stake funds can provide primary capital for growth initiatives, succession planning or other internal uses or secondary capital to founders and other stakeholders, or a combination of the two. The cash flows in which a GP

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stake fund invests can be customized in each circumstance to address the particular requirements of the underlying manager and its other stakeholders. In recent years, GP stake funds have broadened their remit to provide preferred equity or debt capital to alternative investment managers, giving managers a variety of options across its capital structure.

These funds attract sophisticated institutional investors, including pension funds, sovereign wealth funds, endowments, and ultra-high-net-worth family offices, seeking diversified exposure to the predictable revenue streams of management fees and the potential upside of carried interest. The appeal for GPs lies in the ability to access growth capital to scale their operations, facilitate succession planning, or strengthen their balance sheets, often without relinquishing operational control. These arrangements offer investors a unique opportunity to participate in the financial success of leading asset managers while enabling GPs to unlock value and fuel their strategic growth ambitions.

J. *Hedge Funds*

Hedge funds pursue a wide variety of strategies, generally focused on investments in publicly traded securities, derivatives, currencies, commodities or other assets. Strategies include hedged equities (such as long/short, market neutral or short only, often with a particular geographic and/or sector focus), global opportunistic/macro, relative value/arbitrage and event driven. Some hedge fund advisers create value for investors by identifying assets that they believe are mispriced or otherwise will change in value

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(sometimes holding assets for relatively short timeframes). "Activist" hedge fund advisers typically acquire non-controlling stakes in target companies and seek to create shareholder value by influencing the company to alter its governance or leadership or to engage in cost cutting, restructuring or corporate transactions.

K. *Pledge Funds*

In contrast to a typical private fund, which is normally a "blind pool" (where investors are not generally permitted to opt in or out of specific investments, subject to certain limited excuse rights), pledge funds (or club funds) are pools of "soft" commitments from investors who choose whether to participate in investments on a transaction-by-transaction basis. Given the level of involvement required to evaluate each transaction, pledge funds usually are geared toward sophisticated investors. These pools of capital are often 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 4, below. Pledge funds are one way a newer adviser can build its track record before raising a blind-pool fund.

L. *Permanent Capital Vehicles*

Like hedge funds, permanent capital vehicles can continue in perpetuity with sufficient investor interest. Structuring varies from product to product, but generally the vehicle is structured so that the sponsor can raise additional capital

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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 (in tranches or on a staggered/individualized basis). Other products may be structured as open-ended vehicles that continually reinvest investment returns (an "evergreen" fund) rather than distributing proceeds from each investment to investors. Permanent capital vehicles may be private, or publicly listed, and can also be formed as business development companies under U.S. law.

M. *Small Business Investment Companies*

Small Business Investment Companies ("SBICs") are licensed by the U.S. Small Business Administration and are 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. SBICs are eligible for relatively inexpensive government loans, which can result in a larger fund size and less reliance on venture capital firms or banks (which typically offer less favorable loan terms). SBICs are subject to a number of investment restrictions and requirements, including prohibitions on certain types of investments and certain diversification requirements.

N. *Separate Accounts*

Separate accounts (or separately managed accounts) involve a custom management or advisory arrangement for a specific investor. Separate accounts can be documented using a fund

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structure (a "fund of one" with the investor as the sole limited partner) or via an investment management agreement alone. 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 limitations and goals, tailor-made economics and reporting, and other individualized terms. Separate account arrangements can require extensive negotiations and careful consideration of a sponsor's obligations with respect to its other fund products. The sponsor will also need to consider whether a fund of one should be treated as a "private fund" or a "separately managed account" for purposes of its Form ADV reporting, custody of client assets, and other Advisers Act requirements.

O. *Co-Investment Vehicles and Overflow Funds*

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, single 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. Co-investment vehicles allow main funds to reduce risk, address larger equity needs, accelerate capital deployment and bring industry or regional expertise to an investment. Conflicts can arise between co-investors and the investors in the main fund.

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Overflow funds are a particular type of co-investment vehicle that invests in multiple portfolio investments alongside a main fund. Overflow funds typically get a right of first refusal on co-investment opportunities before the main fund manager can offer such co-investment opportunities to other investors.

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3. The Offering

A. *The Fundraising Process*

a. *Generally*. The process of structuring, organizing, marketing and holding an initial closing of a fund can take a year or longer. A typical offering process begins with preliminary meetings and indications of interest. The sponsor then prepares a private placement memorandum and goes "on the road" to market the fund. They sometimes may sound out select/cornerstone investors with a "pitchbook" and a summary term sheet for the fund. A fundraising period then begins, which can last for a number of months leading up to the fund's initial closing. For a closed-ended private fund, one or more subsequent closings are typically held in the 12–18 months following the initial closing, although oversubscribed funds can have shorter fundraising periods or a "one and done" closing. Open-ended private funds like hedge funds will hold periodic closings, often monthly, to accept new investors in perpetuity.

The Fundraising Process – an Overview	
Pre-Marketing	• Pitch book/summary term sheet • Marketing plan • Placement agent • Legal and tax advisors
Structure and Terms	• Structure • Detailed term sheet

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Launch	• Diligence materials • Private placement memorandum • Fund documents • Regulatory marketing filings (including pre-marketing authorizations in certain jurisdictions (if applicable))
Investor Negotiations	• Fund documents • Side letters
Initial Closing	• "Dry" signing (*i.e.*, no capital contributed) • Disclosure update
Subsequent Closings	• Additional investor negotiations, side letters, possible amendments to fund documents
Post-Final Closing	• Side letter MFN 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 the European Union, most other European jurisdictions and increasingly many other jurisdictions also have regulations applicable to the offering of securities, which often include marketing notifications requirements as well as government approvals or permissions before marketing of fund interests may begin in the relevant jurisdiction. See Topics 12.A and 12.B, below.

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c. *U.S. Marketing Rule*. In 2020, the SEC adopted reforms under the U.S. Investment Advisers Act of 1940 ("Advisers Act") to modernize and replace a patchwork regime that included the advertising and cash solicitation rules (Rules 206(4)-1 and 206(4)-3) with a comprehensive, principles-based rule regulating marketing communications and investor solicitations by registered investment advisers ("RIAs"), as well as further amendments to Form ADV and the books and records rule (Rule 204-2) (collectively, the "Marketing Rule"). The Marketing Rule addresses market developments, evolving electronic media and mobile communications technologies and regulatory updates since the adoption of the original advertising and cash solicitation rules over 40 years ago. The Marketing Rule went into effect May 4, 2021, with a compliance date of November 4, 2022.

B. *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).

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(ii) *Legal Description*. These sections typically summarize the key 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. marketing 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" of past investments.

b. *Issues*. Issues to be considered when preparing a private placement memorandum include:

(A) *Methodology*. Performance disclosure must be balanced, including a description of the valuation methods applied. The valuation methods that are 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, RIAs are prohibited from publishing or distributing an advertisement that refers to past specific investment advice in a manner that is not fair and balanced (*i.e.*, that "cherry picks" prior investment recommendations/decisions) or—and more generally—contains any untrue statement of material fact or is otherwise false or misleading. The Marketing Rule also requires that gross

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performance data be accompanied by net performance data, which should be presented with at least equal prominence to facilitate comparison. Additional restrictions under the Marketing Rule apply to the inclusion of related, extracted and hypothetical performance. While the Marketing Rule does not technically apply to exempt reporting advisers and other 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/decisions 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 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 person or persons were primarily responsible for the investment recommendations at the prior firm. The

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RIA must also have the source material necessary to substantiate the prior performance.

(C) *Substantiation*. The Marketing Rule prohibits an RIA from including a material statement of fact in an advertisement if it does not have a reasonable basis to believe it can provide substantiation for that statement upon the SEC's request. If an adviser is not able to provide adequate substantiation upon the SEC's request, the SEC will presume the adviser lacked a reasonable basis for its belief. RIAs should revisit their policies and procedures to ensure that they maintain records of source materials to support all material facts included in marketing materials so they can provide such source materials to the SEC on demand.

(D) *Testimonials and Endorsements*. In addition, RIAs may include testimonials and endorsements in an advertisement only if disclosure, oversight and disqualification requirements are met. For example, an RIA must clearly disclose whether the person providing the testimonial or endorsement is a client, whether such person is receiving compensation for its testimonial/endorsement and any other material conflicts of interest arising from such person's relationship with the RIA. RIAs that use testimonials or endorsements in their advertisements must oversee compliance with the Marketing Rule and in many instances enter into a written agreement with the person providing the

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testimonial / endorsement (see Topic 12.C.d(iv) below). RIAs are also prohibited from using testimonials and endorsements made by "bad actors" as defined in the Marketing Rule.

(E) *Third-Party Ratings*. The use of third-party ratings in an advertisement is generally permitted so long as the third party provides such ratings in the ordinary course of its business and the RIA referencing the rating (*i*) has a reasonable belief that the rating has been derived from a questionnaire or survey that is structured in a manner not to lead to a predetermined result and (*ii*) clearly and prominently discloses certain information, including the name of the person providing the rating, the date the rating was given, the relevant time period that the rating covers and any compensation provided by the RIA in connection with the rating.

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.

d. *Securities Law and Regulatory Compliance*. As the primary document describing the offering of interests in a fund, the

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private placement memorandum must be drafted carefully to ensure compliance with relevant securities laws and regulatory regimes, including:

(i) *Exchange Act.* Rule 10b-5, promulgated by the SEC under section 10(b) of the Exchange Act, prohibits fraudulent conduct (including material misstatements and omissions of any material facts, and acts and practices that operate as a fraud or deceit) in connection with the sale and purchase of securities, including interests in a fund. Each offering participant, including the sponsor, its officers and directors, the general partner and any placement agent, is potentially liable under this provision.

(ii) *Advisers Act.*

(A) All investment advisers (including RIAs, exempt reporting advisers and other unregistered investment advisers) are subject to the general antifraud provisions of the Advisers Act, which prohibit an adviser from engaging in fraudulent, deceptive or manipulative activities. In addition to the general antifraud rules, the Advisers Act also specifically prohibits an investment adviser from making any untrue statement of material fact or omitting 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) and from engaging in any other fraudulent, deceptive or manipulative conduct with

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respect to investors and prospective investors. RIAs are also prohibited under the Marketing Rule from referencing, including or omitting information in an advertisement (including performance results) that would reasonably be likely to cause a misleading inference to be drawn regarding a material fact or otherwise discussing any potential benefits without providing balanced treatment of the applicable risks.

(B) See also Topic 3.B.a(iii), above, and Topic 12.C, below.

(iii) *AIFMD*. Under the 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 whether the fund is marketed to investors in the European Union. To market the fund in the European Union, certain disclosures to investors are required before the investors commit to the fund. These disclosures are typically included in the private placement memorandum or a supplement thereto. See also Topic 12.N below.

(iv) *Other Private Placement Regimes*. Other jurisdictions (such as the United Kingdom, Switzerland, Korea and Japan) also have their own private placement regimes

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that may be applicable to a fund offering. See also Topic 12.A.d below.

(v) *SFDR and Other ESG Regimes*. The European Union adopted the Sustainable Finance Disclosure Regulation ("SFDR"), as amended by the Taxonomy Regulation, which presents certain disclosure and reporting obligations for financial market participants (including funds marketed in the European Union under the AIFMD national private placement regime) and financial advisers. Funds that promote ESG characteristics must provide disclosure in the private placement memorandum regarding how those characteristics are satisfied and monitored, as well as ongoing reporting on an annual basis. See also *Debevoise's White Paper entitled SFDR Compliance for US Funds*. Similar ESG disclosure rules have been proposed in other jurisdictions such as the United Kingdom and the United States.

e. *Supplements*. The private placement memorandum is often supplemented or amended periodically during the fund's offering period (in the case of closed-end funds, typically prior to each closing of the fund) to reflect material developments during the course of the offering, such as changes to senior investment professionals, track record updates, and market and regulatory developments.

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f. *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 the 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, particularly since it will most likely be considered an advertisement under the Marketing Rule.

(ii) *Key Information Document* ("KID"). Starting in 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 jurisdictions in the European Union (see Topic 12.L below), including marketing to so called "friends and families" and even high-net-worth individuals and semi-professional investors.

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C. *Other Primary Fund Documentation*

a. *Fund Agreement*. The fund's operating agreement (for funds structured as limited partnerships, the 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 4 through 8, below.

b. *Subscription Agreement*. This is the document executed by each investor to subscribe for an interest in the fund. The subscription agreement becomes effective when and to the extent it is formally accepted by the fund. Investors typically make representations in the subscription agreement concerning, among other things, their eligibility to acquire an interest in the fund, including with respect to ERISA, tax and securities laws, and anti-money laundering matters. For funds without a separate private placement memorandum, additional risk factors and other disclosures may be included in the subscription agreement. The subscription agreement 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 more sophisticated, with larger internal resources devoted to fund investments, it has become increasingly common to address the specific issues and requirements of an investor via a side letter agreement between the investor and the general partner (or the fund), and the number of provisions included in side letter agreements has proliferated in recent years. Many

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institutional investors now have a list of personalized "standard" side letter requests that they make in respect of all their fund investments. Common issues addressed in side letters include "most favored nation" 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), ESG considerations, investor tax and regulatory concerns, and other matters particular to the specific investor. Note that while a side letter modifies the terms of the fund only with respect to the particular investor that is a party to that side letter agreement, "most favored nation" undertakings in the fund agreement or additional side letters may provide certain other investors with the ability to elect to receive those modified terms as well.

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 and the use of any management fee waiver mechanism.

e. *Guarantee and Escrow Agreements*. Closed-end private fund agreements typically provide that any overpayment of carried interest will be returned to investors at the end of the fund's life, and perhaps also at other intermittent periods before the end of the fund's life (a "clawback"). The clawback obligation

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is often accompanied by a guarantee whereby the sponsor, an affiliate of the sponsor or the individual carry recipients themselves agree to be directly liable to the fund or investors for any required return of carried interest. Some funds may also provide, as an alternative or in addition to a guarantee, that a portion of any carried interest otherwise distributable to the general partner/carried interest partner will be reserved in an escrow account in case any clawback is required.

D. *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;

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(iii) any fees payable to the placement agent (including the amount of fee, which investors' commitments will generate such fees, the time period over which the fees are paid to the placement agent and the "tail" period following termination of the agreement);

(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. *Marketing Rule Compliance*. Because placement agent arrangements will most likely be considered endorsements under the Marketing Rule, the engagement letter should address compliance with the Marketing Rule's disclosure, oversight and disqualification requirements with respect to endorsements. In addition, materials prepared by a placement agent may be attributed to an investment adviser via "adoption" if the adviser explicitly or implicitly approves such

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materials or via "entanglement" if the adviser participates in the preparation of such materials. As a result, in order to comply with the Marketing Rule, placement agent agreements typically provide for prior review and approval by the adviser of any materials used by the placement agent with respect to the fund, as well as related recordkeeping.

d. *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 12.F below.

e. *MiFID Authorization*. When using a placement agent to market fund interests in the European Union, registration is typically required under the European Directive on markets in financial instruments, also called the "MiFID."[3] MiFID 2 rules 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 as stringent as those in the MiFID. This registration of third-country firms

[3] 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).

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is currently not available as the European Commission has not yet made any of the necessary equivalence decisions.

In addition, MiFID 2 requires placement agents 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 United Kingdom and may indirectly impact AIFMs in other EU member states and AIFMs outside the European Union if they use EU placement agents that are required to comply with MiFID 2 rules.

f. *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 federal "pay-to-play" rule and any relevant local or state rules and policies of the relevant investor. See Topic 12.C.b(xv) below.

g. *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" (such as the placement agent's officers participating in the offering), if the fund is relying on Regulation D for an exemption from registration under the Securities Act. A fund is prohibited from making an offering under Rule 506(d) if the placement agent or its covered

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persons are subject to certain disqualifying events. See Topic 12.A.c.iv, below for more information under Rule 506(d). Rule 506(d)(2) provides an exception from disqualification if the fund can establish that it did not know and, despite the exercise of reasonable care, could not have known that a covered person was subject to a disqualifying event.

h. *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 feeder vehicle in connection with a fund investment. See Topic 9.H, below.

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4. Fund Terms: Carried Interest and Distributions

In the United States, 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 carried interest on its behalf. For certain types of fund products, profit sharing is effected through other types of fee constructs that are similar to carried interest, such as incentive fees.

A. *Carried Interest Rate*

Typically, the general partner receives 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 be anywhere from 20% to 30% (with 30% being typical for top-tier funds); while in some lower-yielding funds, such as core/core+ and real estate funds, the range is 10% to 15%. Also, it is becoming common in venture capital funds to see tiered carry structures, where carried interest starts at 20% and ratchets up to higher rates if the fund achieves certain performance targets.

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B. *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 buyout fund the general partner receives its carried interest only 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	Historical 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 carried interest on a "deal-by-deal" basis. Under this approach (which may increase the likelihood of a general partner clawback obligation), 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 carried interest. Rather, the general partner receives carried interest out of the proceeds from the sale of each 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 and (*ii*) apportioned expenses).

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Deal-by-Deal Waterfall Mechanics	
Return of Capital	LPs get back their capital contributions for realized investments and certain expenses
Preferred Return	LPs receive 8%[4] preferred return
Catch-up	GP catches up to the 8% preferred return
Carried Interest Split	80% to LPs and 20% to GP

a. *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 negotiating power to require it.

b. *Expenses*. In buyout funds, carried interest typically is computed net of expenses, including management fees. In venture capital funds, carried interest is sometimes computed gross of expenses.

c. *Current Income*. In strategies that produce current income (*e.g.*, 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 from current income, which could permit the general

[4] Preferred return may vary among sponsors and fund types, but 8% is typical for buyout funds as further described below.

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partner to realize carried interest based on the current income from portfolio investments.

C. *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 (otherwise investors would not have as much incentive to invest in private equity funds over, *e.g.*, index funds). The exception to this rule is venture capital funds, which rarely have a preferred return.

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 C.b. below). Historically, the most common hurdle rate has been 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 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

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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*. Traditionally, 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. It is becoming more common, however, for venture capital funds to include traditional waterfalls.

D. *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.

Third-Party Valuations. Some investors request that a Limited Partner Advisory Committee have the right to approve, or object to, valuations or third-party valuations, particularly in connection with distributions in kind of non-marketable securities.

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E. *Tax Distributions*

As noted above, funds are typically organized as limited partnerships. Under U.S. tax principles, the partners in a partnership generally are taxed on the partnership's income or loss in accordance with their economic interests therein, regardless of whether and in what proportion current distributions are made to the Partners. As a result, if the general partner is entitled to a 20% carried interest, the U.S. members of the general partner may be currently taxable on 20% of the fund's net profits, even if current distributions would otherwise be made entirely to the limited partners (*e.g.*, because the fund has a return of all-capital waterfall). This is often referred to as "phantom income." Tax distributions to the general partner help to ensure that the sponsor's 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.

F. *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

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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 dissolution. However, interim clawbacks occurring during a fund's term are becoming more common for funds with deal-by-deal waterfalls (*e.g.*, at the end of the fund's investment period, at the end of the typically 10-year fund term or even more often, such as at intervals of 2–3 years).

b. *Netting of Taxes.* The general partner typically provides a clawback cap 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. See Topic 12.D for more information regarding what notice is required if the clawback is net of taxes.

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 typically

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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.

G. *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.

The above summary describes the treatment of carried interest under current U.S. tax law. Notably, however, for more than a decade multiple legislative proposals have been advanced to amend the U.S. tax treatment of carried interest. Many of these

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proposals focus on the theory that carried interest, as a type of compensation, should be taxed as wages at ordinary income tax rates (and not at preferential capital gains tax rates).

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

A. *Management Fees*

As noted at Topic 1.A.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 UK funds, the management fee is typically structured as a special profit allocation to the general partner. The management fee is used to, among other things, pay for overhead, salaries and other manager expenses that are not charged to the fund.

a. *Management Fee Rates*. The spectrum of "market" management fee rates can vary depending on a fund's size and strategy. A flat management fee rate is the most common, although some funds may 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. In addition, some sponsors offer management fee discounts as a way to facilitate fundraising, where investors with larger commitments and/or that subscribe at an early closing are charged a reduced management fee rate or are given a "fee holiday" where they are not charged a management fee for a set period of time. Some sponsors may also offer loyalty or "frequent flyer" discounts, where investors that have committed a certain

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amount of capital across the sponsor's funds receive some form of fee discount.

b. *Management Fee Base During Investment Period*. In most cases, during the investment period of a closed-ended private fund (the time frame during which the fund is making new investments, most commonly three to six years in length), 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 Base After Investment Period*. In the majority of private equity funds, the post-investment period (the time during which the fund is only making follow-on investments in portfolio companies it already has an interest in 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 securities or debt). When the post-investment period base 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, which may recover in value. In any event, fee calculations and

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related disclosure are a perennial area of SEC focus and enforcement activity, and fee calculations should closely follow the fund documentation.

d. *Valuations*. Many private equity funds require periodic valuations because their distribution provisions or management fee calculations take into account 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 **Error! Reference source not found.**). Open-ended private funds like hedge funds may conduct valuations on a monthly basis, depending on the timing of management fee payments and when investors may enter and exit the fund.

e. *Step-Downs*. For many closed-end private funds, at the end of the investment period (or earlier, if the sponsor begins raising, or receiving management fees from, a successor fund) the management fee base may change from committed to invested capital and/or the management fee rate may step down to a reduced rate. There may also be a series of step downs in the management fee rate at various intervals following an initial step down.

f. *Duration of Management Fee*. The management fee may be paid through the end of the fund's initial term, through any extension of the initial term or may continue through the fund's final liquidation. If the management fee continues through an extension of the term or through liquidation, the rate may be subject to further step downs or approvals.

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g. *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 in private equity funds.

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	Increasing prevalence of size-based, early closer and "frequent flyer" discounts Including borrowing in post-IP fee base	Increasingly shifting fee base to invested capital after 5–6 years

B. *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 a proposed acquisition of a portfolio company is not consummated because the seller backs out of the deal. "Monitoring fees" and "advisory fees" are earned by the sponsor for monitoring and/or advising portfolio companies.

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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 with respect to the fund's portfolio companies is offset against (*i.e.*, reduces) the management fee payable by fund investors. It is increasingly common for the management fee to be offset by only the portion of such transaction fees that are allocable to management fee-paying investors of the fund—not the portion allocable to co-investors and to the general partner and its affiliates. The SEC has increased its focus on sharing of fee income (especially accelerated monitoring fees), including accuracy of related disclosure and potential broker-dealer registration issues raised by the receipt of transaction-based compensation that is not offset, as discussed in more detail below.

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 any such activity that is dependent on the size and/or success of a transaction is generally viewed by the SEC to be acting as a broker, even where the activities themselves are quite limited. Informally, the SEC staff has indicated that a fund sponsor whose transaction fees are subject to a 100% offset against its

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management fees would not be required to register as a broker-dealer. See Topic 12.F, below.

C. *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 and/or any other sponsor vehicles). The SEC has focused on expense sharing between the fund and other sponsor vehicles and co-investors in recent years. See Topic 12.C.b(vi), below. Types of expenses arising in connection with a fund's activities are:

a. *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.

b. *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) apportioned to each of the sponsor's fund platforms.

c. *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.

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d. *Placement Fees*. As with excess organizational expenses, these are typically paid by the fund but are indirectly borne by the sponsor through a corresponding reduction of the management fee. Fund documents should clearly disclose how placement fees will be paid. See Topic 12.E below for further information regarding required disclosures in light of the Marketing Rule.

e. *Out-of-Pocket Expenses of Completed Portfolio Transactions*. These are typically capitalized into transaction costs and are accordingly borne by the fund.

f. *Allocation of Deal Expenses to Multiple Vehicles*. A co-investment or parallel vehicle generally bears its *pro rata* share of deal expenses 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, as discussed in further detail below.

g. *Broken Deal Out-of-Pocket Expenses*. Funds take a variety of approaches to the issue of how to allocate broken deal expenses. Where co-investors are set to participate in the deal, the fund documents may provide for broken deal expenses to also be allocated to them on a *pro rata* basis, although most commonly the fund still bears all broken deal expenses. In some instances, allocation of broken deal expenses may track allocation of break-up fees. If 100% of all break-up fees are payable to the fund, then the fund will likely be liable for payment of all broken deal expenses. Enforcement actions in

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this area have focused on whether the fund documents clearly disclosed how broken deal expenses would be allocated.

h. *In-House and Operating Partner Expenses*. It has become increasingly common for private fund sponsors to allocate as fund expenses a portion of certain "in-house" costs, such as for the sponsor's legal and accounting teams, based on the services they provide to the fund. Similarly, there is a trend in sponsors designating groups of operating partners (who may be employees of the sponsor or third-party consultants) that provide various value creation services to portfolio companies, with related expenses being chargeable to the fund. In some instances, the amount of such in-house or operating partner expenses borne by the fund may be subject to a cap. Any such fund expenses should be properly disclosed in the fund agreement.

i. *Expenses of Other Affiliated Service Providers*. The expenses of service providers that are affiliates of the sponsor may be paid by the fund and/or a portfolio company of the fund for a variety of different services. Given the conflicts of interest that may be present in such arrangements, they should be properly disclosed in the fund documents.

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6. Fund Terms: Closing the Fund and Making Investments

A. *Size of the Fund*

Most offering documents include the sponsor's target size for the fund. Sponsors are incentivized to raise the largest fund possible to generate maximum management fees, so investors often ask for a cap on the fund size in order to focus the sponsor's attention on pursuing only the most attractive investment opportunities that are suitable for the relevant fund. Sponsors typically accept a cap, which is often 20%–30% above the target fund size.

B. *Sponsor Investment in the Fund*

Most sponsors invest between 1% and 5% of a fund's committed capital. The sponsor's investment may be made through the general partner's commitment to the fund through a special limited partner or other investors affiliated with the sponsor or, less commonly, the sponsor may invest alongside the fund in each of the fund's portfolio companies.

C. *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 longer terms of 12 to 14 years. Infrastructure funds tend to have terms of 10 to 12 years. Real

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estate, debt and venture capital funds often 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 to allow for an orderly liquidation of the fund's portfolio. Such extensions often require the consent of the fund's Limited Partner Advisory Committee.

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 8 below.

e. Following the end of a fund's investment period, the fund is generally prohibited from making new investments but may complete in-process investments and make follow-on investments.

D. *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 investors 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 draws down investors' committed capital to make one or more portfolio investments before the final closing (rather than funding such acquisitions utilizing a subscription line credit facility, as is typical

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and further described below), subsequent closing investors typically buy in at the acquisition cost of the previously acquired portfolio securities plus interest (often 8% or 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.

Some investors are limited by law or internal policy to having their commitment represent no more than a certain percentage of a fund. If such an investor wishes to make an investment that would exceed its limit based on the current fund size, sponsors will often include a mechanism in the fund's subscription documents such that the investor's commitment ratchets up at each subsequent closing but always remains below the capped percentage interest applicable to such investor.

E. *Drawdowns of Capital*

In contrast to hedge funds (which generally provide for an up-front contribution of an investor's entire subscription amount), closed-ended funds typically draw down capital on an "as-needed" basis for investments or expenses, often with 10 business days' notice.

F. *Subscription Credit Facilities*

A subscription credit facility is a loan facility where the collateral is the unfunded capital commitments of the partners, the general partner's related rights to make and enforce capital calls and the bank accounts where the partners fund their capital contributions. Many funds use subscription credit facilities for short-term

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financing needs in connection with the making of investments (for example, to fund an investment pending receipt of drawdowns from partners), or in anticipation of syndicating a portion of an investment to third parties or limited partner co-investors. Some sponsors use subscription facilities to allow the fund to delay calling capital from partners until the end of the fund's marketing period in order to avoid the true-up contributions/distributions between existing and new partners that would otherwise be necessary at each subsequent closing (as described above).

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

Subscription credit facilities may also include an option for fund borrowers to add their portfolio companies as "qualified borrowers" without an additional pledge of collateral, which gives funds the flexibility to incur indebtedness at different levels of the fund structure. 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 10.B, below.

A Net Asset Value or "NAV" credit facility is a loan facility where the borrowing base is based on the fund's investment portfolio. The collateral typically includes the investment portfolio, including the right to distribution therefrom and bank accounts where the distributions are funded. NAV facilities were initially more prevalent in the case of secondaries funds and credit funds

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but have also become a key focus for buyout funds (and heightened concern for their investors). NAV credit facilities are typically put in place later in the life of the fund, since the unfunded capital commitments of the fund's partners, which is the borrowing base of any subscription credit facilities, would have been called and depleted by then. See Topic 13 for additional details on NAV facilities.

G. *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.

H. *Investment Limitations*

The fund agreement will spell out (in varying degrees of detail) not only what the fund is permitted to do, but also what the fund is *not* permitted to do. A fund agreement might provide that certain (or all) of the stated investment restrictions are waivable by the limited partners or the Limited Partner Advisory Committee. Typical limitations will, of course, vary depending upon the fund's investment strategy but often include the following:

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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 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. Some funds include prohibitions on certain categories of investments, such as real estate or fossil fuels.

d. *Pacing*. Some funds have limitations on the amount of capital that can be drawn down in any given year or over a specified time period.

e. *Hostile Acquisitions*. Many buyout funds are not permitted to engage in hostile acquisition transactions, which are most frequently defined as transactions opposed by the target's board of directors.

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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 and permit their use only for currency hedging or interest rate risk purposes. Funds that make use of these products should be mindful of Commodity Exchange Act requirements (see Topic 12.E below).

h. *Limitations on Investments in Other Funds*. Most funds include prohibitions on investing in other pooled investment vehicles, as investors are concerned about paying two levels of carried interest and management fees and the general partner ceding investment control to another sponsor.

i. *Limits Particular to Real Estate Funds*. Real estate funds often have geographic diversification requirements (*e.g.*, no more than 30% of capital commitments invested in a single metropolitan statistical area for a U.S. fund or no more than 40% of capital commitments invested in a single country for a European fund). These funds often have a cap on the amount that can be invested at any given time in ground-up development projects in order to limit the J-curve effect and the risk to the fund.

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I. *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 established investor policies (*e.g.*, restrictions on investments in tobacco, alcohol or firearms). See, also, Topics 9.B.d.ii and 9.C.a. In some cases, a general partner may exclude a particular investor from participating in an investment or continuing its investment in the fund if its participation would have a material adverse effect on the fund or the investment.

J. *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 forfeiture of the defaulting limited partner's interest in the fund.

K. *Co-Investment Opportunities for Limited Partners*

a. *Generally.* Co-investment opportunities are opportunities for persons, including limited partners, to participate in investments of the fund outside (and generally alongside) the fund often on a fee and carry–free basis (or on reduced fee and carry). Thus, many limited partners are interested in participating in co-investment opportunities in order to increase their exposure to various portfolio companies of the

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fund on reduced or no fee/carry bases. This creates a slight misalignment among limited partners, as many limited partners in the fund prefer that the general partner not be permitted to allocate investment opportunities to co-investors until *after* the fund has received its full appropriate allocation, while those hoping to participate in co-investments are more amenable to providing the general partner with broad allocation rights. It is more common in recent years for fund agreements to expressly permit the allocation of any such investment opportunities to co-investors of any type (limited partners or third parties) in the discretion of the General Partner, subject to its fiduciary duties to the fund. Some fund agreements provide that co-investment 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. However, most fund agreements now provide that the general partner has the right to offer co-investment opportunities in its discretion.

b. *Co-Investment Funds*. Some co-investments may be made directly by the co-investor; in other cases, the sponsor may create and manage a special co-investment fund to pool the commitments of participating co-investors. In recent years, sponsors have also been organizing funds of one and specially managed accounts for repeat co-investors and using such vehicles to hold multiple co-investments for a single repeat co-investor.

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c. *Main Fund Disclosure*. 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.

d. *Co-Investment Fund Key Terms*. In negotiating co-investment arrangements, investors are often focused on the following terms, among others:

(i) *Economics*. As noted above, co-investors typically do not pay fee or carry or at least pay significantly reduced management fees/carried interest. Although some investors are accustomed to co-investing with no fees or carry, certain co-investment arrangements may include fees, including standing co-investment vehicles that participate in multiple investments.

(ii) *Alignment*. Co-investment agreements typically provide for investment in the relevant assets at substantially the same time and on substantially the same terms as the main fund. The agreement will also provide for disposition of investments at the same time and on the same terms as the main fund and may provide "tag" and "drag" rights whereby the co-investor can elect or be required to participate in a sale under certain conditions. Co-investors often negotiate for preemptive rights to participate *pro rata* in future equity and debt issuances by the relevant portfolio companies in order to prevent dilution of their investment, as well as the right to cash out or remain in the co-investment vehicle in the event

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there is a continuation fund transaction with respect to the portfolio company in which the co-investors are invested. There remains uncertainty in the market regarding co-investors' rights in the event of continuation vehicle transactions, which is discussed below.

(iii) *Expenses*.

(A) *Expense Caps*. In co-investment fund agreements, organizational expenses, ongoing fund expenses and transaction expenses are usually outside the co-investor's capital commitment (i.e., they required to be paid by the co-investor on top of/in addition to its capital commitment). In order to avoid unlimited liability for expenses, co-investors generally negotiate for caps on such obligations to be included in the co-investment vehicle governing documents.

(B) *Broken Deal Expenses*. Another area of focus for investors (and the SEC) is broken deal expenses; in particular, how they are allocated among the main fund and any co-investors. Historically, many main fund documents were not specific about how these expenses would be allocated in the event a pursued deal did not close. Following several SEC enforcement actions on the issue, most main fund documents now explicitly state to what extent, if any, broken deal expenses are shared with co-investors. Sharing of these expenses often depends

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on whether the co-investor commits to the investment before or after the asset acquisition agreement is signed. If the co-investor commits before the acquisition agreement is signed, then frequently, the co-investor will bear its share of any broken deal and other transaction expenses (including any reverse termination fees), whereas, if the co-investor commits after the acquisition agreement is signed, they might not bear such expenses. To the extent co-investors agree to bear broken deal expenses, they often push for the right to participate in any fees that might be generated by a broken deal—arguing that if they are willing to bear the potential expense, they should also have a right to any "upside."

(C) *Offsets.* Co-investors are also interested in the mechanics of transaction fee offsets vis-a-vis the main fund. In the main fund, the fund's *pro rata* share of certain transaction fees received by the sponsor from the fund's portfolio companies typically reduces the management fee payable by limited partners. If a co-investment arrangement includes a management fee, co-investors usually expect a similar offset with respect to the portion of such transaction fees attributable to the co-investment. If a co-investment arrangement is fee-free, or to the extent the transaction fees exceed the management fee, the sponsor may be entitled to retain that portion of such transaction fees without offset.

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(iv) *Follow-Ons*. Unlike in main fund documents, commitments to co-investment vehicles often do not include a reserve for follow-ons. Instead, co-investment fund documents usually provide that investors will be given the opportunity to participate *pro rata* in follow-on opportunities. If there is a shortfall resulting from existing co-investors and main fund investors not contributing the full amount required for a follow-on investment, the general partner will have the right to bring in additional co-investors. The introduction of new co-investors can give rise to issues regarding valuation and dilution as well as conflicts of interest regarding dispositions.

(v) *GP-Led Secondaries*. Co-investors are also increasingly interested in how they will be affected by any continuation vehicle transaction in the main fund that relates to portfolio companies in which co-investors participate. Co-investment agreements may not be clear about what happens in this scenario, particularly whether a GP-led secondaries transaction is treated as a "disposition" by the main fund that triggers rights and obligations under the co-investment agreement. Co-investors often have different expectations and preferences than main fund investors regarding a proposed continuation transaction, especially if they view the terms and economics of the continuation fund as less attractive than their original deal. Any transfer of assets from the main fund to a continuation fund utilizing a different valuation than a co-investor's entry valuation may also disrupt alignment and present a

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conflict of interest for the general partner, if co-investors do not also participate in the transaction. For more information on GP-led secondaries, see Section 13.A., below.

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7. The Relationship Between General Partner and Limited Partner

A. *Conflicts of Interest*

Conflicts of interest provisions, including deal-flow allocation, expense sharing, co-investment and affiliate transactions, are drawing scrutiny from investors and, increasingly, from the SEC. The disclosure and mitigation of conflicts of interest are primary areas of focus for SEC examinations with respect to private fund sponsors and have been the basis for a number of SEC enforcement actions (see Topic 12.C.b(i)(A) below). Related issues include:

a. *Formation of Successor Funds*. Many investors will seek to limit the ability of the sponsor (and/or the sponsor's team of investment professionals) to form other funds or accounts during the investment period of an existing fund that have investment strategies similar to that of such existing fund (also known as a "successor fund"). However, sponsors are increasingly seeking to limit the scope of the successor fund restriction. Some sponsors will agree to step down the management fee to a post-investment period rate at the time that any successor fund is formed to address investor requests that the sponsor not earn two management fees from substantially similar products at the same time.

b. *Deal Flow Allocation*. Sponsors generally have some discretion over how to allocate investment opportunities, but many investors will seek explicit disclosure of how investment opportunities will be allocated among the fund, other funds

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or separately managed accounts sponsored by the manager and co-investors.

(i) Where a sponsor offers multiple funds or other products (including separately managed accounts) with overlapping investment strategies, or where a successor fund has been formed, investments may be allocated on a *pro rata* basis (based on each vehicle's available capital commitments), on a rotation basis or in the general partner's discretion, which is the more common approach today. However, the fund's governing documents commonly will provide the specific applicable allocation parameters across these various types of products (*i.e.*, dollar or percentage caps, which product will have a "first look," etc.).

(ii) Transactions involving 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. One common example is when a sponsor has an equity fund and a credit fund that could invest in differing levels of the "capital stack" of the same portfolio company. Sponsors should expect that investors will request that the sponsor implement conflict mitigation and disclosure mechanisms.

(iii) Managers or general partners who are RIAs should develop compliance policies and procedures setting

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forth investment allocation policies and disclose those policies or summaries of those policies to investors.

c. *Co-Investments by the Manager, Its Affiliates or Its Employees*. In order to alleviate potential investor concerns over "cherry-picking" (*i.e.*, manager affiliates choosing to participate only in certain best performing investments), co-investments by manager affiliates have traditionally only been permitted on a *pari passu* and lock-step basis with investors or subject to a specified annual (or overall) cap. Some sponsors are requesting more flexibility to modify participation in investments on a case-by-case basis within a set percentage of the overall investment size. Sponsors requesting this flexibility often state that they would like the flexibility to permit deal team members to participate on an investment-by-investment basis.

d. *Affiliate Transactions.*

(i) *Cross Transactions*. Cross transactions (*i.e.*, sales or purchases of securities between affiliated vehicles) between the fund and other funds, separately managed accounts or clients sponsored or advised by the manager or 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

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prior to such transactions to approve the cross transaction notwithstanding any such conflict.

(ii) *Pre-Existing Interests*. The fund is often also restricted in its ability to purchase an interest in a portfolio company in which an affiliated person holds a pre-existing interest.

(iii) *Warehousing Transactions*. Occasionally, a sponsor may wish to purchase an investment on behalf of the fund prior to the fund being formed or during the fundraising process when the fund may not have raised sufficient capital to fund the investment. A sponsor's purchase of an investment on behalf of a fund is often referred to as "warehousing" or a "bridge." The fund agreement might contain specific provisions regarding how such warehoused deals are to be transferred to the fund once the fund is up and running. Terms that may be specified in the fund agreement include the timing by which the transaction must be completed, the pricing of the asset and any additional deal expenses or carrying costs borne by the fund.

(iv) *Principal Transactions*. A principal transaction occurs when an adviser, directly or indirectly, knowingly purchases any security from or sells any security to a client. A principal transaction is prohibited under Section 206(3) of the Advisers Act unless the adviser, prior to the completion of the transaction, discloses in writing the terms of the transaction to the client and obtains the client's informed consent—in the

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context of a fund this would commonly involve disclosure to fund investors and obtaining investor or LPAC consent. The SEC staff interprets Section 206(3) to require an adviser to satisfy the disclosure and consent requirements on a transaction-by-transaction basis.

(v) *Service Transactions*. 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.). To the extent any income from such transactions does not offset the management fee (see Topic 5.B.b), 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.

B. *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 continues to be 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

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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 a material violation of the fund agreement or the investment management agreement (which may be subject to a cure right), a conviction of a felony or a material violation of law having a material adverse effect on the fund. Sponsors are increasingly trying to require a final, non-appealable judgment of the "bad" acts listed above in order to be carved out from protection of the indemnification provisions; however, investors will typically resist this in fund agreement negotiations. Often, indemnification is also not available for claims relating to internal disputes among general partner and manager affiliates or derivative claims brought by a majority-in-interest of the limited partners.

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Indemnification
When It's Unavailable:

• Sponsor-related persons:
  o Have engaged in fraud, gross negligence, willful malfeasance or reckless disregard of duties
  o Have engaged in a material violation of the fund agreement or the investment management agreement
  o Have been convicted of a felony or a willful violation of law having a material adverse effect on the fund
• Claim relates to internal disputes among general partner and manager affiliates
• Derivative claim has been brought by a majority-in-interest of the limited partners

C. *All-Partner Givebacks*

a. The general partner is often permitted to "claw back" from all the partners amounts distributed to them to the extent needed to satisfy the fund's indemnification or other

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obligations. This type of provision is referred to as an "LP payback" or, more accurately, "all-partner giveback," which should not be confused with the general partner clawback, which protects against overdistributions of carried interest (discussed at Topic 4.F, above). Similar to the general partner clawback, however, the all-partner giveback should protect the fundamental economic deal (*e.g.*, the 80/20 deal) with regard to sharing of gains.

Returnable distributions under an all-partner giveback provision are often subject to limitations as to timing and/or amount.

All-Partner Givebacks	
Limitations	**Economics**
• *Amount*: Most commonly, the lesser of (a) 15–30% of commitments and (b) 100% of distributions actually received by the Partner • *Timing*: Most commonly 2–4 years after the relevant distribution, although sometimes the time frame is measured from the dissolution of the fund • *Purpose*: To cover indemnification or other obligations of the fund	• An LP giveback can alter the economic arrangement between the Partners if not properly implemented

D. *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 or

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generally long-standing/meaningful relationships with the sponsor. 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 (as described above) and "assignments" of the investment advisory agreement), 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.

Sometimes, limited partners request an observer seat on the Advisory Committee so that they can attend the meetings of the committee and receive materials sent to the Advisory Committee, even if they are not granted a vote. Increasingly, a limited partner's ability to vote or receive materials in connection with its membership on an Advisory Committee may be implicated by U.S. federal regulations (including, for certain non-U.S. investors, by CFIUS).

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.

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Sophisticated limited partners may request an opinion from local counsel in this respect.

b. *Indemnification.* Members of Advisory Committees are typically indemnified against most liability that might arise from their service.

Typical Limited Partner Advisory Committee	
Roles	**Features**
• Approving conflicts of interest • Voting on matters waivable by the Advisory Committee under the fund agreement • Sometimes approving the general partner's valuation methodology	• No fiduciary duties to the fund or limited partners • Limited liability • Indemnification against most liability that would arise from their service

E. *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).

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8. Fund Terms: LP Remedies

> Unlike hedge funds or open-end or "evergreen" funds, which typically allow limited partners to redeem their interests periodically, closed-end 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 in this regard may include some (or many) of the following:

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Remedies at a Glance

- Key Person Suspension: Suspension of fund's investment period if specified key individuals leave the manager
- Change in Control: Right to terminate the fund's investment period (or term) if there is a change in control of the manager or general partner (*i.e.*, a transfer of a certain threshold of voting or economic interests in the general partner or manager)
- GP Removal (with or without cause): Right to remove and replace the general partner, either without cause, or if the general partner violates the applicable standard of care, breaches the fund agreement or engages in other "disabling" conduct
- Dissolution (with or without cause): Dissolution of the fund, either without cause, or if the general partner, manager or "key persons" violate the applicable standard of care, breach the fund agreement or engage in other "disabling" conduct
- Suspension of Investment Period (with or without cause): Suspension of the investment period, either without cause, or if the general partner, manager or "key persons" violate the applicable standard of care, breach the fund agreement or engage in other "disabling" conduct

A. *For-Cause Remedies*

a. *Key Person Events*. A "key person" provision typically causes a suspension of the fund's investment period 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.

(A) 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, most funds go into an

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automatic suspension period, during which no new investments may be made. A minority of funds require a vote of the limited partners to cause such suspension.

(B) Many fund agreements include a right to designate qualified replacement investment professionals as new "key persons" 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.

(ii) *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, 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

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manager may need to seek the consent of the limited partners or a Limited Partner Advisory Committee.

b. *Suspension of the Investment Period/Dissolution of the Fund.* 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" violate the applicable standard of care, breach the fund agreement or engage in other "disabling" conduct.

c. *General Partner Removal.* 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 entity if the general partner violates the applicable standard of care, breaches the fund agreement or engages in other "disabling" conduct.

(i) *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 provisions and early suspension of investment period remedies described above. Sometimes, the "cause" triggers also mirror the "bad act" carve-outs described in the exceptions to the fund's indemnification protections.

(ii) *What Happens to the Carried Interest?* Often, the removed general partner's fund interest is converted

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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, the general partner's carried interest is subject to a "haircut" of 25–50% (*i.e.*, the general partner only receives 50–75% 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 at the time of the removal, with the purchase price taking into account the agreed carried interest entitlement.

(iii) *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 6–18 months' worth of management fee to which the general partner would have been entitled had it not been removed), particularly in the case of a no-fault removal.

B. *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

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of investors forcing a decision on the majority, or to give a single large investor a unilateral termination right.

b. *No-Fault GP Removal*. Some funds also give the limited partners the right to remove the general partner without cause. This is typically a sponsor's least favored remedy (and many sponsors resist including such a provision) because it permits another manager to manage the fund's assets. Funds typically only allow for removal of the general partner without cause if necessary to comply with banking regulations.

C. *What Happens to the Management Fee?*

In connection with an early termination of the investment period (either with or without cause), the management fee generally steps down to its post-investment period base. See Topic 5.A, above.

D. *Withdrawal*

Closed-end 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 (or be excused from making further investments) if there is a violation of their placement agent policy. Withdrawals from a fund are often difficult from an operational perspective, given the complexities of valuing a limited partner's interest and finding sources of liquidity. From the general

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partner's perspective, it is preferable for a limited partner to transfer its interest rather than withdraw.

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9. 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 10 and 12 below.

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9. Common Private Equity Fund Investors

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

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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, but not limited to, 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" includes 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) *VCOC Exemption*. Another exemption under ERISA is for funds that qualify as "venture capital operating companies." The DOL regulations on this subject are complex, but in general they require that the fund obtain "management rights" with respect to at least 50% of its portfolio investments (based on cost basis) and exercise those rights in the ordinary course of its business with respect to at least one portfolio company at the times specified in the regulations. In order to

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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 the fund with the ability 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 12.B.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

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arrangements (which may impact payments of carried interest), (*ii*) fiduciary duties, (*iii*) prohibited transactions, (*iv*) retention of transaction fees, (*v*) other fee arrangements, including placement fees 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, 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 10.B below.

B. *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, but are not limited to, 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.

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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 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

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so it can honor its indemnification obligations). See Topic 7.B 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. In recent years, the political climate has, in some states, led to an adverse reaction to private equity funds that place a primary emphasis on ethical investing. Therefore, fund sponsors must strike a balance between these competing policies. For example, one recent law, the Oklahoma Energy Discrimination Elimination Act of 2022, prohibits Oklahoma plans from investing in private equity funds that boycott the energy industry.

C. *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 2.N above), but they also invest directly in pooled multi-investor funds. SWFs often make very large commitments to funds, and in return often seek to negotiate fee breaks, priority co-investment opportunities and/or increased

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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 10.D below for an overview of special tax considerations applicable to non-U.S. governments subject to special exemptions under section 892 of the Code.

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e. *Regulatory Concerns*. See Topic 12.U below for a discussion of U.S. regulation of sovereign wealth fund investments in areas sensitive to national security and critical infrastructure. See also Topic 12.G below for an overview of the non-U.S. anti-money laundering and "know your customer" regulations that may affect investments by sovereign wealth funds.

D. *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."

E. *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.

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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 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 12.I 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

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may provide that BHC investors hold non-voting equity interests as necessary.

F. *Non-U.S. Regulated Entities*

The regulatory position of non-U.S. investors may impact their investment in funds. These investors may include insurance companies (see Topic 9.D above), banking entities (see Topic 9.E above) and development banks. Development banks like the European Investment Fund can often be cornerstone investors, particularly for first-time funds, but often have extensive commercial and other requests relating to fund terms. Sponsors that seek funding from development banks should expect extensive negotiation and may not wish to hold closings with other investors before finalizing terms with the development bank.

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 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,

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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 that every German pension fund or scheme will request before subscribing to a fund. In some cases, these guidelines materially affect the capacity of regulated investors to invest in funds managed by non-EU managers. Investing in funds organized in the Cayman and Channel Islands is difficult and, sometimes (depending on the investment strategy of the fund), not possible for such investors. In addition, these guidelines may restrict a sponsor's leverage and investment profile, which may lead to sponsors wishing to create parallel funds to accommodate investors such as German pension funds and certain other EU insurance companies.

G. *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

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any number of the concerns and requirements described above. One such concern relates to sensitivities to fees and expenses, given that many funds of funds will charge separate fees and expenses to their underlying investors.

H. *Private Foundations and Endowments*

These types of investors have special tax concerns in addition to concerns about UBTI (see Topic 10.B 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)—exceed a specified threshold.

I. *Charities and Universities*

Charities have certain fee and tax concerns that may set them apart from other investors (see Topic 10.B below). Additionally, they may have to meet certain investment objectives favoring environmental and social governance issues.

University investors come with a similar set of considerations to public pension plans. In addition, sponsors may encounter a slower closing process when dealing with university and college investors compared to certain other types of institutional investors.

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J. *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 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, then 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.

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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 12.J below.

K. *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-

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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 regulatory restrictions and enforcement than offerings to institutional investors. See Topic 3.B above.

L. *Future Considerations*

Despite recent turmoil in the market for cryptocurrencies, there may still be increased investor appetite for exposure to cryptocurrency and crypto-related investments, and for increased tokenization of private equity markets. Tokenized funds may simplify the process of investing in a fund by reducing anti-money laundering and "know your customer" obligations and may make it easier for sponsors and investors to make contributions to a fund, receive distributions from a fund and to track returns. Certain private equity funds have embraced blockchain technology to accommodate certain types of investors.

At the same time, however, cryptocurrencies have been associated with market volatility and fraudulent practices. Regulation of blockchain technology remains unclear and can often lead to conflicts with anti-money laundering rules. Funds or a strategy that invests in cryptocurrency and related investments should remain aware of these issues throughout the fund's life. See Topic 12.U below for further discussion of cryptocurrencies and related issues.

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10. Investor Level Tax Issues

A. *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 consider 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. 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, as well as the recycling of disposition proceeds, could result in partners realizing income for U.S. tax purposes, even though an investor realizes no current cash income.

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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 as ordinary or dividend income. The PFIC rules generally provide that distributions from a PFIC and gain from the disposition by the fund of an interest in a PFIC could be subject to a substantial interest charge and could be characterized as ordinary income (rather than as capital gain) to certain U.S. shareholders, unless an election (referred to as a QEF Election) is made to include income and gain realized by such PFIC on a look-through basis.

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

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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.

B. *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 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-

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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, then 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 if the debt is outstanding on the date of the sale or during the 12-month period prior to sale. In addition, if a fund sells its interest in a flow-through entity that has acquisition indebtedness, then the portion of the gain attributable to the debt would be UBTI. The tax treatment of amounts borrowed by a fund for administrative convenience (*e.g.*, to bridge capital calls) is complex. However, in our experience, many funds take the position that short-term borrowing of this nature, which is incurred solely for administrative convenience, is not treated as acquisition indebtedness.

(C) *Fee Income*. If a fund were to regularly render services for fees, then it would likely be engaged in a trade or business, and the fees would likely be UBTI. Typically, a fund does not perform any services; it merely invests. It is possible, however, that reductions in the management fee resulting from transaction fees, monitoring fees, directors'

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fees and other similar fees may be treated as UBTI to U.S. tax-exempt investors.

(D) *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 individuals.

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.

C. *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.

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

(ii) *United States Real Property Interests*. Under 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 considered 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 also 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

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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 10.E, 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 the disposition of a "United States real property interest" and on capital gain 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

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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 U.S. tax returns on gains from the sale of USRPHCs.

(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.

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(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 non-U.S. partner's return. In addition, if any portion of a non-U.S. partner's gain on the disposition of an interest in the fund would be treated as ECI, then such sale may be subject to a 10% withholding tax on the gross amount received for such interest.

(A) *Partnership Secondary Liability*. A U.S. fund will bear secondary liability for withholding taxes that arise in connection with the transfer by a non-U.S. partner of an interest in a partnership that is engaged in a U.S. trade or business. Although the purchaser of the interest is primarily liable to withhold unless applicable exemption certificates have been obtained, the fund will have a secondary withholding obligation on subsequent distributions to the purchaser if the fund is unable to confirm that the purchaser has complied with the applicable withholding requirements.

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.

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D. *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 outside the United States in a year, then 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

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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 10.E, below.

E. *Structuring Mechanisms*

a. Most funds have abandoned the historic approach to protecting investors from UBTI, ECI and sometimes "commercial activities" by simply covenanting to avoid such income. Similarly, most funds no longer allow investors to opt out of investing in these deals. Instead, funds now offer 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.

b. *Blocker Corporations*. As the use of blocker corporations has become more prevalent, the market has begun to coalesce around the treatment of certain common blocker issues.

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(i) *Exiting Blocked Investments*. Funds will often exit operating partnership investments that are partially held beneath a blocker (a "Blocked Investment") by (*1*) the fund and the blocker each selling its interests in the Blocked Investment, and the blocker then distributing the after-tax proceeds to the fund; or (*2*) the fund selling the shares of the blocker along with the interests that the fund holds directly in the investment.

(A) *Tax Consequences*. Assume a fund owns 50% of a Blocked Investment directly and 50% through a blocker. The total cost of the investment was $200 and the investment's fair market value at the time of exit, ignoring the blocker, is $400. Further, assume that there is no depreciation during the holding period (so that tax basis in the assets remains $200).

(1) *Sale of the Portfolio Company by the Blocker*. If the blocker sells its interest in the Blocked Investment, then the blocker and the fund will each receive $200. Of the $200 the blocker receives, the blocker must pay $21 of taxes on the $100 of profit based on a corporate tax rate of 21%, leaving the fund with a total of $379. On the other hand, the buyer gets the benefit of a full basis step-up of $200, which generally will be amortizable over 15 years.

(2) *Sale of the Blocker by the Fund*. If the fund instead sells the blocker alongside its direct

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interest in the operating partnership, then the buyer is forfeiting $100 of amortizable tax basis (*e.g.*, a $21 tax shield). However, this tax shield is spread over 15 years, whereas the $21 of tax, which is borne by the blocker in the first scenario, is immediate. Overall, the benefit to the fund of selling the blocker outweighs the cost to the buyer, and, in a rational market, the tax saved by the fund will be greater than the discount in price paid by the buyer due to the reduction in amortizable tax basis (the so-called "blocker discount"). Accordingly, sales of blockers have become increasingly common in a competitive sales process.

(3) *Allocation of the Blocker Discount*. If a fund decides to sell the stock of a blocker, then the fund must decide who will bear the economic impact of the blocker discount.

I. *Pro-Rata* Allocation of Blocker Discount. Some fund agreements require all partners to share the discount, as (*i*) the fund needed capital from all partners to make the investment, and as such it is equitable for all parties to bear the discount, and (*ii*) it can be difficult to calculate the blocker discount with a high degree of precision.

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II. Allocation Solely to Blocked Investors. Most fund agreements provide that a fund may choose to allocate the blocker discount solely to the investors who elect to invest through the blocker. Many sponsors and investors see it as an equitable allocation of the cost associated with the sale of the blocker. Many funds will negotiate with co-investors and management participants in an operating partnership that it may sell the blocker at the same price per unit as other sellers. While this benefits blocked investors, it disadvantages (and therefore creates potential conflicts for) the fund's unblocked investors (including the general partner in respect of its carried interest).

(ii) *Buying an Existing Blocker and Using It as the Fund's Blocker*. When a fund buys an operating partnership from another private equity fund, the seller will likely want the fund to acquire its blocker. There are two primary approaches when it comes to addressing the existing blocker.

(A) *Two Investments*. One approach is for funds to view the transaction as two investments. An investment in a corporation and an investment in an operating

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partnership. The fund would then add a blocker for the investment in the operating partnership. For example, assume the fund is buying an operating partnership that is 50% owned directly by the selling sponsor and 50% owned by a blocker and that the purchasing fund also needs to be blocked for 50% for its investment in the operating partnership. For the investment in the operating partnership, most fund sponsors have historically set up a second blocker. As a result, 75% (50% held by the fund for all investors through the existing blocker and 25% held by the fund for its tax-sensitive investors through the second blocker) of the interests in the underlying operating partnership are held through a blocker, while the fund only needs 50% to be blocked. Because the exit will be structured as a sale of the blockers, creating multiple blockers shrinks the amount of step-up available that can be offered to a future buyer.

(B) *A Single Consolidated Investment*. An alternative approach is to attempt to use the selling fund's blocker as the blocker for the purchasing fund's blocked investors and therefore to avoid creating excess tax leakage inherent in the use of a second blocker. However, there are tax detriments associated with purchasing the existing blocker—most significantly, there is no amortizable step-up associated with the purchase of the stock of the blocker. While it may be possible to implement this second option in a manner that is fair to all investors,

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for example, by having the blocked investors of the purchasing fund receive the full benefit of any blocker discount associated with the purchase of the blocker, this approach creates additional complexity and may still raise structuring concerns, especially where the existing blocker is larger than necessary for the purchasing fund.

(iii) *Carried Interest Calculation*. With respect to the calculation of the general partner's carried interest, in our experience, most funds calculate the general partner's carried interest on a gross basis without considering taxes borne by the blocker or reduced proceeds as a result of a blocker discount.

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11. Structuring the Manager and the General Partner; Asset Management M&A

A. *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), and the buildup of goodwill, and may simplify estate planning for the investment professionals.

Optimizing the structure of the manager and the general partner may involve significant effort and expense. Issues to be considered include the following:

a. Compensating individual investment professionals and other employees.

b. U.S. federal, state and local taxation and, 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. Non-U.S. marketing requirements.

e. Governance.

f. Liability issues.

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g. Subadvisor and satellite office arrangements.

B. *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.

C. *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) Adjustments in connection with promotions of existing investment professionals.

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(iv) Vesting (timeline, daily pro ration vs. cliff vesting, adjustments due to manner of departure, etc.).

(v) Reallocation of unvested carried interest in connection with a departure.

(vi) General partner option to buy back vested interests following a termination for cause or breach of surviving covenants.

(vii) Dilution and allocation of carried interest in connection with the sale of a portion of the general partner or manager to a third party.

(viii) General partner removal provisions.

(ix) 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.

(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

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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 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.

D. *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 (to the extent otherwise permissible under the Marketing Rule). Such covenants are particularly important when the investment professional does not have a separate employment agreement with the sponsor. Consider that restrictive covenants may be unenforceable under certain state laws.

E. *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

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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).

F. *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.

G. *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, then the adviser may be subject to authorization requirements for rendering investment advice and brokerage services in the European Union under MiFID (see Topic 3.D.e, above).[5] The same authorization requirements may apply to advisers operating from the European Union.

H. *European Outsourcing Restrictions*

AIFMs in the European Union can delegate management functions only when complying with regulatory restrictions, and the AIFM must notify the competent regulator of any such

[5] In certain cases, an exemption under the so-called "group privilege" may be available.

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delegation. 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" that 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. Going forward, it is expected that the delegation requirements will be subject to some additional reporting requirements under the revised AIFMD II, which is expected to be adopted later this year.

I. *AIFM for Hire*

a. It is possible to use an external service provider manager that has the required authorization as AIFM of the fund. The option is often used by non-EU sponsors 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 (non-discretionary) 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 provide non-discretionary 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), then attention is required to

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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 3.D.d, above.

J. *Asset Management M&A*

Over the last several years, fund sponsors have increasingly participated in minority stake sales, majority stake sales or other financings, whereby the sponsor agrees to sell or finance a portion of its fee income, carried interest or capital interest in its underlying funds to one or more third parties. Buyers in this market were historically large institutional investors seeking to solidify relationships with investment managers, reduce their overall fees paid to a sponsor or to diversify their capabilities or portfolios. In recent years, however, a growing number of alternative asset managers have established investment funds focusing specifically on these types of transactions, which has led to an increase in the number of these transactions and participation in such transactions by a broader variety of sponsors across a variety of strategies and sizes. These minority GP stake investors have increasingly focused on providing strategic services to underlying sponsors as a differentiator from other GP stake platforms. In addition, many large alternative asset managers seek to expand their fund product offerings by acquiring majority positions in smaller sponsors, which allows a manager to acquire an existing team, portfolio and track record quickly. Proceeds from such transactions are often used to grow a sponsor's business, which often means financing GP commitments to new funds or to raise new fund products, provide liquidity to senior or retiring members of the investment team or facilitate a transition to the next generation of investment

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professionals. Investors in this space are capable of investing across the capital structure of underlying fund sponsors and have established investment products to invest in common equity, preferred equity or debt instruments.

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12. Regulatory Issues

A. *U.S. Securities Act and Other Private Placement Regulations*

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

b. *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.

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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 that, among other things, permits an offering of interests to an unlimited number of "accredited investors" (as defined in Rule 501(a) of Regulation D) and up to 35 non-accredited sophisticated investors but prohibits the use of a "general solicitation" (such as, for example, an advertisement, speaking to the press or at seminars or conferences, communications on a publicly accessible website, cold-calling, etc.). If there has been a general solicitation, then the fund may be required to cease the offering for a "cooling off" period.

(ii) *Rule 506(c)*. Rule 506(c) of Regulation D 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

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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 (*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 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.

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(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).

B. *U.S. Investment Company Act*

In general, any issuer of securities that 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 (*but see '33 Act, AIs*)	Qualified purchasers (excluding knowledgeable employees)
Investor limit	100 (excluding knowledgeable employees)	None (*but see '34 Act, <2000*)
Statutory look-through	10% beneficial owners who are "private funds" (*i.e.*, 3(c)(1) or 3(c)(7))	None (*but see* ICA Rule 2a51-3)
Non-statutory look-through	Yes	Yes

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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 12.B.a(ii) 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, then 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.

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(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 in the United States if either (*A*) fewer than 100 U.S. persons beneficially own the fund's securities (section 3(c)(1) of the Investment Company Act) or (*B*) all U.S. persons who own securities of the fund are "qualified purchasers" (section 3(c)(7) of the Investment Company Act). For these purposes, only

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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

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(*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.

C. *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 required to register with the SEC under the Advisers Act if they have more than $150 million in assets under management.

(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

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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 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

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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:

(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,

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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 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 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 interest between different clients,

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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 private 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 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

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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. Form PF must be amended annually and more frequently depending on the nature of the funds. Generally, RIAs to private equity funds must file quarterly reports to reflect specific transactions that may have occurred in the last quarter, while RIAs to hedge funds must file updates within 72 hours of enumerated events or transactions.

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(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.

(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

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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 12.B.b above) and all the limited partners meet a "qualified client" test, (*B*) the fund relies on section 3(c)(7) of the Investment Company Act (see Topic 12.B.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 12.A.d above)) or (*D*) the fund is a BDC and the compensation does not exceed 20% of realized capital gains.

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(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 direct or indirect transfer of a controlling interest in the RIA (*e.g.*, an acquisition of the RIA or the entrance or departure of a control person of the RIA).

(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 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

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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 will be distributed to fund investors within 120 days (180 days, in the case of a fund of funds) after the end of its fiscal year.

(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

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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 12.C.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 12.C.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 the information required by Part 1A; rather, it is only required to provide certain identifying information concerning the ERA and the private funds that it manages.

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(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 12.C.b(i) above). Similarly, ERAs are subject to the "pay-to-play" restrictions (see Topic 12.C.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.

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(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 12.C.b(xv) above.

d. *Investment Adviser Marketing*.

(i) In 2022, the SEC updated the rules that govern investment advisor marketing communications. The "Marketing Rule" applies to any investment adviser registered or required to be registered that directly or indirectly disseminates an advertisement.

(ii) An "advertisement" is any direct or indirect communication that an investment adviser makes that offers investment advisory services to prospective clients, current clients or private fund investors. Any endorsement or testimonial for which an adviser provides compensation directly or indirectly is also considered an advertisement. One-on-one communications, extemporaneous, live, oral communications and information contained in statutory or regulatory notices, filing or other required communications are not advertisements under the Marketing Rule.

(iii) Advisers are prohibited from making untrue statements of material fact, including information that would be reasonably likely to cause an untrue or misleading implication or inference to be drawn of a material fact relating to the adviser, from discussing potential benefits without providing information about any

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associated material risks or limitations, from referencing specific investment advice that is not presented in a fair and balanced manner, including or excluding performance results or time periods in a manner that is not fair and balanced, and from including any materially misleading information.

(iv) Endorsements, testimonials and third-party ratings may be used in an advertisement if the adviser provides disclosures that clearly and prominently identify whether the "promoter" is a client and whether the promoter is compensated. Similarly, third-party ratings must be accompanied by disclosures that satisfy certain criteria pertaining to the preparation of the rating. The Marketing Rule limits the inclusion of performance results in advertisements.

D. *Private Fund Adviser Rules (vacated)*

In August of 2023, the SEC adopted final rules applicable to investment advisers to private funds (the "PFA Rules"), which covered fee and expense allocation, general partner clawbacks, preferential treatment, adviser-led secondaries and reporting. On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit issued a decision in a case brought by six private fund industry groups challenging the PFA Rules. In National Association of Private Fund Managers v. SEC, No. 23-60471, a unanimous three-judge panel of the Fifth Circuit vacated the PFA Rules in their entirety. The SEC did not petition the U.S. Supreme Court for certiorari or appeal to an *en banc* hearing of the Fifth Circuit, and the Code of Federal Regulations has been updated to reflect the vacatur. The

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PFA Rules remain important for at least two key reasons: (*i*) they indicate areas of possible focus and priorities for SEC examinations and enforcement actions and (*ii*) should the SEC decide to reintroduce or propose similar rules in the future, it may incorporate similar themes from the PFA Rules. Below is a summary of the vacated PFA Rules.

a. *Restricted/Prohibited Activities*.

(i) *GP Clawbacks*. An adviser may not reduce any clawback by the amount of certain taxes unless the adviser provides written notice to investors.

(ii) *Adviser Compliance and Related Fees*. The compliance and examination expenses of an adviser (and related persons) may be allocated to funds only with written notice including the specific dollar amount of expense. Investigation expenses of an adviser may be allocated to funds with disclosure and consent from a majority in interest of fund investors not related to the adviser, unless the investigation results in a sanction under the Advisers Act.

(iii) *Prohibition on Non-Pro Rata Cost Allocations*. Fees or expenses related to a portfolio investment may be allocated on a non-*pro rata* basis only if the allocation approach is fair and equitable and, prior to charging the non-*pro rata* fee or expense to a private fund, the adviser distributes written notice of the non-*pro rata* charge and a description of how the approach is fair and equitable under the circumstances to each investor.

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(iv) *Prohibition on Borrowings from Private Funds*. An adviser may borrow or receive an extension of credit from a private fund client only if the adviser provides disclosure of material terms to, and obtains written consent from, a majority in interest of fund investors not related to the adviser.

b. *Adviser-Led Secondaries*.

(i) *Fairness Opinion and Material Business Relationships*. An adviser must obtain a fairness opinion or a valuation opinion from an independent opinion provider and must prepare and distribute to investors a summary of any material business relationships that the adviser has or has had with the independent opinion provider.

c. *Preferential Treatment*.

(i) *Certain Preferential Treatment Prohibited*. Advisers may not grant an investor in a private fund the ability to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund unless the adviser offers the preferential redemption rights to all other investors or the ability to redeem is required by law. Advisers may also not provide information regarding the portfolio or exposure of a private fund to any investor if the adviser reasonably expects that providing the information would have a material, negative effect on other investors, unless the adviser offers such information to all other existing investors in the fund.

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(ii) *Preferential Treatment Disclosure Requirement*. Advance written notice of any material economic terms that the adviser provides to investors in a fund must be given to prospective investors. Written disclosure of all preferential treatment granted to all investors must be distributed to an investor in (*i*) an illiquid fund, as soon as reasonably practicable after the fundraising period and (*ii*) a liquid fund, as soon as reasonably practicable after the investor's investment in the fund. The adviser must provide annual updates showing specific information on preferential treatment granted since the last disclosure.

d. *Reporting and Audits*.

(i) *Content of Quarterly Reports*. Advisers must provide quarterly reports to investors that include detailed information in the form of (*1*) a fund table, (*2*) a portfolio investment table and (*3*) performance information.

(ii) *Audit Requirement*. Advisers will be required to obtain an audit that complies with the conditions for audits under the Advisers Act custody rule.

e. *Compliance Matters*.

(i) *Annual Compliance Review Documented in Writing*. Registered advisers must, at least annually, review and document compliance reviews in writing.

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E. *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). A CPO that claims the *de minimis* exemption is required (at the time that it makes or reaffirms such claim) to represent that neither it nor any of its principals (as defined for CFTC purposes) is subject to certain covered statutory disqualifications.

b. Additionally, in certain cases, 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.

c. "Commodity interests" for these purposes include (*i*) futures and options on futures traded on exchanges, including

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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. Certain CPO and CTA exemption claims, including a claim for the *de minimis* exemption from CPO registration, must be reaffirmed on an annual basis within 60 days following the end of each calendar year.

e. 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.

F. *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.

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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*) are not, and for the past 12 months have not been, "associated persons" of a broker-dealer, (*B*) do not receive commissions or other transaction-based compensation in connection with securities transactions, (*C*) perform substantial duties other than sales activities and (*D*) 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.

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(A) *Marketing Materials*. Placement agents that are registered broker-dealers and members of FINRA are subject to advertising rules (including FINRA Rule 2210) which cover written fund marketing materials either produced or distributed by the member. Depending on the facts, FINRA may consider this rule to cover a private placement memorandum. FINRA Rule 2210 prohibits marketing materials from including predictions of performance which may apply to target returns, depending on circumstances. In addition, FINRA 2210 has been interpreted to limit the permissibility of using IRRs, particularly those that are not produced in a manner consistent with GIPS. As of late 2023, FINRA has proposed an amendment to Rule 2210 that would liberalize the use of projections and targets to partially (but not fully) align the rule with the SEC's 2020 marketing rule for investment advisers.

c. *Transactions by Funds and Portfolio Companies*. Private equity sponsors may wish to engage in a variety of activities on behalf of funds and portfolio companies, including identifying, providing advice on, structuring, negotiating and executing transactions involving securities and 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.

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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 5.B.c above.

d. *Broker-Dealer Ownership*. Acquisition of a 25% direct or indirect ownership interest in a broker-dealer requires the broker-dealer to obtain approval by FINRA, a process that can take substantial time and may affect timing for closing a deal. In addition, acquisition has certain regulatory entailments that a fund sponsor should consider as part of its deal diligence. In particular, Form BD (the registration form for a broker-dealer filed with the SEC) requires disclosure of direct and indirect owners with a 25% ownership level (measured at each link in the ownership chain) and this information is published by FINRA on its BrokerCheck system. Fund investors are not exempt from this requirement. In addition, under FINRA Rule 5130, broker-dealers distributing securities in an IPO are generally prohibited from selling IPO shares to "restricted persons" including direct and indirect owners of a broker-dealer that are required to be disclosed on its Form BD.

G. *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,

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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 legal regime requires, for example, the designation of certain money laundering reporting officers; certain training for all 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 EU member states are required by a European Directive to implement anti-money laundering legislation, which may affect local funds and sponsors. Additionally, EU countries must establish a register listing the beneficial owners of many legal entities, including funds established in the European Union. The U.S. regulatory landscape is somewhat different in that it currently does not require private funds and their sponsors to adopt formal anti-money laundering compliance programs; however, private funds and their sponsors ordinarily adopt voluntary compliance programs. Such programs are intended to mitigate risks of involvement in criminal money laundering and may be expected (or even demanded) by certain counterparties, particularly financial institutions providing banking and credit services. 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.

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b. *Sanctions*. A related set of issues involves economic and trade sanctions. For example, the United States, the European Union, the United Kingdom and, increasingly, numerous other jurisdictions maintain (similar but not identical) sanctions that prohibit citizens and residents of, as well as entities created or operating in, their jurisdictions from doing business with certain sanctioned countries, individuals and entities. Historically, these sanctioned parties were often alleged to be engaged in terrorism, weapons proliferation, narcotics distribution and other criminal activities but, increasingly, sanctions also are adopted to address human rights concerns and foreign policy challenges. If a fund holds assets belonging to persons or entities controlled by or associated with sanctioned individuals or entities, then the fund must "block" or freeze such assets and report them to the relevant government, and a fund may be restricted from participating in a transaction involving a sanctioned person or its interests, even if the fund doesn't hold assets of the sanctioned person.

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, including in the United States. Unlike private funds, 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. Broker-

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dealers also are 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). A failure to comply with these obligations can result in enforcement action or, for willful violations, potential criminal liability.

H. *U.S. Beneficial Ownership Information Reporting*

a. The United States is implementing a new regime under the Corporate Transparency Act that will require certain legal entities created through the filing of a document with a secretary of state or similar office under the law of a state or Indian tribe, or registered to do business in the United States through such a filing, to report information about their beneficial owners and control persons to the Financial Crimes Enforcement Network ("FinCEN") within the U.S. Treasury Department. The regime exempts from the reporting obligation 23 types of entities, including, among other exemptions, RICs, RIAs, private funds (*i.e.*, 3(c)(1) or 3(c)(7)) identified on the RIA's Form ADV and certain entities the ownership interests of which are controlled or wholly owned by an RIA or certain other types of exempt entities (but not *per se* the subsidiaries of private funds). Analysis may be required with respect to entities in a private fund structure (*e.g.*, U.S. joint ventures, special purpose vehicles) to determine whether a beneficial ownership reporting obligation applies or an exemption is available. In addition, sponsor-affiliated personnel may, in some cases, be obligated

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to provide personally identifying information for purposes of the beneficial ownership reports filed by joint venture or portfolio companies that are not themselves eligible for an exemption (*e.g.*, if such individuals are deemed to exercise "substantial control," as defined in FinCEN's regulations, over the reporting company in question). Notably, an entity formed outside the United States is not in scope for the reporting requirement, unless it registers to do business in a U.S. state.

I. *Merchant Banking and Volcker Rule*

Fund sponsors that are regulated as Financing Holding Companies ("FHC") 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 9.E.b above.

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J. *Cybersecurity Policies and Procedures and Risk Management*

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 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

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update procedures to respond to changing risks and ensure that 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 advisers to secure their investors' assets.

K. *U.S. Privacy Laws*

Funds whose investors include natural persons are subject to regulations (of the SEC and/or CFPB) restricting the ability of financial institutions to disclose an individual's non-public personal financial information to non-affiliated third parties under rules implementing the Gramm-Leach-Bliley Act (GLBA). These regulations 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 natural person investors (not trusts or pension plans). The SEC and FTC have also issued regulations under GLBA requiring the use of data security safeguards. Non-U.S. Funds may be subject to these U.S. GLBA regulations to the extent they provide

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financial services to U.S. consumers and customers as defined under the regulations.

Funds who conduct business in California and have data from California residents such as directors, officers or beneficial owners of investors are subject to the California Consumer Privacy Act ("CCPA"), which contains provisions similar to the GDPR, including substantive cybersecurity requirements. Such requirements include making specific privacy notice disclosures, offering rights to individuals, and specific contractual provisions with service providers that process data subject to the CCPA.

L. *GDPR*

The European Union'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. and other non-EEA established companies to the extent they target or monitor EEA data subjects, including many PE firms that actively fundraise in the European Union. 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 when and how they collect and use information of EEA data subjects. Covered entities also must inform consumers when their data is collected and provide certain prescribed information and respond to individuals' requests about their data. The GDPR also strictly controls when and how information can be moved out from the EEA to the United States and other non-EEA jurisdictions. Broadly equivalent obligations exist in the United Kingdom under the UK Data Protection Act, incorporating the GDPR into UK law.

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M. *Investments in Regulated Industries*

In some cases, a fund's investment strategy will involve acquisitions in regulated industries, such as energy and other public utilities, transportation, insured depository institutions, insurance companies and other financial services, the defense industry, government contracts, healthcare or ports. These investments may require prior approval under, or compliance with, U.S. or foreign legal regimes and may impose burdens on the fund, its investors or the sponsor. Further issues may be encountered if the fund or its sponsors are foreign.

For example, a fund that invests or may invest in media companies licensed by the Federal Communications Commission likely will need FCC consent to own controlling interests in those companies. In addition, it usually will want to include FCC-specified provisions in its fund agreement (or in the governing documents of an alternative investment vehicle) to ensure that investors are insulated from having attributable interests in those companies and, accordingly, that the fund, as well as its media companies and investors, will be able to comply with the FCC's multiple- and cross-ownership rules.

N. *AIFMD*

a. *AIFM*. The AIFMD is concerned with regulating managers who manage and/or market funds in the European Union. See also Topic 3.B.d(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

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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 that is established in the European Union. It is not relevant for funds that 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 certain systems and controls (including with respect to remuneration of the manager's staff).

c. *Pre-Marketing*. In an attempt to address barriers to the efficient cross-border marketing of investment funds across

[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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the European Union, the EU legislator adopted Directive 2019/1160/EU (the "Cross-Border Distribution of Funds Directive") that amends the AIFMD and aims to create a consistent pre-marketing regime. It defines pre-marketing as the provision of information or communication on investment strategies or investment ideas by an AIFM to potential EEA professional investors in order to test their interest in an AIF that is not yet established, or that is established, but not yet notified for marketing. The Cross-Border Distribution of Funds Directive also introduces a pre-marketing notification requirement to EU AIFMs that need to file within two weeks of their having begun pre-marketing an informal letter to their home state regulator specifying the member states in which, and the periods during which, the pre-marketing is taking or has taken place and a brief description of the pre-marketing, including information on the investment strategies presented. For non-EU AIFMs it is up to each EEA member state to decide if and how it applies the pre-marketing rules to non-EU AIFMs or non-EU AIFs. Currently, only Finland, Germany, Luxembourg and the Netherlands request a pre-marketing notification from a non-EU AIFM.

d. *Marketing Notification for Non-EU Managers*. In general, for a non-EU manager to market a fund to professional investors in the EU, 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

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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.

e. *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.

O. *ESG Disclosure Regulations in the European Union*

a. *SFDR*. In 2019, the European Union adopted the Sustainable Finance Disclosure Regulation (the "SFDR").[7] The SFDR first and foremost is about transparency. It seeks to create a harmonized set of rules on sustainability-related disclosures by funds and their managers to make sustainability aspects of an investment easily comparable for investors. Funds and managers must disclose the integration of sustainability risks and principal adverse impacts on sustainability in investment decisions. Funds are also required to make certain heightened

[7] Regulation (EU) 2019/2088.

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disclosures to their investors if they claim to promote "environmental or social characteristics" or undertake "sustainable investment objectives." These heightened disclosures under SFDR are in the form of website disclosures, pre-contractual disclosures in marketing communications and periodic disclosures. The SFDR also provides forms and guidelines to ensure uniformity in the information being disclosed.

b. *Taxonomy Regulations*. Supplementing the SFDR, the European Union also adopted the Taxonomy Regulation.[8] The Taxonomy Regulation introduces uniform criteria for "environmentally sustainable economic activities" and defines "environmental objectives." The investment activities of funds may or may not be taxonomy-aligned. Either way, a fund has to disclose its election to its investors. The Taxonomy Regulation is intended to boost investor confidence since it encourages funds and its managers to make voluntary disclosures on the environmentally sustainable economic activities they invest in even when they have no obligation to do so.

c. *Corporate Sustainable Reporting Directive*. The European Union's Corporate Sustainability Reporting Directive (the "CSRD") that entered into force on January 5, 2023 will require companies with securities listed on an EU-regulated market, or non-listed private EU companies large enough to be in scope, to include in their annual reporting extensive sustainability-related information in accordance with the

[8] Regulation (EU) 2020/852.

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European Sustainability Reporting Standards (ESRS). Sustainability information comprises information on a company's governance and environmental and social impacts, including in its "value chain" (suppliers and customers). In determining the relevant information to report, companies will need to conduct a materiality assessment in line with the principle of "double materiality": companies must consider both (*i*) the impacts of their activities on people and the environment from the perspective of society as a whole and (*ii*) how sustainability matters affect the company from a financial risk perspective. Following implementation into the national law of EU Member States, the CSRD's requirements will be phased in for reporting periods beginning on or after January 1, 2024. From 2028, CSRD will apply in a broader form to EU subsidiary companies that are in scope, where their ultimate parent company is established outside the European Union. In 2028, the EU subsidiary will additionally prepare a consolidated sustainability report at the global group level of its ultimate non-EU parent company. This requirement is conditional on the non-EU company at group level (or, if not applicable, individual level) generating a net turnover of more than €150 million in the European Union for each of the last two consecutive years. Worldwide companies with EU operations may therefore choose to comply with CSRD voluntarily on a global basis before 2028, to avoid the administrative burden of applying CSRD reporting to different parts of its global operations at different times.

d. *Corporate Sustainable Due Diligence Directive*. The Corporate Sustainability Due Diligence Directive ("CSDDD") came into

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force in July 2024, with its provisions first applying from July 2027 to the largest EU and non-EU companies in scope. The regime introduces human rights, environmental and governance due diligence obligations for in-scope companies and their subsidiaries' operations and in their "chains of activities," which generally are supply and distribution chains. CSDDD provides that parent companies and individual subsidiary companies can be in scope. Asset management groups will therefore need to determine which companies in their group are in scope of CSDDD by reference to the threshold tests. The threshold tests are applied on a group-wide basis for the "ultimate parent company of a group" (by reference to consolidated financial statements), and on a stand-alone basis for subsidiary companies. All companies that are in scope of CSDDD must adopt and put into effect a climate transition plan, with emissions reduction targets for each significant category of their Scopes 1, 2 and 3 greenhouse gas emissions.

P. *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

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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.

Q. *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, Luxembourg and the United Kingdom. The United States is not participating in CRS; the requirements of FATCA and CRS are similar, rendering CRS participation unnecessary since information on U.S. persons is already obtained via FATCA. Funds organized in participating countries need to consider the compliance and reporting aspects of CRS.

R. *Mandatory Disclosure Regimes ("MDR")*

MDR (part of the OECD Base Erosion and Profit Shifting initiative) requires disclosure of certain arrangements containing specific indications of tax abuse. In the European Union, MDR has been introduced via the sixth iteration of the Directive on Administrative Co-operation ("DAC6" Council Directive EU/2018/822 amending Council Directive EU/2011/16). EU Countries are required to comply with DAC6, although fund

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structuring is unlikely to trigger a reporting obligation. In the United Kingdom, MDR has been separately enacted, with narrower requirements than DAC6. Certain other countries are introducing their own regimes based on MDR. Funds need to be mindful of MDR; although, as stated, a typical fund structure is unlikely to result in an issue, investors may seek assurance that this has been adequately considered.

S. *Base Erosion and Profit Shifting*

The OECD Base Erosion and Profit Shifting ("BEPS") initiative is a collection of "action points" that have resulted in changes to the domestic law of a number of jurisdictions together with the provisions of many bilateral tax treaties with a view to countering arrangements perceived to be abusive from a tax perspective. In addition to MDR, funds may need to consider a number of these such as hybrid mismatches, treaty abuse and interest limitation. In the European Union, the action points have frequently been enacted by way of directive; in addition to DAC6, there have been two iterations of the Anti-Tax Avoidance Directive ("ATAD" – Council Directive EU 2016/1164 and "ATAD II" – Council Directive EU/2017/952) to address the BEPS actions. None of the BEPS initiatives are designed to target fund structures, but addressing them may nonetheless require some consideration, especially since, as with MDR, investors frequently seek assurance that BEPS has been properly analysed.

T. *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

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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 12.C.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.

U. *CFIUS*

The Committee of Foreign Investment in the United States ("CFIUS") reviews foreign equity direct and indirect investment in U.S. businesses, with its jurisdiction extending to both controlling investments and certain non-controlling investments in sensitive businesses that may raise national security concerns ("covered transactions").

Regarding the latter, CFIUS may review transactions by which non-U.S. persons make minority investments in U.S. critical technology and critical infrastructure businesses, and U.S. businesses that maintain and collect sensitive personal information. In addition, CFIUS has adopted regulations that require mandatory declarations for certain non-passive investments, including certain substantial investments by foreign government entities, such as sovereign wealth funds.

A piece of good news for fund sponsors in the context of a fundraising is that the governing statute and implementing regulations provide an "investment fund safe harbor," which exclude from the definition of a "covered transaction" a passive

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limited partnership 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.

(iii) The foreign investor may not have access to material nonpublic technical information (*i.e.*, that is closely related to critical technologies or critical infrastructure of the U.S. business) or certain other rights.

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 a 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.

In light of foreign investments in U.S. portfolio companies, whether made directly or indirectly through a general fund,

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separate account or co-invest vehicle, a sponsor must take these requirements into account, ideally both in drafting fund documents and in considering whether a CFIUS filing must, or prudentially ought to, be made prior to the time the fund makes an investment in a U.S. business.

V. *World Sky*

A sponsor should carefully consider the securities offering requirements of each non-U.S. jurisdiction where fund interests are to be marketed. Securities offering requirements vary greatly among non-U.S. jurisdictions. In some cases, the fund will need to engage a locally licensed agent. Many jurisdictions have local filing, registration or ongoing reporting requirements, for one or more of the general partner, the manager or the fund itself. For example, prior to marketing a fund to Japanese investors, a notification must be filed with the Japanese regulators or a Japanese placement agent must be engaged. In Korea, generally all marketing activity must be conducted through a local licensed agent, and the fund must be registered with the Korean regulator prior to admitting a Korean investor. For each non-U.S. jurisdiction where the fund is marketed, applicable securities legends should be included in the sponsor's offering documents, and investor representations may need to be obtained in the subscription documents. Debevoise maintains an international survey that tracks securities law requirements in over 70 jurisdictions.

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13. Private Fund Transactions

Fund restructurings, otherwise known as GP-led Secondaries, are strategic transactions that typically provide liquidity to existing investors and, depending on the transaction type, can offer certain incentives to sponsors or address certain, structural fund issues. Over the last few years, the market has seen a significant increase in GP-led Secondaries, principally driven by the dramatic uptick in continuation fund transactions. Common GP-led Secondaries also include tender offers, dividend recaps (*i.e.*, NAV loans), preferred financing and collateralized fund obligation transactions.

A. *Continuation Fund Transactions*

Generally speaking, a continuation fund transaction involves a sponsor moving one or more current portfolio investments into a new vehicle (the continuation fund) and, in connection therewith, offering current investors an option to take liquidity or continue their investment in the subject assets in some manner. New secondary market investors capitalize the continuation fund with the cash necessary to provide liquidity to electing current investors.

a. *Types*. There are four main types of continuation fund transactions: (*i*) Single-asset, (*ii*) multi-asset, (*iii*) strip sales and (*iv*) full fund.

   (i) *Single-Asset*. This has become the dominant transaction type in the GP-led secondaries market over the last few years. The subject portfolio company is typically high performing, but in need of additional capital for continued growth, and these types of GP-led

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secondaries typically occur around the middle of a fund's lifecycle. This transaction type provides an opportunity for funds to better position their high-performing portfolio companies to achieve new milestones and breakthroughs that may not otherwise occur if the asset remained in the fund (whether due to capital constraints or the fund's term). Recent, prevailing market practice in this context has been to treat continuing fund investors as reinvesting transaction proceeds (net of carry) into the continuation fund with all investors in the continuation fund participating on the same go-forward economic terms. The alternative, a "status quo" option for existing investors, where the sponsor does not crystalize carry and the rollover investors' economic position remains unchanged, is not overly common in this transaction type, though ILPA has stated this is best practice and prevalence is on the rise.

(ii) *Multi-Asset*. This transaction type, similar to a single asset continuation fund but concerning multiple portfolio companies of a fund, may appeal to the segment of the secondary investor market that views the lack of diversification in single asset transactions as a detriment or bar to participation. Multi-asset transactions are sometimes structured as "strip sales," where the selling fund sells only a portion, or "strip," of the subject portfolio investments to the continuation fund.

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(iii) *Strip Sales*. Strip sale continuation fund transactions are a variation of the continuation fund transaction type, wherein the fund sells only a portion of one or more portfolio companies to the continuation fund. Where the transaction thesis is as simple as locking in early gains and boosting DPI for current investors (and not, *e.g.*, a need for significant go forward capital to support downstream operations), strip sales can offer logistical advantages where sponsors do not offer any options to existing investors (*i.e.*, eschewing the need for an LP election process). Additionally, where a meaningful portion of the subject assets is retained by the selling fund, the sponsor will often be able to resist certain governance controls that secondary investors in continuation funds typically seek (*e.g.*, controls/vetos with respect to asset disposition and no fault removal).

(iv) *Full Fund*. This transaction type concerns all (or substantially all) of a fund's existing portfolio investments. Unlike single and multi-asset continuation fund transactions, which typically concern a fund's better performing investments and occur during the middle of a fund's lifecycle, full fund transactions are often undertaken to address a fund term problem, *i.e.*, the fund is at the end of its life, and a significant portion of investors want liquidity, but liquidating the portfolio may not make sense from an economic perspective or a failed asset sale process has already been run. Frequently, these transactions are undertaken by funds that are not "in the carry," and as such this transaction type sees the

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most frequent use of an economic "status quo" option presented to existing investors.

b. *Conflicts of Interest*. Continuation fund transactions are by their nature conflicted transactions, with a fund selling assets to an affiliate (the continuation fund). These types of transactions are typically prohibited by a fund's limited partnership agreement unless consent from the fund's limited partner advisory committee or investors is obtained. In order to mitigate this conflict of interest, and position the transaction for approval by the required constituency (typically the advisory committee), the market has developed a set of best practices.

(i) *Pricing and Broker Engagement*. Investors will want to know that the sponsor has obtained a good price for the subject assets. Typically, this is achieved by the sponsor engaging an intermediary to solicit interest from the secondary investor community and run an auction process.

(ii) *Selection of Lead Investor*. Typically, the continuation fund will be anchored by one or more secondary investors, *i.e.*, the "Lead Investor." The Lead Investor negotiates the transaction on behalf of the continuation fund (and indirectly on behalf of all other new investors and existing investors electing to continue their investment in the subject assets). The Lead Investor will also often control post-closing enforcement of the purchase agreement between the fund and the

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continuation fund, alleviating this potential source of conflict for the sponsor.

(iii) *Sponsor Reinvestment*. One of the hallmarks of conflicts mitigation in continuation fund transactions is investment by the sponsor in the continuation fund transaction at the new price established by the secondary investor auction process. The market expectation is that 100% of the sponsor's existing capital interest in the subject assets and carried interest generated by the transaction will be reinvested (typically via a tax-free rollover) in or alongside the continuation fund. It is somewhat common to carve out capital and carry attributable to inactive selling fund GP members from this requirement. Additionally, where the quantum of the sponsor reinvestment is low (*e.g.*, representing less than 5% of the capitalization of the continuation fund), whether due to the selling fund not being "in the carry" or a sponsor electing to structure a status quo option (*i.e.*, electing not to crystalize carry in connection with the transaction), it is not uncommon for Lead Investors to require additional cash investment from sponsors.

(iv) *Investor Consent*. The type of investor consent (advisory committee or limited partner) required to clear the sponsor's conflicts of interest is principally a function of the fund's limited partnership agreement. By and large, these agreements will give the fund's advisory committee the authority to review and approve material conflicts of interest. Precisely what the advisory

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committee must review and approve (*i.e.*, the conflict, the price or all terms of the transaction) may depend on the terms of the fund's limited partnership agreement.

(v) *LP Election Process; Disclosure*. In connection with presenting current fund investors the opportunity to elect liquidity in connection with a continuation fund transaction, current investors are provided with a disclosure memorandum, similar to a PPM, that, among other things, provides all information necessary to make an informed decision as to how to participate in the transaction and discloses all conflicts of interest, including how such conflicts have been mitigated. Investors will typically be given at least 20 business days to consider their options and submit their elections.

(vi) *Co-Investors*. As discussed above in Section 6.K.d.v., continuation fund transactions can pose additional challenges when the underlying assets were acquired with the participation of co-investors, who may have invested in those assets alongside the main fund on more favorable terms and/or during a follow-on round. Co-investors often have different expectations and preferences than main fund investors regarding a proposed continuation transaction, especially if they view the terms and economics of the continuation fund as less attractive than their original deal.

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c. *Procedural Considerations*.

(i) *Timeline*. From marketing (if the sponsor has engaged an intermediary for price discovery) to closing, most continuation fund transactions typically take around six months to complete. As noted above, strip sales can be accomplished on a more expedited basis to the extent fund investors are not presented with any options.

(ii) *LPA Amendments*. Many continuation fund transactions are structured in a tax-efficient manner via distribution of underlying equity to continuing investors followed by recontribution to the continuation fund. As such, the Fund LPA will often need to be amended to permit non-*pro rata* distributions and distribution of illiquid securities. Consent to any necessary LPA amendments is sought from current investors as part of the election process.

B. *Tender Offers*

A tender offer is a fund-wide GP-led secondary transaction in which the fund sponsor presents an offer from a secondary investor (or consortium of investors) to its existing investors who have the option to sell their interests in the fund. Unlike continuation fund transactions (which are asset realization events for the fund), in tender offer transactions it is the interests in the fund that are being sold directly. As such, typically fund terms do not change and the transaction does not generate any carried interest for the sponsor. This transaction type is often pursued when sponsors need to deliver a liquidity option to current investors, and will often take place around

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the time the sponsor is fundraising for new products. A tender offer transaction may also include a stapled primary investment component in which the secondary buyer commits additional capital for future investments, either through the existing fund or, more commonly, as a stapled commitment to the sponsor's current fund. The staple is a conflict of interest for the sponsor and should be disclosed in the tender materials distributed to investors.

C. *Financing Transactions*

As an alternative to GP-led secondary transactions involving a transfer of assets, certain financing transactions can also deliver liquidity to investors.

a. *NAV Financing*. NAV financing is a tool that can be utilized by funds to obtain liquidity. Funds that are beyond or in the later part of their investment periods typically have a limited amount of uncalled capital that can be used to secure borrowing under any subscription credit facility. As an alternative, these funds can enter into NAV financing transactions where the amount of loans available is calculated based on the net asset value of the funds' investment portfolio. Typically, NAV financing loans are repaid from the distributions made by the underlying portfolio that forms the borrowing base for the loan. Lenders may obtain a pledge of the deposit and securities accounts that receive such distributions, as well as a direct or indirect pledge of the fund's interest in the underlying portfolio that forms the borrowing base, as collateral.

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b. *Preferred Financing*. In a fund finance context, preferred financing refers to the issuance, in exchange for third-party financing, of new equity interests in a fund (or subsidiary) that rank junior to debt but have priority over the common equity of a fund with respect to distributions. Preferred financing is commonly issued by a newly formed special purpose vehicle ("SPV") formed by the existing fund and, possibly, related funds. In this structure, the existing and related funds contribute one, some or all of their portfolio investments to the SPV, which then issues common equity to the existing fund and preferred equity to the preferred financing provider. The economic terms of preferred equity are typically implemented through a distribution waterfall in the SPV governing documents. While Preferred financing is often used to provide fund investors with liquidity, proceeds may also be used to fund follow-on investments, to support a portfolio company with a capital injection where it cannot get financing on a standalone basis, to repay existing fund or portfolio company debt, or to bridge capital calls from existing investors. Preferred equity thus represents an alternative to NAV financings but is often on terms that tend to be more bespoke and tailored to the needs of the issuer fund and a particular transaction than a typical NAV financing, and is typically more expensive than debt, reflecting the assumption of equity risk and the greater flexibility afforded the issuer fund.

c. *CFOs*. A "collateralized fund obligation" or "CFO" is a product intended to (*i*) allow fixed income investors to gain exposure to private funds on an efficient risk-based capital, rated basis; (*ii*) provide fund sponsors an avenue to raise primary capital

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from equity investors and make GP co-investments in their funds on a levered basis; and (*iii*) offer a secondary solution for investors seeking liquidity against their existing positions. The structure typically involves the sponsor setting up a bankruptcy-remote SPV that issues rated loans or rated notes in a Rule 144A private placement. The SPV uses the proceeds of the debt to make commitments as a limited partner in one or more funds managed by the SPV sponsor. The structure also involves the SPV issuing equity which may be in the form of subordinated notes or equity interests. CFOs have been attractive to insurance companies looking for opportunities to invest in a diversified portfolio of funds with favorable regulatory capital treatment and to funds looking for ways to access additional capital. Note, changes to statutory accounting principles and related rules applicable to insurance companies accounting for investments are being considered that may have the potential to impact the regulatory capital treatment of CFOs. We expect further innovations as market participants react to regulatory developments.

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GLOSSARY OF KEY TERMS

Advisers Act:	U.S. Investment Advisers Act of 1940, as amended
AIFM:	Alternative investment fund managers
AIFMD:	European Alternative Investment Fund Managers Directive
AIV:	Alternative investment vehicle
BHC:	Bank holding company
BHC Act:	U.S. Bank Holding Company Act of 1956, as amended
CCPA:	California Consumer Privacy Act
CFC:	Controlled foreign corporation
CFIUS:	Committee on 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

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GLOSSARY OF KEY TERMS

CPO:	Commodity pool operator
CRS:	Common Reporting Standard
DOL:	U.S. Department of Labor
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
ESMA:	European Securities and Market Authority
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

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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
GDPR:	EU's General Data Protection Regulation
GIPS:	Global Investment Performance Standards
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

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GLOSSARY OF KEY TERMS

PRIIPS:	Packaged Retail and Insurance-based Investment Products
REIT:	Real estate investment trust
REOC:	Real estate operating company
RIA:	Registered investment adviser
RULPA:	Delaware Revised Uniform Limited Partnership Act
SARs:	Suspicious activity reports
SBIC:	Small business investment company
SEC:	U.S. Securities and Exchange Commission
Securities Act:	U.S. Securities Act of 1933, as amended
SOTUS Fund:	Solely Outside the U.S. Fund
SWF:	Sovereign wealth fund
UBTI:	Unrelated business taxable income
U.S. GAAP:	U.S. generally accepted accounting principles
USRPHC:	U.S. real property holding corporation
VCOC:	Venture capital operating company

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Volcker Rule: Section 13 of the BHC Act

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