The Sword and the Shield: Using Compliance and your Documents as Sword and Shield

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SadisGoldberg LLP

Interactive Brokers

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WHAT IS THE ORIGIN OF THE TERM "HEDGE FUND"

- The term "**hedge fund**" is not defined or used in the federal securities laws and has no precise legal definition. Generally, the term is used to describe private investment vehicles that engage in active trading of various types of securities and commodities including equities, government securities, financial futures, options and foreign currencies. Hedge funds often employ sophisticated investment techniques such as arbitraging, leveraging and hedging.

- It is generally agreed that the first hedge fund was established in 1949 by A.W. Jones. Mr. Jones employed a hedge concept in which he used short selling as a way to protect his portfolio from misjudgments on the general trend of the market. He also leveraged his long positions in order to neutralize general market risks and to tie performance more clearly to his stock selecting ability.

Hedge Funds are highly speculative and investors may lose their entire investment.

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THE THREE A'S

The hedge fund industry remains dominated by the three A's -

Alternative, Absolute, and Alpha

- **A**lternative: Describes the illiquid nature of hedge funds and their atypical investment/trading strategies—this is evidenced by the proliferation of non-exchange traded, illiquid investments (such as life settlements, mezzanine financing, distressed debt), which are moving towards the buyout sphere.

- **A**bsolute: Describes the types of returns that hedge funds expect—they are not bench marked against the S&P or Willshire, etc., but rather against their own returns, with zero as the benchmark for performance.

- **A**lpha: Without getting into the economic terms, is simply the portion of the return that is independent of the market's performance. In other words, that which is attributable to the skills of the hedge fund manager.

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KNOW YOUR INVESTOR

(i) How much money have I soft circled?

- What type of investors have you identified for investment (i.e. soft circled)?
- Are they institutional investors or individual investors? Are they domestic (US based) or offshore (foreign)?
- If the investors are individuals, are they accredited only or are they qualified clients?
- If the investor is institutional, is it (a) US taxable; (b) US tax exempt; or (c) foreign person (non-US person)?

(ii) Is the investor subject to ERISA?

WHY YOU NEED ACCREDITED INVESTORS

Under the Securities Act of 1933, as amended (the "**1933 Act**"), a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements. The 1933 Act provides companies with a number of exemptions. For some of the exemptions, such as rules 505 and 506 of Regulation D, a company may sell its securities to what are known as "Accredited Investors" without having to register.

Rule 501 of Regulation D states that an **individual** is an Accredited Investor if the individual:

- Has a net worth, or joint net worth with that person's spouse, that exceeds $1,000,000 (excluding the value of the individual's primary residence); or
- Has income in excess of $200,000 (or joint income in excess of $300,000) in each of the two most recent years with a reasonable expectation of achieving the same income level in the current year.

An **entity** is an Accredited Investor if it:

- Is owned exclusively by accredited investors; or
- Is not formed for the specific purpose of acquiring an interest in the investment vehicle and has total assets in excess of $5,000,000.

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WHY YOU NEED QUALIFIED CLIENTS

- In order for managers who are registered investment advisers (RIAs) to receive performance-based fees, the fund's investors need to be deemed "Qualified Clients."

- Under Rule 205-3 of the Investment Advisers Act, "Qualified Clients" are individuals or entities that:

  - Have a net worth of $2,100,000 (excluding the value of their primary residence);

  - Have at least $1,000,000 under management with the RIA;

  - Are a "Qualified Purchaser" under the Investment Company Act; or

  - Are an officer, director or a knowledgeable employee of the RIA.

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COMPENSATION:
PERFORMANCE AND MANAGEMENT FEES

Hedge fund managers are typically compensated based on fund performance.

In today's volatile marketplace, fund managers face extreme downward pressure on pricing, particularly with regard to management fees.

PERFORMANCE FEES/INCENTIVE ALLOCATIONS

- Performance fees are common and certain funds charge significantly greater fees.
- Most funds have historically charged a 20% fee on all profits.
- Some funds also incorporate a "hurdle rate" which requires the fund to exceed a certain minimum rate of return before the performance fee is assessed. *This however is not the industry norm and is more often seen in venture and/or private equity firms or firms with emerging managers.*

MANAGEMENT FEES

- The management fee is usually assessed on net present value of assets under management (the "NAV").
- Today managers are often pressured to provide a budget and expense schedule (especially emerging managers).

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HIGH WATERMARK

Performance fee calculations usually incorporate a high watermark concept, which requires the fund manager to make up any prior un-recouped losses before earning a performance fee on current profits.

Some funds incorporate a "catch-up," which allows a manager to collect one half of its normal incentive fee if the fund has gains from a lower position than the high watermark. Once the high watermark is exceeded the full performance fee is reinstated. This partial performance fee payment assists the manager in retaining talent and should deter the manager from taking unnecessary risks in order to achieve the high watermark.

COMMON MISTAKES

- Do not assume that having traded at a large hedge fund or bank makes you a good hedge fund manager.
- Do not believe that investors will ignore your lack of pedigree (*i.e.* your lack of work at a name-brand firm or fund) or stand-alone track record just because you worked at the "right" firm.
- Do not present business plans that assume double-digit performance and exponential asset growth in year 1-3 without sufficient consideration.
- Do not make the short-sighted decision to forego seed capital in order to maintain economics.
- Do not fall for the misconception that running a hedge fund, however small, is glamorous.

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COMMUNICATION

- Explain to investors how you intend to make them money.
- Describe the competitive advantages or “key differentiators” that you believe set you apart from other funds.
- Know why an investor should choose you instead of a more established manager in the same strategy.
- Establish credibility by outlining the organization and management experience in your marketing materials.
- Stay in regular communication; not just in good times.
- Listen and adapt.

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TREAT INVESTORS LIKE TRUE PARTNERS/CUSTOMERS

- Treat each investor in a fair and equitable manner in accordance with the fund's fiduciary obligation.
- Invest your own money in the strategy. Aligning your interest via "skin in the game" is a strong selling point.
- Remember that humility can be an asset in building a successful business in this market.
- Believing in yourself will go a long way to helping investors believe that you can make them money.
- The customer is always right.

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WILLINGNESS TO PROVIDE TRANSPARENCY

- Transparency is absolutely critical to mitigate concerns of fraud risk.
  - Define your risk management controls, targets, guidelines, portfolio and position risk measures.
  - Provide weekly/monthly/annual performance estimates, schedule calls and access to investment team.
  - Provide annual audited financial statements.
- It is the fund manager's obligation to mitigate confidentiality concerns.

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REGULATIONS: INVESTMENT COMPANY ACT

- Although generally private funds—including hedge funds—meet the definition of an "investment company" under the Investment Company Act of 1940 (the "**Investment Company Act**"), most hedge funds are exempt from registering as investment companies by relying on one of the statute's exceptions under Section 3(c)(1) or Section 3(c)(7):
  - 3(c)(1): private funds that are owned by not more than 100 persons and are not making a public offering of its securities.
  - 3(c)(7): private funds that are owned exclusively by "qualified purchasers" and are not making a public offering of its securities.
- Absent an exception from the definition of the term "investment company," a hedge fund must register.

SECTION 3 (C)(1) OF THE INVESTMENT COMPANY ACT

- Section 3(c)(1) of the Investment Company Act excepts from the registration requirements of the Investment Company Act an investment vehicle that meets two tests:
  - It cannot have more than 100 beneficial owners; and
  - It cannot make or propose to make any public offering of its securities.
- The SEC has taken the position that the private placement test under Section 3(c)(1) is met if the offering of securities meets the criteria of Section 4(2) of the Securities Act, or Rule 506 of Regulation D.
- In determining the number of beneficial owners of a hedge fund, each individual investor is counted separately. Securities of a Section 3(c)(1) fund jointly owned by both spouses are considered owned by one beneficial owner.

SECTION 3 (C)(7) OF THE INVESTMENT COMPANY ACT

Under 3(c)(7), a qualified purchaser is defined to include an investor that meets any of the following criteria:

- An individual or family-owned business not formed for the specific purpose of acquiring the interest in the fund that owns at least $5 million in investment assets;
- A trust not formed for the specific purpose of acquiring the interests in the fund for which the trustee and settlor are qualified purchasers; or
- A company, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests at least $25 million in investment assets.

- Although under Section 3(c)(7) a fund can have an unlimited number of investors, if a fund has any class of equity securities owned by more than 1,999 investors, it must register its securities with the SEC under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**").

- **Many smaller funds do not seek an exemption under 3(c)(7) because most of their underlying limited partners do not meet the higher threshold definition of a qualified purchaser.**

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MARKETING/BLUE SKY

Because Sections 3(c)(1) and 3(c)(7) of the Investment Company Act prohibit hedge funds from making public offerings, funds must sell their securities in accordance with the private offering rules under the 1933 Act.

BLUE SKY

The 1933 Act generally requires companies to either file a registration statement with the SEC if they want to sell their securities publicly, or comply with private placement rules under the 1933 Act. Though the securities of hedge funds are not registered under the 1933 Act, they remain subject to the anti-fraud provisions of the 1933 Act.

PRIVATE PLACEMENTS/REGULATION D
ACCREDITED INVESTOR

- Hedge funds raise capital via private placement under Regulation D of the 1933 Act, which means the shares are not registered.
- Under the current versions of Rule 501(a) of Regulation D and Rule 215, "accredited investor" is defined to include, among other things, any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase, exceeds $1,000,000 (excluding the value of the individual's primary residence)*; or who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

** However, the amount of indebtedness secured by an investor's primary residence may also be excluded from the net worth calculation in an amount up to the fair market value of the residence. Indebtedness secured by the primary residence (1) in excess of the value of the residence or (2) incurred within 60 days preceding the sale of securities to the investor (other than in connection with the acquisition of the residence) should be considered a liability and deducted from the investor's net worth for this purpose.*

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REGULATIONS: ADVISERS ACT AND DODD FRANK

Before the Dodd-Frank Act made registration mandatory for hedge fund advisers with more than $150 million in assets under management ("**AUM**"), hedge funds were primarily regulated through their managers or advisers, under the anti-fraud provisions of the Investment Advisers Act of 1940 (the "**Advisers Act**").

Nothing has increased the angst of a manager (other than trying to get capital) and subtracted from the bottom-line more than regulation.

Here are basics:

- Hedge funds within the US are subject to regulatory and trade reporting and record keeping requirements that also apply to other investors in publicly traded securities.

- Most hedge funds file for an exemption under the securities laws, however, managers must determine whether they need to register with either the SEC and/or the state in which the manager operates.

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REGULATIONS: ADVISERS ACT AND DODD FRANK

- The Dodd-Frank Act sought to increase regulation of financial companies, including hedge funds.
- Dodd-Frank generally requires investment advisers with AUM of $100 million to register as investment advisers with the SEC.
- The Advisers Act generally requires advisers with private pools of capital exceeding $150 million in AUM to register with the SEC.
- Hedge fund managers who manage less than $100 million in AUM are generally overseen by the state in which the manager is domiciled and are subject to such state regulations.

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NEW EXEMPTIONS UNDER DODD-FRANK

- Hedge fund managers who manage less than $150 million in AUM may be eligible to rely on an exemption under the Advisers Act or similar state regulation.

- The Dodd-Frank Act contains exemptions for certain advisers, specifically:

  - Advisers solely to private funds (or solely to venture capital funds)
  - Foreign advisers
  - CFTC advisers
  - Family offices

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New Exemptions Under Dodd-Frank
Private Fund Advisers

Private Fund Advisers

- The rules exempt from registration an adviser that advises only "qualifying private funds" and manages private fund assets under management "in the United States" of less than $150 million.
- For purposes of this exemption, a "qualifying private fund" is any private fund that is not registered under the Investment Company Act and has not elected to be treated as a business development company pursuant to the Investment Company Act. It includes a private fund that relies on the exception from the definition of "investment company" contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act, as well as a fund that qualifies for another exclusion from the definition of an "investment company" as defined in Section 3 of the Investment Company Act, provided that the investment adviser treats the fund as a private fund under the Advisers Act.
- Advisers relying on this exemption must calculate, on an annual basis, the amount of the private fund assets they have to ensure that their private funds remain under $150M in AUM in the aggregate. For purposes of the calculation, "*assets*" includes managed assets, regardless of whether they are managed for compensation, as well as uncalled fund capital commitments.

New Exemptions Under Dodd-Frank
CFTC Registered Advisers

CFTC Registered Advisers

- The Advisers Act currently contains an exemption for any investment adviser that is registered with the CFTC as a commodity trading adviser:
    - whose business does not consist primarily of acting as an investment adviser (as defined under the Advisers Act);
    - and that does not act as an investment adviser to a registered investment company or a business development company.
- The Dodd-Frank Act adds an exemption for any investment adviser that is registered with the CFTC as a commodity trading adviser and advises a private fund, provided that such an adviser must register with the SEC if the business of the adviser later becomes predominately the provision of securities-related advice.

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ERAs and Reporting Requirements

- Managers relying on the private (or the venture capital) fund exemptions will be Exempt Reporting Advisers ("**ERAs**"), subject to certain limited public reporting requirements, including certain parts of Form ADV, and certain limited compliance obligations.

- For private fund advisers who have no place of business in the United States and who do not manage US qualifying private funds, the conservative position is that these advisers should consider filing as exempt reporting advisers if they have US persons in their offshore funds under the theory that the means and instrumentalities of the US were involved in obtaining the US clients.

- The SEC may impose additional reporting requirements upon certain ERAs inclusive of audits pertaining to books and records.

Fees and Qualified Clients

- For SEC (and state) registered hedge fund advisers to charge an incentive or performance fee, the investors in the funds must be "qualified clients" as defined in the Advisers Act Rule 205–3.

- To be considered a qualified client, an individual must have $1mm in assets invested with the adviser, or a net worth in excess of $2.1mm (excluding primary residence) or be a certain high-level employee of the investment adviser.

Under the Dodd-Frank Act, the SEC is required to periodically adjust the qualified client standard for inflation.

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SOME THINGS TO BE AWARE OF

PRINCIPAL TRANSACTIONS

- Some of you might be affiliated with a broker/dealer, you might trade through your broker/dealer.
- If you do, you'll have to adhere to the principal transaction rules of Section 206(3) of the Advisers Act:

  Prohibits an Adviser, acting as a principal for its own account, from knowingly selling any security to or purchasing any security from a client for its own account, without

  - Disclosing to the client in writing the capacity in which it (or an affiliate such as a broker-dealer) is acting; and
  - Obtaining the client's consent before the completion of the transaction.
- The principal transactions rules are a very thorny issue and one (along with best execution, disclosure and fees) that is a hot button topic with the SEC.

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SOME THINGS TO BE AWARE OF

CUSTODY

- Advisers Act Section 223 requires SEC-registered investment advisers to take such steps to safeguard client assets over which such adviser has custody as prescribed by SEC rules, including, without limitation, verification of such assets by an independent public accountant. This change does not appear to impact the existing Advisers Act custody rule (Rule 206(4)-2), which the SEC last amended effective early 2010.

- Custody includes:

    - Physical possession of client assets;

    - Any arrangement under which an adviser is permitted or authorized to withdraw client assets (for example, the ability to deduct fees); and

    - Any capacity that gives an adviser legal ownership or access to client assets (such as acting as general partner of a pooled investment vehicle).

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SOME THINGS TO BE AWARE OF

CUSTODY

The Custody Rule requires that:

- Client assets must be maintained with a "qualified custodian" such as a bank or broker-dealer;
- The adviser must have a reasonable basis to believe (after "due inquiry) that the qualified custodian sends account statements directly to the clients at least quarterly. If the adviser sends it own account statements to clients, it must advise its clients to compare account statements sent by the adviser with the account statements sent by the custodian;
- If the adviser opens the custodial account, the adviser must notify clients in writing of the qualified custodian's name, address, and the manner in which the assets are maintained; and
- Undergo an annual surprise examination by an independent public accountant to verify client assets. (If an adviser has custody *solely* because it has authority to deduct advisory fees is not required to obtain a surprise examination.)

Unless client accounts are maintained by an *independent* qualified custodian (i.e., a qualified custodian other than the adviser or a related person), the adviser must:

- Have a surprise exam by an independent public accountant; and
- Obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB").

SOME THINGS TO BE AWARE OF

EXEMPTION FROM THE SURPRISE EXAMINATION REQUIREMENT.

- An adviser to a pooled investment vehicle (*i.e.*, a hedge fund or other private investment fund) that is subject to an annual financial statement audit by an independent public accountant who is registered with, and subject to regular inspection by, the PCAOB and that distributes the audited financial statements prepared in accordance with GAAP to the vehicle's investors, is deemed to satisfy the annual surprise examination requirement.

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Manifesting Support for Compliance Efforts

A "Culture of Compliance"

- Senior management must convey to employees that everyone's cooperation with compliance policies and with compliance staff is expected. Senior management must demonstrate a culture of compliance by attending and participating in continuing education programs, including annual compliance training.

- When senior management is consulted on compliance issues, such as when an employee seeks the reversal of a disciplinary sanction or the modification of a procedure suggested by the compliance staff, senior management should make a decision that is consistent with and supportive of the firm's overall compliance program.

- Senior management should be available to whistleblowers and should ensure that the firm responds promptly and properly to allegations of misconduct.

- Since senior management controls budgeting, it can ensure that adequate resources are dedicated to compliance efforts.

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GUIDANCE FROM SEC

CURRENT FOCUS OF SEC

The SEC has identified several current focus areas of the Office of Compliance Inspections and Examinations ("**OCIE**") for investment advisers.

PORTFOLIO MANAGEMENT

Losses may provide an impetus for portfolio managers to trade more aggressively than they should or to deviate from investment objectives in order to make up losses, and perhaps also to catch-up on performance-based fees. This is an area where compliance personnel should be active.

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GUIDANCE FROM SEC

FINANCIAL CONTROLS

OCIE examiners will continue to focus attention on controls which are intended to protect investors' accounts. And, if you're an adviser in precarious financial condition, you must disclose this fact to clients.

VALUATION

This includes controls and procedures for valuation of illiquid and difficult-to-price securities. Reluctance to fair value or mark down prices cannot take precedence over the firm's pricing procedures — investors and fund shareholders have a right to know the current value of their holdings. Investment advisers which rely on broker quotes (as opposed to market or exchange pricing quotes) must be particularly alert to the possibility of "accommodation quotes," which don't reflect prices at which the security could actually be sold. At its worst, this could be fraudulent conduct.

SEC GUIDANCE

In addition to these focus areas, OCIE examiners will also be focusing on the following other compliance risks:

SUITABILITY AND APPROPRIATENESS OF INVESTMENTS FOR CLIENT

Examiners will focus on whether securities recommended and investments made for clients and funds are consistent with disclosures, the client's investment objectives and any investment restrictions, and with the adviser's obligations to clients to only recommend securities that are suitable or appropriate. Advisers should make a reasonable inquiry as to the client's financial situation, investment experience and investment objectives.

Examiners will focus in particular on how firms are interacting with their senior citizen clients, as well as structured products and other complex derivative instruments, variable annuities, niche ETFs, managed pay-out funds, and 130/30 funds.

SEC GUIDANCE

DISCLOSURE

Examiners will focus on ADVs, performance advertising, marketing, fund prospectuses and any other information or disclosures provided to clients, investors or shareholders. Examiners will be looking specifically at expense disclosures, conflicts of interest disclosures and performance figures, among others.

CONTROLS TO PREVENT INSIDER TRADING

Examiners are focusing on the adequacy of policies and procedures, information barriers, and controls to prevent insider trading and leakage of information including the identification of sources of material non-public information, surveillance and forensic testing, physical separation, and written procedures. Controls to prevent insider trading should be strong in any environment.

SEC Guidance

Trading, Brokerage Arrangements and Best Execution

Examiners will be looking at whether brokerage arrangements are consistent with disclosures, whether the firm seeks best execution, and whether soft dollars are used appropriately (consistent with disclosures and in compliance with Section 28(e) safe harbor). They will scrutinize the use of an affiliated broker-dealer or any undisclosed relationships with a broker-dealer for excessive commissions, kick-backs and other conflicted relationships.

Proprietary and Employees' Personal Trading

This is a basic part of any compliance program — when examiners find weaknesses in this area, it gives them concern about the firm's commitment to addressing other conflicts of interest.

SEC Guidance

Undisclosed Payments

Examiners are looking for compensation or payment arrangements that may be part of revenue-sharing, or other undisclosed arrangements with third parties. These payments may be made to increase fund sales or assets under management (such as fund networking fees and payments by advisers to broker-dealers for obtaining space on the firms' recommended adviser list). Undisclosed payments may also involve misappropriation of adviser/fund/broker-dealer assets by, for example, creating fictitious bills and expense items, or receiving kick-backs from a service provider.

Safety of Customer Assets / Cyber-security

Examiners will look at whether brokers, funds and advisers have effective policies and procedures for safeguarding their clients' assets from theft, loss, and misuse. Advisers should be regularly reviewing their own systems and policies/procedures as well. Make sure that advisory clients' money is with a qualified custodian and review prime brokerage relationships. You may want to ensure that the process for sending account statements to clients has controls to ensure that the account statements cannot be intercepted or falsified.
Examiners will also continue to focus on controls for compliance with Regulation S-P with respect to customer information.

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SEC Guidance

Anti-Money Laundering

Examiners will look at whether funds are complying with obligations to have effective policies and procedures to detect and deter money-laundering activities, whether these policies and procedures are regularly tested for continued effectiveness, and whether actual practices are consistent with the policies and procedures.

Compliance, Supervision, and Corporate Governance

Examiners will focus in particular on supervisory procedures and practices at branch offices, on supervision and controls over traders, whether funds have appropriately-constituted boards and have considered required matters (e.g., valuation procedures), and whether firms have implemented effective internal disciplinary processes. This will include scrutiny of the adequacy of firms' forensic testing to detect unsuitable or aberrant trades, misallocations or other trading issues.

General Compliance Issues

Type of Client

An adviser should review strategies employed for each client keeping in mind each client's individual goals.

- Some clients use financial intermediaries, such as consultants, and are often governed by an investment committee or investment board. The adviser needs to ensure that it has regular dialogue with consultants and/or investment boards to ensure that it is following the current mandate for that client.

- Advisers should review the investment management agreement (the "**IMA**") for each fund on an annual and/or semi-annual basis to ensure all procedures are being followed (thereby lessening the likelihood of an inadvertent breach or default).

- The adviser has to ensure that its formal procedures are followed for reviewing the portfolio, reallocating assets and updating investment guidelines as needed. Notes from such meetings should be kept with the client's records.

- If an adviser's client is a tax-exempt entity or governed by ERISA or other regulations, the adviser's strategy may be impacted. Similarly, an adviser to a governmental plan may be subject to certain state or local regulations.

General Compliance Issues

Reporting

- Client reporting requirements should be reviewed carefully to determine that the adviser is both capable of and willing to produce the types of reports specified in the IMA.
- Certain clients may have special reporting requirements that require extra resources to produce.

VALUATION AND LIQUIDITY ISSUES

THIRD PARTY PRICING SERVICES

Advisers should seek to rely upon independent and objective pricing sources, such as last bid/ask prices on nationally recognized exchanges. Certain types of pricing services or broker quotes for harder to value or thinly traded/illiquid securities often rely on stale or subjective pricing criteria.

CROSS TRADES

An adviser's trading of securities among client accounts can create risks that securities will be "dumped" from one client account to another, that the securities may be mispriced because they are not traded in the open market, or that one client may otherwise be disadvantaged.

Cross trades of thinly traded or illiquid securities is extremely problematic, in that there may be no secondary market pricing support or other documentation to support a price that sufficiently represented fair market value (*i.e.*, trade execution data, the latest bid and ask quotes, and information about offerings of similar securities).

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INVESTMENT MANAGEMENT AGREEMENTS (IMAS)

REVIEW PROCESS

- Each client's IMA should be reviewed on a no less than semi-annual basis and adviser should solicit feedback on the IMA and related investment guidelines from personnel servicing or monitoring the account to ensure that the obligations imposed by the IMA can be met.

- The IMA should accurately describe operational processes in place.

- Key functions include portfolio management, compliance and operations (including fee calculation and processing, client reporting and proxy voting). It is good practice to establish a team within the portfolio team who regularly review contractual provisions that relate to their function.

- The IMA should clearly describe the scope of the adviser's investment authority, including, for example, (a) discretionary vs. non-discretionary authority; (b) the application of specific investment restrictions or guidelines; (c) the ability to act on shareholder, bondholder or creditor committees; (d) authorization to invest in shares of an affiliated mutual fund; and (e) the ability to select brokers.

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Fees

Calculation Methodology

If an adviser uses a standard method for calculating fees, this should be specified in the IMA. Even if a variety of fee calculation methods are accepted, it is still prudent to have personnel responsible for fee calculation confirm that they can accommodate an unusual request. Fee provisions should set forth, among other things, the billing period, whether fees are payable in advance or arrears, how and by whom the account is valued, and whether fees are deducted from the account or invoiced to the client.

MOST-FAVORED-NATION PROVISIONS; PROXY VOTING

MOST-FAVORED-NATION ("MFN") PROVISIONS

An adviser that accepts MFN provisions should have a process for tracking such provisions and analyzing each new fee arrangement to determine whether it triggers existing MFN requirements. Ideally, advisers will want MFNs to apply prospectively on an "all or nothing basis" to accounts of similar size, with the same strategy and servicing requirements.

PROXY VOTING

The IMA should indicate whether the adviser or client is responsible for voting proxies. If a client requires the adviser to vote proxies in accordance with the client's own proxy voting policy, the adviser personnel responsible for proxy voting should review the policy to confirm that they will be able to comply.

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MARKETING MATERIALS

All investment advisory communications, including marketing and advertising materials, are subject to the antifraud provisions of the Advisers Act. Rule 206(4)-1 prohibits an RIA from using any advertisement that "contains any untrue statement of material fact or is otherwise misleading."

In addition to the general antifraud provisions, any communication that is deemed to be an advertisement is subject to further requirements.

WHAT IS AN ADVERTISEMENT?

The Advisers Act defines "*advertisement*" to include any written communication addressed to more than one person. If a communication is truly tailored to one individual client, it will not constitute an "advertisement" and will be subject only to general antifraud considerations. However, if the same piece is simply individually addressed to several clients, it will be considered an advertisement subject to specific advertising prohibitions (for example, testimonials and past specific securities recommendations).

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ADVERTISEMENTS: SPECIFIC PRACTICES

PREDICTIONS/PROMISSORY STATEMENTS

In general, marketing materials should not contain promissory language, predictions of investment results, or exaggerated claims or opinions. For example, statements such as "Asian markets will make a strong comeback over the next 12 months," or "our investment approach reduces risk" would be viewed as misleading. Statements of opinion are generally permissible, as long as they are not exaggerated and it is clear to the reader that the speaker/writer is stating his opinion. All factual statements must be supported by back up materials retained and filed so as to be easily retrievable should a question arise.

TESTIMONIALS/CLIENT LISTS

The SEC generally prohibits client testimonials and endorsements. A testimonial is any statement by a former or current client that endorses the adviser or refers to the client's favorable investment experience. Although simply providing a list of clients may be deemed to be a prohibited testimonial, the SEC has permitted use of a client list where:

- The adviser does not use performance-based criteria to determine which clients to include on the list. For example, use of a client list that includes only clients that have experienced above-average performance would be deemed misleading; however, one that includes all clients that are schools or companies with over 500 employees would be permissible; and
- Each list includes a disclaimer stating: "It is not known whether the listed clients approve or disapprove of the adviser or the advisory services provided"; and
- Each list includes disclosure about the objective criteria used to determine which clients were included on the list. For example, a list of all ERISA clients. Written permission to use a client's name should be sought from all clients who are proposed to be named.

ADVERTISEMENTS

NAMING SPECIFIC SECURITIES

References to past specific securities recommended or purchased by the adviser for one or more separate accounts are generally prohibited unless the adviser also provides a list of all recommendations made by it over the past year. The primary concern is that an adviser could "cherry pick" its past profitable trades while omitting the unprofitable ones.

Notwithstanding the above, the SEC staff has permitted advisers to refer to specific securities in periodic reports to clients without including a list of all of its recommendations over the past year, subject to the following conditions:

Objective Criteria - The adviser must use objective, non-performance based criteria to select the specific securities that it will identify in the communication and must disclose what those criteria are. In addition, it must apply the same criteria consistently in future communications; that is, if adviser used one set of criteria to identify securities in one quarter, it may not apply different criteria in subsequent quarters.

Unbiased Performance-Based Criteria - Subject to certain limitations, the adviser may be able to use a list showing the relative contribution to performance of certain securities. The methodology to select such securities must be objective/mechanical, such as a list of the "Top 5 Best and Worst Performers" and present the profitable and unprofitable recommendations with equal weight.

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CAVEATS

Any discussion of specific securities should be accompanied by disclosure such as the following:

> "The information provided is not a recommendation to purchase, sell or hold any particular security. The securities identified do not represent an account's entire holdings and in the aggregate may represent only a small percentage of such holdings. There is no assurance that securities purchased will remain in an account's portfolio, or that securities sold will not be repurchased. In addition, it should not be assumed that any securities transactions discussed were or will prove to be profitable. The securities identified may not be suitable for all investors in all circumstances."

DISCLOSURE REGARDING EXCEPTED ACCOUNTS

If a featured security has not been purchased or sold for all accounts in a given investment category, for example, because of special investment restrictions or cash flow, that fact must be disclosed.

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USE OF REPRINTS

If an adviser elects to distribute a reprint of an article (via mail, website or otherwise) it is responsible for the content of the article. The following general guidelines apply to reprints:

1. Permission to reprint the article should be obtained from the publisher/owner of copyrighted material.

2. The reprint should show the date of the article and name of the publication.

3. Only articles published by unbiased third parties should be used, and cannot include a statement of a client's experience or endorsement.

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SOCIAL NETWORKING

Although the SEC has not issued formal guidance regarding social networking sites, its general statements on the subject recommend that advisers treat information posted on social media as if it were a piece of advertising.

- Postings should be pre-approved and regularly reviewed to ensure that they do not contain untrue statements of fact and are not otherwise false or misleading. Inappropriate postings on the site from others should be promptly removed.

- Testimonials *(i.e.*, recommendations or marking of other sites as "like" or "favorite") must be avoided.

- Have a process for archiving what has been disseminated via social networking sites.

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TRACK RECORD

An important part of any fund's performance is establishing a track record. When seeking to establish a track record the adviser should disclose:

- Whether the managers responsible for the track record will have a substantial and continuing role in managing the product or service being offered;
- Whether the products or services offered are substantially similar in terms of investment objective, restrictions, strategy, and size to the account(s) in the track record;
- The use of proxy performance; and
- Any and all material differences in the account(s) comprising the track record and the product or service being offered.

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LINKING PERFORMANCES

- Linking performance refers to the practice of joining the performance records of two (or more) accounts to create one continuous track record over a period. For example, linking the first 5 years of performance results with the performance results of a new portfolio, which has a one year track record, for the purpose of creating a longer track record for a particular investment strategy.

- Linking performance records should only be permitted if there is a compelling business reason and only with comprehensive disclosure of all material facts.

- In addition, the manner in which linked performance is presented can affect whether it is deemed to be misleading and deceptive. For example, year-over-year returns that do not "blend" the two performance records are preferable to showing compounded returns over time or average annual returns over the entire linked period.

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RECORD KEEPING

RECORD KEEPING

Rule 204-2 requires that advisers maintain books and records with respect to their investment adviser activities, including both general business records and all records relevant to the investment activities/performance and regulatory compliance obligations.

- All records pertaining to client accounts should be kept in a manner that allows easy retrieval.
- All records pertaining to internal procedures (*e.g.*, pre-clearance, outside activity and indirect compensation forms) must be maintained for the fund and any fund it manages, advises or sub-advises.
- Records for any violations of procedures must be maintained.
- Records for each client's agreement (with updates, if any) should be kept on file.
- An adviser that identifies specific securities in its communications is subject to additional recordkeeping requirements. Among other things, it must keep:
    - A complete list of all securities purchased and sold during the prior year; and
    - A description of the criteria used to select the securities identified.

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Solicitation

RULE 206(4)-3 CASH PAYMENTS FOR CLIENT SOLICITATIONS

Cash payments for client solicitations are permitted:

- With respect to solicitation activities for the provision of impersonal advisory services only; or

- To someone who is (A) a partner, officer, director or employee of such investment adviser or (B) a partner, officer, director or employee of a person which controls, is controlled by, or is under common control with such investment adviser: *provided,* that the status of such solicitor as a partner, officer, director or employee of such investment adviser or other person, and any affiliation between the investment adviser and such other person, is disclosed to the client at the time of the solicitation or referral.

- Any payment made to a third party for client solicitations must be documented (as specifically required in the Rule) and the adviser must keep a record of same.

Solicitation

RULE 206(4)-3 CASH PAYMENTS FOR CLIENT SOLICITATIONS

An investment adviser may pay a cash fee to a third-party solicitor if:

1. The third-party solicitor would not otherwise be disqualified from being an investment adviser; and

2. The investment adviser enters into a written agreement with the third-party solicitor which:

   i. describes the solicitation activities to be engaged in on behalf of the investment adviser and the fee to be paid,
   ii. contains an undertaking by the solicitor to perform his duties under the agreement in a manner consistent with the instructions of the investment adviser and the provisions of the Advisers Act and rules thereunder, and
   iii. requires that the solicitor, at the time of the solicitation, deliver to the client a current copy of the adviser's ADV Part 2 and a separate written disclosure statement describing the terms of the solicitation arrangement, including that the solicitor is being compensated by the adviser.

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FORM ADV

- Part 2 of Form ADV requires that the brochure be electronically available to prospective clients *via* the IARD site and that the brochure be written in plain English (as opposed to multiple choice or "check the box" format).

- Additional guidance on how SEC-registered advisers may complete Form ADV is posted on the SEC's website at http://www.sec.gov/divisions/investment/iard.shtml.

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JOBS Act

- The first change to Rule 506 eliminates the prohibition on general solicitation and general advertising for certain offerings, including hedge fund offerings, provided that the conditions of the new rule are met.

- Hedge fund issuers will be able to use a number of previously unavailable solicitation and advertising methods when seeking potential investors. However, with these new marketing opportunities also comes greater responsibility and greater restriction.

- The final rule permits issuers to use general solicitation and general advertising to offer their securities if, among other things, issuers take reasonable steps to verify "accredited investor" status, and all purchasers of the securities are accredited investors – meaning that, at the time of the sale of the securities, they fall within one of the categories of persons who are accredited investors, or the issuer reasonably believes that they do.

- Determination of the reasonableness of the steps taken to verify that an investor is accredited is by an objective assessment by an issuer, and the final rule provides a non-exclusive list of methods that issuers may use to satisfy the verification requirement for individual investors.

Interactive Brokers, LLC

in conjunction with

Sadis & Goldberg LLP

present:

The Sword & The Shield

Paul Marino

Partner, Financial Services and Corporate Groups

Eliott Frank

Partner, Regulatory and Compliance Group

Sadis & Goldberg LLP

Interactive Brokers Group
Strength & Security

- Over $6.7 billion in net equity capital.
- No sub-prime risk.
- No TARP funds.
- Over 1 million trades per day.
- Over 565,000 clients worldwide.
- Market access to 120 market centers.
- Real time Margin system continuously enforces trading limits

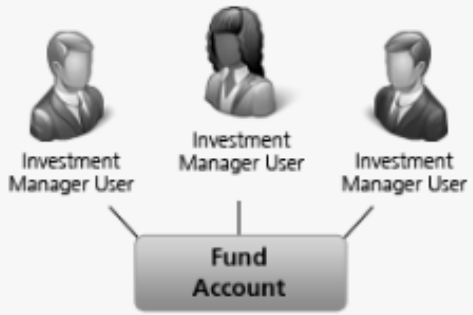
Interactive Brokers LLC

Account Types

Single Pooled Hedge Fund:

Single Fund Account Structure

A single fund managed by an investment manager.



Hedge Funds are highly speculative and investors may lose their entire investment.

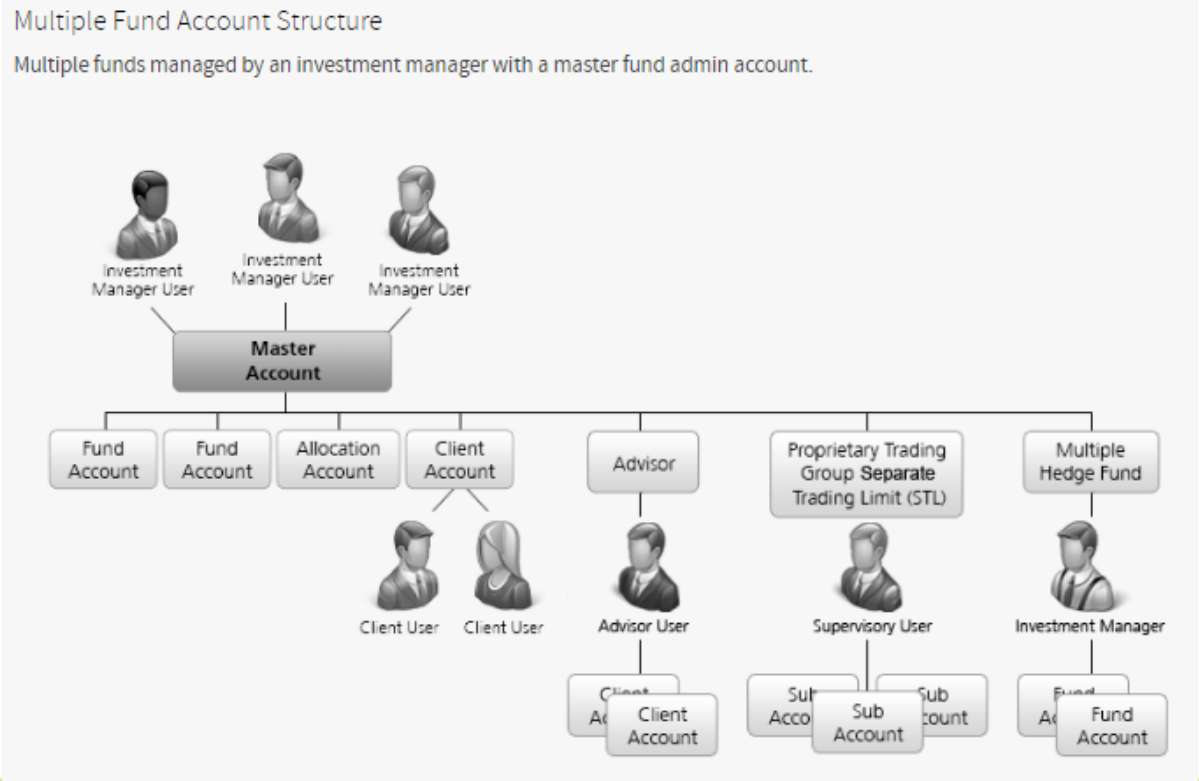
Single Fund Account with Trading Strategy Sub Accounts Structure

A single account with one or more users. Configuring authorized trader sub accounts adds the ability to maintain multiple sub accounts for different strategies.

Interactive Brokers LLC

Account Types

Multi-Fund Hedge Fund:



Hedge Fund Reporting

Interactive Brokers LLC

Stock Loan Capabilities

From trade date, to settlement date, our securities financing team is available to you. In addition, our TWS provides a robust automated trading solutions to our clients.

Interactive Brokers offers transparent rates, global reach, and dedicated service representatives. Automated lending and borrowing tools give you the advantages you expect from Interactive Brokers.

Interactive Brokers LLC
Stock Loan Capabilities

Availability

On trade date, it's all about availability. Our depth of availability not only helps to locate hard-to-borrow securities; but, also gives you protection against buy-ins and recalls.

IB offers clients two ways to view available shares for shorting in real time:

1. Clients can view the number of shares that are available to short, as well as the current interest rate charged on borrowed shares and the current Fed Funds rate in Trader Workstation
2. Clients can search for real-time availability online with the Short Stock Availability Tool. You may also opt to be notified when a borrow becomes available.

Transparent Rates

Interactive Brokers LLC brings transparency, reliability and efficiency to the stock loan market using automated price discovery and improved credit-worthiness. Our stock loan and borrow rates are very competitive. The SLB desk uses a combination of sources to develop indicative rates, which are displayed along with borrow availability in our automated securities financing tools.

Unique to IB, we display 3 years of borrow fee history directly on Trader Workstation.

Interactive Brokers LLC

Stock Loan Capabilities

Global Reach

Our Global reach starts with our breadth of product offering and extends to our securities financing services. Connectivity to multiple counterparties around the globe enables, our clients to execute short sale strategies. In the United States alone we have access to more than 60 counterparties, including agent lenders and broker dealers. Our global reach doesn't stop there. We maintain dedicated, professionally-staffed Securities Lending desks in the United States, Europe and Asia which are ready to help you with all of your securities financing needs and to answer any questions.

Automated Tools

IB has always provided sophisticated, automated technology to our clients, and our securities lending services are no exception. We offer a variety of stock loan and borrow tools.

Stock Yield Enhancement Program

Earn extra income on the fully-paid shares of stock held in your account by joining IB's Stock Yield Enhancement Program. This plan allows IB to borrow shares from you in exchange for cash collateral, and then lend the shares to traders who want to sell them short and are willing to pay a fee to borrow them. Each day that your stock is on loan, you will be paid a loan fee based on market rates.

You share a percentage of this program with IB, (currently 50%), for the firm's management of the program.

Interactive Brokers LLC

Hedge Fund Capital Introduction Program

Hedge Fund Marketplace

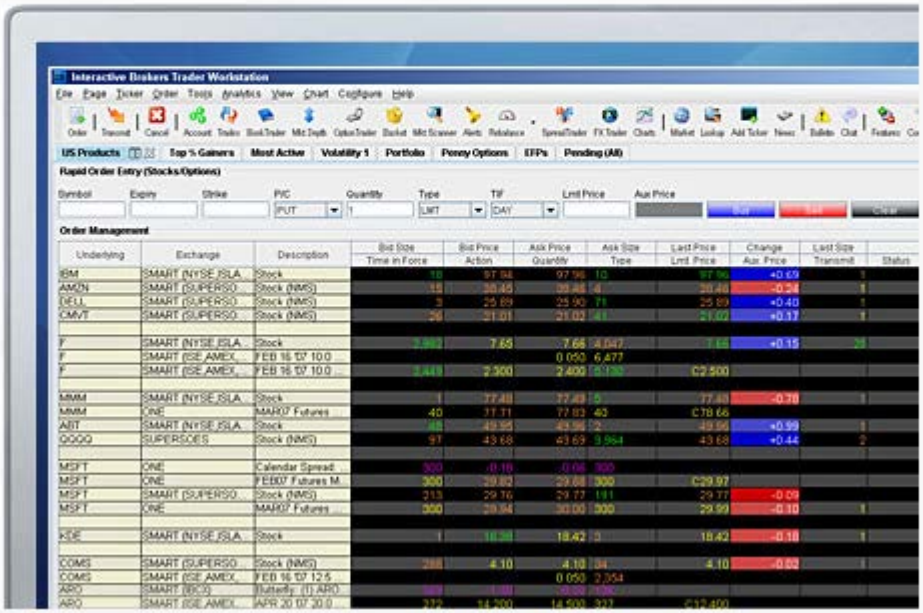
The Hedge Fund Marketplace gives you access to our online version of a traditional Capital Introduction program and is designed to help Hedge Funds who use us as their principal Prime Broker market their Funds to our customers who are Accredited Investors and Qualified Purchasers, as well as other Hedge Funds who have opened their funds to investing by qualified IB clients.

The Hedge Fund Marketplace is provided free of charge to all Hedge Funds who use us as their principal Prime Broker and have at least $3 million in assets under management. In addition, eligible Hedge Fund accounts must have a demonstrated track record of trading for at least one year along with a third party fund administrator.

Trader Workstation Classic View

Classic TWS

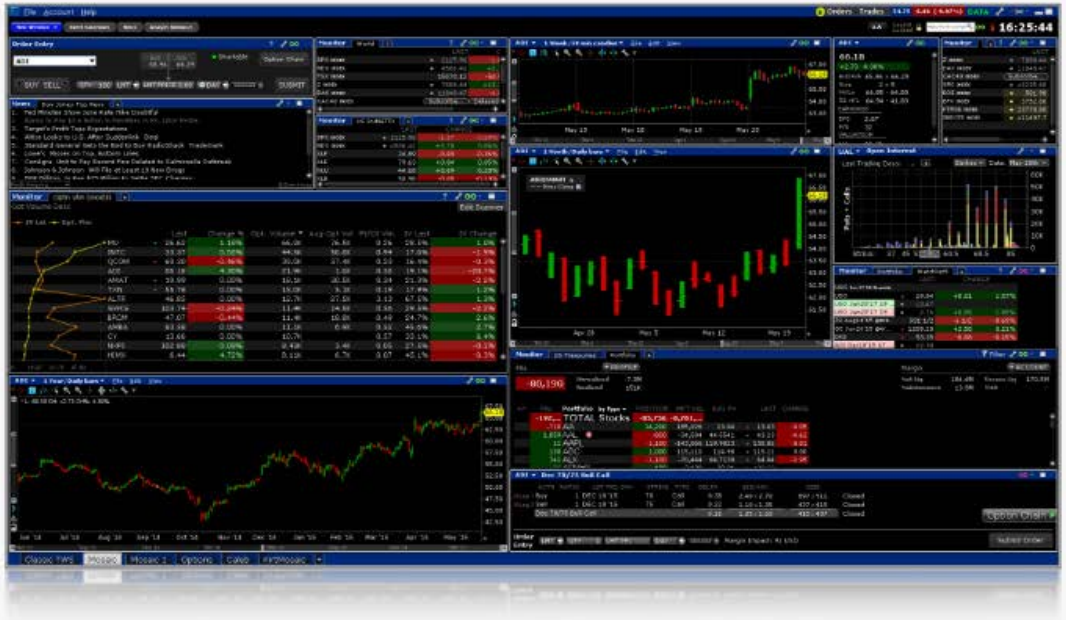
Classic TWS offers quick click order entry from bid and ask prices, with the order row displayed directly beneath the Market Data row. Classic TWS is always available to traders who need more advanced tools and algos.



Trader Workstation Mosaic View

TWS Mosaic

Mosaic provides intuitive out-of-the-box usability with quick and easy access to comprehensive trading, order management, chart, watchlist and portfolio tools all in a single, customizable workspace.



Interactive Brokers Useful Links:

Hedge and Mutual funds: https://www.interactivebrokers.com/hmf/en/main.php
Reports: https://www.interactivebrokers.com/features/#reports
Prime Brokerage: https://www.interactivebrokers.com/en/index.php?f=3182
Execution Service: https://www.interactivebrokers.com/en/index.php?f=930
Trade Desk: https://www.interactivebrokers.com/en/index.php?f=commission&p=tdesk

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(203) 618-8059

amclean@interactivebrokers.com

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Futures are not suitable for all investors. The amount you may lose may be greater than your initial investment. Before trading futures, please read the CFTC Risk Disclosure. For a copy visit interactivebrokers.com.

Security futures involve a high degree of risk and are not suitable for all investors. The amount you may lose may be greater than your initial investment. Before trading security futures, please read the Security Futures Risk Disclosure Statement. For a copy visit Interactivebrokers.com.

There is a substantial risk of loss in foreign exchange trading. The settlement date of foreign exchange trades can vary due to time zone differences and bank holidays. When trading across foreign exchange markets, this may necessitate borrowing funds to settle foreign exchange trades. The interest rate on borrowed funds must be considered when computing the cost of trades across multiple markets.

The Order types available through Interactive Brokers LLC's Trader Workstation are designed to help you limit your loss and/or lock in a profit. Market conditions and other factors may affect execution. In general, orders guarantee a fill or guarantee a price, but not both. In extreme market conditions, an order may either be executed at a different price than anticipated or may not be filled in the marketplace.

There is a substantial risk of loss in trading futures and options. Past performance is not indicative of future results.

Any stock, options or futures symbols displayed are for illustrative purposes only and are not intended to portray recommendations.

Interactive Brokers LLC is a member of NYSE FINRA SIPC

Interactive Brokers LLC is registered with HKSFC and is a participant of the Sydney Futures Exchange (SFE)

Hedge Funds are highly speculative and investors may lose their entire investment.