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Fund Formation Checklist for a Private Equity Fund

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This fund formation checklist for private equity funds concentrates on formation and structuring prior to drafting the primary and ancillary documents commonly used in the launch of a private equity fund. Private equity funds are usually “blind pools” established by a fund sponsor to aggregate the capital of passive investors to originate private equity investments and negotiate their acquisition and investment. The checklist navigates the user through certain key decisions in front of drafting the requisite documents and through many material terms. It also introduces the user to the various parties both essential and optional to private equity fund launch and operations. The checklist assumes the following:

- The private equity fund’s fundraising shall occur pursuant to a private offering exemption, which makes it exempt from registration under the Securities Act of 1933, as amended (the Securities Act);
- The private equity fund is deigned to be a private fund or a qualified purchaser fund in reliance on the exclusion from the definition of an investment company under the Investment Company Act of 1940 (the 40 Act), as amended, pursuant to Section 3(c)(1) or Section 3(c)(7) and thus are not registered under the 40 Act;
- The private equity fund’s investment adviser is registered under the Investment Adviser Acts of 1940, as amended (the Advisers Act) or is exempt from registration thereunder.

Each private equity fund varies in relation to its general structure, the key entities in its organizational makeup and management, its economics including its fundraising methods (*i.e.*, Regulation D (sections 506(b) or 506(c)), Regulation S, Regulation A+, Title III crowdfunding, etc.), the timing of fund closings, the fund’s term, investment and divestment periods, the fund’s governance, methods for managing conflicts, its regulatory structure and compliance including with respect to federal securities and other federal laws affecting fund formation and operation. Universally, the key monetary incentives for fund sponsors are the management fees and the profit participation from the investments of the fund. Further, historically, private equity funds had no governing body such as a board of directors but, post-Madoff, the use of an advisory committee comprised of non-investor directors and principal investors has increased in frequency. Consequently, this checklist should be tailored to reflect these foregoing terms and the intended as well as the type of assets sought.

By way of background, the fund manager typically receives compensation through (i) an annual management fee equal to a designated percentage of 2% of capital under management, which is taxed at ordinary income rates plus (ii) a 20% profits interest, usually referred to as a “carried interest”. Currently, the U.S. Internal Revenue Code taxes the carried interest received by the fund manager as capital gain instead of the higher rates for ordinary income only if the fund manager received the distribution from an entity that is taxed as a pass-through entity, such as a partnership or limited liability company, and the fund manager owns an equity interest in the pass-through entity. When the private equity fund sells an investment for a profit, it passes the resulting gain to the partners as capital gain at substantially lower rates than as ordinary income. Consequently, nearly all funds and the fund managers or general partners are structured as limited liability companies or partnerships so less deviation is seen in this area than with regards to other fund structuring matters.

This checklist presents the primary structuring points and documents required for a private equity fund, which should be updated periodically especially if relied on as a “to-do” list.

For additional information on Fund Formation basics and the relevant parties, see the following forms and practice notes:

- [Introduction to Private Investment Funds](#)
- [Key Differences between Hedge Funds and Private Equity Funds Comparison Chart](#)
- [Understanding the Structure and Organization of Private Equity Funds](#)
- [Private Equity Fund Life Cycle](#)
- [U.S. Regulatory Framework for the Offering of Private Equity Fund Securities](#)
- [Drafting a Term Sheet for a Private Equity Fund](#)

FUND FORMATION CHECKLIST

Checklist Definitions -- The following key of terms and party definitions was utilized in this Checklist above:

Term	Party
FC	[], U.S. fund counsel for the Fund
OC	[], offshore fund counsel for the Fund
Custodian	[], the Fund’s Custodian
Administrator	[], the Fund’s Administrator
TC	[], tax counsel for the Issuer
IRS	Internal Revenue Service
SEC	Securities and Exchange Commission
Sponsor	[], the Sponsor (<i>i.e.</i> , the client)
IPC	[], Intellectual Property/Trademark Counsel
CAB or CABs	capital acquisition brokers
CAB Rules	capital acquisition broker-dealer-lite rules

DECISION/TO-DO ITEM	RESPONSIBLE PARTY	STATUS	COMPLETE
<u>Preliminary Fund Planning</u>			
1. Choose the fund’s name taken care to select a name that does not infringe on others	Sponsor and IPC		
2. Register the Fund’s name, phrase, logo, symbol, design, or image (or any combination of the foregoing) to protect from infringement by others	IPC		
<u>General Fund Structure</u>			
1. Determine if forming a limited liability company or limited partnership	FC		
2. Form the limited liability company or limited partnership	FC		
3. Complete and file a Form SS-4 to obtain an Employer Identification Number (“EIN”) from the Internal Revenue Service (“IRS”) for the fund	FC		

<p>4. Prepare the operating agreement or limited partnership agreement for the fund [I think this should probably be the last item – so right after item 12 (or 11 as renumbered) – since it is only after you know if you’re going to let in different types of investors and accommodate their needs that you’ll know what their operating agreement should look like – unless maybe we’re talking about only doing form documents at this stage.]</p>	<p>FC</p>		
<p>5. Determine if accepting non-U.S. investors – if so – form either (a) an offshore “feeder” entity or (b) a parallel fund or (c) leave as a standalone domestic pass-through fund depending on where the sponsor will offer the interests in the fund</p> <p>6. Feeder funds can be structured as “blockers” taxed as corporations for U.S. federal income tax, which would invest in the fund as a limited partner.</p> <p>7. Usually, parallel funds co-invest and co-divest in conjunction with the fund on a <i>pro rata</i> basis.</p> <p>8. Thorough tax assessment of the investors and fund’s circumstances is essential to structuring a fund and offering its interests effectively, which is profoundly intricate when the fund will offer interests in multiple jurisdictions.</p>	<p>FC, TC and Sponsor</p>		
<p>9. If applicable, select the offshore jurisdiction in which to form the feeder or parallel fund such as Cayman Islands, Mauritius, etc. and retain local counsel</p>	<p>FC and/or Sponsor</p>		
<p>10. If applicable, form feeder or parallel fund and governing documents.</p>	<p>OC</p>		
<p>11. If applicable, review the formation and governing documents for the feeder or parallel fund.</p> <p>Typically, the governing agreement of a parallel fund will also be substantially the same as the governing agreement for the main fund depending on amendments for the topics discussed herein. Usually, a parallel fund will be aggregated with the main fund for purposes of overall size cap and for purposes of voting under the fund agreements.</p>	<p>FC</p>		
<p>12. Decide whether to accommodate and structure for other special types of investors, e.g., ERISA, bank holding company, tax exempt, etc.</p>	<p>FC, TC and Sponsor</p>		

Fund Management			
<p>1. General Partner/Managing Member - The private equity fund model vests extensive management authority in the general partner (LP) or the managing member (LLC). Form the corresponding entity that will manage the fund [After this, we should have form the GP entity, and get its EIN using form SS-4 – similarly to the way we have for the above section for General Fund Structure]</p>	FC		
<p>2. Prepare the operating agreement or limited partnership agreement for the fund’s general partner or managing member [Again, I think this probably should go after 6 (or 5 as renumbered), since governance will impact the operating agreement]</p>	FC		
<p>3. Complete and file a Form SS-4 to obtain an EIN from the IRS for the general partner or managing member</p>	FC		
<p>4. Structure fund management compensation –</p> <ul style="list-style-type: none"> a. Manager receives an annual management fee <ul style="list-style-type: none"> i. Investment Period: percentage of the fund’s total capital commitments ii. Post-Investment Period: percentage of the fund’s invested capital b. Manager receives a carried interest c. Manager receives a percentage of the fund’s profits 	FC and Sponsor		
<p>5. Governance – Determine whether the Fund will have an advisory committee. If so, determine whether the advisory committee will be comprised of investors or third parties or a combination of both.</p>	FC and Sponsor		
<p>6. Governance – If applicable, prepare governing documents for the advisory committee such as frequency of meetings, scope of the committee’s authority, etc.</p>	FC and Sponsor		
<p>7. Administrator – Determine whether to retain a third-party administrator to oversee fund administration rather than be administered by the fund manager alone (the former is more common post-Madoff)</p>	FC and Sponsor		
<p>8. If a third-party administrator is desired, locate a reputable third-party administrator</p>	FC and Sponsor		
<p>9. Negotiate third-party administrator agreement with the fund</p>	FC		
<p>10. Custodian - Retain a third-party custodian for one or more of the following services –</p> <ul style="list-style-type: none"> a) Account opening: open fund account, securities account; 	FC and Sponsor		

<p>b) Asset custody: set separate accounts for different equity investment funds under custody, guarantee the consistency between amount, accounts and vouchers, and ensure the integrity and independence of fund assets;</p> <p>c) Fund transfer and payment: timely handle the clearing and delivery of fund assets according to instructions of fund manager;</p> <p>d) Custody reports: Submit reports on fund custody service and financial statements to fund investors and regulatory authorities.</p> <p>e) Record keeping: Keep fund custody records, account books, reports and other materials.</p>			
<p>11) Negotiate third-party custodian agreement and decide on the foregoing services.</p>	<p>FC and Sponsor</p>		

ITEM	RESPONSIBLE PARTY	STATUS/NOTES	COMPLETE
<u>Draft the Principal Legal Documents</u>			
<p>1) Private Placement Memorandum (“PPM”) – draft key information about the fund including at a minimum:</p> <ul style="list-style-type: none"> • Business section Discuss investment strategy, sponsor bios, track-record (positive and negative) • These sections typically include a discussion of the Fund’s investment strategy and process, market commentary, and a description of the sponsor (including relevant team biographies) • Risk factors • Disclose the management fee/incentive allocation/carried interest • Draft details of offering expenses (including sales commissions) • Disclose the fund’s fees to be charged • Disclose the description of the use of proceeds raised from the sale of the interests • Discuss offering terms • Disclose fund closings and release of funds • Disclose the rescission/lock-up • Disclose conflicts of interest • Disclose tax matters • Disclose procedures for capital calls • Generally - sponsor’s ability to call capital is any time of unfunded commitments • Disclose consequences for failure to fund timely capital calls – <ul style="list-style-type: none"> o is dilution a possible penalty? 	<p>FC</p>		

<ul style="list-style-type: none"> o is involuntary redemption a possible penalty? • Disclose policy on use of leverage, if any • Summarize operating agreement/ limited partnership agreement • Discuss the managing member/ general partner and the custodian and administrator, if applicable 			
<p>2) The fund’s Limited Partnership or Operating Agreement should address:</p> <ul style="list-style-type: none"> • Object/purpose • Limitation of liability • Management • Indemnification • Fees <ul style="list-style-type: none"> o Management fees o Transaction fees o Custodian fees o Investment Adviser fees o Administrator fees o Other fees • Fund expenses • Valuation of Assets • Assignment and transfer • Capital contributions • Capital commitments • Capital calls • Lockouts • Redemptions • Reinvestments Determine and disclose the fund’s policy on reinvestment – usually not allowed except for investments exited within a year of the investment (and early in the fund’s life if a limited term fund). Generally, reinvestment by the fund increases the investor’s unfunded commitments subject to the investors’ original fund commitment. • Distributions <ul style="list-style-type: none"> o Draft the waterfall provision to administer the distribution of priority of proceeds from investments; distributions are made in “tiers”. o Each tier administers a ratio to sponsor and a ratio to investors; once each tier is satisfied the succeeding tier applies. o Determine hurdle rate and catch-up allocation 	<p>FC and TC</p>		

<ul style="list-style-type: none"> o Determine if using clawback of carried interest (net of tax or is guaranteed). o Allocations of profits and losses, and corresponding items of taxable income, gain and loss among the partners. • Defaulting Limited Partners • Tax matters, including those relating to tax audits of the Fund. 			
<p>3) Draft the Fund Subscription Agreement with standard representations and warranties and any unique items necessary for the fund</p>	FC		
<p>4) Draft the Investor Questionnaire</p>	FC		
<p>5) Draft the Investment Management Agreement</p>	FC		
<p>6) Draft any Side Letters, to grant special rights and privileges to important investors as applicable</p>	FC		
<p>7) Determine whether fund will adopt a “most favored nation” (MFN) policy or favored treatment accorded to a country</p>	FC and Sponsor		
<p>8) Draft Placement Agency Agreement if Applicable</p>	FC		
<p><u>Securities Matters & Fund Raising Methods</u></p>			
<p>1) Determine which private offering exemptions from registration with the SEC will be relied upon; popular methods include:</p> <ul style="list-style-type: none"> • Rule 506(b) - the fund may sell its securities to up to 35 non-accredited investors who meet sophistication requirements and an unlimited number of accredited investors. There is no limit on the offering size but it may not be advertised. • Rule 506(c) – the fund may use general solicitation but may admit only accredited investors. There is no limit on the size of the offering. • Regulation A – The “mini-IPO” exemption to raise up to (i) \$20 mil (Tier 1) or (ii) \$50 mil (Tier 2) from accredited and non-accredited investors using general solicitation with an SEC reviewed offering circular provided to investors along with reviewed or audited financial statements. 	FC, Sponsor and Placement Agent		

<ul style="list-style-type: none"> Regulation S – If offering interests in the fund to non-U.S. persons without setting up a separate offshore fund provided the offering and sale occurs offshore. <p>Note - Rule 506 and Reg. S may be used concurrently, if the issuer complies with both fully in their respective jurisdictions.</p>			
<p>2) Draft private offering exemption language and applicable requirements to protect the exemption in the PPM (further to #1 above)</p>			
<p>3) Draft private offering exemption language and applicable requirements to protect the exemption in the Subscription Agreement (further to #1 above)</p>			
<p>4) Draft private offering exemption language and applicable requirements to protect the exemption in the Limited Partnership Agreement or Operating Agreement (further to #1 above)</p>			
<p>5) Determine the offering price of the fund’s interests.</p>			
<p>6) Determine the fund size including the maximum number of fund’s interests to be offered, which affects management fees, timing of follow-on funds, and the appeal to portfolio companies as an investor.</p>	Sponsor		
<p>7) Determine the fund’s minimum offering amount that will constitute a viable launch and operation (depends on the fund’s investment focus, the projected deal size and number of investment professionals).</p>			
<p>8) Application for EDGAR Codes: Apply for EDGAR Codes to file the Form D with SEC within 15 days of initial closing</p>			
<p>9) If relying on Regulation A, file the Form 1-A with the SEC and address the SEC’s questions and comments. Then file the final prospectus after being “qualified” by the regulators. Then launch the offering and prepare and file annual and semi-annual report to SEC and an Annual Audit for Tier 2 (\$50 million raises (not \$25 million))</p>			

<p>10) If relying on Regulation D, file an SEC Form D notice of the sale of fund interests with the SEC within 15 days of the first sale under Reg. D to ensure that the private placement falls within the black letter of Reg. D.</p>	<p>FC</p>		
<p>11) Evaluation whether Blue Sky filings are required. If so prepare.</p>	<p>FC</p>		
<p>12) Determine if fund managers will receive transaction fees related to acquisitions or dispositions of portfolio companies and securities assets may be able to rely on SEC’s FINRA rules governing “capital acquisition brokers” (“CABs”) that elect to be governed under the “broker-dealer-lite” rule set (“CAB Rules”) for private placements of private fund interests. Alternatively, determine whether the fund managers will rely on Rule 3a-4 promulgated under the Exchange Act of 1934, as amended.</p>	<p>FC and Sponsor</p>		
<p>13) If the fund managers will rely on CAB Rules, draft risk factors and limitations and boundaries to which the fund managers must adhere in the PPM</p>	<p>FC</p>		
<p>14) Determine if placement agents will be used for the fund offering and if so if the placement agents will be fully licensed or rely on the CAB Rules (CABs may only act as placement agent in private offerings to institutional investors).</p>	<p>FC and Sponsor</p>		
<p>15) Draft placement agents agreement for the fund and if applicable the offshore fund.</p>	<p>FC</p>		

In large part due to the necessity to provide specific information to nonaccredited investors that private fund managers may not be able or will to provide, most private funds avoid selling to non-accredited investors even when relying on Rule 506(b) thus the investors must meet the accredited investor standard, which requires (in the case of an individual) that the investor have (i) a net worth, or joint net worth with the person’s spouse, that exceeds \$1 million excluding the value of the primary residence of such person, or (ii) income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years, and a reasonable expectation of the same income level in the current year.

Checklist Key -- The following key may be helpful for the status column of this Checklist:

Term	Status
IP	In process
D/C	Drafted and circulated
F	Finalized
Reg. D	Regulation D
F/NS	Finalized and not signed
F/S	Finalized and signed
N/A	Not Applicable
Pending	Status Pending, discussed with Sponsor and awaiting response
O	Ordered

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