Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Working with Placement Agents

When raising a fund, whether for the first time or not, one of the first questions is, "Should I use a placement agent?" More and more often, the answer is "yes." Emerging managers are looking to establish themselves and gain entrée to institutional investors, while other fund managers with an established investor base may be looking to expand or may simply need someone to handle the significant logistics of going on the road to market a new fund. The best placement agents can not only help market the fund and open doors, but they can also help shape business plans, negotiate major terms with investors, and provide valuable insight on market conditions. However, engaging placement agents gives rise to a number of important issues that fund managers should keep in mind when selecting and working with these agents.

Scope of Engagement

Exclusivity vs. Nonexclusivity

Many placement agents will request that they be engaged on an exclusive basis—i.e., they want the fund manager to agree that no other placement agent will be engaged to raise money for the same fund. Whether or not exclusivity is appropriate depends on the facts and circumstances of the situation. Exclusivity may be appropriate where a placement agent and the manager are confident the placement agent is able to raise significantly more than the fund manager is seeking, or where the placement agent is willing to take ownership of the entire fundraising process beyond providing mere introductions to its own client list (e.g., drafting private placement memoranda (PPMs) and other marketing materials, providing advice on negotiating terms). Agreeing to an exclusive placement agent may not be appropriate, however, if a fund seeks significantly more money than a particular placement agent is able to raise or if the placement agent has a particular client list in a niche market (e.g., foundations, family offices, pensions). Fund managers may also demand exclusivity of the placement agent and should consider requesting that the placement agent agree not to work as a placement agent with respect to any other fund with a similar investment focus (e.g., no other cleantech funds).

Determining Who Gets Credit for Which Investors

Among the most keenly focused-upon areas of any agreement between a fund manager and a placement agent (the Placement Agreement) is the method by which a placement agent will be given credit for the investors it brings to the fund. Note that this issue exists whether a single placement agent or multiple placement agents are used, because even if only one placement agent is hired, the fund manager may have existing relationships that overlap with those that a placement agent has or proposes to develop. Because placement agents are typically compensated on the basis of a percentage of the total capital commitments made to a fund by investors that the placement agent brings to the fund, it is important to clearly establish the rules for determining which investors a placement agent is to be given credit for bringing to the fund. While methods vary based on the circumstances, the two most common approaches are (1) agreeing to a schedule of targeted investors that the placement agent will approach, or (2) agreeing to certain objective criteria by which investors will be identified as having been brought to the firm by the placement agent. An example of an objective criterion is requiring that at least two face-to-face meetings occur between the placement agent and an investor in order for such investor to be deemed to have been brought to the fund by the placement agent. Fund managers should be careful to exclude from any engagement the commitments made by the general partner and its principals, employees, affiliates, and associated friends and family.

Functions of the Placement Agent

As noted above, placement agent engagements can vary widely in scope and responsibility. Therefore it is important that the functions of the placement agent be clearly set forth in the Placement Agreement in order to remove any ambiguity regarding its duties. These duties may include any combination of the following:

- Consulting with the fund manager as to strategy and tactics for initiating discussions with prospective investors
- Drafting marketing materials (e.g., PPMs and slide presentations)
- Identifying and making initial contact with prospective investors
- keeping a list of all prospective investors contacted by the placement agent and, to the extent feasible, a record of the level of interest of those investors contacted
- Arranging and attending meetings between prospective investors who have received offering materials and representatives of the fund manager
- Forwarding to the fund manager any requests for additional information by prospective investors and assisting the fund manager in responding to such requests
- Advising with respect to market terms and conditions in fund agreements
- Maintaining a master investor log and marketing records for the placement of interests under the Placement Agreement and reporting to the fund manager on a regular basis with respect to contacts made with prospective investors

It is also important to have an overarching covenant that the placement agent will act in accordance with the instructions of the fund manager. One important example of this is requiring that the placement agent suspend all of its activities on behalf of the fund at any time that the fund manager instructs it to do so.

Ability of the Placement Agent to Delegate

Generally, a placement agent should not be permitted to delegate its duties under a Placement Agreement to others without the fund manager's consent. Fund managers typically hire a placement agent on the basis of their comfort with the individuals at the placement agent that they have met, and any ability to delegate would undermine such comfort. If a placement agent is permitted to delegate, the agreement between the placement agent and the fund manager should clearly state that the placement agent remains liable for all of the acts of its delegates. In addition, the placement agent must agree that all delegates will be required to agree to the terms of the Placement Agreement.

Placement Agent Fees

Typically, the fees paid to a placement agent are calculated as a percentage of the total capital commitments to the fund that were made by investors introduced to the fund by the placement agent. With respect to private equity and venture capital funds, these fees are due only once per investor's commitment, unlike hedge funds, which may pay ongoing quarterly fees. A placement agent should only be given credit for the amount of capital commitments made by investors that are admitted to the fund by the general partner of the fund. An interesting nuance, for which there is no universal approach in the market, is whether a placement agent should refund its fees if an investor that the placement agent brought to the fund ultimately defaults.

In addition to how much a placement agent is to be paid, there is also the question of when the placement agent is to be paid. Administratively, it is easiest for a fund manager to agree in the Placement Agreement that all of the placement agent's fees with respect to the fund being raised will be paid some reasonable period following the final closing of such fund. Some placement agents will seek payment sooner than the final closing of a fund, but keep in mind that the payment of the placement agent should, at a minimum, be timed such that the fund manager shall have been able to make and receive capital calls from the investors in the fund before being obligated to make payments to the placement agent. In some circumstances, placement agents may agree to be paid with promissory notes until such time as capital is called from the investors in the fund.

Sequel or Follow-on Funds

Placement agents sometimes request the right to act as placement agent for any sequel fund that may be formed by a fund manager. This should be resisted as the facts and circumstances that will exist at the time of raising a sequel fund are very difficult to predict. At most, a fund manager should only agree to notify the placement agent of any sequel fund and meet with the placement agent to discuss, without any obligation or inference, whether the placement agent will be retained for the sequel fund.

Even if a placement agent receives no assurances regarding acting as placement agent for a sequel fund, it often requests to be paid with respect to any investors it introduced to the initial fund that thereafter invest in a sequel fund. If a fund manager agrees to this concept, it is best to narrow the scope of what is meant by a "sequel fund," such that only a fund with an investment focus substantially similar to the original fund will qualify, and to determine whether a mere introduction will suffice, as opposed to actual investment in the prior fund. In addition, the fee rate is typically substantially lower with respect to the sequel fund.

Securities Laws Compliance

With limited exception, placement agents must be registered as broker-dealers with the Securities and Exchange Commission (SEC). It is also important for placement agents to be registered or licensed, as applicable, with all relevant state and local authorities (although many of such requirements are preempted by registration at the federal level). Finally, the professionals within a placement agent must have appropriate licenses, as required or issued by the SEC, FINRA, states, or local authorities. As such, fund managers should seek appropriate representations in the Placement Agreement to ensure that the placement agent and its professionals are registered and licensed.

A separate securities laws compliance issue is the manner in which the placement agent engages in its activities. It is important that the placement agent not engage in any general solicitation or advertising of the fund, and that it make offers in the fund only to persons it believes are suitable in light of the securities laws exemption the fund is relying upon, and with whom such placement agent has preexisting relationships. In addition, the fund manager should retain complete control over what information is provided to prospective investors and the format in which such information is provided. These steps are necessary to protect the fund's exemption from the federal securities laws, including without limitation federal laws that require registration of securities offerings and federal laws that require registration of investment companies. The Placement Agreement should contain covenants from the placement agent covering these concepts. In addition, the Placement Agreement should make it clear that the placement agent will be required to provide a certificate to the fund's legal counsel in connection with each closing of the fund in which the placement agent certifies it has complied with such manner of offering restrictions.

Government Plan Investors and Placement Agents

The use of placement agents by fund managers when soliciting government pension plans to invest in private investment funds is under intense scrutiny at the time of this article. So-called "pay to play" scandals and other conflict-of-interest issues involving such plans, including some of the largest plans in the United States, will undoubtedly lead to greater regulation and transparency when soliciting government plans and may even result in a total ban on using placement agents to do so. In any event, it is advisable when engaging a placement agent to address the issue of whether such plans will be a target in the fundraising, whether the placement agent will be involved, and whether the placement agent or any of its affiliates have any relationships with the plan trustees or other government officials (e.g., familial relationships, political donations) that would preclude them from participating in any solicitation.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

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