

## Legal, Banking and Fund Administration: Three Critical Elements for New VC Funds.

The first in a three-part series on building your fund's foundation.



### Key takeaways:



Ensure your legal team will make your fund formation documents bulletproof.



Leverage your banking partner for expertise and advice, in addition to banking.



Make sure you can rely on your fund administrator to account for every penny that flows into and out of your fund.



By Kristen Ostro, Strut Consulting

Starting a venture capital (VC) fund is a big job, especially if you're doing it for the first time. Nearly everyone makes mistakes and understandably so. Until recently, much of the information has been in the hands of a privileged few. But that's no longer the case. Today, emerging managers can rely on an array of partners, resources and tools to help navigate the fund formation process and start investing. In fact, the barriers to starting a fund of your own have **never been lower**.

However, before you make your move, there are three critical steps you need to take to ensure your fund has a solid foundation.

# 1 Secure legal counsel.

There's been a new wave of fund formation in recent years, with [Angellist](#) debuting the [rolling VC fund](#) in early 2020 and startups like [Allocations](#) aiming to take the fund formation process digital. These changes are likely to shake up the way the legacy law firms have done things for decades.

## What does legal do?

Most critically, legal helps prepare your fund's limited partnership agreement (LPA), which essentially sets the rules for your entire fund. LPAs vary widely across fund and partnership structures. Generally, they address topics like the terms of the partnership, the investment strategy and the responsibilities of the general partner and the limited partners. Ultimately, the LPA is the bible of your fund, and it needs to be done correctly the first time.

A poorly drafted LPA can cause delays and complications — not to mention major legal bills. In fact, going back to fix a poorly done LPA may cost two to three times what you pay to do it right the first time. And that's not a small figure. For a well-executed LPA, you may expect to pay \$50,000–\$200,000 per fund formed, depending on the size of your fund and the complexity of the LPA.

## When do I need a legal team, and how do I pick the right firm?

If you're using a best-in-class law firm, rather than one of the newer options mentioned earlier, lining up your legal counsel should be one of the very first steps in the active fundraising process. You'll need legal to draft your LPA and send fund documents to your committed investors, as you move toward a first close.

Picking the right firm means balancing their expertise (ideally, you want the very best and most experienced) against what you can afford. After all, this is one of your largest and most important expenses.

## LPA need-to-knows

As a general partner (GP), you need to pay attention to four key elements of your LPA:

### Management fees and carried interest.

Most funds operate on a 2-and-20 model, meaning 2% of the fund's total assets will be carved out as the management fee, and the GP participates in 20% of the profits. The management fee is held in a separate management company account, which pays for operating expenses, salaries and other items that allow the fund to run like a business. Additionally, most funds keep a percentage of the profits in excess of the amount the GPs initially contribute (typically 1%–5%). This acts as a type of performance fee to motivate the fund's overall performance and is known as carried interest.

### Audit.

Most standard LPAs require an annual audit to maintain transparency and accurate financial reporting standards. Audits can be pricey, so be sure to budget for them and work with a reputable firm. For a new fund in the \$50 million–\$100 million range, you may expect to pay \$20,000–\$30,000 annually for an audit, or \$250,000–\$275,000 over the life of a 10-year fund, according to [Frank, Rimerman + Co.](#)\* Since sub-\$10 million funds have limited resources, audits can sometimes be waived in the LPA. If your fund fits this bill, talk to your legal counsel about your audit options.

### Key man life.

For most sole-GP or two-GP funds, key man life insurance is required. (It's also used for some multiple-GP partnerships.) Key man is a life insurance policy on a business's critical person or people — the ones needed for the fund to function. For obvious reasons, limited partners (LPs) want their investment protected, should something awful happen to leadership.

### Your GP commitment.

This is the amount of personal capital (typically 1%, but often more) the managing GP or GPs are expected to contribute to the fund. The objective is for GPs to have significant skin in the game in relation to the LP commitments.

## Who pays for what?

Now, some good news: Given how expensive legal is, most LPAs dictate you get a break on the cost of fund formation, which is reimbursed by the fund account and does not come out of management fees.



## The day-to-day: From term sheets to contract reviews

After the LPA is signed, legal constructs [term sheets](#) for the investments you'll be making on a regular basis. (Check out other examples from [Cooley](#) and [Y Combinator](#).) You'll want a legal advisor who is well versed in term sheet best practices and can make recommendations on how to construct yours to accurately reflect your investment objectives.

Your legal team is also the go-to for all contract reviews, service provider contracts, one-off legal needs, etc. You can often find a second, more affordable legal team to handle these needs at a significant cost savings, or you can take advantage of e-legal or online legal options.

\* Frank, Rimerman + Co., Sept. 14, 2020.

# 2 Open a bank account.

Now that you've got some LP commitments and it's time to do a first fund close, you're ready for the next step: banking. And while you definitely need a bank account, you're going to need a whole lot more than that as a new venture capitalist.

## What to look for in a bank partner

As a new venture capitalist, you need a banker that is an absolute expert in VC, from the mechanics of capital calls to the needs of portfolio companies and the challenges that emerging managers face. Find a partner that:

- Offers a full suite of best-in-class banking services and products
- Has deep expertise in your industry and/or the industry you're investing in
- Can be a foundational piece of your portfolio service/platform offering by providing banking services and credit options for your portfolio, as well as a suite of services to support your founders on a personal level
- Has significant market share and credibility
- Builds strong relationships and has a network they can introduce you to
- Supports you with critical, targeted business advice

## Added value

In addition to the above, the ideal banking partner:

- Is ready to take action when the unexpected happens (hello, COVID). For instance, your banking partner might advise you on how to navigate a crisis
- Shares best practices and information about how your peers are addressing business challenges
- Advises you on the types of LPs that fit your investment stage or focus
- Provides meaningful advice on your pitch deck
- Could potentially invest as an LP in your fund via its venture investment arm

## Critical VC banking functions

In addition to serving as an expert advisor and relationship-builder, your banking partner can support your fund and your portfolio companies with an array of banking products and services, including:

- Fund/capital account(s)
- Credit cards
- Checks
- Private banking and wealth advisory
- Management company account(s)
- Fund capital call line of credit
- Loans and growth capital financing for the portfolio
- Ability to bank globally

# 3 Find the best fund admin for you.

Now that you're really underway, it's time to find a fund admin you can rely on. We'll get into the details in "[The emerging manager's guide to fund administration](#)," but for now, here's a quick overview.

## What is a fund admin?

In technical terms, a fund administrator is an outsourced third-party service provider that protects investor interest in the fund by independently verifying its assets and valuations. More important for you, a fund admin is your financial go-to, helping you keep the finances of the fund straight, thereby making you look good to your LPs and founders — a real win-win partnership.

## What does a fund admin do, exactly?

From cash management to capital calls, quarterly reporting to valuations, and facilitating your annual tax and audit preparation, your fund admin is actively involved in every penny that comes in and goes out the door of your fund.

## How much does fund admin cost?

Fund administration tends to be expensive. Most fund admins use one of the following fee structures:

- A fee for the number of LPs per fund
- An annual retainer amount per fund
- A fee based on a suite of services or a service package that encompasses the scope of work

Choose the approach that works for your budget and your preferences. And note that after your relationship is well established, some fund admins may take a small piece of fund carry in exchange for a reduced annual service fee.



# Build a firm foundation for your fund.

With the right legal, banking and fund administration partners in place, you'll be well on your way to building a strong, stable VC fund. Strut Consulting and Silicon Valley Bank would be honored to be partners on your journey.

## Additional resources for emerging managers:

- The Emerging Manager's Guide to Fund Administration
- VC Insurance 101: Protecting Your Fund, Your Investors and Yourself

Access further articles and resources  
on our [Emerging Manager Insights](#) page.

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