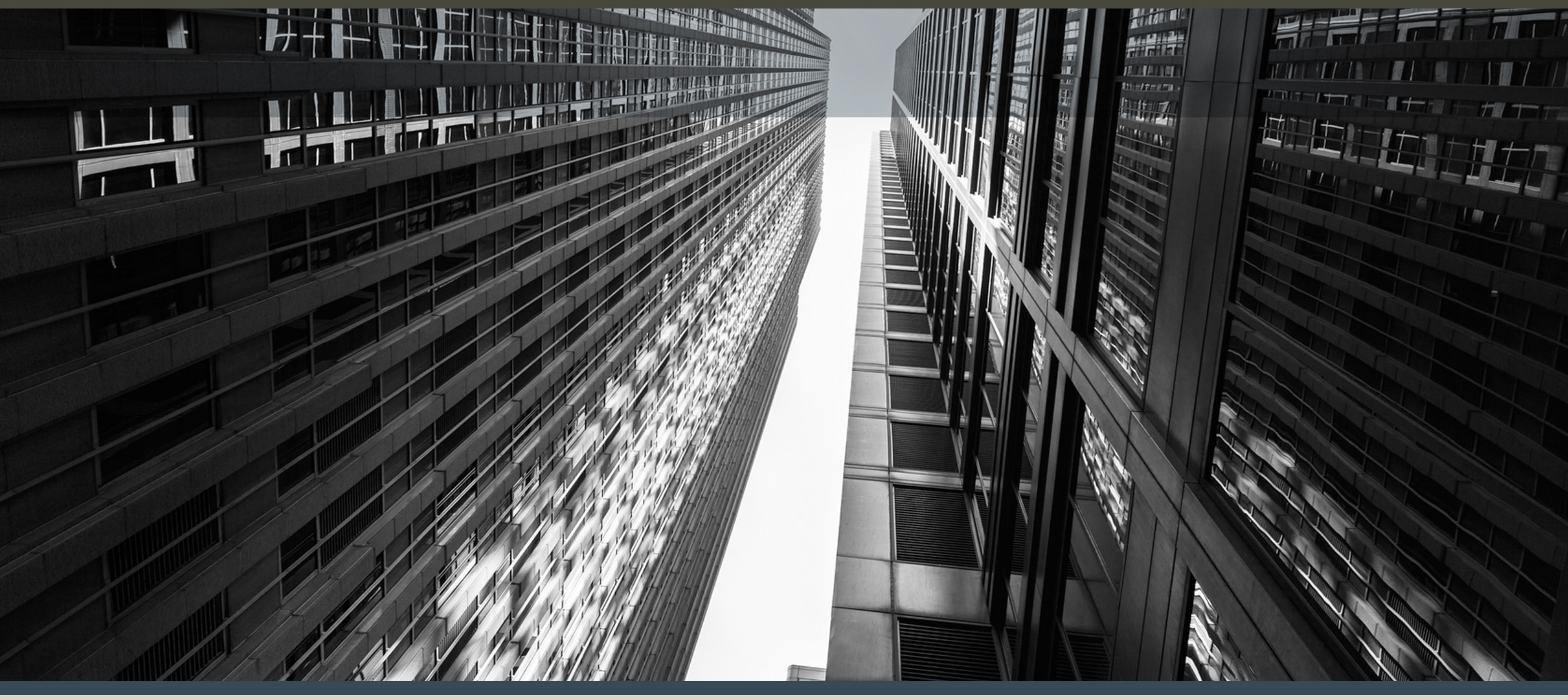
FORMING AND OPERATING A HEDGE FUND

A Guide for Emerging Fund Managers

By John S. Lore, Esq.



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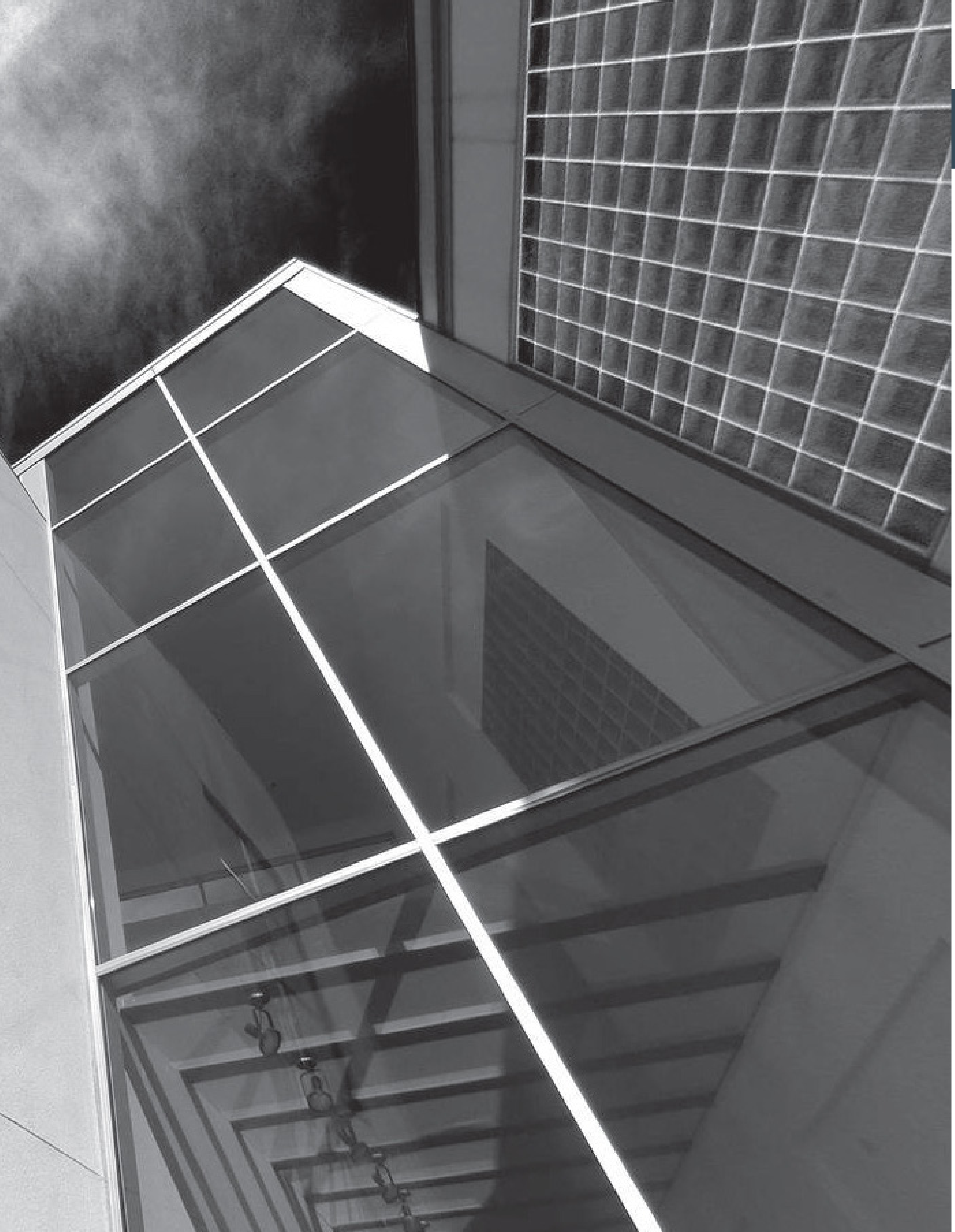
ABOUT THE AUTHOR

John S. Lore, Esq. is the managing partner of Capital Fund Law Group, an investment fund law boutique focused on domestic and offshore hedge fund formation and compliance. Mr. Lore advises established and emerging fund managers throughout the United States in forming and operating hedge funds, private equity funds, real estate funds and other private securities offerings across multiple industry sectors.

Mr. Lore advises investments on all aspects of their business, from capital raising and fund formation to implementation of their business models. His representation of a broad range of asset managers allows him to keep abreast of emerging trends and regulatory changes. Prior to founding Capital Fund Law Group, Mr. Lore practiced corporate and securities law at a number of law firms, including the investment funds division of Akin Gump Strauss Hauer & Feld, one of the largest international law firms in the world, in its New York City and Moscow offices.

Mr. Lore received his Juris Doctorate, with honors, from the University of Utah, S.J. Quinney College of Law, where he served as a senior member of the *Utah Law Review* staff. John Lore is a frequent panelist and presenter at various investment fund and Regulation D professional and educational events. Mr. Lore is a holder of the Series 65 Investment Adviser Law Examination.



ABOUT CAPITAL FUND LAW GROUP

Capital Fund Law Group advises emerging and established hedge fund managers on all aspects of fund formation and ongoing operations. Our attorneys have spent their legal careers structuring hedge funds and other private securities offerings. We form investment funds for sponsors throughout the United States and internationally varied investment strategies, fund vehicles, jurisdictions and industry sectors.

Our firm advises hedge funds of all investment strategies and asset classes, including: long/short equity, fixed-income, event-driven, multi-strategy, quantitative, and sector funds (including health care, technology, energy, and others) as well as real estate and private equity funds.

Our attorneys are regularly called upon to give presentations at securities law and investment fund forums and educational panels.

A. Our Services

Capital Fund Law Group is committed to providing the highest quality of services on a personal level and in a timely manner. We offer flat-fee engagements, which include start-to-finish counsel with all aspects of launching a domestic or offshore hedge fund. Our services include:

- structuring market-appropriate investment fund terms to compensate fund sponsors, properly allocate risk and secure tax advantages for the fund sponsors and investors;
- preparing the private placement memorandum to disclose the fund's investment terms, trading strategy, management background, risks and other necessary issues;
- preparing the limited partnership agreement or operating agreement governing the fund;
- preparing the investment management agreement between the fund and the investment management company;
- forming the most advantageous entities in the appropriate jurisdictions;
- preparing and filing the fund's federal Form D as required by the securities registration exemption found in Rule 506 of Regulation D;
- advising the fund sponsors on marketing and operating issues;
- coordinating with the fund administrator, auditor, prime broker and other service providers; and
- advising on capital raising issues and sources.

B. Our Philosophy

No two funds are identical and each client has unique objectives and circumstances. We use a client-based approach to our fund structuring and analysis. Our clients routinely comment on the excellence of our personal service and the time we take to properly understand and implement the client's unique circumstances and objectives. Capital Fund Law Group is committed to providing the highest quality of services on a personal level and in a timely manner.

INTRODUCTION

This ebook provides a guide through the process of structuring, launching and raising capital for domestic and offshore hedge funds and other private investment funds. In this book, we highlight pitfalls that fund sponsors should watch for and suggest best practices to safely and effectively navigate the process of forming and operating a fund.

The ebook is divided into three main parts, ascending in the level of detail and complexity.

Part I

Part I provides an overview of the hedge fund formation process and discusses some of the broad topics and key considerations involved in forming a fund, including:

- how to avoid securities liability as a hedge fund manager;
- who is eligible to invest in a fund;
- how to legally market a hedge fund to investors;
- when it is appropriate to start with an incubator fund;
- what service providers are needed to operate a hedge fund; and
- what documents are needed to launch a hedge fund.

Part II

Part II gives an in-depth discussion of key investment terms, structure and regulatory considerations involved in forming a fund, including:

- setting market-appropriate investment terms;
- structuring the fund to minimize taxes for the sponsor and investors;
- properly securing appropriate securities registration exemptions;
- satisfying investment advisor registration requirements;
- determining whether commodities regulation registration is needed; and
- maintaining regulatory compliance.

Part III

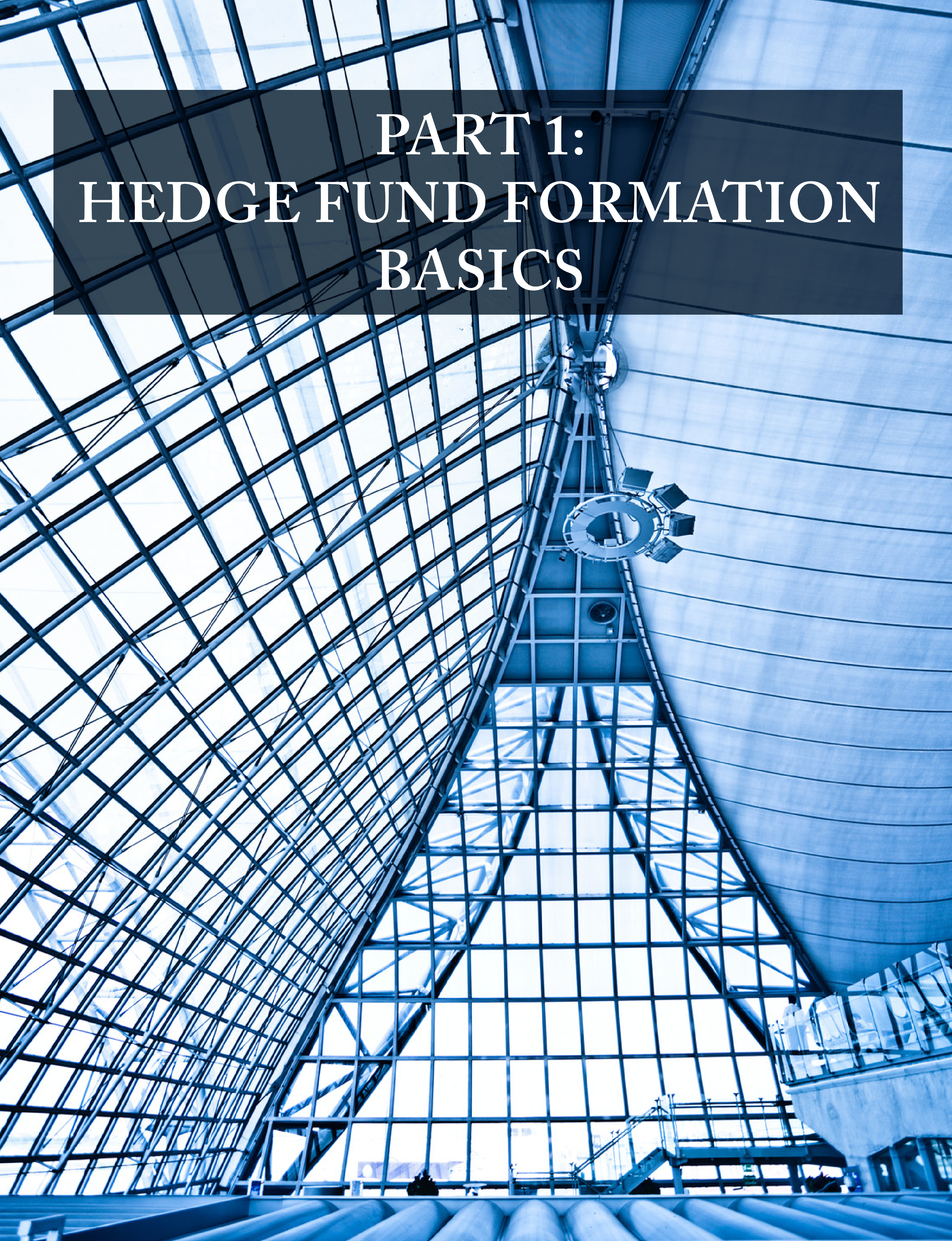
Part III is a brief excerpt of a sample hedge fund private placement memorandum (PPM) for a fictitious master-feeder hedge fund. The excerpt contains footnoted explanations of key provisions of a properly-structured PPM, as well as a deeper level discussion of certain hedge fund topics. Part III also highlights common drafting errors and how to avoid them.

The model PPM places particular emphasis on the risk factor section, which is one of the most important and most customized components of a hedge fund PPM. Part III gives readers a sample of the level of detailed disclosure that should be expected in a properly drafted offering memorandum.

Glossary

The complexity of investment fund regulation requires an investment manager to be familiar with key investment fund legal terminology. Throughout the ebook, key definitions are highlighted in blue and linked to definitions and explanations in the glossary.

PART 1: HEDGE FUND FORMATION BASICS



I. AVOIDING POTENTIAL LIABILITY

Operating a hedge fund entails significant legal exposure, with substantial liability for improper disclosure. Even inadvertent mistakes can lead to substantial personal liability.

A. Improper Offering Document Preparation Could Result in Fraud Violations

The SEC, the CFTC, the NFA and state securities commissions have developed a network of complex regulations with which a fund sponsor must comply to avoid liability. In recent years SEC regulations have undergone and continue to undergo major shifts, largely in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank 2010) and the Jumpstart Our Business Startups Act (JOBS Act 2012).

Failure to properly navigate the complex and continually changing regulations carries significant liability, including personal civil liability and criminal penalties in some cases.

i. Liabilities for Violating Federal Anti-Fraud Provisions

Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), imposes liability on a person who misrepresents or omits a material fact in connection with the sale of securities. The primary penalty imposed is a rescission of the investor's contract to purchase the security. A rescission of the contract means that the company, and in some cases an officer or director, would be required to repay the purchase price of the investment made, together with interest, attorney fees, and other costs.

Payment of the liability under this section can be ordered by the court against the individual directors' and officers' personal assets. Furthermore, if the SEC can prove that the material omissions or misstatements were willful, a court can impose fines on individuals of up to five million dollars and/or imprisonment of up to twenty years.

ii. Liabilities for Violating State Anti- Fraud Provisions

Similar to the SEC, each state has its own securities laws that effectively piggyback the Exchange Act and impose civil liability on persons who misrepresent or omit material facts. They include personal liability against directors and officers. Thus, after the SEC imposes its penalties, each state in which a security was sold may then impose its own penalties against the directors and officers of the issuing company.

B. Proper Legal Advice and Careful Disclosure

Hedge fund disclosure documents not only require specific disclosures of present information about the fund and its managers, but also requires a recitation of potential risks of the investment (known as risk factors). Risk factors vary significantly from one fund to another and require the drafting attorney to foresee potential contingencies and assumptions that may result in unfavorable investment outcomes.

The risk factors must be crafted to fit specific risks that the fund may face. Experienced securities counsel will help the fund sponsors make the proper disclosures required throughout the Private Placement Memorandum and protect the fund from unintentionally making misleading statements and material omissions. A hedge fund PPM requires specific language, drafting style, disclosures, and content.

Unintentionally deviating from the disclosure requirements can result in serious consequences for the issuer and its directors, officers, and managers. An experienced hedge fund attorney by your side will guide you through the complex regulations promulgated by the SEC, FINRA and the states, and help you minimize tax liability.

II. SELECTING HEDGE FUND SERVICE PROVIDERS

Emerging hedge fund managers face a maze of regulatory and tax considerations, investor reporting requirements, and business operation issues. Managers must also balance investor relationships, capital raising, developing their investment strategies, and a myriad of other roles.

Experienced and committed service providers play a vital role in guiding managers through their various responsibilities. A skilled team of service providers helps managers avoid devastating mistakes and can free them to perform their most important roles of raising capital and executing the fund's investment strategy. Choosing the right team of service providers can mean the difference between an emerging fund's success or failure.

A. Legal Counsel

A hedge fund attorney is usually the initial contact for startup fund managers. The hedge fund managers work closely with the attorney to develop the fund's structure and terms, in light of the fund's investment strategies. The hedge fund attorney advises the managers on applicable regulatory obligations including required filings, examinations and registrations.

Once the fund's terms and regulatory structure are defined, the hedge fund attorney will begin preparation of the hedge fund's offering documents (including the PPM, partnership agreement, subscription agreement, and certain regulatory filings.) Further, the hedge fund attorney will refer managers to other needed service providers, including administrators, prime brokers and auditors.

After the offering documents have been finalized, the hedge fund attorney will act as an ongoing resource and will assist the fund on an as-needed basis with the legal and operational issues. Among the ongoing services that the hedge fund attorney will provide include the following:

- review marketing and promotional material;
- provide answers to investor questions;
- prepare amendments to fund offering documents as needed;
- prepare side letter agreements for strategic investors;
- answer structural and operational questions;
- assist managers with modifications to the fund; and
- advise managers on the eligibility of certain investors.

Choosing a hedge fund legal advisor is among the most important decisions that an emerging manager will face. Prospective fund managers should seek for fund counsel with substantial knowledge of the hedge fund industry from both a regulatory and business perspective. It is also vital that the hedge fund attorneys be committed to working directly with the fund manager through all aspects of the fund formation process.

In addition to the experience of the fund attorney, the cost of legal startup services is a key consideration when selecting counsel. Legal startup costs are typically born by the fund, and can cause substantial drag on the fund's reported performance. A reputable boutique law firm provides the advantages of a specialized law practice, while keeping formation costs manageable. Boutique law firms also tend to provide direct access to the firm's partners.

B. Administrator

The administrator acts as an intermediary between the fund's managers and investors and provides an additional layer of protection to investors. The hedge fund administrator provides accounting and back office functions for the hedge fund.

The administrator provides an independent calculation of the net asset value (NAV) of the fund portfolio, calculates performance compensation, and provides periodic financial performance statements to investors. The administrator also typically handles the investor subscription process and reviews incoming subscriptions. A relatively new service provided by hedge fund administrators is a "second signer" service, designed to provide investors increased security against hedge fund fraud. A "second signer" agreement requires the fund's management to obtain a signature from the administrator prior to making a transfer or withdrawal from the fund's account. In addition to the above, the hedge fund administrator may perform the following:

- portfolio and cash reconciliation reporting;
- investor services;
- treasury services;
- tax compliance services;
- audit report preparation and auditor coordination; and
- SEC compliance and consulting

Depending on jurisdiction and other factors, a fund may or may not be required to use the services of an administrator. Regardless of legal requirements, using one is strongly encouraged and has become a *de facto* requirement among sophisticated investors. Outside verification of the fund's financial performance creates a needed layer of protection for investors. Additionally, having calculations prepared by a skilled fund administrator significantly decreases the difficulty and cost of an outside audit. Your hedge fund attorney can direct you to administrators that are aligned with your strategy needs and budget requirements.

C. Auditor

From an investor's perspective, the reputation of the auditing firm is among the most important due diligence items when investing in a fund.

The auditor works closely with the hedge fund manager to assess the valuation of the fund. The auditor will carefully review the fund's account statements, which are usually prepared by the fund administrator.

Audited financial statements contain a wealth of information not only about the financial position of the fund, but also regarding key decisions the fund has made, expense levels and the overall opinion of the auditor of the financial statements.

Your hedge fund attorney will make recommendations for auditors appropriate for your fund.

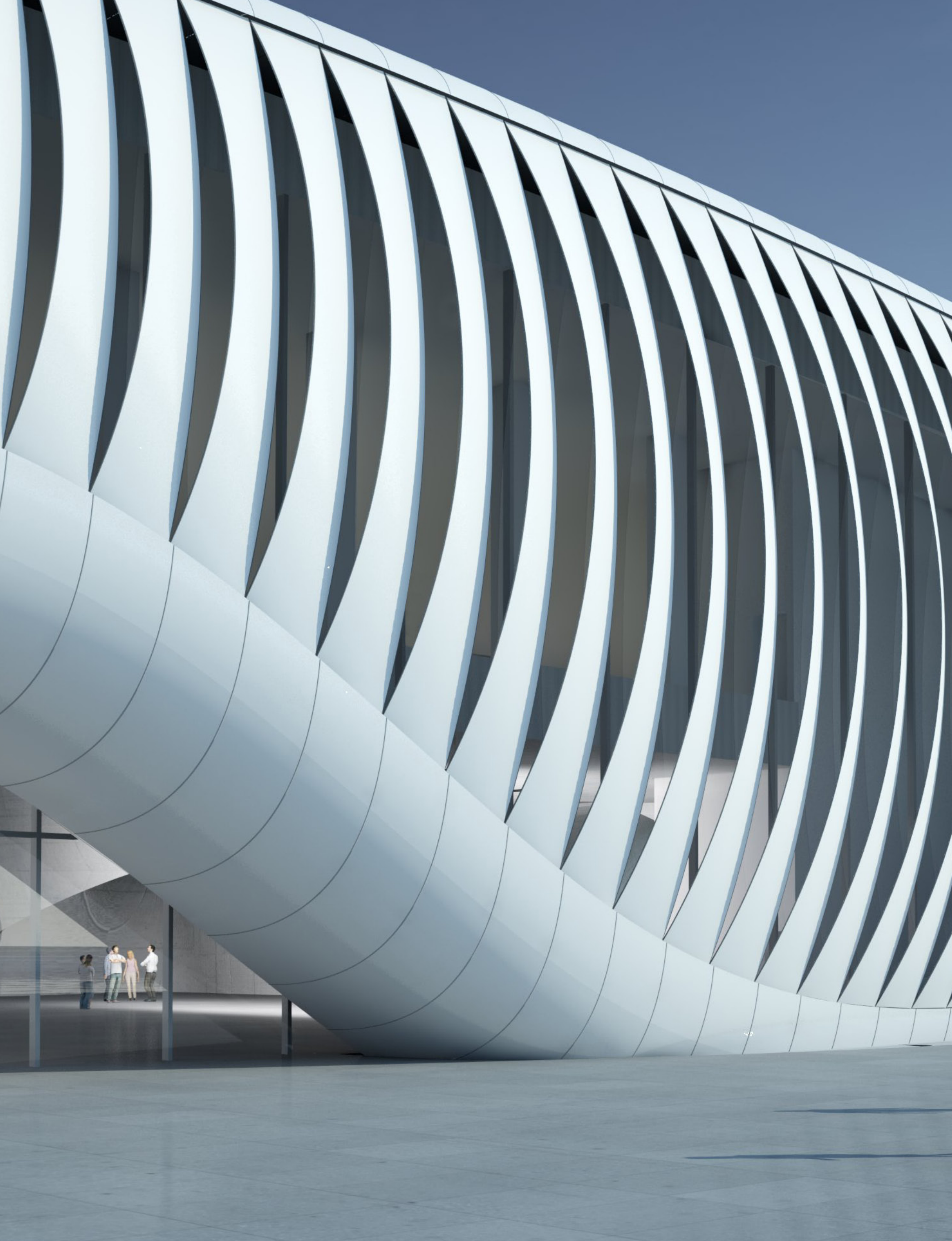
D. Prime Broker/Custodian

A prime broker is a central broker through which the fund executes most or all of its trades and that acts as custodian of the fund's assets. When the hedge fund executes trades through other brokers, the prime broker works with the executing brokers to settle

and transfer all assets through the prime broker. This custodial relationship facilitates simpler reporting of the fund's positions (which in turn simplifies the work of the administrator and auditor).

In addition to custodial services, prime brokers can provide leverage and margin, facilitate short sales, provide soft dollar arrangements, perform portfolio analysis, stress testing and other services.

Most prime brokers are large Wall-Street institutions that are generally not able to service a hedge fund until it reaches $100 million or more in assets under management. However, a mini-prime broker or "introducing broker" acts as a liason between a hedge fund and the large prime brokers, providing startup fund managers access to the full range of services provided by prime brokers. Most startup hedge funds begin their fund with an introducing broker. Your hedge fund attorney can suggest introducing brokers or prime brokers appropriate for your fund.



III. HEDGE FUND OFFERING DOCUMENTS

Your hedge fund attorneys will prepare five core documents, which are necessary to launch the fund:

(A) a private placement memorandum, (B) a limited partnership agreement, (C) a subscription agreement, (D) an investment management agreement, and (E) a management company operating agreement.The attorneys will also prepare and file the necessary regulatory filings (which can include Form D filings, investment advisor registration and commodities registration). Regulatory filings will be discussed in subsequent chapters.

A. Private Placement Memorandum

A private placement memorandum (PPM) is a securities disclosure document that provides investors with material information about the fund to enable an investor to make an informed investment decision. Similar to a prospectus in an initial public offering, a PPM provides potential investors with specific information about the terms of the fund, the structure of the investment, background of the managers and other disclosure issues.

B. Limited Partnership Agreement

The limited partnership agreement (or in the case of an LLC-based fund, an operating agreement) is the legal governing document of the fund. The limited partnership agreement outlines the terms of the fund and rights of an investor and fund manager. In contrast with the private placement memorandum, which is written in plain English (accessible to non-legally trained readers), the fund's limited partnership agreement is a lengthy and complex legal document. Among the terms of the limited partnership agreement are:

- a description of the powers and activities of the general partner (typically also the fund manager);
- a thorough discussion of all fees and expenses, including management, performance or other potential fees as well as legal startup costs, brokerage, administration, and audit expenses;
- an explanation of the allocations and distributions of profits to all partners, including how profits are calculated and timing of distributions;
- a description of withdrawal provisions, including minimum and maximum withdrawal amounts, lock-up periods, gates, and distribution dates; and
- a designation of power of attorney, which authorizes the fund manager to act on the limited partner's behalf for such purposes as voting the fund's securities, buying and selling fund securities, admissions of new limited partners, and amendments to fund formation documents and other documents necessary for continued fund activity.

To become a limited partner of a fund, an investor must sign a countersignature page in which he or she agrees to be bound by the terms of the agreement.

C. Subscription Documents

Subscription documents provide investors with a description of the steps necessary to purchase limited partnership interests in a fund and provide fund managers with eligibility information about the investor. This is the investor's contract with the fund, which specifies the subscription amount and outlines the terms under which the investment is being made. For fund managers, this document requires investors to attest that they meet certain eligibility standards, such as being an "accredited investor" or "qualified client", as required by SEC regulations and state law.

D. Investment Management Agreement

The investment management agreement is an agreement between the fund and the investment management company (often the same entity as the general partner). It defines the services that a fund manager will provide. It also assigns to the fund manager a power of attorney over the fund's assets, including the contributions made by the limited partners, and gives the fund manager the broad discretionary authority to manage such investor funds and securities in a manner that the fund manager believes is consistent with the investment strategy of the fund. Since the fund manager and the fund are controlled by the same individuals, the investment management agreement is typically signed by the same individuals on both sides.

E. Management Company Operating Agreement

The fund manager operating agreement is the legal governing document that provides for the rights of the founders of the fund. This document specifies how ownership of the fund is divided among the principals of the fund. The management company operating agreement and its contents are not disclosed to investors.

F. Form D Filings, Investment Advisor Registration

In addition to the five core fund documents, the hedge fund attorneys will prepare applicable SEC and state filings, including Form D filings and in some cases, investment advisor registration and CFTC registration, which will be discussed in detail in Part II of the book.

IV. COMMON HEDGE FUND STRATEGIES

Hedge fund strategies encompass a broad range of risk tolerance and investment philosophies within a wide array of instruments, including debt and equity securities, commodities, currencies, derivatives, real estate and other investment vehicles. The horizon of hedge fund investment strategies has seen unprecedented expansion in recent years. Investment terms are driven in large part by the fund's strategy and level of liquidity.

Below is a description of some of the more common hedge fund strategies.

A. Long/Short Equity

One of the most commonly used strategies for startup hedge funds is the long/short equity strategy. As the name suggests, the long/short equity strategy involves taking long and short positions in equity and equity derivative securities. Funds using a long/short strategy employ a wide range of fundamental and quantitative techniques to make investment decisions. Long/short funds tend to invest primarily in publicly traded equity and their derivatives, and tend to be long biased. Long/short funds also tend to have fairly straightforward investment fund terms. Accordingly, lock-ups, gates and other withdrawal terms in long-short funds are usually on the more permissive side because of the ease of liquidating positions to facilitate investor withdrawals.

B. Credit Funds

Credit funds make debt investments based on lending inefficiencies. The financial downturn of 2008-2009 brought a resurgence in credit funds, which tend to follow cyclical patterns. Credit funds include distressed debt strategies, fixed income strategies, direct lending and others.

i. Distressed Debt

Distressed debt involves investment in corporate bonds, bank debt, and occasionally common and preferred stock of companies in distress. When a company is unable to meet its financial obligations, or is in a liquidity crisis, its debt is devalued. Distressed debt funds use fundamental analysis to identify undervalued investments. Hedge funds that invest in distressed debt need to employ more stringent lock-up and withdrawal terms, including side pockets (accounts to separate illiquid assets). A fund sponsor looking to form a distressed debt fund should speak with a hedge fund attorney to determine whether a private equity fund would be more appropriate. Unlike hedge funds, which allow regular withdrawals, private equity funds are usually closed-ended and have a finite duration, usually between five and ten years.

ii. Fixed Income

Fixed income funds invest in long-term government, bank and corporate bonds, debentures, convertible notes and capital notes, and their derivatives, which pay a fixed rate of interest. Many fixed income funds have lower risk tolerances than distressed debt funds and place capital preservation as a higher priority, leading to more diversification and volatility-reducing strategies. A common fixed income hedge fund strategy is fixed income arbitrage, discussed below.

C. Arbitrage

Arbitrage strategies seek to exploit observable price differences between closely-related investments by simultaneously purchasing and selling related investments, while minimizing volatility. When properly used, arbitrage strategies produce consistent returns with relatively low risk. However, because price inefficiencies between investments tend to be slight, arbitrage funds must rely heavily on leverage to obtain substantial returns.

Due to heavy use of leverage, some arbitrage firms have suffered monumental losses when pricing differences unexpectedly shifted. For example, Long Term Capital Management, the infamous fixed income arbitrage fund from the 1990s that suffered catastrophic losses and had to be bailed out by a government-brokered consortium of Wall-Street banks.

i. Fixed Income Arbitrage

Fixed income arbitrage seeks to exploit pricing differences in fixed income securities, most commonly by taking various opposing positions in inefficiently priced bonds or their derivatives, with the expectation that prices will revert to their true value over time. Common fixed income arbitrage strategies include swap-spread arbitrage, yield curve arbitrage and capital structure arbitrage. The fictitious fund used for the model hedge fund PPM excerpt in Part III of this book is based on a fixed income arbitrage strategy.

ii. Convertible Arbitrage

Convertible arbitrage seeks to profit from price inefficiencies of a company's convertible securities relative to its stock. At its most basic level, convertible arbitrage involves taking long positions in a company's convertible securities while simultaneously taking a short position in a company's common stock. Although simple in theory, proper execution of convertible arbitrage strategies requires careful timing to avoid losses. Furthermore, the increasing popularity of convertible arbitrage has had the effect of diminishing available price inefficiencies, making it difficult to achieve significant returns without using extensive leverage.

iii. Relative Value Arbitrage

Relative value arbitrage, or "pairs trading" involves taking advantage of perceived price discrepancies between highly correlated investments, including stocks, options, commodities, and currencies. A pure relative value arbitrage strategy involves high risk and requires extensive expertise.

iv. Merger Arbitrage

Merger arbitrage involves taking opposing positions in two merging companies to take advantage of the price inefficiencies that occur before and after a merger. Upon the announcement of a merger, the stock price of the target company typically rises and the stock price of the acquiring company typically falls. Merger arbitrage is a form of event-driven hedge fund strategy, discussed below.

D. Event-Driven

Event-driven strategies are closely related to arbitrage strategies, seeking to exploit pricing inflation and deflation that occurs in response to specific corporate events, including mergers and takeovers, reorganizations, restructuring, asset sales, spin-offs, liquidations, bankruptcy and other events creating inefficient stock pricing. Event-driven strategies require expertise in fundamental modeling and analysis of corporate events. Examples of event-driven strategies include: merger arbitrage, risk arbitrage, distressed debt, and event-based capital structure arbitrage.

E. Quantitative (Black Box)

Quantitative hedge fund strategies rely on quantitative analysis to make investment decisions. Such hedge fund strategies typically utilize technology-based algorithmic modeling to achieve desired investment objectives. Quantitative strategies are often referred to as "black box" funds, since investors usually have limited access to investment strategy specifics. Funds that rely on quantitative technologies take extensive precautions to protect proprietary programs.

F. Global Macro

Global macro refers to the general investment strategy of making investment decisions based on broad political and economic outlooks of various countries. Global macro strategy involves both directional analysis, which seeks to predict the rise or decline of a country's economy, as well as relative analysis, evaluating economic trends relative to each other.

Global macro funds are not confined to any specific investment vehicle or asset class, and can include investment in equity, debt, commodities, futures, currencies, real estate and other assets in various countries. Currency traders rely heavily on global macro strategies to forecast relative currency values. Likewise, interest rate portfolio managers, who trade instruments that are keyed into sovereign debt markets are heavily involved with global macro fundamental analysis.

G. Multi-Strategy

Multi-strategy funds are not confined to a single investment strategy or objective, but instead use a variety of investment strategies to achieve positive returns regardless of overall market performance. Multi-strategy funds tend to have a low risk tolerance and maintain a high priority on capital preservation. Even though multi-strategy funds have the discretion to use a variety of strategies, fund managers tend to focus primarily on one or more core investment strategies.

V. WHO CAN INVEST IN A HEDGE FUND?

There are two standards of investor suitability that may apply to investment fund investors, depending whether the fund manager is required to be registered as an investment adviser: (i) the "accredited investor" standard; or (ii) the significantly higher "qualified client" standard.

A. The Accredited Investor Standard

Even in states where hedge fund managers at a given level of assets under management are not required to register as an RIA, all U.S. investors must at least be accredited investors. States that do not require registration as an RIA include New York, California, Connecticut, Georgia, Florida, Pennsylvania and many other (principally Eastern) states. However, all U.S. investors should at least be accredited investors.

The accredited investor standard is the investment suitability standard under Regulation D, the safe-harbor exemption from registration under the Securities Act for private securities offerings. An accredited investor is an investor that meets either the net worth or income test established by the SEC.

i. The Net Worth Test

For individuals, the investor must be a natural person whose individual net worth or joint net worth with his or her spouse, exceeds $1 million. Net worth means the excess of total assets (excluding a principal residence) at fair market value minus total liabilities. An entity or trust investor must have a minimum net worth of $5,000,000.

ii. The Income Test

Alternatively, an accredited investor can also be a natural person who has 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.

B. The Qualified Client Standard

Hedge fund managers that are subject to federal or state investment adviser registration may only receive performance based compensation from "qualified clients"; a qualified client generally includes:

- (i) an individual that has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million at the time the contract is entered into, exclusive of primary residence; or
- (ii) an individual with at least $1 million under management of the investment adviser.

C. Principals of the Fund

Executive officers, directors, and general partners of the fund, by their position and responsibilities, can qualify as accredited investors and qualified clients without meeting the income or net worth requirements.

VI. MARKETING A HEDGE FUND

A. Seed Raise

Typically, the starting point for finding seed investors is direct contacts of the fund's directors, managers, officers, or employees. These individuals can raise investments 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, or other specified self-regulating agency. Further, the company should be aware of the SEC's bad actor disqualification for individuals that have been expelled or suspended from membership of any self-regulatory organization, or have been convicted of securities violations. Should the company have any concerns that an associated person might fail one or more of the above provisions, it is strongly urged you speak with our firm before proceeding.

B. Using Intermediaries to Raise Capital

After the initial seed raise, many funds find it advantageous to raise capital through suitable intermediaries. When using intermediaries, a fund must (unless conducting a Rule 506(c) offering, which allows advertising) ensure that the intermediaries follow the rules requiring substantive pre-existing relationships with any prospective investors, and avoid advertising and solicitation. Intermediary violations of securities rules and regulations can subject the fund to the same liabilities as if the fund had committed the violations.

C. Broker-Dealer Placement Agents

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 will agree to participate as a placement agent, it will perform a due diligence review of the fund to establish that the fund meets the risk profile of the broker-dealer and its insurer.

D. Finders

The use of individuals not registered as broker-dealers as intermediaries (so called "finders") is allowed only in an extremely narrow set of circumstances. Generally, providing transaction-based compensation to a finder for selling securities is illegal, although it remains a common practice. The SEC has noted the widespread use of finders and as a result has increased its enforcement against unregistered individuals and imposed liability for noncompliance.

Concurrently, the SEC has also intensified its enforcement actions against issuers and the officers or directors of the issuers who employ finders in violation of SEC regulations. Because engaging finders can subject a fund and its management to significant liability, we strongly recommend that finders be avoided. If you have specific questions on the use of finders, please call our office to discuss your specific circumstances.

E. General Advertising

For decades, federal and state securities regulations have contained a general prohibition against an issuer or its agents using general 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.

For most hedge fund offerings, that prohibition is still in place, and fund managers should insure that when raising capital, no advertising is conducted. Further, fund managers need to be cautious that the fund manager or its agent has a substantive pre-existing business or personal relationship with a potential investor prior to discussing the offering. However, a recent regulatory development has paved the way for hedge funds to engage in advertising, although much is still unknown about potential risks and implications of relying on the new regulatory structure.

i. The JOBS Act Allows Advertising for Certain Offerings

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

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, hedge 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.

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

Under the newly adopted Rule 506(c), a hedge 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); and
- the fund takes "reasonable steps" to verify that investors are accredited.

a. 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.

b. 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.

c. 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. These changes are briefly summarized as follows:

- the federal Form D, which is presently required to be filed 15 days after the first sale of securities, would need to be filed 15 days before engaging in advertising; and
- written solicitation materials would need to be submitted to the SEC by the first day they are used and would be required to bear specified legends and disclosures.

d. Advertising Must Not Be Misleading.

State and federal law against misleading statements or material omissions are unchanged by this rule change. The standard for what constitutes a "misleading statement" in a securities offering is much stricter than the general standard for misleading advertising. Even a seemingly innocent mistake in wording could have serious consequences. A securities attorney should review all marketing and advertising material.

e. No Other Offerings Affected.

Note that this rule affects only offerings under Rule 506 that are sold exclusively to accredited investors. No other offerings are affected and the ban against advertising will remain in place.

VII. BEGINNING WITH AN INCUBATOR FUND

For managers without ready access to initial investors, an incubator fund provides a cost effective way to begin building a marketable performance record using the managers' personal funds. An incubator fund allows a fund manager to fine-tune its trading strategy while creating a marketable track record. Incubator funds typically remain in place from three to twelve months, during which time the managers can contemporaneously prepare for any applicable FINRA examinations, file for regulatory registrations, prepare the fund's marketing documents, website, and work with legal counsel to prepare the fund's offering documents.

A. Why an Incubator Fund?

Trading in a startup hedge fund involves different strategies than trading as part of an organization. Securities laws make it difficult for a manager to use prior performance figures to promote a new fund. The concept of "cherry picking" discourages a manager from disclosing certain personal performance while omitting others. The incubator fund allows a manager to show actual performance in the same entity structure that will eventually be used for the fund vehicle.

i. Structure

An incubator fund is an investment fund structure comprised of a limited partnership as the fund entity and an LLC as the management company entity. The same entities will eventually be used for the hedge fund. Unlike a full hedge fund, an incubator fund does not include the securities offering documents and regulatory filings necessary to sell to outside investors.

ii. Minimal Regulatory Requirements

Because an incubator fund does not have outside investors, it is generally not subject to many of the regulatory and filing requirements required by federal and state law, such as investment advisor registration, commodities registration and Form D filing. However, a manager should check with a hedge fund attorney prior to concluding which regulatory requirements must be satisfied.

iii. Cost

An incubator fund significantly reduces start-up capital risk while the strategy is tested. The cost to form an incubator fund is considerably lower than the cost to form a hedge fund. The incubator fund can be easily transitioned to a full hedge fund once the fund sponsors have established a performance record (usually between three to twelve months).Since an incubator fund formation involves some of the work that will be performed in forming the hedge fund, our firm offsets the cost of the incubator fund against the subsequent preparation of the full hedge fund formation documents.

B. Self-Funded

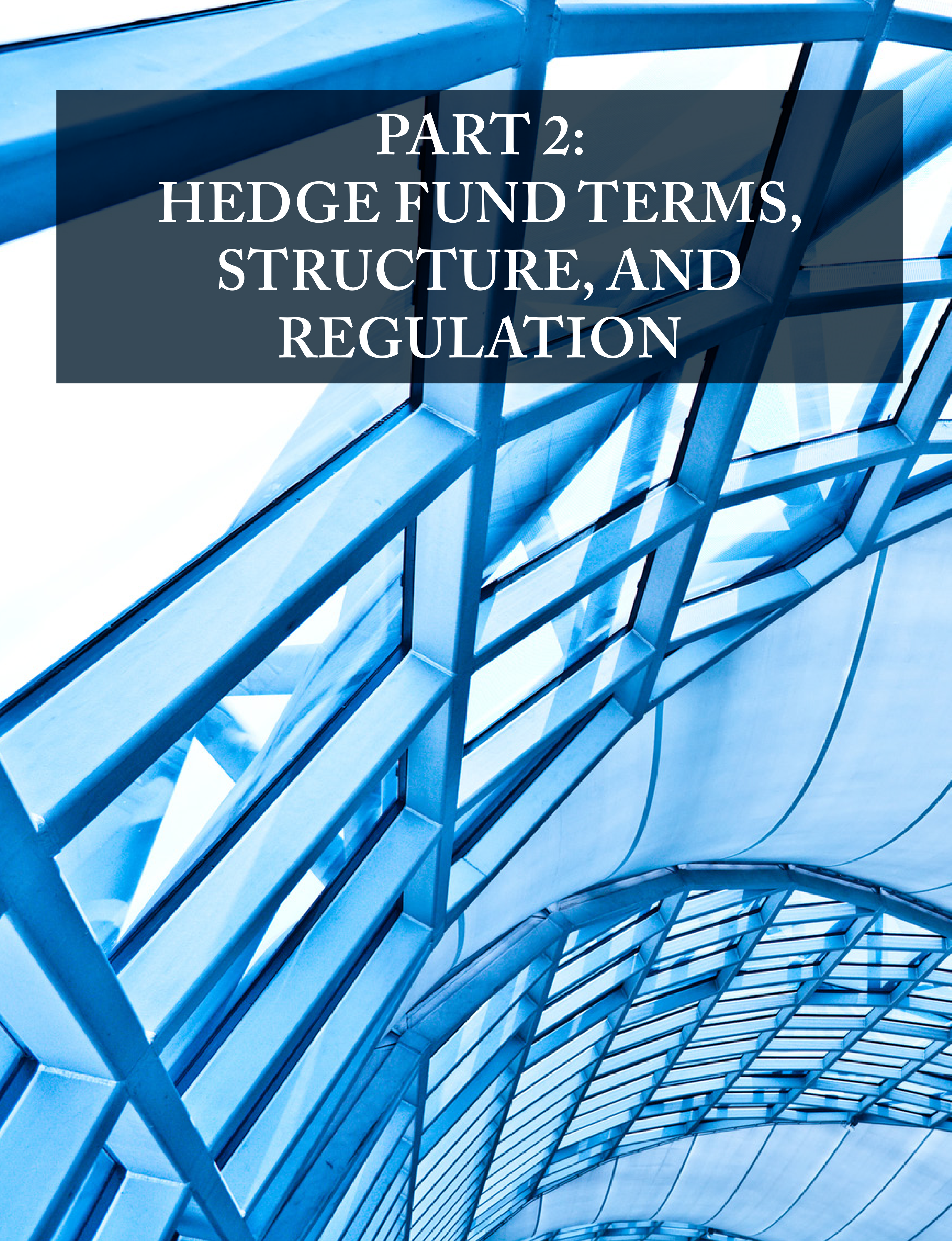
With very few exceptions, the incubator fund should not accept outside investors. Even investment from close friends and family can run afoul of state and federal securities law. Likewise, a sponsor should not borrow capital from others to invest in the incubator fund. You should consult a hedge fund attorney prior to accepting any outside funds from any source.

C. How is an Incubator Fund Taxed?

An incubator fund is generally set up using a pass-through fund entity (typically a Delaware limited partnership). The fund's realized income and gains are only taxed at the individual level. Tax gains and loss pass through to an investor's tax return. Items on Schedule K-1 retain their tax character for the manager.

D. Transition to a Full Hedge Fund

To transition to a hedge fund, legal counsel will assist the fund managers in the preparation of formal offering documents. Will include a private offering memorandum, partnership agreement, and subscription documents, as well as the necessary regulatory filings and applicable registrations.



PART 2: HEDGE FUND TERMS, STRUCTURE, AND REGULATION

VIII. COMMON HEDGE FUND TERMS

As part of the hedge fund formation process, the fund manager works closely with the fund legal counsel to craft the terms to which the fund and its investors will be bound. When properly structured, hedge fund offering documents contain terms that adequately protect the fund sponsor and are attractive to investors. Hedge fund terms are driven by the market trends within the fund's specific strategy, asset class and the particular needs and objectives of the fund.

The following is a brief summary of some of the most common hedge fund terms.

A. Hedge Fund Manager Compensation

Hedge fund manager compensation typically consists of: (a) an annual management fee; and (b) a performance allocation, also referred to as incentive allocation, or carried interest. The latter is not technically a "fee," but rather a capital allocation, as will be discussed below.

i. Management Fees

A management fee is assessed annually, typically ranging from 1% to 2%, of the aggregate assets under management of a fund, regardless of the fund's performance. The management fee is intended to cover manager salaries and general overhead. The management fee is deducted from each investor's account periodically (usually in advance) as set forth in the offering documents.

Prior to 2008, a 2% management fee was standard for most funds, with some funds charging up to 3%. Following the economic contraction, there was a general trend to significantly lower management fees, and rely more heavily on performance allocations, where compensation is earned only when funds perform in positive territory. In recent years we have seen the management fees creep back up to the 1.5% to 2% range. Emerging funds seeking to entice investors often elect to initially maintain a low management fee or to forgo it entirely until the fund has shown proven success.

ii. Performance Allocation

The performance allocation is one of the defining characteristics of hedge funds and private equity funds and distinguishes them from mutual funds, which charge only a management fee. A performance allocation is a percentage of the increase in the value of the fund assets (usually around 20%) allocated to the fund's general partner as an incentive for positive performance. The performance allocation is intended to align the interests of the fund manager with those of the investor and provide significant upside potential for fund managers. As with the management fee, there is variance among funds in the percentage charged. It can range from 10% to 50% depending on the fund's structure and performance, but are typically from 15% to 30%.

iii. Tax Advantages of the Performance Allocation

As mentioned above, the performance allocation is not designated as a "fee," but rather a "capital reallocation of the profits" of the fund, which, if permitted by the offering documents, can be drawn by the manager at the manager's discretion or at regular intervals. The distinction is for tax purposes. A fee is compensation for services rendered. For a fund manager, the investment management fee is always subject to ordinary income rates and is considered self-employment income and subject to FICA taxes (in addition to the Unincorporated Business Tax for fund managers located in New York City).

When properly structured, a performance allocation is not considered a "fee," but a reallocation of partnership profits from an investor's capital account to the general partner's capital account. In other words, the investors are never allocated the 20% profit allocation, and the amount is treated as profit allocated directly to the fund's general partner. Where the fund holds positions longer than one year, the performance allocation can result in long-term capital gains treatment. Where the fund holds short-term investments, the allocation would be considered short-term capital gains (which is the same as ordinary income). However, short-term capital gains are not considered self-employment income and with certain exceptions are not subject to Social Security taxes.

iv. High Water Marks

To prevent a manager from receiving duplicate performance compensation following periods of volatility, most funds allow investors to recoup past losses before the fund manager is entitled to receive additional performance compensation.

To accomplish this, a high water mark is established immediately following the allocation of incentive compensation. Under the "loss carry forward" terms, fund management is only entitled to be compensated for performance that exceeds the prior "high water mark."

B. Hurdle Rates

Some funds require the investment manager to achieve a certain level of return, either as a fixed percentage or a benchmark rate (such as LIBOR or the S&P 500) before managers are entitled to receive performance compensation. Hurdle rates can be either a "hard hurdle" or "soft hurdle."

A hard hurdle means that the manager only receives performance compensation that exceeds the hurdle rate. A soft hurdle means that no performance compensation is received if performance falls short of the soft hurdle rate, but once the soft hurdle rate is exceeded, the manager is entitled to the entire performance compensation.

C. Contribution & Withdrawal

Contribution and withdrawal provisions are among the most important terms of the fund offering. Provisions vary significantly from one fund to another to meet the needs of a given fund's strategy and investor base.

i. Minimum Initial Contributions

Hedge fund offering documents typically contain minimum investment thresholds as a condition to investment. Each additional investor adds an administrative burden and a degree of liability to the fund. Additionally, the number of investors allowed in any given fund is finite. In a 3(c)(1) fund the number of investors is currently limited to 100 investors.

Generally the investment minimum amounts are set in the discretion of the fund manager. Note however, that funds organized under the laws of the Cayman Islands require a statutory minimum initial investor contribution of $100,000. We generally recommend setting a minimum between $100,000 and $250,000 for most funds (with manager discretion to accept lesser amounts).

ii. Lock-up Period

It is typical for a hedge fund to require an initial lock-up period of one year or more, before investors can withdraw invested funds, after which quarterly or semi-annual redemption is allowed. The lock-up period can be shortened or lengthened depending on the fund's investment strategy. Lock-ups usually range from six months to two years.

If a fund strategy involves fairly illiquid investments, such that a one to two year lock-up period is insufficient, the sponsor should consider a closed-end private equity fund.

iii. Gates

To prevent funds from being forced to inconveniently liquidate investment positions to satisfy large redemption requests, many hedge funds limit the percentage of the portfolio that can be withdrawn in any given redemption period (often 10%-25%). This is known as a gate. In 2008-2009 a large number of funds invoked gate provisions to prevent being forced to sell assets at unfavorable terms.

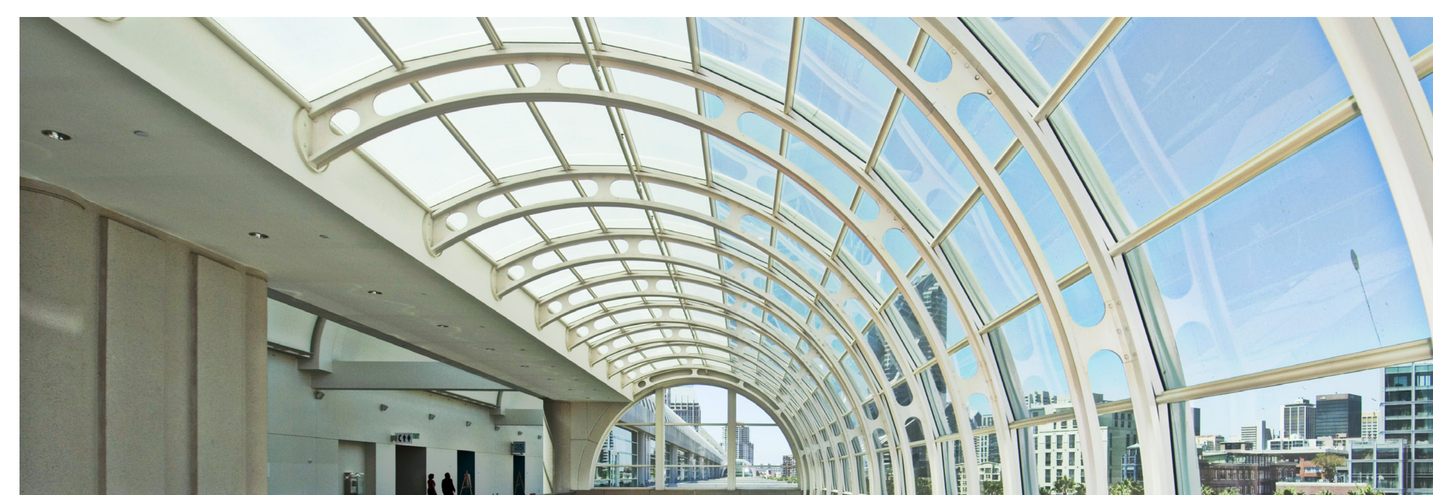
D. Fund Expenses

During the formation process the fund sponsor designates which of the expenses of the fund will be borne by the manager and which will be borne by the fund.

Typically, the fund bears expenses directly related to forming and operating the fund, including: legal formation costs, accounting and administrative services, regulatory filings, brokerage costs, clearing costs, etc. Note that most funds amortize startup costs over a 60 month period, to prevent early investors from being unfairly impacted, even though it is not in alignment with GAAP.

E. Side Letters

Most offering documents allow the management team to negotiate special terms (known as side letters) that are not applicable to other investors. Often the special arrangement involves better economic terms, such as reduced management or performance fees, or more convenient withdrawal terms. Care must be taken, however, not to allow side letters to prejudice other investors. For example, side letters that provide additional information rights or preferential liquidity treatment should be avoided.



IX. HEDGE FUND STRUCTURE AND JURISDICTION

The structure of a hedge fund is dependent on a number of tax, regulatory, and financial considerations. Fund structure is also driven in large part by the fund's strategy, such as the degree of liquidity of the portfolio investments. The fund structure should be based on careful and thorough analysis with assistance of an experienced fund attorney.

A. Open vs. Closed-End Fund Structures

A closed-end fund is an investment fund intended to last for a fixed term, usually between five and ten years. Investors in a closed-end fund are generally not permitted to make withdrawals or additional capital contributions during the life of the fund. Most private equity funds, venture capital funds, real estate funds and other funds investing in illiquid assets are structured as closed-end funds. Most hedge funds, on the other hand, invest primarily in liquid assets, and are structured as open-end funds, allowing investors to make periodic redemptions and contributions (subject to limitations in the fund's offering documents).

Closed-end funds typically have a fixed duration (usually from five to ten years) and do not allow early redemptions. Rather, investors are redeemed on a pro-rata basis upon the sale of assets and liquidation of the fund. Additionally, closed end funds typically require investors to make a legal commitment to invest in the fund (a capital commitment) at a future date when the fund managers are ready to deploy committed capital (a capital call).

In contrast, most open-end funds require immediately deployable funds (or in-kind asset contributions). Closed-end funds typically use a distribution waterfall detailing how funds will be distributed when portfolio investments are sold. For example, an investor typically will receive his or her initial investment plus a specified preferred return before the fund manager receives distributions.

B. 3(c)(1) Funds vs. 3(c)(7) Funds

The Investment Company Act of 1940 generally requires investment companies to register with the SEC. Hedge funds can be structured under one of two exemptions from registration under the Investment Company Act of 1940. Section 3(c)(1) allows a fund to have up to 100 investors. Section 3(c)(7) allows a fund to have up to 2,000 investors, but requires a significantly higher net worth suitability requirement for each investor.

i. 3(c)(1) Funds

A 3(c)(1) fund is limited to 100 investors, all of which should be "accredited investors" pursuant to Regulation D. An Accredited investor (if an individual) must have either (i) a minimum of $1 million net worth or (ii) $200,000 annual income/$300,000 if combined with spouse, or (if an entity or trust) a minimum of $5 million net worth. As a general rule, most startup funds are structured as 3(c)(1) funds because of the lower investor suitability requirements.

ii. 3(c)(7) Fund

A 3(c)(7) fund must be owned by "qualified purchasers." A qualified purchaser (if an individual) must have a minimum of $5 million in net investments, or (if an entity or trust) a minimum of $25 million in net investments. Section 3(c)(7) funds may technically have unlimited investors but typically limit the number of investors to 2,000to avoid registration under the Securities Exchange Act of 1934 as a publicly traded partnership. Because of the high barrier to investment, the 3(c)(7) exemption is typically used only by established funds backed by institutional investors.

C. Domestic and Offshore Fund Structures

Another initial consideration when structuring a hedge fund is whether to form the fund domestically, offshore or both. If a fund sponsor expects to have only U.S. investors, a domestic entity is sufficient. However, if a sponsor anticipates significant participation by offshore investors or U.S. tax-exempt investors (IRAs, pension plans, endowments, etc.) an appropriate offshore fund will be needed to shield such investors from U.S. tax liability.

i. Domestic Fund Structure

A domestic-only hedge fund structure is typically comprised of the following entities:

- A limited partnership to act as the fund entity (although LLCs are becoming increasingly popular). The fund entity is formed in the state of Delaware.
- An LLC to act as the investment manager and general partner (GP) of the fund (managing member in the case of an LLC). The investment manager/GP entity is typically formed in the jurisdiction of the fund sponsor. In some cases the general partner and the investment manager are formed as two separate entities, such as when multiple funds are contemplated, or if the fund will be managed in New York City (for local tax reasons).

Investors become limited partners of the fund and all the trading activity of the fund takes place within the fund entity. The management fees and performance compensation are paid to the investment manager/GP, which is owned by the fund sponsors.

ii. Offshore Fund Structures

When properly structured, an offshore fund structure blocks offshore and tax-exempt U.S. investors from direct U.S. tax liability. The most common offshore fund structures are the master-feeder structure and the side-by-side structure.

a. Master-Feeder Fund

A master feeder structure consists of a domestic feeder fund and an offshore feeder fund (in a tax-free jurisdiction) that feed into a single offshore master fund, where all the trading activity of the fund takes place.

b. Parallel Fund Structure

A side-by-side structure has a U.S. fund and offshore fund that parallel each other in trading and have the same investment manager but maintain separate investment portfolios.

D. Offshore Jurisdiction

Once the structure of the offshore fund has been determined, the next step is choosing an offshore jurisdiction. While hedge funds can be formed in a number of reputable jurisdictions, the most common jurisdictions are the Cayman Islands and the British Virgin Islands (BVI).

i. Cayman Islands

The Cayman Islands has historically been the top choice for offshore funds because of its business friendly structure, stable government and well developed investment laws. Cayman Islands is a tax-exempt jurisdiction, allowing offshore investors and U.S. tax-exempt investors (that would otherwise be subject to UBTI taxes) to avoid paying US taxes on investment gains. The Cayman Islands is the world leader as a jurisdiction for hedge fund domicile.

ii. British Virgin Islands (BVI)

BVI is a popular jurisdiction for offshore hedge funds and other private funds. BVI has recently gained the reputation as being a cost-effective and convenient jurisdiction. BVI's regulatory structure has sought to create a flexible jurisdiction with streamlined processes and strong legal certainty. BVI's regulatory filing fees are considerably lower than those of the Cayman Islands and does not require a country-specific audit, as does the Cayman Islands.

X. PROPERLY SECURING A REGULATION D EXEMPTION

Selling a hedge fund investment is a sale of securities, and as such, the fund must obtain an exemption from SEC and state registration. The Securities Act of 1933, often referred to as the "Securities Act" is a federal statute that governs securities at issuance to ensure that investors can make informed decisions about investments. This act establishes laws against misrepresentation and fraudulent activities in the securities market. Section 5 of the Securities Act requires that all non-exempt securities issuances be registered with the SEC.

Regulation D contains safe harbor provisions that provide exemptions for securities issuers (including hedge funds) from federal registration. These include exemptions under Rule 504, Rule 505, and Rule 506. Rule 506 is the most commonly relied upon exemption in private offerings, accounting for more than 90% of offerings, according to SEC statistics, and the only exemption that a hedge fund should typically consider.

A. Rule 506 Exemption

Rule 506 is governed by Section 4(a)(2) of the Securities Act of 1933 (the "Securities Act"). It permits a company to offer securities to an unlimited number of accredited investors and up to 35 unaccredited investors. It is strongly discouraged for a fund to have even one unaccredited investor, because of the significantly increased liability.

i. Federal Preemption Over State Law

Rule 506 is unique among the Regulation D exemptions, in that with a properly prepared Regulation D offering, there is no need to register at the state level or find any state exemption. Congress has specifically preempted states' authority to review securities exempted under Rule 506 or impose additional requirements through the National Securities Markets Improvement Act of 1996 (NSMIA). The NSMIA effectively took away the states' power to review an offering under Rule 506. States may only require that issuers submit a notice filing with the state and impose filing fees, typically between $200 – $700 per state.

ii. Reduced Risk of Losing the Exemption

Additionally, if an offering under Rule 506 is made to only accredited investors, the company making the offering will not lose its exemption from failure to make any prescribed disclosures as could be the case with other exemptions. A private placement memorandum should be drafted carefully to protect the company from violations of the "anti-fraud" provisions under the Securities Act and the Exchange Act as well as state securities laws.

iii. Advertising

Recently, the SEC adopted final rules lifting the ban on general solicitation and advertising under Rule 506 for offerings in which the issuers took reasonable steps to verify that all purchasers of its securities qualified as accredited investors. This is now known as Rule 506(c), Non-advertised offerings are designated as Rule 506(b) offerings. Allowing advertisement in exempt private offerings is a major shift in the regulatory system, and presents opportunities to issuers never before available. However, the new regulations (as well as additional proposed regulations) require additional burdens on issuers, which should be carefully considered.

B. State Exemptions

In addition to the federal exemptions, state securities laws, also known as Blue Sky Laws, require funds to either register their securities or find an applicable exemption. States may not impose additional registration requirements with respect to an offering relying on Rule 506 for federal and state exemption other than to require a notice of Form D and a filing fee.

C. Form D Filing

Form D is a federal notice of an exempt securities offering that is filed with the SEC when relying on Regulation D for an exempt offering. This document discloses biographical information about the fund and the managers. Form D is not subject to a review or approval by the SEC, but is a required notification document, and must be filed within 15 days of the first sale to investors and if the offering is ongoing, the Form D must be filed again in one year.

A Form D must be filed each subsequent year while the offering remains open. The fund must also disclose any sales compensation that has or will be paid directly or indirectly in connection with the sale of securities. Our firm offers issuers assistance in preparing and filing Form Ds as part of our flat fee services.

ii. State Requirements

In addition to the federal Form D requirements, individual states require Form D notification filings. Note that the state of Florida does not currently require any notice filing. Each state's requirements differ on the content requirements of the required notice-filing. Most states require the notice-filing to be made within fifteen days after a resident of the state makes an investment. Note that New York requires that the notice-filing be made prior to any offer of securities within the state.

XI. INVESTMENT ADVISOR REGISTRATION

A. Requirements for investment advisor registration

Not all hedge funds are subject to investment advisor registration. To determine whether a fund needs to register, we ask our clients the following four questions:

(i.) Will the fund invest in "securities?"

(ii.) What will be the size of the fund?

(iii.) In what state will the fund management team physically located?

(iv.) In what states will the investors be located?

i. Will the fund invest in "securities?"

Only funds that invest in securities are required to register as an investment advisors. Funds that invest only in commodities, futures, currencies, real estate investments, or certain private equity investments, would not be subject to investment advisor registration.

The definition of a "security" is very expansive, and covers a broad range of investment instruments, schemes and structures. Consult with an experienced securities attorney before concluding that a fund does not invest in securities.

ii. What will be the size of the fund?

A securities hedge fund manager that manages over $150 million is automatically required to register as an investment advisor with the SEC. All other managers are subject to state regulation and, depending on the state, may be subject to registration.

iii. In what state is the hedge fund management team physically located?

In most states, a hedge fund that invests in securities and has less than $150 million under management must register as a state investment advisor in the state where the primary operations of the fund manager are located (note that establishing a business in a state other than where the managers are physically located will have no effect on jurisdiction).

Several states, including California, New York, New Jersey, Connecticut, Georgia, Florida, and many other (primarily Eastern states) recognize an exemption from registration for managers that solely advise private funds. At the outset, hedge funds in these jurisdictions are exempt from registration both at the SEC and state level. Note that managers that advise only venture capital funds, regardless the state of domicile, are generally exempt from state or federal RIA registration.

Note that once a fund in one of these jurisdictions passes the $25 million threshold, it will be required to file a truncated registration with the SEC, which entails much lighter disclosure than full registration, and once a fund passes $150 million in assets under management it will be required to be fully registered with the SEC.

Funds that are subject to SEC or state registration can only accept performance compensation from "Qualified Clients," while funds that are not subject to advisor registration may (subject to limitations) accept investments from only "Accredited Investors." See Chapter V*: Who Can Invest in a Hedge Fund* for a description of the accredited investor and qualified client standards.

iv. In what states will the investors be located?

Many states require hedge fund investment managers to register in the state once a certain threshold of investors has been reached (usually five). In many states, this will only be triggered if an investment manager is required to register its own state. Consult a hedge fund attorney to understand your registration obligations in any given state.

B. Investment Advisor Representatives.

In addition to registration of the RIA firm, require each individual performing advisory services on behalf of an RIA must register as an investment advisor representative. Most states require advisor representatives to submit a Uniform Application for Securities Industry Registration or Transfer (U-4), containing specific background information about the advisor representative.

C. Series 65 Examination

Most states require advisor representatives to pass the Series 65 examination (or an equivalent examination combination or professional designation). The Series 65 examination is a 130 question multiple choice test administered by FINRA covering topics such as: securities regulations, ethical guidelines, security products, methods for evaluating securities, securities trading strategies, principals of economics, and others.

D. Documents Required for Registration

The first step in the registration process is setting up accounts with the Investment Advisor Registration Depository (the "IARD"), and WebCD. Upon receiving the necessary login information (known as the entitlement package) investment counsel can begin to prepare the necessary registration documents.

i. ADV Parts 1 and 2

The principal component of federal or state registration is the Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers (ADV). The ADV has two parts: Part 1 requires disclosure regarding the business operations of the advisor and background information about the controlling individuals. Part 2 is a written disclosure statement discussing the services to be rendered, fees imposed, conflicts of interest, and other information that is material to investors. Part 2 must be given to investors and potential investors and must be updated annually (or more frequently if the RIA makes material changes).

a. Form ADV Part 1

As previously noted, Form ADV Part 1 requires disclosure regarding the business operations of the advisor and background information about the controlling individuals. Form ADV Part 1 is further subdivided into two subparts: Part 1A and Part 1B. Part 1A is used for both SEC and state registrations. Part 1B is used only for state registrations. Form ADV part 1 must be filed online through the FINRA system as part of the investment advisor registration process.

1. ADV Part 1A

Part 1A is a 46 page document consisting of twelve sections, three schedules, and a disciplinary reporting

page. ADV Part 1A contains the following: (1) general background information about the investment advisor, its owners, and officers; (2) discussion about business practices, including services provided and fees to be charged; (3) other activities of the investment advisor; and (4) certain disclosures about civil, criminal or other actions against the investment advisor, its owners, and officers. The information in these sections is supplemented by the schedules and disciplinary reporting page.

There are three schedules in Part 1A of Form ADV, called Schedules A, B, and D. Schedule A lists all direct owners of the investment advisor with an ownership interest of at least 5% and information about certain executive officers or individuals performing similar functions. Schedule B lists all indirect owners of investment advisor with an ownership interest of at least 25%. Schedule D lists various miscellaneous information about the investment advisor such as information about the investment advisor's website, affiliated organizations, wrap fee programs, and location of records.

2. ADV Part 1B

Part 1B of Form ADV is an eleven page document used for investment advisors registering with specific states and not the SEC. It requests information about the states of registration, the individual in charge of supervision and compliance, proof of bonding, and outstanding judgments, liens, and investment related arbitrations.

b. ADV Part 2

Part 2 of Form ADV is a written disclosure statement required for federal and state investment advisor registration. It is further divided into two subparts. Part 2A is commonly referred to as the Firm Brochure, while Part 2B is referred to as the Brochure Firm Supplement. Federal registration requires investment advisor applicants to prepare only a Firm Brochure; while state registrations generally require applicants to prepare both the Firm Brochure and the Firm Supplement.

1. Firm Brochure (Part 2A)

The Firm Brochure discloses specific information about an investment advisor and must be written in a narrative format and in plain English. It is composed of numerous section headings, in which an investment advisor discloses information including: (1) the advisory services of the firm; (2) fees and compensation that the firm charges for its services; (3) types of clients of the firm; (4) code of ethics and personal trading; (5) brokerage practices; (6) custody of funds and investment discretion; and (7) financial information about the firm. State registrations and investment advisors must also disclose certain state required information in additional sections.

The Firm Brochure is considered a public document that will be published with the Investment Advisor Public Disclosure (the "IAPD"). It also must be provided to clients either prior to or at the time that the client enters into an investment advisory agreement with the investment advisor. Therefore, it must be carefully drafted to conform to the specific requirements of federal and state regulators.

Failure to provide proper disclosures and other required information can result in rejection of an investment advisor's application. Additionally, if the Firm Brochure contains false or misleading information, its publication can result in criminal or civil liability against the investment advisor, its owners, and officers. After initial registration, the Firm Brochure must be amended annually or at any time that the included information becomes materially inaccurate.

2. Brochure Supplement (Part 2B)

The brochure supplement is required only for registration with certain states and not the SEC. It requests information in narrative format discussing additional background information about the firm and the individual advisor representatives, as required by the states.

Investment advisor registration requires disclosure in compliance with complex state and federal regulation. An RIA registration applicant should consult an experienced investment attorney to assist it in navigating the intricacies of Form ADV.

i. Code of Ethics/ Compliance Manual

The SEC requires the RIA to provide a code of ethics outlining internal policies relating to ethics matters, as well as a policies and procedures manual outlining the advisor's policies to protect investor interests and comply with advisor regulations. Some states require RIAs to submit a code of ethics, and/or compliance manual.

ii. Bonding Requirement

Most states require RIAs to provide a surety bond, in a statutory amount. The bonding requirement can also be satisfied by providing proof of net assets of a statutory amount, accompanied by audited financials. Hedge funds that have custody of client assets and as such are required to obtain a larger bond or show a higher net worth than non-custodial advisors.

iii. Ongoing RIA Compliance Obligations

Following registration, an RIA becomes subject to ongoing compliance obligations, including annual license renewals, detailed recordkeeping, ongoing investor disclosure requirements and in some cases, maintenance of compliance/ethics manuals. Investment advisors should work closely with an experienced investment management attorney to maintain compliance with its obligations.

a. Annual Renewals

SEC and state registered investment advisors are required to annually update their ADV in the form of an annual amendment. Investment advisor representatives are likewise required to renew their state or federal registration. Renewals are processed through the IARD system. An RIA or its representative that fails to timely and properly renew its registration can face significant penalties, including loss of the RIA.

b. Record Keeping

One of the most important compliance issues for investment advisors is proper record keeping. Detailed records and ledgers must be kept to document accounts, purchase and sales history, transactions, advertising and performance claims, personal transactions of advisor representatives, investor disclosure, powers of attorney, and many other advisory matters.

c. Ongoing Client Disclosure

As a fiduciary, the RIA's first duty is to act in the best interests of its clients. This involves providing full and adequate disclosure to clients on all matters involving the investment advisor relationship, including potential conflicts of interest. SEC and state regulations require advisors to provide specific disclosures to investors regarding fees, conflicts and procedures. As changes to the RIA's business occur, it must be diligent in identifying potential disclosure events and make the proper amendments. Legal counsel will then be able to make the appropriate amendments to the Form ADV Part 2 and properly revise the fund's offering documents.

d. Maintenance of Compliance/Ethics Manuals

If an RIA is required to have a compliance manual and/or ethics manual, care must be taken to observe their requirements. When specific procedures are improperly followed, the RIA has a duty to keep a record of violations and record of corrective action taken. Additionally, compliance manuals must be continuously reviewed and revised to keep them updated with current law and in line with business practices and objectives.

XII.HEDGE FUNDS INVESTING IN COMMODITIES

Any hedge fund trading in commodities, futures or swaps must comply with the Commodities Exchange Act or obtain the appropriate registration or exemption. Any hedge fund trading in commodity interests is considered a commodity pool. The sponsor of a commodity pool is a commodity pool operator (CPO) and the manager of a commodity pool is a commodity trading advisor (CTA).

A. What is a commodity Interest?

Commodity interests include: futures contracts, options on futures contracts, and, as was recently added by Dodd-Frank, swaps. Certain foreign exchange transactions are considered swaps, including cash-settled forex forwards, currency swaps, and cash-settled forex swaps. Security-based swaps are not considered a commodity interest. Note that investments in a fund that trades in commodity interests are also considered commodity interests.

B. CPO/CTA Registration

Unless an exemption applies, hedge funds that meet the above definition are required to register with the Commodity Futures Trading Commission (CFTC) as a CPO and CTA and become a member of the National Futures Association (NFA). Associated persons of a CPO/CTA are required to pass a proficiency examination. As part of the NFA membership application, hedge funds must submit offering documents to the NFA for its review and approval, as well as submitting to an annual audit.

Full CPO registration is an involved process that takes from six to eight weeks. The fund must submit Form 7-R and associated persons must submit Form 8-Rs along with fingerprints and proof of completion of the proficiency examination.

C. Streamlined Process for Funds with only "Qualified Eligible Participants"

Rule 4.7 provides relief from some of the regulatory burdens, including recordkeeping, disclosure and reporting requirements for CPOs that offer interests solely to "Qualified Eligible Participants" (QEP). The definition of a QEP is defined in Rule 4.7 of the Commodity Exchange Act and is quite complex and beyond the scope of this ebook. Please call Capital Fund Law Group to discuss the multi-prong definition of a QEP.

D. The *de minimus* Exemption

The most common exemption from commodities registration is Rule 4.13(a)(3), often referred to as the "*de minimus* exemption." Hedge funds that invest in limited commodities interests, which represents a small enough percentage of the fund's assets under management, can obtain an exemption under Rule 4.13(a)(3). To meet the *de minimus* exemption two tests must be met:

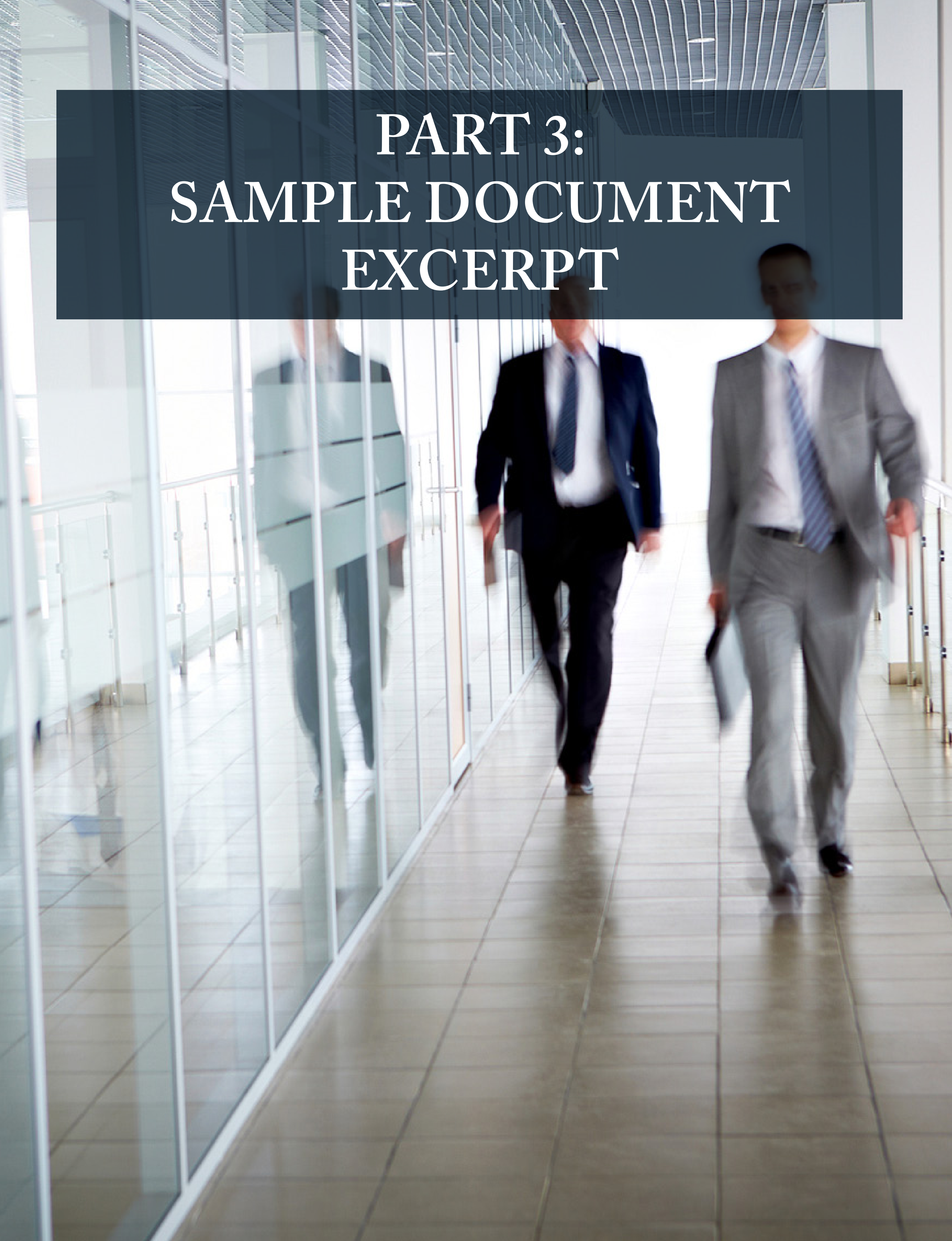
- aggregate initial margin and premiums cannot exceed 5% of the aggregate value of the fund's portfolio; and
- the aggregate net notional value cannot exceed 100% of the liquidation value.

To use the *de minimus* exemption, a fund sponsor must file a Notice of Claim for Exemption with the NFA. An affidavit confirming that the commodities interest fall within the exempt threshold must be filed yearly thereafter.

Note that the advertising and solicitation offering available under the JOBS Act and Rule 506(c) does not apply to a fund engaged in commodities investing, even if the fund is exempt under the de minimus exemption. However, in 2014, the CFTC issued an exemptive order to address this issue.

The exemptive order applies only to issuers that rely on Regulation D Rule 506(c), as well as certain Rule 144 issuers. The order permits general solicitation for Commodity Pool Operators (CPSOs) relying on the de minimus exemption. Unlike Rule 506(c), the CFTC exemption is not self-executing. To use this exemption, CFTC regulated hedge funds must file a claim for exemptive relief.

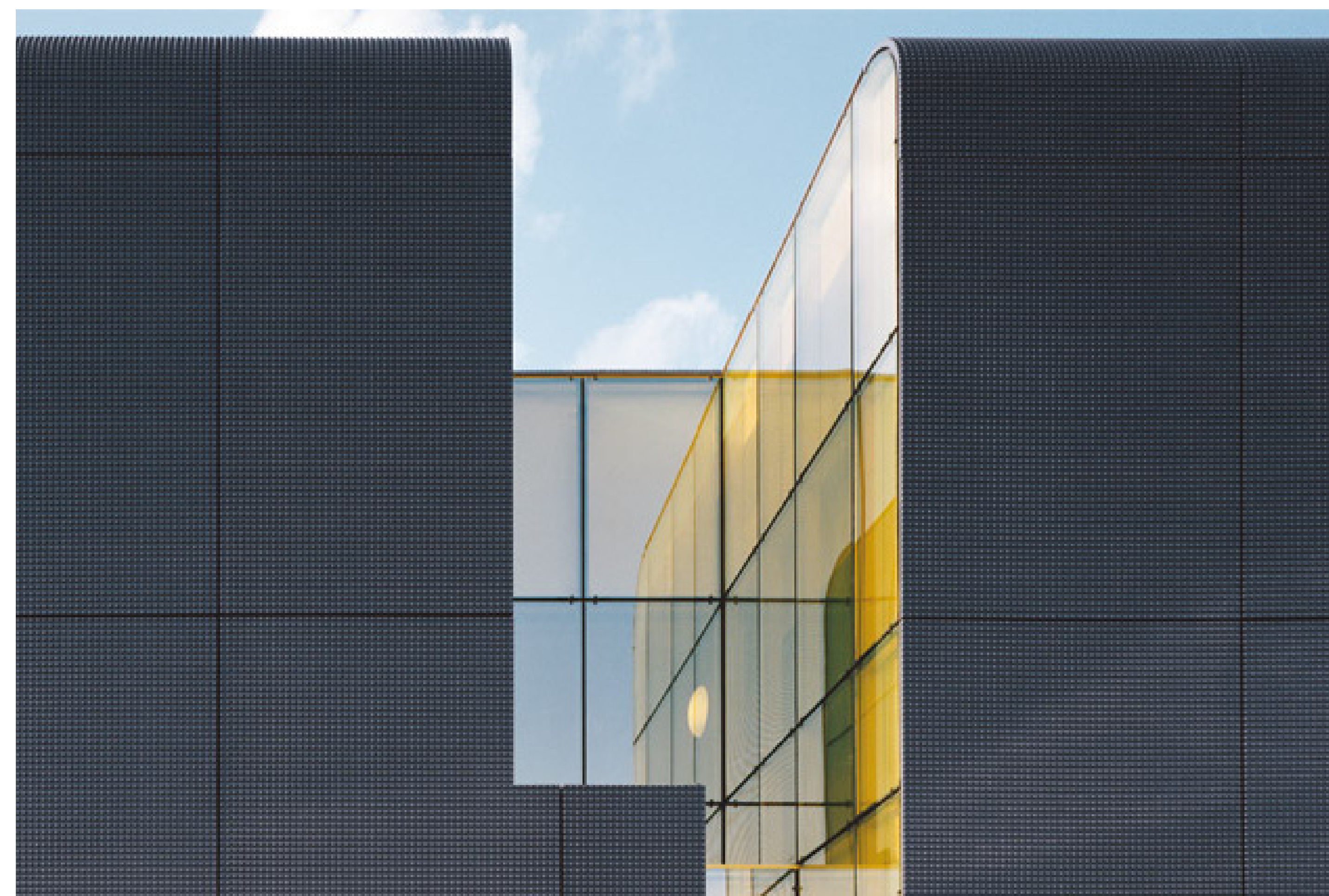
PART 3: SAMPLE DOCUMENT EXCERPT



PPM EXCERPT WITH ILLUSTRATIVE EXPLANATIONS

The Following is a concise model excerpt of a hedge fund private placement memorandum (PPM) with footnoted explanations of the PPM provisions. The PPM is based on a fictitious master-feeder hedge fund using a global fixed-income arbitrage strategy. XYZ Feeder Fund, LP is a domestic feeder fund to a Cayman Island master fund. The accompanying explanations discuss the reasons behind certain disclosure language as well as detailed examination of certain fund topics and how they apply to the disclosure document. The excerpt also provides drafting tips, best practice recommendations, potential pitfalls and common mistakes in hedge fund PPMs.

Although the XYZ Feeder Fund, LP uses a fixed-income arbitrage strategy, the explanations provide information that should be helpful to fund managers using any strategy.



Name of Offeree: ________________________________[1] Memorandum No.: ____________________[2]

CONFIDENTIAL PRIVATE PLACEMENT MEMORANDUM

PLACEMENT OF LIMITED PARTNERSHIP INTERESTS

XYZ FEEDER FUND, LP[3]

(A DELAWARE[4] LIMITED PARTNERSHIP[5])

THE LIMITED PARTNERSHIP INTERESTS IN XYZ FEEDER FUND, LP (THE "FUND"), HAVE NOT BEEN REGISTERED WITH OR RECOMMENDED BY THE SECURITIES EXCHANGE COMMISSION, ANY STATE SECURITIES COMMISSION OR ANY OTHER GOVERNMENTAL

1 Managers must carefully track the circulation of the PPM and the other fund offering documents to remain in compliance with the registration exemption under the Investment Company Act of 1940 (the "Investment Company Act") to show that the fund is not making a "public offering." Additionally, tracking circulation of offering documents is essential to satisfy New York's pre-offer Regulation D filing requirement and to satisfy potential SEC or state audits. Beyond the regulatory requirements, as a practical matter it is important to know which version of an offering document was given to which investor, as modifications are common.

Each PPM should bear the name of the intended offeree and a unique identifying number. The fund manager should maintain a spreadsheet showing the name and number of each PPM distributed, together with the date of offer, the version of the document, and a description of any written information provided to the investor.

2 As noted above, each memorandum should be numbered, preferably non-sequentially.

3 The fictitious fund in this illustrative PPM excerpt is a New-York-based feeder fund set up as a limited partnership feeding into a Cayman Islands master fund, with separate general partner and investment management company entities.

4 Domestic hedge funds are typically structured as either limited partnerships or limited liability companies (LLCs). Limited partnerships have historically been the entity of choice for most funds, although LLCs are gaining in popularity. LLC-structured hedge funds can present some complication for investors in certain states and municipalities. Most funds opt for the limited partnership structure unless there is a specific reason to use an LLC. One situation where the LLC fund is especially useful is in a multi-series fund, where multiple fund series can be created without the effort and expense of filing additional formation documents for successive funds.

5 Delaware is the most popular jurisdiction for domestic hedge fund entities. Delaware provides well-developed limited partnership laws and an investment-experienced judiciary.

OR SELF REGULATORY AGENCY. NO GOVERNMENTAL AGENCY[6], INCLUDING THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION, NOR ANY SELF-REGULATORY AGENCY HAS PASSED UPON THE ACCURACY OR ADEQUACY OF THIS CONFIDENTIAL PRIVATE PLACEMENT MEMORANDUM. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

INTERESTS IN THE FUND ARE NOT REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED ("SECURITIES ACT"), IN RELIANCE ON THE PROVISIONS OF REGULATION D UNDER THE SECURITIES ACT. THE INTERESTS ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE AND GENERALLY MAY NOT BE TRANSFERRED OR RESOLD EXCEPT AS PERMITTED UNDER THE SECURITIES ACT AND APPLICABLE STATE SECURITIES LAWS, PURSUANT TO REGISTRATION THEREUNDER OR EXEMPTION THEREFROM, AND AS PERMITTED IN THE FUND'S AGREEMENT OF LIMITED PARTNERSHIP.

INTERESTS IN THE FUND ARE NOT FREELY MARKETABLE AND INVOLVE A HIGH DEGREE OF RISK. SEE THE DISCUSSION UNDER "Certain Risk Factors" AND ELSEWHERE HEREIN.

The date of this Confidential Private Placement Memorandum is January 1, 2015.[7]

6 This required disclosure informs investors that the notice filing of a Regulation D offering does not imply that the SEC or any state has sanctioned the offering. This seeks to clarify that the filing of a Form D notice filing does not involve government approval, as in the case of a public offering. New York requires a submittal of the offering in connection with the Form D notice filing prior to making an offering in the state but does not approve or disapprove the offering. Other states will review certain hedge fund managers that are required to register as a state-regulated investment advisor. Additionally, when a broker-dealer is used as a placement agent, the offering documents must be reviewed by FINRA.

7 Generally the date of a PPM does not reflect the date that the PPM was given to an investor, but the date on which the most recent version of the PPM was finalized. When material changes occur that affect the fund or its management, such changes should be reflected in an amended PPM and the date should be modified accordingly.

INTRODUCTION

XYZ Feeder Fund, LP (the "Fund"), is a limited partnership organized under the laws of the State of Delaware on January 1, 2015. The general partner of the Fund is XYZ General Partner, LLC, a NewYork limited liability company (the "General Partner")[8] . XYZ Investment Manager, LLC is the investment manager to the Fund (the "Investment Manager").[9]

The Fund expects to invest substantially all of its assets in XYZ Master Fund Cayman Ltd. (the "Master Fund"), a business company incorporated under the laws of the Cayman Islands. XYZ OffshoreFeeder Fund Cayman Ltd. (the "Offshore Fund"), a business company incorporated under the laws of the Cayman Islands, has an investment objective and a strategy identical to the Fund, and it will alsoinvest substantially all of its assets in the Master Fund. The Offshore Fund was established to serve as an investment vehicle for investments from certain U.S. tax-exempt persons and non-U.S. persons. The Investment Manager provides investment advisory services to the Offshore Fund and the Master Fund.

8 The general partner and management fund entities are established in the jurisdiction in which the fund's management team is physically located, whereas the limited partnership (the fund entity) is established in Delaware. For purposes of determining state investment advisor jurisdiction, a management company must look to the state in which its primary investment activity is located.

As noted in Chapter XI, some states have exemptions for investment fund managers from state investment advisor registration (up to certain AUM level and number of funds) while others do not. Wyoming, in fact, has no state investment advisor statute whatsoever. Fund managers often inquire as to whether they can form the general partner/management company in a state in which the manager is not physically located and thus be governed by state law. Unfortunately, the only way for a fund manager to avail itself of a state's law is to physically move the business operations to the state, or at least have a key individual residing and working in the state.

9 Many hedge funds combine the functionality of the general partner and the investment manager into a single entity. This is usually an appropriate and cost effective structure for a startup fund manager looking to manage a single fund. There are, however, circumstances in which the general partner and the management company should be established as separate entities.

First, two separate entities should be created when the management team is located in New York City to shield the general partner from New York City's Unincorporated Business Tax (UBT). New York City imposes UBT on any person or entity carrying on a trade or business in the city. If the general partner's business activity is limited to holding a carried interest in the fund, rather than active management, the general partner would fall within the "trading for one's own account" exemption.

Second, when multiple funds are established, a single management company typically manages all the funds collectively, up to a maximum of fifteen funds (per the Investment Advisors Act of 1940). However, each fund should have its own independent general partner that shields the performance capital allocations from liability from the other funds managed by the investment manger.

This Confidential Private Placement Memorandum (this "Confidential Memorandum"), relates to the offering of limited partnership interests of the Fund (the "Interests"), and sets forth information with respect to the investment objective and policies of the Fund, certain risks related to an investment in the Fund, management of the Fund and its investments, the principal terms of the Agreement of Limited Partnership of the Fund dated January 1, 2014 (the "Partnership Agreement"), the terms upon which the Interests are being issued, the suitability requirements for an investment in the Fund and certain other matters.[10] However, this Confidential Memorandum does not address all aspects of the topics described herein and this Confidential Memorandum may not contain all of the information that a potential investor may deem material for purposes of deciding whether to invest in the Fund. In making an investment decision, potential investors in the Fund must rely upon their own examination of the Fund and the terms of this offering, including the merits and risks involved.

INTERESTS ARE SUITABLE ONLY FOR SOPHISTICATED INVESTORS FOR WHOM AN INVESTMENT IN THE FUND DOES NOT CONSTITUTE A COMPLETE INVESTMENT PROGRAM AND WHO FULLY UNDERSTAND AND ARE WILLING TO ASSUME THE RISKS INVOLVED IN THE FUND'S INVESTMENT STRATEGY.[11] THE FUND EXPECTS TO INVEST SUBSTANTIALLY ALL OF ITS ASSETS IN THE MASTER FUND. THE INVESTMENT PRACTICES OF THE FUND AND THE MASTER FUND, BY THEIR NATURE, MAY BE CONSIDERED TO INVOLVE A SUBSTANTIAL DEGREE OF RISK. (SEE "Investment Objective and Strategies" and "Certain Risk Factors".)

The minimum investment in the Fund is $250,000, except that the General Partner reserves the right, in its sole and absolute discretion, to accept subscriptions in lesser amounts from investors who otherwise satisfy the Fund's suitability criteria. Additional investments may be for a minimum of $50,000, unless otherwise determined by the General Partner in its sole and absolute discretion. The Interests in the Fund are being offered solely to a limited

10 It is vital that the PPM properly reflect the underlying limited partnership agreement and subscription agreement. In performing offering document reviews from prior drafters, we often discover significant discrepancies between the summarized terms of the PPM and the actual terms of the limited partnership agreement. One reason for this is that fund managers, and unfortunately some legal counsel, view the PPM as the primary offering document, to which a limited partnership agreement may be quickly conformed.

It is important to understand the distinction between the functions of the PPM versus that of the limited partnership agreement and subscription agreement. The PPM is not a binding contractual document, but a disclosure of the terms and risks of investment in the fund and a summary of the binding investment terms in the limited partnership agreement and subscription agreement.

11 The suitability standard disclosed here (and later attested to in the subscription agreement and investor questionnaire) provides that the offering is only suitable for sophisticated investors for whom the offering does not constitute a complete investment program. As discussed in Chapter V, if an investor is "accredited" it need not also meet the "sophistication" requirement. Even though all of the investors are accredited (under Regulation D) or qualified clients (under the Investment Advisors Act of 1940) this language should still be included for an extra layer of protection, even if not strictly required from a regulatory perspective.

number of investors, each of which qualifies as (1) an "accredited investor," as defined in Rule 501 of Regulation D under the Securities Act; (2) a "qualified client," as defined under Rule 205-3(d)(1) of the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act"), or a "qualified purchaser" or a "knowledgeable employee," as defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended (the "Investment Company Act"); and (3) a "United States person" as defined in the Internal Revenue Code of 1986, as amended (the "Code"). There will be no public offering of Interests, no trading market for the Interests will develop and the Interests will be subject to substantial restrictions on transfer.

Pursuant to the Partnership Agreement, the General Partner is entitled to receive an incentive allocation based upon the increase in value of the Fund. There are certain risks to investors associated with performance fees. (See "Certain Risk Factors – Management Fees and Incentive Allocation".)[12]

IMPORTANT INFORMATION REGARDING THIS CONFIDENTIAL MEMORANDUM

This Confidential Memorandum, including the exhibits hereto, is confidential. By accepting delivery of this Confidential Memorandum, the recipient agrees not to reproduce or disclose any of its contents to any person, other than the potential investor's spouse, employees and professional advisors, without the prior written consent of the General Partner. The recipient further agrees promptly to return this Confidential Memorandum and all related documents, without retaining any copies thereof, in the event that the potential investor does not purchase any Interests, if the prospective investor's subscription is not accepted, or if the offering is terminated. Notwithstanding the foregoing, each potential investor (and each spouse employee, representative or other agent of the potential investor) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of an investment in the Fund and all materials of any kind (including opinions or other tax analysis) that are provided to the potential investor relating to such tax treatment and tax structure (as such terms are defined in Treasury Regulation Section 1.6011-4).

This Confidential Memorandum contains forward-looking statements based on the experience of the General Partner and the Investment Manager and expectations about the markets in which the Fund intends to invest and the methods by which the General Partner and the Investment Manager expect to invest in those markets. Those statements are sometimes indicated by words such as "expects," "believes," "seeks," "may," "intends," "attempts," "will" and similar expressions. Such forward-looking statements are not guarantees of future performance and are subject to many risks, uncertainties and assumptions that are difficult to predict. Therefore, actual returns could differ materially and adversely from those expressed or implied in any forward-looking statements as a result of various factors. None of the Fund, the General Partner or the Investment Manager undertake any obligation to revise or update any forward-looking statement for any reason.

THE SECTION ENTITLED "Certain Risk Factors" IN THIS CONFIDENTIAL MEMORANDUM

12 A key concept of a securities offering document is to include multiple references to important information or key risks. When a discussed topic can be found in greater detail elsewhere in the PPM, a cross-reference to the specific section should be included.

DISCUSSES SOME OF THE IMPORTANT RISK FACTORS THAT MAY AFFECT THE FUND'S RETURNS. THERE CAN BE NO ASSURANCE THAT THIS CONFIDENTIAL MEMORANDUM DISCUSSES ALL SUCH RISKS. PROSPECTIVE INVESTORS SHOULD CAREFULLY CONSIDER THOSE RISKS, IN ADDITION TO OTHER INFORMATION IN THIS CONFIDENTIAL MEMORANDUM AND THE RESULTS OF THEIR OWN INDEPENDENT REVIEW OF THE FUND, BEFORE DECIDING WHETHER TO INVEST IN THE FUND.[13]

THERE MAY BE CONFLICTS OF INTERESTS BETWEEN THE LIMITED PARTNERS, THE GENERAL PARTNER AND THE INVESTMENT MANAGER. (SEE "Certain Risk Factors – Conflicts of Interest" and "Management – Conflicts of Interest".)

This Confidential Memorandum constitutes a solicitation for offers to purchase rather than an offer to sell. THIS CONFIDENTIAL MEMORANDUM DOES NOT CONSTITUTE AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY IN ANY STATE OR OTHER JURISDICTION IN WHICH SUCH AN OFFER OR SOLICITATION IS NOT AUTHORIZED.

Although the information specified in this Confidential Memorandum is believed to be accurate, none of the Fund, the General Partner or the Investment Manager makes any expressed or implied representation or warranty as to the accuracy or completeness of that information. NO PERSON OTHER THAN THE GENERAL PARTNER HAS BEEN AUTHORIZED TO MAKE ANY REPRESENTATION, OR GIVE ANY INFORMATION, WITH RESPECT TO THE FUND, EXCEPT THE INFORMATION CONTAINED IN THIS CONFIDENTIAL MEMORANDUM AND IN OTHER DOCUMENTS DISTRIBUTED BY THE GENERAL PARTNER, AND ANY SUCH REPRESENTATIONS OR INFORMATION, IF GIVEN, MAY NOT BE RELIED UPON.[14]

13 Risk factors are intended to convey the major areas of risk that an investor may face when investing in a fund. Risk factors need not (and cannot) be an exhaustive enumeration of all potential risks or potential obstacles that the fund may encounter. Rather, the risk factors provide a roadmap of key considerations that an investor should consider before investing in a fund. Of utmost importance is that the risk factors be tailored to the strategy and structure of the fund. Generalized risk factors, while important and necessary, are insufficient if not accompanied by thorough disclosure of risk exposure specific to the fund.

14 While this clause attempts to mitigate statements conflicting with the PPM by telling the investor they may not rely upon them, the effectiveness of such language in a court proceeding is uncertain. Any statement made by a representative of a hedge fund to a prospective investor concerning the offering, whether verbal or written, has the potential to be construed as a representation, warranty, or material misstatement.

Fund sponsors have to be just as careful when crafting statements in marketing material, presentations and email as they would be when making disclosures in the PPM. Your investment fund counsel should review all marketing material prior to circulation. Marketing material should bear legends instructing investors to make investment decisions based on the PPM.

IT IS EXPECTED THAT EACH POTENTIAL INVESTOR WILL PURSUE AN INDEPENDENT INVESTIGATION REGARDING THE FUND AND AN INVESTMENT IN THE INTERESTS. Prospective investors and/or their advisers, upon request to the General Partner, will be furnished with or will be able to obtain all financial, business and other information with respect to the Fund and its proposed business if available without unreasonable effort or expense. (See "Access to Information".)

The description in this Confidential Memorandum of certain terms of the Fund's Partnership Agreement and the other agreements referred to in this Confidential Memorandum are summaries only, and do not purport to be complete. These summaries may omit information significant to a particular prospective investor. These summaries are qualified by reference to the complete versions of the agreements, and potential investors are urged to review these agreements carefully. A copy of the Fund's Partnership Agreement and of the Subscription Agreement that each investor will be required to sign are attached as exhibits to this Confidential Memorandum, and copies of the other agreements referred to in this Confidential Memorandum are available upon request from the General Partner.

Information specified in this Confidential Memorandum is as of the date of this Confidential Memorandum. Neither the delivery of this Confidential Memorandum nor any transaction entered into as a result of this Confidential Memorandum shall create, in any circumstance, the implication that there has been no change in any information specified in this Confidential Memorandum after the date specified on the front cover of this Confidential Memorandum.

THE CONTENTS OF THIS CONFIDENTIAL MEMORANDUM SHOULD NOT BE CONSIDERED TO BE LEGAL OR TAX ADVICE, AND PROSPECTIVE INVESTORS SHOULD CONSULT WITH THEIR OWN COUNSEL AND ADVISERS AS TO ALL MATTERS CONCERNING AN INVESTMENT IN THE INTERESTS.[15]

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15 Under the Employee Retirement Income Security Act of 1974 ("ERISA"), a hedge fund becomes subject to significant increased regulatory: obligations and fiduciary liability if more than 25 percent of the fund's assets under management are subject to ERISA.

In calculating the ERISA percentage of assets under management, all assets owned by the general partner or its affiliates is excluded from the denominator. The calculation must be made on a class-by-class basis, so that in a multi-class fund, if any class holds more than 25% of the assets under management, the entire fund becomes a plan asset fund. The Internal Revenue Code of 1986 and the Pension Protection Act of 2006 present additional issues for fund managers that are ERISA plan asset funds.

The Fund reserves the right to withdraw this offering at any time prior to the acceptance of investor subscription agreements and to terminate the offering of Interests any time thereafter. The Fund further reserves the right to accept or reject in its sole and absolute discretion and for any reason whatsoever, any offer by an investor to purchase securities.

FIDUCIARIES OF EMPLOYEE BENEFIT PLANS SUBJECT TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, AS AMENDED ("ERISA"), SHOULD CONSIDER WHETHER INVESTMENT IN THE FUND IS PRUDENT AND OTHERWISE IN COMPLIANCE WITH ERISA. THE GENERAL PARTNER INTENDS TO RESTRICT ADMISSION OF LIMITED PARTNERS AND THE TRANSFER OF INTERESTS SO THAT EMPLOYEE BENEFIT PLANS WILL NOT HOLD, DIRECTLY OR INDIRECTLY, 25% OR MORE OF THE INTERESTS.

IRS CIRCULAR 230 NOTICE: THE INFORMATION CONTAINED IN THIS CONFIDENTIAL MEMORANDUM AS TO U.S. FEDERAL TAX MATTERS IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF AVOIDING U.S FEDERAL TAX PENALTIES. SUCH INFORMATION IS PROVIDED TO SUPPORT THE PROMOTION OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED IN THIS OFFERING DOCUMENT. YOU SHOULD SEEK ADVICE BASED ON YOUR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISER.

NOTICE TO RESIDENTS OF FLORIDA:

UPON THE ACCEPTANCE OF FIVE (5) OR MORE FLORIDA INVESTORS, AND IF THE FLORIDA INVESTOR IS NOT A BANK, A TRUST COMPANY, A SAVINGS INSTITUTION, AN INSURANCE COMPANY, A DEALER, AN INVESTMENT COMPANY AS DEFINED IN THE INVESTMENT COMPANY ACT OF 1940, AS AMENDED, A PENSION OR PROFIT-SHARING TRUST, OR A QUALIFIED INSTITUTIONAL BUYER (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT), THE FLORIDA INVESTOR ACKNOWLEDGES THAT ANY SALE OF AN INTEREST TO THE FLORIDA INVESTOR IS VOIDABLE BY THE FLORIDA INVESTOR EITHER WITHIN THREE DAYS AFTER THE FIRST TENDER OF CONSIDERATION IS MADE BY THE FLORIDA INVESTOR TO THE ISSUER, OR AN AGENT OF THE ISSUER, OR WITHIN THREE DAYS AFTER THE AVAILABILITY OF THAT PRIVILEGE IS COMMUNICATED TO THE FLORIDA INVESTOR, WHICHEVER OCCURS LATER. [16]

[End of section excerpt. This section has been significantly shortened for use in this sample]

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16 State legends contain specific state securities requirements and restrictions specific to investors residing in a given state. Many of the state restrictions found in state legends, particularly those that add requirements for purchaser eligibility, are not applicable to Regulation D Rule 506 offerings, since Rule 506 preempts state law. However, a number of state legends, including the Florida legend, contain important restrictions and disclosures required by state law.

SUMMARY[17]

The following summary is qualified in its entirety by the more detailed information contained elsewhere in this Confidential Private Placement Memorandum (this "Confidential Memorandum"). Prior to making an investment in Zeus Alpha, LP (the "Fund"), each person who is considering investing in the Fund should read the various other documents described herein, some of which are attached as Exhibits[18] to this Confidential Memorandum and the remainder of which are available upon request from the General Partner.

The Fund

The Fund is a limited partnership organized under the laws of the State of Delaware on January 1, 2014. The General Partner of the Fund is XYZ Partners, LLC, New York limited liability company (the "General Partner"). The general partner, is the investment adviser to the Fund (the "Investment Manager") and formulates and implements the Fund's investment program.

The Master Fund

The Fund expects to invest substantially all of its assets in XYZ Master Fund Cayman Ltd. (the "Master Fund"), a business company incorporated under the laws of the Cayman Islands.[19] The Fund may, however, invest a portion of its assets directly rather than investing through the Master Fund.

In addition to the Fund, XYZ Offshore Fund Cayman Ltd. (the "Offshore Fund"), a business company incorporated under the laws of the Cayman Islands, will also invest substantially all of its assets in the Master Fund. The Offshore Fund has an investment objective and a strategy identical to the Fund, and it was established to serve as an investment vehicle for investments from certain U.S. tax-exempt persons and non-U.S. persons. The Investment Manager also provides investment advisory services to the Offshore Fund and the Master Fund.

17 The summary of terms provides highlights of the key components of the offering, the fund structure, compensation provisions and key fund terms. Each of these items would be dealt with in detail in the body of a typical PPM. For purposes of this excerpt, we have necessarily shortened the summary of terms to include only a few of the many fund provisions. Notably, we have not included information summarizing the fictitious investment strategy and management information.

18 The PPM is only one of a number of private placement offering documents, which are typically attached as exhibits to the PPM. These include: (i) the limited partnership agreement (operating agreement if an LLC-based fund); (ii) the subscription agreement/investor questionnaire; (iii) form ADV Part II brochure supplement (if the fund manager is required to register as an investment advisor).

19 Under the master-feeder structure, both the U.S. and offshore feeders invest into a master offshore fund, which then allocates investments on a pro-rata basis from each of the feeders. Investment gains and losses are likewise allocated between the domestic and feeder funds.

References in this Confidential Memorandum to the investment program and related matters of the Fund also include the Master Fund, as applicable.

The portfolios of the Fund and the Offshore Fund may differ to the extent that investments made directly by one might not be made by the other. This could occur for a variety of reasons, including, without limitation, because of different tax and regulatory considerations applicable to the Fund and the Offshore Fund. Such differences will result in differences between the returns of the Fund and the Offshore Fund.

Risk Factors[20]

There are a number of risks associated with becoming a limited partner of the Fund (a "Limited Partner"). An investment in Interests will be subject to various risks, including, but not limited to, risks relating to the newly formed nature of the Fund; certain strategic, investment and market risks; the use of leverage and other investment techniques; and the illiquid nature of Interests. There can be no assurance that the Fund will achieve its investment objective or be able to meet redemption requests. In addition, an investment in the Fund involves a high degree of risk and is suitable only for sophisticated investors for whom an investment in the Fund does not constitute a complete investment program and who fully understand and are willing to assume the risks involved in the Fund's investment strategy. (See "Certain Risk Factors".)

The Investment Manager[21]

The Investment Manager provides investment advisory services to the Fund, the Offshore Fund and the Master Fund

The Investment Manager is currently exempt from registration with the Securities and Exchange Commission (the "SEC"), as an investment adviser under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and is currently exempt from registration as an investment adviser with the State of New York.[22]

The Investment Manager is responsible for implementing the Fund's compliance

20 Proper risk factor disclosure is at the heart of a well drafted PPM. Risk factors should be specific, relevant to the investment strategy and management background, and thorough. Inadequate attention to risk factors (or relying on boilerplate risk factors) can be problematic.

21 When the investment advisor and the investment manager are split into separate entities as is done in New York or in fund structures requiring successive funds, it is the investment manager, rather than the general partner, that performs most of the services for the fund.

22 The investment advisor registration is performed by the investment manager entity, rather than the fund entity.

program and for performing administrative duties and managing the ongoing business operations of the Fund. Without limiting the generality of the foregoing, the Investment Manager is responsible for making investment decisions on behalf of the Fund. The Investment Manager initiates all orders for the purchase and sale of securities and other investments on behalf of the Fund, selects the brokers and dealers with and through which the Fund invests and is responsible for the day to day management of the Fund's investment activities and holdings. The Investment Manager is also responsible for performing the necessary research and acquiring the necessary information to make investment decisions. (See "Management".)

Capital Accounts

The Fund will establish and maintain on its books a Capital Account ("Capital Account"), for each Limited Partner and the General Partner, into which its capital contribution(s) ("Capital Contribution"), will be credited and in which certain other transactions will be reflected. (See "Allocation of Gains and Losses.")

Management Fee and Incentive Payments

Management Fee. For the services it renders to the Fund, the Investment Manager shall receive a monthly management fee equal to 0.1666% (2.00% annually) of each Limited Partner's Capital Account (the "Management Fee"). The Management Fee is accrued as of the first business day of each calendar month. The Management Fee is payable monthly in advance.[23] A pro rata Management Fee will be charged to Limited Partners on any amounts permitted to be invested during any month, but will not be refunded on any amounts permitted to be withdrawn during any month. The Investment Manager, in its sole and absolute discretion, may waive any or all of the Management Fee in respect of any Limited Partner without notice to or the consent of other Limited Partners. (See "Fees".)

Incentive Allocation. The General Partner will receive the Incentive Allocation, as described below. The General Partner, in its sole and absolute discretion, may waive any or all of the Incentive Allocation[24] in respect of any Capital Account without notice to or the consent of other Limited Partners. (See "Incentive Allocation.")

23 Management fees are typically paid monthly or quarterly and can be paid in advance or in arrears (usually in advance).

24 Although the fund has the authority to waive or reduce the inventive allocation and management fees, such as performance allocation, it is generally not advisable to do so. One question we encounter often is whether a fund can waive the incentive allocation to allow accredited investors that are not qualified clients to invest in a fund of which the manager is registered as an RIA. Although it may be technically allowed, such an arrangement causes concern for the remaining investors and can lead to investor dissatisfaction and disclosure issues.

Expenses[25]

The General Partner and the Investment Manager are responsible for and pay their own ordinary office overhead expenses, which include rent, supplies, secretarial expenses, printing and stationery, charges for furniture and fixtures and compensation of administrative personnel. All other expenses are borne by the Fund including, legal, accounting, audit and other professional expenses, direct office expenses, including but not limited to postage, overnight delivery and information systems, investment expenses such as commissions, taxes, interest charges, borrowing charges for securities sold short, custodial fees, administrator fees, financial institution service charges and all other expenses related to the purchase, sale, clearance and holding of Fund assets.

The Fund's initial offering and organizational expenses were advanced by the General Partner. The Fund will reimburse the General Partner for the payment of such costs and expenses, and these expenses may be amortized in equal monthly amounts over a period of up to thirty-six (36) months. Such treatment is not in accordance with generally accepted accounting principles ("GAAP"), and the General Partner may determine to accelerate such amortization or make other GAAP conforming changes for financial reporting purposes if the General Partner believes that doing so would be in the best interests of the Fund. (See "Expenses.")

Allocation of Gains and Losses

Limited Partners. The net capital appreciation or net capital depreciation of the Fund as of the end of each calendar month (as described below) will be allocated to each Limited Partner pro rata in proportion to each Limited Partner's Capital Account as of the beginning of each calendar month. For financial accounting purposes, net capital appreciation or net capital depreciation of the Fund will be determined on the accrual basis of accounting and will be deemed to include net unrealized appreciation or depreciation on securities positions as of the end of each fiscal period.

In the event that the General Partner determines that for tax or regulatory reasons, or any other reason as to which the General Partner and any Limited Partner agree, such Limited Partner should not participate in the net capital appreciation or net capital depreciation, if any, attributable to any security or type of security, or to any other transaction, the General Partner may allocate such net capital appreciation

25 It is industry standard for the hedge fund to bear the cost of the fund formation, administration, accounting, custodial and prime brokerage fees, auditing, trading costs and similar fund-specific items. However, some funds find it advantageous in capital raising to limit the expenses that are passed on to the fund and use the management fee for some of the fund expenses, particularly in very small funds, where expenses can dramatically affect performance.

or net capital depreciation only to the Capital Accounts of holders of general and limited partnership interests of the Fund, (the "Partners"), other than such Limited Partner, and if appropriate, may establish a separate memorandum account in which only the remaining partners having an interest in such security, type of security, or transaction shall have an interest and net capital appreciation and net capital depreciation for such separate memorandum account shall be separately calculated. (See "Allocation of Gains and Losses".)

Incentive Allocation. The Fund will make an annual performance-based allocation (the "Incentive Allocation"), to the General Partner. In general, the Incentive Allocation will be an amount equal to 20% of the excess of (1) the net capital appreciation (less any net capital depreciation) otherwise allocable for such year (the "Excess Capital Appreciation"), to each Limited Partner's Capital Account over (2) any balance remaining in such Limited Partner's Loss Recovery Account (defined below) for the applicable period ***provided, however,*** that the Excess Capital Appreciation exceeds the sum of (i) any balance remaining in such Limited Partner's Loss Recovery Account (defined below) for the applicable period and (ii) the Hurdle Amount (defined below) with respect to such Capital Account.

To calculate the Incentive Allocation, a "Loss Recovery Account" [26] will be established for each Limited Partner, the opening balance of which will be zero. As of the end of each calendar year, the balance in each Limited Partner's Loss Recovery Account will be increased by any net capital depreciation, or reduced by any net capital appreciation, allocated to such Limited Partner's Capital Account for such year. The balance in a Loss Recovery Account will never be reduced below zero. The net capital appreciation and net capital depreciation are calculations based on the Net Asset Value (as defined below) of the Fund's securities at the beginning and ending valuation periods as determined in accordance with the Partnership Agreement.

The "Hurdle Amount" is calculated by multiplying: (1) two percent (2%) (the "Hurdle Rate")[27] , and (2) the opening balance of each Capital Account as of

26 A Loss Recovery Account refers to the high water mark, which prevents the general partner from receiving multiple incentive allocations when the portfolio has reduced in value. The high water mark is discussed in detail in Chapter VIII.

27 A hurdle rate requires a fund to achieve a certain level of return, either as a fixed percentage or a benchmark rate (such as LIBOR or the S&P 500) before managers are entitled to receive performance compensation. Hurdle rates can be either a "hard hurdle" or "soft hurdle." A hard hurdle means that the manager only receives performance compensation that exceeds the hurdle rate. A soft hurdle means that no performance compensation is received if performance falls short of the soft hurdle rate, but once the soft hurdle rate is exceeded, the manager is entitled to

the beginning of such fiscal year after giving effect to any withdrawals from, and distributions by, the Fund relating to prior periods. The Hurdle Amount will not be cumulative from year to year. The Hurdle Amount will be appropriately adjusted for periods of less than one year using the applicable Hurdle Rate.

For a Limited Partner's initial Capital Contribution, an Incentive Allocation will be charged with respect to such Limited Partner's Capital Account and declared and paid on the last day of the calendar year in which the investment was made. Accordingly, the first Incentive Allocation with respect to an investment generally will be calculated based upon a period of less than 12 months. Thereafter, the Incentive Allocation will be based upon the net capital appreciation, if any, allocable to such Limited Partner's Capital Account each year.

The General Partner, in its sole and absolute discretion, may waive or reduce the Incentive Allocation with respect to any Capital Account; any such waiver or reduction will not increase the Incentive Allocation with respect to other Capital Accounts whose Incentive Allocation is not so waived or reduced. The General Partner may, in its sole and absolute discretion, agree that certain Capital Accounts be subject to different Incentive Allocation arrangements as it deems appropriate, all without notice to or consent of the Limited Partners.

No Incentive Allocation will be charged to the General Partner's Capital Account.

Determination of Net Asset Value[28]

The net asset value of the Fund (the "Net Asset Value") is determined in accordance with the terms of the Partnership Agreement and is generally equal to the amount by which the value of the Fund's assets exceeds the amount of its liabilities. Net Asset Value determinations are made by the General Partner as of the end of each quarter (or other period, as the case may be) in accordance with United States generally accepted accounting principles ("U.S. GAAP") consistently applied.

In making such determinations, securities which are listed on a national securities exchange or over the counter securities listed on Nasdaq are valued at their last sales

the entire performance compensation. This example uses a hard hurdle.

28 One of the vital services performed by the fund administrator is calculating the net asset value of the fund portfolio. The assets of the portfolio must be valued in order for an open-end fund to calculate performance fees, management fees, taxes, investor redemptions, and other functions. Calculating the net asset value of a fund that invests in liquid securities or provides lending investments is much simpler than calculating illiquid securities, including real estate, private equity, etc. As a general rule, such funds would be better structured as closed-end funds, where performance compensation and investor payout occurs upon the sale of an asset.

price on such date, or, if no sales occurred on such date, at the "bid" price for a long position and the "ask" price for a short position.

For securities not listed on a security exchange or quoted on an over-the-counter market, but for which there are available quotations, such valuation will be based upon quotations obtained from market makers, dealers or pricing services. The General Partner may, in accordance with the Partnership Agreement, use other methods of valuing securities if it believes that an alternate method is preferable. Securities which have no public market and all other assets of the Fund are considered at such value as the General Partner may reasonably determine. All values assigned to securities by the General Partner pursuant to the Partnership Agreement are final and conclusive as to all Partners.

[End of section excerpt. This section has been significantly shortened for use in this sample]

CERTAIN RISK FACTORS [29]

An investment in the Fund may be deemed to be a speculative investment and is not intended as a complete investment program. It is designed only for sophisticated persons who are able to bear the risk of loss of their entire investments. Among the risks that should be carefully evaluated by a prospective investor before making an investment in the Fund are the following:

Investment Risks

Specialized Investment Skills. Successful arbitrage investing is a specialized investment approach requiring a combination of extensive quantitative and qualitative skills. Both the experience and judgment of the Investment Manager, as well as its use of sophisticated analytical tools, will be integral to the success of the Fund's investment strategy. Failure of the manager to successfully execute the intended strategy could lead to poor fund performance.

29 The risk factor section is one of the most valuable components of a private placement memorandum for liability mitigation. Risk factors should be one of the first sections in a private placement memorandum. This section is usually quite voluminous, often spanning dozens of pages, and covering many subcategories, with disclosures ranging from broad and generic risks to highly specific risks covering the investment strategy, sub strategy, or market sector. In this illustrative excerpt, we have provided two of the many risk factor categories (which have been shortened considerably for this excerpt). These are: "Investment Risks," and "Risks Related to Particular Types of Investments." Other risk categories that would be included (depending on the fund structure and strategy) include: market risk, partnership risk, management risk, regulatory risks, tax risk, and others.

Changes in Investment Strategies. There can be no assurance that the Investment Manager will be successful in implementing the Fund's investment strategy. The Investment Manager may from time to time formulate new approaches to carry out the Fund's investment objective, and there can be no assurance that any of such new approaches will be successful.[30]

Investment Risks in General. The Fund will engage in speculative investment strategies. The prices of instruments in which the Fund will trade may be volatile. Market movements are difficult to predict and are influenced by, among other things, government trade, fiscal, monetary and exchange control programs and policies; changing supply and demand relationships; national and international political and economic events; changes in interest rates; and the inherent volatility of the financial markets. In addition, governments from time to time intervene, directly and by regulation, in certain markets, often with the intent to influence prices directly. The effects of governmental intervention may be particularly significant at certain times in the financial instrument and currency markets, and such intervention (as well as other factors) may cause these markets and related investments to move rapidly and lose value.

General Economic Conditions. The success of any trading activity may be affected by general economic conditions, which may affect the level and volatility of securities prices, interest rates and the extent and timing of investors' participation in the markets for currencies, securities and other instruments. Unexpected changes in volatility or liquidity in the markets in which the Fund directly or indirectly holds positions could impair the Fund's ability to carry out its business or cause it to incur losses.

Debt and Other Income Securities. The Fund intends to invest in fixed income and adjustable rate securities. Fixed income securities, such as many of the bonds in which the Fund is likely to invest, are subject to interest rate, market and credit risk. Interest rate risk relates to changes in a security's value as a result of changes in interest rates generally. Even though such instruments are investments that may promise a stable stream of income, the prices of such securities are inversely affected by changes in interest rates and, therefore, are subject to the risk of market price fluctuations. In general, the values of fixed income securities increase when interest rates fall and decrease when interest rates rise. Market risk relates to the changes in the risk or perceived risk of an issuer, asset class, country or region. Credit risk relates to the ability of the issuer or underlying assets to make payments of principal and interest. The values of income securities may be affected by changes in the credit rating or financial condition of the issuing entities.[31]

30 Regardless of the fund's intended strategy, managers should usually maintain the flexibility and discretion to modify or mix strategies to achieve its investment objective.

31 When disclosing investment strategy risks, fund managers are often tempted to add mitigating language explaining why their strategy has a high probability of avoiding the disclosed risks. Such risk factor clauses are simple to identify: They often begin with "while," "though" or "however." SEC releases have given specific guidance to avoid mitigating language in risk factors. Risk factors should be limited to identification and brief description of material risks. That is not to say disclosure of mitigating strategies should not be discussed in the PPM, but the language should not appear in the risk factors. The appropriate place to elaborate on risk mitigation strategies is the investment strategy and business sections.

Market Risk. The profitability of a significant portion of the Fund's investment methods depends to a great extent upon correctly assessing the future course of the relative price movements of securities and other investments. There can be no assurance that the Investment Manager will be able to predict accurately these price movements. Regardless of the hedging methods employed, there is always some and occasionally a significant degree of market risk inherent in the Fund's core portfolio trading strategies.

Instruments Below Investment Grade. The global securities in which the Fund may invest include instruments that have low ratings that indicate that the ratings agencies view them as highly risky and have predominantly speculative characteristics with respect to their capacity to pay interest and repay principal. The Fund may invest in bonds rated lower than investment grade, which may be considered speculative. The Fund may also invest a substantial portion of its assets in high-risk instruments that are low rated or unrated. The market values of these instruments tend to reflect short-term corporate, economic and market developments and investor perceptions of the issuer's or underlying collateral's credit quality to a greater extent than lower yielding, higher-rated bonds. In addition, it may be more difficult to dispose of, or to determine the value of, high-yield, high-risk bonds.

Leverage Risk. The Fund, when it is deemed appropriate by the Investment Manager and subject to applicable regulations (including margin requirements), intends to use leverage to attempt to capitalize on situations where the Investment Manager believes there is a high probability that a particular investment strategy will be profitable. The extent to which such leverage is used fluctuates depending on market conditions. To the extent that the Fund uses leverage, the Fund's net assets will tend to increase or decrease at a greater rate than the overall market (i.e., it may have an amount greater than its net assets subject to market risk). While the use of leverage can substantially improve the return on the Fund's investments, such use also may increase the adverse impact of unfavorable price movements. In extreme cases, a significant loss of equity could require the Investment Manager to execute trades based solely on the need to generate investable funds rather than as part of the Fund's core portfolio trading strategies. Under these circumstances, the Investment Manager could be forced to liquidate securities or other assets held by the Fund under less than favorable conditions. Use of leverage will subject the Fund to risks normally associated with debt financing, including the risk that the Fund's cash flow will be insufficient to meet required payments of principal and interest. The risk exists that indebtedness on the Fund's investments will be subject to margin calls due to asset devaluation, which in turn could force the Fund to sell assets at unfavorable prices. In addition, the Fund expects to incur indebtedness, which may carry variable interest rates, and such debt creates higher debt service requirements if the market interest rates increase. The Fund may engage in transactions to limit its exposure to rising interest rates as, in the Investment Manager's sole and absolute discretion, are appropriate and cost effective, and such transactions could expose the Fund to the risk that such transactions may not adequately perform and cause the Fund to lose anticipated benefits therefrom.[32]

Concentration. The Fund has the ability to concentrate investments. Concentration may create the risk that the Fund could change in value suddenly based on potential exposure of a significant amount of assets to a limited area

32 The use of leverage is a key risk factor that should be thoroughly disclosed. This illustrative excerpt assumes that the fund has no present intent to use leverage. A fund that has a strategy that relies on significant levels of leverage should include several risk factors disclosing various facets of how the leverage could affect fund performance and investment loss.

of investment. The Fund could be subject to significant losses if it holds a large position in a particular investment that declines in value or is otherwise adversely affected, including default of the issuer or underlying collateral.

Limited Liquidity. In certain circumstances, certain of the Fund's holdings may become illiquid and unable to be sold. This could adversely affect the ability of the Fund to dispose of these securities, including to meet redemption obligations.

Valuation of Certain Investments. Because the secondary markets for certain investments, such as bank loans, may be limited, it may be difficult to value such investments. Where market quotations are not readily available, valuation may require more research than for more liquid investments. In addition, elements of judgment may play a greater role in valuation in such cases than for investments with a more active secondary market because there is less reliable objective data available. (See also "Risk Factors – Management Risks – Valuation of Investments.")

Ability to Participate in Rule 144A Offerings. Most new issues in the bond market rated lower than investment grade are sold pursuant to Rule 144A under the Securities Act. As such, they can only be purchased by "qualified institutional buyers" ("QIBs"). The Fund does not initially expect to qualify as a QIB, and will therefore not be eligible to invest in new bond issues that are limited to QIBs. This may initially limit the Fund's ability to participate in certain investments and could potentially limit its ability to generate high returns.

Prepayment Risk. Prepayment risk is the risk that principal on fixed income securities may be paid prior to the stated maturity date. This risk is especially acute for those instruments without call protection, such as bank loans and certain other instruments, which may be paid at any time. If the Fund purchases an investment at a premium, a faster than expected prepayment rate will reduce both the market value and the yield to maturity from those that were anticipated. A prepayment rate that is slower than expected will have the opposite effect of increasing yield to maturity and market value. Conversely, if the Fund purchases an investment at a discount, faster than expected prepayments will increase, while slower than expected prepayments will reduce, yield to maturity and market values. Prepayment of fixed income securities can be expected to accelerate during periods of declining interest rates.

Margin Risk. Markets in futures, options and other derivatives contracts can be highly volatile and investment in them carries a high risk of loss. This stems from the margining system applicable to such contracts that generally involves a comparatively modest performance deposit in terms of the overall contract value, so that a relatively small market movement can have a disproportionately dramatic effect on the value of an investment. If the market movement is favorable, a good profit return may be achieved, but an equally small adverse market movement can result not only in the loss of the entire amount of margin on deposit, but may also expose the Fund to the distinct possibility of a loss exceeding the initial margin requirement.

If the market moves against the Fund, the Fund may be called upon to deposit substantial additional margin, at short notice, to maintain its position. Failure to provide such additional funds within the time required may result in the Fund's position being liquidated at a loss and the Fund will be liable for any resulting deficit.

Counterparty Risk. The Fund will be subject to the risk of the inability of any counterparty (including any prime broker and custodian) to perform with respect to transactions, whether due to insolvency, bankruptcy or other causes. The Fund may utilize swaps and other derivative transactions. To the extent the Fund invests in repurchase agreements, swaps, forwards, futures, options and other "synthetic" or derivative instruments, counterparty exposures can develop and the Fund bears the risk of nonperformance by the other party on the contract. This risk may differ materially from those entailed in exchange-traded transactions which generally are supported by guarantees of clearing organizations, daily marking-to-market and settlement, segregation and minimum capital requirements applicable to intermediaries. Transactions entered directly between two counterparties generally do not benefit from such protections and expose the parties to the risk of counterparty default. In international securities markets the existence of less mature settlement structures and systems can result in settlement default and exposure to counterparty credits. In addition, entering into these types of agreements involves, to varying degrees, elements of credit and market risk. Such risks include the possibility that there is no liquid market for these agreements and there may be unfavorable changes in the fluctuation of interest rates and market value. These types of agreements also involve the risk of mispricing or improper valuation and the risk that changes in the value of the derivative may not correlate with the underlying asset, rate, or index.

Use of Hedging. The Investment Manager may employ certain hedging techniques, directed primarily toward general market risks, but is not required to do so. If employed, hedging against a decline in the value of a portfolio position does not eliminate fluctuations in the values of portfolio positions or prevent losses if the values of such positions decline, but establishes other positions designed to gain from those same developments. For a variety of reasons, the Investment Manager may not seek or be able to establish a sufficiently accurate correlation between hedging instruments and the portfolio holdings being hedged. Such imperfect correlation may prevent the Fund from achieving the intended hedge or expose the Fund to risk of loss. In addition to possible losses on the position sought to be hedged notwithstanding the attempted hedge, the Fund could incur losses on the hedging position itself.

Moreover, all hedging strategies necessarily involve costs, which could be significant, whether or not the hedge sought is successful. The Fund may invest in markets or instruments as to which hedging strategies are limited or unavailable. Hedging instruments which are potentially available may nonetheless involve costs or risks which the Investment Manager deems prohibitive in the context of the Fund. Hedging, if employed at all, is expected to be employed as a technique to seek to limit certain market risks. As a general matter, the Fund's portfolio is still exposed to risks attendant to its investment strategy, which risks are not generally hedged.

Risks Related to Particular Types of Investments[33]

(a) ***Risks Associated with Participations:*** A portion of the Fund's investments may be in the form of participations. In these cases, the Fund generally will have no right to directly enforce compliance by the borrower with the terms of the loan agreement, nor any rights of set-off against the borrower, and the Fund may not directly proceed against the collateral supporting the loan. In addition, when the Fund acquires a participation, its ability to receive principal and interest may be subject to the credit risk of the lender from which the participation originates. A selling lender may sell or otherwise dispose of its interest in the loan after the Fund acquires the participation, in which case the credit of the new owner of that interest would be substituted for the credit of the original selling lender. Moreover, to the extent that a loan has been participated out, the originating lender will have a substantially reduced interest, or none at all, in the debtor's performance under the loan, and may have other business relationships with the borrower that conflict with the interests of the Fund as loan participant.

33 This section contains risk factors that pertain to specific investments in which the fund will engage. It is beyond the scope of this ebook to provide further explanations of the underlying instruments and strategies. Rather, these are provided to show the degree of specificity that should be included in a hedge fund offering document's risk factors.

(b) ***Lender Liability Considerations:*** A number of judicial decisions in the United States have upheld the legal right of borrowers to sue lending institutions on the basis of various evolving legal theories (collectively termed "lender liability"). Generally, lender liability is founded upon the premise that the institutional lender has violated a duty (whether implied or contractual) of good faith and fair dealing owed to the borrower or has assumed a degree of control over the borrower resulting in creation of a fiduciary duty owed to the borrower. By purchasing bank loans, the Fund may be subject to risks of lender liability.

(c) ***Environmental Liability of Portfolio Investments:*** Collateral (whether or not real property) that secures bank loans may have associated environmental liabilities and borrowers may participate in activities with environmental implications. In the event a bank loan is secured by collateral with environmental liabilities or is made to a borrower that has environmental liabilities, it is possible that the ability of the borrower to repay the bank loan or to make interest payments will be impaired as a result of expenses related to the environmental liabilities. In addition, while the Fund does not intend to participate in the management of any borrower, if the Fund were nonetheless deemed to be an "operator" of a borrower under applicable environmental laws, the Fund could itself become liable for those environmental liabilities. Environmental liability could also arise as a result of the Fund becoming the owner, through foreclosure or otherwise, of collateral with environmental liabilities. Any such Fund liability would affect all assets of the Fund and such liability would not necessarily be limited to the value of the particular bank loan with respect to which the liabilities have arisen.

Non-Investment Grade Bonds. The Fund's investments in non-investment grade bonds will be predominantly speculative because of the credit risk of the issuers or underlying collateral. While normally offering higher yields, non-investment grade bonds typically entail greater potential price volatility and may be less liquid than higher-rated securities. Issuers or underlying collateral of non-investment grade bonds are more likely to default on their payments of interest and principal owed to the Fund, and such defaults will reduce the Fund's net asset value and income distributions. The prices of these lower rated obligations are more sensitive to negative developments than higher rated securities. Adverse business conditions, such as a decline in the issuer's or underlying collateral's revenues or an economic downturn, generally lead to a higher non-payment rate. In addition, a security may lose significant value before a default occurs as the market adjusts to expected higher non-payment rates. Adverse publicity and changing investor perceptions may affect the ability to obtain prices for or to sell these securities.

Other Instruments and Future Developments. The Fund may take advantage of opportunities in the area of options on securities, swaps, swaptions and other synthetic or derivative instruments that are not presently contemplated for use by the Fund or that are not currently available, but that may be developed, to the extent such opportunities are both consistent with the Fund's investment objective and legally permissible for the Fund. The Fund may become a party to various other customized derivative instruments entitling the counterparty to certain payments on the gain or loss on the value of an underlying or referenced instrument. All of the investments described above could magnify the gain or loss that would be incurred in a direct investment in the underlying securities or trading positions and may be made without the approval of Limited Partners.

Collateralized Debt Obligations. The Fund's investments in collateralized debt obligations ("CDOs"), may involve a high degree of business and financial risk particularly due to the limited recourse or non-recourse nature of the obligations (i.e., payable solely from the assets pledged by the issuer of such obligations), the subordination of such obligations and the character of the collateral securing such obligations. The underlying collateral of any CDO may consist primarily of non-investment grade loans and interests in non-investment grade loans. The collateral may also include bonds, structured finance obligations and synthetic securities. These assets are subject to liquidity, market value, credit, interest rate, prepayment and certain other risks that are generally greater than those of investment grade corporate obligations. These risks could be exacerbated to the extent that the Fund is concentrated in one or more particular types of collateral obligations. The underlying loans are also subject to prepayment risk, which may affect the market value of those loans and the collateralized obligation.

Options. The Fund will utilize options in furtherance of its investment strategy and for both investment and hedging purposes. Options positions may include long positions, where the Fund is the holder of put or call options, as well as short positions, where the Fund is the seller (writer) of an option. Although option techniques can increase investment return, they can also involve a relatively higher level of risk. The writing (selling) of uncovered options involves a theoretically unlimited risk of a price increase or decline, as the case may be, in the underlying security. The expiration of unexercised long option positions effectively results in loss of the entire cost or premium paid for the option. Option premium costs, as well as the cost of covering options written by the Fund, can reduce or eliminate position profits or create losses as well. The Fund's ability to close out its position as a purchaser of an exchange-listed option is dependent upon the existence of a liquid secondary market on option exchanges. On occasion the Fund may also utilize options, particularly in foreign markets, which may have limited liquidity.

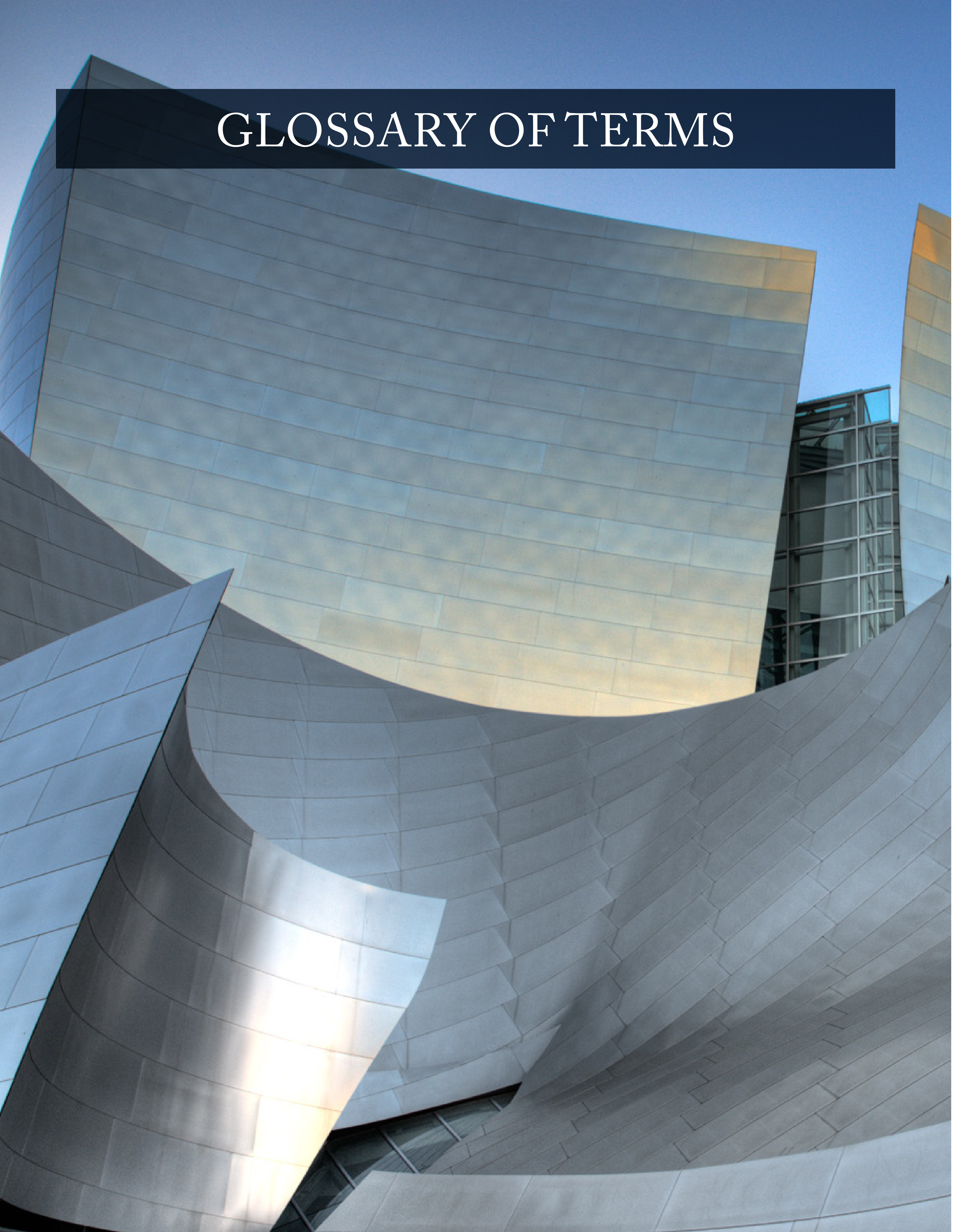
Warrants. The Fund may hold warrants as a result of a workout of debt. Warrants are instruments that entitle the holder to buy a fixed income or other debt security at a specific price for a specific period of time. Changes in the value of a warrant do not necessarily correspond to changes in the value of its underlying security. The price of a warrant may be more volatile than the price of its underlying security, and a warrant may offer greater potential for capital appreciation as well as capital loss. Warrants do not entitle a holder to coupon or other interest payments with respect to the underlying security and do not represent any rights in the assets of the issuing company. A warrant ceases to have value if it is not exercised prior to its expiration date. These factors can make warrants more speculative than other types of investments.

Synthetic Bonds. Incidental to other transactions in fixed income securities and/or for investment purposes, the Fund may combine options on fixed income securities with cash, cash equivalent investments or other fixed income securities in order to create "synthetic" bonds that approximate desired risk/ return profiles. This may be done where a "non-synthetic" security having the desired risk/return profile either is unavailable or possesses undesirable characteristics. The use of synthetic bonds may involve risks different from, or potentially greater than, risks associated with direct investments in securities and other assets. Synthetic bonds may increase other Fund risks, including market risk, liquidity risk, and credit risk, and their value may or may not correlate with the value of the relevant underlying asset.

Derivatives. The Fund may utilize derivatives for hedging or for other purposes related to the management of the Fund. Derivatives may be entered into on established exchanges or through privately negotiated, or "over-the-counter" ("OTC"), transactions. Generally, derivatives are financial contracts whose value depends upon, or is derived from, the value of an underlying asset, reference rate or index. Examples of derivatives that the Fund may use include futures, options, swaps (including interest rate and credit default swaps), forwards, credit-linked securities and other hybrid instruments. Derivative instruments are specialized products that require investment techniques and risk analyses different from those associated with stocks and bonds. These instruments typically allow an investor to hedge or speculate upon the price movements of a particular security, financial benchmark or index at no cost or at a fraction of the cost of investing in the underlying asset. The use of a derivative requires an understanding not only of the underlying asset but also of the derivative itself, without the benefit of observing the performance of the derivative under all possible market conditions. As the value of this type of instrument depends largely upon price movements in the underlying asset, many of the risks applicable to trading the underlying asset are also applicable to trading derivatives related to such asset.

Risks associated with using derivatives include the risk of mispricing or improper valuation of derivatives and the inability of derivatives to correlate perfectly with underlying assets, rates and indices. Many derivatives, in particular privately negotiated derivatives, are complex and often valued subjectively. In addition, improper valuations can result in increased cash payment requirements to counterparties or a loss of value to the Fund. Certain derivatives have the potential for unlimited loss regardless of the size of the original investment. The market for credit derivatives is somewhat illiquid and there are considerable risks that it may be difficult to either buy or sell the contracts as needed or at reasonable prices. Although the Investment Manager will implement risk management techniques designed to limit potential losses, such techniques may not accurately predict all derivatives trading risks.

[End of illustrative excerpt]



Accredited Investor: An accredited investor is an investor that meets certain income or net worth requirements set by the Securities and Exchange Commission under Rule 501 of Regulation D. For individuals, the income requirement is $200,000 annual income (or $300,000 when combined with a spouse) for the preceding two years with the reasonable expectation of achieving the same in the coming year. The net worth requirement is $1,000,000. "Net worth" means the excess of total assets at fair market value, including principal residence, but only if the current encumbrances on the primary residence exceed the fair market value of the principal residence, home furnishings and automobiles, over total liabilities.

Administrators: Hedge fund administrators perform certain back office accounting, operations and valuation services. Administrators send periodic financial performance reports to investors, process subscriptions, calculate periodic net asset value for the fund portfolio, calculate performance compensation and perform many other important support functions.

Anti-Fraud Provisions: Anti-fraud provisions refer to Section 17(a) of the Securities Act of 1933, Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 that require issuers to make certain required disclosures to investors when offering and selling securities. Additionally, each state has its own securities fraud provisions. The anti-fraud provisions prohibit the making of a misstatement or omission of a material fact in connection with an offering of securities. The company and its officers and directors can be held liable for violations.

Blue Sky Laws: Blue sky laws are state laws governing the issuance and registration of securities within that state. Blue sky laws contain registration requirements and anti-fraud provisions. Investment funds and most other private placement issuers rely on exemptions from the registration requirements of state law, most often Regulation D Rule 506. Even with the registration exemption, Regulation D issuers must still file a Form D notice filing and pay a state statutory fee in each state where investors have subscribed. This notice filing is often referred to as a "blue sky" filing.

Broker-Dealers: A broker-dealer is an individual or firm that purchases or sells securities for itself or on behalf of others, often acting as a placement agent. Broker-dealers must be registered with FINRA and are subject to extensive regulation. Only registered broker-dealers are permitted to accept commissions or other transaction-based compensation for making capital introductions. So-called "finders" or unregistered placement agents that make capital introductions are not permitted to accept any form of transaction-based compensation for capital raising efforts.

BVI (British Virgin Islands): The British Virgin Islands (BVI) is a popular jurisdiction for offshore hedge funds and other private funds. The BVI has gained the reputation as being a cost-effective and convenient jurisdiction. BVI's regulatory structure has sought to create a flexible jurisdiction with streamlined processes and strong legal certainty. BVI's regulatory filing fees are considerably lower than those of the Cayman Islands.

Capital Account: A capital account is an account on the fund's books that shows the equity owner's net investment in the fund. It is calculated by taking the capital contribution of the owner, adding the owners' share of fund's profits, and then subtracting the owner's share of fund losses in addition to the distributions or returns of capital. Capital accounts are used in limited partnerships, LLCs and other flow-through, partnership-based entities.

Cayman Islands, Offshore Fund Jurisdiction: The Cayman Islands is the world leader as a jurisdiction for hedge fund domicile, with the BVI coming in second. The Cayman Islands has historically been the top choice for offshore funds because of its business friendly structure, stable government and well-developed investment laws. Cayman Islands is a tax-exempt jurisdiction, allowing offshore investors and U.S. tax-exempt investors to avoid paying US taxes on hedge fund gains.

Closed-End Fund: A closed-end fund is an investment fund intended to last for a fixed term, usually between five and ten years. Investors in a closed-end fund are not generally permitted to make withdrawals or additional capital contributions. Most private equity funds, venture capital funds, real estate funds and other funds investing in illiquid assets are structured as closed-end funds.

Commodity Exchange Act: The Commodity Exchange Act prohibits fraudulent practices in trading futures contracts and other commodity derivatives, and provides for regulation of the managed futures industry. Any hedge fund manager trading in commodities or futures must comply with the Commodities Exchange Act.

Compliance Manual: The SEC requires the RIA to provide a policies and procedures manual (Compliance Manual) outlining the advisor's policies to protect investor interests and comply with advisor regulations.

(CPO) Commodity Pool Operator: A commodity pool operator is a pooled investment vehicle (including a hedge fund) that invests in commodities, futures and other instruments covered by the Commodity Exchange Act. Absent an applicable exemption, a CPO must register with the Commodity Futures Trading Commission (CFTC) and become a member of the National Futures Association (NFA).

(CTA) Commodity Trading Advisor: A commodity trading advisor (CTA) is an individual or organization that, for compensation, provides advice regarding investment in commodities futures and other instruments covered by the Commodity Exchange Act. Absent an applicable exemption, such advisors must register with the Commodity Futures Trading Commission (CFTC) and become a member of the National Futures Association (NFA). Associated persons of a CTA must pass the Series 3 Examination.

(CTFC) Commodity Futures Trading Commission: The Commodity Futures Trading Commission (CFTC) is an independent federal agency created by the Commodity Exchange Act to regulate the commodities futures and commodities options markets in the United States. Absent an exemption, a hedge fund that trades commodities derivatives must register with the CFTC as a commodity pool operator (CPO) and its associated persons must pass the Series 3 examination. CFTC registration requires membership in the National Futures Association (NFA), a self-regulatory organization responsible for overseeing the managed futures market.

Dodd-Frank Wall Street Reform and Consumer Protection Act: The Dodd-Frank Wall Street Reform and Consumer Protection Act is a federal law enacted in 2010. The Dodd-Frank Act brought sweeping changes to financial regulation affecting almost every component of the financial services industry. The most monumental change for hedge fund regulation was an enactment found in Title IV, requiring certain previously exempt investment advisers to register under the Investment Advisers Act. Regulation resulting from Dodd-Frank also made changes to the definition of investor suitability standards of an "accredited investor" and a "qualified client."

Finder: A finder is an individual who is not registered with FINRA as a broker-dealer, but who locates potential investors on behalf of an issuer and then facilitates the introduction between the investor and the company. A finder may not receive transaction-based compensation.Only registered broker-dealers may receive transaction-based compensation.

(FINRA) Financial Industry Regulatory Authority: Financial Industry Regulatory Authority (FINRA) is a regulatory agency that assists the SEC in regulating financial markets. Specifically, FINRA handles all the registrations of broker-dealers eligible to solicit investments to investors. All state and federal investment advisor registrations are processed through FINRA's Investment Advisor Registration Depository (IARD) system. FINRA administers the various licensing examinations from the securities financial markets.

Form D: An SEC form used to file a notice of an exempt offering of securities under Regulation D. Privately held companies that raise capital (including hedge funds) are required to file a Form D with the SEC.

Form U-4: The SEC and most states require advisor representatives to submit a Uniform Application for Securities Industry Registration or Transfer (U-4), containing specific background information about the advisor representative.

Forward-Looking Statements: Forward-looking statements are statements made in a private placement memorandum (or public securities disclosure) that are predictive of events to occur, but which have not actually occurred. They are predicated through the use of certain words and are based on certain assumptions. Should the statements fail to come to fruition, actual results, performances, or goals could be materially different than those proposed. The use of forward-looking statement requires care, and must be accompanied by appropriate explanatory language.

Fund Sponsor: Also known as the fund manager, the fund sponsor is the individual that organizes, manages and makes investment decisions in a hedge fund.

Gate: To prevent funds from being forced to untimely liquidate investment positions to satisfy large redemption requests, most hedge funds limit the percentage of the portfolio that can be withdrawn in any given redemption period (often 10%-25% of Assets Under Management). This is known as a gate. In 2008-2009 a large number of funds invoked gate provisions to prevent being forced to untimely liquidate poor-performing investments.

High Water Mark: To prevent a manager from receiving duplicate performance compensation following periods of volatility, most funds allow investors to recoup past losses before the fund manager is entitled to receive additional performance compensation. To accomplish this, a high water mark (or loss carry forward provision) is established immediately following the allocation of incentive compensation. Under the "loss carry forward" terms, fund management is only entitled to be compensated for performance that exceeds the prior "high water mark."

Hurdle: Some funds require the investment manager to achieve a certain level of return, either as a fixed percentage or a benchmark rate (such as LIBOR or the S&P 500) before managers are entitled to receive performance compensation. Hurdle rates can be either a "hard hurdle" or "soft hurdle." A hard hurdle means that the manager only receives performance compensation that exceeds the hurdle rate. A soft hurdle means that no performance compensation is received if performance falls short of the soft hurdle rate, but once the soft hurdle rate is exceeded, the manager is entitled to the entire performance compensation.

Intermediary: An intermediary, also referred to as a placement agent, is a person or organization that assists a fund in raising capital. Intermediaries can include broker-dealers, regulated by FINRA, as well as unregistered finders. Care must be taken when entering into any transaction with a finder, since only registered broker-dealers are allowed to be paid transaction-based compensation for making a capital introduction.

Investment Advisor: (Also spelled "investment adviser"). Investment Advisors are firms or individuals that receive compensation for advice on investing in securities. Hedge funds that invest in securities must either register with the appropriate jurisdiction as an investment advisor or satisfy an exemption.

Investment Advisers Act of 1940: The Investment Advisers Act is a federal statute regulating individuals and entities that, for compensation, provide investment advice, analysis or recommendations regarding securities or securities markets. With the exception of Wyoming, each state has its own version of the Investment Advisers Act. Hedge fund managers that invest in securities must comply with federal and state investment advisers act statutes.

Investment Advisor Representatives: Individuals who work for investment advisory companies whose main responsibility is to provide investment advice. In addition to registration of the RIA firm, most states require each individual performing advisory services on behalf of an RIA firm to register as an investment advisor representative. Most states require advisor representatives to submit a Uniform Application for Securities Industry Registration or Transfer (U-4), containing specific background information about the advisor representative. A number of states require advisor representatives to provide fingerprinting.

Investment Management Agreement: The investment management agreement is an agreement between the fund and the investment management company (often the same entity as the general partner). It defines the services that a fund manager will provide. It tpically gives the fund manager broad discretionary authority to manage the fund's investments in a manner that the fund manager believes is consistent with the investment strategy of the fund. Since the fund manager and the fund are controlled by the same individuals, the investment management agreement becomes a document signed by the same individuals on both sides.

Investor Suitability Questionnaire: An investor suitability questionnaire is a document filled out by an investor seeking to purchase securities in a private offering. The questionnaire asks the investor to attest that he or she meets the appropriate investor qualification standards required by the SEC. This is typically included with the subscription agreement.

JOBS Act: The JOBS Act is the Jumpstart Our Business Startups Act, a federal law that was enacted in 2012. This act loosened the restrictions on capital raising for small businesses including, most notably, requiring the SEC to lift the ban against general advertising and solicitation on certain Regulation D private offerings.

Limited Partnership Agreement: The limited partnership agreement (or in the case of an LLC-based fund, an operating agreement) is the legal governing document of the fund. The limited partnership agreement outlines the terms of the fund and rights of the investor and fund manager. In contrast with the private placement memorandum, which is written in plain English, the fund's limited partnership agreement is a complex legal document.

Lock-ups: It is typical for a hedge fund to require an initial lock-up period of one year or more before investors can withdraw invested funds, after which quarterly or semi-annual redemption is typically permitted. The lock-up period can be shortened or lengthened depending on the fund's investment strategy.

Management Fees: A management fee is assessed annually, typically ranging from 1% to 2% of the aggregate assets under management of a fund, regardless of the performance of the fund. The management fee is intended to cover manager salaries and general overhead. The management fee is deducted from each investor's account periodically (usually in advance) as set forth in the offering documents.

Master-Feeder Structure: This hedge fund structure involves creating both an offshore and onshore feeder fund, and an offshore master fund to facilitate investment by foreign investors and tax exempt US investors. Investors invest in the feeder fund, which invests in the master fund.

Material Omissions: Material omissions are misstatements, willful or unintentional, or omissions of material facts in association with an offering of securities.

National Futures Association: The National Futures Association (NFA) is a self-regulatory organization established by the Commodities Futures Trading Commission (CFTC) to regulate the managed futures market and ensure compliance with the Commodities Exchange Act. The NFA acts as a watchdog organization to prevent commodities investment fraud.

National Securities Markets Improvement Act of 1996: The National Securities Markets Improvement Act of 1996 (NSMIA) was passed by congress to amend and simplify former security acts to create one standard code for all companies and regulators. Because of NSMIA, offerings made in reliance of Rule 506 preempts state securities registration regulation.

Operating Agreements: The fund manager operating agreement is the legal governing document that provides all of the rights of the founders of the fund. This document specifies how ownership of the fund is divided among the principals of the fund. The management company operating agreements or its contents is not disclosed to investors.

Performance Allocation: The performance allocation is one of the defining characteristics of hedge funds and private equity funds and distinguishes them from mutual funds, which charge only a management fee. A performance allocation is a percentage of the increase in the value of the fund assets (usually around 20%) allocated to the fund's general partner as an incentive for positive performance. The performance allocation is intended to align the interests of the fund manager with that of the investor and provide significant upside potential for fund managers.

Placement Agent: A placement agent assists the alternative investment community or private companies seeking to raise capital through private placement. Placement agents should be registered broker-dealers to accept transaction-based compensation.

Private Placement Memorandum (PPM): A private placement memorandum ("PPM"), also known as a private offering memorandum, is a securities disclosure document used in a private offering of securities. From an investor's point of view, the purpose of a PPM is to obtain needed information about the security and the company, both good and bad, to allow investors to make an informed decision about whether to invest in the fund. From the fund's perspective, the purpose of a PPM is to provide the necessary disclosures about the fund to protect it against claims of misstatements or omissions.

Qualified Clients: Hedge fund managers that are subject to federal or state investment advisor registration may only earn a performance allocation from investors that are "qualified clients". A qualified client generally includes:

1. an individual or a company that has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2,000,000 at the time the contract is entered into, exclusive of primary residence; or

2. an individual with at least $1,000,000 under management of the investment adviser.

Regulation D: Regulation D is to safe harbor SEC regulation promulgated under the Securities Act, which governs private placement securities exemptions, allowing issuers the ability to sell securities without registering with the SEC. Hedge funds that have U.S. investors almost always rely on Regulation D, specifically, Regulation D Rule 506.

Regulation D Rule 504: Regulation D Rule 504 is governed by Section 3(b) of the Securities Act. This rule is a safe harbor provision for private offerings that will not exceed one million dollars from an unlimited number of investors. A company that follows the requirements of Rule 504 is exempt from registering its securities with the SEC, but is still subject to state registration in each state in which the company offers securities unless the company finds a state registration exemption. Thus, even in offerings of less than one million dollars, we recommend that issuers rely on Rule 506 rather than Rule 504 when possible, to avoid being subject to state registration requirements. Rule 504 is most commonly used when the company needs to raise capital from more than 35 unaccredited investors and the company is not eligible for a Rule 506 exemption. In certain cases, Rule 504 may be used with general advertising without federal registration. However, such an offering would require registration or a state exemption in every state in which it is offered.

Regulation D Rule 505: Regulation D Rule 505, like Rule 504, is governed by Section 3(b) of the Securities Act. It is a safe harbor provision for offerings that will not exceed five million dollars. Because of the benefits that are offered under Rule 506, this exemption is rarely relied upon, except as a backup exemption. Rule 505 permits the issuer to offer securities to no more than 35 unaccredited investors. This rule prohibits general solicitation or advertising to potential investors. Rule 505 requires that strictly prescribed information be given to the unaccredited investors, including audited financial statements.

Rule 10b-5: Rule 10b-5 is an SEC regulation under the Securities and Exchange Act of 1934, which prohibits the use of false statements, omission of information and other deceptive practices in transactions involving stocks and securities. The company and its officers and directors can be held liable for violations.

Securities: Securities are financial or investment instruments that represent ownership positions in a company, a creditor relationship with the company, or some derivative of either ownership or evidenced debt. Securities include a broad array of financial instruments, contracts and compensation schemes.

Securities Act of 1933: The Securities Act of 1933, often referred to as the "Securities Act" is a federal statute that governs securities at issuance, including the transparency of financial statements to ensure that investors can make informed decisions about investments. This act establishes laws against misrepresentation and fraudulent activities in the securities market. Section 5 of the Securities Act requires that all non-exempt securities issuances be registered with the SEC. The most common exemption for an issuer of private securities is Regulation D, which includes Rule 504, 505, and 506 (including the new Rule 506(c)).

Securities Exchange Act of 1934: The Securities Exchange Act of 1934, often referred to as the "Exchange Act" governs securities transactions after issuance (i.e. on secondary markets) and regulates the exchanges and broker-dealers in order to protect the public. The Exchange Act imposes ongoing reporting requirements on certain companies that have registered with the SEC under the Securities Act (reporting companies). Private issuers, including private investment funds, seek to avoid the burdensome ongoing requirements of the Exchange Act by qualifying for exemption from registration under the Securities Act (most often under Regulation D, specifically Rule 506), making such private issuers also exempt from the ongoing reporting requirements of the Exchange Act.

Series 65 Examination: Most states require advisor representatives to pass the Series 65 examination (or an equivalent examination combination or professional designation). The Series 65 examination is a 130 question multiple choice test administered by FINRA covering topics such as: securities regulations, ethical guidelines, security products, methods for evaluating securities, securities trading strategies, principals of economics, and others.

Side-by-Side Structure: Also known as a Parallel fund structure, a side-by-side structure has a U.S. fund and offshore fund that parallel each other in trading and have the same investment manager but maintain separate investment portfolios.

Side Letters: Most offering documents allow the management team to negotiate special terms (known as side letters) that are not applicable to other investors. Often the special arrangement involves better economic terms, such as reduced management or performance fee, or more convenient withdrawal terms. Care must be taken, however, not to allow side letters to prejudice other investors. For example, side letters that provide additional information rights or preferential liquidity treatment can present significant liability.

Side Pockets: Side pockets are accounts designed to separate liquid from illiquid assets used in hedge funds.

Subscription Agreement: A subscription agreement is an application by an investor to engage in a limited partnership in which the company agrees to sell a certain number of shares at a specific price to the investor. The investor in turn agrees to pay that price for the shares. The investor questionnaire is typically included or integrated with the subscription agreement.

Transaction-based Compensation: Any compensation of an individual or firm in the form of commission or sale of securities for capital introduction is transaction-based compensation. Transaction-based compensation may only be paid to FINRA registered broker-dealers.

UBTI Taxes: The Unrelated Business Taxable Income (UBTI) Tax applies to income generated by a tax-exempt organization by means of taxable activities. This type of income is generated outside of normal business operations. US tax-exempt investors, including RIAs and pension plans, may be subject to UBTI if the fund employs certain types of leverage as part of its investment strategy. To avoid UBTI, such investors should invest through a tax-exempt offshore investment fund, most commonly through a master-feeder or side-by-side structure.

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CONTACT INFORMATION

We would be delighted to discuss your private placement or answer any questions that you might have about your offering. John Lore's complete contact information is as follows:

John S. Lore, Esq.

222 South Main Street Suite 500

Salt Lake City, Utah 84101

Phone: (801) 456-3620

jlore@capitalfundlaw.com

capitalfundlaw.com

A MUST READ FOR HEDGE FUND MANAGERS

This publication provides an in-depth guide to assist emerging hedge fund managers through the process of successfully structuring, launching, and raising capital for a domestic or offshore hedge fund. Hedge fund attorney John Lore highlights pitfalls that fund sponsors should watch for and suggests the best practices to safely and effectively navigate the process of forming and operating a hedge fund. This book also contains a sample hedge fund private placement memorandum excerpt, with footnoted explanations of key hedge fund provisions.

ABOUT THE AUTHOR

John S. Lore, Esq. is the managing partner of Capital Fund Law Group, an investment fund law boutique focused on domestic and offshore hedge fund formation and compliance. Mr. Lore advises established and emerging fund managers throughout the United States in forming and operating hedge funds, private equity funds, real estate funds and other fund vehicles.

Prior to founding Capital Fund Law Group, Mr. Lore practiced corporate and securities law at a number of law firms, including the investment funds division of Akin Gump Strauss Hauer & Feld in its New York and Moscow offices. Mr. Lore received his Juris Doctorate, with honors, from the University of Utah, S.J. Quinney College of Law, where he served as a senior member of the *Utah Law Review* staff. Mr. Lore is a holder of the Series 65 Investment Adviser Law Examination.

CAPITAL FUND LAW GROUP, P.C.

222 S. Main Street, Suite 500

Salt Lake City, Utah 84101

capitalfundlaw.com

(801) 465-3620