

Legal and Compliance Issues Involved in Raising Money for Hedge Funds

Presented by

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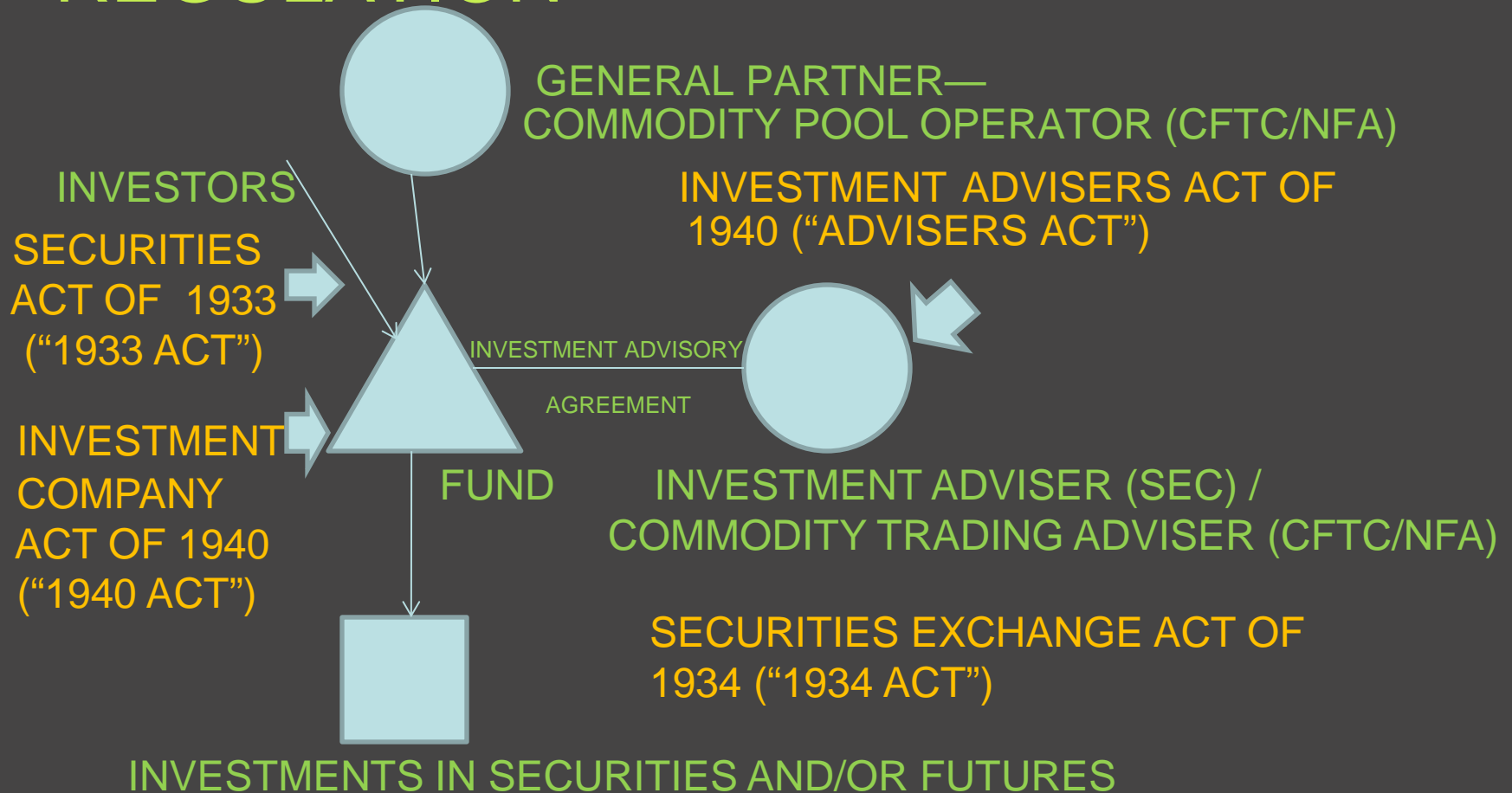
www.armorcompliance.com

TOPICS

- Part I: Legal and Compliance Issues for Hedge Funds
- Part II: Legal and Compliance Issues for Hedge Fund Managers

PART I: Legal and Compliance Issues for Hedge Funds

QUICK OVERVIEW OF U.S. FEDERAL SECURITIES AND FUTURES REGULATION



Legal and Compliance Issues for Funds

- SEC Compliance
 - Must Comply with Section 4(2) under 1933 Act and Regulation D
 - No General Solicitation and Advertising (unless relying upon JOBS Act)(see 10/14 presentation)
 - Substantive, Pre-existing Relationship
 - Each investor should be an “Accredited Investor”
 - Each investor may also need to be a “Qualified Purchaser” if Fund is a 3(c)(7) fund
 - Each investor may also need to be a “Qualified Client” if hedge fund manager is registered

Legal and Compliance Issues for Funds

- CFTC/NFA Compliance

- A Fund can have one of 3 statuses for purposes of the CFTC/NFA:
 - A commodity pool managed by a commodity pool operator (“CPO”) registered with the CFTC and a member of the NFA
 - An commodity pool managed by an exempt CPO
 - Common CPO exemptions are 4.13(a)(1), 4.13(a)(2) and 4.13(a)(3)
 - Not a commodity pool (i.e. no futures or swaps)
- If Fund is managed by a registered CPO, the Fund should limited marketing to “qualified eligible persons” pursuant to NFA Regulation 4.7.

Legal and Compliance Issues for Funds

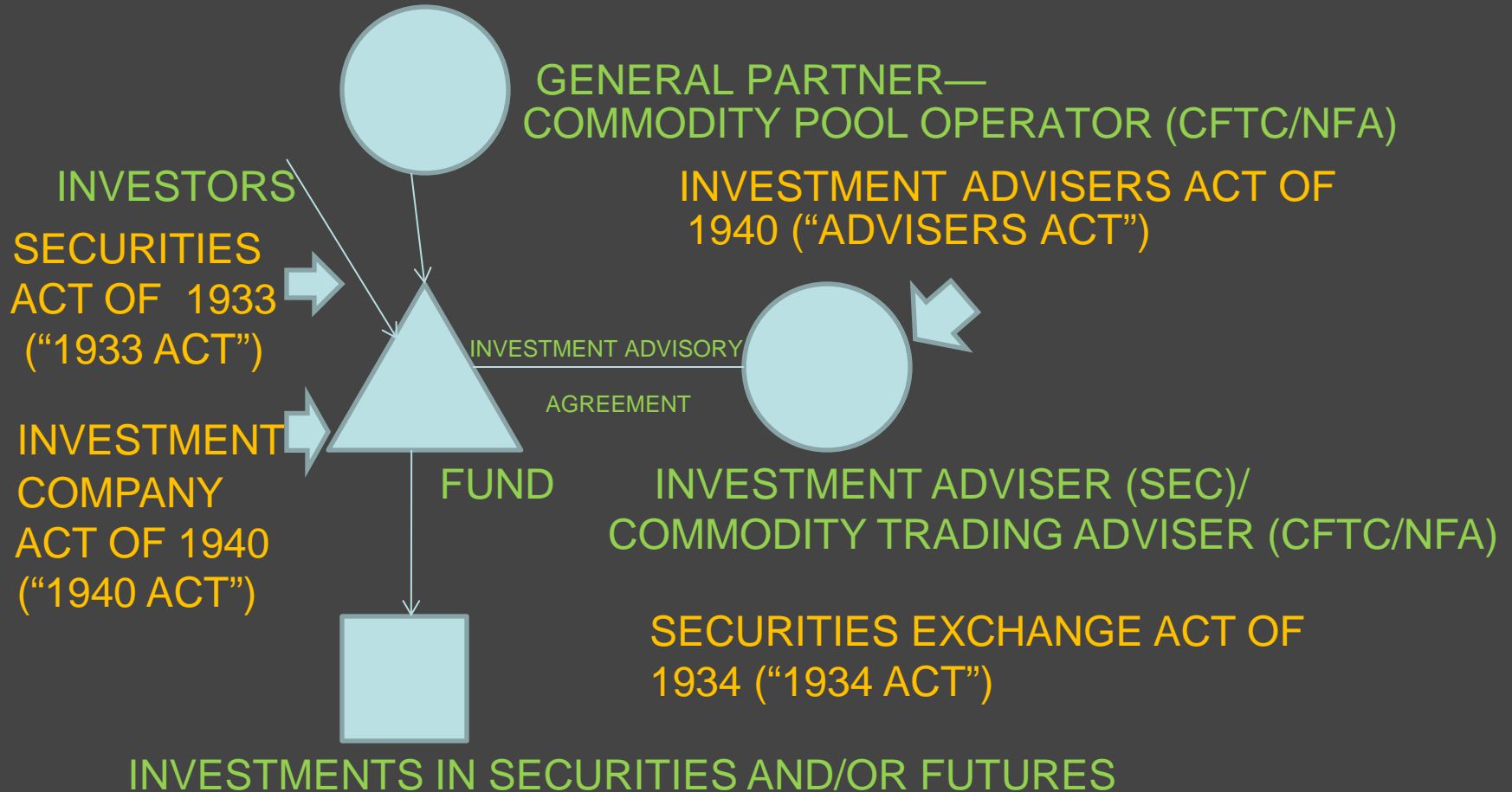
- Best Practices for Private Placement of Funds
 - Fund Documents Must Include Appropriate Legends and Disclaimers
 - Should only use marketing materials approved by CCO, if applicable
 - Should number each private placement memorandum and log distribution
 - Must file Form D with SEC and state blue sky filings within 15 days of Fund closing
 - Blue sky filings depend on residence of investors
 - www.blueskychart.com

Legal and Compliance Issues for Funds

- Placement Agents
 - What is a Placement Agent?
 - Difference between Placement Agents and Solicitors
 - FINRA Broker-Dealer Must be Paid Compensation based on Sale of Securities
 - Employees who are Broker-Dealer Registered Representatives Must be Monitored
 - Licensing Requirements (Series 7 and 63)
 - www.finra.org
 - Must amend Form D if paying broker-dealer

PART II: Legal and Compliance Issues for Hedge Fund Managers

QUICK OVERVIEW OF U.S. FEDERAL SECURITIES AND FUTURES REGULATION



Legal and Compliance Issues for Hedge Fund Managers

- U.S. Investment Advisers Act
 - Federal law governing “investment advisers”
 - any person or entity who for compensation is engaged in the business of advising others as to the value of securities, as to the advisability of investing in, purchasing, or selling securities, or who issues, or promulgates analyses/reports concerning securities
 - A registered investment adviser (“RIA”) prepares and files Form ADV Part 1A, 2A and 2B
 - Information about RIAs is available at www.sec.gov
 - Exemption from investment adviser registration available for fund managers who manage less than \$150 million in regulatory assets under management

Legal and Compliance Issues for Hedge Fund Managers

- 4 Different Statuses for Hedge Fund Managers
 - Registered with the SEC as an investment adviser
 - Registered with one or more states as an investment adviser
 - Filing as an exempt reporting adviser with a particular state and perhaps the SEC (if assets are greater than \$25 million)
 - Not registered and not an exempt reporting adviser (i.e. NY managers with less than \$25 million and certain number of clients)
- A hedge fund manager's status above may add additional level of compliance to manager's efforts to raise capital
- For example, Rule 206(4)-3 and advertising rules apply to SEC-registered investment advisers and some state-registered advisers depending on state law

Legal and Compliance Issues for Hedge Fund Managers

An “advertisement” includes any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers:

- any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell
- any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell
- any other investment advisory service with regard to securities

Legal and Compliance Issues for Hedge Fund Managers

Rule 206(4)-1, the SEC's Advertising Rule, prohibits registered investment advisers from circulating or distributing advertisements with any of the following:

- testimonials of an adviser's advice or other services (exception for partial lists of clients)
- past specific recommendations unless advertisement sets out a list of all recommendations made by the adviser within at least the prior one-year period
- any graph, chart, formula or other device that can, by itself, guide the investor as to what securities should be bought or sold

Legal and Compliance Issues for Hedge Fund Managers

- Advertising, which may include email communications, cannot contain any untrue statement of material fact or which is otherwise false or misleading and must disclose risks of investing in hedge funds
- Model (not actual) performance must disclose:
 - the limitations inherent in model results
 - material changes during the years portrayed
 - that some of the securities or strategies do not relate to the adviser's services
 - that the actual investment results of adviser's clients were materially different than those in the model

Legal and Compliance Issues for Hedge Fund Managers

- Net of Fees Requirement:
 - General rule is that performance should reflect the deduction of advisory fees and other expenses, although there are some exceptions.
 - All advertising materials and performance composites should be preapproved by Chief Compliance Officer prior to distribution, if applicable
 - Superlative language should generally be avoided

Legal and Compliance Issues for Hedge Fund Managers

- NFA Promotional Material Rules (NFA Rule 2-29)
 - No employee shall make any communication with the public that operates as a fraud or deceit, employs a high-pressure approach or makes any statement that futures trading is appropriate for all persons. Cannot engage in any radio or television advertising.
 - Shall not use any promotional material that is likely to deceive, contains a material misstatement of fact or which knowingly omits a fact that makes the material misleading.
 - Shall not mention possibility of profit unless accompanied by an equally prominent statement of risk of loss.
 - Shall not include any reference to actual past performance without disclaimer that “Past results are not necessarily indicative of future returns.” Must include all other appropriate disclaimers.

Legal and Compliance Issues for Hedge Fund Managers

- NFA Promotional Material Rules
 - All statements of opinion must be clearly identifiable as such and must have a reasonable basis in fact.
 - All data must include sources and the page on which it appears.
 - All data and charts must include an “as of” date.
 - Each presentation must include contact information on the first page.
 - Each marketing piece should be reviewed and approved in writing by CCO, if applicable, prior to first use and must be filed as records
 - Promotional material rules do not apply if relying upon NFA Regulation 4.7

Legal and Compliance Issues for Hedge Fund Managers

- Regulation 4.7 Compliance
 - Hedge fund manager who claims an exemption pursuant to Regulation 4.7 must comply with the requirements of Regulation 4.7
 - If not Regulation 4.7 exempt, manager's compliance will be significantly greater and more burdensome
 - Each prospect must be a “qualified eligible person.” U.S resident can have total assets in excess of \$1 million or annual income for past two years in excess of \$200,000
 - A trust, fund or governmental entity must have assets in excess of \$5 million
 - Offshore investors generally qualify as “QEPs”

Legal and Compliance Issues for Hedge Fund Managers

- NFA Bylaw 1101 requires NFA members to make two determinations:
 - Whether it is doing business with an entity that is required to be registered with the CFTC
 - If so, whether such entity is a member of the NFA
- CFTC registration and NFA membership status is available at www.nfa.futures.org

QUESTIONS?

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