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Virtual Event Series

Fund Structures for Fundraising

Guest Speaker:

John Phillips

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DiffuseTap: Fund Structures for Fundraising

Last time on DiffuseTap, **John Phillips, Principal at Griffin Phillips LLC** talked to us about how to craft the perfect out-of-the-box fund structure, what opportunities lie in cross-border financing, and why location is key to efficient fundraising.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas) … straight from your armchair like a boss.

Meet the Speaker

JOHN PHILLIPS is an industry veteran with a knack for building creative investment vehicles and fund structures. With over three decades in the industry, he currently serves as Principal at Griffin Phillips LLC, where he finds and creates the best investment vehicles within jurisdiction for clients. His effort culminates in an operational platform and fund structure that gives investors an opportunity to gather assets for their investment strategies with the best rates of return. LinkedIn: @johngphillips

About Diffuse®

We are an alternative fund platform offering differentiated investment products. From digital assets to VC funds and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information, visit www.diffusefunds.com.

KENNY ESTES: Today's speaker is Mr. John Phillips. So John, do you want to do a brief introductory spiel on yourself?

JOHN PHILLIPS: I have been 35 years in the business of developing products in 15 different jurisdictions globally. That includes everything from broadly distributed funds to private placements to a variety of one-offs. In Canada, there are three specific revenue laws that are a result of me putting funds together that push their limits. Same thing here in the States, but not three. We just have one.

My job is to figure out a viable and legal solution to any fund structuring problems. I've been with most of the Chicago-based firms, such as Guggenheim, Calamos, Nuveen, and First Trust at different points in time, building products for them. I've been independent for the last 10 to 11 years, building products contractually and solving issues from Brazil to Canada.

AYLA KREMB: Awesome. Thanks for the intro. I think we'll just hop straight in with a bunch of questions to make sure we get the most out of your time here. Maybe we'll start off with something obvious. How does the fund structure really influence the GP's ability to fundraise?

JOHN: Fund structure is probably the secondary or tertiary answer. The first set of questions for somebody raising funds is what are they doing it for? Am I funding a specific company? Am I planning to go IPO, who am I selling to, etc.? Once you get there and you know the answers to those questions, you can create a fund that basically allows a GP to know who they're going to, under what circumstances, and where the pitfalls are in either Securities Act exemptions or 40 Act exemptions. It's really about knowing who you're selling to, what you're selling, and what you want the end result to be. The fund structure works for that gap to reach those goals.

KENNY: Okay, so let me ask you this. What does a creative fund structure look like? There are a lot of VCs in the room and a few hedge funds who are doing relatively standard Reg D funds. What are some of the options that you run into when you start thinking outside the box?

JOHN: One of the things I'm looking at right now – and it's a bit more of a registered product – is a SPAC. Blank check companies are suddenly getting back in vogue. In fact, I read an article the other day that said SPACs were outperforming regular IPOs.

In the private placement world, it's really the Reg As. Reg A+ is where you're really intending to raise funds for an OTC listing. Reg Ds, where you've lost your 505 but your 506 is in 506 Cs, are a great way to raise funds for a specific purpose. Your biggest issue is that you have to make sure you're not dealing in investing, or you might have to get a 3C1 or a 3C7 exemption from the 40 Act.

I recently built a master limited partnership, which is another very interesting answer. When you're doing a broad distribution and you want to get listed but you're dealing with hard assets, not securities, that is an interesting placement. There are a couple interesting structures. I think one thing that many

American managers forget is that there are good reasons to look at, maybe, Cayman, or Dublin, or Luxembourg. I built a couple of structures there that were interesting and were built more around total return swap and debt to avoid some tax and controlled foreign corporation issues.

KENNY: There's a bunch of words in there that I think were the first time I heard them, so I'm assuming much of the audience is in the same position. Master limited partnership, for instance, you kind of went over that quickly. What is a Master limited partnership, and what is the CliffsNotes version of the pros and cons of going with something like that, which is relatively innovative?

JOHN: Yeah, I don't know how innovative it is, but it's one of those products that come and go with vogue. I think the best way to look at a Master limited partnership is it is a registered structure that can hold non-securities. That includes real estate, timber, and other commodities that are difficult to put into a listed 40 Act or a listed 33 Act structure. With a master limited partnership, you can broadly distribute those because you could list them.

It's one of the few LP structures that works well with listing on an exchange for broad distribution. People have used them or looked at them for crypto, because crypto won't fit into a 40 Act structure. It will work on a 33 Act structure, but not a 40 Act structure. It's a way to bring a non-security to the market for broad distribution, where it wouldn't work in a mutual fund or an ETF.

AYLA: One of the questions in the chat is around foreign structures. What are some of the benefits of, for example, locating your entity in the Caymans? What are some of the benefits there for us investors to be able to invest in those vehicles?

JOHN: Cayman and places like Dublin, or Luxembourg, or Mauritius, or some of these other ones are really built for tax benefit. Here in the States, we are taxed on transactions for taxes, sales, and all that kind of stuff. But in Dublin and Cayman, the funding structure itself does not expose us to tax.

You have to be careful in many senses, because if you have a Cayman or Dublin structure and you want to get US investors into it, you can run afoul over 144A or you can run afoul of the 40 Act if you exceed 100 investors. But generally, you're going overseas to take advantage of fund structures that are tax efficient.

You can do investing especially in non-securities and hedge fund-like structures that you wouldn't be able to in the States. You are limiting yourself to qualified, and sometimes accredited investors though, and you have to be careful about your number limits, but they do give you a tax advantage and sometimes, the ability to do structures and invest in things that you couldn't invest in here in the States.

KENNY: Fascinating. So some more flexibility and some tax efficiency. When we're talking about international, I've seen that there's a lot of interest lately in listing in Canada, whether it's on the CSE or the TSX. And people are starting to figure out how to apply that to something that looks more like an investment vehicle or potentially a fund.

You said you had three laws in Canada that were written (I have zero, by the way, I think most people also have zero), so that's very interesting. But what does taking a fund to Canada look like? What are the advantages and disadvantages in your mind?

JOHN: Well, one of the things right now is I helped structure a cannabis fund here in the States. One of the issues here is because cannabis or companies touching the plant, as they refer to them, cannot list or sell broadly here in the States, we have discovered that the CSE and the NEO market in Canada are exchanges where anybody can buy a security. The CSE and NEO do not comply with US federal law. But the TSX and the TSX Venture, which are the two main exchanges in Canada, do comply with US law.

You can do a fund on the CSE. I was talking to a client about listing some of their ETFs up in Canada on NEO and the CSE. You can list the fund up there. And you can invest and operate in cannabis, where here in the States, you couldn't. But because it's listed on a recognized exchange, a US person could invest in it as long as they've got a broker-dealer that can sub custody their assets in Canada. That's one of the reasons that the CSE or NEO works. They don't comply with US federal law.

AYLA: Most of the time, people have already started the process of setting up their fund. At this point, they have a structure in place to work with the lawyer, and so on. For people trying to raise funding as we speak, who are running into some zesty LP questions that are very into structures, how can they troubleshoot some of the issues that they might be experiencing? What can they do to troubleshoot their own structure to see if they might be hampering their own fundraising efforts?

JOHN: There's really two things you need to look at. And a lot of times, the PPM is fairly straightforward. It is describing what you're going to invest in. I think there are times when you may want to come back and change some of the fee parameters. If you find out that it doesn't work, then you have to make it apply to people who have been in the structure. Everybody needs to be treated the same, unless they can be identified as specifically different for some specific reason.

A lot of times I find that people are really trying to go back and change more of the, not tax, but maybe the accounting side of the business. And that's really something that you go to your local accountant to try and figure out how to track certain characteristics that are creating a tax problem, or that your limited partners are getting exposure that they don't want. Sometimes, you can correct that with either an accountant or a lawyer who deals more with the accounting side of those funds.

But most of the time, I find that any changes once you get up and running has to do with either the sales charge, or the fees. And usually the problem is that the reps aren't getting paid enough. Or two, you're trying to solve a problem where your tax exposures, usually for either expenses or revenues, need to be adjusted. Hopefully, you find that out early before you bring too many people under the umbrella.

KENNY: How do you find out? When you're out there raising money, do investors come back and say "Hey, you're not paying your accounting agents enough"? Where does the feedback come from?

JOHN: Your feedback is going to initially come from your broker-dealer network when they're running into problems as they're trying to sell this product to their clients. Sometimes, it's even earlier than that. It's when they come back and say, "you know what, you're not paying me an 8% sales charge on this." That's one of your early warnings.

The broker-dealer network gives you a, let's call it, an informal focus group response, and a lot of times that's from their own needs or from their clients' needs. Your accounting problems usually come up after the first tax year, when the tax K9, K1, or hopefully the K8 comes in. That's when you get a good look at what you bought, and so you must deal with those accounting issues. The latter is probably what I see more of than the former.

AYLA: One of the questions that came up in the chat comes back to the types of structures. The rolling VC fund structure has gained some popularity a little bit within the last 18 months or so, especially for small seed rounds. That and going SPV by SPV. What do you think of rolling and pulling fund structures versus standard fund structures?

JOHN: That was one I'm not that familiar with. I've done very few VC funds. And when you're in the Reg D world, which is a securities tax exemption, you really can't do a lot of rolling. And when you're in a 3C1 or 3C7, which is a 40 Act exemption world, you can do stuff with the 7s, but not with the 1s. I'm not very familiar with that kind of rolling fund structure. I just found it by experience.

KENNY: It's just too boring, that's really what it is.

AYLA: Exactly. It's not advanced enough. Where's the fun in that?

JOHN: The VC and especially the PE world are highly specialized. And even though they had the same problems to make sure they're exempted from the right listing requirements; you must be careful because most of them will have to look at Securities Act or 33 Act exemption. But at the same time, if they're dealing too much in buying and selling underlying securities, they can be caught in a 40 Act and deemed to be a registered investment company, which is a major disaster.

What most of them should or could do is they should consider a 3C1 exemption. However, that lays down some limits on people. On a 3C1, you can only sell to 100 investors. It's kind of a problematic world, you just must know where your exemptions are and what they include. In a reg D world, you must be careful that you don't have what are mirror offerings. In the rolling world, that is slightly outside of my territory.

KENNY: We got a couple questions in the chat going back to master-feeder structures. If you want to set up a master-feeder, where should the master be, and where should the feeder be? The Caribbean islands seem to be popular, but why is that? Are there advantages and disadvantages to picking BVI, Caymans, or the Bahamas in your experience?

JOHN: Most are fairly narrow differences. I have a predominance of Southeast Asian investors and I would go for the Caymans every time. If I am looking at more Latin American investors, then I would go for BVI. It has to do with where potential investors, including both high net worth individuals or institutional investors, are comfortable working. I structured a deal out of the Caymans because a good number of our investors were Japanese, and that is an area that they have a high level of comfort with.

If I'm selling to Europe, I tend to go to Dublin. Unless it's a hard asset structure, then I'll go to Luxembourg. There are nuances to the laws in those environments, but most of them are tax advantaged. Those are considerations, but a lot of times, it is more about who you're selling to, and where they are institutionally comfortable dealing with. A lot of times it also has to do with tax treaties and their tax authorities in the country that they're investing from, and if they are familiar with certain structures in certain jurisdictions. When I'm deciding on a Cayman, or a European, or even a Mauritius environment, those have more to do with who my investors are than what my investment is.

KENNY: That's one of the sound bites that I'm surprised you haven't dropped yet, which is, as you've given to us multiple times, always start with your investor and then work backwards.

JOHN: Yes. I can build you a beautiful structure, but I might build it in a completely inappropriate place if I don't know who you're selling to.

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