
HEDGE FUND MARKETING IN AN ERA OF REGULATORY UNCERTAINTY

R K & O RICHARDS KIBBE & ORBE LLP

**One World Financial Center
New York, NY 10281
212.530.1800**

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Marketing a hedge fund involves a myriad of considerations, including compliance not only with the regulatory requirements and restrictions of the jurisdiction in which the hedge fund is domiciled but also the requirements and restrictions of each jurisdiction in which the fund's target investors live. Here, we address the status of hedge fund regulation in the United States, with a particular focus on its implication for hedge fund marketing efforts.

In summary, we recommend: (i) targeting solicitations to individual potential investors or, to a discrete group of accredited investors, preferably already known to the hedge fund adviser; (ii) disclosing the risks and potential disadvantages of a hedge fund investment, as well as particular risks involved in investing in the particular fund at issue; (iii) restricting discussions of performance to actual past performance, net of fees charged; and (iv) disclosing statutory investor-eligibility requirements.

These marketing recommendations must be understood against the broader context of accelerating initiatives to regulate the hedge fund industry in the United States.

I. THE INCREASING PROSPECT OF SEC REGULATION OF HEDGE FUNDS.

A. Recent Legislative Proposals Would Require More Hedge Fund Registration.

Earlier this year, the collapse in value of various collateralized debt obligations ("CDOs") based on sub-prime mortgages had a dramatic impact on the U.S. financial markets. Because many of these CDOs were held by hedge funds, the sub-prime mortgage debacle has brought increased scrutiny of hedge funds and increased concerns about liquidity. Some hedge funds have slowed, capped or blocked redemptions by investors. In turn, these actions have added to the uncertainty and pressure on all market participants. Some investors are even reported to be unwinding positions in funds that are performing well because of the desire to diminish risk.

In the wake of these events, it appears that enthusiasm for regulation of hedge funds has resurfaced. Recently, Senator Charles Grassley introduced a bill in Congress that would require hedge fund advisers to register with the Securities and Exchange Commission ("SEC"). The "Hedge Fund Registration Act" proposes an amendment to Section 203(b)(3) of the Investment Advisers Act of 1940, which currently exempts from registration certain investment advisers (most importantly, those managing assets for fewer than 15 investors) and would authorize the SEC to require all investment advisers, including hedge fund managers, to register with the SEC. The bill would, however, exempt investment advisers who: (1) manage less than \$50 million in assets, (2) for fewer than fifteen investors, and (3) do not hold themselves out to the public as investment advisers.

The Hedge Fund Registration Act is effectively a legislative override of a court decision striking down a December 2004 SEC rule that would have required many more hedge fund managers to become registered advisers subject to regulation and oversight by the SEC. Prior to the December 2004 rule, the "private adviser exemption" under the Investment Advisers Act allowed advisers with fewer than fifteen "clients" over the past twelve months not to register.

¹In some jurisdictions, this memorandum may constitute attorney advertising. This memorandum was prepared as a service to clients and other friends of RK&O to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied upon as legal advice.

The SEC had interpreted “client” to refer to the fund itself, rather than to its investors. In the SEC’s December 2004 hedge fund rule, however, the SEC equated “client” with “investor,” thereby requiring many hedge fund managers to register.

That rule was challenged in Goldstein v. the Securities and Exchange Comm’n, No. 04-1434 (D.C. Cir. Jun. 23, 2006), before the D.C. Circuit Court of Appeals. The Circuit Court in Goldstein rejected the SEC’s argument that it could define “client” to mean “investor” and declared the 2004 rule arbitrary. Prior to the court’s decision in Goldstein, more than 1,200 hedge fund advisers had voluntarily registered with the SEC. After the Goldstein decision, many of those hedge fund advisers withdrew their registrations and the push to regulate hedge funds in the United States appeared to have been stymied for a period of time.

B. A Changing Class Of Hedge Fund Investors May Support Increased Hedge Fund Regulation.

In addition to the perception that hedge fund investments contributed to the market disruption resulting from sub-prime mortgage defaults, there is a perception that a broader range of investors have direct or indirect exposure to hedge funds and that these investors require greater protection.

Recent attention has been paid to the fact that, now more than ever before, the population of investors who may directly invest in hedge funds includes not only sophisticated, high net worth individuals and institutions, but also less-sophisticated, less-wealthy individuals. For example, more investors meet the “accredited investor” standard applicable to 3(c)(1) funds than ever previously – having an individual net worth of more than \$1 million or an income of at least \$200,000 in each of the past two years with a reasonable expectation of the same income in the current year. The accredited investor threshold was established in the 1980s. Today, a much larger portion of the population meets that test, particularly because the \$1 million asset threshold includes the value of the investor’s residence.²

Less sophisticated and less wealthy individuals may also be indirect hedge fund investors. Until recently, hedge funds were limited in the amount of pension plan equity they could receive. However, the Pension Protection Act effectively eliminated such restrictions with regard to governmental pension assets, raising the prospect of even greater pension asset investment in such funds. These developments, along with the introduction of “funds of funds” which accept smaller investments than traditional funds, have altered the class of hedge fund investors and will likely lead to further calls for increased regulation of hedge funds investments.

C. The SEC Has Focused Increased Attention On Hedge Fund Fraud And Insider Trading.

Recently, the SEC has indicated that it intends to fully assert its authority to protect investors in connection with the activities of hedge funds, both through rulemaking and through the deployment of additional enforcement resources.

²On December 27, 2006, the SEC proposed a regulation that would raise the accredited investor threshold from \$1 million to \$2.5 million in assets (excluding the value of the investor’s home). In May 2007, the SEC voted to propose more general additions to the definition of accredited person and to delay any final action in that regard until it had more time to consider comments it had received.

First, in August 2007 the SEC adopted an anti-fraud rule that applies broadly to “pooled investment vehicles,” including hedge funds. That rule is designed to clarify that an adviser is prohibited from defrauding the ultimate investors in the fund, not just an entity client of the adviser. Rule 206(4)-8 of the Investment Advisers Act provides that it constitutes “a fraudulent, deceptive, or manipulative act, practice, or course of business . . . for any investment adviser to a pooled investment vehicle to (1) make any untrue statement of a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle, or (2) otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investor vehicle.”

The rule is limited to enforcement by the SEC; it does not create a private right of action. However, it is expansive in other ways: it applies to investment advisers of all types of pooled investment funds, registered and unregistered funds alike; it does not require proof that the investment adviser acted with an intent to deceive, manipulate or defraud; and it is not limited to situations involving “the purchase or sale of a security.” Accordingly, the rule creates an SEC enforcement action for negligent deceptive practices and statements by investment advisers, regardless of whether an offer, sale or redemption is involved. This rule applies to marketing materials used by hedge funds or promoters of hedge funds and heightens the attention that must be paid to their accuracy and completeness.

Second, in July 2007 SEC Chairman Christopher Cox announced that the SEC had decided to establish a special unit within its enforcement division to crack down on what is perceived to be a growing problem of insider trading in the hedge fund industry. Then, in September 2007, media attention focused on a 27-page information request sent by the New York Regional Office of the Securities and Exchange Commission to registered investment advisers in advance of inspections of such advisers. *SEC Pushes for Hedge Fund Disclosure*, Wall Street Journal, September 19, 2007, p. C2. Among the many types of information that the SEC examiners now request are the following:

- Disclosure of threatened, pending and settled litigation or arbitration to which the adviser was a party, including a description of the allegations forming the basis of each issue, the status of each pending issue, and a brief description of any “out of court” or informal settlement.
- Disclosure, relating to receipt of non-public information/misuse of non-public information, of a list of companies for which employees of the adviser or affiliates of the adviser serve on creditors’ committees.
- Disclosure of all securities held in any client account during the past two years that were involved in a bankruptcy work out, identifying, for each security listed, all accounts that held equity and/or fixed income positions in the issuer at the time of the bankruptcy filing.

As a result of all of the foregoing developments, hedge funds may find that they are subject to greater scrutiny and calls for regulation in the near term. It is in this context that we highlight SEC and NASD (now FINRA) guidance regarding appropriate means of soliciting investors to hedge funds.

II. REGULATION OF HEDGE FUND MARKETING

In order to avoid the requirement to register their securities under the Securities Act of 1933, hedge funds must be sold via a private placement. In most instances, as stated in SEC Rule 502 (c), such privately placed funds may not be offered or sold “by any form of ‘general solicitation’ or ‘general advertising,’ including, but not limited to, the following:

- Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; or
- Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Limited by these restrictions, hedge funds may wonder how to market their funds. Below, we offer some suggestions based on prior SEC statements and based on guidance provided by the NASD (now FINRA) to its members in setting forth guidelines for marketing hedge funds.

A. Limited Audience For Solicitations

First and foremost, although the SEC has not defined the terms “general solicitation” and “general advertising,” it is clear that solicitations provided to a general audience will run afoul of Rule 502(c). Indeed, the SEC has indicated that it believes that the following actions violate Rule 502(c):

- Mass mailings;
- Speaking to the media referencing an investment currently offered or contemplated, particularly where the discussion is an attempt to “condition the market” by making reference to the success or attractive return of previous investments; and
- Print, radio and television advertisements or solicitations regarding funding or investment matters.

Accordingly, hedge funds should limit the audience from which they solicit investments, preferably to individuals or entities with which they have a pre-existing relationship. Even in the potentially fruitful situation of participating in an investment forum, hedge fund advisers should take care that the attendees are limited to accredited investors and, preferably, to investors with whom the advisers has a pre-existing relationship.

B. FINRA Guidelines Regarding The Content Of Solicitations

In 2003, the NASD (now FINRA) studied hedge fund marketing materials and then issued guidance for member firms in the form of a member update regarding the marketing of hedge funds by its members. FINRA maintains this general guidance today. Although this guidance does not apply to hedge funds themselves, it provides a useful framework for hedge fund marketing materials. In reviewing member marketing of hedge funds, the NASD found that hedge fund sales literature included “unbalanced presentations about the particular hedge funds being offered” and, therefore, failed “to provide investors with a sound basis for evaluating whether to invest in the funds.” NASD Member Update October 9, 2003, NASD Review of Hedge Fund Advertising Results in Formal Action. The NASD’s review identified four general areas of concern in hedge fund advertising: 1) risk disclosure; 2) misleading and exaggerated language; 3) performance; and 4) general solicitations. We address these areas below.

1. Risk Disclosure

According to the guidance, hedge fund promotional materials must be a balanced, fair presentation of the risks and potential disadvantages of hedge fund investing. Communications regarding hedge funds and funds of hedge funds must adequately disclose the risks associated with these products. Presentations must address the risks associated with hedge funds in general, as well as the specific risks associated the fund being offered including, but not limited to, the risks associated with a fund’s structure, investment strategies, portfolio securities, tax treatment, etc. For example, members must balance sales material or oral presentations that promote the advantages of hedge fund investing with full disclosure of the risks that hedge funds present, including the fact that hedge funds:

- Often engage in leveraging and other speculative investment practices that may increase the risk of investment loss;
- Can be highly illiquid;
- Are not required to provide periodic pricing or valuation information to investors;
- May involve complex tax structures and delays in distributing important tax information;
- Are not subject other same regulatory requirements as mutual funds; and
- Often charge high fees.

NASD Notice to Members 03-07, NASD Reminds Members of Obligations When Selling Hedge Funds.

In addition, it may also be advisable to highlight to potential investors the fact that a hedge fund investment may not be suitable for all investors and, in particular, to suggest that it is suitable

only for the most sophisticated investors. Indeed, some NASD comments have called for disclosure of accredited investor requirements in hedge fund marketing materials.

2. Performance

Hedge fund managers should restrict discussions of performance results to actual performance of the fund being promoted. The NASD has noted that some marketing materials contain language that states or implies that an investor can expect a specific rate of return from investing in a fund. *See, e.g.*, NASD News Release (Oct. 25, 2004), NASD Fines Citigroup Global Markets, Inc. \$250,000 in Largest Hedge Funds Sales Sanction to Date. Such projections or predictions of investment results are prohibited. Generally, funds should be very cautious about forward-looking statements with respect to securities investments. Moreover, where a fund has experienced a period of extraordinary performance, disclosure of the reasons for extraordinary market performance, and the fact that such performance may not be repeated in the future, is advisable.

Particularly new funds need to be cautious regarding their marketing materials because any attempts to attribute the performance of another product to a new fund that has either a limited operating history or no operating history may be misleading.

3. Misleading Or Exaggerated Language

In its first Compliance Alert letter to the chief compliance officers of registered firms, the SEC staff stated the most common deficiency in adviser advertising was that “many” advisory firms did not include in the advertisements of their performance returns the disclosures necessary to prevent their advertising from being misleading. For example, firms did not

- deduct advisory fees from performance results,
- disclose whether results reflected dividends, or
- disclose differences with the particular index being used to benchmark performance claims.

SEC Office of Compliance Examinations, Compliance Alert, June 2007 (“Compliance Alert, June 2007”).

FINRA’s member conduct rule inherited from the NASD provides that no material fact or qualification may be omitted from marketing materials if the omission would cause the communication to be misleading. In the context of hedge funds, FINRA generally considers the disclosure of the inherent and particular risks of an investment, investment strategy or underlying assets, liquidity restrictions, withdrawal rights and fees, and performance fees and charges, to be material. Thus, performance calculations should be presented net of the fees charged. If the performance description is not calculated net of fees charged, the fees to be deducted must be disclosed, along with a disclosure that the funds’ performance would be lower if the fees were

deducted. Performance presentations should also illustrate downside volatility and should not highlight only successful investments or reporting periods with positive results. Note that providing a prospectus does not satisfy the duty to provide balanced sales materials and oral presentations.

Exaggerated, unwarranted or misleading statements or claims are prohibited. Typically, the use of superlatives in the description of the fund or its performance is not advisable. The use of objective language to describe the fund's performance is advised.

The NASD noted particular deficiencies where disclosures:

- Make unbalanced presentations about the particular hedge funds being offered.
- Contain exaggerated, unwarranted or misleading statements or claims, unwarranted forecasts or projections of future performance.
- Refer to a hedge fund as an "ideal fund for conservative investors" when the fund had a limited operating history, was speculative and involved a high degree of risk.
- Indicate that hedge funds are subject to regulatory oversight.
- Present hypothetical results for specific hedge funds that had limited operating history or no operating history.
- State that a fund's objective is to produce a steady or predictable return when, in fact, the fund's prospectus did not disclose such an objective.
- Use language that states or implies that hedge funds for funds of funds are appropriate for all investors or should be part of all investors' portfolios.
- State or imply that an investor can expect a specific rate of return from investing in a fund.

Member Update (October 9, 2003), NASD Review of Hedge Fund Advertising Results in Formal Action.

4. General Solicitations Of The Public

As discussed above, general solicitations of the public by hedge funds are prohibited.

C. Best Practices Noted By The SEC

Recently, the SEC's Office of Compliance Inspections and Examinations ("OCIE") offered examples of policies and procedures in place at the firms with fewer performance advertising deficiencies. Such policies include:

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- A multi-level review process among an adviser's performance group, portfolio managers, and marketing group for the accuracy of marketing materials prior to their use;
 - The creation of 'tolerance reports' on a monthly basis to compare all composite accounts to their respective benchmarks, with any material discrepancies being investigated;
 - A composite committee review of all accounts on at least a quarterly basis to ensure proper composite construction and maintenance; and
 - The use of a second independent pricing service to periodically verify the accuracy of prices supplied by the primary pricing service, with any material discrepancies in prices being investigated.

Compliance Alert, June 2007. Adoption of such practices will be beneficial to any marketing compliance program.

III. CONCLUSION

Above, we have highlighted guidance from the SEC and its staff, and FINRA and its predecessor, the NASD, regarding how hedge fund solicitations may not be conducted. That guidance can be distilled into four points for soliciting new investors:

- Target solicitations to individual potential investors or, to a discrete group of accredited investors, preferably already known to the hedge fund adviser.
- Disclose the risks and potential disadvantages of a hedge fund investment, as well as particular risks involved in investing in the particular fund at issue.
- Restrict discussions of performance to actual past performance, net of fees charged.
- Disclose the accredited investor requirements.

This memorandum was prepared as a service to clients and other friends of RK&O to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

ABOUT THE AUTHORS

Lucinda O. McConathy & Patricia C. O'Prey

Lucinda O. McConathy and Patricia C. O'Prey are partners in the law firm of Richards Kibbe & Orbe LLP. Ms. McConathy and Ms. O'Prey represent hedge funds, commercial banks, investment banks, brokerage firms, and other financial services institutions, along with individual traders and executives, in private civil litigation and government investigations and litigation. They also advise clients on compliance issues to avoid litigation and advise on litigation arbitrage positions. They work closely with the attorneys in RK&O's transactional practice to assist in structuring complex transactions so as to minimize future litigation risk. Ms. McConathy and Ms. O'Prey have developed a particularly strong expertise in litigation and related advice involving the capital markets, financial services, and securities industries. Ms. McConathy may be reached in RK&O's Washington D.C. office at (202) 261-2992 and Ms. O'Prey may be reached in RK&O's New York office at (212) 530-1969. The firm's general telephone number is (212) 530-1800. RK&O's website is www.rkollp.com.

James R. Hedges, IV and Charlotte Luer

James R. Hedges, IV and Charlotte Luer are partners in LJH Financial Marketing Strategies. Mr. Hedges is also President and Chief Investment Officer of LJH Global Investments, is the author of *Hedges on Hedge Funds*, and frequently appears in the media to discuss hedge fund thought leadership issues. Ms. Luer has 20 years of experience in investor relations and financial marketing, and has worked with LJH since 1995, initially as a partner in the firm's marketing agency prior to joining the firm's in-house marketing team. LJH Financial Marketing Strategies provides marketing and investor relations support to asset management companies, private equity firms, service providers and hedge funds ranging from multi-billion dollar firms to emerging managers. They may be reached in LJH's New York office at (212) 925-8703 or via email at jhedges@ljh.com or cluer@ljhfm.com. The firm's website is www.ljhfm.com.

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**One World Financial Center
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LJH **FINANCIAL MARKETING**
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