

# MARKETING AN EMERGING INVESTMENT FUND

A Brief Guide For Emerging Fund Managers

By John S. Lore, Esq.



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# MARKETING AN EMERGING INVESTMENT FUND

## LEGAL AND BUSINESS CONSIDERATIONS WHEN RAISING CAPITAL

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There are significant risks involved in marketing an investment fund, both from a regulatory and investor disclosure perspective. Care must be taken when conducting marketing efforts to avoid running afoul of regulatory restrictions and overstepping disclosure parameters. Legal counsel should be involved at each step of a fund's marketing process.

In addition to the legal marketing issues involved, there are practical, business considerations when marketing a fund that can be outcome determinative. In our work with funds of varying sizes, backgrounds and strategies, we have seen a number of key factors that influence a fund's marketing success.



**This white paper addresses some of the legal and business issues that fund managers should consider with when raising capital for an emerging fund. It also looks in detail at the new rules.**

A fund's ability to raise capital is dependent on the following principal factors:

- Pedigree
- Performance
- Assets under management
- Access to investment intermediaries
- Execution of a sound marketing strategy

### **PEDIGREE**

The education and experience of the fund management team plays a crucial role in attracting capital. Bringing on an advisory board consisting of experienced professionals in the areas of portfolio 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 of each provider. The quality of the service providers says much about the quality of the fund's management.

### **PERFORMANCE**

The performance of the fund is clearly the top consideration when raising capital. However, the key to performance is showing consistent attractive performance over time. Care must be taken to comply with regulatory requirements when disclosing fund performance. Managers should work closely with an investment fund attorney and auditor to comply with regulations regarding performance disclosure.

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Most funds progress through predictable funding stages as they grow their asset base, starting with seed financing. As the fund hits certain asset thresholds, they are able to attract investors with increasing levels of sophistication and resources, which usually spans a number of years.



## ASSETS UNDER MANAGEMENT

Many emerging fund managers make the mistake of believing that their fund will be able to immediately attract institutional level investors based on exceptional performance alone. While performance is necessary, a fund must also be of a sufficient size to satisfy the risk tolerance of large investors. Until a firm increases its assets under management to a significant size (which can vary by fund strategy, investor base, and other factors) emerging managers will need to rely initially on investors that are contacts of the management team and intermediaries.

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“To be successful, a fund manager should approach its marketing strategy with as much seriousness as its portfolio investment strategy.”

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Typically, the starting point for finding seed investors is direct contacts of the fund’s directors, managers, officers, or employees. These individuals can raise capital from investors with whom they have existing relationships. However, an issuer should be aware of the SEC’s

disqualification of certain individuals, including those currently under order of suspension or expulsion from the SEC or FINRA, as well as other agencies. Seed investor arrangements vary from fund to fund, depending on the size of the seed investment and the relationship with the fund sponsor. Some seed investors expect ownership interest in the general partner, while others expect only concessions on fees. Fund sponsors should work closely with experienced legal counsel when negotiating seed funding arrangements.

## INVESTMENT INTERMEDIARIES

After the initial seed raise, 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 must ensure that the placement agent follows the rules requiring substantive pre-existing relationships with any prospective investors, and avoid advertising and solicitation (unless conducting a Rule 506(c) offering, which allows advertising). Intermediary violations of securities rules and regulations can subject the fund to the same liabilities as if the fund had committed the violations.



## BROKER-DEALERS

Only broker-dealers registered with FINRA may 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 will agree 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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"There is still much uncertainty regarding the potential risks and implications of relying on the new advertising regulatory structure"

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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 designing a marketing strategy, a new 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 its marketing strategy with as much seriousness as its portfolio investment strategy. We advise our fund clients on the legal and business aspects of raising capital. As a professional courtesy to our clients, we also provide [introductions and resources](#) to guide them toward capital sources that we have found to be effective for emerging managers.

## NEW ADVERTISING RULES

A recent development in investment fund advertising is the availability of advertising and general solicitation as a means to raise capital, made possible by the JOBS Act. For decades, federal and state securities regulations have contained a general prohibition against an issuer or its agents using advertisements or solicitations in connection with most private placements. The prohibition has



included such methods as television, radio, print, internet advertisements, cold calling (calling individuals that the issuer or its agents have no prior relationship with), distributing brochures to potential investors, setting up booths at shows, fairs or other events and soliciting individuals or companies with whom the agents do not have a pre-existing relationship.

Under the newly adopted regulations, an investment fund is permitted to engage in advertising and solicitation if it complies with certain requirements. Relatively few investment funds have used this new advertising model yet. There is still much uncertainty regarding the potential risks and implications of relying on the new advertising regulatory structure. A qualified investment fund attorney should be heavily involved in structuring any advertising program.

### The JOBS Act Allows Advertising for Certain Offerings

In September of 2013 the SEC implemented provisions of the JOBS Act to lift the ban on advertising and general solicitation for certain Regulation D private placement offerings (as well as 144 offerings). At the same time, the SEC proposed new rules that will require additional regulatory burdens

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The lifting of the ban on advertising represents one of the most fundamental shifts to securities regulation in nearly 80 years. Under the new rules, investment funds and other private issuers seeking to raise capital are now permitted to market their private placement publicly to accredited investors, via social media, print materials, email, group seminars and other means.

### Lifting of the Advertising Ban for Private Placements–New Rule 506(c)

Under the newly adopted Rule 506(c), an investment fund is permitted to engage in advertising and solicitation if:

- All purchasers are accredited investors (generally \$1 million dollar net worth excluding residence or \$200,000 net income--\$300,000 when combined with spouse); and
- The fund takes “reasonable steps” to verify that investors are accredited.

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### What are Reasonable Steps?

The SEC has provided a non-exclusive list of ways to verify whether an investor is accredited (among the list, only the first will be acceptable to most private fund managers):

- obtaining written certification from a licensed attorney, CPA 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; and
- reviewing bank and brokerage documents, together with self-certification by the investor.

### Will Advertising Be Effective in Raising Capital?

Many practitioners and commentators have expressed doubt as to whether advertising

will be an effective way to reach accredited investors. The argument is that accredited investors may be somewhat more leery of telemarketing, advertisements and direct mail than would the general populace. Advertisements directed toward investments may be treated with suspicion.

There is also deep concern that advertising private placements will introduce a new pathway for fraudulent offerings. Fund management will need to exercise skill and discretion in promoting their offerings.

### Proposed Rules Requiring Additional SEC Disclosures

In addition to lifting the ban on advertising and solicitation, the SEC proposed new rules that place additional regulatory burdens on issuers using this rule, especially for those using advertisements in written form. These changes will not go into effect until finalized and adopted.

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John S. Lore, Esq. is the managing partner of Capital Fund Law Group, a boutique law firm providing expertise focused on the alternative investment industry. Call **801.456.3620** or email us to schedule a consultation to discuss your fund.

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