

Starting & Operating a Private Fund:
Legal & Accounting
Pitfalls to Avoid, Tips & Tricks, Practical Advice

May 18, 2005
Opal Emerging Manager's Summit
Chicago Renaissance Hotel

Maurice Berkower, CPA
and
Nancy Fallon-Houle, Attorney

[Handouts – Paper and CDs on table and NFH Booth]

- **Objective Statements**
 - **For Panel [MB or NFH]**
 - Legal, Financial and Business Issues in Forming a Fund:
 - Intellectual Property & Corporate Law – Before Start
 - Entity Structure – Tax & Legal
 - Due Diligence
 - Relationship Among Founders
 - Tax & ERISA
 - Fund Manager Income and Allocation
 - Conflicts and Fiduciary Duty
 - Fund Accounting; K-1's
 - Securities Laws & Anti-Money Laundering Laws
 - Audited Financial Statements
 - Running the Fund as a Business
 - Performance Reporting
 - **For Fund [NFH]**
 - Fund Exempt from Securities Registration, but in Compliance with Disclosure and Notice Requirements
 - Simple structure.
 - Flexible structure for growth and management control
 - Tax efficient (to Investors and to the Manager)
 - Revenue-producing to Manager and Investors
 - Modest risk of personal capital

[Handouts – Paper and CDs on table and NFH Booth]

- Definition of Hedge Fund
 - Traditionally a Long-Short Equities Fund
 - Now any fund that trades securities, options, or futures

Before forming the Fund & Manager entities, or before early fund trading starts, **Build a strong legal foundation; Prevent deal breakers:**

- **Ownership of Intellectual Property Rights [NFH]**
 - **Trading Strategy and Track Record, where, who, when? Yours to use?**
 - Trading Strategy Belongs to Whom?
 - Developed Where? While employed at another company?
 - **Might former company, or its employees, own or have a claim to it?**
 - Co-developed with another individual?
 - If so, legal rights assigned to you?
 - Might a colleague have a claim to it?
 - Track Record Belongs to Whom?
 - Same questions apply.
 - **Goes to the issue of whether you can publish the track record as your own.**
- **Non-Compete Agreement with Current Employer? [NFH]**
 - Does your current, or former, employer's Non-Compete Agreement or Employment Agreement **impede your starting your business?** To what degree? Applicable after you leave?
 - Employer perhaps **negotiable** on a supplement to the agreement that would allow you to start your business, compete in their space, but not steal their customers or employees?
- **Name Check [NFH]** Critical to stake claim to name rights before business formation.
 - Importance of **national, if not global, name check**, given global use (and surveillance) of business names through Internet.
 - **Allow sufficient time**, because your first choice, or several choices, of name will very likely be taken in your industry (the scope of which is all financial services, Funds, IA, perhaps banking and insurance industries.)
 - **May not use a key word used by another Fund or Manager as their key word**
 - **May not use a group of key words that sounds, looks or smells like an existing one.**

[Hand out – Name Selection Check list]

[Hand out - Incorporation / LLC Formation Checklist, including search vehicles & techniques for “knock out” name search]
[Hand out - Corporate Maintenance Checklist”

- **Protection of Your Intellectual Property**
 - **NDA & Noncompetes for Employees and Partners** to prevent them from leaving and starting a competing business – Viable, logical, practical?
 - Balance how much to disclose in Offering Memo vs. Proprietary Info.
 - **Trademark the name – Federal and State**
 - Is protection of your Trading Strategy Possible? Business Process Patent option?
-
- **Fund and Fund Manager - Legal Structure [MB& NFH]**
 - **Legal protection for Fund Managers** is in the **entity** – Don't leave home without one. Risk Personal capital generally only to the extent of amount invested in the entity (except for fraud or securities law liability) **[NFH]**
 - **LP or LLC for Fund. LLC or S Corp Fund Manager [MB]**
 - Two entities: One for fund, one for Manager – Form before trade
 - Investment partnership vs. Trade or Business
 - Salary & distribution issues **[MB covering tax]**
 - Compare Investment partnership vs. Trade or Business **[MB]**
 - Save complex structures, such as master feeder trusts, for your second fund, or for an offshore fund; Complex structures can built on these early entities. **[MB or NFH]**
 - **Offshore Funds –**
 - Tax exempt investors – UBTI
 - Master Feeder vs Side by Side
 - Master Feeder Offshore Funds – Only reason to go offshore is if you have a tax exempt investor (trust or 501(c)(3) **[MB]**
 - **Delaware vs. Your Home State:**
 - Tax: **[MB]** - Illinois replacement tax based on ____.

- Nexus: Corporate qualifications required in any state in which you have an office, have employees, or “do business”.... more than one state = qualifications in all states **[NFH]**
 - Formation Fees in each state
 - Registered Agent Fees in states where no office
 - Corporate annual fee to all state (“Franchise Tax”) – **[NFH]**
- Previously Delaware LP and LLC law was more well developed. Now the Uniform LP act in most all states eliminates allure of DE. LLC law everywhere is less well developed, but following partnership law to some degree.

[Hand out - Filing Fees For Business Formation]

- **Due Diligence - Clean Background is Key [NFH] –**
 - Your Past will Be Open to Investors in Offering Memo.
 - If you are not comfortable with that, then don’t become a fund manager, or a partner, or key employee, of the Manager.
 - OPM – in highly regulated industry – securities, play by rules
 - Investors & Asset Allocators will conduct DD on Fund Managers:
 - Background check, regulatory dings, failed company in past criminal, tax liens, bankruptcy,– **DD before you jump into bed with a partner, even someone you know**
 - DD on Fund Manger Principals, the entity itself, and prior business and legal history
 - Business reputation

[Hand out – Due Diligence Questionnaire for Private Placements]

- **Relationship Between Founding Fund Managers [NFH]:**
 - The “Pre-Nup” agreement / Business Succession Planning
 - Issue spotting for Founders’ Agreement, discussion items among your founding business partners
 - ½ of startups loose one person within the first 12 months to one of the above.
 - **Death, Disability Divorce, “Cheating”- Side Action, Departure.**
 - Do you really want to be partners with the spouse of one of your partners, if your partner dies? Who gets shares? How much? Buy out?
 - How to split up company, in break up, split off or dissolution **NFH]**
 - How to value it, in break up, split off or dissolution? **[MB]**
 - Agreement costs time and legal fees, but worth its weight in gold

- Do you want a Defensive approach (litigation, or animosity) to determine parties intentions or Offensive approach (agreement prepared in advance)?]
- Multiple Owners of Management Company **[NFH]**
 - Discuss with partners before starting business and paper it.
 - **Cash invested vs. sweat equity vs. property** (intellectual or tangible)?
 - **Who will own what %?**
 - **Valuation** for new partners buying in and old principals exiting
 - **Who will provide additional capital - if more seed money needed?**
 - Address best case and worst case scenarios and prepare for them.
- VC fund incubators: ? They want large equity for investment in Fund Manager entity. Sound idea? At what stage? **[MB and NFH]**
- **Taxation of Entity, Owners & Investors [MB]**
 - **UBTI [MB]**
 - **ERISA Investors [MB]**
 - **IRA's – Could be an issue of self-dealing**
 - Plan asset rule; ERISA Plans must not exceed 25% of AUM
 - **Manager's money counts in numerator but not in denominator.** It is a double whammy (that's a technical term).
 - **If Mgr money is non-ERISA and non-IRA, leave it out of the calc.** The denominator is 200 and the number is how ever much of the 200 is ERISA or IRA.
 - **If the fund is "plan assets", the Manager has to be careful about charging management and incentive fees to his own IRA. It could look like a premature distribution of IRA assets to its beneficiary.**
 - Positions and side pockets
 - Not suitable for all investors
 - Investor\Trader - Trade or Business
 - Mark to Market
 - Partner tax allocations and reporting [differ from economic allocations]
 - Wash Sales
 - **Effect of new 60/40 rule:** 1256 contracts are split 60% long term, 40% short term. The participant wanted to know if that applies to section 1256 contracts in the fund, which it does.
 - Illinois Replacement tax if not covered above
 - State Tax Return Filings where investors reside

- **Making Money as a Fund Manager - Fee Structure [MB]**
 - Management Fees (Asset-based) fee
 - Valuation - "Marking" or valuing portfolio Marked to Market, Investor/Trader [MB]
 - Incentive Fees – Profit-based fee (or "profit allocation" to enhance tax benefit)
 - How is Profit Calculated? – Profit allocation
 - **Fee waivers & Wisdom of [NFH]**
 - Quarterly versus Monthly Accounting –
 - Trends,
 - Frequency of calculations,
 - Cost
 - Investor Expectations
 - Special or discount fees for early or larger investors – Wisdom of, and Issues surrounding
 - Operating expenses,
 - Employee salaries
 - Rent
 - IT Costs
 - Need for competitive features/structure, but still have to make money or fund will be out of business.
 - Hurdle rates
 - High water Marks / “draw downs”
 - Business success versus attractiveness to investors
 - Operating expense and employee salaries, rent managers' salaries, drags down performance,
 - Wisdom of negotiating fees with certain investors

- **Capital Contributions, Partner Allocations, Redemptions, Withdrawals by Investors, Lock-Up periods, Valuation [NFH and MB]**
 - Tied to liquidity of fund's investments [NFH and MB]
 - Frequency [MB]
 - Lock-up period for hedge funds, and not applicable to future funds [NFH] – Lock-Up tied to liquidity
 - “Stuffing” the departing investors [MB]
 - Marked to Market, Investor/Trader

- **Creating Additional Funds [NFH]**
 - Material differences required between funds in order to avoid “Integration” under securities laws
 - Issues with using multiple strategies or single strategies [MB, NFH]

- Conflicts of Interest *
- ***Conflicts of Interest & Fiduciary Duty, in Trading or Investing by Fund [NFH & MB]**
 - Single or multiple strategies – differences must be material
 - Trade Allocation with in one fund
 - Multiple Funds – Trade allocation
 - Proprietary trading
 - Capacity
 - Transparency of trades and NAVs
 - Employee personal trading
 - Front Running
 - Must watch the trades its your fiduciary duty
 - Trades must be disclosed and Managed Internally
 - Illiquid securities?
 - Futures
- **Audited Financial Statements [MB]**
 - Investors expect financials to be audit, even though not required.
 - Organization costs
 - Disclosure of Positions greater than 5% of net assets – positions disclosed – no audited exceptions allowed
 - Use of Margin / Leverage disclosed
 - Other Audit Issues – Private
 - **Audit Opening Balance Sheet if even ONE nonaccredited investors [NFH]**
 - Performance reporting and financial statement disclosure and the importance of proper reporting to individual partners.
- **Adhere to Corporate formalities, No short cuts – You’re heading for the big leagues [NFH}**
 - **Do all the formation filings right, and DO them, plus Resolutions, Equity issuances**
 - Sophisticated Investors want to see papered transactions (prior transactions) before they invest: LLC agreement; employment agreements; outside party agreements)
 - Expensive to retroactively paper agreements.
- **Operational Documents Needed for Fund: [NFH]**
 - Founders Agreement;
 - Offering Memo;
 - LLC or LP Agreement;
 - Subscription Agreement.

- Trading / Brokerage Agreement or agreements for the actual business of the fund or business;
-

- **Securities Law Issues for Exempt (Private) Funds (& Regulatory Compliance For Exempt Funds [NFH]**

- “Unregistered” does not mean “unregulated” [NFH]
- **Even the Exemptions from registration require compliance (filings, disclosure and adhering to conditions), in order to be effective.**
- Interests being offered **are** securities
- Multiple layers of regulation apply – 4 securities acts, plus 1 commodities act, and the US Patriot act (AML).
- **Risk of non-compliance is:**
 - **Regulatory action by SEC or states, or both, and**
 - **Investor lawsuits**
 - **Rescission means give all the money back, at the value the investor invested, not at current value.** (Plus interests and attorney’s fees.) [State laws all different]

[Handout – “Securities Regulation of Private Funds”]

Handout – “Securities & Futures Regulation of Private Funds”]

[Handout – Private Offering Exemption FAQ Chart]

- **The 1933 Act & Exemptions; What is a Security?**

- 1933 Act :
 - If you sell a security, it must first be either registered or exempt.
 - If you sell an unregistered, and non exempt security you can be subject to civil and criminal penalties
- What is a Security: If an investor gives you money with intention of making a profit, through your efforts, and not through his own efforts, then the interests are securities;
 - Even sales to 1 investor, or to your Mom; or to a few guys in the industry.
 - Any person investing cash in exchange for your interests or equity.
 - Equity interests to consultants, employees, board members, for services, are securities
 - LLC and LP interests are securities
 - Loans are not securities if fixed interest rate and fixed payments with no equity kicker.

- **Key: Find exemption from registration, and comply with its conditions.**
- ***Exemptions are from registration, but from disclosure, or notice filings, or from conditions of exemption.***
- ***Three keys to staying out of trouble under securities laws:***
 - ***Disclosure***
 - ***Complying with the Conditions of the Exemptions***
 - ***Notice Filings and***
 - **Disclosure** is key; but time consuming and costly
 - can be curtailed in a few limited circumstances.
 - **All exemptions have conditions, even the self-executing exemptions. Know them and comply with them.**
 - **Notice filings** always required (except a few very, very limited circumstances):
 - Don't blow them, you can lose the exemption
 - Most notice filings required only after sale
 - **Blue Sky Law- State** Filings are required in each state in which investors reside. New York is pre-sale filing.
- **Rule 10b-5 – Antifraud Rules – Full and Fair Disclosure**
 - **Issuer must give investors all information material to their investment. No omissions or misstatements or shading facts**
- **Seed Capital – 4(2) Private Offering Exemption –**
 - 4(2): Very small, very private, group (3 people?)
 - Very close friends
 - “trader friends” or “friends in the business” who know the business inside and out
 - Folks who would never sue you if the deal crashes and you lose all their money
 - Disclosure can be curtailed? Perhaps no offering memo, at least at this point?
 - Or Highly sophisticated investor – (though they may ask for disclosure book)

Or

- **Regulation D 506 Private Offering Exemption; Conditions & Characteristics: Most preferable Exemption [NFH]**
 - Safe harbor, clearly defined exemption

- Blue Sky is uniform in all states except NY and CT
 - But disclosure book required and other conditions:
 - Unlimited \$ amount offered
 - Unlimited Number of Accredited Investors (or 99 if 3(c)(1))
- **Manner of Offering: No general Solicitation, no public notice or postings**
- Private vs. Public Offering or Fund – Avoid public offering status, or risk full registration requirement or enforcement
 - **Illegal to Offer Your Fund on the Internet, except to people you already know**
 - No website postings of Offering Memo/ Disclosure doc allowed, per SEC.
 - No website: yours or anyone else's, does not remove legal responsibility
 - IPO.Net and Lamp Technologies apply to brokered funds only
 - **Password protected access must be to your own existing investors, not to prospective investors**
 - No Cold Calls, No Advertising, no newspaper ads, even local, no phone solicitations to people you don't know in advance
 - Plant an article about your fund in a news publication, then it's an illegal general solicitation.
 - However, if they contact you for interview, perhaps not. Careful not to say any thing about fund or the offering, only about fund manager and track record
 - Pre-existing relationship required
 - Or private introduction through a pre-existing relationship required
 - Perhaps Cold calls to Institutional Investors / Professional VCs are probably OK??? Gray area *without a pre-existing relationship, Truly Institutional required: (banks, insurance companies, pension funds, BD firms, VC investment firms).*
 - VC Conferences? Gray area? Look to qualification of attendees
 - Public or general solicitation will blow private placement exemption, leaving you with an unregistered public offering, and the liability to return all the money investors invested
- **Sell to Accredited Investors (unlimited) and only 35 Nonaccredited investors**
- Accredited Investor:

- \$1 million Net Worth or
 - \$200K income, or
 - \$300K with spouse
 - Nonaccredited investors limited to 35
 - Nonaccrediteds must be Sophisticated
 - What about family who are not accredited?
 - **Audited Financials requirement for nonaccrediteds, even 1 nonaccredited investor.**
 - **Blue Sky Law – Notice** Filings required with the SEC and in each state in which investors reside; notice filings only if Reg D. *[Hand out summarizing 50-state notice filing requirements.]*
- **1940 Act (Investment Company Act of 1940) & Exemptions [NFH]**
 - Avoiding Regulation as an investment company
 - An investment company is any fund that buys and sells the securities of other issuers (i.e., your fund, buys and sells securities of other companies). However an investment company is a public fund
 - Avoid classification as public fund.
 - Section 3(c)(1) of '40 Act:
 - **Less than 100 beneficial owners,**
 - Counting investors is complicated
 - **Privately sold,** no public solicitation, and
 - **Complies with Regulation D (1933 Act)**
 - Section 3(c)(7) of '40 Act:
 - All investors are "**qualified purchasers,**"
 - Can sell up to 499 investors,
 - **Privately sold,** no public solicitation
 - Complies with Regulation D (1933 Act),
- **Disclosure Document / Offering Memo [NFH]**
 - **Full and fair disclosure of all info material to investment decision, required by 10b-5 – whole truth and nothing but truth**
 - Regardless of whether investors are Accredited
 - **Any missing or inaccurate info becomes fodder for an investor lawsuit if they lose money with you.**
 - **Rely on the YOU the Fund Manager to provide info**
 - **No exaggerations or omissions, you'll get caught**
 - Also the marketing doc, therefore:

- **Balance marketing with full disclosure**
 - That means written disclosure document, in all but a few circumstances. *
 - The **“CYA” Document** – Disclosure Document
 - Even Exempt Offerings must have disclosure – how to provide disclosure?
 - The single most important, and often overlooked, condition of securities compliance
 - A condition to keep liability at bay if lawsuit
 - Everything in it is true, and not misleading.
 - Not promising to make money:
 - Nor even that its a fair deal,
 - Can even say “we are taking your money and losing it all”
 - Just true facts of people, fund, strategy, industry
 - If you are **uncomfortable disclosing** it, its material
 - **Protect, not insulate, from liability**
 - Time Management Business Tool
 - Can Cover much of your presentation first in writing
 - Investors like to see electronic first
 - Saves “too much talking”
 - Providing **consistent information to each** investor
 - Ticket in the door with investors
 - Must also **update disclosure** for facts or occurrences that render the previously disclosed facts inaccurate
[Hand Out – Why Offering Memo Required]
- ***When securities disclosure document requirements apply to friends, family, traders:**
 - When You Can Get By Without a Disclosure Doc:
 - Where the investor would never sue you if you lost all their money.
 - Very close family, 1st degree relative, who knows you and the business and its risks.
 - Very, very, very close friends
 - Money changes things
 - Highly sophisticated, professional, institutional investors (like VCs)
 - But they will ask for a disclosure document
 - Only a few – 3 or 5 ? Perhaps 10 too many?

- Other methods of accomplishing disclosure under 10b-5
 - (“stack of docs”, no book, if all accredited.)
 - Number not relevant, but relationship & sophistication are
- Disclosure **Doc Highlights [NFH]**
 - Bios
 - Strategy (to extent can explain without disclosing proprietary)
 - Industry Description,
 - Fees to Manager
 - Lock Ups
 - Corporate and Personal Due Diligence,
 - Conflicts
 - Financials
 - Risk Factors
 - Summary of all material agreements & info
 - Litigation, pending or threatened
 - Prior performance (if relevant)
 - Tax Section
 - “your own doc, customized, no boiler plate
- **Audited Financial Statements [MB]**
 - Audit opening balance sheet required if even 1 non-accredited
 - Investors expect audit, even if not required; now customary
 - Use of Margin/Leverage affect on audit
 - Disclosure of Positions greater than 5% of asset – positions disclosed – no audited exceptions allowed – disclosure - or opening to do the special report
 - Other Audit Issues
- **Futures Law [NFH]**
 - **When futures laws apply single managed account is not- individual separate accounts**
 - **NFA Exams**
 - **CFTC filings** and the Rule 4.7 Fund, super accredited investors
 - Using Futures to Hedge
 - Options in indexes are futures, while options on securities are not.
 - No Blue sky for commodities Acts.
 - 4.13 a 3 and a4
- **Futures Trading Funds – "Pools" [NFH]**
 - **Even small amount of futures can trigger CFTC registration and disclosures**; even if futures trading is dominant, still can avoid much of regulation if investors all are "qualified eligible participants"
 - Definition of QEPs

- new relief from CFTC for certain futures funds
- All one disclosure doc for Securities / Reg D, and Futures
- If formerly CTA with, D-Doc, can use that as basis to start

- **Investment Adviser Registration [NFH]**
 - **Whoever renders investment advice must be registered, or exempt**
 - **15 client exemption**
 - **Fund counts as 1 client, until 2006 with new SEC law.**
 - **If no managed accounts and only one fund, then no IA registration until 2006**
 - **If the one fund has less than 15 investors, then no IA registration**
 - **In 2006, new SEC Rule will start looking through the fund and counting all fund investors individually.**
 - **State versus Federal registration - <25 million AUM (Assets Under Management)**
 - **Managed Accounts = IA, versus trading a Pool.**
 - **Fund registration versus IA registration**
 - **Making trades all as one group, or making individual trades for each managed account?**
 - **Managers who run Multiple Funds, help investor decide between 2 funds, is an IA**
 - Exemption allows profit-based compensation without regard to financial condition of investor
 - Fund Manager May Need to Be an IA anyway
 - Recent hedge fund scandals, SEC now requiring investment adviser registration of all hedge fund managers, whose funds have more than 15 investors, starting in 2006 [NFH]
 - Comment Wilmer Cutler Pickering – SEC has exceeded its authority in proposing Rule change, need to go back to Congress [NFH]
 - 2/3 of the largest fund managers are registered IAs –
 - Institutional money will not invest in your fund if you are not an IA

- **Anti-Money Laundering Requirements [NFH]**
 - **Know your customer. “Don’t ask, don’t tell” is Dead.**
 - **Certifications required “This is not terrorist funding money”.**
 - Take only Money you know, or bank you know,
 - If it’s a foreign source, or foreign bank, compliance manual procedures.
 - Who covered? Driver’s licenses.
 - Regs not out yet.
 - Exemptions for smaller funds may apply.

- **In all docs anyway, even though does not apply to US investors.**
- **Money finders** – Generally using them to sell your fund is **illegal**, if they are not registered securities brokers under 1934 Act.) **[NFH]**
- **Prime brokers cap intro – disclosure item, not formal, may intro you, but creates a conflict of interest**
- Selection of Broker – When to add prime broker?
- **Business Issues [ALL]**
 - This is a business, you are no longer a trader.
 - Responsibilities fund managers undertake to investors, on start-up and through operations on above
 - Do you want to own and run your own business?
 - Marketing, Schmoozing, plus doing the work of trading.
 - **Timely compliance.**
 - Must do work, **paperwork**, you don't want to do.
 - Manage people, **back office – IT, accounting, hiring service providers**
 - Make sure you can make a living at it, or don' quit day job yet.
 - Implementing structure and strategies to maximize profits for managers and investors
 - **Establishing Track Record**; time frame for doing so
 - Family and Friends
 - How does one establish track record? Is institutional money required ? How far back?
 - All your track record counts
 - **Reasonable expectations as to cost and timing –**
 - Funding the fund with your own money or find seed funder
 - Time line for seeking help from professional service providers and out-sourced functions: Lawyers, accountants, Prime brokers, back office, technology / server / network professionals, Website
 - Ask your service providers for referrals to other services providers
 - Need for quality administrator/accountant/lawyer/prime broker/back office - interviews - No
 - **Importance of having technology and accounting systems in place, either internally or outsourced – USE THEM!**
 - Run the business like a business, keep records
 - Importance of communication with Investor partners
 - Understanding Capital formation –

- Winning an allocation or an investor
- Surviving the Due Diligence process of investors
- Meeting With Sophisticated Investors
- Due Diligence Preparation and Responses
- How do you do an AIMR audit, how do you contact them, and how much does it cost ?
- How Will SEC Come down on hedge funds – custody rule
- Compliance officer requirements – not adopted yet.

\\nfh-efp-dc\users\nfhpc files\Speeches\Opal Emerging Managers Summit\Start-Up Funds Panel 5-18-05 -
Bullet Points in Detail edited 5-15.doc