Capital Fund Law

Marketing an Emerging Investment Fund

A brief guide for emerging fund managers

This white paper addresses some of the legal and business issues that fund managers should consider when raising capital for an emerging fund.

A manager's ability to raise capital is an important component in managing a successful fund. Properly-prepared marketing materials can play an important role in an investment fund's success yet are often overlooked. This oversight is especially prevalent among emerging fund managers. If developed compliantly and appropriately, the inclusion of promotional materials may offer potential advantages by providing an overview of the fund—such as its strategy, performance, and manager pedigree. Marketing materials can be useful in a prospective investor's decision-making process and will likely benefit the fund manager when securing investor commitments.

However, significant risks arise when preparing a fund's marketing materials, both from a regulatory and an investor disclosure perspective. When conducting marketing efforts, the involvement of legal counsel during each step of the fund's marketing process is essential. A fund manager who fails to engage knowledgeable and experienced securities attorneys runs the risk of exposure to overstepping disclosure parameters and violating regulatory restrictions (all of which can be detrimental to the fund's capital-raising capabilities).

In addition to the legal issues involved in a fund's marketing materials, there are practical business considerations a fund manager will encounter. In our work with funds of varying sizes, backgrounds, and strategies, we have seen several key factors that influence a fund's marketing success.

The ability to raise capital is heavily dependent on the following principal factors:

- Pedigree
- Performance
- Assets Under Management
- Access to Investors & Intermediaries
- Marketing Strategy
- Advertising Rules

Pedigree

The education and experience of the fund management team will play a crucial role in attracting capital. Bringing on an advisory board consisting of experienced professionals in the areas of portfolio and risk management, operations, capital raising, and compliance can help buttress the fund's pedigree and ability to raise capital.

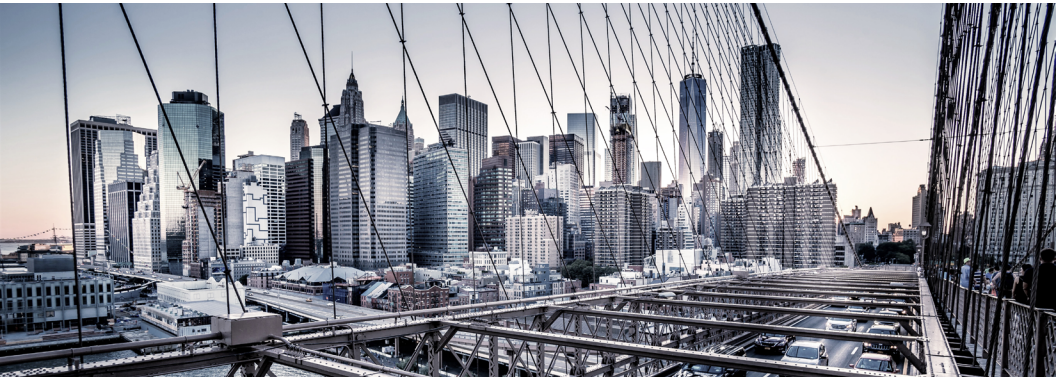
When selecting service providers, including the investment fund attorney, administrator, and auditor, funds should consider the professional background and reputation of each provider. The quality of the service providers says much about the quality of the fund's management team.

Performance

The performance of the fund is a top consideration for potential investors whenever a fund is raising capital. The key to demonstrating a favorable performance is showing consistent, attractive, and authentic returns over time. Care must be taken to comply with regulatory requirements when disclosing fund performance, including comparable performance, inclusion of all losses and other positions, fees, and expenses.

Some investment funds are tempted to use traditional marketing tools used in other industries, but this would be a grave mistake. Client testimonials, past recommendations, charts and graphs, partial client lists, or references to "free" services are particular areas of concern. A fund should only include this material of it has a legitimate reason to do so, working with legal counsel to ensure the content is compliant with all the governing rules.

Client testimonials and past recommendations are almost always misleading because they tend to emphasize favorable client experiences while excluding the less desirable. Often referred to as "cherry-picking," this could give the impression similar experiences are



typical for all clients of the adviser. Managers would be wise to work closely with an investment fund attorney and auditor to comply with regulations regarding performance disclosure.

Furthermore, the representation of a graph, chart, formula, or other device used for the purpose of determining which or when securities should be bought or sold will almost always fail to pass the scrutiny of the Security Exchange Commission (SEC).

A fund manager utilizing an advertisement referencing free services is strictly prohibited unless there is, in fact, no obligation associated, financially or otherwise. Whether directly or indirectly, a manager is not allowed to publish, circulate, or distribute an advertisement where a material fact contains any untrue statement or may be deemed false or misleading, whether directly or indirectly.

A fund's marketing materials should be selective and precise, only including verifiable data that is compliant with all the governing rules. Track records from investment strategies not consistent with the fund should be avoided unless explicitly disclosed. Similarly, personal track records of managers should be avoided as they are generally not consistent with the fund's strategy.

Disclosing performance requires the disclosure of whether or not the performance metrics are net or gross of fees (performance fees and management fees) and other fund expenses. Fund fees and expenses can cause significant reductions to performance records. Managers should work closely with an investment fund attorney and auditor to comply with regulations regarding performance disclosure.

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Most funds advance through predictable funding stages as they grow their asset base, starting with seed financing. As the fund hits certain asset thresholds, it can attract investors with increasing levels of sophistication and resources, which usually spans many years.

Assets Under Management

Many emerging fund managers are misguided in assuming they will be in a suitable position to attract institutional-level investors based on exceptional performance alone.

While performance is important, a fund must also be of sufficient size to satisfy the risk tolerance of large investors. Until an investment firm increases its assets under management (AUM) to a significant size (which can vary by fund strategy, investor base, and other factors) to attract institutional investors, emerging managers will initially rely on seed investors, networks of the management team, and then intermediaries.

Seed Investors

A seed investor is a high net worth individual who contributes initial funding in exchange for equity in the firm, often in the form of ownership interest in the general partner, fund advisory board or committee seat positions, or a portion of management and/or incentive fees. Stipulations between the seed investor and the fund manager may vary from fund to fund, depending on the size of the seed investment and the relationship with the fund's manager.

Most seed investors are seasoned and aware of the high risk associated with their investment. As such, when determining where to allocate their financial backing, the seed investor will expect to see a dedicated and well-balanced fund management team in place, ready and able to implement their marketing and portfolio investment strategy.

Typically, the starting point for finding seed investors is by approaching direct contacts of the fund's directors, managers, officers, and employees. These individuals may have a greater ability to raise capital from investors with whom they have existing relationships.

Seed funding arrangements commonly have terms, such as partial ownership or decision-making powers, that would subject the investor to the "Bad Actor Disqualifications" test, set forth under Rule 506 of Regulation D under the Securities Act of 1933. Thus, a fund manager must be certain the seed investor is not subject to any Bad Actor events or restrictions, including those currently under an order of suspension or expulsion from the SEC, the Financial Industry Regulatory Authority (FINRA), the Commodities and Futures Trading Commission (CFTC), the National Futures Association (NFA), or any other self-regulating agencies.

After seed investors are established, a fund will generally grow through marketing the networks and contacts of the management team and seed investors. Different than seed investors, these next-level-of-high-net-worth individuals don't generally require special terms or conditions for investment as the seed investors did. Provided the terms of the offering are near market terms, they will invest based on the strategy of the fund, the per-

formance generated since launch, and their prior relationships with management and seed investors.

Investment Intermediaries

After the initial seed round, many funds find it advantageous to raise capital through a placement agent, an intermediary that introduces the fund manager to capital. When using a placement agent, a fund manager must ensure that the placement agent follows the rules requiring substantive, pre-existing relationships with any prospective investors, avoiding general advertising and solicitation (unless conducting a Rule 506(c) offering, which allows advertising).

Intermediary violations of securities rules and regulations can subject the fund and its management team to the same liabilities as if the fund itself had committed the violations.

Only broker-dealers registered with FINRA can receive transaction-based compensation for raising capital. Broker-dealers tend to be very selective in accepting engagements, as broker-dealers and their insurers carry significant liability in connection with private offerings. Before a broker-dealer agrees to participate as a placement agent, they will perform a due-diligence review of the fund to establish that it meets the risk profile of the broker-dealer and its insurer.

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Marketing Strategy

Even with a solid pedigree and outstanding performance, a fund will have difficulty growing its investor base without a well-designed and -implemented marketing strategy. In developing a marketing strategy, an emerging manager would be well-served to rely on the assistance of a marketing professional, such as a marketing consultant or advisory firm with substantial experience raising capital for investment funds.

To be successful, a fund manager should approach their marketing strategy with as much seriousness as the portfolio investment strategy. We will be releasing additional information regarding this topic—check our website for updates and subscribe to our mailing list.

Advertising Rules

Before the creation and signing of the Jumpstart Our Business Startups Act (JOBS Act) in 2012, federal and state securities regulations maintained a general prohibition against an issuer or its agents from using general advertisements or solicitations in connection with private placements.

Section 201(a) of the JOBS Act required the SEC to eliminate the prohibition of general advertising and solicitation to raise capital. To accommodate this new requirement, the SEC adopted amendments under Rule 506 of Regulation D, which became effective in 2013. Under these amendments, the standard of accreditation is much higher and the accreditation verification process much stricter than that of Rule 506(b), which allows for an investor to self-certify that they accredited when subscribing to an offering.

Under Rule 506(c) of Regulation D, an issuer may use general solicitation to attract potential investors to invest in its fund so long as the fund takes "reasonable steps" to verify they are accredited investors and follows other regulatory requirements.

What are Reasonable Steps?

The SEC has provided a non-exclusive list of ways to verify whether an investor is accredited:

- obtaining written certification from a licensed attorney, certified public accountant, or broker-dealer certifying that the professional has reviewed documentation indicating that the investor meets the accreditation standard;

- reviewing recent IRS forms, along with self-certification by the investor; or

- reviewing bank and brokerage documents, together with self-certification by the investor.

Advertising: Is it Effective?

After the enactment of Rule 506(c), many practitioners and commentators expressed doubt as to whether using general advertising and solicitation would be an effective way to reach accredited investors. It seems these doubts were substantiated, at least to a degree.

Since the rule became effective in 2013, fewer than 10% of Regulation D offerings have relied on Rule 506(c). The low number of 506(c) offerings likely exist because of the rule's enhanced verification burden imposed on accredited investors and non-US persons' investors. Additionally, there has been a recent acceleration in fraudulent offerings—made simpler through the ability to generally advertise, reaching a broader, more vulnerable, and less educated audience.

High net-worth individuals have a greater sense of duty to protect their personal and financial records and, thus, are potentially less willing to divulge sensitive materials, such as tax returns and wealth management statements, to fund managers for verification purposes. Without having a pre-existing relationship with the manager, investors are likely to view poorly prepared investment-directed advertisements with suspicion and uncertainty.

Previously, non-US persons investing in domestic funds were deemed accredited investors regardless of whether they met the income test or net-worth threshold. Now, funds relying on 506(c) are required to verify the accredited investor status of all non-US persons, which had not been necessary under the prior Rule 506 exemption, codified under the JOBS Act in Rule 506(b). Based on the additional verification requirements, funds have been more reluctant to rely on the 506(c) exemption when raising capital from non-US persons, as its use

would likely reduce a fund's potential offshore investor pool.

There is also deep concern that advertising private placements has introduced a new pathway for fraudulent offerings. With the internet and social media at our fingertips, criminals can quickly and with minimal effort, disseminate emails, brochures, video ads, and more, promoting Ponzi-schemes and non-existent offerings. As a result, the SEC and other self-regulating agencies have been tasked with developing stricter methods to mitigate these issues. Fund managers must exercise skill and discretion in promoting their offerings.

SEC Response

Based on recent trends regarding the use of marketing materials, including brochures, emails, ads, websites, etc., the SEC has begun cracking down on fund managers using deficient marketing materials. In September 2017, the Office of Compliance Inspections and Examinations issued a risk alert discussing the most frequent advertising and compliance issues they had found involving fund managers violating the advertising rules under Rule 206(4)-1 of the Investment Advisers Act of 1940, as amended.

This alert named the following: misleading performance results; misleading one-on-one presentations; misleading claim of compliance with voluntary performance standards; cherry-picked profitable stock selections; misleading selection of recommendations; lack of compliance policies and procedures reasonably designed to prevent deficient advertising practices; misleading use of third-party rankings or awards; misleading use of professional designations; and testimonials.

Proposed Rules

Most recently, in November of 2019, the SEC issued new proposed rules that would affect all fund managers regardless of whether said fund manager is registered as an investment adviser, exempt reporting adviser, or one who is exempt from registration.

The proposed rules seek to expand the definition of advertisement to "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser."

Under the proposed rule, the following four categories of communications would be exempt from the definition of an advertisement:

"**(A)** Live oral communications that are not broadcast on radio, television, the internet, or any other similar medium;

(B) A communication by an investment adviser that does no more than respond to an unsolicited request for specified information about the investment adviser or its services, other than (i) any communication to a Retail Person that includes performance results or (ii) any communication that includes hypothetical performance;

(C) An advertisement, other sales material, or sales literature that is about an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or about a business development company ("BDC") and that is within the scope of rule 482 or rule 156 under the Securities Act of 1933 (the "Securities Act"); or

(D) Any information required to be contained in a statutory or regulatory notice, filing, or other communication."

What's Next?

The SEC considered broadening the rule to allow for flexibility in interpretations as ever-changing technological advances are utilized by fund manager in their marketing campaigns. The expansion of the definition of advertisement should help alleviate many of the questions of what will be considered an advertisement, as the default will likely be that a marketing product is an advertisement unless meeting one of the above-mentioned specific exceptions.

We will continue to follow the development of these rules. Look for updates from us on our website and through our mailing list.

Capital Fund Law Group

Capital Fund Law Group is a boutique investment management law firm focused on advising hedge funds, private equity funds and real estate funds, including qualified opportunity zone funds. Our hedge fund and private equity attorneys have spent their legal careers focused on the investment fund industry. Capital Fund Law Group is positioned to offer a highly sophisticated solution to emerging and established funds.

To learn more about the services Capital Fund Law Group offers, please visit our website or contact us at 212.203.4300.

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