



A Boutique Law Firm for the Investment Community

**AN OVERVIEW OF LEGAL
COMPLIANCE REQUIREMENTS
FOR TEXAS-BASED
HEDGE FUND MANAGERS
AS OF January 1, 2010¹**

1. Registration with the Texas State Securities Board

- Initial Registration. All Texas-based hedge fund managers must register as investment advisers either with the Securities and Exchange Commission (SEC) or the Texas State Securities Board (Securities Board), with certain limited exceptions.² This information sheet assumes that you are registered with the State of Texas.
- IARD and Form ADV. The first step in applying for registration is to apply for access to the Investment Advisor Registration Depository (IARD) system. The registration and form ADV are filed electronically with the IARD.
- Additional Materials for Securities Board. After the Form ADV is filed and the fees are paid, the Securities Board will require: (1) copies of your formation documents, (2) a certified balance sheet, your fee schedule, (3) your advisory contract, and (4) a copy of all marketing documents and subscription documents for the Fund.
- Adviser Representative. As a Texas registered investment adviser, you must have at least one officer, partner or other control person registered with the state as an investment adviser representative. In addition, each portfolio manager or member of the investment committee should register as an investment adviser representative. The Texas Securities Board requires written examinations. Your representative must pass the Series 65 Exam or a similar exam, with certain limited exceptions.³ Registration is accomplished by filing a Form U-4 via the Central Registration Depository System (CRD) system.

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² See Section 12 of the Texas Securities Act. Section 109.6 of the Texas Administrative Code provides that private fund managers must register if the fund has natural (as opposed to institutional) investors that are permitted to withdraw within two years. Hedge Fund Advisors with less than \$25 million under management are not eligible for SEC registration and may have to register with one or more states (this threshold may be raised to \$100 million pursuant to legislation currently pending before congress).

³ See Rule 116.3 of the Texas Administrative Code.

- Posting Registration Certificate. Your registration certificate should be conspicuously displayed at your place of business.⁴
- Annual Renewal. Your Texas registrations must be renewed prior to December 31 of each year to avoid paying penalties.
- 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 material changes to the information presented.
- Part II of Form ADV. Part II of your Form ADV must be amended and sent to your investors at least once a year (or you must offer in writing to provide Part II or an equivalent brochure upon request, and without charge).⁵
- Post-Registration Reporting Requirements. Rule 116.9 of the Texas Administrative Code requires you to promptly report certain information regarding your partners, directors, executive officers and 10% owners to the Texas Securities Commissioner. This includes, among other things, felonies, fraud, bankruptcy or securities law violations, all of which must be reported within 30 days.

2. Requirements Related to Capital Raising

- Marketing Compliance. Marketing materials and offering documents should only be sent to prospective investors with whom you have a pre-existing relationship.⁶ All marketing materials must comply with SEC and Texas marketing rules.⁷ 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 and Texas 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.⁸
- Advisory Contract/ Subscription Documents. You should have a written advisory contract and subscription documents that meet the requirements of Rule 116.12 of the Texas Administrative Code. The advisory contract must prohibit assignment of the contract without the consent of the client. Your subscription agreement must have an acknowledgement that the investor has been furnished Part II of your Form ADV. You should not countersign the

⁴ See Rule 116.4 of the Texas Administrative Code. Effective September 1, 2009, this certificate must be printed from the website: www.ssb.state.tx.us/cert.

⁵ See Rule 116.11 of the Texas Administrative Code.

⁶ 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.

⁷ See Rule 116.15 of the Texas Administrative Code and new rule 206(4)-8 under the Advisers Act.

⁸ See Rule 116.7 of the Texas Administrative Code.

subscription agreements until your counsel has reviewed the subscription to determine investor eligibility.

- Website. If you have a website, it should be reviewed by legal counsel to make sure you are not inadvertently violating the Investment Advisers Act of 1940 (the “Advisers Act”) or the Investment Company Act of 1940.
- Use of inside and outside solicitors. Both Texas and federal laws regulate how you can compensate employees and outside finders or solicitors for investor referrals. In addition, you must closely supervise both inside and outside solicitors to ensure compliance with state and federal securities laws. Finally, such arrangements must be disclosed in your Form ADV, 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.⁹
- 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.¹⁰ In addition, you should keep a detailed log of all persons to whom you sent 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 the Investment Company Act by ensuring that you have no more than 100 investors in your 3(c)(1) fund and that all investors in your 3(c)(7) fund are qualified purchasers. 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. 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 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.

⁹ In Release IA-2910, the SEC proposed Rule 206(4)-5 to the Advisors Act, which would prohibit certain “pay to play” practices, including certain political contributions or payments made either directly or indirectly to government officials.

¹⁰ See Rule 116.11 of the Texas Administrative Code.

- Investor Accreditation and Performance Fee Qualification. Completed subscription documents must be carefully reviewed before accepting any investment to ensure investor accreditation and qualification. In addition, a performance fee cannot be charged to any investor who does not meet the requirements of Rule 116.13 of the Texas Administrative Code.
- Side Letters. You should consult counsel before entering into any side letter with an investor, and the details of the side letter should be disclosed to your other investors in your Form ADV and your private placement memorandum.
- 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.
- 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 NASD Rule 2790 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 2790 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 policy with your offering materials, and update and distribute your privacy policy to your investors at least annually.

3. Ongoing Compliance Requirements of Hedge Fund Managers

- Compliance Policy. Texas registered advisers must have a compliance program that meets the requirements of Rule 116.10 of the Texas Administrative Code. This includes a written compliance manual as well as education and supervision of your staff on compliance obligations. 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 manuals annually.

- Code of Ethics and Personal Trading Policy. You must have a written code of ethics that addresses personal trading and conflicts of interest.¹¹ Your code of ethics should establish a personal trading policy that requires all trades to be cleared by your chief compliance officer to prevent your employees and partners from inadvertently making 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 Texas and 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 the “cherry picking” rule.¹²
- 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 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 Form ADV and review you compliance with the policy quarterly.

¹¹ See Texas Administrative Code Rule 116.14.

¹² See Texas Administrative Code Rule 116.15.

- Schedules 13D and 13G. If you exercise investment discretion or voting power over more than 5 percent of any class of publicly traded 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,¹³ 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. The rules of the Texas Securities Commissioner require you to maintain certain records for five years.¹⁴ This includes, among other things, records related to marketing, trading and investor communications. The staff of the Texas Securities Commissioner has the right to review all your records, regardless of whether they are required to be maintained.
- Surprise Inspections. Under Rule 116.7 of the Texas Administrative Code, the staff of the State Securities Commissioner may make a surprise inspection, without notice, to ensure your compliance with the Texas Securities Act and the Texas Administrative Code. In addition, the SEC has jurisdiction to examine your firm and inspect your books and records for compliance with certain SEC rules that apply to both registered and unregistered investment advisers and the funds that they manage.¹⁵
- 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.

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

¹⁴ See Rule 116.5 of the Texas Administrative Code.

¹⁵ This includes the SEC's new anti-fraud rule 206(4)-8 under the Advisers Act, which applies to all pooled investment funds.

- Custody. 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) send your investor audited financial statements within 120 days of the end of the fund’s fiscal year (or 180 days in the case of a fund of funds).
- 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.
- Direct Investments. If you become aware of a potential PIPE¹⁶ or other direct investment transaction, 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 must be careful how you unwind your short positions and not cover any short position with securities purchased in a PIPE or other direct investment 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.
- Principal and Agency Cross Transactions. Any transaction in which you sell or buy securities from your fund, as well as any trades you arrange between your funds, should be reviewed from a legal standpoint prior to execution.
- Trade Aggregation and Allocation. If you have more than one fund or other managed account, you may have a conflict of interest in aggregating trades and allocating trades among your funds and other clients. You should have a written policy that addresses trade aggregation and allocation and disclose this policy to your investors.
- Offshore Fund. If you have an offshore fund, 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

¹⁶ 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.

Accounts (the “FBAR Form”) with the US Treasury by June 30 of the following year. This includes any interest in an offshore hedge fund.

- Management Company Financials and State Franchise Tax. You should keep financial statements for your management company that comply with Rule 116.5 of the Texas Administrative Code. Even if your management company is not subject to federal income tax, it may be subject to the new Texas margin tax. You should consult with a tax adviser on the best way to structure your management fee and performance fee from both a federal and state tax standpoint.

This outline has been prepared for informational purposes only and does not constitute 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.