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CLIENT ALERT

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Time to Update Your Subscription Documents

As a result of the Dodd-Frank Act and other recent SEC and FINRA rulemaking, hedge fund and other investment fund managers will need to update their subscription documents. There are three major changes of which you should be aware:

- New definition of “accredited investor”
- New definition of “qualified client”
- New FINRA Rule 5131 “Anti-Spinning” Rule.

Accredited Investors

Section 413(a) of the Dodd Frank Act requires the SEC to amend the definition of “accredited investor” to exclude the value of an investor’s primary residence from the calculation of the investor’s net worth. Under the new standard, which took effect on the enactment of Dodd Frank in July 2010, accredited investors who are natural persons must either have a net worth in excess of \$1 million, excluding the value of the investor’s primary residence, or income exceeding \$200,000 for an individual or \$300,000 for a married couple. If you have not already updated your subscription documents to reflect this change, you should do so now.

The SEC has proposed a new rule to 1) bring its rules into compliance with the amended standard, and 2) clarify how to treat mortgage debt in the calculation of the value of the primary residence. The proposed SEC rule calculates the value of the primary residence by subtracting the debt secured by the property from its estimated fair market value. Thus, an investor’s net worth is only reduced by the equity in her primary residence. Nevertheless, if the investor is upside down in that residence, the debt in excess of the property’s value will be considered a liability and must be deducted from the investor’s net worth. As proposed, the definition of “accredited investor,” for an individual will read as follows:

“Any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of purchase, exceeds \$1,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the

property the amount of debt secured by the property, up to the estimated fair market value of the property.”

Existing investors do not have to be re-qualified; however, investors who no longer satisfy the accredited investor standard may not be treated as accredited investors for subsequent investments. Whether an investor is accredited is measured at the time of each investment. Therefore, you will need to have existing investors fill out updated subscription documents at the time of each new investment. You will also want to note that Dodd-Frank requires the SEC to revisit the accredited investor standard every four years.

Performance Fees and Qualified Clients

The Dodd-Frank Act also requires the SEC to revise the definition of “qualified client” under Rule 205-3 of the Investment Advisers Act of 1940. Under the Investment Advisers Act, investment advisers (including hedge fund managers), cannot charge performance fees (including incentive allocations or carried interest) to investors who are not qualified clients. Under a recently issued SEC Order, effective September 19, 2011, an individual must have at least a \$2 million net worth or at least \$1 million under management with the adviser to qualify. Previously, clients only needed a \$1.5 million net worth or \$750,000 under management.

Subscription documents should now reflect these new thresholds. Existing (pre-September 19th) clients need not be re-qualified. However, both new (post-September 19th) clients and any new investments made by existing clients must meet the heightened standard. Although the order does not require clients to exclude the value of their primary residences when determining net worth, the SEC has proposed a rule that would do so. We recommend that subscription documents be updated to exclude the value of the investors’ primary residence for purposes of determining the investors’ net worth for both the accredited investor and qualified client standards.

New Issues and Restricted Investors

Hedge fund managers investing in new issues will need to update their subscription documents to reflect new FINRA Rule 5131, which takes effect September 26, 2011. Also known as the Anti-Spinning Rule, Rule 5131 prohibits a FINRA member broker-dealer from allocating shares of a new issue (IPO) to accounts (including hedge funds) in which beneficial interests are held by “covered persons.” Covered persons are generally defined as:

- executive officers or directors of public companies;¹

¹ A “public company” is defined in FINRA Rule 5131(e)(1) as any company that is registered under Section 12 of the Securities Exchange Act of 1934 or files periodic reports pursuant to Section 15(d) thereof.

- executive officers or directors of covered non-public companies;² or
- persons materially supported by such an executive officer or director.

This definition applies to current, former, and prospective clients of a broker-dealer. The intent of the new rule is to prevent the allocation of new issues by brokers in exchange for business.

FINRA permits a “de minimis” exception, allowing IPO allocations to an account if 1) the covered persons’ aggregate beneficial interests do not exceed 25% of the account in question, or 2) the account has implemented procedures to reduce aggregate beneficial interests to below 25% (and will follow them). FINRA also exempts institutional accounts (which are also exempt under FINRA Rule 5130(c)). To comply with the new rule, hedge fund managers that invest in IPOs should screen all current and prospective investors to make sure that either 1) less than 25% of each fund’s investors are covered persons, or 2) the fund’s partnership agreement allows the manager to restrict allocations to covered persons.

You should also note that even if a client is not restricted under the Anti-Spinning Rule, that client may still be a “restricted person” under other new issues rules. For example, Rule 5130 restricts FINRA members from buying new issues from—or selling new issues to—any account in which a “restricted person” holds a beneficial interest. Here, “restricted person” generally refers to broker-dealers and related portfolio managers. Rule 5130 exemptions are similar to the Rule 5131 exemptions, with the major difference being a 10% de minimis exception, as opposed to the 25% exception in Rule 5131. Therefore, an IPO allocation can be made to a hedge fund account so long as 1) covered persons have less than a 25% beneficial interest in such allocation and 2) restricted persons have less than a 10% beneficial interest in such allocation.

Conclusion

You should review your subscription documents now to make sure that they comply with the new requirements that apply to you. These three changes are representative of the new regulatory atmosphere under Dodd-Frank that is causing a myriad of changes to business as usual for hedge fund managers and investment advisers. Fortunately, these changes to your documents can be made easily.

Please contact George Lee at 214-377-4852 or Evan Stone at 214-377-4851 if you have any questions.

² A “covered non-public company” is defined in FINRA Rule 5131(e)(3) as any non-public company with: (i) income of at least \$1 million in the last fiscal year or in two of the last three fiscal years and shareholders’ equity of at least \$15 million; (ii) shareholders’ equity of at least \$30 million and a two-year operating history; or (iii) total assets and total revenue of at least \$75 million in the latest fiscal year or in two of the last three fiscal years