English and US venture capital funds: key features
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What is a venture capital fund?
A brief history of the venture capital industry

Fund structure
Limited partnership
Delaware
England and Scotland
Salient features of a Scottish limited partnership
Private fund limited partnership regime
Further legislative reform?

Dramatis personae
Fund principals and sponsors
General partner
Limited partners
Managers and advisers
Advisory committees

Fund economics
Capital contributions
Distributions
Waterfall
Timing
Tax efficient carried interest
Management fee
Establishment expenses

Fund documentation
Offering memorandum
Limited partnership agreement
Side letters
Management / advisory agreements
An overview of the key features of UK and US venture capital funds and the differences between them.

Venture capital funds are a significant source of capital for private early stage and growth companies in the United States of America and, increasingly, in the United Kingdom and many continental European jurisdictions. Over the last quarter of a century, as the US venture capital model has become more familiar and investment opportunities for funds more readily apparent, the European investor base has grown considerably and venture capital is now recognised in Europe as an important alternative asset class in its own right.

This practice note provides an overview of the basic structure of a typical venture capital fund, highlights some differences between English and US venture capital funds and outlines some of the UK and US issues involved in forming and marketing a venture capital fund.

This practice note addresses certain aspects of Scottish limited partnerships. The laws that govern limited partnerships formed under the laws of the British Virgin Islands, the Cayman Islands, Guernsey or Jersey fall outside the scope of this note.

**What is a venture capital fund?**
A venture capital fund is an actively managed collective investment vehicle that invests almost exclusively in securities that are not publicly listed or traded. The purpose of the fund is to provide a return to its investors over
the life of the fund, which will typically be around ten years. A fund’s focus is normally on capital appreciation rather than income generation, which it achieves by acquiring a portfolio of equity interests in privately-held companies (commonly referred to as portfolio companies) and managing these investments to maximise their value on disposal or exit. Portfolio company exits can take different forms, including flotations or initial public offerings or trade sales.

Many venture capital funds are sector, size and/or geographically specific. The size of venture capital funds themselves may vary from as little as a few million dollars to hundreds of millions of dollars, which reflects the appetite of investors for the track record of the principals and the purpose of the fund.

Venture capital funds usually invest in early-stage companies with strong growth potential. That investment may therefore represent seed, early-stage, expansion or later-stage capital. Venture capital funds also typically invest in technology-based sectors such as artificial intelligence, biotech and healthcare, cyber security and information and communications technology.

Venture capital funds take minority stakes in businesses, often alongside other venture capital funds and investors (including the founders of those businesses).

As the industry has matured and market practice has developed, funds have increasingly become labelled according to their purpose, specialisation, ownership and management characteristics, and a range of sub-categories and classifications have emerged (see Fund descriptions).

Venture capital funds should be distinguished from:

- Angel Investment. This is the provision of equity investment by high net worth individuals directly out of their own resources rather than by various persons indirectly through a fund. Angel investment tends to occur earlier in a company's life than venture capital investment.

- Buyout funds or leveraged buyout funds. These funds are a primary subcategory of private equity funds (see Practice note, English and US private equity funds: key features) (venture capital funds being the other primary subcategory) and they tend to invest in more mature businesses, usually taking a controlling interest and leveraging their equity investment at the portfolio company level with substantial amounts of third party debt (see Practice note: overview, Private equity buyouts: overview). Buyout funds are typically significantly larger than venture capital funds, which reflects the relative size of their target investments.

- Hedge funds. These are privately-held investment vehicles that usually have far more wide-ranging, and often opportunistic and short-term, investment and trading strategies than venture capital funds. The structure of a hedge fund is usually very different from a typical venture capital fund. It is typically open-end with unlimited life and is often leveraged at the fund level.

- Debt funds. These provide subordinated debt as part of the financing packages that support leveraged buyouts and other highly leveraged debt financings, and are often involved in the same sectors as private equity funds. The structure of a debt fund is typically similar to that of a private equity fund. For further information on debt financing, see Practice note: overview, Acquisition finance: debt for buyouts.

A brief history of the venture capital industry
The venture capital industry traces its origins to the creation in 1946 by Georges Doriot of American Research and Development Corporation. US post-war government policy facilitated the expansion of the industry which accelerated in the late 1970s.
By contrast, the UK venture capital industry only grew significantly in the 1980s, albeit that 3i, the UK private equity and venture capital firm, was founded in 1946 by the Bank of England and various British banks. It was not until the late 1990s that venture capital started to gain traction in continental Europe.

Many of the most famous companies in the world began life with venture capital funding. These include Avis, Cisco, Compaq, Google, Facebook, Skype, Yahoo and Xerox.

The four largest investor hubs worldwide for venture capital funds are Silicon Valley, New York, Massachusetts and London.

**Fund structure**

The primary fund vehicle will usually be a limited partnership. The wider fund structure may, however, involve a number of other fund vehicles, such as feeder funds and parallel funds. A fund also comprises numerous other parts, involving a cast of players that includes the fund's advisers, managers and investors (see Typical European venture capital fund structure and Dramatis personae).

**Limited partnership**

The limited partnership is the traditional US fund vehicle and is highly familiar to investors. Limited partnerships are also commonly used by UK and European fund houses, often with modified features to reflect local tax and regulatory requirements (see Typical European venture capital fund structure).

The key features of a limited partnership are:

- Two categories of partner:
  - the general partner. There will only usually be one general partner that will have control over the management of the limited partnership and unlimited liability to third parties for the debts and obligations of the limited partnership; and
  - limited partners. There will often be many, and they are essentially passive investors without active management rights. A limited partner's liability to the partnership and its creditors is generally limited to the amount of capital that it agrees to contribute to the partnership.

- A limited partnership agreement that governs the relationship between the partners, the content of which is only lightly regulated and that is a matter of negotiation between the partners (see Limited partnership agreement).

- Freedom from many of the legal constraints and formalities usually applicable to corporate entities. This flexibility is a significant attraction.

- Recognition as a partnership, not a corporation, under domestic tax law and, as a consequence, "fiscal transparency", meaning the partners are treated for tax purposes as having invested directly in the underlying partnership assets, with no (or limited) taxation at the entity level.
A venture capital fund will generally seek to use a legal form that is tax efficient, marketable and familiar to investors in its target jurisdictions. As there is no single fund type that fits all, if a fund seeks to target investors in a number of different countries, it may use a number of fund vehicles tailored to specific jurisdictions as feeder funds or parallel funds (see Fund descriptions).

As a rule of thumb, venture capital funds which are targeted principally at US investors will tend to use limited partnerships established under the laws of the State of Delaware, USA. Funds that are targeted principally at investors in the UK and investors in non-member states of the European Union will tend to use limited partnerships established under the laws of the Cayman Islands, England, Guernsey or Jersey. These are invariably described as English limited partnerships. The English limited liability partnership, introduced by the Limited Liability Partnerships Act 2000, has not generally been adopted as a vehicle for venture capital funds as an alternative to the traditional limited partnership (for various reasons, including regulatory and tax considerations).

In the USA, limited liability companies are used for hedge funds, and generally not for venture capital funds. This is largely due to historical market practice and the existence of a larger body of developed US case law for limited partnerships than is the case for limited liability companies (limited liability companies do not have a lengthy history given that they did not exist prior to 1977 and their usage as a business entity (in any industry) did not become prevalent in the USA until the mid-1990s).

**Delaware**

In the USA, the formation of business entities is a matter of state, not federal, law. The majority of US venture capital funds are formed as limited partnerships under the Delaware Revised Uniform Limited Partnership Act (Delaware Act). This is a matter of choice and the promoters of the fund are not required to have any substantive connection with Delaware to form a limited partnership under Delaware law. A Delaware limited partnership is not required to disclose the identity of its limited partners to any governmental or regulatory authority so as to become a matter of public record.

Delaware takes seriously its status as the pre-eminent US state for the formation and incorporation of business entities and the Delaware Act is revised frequently, usually annually. The Delaware courts are also regarded as among the most business-oriented in the USA and there is a developed body of Delaware case law about limited partnerships. Most of the limited partnership statutes of the other US states are similar to the Delaware Act, although there can be substantive differences.

**England and Scotland**

English and Scottish law that applies to limited partnerships stems from a combination of:

- The common law of partnership, mostly based on case law.
- The Partnership Act 1890, as amended (PA 1890), which sets out a broad code for English and Scots partnerships generally (and which was intended to bring together the general common law on the topic and has not been amended to any material extent since 1890).
- The Limited Partnerships Act 1907, as amended (LPA 1907), which gives statutory recognition to limited partnerships and provides for their registration as well as modifying the PA 1890 to afford limited liability to limited partners.
A fund does not need to be permanently established in England to be treated as an English limited partnership. An English limited partnership formed under the LPA 1907 must, however, carry out some business in England at the time of its formation. Thereafter, it is possible to migrate an English limited partnership offshore, although care is often taken to preserve some connection with England to bolster the choice of English governing law.

**Salient features of a Scottish limited partnership**
The principal difference between an English partnership and a Scottish partnership (whether general or limited) is that the latter has legal personality separate from that of its partners (by virtue of section 4(2) of the PA 1890). This makes a Scottish limited partnership attractive for use as a carried interest vehicle and as the primary fund for a venture capital fund of funds (not least due to simpler filing requirements at Companies House). A Scottish limited partnership is not a body corporate for the purposes of Scottish law.

Scottish law appears to require a Scottish limited partnership to observe various requirements in order to ensure that it is respected as a Scottish limited partnership. These include the requirement for its general partner to be a Scottish limited company and for its general partner to hold meetings of its board of directors in Scotland. These requirements can be burdensome.

**Private fund limited partnership regime**
An English private fund limited partnership (PFLP) is an English limited partnership that has been designated as a PFLP (see Practice note: overview, Private fund limited partnerships (PFLPs)).

The PFLP regime was introduced in the UK on 6 April 2017 for private investment funds structured as limited partnerships.

The aim of the PFLP regime is to reduce some of the administrative and financial burdens which have made England and Scotland less attractive as a domicile for investment funds, in comparison to more flexible regimes in jurisdictions such as the Cayman Islands, Guernsey, Jersey and Luxembourg.

A PFLP differs from an ordinary English limited partnership in the following key ways:

- Limited partners in a PFLP are not required to contribute capital or property to that PFLP. If they do so, they may withdraw that capital or property without being liable for the debts and obligations of the PFLP in respect of the amount withdrawn.
- The PFLP introduced a non-exhaustive list of safe harbours that permit a limited partner in a PFLP to undertake certain activities without being regarded as taking part in the management of that PFLP.
- Fewer changes in respect of a PFLP need to be notified to the registrar, and a PFLP is not required to advertise any such changes in the London Gazette or the Edinburgh Gazette (with the exception of the requirement to advertise that a person has ceased to be the general partner of a PFLP).
- Limited partners do not have to comply with certain aspects of the PA 1890, including the duties to render accounts and to account for profits from competing businesses, since such duties are regarded as being irrelevant to their role as passive investors.
• Limited partners may decide whether to wind up the PFLP where the PFLP has no general partner and may nominate a third party to wind up the PFLP on their behalf.

Further legislative reform?
The difficulties for the UK venture capital industry in using vehicles that are subject to uncertain and, in places, archaic, laws have been stressed by commentators over the years. In response, the Law Commissions of Scotland and England and Wales issued a joint consultative paper in 2003 on possible reform of the laws relating to limited partnerships. Save for the introduction of the PFLP regime, however, little concrete action has resulted.

Dramatis personae
The major participants in the formation and operation of a venture capital fund are as follows:

Fund principals and sponsors
The fund’s principals are responsible for the management of the fund and for choosing its investments. Generally, they are the owners or employees of, or partners in, the fund manager or financial institution that is the fund’s promoter or "sponsor". The main tasks of the principals are to identify, evaluate and make investments in portfolio companies, to become involved in the management of portfolio companies in order to maximise their value prior to exit and to achieve successful exits for the fund. Investors will often make their decision to invest in a fund on the identity of the fund house, the principals of the fund and their respective track records.

Limited partners will often expect the principals and/or sponsor of a venture capital fund to make a capital commitment to the fund. Such capital commitment typically ranges from 1% to 5% of the capital raised by the fund and may be made through the general partner, or by the principals or the sponsor acquiring direct or indirect limited partnership interests in the fund. Those obligations of the principals and/or sponsor serve to align their interests with those of the venture capital fund and prospective limited partners will often view this obligation to commit capital as a key business term.

General partner
The general partner is ultimately responsible for the management of the limited partnership (although it will typically delegate substantially all of that responsibility to an investment manager or an investment adviser to benefit from limited liability and for regulatory reasons). Almost invariably, the general partner of a venture capital fund will be a limited liability entity (a Delaware limited liability company in the case of US funds) that is formed by the principals and/or sponsor of the venture capital fund.

Limited partners
The limited partners are responsible for contributing most of the fund's capital (see Capital contributions). Limited partners may be institutional investors such as endowments, family offices, pension funds and retirement systems. They may also be high net worth individuals who, given securities law requirements, will usually be sophisticated investors. Once committed, a limited partner will generally not be entitled to withdraw from a fund or to transfer its limited partnership interest, although the general partner will have the discretion to permit transfers. The emergence of secondary funds (see Fund descriptions) has given more scope for limited partners to find buyers for their limited partnership interests.

Limited partners are generally not permitted to control or participate in the management of the fund and doing so may prejudice their limited liability (and have other consequences). The Delaware Act specifies a number of activities that a limited partner may undertake in relation to the limited partnership without compromising its status. Failure to adhere to these constraints may result in the limited partner being liable to persons who conduct business with the limited partnership and who reasonably believe, based on the limited partner's conduct, that the limited partner is a general partner.

In contrast, section 6(1) of the LPA 1907, which prohibits a limited partner from taking part in management, does not include any similar list of safe harbours and, under English partnership law, limited liability is lost whether or not a third party is aware of a limited partner's participation in management. This is not, however, the case for PFLPs (see section 6A of the LPA 1907) (see Typical European venture capital fund structure).

A venture capital fund may be required to take special measures depending on the identity of its limited partners. For instance, a fund with US pension plan investors may have to address the requirements of the US Employee Retirement Income Security Act of 1974 (ERISA) (see ERISA).

Managers and advisers
Most funds (or their general partners) appoint a manager or investment adviser (or both) to manage the fund's investments and/or to advise the fund about its investment strategy. The manager is usually a limited liability entity (a limited liability company in the case of US funds). The manager may be part of an established fund management group or an affiliate formed by the fund's principals.

In the USA, the expressions "manager" and "adviser" are often used interchangeably, with persons expressed to be advisers carrying out what would be regarded in the UK as a management role (and vice versa). In the UK, the distinction can be significant in terms of the different obligations and regulatory capital requirements applicable to managers and investment advisers. Care must therefore be taken to ensure that the structure of a fund management group operating in the UK, and in particular the balance between its offshore and onshore activity, is efficient in regulatory capital terms.

Advisory committees
Most of the larger venture capital funds have an advisory committee or advisory board which consists of representatives of the limited partners who are usually selected by the general partner. The committee’s role is to consult with and provide its views on a range of fund related issues, in particular conflicts of interest and valuation questions.
However, this role is limited to an extent by the legal constraints on limited partners taking part in management of the fund.

Venture capital funds may also have investment committees (at the general partner or manager level) which comprise some or all of the principals.

**Fund economics**
The key economic features of a venture capital fund are:

**Capital contributions**
Limited partners are asked to commit a specified amount of capital when they acquire an interest in a venture capital fund. The capital contributions will be used to make fund investments and pay fund expenses. Limited partners will not generally be asked to contribute all (or, indeed, any) of their capital commitment at the time of their initial subscription to a limited partnership (other than in the case of an English limited partnership (which is not a PFLP) where section 4(2A) of the LPA 1907 requires that some, albeit nominal, contribution must be made on admission as a limited partner).

The manager of a venture capital fund will generally not want to have excess cash sitting idle, for to do so may negatively affect the fund's rate of return since the purpose of the fund will not be to manage cash or near-cash assets. This may in turn affect the amount of carried interest that that general partner receives.

Instead, a fund will call for, or draw down, capital contributions, on an as needed basis, generally as the fund makes investments, and commonly on notice of about ten business days. A fund may also excuse or exclude certain limited partners (who may be subject to restrictions on the investments they may make) from draw downs in respect of certain acquisitions, for instance where they relate to armaments, gambling or tobacco.

Failure by a limited partner to make a capital contribution when requested can have serious adverse consequences for a venture capital fund. Limited partnership agreements will usually deal severely with a defaulting limited partner, and the possible consequences of default under those agreements include the forfeiture of all or a significant portion of the limited partner's interest or the forced sale of that interest. The ability of funds to enforce such provisions in certain jurisdictions, including England, may be constrained due to restrictions on the enforceability of penalty clauses and similar rules of law.

Usually, the limited partnership agreement will provide for an investment period (for instance, the first five years of a ten-year fund), after which the fund will not be able to make new investments. Following the end of the investment period, capital calls will generally only be made to fund follow on investments in existing portfolio companies or to pay fund expenses. It may be that, over the life of a fund, a limited partner is not required to contribute all of its committed capital.

Once the fund has invested its capital and realised its investments, the fund cannot generally reinvest that capital and must return it to the limited partners. Exceptions are, however, frequently made to permit the reinvestment of capital from investments that are realised, provided that the total invested capital of a fund does not exceed a specified limit (usually 110% to 120% of the fund’s aggregate capital commitments).
In the USA, subject to certain exceptions, a limited partner is generally not liable to return distributions which it has received (although some limited partnership agreements include limited partner clawback provisions that require a limited partner to return distributions, if necessary, to satisfy certain liabilities of the fund).

By contrast, a limited partner of an English limited partnership that is not a PFLP which receives back any part of its capital contribution before dissolution of the partnership is liable for the debts and liabilities of the partnership up to the amount of capital paid back (section 4(3), LPA 1907).

In the past, this issue has been substantially mitigated by taking steps to characterise part of the limited partners' commitments as advances, rather than capital. Such advances may then be returned to the limited partner before dissolution of the limited partnership without putting the limited partner at risk of having to repay those amounts. Advances to capital ratios of 99.9:0.1 are not uncommon.

The prohibition on the withdrawal of capital does not apply to a PFLP (see section 4(3A) of the LPA 1907).

**Distributions**

The timing and manner in which a venture capital fund makes distributions to its partners is contained in the limited partnership agreement. This has led to a number of different permutations, although US and UK market practice has developed certain basic models that are frequently used.

**Waterfall**

The distribution provisions in the limited partnership agreement of a venture capital fund, commonly referred to as the waterfall, are often the most complex part of that agreement and afford considerable scope for creativity and subtlety. In substance, they will operate to share profits between the investors and the management team (that is, the principals and any sponsor) so that the management team earns a return that is disproportionate to its capital investment. The management team's profit entitlement is commonly referred to as the carried interest (or "carry" or "promote") and serves to incentivise the management team to make the fund a success.

A typical waterfall will operate as follows:

- First, the fund will return the capital contributions of limited partners.
- Next, provided that the capital contributions of limited partners have been returned to them, excess distributable proceeds will usually be divided between the limited partners and the general partner, typically in the ratio 80:20.

The above description reflects a “European” style waterfall. There is also an “American” style waterfall in which only the capital contributions that were used to fund (i) portfolio company investments that have been disposed of, and (ii) fund expenses (or a pro rata portion of fund expenses) are returned to the limited partners prior to the division of proceeds between the limited partners and the general partner in an 80:20 ratio.

A European style waterfall is most common in smaller or first time funds, with the use of an American style waterfall typically being limited to the top tier funds which have the track record (and hence the negotiating leverage) to
command the more sponsor friendly American style waterfall. An American style waterfall represents a higher risk of over distribution of carried interest to the sponsor (and hence a higher clawback risk).

Each successive distribution by a fund will usually be calculated on an aggregate cumulative or "fund as a whole" basis, so that any losses from a realised investment must be set off against the gains made on previously realised investments (and vice versa) for the purpose of calculating the overall entitlement to carried interest. As a result, later losses can reduce earlier gains so that, on a fund as a whole basis, the overall return of investors may fall below prior levels or even be eliminated entirely. This may mean that earlier carried interest payments prove to have been overpayments. To deal with this situation (which can also arise with the European waterfall but is less likely to do so), most funds impose a clawback on the general partner or the carried interest vehicle that requires the repayment of any excess carried interest it receives (usually on an after-tax basis). This obligation is often supported by personal guarantees from the sponsor or the principals (or similar contractual obligations contained in the legal documentation which governs the fund). Those guarantees are usually given on a several basis based on the amount of carried interest received.

A venture capital fund will often distribute cash it generates that is not attributable to portfolio investments (such as interest on idle funds) to the partners in proportion to their respective partnership interests, so that no carried interest is paid on those distributions.

Many English and US funds also provide for tax distributions to be made prior to any other distributions. These are payments from the venture capital fund to its partners, or often just its general partner, to cover the tax payable on allocated profits. In the absence of a tax distribution, a partner may be required to pay tax in respect of allocated profit without having received any distributions from the fund. This is known as a dry tax charge.

**Timing**

The timing of distributions will be at the discretion of the general partner, unless the limited partnership agreement provides otherwise. A limited partnership agreement will often provide that a distribution should be made to limited partners within a specified period following the disposal of a portfolio company, subject to the retention of amounts that the general partner decides are necessary for the operation of the fund, payment of its liabilities and expenses, and the establishment of reserves. Whilst distributions will often be made in cash, the limited partnership agreement will usually provide that distributions may also be made to limited partners in kind or in specie (for example, marketable securities of portfolio companies that have been brought to the market by way of flotation).

A fund’s remaining assets must be distributed on its winding-up, usually in accordance with its distribution waterfall, subject to payment of the fund's expenses and taking into account any clawback arrangements.
Tax efficient carried interest
In a US fund, the carried interest will generally be payable to the fund’s general partner (or a carried interest vehicle which is an affiliate of that general partner) as an allocation of the fund’s profits. For teams of principals based in the UK, however, the tax efficiency of the carried interest is dependent on securing a UK tax treatment that does not:

- Characterise the carried interest as income received by them, either on the basis that the income is received in connection with their employment within the management group, or because the carried interest falls within a set of rules introduced in 2016 that apply income tax rather than capital gains tax treatment to carried interest in funds which hold short term investments.
- Attribute to them any part of the income and gains of the fund unless and until the fund’s returns meet the relevant hurdle rate and the carried interest starts to be payable to the management team.

For further discussion of the taxation of private equity fund executives, see Practice note, Private equity funds and executives: tax.

The British Venture Capital Association (BVCA) has agreed with HM Revenue & Customs (HMRC) a model partnership carried interest structure to which it will afford this desirable tax treatment provided that other requirements imposed by HMRC are met (including that the principals are remunerated at full arm’s length rates for
their activities as employees or directors of the manager). The agreed BVCA model (available at www.bvca.co.uk) envisages the carried interest being routed to the principals through a separate limited partnership interest rather than through the general partner interest. Whilst HMRC does not rule out affording similar treatment to alternative carried interest structures, it does not commit to doing so. Most UK-based teams of principals therefore stick closely to the BVCA model and route the carried interest through a separate special limited partnership interest (see Typical European venture capital fund structure).

Management fee
The manager of the venture capital fund will usually be paid a management fee quarterly in advance, in addition to the payment of carried interest. The fee is intended to cover the general overheads of the manager of the fund.

In a US fund, the manager will usually be paid the fee directly by the fund. At first, and later if the fund is not profitable, the fee will usually be funded out of the commitments that the limited partners have made to the fund. In the UK, the general partner will more usually receive a priority distribution out of profits equal to the management fee and will then be responsible for paying the fee to the manager out of this profit share. Before profits arise, the general partner will be entitled to borrow the amount required to meet the fee out of drawings from the limited partners against their commitments, which it will be required to repay out of the priority profit share in due course. The tax efficiency of this arrangement arises from the fact that in some jurisdictions an investor may not receive any tax deduction for management fees it has paid. However, if the general partner's share of profits is increased, the investor's share of profits will be correspondingly reduced, as will the tax applicable to those profits.

The management fee is typically between 1% and 2.5% per annum of the capital committed to the fund for the period up to the end of the investment period. At the end of that period, it is usually reduced to a percentage of the capital that the fund has actually invested (which is typically calculated from time to time so as to ignore capital attributable to investments that the fund has realised, written down or written off).

The manager or general partner of the fund (or their affiliates) will often receive fees in relation to investments made or planned to be made by the fund (for instance, directors' fees or consulting fees for services provided to portfolio companies). Typically, the recipient will be permitted to retain these fees, provided that they are set off in whole or in part against the management fee or the general partner's share of profit.

Establishment expenses
The establishment or organisational expenses of a venture capital fund will frequently be paid by the fund itself up to a specified limit. Any excess over that limit will be payable by the general partner out of its own resources or will be set off against the management fee.

It is common practice for the fees of placing agents to be paid by the general partner of a fund or offset against the management fee payable to the manager of the fund.

Fund documentation
The principal documents relating to the formation of a venture capital fund are:
**Offering memorandum**

The offering memorandum, or private placement memorandum, is used by the majority of venture capital funds as its principal formal marketing document. Since interests in the fund will not be publicly offered or listed, there are generally limited requirements for the contents of the offering memorandum for a venture capital fund in either England or the USA.

The contents of an offering memorandum for a venture capital fund will vary from fund to fund, but will generally include the following:

- A description of the purpose and investment policies of the fund.
- Details of the projected size of the fund, plus any maximum or minimum limitations on the amount of money to be raised.
- Details of the track record of the fund house, and the background and track record of each of the principals of the fund, together with an explanation of why they consider they have the experience to make the fund a success.
- Details of any capital committed to the fund or co-investment with the fund by the general partner, the manager or their respective affiliates.
- A description of the principal terms of the fund: in essence, a summary of the limited partnership agreement (see *Limited partnership agreement*).
- A general description of particular tax and regulatory issues that are relevant to the fund, such as ERISA.
- A risk factors section, that sets out the most significant risks associated with an investment in the fund.
- A statement of the restrictions on the offering and sale of interests in the fund under the laws of various jurisdictions, since the offering memorandum will be subject to the securities laws of the jurisdictions in which it is distributed (see *Regulatory concerns*).

**Limited partnership agreement**

The terms that govern the relationship between the partners are set out in the limited partnership agreement of the fund. Both the Delaware Act and applicable English law include default provisions that will govern the internal relations of the limited partnership in the absence of express or implied agreement to the contrary between the partners (see *Limited partnership*). Most venture capital funds will not wish to rely on any of those default provisions and will instead provide for their internal governance in elaborate limited partnership agreements. The governing law of those limited partnership agreements will invariably be the law of the jurisdiction in which the limited partnership is formed.

The limited partnership agreement is often heavily negotiated between the general partner and the limited partners at the time of the fund’s formation. Naturally, the leverage that a prospective limited partner has to influence the terms of the fund will depend on the amount of capital it plans to commit and its appetite for negotiation. Some institutional investors have detailed requirements and settled opinions regarding the contents of the limited partnership agreement.
In addition to the financial arrangements between the partners (see Fund economics), some of the key areas that the limited partnership agreement addresses are:

- **Investment objective.** Approaches vary from the inclusion of fairly specific investment criteria to references to the investment purpose as specified in the offering memorandum of the fund (see Offering memorandum).

- **Investment restrictions.** The limited partnership agreement will usually stipulate some express limits on the investments that the fund may make, for example by:
  - prohibiting the investment of more than a specified portion of the commitments to the fund (often between 10% to 25%) in any one portfolio company;
  - prohibiting investments in other venture capital funds;
  - restricting borrowing;
  - limiting foreign investments;
  - restricting investment in portfolio companies that are affiliates of the principals; and
  - in some cases, imposing ethical restrictions on investments.

- **Closing dates.** The date on which the fund first accepts investors is generally referred to as the initial or first closing date. The limited partnership agreement will often provide for subsequent closing dates on which the fund may admit additional limited partners (provided that they pay for an appropriate share of the investments already made, and expenses incurred, by the fund, usually with interest). The fund generally makes these catch up payments to the existing limited partners and to the manager, in respect of its additional entitlement to the management fee).

- The fund is typically only permitted to hold subsequent closing dates during a period of up to one year following the initial closing date. After that time, investors will wish the principals to concentrate primarily on the fund’s investment objective, rather than raising additional capital.

- **Term.** A life span of ten to twelve years from the initial closing date of the fund is most common, and limited extensions to the term are often permitted to provide for an orderly winding up of the fund.

- **Early termination.** The limited partnership agreement will usually provide for the early termination of the fund (or for the curtailment of new investment) by the decision of limited partners that own a specified proportion of the commitments to the fund if certain events occur. These can include the failure of named key principals to remain involved in the fund’s management or the material breach of the limited partnership agreement by the general partner. Some funds also permit a "no-fault divorce" if approved by a high proportion of the limited partners.

- **Time and attention/non-competition.** Since the limited partners will be concerned that the management team devotes sufficient attention to the fund, the limited partnership agreement will usually include provisions such as prohibitions on the formation of, or investment by, similar competitor funds until the investment period has expired or at least 75% of the commitments to the fund have been invested or used to satisfy the expenses and liabilities of the fund. Exceptions would include prior funds and qualifying co-investment vehicles.

- **Indemnity.** The limited partnership agreement will usually include a wide-ranging indemnity and limitation of liability in favour of each of the general partner, the limited partners, the manager, the advisory committee and each of their respective officers, employees and agents. This will not apply where a person has been grossly negligent or has acted in bad faith or, where the manager or adviser is regulated by the
Financial Conduct Authority of the United Kingdom, it has breached a provision of the Financial Services and Markets Act 2000, as amended (FSMA) (see UK).

- Transfers and withdrawals. Transfers of limited partnership interests and withdrawals by limited partners will usually be restricted by the limited partnership agreement, except where the continued involvement of a limited partner may cause regulatory problems.
- Reporting. Funds are usually required to provide periodic financial, tax and other information to investors.

Side letters
The general partner of a venture capital fund may enter into side letters with specific investors in order to set out bespoke arrangements not reflected in the limited partnership agreement. For example, an institutional investor may be required to invest in funds that observe certain ethical investment restrictions, and certain regulatory or tax restrictions. The fund may agree in a side letter to observe those restrictions. Traditionally, the recipients of side letters were the principal investors in the fund or large institutional investors to whom the general partner was willing to provide certain preferential treatment.

Limited partners have, however, become more demanding and requests for side letters have increased in number and extent so that it is now common for many larger prospective limited partners to demand most favoured nation (MFN) side letters that offer each such limited partner the same rights as each other recipient of a side letter (or at least the recipients of other side letters that have made commitments of the same size as, or a smaller size than, that limited partner).

The growing burden placed on fund managers by side letters, especially the inappropriate or inadvertent extension of specific requirements through MFN arrangements, has led to an increased focus on side letter management and attempts to address limited partners' genuine concerns in a more organised manner. This includes incorporating into the limited partnership agreement items that are commonly requested in side letters (at the expense of a lengthier limited partnership agreement).

In addition, a recent focus of the US Securities and Exchange Commission (SEC) has been the appropriate disclosure of side letter rights, particularly insofar as they establish differential benefits.

Management / advisory agreements
The management agreement sets out the terms on which the venture capital fund appoints the manager of the fund and provides management services and investment advice to the fund and/or its general partner. The management agreement will usually set out the manager’s duties, limitations on the other activities of the manager, provide for the payment of fees and expenses and for the indemnification of the manager and its officers and employees.

In a US fund, the management agreement is usually made between the fund and the manager. For UK and European funds, the management agreement will often be between the general partner and the manager for tax reasons and, sometimes, to ensure efficient regulatory structuring (see Management fee). For UK funds with a separate investment adviser there will also be a separate advisory agreement made between the manager of the fund and the investment adviser that sets out the responsibilities of the investment adviser.
Where the sponsor of a fund wishes to avoid extensive UK regulation it is not uncommon for a UK fund or its
general partner to be managed by an offshore manager which is itself advised by an onshore investment adviser. That
onshore adviser will be an affiliate of the offshore manager and will take advantage of the group exemption in the
Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (Regulated Activities
Order). In this situation, the advisory agreement should be made between the manager and the adviser. However,
for such a structure to be effective, the UK adviser must avoid engaging in any activity outside the group exemption
(which is far from all encompassing) and the offshore manager must have genuine substance (that is, it must
genuinely perform the act of decision-making offshore and not simply rubber-stamp the acts of persons who are
based in the UK). The need for substance means that this approach may not be viable for the management team of
a small fund, which may struggle to maintain a genuine offshore presence.

As a result of the increase in the regulation of private investment funds in Europe since the global financial crisis, the
sponsors of first-time and small funds that do not have the appropriate regulatory permissions in the UK will often
appoint a third-party service provider to act as the investment manager, or alternative investment fund manager,
of their funds until they become appropriately authorised.

Subscription booklet
Prospective investors in the fund will usually be asked to complete a complex package of documents, which consists
of a subscription agreement and an investor questionnaire, which is often referred to as the subscription booklet.

The subscription agreement contains the formal offer from the fund to the prospective investor to acquire a limited
partnership interest in the fund and will commonly include the following:

- Provisions regarding the mechanics for the investor to acquire an interest in the fund and conditions
  precedent to that investment.
- A power of attorney in favour of the general partner (in order to facilitate the execution of documents
  relating to the fund).
- Limited representations and warranties from the fund to the investor. These will cover matters such as the
due formation of the fund and compliance with regulatory matters.
- Representations and warranties from the prospective investor to the fund. These will cover the status,
suitability and investment intent of the investor, and are in large part designed to ensure that the fund
complies with applicable regulatory requirements and to protect the fund against legal action by persons
which make unsuitable or uninformed investment decisions.

The investor will be required to specify the amount of its commitment in its subscription agreement. Subscriptions
are generally irrevocable and capable of acceptance by the general partner of the fund at any time. For certainty's
sake, a long-stop date may be included by which an offer to acquire an interest in the fund will lapse if the fund has
not accepted that offer before that date.

The investor questionnaire is designed to elicit information to ensure that the fund complies with applicable
regulatory requirements or, more accurately, so that the fund can avoid certain onerous rules (see Regulatory
concerns).

Non-US funds that plan to offer interests to US investors will wish to ensure that they comply with US requirements
and, consequently, will address those requirements in the subscription booklet.
Legal opinion
It is no longer common for the fund’s legal advisers to address a legal opinion to all of the limited partners. Some large institutional investors may, however, still require such an opinion. If the fund’s legal advisers were to give such an opinion it would usually cover the formation and good standing of the limited partnership, the general partner and the manager, the due admission of the limited partners to the limited partnership and compliance with certain applicable laws. The opinion may also address the limited liability of the limited partners and the tax status of the limited partnership.

Management team documents
The relationship between the principals of the fund and the sponsor of the fund will, in the case of a US venture capital fund, often be regulated by the documents that govern the general partner and the manager, and in the case of an English venture capital fund, the ownership and structure of the special limited partner that is entitled to the carried interest (which might, for example, be another limited partnership, a trust or an offshore entity) (see Typical European venture capital fund structure).

The arrangements may be complex, in particular with respect to the allocation of the fund’s carried interest between the principals, which often include vesting, good leaver and bad leaver provisions. These are private and sensitive documents that a venture capital fund would rarely make available to its investors.

Regulatory concerns
When establishing a US or a UK fund, participants need to consider the effect of a wide range of regulatory issues.

USA
A US venture capital fund will generally aim to avoid some fairly onerous US legal and regulatory restrictions by careful structuring of the offering and sale of its interests and by management of the persons that are permitted to invest in the fund.

ERISA
ERISA is a significant concern for any venture capital fund, whether or not established in the USA, that proposes to raise money from US pension plans or other US employee benefit plans. In order to protect participants in employee benefit plans, ERISA imposes strict fiduciary standards on the management of plan assets. In the case of a venture capital fund with an ERISA plan as an equity investor, these may include all of the fund’s assets.

The ERISA restrictions are regarded as too onerous by venture capital fund managers to merit being subject to those restrictions. Therefore, in order to access ERISA plan funds, whilst avoiding the application of ERISA's fiduciary
duty requirements, a venture capital fund will generally structure itself so as to be able to rely on one of the following ERISA exemptions:

- The insignificant interest exemption, which applies where benefit plan investors own less than 25% of the value of each class of the equity interests of a fund, disregarding equity interests that the general partner and its affiliates hold. While this is a fairly simple test to apply, it limits the amount of capital that a fund can raise from benefit plan investors if it has even a single ERISA plan investor. This test is generally applied to each fund vehicle (including a feeder fund or a parallel fund) independently.

- The venture capital operating company (VCOC) exemption, which applies if at least 50% of the investments of a venture capital fund, measured by cost, are in "qualified venture capital investments", which are investments in entities engaged in the production or sale of a product or service (other than the investment of capital) with which the fund has specific contractual rights substantially to participate in or influence the conduct of management of the entity.

Limited partners that are subject to ERISA must receive certain reports that comply with ERISA. New ERISA fiduciary rules have been implemented that make it significantly more difficult to market interests in, and obtain investments from, investors that wish to use their individual retirement accounts and similar retirement plans to invest in a fund.

**Investment Company Act**

The *Investment Company Act of 1940* (ICA) imposes significant requirements on the management and operation of investment companies, a broadly defined term that would include most venture capital funds in the absence of an exemption. A fund invariably will not want to be subject to the ICA, since investment companies must be registered with the SEC and the cost and operating implications of investment company status would render the fund all but unworkable. The two most widely relied upon exemptions in the ICA are:

- Section 3(c)(1) of the ICA, which exempts a fund that has no more than 100 beneficial owners of its securities at any time during its life and that has not made and does not plan to make a public offering of its securities. Complex special rules and look through provisions apply to the calculation of the 100 beneficial owner limit.

- Section 3(c)(7) of the ICA, which exempts a fund of which the equity owners consist entirely of qualified purchasers, irrespective of number, provided that the fund has not and does not plan to make a public offering of its securities. Broadly speaking, "qualified purchasers" include individuals holding US$5 million or more of investments and entities holding US$25 million or more of investments.

Section 3(c)(1) and 3(c)(7) funds can be, and often are, established in parallel by promoters.

**Investment Advisers Act**

The general partner and the manager of, and any adviser to, the fund must determine whether they are required to register with the SEC under the *Investment Advisers Act of 1940* (Advisers Act) or with state regulators under applicable state law. In the past, many funds could take advantage of an exemption from registration under the Advisers Act for advisers with fewer than 15 clients and which generally did not hold themselves out to the public as investment advisers.
In 2012, however, the relevant rules were substantially revised and now generally require investment advisers of venture capital funds to undertake at least a limited degree of registration with the SEC or comparable state regulators (with state regulators generally being invoked if total assets under management are less than US$100 million) as what is known as an “exempt reporting adviser”. Such limited registration obligations are less onerous than the obligations imposed on an investment adviser which advises funds other than venture capital funds or which advises separate accounts.

Securities Act
The offer and sale of interests in a venture capital fund will be an offer and sale of securities for the purposes of the US Securities Act of 1933 (Securities Act). Therefore, the securities must be registered with the SEC (a highly unattractive proposition) unless an exemption from registration is available.

Most offerings of interests in venture capital funds are made pursuant to the safe harbour for private placements in Rule 506(d) of Regulation D under the Securities Act, which permits sales to an unlimited number of accredited investors (especially wealthy individual and institutional investors) and up to 35 non-accredited investors, provided that the sponsor of the fund does not engage in the general solicitation of investors.

More recently, Rule 506(c) of Regulation D under the Securities Act was enacted and permits the offer of interests in venture capital funds by way of general solicitation, subject to a number of additional requirements (including that the sponsor of the fund undertakes independent due diligence to verify that all prospective investors in the fund are appropriately qualified).

It is important to note that, whether or not an offering and sale of securities is registered under the Securities Act, it will be subject to the US anti-fraud rules. Care must always be taken to ensure that the offering materials for a fund are accurate and not misleading.

In certain circumstances, persons that offer or sell interests in venture capital funds may be required to register as broker-dealers with the SEC under the Securities Exchange Act of 1934. However, this can sometimes be avoided under the so-called "issuer exemption" or by using a placement agent that is already a registered broker-dealer.

UK
The following regulatory issues apply:

Establishing a collective investment scheme
A fund may amount to an unregulated collective investment scheme (CIS) and, if so, establishing or operating it in or from the UK will be a regulated activity under FSMA and the Regulated Activities Order (see Practice note, Regulated activities: establishing, operating or winding up a collective investment scheme).

An English limited partnership will generally be a CIS, although Delaware and certain other overseas limited partnerships may be able to take advantage of an exemption from CIS status available for certain bodies corporate
that are not open-ended investment companies under paragraph 21 of the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (SI 2001/1062).

**Investment management and advisory activities**
The provision of management, advisory and arranging services to a fund or its investors in or from the UK are regulated activities for the purposes of section 19 of FSMA and the Regulated Activities Order, which may be carried out only by persons that are authorised persons under FSMA, unless an exemption applies (see Practice note: Regulated Activities Order: overview).

**Marketing limited partnership interests**
To market venture capital funds in the UK, sponsors and their placement agents must comply with various restrictions (see Practice note, Restrictions on the promotion of collective investment schemes).

**AIFM Directive**
The Alternative Investment Fund Managers Directive of the European Union (2011/61/EU) (AIFM Directive) introduced a harmonised (and controversial) regulatory framework for managers of alternative investment funds (known as AIFs), including requirements relating to authorisation, administration, remuneration, marketing and depositaries (see Practice note: overview, Hot topics: AIFMD). Crucially, the AIFM Directive may apply under certain circumstances to managers that are based outside the European Union.

Member states of the European Union were required to implement the AIFM Directive by 22 July 2013. In March 2018, the European Commission published two legislative proposals about the AIFM Directive as a result of the concerns of the Commission that various factors are restricting the crossborder activity of investment funds and that the European Union investment funds market has not yet exploited its full potential in terms of cross-border distribution.

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**Typical European venture capital fund structure**
See the pdf file for this diagram.

<table>
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<th>Fund descriptions</th>
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<td>Funds are often described according to their purpose, sector or background. These are some of the more common fund labels:</td>
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• **Biotech, hitech and nanotech funds** focus on portfolio companies in those particular technology sectors.

• **Captive or semi-captive funds** are funds established by, and with strong links to, a particular investor, for instance a financial institution. Many investment banks formed their own captive funds in the 1990s to invest both their own and their clients’ assets.

• **Feeder funds** are funds that are specifically created to invest in a single fund. The use of feeder funds is popular to access demand from wealthy individuals. Feeder funds can offer such investors access to popular funds they would otherwise not have (many funds formed by principals with proven track records are oversubscribed) as well as enabling demand to be aggregated, allowing high minimum subscription levels to be met collectively. Another advantage (from the manager’s perspective) is that the manager of the feeder fund is often able to maintain the confidentiality of its client list from the manager of the underlying fund.

• **Fund of funds** are funds that invest in a range of private equity funds. They often offer access to investment opportunities not otherwise available to an investor and allow investors to diversify their portfolio between management teams. They might be unable to do this alone, lacking the expertise and resources to build and manage a diversified portfolio.

• **Mega funds** are generally the largest buyout funds that are raised by the most successful and established fund houses, and often raise commitments of hundreds of millions or billions of dollars.

• **New gen or spin-out funds** are funds where the management team is raising its first fund on its own, having previously been with another, more established, fund management group.

• **Pan-European funds** target investments across a range of European jurisdictions rather than focusing on a single country.

• **Parallel funds** invest alongside each other in the same portfolio.

• **Real asset funds** invest in real assets such as infrastructure, real estate and sustainable resources.

• **Secondary funds** are funds that specialise in acquiring interests in private equity funds through the secondary market, rather than the primary market. Ownership in an existing private equity fund can often be purchased directly from another investor at a discount, which can allow a secondary fund to gain exposure to a fund that has been closed to additional investors and allows the existing investor to exit an investment prematurely. A secondary fund differs from a fund of funds in that it acquires interests in funds after the fundraising period for those funds has closed.

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