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The Changing Face of Capital Introduction

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A series of regulatory initiatives by the National Association of Securities Dealers, Inc. (NASD) and speeches and releases by the Securities and Exchange Commission (SEC) and its staff are having a major impact on the capital introduction services that prime brokers offer hedge fund managers. These regulatory initiatives and changes also could impact how private investment funds (or hedge funds) offer their interests to investors. Let's review capital introduction practices, the directions that the NASD and SEC have been taking and, in light of recent events, what practices might be best for hedge fund managers.

What is Capital Introduction?

"Capital introduction" is a general term used to describe the service often offered by prime brokers to their customer hedge funds, and the managers of such funds, of introducing potential investors to such managers. Prime brokers generally offer capital introduction as a "free" service (in the sense that there is no specified added charge for introduction services) and an informal means for hedge fund managers to meet institutional investors.


Capital introduction is becoming more important as competition for assets among managers increases. From 2004 to 2005, the proportion of European hedge fund managers citing capital introduction as an important factor in evaluating prime brokers doubled from 7% to 14%. "This shift

clearly indicates that, as hedge funds proliferate in Europe, individual funds are having a tougher time attracting new capital," stated Greenwich Associates consultant Frank Feenstra (Greenwich Associates' 2005 *European Fixed-Income Research Study*).

Capital introduction differs from third-party marketing. In general, third-party marketing means the practice of specifically paying a registered broker-dealer to actively seek out interested investors and solicit those investors to invest in a hedge fund.

The NASD's and SEC's Evolving Positions

The NASD recently turned its attention to capital introduction services. Hedge fund managers are not broker-dealers and are not members of the NASD subject to its rules and inspection programs. However, prime brokers and broker-dealer third-party marketers are. In January 2006, the NASD sent a letter to certain prime brokerage firms and others known to service the hedge fund industry. The NASD requested, for the years 2004 and 2005, a detailed description of all capital introduction services being provided, including a listing of meetings, seminars, conference calls and other functions, copies of agendas, speaker outlines, presentations and materials distributed to attendees. The letter asked who paid the costs in connection with capital introductions and what compensation the firm received, as well as the names of all firm personnel



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involved in capital introductions and the hedge funds for which capital introduction services were performed. Although not specifically addressing capital introduction, NASD guidance, such as NASD *Notice to Members 03-07* dealing with sales practices involving hedge funds, may suggest that certain capital introduction services could be deemed to be recommendations, thereby triggering suitability obligations.

On March 21, 2006, the NASD hosted a seminar on hedge funds. Given the recent attention to these services, as part of its sales practices discussion, the NASD will specifically address capital introduction services by prime brokers and applicable NASD Rules. It will be instructive to see the NASD's current views on capital introduction services.

The SEC also has addressed capital introduction services. In September 2003, capital introduction was covered by the SEC staff in a report entitled "Implications of the Growth of Hedge Funds." In the report, the staff questioned the assertion that prime brokers engaging in capital introduction were not acting as brokers or investment advisers. The staff recommended that the SEC and NASD monitor capital introduction closely, including ascertaining whether applicable regulatory requirements were being met by prime brokers with respect to such activities. In June 2005, then director of market regulation, Annette Nazareth, stated that capital introductions created a conflict of interest for prime brokers, particularly if the prime broker receives a fee from the hedge fund or the employee making the introduction, and also makes investment recommendations to the client.

A hedge fund manager's acceptance or use of capital introduction services, or its consideration by the manager as a potential factor in its brokerage placement practices and duty of best execution, raise disclosure issues both in offering documents and, if the manager is an SEC-registered investment adviser under the Investment Advisers Act of 1940 (the Advisers Act), and its Form ADV, as well. Capital introduction activities also may be viewed as an incidental or other benefit received by a manager, including as a form of "soft dollar" benefit. Generally, "soft dollars" refer to those products and services (traditionally, research reports) provided by brokers and paid for by managers through commission dollars. Many managers operate under

the safe harbor of Section 28(e) under the Securities Exchange Act of 1934 (Securities Exchange Act) for research-related products and services. Soft dollars are a "hot button" item with the SEC (for example, the SEC recently proposed new rules tightening the "soft dollar" regulations (see, SEC Interpretive Release No. 34-52635, Oct. 19, 2005)). Given the nature of capital introduction services, the SEC could view capital introduction as a soft dollar benefit falling outside of the safe harbor of Section 28(e) and accordingly require heightened disclosure by managers.

The SEC routinely inspects SEC-registered advisers and broker-dealers. In addition, materials obtained by the NASD in its examination of broker-dealers can be, and regularly are, referred to the SEC. SEC review could result in noted deficiencies and action taken if the adviser's hedge fund offering materials or Form ADV disclosures are deficient, which could include enforcement action in egregious cases. In addition, even those investment advisers that are not SEC-registered are subject to the anti-fraud provisions of the Advisers Act and, accordingly, if circumstances warrant, the SEC could inspect such unregistered advisers and take action, including enforcement action, if their disclosures, in the SEC's view, are materially deficient.

How to Address Evolving Concepts of Capital Introduction

An important consideration in selecting a prime broker is the capital introduction services that the prime broker provides. These services range from (i) being included in a book made available to high-net-worth and institutional clients of "recommended" hedge funds, (ii) seminars where hedge fund managers present information to high-net-worth and institutional clients/customers of the broker, and (iii) meetings by managers one-on-one or with a limited number of high-net-worth and institutional investors. While arguments have been raised as to whether suitability obligations attach to such high-net-worth and institutional investors, such issues have not yet been formally settled. In any event, the NASD's sensitivity to these activities should cause the prime broker to be more circumspect in making capital introductions.



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The anti-fraud rules under the Advisers Act and the Securities Exchange Act apply to statements and materials prepared by hedge fund managers. Given the increased number of hedge fund managers who have recently become SEC-registered under new SEC rules effective February 1, 2006, and thereby subject to routine SEC scrutiny, and the increased possibility that untoward statements or presentations may be referred by the NASD to the SEC, managers should have heightened sensitivity to the capital introduction process. Most important would be a review of the offering memorandum, and Form ADV as applicable, to be sure such documents are accurate, complete and current in their disclosures. Prudence would dictate inclusion of disclosure of potential capital introduction benefits in a generic soft dollar or brokerage arrangements section. This would be even more important if any expense whatsoever, including seminar fees, hotel costs, or travel, are paid or waived by the prime broker. Moreover, if any materials,

other than the fund's offering memorandum, are to be distributed, those materials should be carefully reviewed by the manager for their accuracy and completeness and compliance with applicable law. For example, the NASD has brought an enforcement action against a broker even where the offering memorandum was accurate, complete and furnished to prospective investors, but the supplemental literature was not accurate and balanced in its presentation. It is not a far step to see an SEC enforcement action on the same set of facts. ■

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