Willow
LEGAL ADVISORS PLLC

Private Equity Glossary

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Accredited Investor

An accredited investor is an individual or entity that is permitted by law to trade unregistered securities. The SEC defines the criteria of an accredited investor in Regulation D of the Securities Act, which regulates private offerings. Individuals typically qualify as accredited investors by meeting the dollar threshold for income or net worth, while entities can qualify in a variety of different ways. The distinction for accredited investors is designed by the SEC to ensure that unregistered securities are only offered to financially sophisticated and experienced investors who understand the risks associated with reduced regulatory disclosures.

Advisers Act

The Investment Advisers Act of 1940, or the "Advisers Act," is a U.S. federal law that requires certain financial advisers to conform to regulations designed to protect investors. The Advisers Act requires that those financial advisers register with the SEC or other comparable state authorities. In general, the Advisers Act holds financial advisers to a fiduciary standard that is designed to avoid conflicts of interest or unfair dealings with clients.

Alternative Investment Vehicle

An alternative investment vehicle, or "AIV" is an entity that is formed separately from the main fund partnership. A portion of investors' capital contributions is invested in the AIV, which then invests in a portfolio company. A fund may form an AIV for a variety of reasons, such as for favorable tax treatment when investing in a company outside the U.S. or an investment that could adversely affect a tax-exempt investor.

Angel Investor

An angel investor, or "seed investor," is an individual who finances startup companies in exchange for ownership equity. In addition to providing funding, an angel investor may also provide advice or industry knowledge to help the company grow. This type of investment is typically very risky but can offer huge returns if a startup becomes successful.

Blue Sky Laws

Blue sky laws are state-level securities regulations that require offerings or sales of securities to be registered with a state agency and to disclose certain information relating to the terms of the offering. The laws vary from state to state, but blue sky laws will typically create civil and regulatory liability for any issuer or broker that fails to comply with the regulations enacted by the state. Because each state has its own set of blue sky laws, an issuer of securities will often need to register with each state in which it intends to do business.

Capital Call

A fund will issue a capital call, or "drawdown notice," to its investors when a portion of investors' capital commitments is required by the fund. Typically, the general partner or fund manager will issue capital calls on an as-needed basis when the fund has identified a new investment or incurred expenses. After a capital call, investors must contribute the required amount to the fund within the agreed-upon period (generally within 5-10 days after the capital call).

Capital Commitment

A capital commitment, or "subscription," is an amount that an investor has promised to pay a fund when joining as a limited partner. Typically, an investor will subscribe to a fund by committing to pay a certain amount of money to the fund over the life of the fund, but the investor has no obligation to pay until the fund has issued a capital call, after which the investor must pay the called amount within the agreed-upon period.

Carried Interest

Carried interest, or "carry," is the share of fund profits earned by the general partner of the fund. Because the fee is linked to the performance of the fund, carried interest serves as incentive to the general partner to ensure that the fund performs well. Additionally, carried interest is typically only paid if the fund achieves a specified minimum rate of return.

Clawback

Clawback is the mechanism that allows investors to reclaim any carried interest that the general partner received in excess of the amount due. The clawback amount is typically calculated upon liquidation and averages the carried interest across the life of the fund, rather than permitting the general partner to receive carried interest based on any gain during a single year that the fund did not maintain over its life.

Clawback Guaranty

A clawback guaranty is a contract that imposes joint and several liability on the members or parent company of the general partner for a general partner's clawback obligations. Meaning, the individuals or entities that give the guaranty will be liable to pay the clawback amount if the general partner cannot. This type of agreement provides increased protection for the limited partners but is often disfavored by general partners.

Co-Investment

A co-investment is an investment made by certain limited partners in a fund alongside, but separate from, the main fund. When the fund becomes aware of an investment opportunity but is unwilling or unable to invest in the transaction for the full investment amount, the general partner may offer a co-investment opportunity to some of the limited partners for the portion not covered by the fund. Depending on the circumstances of the transaction, the co-investors may either invest directly in the portfolio company or through a separate vehicle created for such purpose.

Commitment Period

The commitment period, typically 3 to 5 years, is the timeframe in which the fund is permitted to call capital from investors and make fund investments.

Crowdfunding

Crowdfunding is the practice of using small capital investments from a large quantity of investors to fund a startup or other business venture. Although there are different types of crowdfunding, in the private equity industry, the term typically refers to "regulatory crowdfunding" which involves the issuance of securities that are exempt from registration, provided the issuer and investor satisfy certain requirements imposed and regulated by the SEC.

Drawdown Notice

A fund will issue a drawdown notice, or "capital call," to its investors when a portion of investors' capital commitment is required by the fund. Typically, the general partner or fund manager will issue drawdown notices on an as-needed basis when the fund has identified a new investment or incurred expenses. After a drawdown notice, investors must contribute the required amount to the fund within the agreed-upon period (generally within 5-10 days after the capital call).

ESG

Environmental, social, and governance or "ESG" issues are a growing factor in investment considerations. ESG often refers to a set of standards that are used to screen portfolio companies when evaluating an investment opportunity. Investors typically look at a variety of criteria to determine whether a company is a responsible corporate citizen. For example, environmental criteria may include the company's indirect greenhouse gas emissions or treatment of animals, while governance criteria include the company's leadership transparency and diversity.

FATCA

The Foreign Account Tax Compliance Act, or "FATCA," is a federal law that requires U.S. taxpayers, including private equity funds, to annually report certain offshore accounts and assets to the IRS. The law also requires certain foreign entities to report on the foreign assets held by U.S. citizens. Non-compliance by a taxpayer or foreign entity can subject the offender to severe penalties. The purpose of FATCA was to combat tax evasion achieved through offshore accounts.

Feeder Vehicle

A feeder vehicle, or "feeder fund" is a sub-fund that is often part of a larger umbrella of funds that feed into a master fund vehicle that makes portfolio investments. The feeder vehicles typically aggregate investments in the master fund vehicle to reduce costs and achieve economies of scale. Additionally, a feeder vehicle may be established to offer investment flexibility for certain investors, such as those subject to ERISA or tax-exempt investors. A feeder vehicle typically "feeds" capital into the master fund in such a way that any adverse or unwanted effects on the investor are minimized.

Follow-On Investments
A follow-on investment is a subsequent investment in a fund's existing portfolio company. This type of investment is often made to enhance the value of an investment by capitalizing on growth or protecting the initial investment at a later stage of funding.

Fund-of-Funds
A fund-of-funds is an investment vehicle that invests in other types of funds. Rather than holding equity, stocks, or bonds, a fund-of-funds invests in other mutual funds, hedge funds, or private equity funds. The advantage of a fund-of-funds is the broad diversity in its investments; however, it is often subject to higher investment fees due to the multiple layers of management.

General Partner
A general partner, or "GP," is the partner in a limited partnership that manages the day-to-day operations of the partnership. With respect to a private equity fund, the GP acts on behalf of the fund partnership and is responsible for raising capital from investors, identifying investment opportunities, managing investments, and overseeing the fund's liquidation. Because the GP controls the business affairs of the partnership, the GP has unlimited liability with respect to the partnership's business.

ILPA
The Institutional Limited Partners Association, or "ILPA," is a trade association that focuses on assisting institutional investors in the private equity market. The ILPA seeks to promote investor-friendly industry best practices and creates investor-friendly form documents and reporting templates.

Institutional Investor
An institutional investor is an entity that pools money and invests on behalf of individual investors. Common examples of institutional investors include banks, pension funds, hedge funds, unions, and insurance companies. Often seen as more sophisticated than retail investors, institutional investors are subject to less restrictive regulatory oversight.

Investment Company Act
The Investment Company Act of 1940, or the "1940 Act" or "ICA," is a U.S. federal law that was enacted to regulate investment companies, which are entities primarily engaged in the business of investing and reinvesting in securities. The 1940 Act requires investment companies to register with the SEC and to abide by extensive regulations, however, most private equity funds avoid these regulatory requirements by relying on an exception to registration, such as by only issuing securities to qualified purchasers.

Limited Partner

A limited partner, or "LP," is a partner in a limited partnership with a passive role. An LP is typically a third-party investor who contributes capital to the partnership but does not participate in its daily operations. Because LPs have limited control rights with respect to the partnership, LPs also enjoy limited liability with respect to the partnership's affairs.

Limited Partnership Agreement

The limited partnership agreement, or "LPA," is the governing document of a limited partnership. The LPA defines the rights, relationships, and responsibilities between the general partner and the limited partners. The LPA outlines fees, reporting requirements, and the lifecycle of the fund, as well as many other details necessary for the operation of the fund partnership.

Limited Partner Advisory Committee

The limited partner advisory committee, or "LPAC," typically consists of representatives appointed by LPs with the largest capital commitments to the fund and is formed to advise the GP on specific fund issues. Typically, the role and responsibilities of the LPAC are outlined in the LPA. The LPAC is often vested with the power to vote on behalf of all LPs concerning certain issues, rather than requiring the GP to seek the express approval of all LPs.

Management Fee

The management fee is an annual fee charged by the manager of a fund that is typically calculated as a percentage of the committed capital of the fund, such as 2%. This fee is paid as consideration for the operational expenses of the fund manager and is not tied to the performance of the fund.

Manager

The manager of a private equity fund often refers to the operating entity that employs investment professionals and is responsible for making and managing fund investments. The manager is typically an affiliate of the fund GP; however, the fund manager often works with multiple funds simultaneously while the GP is specific to a single fund. The term "manager" can also refer to an individual investment professional who is appointed to the governing body of a specific fund investment, such as a board of managers of a fund portfolio company.

Most Favored Nation Clause

A most favored nation clause, or "MFN clause," protects early fund investors by granting them the future opportunity to receive any more favorable rights and benefits negotiated by later fund investors. MFN clauses are often negotiated by individual investors in a side letter and typically obligate the fund GP to inform MFN investors of any more favorable terms accepted by the fund GP and to permit such MFN investors to elect to receive the same terms.

Portfolio Company

A portfolio company is a separate legal entity in which a fund invests.

Preferred Return

Preferred return, or "hurdle rate," is the minimum rate of return that must be earned by LPs before the GP is entitled to collect carried interest. The preferred return acts as a "hurdle" that must be overcome before other profits are distributed.

Private Equity

Private equity refers to a source of investment capital that is funded by private, pooled investments. Typically, a private equity sponsor forms a fund that accepts investments from various sophisticated investors and then pools those investments to invest capital into portfolio companies. Investments in private equity funds are typically subject to a finite term, however, the investments are relatively illiquid during that term. Because, even though a private equity fund may invest in public companies, the fund remains private.

Private Placement Memorandum

A private placement memorandum, also known as an offering memorandum or "PPM," is a document that provides potential investors with confidential information about an investment opportunity. The purpose of a PPM is to allow investors to make an informed decision about the investment. The PPM functions almost like a business plan for a fund, in that it provides detailed information about the security for sale. A PPM typically includes details such as investment terms, fees, objectives, information about the management team, historical results, and risk factors.

Qualified Institutional Buyer

A qualified institutional buyer, or "QIB," is a class of investor defined under Rule 144A of the Securities Act that qualifies the investor for less regulatory oversight by the SEC than other investors. A QIB is seen as financially sophisticated and less in need of the protection given to investors by securities regulations. Typically, an institution is regarded as a QIB if it invests at least $100 million on a discretionary basis; however, different requirements apply to certain financial institutions.

Qualified Purchaser
Qualified purchaser is a status afforded under the Investment Company Act to individuals and entities that have an aggregate investment portfolio above certain established thresholds. Typically, a qualified purchaser is an individual or family-owned business that owns at least $5 million in investments or an entity that manages or holds at least $25 million in investments (or is an entity owned entirely by other qualified purchasers). The benefit of having qualified purchaser status is the ability to participate in a broader range of private investment opportunities.

Regulation D
Regulation D of the Securities Act provides exemptions from the SEC's general registration requirements governing the offer and sale of a company's securities. Although an issuer of securities may be exempt from registration under Regulation D, the exempt issuer is required to file certain paperwork, such as Form D, and make certain disclosures, to the SEC regarding any unregistered securities offering. Nearly all private equity funds raise capital under Regulation D.

SEC
The Securities and Exchange Commission, or "SEC," is the U.S. federal regulatory agency that is responsible for protecting investors, enforcing securities laws, and regulating securities markets. The SEC creates rules designed to protect investors from unfair practices and promote transparency in investment markets.

Secondary Market
The secondary market in private equity refers to the buying and selling of existing investments in private equity funds. An LP in an active private equity fund may desire to sell its interest to a third party, who would be purchasing the LP's interest in current fund investments and the obligation to fund the selling LP's unfunded capital commitment. To participate in the secondary market, both the current LP and potential purchaser must comply with the governing LPA, which is often both time and labor-intensive and significantly more complex than buying and selling publicly traded securities.

Securities Act
The Securities Act of 1933, or the "Securities Act," is a U.S. federal law that was enacted after the stock market crash of 1929. The law—sometimes known as the "truth in securities law," requires issuers of securities to register their securities with the SEC. The purpose of registration is to promote transparency so that investors can make informed decisions when purchasing securities.

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Side Letter
In private equity, a side letter is an agreement between the fund GP and a single LP that alters the terms of the LPA as applied to that investor. The fund GP often agrees to enter a side letter with an individual investor to address certain regulatory requirements of the investor or to accommodate an investor making a large capital commitment.

SPAC
A special purpose acquisition company, also known as a "blank check company" or "SPAC," is a company listed on a public stock exchange that is formed for the sole purpose of acquiring an existing operating company. The SPAC typically raises funds through an initial public offering (IPO) but can also seek investments through a private offering of SPAC securities (a PIPE offering) before the IPO. If the SPAC does not acquire a company within two years after its IPO, it must return the investors' funds.

Sponsor
A sponsor is an investment firm that manages a private equity fund. The sponsor is responsible for forming the fund, raising capital, and providing investment expertise. The sponsor is typically either the same entity as the general partner and manager of the fund or closely affiliated with those entities.

Subscription Agreement
A subscription agreement is an application that a potential investor submits to subscribe for a limited partnership interest in a private equity fund. The subscription agreement requires potential investors to make various representations, warranties, and disclosures to enable the fund GP to ensure that each admitted LP satisfies all applicable regulatory requirements for the offering, such as being an accredited investor. Additionally, a fully executed subscription agreement serves as a contract between the LP and the fund that outlines certain terms specific to that LP, such as such LP's capital commitment to the fund.

Successor Fund
A successor fund is a private equity fund that is formed by a sponsor after a successful initial fund. To capitalize on the success of an initial fund, a private equity sponsor uses the performance of its initial fund to generate interest in the successor fund. The successor fund typically has a legal name that is similar to its predecessor fund. LPAs often include terms that restrict the fund sponsor from forming a successor fund until after the initial fund is fully (or almost fully) invested. This restriction serves to keep the fund's key persons focused on the initial fund and to prevent the successor fund from competing in investment opportunities.

Unfunded Capital Commitment
The unfunded capital commitment is the portion of investors' capital commitments that have not yet been contributed to the fund. Generally, unfunded capital commitments are not considered liabilities of the investor or assets of the fund until the fund issues a capital call to investors for some portion of the unfunded amount.

Unicorn
A unicorn is a privately held startup company that is valued in excess of $1 billion. The valuation is typically based on the company's growth projections, rather than the company's existing assets. The term was popularized by Aileen Lee, a venture capitalist, to signify the rarity of finding such a company in private equity.

Venture Capital
Venture capital is a form of private equity that finances the growth of startup companies and small businesses. Venture capitalists invest in emerging and early-stage companies based on high-growth potential, rather than an established track record, and are therefore considered to have a high risk of loss. However, venture capitalists are attracted to this type of investment because they can negotiate favorable terms with large payouts in the event the company is successful.

Waterfall
A waterfall is a method in which profit distributions are allocated among the fund GP and LPs. A waterfall defines sequential distribution tiers with each tier allocating a different portion of the fund profits to the GP, on the one hand, and the LPs, on the other hand. As the GP achieves greater returns for the fund, and hence satisfies different tiers of the waterfall, the portion of the profits allocated to the GP increase. The purpose of the waterfall is to incentivize the fund GP to maximize the fund's profitability for all investors. A customary distribution waterfall for private equity sponsors includes four tiers: the return of capital, the preferred return, the catch-up tranche, and the carried interest.