

Funds in Focus 2018: Private Investment Funds Annual Review Conference

Breakout Out on Your Own: Spin-Out
and Fundraising Considerations

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Agenda

- Considerations Before You Leave
- Developing Your Fundraising Strategy
- Setting Up a New Firm



Considerations Before You Leave

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Negotiated Exit

- Ongoing administrative needs
- Team consideration / exit agreements
- Existing portfolio / funds
- Cornerstone investment
- Carried interest / GP commitment
- Information flows
- Office space

Contentious Exit

- Portability of track record
- Restrictive covenants
- Regulatory oversight / admin
- Long term financial incentives



Developing Your Fundraising Strategy

Negotiating Terms with Your Anchor Investor

- Identifying Potential Anchors
- Anchor Terms
 - Business, Legal and Regulatory Considerations
- Pre-Initial Closing Investments with Your Anchor Investor

Building Momentum for Your Fundraise

- Utilizing Placement Agents and Financial Advisors
 - Key Benefits
 - Key Concerns
- Populating Your Data Room
 - NDAs
 - Marketing Materials and Key Fund Documents
 - Fund and Operational DDQs
 - Budget

Offering Closing Incentives

- Fee Discounts
- Carry Discounts
- Co-Investment Rights
- Information Rights

Key Considerations for Forming Your Fund

- Determining Fund Terms
 - Closed-End vs. Evergreen / Permanent Capital
 - Fund Size (Target vs. Cap)
 - Economics (Fees and Carried Interest / Performance Allocations)
 - Key Person Events
 - Sponsor Commitment
- Determining Fund Structure
 - Tax Considerations
 - Regulatory Considerations
 - Investor Preferences
- Formulate a Side Letter Policy



Setting Up a New Firm

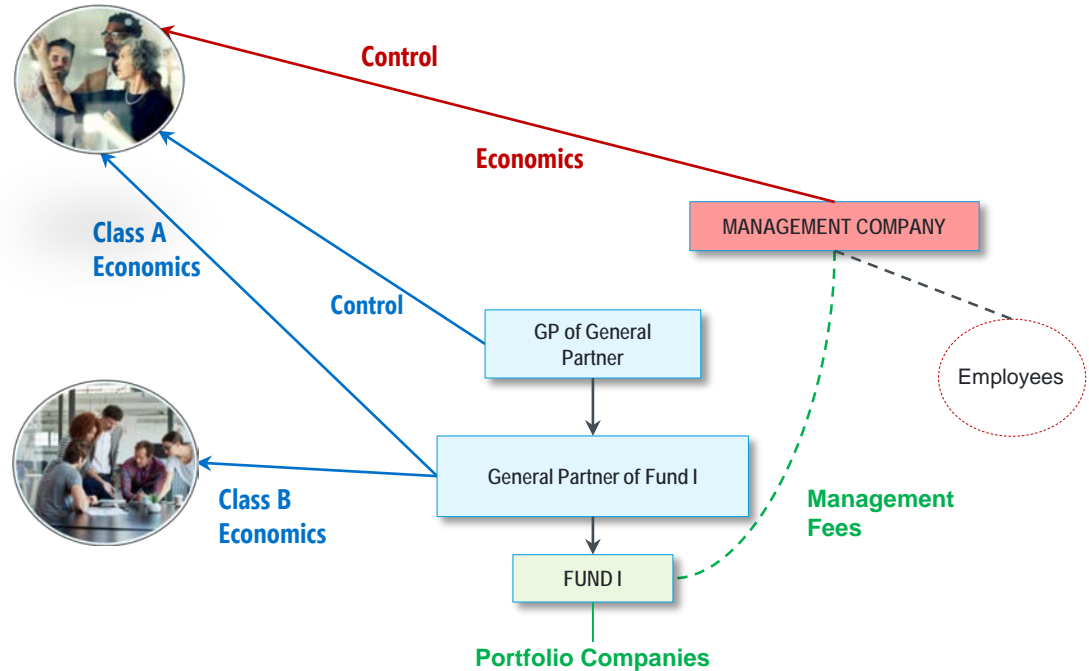
Themes and Basic Structure

➤ Governance

- Voting & Control
- Growth & Succession
- Alignment of Interests
- Covenants
- Compliance

➤ Economics

- Compensation/Profit
- Capital interests
- Carried interest



Management Company: New Firm, Clean Slate

- Firm culture, firm brand, firm franchise
- Enterprise value
- Flexibility
 - Growth
 - Succession
- Operational and legal considerations

General Partner

- Fund governance: control & voting
- Capital interest: contributions, distributions, clawbacks
- Economics of admissions / departures
- Carried interest: vesting
- Covenants
- Tax matters and personal planning

Carried Interest: Some Things to Consider

- Classes of participants
- Vesting: Incentivizing the team
 - No-fault vesting v. triggering “for cause” event (covenants)
 - Departures: voluntary v. mandatory
 - Dilutions / accretions over time
- Vesting Schedules
 - Cliff?
 - Straight line over Fund’s investment period?
 - Front-end loaded? Back-end loaded?
 - Fund benchmarks (e.g., investment period, distribution waterfall, successor fund)
- No one size fits all

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Sample List of Anchor Investors Terms

Below is a list summarizing some of the most common rights requested by anchor investors in connection with their investment in a fund. The types and structure of rights ultimately agreed upon will depend on a variety of factors including, among others: (1) the timing and size of the anchor investor's commitment to the fund, (2) whether the anchor investor is also providing the fund sponsor with "seed capital," (3) strategic benefits the anchor investor may bring to the table such as access to proprietary deal flow or industry expertise, and (4) marketing assistance provided by the anchor investor including name recognition, participation in road show meetings and introductions to potential investors.

For example, an anchor investor that only makes a significant first-closing commitment to the fund may be entitled to additional rights vis-à-vis the fund only such as better fund economics, expanded reporting rights and/or coinvestment rights; while an anchor investor that also provides the fund sponsor with seed capital and strategic benefits may also receive a stake in the general partner (GP) and/or fund manager, which could include some management rights as well as an interest in carry and fees.

Providing anchor investors with unique rights presents various challenges for a fund sponsor, some of which are described in the table below. Below are some additional issues fund sponsors should consider when determining the scope and structure of an anchor investor's rights¹.

Legal Issues

Fund sponsors should consider how the anchor investor's rights should be limited or forfeited, including if the anchor defaults on its fund commitment or other obligations or fails to deliver the types of strategic benefits that formed the basis for its additional rights. This issue can be addressed to some extent by making an anchor investor's fund-level rights contingent upon its good standing as an investor. When an anchor investor has a stake in the GP or fund manager, these issues can be addressed through various removal, buy-out or forfeiture mechanics. These mechanics are often extensively negotiated, which can delay fund closings and significantly raise the organizational costs of the fund raise (some or all of which may not be allocable to the fund). Fund sponsors must also ensure that any anchor rights synchronize with fund agreements and the sponsor's (or its affiliate's) applicable internal policies and procedures (e.g. policies governing investment allocations, expenses, access to material non-public information).

Regulatory Issues

Many of the rights granted to anchor investors are often provided in side letters. Although the U.S. Securities and Exchange Commission (SEC) has not expressed an official view on the use and propriety of side letters, statements by the SEC's staff, other regulatory bodies and thought leaders suggest that certain side letter terms could violate securities regulations such as the anti-fraud provisions of the U.S. Investment Advisers Act and the prohibition on materially misleading omissions in disclosure documents under the U.S. Securities Exchange Act. Disclosing the general types of rights granted to anchor investors in the fund's Private Placement Memorandum mitigates this regulatory risk to some extent. In some cases, the type of rights granted to an anchor investor can be so fundamental to the

¹ The issues identified below are being provided for illustrative purposes only and are not the only issues to be considered in the context of granting anchor investor rights.

operations of the fund that more detailed disclosure, or even explicit provisions covering these rights within the fund's governing documents, may be appropriate.

If an anchor investor receives an interest in the GP or fund manager, or will be providing advice with respect to the fund's investment activities, additional disclosure to the fund's investors are necessary including, in some cases, disclosure around the scope of the anchor investor's relationship in the Form ADV filed by the fund sponsor (or its affiliate) with the SEC. An anchor investor may object to this type of regulatory disclosure, which could impact its business relationship with the fund sponsor.

Investor Relations

Although providing anchor investors with unique rights is common, other institutional investors that make significant commitments may insist on receiving similar rights notwithstanding the fact that they may be investing at a subsequent closing or with a smaller commitment--particularly when the additional rights concern fund economics. Navigating these investor relations issues can be challenging--particularly for a first-time fund sponsor looking to establish long-term relationships with potential investors. One of the biggest concerns for fund sponsors, aside from alienating a potential investor, is being compelled to offer anchor investor rights to a broader universe of investors than it initially anticipated and having to live with these rights over multiple subsequent funds.

Right	Description
Management Fee Discount	<p>Anchor investors often receive a discount on their management fees either through a reduced rate and/or by calculating fees on their invested capital during the fund's term (instead of commitments during the investment period).</p> <p>A management fee discount can also be structured as a rebate.</p>
Better Distribution Rights	<p>Anchor investors may receive unique distribution rights, which can take the form of a separate waterfall or a rebate of carried interest payable on their investment.</p> <p>For example, a separate waterfall could provide a return of capital on the fund as a whole (if the waterfall used for other investors returns capital on a deal-by-deal basis), a higher preferred return, lower carried interest percentage and/or a slower or no "GP catch-up."</p>
Participation in Carried Interest	<p>An anchor investor's right to participate in carried interest can be structured in a variety of ways, including:</p> <ul style="list-style-type: none"> • Through a stake in the GP/carried interest partner; • Via side letter by entitling the investor to a set percentage of carried interest actually distributed to the GP/carried interest partner.

Right	Description
Expanded Reporting Rights	<p>In addition to reports provided to anchor investors to address their regulatory or policy requirements, an anchor investor may also require additional information from the fund or its manager, such as:</p> <ul style="list-style-type: none"> • updates on investment pipeline; • deal memos containing summary information on proposed investments (details on the investee company, investment structure, business plan and financial information on the investee company), along with a right to discuss the deal memo with fund management; • reports on carried interest distributed to existing principals and personnel and details of any incentive awards granted to new personnel; and • notice of any litigation, regulatory investigations, SEC audits, deficiency letters and tax proceedings concerning the fund, the GP or its affiliates--including entities that may not be involved in managing the fund. <p>Anchor investors may also request the right to meet with key management personnel on a periodic basis to discuss the fund's financial reports, investment portfolio and other matters related to the fund.</p>
Coinvestment Rights	<p>Anchor investors may want the right to co-invest with the fund—often on a no-fee, no-carried interest basis. Coinvestment rights can be provided for via side letter or “hard-wired” into the fund agreement.</p> <p>An anchor investor's coinvestment rights can also be structured using a pledge fund or other co-investment vehicle to which the investor will make a (notional or firm) commitment to be invested in opportunities within the fund manager's discretion, pursuant to a pre-agreed set of guidelines or subject to the investor's approval on a deal-by-deal basis.</p>
Unrestricted MFN Rights	<p>Anchor investors can receive broader “most favored nations” protection with respect to side letters granted to other investors in the same fund. MFN rights granted to anchor investors may be unrestricted by commitment amount. Anchor investors may also resist typical MFN carve-outs; nevertheless, restrictions based on tax, regulatory and policy considerations are common.</p>
Expense Reimbursement	<p>Anchor investors may insist on the fund sponsor bearing a portion of the investor's legal expenses in connection with negotiating fund documents.</p>
Right to Reduce Commitment	<p>An anchor investor may have the right to reduce its commitment if the fund sponsor fails to raise a specified amount of commitments as of the fund's final closing. An anchor investor may be entitled to retain any special rights awarded to it notwithstanding any reduction of its commitment.</p>

Right	Description
Right to Make Additional Investments without Paying Late Fee	Anchor investors may be entitled to upsize their commitments at future closings without paying the same late admission charge applicable to other subsequent closing investors.
Investment Committee Representative	An anchor investor may seek the right to appoint a member to the fund's investment committee, typically only as an observer. This right is typically reserved for investors that provide seed capital or other significant strategic benefits to the fund sponsor.
Other Management Rights	An anchor investor that receives an equity interest in the fund manager may also have the right to participate in the fund manager's governance with respect to management operations in general and/or its actions on behalf of the fund.
Investor Consent Rights	<p>Anchor investors may have blocking rights with respect to a variety of fund-related actions, including:</p> <ul style="list-style-type: none"> • accepting investor commitments beyond a specified cap on fund size; • making investments beyond agreed-upon concentration limits or that violate the investor's specific policies; and • amending the fund agreement in any manner that adversely affects the anchor investor.
Commitments to a Successor Fund	Anchor investors may have the right (but not the obligation) to participate on the same terms in the fund sponsor's successor funds.
Best Practice Investment Policies	Many anchor investors require fund managers to adopt, and cause the fund's portfolio companies to adopt, the investor's written best practice investment policy, including those related to environmental, social and governance issues. They are often vaguely drafted and rarely tailored to a particular fund sponsor's business.