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Chapter Six:
Marketing Hedge Funds — Conducting Private Placements in the US

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Marketing private investment funds in the United States requires the fund sponsor to promote the fund without engaging in a public offering. This chapter provides an overview of the relevant regulatory issues that arise in conducting private offerings, including a discussion of eligible offerees, permissible offering methods, permissible purchasers, and some other issues that may be relevant to a private placement of interests in a hedge fund in the United States.

Both the Securities Act of 1933, as amended (the 1933 Act), and the Investment Company Act of 1940, as amended (the Investment Company Act), have a substantial impact on the way that hedge funds are sold to investors in the United States. Generally, the 1933 Act requires the registration of any non-exempt security offered or sold through interstate commerce, but offers an important exemption from registration for transactions 'not involving any public offering'. Regulation D under the 1933 Act provides a safe harbor for private placements of securities intending to qualify for the private placement exemption under Section 4(2) of the 1933 Act. The Investment Company Act also must be taken into consideration by hedge fund sponsors when planning an offering. Section 3(c)(1) of the Investment Company Act provides an exception from regulation as an investment company for any fund beneficially owned by 100 or fewer investors that is not making a public offering of the securities it issues, and Section 3(c)(7) of the Investment Company Act provides a similar exception for any fund owned solely by qualified purchasers.

Regulation D under the 1933 Act

Private placements of hedge fund securities are typically made under Rule 506 of Regulation D. If an offering of securities falls within the safe harbor provided by Regulation D under the 1933 Act, no registration of the securities under the 1933 Act is required. Private placements under Rule 506 may be made to an unlimited number of 'accredited investors' and up to 35 non-accredited investors. Sales are often limited to accredited investors to simplify the offering. In addition to the substantive requirements of Regulation D, an issuer files a notice of sale of the privately placed securities with the Securities and Exchange Commission (SEC) within 15 days of the first such sale. Regulation D prohibits general solicitation and general advertising.

Accredited investors
Under Rule 506, the issuer must have a reasonable belief that an investor is an accredited investor at the time of the sale of securities. Rule 501(a)(1) of the 1933 Act defines accredited investors to include the following:

- individuals with a net worth of more than $1 million;
- individuals with incomes of more than $200,000 (or joint income of $300,000 for married couples) per year for the past two years, with a reasonable expectation that such income levels will be attained in the current year;
- US banks;
- US savings and loans;
- US insurance companies;
- US registered brokers and dealers;
- US registered investment companies;
- business development companies;
- specified state pension funds and specified Employee Retirement Income Security Acof of 1974 (ERISA) plans with total assets of more than $5 million;
- certain corporations and trust entities with total assets of more than $5 million; and
- any entity, all of whose equity owners are accredited investors.

Proposed rule — accredited natural persons
In December 2006, the SEC proposed Rule 509 of Regulation D under the 1933 Act. As proposed, Rule 509 would redefine accredited investor as it applies to individuals investing in hedge funds that rely on the Section

3(c)(1) exception from regulation as an investment company. The new 'accredited natural person' definition would consist of a two-part test. An individual would have to meet the same net worth or income test in Rule 501(a)(1) noted above. However, the accredited natural person definition would also require that the individual hold $2.5 million in investments (exclusive of a residence). This second prong of the test would also contain an inflation adjustment beginning in 2012. Accredited investors that are already invested in Section 3(c)(1) hedge funds would be grandfathered as to existing investments. If, however, those investors did not subsequently meet the requirements of the second prong of the test, they would not qualify as accredited investors when making any new investments.

Sophisticated non-accredited investors

Under Rule 506, interests in a fund may be sold to up to 35 non-accredited investors. Even though these investors do not meet the standard for qualifying as an accredited investor, they must have the knowledge and experience in business and investments sufficient to evaluate the merits and risks of the securities offered. Sales to non-accredited investors trigger certain disclosure requirements under Regulation D.

Proposed Rule 509 would not change the ability of a Section 3(c)(1) fund to seek out 35 non-accredited investors.

Issuer's burden of proof

Because the burden of proof to establish the private nature of an offering falls on the issuer, the fund must be able to identify each offeree and have information to support the conclusion that each was eligible. In order to meet this burden, the issuer should:

- Keep detailed records describing the attributes of the prospective offeree which would support the conclusion that the offeree is an accredited investor, or otherwise eligible, and that an investment in the particular securities that are subject to the offering may be appropriate.

- Keep detailed records of the identity of recipients of all offering materials. Each offering memorandum and any other descriptions of the fund (including all sales materials) should be numbered so as to facilitate tracking.

- The investor's eligibility must be established each time securities are sold. A conclusion that the investor is an eligible offeree at the time of the initial sale is not sufficient. Various methods can be utilized to achieve this confirmation. One common method is for the fund to obtain a representation from the purchaser to the effect that information about the investor previously provided to the fund remains current.

Methodology of the offering

No general solicitation or advertising

Offers of securities in private placements may not be made through a general solicitation or general advertising. Accordingly, under the private placement framework, two inquiries should be made to determine whether a particular communication is permissible in the context of a private placement, namely:

- Is the communication a general solicitation or general advertisement?

- Is the communication made by or on behalf of the issuer to offer or sell the securities?

If the answer to either of the questions is no, the communication should be permissible under the Regulation D safe harbor. The SEC, however, takes a very broad view of the types of communications that may be deemed to be offers.

Although the definition of a general solicitation is somewhat vague, there are some bright-line rules:

- Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media, broadcast over the television or radio, or available on a publicly accessible Internet site, is considered a general solicitation and must be avoided.

- Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising is also prohibited.

There is no bright-line test for the number of offerees that is permissible in a private placement to accredited investors; in theory, there is no limit to the number of offerees. However, the fund should bear in mind that a larger number of offerees may be seen as evidence of a general solicitation.

Offerings through the Internet

Because general solicitation and general advertising are forbidden in the context of private placements, issuers should be careful when using the Internet to market private offerings. Issuers should take the following steps when marketing a private placement on the Internet:

- Websites should be password protected, giving access to the information on the sites only to those persons to whom paper offering materials could be given.

- Prospective investors who receive passwords should be required to agree that the password will not be given to others or misused by the investor. This is analogous to confidentiality pledges that are given by recipients of paper offering materials.

- Passwords given to financial intermediaries should be accompanied by an agreement that requires the intermediary to comply with the private offering requirements. The password must not be used to generate interest from clients in a manner that would constitute a general solicitation. Parallel restrictions are imposed in the paper offering context.

A September 2003 SEC report on hedge funds noted that the proliferation of information on the Internet regarding hedge funds raises questions regarding how to effectively target information to eligible investors without violating the restrictions on general solicitation and general advertising. The SEC report also recognized that questions exist as to whether information concerning a hedge fund adviser's services and activities (as opposed to information about a specific hedge fund) is consistent with existing regulatory guidelines. In addition, the SEC report stated that it may re-evaluate the prohibition on general solicitation and general advertising in the context of marketing hedge fund products to certain sophisticated investors.

Whether a particular communication may be considered a general solicitation or advertisement depends on the facts and circumstances, and requires evaluation of the context of the promotions and the use of each communication in relation to the offering of securities.

Presentations
Presentations may only be made through direct contact with approved offerees.

Pre-existing relationships
A pre-existing relationship between the issuer, or a person acting on its behalf, and the person solicited is a factor that can be used to establish that no general solicitation or general advertising was used in connection with the offer. The relationship must be sufficient to show that the issuer had adequate knowledge of that person's financial circumstances and sophistication to establish that he or she is an eligible investor for the offering. Substantive relationships are:

- deemed to arise from some form of contact between the issuer or person on behalf of the issuer and the potential offeree; and
- sufficient for the issuer to determine that the potential offeree qualifies as an accredited investor.

The relationship does not have to fit a particular form, nor does it have a required duration. It does not have to be a contract or an account relationship. Any relationship where the issuer or a person acting on the issuer's behalf becomes aware of the potential offeree's financial status should be sufficient.

The required relationship generally exists between a broker-dealer and its brokerage client because of the substantive nature of the relationship required by the broker-dealer's fair dealing and suitability obligations. The relationship may also exist between the investor and an agent of the issuer, such as a placement agent, employee, or the investment advisor. In most cases, the SEC uses a facts and circumstances test to determine whether a pre-existing relationship exists.

Questionnaires
Questionnaires may be used to establish a relationship that is sufficient to avoid a general solicitation or advertising with potential investors with whom the issuer has no prior relationship. The questionnaire must evaluate the potential investor's sophistication and financial circumstances such that an offer to that individual would be appropriate in light of the suitability standards established by the issuer. The questionnaire should:

- include factual questions designed to determine the potential offeree's financial status and provide a basis for determining suitability;
- provide a reasonable basis to believe the potential investor is an accredited investor; and
- be generic in nature and make no reference to any specific investment currently offered or contemplated for offering.

Questionnaires used by broker-dealers prior to the offering may create a substantive pre-existing relationship. At least for private funds, questionnaires may generally be used even if the offering has commenced. Generic questionnaires may also be posted on an Internet site to pre-screen investors who otherwise do not have an existing relationship with the intermediary. Access to information regarding specific private placements posted on the site should be conditional on the satisfactory completion and review of the questionnaire. In connection with continuous offerings by funds relying on Section 3(c)(1) or 3(c)(7) under the Investment Company Act, the SEC has stated that a 30-day waiting period between the qualification of an investor

and an investment in a private offering is generally sufficient under the circumstances.

Institutional investors

A limited, private solicitation of institutional investors may qualify as a private offering under the 1933 Act. Approaches to investors in the absence of circumstances that would clearly support the notion of a pre-existing relationship with the issuer or the questionnaire technique should only be made to institutions (not individuals) and based upon the knowledge from public sources that the investor is clearly financially sophisticated, able to analyze and bear the risk of the investment proposed, and otherwise eligible to make the investment.

Other criteria

In addition to ensuring that all offerees of the securities are accredited investors, hedge fund operators must also consider other factors that may place further limits on the types of investors to whom the securities may be sold.

Investment Advisers Act of 1940

Generally, performance-based fees may not be charged to US clients by registered investment advisers, other than 3(c)(7) funds. However, an exemption exists where the clients are 'qualified' under Rule 205-3 under the Investment Advisers Act of 1940, as amended. This requires that each investor in a 3(c)(1) hedge fund paying a performance-based fee to a registered investment adviser be a 'qualified client' (with certain 'knowledgeable employee' exceptions).

Investment Company Act of 1940

In addition to avoiding registration under the 1933 Act, hedge funds typically seek to avoid regulation under the Investment Company Act. The typical exceptions, Sections 3(c)(1) and 3(c)(7), are described in Chapter XX. The number or type of investors to whom the fund may be sold will be limited by the applicable section.

Who can sell?

Issuer exemption

Issuer

As a general matter, people who are in the business of effecting transactions in securities for the accounts of others are required to register as broker-dealers under the Securities Exchange Act of 1934, as amended (1934 Act). However, broker-dealer registration under the 1934 Act is not required of any person who buys or sells securities for his or her own account, either individually or in some fiduciary capacity, but not as part of a 'regular business'. A person would likely be considered to be a broker-dealer in securities if he or she earned compensation tied to the offer or sale of securities. Accordingly, hedge funds and their managers typically avoid broker-dealer registration requirements under the 1934 Act because they do not hold themselves out as being in the business of effecting transactions in securities for the account of others, and any sales of fund interests are purely incidental to their investment business. Hedge funds and managers that are not broker-dealers under the 1934 Act should not generally be deemed to be broker-dealers under state law. However, state regulations vary.

Associated persons

Associated persons of the issuer (the hedge fund) may also be potentially subject to broker-dealer registration, but they generally qualify for an exemption from registration as broker-dealers. Associated persons include partners, directors and employees of the fund or its manager. Pursuant to a non-exclusive safe harbor under the 1934 Act relied upon by many hedge funds, no registration is required of an associated person if the person:

- is not subject to any statutory disqualification;
- is not being compensated by sales-based compensation in connection with participation in the offering;
- is not an associated person of a registered broker-dealer; and
- performs substantial duties for the issuer that are not connected to the offering, and additionally, was not a broker-dealer or an associated person of a broker-dealer within the preceding 12 months and does not participate in the selling of securities for any issuer more than once every 12 months.

Registered broker-dealers

Subject to the limited issuer exemption described above, offerings of securities generally must be made through a registered broker-dealer. The SEC has taken the approach that anyone conducting activities related to the offer, sale, or inducement to purchase or sell any security within the United States must register as a broker-dealer (even if offers and sales are directed exclusively offshore). The hedge fund should require the broker-dealer to sign an agreement to comply with the requirements of the private placement to ensure that the broker-dealer does not engage in a general solicitation.

Selecting representatives to be involved in the offering, the placement agent should consider:

- the compliance and regulatory history of the potential representative; and
- the representative's record on previous offerings.

Furthermore, representatives chosen should be required to sign a compliance certification indicating adherence to the conditions of the private placement.

The National Association of Securities Dealers (NASD) has been active in policing alleged abuses in hedge fund marketing. In February 2003, the NASD issued a notice to its broker-dealer members regarding sales practice obligations when selling hedge funds. The notice set forth the following guidelines:

- Promotion of hedge funds must be balanced by a fair presentation of the risks and potential disadvantages of investing. Members must also provide investors with any offering memoranda.

- A member that recommends hedge funds must have a reasonable belief that the product is suitable for any investor. In order to determine whether the hedge fund is suitable, the member must conduct due diligence with respect to the hedge fund.

- A member's internal controls must ensure that sales of hedge funds comply with all relevant NASD and SEC rules.

- A member must train associated persons about the characteristics of, and risks associated with, hedge funds.

In December 2003, the NASD liberalized its position on the use of 'similar account' performance information by members, and now permits the use of similar account performance presentations with Section 3(c)(7) qualified purchasers.

Banks

Prior to the enactment of the Gramm-Leach-Bliley Act (GLB) in November 1999, banks enjoyed a broad 'status' exemption from registration as broker-dealers. Although the GLB diversified the financial activities in which banks were permitted to engage, it also limited their activities as broker-dealers if they wished to avoid registration. Private placements may be conducted directly by bank employees only if the bank is not affiliated with a broker-dealer engaged in dealing, marketing or underwriting activities other than with respect to exempted securities. Additionally, there is a size limitation on the direct private placement activities of banks.

In December 2006, the SEC and the Board of Governors of the Federal Reserve System proposed a new Regulation R to implement the bank/broker provisions of the GLB. In addition, the SEC issued a proposed companion release intended to complement Regulation R and address certain bank/dealer activities, among other related matters.

Additional issues in connection with private placements

State private placement requirements

States are no longer permitted to impose substantive regulation or registration requirements on 'covered securities', including securities sold in private placements under Rule 506 of Regulation D, if certain conditions are met. However, states may impose notice filing requirements substantially similar to those required under Regulation D, and may charge a related filing fee. States may also investigate and bring enforcement actions in connection with alleged fraudulent or unlawful activities.

Meaning of 'qualified purchaser'

In December 2001, the SEC issued a proposed rule under which issuers could offer and sell securities to qualified purchasers without having to comply with state registration requirements. The proposed rule was issued in order to implement a provision of the National Securities Markets Improvement Act of 1996. The SEC's proposal defines 'qualified purchaser' for these purposes (and unlike Investment Company Act purposes) to mean an accredited investor as defined under Rule 501(a) of Regulation D under the 1933 Act. The SEC has not taken any further action on the proposal.

Securities Exchange Act of 1934

Section 12(g) of the 1934 Act requires certain domestic issuers of securities, absent an exemption, to register such securities under the 1934 Act if they are held of record by 500 or more persons and the issuer has assets of more than $10 million. Accordingly, most domestic hedge funds limit their beneficial ownership to 499 persons (offshore funds can generally avoid registration under the 1934 Act by limiting their US holders to fewer than 300).

Employee Retirement Income Security Act of 1974 (ERISA)

If 25% or more of the value of any class of equity securities of a hedge fund is held by employee benefit plans, significant substantive regulations under ERISA may apply to the fund. Accordingly, hedge funds typically seek to ensure that less than 25% of their interests are held by 'benefit plan investors'.

In August 2006, the Pension Protection Act of 2006 (the Act) was enacted. In addition to changes in the funding and tax law requirements for employee benefit plans, the Act modified the definition of 'benefit plan investor' significantly, for purposes of the foregoing 25% plan asset test. Under the new definition, a benefit plan investor includes only an employee benefit plan which is subject to ERISA, any plan to which Section 4975 of the Internal Revenue Code of

1986 applies, and any entity whose underlying assets include plan assets by reason of such a plan's investment in such entity. As a result, the definition of benefit plan investor no longer includes governmental and non-US benefit plans for the purpose of the 25% plan asset test.

Commodity Exchange Act

A hedge fund that utilizes a futures trading strategy (even in conjunction with securities trading) will generally be deemed a 'commodity pool' under the Commodity Exchange Act, thereby subjecting the fund and its manager to registration and substantive regulation as a 'commodity pool operator' under that Act. Exemptions from certain of these requirements are available, including exemptions based on the nature of the fund's investors and the extent of the fund's futures activity. See Chapter XX.

Anti-fraud rules

It is important to note that regardless of whether a securities offering is exempt under federal or applicable state securities laws, the general anti-fraud provisions under these laws will apply to the offering and those conducting the offering, wherever the offering is taking place, including outside the United States, if any offering-related activity is conducted in or from the United States.

Conclusion

As is evident from this overview, the marketing of hedge funds in the United States is subject to a number of regulatory considerations, many of which are highly dependent on the surrounding facts and circumstances. This chapter is only a summary of certain of the relevant regulatory provisions, and is not a substitute for the advice of counsel.