

# Asset Management Adviser

News and analysis for the asset management industry November 2013

## Advertising A new growth factor for hedge funds?

The SEC has adopted new guidance that ends the 80-year ban on general advertising and solicitation of private investment funds.

The revised rules, mandated by Title II of the Jumpstart Our Business Startups Act (JOBS Act)<sup>1</sup>, apply to hedge funds, private equity groups, venture capital firms and other private funds. Restrictions on who can buy private funds remain: purchasers must be “accredited investors,”<sup>2</sup> notably individuals with assets exceeding \$1 million or annual income above \$200,000. In fact, recognizing the increased risk of sales to unqualified buyers through general solicitation, the SEC

has substantially tightened verification procedures for accredited status<sup>3</sup>.

### Industry impact

#### A new era?

How hedge fund managers will react to this new freedom is now the topic of vigorous debate. Some predict a collective yawn. Why would an industry whose managers and investors have always shunned unnecessary attention — and whose capital increasingly comes from an institutional base little swayed by advertising — suddenly yearn to be in the spotlight? Other observers view the liberalized guidance as an epochal event, with the potential to fundamentally change how firms obtain capital, compete



<sup>1</sup> Title II of the Act, signed into law by President Obama in April 2012, states in part: “Offers and sales [of securities] exempt under [Rule 506 of Regulation D] shall not be deemed public offerings under the federal securities laws as a result of general advertising or general solicitation.” Rule 506 of Regulation D, under which most hedge funds operate, provides a safe harbor exemption to the general rule requiring securities registration.

<sup>2</sup> See the SEC definition of accredited investor at [www.sec.gov/answers/accred.htm](http://www.sec.gov/answers/accred.htm).

<sup>3</sup> Advertising will still be subject to the general anti-fraud provisions of Rule 10(b) and 10b-5.

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in the marketplace and staff their organizations. Meanwhile, wary investor advocates worry the new rules simply mean more people will be taken for a ride by unscrupulous operators.



### Upgraded websites

There's no doubt that the updated guidance opens up many advertising avenues. Michael Patanella, Grant Thornton LLP's National Asset Management sector leader, comments: "It used to be that the main way hedge funds spoke to the public was through a conference, with a few quotes from speakers perhaps getting picked up by publications. Now a whole range of promotional vehicles is available to funds — from something as basic as a brochure to full-page print ads. Fund websites, which are currently password-protected pages restricted to performance data for existing customers, could become an important marketing tool."

Indeed, content-rich websites — with information about the fund's investment team, philosophy and process; risk controls; performance; terms; and so forth — could become *de rigeur* for hedge funds, just as they are for large

corporations. Also, more managers will likely participate in industry databases, making it easier for investors to identify and compare them within a strategy. The final result should be greater transparency in the hedge fund industry.

### A wider market for capital

For an industry that has traditionally courted only the ultrawealthy, the new rules dramatically expand the number of investors — and the amount of capital — it can effectively pursue. Carlyle, the large private equity firm, believes accredited investors have wealth totaling \$10 trillion, twice the value of the money invested in hedge funds and buy-out funds combined<sup>4</sup>. The SEC estimated 7.4% of U.S. households, at least 8.7 million, qualified as accredited investors as of 2010 — but just 234,000 participated in Rule 506 offerings<sup>5</sup>.

**"This group of smaller investors could represent a fresh source of capital for startup funds."**

– Michael Patanella, Asset Management Sector Leader

Says Patanella, "There are many individuals who aren't with the large wealth managers, who don't have the level of assets — say \$5 million — where hedge funds have been made available to you. So this substantial group of smaller investors could represent a fresh source of capital for startup funds. Some of these firms may be happy to take

investors who can put in \$500,000. Sure, at that level you'll need lots of investors; but the startups may still find it an attractive strategy."

Whether advertising will prove cost-effective for acquiring capital is the crucial question. "You have to remember that hedge funds have had to pay people to bring money in, which can be very expensive," says Joseph Magri, Grant Thornton Audit senior manager, Asset Management. "Instead of paying asset allocators to bring money to you, advertising could well give funds the freedom to attract capital over a wide geographical area and let you run your own show."

At the same time, he notes some fund managers may get sticker shock when they learn how expensive advertising can be — both to create and execute. Moreover, as described below, there are regulations for advertisers that increase compliance costs. And then there are the higher charges for servicing large numbers of investors.

Nevertheless, investments in advertising budgets could have a snowball effect on the hedge fund world that ultimately yields substantial returns. "The most effective marketing in this business is done through word-of-mouth," says Patanella. He believes a virtuous circle could ensue, where advertising creates (1) new investors who, happy with their investment, recommend private funds to (2) friends and relatives, who make purchases that convince (3) fund managers that advertising is cost-effective ... who then buy more advertising.

<sup>4</sup> "Advertising hedge funds: Bull marketing," *The Economist*, June 8, 2013,

[www.economist.com/news/finance-and-economics/21579032-alternative-investment-firms-are-preparing-pitch-public-bull-marketing](http://www.economist.com/news/finance-and-economics/21579032-alternative-investment-firms-are-preparing-pitch-public-bull-marketing).

<sup>5</sup> Final Rule, Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, p. 75, [www.sec.gov/rules/final/2013/33-9415.pdf](http://www.sec.gov/rules/final/2013/33-9415.pdf).

## Advertising – A new growth factor for hedge funds? (continued)

### Less interest from older firms

Well-established funds, however, with easy access to institutional money, may not be eager to romance smaller investors. Patanella comments, “There is some truth to the industry adage that ‘the more investors you have, the more problems you have.’ Two investors at a \$1 billion each require a lot less work than 4,000 investors at \$500,000 each.” General solicitations may hold little allure for many well-established funds that, rather than solicit capital, often have to turn it away. But startup players could embrace the eased rules as part of a broad business strategy centered on attracting a wide universe of relatively small investors, with the products and operations to support it.

One worry that all firms have is that increased advertising brings increased SEC attention. That fear may not be

unfounded. Says Patanella, “The SEC staff is focused on communications to investors; they are a major factor in exams. The more you put out, the greater scrutiny you invite.”

### Organizational change

Another major consideration is operations and staffing. Designing and executing an advertising campaign, buying newspaper space and TV time, and gauging performance all require different skills than those of the traditional in-house funds marketing geared toward informing investors of the fund’s progress. And the required know-how is certainly beyond that of a CFO at a small fund who, in a tightly staffed office, may have taken on some incidental marketing duties.

“Advertising demands a completely different skill set than most funds have

at their disposal,” says Patanella. “Law firms can help you on the legal end. But putting together a website, deciding what your partners are going to say in a video clip, communicating with advertising agencies ... this is all very new to most funds. Firms will have to decide how to staff this function. Can it be outsourced, or do you need to bring in new talent?”

“And remember, many of your new investors will have no experience with hedge funds. They’re going to need more hand-holding than the traditional alternative investment client. They’ll have questions — who in your organization is going to answer them?”

### New guidance specifics

#### Verifying accredited investor status

Turning to the specifics of the new guidance, under securities law there are two ways an individual can be accorded “accredited investor” status:

(1) Have an individual net worth above \$1 million, excluding a primary residence.

(2) Have individual income above \$200,000 in each of the two most recent years (or a joint income with a spouse over \$300,000), with a reasonable expectation of the same income in the current year<sup>6</sup>.

Traditionally, hedge fund investors have mostly just “checked a box” to satisfy the accredited investor requirement. Such self-accreditation by an investor will no longer be sufficient if an issuer uses general advertising.



<sup>6</sup> See the SEC definition of accredited investors at [www.sec.gov/answers/accred.htm](http://www.sec.gov/answers/accred.htm).

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Initially, the SEC had contemplated a principles-based method, suggesting several factors that could be relevant to whether an issuer's verification is "reasonable." These included:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount<sup>7</sup>.

But to satisfy issuers seeking safety in the verification process, the SEC included a list of specific, nonexclusive and nonmandatory methods in its recent release. These include:

- documents for satisfying the income requirement (e.g., 1040s, W-2s);
- documents for satisfying the net worth requirement (e.g., bank and brokerage statements); and
- written confirmation from third parties (including broker-dealers, SEC-registered investment advisers, attorneys and certified public accountants)<sup>8</sup>.

### Grandfathering of existing investors

The rules also allow for grandfathering of purchasers who bought securities in a Rule 506 offering as accredited investors before Sept. 23, 2013, permitting them to self-certify that they continue to qualify for that status<sup>9</sup>.

### Bad actor disqualification

At the same time the SEC rescinded rules on advertising, it also issued new regulations on so-called bad actors. Almost all hedge funds offerings are made under Rule 506 of Regulation D, which exempts them from the requirement to register the securities

with the SEC. The new guidance disqualifies a fund from reliance on the safe harbor provided by Rule 506 if a covered person — notably, officers, 20% owners and fund managers — engages in "disqualifying events," including criminal convictions, court orders, final orders and other orders in connection with violations of securities laws.

By law, the rules are "substantially similar" to the bad actor provisions of Regulation A, another exemption from registration, used for certain small offerings<sup>10</sup>.

## SEC proposed rules

The SEC has proposed rules that would impose additional filing and disclosure requirements on issuers using general solicitation and advertising in Rule 506 offerings<sup>11</sup>.

1. Issuers would be required to file Form D, the notice required for an issuance for a Rule 506 offering, at least 15 calendar days before the solicitation.
2. Within 30 days of completing an offering, issuers would be required to update the information contained in the Form D and indicate that the offering has ended.
3. An interdivisional group within the SEC has been created "to evaluate the range of accredited investor verification practices used by issuers and other participants in these offerings, and endeavor to identify trends in this market..."<sup>12</sup> To assist with the work plan, issuers would be required to provide information on:
  - identification of the issuer's website,
  - expanded information on the issuer,
  - the offered securities,
  - the types of investors in the offering,
  - the use of proceeds from the offering,
  - information on the types of general solicitation used, and
  - the methods used to verify the accredited investor status of investors.
4. A one-year disqualification (or timeout) from reliance on Rule 506 in the case of Form D filing failures.
5. The inclusion of certain legends or cautionary statements in any written general solicitation materials (these are already in wide use).
6. If a private fund's general solicitation materials include performance data, requiring additional disclosures for private funds, a telephone number or a website where an investor may obtain current performance data must be included.

<sup>7</sup> Final Rule, p. 27.

<sup>8</sup> Ibid, pp. 35-39.

<sup>9</sup> Ibid, p. 39.

<sup>10</sup> SEC, "Disqualification of Felons and Other 'Bad Actors' from Rule 506 Offerings," [www.sec.gov/rules/final/2013/33-9414.pdf](http://www.sec.gov/rules/final/2013/33-9414.pdf).

<sup>11</sup> SEC, "Proposing Amendments to Private Offering Rules," Fact Sheet, July 10, 2013, [www.sec.gov/news/press/2013/2013-124-item3.htm](http://www.sec.gov/news/press/2013/2013-124-item3.htm).

<sup>12</sup> "Current SEC Priorities Regarding Hedge Fund Managers," Norm Champ, Director of the Division of Investment Management, Speech, Sept. 12, 2013, [www.sec.gov/News/Speech/Detail/Speech/1370539802997#.UkiiA4ZNKSo](http://www.sec.gov/News/Speech/Detail/Speech/1370539802997#.UkiiA4ZNKSo).

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### Conclusion

Hedge funds have been under pressure the past few years. Competition from other investment vehicles has been strong, and the industry's reputation has suffered from the misdeeds of some fund managers. Against this backdrop, industry participants are evaluating the new rules for advertising and thinking about what they might do for them. The process is just beginning, and the early response has not been overwhelming. Nevertheless, it seems likely that startup funds will give careful consideration to the use of advertising for attracting more investors and broadening their capital base.

### About the newsletter

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