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Marketing

Participants at Hedge Fund Compliance Summit Detail Best Practices with Respect to Insider Trading, SEC Examinations, Risk Mitigation, Marketing Materials, Valuation and Avoiding Investor Lawsuits: Part Two of Two

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By Jennifer Banzaca, *Hedge Fund Law Report*

On November 15 and 16, 2010, Financial Research Associates, LLC and the Hedge Fund Business Operations Association presented a Hedge Fund Compliance Summit at the Princeton Club in New York City. In our issue of November 24, 2010, we detailed the key insights of Summit participants on topics including insider trading; the use by hedge fund managers of consultants and expert networks; sharing of information among personnel at different hedge fund managers; market rumors; insider trading considerations in connection with bank debt trading; and how to prepare for, handle and follow up on SEC examinations. See "Participants at Hedge Fund Compliance Summit Detail Best Practices with Respect to Insider Trading, SEC Examinations, Risk Mitigation, Marketing Materials, Valuation and Avoiding Investor Lawsuits: Part One of Two," Hedge Fund Law Report, Vol. 3, No. 46 (Nov. 24, 2010). As we observed in that article, the timing of the Summit was fortuitous because two weeks after it, *The Wall Street Journal* and other sources disclosed a wide-ranging, inter-agency insider trading investigation focusing on hedge fund managers, expert networks and other alternative research providers, investment banks and others. See "Lessons for Hedge Fund Managers and Expert Network Firms from the Government's Criminal Complaint against Don Chu, Formerly of Primary Global Research LLC," Hedge Fund Law Report, Vol. 3, No. 47 (Dec. 3, 2010).

This article finalizes our coverage of the Summit. Specifically, this article summarizes the most relevant points made by Summit participants with respect to: the revised "accredited investor" definition in Dodd-Frank; the consequences of violating Regulation D, and how to mitigate those consequences; how to negotiate the apparent conflict between the prohibition on general solicitation of Regulation D and the expanded disclosures required by revised Form ADV, Part 2; the importance of consistency between marketing materials and fund documents; recordkeeping with respect to hedge fund manager websites; the distinction between specific representations in and collective impressions created by marketing materials; rules with respect to presentation of performance information; four specific items that the SEC looks for in valuation policies and procedures of hedge fund managers; six specific red flags that the SEC looks for with respect to valuation in the course of inspections and examinations of hedge fund managers; big boy letters;

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what provisions in side letters may, in the view of the SEC, need to be disclosed to hedge fund investors; and why the fraud exclusion in D&O and E&O insurance policies may often be moot.

Marketing Materials

Steven M. Felsenthal, General Counsel and Chief Compliance Officer of investment management firm Millburn Ridgefield Corporation, and Guy Talarico, CEO and Founder of Alaric Compliance Services, LLC, jointly presented a panel on marketing and advertising compliance. The panel covered a lot of ground, notably including the following topics:

Revised Accredited Investor Definition

Generally, a natural person must be an "accredited investor" as defined in Rule 501 of Regulation D, the private placement safe harbor promulgated under Section 4(2) of the Securities Act of 1933, as amended, in order to invest in a domestic hedge fund. A person may qualify as an accredited investor by passing either an income test or a net worth test. Under the income test, a natural person is an accredited investor if he or she had individual income in excess of $200,000 in each of the two most recent years or joint income with his or her spouse in excess of $300,000 in each of the those years, with a reasonable expectation of reaching the same income level in the current year. Under the net worth test, a natural person is an accredited investor if he or she has a net worth of at least $1 million.

Dodd-Frank modified the net worth test, but did not change the income test. Specifically, Dodd-Frank modified the net worth test by providing that a natural person may no longer include the value of his or her primary residence in determining whether he or she has a net worth of at least $1 million. (Prior to enactment of Dodd-Frank, natural persons were allowed to include the value of the primary residence in making the net worth calculation.) On July 23, 2010, the SEC issued guidance providing that in calculating net worth, a natural person may exclude the amount of any indebtedness secured by his or her primary residence up to the fair market value of the primary residence, but must include (that is, subtract from) net worth any indebtedness secured by his or her primary residence in excess of the fair market value of the primary residence. See "Modification of Definition of Accredited Investor Requires Hedge Funds to Revise Their Subscription Agreements," Hedge Fund Law Report, Vol. 3, No. 31 (Aug. 6, 2010).

Felsenthal and Talarico offered the following insights and suggestions based on the revision of the net worth test:

1. Hedge fund managers should revise their funds' subscription documents to incorporate the new net worth test.
2. To the extent managers employ suitability questionnaires to prequalify potential investors, managers should similarly update such suitability questionnaires to incorporate the new net worth test.
3. To the extent managers participate in capital introduction meetings arranged by prime brokers or others, or speak to audiences organized by prime brokers or others, they should ensure that the prime broker or other person coordinating the meeting or speech has prescreened attendees based on criteria that include the revised net worth test.
4. Felsenthal noted that there may be ways to structure or restructure home ownership, mortgage debt or home-equity loans to better accommodate the revised net worth test.

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5. In theory, if a domestic hedge fund issues interests in violation of Reg D – for example, by offering interests to more than the permitted number of non-accredited investors – investors who purchased interests during the period of noncompliance may have a rescission right, that is, the right to put their interests back to the fund at cost. If fund interests decline in value from the date of purchase to the date of discovery of a violation of Reg D, fund investors – especially shorter-term investors – may wish to obtain and exercise such a rescission right. (Note, too, that a legal rescission right would trump a gate, redemption suspension or other contractual restriction on liquidity.) However, the panelists noted that such a rescission right is rarely, if ever, granted based on a violation of Reg D, for two primary reasons. First, a fund that inadvertently violates Reg D can impose on itself a “cooling off” period during which it does not offer interests. Typically, such a cooling off period lasts six months. Second, investors traditionally have not had a reliable mechanism for discovering violations of Reg D. (However, the expanded disclosures called for by revised Form ADV, Part 2, may create such a mechanism.)
6. The panelists noted that, facially at least, there appears to be a conflict between the deeper fund-specific disclosure required by revised Form ADV, Part 2, and the prohibition of “general solicitation” under Reg D. That is, a concern has been expressed in the hedge fund community that completing and filing revised Form ADV, Part 2 in the level of depth that appears to be called for would conflict with the obligation under Reg D to not publicly disclose fund-specific information. The panelists had at least two responses to this concern. First, they suggested that hedge fund managers comply with the disclosure requirements of revised Form ADV, Part 2 by disclosing as much as is called for, but not more. That is, they suggested that the SEC would be unlikely to take action against a hedge fund manager for violation of one SEC rule based on that hedge fund manager’s compliance with another SEC rule. Second, they noted that this apparent conflict is not new: for years, registered hedge fund managers have publicly disclosed some fund-specific information on Form ADV, and the SEC has not construed such disclosure as a violation of Reg D.

Consistency of Marketing Materials and Fund Documents

Talarico noted that in the course of inspections and examinations, the SEC frequently looks for inconsistencies between marketing materials and fund documents (including internal policies and procedures), and between fund documents and actual practices. Accordingly, Talarico and Felsenthal emphasized the importance of consistency among marketing materials, fund documents and actual practices. They made the point – and we have heard it made with some frequency – that in the course of inspections and examinations, hedge fund managers are often “hoist by their own petar.” The SEC commonly notes as a deficiency at inspected or examined hedge fund managers a failure to comply with representations in marketing materials, fund documents or internal policies and procedures, as opposed to a failure to comply with external law. Such violations are typically inadvertent – the result of inadequate monitoring or updating – rather than on purpose, but nonetheless, grounds for a deficiency finding or, depending on the nature of the violation, more severe sanctions. Such violations can be prevented or mitigated by: continuous monitoring of consistency among documents; periodic review and updating of documents; and review and updating of documents before they are used by in-house or third-party marketing personnel. “You want to make sure that either your internal marketers or any third-party marketers have not misrepresented any information about your firm or your funds,”

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Talarico noted. See "Three Significant Legal Pitfalls for Hedge Fund Marketers, and How to Avoid Them," Hedge Fund Law Report, Vol. 3, No. 36 (Sep. 17, 2010).

Websites

The panelists noted that the SEC expects hedge fund managers to act according to the representations on every iteration of their websites. That is, although a website may be revised with some frequency, for compliance purposes, the prior "versions" of the website do not go away, even if they contained information that is superseded by a subsequent version. Talarico suggested that "when the website is updated, you want to take a snapshot of the website and include it in a file. If you update certain policies, disclosures or requirements, you want to have a record of your previous policies and when the changes were made. Websites are constantly updated and you want to document all changes you make to them. If there is a review during that time, you have a record of changes." Felsenthal pointed out that it is usually possible to automatically archive webpages and screenshots. Therefore, maintaining a record of website changes is not as daunting an administrative prospect as it may seem.

On the intersection of hedge fund compliance and technology issues generally, see "Key Elements of Electronic Communications Policies and Procedures for Hedge Fund Managers," Hedge Fund Law Report, Vol. 3, No. 44 (Nov. 12, 2010).

Specific Representations and Collective Impressions

Felsenthal emphasized the real but underappreciated risk that each of the representations in marketing materials alone may be accurate, but the collective impression created by marketing materials may be misleading. Such an outcome may be the result, for example, of the selection and arrangement of representations, the context in which print materials are presented, or other factors. The SEC is sensitive to the potential for marketing materials overall to mislead investors and potential investors, even if those marketing materials contain only accurate representations. As Felsenthal said, "every fact in your marketing materials may be true, but collectively, the information might be misleading. You have to review the documents for the overall impression the information gives investors to be sure it is not misleading."

Performance Information

The rules governing presentation and ownership of performance information are complex and very important, particularly for traders, analysts or portfolio managers moving to new hedge fund managers, or start-up managers. Presentation of performance information in marketing materials is a topic we have covered and plan to continue covering. See, e.g., "How Can Start-Up Hedge Fund Managers Use Past Performance Information to Market New Funds?," Hedge Fund Law Report, Vol. 2, No. 50 (Dec. 17, 2009); "Global Investment Performance Standards Facilitate Reliable, Apples-to-Apples Comparisons by Hedge Fund Investors, and Offer Marketing Opportunities for Hedge Fund Managers," Hedge Fund Law Report, Vol. 3, No. 9 (Mar. 4, 2010). Ownership of performance information is a topic we plan to cover in depth.

Felsenthal and Talarico made two brief points on performance information that should be mentioned. (As they observed, for time reasons, their discussion was not exhaustive.) First, the rules governing presentation of performance information under the Investment Advisers Act of 1940 (Advisers Act) are promulgated under Section 206 of the Advisers Act, the anti-fraud section. Therefore, as a general matter, marketing materials that present performance information in a manner that does not comply with relevant rules may constitute fraud. Second,

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the starting point of any analysis of the consistency of presentation of performance information with relevant Advisers Act rules should start with the 1986 no-action letter issued to Clover Capital Management, and should continue with its progeny. See Clover Capital Mgmt., Inc., SEC No-Action Letter (Oct. 28, 1986).

Valuation Best Practices

Azam Riaz, a Staff Accountant at the SEC who, among other things, conducts inspections and examinations of hedge fund managers, offered important insight on two related topics: (1) what the SEC looks for in a hedge fund manager's valuation policies and procedures; and (2) what "red flags" raise concerns for the SEC with respect to valuation.

Regarding the first topic, Riaz noted that in the course of its inspections and examinations of hedge fund managers, the SEC checks to ensure that:

1. Managers have valuation policies and procedures in place, especially covering illiquid or hard to value assets;
2. Such policies and procedures are being consistently applied and regularly followed;
3. Such policies and procedures are regularly reviewed and, as required, updated; and
4. Investors are provided with disclosure regarding such policies and procedures in a level of detail that is appropriate under the circumstances and in light of the fund's strategy.

Regarding the second topic, Riaz identified the following six "red flags" that raise concern in the course of SEC inspections or examinations:

1. Portfolio managers or traders that are responsible for valuing their own portfolios or investments;
2. Portfolio managers with the right to override valuations arrived at by non-portfolio management personnel;
3. Different values for the same or similar assets in different funds or accounts;
4. Inconsistency among any of the following: (1) disclosures in the PPM or other offering documents with respect to valuation; (2) valuation policies and procedures outlined in the compliance manual; or (3) actual valuation practices employed by the manager.
5. Valuations whose only support is from a market maker;
6. Valuations of a security that are static for an extended period. In the case of such static valuations, the SEC will want to know why the manager has not changed the price at which it marks the relevant security, and what efforts it undertook to secure additional quotes or prices for the security.

Leo Miranda, Senior Manager at Deloitte & Touche LLP, emphasized the importance of documenting valuation policies and procedures, and valuations themselves. "You cannot over-document your valuations policies and procedures," Miranda said. "You want to have those policies available for review and you want to make sure that your policies and procedures are clearly outlined. You don't want to raise concerns by having confusing or conflicting policies in place."

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Avoiding Investor Lawsuits

A final panel at the Summit discussed how hedge fund managers can avoid investor lawsuits. (However, as we have discussed, lawsuits by investors against managers have been rarer – especially during 2008-2009 – than many industry participants anticipated. See "Why Are Most Hedge Fund Investors Reluctant to Sue Hedge Fund Managers, and What Are the Goals of Investors that Do Sue Managers? An Interview with Jason Papastavrou, Founder and Chief Investment Officer of Aris Capital Management, and Apostolos Peristeris, COO, CCO and GC of Aris," Hedge Fund Law Report, Vol. 2, No. 52 (Dec. 30, 2009).) This panel covered three topics of note: big boy letters, side letters and D&O insurance.

Big Boy Letters

Arthur Jakoby, a Partner and Chair of the Title Insurance Group at Herrick, Feinstein LLP, noted that hedge fund managers frequently enter into so-called "big boy" letters with respect to specific investments. The general goal of such letters is for the counterparty to memorialize its acknowledgment that the hedge fund manager has information material to the relevant trade, and the counterparty is trading with the hedge fund despite the information asymmetry. (Alternatively, the hedge fund manager may be the party that recognizes by letter the counterparty's privileged access to information.) The purpose of such a letter is to prevent a post-trade legal claim by the party with less information – the "big boy" – that the party with more information unfairly took advantage of its superior information in entering into the trade. For more on big boy letters, see "Big Boys Don't Cry: How 'Big Boy' Provisions Can Help Hedge Fund Managers Avoid Liability for Insider Trading Violations," Hedge Fund Law Report, Vol. 2, No. 48 (Dec. 3, 2009).

According to Jakoby, "while helpful in some situations, big boy letters are not a defense in all cases." He went on: "There is some dispute with respect to the legality of big boy letters because the Securities Exchange Act of 1934 does not allow waivers of liability for securities fraud. Big boy letters may or may not be usable in private securities litigation. So, there's no guarantee you can rely on these letters to protect yourself." Jakoby also highlighted the "downstream" issue: if a hedge fund purchases a security under the terms of a big boy letter then wishes to sell the security, the hedge fund likely has a legal obligation to at least disclose the big boy letter to the downstream purchaser, and more likely has an obligation to enter into a "back to back big boy letter" with the downstream purchaser. Otherwise, the selling hedge fund may be liable for the omissions of the entity from which it purchased the security.

Side Letters

Riaz, of the SEC, suggested that hedge fund managers should disclose the existence of side letters to all investors in the fund. He also suggested that under certain circumstances, managers may have an obligation to disclose some or all of the terms of certain side letters to all investors. In particular, Riaz noted that provisions in side letters that grant preferential liquidity to some investors would receive heightened scrutiny from the SEC in investigations or examinations.

D&O and E&O Insurance

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The key take away on this point was that although most D&O and E&O insurance policies purchased by hedge fund managers do not cover fraud, they do provide for advancement of attorneys' fees, and most lawsuits alleging fraud settle before final determination. Therefore, the fraud exclusion is, in many cases, moot. As Jakoby explained, "the policy will pay out all legal fees until a finding of fraud. If there is no finding of fraud, you are covered."

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