Hedge Funds; Exempt From Registration and Regulation?

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Hedge funds are entities that manage pools of money on behalf of investors. In many ways they operate in a manner similar to mutual funds. However, hedge funds are exempt from registration and regulation under the Investment Company Act of 1940 (the Act which regulates the mutual fund industry). They are exempt because of two provisions of the Investment Company Act of 1940, Section 3(c)(1) and Section 3(c)(7). The former permits sales to up to 99 investors (only 35 of which may be non-accredited investors…. more on this later) and the latter permits sales to up to 500 investors all of whom must be "super" investors or what are known as Qualified Purchasers. Without going into too much detail, these are persons and entities that have $ 5,000,000 in investments or who manage more than $ 25,000,000 in investments.

There has been much literature written about the nature and qualification, as well as the number, of investors in both 3 (c) (1) and 3(c)(7) funds, that is, who can be an investors and who cannot. There is another aspect of marketing interests in a hedge fund, however, that is often not emphasized or understood well enough. That is the added requirement in marketing both Section 3(c)(1) and Section 3 (c)(7) funds that all sales of interests must be made in a non-public offering, or, put another way, must be sold in a private placement.

While many people agonize over who and who may not invest, broker dealers overlook the private placement requirement at their peril. Further, what constitutes a private placement may not be as clear as one may think. In this, as in all aspects of securities laws, the Securities and Exchange Commission has much to say concerning exactly what is, and what is not, a valid private placement.

The starting point for what constitutes a private placement is Section 4(2) and Section 3(b) of the Securities Act of 1933, as amended. The former merely states that an offering "not involving a public offering" need not be registered under Section 5 of the Act. It is Section 5 of the Act that requires the filing of the familiar registration statement in connection with public offerings and which distinguishes public from private offerings. Section 3(b) of the Act merely states that the Securities and Exchange Commission may exempt from registration any offering or type of offering from registration under Section 5, so long as the offering is not in excess of $5,000,000.

To meet the requirement in Investment Company Act of 1940 Section 3(c)(1) and Section 3(c)(7) that the interests in the hedge funds may not be sold in a public offering, the offering must fit under either Section 3(b) or Section 4(2) of the Securities Act of 1933. Since Section 3(b) exemptions are limited to $5,000,000, the more logical exemption is Section 4(2) which has no dollar limit. In short, to be a validly offered hedge fund under the Investment Company Act, the interests in the hedge fund must be offered in compliance with Section 4(2) of the Securities Act.

So, what's the big deal? The big deal is that qualifying an offering under Section 4(2), while not difficult, must be done with great care to ensure compliance with long standing court decisions and Securities and Exchange Commission rules and regulation. While this is not exactly a mine field, still, a misstep can be disastrous. The Securities and Exchange Commission has offered significant guidance on how properly to structure an offering to meet the requirements of Section 4(2). This is Regulation D, consisting of Rule 501 through 508. Basically Rule 506 states that so

long as sales made only to "accredited investors" (or no more than 35 non-accredited investors) the offering will be a valid Section 4(2) private placement. A common misconception, however, is that so long as the offering is confined only to accredited investors, the broker dealer may sell interests in the hedge fund with impunity.* However that is not the only requirement. SEC Rule 506 imposes a further restriction. This additional requirement is that there can be no "general solicitation."

What this means is that it is not enough that the offering was confined to accredited investors. It means that the accredited investors solicited must be known ahead of time to the broker/dealer, they must be existing clients If new clients are solicited fro the purpose of investing in a given hedge fund, then the broker dealer will have violated the "no general solicitation" rule. For example, were a broker/dealer to put an ad a newspaper seeking only accredited investors, while that would satisfy the first requirement of SEC Rule 506, it would violate the second requirement of no "general solicitation". Similarly, and perhaps closer to home, a broker/dealer may not put a general solicitation for a hedge fund on the Internet, even if it clearly stated that it was open only to accredited investors. That too would defeat the general solicitation prohibition.

So to whom may a broker/dealer offer interests in a hedge fund and not run afoul of the general solicitation requirement? The answer is to existing clients. Fine, but what is an existing client? Can the general solicitation for accredited investors, in general go out on Monday, someone calls on Tuesday and is that person an existing client on Wednesday to whom a hedge fund may be sold? The answer is no.

The general solicitation issue ties in with the "know your customer" rule. To truly be an existing client, the client must be one that has been integrated into the broker dealer network fully, been assigned an account manager, and has been brought into the fold, so the speak, just like any other new client. The client can not have been solicited specifically for the purpose of investing in a specific hedge fund. The length a time a client must be a client to be an "existing client" for general solicitation purposes is in the order of 90 days. While it is permissible to suggest that the broker dealer has hedge fund to offer, it is not permissible to lure a client into the broker dealer firm by offering a specific hedge fund.

On the plus side, however, is that once a client is an "existing client" that client may be offered hedge funds and there will be no general solicitation, even if a given broker dealer has thousands of eligible accredited investors as clients. *It is not the number that trips general solicitation, it is the relationship.*

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* An accredited investor in defined in SEC Rule 501 basically as a broker/dealer, financial institution, company or trust with more that $5,000,000 in assets or an individual with two years of annual income of at least $ 200,000 ($300,000 with spouse) or net assets of $5,000,000. An unaccredited investor is everybody else.

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