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Proskauer's Hedge Start: What Key Exemptions Apply to Hedge Funds?

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We have separately discussed the common exemptions from registration of a fund manager with the Securities and Exchange Commission (SEC) as an investment adviser and from registration with the Commodity Future Trading Commission (CFTC) as a commodity trading advisor or commodity pool operator. This article will discuss the basic exemptions under which most hedge funds operate from the requirement to register a fund and its securities under U.S. federal securities laws.

Private Placement Exemption

Shares in a private fund may be offered without registration with the SEC pursuant to a "private placement" under SEC Regulation D. Regulation D provides a non-exclusive definition of an exempt non-public offering. The basic requirements of Regulation D are relatively straightforward:

- No general solicitation or advertising by the fund is permitted (including marketing through newspapers, other media or a web site).
    - A fund manager that is registered with the SEC can advertise its own services, so long as the advertisement does not refer to a private fund that it manages.
    - SEC Rule 506(c) of Regulation D permits general solicitation or advertising under certain limited circumstances, provided that certain additional steps are taken to confirm the accredited investor status of each investor. However, it is still relatively uncommon for fund managers to advertise relying on this provision, in part because of the risk of attracting additional scrutiny from the SEC.

- All investors must be "accredited investors" (generally individual investors with at least $1 million net worth and entities with at least $5 million net worth).
    - Up to 35 qualified non-accredited investors may participate in limited circumstances but only if additional disclosure information is provided and if certain additional filings are made under state securities laws. Accordingly, we usually recommend limiting hedge fund offerings to accredited investors.

- Form D (a relatively simple notice) must be filed with the SEC on an annual basis to report certain information regarding sales made to investors by the fund.

Accredited Investor Definition

Accredited investors are defined to include:

- A natural person whose individual net worth, or joint net worth with a spouse or spousal equivalent, at the time of purchase exceeds $1,000,000.
    - Net worth for this purpose generally means the excess of an investor's total assets (excluding the investor's primary residence) over the investor's total liabilities.

- A natural person who had an individual income in excess of $200,000 in each of the last two calendar years or joint income with a spouse or spousal equivalent in excess of $300,000 in each of those years and who has a reasonable expectation of reaching the same income level in the current calendar year.
- A corporation, partnership, business trust, tax-exempt organization or other entity with total assets at the time of purchase in excess of $5,000,000, which was not formed for the purpose of investing in the fund.
- Any entity in which all of the owners are accredited investors as described above.

Investment Company Act Exemptions

A private investment fund must also qualify for an exemption from the requirement to register with the SEC under the Investment Company Act of 1940 (the law that governs U.S. mutual funds). There are two exemptions that apply to most hedge funds:

- Section 3(c)(1) of the Act provides an exemption for an investment fund if it is owned by not more than 100 beneficial owners. However, various "look through" provisions apply when counting the 100 investors, so this exemption is generally less desirable.
    - In particular, it is necessary to "look through" and count toward the 100 investor limit all of the investors in any other private fund that acquires 10% or more of the interests issued by the fund.
    - In the case of an investment fund organized outside the United States, only the U.S. investors in the fund count toward the 100 investor limit.

- Section 3(c)(7) of the Act provides an exemption for an investment fund if all of the investors meet the definition of a "qualified purchaser."

    - In the case of a fund organized outside the United States, only the U.S. investors in the fund need to satisfy the “qualified purchaser” test.

Qualified Purchaser Definition

The definition of a qualified purchaser is more restrictive than the accredited investor test, and includes:

- A natural person with at least $5 million in investments (as defined below).
- A corporation, partnership, business trust, tax-exempt organization or other entity with at least $5 million in investments and which is owned by certain related individuals (generally immediate family members) or by a trust or foundation established for the benefit of such related persons.
- A trust not formed for the purpose of making the investment, for which the person making the investment decision meets the qualified purchaser test.
- Any other person or entity which owns or invests on a discretionary basis at least $25 million in investments (other than another investment fund which controls, is controlled by or is under common control with the 3(c)(7) fund).
- Any “knowledgeable employee” of the issuer, which includes any executive officer, director, trustee, advisory board member or any other employee (other than an employee performing solely clerical, secretarial or administrative functions) who, in connection with his or her regular functions or duties, participates in the investment activities of the fund (or other funds managed by the manager), provided that such employee has been performing such functions for the fund or another fund (including funds managed by other managers) for at least 12 months.
    - The “knowledgeable employee” test permits any employee who is active in the management of a hedge fund’s investment to invest in the hedge fund.
    - Marketing, compliance, operational and accounting personnel generally do not qualify as knowledgeable employees.
- Any entity in which all of the owners are qualified purchasers as described above.

The SEC has defined “investments” broadly for purposes of the qualified purchaser test to include securities (other than certain securities of an issuer that controls, is controlled by or is under common control with the investor); real estate held for investment purposes (excluding an investor’s principal residence); financial contracts (such as swaps or over-the-counter options) held for investment purposes; and cash and cash equivalents held for investment purposes. In calculating an investor’s total “investments”, any indebtedness incurred to acquire such investments must be deducted. A natural person may include investments held jointly with a spouse, and an entity may aggregate investments that it owns with its majority-held subsidiaries.

State Blue Sky Laws

Most states have securities laws, often referred to as “Blue Sky laws,” which require the registration with the appropriate state agency of securities being offered or sold within the state or to residents of the state. If an offering is made only to accredited investors under Regulation D, then it is not necessary to register under any state laws, although it will be necessary to make a notice filing and pay a fee in many states where interests in the fund will be offered. Many states have exemptions if the filing is only made to institutional investors.

Placement Agents

If a placement fee or commission is paid to any person or entity with respect to a sale of an interest in a fund to a U.S. investor, then the recipient of the fee will be required to register with the SEC as a broker-dealer and also may be required to register under the laws of a state in which the sale is made.

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