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Investment Funds 2022

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Law and Practice

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1. MARKET OVERVIEW

1.1 State of the Market

The private markets asset class continued its impressive rise from the early depths of the pandemic throughout 2021. Venture capital, growth and private credit funds were raised at a robust pace during 2021, continuing the trends seen in the second half of 2020, and leverage dynamics between sponsors and investors remained largely unchanged. Despite the ongoing effects of the pandemic and growing concerns about inflation, in most respects the level of fundraising and deal-making activity in 2021 exceeded activity levels in recent years. With continued confidence in the returns possible in private markets and the strong growth experienced in the public markets in 2021, many institutional investors maintain their high conviction to continue to invest (and, in many cases, increase their exposure) in private equity, venture capital, growth and private credit.

2. ALTERNATIVE INVESTMENT FUNDS

2.1 Fund Formation

2.1.1 Fund Structures

Limited Partnership

The limited partnership continues to be the structure of choice in the private markets industry (regardless of jurisdiction). Of course, this is not surprising given that the industry participants fully understand the limited partnership structure, the varied roles of the participants in a limited partnership and the legal consequences thereof (ie, the general partner has control and unlimited liability for the debts and obligations of the fund and the limited partners are not involved in the active management of the fund and, as a result, have limited liability).

Investors and sponsors prefer not to have to perform diligence and understand uncommon structures (even if those structures ultimately provide the same fundamental outcome), as doing so adds unnecessary time and expense to the already burdensome process investors undertake to commit to new fund investments. The process of underwriting a sponsor, team, strategy, opportunity and the like from an investment, operational and legal perspective is both time-consuming and expensive. Sponsors understand that introducing additional complexity into this process by using uncommon legal structures does nothing more than complicate and protract the fundraising process.

“Parallel Fund” and “Master-Feeder” Structures

Private equity funds and growth funds focused on North America continue to predominately use the “parallel fund” structure for raising capital. The parallel fund structure involves forming two or more limited partnerships, each of which is controlled by the fund sponsor as the general partner. Each limited partnership is structured to address the tax, legal, regulatory or similar needs of the relevant domestic and international investors who desire to participate in the fund. Each limited partnership formed then invests side by side (in parallel) with the other limited partnership(s). This structure enables institutional investors to invest in the fund opportunity in as efficient a manner as possible.

While the parallel fund structure is the most common approach for private equity funds and growth funds, other structures can be used, including the “master-feeder fund” structure. Under the master-feeder structure, the sponsor forms limited partnerships designed to address legal, tax, regulatory or similar needs of potential investors. Investors then select which limited partnership is most appropriate for the investor. Each of these limited partnerships is considered

a “feeder” vehicle that in turn makes commitments to an underlying limited partnership commonly referred to as a “master” vehicle. The aggregate commitments of each feeder vehicle to the master vehicle equals the total commitments made to the feeder vehicle by the feeder vehicle’s underlying investors. The investments are then made by the master vehicle.

Like private equity, certain private credit funds that are in the business of originating debt investments will likely use a variant of the parallel fund structure given certain negative tax implications that may arise for participating international investors if they participated in an investment vehicle that is active in a trade or business in the United States. Under this variant structure, the limited partnership formed for domestic investors to participate will originate the investment and, after a certain period of time, the limited partnership will sell a participation in the investment to the limited partnership formed for international investors. This structure mitigates potentially negative consequences for participating international investors while allowing them to participate in the strategy.

Preferred Structure for Venture Capital Funds

Venture capital funds will often be formed as a single limited partnership and will not utilize either the parallel fund structure or the feeder fund structure. As such, both domestic and international investors will invest in a single limited partnership that will make all investments in the portfolio. This difference relative to private equity funds and growth funds is driven by the fact that the securities held by a venture capital fund will be in entities that are corporations for income tax purposes. Private equity funds and growth funds will invest in securities in both corporations and also limited liability companies and limited partnerships that are treated as “flow-through” entities for federal income tax purposes, meaning that the tax consequences

of their operations will be taxable at the level of the partners or members of such entity.

2.1.2 Common Process for Setting Up Investment Funds

Strategy continues to play a substantial role from a regulatory perspective and the requirements will vary accordingly. Venture capital continues to benefit from an exemption from registration under the Investment Advisers Act, while certain real estate-focused sponsors may have the opportunity to be exempted entirely. Private equity, of course, will continue to be subject to registration requirements for the investment manager and, thus, be subject to the fiduciary obligations imposed on registered advisers and the related disclosure requirements.

The registration requirements do require enhanced disclosure and regular updates requiring appropriately trained and competent compliance personnel.

2.1.3 Limited Liability

Investors in limited partnerships generally have limited liability for the debts and obligations of the limited partnership, with their exposure limited to their interest in the limited partnership (inclusive of their unfunded capital commitments) so long as the limited partner (i) does not participate in the “management and control” of the limited partnership, (ii) hold itself out as a general partner, or (iii) deal with third parties who reasonably believe the limited partner is acting as a general partner. The limited partners are also subject to any contractually agreed obligations, including the obligation to return distributions previously received from the limited partnership pursuant to “recycling” and “LP give-back” provisions contained in the limited partnership agreement.

Investors need to carefully review terms to ensure that the governing documents of their investments do not expose them to unlimited

liability by contract. This is particularly relevant in the context of co-investment vehicles, which frequently charge fees and expenses outside an investor's capital commitment.

Finally, most jurisdictions include limited statutory return obligations. For example, in Delaware, limited partners may be obligated to return distributions to the extent the limited partnership is insolvent at the time of receipt of the relevant distribution.

2.1.4 Disclosure Requirements

The governing law of the jurisdiction under which the limited partnership is formed effectively provides that all disclosures and reporting may be determined and qualified in their entirety pursuant to the terms of the limited partnership agreement. As a result, investors must negotiate for any necessary or desired disclosure and reporting. Note, however, that certain regulator regimes, such as the Investment Advisers Act of 1940 (the "Advisers Act"), impose certain disclosure and reporting obligations. Investment advisers subject to the Advisers Act may be required to prepare and file certain reports with the US Securities and Exchange Commission (SEC). In addition, investment advisers subject to the Advisers Act may be required to provide certain clients and prospective clients with disclosure statements. Sponsors should carefully consider their obligations with legal counsel and other service providers with the relevant experience and expertise.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Investor appetite for alternative funds (primarily private markets) is substantial and continues to grow given the returns historically provided in the private market asset classes – returns that many studies show outperform public markets. Investors include corporate strategic investors,

corporate pensions, public pensions, development finance institutions, single and multi-family offices, foundations, endowments, sovereign wealth funds, high net worth individuals, insurance companies, funds of funds, discretionary account managers, banks and financial institutions. In addition, as regulators contemplate changes to the rules that have historically blocked access by retail investors to private equity funds, the appetite for alternative funds in the United States is poised to increase dramatically.

2.2.2 Legal Structures Used by Fund Managers

The primary legal structure utilised is the limited partnership, with the sponsor serving as the general partner and the investors as limited partners. Occasionally, a limited liability company will be used, though it is very rare.

2.2.3 Restrictions on Investors

Under applicable laws and regulations, depending on the particular exemption the fund will utilise under the Investment Company Act of 1940, investors will be required to be either "accredited investors" or "qualified purchasers". Further, if the sponsor is a registered investment adviser, the investors must also be "qualified clients".

2.3 Regulatory Environment

2.3.1 Regulatory Regime

Generally, private markets funds must be raised under an available exemption from the Securities Act of 1933, as amended. Further, depending on the strategy pursued by the sponsor, the SEC may have oversight pursuant to registration under the Investment Advisers Act of 1940, as amended.

2.3.2 Requirements for Non-local Service Providers

Legal providers are subject to oversight of the licensing authorities pursuant to which they are authorised to practise law. Accounting firms are likewise subjected to licensing requirements and oversight by the SEC. Any custodian financial institution will be subject to regulatory oversight and applicable laws.

2.3.3 Local Regulatory Requirements for Non-local Managers

If required or otherwise eligible to register as a registered investment adviser under the Investment Advisers Act of 1940, as amended, there will be no state-level registration requirements. However, applicable regulatory filings in connection with relying on a regulatory exemption under the Securities Act of 1933, as amended, may be required. Non-US sponsors offering investment opportunities within the USA may well be subject to US federal and state regulatory requirements depending on the scope of their offering. Non-US sponsors should carefully consider their regulatory obligations with legal counsel and other service providers with the relevant experience and expertise.

2.3.4 Regulatory Approval Process

Limited partnerships are not required to be registered.

2.3.5 Rules Concerning Marketing of Alternative Funds

Compliance with private offering exemptions under Regulation D or Regulation S promulgated under the Securities Act of 1933, as amended, will be required in order to avoid the offering of the interests in the limited partnership as a public offering with attendant filing requirements.

2.3.6 Marketing of Alternative Funds

Alternative funds may only be marketed to investors who have a sufficient level of sophistica-

tion and wealth. Depending on the anticipated exemption the fund sponsor is seeking from having the fund being deemed to be an investment company under the Investment Company Act of 1940, investors will need to be either “accredited investors” under promulgated regulations and guidance from the SEC or a “qualified purchaser” under prevailing applicable laws and regulations. In addition, if the alternative investment sponsor is a registered investment adviser under the Investment Advisers Act of 1940, the investors will have to be “qualified clients”, meaning they have sufficient assets managed by the alternative fund sponsor (inclusive of their commitment to the alternative investment fund).

Sponsors should carefully consider the regulatory requirements with legal counsel with relevant experience and expertise to ensure that the prospective investors are appropriately qualified to hold the interests and will not cause any regulatory concerns in the formation, management and operation of the alternative investment fund.

2.3.7 Investor Protection Rules

In addition to the fiduciary and disclosure obligations imposed upon the sponsor of the alternative investment fund under the applicable provisions of the Investment Advisers Act of 1940, investors are provided protections under the anti-fraud requirements of the Securities Act of 1933, as amended, as well as the laws of the jurisdiction under which the alternative investment fund is formed. It is important to note that the fiduciary obligations imposed on the general partner under the laws of the jurisdiction in which the fund is formed may be enhanced, restricted, modified and eliminated pursuant to the terms of the limited partnership agreement. As such, investors must carefully review and negotiate the terms of the limited partnership agreement to ensure they understand the relationship. It should be noted further, however, that the general partner of a limited partnership is not permit-

ted to eliminate the implied contractual covenant of good faith and fair dealing.

2.3.8 Approach of the Regulator

The SEC regulates investment advisers primarily under the Investment Advisers Act of 1940 and rules adopted pursuant thereto. The SEC provides published guidance in connection with the registration requirements and processes required to register as an investment adviser and maintain compliance therewith. Face-to-face meetings would generally occur only in connection with inspections and examinations conducted by the SEC.

2.4 Operational Requirements

Operational requirements as to the management of alternative funds will be determined in accordance with the terms of the limited partnership agreement governing the management and operation of the alternative investment fund and applicable provisions of the Investment Advisers Act of 1940, as amended. The provisions of the limited partnership agreement, among other matters, will set forth:

- the strategy and applicable investment restrictions for the fund;
- the form and timing of reports to be provided to the limited partners;
- the valuation methodology for the assets of the alternative investment fund;
- the expenses properly chargeable to the alternative investment fund and those properly chargeable to the investment sponsor; and
- any restrictions on borrowing (if any).

2.5 Fund Finance

Subscription facilities have become commonplace in the private markets area, as they provide sponsors the ability to manage capital calls, act quickly on investment opportunities and mitigate the J-curve, while providing an increased IRR (internal rate of return) to investors (though at a

cost to the MOIC (multiple on invested capital) realised given the interest expense of the subscription line, as well as the maintenance and set-up costs thereof).

While the use of subscription facilities is by no means a new phenomenon, the low interest rate environment over the last decade has led to their increased use. Subscription facilities are generally backed by the capital commitment of the limited partners, and financial institutions providing subscription facilities to private equity funds look to the credit quality of the underlying limited partners to underwrite the borrowing and set leverage limitations. Financial institutions generally require the general partner of a private equity fund to which it is providing a subscription facility to pledge the right to call capital from investors and the assets of the fund and of the general partner as security for the borrowing.

2.6 Tax Regime

Limited partnerships formed in the USA are generally structured as flow-through entities, meaning the limited partnership itself is not taxed (only subject to informational tax filings), with all income, gains, losses and deductions of the limited partnership being reported by the partners (limited partners and general partner) based on their proportionate share thereof.

3. RETAIL FUNDS

3.1 Fund Formation

3.1.1 Fund Structures

Retail funds are generally not common in the United States with respect to alternative investment funds, and as such no information is available in this chapter.

3.1.2 Common Process for Setting Up Investment Funds

See **3.1.1 Fund Structures**.

3.1.3 Limited Liability

See **3.1.1 Fund Structures**.

3.1.4 Disclosure Requirements

See **3.1.1 Fund Structures**.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

See **3.1.1 Fund Structures**.

3.2.2 Legal Structures Used by Fund Managers

See **3.1.1 Fund Structures**.

3.2.3 Restrictions on Investors

See **3.1.1 Fund Structures**.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

See **3.1.1 Fund Structures**.

3.3.2 Requirements for Non-local Service Providers

See **3.1.1 Fund Structures**.

3.3.3 Local Regulatory Requirements for Non-local Managers

See **3.1.1 Fund Structures**.

3.3.4 Regulatory Approval Process

See **3.1.1 Fund Structures**.

3.3.5 Rules Concerning Marketing of Retail Funds

See **3.1.1 Fund Structures**.

3.3.6 Marketing of Retail Funds

See **3.1.1 Fund Structures**.

3.3.7 Investor Protection Rules

See **3.1.1 Fund Structures**.

3.3.8 Approach of the Regulator

See **3.1.1 Fund Structures**.

3.4 Operational Requirements

See **3.1.1 Fund Structures**.

3.5 Fund Finance

See **3.1.1 Fund Structures**.

3.6 Tax Regime

See **3.1.1 Fund Structures**.

4. LEGAL, REGULATORY OR TAX CHANGES

4.1 Recent Developments and Proposals for Reform

Given the current political climate in the United States, it would be reasonable to expect changes in applicable tax laws and in the applicable regulatory environment.

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of the largest and most active sovereign wealth funds, endowments, insurance companies, public pension plans and financial institutions. The attorneys in the Investment Funds Group are known for their depth of experience representing public and private fund clients with a mission-driven approach that focuses on practical advice and long-term funding. The team counsels clients from start to finish, representing them in a wide range of investments, from direct investments to exotic, strategic structures, co-investments and secondaries.

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