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Technology

Hedge Fund Managers Use Technology to Expand Marketing Efforts while Complying with Regulation D

By Jennifer Banzaca

Hedge fund managers are frequently described as a "secretive" bunch. To the extent that characterization is valid, its roots may reside in the recognition that for hedge fund managers, publicity carries with it substantial potential downside, and little possibility for upside. One of the more notable potential downsides is that any advertising or marketing by hedge fund managers may be construed as a "general solicitation" of investors. Since many hedge funds offer their interests to qualifying persons in reliance on Regulation D under the Securities Act of 1933, and Reg D prohibits general solicitations, hedge fund managers are effectively prohibited from advertising.

"Reg. D is designed as a limited safe harbor, and specifically prohibits general solicitations to raise money under the regulation," noted Jonathan Blinderman, head of the Entertainment and New Media practice group at Glaser, Weil, Fink, Jacobs & Shapiro. "Any strategy that is designed to work around the limitation must be approached cautiously, as the strategy will inherently work against the intent of the regulation."

Digital Rights Management

However, some hedge fund managers are starting to use technology to expand their marketing efforts while staying within the letter and spirit of Reg D. Specifically, some managers are employing digital rights management (DRM) – or enterprise rights management (ERM) – software to control the flow of data about the fund disseminated to potential investors. Notably, these managers are not using DRM technology to circumvent Reg D solicitation limitations; rather, the technology merely enables managers to provide, with increasing precision, information to potential investors while protecting the data from falling into the hands of unqualified investors or the media.

Craig Carpenter, General Counsel at Recommind, noted that DRM software is facilitating increased marketing efforts by hedge fund managers. He noted that DRM gives hedge fund managers significant control over how their marketing materials are distributed and who can see the information. Absent such control, managers have for years been sensitive to the possibility that marketing materials (e.g., a PPM or pitch book) sent by mail or e-mail to qualifying investors could be redistributed to just about anyone, and such redistribution (even absent intent on the part of the manager) could jeopardize the fund's ability to rely on Reg D. According to Carpenter, DRM software addresses that concern by prohibiting access to those who were not granted permission to view the documents.

"In the eyes of the law, it's not enough to say that the marketing program was set up in the right way and it isn't the manager's fault it happened to be implemented in a way that wasn't proper," Carpenter explained. "With data rights software, managers can explicitly verify to whom the data was sent and how it was used. DRM software allows you to be able to prove the controls you have in place. There's a reporting element that allows hedge funds to show how their marketing program was set up and who it was sent to. You can generate reports as to who accessed information, when it was accessed and what they saw. You wouldn't be able to do that without the DRM software."

Regulation D

Under Reg D, a hedge fund manager and any person acting on its behalf may not solicit an investment in a fund offered by the manager by any form of general solicitation, which includes (in the language of Reg D) "any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio, and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising."

Many hedge funds organized in a US jurisdiction – for example, Delaware limited partnerships – offer their interests (e.g., limited partnership interests) to investors in reliance on Reg D so that the offering of interests is not construed by the SEC as a public offering. They do this because a public offering of securities is subject to a range of regulations and disclosure obligations that hedge fund managers would prefer to avoid. The policy behind this rule is that while investors in a public offering of, say, common stock by a major public company may include unsophisticated retails investors, Reg D is only available where all of the investors meet certain income or asset tests. Since "big boys" do not need, in theory, all the protections of the public offering rules, Reg D provides a safe harbor from the public offering rules for offerings made exclusively to "accredited investors" (a term defined in the regulation).

Another of the conditions of Reg D is no general solicitation. As a consequence, hedge fund managers cannot mass market their products. Rather, their marketing efforts must proceed through narrow channels, such as password protected websites in which the distribution of passwords is scrupulously monitored and limited to accredited investors. The general public may see the homepage, but the homepage is not allowed to list any information about the actual fund.

Last year, the SEC proposed a change to Reg D that would allow limited advertising to large accredited investors. The proposed rule change would permit advertising only in the context of sales of fund interests to large accredited investors, and would limit permitted advertising to include information commonly found in the "tombstone" ads that appear in newspapers following the closing of transactions. The rule change also would permit limited additional advertising to be available in a password-protected database accessible only by large accredited investors. The proposed rule change has not been adopted.

How DRM Can Facilitate Advertising by Hedge Fund Managers

DRM and ERM technologies control access to fund documents, e-mails and intranet web pages. The technologies are typically used to prevent unauthorized access to and use of proprietary documents.

Hedge funds are hesitant to put marketing materials on the Internet or into emails because information sent via such distribution channels could be easily and quickly redistributed, in violation of Reg D. Glaser Weil's Blinderman suggested that the retransmission problem could be solved with DRM software. "It's all about control of the

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information and I think DRM has come along far enough that when properly implemented, you can use it for electronic distribution of your fund information and adequately control its distribution so as not to violate Reg D."

Blinderman said the software does not magically allow hedge funds to take out newspaper advertisements or broadcast television commercials, but it will allow managers to distribute information about the fund to potential investors without fear that those people in turn will widely redistribute the information, thereby undermining a fund's eligibility to rely on Reg D. The management of the flow and use of the information provides an extra layer of protection for fund managers.

Protection Travels with Data

Ed Gaudet, senior vice president of corporate development and marketing at Liquid Machines, which provides ERM technology programs to hedge funds and other financial institutions, said that because protection travels with data, ERM- or DRM-protected marketing materials issued by funds couldn't be viewed by anyone without permission. Therefore, should someone who is not known to the manager to be an accredited investor receive fund marketing materials, the manager will be able to withhold from that person permission to view the materials.

Another protection provided by DRM software is that it can establish ethical walls between various hedge fund departments, so, for example, sales and marketing activity is keep separate from the trading desk. "It is required that these distinctions be in place, and the software can keep conflicting departments properly separated," Gaudet noted. As an added protection, "compliance staff can be given access to data from all departments and monitor what is going on to ensure the rules are not being circumvented."

George Michaels, principal at G2 Systems and former chief technology officer at Carlson Capital, said one way hedge funds can distribute fund information is through a hedge fund database. Protected marketing information could be uploaded to the website and reviewed by subscribers to the site. Access to such sites is limited to persons known to the fund to be accredited investors and, in limited circumstances, to the media. Therefore it is unlikely that unqualified investors could review the information.

"I think the safest way for hedge funds to market themselves with data-rights protected information is to do it through an intermediary because there cannot be that interaction between a hedge fund manager and individuals," Michaels said. "Given Reg D, the best way to make DRM work in this context is to give the protected information to a third party data provider to work as a clearinghouse."

Augmenting In-Person Meetings

According to Mark Coriaty, director of professional services at Eze Castle, hedge funds are also using DRM technology to augment personal meetings. Managers working with potential new investors still give out traditional pitch books at in-person meetings, and the general solicitation concerns raised by pitch books can be mitigated by carefully screening the parties to whom they are given, monitoring the content to exclude especially sensitive data and, if practicable, entering into a confidentiality agreement. Following in-person meetings, hedge fund managers can allow potential investors

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to log in to a website to view additional data, and that data can be protected by DRM software. Notably, the locus of the most sensitive data can migrate, in the era of DRM technology, from the pitch book to the website – this, among other things, can lessen concerns that a pitch book will fall into the wrong hands, thus jeopardizing a private offering.

For hedge funds that submit information to various news and data websites – in particular, those that submit their own information in exchange for index information, the classic "give-to-get" model – Coriaty said the protected data can be sent through a secured portal or e-mailed to those sites so the hedge funds can get index information back from those sites.

"You're going to leverage the technologies you have, either a custom portal or a third party CRM system to control the data that can be viewed and seen by either investors or potential investors," Coriaty said. "Marketing is still very specific to accredited investors. People aren't taking billboards out or handing out leaflets. They do still follow those guidelines and I think in the past you'd see a lot of pitch books being presented and a lot of in-person meetings and I think as a follow-up now they are offering a portal they can log into so they can see past performance."