



A Boutique Law Firm for the Investment Community

**AN OVERVIEW OF LEGAL
COMPLIANCE REQUIREMENTS
FOR SEC REGISTERED
HEDGE FUND MANAGERS
AS OF MAY 1, 2010¹**

1. Registration with the SEC

- **Initial Registration.** A hedge fund manager is an “investment adviser” for purposes of the Investment Advisers Act of 1940 (the “Advisers Act”) and the related rules (the “Adviser Act Rules”). Therefore, hedge fund managers must register with the Securities and Exchange Commission (the “SEC”) unless the manager qualifies for an exemption.² This overview assumes that you are registered with the SEC.
- **IARD and Form ADV.** The first step in applying for registration is to apply for access to the Investment Adviser Registration Depository (IARD) system. Registration with the SEC is accomplished by filing Form ADV Part I electronically through the IARD system. In addition, you may need to notice file with one or more states through the IARD system. This is done by indicating the states in Item 2.B of the Form ADV and paying any required state filing fee through the IARD system. Finally, some states also require advisers to register or notice file one or more individuals as investment adviser representatives by filing a Form U-4 through the IARD system and paying the required filing fee.
- **Annual Renewal.** Your state filings must be renewed each year by paying the annual renewal fees through the IARD system in early December of each year. You should receive an e-mail from FINRA in November alerting you of your renewal obligations and deadlines.
- **Part I of Form ADV Amendment.** Part I of Form ADV must be amended through the IARD system within 90 days after the end of the adviser’s fiscal year, and more frequently if there are certain changes to the information

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² Currently, if a manager has less than \$30 million under management or less than fifteen clients (a fund is generally counted as one client), the manager is exempt from registration with the SEC, but may have to register with one or more states. A manager is not eligible to register with the SEC unless it has at least \$25 million under management. There is currently legislation pending in Congress that would raise the minimum threshold to \$100 million, but eliminate the exemption for managers with less than 15 clients.

presented.³ Your ADV Part I will be available to the public on-line via the IARD system.

- **Part II of Form ADV.** If you are SEC registered, Part II of Form ADV (the “ADV Part II Brochure”) is not filed with the SEC. Instead, you must keep a copy of the ADV Part II Brochure in your records and give a copy to each of your investors at the time they invest. Your ADV Part II Brochure should be updated annually and more frequently if any material change occurs. Once a year, and more frequently if there are material changes, you must either send your investors a copy of your ADV Part II Brochure or make a written offer to furnish it without charge.⁴
- **Post-Registration Reporting and Disclosure Requirements.** Rule 206(4)-4 requires a registered adviser to make additional disclosure to clients upon the occurrence of certain events. The first such event is when an adviser experiences an “impaired financial situation,” which is generally when an adviser’s financial condition is “reasonably likely to impair the ability of the adviser to meet contractual commitments to clients.” The second such event is when an adviser or one of its principals or employees becomes involved in a legal or disciplinary matter that is material to an evaluation of the adviser’s integrity or ability to meet its contractual commitments to clients. Events that must be disclosed include (1) felony or misdemeanor convictions or other civil or criminal findings involving an investment-related business or other types of fraud and (2) findings by the SEC or a self-regulatory organization that a person was involved in a violation of an investment statute or regulation or caused an investment-related business to lose its right to conduct business. Disclosure of any triggering event must be made promptly to existing and prospective clients. Disclosure may be made by prompt distribution of an amended ADV Part II. In addition, your ADV Part I and U-4 should be updated to reflect the disclosure within 30 days after it occurs.

2. **Fiduciary Duties**

The U.S. Supreme Court has held that investment advisers owe fiduciary duties to their clients.⁵ This includes a general duty to place the interests of clients ahead of the interests of the adviser and its personnel. Specific fiduciary duties include:

- Obtaining best execution for client transactions⁶
- Allocating investment opportunities fairly⁷

³ See Item 4 of the Form ADV General Instructions or Rule 204-1(b) of the Advisers Act.

⁴ See Rule 204-3(c) of the Advisers Act.

⁵ SEC vs. Capital Gains Research, 375 U.S. 180 (1963).

⁶ Best execution means that an adviser must execute each securities transaction so that the client’s total costs or proceeds are the most favorable under the circumstances.

- Using soft dollars in a manner consistent with the safe harbor provided by Section 28(e) of the Exchange Act⁸
- Resolving trade errors in the client’s favor and bearing the cost of correcting any error
- Accurately valuing securities held in client portfolios
- Supervising employees to ensure compliance with federal securities laws⁹
- Avoiding principal and agency cross transactions¹⁰

3. **Requirements Related to Capital Raising**

- **Marketing Compliance.** Generally, because you have fiduciary duties to your investors and potential investors, you must not make false or misleading statements and may not omit material information necessary to make statements made not misleading.¹¹ In addition, all marketing materials must comply with specific SEC marketing rules.¹² Any performance reporting or reference to specific investments in marketing materials should be vetted by legal counsel. Even letters or reports to existing investors are considered marketing materials subject to SEC rules. In addition, you must keep copies of all marketing materials, as well as written support for any performance results reported, for at least 5 years from the time they are last used.¹³
- **Advisory Contract/Subscription Documents.** SEC rules require your advisory contract and your subscription documents to have certain provisions. For example, your advisory contract must prohibit assignment of the contract without the consent of the client.¹⁴ Your subscription agreement must have an acknowledgement that the investor has been furnished Part II of your Form ADV. In fact, you should not countersign the subscription agreements until your CCO or counsel has reviewed the subscription to determine investor eligibility.

⁷ Advisers must not favor client or personal accounts that may benefit the adviser financially, such as allocations to accounts paying higher performance fees. You should also guard against your employees “front running” your client accounts. Your policies on allocation should be set forth in your ADV Part II Brochure.

⁸ Your soft dollar policy should be disclosed in your ADV Part II Brochure.

⁹ See Advisers Act Section 203(e)(6)

¹⁰ Principal transactions are transactions between the advisor and a client account, for example if the adviser or one of its principals sold securities from its personal account to a client account. Cross agency transactions are transactions between client accounts. Section 206(3) of the Advisers Act and Advisers Act Rule 206(3)-2 prohibit transactions between your fund and the adviser or any principal of the adviser, unless there is adequate disclosure and advance consent of your investors.

¹¹ See Advisers Act Section 206 and Advisers Act Rule 206(4)-8, which apply to all hedge fund managers, whether or not they are registered with the SEC.

¹² See Rule 206(4)-1, and rule 206(4)-8 under the Advisers Act.

¹³ See Rule 204-2(e)(3) of the Advisers Act.

¹⁴ See Section 205(a)(2) of the Advisers Act.

- Website. If you have a website, it should be reviewed by legal counsel to make sure you are not inadvertently making a public offering of the Fund under the Securities Act of 1944 or the Investment Company Act of 1940.
- Use of inside and outside solicitors. Federal laws regulate how you can compensate employees and outside finders or solicitors for investor referrals.¹⁵ You must closely supervise both inside and outside solicitors to ensure compliance with state and federal securities laws. You must also disclose such arrangements in your Form ADV Parts I and II, and any person who has been paid compensation in connection with the sale of fund interests must be identified on Form D (see “Regulation D and Blue Sky” below). Finally, the SEC has proposed rules that would prohibit investment advisers from making payments to third persons for the purpose of soliciting government entities for advisory business.¹⁶
- PPM and Part II of Form ADV. A copy of your private placement memorandum and Part II of Form ADV must be delivered to investors at least 48 hours prior to each investment, or the investor must be given 5 days to withdraw the investment from the time these documents are delivered.¹⁷ In addition, you should keep a detailed log of all persons to whom you send offering documents, regardless of whether they invest or not. The log should identify the nature of your pre-existing relationship with each offeree and the date the offering materials were sent to the offeree.
- Investment Company Act. You must maintain your exemption to registration under either Section 3(c)(1) or 3(c)(7) of the Investment Company Act. You are exempt if you have no more than 100 investors in your 3(c)(1) fund and no more than 499 investors in your 3(c)(7) fund. In addition, all investors in your 3(c)(7) fund must be qualified purchasers. When a partnership or other entity invests in your fund, you may need to count the underlying investors in the entity as investors in your fund. In addition, to maintain your exemption, you must not publicly offer investments in your fund, and have no present intention to do so.
- Regulation D and Blue Sky. Marketing materials and offering documents should only be sent to prospective investors with whom you have a pre-existing relationship.¹⁸ When you offer interests in any fund to new or existing investors, you must comply with state and federal securities laws. For each offering, you must file a Form D with the SEC within 15 days after

¹⁵ See Rule 206(4)-3 of the Advisers Act. Because interests in the Fund are securities, any solicitor or finder of investors for your Fund would need to be a registered broker dealer.

¹⁶ In Release IA-2910, the SEC proposed Rule 206(4)-5 to the Advisers Act, which would prohibit certain “pay to play” practices, including certain political contributions or payments made either directly or indirectly to government officials.

¹⁷ See Rule 204-3(b) of the Advisers Act.

¹⁸ To maintain your exemption under the Investment Company Act, you must comply with the private placement requirements of Regulation D of the Securities Act, which prohibits general solicitation.

the first sale and make Blue Sky filings with each state where you offer interests in your fund, with certain limited exceptions. Form D must now be filed electronically with the SEC through the EDGAR system. In addition, your marketing and offering documents should be reviewed by a qualified attorney for securities law compliance.

- Investor Accreditation and Performance Fee Qualification. Completed subscription documents must be carefully reviewed before accepting any investment to ensure investor accreditation and qualification. If you have a 3(c)(1) fund, you cannot charge performance fees to any investor who does not meet the requirements of Rule 205-3 of the Advisers Act.¹⁹
- Side Letters. Side letters are being closely scrutinized by the SEC. Because a hedge fund manager has fiduciary duties to all investors, it cannot unfairly favor one investor over others without adequate disclosure. You should consult counsel before entering into any side letter with an investor. Furthermore, the details of the side letter should be disclosed to your other investors in your ADV Part II Brochure and your private placement memorandum. In particular, side letters that give greater transparency or liquidity to particular investors could be problematic.
- Patriot Act and Anti-Money Laundering. You must have a written anti-money laundering (AML) policy that should be strictly adhered to and reviewed periodically. An administrator of the policy must review all new money coming in from both new and existing investors for compliance with your AML policy, and train your employees annually on how to administer the policy. Typically, your CCO will also be your AML officer.
- ERISA Compliance. You should monitor your investors to ensure that less than 25% of each fund is held by ERISA plans to avoid having to comply with ERISA laws. You should also periodically request an update of your investors' ERISA status.
- New Issues. You should determine if your investors are "restricted persons" under FINRA Rule 5130 who are not eligible to participate in initial public offerings ("New Issues"). If the fund invests in New Issues, your restricted investors cannot participate in the investment. In addition, Rule 5130 also requires an annual certification of New Issue eligibility compliance, which may be obtained through negative consent letters.
- Privacy Policy. Investment advisers, whether registered or not, are subject to SEC and Federal Trade Commission regulations governing the privacy of certain confidential information. You should include your written privacy

¹⁹ Generally, you cannot charge a performance fee to investors who are not "qualified clients," which includes investors who have a net worth of at least \$1.5 million. The prohibition on performance fees does not apply to a fund that is exempt under Section 3(c)(7) of the Investment Company Act.

policy with your offering materials, and update and distribute your privacy policy to your investors at least annually.

4. Ongoing Compliance Requirements of Hedge Fund Managers

- **CCO and Compliance Manual.** SEC registered advisers must have a compliance program that meets the requirements of Rule 206(4)-7 of the Advisers Act. This includes a written compliance manual and designation of a Chief Compliance Officer (“CCO”) responsible for administering compliance procedures and policies. Your compliance manual should be tailored to the activities of your firm. In addition, you should hold quarterly compliance meetings and review and update your compliance manual at least annually.
- **Code of Ethics and Personal Trading Policy.** Rule 204A-1 of the Advisers Act requires a registered adviser to have a written code of ethics. Your code of ethics must establish a personal trading policy that covers all “access persons.”²⁰ Rule 204A-1 also requires trades to be cleared by your chief compliance officer to prevent the inadvertent making of personal trades in front of your funds (front running) or trading on inside information. If you have access to material inside information regarding publicly traded companies, you should maintain a restricted list of those companies and implement procedures to lock down both personal and fund trading in those companies. Your code of ethics should also address conflicts of interests such as the giving and receipt of gifts to and from outside vendors.
- **Quarterly Letters.** All letters and reports to investors should be reviewed by legal counsel to make sure that SEC performance reporting rules are followed. You also should be careful when discussing specific investments in your quarterly letters and other marketing materials so as not to run afoul of Section 206 of the Advisers Act.
- **Valuation.** You should have a written pricing policy that complies with the “fair value” requirements of FASB 157. In addition, the SEC requires you to value all of your portfolio investments in a manner consistent with your written pricing policy. The SEC believes managers have a conflict of interest that might lead them to inflate values to increase their compensation. As a result, you should have a non-manager review pricing monthly to ensure compliance with your pricing policy. Finally, side pockets should not be used to conceal poorly performing assets.
- **Best Execution.** You should have a written policy that requires best execution for all securities transactions. Best execution generally requires you to

²⁰ Access persons are any of your supervised persons who have access to nonpublic information regarding any client’s purchase or sale of securities, or nonpublic information regarding the portfolio holding of your Fund.

consider the full range and quality of a broker's services when you place trades, including the execution capability, commission rate, financial responsibility and responsiveness of the broker. You should review trading and execution quarterly with your head trader to ensure compliance with your policies.

- Soft Dollar Arrangements. You should also have a written soft dollar policy, even if you believe that you do not use soft dollars. The SEC views even the receipt of research from an executing broker as a use of soft dollars, if you could have received a cheaper commission elsewhere. Therefore, you should describe your policy and your use of soft dollars in your private offering memorandum and your ADV Part II Brochure and review your compliance with the policy quarterly.
- Schedules 13D and 13G. If you exercise investment discretion or voting power over more than 5 percent of any class of publicly traded voting securities, you must file a Schedule 13D or 13G with the SEC within 10 days after acquiring more than 5%. Schedules 13D must be amended promptly if there are certain changes, and Schedules 13G must be amended by February 14 of each year, and more frequently if there are certain material changes.
- Section 16 Filings. If you hold beneficial ownership of more than 10 percent of any class of equity securities, you may be required to file reports on Forms 3, 4 and 5 with the SEC.
- 13-F Filings. If as of the last day of any calendar month your firm has investment discretion over \$100 million or more (by fair market value) of certain equity securities,²¹ you must file a 13-F report with the SEC as of December 31 of that year, and as of the close of each quarter during the following calendar year. The report must be filed within 45 days after the relevant reporting date.
- Record Retention. You should have a record retention policy that covers your written records, as well as e-mails and instant messages. Rule 204-2 lists the books and records you must maintain. This includes, among other things, records related to marketing, trading and investor communications. More specifically, there are significant requirements regarding the keeping of performance information.²² The SEC claims the right to review all your records, regardless of whether they are required to be maintained.
- SEC Inspections. The SEC has jurisdiction, under Section 204 of the Advisers Act, to examine your firm and inspect your books and records for compliance with certain SEC rules that apply to both registered and

²¹ The SEC publishes a list of 13-F securities on its website.

²² See Rule 204-2(a)(16).

unregistered investment advisers and the funds that they manage.²³ The SEC can review all of your records, including records that are not required to be kept under the Advisers Act.

- Disaster Recovery and Business Continuation. You should adopt a disaster recovery and business continuity plan that provides for what happens when there is a disaster such as what happened on September 11, 2001. You should provide for IT contingency arrangements that would allow you to operate from off-site. In addition, you should have a plan that provides for what happens to your fund if your portfolio manager or another principal person at your firm dies or is incapacitated.
- Custody. If you or an affiliate is the general partner or manager of your Fund, you will be deemed to have custody of the assets of the Fund. You should (1) hold fund assets with a “qualified custodian” in the name of the fund; (2) notify clients of the name of the qualified custodian and the manner in which the assets are being held; and (3) engage a public accounting firm that is registered with the PCAOB to audit the Fund’s financial statements and (4) send the audited financial statements to the Fund’s investors within 120 days after the Fund’s fiscal year end.²⁴
- Proxy Voting. You should have a written proxy voting policy that addresses potential conflicts of interest that may arise when you vote proxies on behalf of your funds. This policy should be described in your offering documents and your ADV Part II Brochure. Note that the SEC will view proxy authority as giving you the fiduciary duty to vote in you investors’ best interests. Under Rule 206(4)-6, you must (1) adopt and implement written policies and procedures to ensure that proxies are voted in the best interests of clients; (2) disclose to clients how they may obtain information about how you voted with respect to their securities and (3) describe to clients your proxy voting policies and procedures and, upon request, provide a copy of the policies and procedures to the requesting client. You must also maintain a record of all votes you make on behalf of client accounts, and any documents that were material to making a decision on how to vote.
- Direct Investments. If you become aware of a potential PIPE²⁵ or other private investment transaction in a publicly traded company, you should put in place procedures to make sure you do not trade in the securities of the company in advance of the announcement of the transaction. In addition, you

²³ This includes the SEC’s new anti-fraud rule 206(4)-8 under the Advisers Act, which applies to all pooled investment funds.

²⁴ See Rule 206(4)-2 of the Advisers Act. If the Fund is not audited, the adviser would need to engage a PCAOB accounting firm to do an annual surprise examination.

²⁵ Private Investment in Public Equity. The SEC has recently formed a special team to investigate firms that invest in PIPE transactions. The SEC is particularly concerned with how a firm trades around the announcement of the PIPE, including how it unwinds any short positions after the announcement.

must be careful how you unwind your short positions and not cover any short position with securities purchased in a PIPE or other private transaction.

- Shorting Regulations. You should make sure that your short sales comply with Regulation SHO, Section 16(c) of the Exchange Act and Rule 105 of Regulation M. If you beneficially own more than 10% of any class of publicly traded equity securities, you may not hold a short position in that security.
- Offshore Fund. For offshore funds, offshore counsel will need to be engaged and other issues addressed. Tax counsel should also be consulted to determine whether an offshore fund is necessary or appropriate for certain investors. In addition, certain investments held in an offshore fund may generate effectively connected income if not structured properly, which might inadvertently create U.S. tax liability.
- FBAR Filings. Each US person that has a financial interest in or signature authority over a foreign bank, securities or other financial account is required to file IRS Form TD F 90-22.1, the Report of Foreign Bank and Financial Accounts (the “FBAR Form”) with the US Treasury by June 30 of the following year. This includes any interest in an offshore hedge fund.

This overview has been prepared for informational purposes only and does not constitute tax or legal advice. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. If you have any questions about any of the foregoing, please contact George Lee at (214)377-4851 or Evan Stone at (214)377-4852.