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Introduction to Private Investment Funds

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Private investment funds, such as hedge funds and private equity funds, are popular investment vehicles for sophisticated investors and for investment managers. The principal advantages offered by these funds are that they enable investors to participate in more aggressive liquid and illiquid investment opportunities with talented investment managers, enable managers to raise capital without the cost and obligations of SEC registration, facilitate incentive compensation of investment managers, and allow for the pass through of tax treatment and other aspects of investments to investors and managers. Private investment funds may be organized as limited partnerships, limited liability companies, or offshore partnerships or corporations. This practice note will introduce private investment funds, their purpose and benefits, and describe the main types of private investment funds.

What Is a Private Investment Fund?

Private investment funds are pooled investment vehicles organized, generally by investment managers, to invest in securities and other assets, such as currencies, commodities, businesses, and derivatives. Private investment funds raise capital from investors without a registered public offering, and are exempt from registration as investment companies. U.S. domestic private investment funds usually take the form of Delaware limited partnerships, limited liability companies or less commonly, business trusts. Offshore funds are generally partnerships or corporations formed in tax haven jurisdictions, such as the Cayman Islands, the British Virgin Islands, Bermuda, and Luxembourg.

While investors have pooled their capital in private investment funds since the dawn of securities, over the last 30 or so years, private investment funds have dramatically increased in number, variety, and total assets under management. A large number of sophisticated investors such as high net worth individuals (and their related trusts and family offices), pension plans, foundations, endowments, insurance companies, and other financial institutions are willing to invest in private investment funds, for instance, in order to have access to "hot" investment managers and access to higher risk investments, with the potential for higher returns. Investors in private investment funds also have the opportunity to participate in larger capital pools which have more weight in private equity deals, such as leveraged buyouts and distressed securities, and to undertake more complex liquid transactions, such as hedging, arbitrage, and diverse quantitative strategies.

Persons who manage private investment funds usually have prior experience as investment managers or backgrounds as executives in the industries in which they invest. Investment managers also appreciate the opportunity to manage larger third-party capital pools, as opposed to investing only their own money or that of their employer (known as proprietary trading).

Professional investment managers typically organize private investment funds in order to seek private financing, rather than raising money in public markets, for the following reasons:

- **SEC registration.** Public investment companies, such as mutual funds, must go through a laborious registration with the SEC. Consequently, private financing is quicker and generally requires a less costly offering process.
- **Public company obligations.** Registered (public) investment companies can attract investment from an unlimited number of investors who do not need to meet standards for sophistication and net worth, but these companies:
    - Are limited in leverage
    - Cannot make certain kinds of investments (such as short sales or margin purchases)

- Are subject to complex regulation and disclosure requirements by the SEC
- Must maintain independent boards of directors
- May be obliged to value their portfolios (or "mark to market") daily
- May be obliged to permit daily withdrawals by investors
- Must satisfy federal tax law requirements concerning diversification of investments and distributions of earnings
- Must keep detailed books and records
- May subject their investment managers to enhanced fiduciary duties
- Must disclose their fee structures in detail
- Generally cannot provide profit-based incentive compensation to investment managers (a key component of private investment funds, as detailed below)

- **Management fee and incentive compensation.** Investment managers typically receive an annual management fee, often 2% of the assets under management, and incentive compensation, often as special allocations of 20% of profits (either upon the sale of an investment, or marked to market on an annual basis). Under current law, incentive compensation paid to an investment manager retains its tax characterization (as qualified dividends or long-term capital gains) when it is passed from the fund to the manager via incentive compensation or carried interest. This arrangement is particularly advantageous for investment managers of funds which generate income characterized as long-term capital gains (like private equity or venture capital funds), which are taxed at a lower rate. There is political pressure to change this pass through, and to allow the investment manager to recognize the beneficial tax characteristics of income from its own investment only, and not from the incentive compensation generated by the capital of its investors.

- **Confidentiality.** Private investment funds also enjoy confidentiality of investments and, unless otherwise provided in the fund's operating agreement or other governing documents, may not be obliged to report their investments, a significant advantage since many investment managers depend on confidentiality for their investment strategies. Exceptions to this confidentiality include large investments in particular U.S. public companies, which must be disclosed under certain provisions of the Securities Exchange Act; and funds or investment managers with more than $100 million in U.S. exchange-traded securities under management have to file quarterly reports disclosing these holdings. As these quarterly reports are made 45 days after the quarter end, they present a dated view of only a portion of a hedge fund's portfolio.

Types of Private Investment Funds

Hedge Funds

A hedge fund is a private investment fund that pursues absolute returns for its investors regardless of market direction, and aims to do so as quickly as possible. Hedge funds employ a variety of liquid strategies to achieve their targeted returns, most prominently leverage and/or short selling, but may also include strategies in equities, currency, bonds, long-short, market neutral, risk arbitrage, and industry concentrations. A hedge fund may focus on a single strategy or a particular asset class, or in the case of a multi-strategy fund, it may pursue a range of related or unrelated approaches.

"Hedge fund" is an imprecise term that came into general use because some of the early well-known private investment funds often hedged investments with shorts or other derivatives. A hedge fund is not obligated to hedge and may in fact be organized without the right to sell short, purchase or sell derivatives or otherwise hedge its portfolio exposure. Hedge funds compensate their managers on an annual basis, and it is generally easier for investors to make additional investments in or to withdraw their investments from hedge funds, as compared to other private funds, due to the relatively liquid nature (and ease of valuation) of the hedge fund's investments.

Private Equity Funds

A private equity fund is a private investment fund that generally invests directly in companies. Private equity investments can be made through leveraged buyouts of private businesses, through purchases of equity or debt securities of private companies, via the acquisition and delisting of public companies, and through acquisition of real estate. These investments are more difficult to both acquire and liquidate. Furthermore, private equity investments are often held for a number of years to allow the fund's strategy to have the desired effect on the acquired company's management and financial results. Because private equity investments are labor intensive, they are made over a period of years, rather than all at once (as in hedge funds). Private equity funds often provide for capital commitments by investors that are called on when an investment in a business is about to be made; investors receive a

return of their investment as businesses are sold by the fund. Private equity fund managers receive a share of their fund's profits once investors have received a return of their investment plus an additional amount, or preferred return, of 8%. Private equity is a good match for investors who do not need immediate or predictable liquidity, and who can wait 10–12 years to see profits returned to them.

Funds of Funds

A fund of funds is a private investment fund that invests in other private investment funds (rather than directly into liquid securities or businesses). The manager of a fund of funds must have a sophisticated understanding of the performance of the funds in which their fund invests. Funds of funds must be selective in choosing the funds that comprise their portfolio, as they need to generate sufficient profits to overcome two "layers" of fees: fees and incentive compensation paid to the managers of the underlying funds, and fees (and potentially additional incentive compensation) payable to the fund of funds manager. Funds of funds also face challenges in providing liquidity to investors; proceeds must first become available from an underlying fund before they can be distributed to investors in a fund of funds. Despite these hurdles, funds of funds continue to be popular with investors who seek diversity in a single investment. Participation in a fund of funds gives small investors collective power to negotiate with fund sponsors, and in some cases, basic access to top fund managers (whose funds may be oversubscribed).

Venture Capital Funds

Venture capital funds are private investment funds that invest in businesses that have little or no operating history or net worth. Venture capital funds are run by one or more professional investors (so-called "angels") who specialize in startup (or "seed" capital) investments and are willing to make an investment in such businesses. Seed investments are what allow start-ups to begin to develop products or services and to define the market for such products or services. Traditional venture capital firms also may provide additional capital after the seed investment, which a business will use for growth. Small businesses that believe they are emerging growth companies often turn to venture capital funds for the capital necessary to expand. Venture capital funds are often formed as "club" funds, in which the investors have the opportunity to opt into (or out of) each investment. Venture capital fund investments are popular among investors who have a significant appetite for risk, and are potentially willing to review and evaluate each prospective investment before it is made.

Related Content

For more information on private equity funds, including a summary of the offering process and regulatory considerations, see the following practice notes:

- Structure and Organization of Private Equity Funds
- Private Equity Fund Life Cycle
- Drafting and Reviewing the Key Documentation for a Private Equity Fund and Its Offering
- U.S. Regulatory Framework for the Offering of Private Equity Fund Securities

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