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Private Equity Pledge Funds: Structuring, Terms and Conditions, Operations, Complying With Investment Advisers Act

THURSDAY, MARCH 5, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Pledge Funds

Mark Proctor | Anne Choe

March 5, 2020

Agenda

1. Pledge Fund – Terms and Structuring
2. Regulatory Considerations

Why Raise A Pledge Fund?

- Pledge fund structure permits a manager that is otherwise unable to attract sufficient locked-up capital to have a “go to” source of capital for investments

What is a pledge fund?

- Investors decide whether to participate in investments on deal by deal basis
- Limited due diligence
- Prearranged terms if participate

Basic Elements of a Pledge Fund

- Agreement to give investors a first look at deals, often in exchange for a fee
- A set process / timeline by which investors decide to participate in each deal
- Prearranged structure and terms for deals that get executed

Advantages of a Pledge Fund

- Gives GP a preferred source of capital
- Enables an investment team to establish a track record without raising a blind pool*
- Enables manager to have some ongoing fee stream
- Allay investor concerns about committing capital to managers with lack of track record or tarnished track record
- Permits manager to represent that it has a source of capital when bidding for portfolio companies
- No netting of deals (maybe)

Disadvantages of Pledge Funds

- Manager takes on risk that capital will not be available for any given deal
- Ongoing fees are lower than with a blind pool; manager must operate leanly
- Sometimes perceived by potential target companies as “tire kickers” and not “serious investors” – could be a disadvantage in an auction process
- Expense/complexity of negotiating the documents upfront

Structural Approaches – Multiple SPVs

- Investment group agreement signed initially; includes ROFO, “capital commitments” and option fee or management fee provisions
  - Often contains framework for investor diligence materials/process
- Separate SPV (can be LP or LLC) for each deal; each SPV has its own waterfall and governance terms
- LPA negotiated upfront at same time as IMA

Structural Approaches – Single Vehicle with Opt-Outs

- Single LP or LLC
- Lets investors opt into or out of each deal – all deals within the same vehicle
- Vehicle may issue a separate class of interest for each deal with a discrete set of investors
  - Alternatively may function just like standard PE fund, but with more robust mechanics around opt-outs and related issues

Pledge Fund Mechanics

- Each investor subscribes for a specific amount
- Investment manager is obligated to present opportunities to fund up to the aggregate subscription amount
- Manager presents investors with a due diligence memorandum describing each investment opportunity. Investors are permitted to opt into (or out of) each investment – typically have 5 to 10 days
- Each investor may opt into a deal for up to its maximum allotment to the deal
  - Investment group agreement may contain overallotment feature
- Any unsubscribed capacity may either be offered to other pledge fund investors or third parties

Expense Allocation Provisions

- Expenses for deals shared by investors who opt in pro rata based on deal sharing percentages
- “Fund-level” expenses allocated based on capital commitments
- Broken deal expenses allocated depending on when the deal “breaks”:
  - If breaks before expiration of the opt-in period: allocated in accordance with “commitments” to pledge fund
  - If breaks after expiration of opt-in period: allocated in accordance with deal sharing percentages

Fees

- “Option” fee on commitments – investors pay a small fee (e.g., 50bps) for the right to a first look at deals
- Management fee – investors pay a management fee on invested capital in each partnership
- Carried interest – investors pay carry on a deal by deal basis
  - Deal point: whether deals are cross collateralized

Key Issues

- Track record: question as to whether returns completely driven by GP's investment discretion (since investors can opt out of deals); each investor has its own returns
- Serial non-participation: how to deal with LPs who don't fund their share of deals?
  - Three strikes rule with penalty, which can be structured as penalty for each opt-out, or increase in "option" fee
  - Manager should ask for right to terminate investment period if there is significant lack of participation in deals
- LP Defaults

Key Issues (cont’d)

- Credit for rejected deals
  - Manager has incentive to show as many deals as quickly as possible to get through ROFO obligation
  - To keep manager from showing deals that are trash LPs may seek to have manager receive reduced (or no) credit for deals rejected by a majority of investors
- Winding Up – it is important for the Manager to be able to terminate the pledge fund if LPs reject too many deals
- Conversion to Blind Pool – Managers may seek to include mechanism to convert the pledge fund to a blind pool

Considerations under the Investment Advisers Act of 1940

- ***At what point would a manager to a pledge fund be required to register with the SEC?***
- Investment advisers are required to register with the SEC unless they qualify for an exemption from registration: (1) the person engages in the business of advising others; (2) about securities; and (3) receives compensation for the advice.
- Pledge fund "option fee" / "administrative fee" vs. a "management fee"
- Regulatory Assets Under Management (RAUM) – includes *"the contractual amount of any uncalled commitment pursuant to which a person is obligated to acquire an interest in, or make a capital contribution to, the private fund."*
  - "Three-strikes" rule in a pledge fund – has an investor then made a legally binding commitment?

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Advisers Act Considerations: Adequate Disclosure of Investment Opportunities

- Disclosure for each specific investment opportunity (e.g., separate offering document for each investment)
  - Rule 206(4)-8 under the Advisers Act – prohibits an investment adviser to a pooled investment vehicle from making false or misleading statements to investors or prospective investors.
  - Rule 206(4)-1 under the Advisers Act – No untrue or misleading statements of material fact.
  - Section 10(b) and Rule 10b-5 – prohibits any person, in connection with the purchase or sale of any security, from engaging in fraudulent or deceptive acts or making misleading statements.

Advisers Act Considerations: Marketing and Advertising (Track Record)

- Whether the manager is fully registered with the SEC or exempt from registration, the adviser will be subject to the anti-fraud provisions of the Advisers Act (Section 206, Rule 206(4)-8) and Rule 206(4)-1 for registered advisers.
- Pledge fund track record disclosures
- Calculation of investment returns on a deal-by-deal basis; pledge fund-level returns.
  - Hypothetical fund-level “net” returns
- Considerations under the SEC’s new proposed advertising rule

Advisers Act Considerations: Expense Allocation

- Fund level expenses are typically borne equally among all investors.
- Expenses for segregated portfolios for each investment are typically borne equally among the participating investors.
- Broken deal expenses are allocated depending on when the deal "breaks":
  - If breaks before expiration of the opt-in period, allocated with "commitments" to the pledge fund
  - If breaks after expiration of the opt-in period, allocated in accordance with deal sharing percentages
- SEC regulatory scrutiny on the disclosure and allocation of expenses:
  - SEC enforcement actions related to the allocation of broken deal expenses (KKR, Lightyear Capital)
  - SEC OCIE's 2020 Examination Priorities – advisers to private funds and undisclosed or inadequately disclosed fees and expenses

Combo Funds

- Overview
  - Combination between a pledge fund and a blind pool
  - Investors make a capital commitment to the “hub” or blind pool fund and separate “commitment” to the “spoke” or pledge fund
  - Each deal may be allocated to the blind pool fund and, potentially, the pledge fund

Combo Funds

- Principal issues
  - Allocation of capital between blind pool and pledge fund
  - Allocation of deals between blind pool and pledge fund
    - Based on investment restrictions in blind pool
    - Set allocation
    - Unsubscribed investment allocation
  - Netting of carried interest
  - Management Fee

Thank You

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