CBIG LAW

Hedge Fund Preparation and Launching Process

At CBIG Law, our attorneys' role in connection with the launch of your hedge fund will involve the preparation and review of the hedge fund's central, key documents. Such key documents include: the private placement memorandum (PPM), limited partnership agreement (LPA), investment management agreement (IMA), subscription agreement, investor questionnaire, all formation documents for the hedge fund, general partner, and investment manager, as well as agreements with third-party service providers. The sale of hedge fund interests to investors constitutes an offering of securities that must be registered with the U.S. Securities and Exchange Commission (the SEC) and state authorities, or meet an exemption from registration under federal or state securities laws. CBIG Law attorneys have a keen understanding of the relevant legal considerations, including compliance with securities laws, when forming a hedge fund and drafting agreements that will be used in offering the hedge fund's interests.

Offering and Closing Mechanics

We typically become involved early in the pre-launch phase of a new hedge fund when a sponsor engages us to help in preparing the legal formation and offering documents. We begin by conducting a thorough intake process to discover the sponsor's and the hedge fund's needs, strategy, goals and objectives, investment criteria, term, fees, investor locations, size (sought after number of investors and assets under management) and other pertinent information that will help determine key points in drafting the offering materials.

After the engagement and our intake process, we will begin with forming all entities and drafting the PPM, followed by the limited partnership agreement (LPA), investment management agreement (IMA) and other subscription documents.

Hedge Fund Private Placement Memorandum

The PPM must provide prospective investors with disclosure of all material facts about the hedge fund, its management, business, and operations, and the offering and its risks, investment objectives, and strategies. In addition, the PPM must disclose all material facts that would keep the disclosures from being materially misleading. Generally, a well-drafted PPM should contain the same information that would be found in a prospectus filed by a publicly-offered mutual fund as part of an SEC registration statement.

Most hedge funds rely on Rule 506 under the Securities Act of 1933 for an exemption from registration with the SEC. Rule 506 allows for a private investment offering to be made to accredited investors so long as the offering is made in compliance with all other securities regulations. CBIG Law discourages hedge fund sponsors from making a private offering available to non-accredited investors when the offering relies on a registration exemption under Rule 506.

Most importantly, the PPM must accurately describe the material terms of the hedge fund's basic legal documents, such as the LPA and IMA. Discrepancies between the PPM and the hedge fund's governing documents create regulatory issues for the hedge fund manager and other detrimental results that investors will likely pursue.

The PPM for a hedge fund typically consists of the following major sections:

- ***Cover page disclosures*** – In addition to basic identifying information, such as the name of the hedge fund and contact details for the investment manager, the key data on these pages includes securities laws legends and disclosures informing the reader that the offering of hedge fund interests will be privately placed and not registered with the SEC or state authorities.
- ***List of service providers*** – The names and addresses of the investment manager, general partner, legal counsel, auditors, administrator, prime broker, and any other material service providers.
- ***Summary of terms*** – The summary identifies the structure of the hedge fund, essential economic terms such as fees, redemptions, distributions, withdrawals, valuation of assets, and minimum investment amounts, lock-up periods, investor suitability requirements, and identifies the key service providers.
- ***Risk factors and conflicts of interest*** – The risk factors section includes warnings of potential downsides of an investment in the hedge fund, including the credentials of the investment manager, nature of the investment strategy, terms of the hedge fund, and any relationships with service providers. The risk factors should cover both general market risk factors and strategy- and fund-specific risk factors.
- ***Investment objective and strategy*** – The investment objective is stated, first in simple terms (such as "to seek capital appreciation"), followed by a more narrative description of how the investment manager intends to achieve its objective, along with any relevant investment limitations or restrictions of the hedge fund.
- ***Management and service provider disclosures*** – The management section includes senior management and investment team's biographies, as well as names the hedge fund's service providers and material personnel or affiliates. It will also describe the basic fee terms between the hedge fund and its service providers.
- ***Tax disclosures*** – Material tax consequences of an investment in the hedge fund will be summarized in the tax section.

The most distinctive section of the hedge fund's PPM is the hedge fund's investment objective and strategy. You, as the hedge fund manager, have the best understanding of the expected investment program and CBIG Law will aid you in framing the description of the objective and strategy and then recommend coordinating risk factors. During the intake and drafting processes, you will prepare a brief summary of the investment program that we will review (and revise as necessary) and then work together to prepare disclosure language suitable for a legal document.

Limited Partnership Agreement

The next, most important document in a hedge fund is the limited partnership agreement (the LPA). The LPA governs the rights and obligations of the general partner and the investors and how they may be admitted as limited partners. The LPA typically has major sections addressing the following:

- ***General Provisions*** – Basic housekeeping about matters such as formation, purpose, and registered address.
- ***Management*** – Describing how the limited partnership is managed, including calculation and payment of the management fee. It will also state that the general partner is responsible for all management decisions, while the limited partners are purely passive investors.
- ***Allocations*** – The major focus of the allocation provisions is the 20% incentive allocation to the general partner.

- ***Withdrawals*** – These provisions set forth the basis on which limited partners may withdraw money from the partnership, including minimum and maximum withdrawal amounts, lock-up periods, liquidity constraints such as gates and suspensions, and distribution dates.
- ***Reporting*** – Addresses the quarterly reports and annual audited reports and tax reporting.
- ***Exculpation and Indemnification*** – Provides broad exculpation and indemnification to management and related persons.
- ***Duration and Dissolution*** – A hedge fund's duration is typically indefinite and interests in the hedge fund will be continuously offered (meaning that new investors may be admitted to the hedge fund on an ongoing basis). If the partnership does dissolve and liquidate, this article governs that process.
- ***Transfers*** – The general rule is that hedge fund interests are not transferable. However, investors may make transfer requests from time to time that the general partner may want to accommodate.
- ***Miscellaneous*** – Typical housekeeping provisions found in any contract, in particular how the LPA can be amended.

Featuring the LPA's amendment provisions. The LPA will usually include a power of attorney provision which will allow the hedge fund manager to act on behalf of investors for delineated purposes, such as buying and selling securities, voting the hedge fund's securities, admitting new limited partners, amending the hedge fund's formation documents, and any other documents necessary for the continued operation of the hedge fund.

A hedge fund may also be organized as a domestic limited liability company, with its main governing document called an Operating Agreement or Limited Liability Company Agreement. Such agreement would be substantially similar in form and substance to a LPA.

Hedge Fund Subscription Agreement and Investor Questionnaire

The subscription agreement sets forth the basis on which a prospective investor will be admitted to the hedge fund. The subscription agreement is signed by the investor and delivered to the hedge fund's agent (either the general partner or administrator) prior to the next investment or closing date for the hedge fund, which is typically the first business day of the upcoming month or quarter. The investor will make many representations and warranties in the agreement, most importantly whether it is an accredited investor, qualified purchaser, qualified client, or non-U.S. person. These representations are typically supported by an investor questionnaire in a check-the-box format, where the investor certifies its investor status.

Investment Management Agreement

The investment management agreement (the IMA) will grant the investment manager the needed authority to invest and trade on behalf of the hedge fund. The IMA governs the terms of the arrangement between the hedge fund and the investment manager, particularly the calculation and payment of the management fee. The IMA will also provide broad exculpation and indemnification to the investment manager and related persons.

Launching the Hedge Fund

After all offering and governing documents have been drafted, reviewed, and revised, the hedge fund will be ready to launch and the final PPM will be ready to send to prospective investors.

At that point, our formation services will be complete and you may begin to raise capital. However, we oftentimes find that emerging hedge fund managers would like additional assistance in managing their compliance requirements for the hedge fund. Most day-to-day operations can be taken care of by the hedge fund's chief operating officer and chief compliance officer, with additional assistance given by the hedge fund administrator. When emerging hedge fund managers ask CBIG Law attorneys to step in, we usually get involved in reviewing new contracts and service agreements, and maintaining ongoing compliance matters, such as filing state Form D requirements, updating Form ADVs, and reviewing marketing materials for potential misleading statements (as this is the most vulnerable area for a hedge fund to trigger an SEC examination).

For more information on launching a hedge fund or other private investment fund, whether domestic or offshore, reach out to us at (202) 556-4455 or visit us at www.cbiglaw.com.