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Edward S. Nadel

Hedge Funds Practice Guide

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Overview

Question 1: What is a hedge fund?

A hedge fund is a privately offered vehicle formed to facilitate investments by one or more investors in specific investment programs. Hedge funds may differ from other privately offered investment funds, such as private equity funds and venture capital funds, on a number of factors, including:

- Investment strategies that they pursue
- Subscription-based rather than commitment-based structure
- Perpetual offering period and perpetual duration
- Ability of investors to redeem

As discussed below, hedge funds are privately offered under the Securities Act of 1933, as amended (the Securities Act) and are not registered under the Investment Company Act of 1940, as amended (the Investment Company Act).

Hedge funds pursue a broad range of investment strategies, including many that overlap with those pursued by other privately offered and registered investment vehicles. Long/short equity funds are very common, with many such hedge funds focusing on generating returns through higher position concentrations, as well as effective and aggressive use of short sales and/or other techniques that mutual funds are generally restricted from utilizing. Hedge funds are active in strategies that utilize detailed research and broad knowledge bases such as global macro strategies that require substantial knowledge of world events and an in-depth understanding of the differing and unique investment products and opportunities available on a global basis. Many hedge funds pursue event-driven strategies that seek to exploit advanced knowledge and expert analysis of the impact that pricing inefficiencies connected to material corporate transactions will have on the securities related to the involved companies. Quantitative hedge funds use enhanced research combined with expertise on systems and programming to design models to guide trading that can take advantage of even small inefficiencies in market values. Hedge funds are active in the credit markets, particularly as increased regulation has reduced the ability of banks to make corporate loans at the pace demanded by the market. Hedge funds have similarly expanded into markets such as real estate that have been traditionally connected to commitment-based funds to exploit similar gaps. Other hedge funds pursue more specialized knowledge and situations, particularly in commodities or specialized financial products.

The hedge fund industry is served by a large number of financial and other service providers. Investment advisors often have multiple relationships with broker-dealers which, depending on the fund's strategy, may include relationships with offices in multiple jurisdictions or those that operate on a global basis. Hedge funds and their advisors aggressively seek to use such relationships to find the best financial terms and opportunities and to access them for capital-raising opportunities and the research and insights that can be provided. Often a hedge fund's brokers provide custodial services, but sometimes full-service or independent custodians are sought as well. Advisors generally seek to have a custodian for their hedge funds in order to assist with complying with the custody rule and other regulations that apply with respect to client assets. Administrators are retained to help funds meet the substantial

compliance and reporting burdens they face, which is particularly vital for hedge funds that trade actively across multiple platforms on a daily basis. Administrators handle the basic reconciliation and recordkeeping, produce investor and financial reports, and typically manage the process and detail connected with investor subscriptions and redemptions. In addition to these back-office services, many administrators have expanded middle-office service offerings that can be provided upon request to manage risks, calculate profits and losses, and sometimes oversee information technology. Depending on the hedge fund's strategy, consultants and other specialists may be vital to understanding the investments and opportunities available to the hedge fund. Fund counsel is required to assist with the fund's formation, offering, and ongoing investment activities, as well as the administration of the manager's ongoing compliance program

For additional information on hedge funds, see Understanding the Structure and Organization of Hedge Funds and Market Trends: Hedge Funds

Applicable Securities Laws and Regulations

Question 2: What are the relevant statutes and regulations governing securities offerings by hedge funds?

The following are the key U.S. federal securities laws governing the formation, offering, and operation of hedge funds:

Securities Act

The Securities Act generally requires that each offer and sale of securities in the United States must either be registered with the Securities and Exchange Commission (SEC) or comply with an applicable exemption from registration. To avoid the time and expense associated with SEC registration, sponsors of hedge funds typically seek to offer their securities pursuant to a valid private placement exemption. For further information on private placements, see Private Placements Resource Kit.

- For offerings within the United States, sponsors of hedge funds generally rely on the registration exemption provided by Rule 506(b) or (c) (17 C.F.R. § 230.506) of Regulation D under the Securities Act. To satisfy Rule 506(b), the offering cannot involve any general solicitation or advertising, and the securities may be sold generally only to investors who satisfy certain criteria regarding income, net worth, asset size, governance status, or professional experience (accredited investors) and up to 35 non-accredited investors that are financially sophisticated. Under Rule 506(c), general solicitation is permitted, but the issuer must take reasonable steps to verify that all of the accepted investors are accredited investors. Companies relying on the Rule 506 exemption must file a Form D with the SEC after they first sell their securities. For further information on Regulation D, see Knowing the Components of Regulation D, Understanding the Classes of Investors in Regulation D Offerings, Filing a Form D, General Solicitation and Startup Capital-Raising under Rule 506 of Regulation D, and Choosing Between a Private Placement under Section 4(a)(2) and Regulation D. For further information on regulating hedge funds in U.S. offerings, see U.S. Regulatory Framework for the Offering of Hedge Fund Securities.

- For offerings outside the United States, hedge funds may also rely on the exemption from registration provided by Regulation S (17 C.F.R. §§ 230.901-905) under the Securities Act, which is available for securities offerings conducted primarily outside of the United States in offshore transactions and where there are no directed selling efforts within the United States. A fund may conduct simultaneous Regulation D and Regulation S offerings. For further information on Regulation S, see Regulation S Transactions, Understanding the Requirements of Rule 144A and Regulation S, and Offshore Offerings by U.S. Issuers.

Securities Exchange Act of 1934 (the Exchange Act)

The Exchange Act requires a U.S. issuer with total assets exceeding $10 million to register with the SEC any class of equity securities held of record by either (i) 2,000 persons or (ii) 500 persons who are not accredited investors. If an issuer is required to register its securities, it becomes subject to rigorous reporting and recordkeeping and other compliance requirements. As a result, hedge funds generally limit the number of their investors to less than 2,000 in order to avoid triggering these requirements. In addition, Rule 10b-5 (17 C.F.R. § 240.10b-5) of the Exchange Act subjects issuers to liability for material misstatements or omissions in connection with the offering of their securities. For additional information on reporting requirements under the Exchange Act, see Periodic and Current Reporting Resource Kit. For additional information on Rule 10b-5, see Liability under the Federal Securities Laws for Securities Offerings.

Investment Company Act

A company that engages primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public must register with the SEC as an investment company or qualify for an exemption from registration. Sponsors of hedge funds typically seek to qualify for an exemption to the Investment Company Act pursuant either to Section 3(c)(1) (15 U.S.C. § 80a-3(c)(1)), which applies to funds that are beneficially owned by not more than 100 persons, or Section 3(c)(7) (15 U.S.C. § 80a-3(c)(7)), which applies to funds that are not publicly offered and that are beneficially owned exclusively by investors that satisfy the significantly higher burden of being qualified purchasers. For further information, see Overview of Exemptions and Exceptions under the Investment Company Act of 1940.

Investment Advisers Act of 1940 (the Advisors Act)

Unlike the Investment Company Act, which regulates the fund itself, the Advisors Act regulates hedge fund managers. Managers that exclusively advise hedge funds (i.e., no managed accounts or non-fund clients) generally may seek exemption from registration under Rule 203(m)-1 (17 C.F.R. § 275.203(m)-1) until their privately funded assets under management exceed $150 million, at which point they will be required to register with the SEC as investment advisors. Practitioners should be aware that an advisor's state of operation and the blue sky laws that apply may materially impact the registration requirements of an advisor. Foreign advisors with U.S. investors or U.S. personnel may be required to register or to make certain basic filings to take advantage of exemptions from registration. Registered investment advisors are subject to additional recordkeeping and reporting requirements, required to have a code of ethics and other compliance policies, and are subject to examination and audit obligations. For further information, see Understanding the Registration Process for Investment Advisers, and Understanding the Proxy Voting Obligations of Investment Advisers.

Blue Sky Laws

While in many cases pre-empted by the federal securities laws to a greater or lesser extent, each state in which a manager operates, or in which an offering of hedge fund interests is conducted, may impose additional restrictions. Such laws are commonly known as blue sky laws. Such blue sky laws may impose notifications, or impose, particularly for smaller managers, filing or registration obligations with respect to the advisor or an offering at the state level. In addition, in connection with a global offering of hedge fund interests, the offering must be conducted in accordance with the applicable laws of each jurisdiction in which the offering is conducted. For further information, see Understanding Securities and Transaction Exemptions under Blue Sky Laws and The Application of Blue Sky Laws to Offerings after NSMIA.

Securities Offering Process

Question 3: What is the typical process for securities offerings by hedge funds, including general steps, timeline, key transaction documents, due diligence process, and required regulatory and stock exchange filings?

As noted above, hedge fund offerings are generally made through private placements. As private placements, they are not subject to the prospectus requirements that apply to offerings made to the public. However, as discussed in more detail below, hedge funds are required to provide to an investor information material to such investor's decision to invest in the fund. In many cases, this is accomplished by the production of an offering memorandum, also referred to as a private placement memorandum, which contains substantive disclosure about the fund. As hedge funds are typically continuously offered, they need to pay careful attention to ensuring that their disclosure materials stay up to date and accurate over time. Further details regarding the typical contents of a private placement memorandum are provided in Question 4 below.

A hedge fund's offering materials generally also include its principal operating document, which varies depending on the jurisdiction of formation and the type of entity and subscription materials and agreements. In a typical hedge fund structure, a Delaware limited partnership or limited liability company is established for U.S. taxable investors, and a Cayman Islands exempted limited partnership or exempted limited company is established for U.S. tax exempt and non-U.S. investors. For the Cayman Islands vehicle, local filings with the Cayman Islands Monetary Authority are also typically required. For forms of operative documents in various contexts, see Operating Agreement (Hedge Fund) (DE LLC) and Administration Agreement (Offshore Hedge Fund) (Cayman Islands).

The third document prepared in connection with most hedge fund offerings is the subscription booklet, which includes the material representations that allow the investment advisor to establish an investor's suitability to make the investment, and the key covenants and agreements between the fund and the investor. Subscription materials generally also include substantial terms connected to the investment and request information about the investor that allows the investment advisor, and its service providers, to establish the investor's identity and source of funds.

A hedge fund's offering documents should describe all of the terms of the fund, including the following:

- Compensation structure of the fund and the advisor, including incentive compensation and management fees
- Clear disclosure regarding expenses that will be borne by the fund and its investors
- Withdrawal or redemption rights and restrictions (including lock-up periods, notice requirements, withdrawal fees, gates, withdrawal suspension provisions, and other redemption limitations)
- Material investment concepts such as participation in new issues, use of commodities or hedging, and use of side pockets or other arrangements related to illiquid or difficult-to-value investments
- Details on the fund's intended use of leverage
- Reporting by the fund to its investors

In addition to the private placement memorandum, operative documents, and subscription documents, side letters may be entered into with individual investors granting such investors special terms on matters such as economics, liquidity, and/or transparency.

Finally, an investment advisory agreement between the advisor and the fund will be entered into and may be shared with interested investors. However, advisors do not generally treat investors as clients or enter into direct advisory agreements with the investors.

Hedge funds that rely on Regulation D in conducting their offerings are required to file Form D within 15 days of the first sale of interests. They may choose to file Form D in advance of such offering date, which can simplify the initial filing. Generally, an update is required at least annually. Depending on the states in which investors reside and the number of investors from each such state, additional state notice filings may be required in connection with additional closings.

For further information, see Drafting and Reviewing the Key Documentation for a Hedge Fund and Its Offering.

Disclosure Obligations

Question 4: What information must be made available to potential investors in connection with securities offerings by hedge funds?

As noted above, most hedge funds rely on exemptions from registration under both the Securities Act and the Exchange Act. Therefore, no specific disclosure form must be used in connection with securities offerings by such funds. However, the antifraud provisions of both Section 17 (15 U.S.C.S. § 77q) of the Securities Act and Section 10 (15 U.S.C.S. § 78j) of the Exchange Act (and particularly Rule 10b-5 thereunder) apply to all securities offerings, whether registered or not. Section 206 (15 U.S.C.S. § 80b-6) of the Advisors Act prohibits any investment advisor, whether registered or unregistered, from committing any fraudulent, manipulative, or deceptive act with respect to an advisory client or prospective client. In addition, as further discussed below, additional requirements apply in connection with the distribution of advertisements by registered investment advisors.

In light of the foregoing, a private placement memorandum (PPM) is generally prepared to serve as the disclosure document in connection with the offering of securities by a hedge fund. Although the content, organization, and style of PPMs can vary widely, a PPM should include all information that is material to a person's decision to invest in the fund (i.e., should not contain any material misstatements or omissions) and will generally include discussion on the following topics:

- Structure of the fund, related entities, and their management
- Investment objectives and strategies of the fund and any investment restrictions or limitations that apply thereto
- Biographies of the key members of the management team
- Discussion of material management conflicts of interest
- Key terms of the fund
- Discussion of material risks associated with the fund and its investment program
- Discussion of the fund's valuation policy and the manager's trade allocation policy
- Description of the indemnification and exculpation provisions that apply to fund management and other service providers and the identity of the prime brokers and description of policies with respect thereto
- Identity of other material service providers, including any fund administrator(s) and custodian(s)

- Disclosure of tax issues that may be unique to the fund or its investment program, and basic explanation of the tax consequences of a fund investment generally
- ERISA, and other regulatory and legal matters relevant to the hedge fund

For a form of private placement memorandum, see Private Placement Memorandum (Hedge Fund Limited Partnership Interests) (DE).

A. Risk Factors

Please describe the common risk factors that are specific or unique to issuers in this industry. Have there been any recent developments or changes that counsel should be aware of when preparing these risk factors?

Risk factors should be carefully considered and matched to the specific details of a fund and its investment program and accordingly, will vary between funds and be dependent on the structure, strategy, and terms of the particular hedge fund. Some of the most common categories include:

General (market) risks, including:

- General investment and trading risks
- General economic conditions
- Past, current, and future market disruption events
- Risks posed by additional legislation and increased regulatory oversight

Strategy-specific risks, including (as applicable):

- Lack of assurance as to the success of the fund's investment strategies
- Diversification risk, particularly for concentrated portfolios
- Use of leverage and margin
- Investments in foreign jurisdictions, including particular risks associated with investments in emerging or undeveloped markets
- Illiquidity of investments
- Securities of sub-investment-grade companies
- Small capitalization companies
- Short sales, derivative instruments, and similar products
- Hedging or, conversely, the unavailability of adequate hedges or the election not to hedge a transaction
- Dependence on occurrence of events
- Broker and other counterparty credit risk exposure

Fund-specific (terms-related) risks, including:

- Risks associated with the fund's incentive compensation structure
- Limited operating history
- Reliance on management team's judgment, stability, and continued employment of key members
- Lack of registration of fund and/or manager and consequent lack of regulatory oversight;
- Limits on control by passive investors
- Lack of liquidity and limitations on withdrawals
- Effects of substantial withdrawals

Conflicts of interest, including:

- Soft-dollar arrangements
- Relationships with prime brokers and other counterparties or services providers
- Compensation arrangements for investor referrals
- Conflicts with other funds and accounts managed by the manager

For additional information on risk factors in general, see How to Draft Risk Factors for a Registration Statement and Market Trends: Risk Factors

B. MD&A and Business

Please provide the key discussion points that counsel should consider when preparing the business and MD&A sections for issuers in this industry.

As noted above, no specific form applies to the MD&A section of a PPM. However, managers and hedge funds should be mindful of the antifraud provisions noted above, which apply to all investment advisors whether or not registered. In addition, in connection with preparing any disclosure with respect to operating results, investment advisors should be aware of Rule 206(4)-1 under the Advisors Act, which prohibits registered investment advisors from distributing any advertisement that is false, misleading, or that contains:

- Untrue statements or omissions of material facts
- Testimonials
- References to past investment recommendations without reference to all recommendations in a period
- Charts, graphs, or other information that would lead an investor to determine specific securities to buy or sell
- Statements that purport to offer a report, analysis, or other service free of charge

Performance results should generally be presented net of fees, commissions, and other expenses that a client would have paid if the client had owned the portfolio. Advisors associated with a Financial Industry Regulatory Authority (FINRA) member should also be aware that FINRA rules may contain material restrictions and requirements related to the presentation of performance data, the use of advertisements, and required disclosures for offering documents.

As the specific prohibitions surrounding advertisements are quite detailed and complex, practitioners should generally adhere to the principle of ensuring that such materials are as straightforward and balanced as possible so as to minimize the possibility of misleading potential investors or of painting an incomplete or inaccurate picture of the investment advisor, the fund, or the offering. Practitioners should also be mindful of ensuring the consistency of such disclosure with the written policies and procedures of their clients with respect to such matters as trade and expense allocation and the resolution of conflicts of interest, in addition to ensuring that such disclosure is consistent with a registered advisor's disclosures on its ADV Part 2A and 2B.

For further information on regulatory provisions, see Understanding the Regulatory Scheme for Investment Advisers and Regulation of Hedge Funds and Their Trading Activities.

C. Other Prospectus Disclosure

Is there any other additional or special disclosure that should be included in the prospectus or registration statement for issuers in this industry, either required by the SEC or from market practice?

The SEC has indicated that they are paying particular attention to the disclosure of expenses that are borne by the clients of investment advisors. Advisors generally have broad latitude to charge expenses to the hedge funds they advise, but great care should be taken to ensure that such expenses have been adequately and completely disclosed and that the advisor's practices do not drift over time from those disclosures. Recent SEC enforcement actions with respect to management fee offsets highlight this issue, such as that settled by W. L. Ross, where an investment advisor's disclosure did not expressly state how certain transaction fees received by the investment advisor would be allocated among its multiple fund clients and co-investors for offset purposes. See In the Matter of WL Ross & Co., Release No. 4494 (August 24, 2016), available at https://www.sec.gov/litigation/admin/2016/ia-4494.pdf. The SEC required that the entire outside fee be used to offset the fund's client management fees notwithstanding the more commonly understood practice of only a party's allocable share of such fee being used as an offset.

The SEC has also been highly focused on the disclosure of conflicts of interest. Advisors are often uncomfortable with the pull between full disclosure of a conflict (and the impact it may have on fundraising and investor confidence) and the level of disclosure that a regulator thinks is required.

D. Additional Disclosure Issues

Please discuss any other special disclosure issues or advice applicable to issuers in this industry.

Because most hedge funds have open-ended offering periods, it is important for managers to ensure that their offering documents are updated to reflect material developments over time so that the disclosures are current and complete as of each date on which new investors are admitted.

Underwriting Agreements

Question 5: What types of underwriting arrangements are commonly used? What are some of the standard clauses and clauses that are heavily negotiated in an underwriting agreement in connection with an offering by a hedge fund?

Many advisors, especially newly formed advisors, conduct the offerings of their sponsored hedge funds themselves. These offerings are directed to friends and family, and generally grow by word of mouth and by the advisors' efforts to expand their network of potential investors. When looking to access a broader market than that provided by their associates, such advisors often turn to placement agents and enter into placement agent agreements and/or platform access agreements to satisfy that need.

In drafting or negotiating placement agent agreements, it is important to ensure that the placement agent does not conduct a public offering or otherwise offer the interests of the hedge fund in a manner inconsistent with the fund's private offering exemptions. A placement agent allows an advisor to access the placement agent's existing network of relationships without conducting a public offering, but it does not absolve the advisor of ensuring that the private offering rules are complied with. Placement agents do not, generally, commit to placing a specific amount of the interests. However, a fund may elect to restrict the capacity it makes available to a placement agent or to set restrictions on the number or size of acceptable investors. Although placement agents frequently process orders for their clients, they do not generally act as principals in such transactions or otherwise purchase and resell interests in the hedge fund. These contracts often include geographic or other restrictions on the targeted investors allowing for multiple agents to service the same hedge fund. Investment advisors should strongly consider expressly excluding certain investors, such as investors that have previously invested in the advisors' funds. For further information on placement agent representations in the context of Regulation D, see Rule 506(c) Representations, Warranties, and Covenants (Placement Agency Agreement).

Placement agents often receive fees directly from the introduced investor, but may instead receive fees from the investment advisor or, with proper disclosure and more rarely, from the hedge fund itself. All placement agent fees must be fully disclosed to and agreed upon by the investors to which they relate. The fees themselves may be structured in a variety of ways, often involving a transactional component, with a front load or similar charge on the amount invested, or a continuing element, often in the form of a fee share with the investment advisor with respect to a client's account or a fee applied to an investor account maintained by the placement agent. Continuing fees should relate to continuing service provided by the placement agent, which often takes the form of the placement agent providing ongoing investor servicing to the client. This typically includes but is not limited to managing investor reporting, and processing investor subscription and redemption requests.

In selecting a placement agent, an advisor should carefully investigate the agent to ensure that it is a licensed broker dealer and not a "bad actor" prohibited from participating in a private offering. An advisor should understand:

- How the placement agent finds or sources prospects
- The procedures the agent has in place to ensure suitability of the potential investor and to screen out regulatory and compliance issues (e.g., investors that trigger anti-money laundering concerns)
- The compliance procedures the placement agent uses to ensure compliance with the private offering rules

For further information, see Rule 506(d) Bad Actor Representations, Warranties, and Covenants

Continuous Disclosure and Corporate Governance

Question 6: What specific continuous disclosure and corporate governance requirements apply to hedge funds?

Hedge funds are not subject to specific continuous disclosure requirements, but are instead guided by the disclosure principles of the anti-fraud rules and by investor demand. Accordingly, they should disclose material information to investors with sufficient frequency and detail to enable investors to monitor fund performance and make informed decisions regarding their investments. While the type of information provided and the appropriate frequency vary greatly among funds, this information typically includes:

- **Annual audited financial statements**
  - Most funds will prepare audited financials both because investors expect them, and because it aids the investment advisor in complying with Rule 206-4(2) (the custody rule).
- **Periodic performance information and risk reports**
- **Disclosure of material developments affecting the fund**

In addition to the foregoing disclosures, hedge funds should establish robust practices and programs around corporate governance, including:

- **Valuation policy and procedures**
  - Hedge funds generally need to value client assets at fair value, rather than cost or book value, to ensure fairness to both subscribing and redeeming investors.
- **Risk management policy and procedures**
- **Trading and operations policies and procedures covering**:
  - Order management and allocation of trades
  - Management of cash, margin, and collateral requirements
  - Operational and accounting processes, including back-office reconciliation, recordkeeping, and other documentation of trading activities
  - Selection, management, and monitoring of service providers and counterparties
  - Best execution practices
    - Best execution refers to the duty of an investment advisor executing orders on behalf of clients to ensure the best execution possible for such orders.
  - Information technology and cybersecurity
  - Business continuity plan
    - This is especially important where the investment advisor is a solo operator or small group.
- **Compliance policy and procedures, including:**
  - Written code of ethics, required for registered advisors, and best practices for all
  - Written compliance manual
  - The handling of conflicts of interest and potential conflicts of interest and/or principal or related party transactions whether through disclosure to and consent of the investors, or through the use of conflicts committees or similar bodies to act on behalf of investors
  - Employee training and oversight.
    - Practitioners should carefully review any regulatory requirements that apply to such staff under state and/or federal securities laws.
  - Appointment of a chief compliance officer
  - Annual review of the compliance program

Stock Exchange Requirements

Question 7: Are there any special listing or corporate governance standards required by major stock exchanges, including NYSE and NASDAQ?

Generally speaking, since hedge funds are offered in unregistered offerings, no special listings, or stock exchange filings are required, although hedge funds offered outside of the United States may be listed on non-U.S. exchanges and may have filing requirements related thereto. If the investment manager of a hedge fund is already a member of an exchange, then some of the restrictions that apply to such member that would not otherwise apply to the fund may become applicable to the fund as well (e.g., FINRA rules with respect to advertisements may impact the marketing materials for the unregistered hedge fund). For additional information on FINRA, see Market Trends: FINRA and Understanding FINRA Regulations and Filings.

Other Key Laws and Regulations

Question 8: What are other key laws and regulations that a securities lawyer working with a hedge fund needs to be aware of?

In addition to the U.S. federal securities laws governing the offering of interests in hedge funds noted above, the following key laws and regulations should be considered:

Exchange Act Reporting Requirements

Section 13 (15 U.S.C.S. § 78m) and Section 16 (15 U.S.C.S. § 78p) of the Exchange Act provide for filing and other requirements in connection with the acquisition of 5% and 10%, respectively, of any class of equity securities of a public company, and contain many other restrictions, including restrictions on short selling, disgorgement of short-swing profits, and related matters. Managers of hedge funds are often obligated to make filings under Rule 13f-1 (17 C.F.R. § 240.13f-1) related to institutional investment managers that exercise investment discretion over accounts with greater than $100 million of Section 13(f) securities. For additional information, see Reporting by Institutional Investment Managers on Form 13F.

Employee Retirement Income Security Act of 1974 (ERISA)

ERISA and the regulations promulgated thereunder impose heightened fiduciary duties on persons who are fiduciaries of certain employee benefit plans (ERISA Plans) and prohibit certain transactions involving the assets of an ERISA Plan and its fiduciaries or other interested parties absent specific exemptions. A hedge fund will be deemed to include plan assets and be subject to the fiduciary standards under ERISA, if the participation by ERISA Plans in such fund is deemed significant. Absent another exemption, participation will be deemed significant if the beneficial ownership of ERISA Plans of any class of equity issued by the fund equals or exceeds 25%, measured at the time of each redemption or subscription. To avoid these consequences, hedge funds typically limit investment by ERISA Plans to less than 25% of any class of equity securities and may act to aggressively redeem such investors in certain circumstances.

Commodity Exchange Act

Under the Commodity Exchange Act, a pooled investment vehicle that directly or indirectly utilizes swaps (including for hedging or other purposes incidental to the vehicle's primary investment strategy) is generally considered a commodity pool. Operators of commodity pools must register with the Commodities Futures Trading Commission (CFTC) as commodity pool operators, and advisors to such pools must register with the CFTC as commodity trading advisors, subject in each case to certain exemptions. The most common exemption utilized by hedge fund managers is CFTC Rule 4.13(a)(3) (17 C.F.R. § 4.13), which allows for commodities trading for bona fide hedging purposes but requires that investors satisfy certain sophistication requirements (generally that they are accredited investors or qualified eligible participants) and places restrictions on the total amount of the commodities transactions. For further information, see The Dodd-Frank Act: Commodity Position Limits and The Regulation of Investment Adviser Custodial Practices.

Industry-Specific Investment Requirements

Investments in companies operating in regulated industries such as banking, broadcasting, and gaming may be subject to additional restrictions, limitations, or filing requirements. In addition, investments in real estate, infrastructure, and agricultural assets may present special tax, legal, and regulatory considerations.

Regulatory Trends

Question 9: What are the major regulatory trends affecting hedge funds?

Hedge funds, because of the wide variety of their investment programs and strategies, are exposed to and can be affected by regulatory trends in any industry or country. Thoroughly understanding your client's strategy, areas of operation, and current and strategic goals is vital to identifying where issues may arise for the client.

Insider Trading

The recent Newman decision has raised insider trading to the level of a hot topic. See United States v. Newman (773 F.3d 438 (2d Cir. 2014), reh'g denied, Nos. 13-1837, 13-1917 (2d Cir. April 3, 2015). Most investment managers already have extensive policies and procedures in place to protect against the misuse of material non-public information by their staff, and such rules have generally been designed to avoid any risk of misuse (rather than to skirt the line). However, because investment advisors generally seek to exploit superior research and knowledge in pursuit of their investment objectives, they often end up having to deal with issues related to the tips and other information such efforts produce. For additional information, see Drafting Insider Trading Policies.

Social Media Use

Social media use and the expansion of technology solutions create special risks for investment advisors and hedge funds. Investment advisors are subject to specific advertising restrictions, including a ban on the use of testimonials by their clients, that are subject to review right now in the context of how to interpret comments made about or by the investment advisor on social media or on forums maintained by the advisor or by third parties. Practitioners are well advised to conduct basic online diligence with respect to their clients and not simply to rely on their statements or policies about their use of social media, particularly for new groups with employees that do not have an extensive background in the industry. For a discussion of social media in the context of public companies, see Social Media Practices and Public Companies Checklist. For a form of social media policy in general, see Social Media Policy.

Cybersecurity

Similarly, cybersecurity is a hot topic both for investment advisors and their service providers. Advisors receive and maintain personally identifiable information with respect to their clients, including in many cases sensitive financial information such as banking details. While the redemption/withdrawal process of a hedge fund (and the inherent delays and detailed processes and review involved) provide a substantial mitigation of the risk of fraudulent redemptions, advisors need to ensure that they are protected in their trading activities and the movement of cash and assets connected thereto. For a form of cybersecurity risk factor, see Cybersecurity Risk Factor.

AIFMD Compliance

Alternate Investment Fund Managers Directive (AIFMD) compliance and its impact on accessing European markets remains a hot topic for advisors seeking to offer in those markets. Many existing funds have already reached an accommodation with the rules and their plans. However, Brexit has the potential to disturb existing solutions that are in place and is likely to cause disruption in the existing status quo.

Commercial Trends

Question 10: What are the major commercial trends affecting hedge funds?

Liquidity Terms

Over the past decade, liquidity terms of hedge funds have become more investor-friendly. This trend has manifested itself in the following forms:

- Shorter lock-up periods and redemption notice periods
- Increased reliance on soft lock-ups (i.e., early withdrawal fees on redemptions during the lock-up period) as opposed to hard lock-ups (i.e., absolute prohibitions on redemptions during the lock-up period)
- Narrower discretion on the manager's ability to suspend redemptions

In addition, restrictions on the amount of redemptions that are permitted on any given date (commonly referred to as gates) are increasingly applied at the investor level rather than on a fund-wide basis, as the latter approach can create adverse incentives on the part of investors to over-redeem.

Continued Pressure on Fees

In addition to the pressure on liquidity noted above, hedge funds are facing increased downward pressure on fees, including both management fees and incentive fees. Fee reductions are often granted to individual investors in side letters, or through the introduction of so-called founders' share classes with discounted fees for early investors.

Convergence of Hedge Funds and Private Equity Funds

Historically, hedge funds have been characterized by the ability of investors to redeem their interests following relatively short lock-up periods. By way of contrast, private equity funds typically have relatively long terms (usually eight years or longer) with no ability for investors to redeem their interests prior to termination. In recent years, as hedge funds have begun to invest in less liquid strategies, the liquidity terms of such funds have evolved to match the liquidity of their underlying investments, resulting in longer lock-up periods, longer redemption notice periods, and stricter gates. In addition, as private equity funds have begun to invest in more liquid strategies, the investment periods and termination dates of such funds have become increasingly shorter, and, with those changes, evergreen funds that allow for perpetual recycling of capital have become more prevalent. These trends have led to a convergence of terms and a blurring of some of the traditional distinctions between hedge funds and private equity funds.

Practice Tips

Question 11: What practice points can you give to lawyers working with hedge funds?

Hedge funds, and the investment advisors that form them, are often on the forefront of complex transactions and new products. It is absolutely vital for legal counsel to understand more than just how to form a hedge fund. Counsel must understand the goals and intentions of the investment advisor, the mechanics of the transactions, the jurisdictions and products, and the moving parts. All this information will inform and guide the structuring and formation process and the crafting of adequate disclosure.

A solid grasp of the advertising and marketing rules is vital for initial conversations with a potential investment advisor client. Often, new managers have little experience with the regulatory side of a hedge fund and are unaware of the potential pitfalls that are inherent when they begin their promotional process, including potentially impairing their private offering or violating the anti-fraud prohibitions with respect to their advertising activities. Anticipating issues that may arise is vital with less-experienced managers to prevent them from violations that can undermine their long-term goals.

Many investment advisors have professional experience with the federal rules on investment advisors and the registration and compliance requirements thereof, but are less familiar with the state blue sky laws that may apply. This distinction is often material for new advisors that may not be eligible for federal registration. Legal counsel needs to be conversant in the state securities laws that can impact a smaller advisor, including the relevant thresholds and how the various exemptions function.

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