English and Luxembourg venture capital funds: key features

by Andrew Wylie, DLA Piper, Michelle Barry and Johan Terblanche, Maples Group

Practice notes | **Maintained** | Luxembourg, United Kingdom

An overview of the key features of UK and Luxembourg 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 Luxembourg venture capital funds and outlines some of the UK and Luxembourg 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 exclusively in the capital structure of early stage and growth companies. 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 capital appreciation rather than income generation, which it achieves by acquiring a portfolio of equity interests in privately-held early stage and growth 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, initial public offerings, trade sales or sales to other funds.

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 by taking minority stakes in businesses, often alongside other venture capital funds and investors (including founders of those businesses). That investment may represent seed, early stage, expansion or later stage capital. Venture capital funds often invest in technology-based sectors such as artificial intelligence, biotech and healthcare, cyber security and information and communications technology.

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 has 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 sub-category of private equity funds (see *Practice note, English and Luxembourg private equity funds: key features*) (venture capital funds being the other primary sub-category) 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, 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 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 notes, Acquisition finance: debt for buyouts* and *Private debt funds: an introduction*.

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, investment manager and investors (see *Typical European venture capital fund structure* and *Dramatis personae*).

In Luxembourg, each type of limited partnership and other fund vehicle may opt into one of a number of different regulatory regimes (see *Regulatory regimes*). Among other considerations, the various regulatory regimes provide certain structuring features that are not available in a traditional limited partnership structure.

Limited partnership

Limited partnerships are the fund vehicles which are most familiar to venture capital investors worldwide and which are commonly used by US, UK and European fund houses, often with modified features to reflect local tax and regulatory requirements, as well as commercial considerations (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
  - the 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 partially prescriptive, so that there is significant scope for the partners to negotiate and settle its terms (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. The Luxembourg *société en commandite par actions*, known as the SCA, being a corporate partnership limited by shares, is an exception to this general rule since it is fiscally opaque (see *Luxembourg*).

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 investors in the EU will tend to use limited partnerships established under the laws of the Grand Duchy of Luxembourg. Funds that are targeted principally at investors in the UK and investors in non-member states of the EU will tend to use limited partnerships established under the laws of the Cayman Islands, England, Guernsey or Jersey. It is generally possible to market interests in those funds in most jurisdictions in the EU in accordance with applicable national private placement regimes. The English limited liability partnership (LLP), 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).

Luxembourg

The legal framework for limited partnerships has existed in Luxembourg for over a century. In 2013, however, the Luxembourg legislature modernised the Luxembourg partnership regime by introducing a new type of partnership vehicle – the special limited partnership (*société en commandite spéciale*, known as the SCSp).

Luxembourg's partnership regime now therefore comprises three types of partnership:

- The common limited partnership (*société en commandite simple*, known as the SCS).
- The special limited partnership (the SCSp).
- The corporate partnership limited by shares (the SCA).

(Collectively, the Luxembourg Partnerships).

Luxembourg Partnerships, in particular the SCSp, and to a lesser extent the SCS, have become the most popular venture capital fund vehicles in Luxembourg. The regimes for the SCSp and the SCS are modelled on the successful Anglo-Saxon limited partnership regimes and offer features similar to foreign partnership regimes applicable in England, Scotland, Delaware and other common law jurisdictions. By contrast, the SCA is incorporated under Luxembourg law and exhibits a number of corporate and partnership characteristics, so that it is a hybrid entity. An SCA is entitled to make elections about its treatment which are respected under the laws of various foreign jurisdictions, including the USA. This can avoid difficulties with entity classification rules which might otherwise arise.

Each Luxembourg Partnership is formed under the Luxembourg law of 10 August 1915 on Commercial Companies (1915 Law), which contains a number of provisions which are particular to each respective type of Luxembourg Partnership. Such provisions in respect of the SCS and SCSp are very limited and therefore they afford great structuring flexibility and contractual freedom.

Each Luxembourg Partnership will also be subject to Luxembourg's general commercial and civil rules. In addition, a Luxembourg Partnership will be subject to a specific Luxembourg funds law if it elects for that law to apply to it (see *Regulatory regimes*) and, to the extent applicable, the supervision of the *Commission de Surveillance du Secteur Financier*, Luxembourg's financial regulator (CSSF).

Salient features of Luxembourg Partnerships

The principal difference between the SCS and the SCA regimes on the one hand, and the SCSp regime on the other, is that an SCS and an SCA has legal personality separate from that of its partners (by virtue of section 100-2 of the 1915 Law) whereas an SCSp does not have legal personality separate from that of its partners. Nevertheless, an SCSp is entitled to hold and register assets and open bank accounts in its own name.

Another difference is that an SCS and an SCA is required to prepare annual accounts, whereas an SCSp is not required to do so.

Regulatory regimes

A Luxembourg Partnership (or any other relevant Luxembourg entity) may opt into one of the following fund regimes available in Luxembourg:

- Reserved Alternative Investment Funds (RAIFs).
- Specialised Investment Funds (SIFs).
- Investment Companies in Risk Capital (SICARs).

Where a Luxembourg Partnership is subject to one of these regimes, specific provisions will apply to that Luxembourg Partnership in addition to the relevant provisions of the 1915 Law.

The application of one of these regulatory regimes can provide additional structuring flexibility and help to accommodate specific commercial and regulatory considerations. Examples of the implications for a Luxembourg Partnership of opting in to one of these regimes include the ability to structure that Luxembourg Partnership as an umbrella fund with multiple compartments or sub-funds (with legal segregation of assets and liabilities to the extent provided under the relevant law), the ability to market interests in that Luxembourg Partnership to "well-informed investors" and the application of specific tax regimes.

Reserved Alternative Investment Fund

A Luxembourg Partnership may be structured as a RAIF, which is not subject to direct supervision by the CSSF and is governed by the Luxembourg law of 23 July 2016 on Reserved Alternative Investment Funds. The ability to establish a RAIF relatively quickly makes it an attractive vehicle for fund sponsors and investors.

That law (rather than the *Alternative Investment Fund Managers Directive* (*2011/61/EU*) (AIFMD) itself) requires each RAIF to be managed by an authorised alternative investment fund manager (AIFM). Each RAIF therefore benefits from the AIFMD marketing passport and an appropriate person may market interests in that RAIF to professional investors in the *European Economic Area* on the basis of the AIFMD passport.

Specialised Investment Fund

A Luxembourg Partnership may be structured as a SIF, which is an operationally flexible and fiscally efficient multi-purpose investment vehicle for institutional and qualifying investors. SIFs are governed by the Luxembourg law of 13 February 2007 on Specialised Investment Funds and are regulated by the CSSF. Whilst there are no restrictions on the type of assets in which a SIF may invest, a SIF is subject to risk diversification requirements.

It is possible for a SIF to be treated as an "alternative investment fund" (AIF) under the AIFMD. It will be necessary for a SIF to be treated as an AIF and managed by an authorised AIFM in order to benefit from the AIFMD marketing passport.

Investment Company in Risk Capital

A Luxembourg Partnership may be structured as a SICAR, a regime which was implemented specifically to facilitate investments in venture capital. SICARs are governed by the Luxembourg law of 15 June 2004 relating to the Investment Company in Risk Capital and are regulated by the CSSF.

In contrast to a SIF, a SICAR is not subject to any risk diversification requirements. A SICAR is, however, permitted to invest solely in assets which represent risk capital. In this context, "risk capital" means the direct and indirect contribution of assets to entities in anticipation of their launch, development or listing on a stock exchange.

Only SICARs which are managed by an authorised AIFM can benefit from the AIFMD marketing passport.

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 Scottish 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, 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 regime 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 of Companies, 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 and 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 based 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 sponsors 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 has unlimited liability for the debts and obligations of the limited partnership and is ultimately responsible for the management of the limited partnership (although it will typically delegate substantially all of that responsibility to an investment manager for regulatory and practical reasons). Almost invariably, the general partner of a venture capital fund will be a private limited liability entity that is formed by the principals and/or sponsor of the venture capital fund.

In the case of a Luxembourg Partnership, its general partner will typically be a *société à responsabilité limitée*, known as a SARL, which is a limited liability company which will have paid up share capital of €12,000 or more.

In general, the general partner of a Luxembourg Partnership will hold 5% or less of the interests in that limited partnership in order to avoid the risk of that general partner being regarded as engaging in commercial activity (which would lead to adverse consequences).

There is no requirement under Luxembourg law for the general partner of a Luxembourg Partnership to be established under Luxembourg law. Typically, however, that is the case. It is also possible for a Luxembourg Partnership to have more than one general partner.

In the case of an English limited partnership, its general partner would be a private limited company, typically with paid up share capital of about £100, or a LLP formed under the *Limited Liability Partnerships Act 2000*.

Limited partners

The limited partners are responsible for contributing most of the fund's capital (see *Capital contributions*). A limited partner's liability is generally limited to the amount of its commitment to the limited partnership under the limited partnership agreement which governs the limited partnership.

Limited partners may be institutional investors such as endowments, family offices and pension funds. They may also be high net worth individuals who 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.

Since the 1915 Law does not provide rules which govern withdrawals or transfers, the limited partnership agreement of a Luxembourg Partnership should contain appropriate provisions about the withdrawal and transfer of interests in that Luxembourg Partnership.

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). Under the 1915 Law, limited partners in a Luxembourg Partnership are prohibited from carrying out acts of management so as to bind that Luxembourg Partnership. The 1915 Law does, however, specify a number of internal acts of management that a limited partner may undertake in relation to the limited partnership without compromising its status and limited liability. Failure to adhere to these constraints may result in the limited partner being liable to persons who conduct business with that Luxembourg Partnership.

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*).

Investment managers and advisers

Most funds (or their general partners) appoint an investment manager or investment adviser (or both) to manage the fund's investments and to advise the fund about its investment strategy. The investment manager or investment adviser is usually a limited liability entity which is duly authorised by the regulatory authority in its home jurisdiction. The investment manager may be part of an established fund management group or an affiliate formed by the fund's principals.

Advisory and investment 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 in cash or in kind on admission as a limited partner).

Under the 1915 Law, a limited partner in a Luxembourg Partnership may make its contribution in cash, in kind or in the form of services.

The investment 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 which that investment manager 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, tobacco, and increasingly to comply with environmental, social and governance (ESG) principles (for further information on ESG principles, see *Environmental, social and governance (ESG) toolkit*).

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).

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), LPA 1907*).

In the case of Luxembourg Partnerships, all distributions, clawbacks, givebacks and escrow or similar arrangements are simply dealt with in the limited partnership agreement and are therefore a matter of negotiation amongst the partners.

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 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 the limited partners.
- Next, provided that the capital contributions of the 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 subsequently 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 sponsors 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.

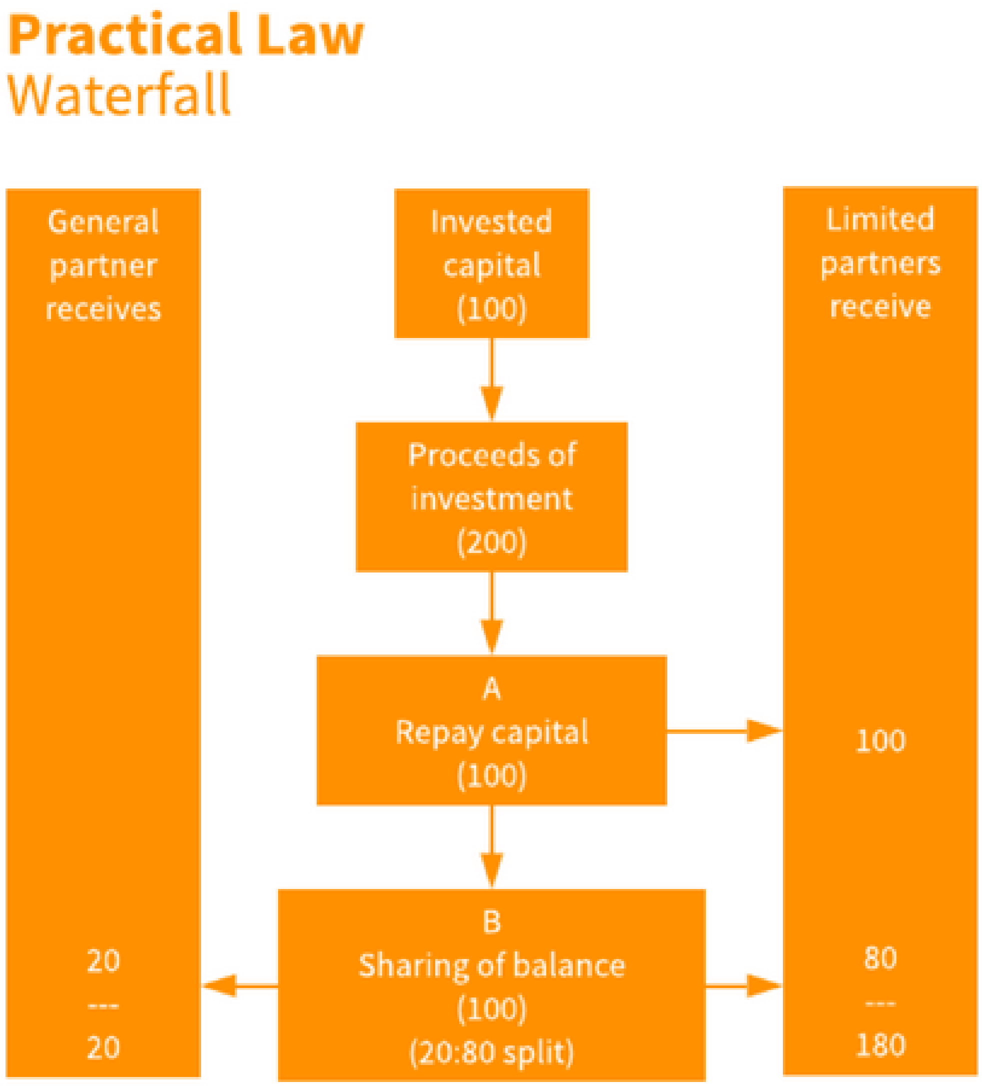
Many English and Luxembourg funds also provide for tax distributions to be made prior to any other distributions. These are payments from the venture capital fund to its partners, or often just its general partner, to cover the tax payable on allocated profits. In the absence of a tax distribution, a 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.

Luxembourg Partnerships are able to accommodate a wide variety of waterfall models.

Timing of distributions

The timing of distributions will be set out in the limited partnership agreement and will often 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 an English or Luxembourg fund, the carried interest will generally be payable to a carried interest vehicle which is an affiliate of the general partner as an allocation of the fund's profits.

For teams of principals based in the UK, 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.

Taxation considerations for executives of venture capital funds are substantially similar to those applicable to private equity executives. For a 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 investment manager of the venture capital fund will usually be paid a management fee, in accordance with the provisions of the limited partnership agreement, often 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 Luxembourg fund, the investment 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 investment 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 investment management fee is typically between 1% and 2% 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 investment 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 investment 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 (commonly known as the PPM), 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 Luxembourg.

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 investment 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.
- 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 considerations*).

The AIFMD prescribes certain information which must be included in the offering memorandum for a venture capital fund where the AIFMD applies to that venture capital fund. For more information, see *Practice note, AIFMD: disclosure and reporting obligations*.

Limited partnership agreement

The terms that govern the relationship between the partners are set out in the limited partnership agreement of the fund. Both applicable English and Luxembourg 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 an elaborate limited partnership agreement (as supplemented by an offering memorandum). 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 20%) 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 and/or ESG 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 investment 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 key person provisions, 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 investment 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 investment manager or investment adviser is regulated by the *Financial Conduct Authority*, it has breached a provision of the *Financial Services and Markets Act 2000*, as amended (FSMA) (see *Specific UK regulatory considerations*).
- 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).

Investment management/advisory agreements

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

The investment management agreement is usually made between the fund, acting through its general partner, and the investment manager. For funds with a separate investment adviser there will also be an advisory agreement made between the investment 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)* (RAO). For more information, see *Practice note, General exclusions in the RAO*. 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 or Luxembourg, as appropriate, will often appoint a third-party service provider to act as the investment manager, or AIFM, 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.

- A range of KYC/AML information to be provided by the prospective investor.

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 considerations*).

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, good standing and capacity of the limited partnership and the general partner and the due admission of the limited partners to the limited partnership. 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 often be regulated by the documents that govern 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 considerations

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

AIFMD

The AIFMD introduced a harmonised regulatory framework for managers of AIFs, including requirements relating to authorisation, administration, remuneration, marketing and depositaries (see *Practice note, A guide to the AIFMD: index*). Crucially, the AIFMD can apply under certain circumstances to managers that are based outside the EU.

Both the UK and Luxembourg implemented the AIFMD into their domestic law by 22 July 2013 (as required by the AIFMD).

The most attractive feature of the AIFMD for fund sponsors is the ability to take advantage of a marketing passport whereby an AIFM may market interests in a venture capital fund which it manages to professional investors in any member state of the EU without needing to comply with the national private placement rules of each relevant member state of the EU.

Nevertheless, the AIFMD itself imposes certain requirements on AIFMs which wish to manage AIFs or market interests in venture capital funds in the EU, and it is not the case that all member states of the EU have implemented the AIFMD into their domestic law in an identical manner or that the regulatory authorities in each member state of the EU interpret the AIFMD in the same manner.

The UK withdrew from the EU at 11.00 pm GMT on 31 January 2020 upon the coming into force of the UK-EU Withdrawal Agreement.

The withdrawal agreement provides for a "transitional period" which the UK and the EU have agreed will remain in place between 1 February 2020 and 31 December 2020 in order to enable the UK and the EU to negotiate additional arrangements in respect of that withdrawal. The withdrawal agreement continues many aspects of the relationship between the UK and the EU and the AIFMD will remain in force in the UK throughout that transitional period. For more information about the impact of Brexit on AIFMs and their funds, see *Practice note, UK implementation of AIFMD: Impact of Brexit*.

Specific Luxembourg regulatory considerations

To the extent that a Luxembourg Partnership opts into a specific regulatory regime in Luxembourg (see *Regulatory regimes*), it will need to comply with the requirements of that regime. The regime for SICARs and the regime for RAIFs that operate on the same basis as SICARs (which invest exclusively in risk capital investments) were specifically implemented for funds pursuing venture capital investments.

Unless a relevant exemption applies, the offering of interests in a Luxembourg Partnership may be subject to *Prospectus Regulation((EU) 2017/1129)* and therefore the Luxembourg Law of 16 July 2019 on Prospectuses for Securities.

The provision of management, advisory and arranging services to a Luxembourg Partnership or its investors in or from Luxembourg are regulated activities under Luxembourg law and only persons which are authorised by the CSSF may carry out those functions, unless an exemption applies.

Specific UK regulatory considerations

In addition to the AIFMD, the following UK regulatory considerations apply to venture capital funds:

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 RAO (see *Practice note, Regulated activities: establishing, operating or winding up a collective investment scheme*).

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

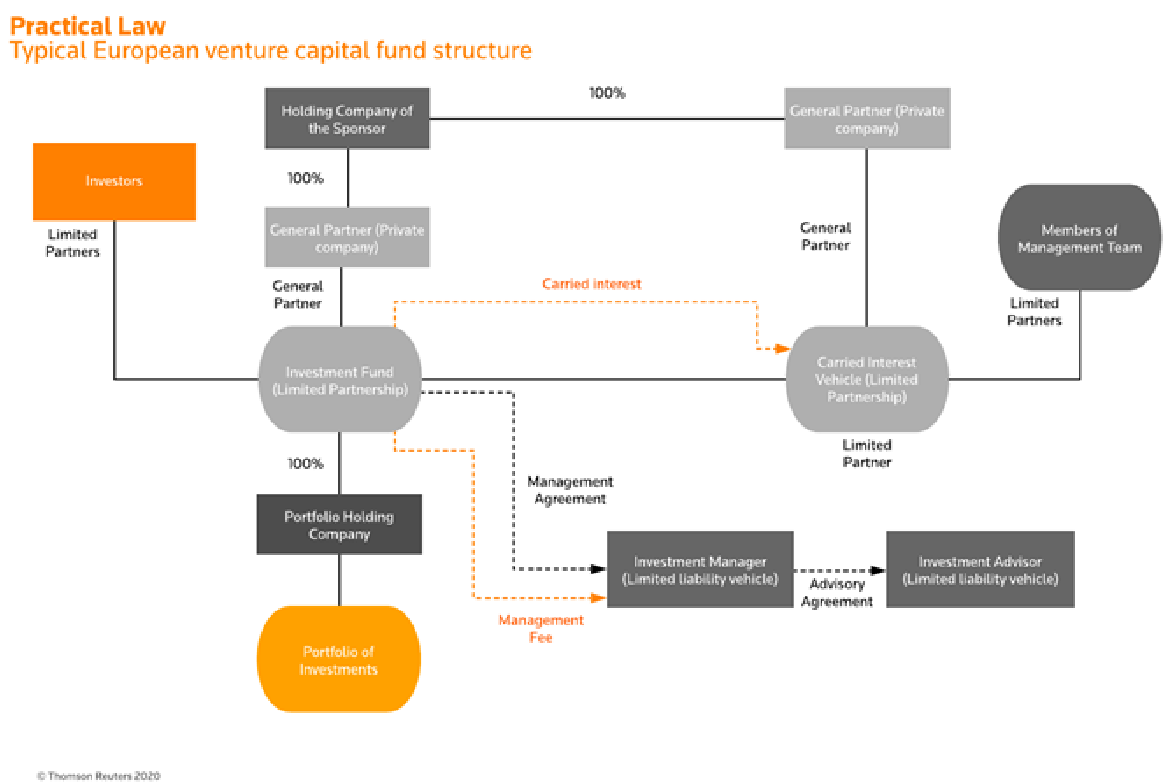
Investment management and advisory activities

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 RAO, 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 under the AIFMD and/or the UK financial promotion regime (see *Practice note, Restrictions on the promotion of collective investment schemes*).

Typical European venture capital fund structure



Fund descriptions

Funds are often described according to their purpose, sector or background. These are some of the more common fund labels:

- **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 underlying 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.
- **Infrastructure funds** generally invest in large infrastructure projects with a view to ensuring predictable income flows.
- **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 estate funds** invest in real estate and real estate related assets (with strategies which include core, opportunistic and value-add).
- **Secondary funds** are funds that specialise in acquiring interests in funds through the secondary market, rather than the primary market. Ownership in an existing 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.

Andrew Wylie is a Partner and International Head of Investment Funds at DLA Piper, London, Michelle Barry is a Senior Associate and Johan Terblanche is Head of Investment Funds and Managing Partner of Maples and Calder, in the Maples Group's Luxembourg office.

END OF DOCUMENT

