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How to start a Private Equity Fund

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Introduction

When setting up a private equity fund, the following matters will need to be looked at and considered:

- regulatory authorisation
- fund structure and jurisdiction
- eligible investors
- carry arrangements
- other key fund terms
- service providers
- investment structuring

In order to address these issues, you will need to seek professional advice from legal counsel.

Regulatory authorisation

In most jurisdictions, the investment manager of a private equity fund will require regulatory authorisation or licensing in order to be able to carry out its activities lawfully. In the UK, the investment manager will generally need to apply to the FSA (from 1 April 2013, the FCA).

The investment manager will also need to comply with the regulatory regime imposed by the Alternative Investment Fund Manager's Directive ("AIFMD") when it comes into force in the UK in July 2013. However, if the investment manager manages assets of less than €500 million, it will only need to comply with a light form of regulation.

Fund structure and jurisdiction

If the fund is set up in the UK it will not need to be authorised by the FSA. In other countries it many need to register with the local regulator. For example, in the Cayman Islands the fund would register with the Cayman Islands Monetary Authority, and in the Channel Islands with the Guernsey or the Jersey Financial Services Commission, as is appropriate.

The standard structure for a private equity fund is a limited partnership. This structure allows profits to be distributed to investors as capital rather than as income profits. Limited partnerships also offer only very few, if any, redemption rights and so suit an investment in illiquid assets which will be held for a long time. Some private equity funds are structured as closed-ended companies with a listing, but they are relatively few and far-between.

The investors in a limited partnership will have no rights to control the partnership, and will be "sleeping partners". Their liability is limited to the amount of capital they have committed, or agreed to commit.

The limited partnership is run by another entity, the general partner, who has unlimited liability for the partnership's obligations to third parties. To tackle the issue of unlimited liability, the general partner is often a company which is set up specifically to act as general partner and, as part of its role, delegates all its investment management duties to a regulated investment manager. The investment manager is often paid its fee from the money received by the general partner.

It is common for investment managers to set up the fund offshore, which may be more appealing to non-UK investors (who may be more accustomed to investing in offshore private equity vehicles). Popular jurisdictions are the Cayman Islands, Guernsey, Jersey, British Virgin Islands and the Isle of Man. There are AIFMD issues to be considered in deciding on the jurisdiction and legal advice is needed on this point.

In the UK, limited partners almost always invest in a limited partnership in cash and debt, with the great majority of the contribution being loan. This is because under English law, if the capital of a limited partnership is returned to investors before liquidation of the partnership, then the investors lose their unlimited liability to the extent of the capital returned. This issue does not generally arise in most offshore structures.

Eligible investors

In the UK, private equity funds may only be marketed to certain restricted categories of investor. As a result, they are generally directed at institutional investors, such as pension funds, and sophisticated high net worth individuals or family offices, and are not available to the general public.

Carry arrangements

One of the most crucial aspects of the structure of a private equity fund, and one which greatly influences the drafting of the limited partnership agreement and offer documentation, is the fee structure and the use of a carried interest, or carry.

Typically, this is a special profit share (normally 20%, or 10% in a fund of funds structure) which is paid out to the general partner or investment manager once investors have reached a specified level of return (normally this will be once they have received distributions of an amount equal to their drawn-down capital together with an annual "preferred return" thereon from draw-down).

There is normally a "claw-back" mechanism, with a proportion of the carry being held in escrow to allow carry to be repaid if, later in the fund's life, it is found that the investment manager has been paid too much. This can commonly happen when a fund has begun to distribute the carried interest in advance of its expected termination date, but an under-performing investment is later realised and impacts adversely on the investment manager's entitlement.

There are also generally provisions for the set-off of any other remuneration, for instance netting off advisory fees received by the investment manager, or expenses relating to any "broken deals", against the carried interest, either in part or wholly. It is common for carry entitlements to be awarded to individual members of the investment manager team as an incentive, typically through tax-effective carry vehicles such as limited partnerships.

This is highly tax-sensitive, particularly in the UK, where carried interest may be liable to be taxed to income as emoluments unless properly structured.

Other key fund terms

Limited partnership agreements are lengthy and complex, and their terms are generally influenced by a range of market-standard expectations on matters such as the length of the fund and the ability to remove the investment manager or terminate the fund. For example, investors may want to restrict the investment manager from setting up any competing fund until the fund is at least 75% invested, or may want the investment period (the initial four or five-year term during which the investments are scheduled to be made) to be frozen if "key men" depart, perhaps leading to termination of the fund if that individual is not satisfactorily replaced.

Where sovereign wealth investment is likely, there may be so-called "excuse rights" aimed at excusing investors from being required to commit to any investment which contravenes relevant religious, ethical or statutory restrictions.

The fund may also appoint an investor committee to act as a forum allowing investors to monitor the performance and activity of the investment manager and any potential conflicts of interest. It should be noted that this body is not allowed to have any input into the management of the fund.

The fund may also have an advisory committee which has powers to liaise with and advise the investment manager on investment, though the advisory committee may not give binding investment advice.

Service providers

In addition to the investment manager, the fund will normally have an administrator, who will be responsible for liaising with investors, arranging limited partner, investor committee or advisory committee meetings, valuing the assets of the fund, calculating carry payments and arranging distributions.

The AIFMD will impact on many of the duties and activities of administrators, as regards EU-based funds. The AIFMD also requires EU-based funds, or funds promoted in the EU, to have a depositary, to hold the assets of the fund, monitor cash flows and supervise the manager's activities.

In some cases, there may also be an investment advisor, to advise the manager, for instance on investment in any jurisdiction beyond the manager's specific knowledge.

The fund will also need lawyers, who will be responsible for establishing the fund and preparing and negotiating the various fund documents, including the limited partnership agreement, offering memorandum (or equivalent), management agreement, any investment advisory agreement and subscription documentation.

The fund may also require tax advisors, to enable the manager to determine the right structure and help structure the carry arrangements.

Investment structuring

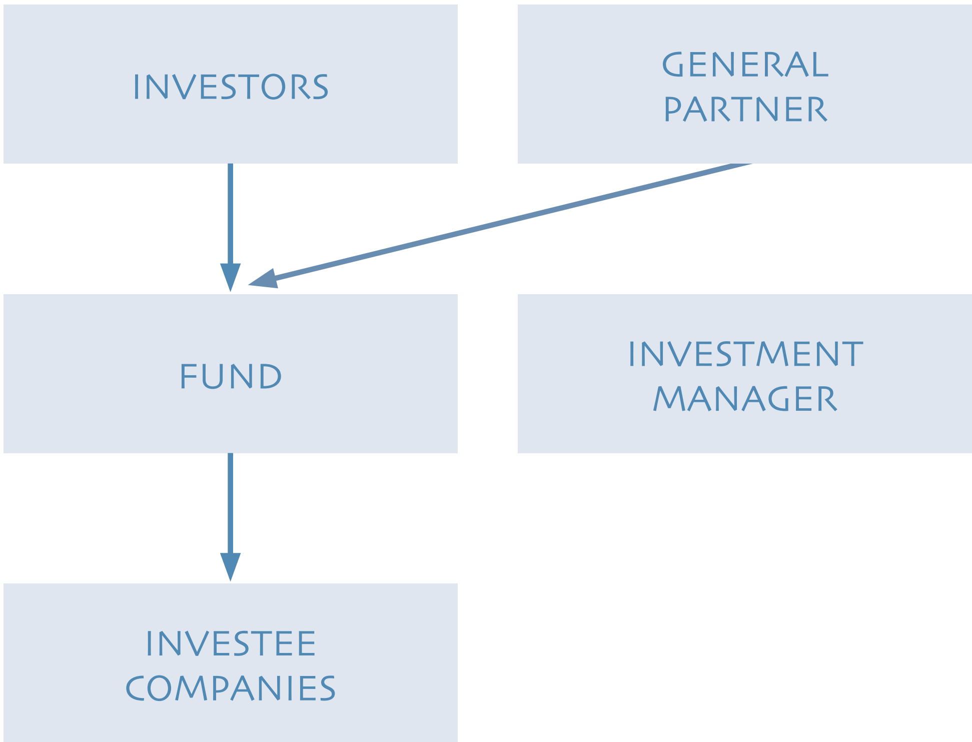
A further important aspect is the structuring of the actual investments to be made by the fund, particularly where those investments are to be leveraged by borrowings. This is another tax sensitive area and it may be necessary to set up special purpose vehicles to optimise the tax position.

Timing

A private equity fund can take an average of approximately three months to set up and hold its first closing, but this timing depends on a number of factors, not least the responsiveness and cooperation of the relevant parties, whether or not the investment manager is authorised and the progress (or otherwise) of any negotiations with any key investors.

APPENDIX

Diagrammatic example of a typical fund structure



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cummings solicitors

42 Brook Street, London W1K 5DB +44 20 7585 1406 | Neuhofstrasse 3d, CH-6340 Baar +41 41 544 5549