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CUMMINGS PEPPERDINE ON VENTURE CAPITAL FUNDS

SPEEDREAD

1. WHAT IS A VENTURE CAPITAL FUND?

A venture capital fund is a collective investment vehicle which invests in early-stage companies which have been selected for their growth potential in accordance with a defined investment strategy and policy. In contrast to a private equity fund, a venture capital fund takes a minority rather than a controlling stake

The purpose of a venture capital fund is not to provide, but rather income to its investors, "Limited Partners", but rather a capital return during and at the end of the fund's life. This is commonly around ten years.

2.HOW IS A VENTURE CAPITAL FUND STRUCTURED?

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. There will also be a range of necessary functionaries which support the fund and make it "work". These include investment advisers, investment managers, administrators, and custodians. More information is given below.

3.WHAT IS A LIMITED PARTNERSHIP?

The limited partnership is the traditional venture capital fund vehicle and so is familiar to investors.

It generally has two categories of partner:

(i) The general partner who has control over the management of the limited partnership and unlimited liability to third parties for the debts and obligations of the limited partnership; and

(ii) The limited partners who 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, hence the name.

More information on these categories of partner is given below.

4. WHAT IS A LIMITED PARTNERSHIP AGREEMENT?

The limited partnership will be governed by a limited partnership agreement. This sets out the relationship between the partners and it often highly negotiated, with negotiations often concentrating on the requests of any cornerstone investor.

As a limited partnership is free from many of the legal constraints and formalities which applicable to corporate entities, the agreement can generally meet the characteristics of particular circumstances.

5. LIMITED PARTNERSHIPS AND TAX

A partnership is not a corporation under UK tax law and, as a consequence, it is fiscally transparency. This means that it is looked through for tax reasons and the partners rather than the limited partnership meaning that the partners are treated for tax purposes as having invested directly in the underlying partnership assets, with no (or limited) taxation imposed on the limited partnership.

6. WHO ARE THE 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, if there is one, the financial institution which acts as the fund's promoter or "sponsor".

The principals and/or sponsor will make a capital commitment to the fund. This is commonly equal to 1% to 5% of the capital raised by the fund, though it can be lower, and is generally made via the general partner. One purpose of this is to ensure that the interests of the principals and/or sponsor are aligned with those of the limited partners. This is often viewed as a key business term with both investors and the FCA happy to see "skin in the game" from the main players.

7. WHAT DOES THE GENERAL PARTNER DO?

The general partner is ultimately responsible for the management of the limited partnership. They do not often act as the fund manager as well but rather delegate this function to the investment manager and/or investment adviser. Almost invariably, the general partner will be a limited liability company in order to extend the protection of limited liability to the owners and directors of the general partner as well.

8. WHAT DO THE LIMITED PARTNERS DO?

The limited partners are the investors in the fund. They contribute most of the fund's capital and then "fall asleep", leaving the running of the fund to the general partner and its functionaries. This is why limited partners are also referred to as sleeping partners.

Once they have made an investment commitment, limited partners will generally not be entitled to withdraw from a fund or to transfer their limited partnership interests, although the general partner may have the discretion to permit transfers.

Limited partners are generally not permitted to control or participate in the management of the fund. They must remain sleeping partners. If they do not, their tax status and limited liability status may be adversely affected.

9. WHO ARE THE INVESTMENT MANAGERS AND ADVISERS?

As explained above, the general partner will often appoint a separate entity to act as the investment manager or investment adviser and manage the fund's investments and/or to advise the fund about its investment strategy.

Some funds may also appoint an advisory committee or advisory board. The members are generally representatives of the limited partners and are selected by the general partner. Its role is to consult with investors, liaise with the investment manager and provide views on a range of fund related issues, in particular conflicts of interest and valuation questions. It may not, however, take part in investment activities which require FCA authorisation.

10. WHAT FEES DOES THE FUND PAY?

As well as set up fees, the fund will pay each of its functionaries and the majority of these fees will be paid to the investment manager.

The investment manager takes fees in two forms. The first is a management fee which is intended to cover the investment manager's running costs and allow it to stay in business during the life of the fund. This is typically set at 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 point it may be reduced to a percentage of the capital which the fund has invested.

The second fee is a carried interest, which is based on the gains made by the fund and structured in a tax efficient manner. The effectiveness of this tax efficiency depends on the carry not being seen as an income paid to the investment manager, 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 which apply income tax rather than capital gains tax. In addition, no of the income and gains of the fund may be attributed to the investment manager unless and until the fund's returns meet the relevant hurdle rate. Only then may the carried interest be payable to the management team.

Helpfully, the British Venture Capital Association has agreed a model partnership carried interest structure with HM Revenue which should afford tax efficiency provided that other requirements imposed by HMRC are met, such as only remunerating the principals at full arm's length rates. Most teams of principals stick closely to the BVCA model and route the carried interest through a separate special limited partnership interest.

11. HOW DO INVESTORS RECEIVE THEIR GAINS?

The timing and manner in which a venture capital fund makes distributions to its partners is set out in the limited partnership agreement, which partly accounts for the length of negotiations in finalising this document.

Commonly the distribution provisions set out the terms of a waterfall, and this is the most complex part of the limited partnership agreement. The purpose of a waterfall is to share the fund's profits between the investors and the management team so that the management team earns a return that is disproportionate to its capital investment via a carried interest. The carry also serves to incentivise the management team.

Typically, the waterfall will flow in the following order:

- First, the fund will return the capital contributions of limited partners;
- Secondly, provided that the capital contributions of limited partners have been returned to them, excess distributable proceeds will be divided between the limited partners and the general partner, typically in the ratio 80:20 and often with a hurdle, which may rachet.

Each successive distribution will be calculated on an aggregate cumulative or "fund as a whole" basis, so that any losses from a realised investment are set off against the gains made on previously realised investments (and vice versa). This means that losses made in the later part of the fund's life 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 carried interest payments prove to have been overpayments, and so the fund must be allowed to impose a clawback requiring repayment of any excess carried interest (usually on an after-tax basis). This obligation is often supported by personal guarantees from the the principals, given on a several basis and based on the amount of carried interest received.

The timing of distributions should be set out in the limited partnership agreement. They may made to limited partners within a specified period following the disposal of a portfolio company, subject to a retention amount and clawback provisions in relation to the investment manager's fee. It can be made at the end of the life of the fund, but this is less common.

Distributions will often be made in cash but the limited partnership agreement will usually allow them to be made in kind or in specie (for example, marketable securities of portfolio companies that have been brought to the market by way of flotation).

Any remaining assets are distributed on winding-up, usually in accordance with its distribution waterfall, subject to payment of the fund's expenses and taking into account any clawback arrangements.

The Cummings Pepperdine Online Training Programme, includes sections focussing on Venture Capital Funds, has been designed by a specialist board of compliance consultants, solicitors, chartered accountants, tax advisors and regulatory consultants. We believe that we are the only firm which offers training created by this range of qualified advisors.

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