

# United States

## Regulation

HEDGE FUNDS 2009

### Hedge fund managers/advisors

#### Regulation

##### Authorization requirements and process

While hedge fund managers/advisors are not currently required to be registered in the United States, many elect to register with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940.

Managers/advisors who want to register must apply for registration on Form ADV, Parts I, and II.

Part I asks for information about an advisor's business, the person(s) who own or control the advisor, and whether the advisor or certain of its personnel have been sanctioned for violating the securities laws or other laws. Part I is available in electronic format and is both filed and amended through the Investment Adviser Registration Depository (IARD) system.

Part II is a written disclosure statement (or a written brochure) that provides information about business practices, fees, and conflicts of interest the advisor may have with its clients. Part II must be completed in paper format. At this time, IARD is not prepared to accept electronic filings of Part II. Part II is a disclosure statement that an advisor must use to provide information to clients and potential clients.

The Hedge Fund Transparency Act of 2009 was just introduced in January 2009. The Act would require hedge funds to register with the U.S. Securities and Exchange Commission or provide certain disclosures. In addition, the Act would include compliance with recordkeeping and anti-money laundering requirements. The Act has prompted substantial debate and has not yet been approved. There is high uncertainty as to whether the Act will pass and what its final form would be.

### Typical timescale to receive approval

If the hedge fund manager/advisor chooses to register with the SEC, generally 45 days after receipt of the Form ADV the SEC will declare an applicant's registration effective. The SEC will mail an Effective Order to an advisor once an advisor's registration is declared effective. An advisor can also check on IARD under the heading Registration Status to see if its registration has been declared effective by the SEC.

### Regulatory capital requirements

There are no regulatory capital requirements for fund managers/advisors in the United States. However, it is a common practice for the General Partners (GP) in a private fund to maintain a minimum capital account. This practice is typically disclosed in the offering memorandum for private funds.

In rare instances where the hedge fund adviser registers with a state instead of the SEC, there may be a nominal capital requirement.

### Significant restrictions on marketing to investors

Marketing is not permitted, or is strictly limited in some circumstances, for non-registered investment companies. Furthermore, the distribution of shares in a private investment fund in the United States requires the fund sponsor to promote the fund without engaging in a public offering. This same restriction applies to offshore funds, in that they may not offer or sell their securities by means of a public offering in the United States unless they get an order from the SEC.

Private funds, such as, hedge funds, are subject to the same prohibitions against fraud as are other market participants, and their managers have the same fiduciary duties as other investment advisors. As fiduciaries, they have a duty to act to the benefit of their clients and to disclose all material facts. Private funds are also subject to the antifraud provisions and statutes under federal securities laws.

There are other sources of regulation that apply with regard to broker-dealers in the sale of shares in a private fund. Under NASD regulations, a broker-dealer has certain suitability obligations when selling hedge funds requiring the use of a reasonable-basis suitability or customer-specific suitability. A reasonable basis is fulfilled when a broker conducts due diligence with respect to the hedge fund, and in the case of a fund of hedge funds, with respect to the underlying hedge funds. Using a customer specific basis, brokers must ensure that a recommendation is suitable for a specific customer based upon an examination of the customer's financial and tax status, the customer's investment objectives, and such other information used or considered to be

reasonable by such member or registered representative in making recommendations to the customer.

Brokers that sell hedge funds must ensure fair and balanced sales materials. Full disclosure of the risks that hedge funds present must be provided by both broker-dealers and advisors/managers to private funds.

## Hedge fund structures

### Regulation

#### Authorization requirements

Section 4(2) of the Securities Act of 1933 ('33 Act) allows a broad exemption from registration and prospectus delivery for transactions not involving a public offering, known as the private placement or private offering exemption. Availability is contingent upon sophistication of the investor and access to type of information normally in prospectus.

Rule 506 of Regulation D under the '33 Act provides a safe harbor for private placements of securities intending to qualify for the private placement exemption pursuant to Section 4(2) of the '33 Act. Private placements under Rule 506 may be made to an unlimited number of 'accredited investors' and up to 35 non-accredited investors. Sales are often limited to accredited investors to simplify the offering. In addition to the substantive requirements of Regulation D, an issuer files a notice of sale of the privately placed securities with the SEC within 15 days of the first such sale. Regulation D also prohibits general solicitation and general advertising except in limited cases where the states allow solicitation to accredited investors.

Hedge funds also fall under the definition of a private fund. A private fund can be an investment company that is exempt from registration pursuant to Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. To qualify for exemption under section 3(c)(1) there must be no public offering, current or proposed, and no more than 100 owners of securities (with limited exceptions), other than short-term paper. To qualify for redemption under Section 3(c)(7), there must be no public offering, current or proposed, and all securities owned by qualified purchasers (with limited exceptions).

#### Restrictions on types of investments, concentration levels, and the manner in which hedge funds can invest and/or strategies

Non-registered investment companies, such as private funds that meet exemption requirements, are limited to the investment guidelines as specified in the offering memorandum and subscription documents.

Registered investment companies are required to follow the requirements under Investment Company Act of 1940 around diversification and concentration to meet the definition of such registered investment company.

### Rules regarding the publishing of the accounts and prospectuses

Other than in respect to a fund whose activities fall under regulatory requirements, there are no rules regarding the publishing of funds and prospectuses of private funds. Unregistered private funds are not required to make periodic reports.

If the hedge fund elects to register as an investment company under the Investment Company Act of 1940, it must apply on Form N-2 registration statement. If registered, Form N-SAR (Semi-annual report for management companies), Form N-CSR (Annual Certified Shareholder Report of registered management investment companies) and updates to the registration statement will be required.

### Time-scale of establishment of a hedge fund

Not applicable, as there is no regulatory requirement for registration of private funds/hedge funds in the United States. However, if sponsors elect to register the hedge fund or its shares, there is an approval process by the SEC. The timeline may vary based on SEC back log.

## Investors

### Regulation

#### Restrictions on which type of investors can invest in a hedge fund and/or the minimum/maximum number of investors in a hedge fund

For non-registered investment companies (private funds/hedge funds), current requirements command an individual to have at least USD 1 million in net worth, or an annual income of USD 200,000 (or joint income of USD 300,000 for married couples) per year for the past two years with a reasonable expectation that such income levels will be attained in the current year in order to qualify as an accredited investor. In December 2006, the SEC proposed to raise the minimum financial requirements for entry into a hedge fund by an accredited investor to USD 2.5 million in net worth, excluding primary residence, as well as other income tests.

## 5 United States – Regulation

Again, under rule 506 of Regulation D private placements may be made to an unlimited number of 'accredited investors' and up to 35 non-accredited investors.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.