

VC funds – not one size fits all

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The aggregation of private capital for the purpose of investing in startups and emerging and high growth companies continues to be one of the drivers of the global economy. Often, this type of investing is done by “VC funds.” But what does one mean when one says “VC fund”? They come in many shapes and sizes.

In addition to the “traditional” closed-ended 10-year VC fund, there are micro funds, growth funds, opportunity funds, continuity funds, highly specialized sector-specific funds, evergreen funds, funds linked to a venture studio or accelerator, deal-specific SPVs, dedicated co-investment vehicles, etc. Additionally, a wide range of investors are investing in the space as limited partners (LPs): banks, funds of funds, pension funds, corporate strategic investors, high-net-worth individuals, family offices, etc.

With so many types of VC funds out there and so many different types of investors investing in the space, having a clear understanding of the context and unique issues associated with each type of fund and each type of investor is more important than ever. The fundamental business deal in any fund is simple: investors provide money, the fund uses that money to pay expenses (which may include a management fee) and make investments, and then the net returns are shared between the general partner (GP) and the LPs. But attempting to view all these vehicles through the same lens will inevitably lead to confusion and frustration for the team trying to raise a fund (the GP), for LPs trying to evaluate an investment in a fund and for professional service providers trying to assist GPs and LPs with putting it all together. This article highlights a few examples of how differing contexts raise different issues to be taken into consideration during the formation of a VC fund.

The investment objective of a fund, with respect to sector and stage, will impact the way the fund actually operates. For example, the number of investments to be made and the amount of capital that a GP reserves for follow-on investments in a seed stage fund will likely be quite different than in a later stage growth fund. The amount of influence that the GP of a pre-seed stage micro fund may be able to exert on the fund's portfolio companies will be quite different than the influence that a GP managing a fund writing large cheques and leading later rounds can.

Funds that are formed to operate alongside a venture studio or accelerator present a unique set of issues for LPs and GPs to consider. Will the money raised by the fund be used to fund the operations of the venture studio/accelerator or only for investing in companies that are created by the venture studio or participate in the accelerator? If it funds the operation of the venture studio/accelerator, how will the fund be compensated? Will the fund be allowed to invest in companies other than those that are created by the venture studio or that participate in the accelerator? And if so, how much? Should the economics on both types of investments be the same? The list goes on. The approach chosen with respect to each issue will have consequences for the tax and legal structuring of the fund and venture studio/accelerator and the relationship between the two.

Customary terms can take on different significance depending on the type of fund. Again using the venture studio example, conflict-of-interest rules governing the circumstances in which a fund may be able to invest in companies in which members of the GP hold a pre-existing interest obviously cannot apply the same way to a fund formed for the purpose of investing in companies that are spun out from a venture studio as they would apply to a fund that sources investments from the market at large. But what about follow-on investments once the spun-out company becomes a portfolio company of the fund? Should the venture studio team be allowed to continue investing or should all investments in the company be made by the fund? There is more than one way to address these issues.

Regardless of fund type, it is critical that GPs and their audience (i.e., LPs) understand their expectations, requirements and motivations. A pension fund or a regulated bank will have different requirements than the high-net-worth investor and a large corporate strategic investor will have different motivations than a family office investing for financial return. Funds of funds often have detailed reporting obligations to their own investors that they must flow through to underlying funds. Likewise, it is important for investors to know their GPs and understand their capabilities and limitations. A \$10M first-time pre-seed fund will not have the same capacity to deliver on reporting or other matters as the team behind a \$500M growth fund in its fifth vintage.

With so much variety with respect to sector or stage focus, fund size, fund structure and type of investor, it will benefit all parties to make sure they take a step back and assess the context surrounding their particular deal as they approach the fund-raising or fund-investing process. While there are several different negotiation styles and approaches that GPs and LPs may adopt to tackle the various issues that arise during the course of a fund formation, it is clear that a one-size-fits-all approach is not a viable one.