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»» **Safe & Sound Practices****The Marketing Dilemma****By Oliver R. Witte, Managing Editor** [Email this story](#) [Printable Version](#) [Order Reprints](#)

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Chicago (HedgeWorld.com)—Aggressive managers of small hedge funds and start-ups wanting their businesses to grow often feel as if they are walking into a twilight zone when it comes to the rules and regulations of marketing hedge funds. It's not always clear how far a manager can go in attracting investors and what the penalties might be for crossing the none-too-clearly-drawn line.

To help clarify the boundaries between safety and risk, HedgeWorld.com posed a series of questions concerning marketing to a panel of lawyers who represent hedge funds. The panel consists of Barry Barbash, partner in the Washington office of Shearman & Sterling and former director of the Securities and Exchange Commission's division of investment management; George Mazin, partner in Lowenstein Sandler, Roseland, N.J.; Philip H. Harris, partner in Skadden Arps Slate Meagher & Flom, New York; and Bill Natbony, partner in Rosenman and Colin, New York.

Answers, except when noted, reflect the consensus of the panelists.

Q: What happens when a fund manager hires a third-party marketer to find investors?

A: The firm and its sales representatives must register. The sales firm must file a disclosure document, Form BD, with the Securities and Exchange Commission. The firm's sales employees then must register with the National Association of Securities Dealers. Otherwise, investors could rescind the investment and get back the amount of their original contribution, perhaps from the fund manager personally. The trigger for disinvestment could be a significant loss by the fund. In boom times, investors are not looking for a way out.

Q: What if the fund adviser or manager maintains its own marketing staff compensated by commissions on sales?

A: As in the case of third-party marketers, the fund and its sales representative must register.

Q: What if the manager of the fund does some low-key marketing to strangers?

A: Depending on how “some,” “low-key” and “marketing” are defined registration probably would not be required. Since the hedge fund is offering its own securities and the manager is primarily running the fund and not selling it, the manager is safe as long as there is no general solicitation and an investment remains a “private placement.”

Mr. Barbash: The definition of a broker-dealer is interpreted broadly by the SEC and can be read to cover anyone who effects transaction in securities. But over the years, the SEC, through no-action letters, has confirmed that the definition does not include issuers selling their own securities. The SEC staff has expanded that position to say that issuers’ employees — as long as they are not separately compensated — also can sell securities for their employers.

Q: What if a fund does some low-key marketing with employees whose duties involve more than marketing?

A: Registration probably wouldn’t be required, but the manager should make sure that compensation for the fund’s sales representatives is not tied directly to their success in raising money.

Mr. Mazin: Most start-up and small hedge fund managers don’t have the luxury of a dedicated marketing person. This makes the legal gray area even murkier because of the likelihood that the person will receive bonus compensation tied at least in part to marketing success.

Mr. Harris: The situation is ambiguous. The fund is walking a fine line. In the specific formulation of the situation, the fund would lose because the duties of the employees are frankly defined as selling. It’s like pleading guilty if the employee, called to testify, admits to being an unregistered sales representative who receives a fee for every dollar raised or every investor recruited. It might be different if the employee has a generic title and receives a bonus based on a variety of services, mostly for activities other than sales. But if the bonus arrangement is exposed as a sham, the manager is in trouble.

Q: Isn’t there some kind of a “safe harbor” that protects a hedge fund from registration requirements?

A: The Securities Exchange Act of 1934 covers the registration of brokers and dealers. It says that individuals within a company who contact investors, who perform substantial additional services and who are not compensated on their sales activities are safe from registration requirements.

Mr. Natbony: The exemption is fact-specific. The premise is that the individual is not getting paid to sell, but rather to interface with investors and respond to investor inquiries. An additional requirement is that such persons provide investor relationship services with respect to no more than one security during every 12-month period. If a management company has only one hedge fund, the safe harbor is available. But what if there are two or more hedge funds managed by the same management company? It’s a gray area.

Q: In other words, if I fall outside the “safe harbor,” I’m dead?

A: Not necessarily, but the defense becomes more complicated.

Mr. Harris: The 1934 Act has no minimum exemption—no provision that says if you only sell a little bit, you’re OK. The question becomes subtle with internal employees.

Q: How much trouble could I get from the SEC?

A: A disgruntled investor is probably the most immediate and greater threat, but the SEC shouldn't be discounted.

Mr. Natbony: The SEC has been looking more closely at this area. A few years ago, it did a sweep on soft-dollar issues. Now, it's talking about a sweep on marketing issues. It's only a matter of time before the SEC allocates resources to look into this area.

Mr. Barbash: I don't entirely disagree, but he (Mr. Natbony) might have overstated the case a bit. The SEC probably has bigger fish to fry. I'm not sure that the SEC staff would spend countless hours seeking out unregistered sellers of hedge fund shares. I agree that the legal theory exists that could support an SEC enforcement case against an unregistered seller; I don't see the area as an enforcement priority, although that could change with a new SEC chairman.

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