The importance of UK Limited Partnerships for Private Equity & Venture Capital

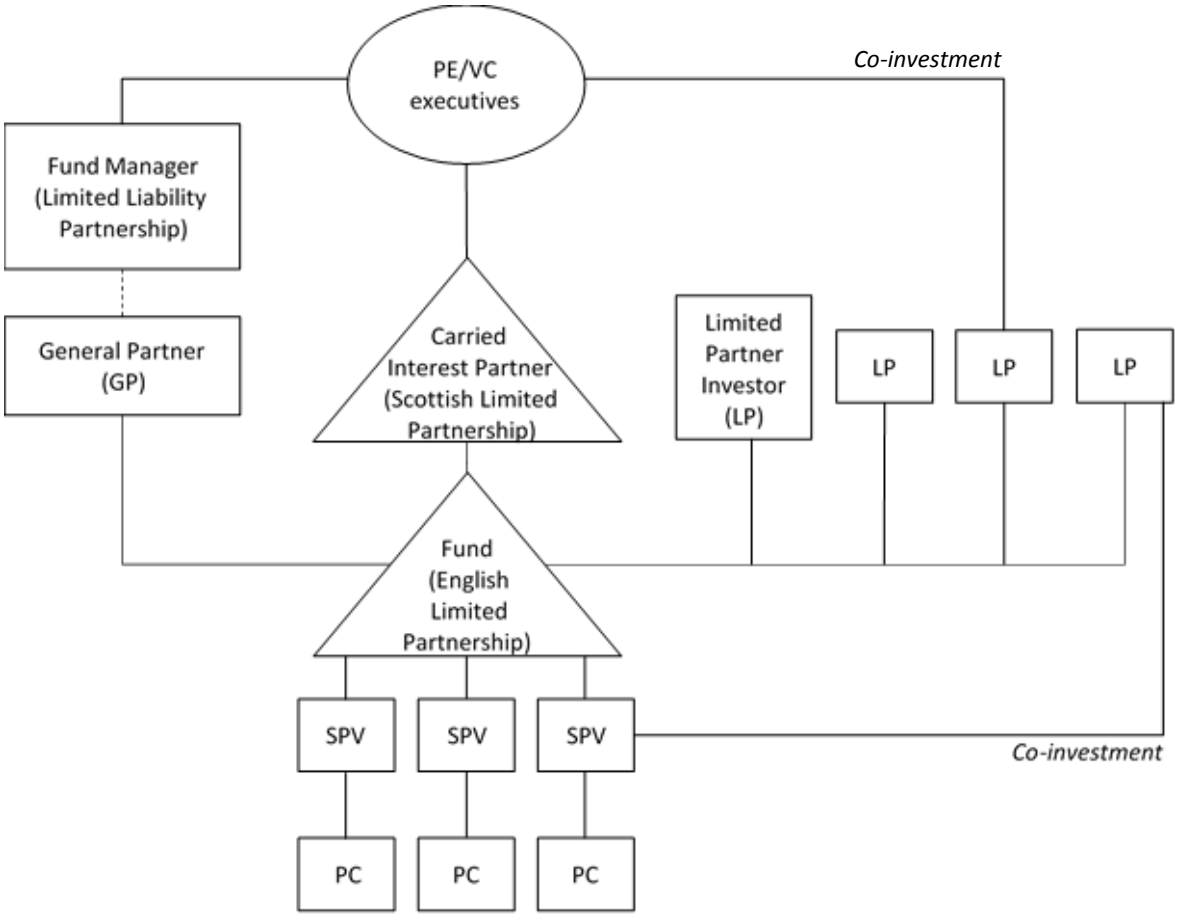
(Note: this technical briefing is for information purposes only and its contents do not constitute advice.)

The limited partnership has, for the past thirty years, been the vehicle of choice for fund managers across private equity and venture capital (PE/VC) to aggregate and put to work the capital of their investors. Similar limited partnership structures are used across other private capital asset classes, including real estate, infrastructure and debt/credit funds. UK limited partnerships (both English and Scottish) are one of the most common fund structures used and one of the reasons why the UK is the second biggest global hub for PE/VC.

This briefing answers a number of questions related to the use of UK limited partnerships by PE/VC:

1. What does a typical fund structure look like?
2. What is the difference between an ELP and SLP, and how are they used?
3. Why are UK limited partnerships used in private equity & venture capital funds?
4. Why are fund structures complicated?
5. In what way is the private equity & venture capital industry regulated?
6. How useful is the new Private Fund Limited Partnership regime?

1. What does a typical fund structure look like?



The fund

A PE/VC fund is typically an English Limited Partnership (ELP), which is formed pursuant to the Limited Partnerships Act 1907. An ELP must have at least one general partner (GP) and any number of limited partners (LP).

PE/VC funds are closed-ended and LP interests are not intended to be transferred or traded. However, they can be transferred to another investor with the consent of the GP although this does not occur frequently over the term of a fund. PE/VC funds have a typical term of ten years with an option to extend, normally by two years.

General partner

The GP is responsible for managing and running the partnership. Although it typically contributes a nominal amount of capital, GPs have unlimited liability and so remain liable for all the debts and obligations of the ELP. As such, GPs are normally a limited liability company or a limited liability partnership.

GPs generally have full power and authority to act on behalf of the ELP and to bind the ELP without prior consultation with any of the LPs.

Limited partner(s)

Any partners that are not general partners are LPs. LPs are essentially the investors in the fund and contribute capital to be pooled and invested. These are typically institutional investors, which can include pension funds, sovereign wealth funds, insurance companies, family offices, university endowments and high net worth individuals. The words “LP” and “investor” are used interchangeably in this document.

As long as a limited partner is not considered to take part in management (unlike a GP), its liability is limited to the capital it has provided to the partnership. The new Private Fund Limited Partnership (PFLP) regime provides greater clarity around this (see below). Note that the limited partnership structure lends itself neatly to passive investment arrangements such as this – where the manager is active and the investors have a limited role.

Portfolio company

The pooled capital of the LPs is invested in portfolio companies (PC), often via special purpose vehicles (SPV)/holding companies.

Manager

The GP often delegates its power and authority to an FCA-regulated manager. Any liability of such a manager will therefore be on a contractual basis. Managers are often limited liability partnerships, the partners being the PE/VC executives. The manager will earn a management fee for managing the fund.

PE/VC executives and the carried interest partner

In order to incentivise the PE/VC executives and align their interests with those of their investors, the executives also earn a share of profits called carried interest after the LPs have received back their invested capital plus a minimum return/profit.

The minimum cash return required by LPs is agreed in advance and documented in the Limited Partnership Agreement (LPA), after which an agreed percentage of the profits is earned by the PE/VC executives. This carried interest is typically passed to another limited partner of the fund, the carried interest partner. The carried interest partner is often a Scottish Limited Partnership (SLP), of which the PE/VC executives are partners. SLPs are often used for this purpose because they have separate legal personality, unlike ELPs, and for that reason cannot become partners in other ELPs (see section 2).
Separately, investors typically require the PE/VC executives to invest in the fund alongside them. This could be through the GP or through a separate LP in the fund. This is a further means to align the interests of the fund manager and LPs.

LP co-investment

Investors can sometimes be given the opportunity to co-invest alongside the fund directly in certain investments of the fund, e.g. where the investment may be too large for the fund to invest in on its own. Funds are often restricted by their investors from investing more than a certain proportion of their capital in any one company, industry or geographical region, so may need a co-investor in certain transactions. A co-investor that already works with and supports the fund, such as an LP, is generally preferred to an external partner.

From an LP perspective, co-investing gives investors the opportunity to take a greater stake in the fund's investments, while not having to pay a management fee to the manager, nor incur carried interest on the co-investment (or bearing such fees/profit allocations at a reduced rate).

PE/VC executive co-investment

In addition to committing to the fund through the GP/manager (see above), the PE/VC executives are also sometimes given the opportunity to co-invest alongside the fund.

2. What is the difference between an ELP and SLP, and how are they used?

The key difference between an ELP and SLP is that an ELP does not have its own legal personality (and so cannot enter contracts or hold property in its own name), whereas an SLP does. In a fund structure an ELP, therefore, undertakes its activities through its GP.

This difference means that SLPs may be used for certain vehicles in a funds context. As referred to above, SLPs are often used as the vehicle of choice for carried interest partnerships. As all partners in an ELP must have separate legal personality, an SLP is typically used for a partnership that is also a limited partner of an ELP.

Separate legal personality is not unique to SLPs – limited partnerships in other jurisdictions, such as Luxembourg and Delaware, have separate legal personality. Limited partnerships in Channel Islands have the option to be designated as having separate legal personality.

3. Why are UK limited partnerships used in private equity & venture capital funds?

This is down to a number of reasons, which are not necessarily unique to the UK limited partnership structure. Although there is no single contributing factor, a combination of the reasons below means that UK limited partnerships are a popular choice for structuring PE/VC funds.

Tax transparency

The tax transparent nature of UK limited partnerships is one of the key reasons such structures are used in PE/VC. Tax transparency prevents double taxation. This would arise if both, firstly, the fund and, secondly, the investor were taxed on the same income or realised investments. The end result of tax transparency is that the fund vehicle is looked through for tax purposes and investors are taxed on profits as though they had invested directly into the underlying asset themselves.

This usually means that investors are only taxed on their profits from the fund in their home jurisdictions, just as they would be if they invested directly in the fund's portfolio companies' shares. It also ensures that certain tax-exempt investors such as pension funds do not indirectly pay tax. As a result, investors in unlisted companies via funds are not put at a disadvantage compared to direct investors, i.e. investors are not penalised for pooling capital to achieve scale and diversification (this is the public policy *raison d'etre* of tax transparent vehicles).

Flexibility

The UK limited partnership offers a great deal of organisational flexibility so that the specific requirements of individual investors can be accommodated. Unlike in a private company (where shareholders of the same class have to be treated equally), the partners can set the rules on matters such as how the profits are shared, how interests in the partnership are transferred and how the business is to be conducted. The terms of the fund are heavily negotiated during the fundraising process (which typically lasts 6-18 months) with the professional investors and their lawyers.

Consequently, it is suitable for nearly all investors, by type (tax paying or exempt, such as pension funds) and geography. This is vital: if the fund structure could not accommodate the needs of various investors, the investors may seek out foreign structures. This may incur significant set-up and transaction costs, reducing the incentive for some investors to commit capital to the fund, which increases the difficulty of fund managers to raise capital for their funds to invest.

Limited liability for LPs

Limiting liability for limited partners is a key reason investors prefer limited partnerships for structuring PE/VC funds. PE/VC investors are passive investors with very little control, who are investing in a relatively illiquid but high performing asset class and do not want to monetarily risk more than that which they have committed to the fund.

UK ecosystem and reputation

Outside the USA, the UK remains the largest hub for PE/VC activity, especially in Europe. UK limited partnerships have been used for more than thirty years to structure PE/VC funds, so investors are highly familiar with the structures. Investors do not like investing in unfamiliar structures as it increases their legal due diligence requirements and creates risk.

In addition, the UK is a broader financial services hub and hence has an established investment management services infrastructure, which is important for both investors and fund managers. This includes banks, administrators, accountants, lawyers and other service providers with a strong understanding of the PE/VC industry, who provide services in various languages and with an efficient cost-value ratio. Set-up and ongoing costs for a fund manager can vary substantially between jurisdictions.

Similarly, the UK has a stable and predictable tax and legal environment, including certainty of limited liability for investors. As the set-up costs for a fund manager are significant, the manager needs to be comfortable that it will not face material new hurdles when establishing a fund in a jurisdiction in the long-term.

The UK also has a robust and highly regarded regulator, the Financial Conduct Authority (FCA). This is important because PE/VC firms look for regulators that have implemented tough anti-money laundering/anti-fraud rules, which are a pre-requisite for investors, but also understand the industry and can provide a proportionate regulatory framework.

PE/VC managers are generally required to put adequate 'substance' into their headquarters for both regulatory and tax compliance purposes. Consequently, the location of their headquarters needs to be close to the location of their team and easily accessible. The UK is an attractive location to live and as a result, managers based in the UK are more inclined to use UK limited partnerships considering the proximity to established investment management services infrastructure with significant experience and expertise in the use of UK limited partnerships, as discussed above.

Prevention of a permanent establishment

UK limited partnerships provide fund managers with flexibility to ensure their activities do not lead to the creation of a "permanent establishment" for the fund in any jurisdiction other than that in which the fund is based, or in which the investors are resident. Creation of a permanent establishment could result in extra taxation for the investors in additional country/ countries. This could result in double taxation of the fund's profits in two jurisdictions or investors being taxed in another country at higher rates than they would have been liable to at home, which would be highly unattractive to those investors.

4. Why are fund structures complicated?

The illustrated diagram above is a simplified model of a PE/VC fund structure. In reality, fund structures often involve additional vehicles and are therefore on first appearance complicated, for a number of reasons.

Fund structures are bespoke and there is not a 'one-size fits all' approach. In particular, the exact structure used will depend on a number of factors including:

- Identity of investors – different investors will have different requirements and sometimes this requires additional parallel or feeder partnerships, with each new partnership requiring a new GP entity.

- Location of fund manager – fund managers may be based in a single jurisdiction, or may have offices in multiple different jurisdictions.
- Type of investments – different fund vehicles are more or less appropriate for different asset classes e.g. private equity, private debt, real estate, infrastructure or other, more liquid securities.
- Location of investments – in some cases, particular fund vehicles may be more suited to investments in particular jurisdictions.

Depending on the specific fact pattern, a fund structure will end up more or less complicated. Some specific examples of how a fund structure can become more complex are given below. This is just to give a flavour of some of the complexities that can arise while structuring international funds – these are only examples.

Funds, particularly those that are larger, often have significant European and international exposure. PE/VC executives raise funds from investors around the globe, and often invest on a pan-European scale, depending on the fund's remit. As such, varying taxation rules and regulation for investors (by type and geography) results in different requirements for different investors.

Although the flexibility of UK limited partnerships is valued highly by both investors and GPs (as outlined above), this also results in complicated fund structures, which can include a mix of UK limited partners and those from other jurisdictions. For example, certain countries may not recognise the tax transparency of a particular structure that may be recognised elsewhere. This leads to specific structuring to ensure transparency for investors from such countries.

Additionally other investors, such as pension funds, may require different structuring to take into account their tax-exempt status. For example, for United States federal income tax purposes, it is possible to "check the box" to treat a vehicle as tax transparent or tax opaque. Some US investors (primarily tax-exempt investors) prefer to invest through a tax opaque structure, while others (primarily US taxable investors) prefer to invest through a tax transparent structure. For this reason, it is not uncommon to have two parallel limited partnerships or a master and feeder fund within the same structure to accommodate both types of investor. Some Dutch investors require that the vehicle they invest in be subject to certain additional restrictions (e.g. no LP can transfer without the consent of all other LPs) otherwise, the fund may not be treated as tax transparent for Dutch investors. As these restrictions are not palatable to non-Dutch investors, these investors would generally invest through a separate ELP.

Further structuring solutions arise from co-investments from both LPs and the PE/VC executives in certain deals (see section 1 above). This can result in more than one fund, which may be managed by the same broader group of PE/VC executives, investing in any one portfolio company.

On a larger scale, fund managers may be managing a number of funds at any one time, which may not necessarily be managed by the same fund executives, which again leads to increasingly complicated structures.

In summary, as PE/VC funds will be structured to accommodate the differing needs of a large range of investors, this will result in multiple limited partnerships being used.

5. In what way is the private equity & venture capital industry regulated?

FCA authorisation

In the UK, most managers need FCA authorisation. A UK limited partnership will typically constitute an unregulated collective investment scheme for the purposes of the Financial Services and Markets Act 2000. The establishment and operation of an unregulated collective investment scheme is a considered a "regulated activity". In order to legally carry out such regulated activity, the fund must be operated by a person authorised by the FCA. Therefore the manager of the fund (either the GP or the manager which the GP has delegated to) will need to be FCA authorised if management activity is to take place in the UK. Where the limited partnership or the GP/management or advisory entities are established in other jurisdictions, the regulatory regimes in each of those jurisdictions must be considered to ensure the GP/manager/advisor are appropriately authorised. UK limited partnership fund vehicles are unlikely to be regulated themselves and although there may not always be a regulated entity/manager in a fund structure, there will be legitimate reasons why they are scoped out of regulation.

Marketing a fund

Marketing limited partnership fund vehicles (i.e. fundraising) is also heavily regulated in most jurisdictions, as they are usually not suitable for non-institutional investors (due to, amongst other things, their illiquidity). As a result, the marketing/fund offering regulations in each of the jurisdictions where the manager intends to market must be considered and complied with in advance of marketing activity commencing.

EU regulation

A limited partnership fund vehicle will almost always fall within the definition of an Alternative Investment Fund (AIF) for the purposes of the EU Alternative Investment Fund Managers Directive (AIFMD). If the fund manager is based in the EU, regardless of where the fund vehicle is located, it will need to be authorised as an Alternative Investment Fund Manager (AIFM) either as a full-scope AIFM if above the threshold for full authorisation (typically €500m for PE/VC) or as a sub-threshold AIFM. An EU full-scope AIFM can apply for the AIFMD marketing passport to market EU AIFs to investors across Europe. The marketing passport is not available to non-EU AIFs or non-EU AIFMs or sub-threshold AIFMs and in these situations, funds are marketed pursuant to individual EU Member State "National Private Placement Regimes".

New investors

Before admitting an investor into the fund, the fund manager will carry out numerous due diligence procedures regarding the status of the potential investor as part of the Know Your Client (KYC) and Anti-money Laundering (AML) checks. Amongst other checks, a PE/VC fund manager will:

- assess the risks of money laundering, financing of terrorism and other illegal activities;
- verify the identity of each investor and the effective beneficial owner of the investment in the PE/VC fund using a risk-based approach permitted under KYC/AML requirements; and
- request an annual report, a certificate of incorporation or registration, and other formal identification.

These KYC procedures on the status of a PE/VC fund's investors are imposed by laws such as the US Foreign Account Tax Compliance Act, the OECD Common Reporting Standard and UK/EU AML regulations, which may give rise to criminal prosecutions. PE/VC fund managers will also have internal models designed to ensure that the KYC test is applied rigorously. Such checks are carried out by the PE/VC fund manager upon the creation of the fund and before acceptance of the subscription of an investor. The BVCA is also a member of the Joint Money Laundering Steering Group that issues sector specific guidance.

6. How useful is the new Private Fund Limited Partnership regime?

Although UK limited partnerships have been the structure of choice for private equity and venture capital funds, the Limited Partnership Act 1907 is over 100 years old and has seen limited modifications over the years. As such, UK limited partnerships have increasingly fallen behind structures in other jurisdictions, which have developed regimes that are fit for purpose and more attractive for both investors and fund managers. The Private Fund Limited Partnership (PFLP) regime has attempted to bring the UK in line with other common jurisdictions.

Apart from reducing administrative burdens for general and limited partners, the new regime provides clarity as to the activities that LPs can undertake, which would not result in loss of their limited liability status.

Limited liability can be lost if the investor participates in the management of any limited partnership. The LP becomes liable for all debts and obligations of the partnership that are incurred if it is deemed they took part in the management of the fund. The LP is not merely liable for the liabilities that arise from its own involvement, but for all partnership liabilities that arise during its period of management.

Under the Limited Partnership Act 1907, there were no express provisions as to what behaviour constituted involvement in management, nor did the law in the UK provide any "safe-harbours." Several common fund jurisdictions such as Luxembourg, Guernsey, Jersey, Delaware (US) and the Cayman Islands have such safe harbours enshrined in statute. Funds now designated under the UK's new PFLP regime will benefit from a non-exhaustive list of actions by LPs that would not be deemed as participation in the management of the partnership.

UK limited partnership law, even with the new PFLP regime, is not unique in its terms or use compared to other common jurisdictions. The aim is to ensure that the UK regime remains attractive and competitive for both fund managers and investors alike. The UK continues to have more extensive transparency and filing requirements when compared to these other jurisdictions.