Hedge Fund Marketing and the JOBS Act

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On April 5, 2012 President Obama signed into law the Jumpstart Our Business Startups Act ("JOBS Act"). Inserted into the Act were provisions on hedge fund marketing and accredited investor restrictions. John Lothian News Editor-at-Large Doug Ashburn spoke with Bart Mallon of Cole-Frieman, Mallon & Hunt LLP about the JOBS Act provisions, what they entail and how it will affect the hedge fund community.

Q: On April 5, 2012 President Obama signed into law the Jumpstart Our Business Startups Act ("JOBS Act"). Inserted into the Act were provisions on hedge fund marketing and accredited investor restrictions. What exactly do the provisions entail?

A: There is not actually any change in marketing provisions per se. What happened is the JOBS Act repealed earlier provisions in the securities laws which did not allow managers to have general solicitations with respect to their offerings. This essentially meant that managers could not solicit by advertising to the public through these private offerings and so managers really had to be careful when trying to grow the assets of their fund. One of the important things to note with respect to the provisions of the JOBS Act is that they can only market more freely if all of the investors of the fund are accredited investors. If they have non-accredited investors coming into the fund, then they cannot use these more liberal advertising means in order to solicit investors.

Q: Does this affect all types of fund structures?

A: For a 3(c)(1) fund structure, the accredited investor limit does not change. These managers are still limited to 99 individual investors. For 3(c)(7) funds, previously the limit was 499 investors. Now, that can be bumped up to 1999 investors. For 3(c)(7) funds, though, all investors must be qualified purchasers, which is actually a higher threshold than that of accredited investors.

Q: What do these marketing rules have to do with the JOBS Act, and why are they a part of it?

A: You have a couple things going on here. As people have been pointing out for a number of years, most of these securities laws were written in the 1930s, with the last one in 1940. The general nature of the industry has changed over the years; the JOBS Act is a reaction to some of the problems with these laws. Technological advances, and the ability of the internet to be a means of connecting with people in a way to market to potential investors - securities laws just do not address those issues. The JOBS Act was trying to find a way to balance investor protection of the securities laws with the ability for managers to go out and communicate and have a sort of certainty with respect to their activities on the internet.

Q: How will this change the way funds structure communication, such as on their web sites?

A: There is going to be a wide range of ways managers will be allowed to advertise. You will see more information available on their web sites and on hedge fund databases. You are also more likely to see hedge funds marketed in publications such as the Wall Street Journal or New York Times. There has also been talk that big fund complexes may have public advertising in sporting venues and such. I don't know if it will come to that, but we are definitely going to see more fund managers trying to get out in front of the investing public and getting their name out there more. It will be interesting to see the avenues with which managers will use.

Q: Critics have suggested that this will be an invitation to some of the less scrupulous operators to come out of the woodwork to take advantage of the new rules. Do you see a problem with that?

A: Certainly, this is going to make the job of securities regulators much more difficult. Right now, with the restrictions, you don't have a lot of managers out there touting performance and those sorts of things. Once you open up the floodgates and everyone starts doing it, it will be a lot harder for the SEC and for the state regulators to keep on top of what all these managers are showing. From a regulatory standpoint, in asking these agencies to enforce these securities laws and protect the investing public amid this deluge of advertising, I think becomes a tough task for the regulators. Savvy marketing people who might not have the best of intentions with respect to customer protections will have an easier time meeting population targets. That is one of the things Congress had to weigh when creating this law - investor protection versus capital formation and spurring the economy.

Q: The SEC has been given a timetable for the creation of a framework for these new rules. What do you expect to see in the SEC rulemaking?

A: I imagine we will see a lot of rulemaking on recordkeeping, and also on being able to back up any statements made in any advertising materials. It is clear that managers are going to need to make sure their investors are accredited investors, so I think there could be more of an onus on managers to do more fact-checking with respect to their investors.

But it really depends on how aggressive the SEC wants to be with respect to overseeing solicitations. The SEC is already an underfunded agency, so if they create more onerous rules for themselves to implement and oversee, they will be taking away from themselves internally. They have their own political balance they need to strike between promulgating rules that they can actually enforce, versus investor protection.

Bart Mallon is a partner and co-founder of Cole-Frieman, Mallon & Hunt LLP, a San-Francisco-based law firm specializing in hedge fund and alternative investment legal services. His areas of specialization include setting up offshore hedge funds and separately managed structured accounts, and registration issues. Mallon is also the author of the Hedge Fund Law blog.