

Hedge fund marketing overview

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Abstract

Purpose – To provide a brief overview of US securities laws that apply to the marketing of hedge funds.

Design/methodology/approach – Summarizes US securities offering rules, including Regulation S and Regulation D at the federal level, state securities laws, antifraud standards, and broker-dealer regulation.

Findings – All securities offered and sold in the USA must be registered with the SEC unless an exemption is available under the Securities Act. Offerings offshore under Regulation S and private placements in the USA under Regulation D offer two such exemptions. Most states have private placement exemptions similar to Regulation D. While certain state-level regulation over the registration of securities has been preempted by federal law, a level of state regulation continues to exist. All US offers and sales of securities are subject to general antifraud standards under both US federal and state laws. Funds and their employees, investment managers and their employees, and any placement agents may not contact any US investor in the USA or any non-US investor from the USA without registering as broker-dealers.

Originality/value – Provides a concise overview of laws and regulations that apply to the marketing of hedge funds.

Keywords Fund management, Financial markets, United States of America

Paper type General review

Marketing strategies

Hedge fund marketing strategies typically fall into two or three distinct traditions. The first tradition is for the fund and its manager/sponsor to market the fund without third-party assistance. Often the manager/sponsor will have employees dedicated to the marketing process and may even compensate them specifically on a commission or bonus basis. The dedicated marketing team approach in the USA usually requires the manager/sponsor to obtain a broker-dealer license. The second tradition is for the fund and manager/sponsor to have informal arrangements with finders and other sourcing agents. The finders are typically compensated through a share of the management and performance compensation received by the manager from investors sourced by the finders. This arrangement can also run afoul of US broker-dealer licensing rules if the finders are compensated on a contingent basis, which is the case more often than not. The third tradition is for funds to enter into formal placement arrangements with major investment firms such as Morgan Stanley, Merrill Lynch and the like. These firms are typically compensated through a placement fee or sales charge, but they may also receive a piece of the fees and other compensation just like the finders. The National Association of Securities Dealers, one of the primary regulators of broker-dealers in the USA, has established fairly strict policies with respect to how US broker-dealers market hedge funds.

The following is a brief overview of the US securities laws that frame the marketing process.

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US Securities Offering Rules

Federal Securities Laws

Pursuant to the Securities Act of 1933 ("Securities Act"), all securities offered and sold in the USA, and in certain cases to "US persons" outside of the USA, must be registered with the SEC unless an exemption from such registration is available under the Securities Act or the regulations promulgated thereunder. Offerings offshore under Regulation S and private placements in the USA under Regulation D provide two such exemptions.

Regulation S. There are two ways in which the Regulation S exemption is generally applicable to hedge funds. First, the offering and sale of an offshore fund's shares will be structured so that the shares are exempt from registration under the Securities Act in reliance on Regulation S. Second, it will also be structured so that the offshore fund will be able to invest in securities offered under Regulation S.

Under Regulation S, in general, any offer or sale of securities that occurs outside of the USA and otherwise complies with Regulation S is exempt from the registration requirements of the Securities Act. In order for the offer and sale of an offshore fund's shares to be deemed to occur outside the USA, the offshore fund may not conduct any directed selling efforts in the United States (i.e. in very general terms, promotional activities of any nature in the USA other than with regard to a non-integrated private placement of the offshore fund shares), and offers and sales of the shares, other than those subject to a non-integrated private placement of offshore fund shares, must be in offshore transactions. An offshore transaction is an offer and/or sale where the investor was outside of the USA, including its territories and dependencies, at the time of the offer and/or sale. Additionally, the offshore transaction requirement can also be satisfied if the offshore fund's shares are sold on a securities exchange, or through the facilities of an approved stock market, outside of the USA. In addition, the offshore fund may not specifically target any offers or sales of its securities to identifiable groups of US citizens who are outside of the USA. As long as an offshore fund complies with the fore-going requirements, the offshore fund's shares should be exempt from registration under the Securities Act.

Further, in order for an offshore fund to invest in securities that have not been authorized for sale in the USA, the offshore fund should not be deemed a US person under Regulation S. In order to be excluded from the definition of US person, an offshore fund, as a non-US entity, must not constitute an organization formed by a US person principally for the purpose of investing in unregistered securities unless it is organized and owned by accredited investors that are not natural persons, estates or trusts. If an offshore fund has no US persons as investors, it will not be a US person under Regulation S. However, if an offshore fund were to allow US tax-exempt investors to purchase shares of the offshore fund, the position could be different. To the extent that US tax-exempt investors are limited to accredited investors that, as noted above, are not natural persons, estates or trusts, the offshore fund should not fall within the definition of US person.

Regulation D. Regulation D will be applicable with respect to an offshore fund in the event that it decides to offer shares to US investors, and will be applicable to all sales of limited partnership interests by an onshore fund. Any such US portion of the offering must be structured to comply with the private placement exemption of Section 4(2) of the Securities Act by applying the principles for statutory private placements as well as the general guidelines for private placements set forth in Regulation D. In order to qualify any such offering in the USA for the safe harbor protection of Regulation D, funds need to satisfy each of the procedural requirements of the provisions of Regulation D applicable to that safe harbor. Generally, these procedures require that the offers and sales of the shares or partnership interests be made on a face-to-face basis with investors, without the use of advertising or other public promotion, such as group meetings or seminars, and that the investors be "accredited investors," meaning that they each have a minimum net worth of \$1,000,000 or have received income for the last two years of at least \$200,000 (or \$300,000 if

jointly with a spouse) and have a reasonable expectation of receiving the same amount in the current year. The net worth amount is often increased to \$1,500,000 in order to permit fund managers that are SEC-registered investment advisers to charge performance-related fees to the funds.

State Securities Laws

An offshore fund, if it were to offer or sell its shares in the USA, and an onshore fund will also need to comply with the securities laws of each state in which they offered or sold their shares or partnership interests. Most states have provisions exempting private placement transactions from registration similar to Regulation D, but the standards and procedures of individual states may vary in numerous respects.

Pursuant to the National Securities Markets Improvement Act of 1996, certain state-level regulation over the registration of securities has been pre-empted by federal law. Nevertheless, a level of state regulation of securities law offerings continues to exist. Accordingly, state securities law compliance should still be expected to involve some modest filing requirements.

Antifraud Standards

All US offers and sales of securities, including those that make any use of the jurisdictional means of the USA (i.e. telephone, internet and other communication links from, through or to the USA), whether publicly registered or privately placed, are subject to general antifraud standards under both US federal and state laws. In general, these standards prohibit the making of material misstatements or the omission of material information in connection with the offer and sale of securities.

At the federal level, these antifraud standards are derived from Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Section 17 of the Securities Act, SEC regulations issued pursuant to such statutory provisions, and the many judicial decisions interpreting these statutes and regulations. In numerous cases, US courts have indicated that they will not allow the USA or its jurisdictional means to be used as a basis for exporting fraud to investors in other countries. Accordingly, it is imperative to note that the antifraud standards of the U.S. securities laws may be applicable in some circumstances to the offer and sale of shares or partnership interests in hedge funds notwithstanding the fact that no US persons participate in or are solicited by the funds or their representatives or agents.

Frequently, state standards parallel the federal standards. Nevertheless, differences do exist.

Broker-Dealer Regulation

Under Section 15 of the Exchange Act, any person deemed to be engaged in the business of effecting transactions in securities for the account of others, including selling or promoting securities of an issuer, in the USA is required to register as a broker-dealer with the SEC unless otherwise exempted from registration. These rules apply to both foreign and domestic US entities that sell securities in either a public offering or a private placement. Numerous state securities laws have similar registration requirements.

A problem with respect to broker-dealer registration will only arise if funds use US jurisdictional means to offer their shares or partnership interests (i.e. telephone, internet and other communication links from, through or to the USA). This would mean, generally, that funds, their employees, the investment managers, their employees, and any placement agents may not contact any US investor in the USA or contact any non-US investor from the USA without registering as broker-dealers. Thus, placement agents that contact potential US investors should be registered US brokers (unless they have established relationships with such US investors and the communications are permitted under Rule 15a-6, the Exchange Act rule that defines certain parameters for communications between US investors and non-US brokers).

On the other hand, there is an exemption from broker-dealer registration for funds that sell their own securities through their own officers and employees as long as the officers/employees do not receive any commissions or other direct compensation for those efforts and a substantial part of their activities consists of activities other than selling securities in the USA.

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