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# FINN DIXON & HERLING LLP

**Matthew Eisenberg  
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**NEW REQUIREMENTS FOR PE, VC AND HEDGE FUND ADVISERS  
UNDER FINANCIAL REFORM LEGISLATION**

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*ADAPTING TO A NEW ENVIRONMENT*



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# Dodd-Frank Wall Street Reform and Consumer Protection Act

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- n Status
  - q Approved by the House of Representatives on June 30, 2010
  - q Expected to be approved by the Senate
- n Title IV – Regulation of advisers to hedge funds and others
  - q Referred to as the “Private Fund Investment Advisers Registration Act of 2010”

## Background – Advisers Act

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- n Investment Advisers Act of 1940 (the “**Advisers Act**”):
  - q adopted at a time of great turbulence in the financial markets
  - q goals:
    - n protect investors
    - n improve disclosure
    - n prohibit fraudulent activities
- n The term “investment adviser” is defined very broadly.
- n Includes most entities that receive compensation, in connection with provision of services to private funds, such as:
  - q management fees
  - q performance allocation
  - q carried interest

## Background – Private Adviser Exemption

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- n Most investment advisers, whether they realize it or not, rely upon the “Private Adviser Exemption” provided by Section 203(b)(3) of the Advisers Act.
- n Available for firms that:
  - q advise fewer than 15 clients;
    - n each fund is counted as one client
  - q do not hold themselves out generally to the public as an investment adviser; and
  - q do not advise investment companies registered under the Investment Company Act.

## High Level Headlines

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### n Upon adoption, the Act will:

- q Eliminate the Private Adviser Exemption

But:

- q Exempt from registration with the SEC (but not the states) advisers to private funds with AUM <\$150 million
- q Exempt advisers to “venture capital funds” – to be defined by the SEC
- q Exclude certain “family offices” – to be defined by the SEC
- q Exempt certain foreign advisers
- q Exempt certain advisers to SBIC’s

## High Level Headlines (cont.)

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- n Upon adoption, the Act will:
  - q Impose new record keeping and reporting obligations
  - q Grant SEC authority to examine certain records and reports
  - q Create the possibility of “regulation-lite” and/or “examination-lite”
  - q Alter the allocation of responsibility between the states and the SEC
  - q Start a one year clock for the SEC to adopt rules
  - q Change the “accredited investor” definition
  - q 3(c)(1) funds charging performance compensation – new investor eligibility standard

## SEC vs. State Regulation – Shift in Responsibility

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The Act will:

- n Significantly alter the division of responsibility for the registration and oversight of investment advisers between the SEC and state securities regulators
- n How? By increasing the minimum assets under management (“**AUM**”) threshold for SEC registration from \$25 million to \$100 million, subject to various exceptions

## What Do We Mean by AUM?

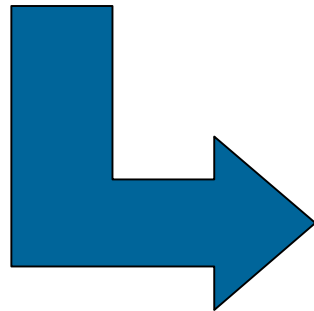
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- n AUM is generally defined to include securities portfolios (including cash and cash equivalents) with respect to which an investment adviser provides continuous and regular supervisory services.
- n We should assume, for now, that capital that has been committed but not called, will likely be taken into account for purposes of calculating AUM.
  - q marketing
  - q management fee

## “Mid-sized” Investment Advisers

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The Act will create a new category of “mid-sized” investment advisers with AUM of between \$25,000,000 and \$100,000,000:



- n required to register with the SEC if exempt from registration in home state or if home state does not conduct examinations of investment advisers
- n permitted to register with the SEC if would otherwise be required to register with 15 or more states

## New Exemption – Less than \$150 million in AUM

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- n New exemption from SEC registration for investment advisers that:
  - n only advise private investment funds and
  - n have AUM of less than \$150 million
  
- n The SEC, in prescribing registration and examination procedures applicable to the investment advisers of “mid-sized private funds” (as opposed to “mid-sized investment advisers”), is required to take into consideration the size, governance and investment strategy of such funds to determine whether they pose systemic risk.
  - n Appears to open the door to differing treatment for investment advisers to different sized funds or fund complexes

## Venture Fund Exemption

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The Act will:

- n Create an exemption from SEC registration for investment advisers that only advise “venture capital funds”
  - q “Venture capital fund” to be defined by the SEC
  - q Venture capital funds will still be subject to record keeping and reporting obligations under the Advisers Act

## The Family Office Exclusion

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- n The Act will create an exclusion from the definition of an investment adviser in the Advisers Act for an investment adviser that qualifies as a “family office”
- n The term “family office” is to be defined by the SEC consistent with current exemptive orders for family offices and recognizing the range of organizational, management and employment structures and arrangements employed by family offices. Current exemptive orders generally provide that an investment adviser meeting all of the following conditions is exempt from registration:

## The Family Office Exclusion (cont.)

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- q would normally qualify as an investment adviser under the Advisers Act, but, in general, manages portfolios for a family office organized for the benefit of a single family (a “**Family**”);
- q does not hold itself out to the public as an investment adviser;
- q only manages the assets of either entities owned, established or controlled by the Family, and/or a very limited number of other persons, such as former and/or current employees and service providers of the Family, or of a limited number of close, long-term Family associates and their descendants; and
- q represents that it will only receive fees necessary to reimburse the investment adviser for reasonable fees and out-of-pocket expenses incurred in connection with its investment advisory services to the Family.

## The Family Office Exclusion (cont.)

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- n Any such definition may not exclude an investment adviser that was providing advice on or before January 1, 2010 to:
  - q natural persons who at the time of investment were officers, directors or employees of the family office and invested prior to January 1, 2010, and who are “accredited investors,” as such term is defined in Rule 501(a) promulgated under the Securities Act;
  - q any company owned exclusively and controlled by members of the family of the family office; or
  - q any SEC-registered investment adviser that (i) provides investment advice for no more than 5% of the value of the total assets as to which such family office renders investment advice and (ii) invests in such transactions on substantially the same terms as the family office (and does not invest in other funds advised by such family office).

## Exemption for Certain Foreign Investment Advisers

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The Act will:

- n Create an exemption from SEC registration for certain foreign investment advisers:
  - q fewer than 15 United States clients (including both direct clients and investors in investment funds advised by the investment adviser); and
  - q less than \$25 million of assets under management from the United States.

## Exemptions for Advisers to SBIC's

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- n New exemption from SEC registration for an entity that advises only:
  - q small business investment companies that are licensed by the Small Business Administration (“**SBA**”) under the Small Business Investment Act of 1958;
  - q entities that have received notice from the SBA to proceed to qualify for a license; or
  - q entities that have a pending application for license and are affiliated with one or more licensed small business investment companies.
- n (Not available to business development companies under the Investment Company Act).

## How AUM Affects Registration

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- n Broadly speaking, registration requirements will break down as follows, based upon the amount of assets under management (“**AUM**”) by a fund adviser:

Assets Under Management	Registration
\$25,000,000 and under	State only, unless an investment adviser to a registered investment company
\$25,000,000 - \$100,000,000	State only, unless (i) an adviser to a registered investment company or a business development company; (ii) would be required to register with 15 or more states if not permitted to register with SEC; or (iii) home state does not provide for registration or does not examine registered investment advisers
Over \$100,000,000	SEC (subject to exemption)

## Exemptions/Reporting Requirements

CATEGORY	EXEMPTION AND REPORTING
Venture Capital Fund	<p><b>Exempt</b> from registration with SEC</p> <p><b>But:</b> subject to record keeping, reporting and examination requirements</p> <p><b>But:</b> possible state registration</p>
<p>Under \$150,000,000 and <u>only</u> private fund clients</p> <p><i>Examples: Hedge funds, private equity funds, others</i></p>	<p><b>Exempt</b> from registration with SEC</p> <p><b>But:</b> subject to record keeping, reporting and examination requirements</p> <p><b>But:</b> possible state registration</p>
Foreign Private Adviser	<p><b>Exempt</b> from registration with SEC</p>
Family Office	<p><b>Excluded</b> from definition of investment adviser</p> <p><b>But:</b> possible state registration</p>

## Record Keeping and Reporting Requirements

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- q SEC is authorized to require any SEC-registered investment adviser to:
  - n maintain records of private funds
  - n file with the SEC such reports regarding private funds
- q All “as necessary and appropriate in the public interest or for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council.”

## Record Keeping and Reporting Requirements (cont.)

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- q Records and reports required to be maintained and subject to inspection by the SEC include:
  - n the amount of assets under management and use of leverage, including off-balance sheet leverage
  - n counterparty credit risk exposure
  - n trading and investment positions
  - n valuation policies and practices

## Record Keeping and Reporting Requirements (cont.)

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- n types of assets held
- n side arrangements or side letters
- n trading practices
- n other information as determined appropriate in the public interest and for the protection of investors or for the assessment of systemic risk
  - q Possible “reporting-lite” - the establishment of different reporting requirements for different classes of fund advisers, based on the type or size of private fund being advised

## Record Keeping and Reporting Requirements (cont.)

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- q Record keeping requirements will be imposed upon advisers to venture capital funds and small private fund advisers (i.e., advisers to private funds having AUM of less than \$150,000,000).
- q Confidential treatment is afforded to the private fund information provided to the SEC (and by the SEC to other agencies).

## Examinations by SEC Staff

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- q The SEC will be required to periodically inspect the private fund information maintained by investment advisers.

## New Accredited Investor Test

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- n Immediately:
  - q Revise the “accredited investor” net worth test for a natural person to exclude the value of the person’s primary residence
- n Optional prior to year 5:
  - q SEC may review the entire “accredited investor” definition
- n Mandatory starting in year 5
  - q SEC must adjust the \$1,000,000 net worth test
  - q SEC must review the entire “accredited investor” definition, at least once every four years

## Overview of the Investment Adviser Registration Process

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- n Investment Adviser Registration Depository (“**IARD**”)
  - q Web-based database and filing system for investment advisers
  - q Administered by FINRA
  - q Enablement application for username and password
  - q Investment adviser submits application for registration via IARD
- n Form ADV (Uniform Application for Investment Adviser Registration)
  - q Form ADV is the investment adviser registration application

# Overview of the Investment Adviser Registration Process (cont.)

## q Form ADV, Part I

**FORM ADV (Paper Version)**  
**UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION**

**PART 1A**

**WARNING:** Complete this form truthfully. False statements or omissions may result in denial of your application, revocation of your registration, or criminal prosecution. You must keep this form updated by filing periodic amendments. See Form ADV General Instruction 3.

Check the box that indicates what you would like to do (check all that apply):

- Submit an initial application to register as an investment adviser with the SEC.
- Submit an initial application to register as an investment adviser with one or more states.
- Submit an *annual updating amendment* to your registration for your fiscal year ended \_\_\_\_\_.
- Submit an other-than-annual amendment to your registration.

**Item 1 Identifying Information**

Responses to this Item tell us who you are, where you are doing business, and how we can contact you.

A. Your full legal name (if you are a sole proprietor, your last, first, and middle names):

## Overview of the Investment Adviser Registration Process (cont.)

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- q Form ADV, Part I (cont.)
  - n Presently, the only part of Form ADV that is filed with the SEC
  - n Information required by Form ADV, Part I
    - q Type(s) of advisory services provided
    - q Number and types of firm personnel
    - q Number and types of clients
    - q Types of compensation arrangements with clients

## Overview of the Investment Adviser Registration Process (cont.)

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- q Form ADV, Part I (cont.)

- q AUM

- q Information about investment adviser's participation or interest in client transactions

- q Identity of executive officers and direct owners:

- § Less than 5%

- § 5% but less than 10%

- § 10% but less than 25%

- § 50% but less than 75%

- § 75% or more

- q Identity of indirect owners:

- § 25% but less than 50%

- § 50% but less than 75%

- § 75% or more

## Overview of the Investment Adviser Registration Process (cont.)

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- q Form ADV, Part I (cont.)
  - q Information regarding certain regulatory, judicial and other disciplinary and enforcement matters of investment adviser and certain related persons
  - q Whether investment adviser has custody of client funds or securities

*[Note: The above list is not exhaustive]*
- n Review by SEC and approval

# Overview of the Investment Adviser Registration Process (cont.)

## q Form ADV, Part II

<b>FORM ADV</b> <b>Part II - Page 1</b>		<b>Uniform Application for Investment Adviser Registration</b>		<table border="1"> <tr> <th colspan="2">OMB APPROVAL</th> </tr> <tr> <td>OMB Number:</td> <td>3235-0049</td> </tr> <tr> <td>Expires:</td> <td>August 31, 2012</td> </tr> <tr> <td>Estimated average burden</td> <td></td> </tr> <tr> <td>hours per response. . . . .</td> <td>4.32</td> </tr> </table>		OMB APPROVAL		OMB Number:	3235-0049	Expires:	August 31, 2012	Estimated average burden		hours per response. . . . .	4.32
OMB APPROVAL															
OMB Number:	3235-0049														
Expires:	August 31, 2012														
Estimated average burden															
hours per response. . . . .	4.32														
Name of Investment Adviser:															
Address:	(Number and Street)	(City)	(State)	(Zip Code)	Area Code: Telephone number: ( )										
<p>This part of Form ADV gives information about the investment adviser and its business for the use of clients.  The information has not been approved or verified by any governmental authority.</p>															
<b>Table of Contents</b>															
<b><u>Item Number</u></b>	<b><u>Item</u></b>				<b><u>Page</u></b>										
1	Advisory Services and Fees .....				2										
2	Types of Clients .....				2										
3	Types of Investments .....				3										
4	Methods of Analysis, Sources of Information and Investment Strategies .....				3										
5	Education and Business Standards .....				4										

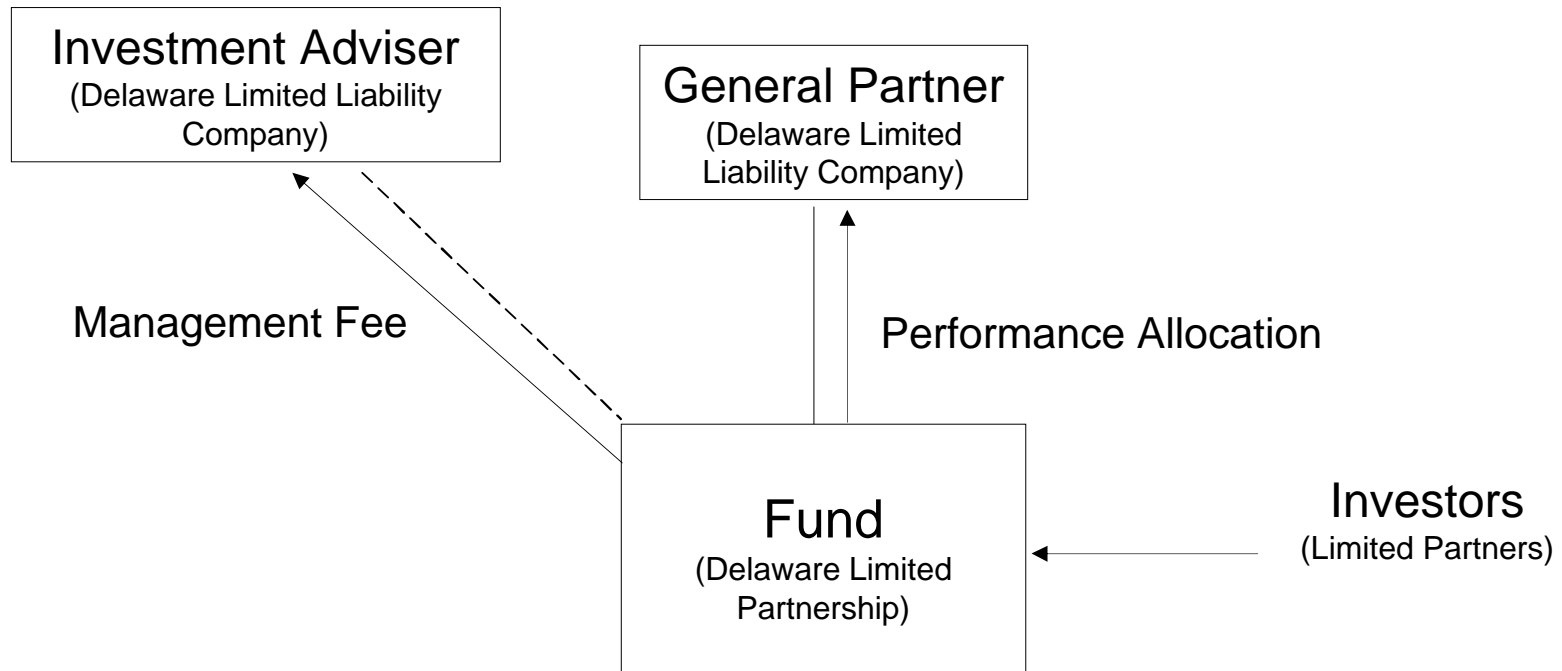
## Overview of the Investment Adviser Registration Process (cont.)

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- q Form ADV, Part II (cont.)
  - n Presently, not required to be filed with SEC
  - n Subject to review during SEC examination
  - n Contains information regarding various aspects of an investment adviser's products and services (including investment funds)
  - n Required to be delivered to investment adviser clients
- n State requirements

# Which Entity(ies) in a Fund Management Complex Will Need to Register?

## Illustrative Domestic Investment Fund Structure



## Highlights of Registration Impact on Investment Adviser

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- n Impact will depend upon:
  - q Facts and circumstances applicable to the investment adviser
  - q Whether SEC adopts rules following enactment of financial reform legislation that vary regulation by type of investment adviser:
    - n Section 408 of legislation requires SEC to consider the “size, governance, and investment strategy” of “mid-sized private funds.”

## Highlights of Registration Impact on Investment Adviser (cont.)

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- n Common areas of impact
  - q Limitations on, disclosure and review (by CCO/compliance) of:
    - n Written / electronic communications
    - n Personal securities transactions
    - n Related party arrangements
    - n Outside business activities
    - n Expenses
      - q Types of expenses
        - § Gifts
        - § Entertainment
        - § Personal expenses
      - q How allocated
    - n Marketing activities
    - n Marketing materials

## Highlights of Registration Impact on Investment Adviser (cont.)

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- n Common areas of impact (cont.)
  - q Books and records
    - n Required by SEC Rule 204-2
    - n Required by written compliance procedures
    - n Necessary to evidence compliance
  - q Various personal actions / activities subject to pre-approval of CCO
    - n Outside business activities
    - n Political contributions: new SEC Rule 206(4)-5 (*Political Contributions by Certain Investment Advisers*)
    - n Gifts / entertainment
    - n Use of firm funds for personal expenditures

## Highlights of Registration Impact on Investment Adviser (cont.)

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- n Common areas of impact (cont.)
  - q Periodic SEC examinations
    - n Interviews with CCO, executive officers, portfolio manager, head trader
    - n Review of firm books and records (on-site and off-site)
      - q Compliance procedures
      - q Code of ethics
      - q Financial statements
      - q Client agreements
      - q Service provider agreements
      - q Correspondence/electronic communications
      - q Marketing materials
      - q Disclosure documents
      - q Personal brokerage account statements
      - q Web site

## Highlights of Registration Impact on Investment Adviser (cont.)

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- n Common areas of impact (cont.)
  - q Periodic SEC examinations (cont.)
    - n Verification of client funds/securities
      - q Investor verification
      - q Service provider verification
    - n Potential enforcement action if deficiencies identified
  - q Increased resource allocation to compliance program
    - n Time allocation of existing personnel
    - n Costs associated with hiring compliance personnel
    - n Compliance-related service provider fees and expenses
    - n Compliance-related technology solutions
- n These and other changes frequently necessitate a change in a firm's compliance "mind-set" or "culture"

## Preparations for Becoming SEC-Registered; Timing

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- n Development of a transition calendar
- n Proper ordering and timing is critical
- n Establishment of a transition / compliance team
  - q Designation of CCO
  - q Designation of other firm personnel that will perform compliance functions
- n Involvement of management
  - q Critical to have “buy-in” regarding the importance of registration and related compliance
  - q Allocation of sufficient firm resources
  - q Visible management support of CCO

## Preparations for Becoming SEC-Registered; Timing (cont.)

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- n SEC Rule 206(4)-7 (*Compliance Procedures and Practices*) requires all SEC-registered investment advisers to:
  - q Adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the SEC rules adopted thereunder
  - q Appoint a CCO
  - q Perform annual review of policies and procedures
- n Development of compliance program
  - q Defining the objective(s) of the compliance program
  - q Review of applicable firm facts / circumstances
  - q Review of applicable laws
  - q Analysis of compliance risks

## Preparations for Becoming SEC-Registered; Timing (cont.)

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- q Preparation of written compliance procedures manual
  - n Customized to address specific firm facts and circumstances
  - n All identified compliance-related risks should be addressed
- n SEC expects an investment adviser's compliance program to be adopted and implemented no later than the effective registration date. Consequently:
  - q Development of compliance program should commence prior to submission of Form ADV to SEC
  - q Implementation of compliance program should take place no later than submission of Form ADV to SEC
- n "Selling" compliance to firm personnel
- n Education

## Third Party Support

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- n Utilization of third parties involves a number of considerations including:
  - q Objective:
    - n Support of in-house compliance department
    - n Provide expertise that does not exist in-house
  - q Due diligence
    - n Competence of personnel
    - n Reputation
    - n Capacity
    - n Policies, procedures and controls adopted and implemented by service provider to ensure, among other things, appropriate (i.e., confidential) treatment of documentation and information

## Third Party Support (cont.)

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- q Supervision / monitoring of service provider
  - n To confirm services are performed properly
- q Cost
  - n In-house vs. external
  - n Allocation to client accounts?

## Outsourcing the CCO Function: A Good Idea?

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- n Short answer: Usually, no.
  - q But, may make sense in limited circumstances, such as a very small firm with limited financial resources
- n SEC Rule 206(4)-7
  - q Requires that CCO be a “supervised person”:
    - n “. . . any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.”
  - q Requires that CCO “administer” the firm’s written compliance procedures

## Outsourcing the CCO Function: A Good Idea? (cont.)

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- q Does not require CCO to have minimum educational or experience requirements
  - n But, SEC will scrutinize experience during an examination
- q Does not specify whether CCO is required to be full-time (versus part-time), or an employee (versus an independent contractor)
  - n Key is ability of CCO to successfully administer the written compliance procedures
  - n If CCO is not full-time employee, then SEC may be expected to scrutinize whether status has an adverse impact on compliance program

## Outsourcing the CCO Function: A Good Idea? (cont.)

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- n Recommendation: An investment adviser should appoint as its CCO an individual who is believed to have the skill set (due to prior experience or otherwise) and the capacity (personality- and time-wise) to successfully administer the firm's written policies and procedures.

## About Finn Dixon & Herling LLP's INVESTMENT MANAGEMENT PRACTICE GROUP

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Finn Dixon & Herling LLP provides specialized legal representation to investment advisers, hedge funds, funds of funds, private equity funds, family offices, venture capital firms, placement agents, and broker-dealers. We advise clients on all aspects of formation and related structuring matters, compliance with federal and state securities laws, investment adviser and broker-dealer licensing, the development and implementation of compliance programs, preparing for regulatory examinations, marketing practices, client and service provider arrangements, personnel matters, strategic transactions, and related tax matters.

Our investment management attorneys draw on decades of collective experience to provide legal services with a high level of sophistication and technical expertise – always with an emphasis on superior partner access and responsiveness. Our extensive knowledge of the investment fund and investment adviser industries, as well as extensive industry contacts, enable us to provide clients with insights on industry trends and current market/business practices, and to approach client-servicing from a perspective that takes into account the business realities that clients face. Each client relationship is approached on an individualized basis, taking into account the specific circumstances applicable to the client as well as the client's expressed needs and preferences.

Our investment management attorneys have represented hundreds of investment funds and their investment managers. The firm represents fund managers located in the U.S., Canada, Europe and Asia, with assets under management ranging from less than US\$100 million to more than US\$10 billion. Clients employ a wide variety of investment strategies and legal structures.

The Investment Management practice group works closely with the firm's other practice groups: Private Equity, Mergers & Acquisitions, Lending and Finance, Tax, Bankruptcy, Employment Law and Litigation.

## Matthew Eisenberg

### Partner

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Matthew Eisenberg has 20 years of experience advising as to all aspects of fund structuring and formation, preparation of fund offering documents, SEC and state investment adviser registration, SEC and state broker-dealer registration, commodity pool operator registration, FINRA and NFA membership, development and implementation of compliance policies and procedures, general contract and compliance matters, regulatory examinations, marketing arrangements and marketing materials, seed financing transactions, leverage arrangements, and derivative transactions.

Mr. Eisenberg is a frequent speaker and panelist at industry events. Recent engagements have covered a variety of topics, including: SEC examinations of investment advisers; the formation and operation of investment funds, investment advisers and broker-dealers; investment adviser registration and compliance matters; manager due diligence; third party marketer due diligence; and marketing arrangements and practices.

Prior to joining Finn Dixon, Mr. Eisenberg was a member and co-founder (1996) of Cobb & Eisenberg LLC, a boutique law firm that specialized in representing investment funds and investment advisers. Prior to 1996, Mr. Eisenberg held associate positions at Winthrop, Stimson, Putnam & Roberts and Rogers & Wells. Mr. Eisenberg is a graduate of New York University School of Law (J.D. 1990) and The State University of New York at Binghamton (B.A. cum laude 1987). Mr. Eisenberg is licensed to practice law in the States of New York and Connecticut, and is a member of the Managed Funds Association, the Regulatory Compliance Association (“RCA”) and the Connecticut Hedge Fund Association. He is also a faculty member of the RCA’s CCO University and a Member of the RCA’s Compliance Officer Code of Professional Conduct Advisory Board.

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## **Erik A. Bergman**

### **Partner**

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Erik A. Bergman is a partner at Finn Dixon & Herling LLP, a Stamford, Connecticut law firm providing specialized legal representation to hedge funds, funds of funds, private equity funds, venture capital funds, offshore investment funds, other pooled investment vehicles, investment advisers, placement agents, broker-dealers and institutional investors. Mr. Bergman advises clients as to fund structuring and formation; preparation and review of fund offering documents and marketing materials; formation and registration of SEC and state registered investment advisers and broker-dealers; FINRA membership and other licensing matters; development and implementation of compliance programs and procedures; ongoing compliance matters and regulatory examinations; preparation and negotiation of marketing/introduction agreements; and investment-related and other matters. Mr. Bergman also represents public companies in connection with securities law issues, and public and private companies, and investment funds, in connection with mergers and acquisitions, investment transactions and other matters.

Before coming to Finn Dixon in 1998, Mr. Bergman was an associate at Pepe & Hazard LLP and Bingham Dana LLP (now Bingham McCutchen LLP). Prior to that, Mr. Bergman worked in the Commissioner's office, at the Connecticut Department of Transportation and served in the U.S. Navy.

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## Charles J. Downey III

### Partner

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Chuck Downey practices in the areas of private equity, venture capital and mergers and acquisitions, among other areas of corporate law. He also represents hedge funds and other entities in connection with securities law issues, PIPE transactions and other matters.

Mr. Downey has significant experience representing private equity, venture capital, growth capital, mezzanine capital and leveraged buy-out funds in all aspects of their activities.

Recent transactions include:

- Numerous platform acquisitions for private equity funds
- Add-on acquisitions ranging in size from \$200 million to \$1 million
- Section 363 acquisitions by strategic and private equity buyers
- Sale processes on behalf of a variety of companies
- Common stock PIPE transactions
- Multi-layered PIPE transactions involving convertible notes, preferred stock and warrants

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## Charles J. Downey III

### Partner

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Mr. Downey also acts as a counselor to a variety of companies regarding their ongoing legal needs, providing advice regarding joint venture agreements, capital raising, employee matters, strategic agreements and debt and equity arrangements and restructurings. Mr. Downey's experience in this area covers a gamut of industries ranging from health care information technology to consumer products to defense contracting.

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