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Pepper Hamilton Seminar Addresses Licensing Requirements, Fund Structures and Other Considerations for Hedge Fund Capital Raising

Posted By *rcavallito* On June 2, 2017 @ 6:00 am In Conferences & Seminars | Comments Disabled

The ability to successfully raise capital is an important harbinger of a hedge fund manager's long-term success and requires managers to make several prefatory determinations, including the development of an overall marketing strategy that determines whether the marketing function will be performed in-house or outsourced to a placement agent or third-party marketer. This consideration can be particularly consequential, because managers who engage or employ external or internal marketers who otherwise should be registered as broker-dealers, but are not, can be subject to stiff penalties, including rescission of improperly solicited investments.

During a recent Pepper Hamilton roundtable, "Investment Management and Hedge Funds: What's Happening Now?," experts discussed capital raising and licensing requirements and considerations for managers weighing whether to employ an in-house marketing team or outsource marketing to a third party. This article summarizes the key points of the roundtable most applicable to hedge fund managers.

Who Should Market the Fund?

No marketing plan can be successful without personnel or contractors to execute it, so hedge fund managers raising capital first must decide whether to keep the marketing function in-house or hire a third-party marketer, placement agent or other party to solicit investments. Each option has its advantages.

The primary benefit of hiring or appointing internal personnel to market the fund is that they likely understand the ins and outs of the manager's business and strategy better than any outside parties. Likewise, firm personnel will exclusively market the fund and the manager, whereas an external marketer divides time among several funds and managers. On the other hand, outsourced marketing generally is less expensive than hiring a new employee, a benefit that may appeal to smaller managers with limited resources.

When evaluating hiring an outsourced marketer, Evan Katz, managing director at Crawford Ventures, advised managers to determine how much time a third-party marketer will devote to their fund(s) and consider how many different funds with similar strategies the marketer represents. "You need to pick fundraisers that are right for your fund," Katz advised. "You want someone that knows and understands your strategy and your firm and can answer questions from investors." (For more on third-party

marketers, see "Key Considerations for Hedge Fund Managers Working with Outside Sales Consultants:" Part One [1] and Part Two [2])

Under What Circumstances Must a Marketer Be Registered?

As a general matter, any person who is compensated, directly or indirectly, for soliciting, offering, arranging or selling any security (including a private fund) is required to be registered as a broker-dealer with the Securities and Exchange Commission and become a member of the Financial Industry Regulatory Authority. Accordingly, if hedge fund managers engage third-party marketers or placement agents, they must be licensed as a broker-dealer or be a registered representative of a licensed broker-dealer. The penalty for using an unlicensed finder, third-party marketer or placement agent could include rescission rights in favor of investors in the fund.

Finder's Exemption

Members of a manager's in-house marketing team also could be subject to broker-dealer registration requirements if their activities extend beyond the limits of a "finder" and reach the broker-dealer threshold. The federal securities laws do not explicitly define the term "finder," but through a series of no-action letters, the SEC has enumerated certain activities a finder cannot engage in. They include:

- Actively soliciting potential investors;
- Advising potential investors about the merits of an investment;
- Participating in the negotiations;
- Participating in the valuation or creating terms of the securities to be sold;
- Collecting, holding or disseminating investor funds;
- Reviewing or drafting any agreements related to an investment;
- Providing assistance to investors in completing the purchase agreement, subscription agreement or other documentation pertaining to an investment;
- Providing financing to any investor;
- Providing assistance to the firm in drafting or distributing any materials including financial data or sales materials; and
- Introducing an issuer or private fund to commercial banks, lawyers or other professionals to facilitate an investment.

Pepper Hamilton partner Gregory Nowak emphasized that it's particularly important for hedge fund managers to scrutinize the nature and structure of the compensation they give internal marketing personnel because anyone who solicits, negotiates or executes investments cannot avoid broker-dealer registration if they are compensated based on the amount of assets raised. In addition, any bonuses awarded cannot be transaction-based, a term which the SEC has broadly construed to encompass direct and indirect economic benefits.

Because it can be difficult to meet the numerous requirements under the Finder's Exemption, Nowak said, for the avoidance of all doubts, it may be more prudent for managers to ensure their marketers are properly licensed and registered. In addition to the risk of rescission of the fund, managers could also face civil liability under Section 20(e) of the Securities and Exchange Act as an aider and abetter to securities fraud.

"With aider and abettor liability you, as a fund manager, have the risk of having to give back money. Moreover, you could also go to jail for aiding and abetting the violation of Section 15a of the '34 Act, which is a criminal statute. It says that it shall be unlawful for you to engage in this activity if you are unlicensed," explained Nowak.

Managers also should be careful when working with the capital introduction teams at their prime brokers, noted Alex Mascioli, CEO of North Street Global. "Capital introduction is a gray area. It's a value-add, and no one receives compensation for introducing capital to our clients. But you want to make sure that's the case. You never want to have that gray area. I think the rule of thumb in the last few years has been that most, if not all, bulge brackets prime brokers and other introducing capital firms have registered their employees with Series 79 just to be safe."

Katz agreed it's a safer play for any kind of marketing personnel to be properly licensed. "If you're going to be in the capital-raising business, no one will take you seriously if you're not licensed to raise capital."

He added, "One of the gray areas is if you're working at a firm and you have 10 different jobs and one of them is capital raising, but you're not paid a commission. But it's clear that if you're raising capital on a full-time basis and you receive a commission, you need to be licensed."

Issuer's Exemption

Nowark said hedge fund managers and their marketing personnel can also rely on Rule 3a4-1 of the Securities Exchange Act of 1934, a nonexclusive safe harbor from broker-dealer registration for "associated persons of an issuer" who are not subject to a statutory disqualification; compensated by the payment of commissions, directly or indirectly, based on the sale of the issuer's (fund's) shares; or associated persons of a broker-dealer. Additionally, associated persons are limited to offers and sales of securities to certain institutional investors, such as a registered broker-dealer, insurance company, bank, trust company or registered investment company; can only participate in one securities offering every 12 months; must perform substantial other duties on behalf of the issuer other than fundraising; and cannot have been a broker, dealer or an associated person of a broker or dealer in the previous 12 months.

According to Nowak, "The Issuer's Exemption under 3a4-1 allows the CEO of the firm and his associates to raise capital for the firm. That has been extended to the fund by saying the manager, general partner or the delegate of the general partner can raise money for the firm. The problem arises when you have a person whose sole role is to raise capital, and that individual will receive a percentage of everything that is brought in. Once you couple raising capital with compensation and you're selling a security, you've entered in the broker-dealer zone, and that person needs to be licensed." Put simply, in-house marketers can sell private fund securities with a Series 7 license under the Issuer's Exemption, but if they are compensated based on commissions, then the compensation must be paid through a registered broker-dealer.

Mascioli further explained the compensation restrictions. "If you're a fund with an internal marketer, that marketer could be salaried coupled with compensation based on the assets brought into the fund. In that case, the person definitely has to be licensed. If any part of their compensation is related to the assets they brought in, they have to be licensed. What a lot of larger funds with internal marketers are doing is having their marketers licensed and housed with a registered broker-dealer. What happens is if

there is an investor who wants their money back, in reviewing the investment, regulators will look to see if there was any portion of that investment at any time that was used to compensate the internal marketer, even in an indirect way. By associating with a registered broker-dealer, the compensation issue is addressed."

Mascioli said where there are questions about whether someone should be licensed or not, it's preferable to be licensed. "It's better to be safe than sorry."

Katz also noted that a manager's size should be among the factors considered when determining whether in-house marketing personnel should be licensed. "If you look at it from the large firm, medium firm and smaller firm perspective, the percentage of internal people that are registered is vastly greater at the large firms—largely because they have such great enterprise value. It's not worth the risk of leaving people unregistered or unlicensed."

General Solicitations

The SEC's adoption of the final rules under the JOBS Act ended the longtime ban on general solicitation or advertising of securities deals under Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933. Under the new rules, managers may rely on a 506(c) offering to advertise the issuance of private securities to the general public so long as only accredited investors buy shares in the fund.

There are substantial benefits to 506(c) offerings, Nowak said. "If you're a fund manager who has filed a Reg D but not a 506(c) general solicitation, both you and your placement agent need to live by the following rules: No general solicitations. No mass emails. No publicity at all. No open websites. No performance table listings. No solicitations to acquaintances until you meet the 30-day 'old and cold' period. With a 506(c) offering, all of these issues go away. You do have to do verification, and you have to have records. The burden isn't that much greater."

Best Practices for Fundraising

Some general best practices for raising capital apply universally, regardless of whether a manager relies on internal or external marketers to solicit investments in a hedge fund.

According to Nowak, managers should consider a 506(c) offering. Additionally, managers who solicit new investors need to be patient or face rescission risk. "A manager is supposed to wait 30 days to solicit new people for investment. If you invest with that person and you lose money, you have the right of rescission. That is the most powerful reason why you should reconsider your aversion to 506(c)."

Nowak noted several additional fundraising best practices, including:

- Asking investors what they are looking for.
- Ensuring that fund documents are sent to the correct contacts at the investor firm.
- Noting how different investors prefer to be contacted, whether via email or phone calls.
- Making email subjects noticeable, including putting the name of email recipient in the subject line.
- Refraining from sending too much information in emails and using bullet points to highlight salient considerations about the fund, strategy and performance.

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[1] Part One: **http://www.hedgefundlcd.com/key-considerations-for-hedge-fund-managers-working-with-outside-sales-consultants-part-one-of-two/**
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