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Private Equity *Fundraising*

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The offering memorandum

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Introduction

Generally, there is no law or regulation that prescribes the form or content of an offering memorandum for a private placement in the UK or US, however, the offering memorandum must comply with applicable securities laws for a private placement of securities which, in the UK and the US, generally requires that all material facts are disclosed and there is no omission of a material fact that would make the disclosure misleading.

In practice, the form and content of offering memoranda vary from fund to fund, but a general market practice has evolved. This chapter outlines the general market practice, including:

- the purposes of the offering memorandum;
- the stages in the life of the offering memorandum;
- sponsor considerations;
- the contents of the offering memorandum;
- the key fund terms that are disclosed in the offering memorandum;
- the verification and updating process; and
- certain marketing and regulatory considerations.

Purposes of the offering memorandum

There are two main purposes of an offering memorandum: (1) to market and promote the fund and its securities, including by describing the key terms of the securities being offered; and (2) to provide legal protection by describing the risks involved and applicable regulatory and tax matters.

Marketing

The offering memorandum is a key marketing tool in offering fund interests. It contains a description of distinguishing factors for the particular fund, including its size, sponsor firm, investment strategy, market opportunity, investment principals, investment process and key terms. A fund sponsor distributes the offering memorandum to each potential investor at the start of the marketing process, but often the fund sponsor will pre-market to a potential investor in person. In the pre-marketing phase, a fund sponsor will typically present an abbreviated or initial short form of the offering memorandum in a 'teaser' or 'flip book' presentation as described below in the section entitled 'Stages of the life of the offering memorandum – Teaser'.

The offering memorandum also serves as the starting point for the business due diligence process as investors in a fund perform detailed business due diligence on the fund and its sponsor, including examining the track record of the investment principals and investment process. In connection with preparing the offering memorandum, the fund sponsor collects, organises and verifies the relevant due diligence information.

Finally, as part of marketing the fund interests, the fund sponsor proposes the fund's key terms. A fund sponsor may engage in the pre-marketing period with a select group of key investors (often referred to in the UK as 'cornerstone investors' and in the US as 'bell cow investors') who may receive a draft of the teaser or offering memorandum and be given an opportunity to comment on the fund's key terms. In these cases, the cornerstone or bell cow investors effectively negotiate the fund terms on behalf of all investors because, after the key terms are circulated more broadly to potential investors, the fund sponsor likely will resist changing those terms as they would have been negotiated with such (usually) substantial investors and smaller investors typically will have less leverage to negotiate further changes.

Legal protection

Because the offering memorandum is used to offer securities, all material terms and conditions must be disclosed without any omission of a material fact that would make the disclosure misleading. Accordingly, all relevant material risk factors and investment considerations should be included in the offering memorandum, as well as a discussion of relevant tax and other regulatory considerations and it is considered best practice to also include a listing of securities law legends setting forth the restrictions on offering securities in the jurisdictions in which offers will be made.

In addition, the offering memorandum, together with the fund's subscription agreement, are used to limit the information on which investors may rely. To acquire fund interests, an investor must enter into a subscription agreement, which includes a representation and warranty by the investor that, in making its investment decision, the investor is not relying on any information or materials other than those contained in the offering memorandum, the subscription agreement and the partnership agreement. By limiting an investor's reliance to the fund's offering materials, which are carefully reviewed and verified, such representation and warranty is intended to foreclose reliance on other statements, for example, those made during an investment presentation.

Stages in the life of the offering memorandum

Teaser

A 'teaser' or 'flip book' is an initial condensed version of the offering memorandum that may be prepared and distributed to investors before the longer offering memorandum is completed. The teaser is often in the form of an investor presentation or flip book and the fund's principals often discuss it in their initial meeting with a potential investor.

The teaser generally contains a high level description of the fund, including its targeted size, investment objectives, key principals and, more commonly for US funds, a summary of the historical investment performance or track record of the fund's principals. It may be unverified (see the paragraph headed 'Verification'), although it is advisable to do so.

Draft offering memorandum

More commonly for UK funds, an offering memorandum is prepared and circulated to potential investors and, in the case of Guernsey and Luxembourg funds, sent to the local securities regulators in draft form. The draft offering memorandum is referred to as a 'red herring' and is marked as a draft prominently on the cover and elsewhere in the offering memorandum. Despite being in draft form, this version of the offering memorandum typically contains all of the information that is in the final offering memorandum, absent changes that result from negotiations with investors or subsequent events that occur between the time the draft and the final version of the offering memorandum is prepared. When a draft offering memorandum is used, the final version is typically distributed to investors prior to the fund's first closing.

US funds typically do not make use of a 'draft' offering memorandum. Instead, US funds generally finalise the offering memorandum before it is sent to investors and any subsequent material changes prior to the initial closing are disclosed in one or more addenda or supplements as described below.

Final form offering memorandum; pre-initial closing addenda

As noted above, the final form of offering memorandum is prepared and distributed to all investors before the fund's first closing. The final form of offering memorandum reflects all material changes to the draft offering memorandum, including any changes to the fund's terms that were negotiated by investors. Where a draft offering memorandum is sent to investors, the final version of the offering memorandum is also sent to investors prior to closing together with a marked version showing all changes made since the prior draft. Where a final offering memorandum has been sent to investors prior to final negotiations, one or more pre-closing addenda or supplements are circulated describing the changes to such offering memorandum.

Addendum for a subsequent closing

An addendum to the offering memorandum must be prepared and distributed prior to a subsequent closing if there is a material change in the information contained in the offering memorandum. Changes that are commonly disclosed in an addendum include (1) material changes to the key fund terms negotiated by investors after the first closing and before such subsequent closing, (2) the identity and size of investments made by the fund in portfolio companies after the first closing and before such subsequent closing, and (3) updates to the track record if it has become materially outdated, including where, as is common recently, market conditions indicate weaker performance for portfolio company investments than was the case at the start of the fund raise. The fund sponsor must consider whether a subsequent addendum is required prior to each closing, bearing in mind that the offering memorandum must be clear, fair and not misleading.

Sponsor considerations

The fund sponsor (i.e., the private equity firm or institution that is raising the fund) typically controls the fund's management, receives all or a significant portion of the fund's carried interest and management fees, and controls the drafting and finalisation of the offering memorandum. The fund sponsor's firm name is typically used in the fund's name and on the cover of the offering memorandum. Due to its control of the fund, the firm may have legal liability for any material errors in, or omissions from, the contents of the offering memorandum, although there are methods of mitigating this potential exposure. Accordingly, the fund sponsor must be diligent in verifying all information contained in the offering memorandum.

An institutional fund sponsor typically includes a discussion of its investment business in the offering memorandum. For example, an institutional firm that has multiple fund products or services (e.g., a firm that has private equity funds, real estate funds, debt investment funds, corporate or other advisory services and/or alternative asset management funds) may include a general description of such businesses. Those fund sponsors also typically describe in more detail the actual or potential conflict of interest risks that may exist between the fund and the fund sponsor's other fund products and/or services.

Contents of the offering memorandum

While the form and content of offering memoranda vary from fund to fund, a fund's offering memorandum generally contains the following sections:

Executive summary

The executive summary introduces the strategy for the fund, the most senior fund principals who manage investments for the fund, a summary of their track record and a summary of the investment criteria for the fund.

Investment highlights

The investment highlights section provides a detailed discussion of the investment strategy for the fund and the process by which investments will be made. This section is one that varies in large part from fund to fund and is typically written by the fund's principals themselves. In describing its investment strategy, a fund typically identifies its target market (e.g., start-up companies, mid-market companies, carve-out or management buyout opportunities, etc.) and geographical scope (e.g., Europe, North America, Asia, etc.). A fund may also discuss the reasons it believes the fund's target market is ripe with investment opportunities. If the fund has an anchor investor, the investor's name and commitment amount also may be included. A fund also outlines its investment process beginning with its anticipated deal flow sources, continuing with its due diligence, investment approval and monitoring processes, and ending with its anticipated exit strategies.

Historical performance

This section sets forth the historical investment performance or track record of past investments with respect to which the fund's principals made investment decisions, whether those past investments were made by a predecessor fund affiliated with the fund's sponsor or, made by a fund managed by a different fund sponsor. Issues that may arise when using a different sponsor's information are discussed in the sec-

tions entitled 'Verification' and 'Marketing and regulatory considerations' below and the fund may need to secure the consent of such other fund sponsor. In addition, the fund must comply with any confidentiality restrictions it has with respect to disclosing information regarding its portfolio companies. Finally, where a fund's general partner or management company is an investment adviser registered with the US Securities and Exchange Commission (SEC), certain requirements under the US Investment Advisers Act of 1940, as amended (the Advisers Act), must be followed when an offering memorandum presents historical performance. These Advisers Act requirements are discussed below in the section entitled 'Marketing and regulatory considerations'.

Investment experience

This section outlines the investment experience of the fund's principals. For each key principal on the investment team and, for larger or institutional funds, each member of the legal and accounting teams that are involved in structuring and closing fund investments (e.g., the CFO and general counsel), their name, age, prior work experience and educational background are typically listed.

Trends in the relevant industry

This section outlines the trends in the industry in which the fund is investing (e.g., healthcare, financial services, technology, real estate). Through its discussion of market trends, the fund sponsor seeks to distinguish itself from its peer funds by demonstrating its expertise in the industry.

Summary of principal terms

The summary of principal terms sets forth the key fund terms that are included in the fund's partnership agreement. This section is typically drafted by the fund's legal counsel and is used to draft the fund's partnership agreement. If, during the course of negotiations with investors, these terms change in any material respect, the fund issuer must supplement or revise this section of the offering memorandum (i.e. through use of an addendum) and circulate it to investors prior to closing their subscriptions in the fund.

Certain investment considerations; risk factors

This section outlines the material risks involved in making an investment in fund interests. This section is typically drafted by the fund's counsel for inclusion in the offering memorandum. It describes the business, market, industry and other risks involved in making an investment in a fund. While this section may vary only slightly from fund to fund because there are common risks involved in private equity investing, care must be taken to tailor the risks to the specific fund and offering. For example, infrastructure funds have different risk profiles than buyout funds.

Legal and tax matters

This section describes the regulatory and tax considerations in making an investment in a fund. Typically, the regulatory discussion describes applicable securities laws and the rules under the US Employee Retirement Income Security Act of 1974, as amended (ERISA), that apply to a fund. Under ERISA, a fund's manager may be treated as a fiduciary with respect to the fund's ERISA investors, unless an exception is available. Because burdensome ERISA requirements would apply if a fund's manager is a fiduciary under ERISA, most funds seek to comply with one of two exceptions by (1) becoming a venture capital operating company or (2) limiting commitments from benefit plan investors to less than 25 percent of commitments (excluding commitments from the general partner and its affiliates).

The securities law disclosure describes the private placement exemption for the offering of fund interests under the securities laws of the country in which the fund is located or organised, restrictions on transfer of fund interests and, for funds with US investors, the fund's exemption from being required to register as an investment company under US federal laws. In addition, for an offering of fund interests to investors in jurisdictions other than the country in which the fund is located or organised, securities law legends are often included to make required disclosures under the securities laws of those other jurisdictions. The legends vary by jurisdiction and may include (1) a statement that an offer is being made only to the recipient of the offering memorandum and may not be made to the public, (2) a citation to the exemption from registra-

tion in that jurisdiction, (3) a limitation on how the offering must be made in such jurisdiction (e.g., only to a limited group of investors or only through a placement agent), (4) a statement that the securities have not been registered under the laws of the local jurisdiction, and/or (5) a statement that the regulatory authority in the local jurisdiction has not approved the offering of the interests in the fund or the contents of the offering memorandum. The securities law requirements for UK offerings and US offerings are discussed in greater detail at the end of this chapter in the section entitled 'Marketing and regulatory considerations'.

The tax matters disclosure addresses the tax treatment of the fund (typically, a partnership or flow-through vehicle, and not a separate taxable entity, under the laws of the country in which the fund is domiciled), considerations for investors in the country in which the fund principals are located (e.g., the UK or US) and, depending on the fund, other relevant jurisdictions (e.g., where investments will be made). The tax section may also address considerations for US tax-exempt investors and non-US investors and certain state and local tax considerations.

Summary of selected investments

Many funds elect to include a section summarising selected investments from prior funds (i.e., prior portfolio companies) to highlight the details of those investments. This often is in the form of a short case study for each such portfolio company and it typically includes a summary box containing the name and location of the company, the date of the initial investment, the prior fund that made the investment, the amount invested, the value realised and the estimated current value of the investment (if not fully realised), in each case, as of a date prior to the date of the offering memorandum. Following such summary information a description of the business of the portfolio company, the structure and background of the acquisition of the portfolio company, the investment rationale, any liquidity events to date and, if the portfolio company investment has not been fully liquidated, the exit strategy would be set out.

Index of defined terms

A separate index of defined terms is sometimes included instead of defining terms throughout the offering memorandum. This is more commonly used for UK funds and for hedge funds and real estate funds where complicated net asset value and internal rate of return formulas are used in defining how the fund will distribute proceeds among the general partner and the investors.

Key terms

The following summarises the key fund terms. These key terms are set forth in the offering memorandum, but are qualified completely by reference to the more detailed provisions contained in the fund's partnership agreement.

Structure of the fund

Private equity funds are typically structured as one or more limited partnerships, whether they are organised in the UK, the US (typically in Delaware), the Cayman Islands or the Channel Islands. The fund's structure is generally determined based upon the composition of the fund's anticipated investor base. Considerations for creating separate funds include (1) the number of investors and their net worth and (2) the tax status of such investors (e.g., tax-exempt investors may require a structure that, for tax purposes, blocks unrelated business taxable income or 'UBTI', which is taxable to them despite their tax-exempt status).

In addition, to provide flexibility after the initial closing, funds may reserve the ability to create 'alternative investment vehicles', 'parallel funds' and 'executive funds'. Alternative investment vehicles are created at the time a fund invests in a portfolio company where the nature of such investment requires a different structure, generally in regulated industries. Parallel funds are created during the fundraising process to address an investor's or a group of investors' particular requirements. Executive funds are sometimes also created to allow certain employees of, and other persons affiliated with, a fund sponsor to invest. Such parallel funds and executive funds typically invest together with the fund on a side-by-side basis, whereas when an alternative investment vehicle is created, it typically makes an investment in a portfolio company in lieu of the fund (and each investor in the fund typically invests through the alternative investment vehicle, in lieu of the fund).

Management/advisory company

The fund's general partner is typically responsible for the management services provided to the fund. However, for some funds, the general partner may appoint a separate management company, controlled by the fund sponsor, to perform management services (including investment advisory services) for the fund or, alternatively, to provide only investment advice with respect to fund investments. Typically, entities that provide only advisory services are not authorised to make investment decisions on behalf of the fund. A fund may consider the following factors in determining whether to implement a management company structure: (1) the ability to manage multiple fund products through one entity and (2) tax and/or regulatory considerations, including the requirement in the UK, generally, that a UK firm providing management and/or advisory services must be authorised by the UK regulatory body, the Financial Services Authority (FSA).

Target size of fund

This section identifies the targeted amount of commitments the general partner seeks to raise from investors, and the fund sponsor will reserve the right to accept aggregate commitments less then this targeted amount. Investors may seek a hard cap on the fund's size based on the size of targeted investments, the investment team and their historical investment pace or to provide the investors with certainty as to how much their ownership (i.e., percentage of aggregate commitments) may be diluted in subsequent closings. Often, a fund sponsor may also indicate the minimum amount of commitments it intends to accept from any one investor, but reserves the right to accept a lesser amount.

This section also may set forth the amount of capital that the general partner and its affiliates will commit to the fund. The amount commitments from a general partner and its affiliates varies from fund to fund, but generally ranges from 1 to 5 percent of aggregate fund commitments. Investors view more as better because larger general partner commitments align the interests of the general partner with those of the investors with respect to capital at risk.

Closings; effective date

In this section, the fund identifies the anticipated timing for the first closing and reserves the right to have subsequent closings. Investors typically require an end date after which no new commitments may be accepted (frequently, the first anniversary of the initial closing date). Investors may also negotiate the minimum amount of commitments required before an initial closing can take place.

A fund may raise commitments from investors and close those commitments before it is ready to start investing. This is often the case when the prior fund has time before its investment period expires and capital available to make new investments. In such cases, the fund implements an effective date concept, where the 'effective date' is the date on which the fund begins to actively seek new investment opportunities. When used, the fund's management fee, investment period and term typically will commence on the effective date rather than the first closing date.

Investment period

The investment period is the period during which a fund may make new investments. This period typically ranges from five to six years after the fund's initial closing or effective date, and is generally subject to early termination upon a key-person event (described below) and, in some funds, upon requisite vote of investors (e.g., investors holding 75-85 percent of commitments) for any reason. A fund reserves the right to call commitments after the investment period to (1) pay for expenses, liabilities and other contingent obligations of the fund, (2) fund then existing commitments and complete investments by the fund that were in process at the end of the investment period and (3) make follow-on investments in existing portfolio companies. Investors may seek to limit the amount of follow-ons pursuant to clause (3) above permitted after the investment period (e.g., to 15 percent or 25 percent of aggregate commitments) in order to limit their post-investment period obligation to fund capital.

Term; early termination

The partnership term typically ends on the ten-year anniversary of the initial closing date or effective date,

subject to extension by the general partner for additional one-year periods (typically up to two/three additional years) and subject to early termination. Investors typically seek to limit the number of times the general partner can extend the fund's term without investor or advisory board consent. Investors also frequently seek the right to terminate the fund early, for example, upon a majority vote of investors 'for cause' or upon a higher percentage investor vote for any reason. Early termination generally is viewed as a 'nuclear' option for investors because if a fund liquidates early, each investor would receive a distribution of illiquid securities in fund portfolio companies without the benefit of having a general partner or management company managing the exit opportunities for those investments. Also, any such distribution may be restricted under the governing documents of the applicable portfolio company.

Investment limitations

A fund typically has a diversification limitation that limits the amount of investments it may make in any one portfolio company (e.g., the fund will not invest more than 20-30 percent of commitments in any one portfolio company). A fund that permits bridge financing (i.e., where the fund invests a larger amount than ultimately desired in a portfolio company with the expectation that it will sell down such investment to a co-investor within 12 to 18 months thereafter) may have a baseline diversification limit (e.g, 20 percent of commitments) and a higher diversification limit when bridge financings are involved (e.g., 30 percent of commitments). Other limitations (for example, limits on investing in jurisdictions outside of the fund's main regional focus) may or may not be referenced in the offering memorandum, but are more fully described in the partnership agreement.

Drawdown and default provisions

A fund draws down or calls capital from time to time to pay expenses, including management fees, and to fund investments. A fund typically gives its investors at least ten business days notice before the required funding date. If an investor does not fund its capital call when due, the general partner may take a number of actions after giving the defaulting investor notice and time to cure the default. The remedies available to the general partner are not typically detailed in the offering memorandum, but are set forth in the partnership agreement.

Distribution mechanics; carried interest

A fund typically distributes proceeds from investments (other than short-term investments) according to a distribution 'waterfall'. This waterfall defines the economic relationship among the general partner and the investors. While the waterfall varies from fund to fund, many US buyout funds distribute investment proceeds in the following order and priority:

1. first, return of contributed capital with respect to realised investments;
2. second, return of contributed capital with respect to a portion of funded expenses (typically in the proportion of realised investments to either commitments or contributed capital);
3. third, preferred return on contributed capital plus a portion of funded expenses (in the same proportion as described in (2) above);
4. fourth, the general partner receives a 'catch up' distribution so that it receives 20 percent of the aggregate amount distributed under the preferred return clause (3) above and this clause (4); and
5. fifth, thereafter, 80 percent to investors and 20 percent to the general partner.

The 20 percent distribution to the general partner described in clauses 4 and 5 above is referred to as the 'carried interest'.[1] Under this approach, the general partner is typically subject to a clawback at the end of the fund's life as described below in the section entitled 'General partner clawback; escrow accounts'.

In the UK, funds historically utilise a 'fund-as-a-whole' model. Before the general partner receives any carried interest distributions, (1) in the standard fund-as-a-whole model, a typical fund returns all drawn capital and preferred return thereon in respect of all investments (whether or not realised) pro rata based on commitments and (2) in the 'super' fund-as-a-whole model, a typical fund returns all commitments (whether drawn or undrawn) plus preferred return on drawn amounts pro rata based on commitments. The

super fund-as-a-whole model generally includes an investor clawback at the end of the fund's life to ensure that the investors are not paid more than their aggregate 80 percent of fund profits.

General partner clawback; escrow accounts

In order to ensure that the general partner receives no more than a 20 percent interest in fund profits, US funds typically incorporate the concept of a general partner clawback. The clawback requires the general partner, at the end of the fund's life, to return to the fund (1) the amount of carried interest distributions it received in excess of 20 percent of the fund's net profits or (2) if the fund has a preferred return, the amount of carried interest distributions received to the extent the investors and the general partner have not received their preferred return on invested capital, in each case, less income taxes thereon. Such returned amounts are then distributed to all investors and the general partner through the waterfall.

Historically in the UK, general partner clawback obligations were rare because investors relied upon an escrow mechanism to prevent overpayment of carried interest to the general partner. The styles of escrow accounts varied from fund to fund, but the basic purpose of the escrow account is to ensure that any accrued carried interest, or a portion thereof, is retained in an escrow account and not distributed to the general partner until it was determined pursuant to a particular formula that no overpayment or clawback risk existed.

Management fee; general partner's share; fee income

A fund typically pays a management fee to the general partner or management company which also will cover all ordinary administrative and overhead expenses incurred in connection with making and monitoring investments. In the UK this is often structured as a profit share so as to obviate VAT concerns and should be referenced as a 'general partner's share'. Where a fund pays management fees, such fees reduce the amount of the fund's commitments available to invest. In a minority of funds, investors may pay a management fee directly to the general partner or management company outside of the fund and in addition to their capital commitment. Under this approach, management fees do not reduce commitments available to the fund to invest.

Management fees typically range from 1.5 to 2.5 percent per annum of an amount equal to (1) during the investment period, capital commitments and (2) thereafter, unreturned invested capital. In some funds, investors negotiate a reduction to the management fee following a key person event, such that the management fee is calculated using the post-investment period formula in clause (2) above. In most funds, management fees are reduced by 50-100 percent of any breakup fees, monitoring fees (e.g., directors' fees or advisory fees) and transaction fees (e.g., underwriting, syndication or success fees) received by the general partner, management company or their affiliates in connection with a fund investment.

Many funds are structured such that the general partner and its affiliates are not required to fund capital calls for management fees. The rationale is that it is more efficient for the general partner and its affiliates not to become out-of-pocket to pay themselves a fee.

Organisational expenses; fund expenses

Organisational expenses are the costs involved in raising the fund, including legal, travel, accounting, filing, printing and capital-raising costs. Investors typically negotiate a cap on the amount of organisational expenses that are paid by the fund (either a percentage of commitments or a fixed monetary amount). The general partner or fund sponsor will pay for any organisational expenses in excess of such cap and typically will bear all placement fees, in particular: a US fund typically will pay the placement fee to the placement agent and thereafter reduce its payment of management fees to the general partner or fund sponsor by an equal amount. The fund (and therefore the general partner and the investors) pays the fund's costs and expenses that are not reimbursed by portfolio companies, including legal, auditing, consulting, financing, accounting and custodial expenses, expenses of the fund's advisory board and expenses involved in preparing tax reports.

Borrowing and guarantees

For UK funds, limitations on borrowing and guarantees by the fund are typically set forth in the offering memorandum. For US funds, limitations on the generation of unrelated business taxable income (UBTI) or effectively connected income (ECI) are typically set forth in the offering memorandum. UBTI restrictions limit the amount of fund investments that are debt-financed, and UBTI and ECI restrictions limit the amount of fund investments made in operating companies organised as flow-through vehicles for tax purposes. Typically, a fund's ability to incur indebtedness is limited to a percentage of commitments, except that a fund may, pending a capital call or during some other short time period, incur indebtedness to fund an investment or pay expenses. Guarantees are also typically limited by amount.

Key-person provisions

Key-person provisions are referenced, and may be summarised, in an offering memorandum. A key-person provision gives the investors the ability to terminate the investment period early if a specified number of key principals cease to be active in the fund's affairs. This is one of the most sensitive topics both (1) for the investors as between the investors and the fund because the investors generally make their investment decision in large part on the identity and track record of the fund's principals and (2) for the fund's principals as among themselves because it may make a fund principal more dependent on other fund principals upon certain events, such as the death or disability of another key person fund principal.

The number of key principals covered by this provision varies from fund to fund and depends on the number and identity of the key principals who are capable of running the fund's operations in the event other key principals are no longer devoting the requisite amount of time and attention to the fund's affairs. The requisite amount of time required to be spent on the fund's affairs varies by fund and by key principal. For large organisations, the most senior principals may have duties not only to the fund, but also to other fund products managed by the sponsor. For smaller organisations, investors typically require that the fund's principals devote a majority or substantially all of their business time and attention to the fund's affairs during the investment period, except for time and attention spent with respect to the prior funds' investments. If the requisite number of key persons cease to be sufficiently active in the fund's affairs according to their time and attention standard, the investment period is typically terminated automatically subject to investor vote to continue the investment period or, less commonly, subject to termination upon an affirmative investor vote.

Change of control provisions

Investors may seek to limit the beneficial ownership of the general partner to the principals involved in making the fund's investments and their family members and estate planning entities. In doing so, investors seek to align the obligation to manage the fund with the benefit of owning the fund management entities and receiving any management fee surplus. Investors may likewise seek to limit beneficial ownership of the management company to prevent a fund sponsor from selling its operations to a third party. Accordingly, transfers of all or a portion (depending on the fund) of a principal's interest in the general partner or management company may require the consent of investors, but transfers to family members, affiliates, estate planning entities or future principals in the general partner or management company are usually permitted.

Reporting

A fund typically furnishes investors with audited financial statements annually, unaudited financial statements quarterly, tax information necessary for the investors to prepare their income tax returns in the fund's jurisdiction annually, and descriptive investment information for each portfolio company annually. Due to confidentiality concerns, a fund typically limits the amount of detail disclosed with respect to portfolio companies.

Removal of the general partner

This is a key term that investors desire, and fund sponsors resist, in a fund partnership agreement. A removal provision allows investors to vote to remove and

replace the general partner (i.e., bring in a new management team that is compensated by the carried interest and management fee). If included, this provision is highly negotiated among the general partner and the investors, including negotiation of the removal triggers (whether for cause or for any reason, and whether by majority or super-majority investor vote) and the economics between the initial general partner and the replacement general partner with respect to the carried interest. In UK funds, removal provisions are more common than early-termination provisions pursuant to which the fund may be liquidated upon a requisite investor vote.

Indemnification

A fund typically indemnifies the general partner, the management company and their affiliates from and against any loss, liability or expense incurred by them by reason of their activities on behalf of the fund or the investors, other than for bad faith, gross negligence or willful malfeasance. Investors often seek to further limit the fund's indemnification obligation in cases of material breach of the partnership agreement, etc.

Transfers

Generally, investors may not sell, assign or transfer their interest in the fund without the prior written consent of the general partner.

Withdrawal; excuse

An investor is generally prohibited from withdrawing capital from a fund and reducing its commitment, except in limited circumstances where such withdrawal is required to avoid a specific legal or regulatory problem for the fund or the investor. A fund may permit the general partner or fund manager to excuse an investor from making one or more particular investments if such investment would cause the investor to violate a material law or regulation or as otherwise agreed among the general partner and such investor.

ERISA policy

In the key terms summary, the ERISA policy section sets forth the exception from ERISA upon which the fund plans to rely. A fund typically qualifies for an exception if it (1) qualifies as a 'venture capital operating company' or (2) limits commitments to the fund by 'benefit plan investors' to less than 25 percent (excluding commitments from the general partner and its affiliates). As noted above, a more detailed discussion of the ERISA regulatory scheme is included in the 'Legal and tax matters' section of the offering memorandum.

Verification

A fund must ensure that the content of the offering memorandum is accurate and complete and thus it should be verified. Investors rely upon the information contained in the offering memorandum in making their investment decision – notably, upon the track record and statements describing how the fund sponsor and the fund principals plan to operate the fund. Failure to ensure that the information in the offering memorandum is accurate and complete may subject the fund sponsor to criminal and civil liability in the jurisdictions in which the offering is made.

Verifying the track record for investments managed by the fund sponsor may take time and diligent effort. Verification becomes even more difficult if another fund sponsor's historical investment performance is used, for example, where a fund principal managed investments while employed by another fund sponsor. In such cases, other than where the information is publicly available, the fund must secure all required consents from the other fund sponsor to ensure the fund has permission to disclose the information. This can be a contentious issue because the other fund sponsor may wish to use that same performance information in its next fund or may be concerned about having legal liability for any inaccuracies in the fund's disclosure of such investment's performance.

A fund should also take care in describing the manner in which the fund will be operated, including accurately describing the types of investments anticipated to be made by the fund. Often, a fund's partnership agreement contains a requirement that investments must be made consistent with the description contained the offering memorandum. Typically, investment guide-

lines are not cited in the partnership agreement itself. Accordingly, the fund sponsor must describe all potential investments that it plans to make so that it is not limited by the description in the offering memorandum when operating the fund.

In the UK, under Section 397 of the UK Financial Services and Markets Act, 2000 (FSMA), it is a criminal offence to deliberately or recklessly make a statement that is misleading, false or deceptive in a material manner, or dishonestly conceal material facts, for the purpose of inducing a person to enter into an investment, including an investment in a private equity fund. Also, and of more practical concern, is the risk that a disgruntled investor may bring a civil action for misrepresentation or negligent misstatement which, if proved, may entitle such investor to damages from the firm sponsor for any loss suffered. In circumstances where the fund operator, manager or adviser is authorised by the FSA, there is a duty to comply with the FSA's rules, including the wide-ranging Principles for Business which include obligations to pay due regard to the information needs of clients and to communicate information to them in a clear, fair and not misleading manner.

Under US securities laws, misstatements, omissions or otherwise misleading content in an offering memorandum may lead to SEC enforcement actions or civil causes of action.

Marketing and regulatory considerations

UK regime

In the UK, the offering memorandum only may be provided to certain types of investors. There are detailed rules – the 'financial promotion' regime – governing the distribution of any invitation or inducement to engage in investment activity (including the acquisition of an interest in a private equity fund) which are set out in FSMA and its subordinate legislation (as modified by European legislation). These rules apply to distribution of the offering memorandum and other marketing activities such as investor presentations and road shows.

Broadly speaking, the rules prohibit communication of a financial promotion (e.g., the offering memorandum) by a firm which has not been authorised by the FSA, unless an exemption applies. Also, an FSA-authorised firm may only communicate a financial promotion for a private equity fund (considered by regulators to be a high-risk product) to certain types of investors. A firm, whether authorised or non-authorised (e.g., an overseas fund), may communicate the offering memorandum to similar types of investors, including, broadly speaking, the following:

- investment professionals, including firms authorised by the FSA to carry on investment business, governments and local authorities, a firm whose ordinary activities involve it participating in private equity funds, and directors and employees of such entities; and
- high-net-worth companies and unincorporated associations, including corporates with called-up share capital or net assets of not less than £5 million, or if the corporate has more than 20 members or is a subsidiary of an undertaking with more than 20 members, £500,000, or a partnership which has net assets of not less than £5 million, or the trustee of certain high value trusts (assets of £10 million).

Certain disclaimer wording must be included in the offering document if a fund relies on these exemptions and, crucially, a fund must put in place proper systems to ensure that only investors in these categories are permitted to subscribe for fund interests. The offering memorandum should state that it may not be copied or distributed to persons other than the party to whom it is addressed.

If a fund plans to invest wholly or predominantly in shares or debentures of unlisted companies (not, for example, direct investments in real estate), the fund may also be permitted to distribute the offering memorandum, and market the fund, to:

- certified high-net-worth individuals (i.e., an individual with either an annual income of £100,000 or more or certain net assets of £250,000 or more, who signs a certificate confirming the foregoing and that

he or she understands that signing the certificate will result in the loss of regulatory protections for him or her), and

- self-certified sophisticated investors (i.e., an individual who has signed a prescribed form of certificate confirming, broadly speaking, that he or she is a member of a business angel syndicate, has made more than one investment in an unlisted company in the prior two years, is working in the private equity sector or is a director of a company with an annual turnover of at least £1 million, and that he or she understands that signing the certificate will result in the loss of significant regulatory protections for him or her).

If the fund is marketed to certified high-net-worth individuals and/or self-certified sophisticated investors, additional legends must be included in the offering memorandum and the written certifications must be obtained in advance. Again, such a fund must put in place systems to ensure that only investors within the relevant categories and who have signed a compliant certificate, are permitted to subscribe for fund interests.

An authorised firm may also promote the fund, and provide the offering memorandum, to:

- existing participants (i.e., a person who is or has in the last 30 months participated in a fund that made similar investments with a similar risk profile to the current fund);
- eligible employees of the fund sponsor, in certain circumstances; and
- certain professional clients (as defined).

In such circumstances, the authorised firm must assess which, if any, of the FSA's Handbook of Rules on financial promotions apply to their particular circumstances.

Finally, in order to avoid being classified as an offering of securities to the public, which would require a prospectus approved by the FSA, the offer should be limited to persons subscribing to invest at least €50,000 (or to fewer than 100 qualified investors, as defined).

US regime

General securities laws considerations

Under US securities laws, to avoid public offering rules and regulations, a private equity fund must offer its securities in a private placement transaction and typically does so under Regulation D of the US Securities Act of 1933, as amended (the Securities Act). Regulation D does not contain specific disclosure requirements, except where securities are being offered to non-accredited investors (which is unusual in an offering by a private equity fund). However, under US anti-fraud principles and custom and practice in the private equity industry, funds typically provide prospective investors with an offering memorandum containing material information regarding the fund and its managers.

US anti-fraud principles also drive the overarching standards that an offering memorandum must satisfy. Pursuant to Rule 10b-5 under the US Securities Exchange Act of 1934, as amended (the Exchange Act), an offering memorandum may not make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Accordingly, offering memoranda will customarily contain a discussion of all material information relating to the fund and its investment manager.[2] An anti-fraud rule has also been adopted under the Advisers Act. This rule enhances the right of the SEC to take action against both registered and unregistered investment advisers that engage in deceptive communications or conduct with respect to investors or prospective investors in pooled-investment vehicles, including private equity funds.

Regulation D

A private equity fund typically makes US offerings of its interests in a private placement exempt from registration under Regulation D. Although Regulation D does not specify the form or content of an offering memorandum, the requirements for a Regulation D private offering generally inform certain aspects of an offering memorandum's contents (and, where a fund offers securities to non-accredited investors, require disclosure of certain types of information).

Regulation D prohibits an issuer of privately placed securities (including a fund sponsor and its representatives) from engaging in any form of general solicitation or general advertising in connection with the private placement. General solicitation and general advertising include any advertisement, article, notice or other communication published in any newspaper, magazine or other media (such as a website) or broadcast over television or radio. The SEC has taken a broad view of what constitutes "general solicitation" or "general advertising" for a privately placed securities offering. In addition, if a fund makes a public offering, it cannot rely on one of two exemptions from registration, typically used by private investment funds, under the US Investment Company Act of 1940, as amended (the Investment Company Act). For US-domiciled funds, the publicity restriction applies both within and outside the US. For non-US domiciled funds, the publicity restriction applies only for the US offering. In light of these restrictions, a fund's offering memorandum routinely includes a prominent notice that it is confidential and statements that each recipient is prohibited both from distributing it to others without prior written consent of the fund's general partner and from disclosing any of its contents that are not already in the public domain.

Regulation D also prohibits resale of securities acquired in a Regulation D transaction without registration or an exemption from registration under the Securities Act and requires that an issuer exercise reasonable care to ensure that the purchasers of the securities are not underwriters. Under Regulation D, one way in which reasonable care may be demonstrated is by notifying purchasers in writing prior to sale that the securities have not been registered under the Securities Act and consequently cannot be resold unless registered thereunder or unless an exemption from registration is available. An offering memorandum typically contains this written notice.

Advisers Act

In certain respects, the Advisers Act applies to all private equity fund offering memoranda – the fiduciary duty provisions and anti-fraud rule of the Advisers Act apply to all investment advisers to private equity funds, without regard to whether they are registered with the SEC as investment advisers. In addition, where a fund's general partner or management company is a SEC-registered investment adviser (RIA), the Advisers Act advertising rules apply and, as described more fully below, require enhanced disclosure and impose restrictions on presentation of performance data in the fund's offering memorandum.

Fiduciary duties and anti-fraud rule

Under the Advisers Act, it is unlawful for any investment adviser, regardless of whether it is a RIA, to engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative or to engage in any transaction, practice, or course of business that operates as a fraud or deceit upon any client or prospective client. In 2007, the SEC adopted an Advisers Act rule enhancing the SEC's right to take action against registered and unregistered investment advisers (including private equity fund general partners and management companies) that engage in deceptive communications or conduct directed toward investors or prospective investors in funds, even if the conduct was negligent and not intentional. This anti-fraud rule applies to communications in offering memoranda and any other communications regarding the track record, experience and credentials of the adviser or its principals, or the adviser's investment strategies for the fund and allocation or other operational policies for investments.

Advisers Act advertising rules

Where a private equity fund's general partner or management company is a RIA, Advisers Act rules and related SEC guidance regarding advertising apply to the fund's offering memorandum, including that such an offering memorandum:

- may not contain any untrue statement of a material fact or be otherwise false or misleading;
- may not refer directly or indirectly to past specific recommendations of the investment adviser (e.g., names of fund portfolio companies) that were or would have been profitable to any person unless certain requirements (discussed below) are met;

- may not present gross performance data unless it presents performance data net of management fees, carried interest and expenses with equal prominence and includes sufficient disclosure; and
- may include historical performance data for other funds managed by the same investment professionals as the fund described in the offering memorandum (for example, by a predecessor entity or by the same portfolio manager while employed by a different adviser) provided that certain requirements are met, including that the information is presented in a manner that is not misleading and that sufficient disclosure is provided.

Under Advisers Act rules, an offering memorandum that includes an adviser's past specific recommendations must set out or offer to furnish a list of all recommendations made by the investment adviser within the immediately preceding period of not less than one year, and such advertisement, and the list if furnished separately, must (i) state the name of each security recommended, the date and nature of each such recommendation, the market price at that time, the price at which the recommendation was to be acted upon, and the market price of each such security as of the most recent practicable date, and (ii) contain a cautionary legend stating that "it should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this list".

Use of track record or performance data in a private equity fund offering memorandum requires special care in light of the Advisers Act rule regarding past specific recommendations (as well as the Advisers Act anti-fraud rule and other anti-fraud considerations under the US securities laws). As a general matter, it is important that presentation of track record or historical performance data include a disclaimer stating that past performance is not a guarantee of future results. In accordance with the rule regarding past specific recommendations, and given the importance of not highlighting select investments with strong performance over more poorly performing investments, an offering memorandum that identifies past specific fund investments should include a comprehensive list of recommendations by the fund's general partner/management company (i.e., portfolio company investments) and the cautionary legend required by the rule.

FINRA restrictions on use of related fund performance data

An offering memorandum must be fair and balanced, and any performance data included therein may not predict future performance or imply that past performance will recur. Where an offering memorandum is distributed by a broker-dealer that is a member of the US Financial Industry Regulatory Authority (FINRA), additional disclosure rules apply. For example, for a fund relying on Section 3(c)(1) of the Investment Company Act for an exemption from registration as an investment company (i.e., the 100-or-fewer beneficial owner exemption), FINRA (previously the National Association of Securities Dealers, Inc.) has taken the position that "related performance information" (e.g., performance of other, separate investment funds managed by the same investment adviser) cannot be included in such fund's offering documents that are considered advertising (e.g., teasers and flip books)[3] distributed by a FINRA member broker-dealer to such fund's prospective and actual investors. ■

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[1] The Advisers Act prohibits investment advisers that are required to register with the SEC from receiving performance-based compensation from an investment advisory client, such as carried interest of a private equity fund, unless an exemption applies (e.g., the client is a fund relying on Section 3(c)(7) of the Investment Company Act, or in the case of a fund client relying on Section 3(c)(1) of the Investment Company Act, the fund investors charged a carried interest are "qualified clients" within the meaning of the Advisers Act).

[2] As a general matter, information is 'material' under the US securities laws if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision.

[3] An offering memorandum generally is not considered advertising.

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