

Private Equity and Hedge Funds:

Regulatory Analysis and Structural Overview

by

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At Fox Rothschild LLP, we have a wealth of experience in creating and forming private equity and hedge funds. Over the years, our strategy has been to work with our clients to develop these entities while also assisting them in their ongoing business operations. As a result of the breadth of our experience, we have produced this handbook as a reference guide for both those contemplating entering into this exciting field or those already in the business seeking a handy resource when a question arises.

In an anticipation of your interest in these fund offerings, we wish to provide you with a summary of the most common compliance-related issues that private equity and/or hedge funds face. Of course, every issue is not covered that you may encounter in raising capital. Therefore, we suggest that you contact us with any question or concern if an issue should arise. Please keep in mind that any deviation from the current statutory and regulatory structure (primarily based in exemptions and exceptions to provisions of the Securities Act of 1933, Securities Exchange Act of 1934, the Investment Advisers Act of 1940 and the Investment Company Act of 1940) for your private equity or hedge fund could subject you and your associates to significant liability.

This handbook has been prepared in two parts. The first part provides a summary of regulatory issues affecting hedge fund formation and operation. The second part contains a generic “Summary of Terms” of the type that would be incorporated within a typical private placement memorandum. In the “Summary of Terms,” we have tried to identify the types of issues that would be relevant for you as a start-up fund and as a baseline for discussion and modification.*

* This handbook has been prepared for internal use only as a generic summary guideline of the regulatory issues affecting private equity and hedge fund formation and operation. It has not been customized for the use of the recipient or to address any specific issues that may be particular to the recipient. This material, absent separate written confirmation by a Fox Rothschild attorney, is not to be relied upon as legal advice, an opinion of Fox Rothschild or as a current statement of the law. Further, this handbook remains the property of Fox Rothschild and is not to be reproduced or provided to any third party.



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Section 1: Regulatory Analysis

Private Equity and Hedge Funds: Definitions

Many (if not all) participants in the private equity fund arena accept that there are several categories of private equity funds. Those funds include, among others: venture capital funds; leveraged buyout or merchant banking funds; hedge funds; funds of funds; and real estate funds. Although we will primarily focus on hedge fund formation, many of the issues discussed below relate to the other categories of private equity funds as well.

The term "hedge fund" is not defined or used in any federal securities law. In fact, the very creation and existence of hedge funds are primarily designed to operate outside the regulatory requirements for investment companies. Thus, the term hedge fund is more amorphous and is used to describe a privately organized, pooled investment vehicle managed by a professional investment manager that often engages in active trading in either a group of securities or commodities, including equities, government securities, municipal securities, futures, options and foreign currencies. Hedge funds usually employ sophisticated investment techniques, including arbitrage leveraging and hedging. Hedge funds are generally not registered under the Securities Act of 1933 (the "Securities Act") nor Investment Company Act of 1940 (the "Company Act").



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Organization

Private equity and hedge funds are typically organized as a private limited partnership or limited liability company with a general partner or managing member. In rare circumstances, certain of these funds are occasionally registered with the United States Securities and Exchange Commission (SEC).

Investors in these funds purchase a share of the fund in return for a fixed percentage of the funds profits, minus fees. These funds ordinarily require significant investments, restrict transferability of the fund interest and limit the times when an investor may redeem their fund interest.

Unlike mutual funds that are subject to mandated liquidity provisions, private equity and hedge funds are free to develop their own redemption rules, and, typically, include “lock-up” provisions.



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Investment Manager and Compensation

This person manages the fund and either makes investment decisions or selects the person who will make the investment decisions.

These managers customarily earn compensation that is tied to the performance of the fund. This compensation is referred to as a performance fee. Performance fees range from 10% to 20%, and are earned when the hedge fund experiences a positive return. The fund manager also earns from 1% to 2% of all assets as an annual fee.

A number of funds also charge significantly greater fees and assess a fixed asset based fee and/or pass through certain expenses to the investor. Performance fee calculations usually also incorporate a high watermark concept requiring the hedge fund manager to make up any prior unrecouped losses before earning a performance fee from current profits. Some funds also incorporate a "hurdle rate," requiring the fund to exceed a certain minimal rate of return before the performance fee is assessed.

Fees can be apportioned directly to the withdrawals from the fund, rather than based on a period of at least 12 months as to mutual funds.



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Investors

Most funds market fund interests solely to institutional investors or wealthy, sophisticated individuals. There are two types of investors: accredited investors and qualified purchasers.

Accredited investors are defined to include, among other things, any bank, broker or dealer, limited liability companies with assets in excess of \$5 million, any natural person with an individual or joint net worth with that person's spouse at the time of purchase exceeding \$1 million, and any natural person whose individual income is in excess of \$200,000 (or joint with a spouse in excess of \$300,000) for the two most recent years. See 17 C.F.R. § 230.501 and 15 U.S.C. §80b-1. Interests in the fund are to be offered exclusively to accredited investors as that term is defined in SEC Securities Act Rule 501 of Regulation D. An investor is considered accredited if the investor is: (a) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase; or (b) a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. There are other categories of investors that are also considered accredited. Please refer to SEC Securities Act Rule 501 for a complete list of categories or call us for more information.

The other form of an investor is a qualified purchaser. The Company Act Section 2(a)(51)(A) defines a qualified purchaser as, among other things: any natural person who owns at least \$5 million in investments; a family owned company that has more than \$5 million in assets; and any other person, who in the aggregate, either owns or invests at least \$25 million for its own account or the accounts of others.

Regardless of the type of investor, to be exempt from registration pursuant to the Company Act, a fund may not be beneficially owned by more than 100 people if sold to accredited investors, or, if sold to qualified purchasers, more than 500 persons. See Company Act § 3(c)(1) and 3(c)(7). Thus, those interested in a fund must be ever vigilant before undertaking business ventures with a fund to ensure that it is not subsumed in some inappropriate venture disguised as a private equity or hedge fund.



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The Fund Business Is Not “Regulation-Less”

Although, at first blush, these funds provide an appearance that the industry is some by-product of the “wild west,” there are, in fact, significant hurdles in place to overcome before entry into this world. There are numerous regulatory considerations when organizing and operating a domestic fund as well as when engaging in business with a private equity or hedge fund. Many of these considerations arise from the interpretation, application and interplay of various statutes, including the Securities Act, the Securities Exchange Act of 1934 (“Exchange Act”), the Investment Advisers Act of 1940 (“Advisers Act”) and the Company Act, as well as state blue sky laws, the Commodity Exchange Act (“Commodity Act”) and applicable tax laws and regulations.



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Offering Funds to the Public and the Securities Act

The Securities Act requires that private equity and hedge funds offered in the United States must structure their offers and sales of interests in these funds as private placements to be exempt from the requirement of registration. Consequently, the vast majority of these funds are offered as private placements. Although Securities Act Section 4(2) exempts offerings of securities if it is not a public offering, the SEC and courts review several factors to determine whether a public offering has occurred, including the number of offerees, the sophistication of the offerees, the nature of the information disseminated and the manner of the solicitation.

Private placements are generally made in accordance with Securities Act Rule 506 of Regulation D, a non-exclusive safe harbor for issuers relying on Securities Act Section 4(2). Regulation D permits sales of fund interests to an unlimited number of an "accredited investors," but limits the sales of a fund interest to 35 non-accredited investors. Securities Act Rule 506 does not limit the dollar amount of securities that can be offered, but Securities Act Rule 502(c) of Regulation D prohibits any offers or sales through general solicitation or general advertising. The SEC looks at the relationship between the issuer and offeree and the method of solicitation to evaluate compliance with these requirements. The offering of interests in these funds is designed to fall within the private offering exemption from registration that is set forth in SEC Regulation D. Among the many requirements that you must abide by to take advantage of this exemption is the requirement that no general solicitation of investors be performed. Accordingly, you may not use cold calling, advertising, mass e-mails or spam, web sites or other similar forms of promotion to solicit investors or promote or solicit investment in your hedge fund.

To help establish that you have complied with the requirements of SEC Regulation D, we generally recommend that you maintain a log sheet to track each set of offering documents that are provided to a potential investor. Each private placement memorandum ("PPM") sent to an investor should be consecutively numbered, and a record should be made of the person's name and address. If the person decides not to invest, every effort should be made to have that person return the PPM and related documents within a reasonable time.

Finally, a notice of sale on a Securities Act Form D must be filed within 15 days of the first sale under Securities Act Regulation D with the SEC and various states. Failure to file will not adversely affect the availability of the exemption but may serve as a basis for the SEC to deny the issuer future reliance on Securities Act Regulation D. Further, it is imperative to update counsel as to when the first investment is received so that counsel may file the Securities Act Form D on behalf of the private equity and hedge fund.



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The Company Act and the Fund as a Private Pool of Capital

Funds are typically organized to avoid the compliance requirements of the Company Act by restricting the fund to less than 100 private investors, or to only “qualified purchasers” if it intends on selling to 500 private investors.

A domestic fund investing in securities is required to register as an investment company under the Company Act, absent an exemption from the definition of the term “investment company.” Section 3(c)(1) of the Company Act exempts from the registration requirements of the Company Act an investment vehicle that meets two tests. It must have no more than 100 beneficial owners; and it must not make or propose to make any public offering of its securities.

The SEC has taken the position that the private placement test under Company Act Section 3(c)(1) is met if the offering of securities meets the criteria of Section 4(2) of the Securities Act, or of Rule 506 of Regulation D.

To determine the number of beneficial owners of a fund, the following applies: each individual investor is counted separately. Securities of a Company Act Section 3(c)(1) fund jointly owned by both spouses are considered owned by one beneficial owner. An investing entity that owns less than 10% of the outstanding voting securities of a fund will be considered one person. Prior to the enactment of the National Securities Markets Improvement Act of 1996 (“NSMIA”), an entity that owned 10% or more of the outstanding voting securities of a fund was considered one person for purposes of the 100 beneficial owner test only if the value of all of its holdings of Company Act Section 3(c)(1) excluded investment companies did not exceed 10% of the investing entity’s assets (the “Second 10% Test”). If the investing entity failed this Second 10% Test, one was required to “look through” the entity to its beneficial owners, each of whom would then be considered a beneficial owner of the hedge fund. NSMIA eliminated the Second 10% Test and counts an owner of any percentage of the hedge fund as one person for purposes of the 100 beneficial owner test except where the 10% or more owner is an investment company, including those companies exempted under Company Act Sections 3(c)(1) and 3(c)(7).

An entity that is not a public or private investment company will be able to own more than 10% of a Company Act Section 3(c)(1) fund and count as one beneficial owner for purposes of the 100-person beneficial owner limit. Company Act Section 3(c)(1) funds will, however, always be required to “look through” with respect to public or private investment companies that own over 10% of their voting securities. Since the amendments to Company Act Section 3(c)(1) were intended to simplify application of the statute and not disrupt existing investment relationships, Company Act Rule 3c-1 was adopted and provides that the amended look-through provision will not apply in the case of an investor that held more than 10% of the outstanding voting securities of a Company Act Section 3(c)(1) fund on or before April 1, 1997, provided that the investor continues to satisfy the Second 10% Test. The SEC has stated that, as a general matter, the determination of whether an investor is subject to the amended look through provision must be



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made each time the investor acquires a voting security of a Company Act Section 3(c)(1) fund. However, the look through provision will not be applied if the investor's proportionate share of the fund's voting securities increased as a result of another investor's withdrawal unless the withdrawal was part of a series of transactions designed to circumvent the look-through provision.

NSMIA also added a new exception from the definition of investment company under Company Act Section 3(c)(7), covering an investment pool that does not make or propose to make a public offering of its securities and whose securities are held exclusively by "Qualified Purchasers." Absent the considerations previously discussed, a Company Act Section 3(c)(7) fund could in theory have an unlimited number of Qualified Purchaser investors. Qualified Purchasers are defined in Section 2(a)(51)(A) of the Company Act as: any natural person (including any person who holds a joint, community property or other similar shared ownership interest in an issuer that is excepted under Company Act Section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than \$5 million of investments, as defined by the SEC; any company ("Family Company") that owns not less than \$5 million in investments and that is owned directly or indirectly by or for two or more natural persons who are related, or by such persons' estates, foundations, charitable organizations or trusts; any trust that is not covered by clause (b) and that was not formed for the specific purpose of acquiring the securities offered, as to where the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clauses (a), (b) or (d); and any person (e.g., an institutional investor), acting for its own account or the accounts of other Qualified Purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments.

Additionally, Company Act Rule 2a51-1 provides that, with two exceptions, a Qualified Institutional Buyer ("QIB") as defined by Rule 144A(a) under the Securities Act of 1933 is deemed to be a Qualified Purchaser. Securities Act Rule 144A generally defines a QIB as certain institutions that own and invest on a discretionary basis \$100 million of securities of issuers that are not affiliated with the institution ("QIB Securities"); banks that own and invest on a discretionary basis \$100 million of QIB Securities and that have an audited net worth of at least \$25 million and certain registered dealers that own and invest on a discretionary basis \$10 million of QIB Securities. The first exception pertains to dealers and coordinates the definition of QIB with that of Qualified Purchaser by requiring the dealer to own and invest on a discretionary basis \$25 million of QIB Securities. A dealer may meet the Qualified Purchaser test by owning and investing on a discretionary basis \$25 million of investments in accordance with Company Act Rule 2a51-1.

The second exception pertains to self-directed employee benefit plans such as 401(k) plans. Such plans will not be considered to be Qualified Purchasers unless each of the participants in such plans are themselves Qualified Purchasers. Company Act Rule 2a51-1 defines "investments" broadly for purposes of determining whether the \$5 million and \$25 million Qualified Purchaser thresholds have been met. Investments include the following: securities,



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except for securities that constitute a “control interest” in issuers other than (i) investment vehicles excluded or exempted from the definition of investment company by Company Act Sections 3(c)(1) through 3(c)(9) or Rules 3a-6 or 3a-7 under the Company Act, (ii) public companies or (iii) large private companies having shareholders’ equity of \$50 million or more; real estate held for investment purposes (this will exclude the personal residence of and property used as a place of business by the prospective Qualified Purchaser); commodity interests, physical commodities and financial contracts that are held or entered into for investment purposes; and cash and cash equivalents held for investment purposes including bank deposits, certificates of deposit, bankers acceptances and similar bank instruments as well as the net cash surrender value of insurance policies.

Investments may be valued based either on their fair market value or cost and must take into account indebtedness incurred to acquire an investment. A Company Act Section 3(c)(7) fund need only have a reasonable belief that the investor is a Qualified Purchaser based upon the investor’s representations but the investor’s status must be assessed each time the investor acquires securities of the fund, unless subsequent acquisitions are pursuant to a binding agreement requiring installments or periodic capital calls. Company Act Rule 3c-5 permits “knowledgeable employees” of a fund and certain of its affiliates to acquire securities issued by the fund without being counted for purposes of Company Act Section 3(c)(1)’s 100 investor limit and permits such employees to invest in a Company Act Section 3(c)(7) fund without meeting the Qualified Purchaser test. It defines a “knowledgeable employee” to include executive officers, directors, trustees, general partners and advisory board members of the fund or its manager as well as other experienced employees who participate in the fund’s investment activities.

To preclude circumvention of the requirements of Company Act Section 3(c)(1), the SEC has required distinct Company Act Section 3(c)(1) funds to be “integrated” for purposes of determining whether they have exceeded the 100 investor limitation if a reasonable investor would view the two funds as being essentially the same based on such factors as the strategies being pursued, the composition of their portfolios and their risk/return characteristics. NSMIA provides in Company Act Section 3(c)(7)(E) that a Company Act Section 3(c)(1) fund and a Company Act Section 3(c)(7) fund will not be treated as a single issuer by the SEC. Thus, even if the two funds are managed in a similar fashion, the investors in a Company Act Section 3(c)(7) fund will not be included in determining the Company Act Section 3(c)(1) fund’s compliance with the 100 investor limitation and non-qualified purchaser investors in the Company Act Section 3(c)(1) fund will not impair the status of the Company Act Section 3(c)(7) fund.



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The Investment Manager and the Advisers Act

The Advisers Act regulates the activities of investment advisers. The manager of a fund generally will fall within the definition of an “investment adviser” under Section 202(a)(11) of the Advisers Act. However, the fund manager may also usually be exempt from registering as an investment advisor under the “private advisor exemption” of the Advisers Act. A person is exempt from registration pursuant to the Advisers Act if the person does not have more than 15 clients. See Advisers Act Section 203(b)(3). An Advisers Act exemption usually exists for the fund manager because the fund only counts as one client for the manager although the fund may have numerous investors. However, please be advised that since the beginning of 2009, numerous bills have been introduced in Congress and by the Obama Administration to repeal this exemption.

Prior to the enactment of NSMIA, investment advisers in the United States were subject to regulation at both the federal and state levels. The Investment Adviser Supervision Coordination Act (“Coordination Act”), which was adopted as part of NSMIA, reallocates regulatory responsibility between the SEC and state regulators based primarily on the size and scope of the investment adviser’s business.

Under the Coordination Act, an investment adviser that is regulated or required to be regulated in the state in which it maintains its principal office and place of business can only be registered with the SEC if it has \$25 million of assets under management or advises a registered investment company. State regulators are preempted from regulating advisers registered with the SEC but retain authority over SEC registered advisers under state investment adviser statutes to investigate and bring enforcement actions against the adviser or persons associated with the adviser, with respect to fraud or deceit and to require, for notice purposes, filings of documents filed with the SEC and payment of state filing, registration and licensing fees.

Section 203(b)(3) of the Advisers Act contains the small adviser exception from federal registration. Advisers Act Section 203(b)(3) exempts from registration: any adviser with fewer than 15 clients during the preceding 12 months, who does not hold itself out to the public as an investment adviser and who does not serve as an adviser to a registered investment company or a business development company.

To determine the number of clients, Advisers Act Rule 203(b)(3)-1 provides a non-exclusive safe harbor for determining who may be deemed a single client under the exemption. The rule’s “natural person” clause provides that a natural person and any minor child of the natural person, any relative, spouse or relative of the spouse of the natural person having the same principal residence and all accounts and trusts of which the foregoing are the only primary beneficiaries will be considered one client.



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The rule's "legal organization" clause had treated as a single client a corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to under the natural person clause) or other legal organization that receives investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members or beneficiaries. On October 26, 2004, however, the SEC approved amendments to Advisers Act Rule 203(b)(3)-1 that required advisers to "look through" each of those funds and count each investor in the funds as a single client. On June 23, 2006, in *Goldstein v. SEC*, the United States Court of Appeals for the District of Columbia Circuit vacated the amendment, finding that the SEC had failed to give adequate reasons for abandoning its previously held position that the hedge fund, rather than its investors, was the adviser's client.

A fund manager that qualifies for the exemption from federal registration and that is managing less than \$25 million (and not advising a registered investment company) will be subject to state registration absent an exemption under state law. Section 1-102(J) of the PA Securities Act of 1972 exempts an investment adviser from state registration if the adviser has a place of business within the state and, during the preceding 12 month period, has not had more than five clients and does not hold himself out to the public as an adviser. Similar exemptions exist in other states.

Registration is of particular significance to funds in that it imposes certain limitations on who can be charged performance based compensation as well as requirements on how such compensation is calculated. Section 205(a) of the Advisers Act applies only to registered advisers, and, generally, prohibits performance based compensation. Advisers Act Rule 205-3 provides an exception to this general prohibition for performance based fees charged to "Qualified Clients." Qualified Clients must (i) have a net worth of at least \$1.5 million (ii) have at least \$750,000 under management by the adviser, (iii) be a "Qualified Purchaser" under Section 2(a)(51)(A) of the Company Act or (iv) fall within certain categories of knowledgeable employees of the investment adviser. Generally, the individual investors in the fund, rather than the fund itself, are considered for purposes of this analysis and the conditions of Advisers Act Rule 205-3 must be applied separately to each investor. A Company Act Section 3(c)(1) fund will be deemed an eligible investor only if all of its beneficial owners are eligible investors. However, a Company Act Section 3(c)(7) fund may enter into a performance fee contract without requiring each investor to satisfy the eligibility criteria of Advisers Act Rule 205-3.



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Exchange Act Requirements

The Exchange Act has several applications to the fund world, including broker-dealer registration to sell these interests, the size of the fund, disclosure of all material information, soft dollar arrangement prohibitions, ongoing disclosure obligations, adherence to stated investment policies and reporting requirements.

Generally, the Exchange Act requires broker-dealer registration to market and sell these interests. However, broker registration of a fund or its manager will not be required because they are not "effecting transactions in securities for the account of others." See Exchange Act § 3(a)(4). Dealer registration will similarly not be required of the fund or its manager because the fund and its manager "buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business." See Exchange Act § 3(a)(5). Most funds and their managers are not required to register because they are considered "traders" as opposed to brokers or dealers in that they do not possess the characteristics of a broker-dealer. In fact, funds and their managers are essentially managing their own account on a continuous basis. Further, the fund and its manager do not possess other characteristics of a broker-dealer since they do not make a market in one or more securities or extend or arrange for the extension of credit in connection with securities activities. Under Section 3(a)(4) of the Exchange Act, broker registration of a fund or its manager will not be required if they do not "effect transactions in securities for the account of others." Similarly, under Exchange Act Section 3(a)(5), dealer registration will not be required of "any person insofar as he buys or sells securities for his own account ... but not as part of a regular business."

However, problems do arise when third parties sell fund interests. Such arrangements require that the third parties register as a broker-dealer or be associated with a registered broker-dealer. Funds and their managers should be cautious when using the service of so-called "finders." Finders are typically unregistered persons who seek to find investors for funds to earn a commission-type fee. The payment of success-based compensation to these individuals is unlawful. Many funds will seek advice if they are permitted to pay "finder's fees" to people who introduce investors to the fund. We recommend that funds only pay finder's fees to entities that are registered as securities broker-dealers. The payment of finder's fees to unregistered individuals or companies raises significant compliance concerns under federal and state securities laws. Further, certain states prohibit such practices and permit investors the opportunity to rescind their full investment if offers of securities are made in violation of the state's securities laws.

Section 12(g) of the Exchange Act requires domestic issuers of securities, with total assets exceeding \$10 million and a class of equity securities held of record by 500 or more persons, to register such class of securities under the Exchange Act, absent an exemption from registration. The administrative burdens of registration may effectively set the outer bounds of the number of investors in a domestic hedge fund at 499.



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Additionally, the Exchange Act requires full disclosure of all material risks to potential investors. For example, when you discuss the investment opportunity with potential investors, it is important to balance the discussion and disclose all of the material risks as well as the potential rewards of the investment. The securities laws require you to disclose all material information about the fund, the management team, the offering and any other items to potential investors. Certain background information related to the fund's managers such as criminal convictions, past SEC actions, bankruptcies and other items are considered material and need to be disclosed. All of the information you provide to investors should be consistent with the information contained in the PPM and/or offering circular. If there have been material developments with respect to the fund or any of the management team the PPM and/or offering circular will need to be updated. Under no circumstances should you make any guarantees that an investor will make a profit by investing in the fund.

The Exchange Act also prohibits soft dollar arrangements. Fund managers previously entered into arrangements where a portion of the commissions generated in trading on behalf of the fund were used to purchase goods and services for the benefit of the fund manager. Such arrangements may raise questions of a conflict of interest when the fund manager effectively pays higher commissions for received goods and services that may not be fully beneficial to the fund on whose behalf the commissions were generated. The portion of commissions that exceeds the lowest available rate that is used to pay for such goods and services is referred to as "soft dollars."

The Exchange Act also has several reporting requirements that may be applicable to these funds. These requirements are similar for other investors. For example, if the fund obtains a significant position in a company or the overall size of the fund's portfolio is substantial, reporting may be required.

Further, fund account statements must accurately represent fund performance. Regulators will pursue enforcement actions against managers personally for misrepresenting profits and losses and distributing false or misleading account statements. Similarly, funds must adhere to stated investment policies. Funds must pursue an investment strategy consistent with its representations to investors. Regulators will pursue enforcement actions against managers personally for losses incurred as a result of an undisclosed change in investment strategy.

The Exchange Act also requires certain reporting to regulators. Initially, Exchange Act Sections 13(d) and 13(g) require disclosure. Once a person or group of persons have acquired direct or indirect beneficial ownership of more than 5% of a class of voting equity securities registered under the Exchange Act, a statement disclosing such ownership must be filed with the SEC with a copy sent to the issuer and, in the case of a filing under Exchange Act Section 13(d), every exchange on which the security is traded. The statement must be filed on Exchange Act Schedule 13D unless the filer can qualify to use Exchange Act Schedule 13G. Such Schedules are filed electronically via the SEC's EDGAR system.



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An Exchange Act Schedule 13D is to be filed within 10 days following the day on which the 5% threshold was breached. Thereafter, amendments are to be filed if there is a material change in the information previously disclosed, including a change of ownership of 1% or more of the outstanding class of securities. Information disclosed in the Exchange Act Schedule 13D includes the identity of the purchaser, the purpose of the acquisition, the source of funds used to purchase the securities, voting power with respect to the securities owned and material contracts and arrangements with respect to the securities.

Exchange Act Schedule 13G is a short form available to three classes of investors provided that they have acquired the securities in the ordinary course of their business and not with the objective of changing or influencing control of the issuer. The three investor classes eligible to use Schedule 13G are “qualified institutional investors” (including registered broker-dealers, most banks, insurance companies, registered investment companies and registered investment Advisers); “exempt investors” (referring to persons holding more than 5% of a class of subject securities at the end of a calendar year, but who have not made the acquisition subject to Exchange Act Section 13(d)); and “passive investors” (investors (i) not seeking to acquire or influence “control” of an issuer and (ii) owning less than 20% of the outstanding shares of any class of securities of such issuer). Qualified institutional investors and exempt investors must file their Exchange Act Schedule 13Gs and send copies within 45 days of the end of the calendar year in which the 5% threshold was breached and within 10 days after the end of the first month in which beneficial ownership exceeds 10% and within 10 days of the end of any month thereafter in which such beneficial ownership increases or decreases by more than 5% as of the last day of such month. Annual filings are also required within 45 days of year end.

Passive investors choosing to report on Exchange Act Schedule 13G are required to file a Exchange Act Schedule 13G within 10 calendar days after acquiring beneficial ownership of more than 5 percent of a class of securities. An investor is not eligible, however, to file on Exchange Act Schedule 13G and must file a Exchange Act Schedule 13D if it has acquired beneficial ownership of more than 5% of a class of voting securities and is unable or unwilling to certify that it is not seeking to acquire or influence “control” of the issuer. Passive investors using Exchange Act Schedule 13G are required to amend their filing within 45 days after the end of the calendar year to report any changes in the information previously filed.

Additionally, the amendments impose several safeguards against abuse of the less intensive reporting obligations of Exchange Act Section 13(g). Passive investors must promptly file an amendment to their Exchange Act Schedule 13G during the year after acquiring beneficial ownership exceeding 10% of the class of subject securities and, thereafter, upon any increase or decrease in beneficial ownership by more than 5%. When a qualified institutional investor or a passive investor no longer holds securities for passive purposes and when the passive investor’s holdings reach 20% or more, such investors will lose Exchange Act Schedule 13G eligibility and are required to file a Exchange Act Schedule 13D within 10 calendar days of that event and will become subject to a “cooling off” period that begins with the date of the triggering event and



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continues until 10 calendar days after the filing of the Exchange Act Schedule 13D. During this cooling-off period, the reporting person is prohibited from voting or directing the voting of the subject securities or acquiring additional equity securities of the issuer or any person controlling the issuer.

Exchange Act Section 13(f) also requires institutional investment managers with investment discretion over accounts holding Exchange Act Section 13(f) securities (voting securities traded on a national securities exchange or quoted on NASDAQ) with a fair market value of at least \$100 million to file a quarterly report on Exchange Act Form 13F with the SEC. Reports are to be filed within 45 days of the end of the first calendar year in which the \$100 million threshold is breached and within 45 days after each succeeding quarter of the subsequent year. The Form 13F discloses all holdings of Exchange Act Section 13(f) securities in excess of 10,000 shares and \$200,000 in aggregate fair market value or principal amount in the case of convertible debt. Institutional investment managers who exercise investment discretion over \$100 million or more in Section 13(f) securities must report their holdings on Exchange Act Form 13F with the SEC. When a fund reaches \$100 million under management, there may be a requirement to file a Exchange Act Form 13F with the SEC.

Further, Exchange Act Section 16 requires “insider” filings. In the event a fund acquires in excess of 10% of a class of voting equity securities registered under the Exchange Act, it will be deemed an “insider” under Exchange Act Section 16. As such, it will be required, pursuant to Section 16(a), to make an initial filing on Form 3 with the SEC disclosing its ownership position exceeding 10%, file updates on Exchange Act Form 4 before the end of the second business day following the day on which a change in beneficial ownership occurs and possibly make annual filings on Form 5 to report transactions in the security not otherwise reported. Section 16(b) also subjects the fund to an obligation to disgorge to the issuer any “short-swing” profits generated from the purchase and sale of the issuer’s securities within a six-month period. Section 16(c) generally restricts short sales during such time as the fund is an insider by preventing short sales unless the insider owns an amount of securities at least equal to the amount being sold short [a short against the box] and delivers the securities within 20 days of the sale or places them in the mail within five days of the sale.



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Commodity Act

The Commodity Act also requires registration for a fund as a commodity pool operator, or, for a manager, as a commodity-trading advisor if the fund trades on an organized futures exchange such as the Futures, Forex and Commodities. If the fund is designed for investments in securities and not futures, foreign exchange or commodities, then registration is probably not warranted. Further, if the fund does invest in futures, foreign exchange or commodities and as long as it does not exceed the *de minimis* level that have been established by the Commodities Futures Trading Commission (“CFTC”), registration will also be unlikely. Prudent planning is required before investing in any of these instruments.



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Anti-Fraud Provisions and Restrictions on Investment Types

Funds and their managers are subject to the anti-fraud provisions of the Securities, Exchange, Advisers, Company and Commodity Acts. Additionally, from time to time, regulations effectively ban certain trading strategies. For example, the SEC recently adopted interim final temporary Rule 204T and Rule 10B-21, an anti-fraud provision designed to deter “naked” short selling.



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State Law Preemption

Funds and their managers are subject to the state securities laws in the states where they obtain investors, but there are also certain exemptions. It is critical to determine in advance the states where the fund will solicit investors in to purchase interests in the fund. Each state has its own set of state securities laws known as blue sky laws, and compliance with these laws when raising money for the fund is imperative. Unless an exemption applies, the fund may have to file a notice with the states where investors reside. Some states, such as New York, require notice filings and the payment of a fee before soliciting investors in the state.

Additionally, prior to the passage of the NSMIA, private placements of funds were required to adhere to state statutes and regulations governing the offering of securities to state residents. Many of these states required filings to qualify the offering for exemption from registration. NSMIA amended Section 18 of the Securities Act to preempt state blue sky laws by prohibiting state governments from requiring registration or imposing merit regulation of offerings of "Covered Securities." Covered Securities include: sales to "qualified purchasers" (defined as accredited investors.); and sales in private transactions under rules or regulations issued under Section 4(2) of the Securities Act. This covers offerings made pursuant to Rule 506 of Regulation D. It does not cover offerings exempt under Rules 504 or 505 of Regulation D or under Securities Act Rule 701 or Regulation A as these exemptions were adopted pursuant to Section 3(b) of the Securities Act.

As described above, states will not be prohibited from imposing notice filing requirements that are substantially similar to those required by rule or regulation under Section 4(2) of the Securities Act in effect as of September 1, 1996. Since Rule 503(a) of Regulation D requires the filing of a Securities Act Form D with the SEC not later than 15 days after the first sale of securities, the filing requirements of the states should now follow Securities Act Rule 503 in terms of the timing of the filing. Even if a state has not amended its securities law to require a notice filing pursuant to NSMIA, NSMIA, nonetheless, requires that issuers pay a filing fee to the state determined pursuant to state law as in effect on October 10, 1996.

States also regulate performance fees for fund managers. The fact that an adviser meets the safe harbor of Advisers Act Rule 205-3 does not prevent a state from further restricting performance fee arrangements if the adviser is subject to state regulation. Most states generally prohibit an investment adviser from charging performance fees, although a number of states, but not all states, provide an exception from such prohibition with respect to an investment adviser that follows Rule 205-3 under the Advisers Act or the version of that Rule that existed prior to its amendment on August 20, 1998.

Additionally, most states' definition of broker-dealer are a combination of the definitions of broker and dealer under the Exchange Act. Moreover, many states' securities laws contain provisions mandating such securities laws be interpreted to promote uniformity with other related and similar



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state statutes and federal regulation. Regarding the interpretation of state securities law definitions, state securities commissions and state courts generally follow with great deference SEC interpretations of similar or identical terms under the federal securities laws. Accordingly, funds that are not deemed to be brokers and/or dealers under the Exchange Act would usually not be deemed to be broker-dealers under state securities laws. However, a fund should carefully review the securities law of the state where it plans to conduct its business.

Finally, states also retained jurisdiction to investigate or bring enforcement actions with respect to fraud or deceit or unlawful conduct by a broker or dealer in connection with securities or securities transactions.



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Tax and ERISA Considerations

Although mutual funds are subject to diversification requirements if they are to receive tax benefits (i.e., a certain percentage of the fund's assets are limited such that the fund may own no more than 10% of the outstanding securities of a portfolio company, and that the portfolio company stock may not constitute more than 5% of the value of the assets of the fund), funds are not subject to such diversification restrictions.

Section 7704 of the Internal Revenue Code ("IRC") and related regulations provide that a partnership with more than 100 investors will be treated as a "publicly traded partnership" and taxed as a corporation if interests in the partnership are traded on an established securities market or a secondary market or the substantial equivalent of such a market. A partnership may be exempt from corporate tax status if it: (1) limits its income to "qualifying income;" (2) limits investor redemptions so as not to provide liquidity equivalent to a secondary market; or (3) limits the number of investors to 100.

Most funds also seek to avoid falling under the Plan Asset Regulations of the Employee Retirement Income Security Act of 1974 ("ERISA") by ensuring that "benefit plan investors" hold, in the aggregate, less than 25% of the value of any class of equity interest in the fund. Congress is currently considering legislation that, if enacted, would revise the plan asset rules so that the assets of an entity would not be treated as "plan assets" if, immediately after the most recent acquisition of any equity interest in the entity, less than 50% of the total value of all equity interests in the entity were held by benefit plan investors. Further, the definition of "benefit plan investors" would be modified to mean only an employee benefit plan subject to ERISA and any plan to which IRC Section 4975 applies. If implemented, these changes would make funds more accessible to benefit plan investors.



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Foreign Regulation

Foreign regulators– most notably, the United Kingdom's Financial Services Authority– are embarking on a review of their regulations regarding the marketing and sale of funds, as well as investigating fund activity. The Hedge Fund Working Group has published “best practice standards” focused on disclosure that some funds have voluntarily adopted.



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FINRA Considerations

Selling fund interests to investors by third parties requires broker-dealer registration. The Financial Industry Regulatory Authority (“FINRA,” previously, “NASD”) is a self-regulatory organization of which all SEC-registered broker-dealers who conduct securities activities in the over-the-counter marketplace must be a member. Although FINRA does not regulate funds, it does oversee broker-dealers that market hedge fund investment products. FINRA has issued Notice to Members 03-07 where securities firms were reminded that when selling funds and funds of funds, certain disclosures and undertakings must be made. These requirements include (1) providing balanced disclosure in promotional material; (2) performing a reasonable basis (due diligence) and customer-specific suitability determinations; (3) supervising those associated persons selling these funds; and (4) training personnel concerning a fund’s features, risks and suitability. See NASD Notice to Members 03-07.



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Self-Regulation

The Managed Funds Association and the Alternative Investment Management Association are also currently drafting a framework for a principles-based regulatory system. While the President's Working Group on Financial Markets has so far endorsed a voluntary self-regulatory regime, that could change under the Obama administration.



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Conclusion

In sum, we caution all those who engage in securities transactions with or on behalf of private equity or hedge funds to be prepared for the ensuing scrutiny that will undoubtedly lead to their doorsteps. Fox Rothschild LLP attorneys remain ready to resolve any inquiries and develop policies and procedures to ensure that you are protected.



Section 2: Structural Overview

Summary of Terms

The following is a summary of the more detailed information typically contained in a Confidential Private Offering Memorandum (a “Memorandum”).

The Partnership:

[ALPHA] Fund I, LP (the “Partnership”) is a Delaware limited partnership. The principal place of business of the Partnership is located at [_____].

Investment Objectives and Trading Strategies:

The Partnership’s objective is to manage a small and mid capitalization long/short equity portfolio focused on generating [above average/superior] market returns over a mid-to-long-term basis. Current income is not a primary investment objective. The Partnership will target companies from [\$35] million to [\$2.5] billion in market capitalization as the Investment Adviser believes these companies typically receive little or no research coverage, yet offer an attractive relationship between enterprise value, growth opportunities and market valuation. The Investment Adviser intends to select securities based primarily on fundamental analysis using its information network and affiliated research personnel to identify and evaluate potential investment opportunities. When feasible, the analysis process may include a detailed review of a company’s financial statements, interviews with management, discussions with suppliers, customers and competitors, and discussions with industry experts. The Investment Adviser believes it can generate superior mid to long-term returns, in part, by relying on Prodigio, a proprietary logarithmic execution and trading strategy owned and licensed from an affiliate. It is the General Partner’s stated intent to cap the overall assets under management of this product to \$_____ million.

INSERT CLAUSE RE DIVERSIFICATION: [The Investment Manager intends to limit the Partnership’s exposure to illiquid or restricted securities to no more than ___% of the Partnership’s assets (as of the time of purchase). However,



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the Investment Manager does not otherwise intend to limit the types of securities or other instruments in which the Partnership may invest, the concentration of investments (whether by sector, industry, country, asset class or otherwise) or the amount of leverage employed.]

The Partnership intends to invest in, hold, sell, trade and otherwise deal in Securities, consisting principally, but not solely, of equity and equity-related Securities that are traded publicly in domestic markets. When deemed appropriate by the Investment Adviser, the Partnership may also invest in preferred stocks, private companies, equity partnership interests, convertible Securities, warrants, options, bonds and other fixed-income Securities, foreign Securities, derivatives and money market instruments. The Partnership may also engage in short selling, hedging and other investment strategies. These strategies may involve the use of leverage through margin trading or other mechanisms.

The General Partner:

The general partner of the Partnership is [_____] Capital Management, LLC (the "General Partner"), a Delaware limited liability company. The General Partner's principal office is located at [____]. The managing member of the General Partner is [____] (the "Managing Member"). The Managing Member intends to make an initial investment on behalf of the General Partner in the Partnership of \$_____.

The Investment Manager:

[____] Capital Management, LLC, a Delaware limited liability company (the "Investment Manager") is responsible for managing the portfolio of the Partnership, and is also responsible for certain administrative matters. The Investment Manager is not registered with the SEC or with the [state] as its presently only manages the pooled funds of the Partnership; thus, fits within an exemption from registration requirements due to its limited number of clients.

Other Activities of the General Partner and the Investment Manager:

Although it does not presently, the Investment Manager may in the future serve as an investment manager to other private investment funds. The General Partner may also serve as a general partner, managing member or investment adviser to other private investment funds. Some or all of these other private investment funds may have investment objectives that



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are similar or different than those of the Partnership, and may also co-invest with the Partnership on the basis of available capital.

Expenses:

The Partnership will reimburse the General Partner for the costs of organizing the Partnership and the initial offering of Partnership Interests (which are not expected to exceed \$_____). The Partnership will be responsible for all of its operating expenses, including, but not limited to, third-party administrator fees, brokerage commissions, all investment-related expenses (e.g., research expenses and travel expenses related to research), legal and accounting expenses, investment expenses such as commissions, custodial fees, bank service fees and other expenses related to the purchase, sale or transmittal of Partnership assets, and overhead expenses of an ordinary and recurring nature. The organizational expenses paid by the Partnership are being amortized over a period of 60 months from the date the Partnership commenced operations.

Each of the General Partner and Investment Adviser is responsible for its own administrative expenses including, but not limited to, office space and salaries of personnel (although the Partnership does intend to sub-lease certain office facilities from an affiliate of the General Partner).

Management Fee:

The Partnership will pay the Investment Manager a quarterly management fee (the "Management Fee") in advance calculated at a rate of 0.50% (i.e., 2.0% per annum) of the value of each limited partner's capital account. The Management Fee will not be returned if a Limited Partner withdraws his, her or its investment before the end of a calendar quarter.

Capital Accounts:

A capital account shall be established for the General Partner and for each Limited Partner. Capital Accounts will be adjusted to reflect allocations of the Partnership's net capital appreciation or depreciation, the Management Fee, the Profit Allocation (as defined below), other Partnership expenses, capital contributions, withdrawals and other similar credits



**Allocation of Net Profits and Losses;
Incentive Allocation to General Partner:**

and debits during the term of the Partnership (the “Capital Account”).

If, with respect to any fiscal year and subject to the loss carryforward provisions below, a Limited Partner has a net profit with respect to his, her or its Capital Account (including realized and unrealized gains and losses), an amount equal to 20% of such net profit will be deducted from such Limited Partner’s Capital Account as of the end of such fiscal year (the “Profit Allocation”) and reallocated to the Capital Account of the General Partner.

No deduction from a Limited Partner’s Capital Account with respect to the applicable Profit Allocation will be made in respect of a fiscal year until any net loss previously allocated to the Capital Account of such Limited Partner has been offset by subsequent net profits allocated to the Capital Account of such Limited Partner. Any such loss carryforward, however, will be subject to reduction for withdrawals by such Limited Partner.

Distributions:

The Partnership intends to accumulate profits for re-investment and does not intend to make periodic distributions.

The Offering:

The Partnership intends to conduct a private offering of a minimum of \$_____ of Partnership Interests (the “Minimum Offering”) and a maximum of \$_____ of Partnership Interests (the “Maximum Offering”). The Minimum Offering will be completed on or before _____ [Insert a date certain] and prior to that time, all proceeds will be maintained in an escrow account administered by [insert name of independent escrow agent].

The minimum initial investment is \$_____, [generally, not less than \$500,000 to \$1 million] subject to waiver in the sole discretion of the General Partner. Interests in the Partnership generally will be sold only to persons who are “accredited investors” as defined in Regulation D of the Securities Act of 1933, as amended. The General Partner may admit limited partners, or accept additional capital contributions from existing partners, on the first day of each month and at such



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other times as the General Partner will, in its sole discretion, permit.

Withdrawals:

Upon at least [60] days' prior written notice to the General Partner, a limited partner may withdraw all or any part of its capital account as of the last day of the month that occurs [generally there is an initial holding period of at least one year] on or after the one-year anniversary of the date of its initial investment in the Partnership and as of the last day of each six-month period thereafter (each a "Withdrawal Date").

In general, upon a limited partner's full withdrawal from the Partnership, at least 90% of the amount of the estimated value of the limited partner's capital account as of the withdrawal date will be paid within 30 days after the withdrawal date. The balance, if any, will be paid promptly after the completion of the audit of the Partnership for such year.

Notwithstanding the foregoing, if withdrawal requests are received as of any Withdrawal Date for more than 20% of the net asset value of the Partnership as of such Withdrawal Date (the "Withdrawal Limit"), the General Partner may, in its sole discretion (i) satisfy all of such withdrawal requests, or (ii) reduce all withdrawal requests pro rata so that aggregate withdrawals as of such Withdrawal Date equal the Withdrawal Limit. To the extent a limited partner's withdrawal request is reduced, any excess will be paid as of the end of the next Withdrawal Date and each Withdrawal Date thereafter subject to the Withdrawal Limit, until the total amount requested to be withdrawn has been paid in full; provided, however, that such withdrawal request will be given priority over any new withdrawals requested for such subsequent Withdrawal Date.

Reports:

Each limited partner will receive unaudited reports of the performance of the Partnership monthly and audited year-end financial statements annually.



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Risk Factors:

An investment in the Partnership involves significant risks and is suitable only for persons who can bear the economic risk of the loss of their entire investment, who have a limited need for liquidity in their investment and who meet the conditions set forth in the Memorandum. There can be no assurances that the Partnership will achieve its investment objective. Investment in the Partnership carries with it the inherent risks associated with investments in securities. Each prospective limited partner should carefully review the Memorandum and the agreements referred to herein before deciding to invest in the Partnership.

Tax Considerations:

The Partnership will not be subject to U.S. federal income tax and each Limited Partner will be required to take into account its distributive share of items of Partnership income, gain, loss and deduction substantially as though such items had been realized directly by such Limited Partner, whether or not actual cash distributions are made to such Limited Partner.

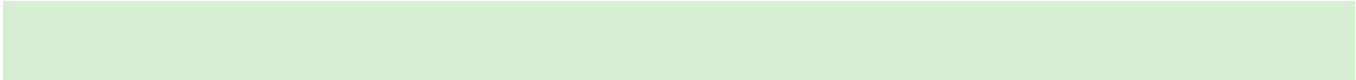
Suitability Standards:

The Partnership may accept subscriptions from pension and profit-sharing plans maintained by U.S. corporations and/or unions, individual retirement accounts and Keogh plans, entities that invest the assets of such accounts or plans and other entities investing plan assets (all such entities are herein referred to as "Benefit Plan Investors"). The General Partner does not anticipate that the Partnership's assets will be subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), or the prohibited transaction provisions of Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), because the General Partner intends to limit the investments in the Partnership by Benefit Plan Investors. Under ERISA and the regulations thereunder, the Partnership's assets will not be deemed to be plan assets subject to Title I of ERISA or Section 4975 of the Code if less than 25% of the value of each class of equity interest of the Partnership is held by Benefit Plan Investors, excluding from this calculation any non-Benefit Plan Investor interests held by the General Partner and certain affiliated persons or entities. The Partnership will not knowingly accept subscriptions for limited partnership interests or permit transfers of limited partnership interests to the extent that



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such investment or transfer would subject the Partnership's assets to Title I of ERISA or Section 4975 of the Code. In addition, because the 25% limit is determined after every subscription to or withdrawal from the Partnership, the General Partner has the authority to require the withdrawal of all or some of the limited partnership interests held by any Benefit Plan Investor if the continued holding of such interests, in the opinion of the General Partner, could result in the Partnership being subject to Title I of ERISA or Section 4975 of the Code.





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Ernest currently represents corporations, limited liability companies, partnerships, broker-dealers, investment advisers, equity funds and other financial institutions. He counsels officers, directors, executives, registered persons and employees in commercial, business, securities, regulatory and litigation matters as well as officer/director regulation and compliance, corporate governance and white collar criminal law issues. He has extensive experience representing these entities and individuals in internal investigations and commercial disputes involving litigation and alternative dispute forums as well as corporate law matters specializing in private placements and initial public offerings. He has represented these entities and individuals in matters involving intellectual property, real estate, contracts and other business issues. Ernest also has extensive experience in the regulatory representation of financial institutions, and the creation of broker-dealers, hedge funds and investment advisers as well as compliance matters.

Ernest's leadership roles within the firm include co-chair of the Securities Industry Practice and co-chair of the White Collar Compliance & Defense Practice.



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Joshua is co-chair of the Securities Industry Practice. He represents major financial services companies in matters throughout the country. He also represents financial advisory companies, individual advisors, and counselors in arbitrations before FINRA. Joshua has also represented individual brokers on disciplinary matters before FINRA and state securities commissions.

Among other work, Joshua provides representation in financial services, trademarks and trade secrets, professional ethics, broker/dealer defense, broker/dealer regulatory, securities, credit card processing services, legal malpractice defense, data security, Fair Debt Collection Practices Act and Fair Credit Reporting Act.

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