

The JOBS Act and Emerging Hedge Fund Managers: To Act or Not to Act

presented by

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October 29, 2014

ARMOR COMPLIANCE LLC

Armor Compliance is a law firm based in Boston, Massachusetts that provide legal and compliance services to hedge funds, private equity funds and registered investment advisers.

Armor Compliance's founder, Douglas MacLean, has over 14 years of experience providing legal and compliance services and has worked for 9 years at major law firms in New York City and Boston.

TOPICS

Part I: JOBS Act Overview

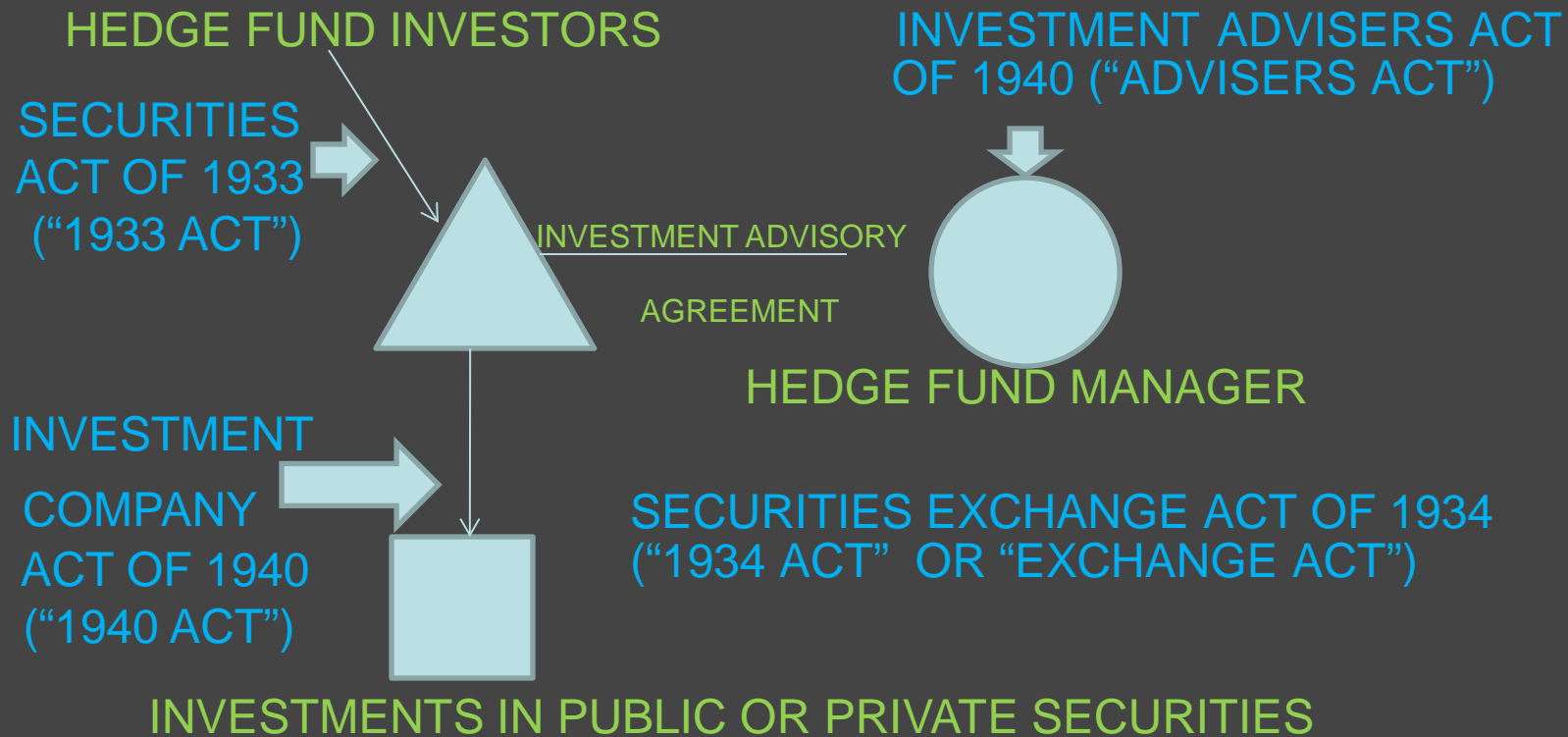
Part II: Proposed Rules

Part III: Other Compliance Issues

Part IV: Cost/Benefit Analysis for Emerging Managers

PART I: JOBS Act Overview

QUICK OVERVIEW OF FEDERAL SECURITIES REGULATION



JOBs Act Overview

- In April 2012, Jumpstart Our Business Startups Act (the “JOBs Act”) was officially passed.
- JOBs Act focuses on easing restrictions for private companies seeking to raise capital.
- The JOBs Act amended the Securities Act of 1933
- Provides that offers and sales exempt from registration under Rule 506 of Regulation D will not be considered public offerings, even if general solicitation and general advertising is used.

JOB Act Overview

- Rule 506 of Regulation D is the safe harbor exemption from Securities Act registration for a private offering of securities primarily to persons who are “accredited investors.”
- Prior to the JOB Act, Regulation D prohibited general advertising and solicitation of private funds and prevented use of any article, advertisement, seminar, meeting or notice to promote an offering.
- JOB Act now allows private funds to engage in such activities.

JOBS Act Overview

- In July 2013, SEC passed final rules regarding the JOBS Act and proposed additional rules.
- Final rules allow private funds to engage in general solicitation and general advertising in offering and selling securities pursuant to Rule 506.
- Private fund managers must take reasonable steps to verify that such purchasers are “accredited investors.”
- Provides a non-exclusive list of methods a fund may use to satisfy verification requirement.

JOBS Act Overview

- As July 2013, hedge funds can now rely upon Rule 506(c) and engage in general solicitation and advertising.
- Hedge funds who are not interested in JOBS Act can continue to rely upon 506(b) and therefore must refrain from general solicitation and advertising but do not need to take reasonable steps to verify the status of accredited investors.
- Funds relying upon Rule 506(b) must have a pre-existing substantive relationship and can be sold to non-accredited investors.

JOB Act Overview

- If hedge funds rely upon Rule 506(c), any general solicitation that occurs after the effective date will not affect the exempt status of offers and sales that occurred prior to the effective date in reliance on Rule 506(b).
- Rule 506(c) requires hedge funds to “take reasonable steps to verify” that purchasers of securities are accredited investors.
- Funds should consider a number of factors when determining the reasonableness of steps to verify that a purchaser is an accredited investor.

JOB Act Overview

- Factors to be considered include:
 - Nature of the purchaser and the type of accredited investor that purchaser claims to be;
 - The amount and type of information that the fund has about purchaser;
 - The nature of the fund offering, such as the manner in which the purchaser was solicited to participate and the terms of the offering, such as the minimum investment amount.
- Hedge fund managers relying upon Rule 506(c) must retain adequate records regarding steps taken to verify status of accredited investors.

JOB Act Overview

- Third-party information can be used that provides reasonably reliable evidence that a person falls within one of the enumerated categories in accredited investor definition:
 - The purchaser is a natural person and provide copies of pay stubs for the two most recent years and the current year;
 - Specific information about average compensation earned at purchaser's workplace by persons at the level of the purchaser's seniority is publicly available;
 - Verification of a person's status as an accredited investor by a third party.

JOB Act Overview

- Reasonable steps to verify accredited investor status does not include checking a box on a questionnaire or signing a form, absent other information about purchaser indicating accredited investor status.
- Terms of the offering will also affect whether verification methods are reasonable.
- SEC provided four specific non-exclusive methods to verify accredited investor status.

JOBs Act Overview

- Verification of natural person on basis of net worth can include review of the following documents: bank statements, brokerage statements and other statements of securities holdings, certificate of deposit, tax assessments and appraisal reports issued by independent third parties.
- Difficult for an issuer to determine liabilities so a consumer report should be obtained and a written representation from such person that all liabilities have been disclosed.

JOB Act Overview

- In verifying whether a natural person is an accredited investor, a hedge fund can satisfy the verification requirement in Rule 506(c) by reviewing copies of any IRS form that reports income, including W-2, Form 1099, Schedule K-1 or a filed Form 1040 for the two most recent years.
- Also need a written representation from such persons that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.

JOB Act Overview

- Issuer is deemed to satisfy the verification requirement in Rule 506(c) by obtaining a written confirmation from a licensed third party.
- Can come from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public account.
- Must represent that such person has take reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor.

JOB Act Overview

- Issuer can satisfy verification requirement for existing accredited investors who invested in a Rule 506(b) offering by providing a self-certification about an accredited investor
- Does not include existing investors who were not accredited investors in Rule 506(b) offering.
- Form D was revised to include Section for both Rule 506(b) and (c).
- Issuers cannot check both boxes on Form D.
- Once general solicitation is made, a hedge fund can no longer rely upon Rule 506(b).

PART II: Proposed Rules

Proposed Rules

- In July 2013, in another release pursuant to the JOBS Act, the SEC proposed additional rules that have not yet passed.
- The existence of these proposed rules and the uncertainty of their passage has caused many hedge fund managers to avoid Rule 506(c).
- Unclear whether these proposed rules will be implemented and if so on what time table.

Proposed Rules

- Proposed rules would amend Regulation D and require the following of private funds:
 - File a Form D at least 15 calendar days in advance before the issuer engages in general solicitation;
 - File a closing amendment to Form D after end of Rule 506 offering within 30 days;
 - Submit, on a temporary basis, written general solicitations materials used in Rule 506(c) offering.
 - Would be disqualified for one year if Form D was not filed if fund or predecessor or affiliate did not comply within the last five years with Form D filing requirements in a Rule 506 offering (Rule 507).

Proposed Rules

- Proposed amendment to Form D (Rule 509) would require private fund to include additional information about offerings conducted in reliance on Regulation D and prescribed legends in any written communications.
- Proposed amendments to Rule 156 would extend antifraud guidance contained in the rule to sales literature of private funds.

PART III: Other Compliance Issues

Other Compliance Issues

- Prior to September 9, 2014, hedge fund managers who were exempt as commodity pool operators pursuant to Rule 4.13(a)(3) or CPOs relying upon Regulation 4.7(b) could not use the JOBS Act;
- Regulation 4.7(b) required that securities be offered only solely to “qualified eligible persons.”
- Regulation 4.13(a)(3) exemption required that securities be offered and sold without public marketing (no general solicitation).

Other Compliance Issues

- These restrictions prevented many hedge fund managers who traded futures or swaps or other products subject to CTC regulation from using the JOBS Act.
- On September 19, the CFTC issued a letter that provides exemptive relief to commodity pool operators who use the JOBS Act from Regulation 4.7(b) and Regulation 4.13(a)(3).
- Exemption is only available to funds who rely upon Rule 506(c) or entities reselling securities pursuant to Rule 144A.

Other Compliance Issues

- CPOs claiming exemptive relief must file a notice with the Division of Swap Dealer and Intermediary Oversight of the CFTC.
 - Notice must provide basic identifying information on the entities claiming exemptive relief;
 - Notice must state whether CPO claiming relief is relying upon Rule 506(c) or is using one or more Rule 144A resellers;
 - Specifies whether CPO intends to rely upon relief pursuant to Regulation 4.7(b) or 4.13(a)(3) and represents that CPO will comply with all other requirements of these regulations.

PART IV:
Cost/Benefit Analysis for
Emerging Managers

Cost/Benefit Analysis for Emerging Managers

- Advantages of Rule 506(c).
- Disadvantages of Rule 506(c).
- Best practices for emerging hedge fund managers who decide to use Rule 506(c).
- Third parties who may be helpful in helping emerging managers who want to pursue Rule 506(c).
- Final Thoughts on JOBS Act and Rule 506(c).

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