

Conducting Due Diligence of Solicitors and Drafting Solicitation Agreements

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Due to the dramatic increase in the last decade in the number of private investment vehicles commonly referred to as “hedge funds,” money managers have experienced increased competition in obtaining new investors. The frenetic growth in the hedge fund industry has also made it difficult for investors to distinguish among the thousands of hedge funds in existence. Most hedge fund managers tout their past performance and investment strategy, while investors try to distinguish managers by conducting background checks and interviews with managers to ascertain their knowledge of the securities industry, and by comparing managers’ track records against competitors in the same asset class. This frenzy has also caused a swelling in the ranks of persons who solicit funds. Although many of these solicitors (also referred to as third party marketers) attempt to bridge the gap between the manager and the investor, are they accomplishing their intended goal, and at what price? This article outlines some of the concerns that hedge fund managers should address prior to entering into a relationship with a solicitor.

Prior to engaging a solicitor, a hedge fund manager should conduct due diligence of the solicitor. Many hedge fund managers have failed to properly conduct due diligence of and negotiate transactions with solicitors. If the hedge fund manager does not possess the skill set necessary to conduct due diligence, it should employ a professional to conduct such due diligence on a solicitor. Key areas of concern with regard to conducting due diligence of a solicitor, prior to entering into a client referral agreement, involve:

1. solicitor’s conflicts of interest, such as a clear disclosure of all sources of income received by the solicitor and other hedge fund managers represented by the solicitor;
2. the method and level of due diligence conducted by the solicitor of each prospective investor;

3. the information provided by the solicitor to the prospective investor;
4. whether the solicitor has been properly licensed under federal and state securities laws;
5. determining the sources and amount of capitalization of the solicitor (e.g., is the solicitor’s business properly funded?); and
6. if the solicitor is a corporate entity, what is the structure of the solicitor and who are its principals.

After conducting proper due diligence, prior to engaging the solicitor, the hedge fund manager should carefully document its relationship with the solicitor. This agreement is commonly referred to as a “Client Referral” or “Solicitation Agreement.” The solicitation agreement should, in part:

1. identify the parties (for example, generally, the solicitor needs to be Series 7 licensed and thus the solicitation agreement should be entered into by the hedge fund manager and the brokerage firm holding the solicitor’s Series 7 license);
2. identify the products for which the solicitor has been engaged to raise assets (a specific hedge fund, all of the hedge funds in existence at the time of entering into the solicitation agreement, or inclusion of all hedge funds to be formed in the future);
3. identify the scope of persons for whom the solicitor will be compensated upon their making an investment (a direct referral or will the solicitor also be compensated for a referral by a person he/she referred);
4. carve out prospective investors with whom the hedge fund manager has already established a relationship but who have yet to make an investment with the hedge fund manager;
5. enable the hedge fund manager to review, control and approve, in advance, the information to be provided by the solicitor to prospective investors;
6. provide the hedge fund manager with an opportunity to review and approve, a list of

persons whom the solicitor intends to solicit, prior to those persons being provided with information regarding the hedge fund manager's financial products; and

7. indemnify the hedge fund manager from liability resulting from the solicitor's actions.

In addition to conducting due diligence of the solicitor and entering into a written agreement with the solicitor, there are other regulatory concerns that require attention. The hedge fund manager should be aware that:

1. Form D must be revised to reflect the engagement of the solicitor; and
2. if the hedge fund manager is registered as an investment adviser with the U.S. Securities and Exchange Commission or a state regulatory agency, it may be necessary for the manager to revise its Form ADV.

Based upon our collective experience organizing hedge funds and providing on-going legal services to hedge fund managers, we believe that many hedge fund managers are employing the services of solicitors who have not been properly screened. Many solicitors are not properly registered or are undercapitalized. Further, many solicitors have relationships with too many hedge fund managers, thereby decreasing the likelihood that they will make a material difference for any one manager. Nonetheless, there are solicitors who are capable of introducing qualified assets to hedge fund managers. The successful solicitors are usually highly selective with whom they will work and perform a valuable service, screening the

hedge fund manager for their investors. Therefore, the successful solicitor will not be opposed to answering questions concerning due diligence but will recognize those questions as a sign of competence. Further, requiring that the solicitor enter into a written agreement with the hedge fund manager serves to protect both the manager's and the solicitor's interests. If a solicitor is truly capable of raising assets for the manager, the solicitor will be properly registered and will require a written agreement documenting the solicitor's fees and the mechanics of their payment. ■

About the Author

Ron S. Geffner, an attorney with Sadis & Goldberg, regularly structures, organizes and counsels investment advisory organizations, broker-dealers, commodity pool operators and other investment fiduciaries. Ron's broad background with federal and state securities laws and the rules and regulations of the National Association of Security Dealers, Commodities Futures Trading Commission and various other regulatory bodies, enables him to provide strategic guidance to a diverse clientele. He provides legal services to hundreds of hedge funds, venture capital funds and funds of funds.

Prior to joining Sadis & Goldberg, Ron was associated with two other New York City-based law firms, where he represented domestic and offshore private investment vehicles, as well as broker-dealers, registered investment advisers and registered investment companies. He began his corporate legal career as in-house counsel to the Investment Management Industry

Services Group of PriceWaterhouse Coopers LLP. He provided legal advice to the Group regarding investment advisers, registered investment companies and broker-dealers.

Ron began his legal career with the United States Securities and Exchange Commission, where he investigated and prosecuted violations of the federal securities laws. He also assisted federal and state criminal agencies such as the Federal Bureau of Investigation, U.S. Attorney's Office and the Attorney General's Office, in connection with their investigations of possible criminal violations of federal and state securities laws.

Ron is often interviewed as a legal expert in the securities industry and has been quoted in Fox News, CBS Morning Show, CBS Evening News with Dan Rather, Squak Box and Power Lunch on CNBC, British Broadcasting Channel, Bloomberg Radio, The New York Times, Bloomberg News, Barron's, Barron's Online, Reuters, Dow Jones, Financial Times, New York Newsday, London Daily News, TheStreet.com, Private Equity Week and other national and international publications. In addition, he has published a number of leading industry and legal articles.

Ron received his J.D. in 1991 from Benjamin N. Cardozo School of Law, and received his B.A. degree in 1988 from Rutgers University. He is a member of the New York and New Jersey Bars, and may be reached via phone (212-947-3793 ext. 21) or e-mail (rgeffner@sglawyers.com).