Regulatory and Case Law Developments Relating to Hedge Fund Subscription Materials

This alert highlights several recent regulatory and case law developments affecting hedge fund managers. The developments summarized below may require updates to investor subscription materials and should be incorporated into subscription materials for new hedge funds.

Proposed Changes to "Accredited Investor" Definition

Safe harbor rules provided by Regulation D under the *Securities Act of 1933*, as amended (the "Securities Act") allow private placement of interests in hedge funds to "accredited investors." The Securities and Exchange Commission (the "SEC") has proposed amendments to the "accredited investor" standards to reflect the requirements of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"). Under the current rules, with respect to a natural person, an accredited investor is "any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year" or "any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000." Under the new proposed rules, the net worth threshold remains at $1,000,000; however, calculation of net worth for purposes of the threshold would *exclude* "the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property, the amount of debt secured by the property" (e.g., the mortgage). In other words, any equity of an investor in his or her primary residence is excluded from such investor's net worth calculation and amounts borrowed in excess of fair market value of the primary residence reduce the investor's net worth under the proposed rules.

The SEC has stated they are considering whether transitional rules may be appropriate to facilitate subsequent investments by an investor who previously qualified as an accredited investor but was disqualified by the change described above.

Revised "Qualified Client" Definition

Hedge fund managers registered with the SEC are generally prohibited from charging performance and incentive fees/allocations pursuant to Section 205(a)(1) of the *Investment Advisers Act of 1940*, as amended (the "Advisers Act"); however, an exemption in Rule 205-3 permits the charging of such fees/allocations if investors are "qualified clients" (including "qualified purchasers").

Under the previously existing rules, a qualified client included, in addition to any person that is a "qualified purchaser" as defined under the *Investment Company Act of 1940*, as amended, "(i) a natural person who or a company that has at least $750,000 under the management of an investment adviser immediately after entering into an advisory contract with the investment adviser, and (ii) a natural person who or a company that the investment adviser reasonably believes has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time an advisory contract with the investment adviser is consummated." The $750,000 and $1,500,000 dollar amounts have been increased to (i) $1 million and (ii) $2 million, respectively.

The SEC has also provided that the dollar amount tests will be adjusted for inflation every five (5) years and that the value of an individual's primary residence will be excluded from calculation of net worth, similar to the change to the definition of accredited investor described above.

Finally, the SEC has adopted transitional rules that generally provide that the changes in the standards described above will apply only on a going forward basis. The transitional rules provide that if a hedge fund

manager was previously exempt from registration with the SEC under Section 203 of the Advisers Act and subsequently registers, the prohibition on charging performance and incentive fees/allocations in Section 205(a)(1) of the Advisers Act does not apply to existing investors, and allow for additional investments by investors who invested prior to the effective date of the revised standards, even if such investors would not otherwise qualify under the revised standards.

New FINRA "Anti-Spinning" Rule 5131

The Financial Industry Regulatory Authority ("FINRA") adopted new Rule 5131(b), effective September 26, 2011, that generally imposes additional restrictions on the allocation of new issues (e.g. initial public offerings) by FINRA member broker-dealers. Hedge fund managers that manage accounts or funds that purchase new issues may need to provide representations related to these restrictions, further described below, to FINRA member broker-dealers, and therefore should receive written representations from their investors if they have not already done so. Note that the restrictions in new Rule 5131(b) are in addition to existing restrictions with respect to new issues required by FINRA Rule 5130.

New Rule 5131(b) provides that a FINRA member may not allocate new issues to any account in which (i) an executive officer or director of a public company or a covered non-public company or (ii) a person materially supported by such executive officer or director (together with the persons described in (i), "Covered Persons") has a beneficial interest if one of the following relationships exists: (x) the company is currently an investment banking services client of the member or the member has received compensation from the company for investment banking services in the past 12 months; (y) if the person responsible for making the allocation decision knows or has reason to know that the member intends to provide, or expects to be retained by the company for, investment banking services within the next three (3) months; or (z) on the express or implied condition that such executive officer or director, on behalf of the company, will retain the member for the performance of future investment banking services. Note that allocations are permitted to accounts in which the collective beneficial interests of Covered Persons associated with a particular company do not exceed 25% of such account.

FINRA members may rely on written representations obtained within the prior 12 months from the beneficial owner of an account as to whether such beneficial owner is a Covered Person with respect to a particular company. Hedge funds that wish to reserve the right to participate in IPOs should solicit these representations from investors as part of their year end process if they have not done so already.

New FATCA Reporting and Withholding Requirements

The Foreign Account Tax Compliance ("FATCA") provisions of the *Hiring Incentives to Restore Employment Act* (the HIRE Act), enacted March 18, 2010, are generally designed to require certain U.S. persons' direct and indirect ownership of non-U.S. accounts and certain non-U.S. entities to be reported to the IRS, and impose a 30% withholding tax if there is a failure to provide required information or otherwise comply with FATCA's requirements. This withholding tax is currently scheduled to be phased in beginning with payments made on January 1, 2014 (although it may be necessary to enter into the FATCA Agreement (as defined below) by June 2013 to minimize the risk of being withheld on).

Clients operating non-U.S. hedge funds and other non-U.S. investment vehicles with U.S. investors will likely fall under this new regulatory regime and should consider updating their subscription materials and fund agreements to include representations and cooperation covenants from investors with respect to withholding, reporting and compliance obligations under FATCA.

FATCA imposes a 30% withholding tax on certain payments made to foreign financial institutions (FFIs) unless certain exceptions apply, as described below. FFIs are broadly defined and include foreign entities engaged primarily in the business of investing, reinvesting or trading in securities or similar interests. These include non-U.S. mutual funds, funds of funds, hedge funds and private equity funds. Payments subject to the withholding tax generally include U.S. source payments of interest, dividends, rents, certain payments with respect to derivative instruments that are treated as "dividend equivalent payments" and other gains, profits and income, as well as any gross proceeds from the sale of any property that can produce U.S. source interest or dividends (potentially including the proceeds of the sale or other disposition of an interest in an FFI).

The 30% withholding tax will not apply if (i) the FFI enters into an agreement (a "FATCA Agreement") with the Internal Revenue Service to undertake certain due diligence, reporting, withholding and redemption responsibilities, (ii) the FFI is a Deemed Compliant FFI (an FFI that complies with certain procedures to ensure that the FFI does not maintain U.S. accounts or is a member of a class of institutions for which the IRS has determined compliance is unnecessary), or (iii) certain other limited exceptions apply.

New Form PF Reporting Requirements

Under Rule 204(b)-1 of the Advisers Act, any registered investment adviser that advises one or more private funds and has at least $150 million in regulatory assets under management ("RAUM") (effectively, gross assets under management plus uncalled capital commitments) attributable to private funds must file a Form PF with the SEC. Form PF requires filers to report certain information on investor composition, further described below. Accordingly, hedge fund managers will want to ensure that subscription materials request the information necessary to respond to these Form PF queries. Form PF filings will be confidential and are intended to assist the Financial Stability Oversight Council in its monitoring of systemic risk in the U.S. financial markets.

Advisers having at least $5 billion in RAUM attributable to hedge funds as of March 31, 2012 must file an initial Form PF within 60 days following June 30, 2012, and other advisers to hedge funds and advisers to fund of funds generally must file an initial Form PF in the first quarter of 2013 based on their RAUM as of December 31, 2012. Among other things, the Form PF will require advisers to hedge funds to provide certain information about investors in such funds, including the percentage of equity beneficially owned by particular types of investors (e.g., U.S. persons, pension plans, non-profits, etc.). Note that with respect to beneficial interests outstanding prior to March 31, 2012 that have not been transferred on or after such date, an adviser may respond to the question regarding equity owned by particular types of investors using good faith estimates based on information currently available to such adviser.

Please see Ropes & Gray Alert "SEC Adopts Reporting Obligations for Advisers to Private Funds on New Form PF" dated November 1, 2011 for additional information on the Form PF reporting requirements.

Limited Partner Access to Books and Records

A recent Delaware supreme court decision (*Parkcentral Global, L.P. v. Brown Investment Management, L.P.,* 1 A.3d 291 (Del. 2010)) involving a hedge fund structured as a limited partnership addressed the general partner's obligation to disclose the names and addresses of other partners upon request by a limited partner. In this case, the court affirmed the lower court's ruling and required the hedge fund general partner to provide to a requesting limited partner the list of other partners, reasoning that none of the *Delaware Revised Uniform Limited Partnership Act* (the "DRULPA"), the explicit terms of the partnership agreement nor federal privacy rules entitled the general partner to withhold the list of partners. §17-305 of DRULPA entitles limited partners to access partnership records if they make a reasonable demand for a purpose reasonably related to

their interest as a limited partner, but the statute also provides that the general partner may establish reasonable standards governing the right to access information and under 17-305(f), that the rights of a limited partner to obtain information may be restricted in the partnership agreement. However, the court also stated in dictum that if the general partner wished to bar access to the names and addresses of partners, it could have done so explicitly in the partnership agreement under §17-305(f) of DRULPA.

While some hedge fund managers have traditionally included a provision restricting access in their subscription materials and partnership agreements, managers that do not have such provisions should consider including them in future materials. Conversely, when investing in funds with partnership agreements that contain such provisions, prospective investors should carefully consider their contractual rights to receive information from the fund in light of the *Parkcentral* decision.

Privacy Notice Reminder

As a reminder, in order to comply with one or both of SEC Regulation S-P and the Federal Trade Commission "Privacy of Consumer Financial Information" regulations, a hedge fund manager is required to notify investors of its policies and practices regarding non-personal information. Accordingly, this is a reminder to provide a privacy notice to your individual investors on an annual basis.

We have drafted model provisions for subscription agreements and other applicable fund documents covering the updates described above. Please contact your Ropes & Gray LLP advisor to discuss incorporating these changes into your existing and future investor subscription materials.