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Broker-Dealers

PLI Panel Addresses Marketing and Brokerage Issues Impacting Hedge Fund Managers, Including Marketing to State Pension Plans, Capital Introduction and Broker Implications of In-House Marketing Activities

Jun. 27, 2013
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At the Practising Law Institute's (PLI) Hedge Fund Compliance and Regulation 2013 program, an expert panel comprised of SEC attorneys and industry practitioners shared insights on topics involving marketing and brokerage issues that impact hedge fund managers. Among other things, the wide-ranging discussion covered the regulatory perils that accompany marketing to government pension funds, including local, state and federal pay-to-play and lobbying laws; capital introduction programs; the European Union's Alternative Investment Fund Managers Directive (AIFMD); broker regulations implicated by in-house fund marketing activities; and investment-related regulations impacting broker-dealers and their hedge fund clients, including the Market Access Rule, circuit breakers, the use of dark pools, short selling, securities lending and large trader reporting. This article summarizes the highlights from the panel discussion that are most pertinent to hedge fund managers.

The panel discussion was entitled "Trading and Brokerage Issues." K. Susan Grafton, a partner at K&L Gates, moderated the panel. The other panelists were Richard A. Gashler, in-house counsel at Sandell Asset Management Corp. at the time of the panel, and now Of Counsel at DLA Piper; Michael Gaw, Assistant Director of the SEC's Division of Trading and Markets; Christian Sabella, who also works in the SEC's Division of Trading and Markets; Barbara A. Stettner, a partner at Allen & Overy LLP; and Michael B. Rogers, Managing Director and Senior Counsel at BNP Paribas.

Marketing to State Pension Funds – Traps for the Unwary

Stettner discussed the regulatory perils that can accompany fund managers' solicitation of state pension funds for investments. Missteps can result in restrictions or prohibitions on dealings with such pension funds for anywhere from two to five years and other consequences.

A single solicitation to a public fund immediately implicates a number of important regulatory regimes:

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- Local regulations pertaining to placement agents. See "How Has the New York Pension Fund Kickback Scandal Changed the Landscape for Placement Agents, and for Hedge Fund Managers who Use Them?," Hedge Fund Law Report, Vol. 2, No. 17 (Apr. 30, 2009).
- Federal and state "pay to play" rules. See "How Can Hedge Fund Managers Participate in the Political Process without Violating Pay to Play Regulations at the Federal, State, Municipal or Fund Level?," Hedge Fund Law Report, Vol. 4, No. 35 (Oct. 6, 2011).
- Restrictions on the provisions of gifts and entertainment.
- Federal, state and local lobbying laws and regulations. See "How Can Hedge Fund Managers Structure the Compensation of Third-Party Marketers in Light of the Ban On 'Contingent Compensation' Under New York City and California Lobbying Laws? (Part Two of Three)," Hedge Fund Law Report, Vol. 4, No. 13 (Apr. 21, 2011).
- Revolving door laws.

She also cautioned that pension funds within a single state can have different rules regarding solicitation efforts. As a result, managers must have access to a current database of information about applicable rules and regulations governing solicitation activities that can be referenced by fund manager personnel.

Managers must be particularly careful about having their employees provide political contributions, donations, gifts or other entertainment to government officials. Concerning lobbying laws, she stressed that a gift is "anything of value." There is generally no exception for traditional "entertainment." In short, if a manager needs to register as a lobbyist before soliciting a state pension fund, it should institute a "no entertainment" policy. Even taking someone out for coffee should be prohibited. This is another area where it is critical for a fund to have a pre-clearance policy. For more on marketing to pension funds, see "How Much Are In-House Hedge Fund Marketers Paid, and How Will Recent Developments in New York City and California Lobbying Laws Impact the Compensation Levels and Structures of In-House Hedge Fund Marketers (Part Three of Three)," Hedge Fund Law Report, Vol. 4, No. 20 (Jun. 17, 2011). She and Grafton observed that best practice for a manager would be to require that all proposed political contributions and solicitations of public pension funds be approved in advance by the firm's legal and/or compliance department. 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); and "Five Best Practices for Avoidance of Pay to Play Violations by Hedge Fund Managers or Their Covered Associates," Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2011).

She stressed that placement agents are also subject to numerous regulations that can restrict their activities and require them to make detailed disclosures. See "Recent Developments in New York City and California Lobbying Laws May Impact the Activities and Compensation of In-House and Third-Party Hedge Fund Marketers (Part One of Three)," Hedge Fund Law Report, Vol. 4, No. 6 (Feb. 18, 2011). Stettner observed that placement agents are usually deemed to be engaging in "procurement lobbying," which would include soliciting a pension fund for an investment. She pointed out that 25 states regulate procurement lobbying, including California, Florida, Massachusetts, New York and Texas. In addition, Los Angeles, New York City and Philadelphia have their own regulations.

Capital Introduction

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Rogers explained that capital introduction is usually effected through a fund's prime broker. Capital introduction is "not a dating service." Rather, it is a "low touch" way for investors to meet with fund managers. The prime broker will attempt to ensure that the manager's meetings with investors do not jeopardize the fund's reliance on the Rule 506 safe harbor from securities registration which currently prohibits a fund from engaging in general solicitation or advertising, at least until the final rules implementing the Jumpstart Our Business Startups (JOBS) Act are adopted. See "JOBS Act: Proposed SEC Rules Would Dramatically Change Marketing Landscape for Hedge Funds," Hedge Fund Law Report, Vol. 5, No. 34 (Sep. 6, 2012). Grafton added that, to avoid implicating the issues she discussed with regard to solicitation of state pension funds, capital introduction should be done in such a way that it does not turn into, or appear to be, a solicitation effort.

AIFMD

Gashler discussed the anticipated impact that the AIFMD will have on U.S. hedge fund managers who wish to raise capital in the EU. In short, until at least 2015, managers marketing funds into the EU will need to do so in reliance on the private placement regime of each EU jurisdiction into which they wish to market their funds. The AIFMD will affect U.S. hedge fund managers by requiring additional detailed disclosures, pre-solicitation filings with local regulators and annual or semi-annual reporting. He does not see a practical workaround for U.S. managers. Even if they form an EU-domiciled fund, they will not be able to use the pan-EU passport available to EU managers, and, in any event, the EU fund will be subject to rigorous AIFMD rules regarding, among other things, custody and valuation of assets. For a detailed look at the impact of the AIFMD on non-EU fund managers, see "Application of the AIFMD to Non-EU Alternative Investment Fund Managers (Part Two of Two)," Hedge Fund Law Report, Vol. 6, No. 24 (Jun. 13, 2013).

Broker Issues Related to In-House Marketing Activities

Stettner explained that the sale of hedge fund securities is a transaction that can subject the person or entity effecting the sale to the broker registration regime contained in Section 15 of the Securities Exchange Act of 1934 (Exchange Act). Generally, a person who sells securities for the account of others must register with the SEC as a broker and become a member of the Financial Industry Regulatory Authority (FINRA). Most hedge funds raise money on a regular basis and are thereby soliciting securities transactions on an ongoing basis. Consequently, in the absence of an exemption, hedge fund employees engaged in selling fund interests would need to register as brokers. See "Do In-House Marketing Activities and Investment Banking Services Performed by Private Fund Managers Require Broker Registration," Hedge Fund Law Report, Vol. 6, No. 16 (Apr. 18, 2013).

Stettner discussed Exchange Act Rule 3a4-1, the so-called "issuer's exemption," which was adopted for corporations whose employees occasionally effected transactions in the corporation's stock. As a condition of the safe harbor, a firm's employee must not be statutorily disqualified (as defined in Section 3(a)(39) of the Exchange Act), cannot receive transaction-based compensation and cannot be an associated person of a broker-dealer. In that regard, a firm employee that is already licensed through a broker-dealer must surrender that license in order for the exemption to be available. Employees retaining old licenses should be a "red flag" for compliance personnel.

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Assuming those three prerequisites are satisfied, the employee must then comply with one of three alternative conditions. First, the employee may market only to a "very small group of very sophisticated institutional investors," a category much more limited than "accredited investors." Stettner said that this is a special test that is "very hard to meet." Second, the employee may not perform marketing activities on a full-time basis and must have other substantial duties with the firm. Third, the employee must engage only in "passive activities such as preparing written marketing materials." Stettner stressed that none of the three alternatives would apply to a person employed as a full-time marketer by a fund. She noted that there is some very preliminary, informal discussion in Washington, D.C. and within the Securities Industry and Financial Markets Association (SIFMA) about updating this rule.

Regulatory Developments Affecting Broker-Dealers and Their Hedge Fund Clients

Gaw and Sabella shared their perspectives on recent regulatory matters impacting broker-dealers and their hedge fund clients. Gaw observed that the SEC is at a "point of transition," given the recent appointment of Mary Jo White as the new Chairman. He expects that, regardless of the direction the SEC takes, it will want "better data and greater analytical capability" to assist it in its rulemaking and supervisory duties.

Gaw noted that, in response to the 2012 market disruption caused by technology breakdowns at Knight Capital Group, former SEC Chairman Mary Schapiro requested that the SEC staff begin exploring ways to provide assurances concerning the integrity of the technological and market access systems of broker-dealers. In that regard, his Division has established an Office of Analytics and Research that will hire individuals with quantitative skills.

Market Access Rule

Gaw pointed out that SEC Rule 15c3-5, adopted under the Exchange Act and known as the "Market Access Rule," was adopted in November 2010, to address regulatory and financial trading risks. It made broker-dealers the "gatekeepers" of the U.S. markets by requiring all order flow to go through dealers' risk management systems prior to reaching an exchange. The rule eliminated "unfiltered" or "naked" access to U.S. exchanges and automated trading systems (ATS).

"Circuit Breakers"

Gaw discussed two measures that the SEC approved in response to the May 2011 "flash crash." First, in 2012, the SEC approved the National Markets System Plan to Address Extraordinary Market Volatility. It is a limit-up/limit-down plan devised by U.S. exchanges and FINRA. The mechanism will put a 15 second brake on trading if a stock hits a pre-determined upper or lower price limit. If the market does not "naturally exit that limit state," there will be an additional 5-minute pause in trading to give the exchanges an opportunity to investigate. Second, the SEC approved changes to the current "circuit breaker" mechanism to reduce the thresholds that trigger a circuit breaker, shorten trading halts and change the index used to measure a market decline.

Dark Pools

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Gaw discussed two 2012 SEC enforcement actions against separate dark pools, Pipeline and Level ATS, that involved violations of Rule 301(b)(10) of Regulation ATS. The defendants failed to protect the confidential trading information of their clients. See "Six Steps That Hedge Fund Managers Should Take to Protect Their Confidential Information When Using or Evaluating Dark Pools," Hedge Fund Law Report, Vol. 5, No. 40 (Oct. 18, 2012). Gaw explained that the duty of confidentiality contained in that Rule is premised on the disclosure provided by the ATS: The key is what the ATS tells its subscribers that it will do with their order information. For instance, a violation will occur if a dark pool operator says it will not reveal orders to anyone, but then does so. Grafton observed that, if a manager decides that it will no longer use a particular broker (for instance, for failing to preserve trade confidentiality), it is important for a firm's policies and procedures to require that its list of approved brokers be updated to reflect that change.

Short Selling and Securities Lending

Sabella noted that the SEC and the SIFMA prime brokerage committee have been discussing possible changes to the portions of the SEC's 1994 prime brokerage no-action letter that relate to short-selling and that are affected by Regulation SHO, which was adopted in 2004. Rogers observed that the main issues concern the interactions and communications between prime brokers and executing brokers. See "Impact of Regulation SHO on the Short Sale Activity of Hedge Fund Managers and Brokers-Dealers," Hedge Fund Law Report, Vol. 4, No. 40 (Nov. 10, 2011).

In addition to those prime brokerage issues, Sabella noted that the SEC is also working on rulemaking pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) with respect to securities lending. The Dodd-Frank Act added new subsection (c) to Section 10 of the Exchange Act, giving the SEC explicit authority over securities lending. The rulemaking will seek to improve transparency in securities lending transactions. In that regard, the SEC has been communicating with various participants in the securities lending industry. Final recommendations are expected in September 2013. In addition, SEC staff members have been involved with the Financial Stability Board's Shadow Banking, Securities Lending and Repurchase Agreement Subcommittee, which is also seeking to assure greater transparency in securities lending. Rogers added that, of particular concern to hedge fund managers is the focus on practices relating to the rehypothecation of securities. For more on rehypothecation, see "How Can Hedge Funds Structure Their Prime Brokerage Arrangements to Protect Themselves?," Hedge Fund Law Report, Vol. 1, No. 22 (Oct. 10, 2008).

Large Trader Reporting

The SEC established its large trader reporting system in 2011 pursuant to Rule 13h-1 under the Exchange Act. Generally, the manager of a hedge fund, not the fund itself, must register and provide its large trader identification number to its broker-dealers. This is a precursor to the "consolidated audit trail" system under SEC Rule 613 that will require exchanges to capture all of the details of certain reportable trades from order to execution.

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