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Marketing

Three Significant Legal Pitfalls for Hedge Fund Marketers, and How to Avoid Them

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By David Chana, *Hedge Fund Law Report*

Until recently, the generally held perception was that the worst a hedge fund marketer could do is fail to raise money. But then came the credit crisis, a raft of new regulations, a newly enlarged and invigorated SEC and a tectonic shift in the hedge fund investor base in favor of more public and private pension funds and other retirement plans. In this fraught new operating environment, hedge fund marketers can do more than fail to benefit the fund: they can affirmatively harm the fund and manager. In particular, marketers can, in different contexts: jeopardize fees; render ideal investors off-limits; subject a manager to complex regulatory schemes from which the manager would otherwise be exempt; and give investors the right to rescind their investments. This article details three significant legal pitfalls that can give rise to these and other harms, and suggests ways to avoid them.

Pay to Play

On July 1, 2010, the SEC adopted Rule 206(4)-5 (Rule) under the Investment Advisers Act of 1940 (Advisers Act). The Rule generally seeks to curtail pay to play practices in the selection by state investment funds, most notably public pension funds, of hedge fund managers and other investment advisers. Broadly, the Rule does this in three ways: (1) by limiting donations by principals of investment advisers and others with an economic stake in winning public fund business to election campaigns of public officials who may directly or indirectly influence the selection of the adviser to manage a public fund; (2) by prohibiting payments by investment advisers to any person for soliciting government entities for advisory services unless that person is (a) a registered investment adviser subject to the Rule or a registered broker-dealer subject to a similar rule to be promulgated by FINRA, or (b) a principal or employee of the adviser; and (3) by revising Advisers Act Rule 204-2 (the recordkeeping rule) to require investment advisers with government clients, or advisers to hedge funds with government entity investors, to maintain records regarding political contributions by the adviser and its covered associates.

Specifically, the Rule prohibits a hedge fund manager or other investment adviser from providing advisory services, including management of "covered investment pools," for compensation to a "government entity" for two years following a "contribution" to an "official" of the government entity by the adviser or its "covered associates." In previous issues, we have described in depth the mechanics and certain implications of the Rule. See "How Should Hedge Fund Managers Revise Their Compliance Policies and Procedures and Marketing Practices in Light of the SEC's New 'Pay to Play' Rule?," Hedge Fund Law Report, Vol. 3, No. 30 (Jul. 30, 2010); "How Will the SEC's New Pay to Play Rule Impact Mergers and Acquisitions of Hedge Fund Management

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Companies?," Hedge Fund Law Report, Vol. 3, No. 31 (Aug. 6, 2010). For present purposes, four aspects of the Rule are particularly important: the definition of "covered associate"; the two-year/six-month look back; the "for compensation" provision; and the limited exceptions. This discussion of these four aspects of the Rule is included here as context for a discussion of specific ways in which hedge fund marketers may violate the Rule, and how to avoid such violations.

Covered Associate

The Rule defines a "covered associate" of an investment adviser as, among other things, (1) any general partner, managing member or executive officer, or other individual with a similar status or function; and (2) any employee who solicits a government entity for the investment adviser and any person who supervises, directly or indirectly, such employee.

Two-Year/Six-Month Look Back

Generally, the Rule attributes to an investment adviser any contributions made by a person who becomes a covered associate of the investment adviser for two years prior to the date on which the person becomes a covered associate. The Rule provides a six-month look-back for any natural person who becomes a covered associate of an investment adviser and does not, after becoming a covered associate, solicit government clients on behalf of the adviser.

For Compensation

The Rule prohibits the provision of advisory services "for compensation" for two years following a contribution contrary to the Rule. Accordingly, if a hedge fund adviser or covered associate makes a contribution contrary to the Rule and is not eligible for an exception or exemption, the adviser may: (1) resign from the advisory engagement; (2) continue providing advisory services, but without compensation; or (3) mandatorily redeem the relevant government entity investor. See "Mandatory Redemptions Enable Hedge Fund Managers to Control Regulatory and Reputational Risks, Contain Costs and Accommodate Maturation of Investor Base," Hedge Fund Law Report, Vol. 3, No. 17 (Apr. 30, 2010). With respect to resignations, the SEC suggested in the Adopting Release that an investment adviser's fiduciary duty may require it to provide uncompensated services "for a reasonable period of time" following the contribution that triggers a violation. See "What Precisely Is 'Fiduciary Duty' in the Hedge Fund Context, and To Whom is it Owed?," Hedge Fund Law Report, Vol. 2, No. 29 (Jul. 23, 2009). Such a period may be required, for example, to enable the government entity investor to find a replacement investment adviser. Similarly, the Adopting Release clarifies that an adviser may not be reimbursed for expenses or costs incurred in connection with providing advisory services during a two-year "time out." See "How Are Hedge Fund Managers Handling Expense Pass-Throughs?," Hedge Fund Law Report, Vol. 2, No. 34 (Aug. 27, 2009).

Exception for *De Minimis* Contributions

The Rule permits an individual to make, without violating the Rule, contributions aggregating up to $350 per election to an official or candidate for whom the individual is entitled to vote, and up to $150 per election to an official or candidate for whom the individual is not entitled to vote. For purposes of the Rule, primary and general elections are considered separate elections.

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Exception for Returned Contributions

The Rule also contains an exception for inadvertent contributions to an official for whom a covered associate is not entitled to vote, subject to the following conditions: (1) the adviser discovers the inadvertent contribution within four months of the date of the contribution; (2) aggregate relevant contributions did not exceed $350; (3) the contribution was returned within 60 calendar days of the date of discovery. An adviser with more than 50 employees may not rely on this exception more than three times in any 12-month period; an adviser with fewer than 50 employees may not rely on this exception more than twice in any 12-month period; and no adviser, regardless of size, may rely on this exception more than once per covered associate.

Exemptive Orders

The Rule also provides that in the case of discovery by an adviser of an impermissible contribution, the adviser may apply to the SEC for an exemptive order. In determining whether to grant such exemptive relief, the SEC may consider whether the adviser had adequate compliance policies and procedures in place, whether it took all available steps to cause the return of the contribution and whether it took other appropriate remedial or preventive measures.

Potential Violations

Three points merit emphasis here. First, based on the fairly broad definition of covered associate and the two-year/six-month look back, more personnel of a hedge fund manager may constitute covered associates than is immediately apparent or logically assumed. Second, the consequences of a prohibited contribution by a covered associate are draconian: a manager may be required to provide uncompensated services or mandatorily redeem important investors – two highly unpalatable options. Third, the exceptions are narrow or, in the case of the exemptive order alternative, of dubious practicability.

What do these points mean in practice? They mean that a manager can violate the rule accidentally, with surprising ease and powerfully adverse consequences. Two examples illustrate how:

1. An employee who lives in Stamford, Connecticut has been working for hedge fund manager X in Greenwich, Connecticut for five years. Most of her tenure was spent in the fund accounting department, but last month she moved into the marketing department to focus on administrative support of marketing professionals. One and a half years ago, she made a contribution to a candidate for governor of California (i.e., a candidate for whom she was not eligible to vote). Last week, the head of marketing brought her to a meeting with CalPERS at the pension fund's headquarters. At that meeting, she answered some questions posed by CalPERS because she was the representative of the manager at the meeting with the relevant information. The meeting went well and CalPERS is considering a significant allocation. However, if the manager accepts that allocation, the manager may be prohibited from charging fees to CalPERS. This is because the promoted employee's presence and participation at the meeting may cause the employee to be construed as soliciting a government entity investor, which in turn would cause the relevant look back period to be two years instead of six months. Also, because the employee was not eligible to vote for the

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gubernatorial candidate at the time of her contribution, her $200 contribution exceeded the $150 exception.

2. Hedge fund manager A acquires hedge fund manager B and all of the members of B's marketing department join A's marketing department. One of the members of B's marketing department is a person (Joe) who previously focused on high net worth investors but, as of one month prior to the acquisition, started focusing on public pension funds. Following the acquisition, Joe focuses on public pension funds as part of A's marketing department. One year ago, Joe made a $400 contribution to a candidate for Governor of New York State, and Joe lives in New York State. A week after the acquisition, Joe accompanies the head of A's marketing department to a meeting with the board of the New York State Teachers' Retirement System (NYSTRS), and actively participates in that meeting. NYSTRS wants to invest, but Joe's political contribution may preclude that investment – or preclude charging fees with respect to the investment, which has a similar net economic effect. This is because Joe solicits government entity investors and made a contribution over the exempt limit (of $350) to an office with the power to influence decision-making over the relevant government entity within the last two years.

Note that neither of these fact patterns involves bad faith or bad acts on the part of the hedge fund manager or any of its personnel, or efforts to circumvent the Rule. In fact, the fact patterns arguably involve socially beneficial behavior by the relevant marketing personnel – participation in the democratic process in the form of reasonably sized political contributions. However, both fact patterns would cause the relevant manager to forego fees or investors, and incur reputational harm.

How could managers X or A in the foregoing hypotheticals have avoided – and how can real-world managers facing similar situations avoid – violations of the pay to play rules? In a few ways:

1. Ban political contributions altogether. However, this is a going-forward remedy, and is insufficient in light of the two-year look back.
2. Collect political contribution histories from each employee of the hedge fund manager going back two years. Restricting such histories to current covered associates is not sufficient because employees that currently are not covered associates may become covered associates.
3. Prescreen all political contributions, that is, require any employee contemplating a political contribution to first run it by the manager's chief compliance officer. Ideally, any request by an employee of the manager to make a political contribution should be in writing, and any consent by the CCO to such a contribution should be in writing. E-mail should be sufficient for these purposes, but electronic and hard copies of any such e-mails should be maintained for the period for which registered investment advisers are required to maintain relevant records.
4. Monitor public records of contributions.
5. Perform pay to play due diligence on any target in a potential acquisition of a hedge fund manager.
6. Perform initial and ongoing political contributions/pay to play due diligence on any third party marketer, placement agent or similar person retained by the hedge fund manager to

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solicit government entity investor business. While such persons do not fit naturally into the definition of covered associate, it is not uncommon for an outside marketer to come in house (into roles that would constitute covered associate positions). Also, the SEC (for example, in an enforcement action) may construe the phrase covered associate expansively, to include agents of covered associates or third parties performing substantially similar functions.

Many of these strategies are discussed in greater detail in "How Should Hedge Fund Managers Revise Their Compliance Policies and Procedures and Marketing Practices in Light of the SEC's New 'Pay to Play' Rule?," Hedge Fund Law Report, Vol. 3, No. 30 (Jul. 30, 2010). Also, we expect to publish a contributed article in an upcoming issue focusing on the compliance implications of the pay to play rule.

Also, no responsible discussion of pay to play matters is complete without noting that the SEC's pay to play rule is just one part of a patchwork of authority governing business interactions among investment managers, government entity investors and intermediaries between the two. In addition to the SEC's rule, state and local laws and rules, and fund-level policies, define the scope of permissible conduct in this context; and some of those laws, rules and policies are more restrictive than the SEC's rule. For example, the New York Attorney General's Public Pension Fund Reform Code of Conduct (New York Code) bans the use of placement agents outright and prohibits campaign contributions related to public pension funds business. Various parties implicated in pay to play matters – most notably, The Carlyle Group – have adopted the New York Code as part of settlement agreements with the New York Attorney General.

Registration Requirements

Pay to play considerations loom large in marketing to public pension funds, but they are not the only considerations. In addition, any person marketing hedge fund interests to a public pension fund must be appropriately licensed or registered. As a principle, this is nothing new. But what is new here is temporary Rule 15Ba2-6T under the Securities Exchange Act of 1934, adopted by the SEC on September 2, 2010, which will require registration with the SEC by municipal advisors on Form MA-T by October 1, 2010 (i.e., within two weeks). While additional clarity remains to be provided by the SEC and the Municipal Securities Rulemaking Board (MSRB, which may share rulemaking or enforcement authority with the SEC with respect to this rule), statements from both the SEC and MSRB suggest that the term "municipal advisor" will include third-party intermediaries retained by hedge funds to solicit business from public pension funds. See "Third-Party Marketers that Solicit Public Pension Fund Investments on Behalf of Hedge Funds May Have to Register with the SEC within Three Weeks," Hedge Fund Law Report, Vol. 3, No. 35 (Sep. 10, 2010). A hedge fund that uses, to solicit public pension fund business, an intermediary required to be registered as a "municipal advisor" but that is not so registered may encounter various negative consequences, potentially including a rescission right on the part of any investor who is invested in the fund based on an introduction by the unregistered person. This same consequence may result from the use by a hedge fund of a third party marketer that is required to be registered as a broker-dealer but that is not so registered. It also may be the case – and this is something we will explore in a future article – that, in certain factual settings, the in-house marketing departments of hedge fund managers may be required to be registered as broker-dealers, and failure to so register may give rise to a rescission right on the part of investors brought in by in-house marketers.

In addition, as noted above, the SEC's pay to play rule prohibits payments by investment advisers to any person for soliciting government entities for advisory services unless that person is (1) a

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registered investment adviser subject to the rule or a registered broker-dealer subject to a similar rule to be promulgated by FINRA, or (b) a principal or employee of the adviser. Thus, the SEC's pay to play rule does not ban the use by hedge fund managers of placement agents to solicit public pension funds, but it restricts hedge fund managers to using only placement agents registered as investment advisers or broker-dealers. Also, as indicated, state, municipal or fund-level laws, rules or policies may impose different and occasionally more restrictive provisions, such as the ban on the use of placement agents in the New York Code. In addition, outside of the United States, marketers must comply with a global patchwork of marketing rules.

The key take aways here are that: (1) appropriate registration and licensure of intermediaries is key in protecting the reputation and stability of investments in the hedge fund; and (2) applicable registration and licensing requirements are continuously evolving. For managers, this means three things: (1) staying abreast of relevant registration and licensing requirements; (2) performing due diligence on any third party marketer before retaining that marketer; and (3) performing "bring down" due diligence on any third party marketer during the term of any relationship and even after the termination of any such relationship, to the extent such a marketer remains eligible to earn fees from the manager. See "What Is the 'Market' for Fees and Other Key Terms in Agreements between Hedge Fund Managers and Placement Agents?," Hedge Fund Law Report, Vol. 3, No. 35 (Sep. 10, 2010).

ERISA Fiduciary Status and Participant-Directed Plans

While the more typical marketing by hedge funds to, broadly, retirement plans involves marketing to public and private pension plans, hedge fund managers also seek from time to time to have their funds included as investment options in so-called participant-directed plans. The most common type of participant-directed plans are 401(k)s and individual retirement accounts. In such plans, beneficiaries generally exercise control over assets in their individual accounts and can select, from among a broad menu of options, the specific investments in which their accounts will be invested. See "401(k) Plans Offer a Powerful Distribution Channel for Hedge Fund Managers Willing to Tackle ERISA, Liquidity and Non-Discrimination Concerns," Hedge Fund Law Report, Vol. 3, No. 35 (Sep. 10, 2010). See also "Is That Your (Interim) Final Answer? New Disclosure Rules Under ERISA To Impact Many Hedge Funds," Hedge Fund Law Report, Vol. 3, No. 33 (Aug. 20, 2010).

As noted by Steven Rabitz and Danielle Motelow, Partner and Associate, respectively, in the Employee Benefits and Executive Compensation Practice Group of Stroock & Stroock & Lavan LLP, in an article published in April of this year: "ERISA and the tax code provide that persons who provide tailored investment advice to participant directed plans cannot generally also offer their own products or services, or otherwise do anything that could cause them to earn a fee, directly or indirectly, absent very limited exceptions." See Steven Rabitz and Danielle Motelow, "DOL's Advice on Advice and Investment Professionals: Take Two," 37 BNA Pension and Benefits Reporter 857 (Apr. 13, 2010). Accordingly, for hedge fund managers marketing to participant-directed plans, it is important that any information conveyed to a sponsor of or participant in a participant-directed plan constitute investment education and not investment advice. This is because if the information constitutes investment advice, the marketer would be precluded by ERISA and the tax code from selling hedge fund interests and investment advisory services with respect to those interests to the participant-directed plan or participant.

While a discussion of the substance of the distinction between education and advice in this context is beyond the scope of this article, the intent of this section is to identify an issue that

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may become more broadly relevant as hedge funds seek to diversify the markets that they target. Participant-directed plans historically have not been an appreciable source of capital invested in hedge funds, but they may grow in importance among hedge fund investors, particularly if a greater proportion of the retirement burden shifts from the government to individuals – as it is likely to as federal entitlement spending grows as a proportion of GDP.

The key take away here: when marketing to participant-directed plans, keep in mind that marketing that verges into the realm of investment advice may cause the investment adviser on whose behalf the marketer is working to become subject to provisions of ERISA that effectively prohibit the potential investor from investing. In other words, with respect to a prospect, once marketing becomes investment advice, the marketer is no longer allowed to market to that prospect. Generally, marketing can become investment advice for these purposes when marketing involves input or recommendations specific to the circumstances of the participant-directed plan or participant, as opposed to fund-specific information described in the private placement memorandum (PPM) or general information regarding investments, general portfolio allocation or economic trends. A marketer, for example, can describe the fund by restating orally what is stated in the PPM, but a marketer cannot – without risking an ERISA violation – described how the fund being marketed fits into the participant-directed plan's or participant's specific portfolio allocation strategy. Of course, this undermines some of the more sophisticated and value-added marketing strategies, namely, those involving customized ideas and particularized pitches. In this context, as in others, reconciling the business imperative of marketing with the legal requirements of ERISA is a delicate balance, best attempted with the aid of informed, business-minded ERISA counsel.

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