

THE POSSIBILITY OF ESTABLISHING HEDGE FUNDS IN THE REPUBLIC OF IRAQ (A COMPARATIVE STUDY)

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Abstract

This research examines how hedge funds are established in the United States, reviewing their legal form and the steps involved. It then examines the possibility of establishing them in the Republic of Iraq and identifies the legal obstacles they face. It also examines the possibility of establishing hedge funds in Iraq under the same legal form as those in the United States, and whether they enjoy the same regulatory flexibility as Iraq.

Keywords: Hedge funds, investment funds, financial investment company, securities

INTRODUCTION

A hedge fund is an investment vehicle that pools funds from multiple investors to invest in investment activities to generate investment returns.

It is a legal principle that this fund, company, or partnership must have a legal personality to conduct business. Therefore, there are certain steps that must be taken by the fund's founders for the fund to acquire this legal personality. Accordingly, Article 22 of Iraqi Companies Law No. 21 of 1997 stipulates that a company acquires legal personality from the date of issuance of the certificate of incorporation. Article 183 states that a simple company acquires legal personality from the date a copy of its contract is filed with the Registrar of Companies. Therefore, and for the above, it is necessary to compare the legal form of hedge funds in the United States and the steps for establishing them with the legislature in the United States of America, and to examine the possibility of establishing hedge funds in the Republic of Iraq in the same manner as the legislature in the United States of America.

Legal form of hedge funds in the United States of America

In the United States, the legislature has not stipulated a specific form for hedge funds. They can adopt any legal structure they wish. However, the investment approach of these funds requires them to adopt a specific form. This approach requires regulatory flexibility. For example, hedge funds use borrowing extensively in their investment activity, and the US Investment Company Act of 1940 prohibits or restricts registered investment funds from borrowing, with the exception of bank debt, provided that they maintain an asset coverage ratio of no less than 300%¹. Therefore, a hedge fund must avoid this law. The way it can avoid this law is through the exemptions stipulated in the same law, in Article III (paragraph 3-1), which exempts from registration an issuer that has 100 or fewer security holders and that does not participate or propose to participate in a public offering of securities. Paragraph 3-7 of the same article also exempts an issuer whose security holders are all accredited and who do not participate or propose to participate in a public offering of securities. For the above, we find that most hedge funds are formed by accredited investors. And rely on closed subscription.

As a result, and to avoid other regulatory requirements, hedge funds opt for two legal forms: a limited partnership, in which the liability of all members is limited to their capital contributions, and all members participate in the management of the company. However, full or partial management may be delegated to a manager appointed in accordance with the articles of association².

And Hedge funds may choose the limited partnership form, which has two types of members, as we mentioned previously, in which there is one or more general partners, and one or more general limited partners³, which is preferred by investors because of the unlimited liability of the general partner, who is responsible for managing

¹ SEC (18) (f) (1), The US Investment Company Act of 1940, as amended.

² SEC (402), Chapter 18 (Limited Liability Company Act), Title 6, The Delaware Code.

³ SEC (101-11), Chapter 17 (Limited Partnerships), Title 6, The Delaware Code.

the company, as well as because of some tax considerations, and the clear separation between the fund's management and the investors, and for this reason most hedge funds take the limited partnership form (Cumming & Johan & Wood 2021, p. 360).

Steps to establish a hedge fund in the United States of America

Establishing a hedge fund requires a number of steps, which may vary slightly from one state to another in the United States. When establishing a hedge fund in Delaware, the following must be done:

CHOOSING THE LEGAL STRUCTURE OF THE FUND

As previously mentioned, most hedge funds take the form of a limited partnership.

DRAFTING THE ARTICLES OF ASSOCIATION AND FILING THEM WITH THE REGISTRAR OF CORPORATIONS

The general partner must draft the hedge fund partnership certificate, which includes mandatory information such as the name of the limited partnership, the name, residence, and mailing address of each general partner, as well as optional information the partners choose to include. The certificate must then be filed with the Delaware Registrar of Corporations¹.

PAY THE REGISTRATION FEE

The registration fee of \$200 USD must be paid².

PREPARING DOCUMENTS

A number of documents must be prepared, including a private placement memorandum, which outlines the investment approach, rewards, and risks.

A limited partnership agreement must also be prepared, which outlines the rights and obligations of the general partner and limited partners (Zask 2013, p. 75).

REGISTERING WITH THE U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

Under the U.S. Investment Advisers Act of 1940, fund managers are required to register if they manage assets in excess of \$150 million. If they manage less than that, they are exempt from registration³.

Under the U.S. Securities Exchange Act of 1934, all securities issuers are required to register and file periodic reports, in accordance with Section 12 of the said Act. However, according to Rule 12h-3 issued by the SEC pursuant to Section 12h of the said Act, an entity with fewer than 500 shareholders or less than \$10 million in capital is exempt. Therefore, if a hedge fund has more than 500 investors, it is required to register and file periodic reports.

REGISTRATION WITH THE COMMODITY FUTURES AND OPTIONS TRADING COMMISSION (CFTC)

Under the Commodity Exchange Act, hedge funds that trade in futures, options, and other derivatives are required to register with the CFTC⁴ unless they are exempt under Regulation 17 C.F.R. Part 4⁵ (Baums & Cahn

¹ SEC (201-1), Chapter 17 (Limited Partnerships), Title 6, The Delaware Code.

² Delaware Corporations Division Fee Schedule, posted on the state's official website, (<https://corpfiles.delaware.gov/AugustFee2024.pdf>), Date of visit (18/2/2025).

³ SEC (203-m-1), Investment Advisers act of 1940.

⁴ Congress created the Commodity Futures Trading Commission (CFTC) in 1974 as an independent agency charged with regulating the futures and options markets in the United States. (Capocci 2013, p.539)

⁵ It is a list issued by the CFTC, and published on its website, via the electronic link (<https://www.ecfr.gov/current/title-17/chapter-I/part-4>), Date of visit (1/3/2025).

2004, p.67-68) , such as funds registered under the U.S. Investment Advisers Act of 1940¹, or funds that trade futures and other derivatives on a limited basis².

Establishing hedge funds in the Republic of Iraq

In Iraq, the Iraqi legislature has not provided any legal provisions directly related to hedge funds, but rather regulated financial investment companies in Financial Investment Companies Law No. 6 of 2011. The same applies to the US legislature, which only provided for them in the Dodd-Frank Act³. Therefore, the US legislature has not prescribed a specific form for hedge funds; rather, the majority of hedge funds opt for the form of limited partnerships. As for Iraq, the Iraqi legislator explicitly stipulated in Article 10/Second of Companies Law No. 21 of 1997 and its amendments that (companies that practice any of the following activities must be joint-stock companies: 1- Insurance and reinsurance 2- Financial investment.) Therefore, a hedge fund cannot take the form of a joint-stock company, due to the previous legal restriction, as well as due to the small number of people in this company, as the aforementioned Iraqi Companies Law stipulated in Article 6/Second that (the number of natural or legal persons in a mixed company or a private limited company may not exceed twenty-five persons...), and thus this is considered a significant difference in the number of people in American hedge funds and the number of people in this type of company.

Also, a hedge fund in Iraq cannot take the form of a joint-stock company, due to the restriction stipulated in Article 2 of the Companies Law No. 21 of 1997 as amended, as well as the limited number of persons in a joint-stock company, as Article 6 of the Iraqi Companies Law stipulates in Third that (the number of natural persons who form a joint-stock company shall not be less than two persons and not more than twenty-five persons, and they shall jointly bear unlimited personal liability for all the obligations of the company.), and also due to the unlimited personal liability of the persons in this company, which is not preferred by investors in hedge funds.

However, hedge funds can be established as a joint-stock company, but hedge funds in the United States are often available to accredited investors, and depend on closed subscription⁴. As we have shown, investors in a hedge fund established in the United States can include 500 investors, and it can include more than 500 investors if it is registered with the US Securities and Exchange Commission (SEC). However, in Iraq, if a hedge fund is established as a joint-stock company, the subscription must be public, as Article 6/First of the Iraqi Companies Law No. 21 of 1997, as amended, states that (a mixed or private joint-stock company is a company composed of a number of persons not less than five, in which shareholders subscribe to shares in a public subscription...), and Article 21/First/2 of the aforementioned law also states that (in the case of a joint-stock company, a certificate of incorporation is issued after the public subscription of shares...), while the public subscription can be avoided by the founders, whose number must not exceed 100 people ⁵, where they can subscribe to 99% of the company's capital and offer 1% for public subscription, for example, as Article 39/Second of the aforementioned Iraqi Companies Law stipulates that (when establishing a private joint-stock company, the company's founders shall contribute no less than 20% (twenty percent) of its nominal capital.), The Iraqi legislator did not specify the maximum percentage mentioned in the aforementioned article, and even

¹ Sec(5-a-1) ,17 C.F.R Part4.

² Sec(13) ,17 C.F.R Part4.

³ SEC (h)(2) , The Dodd-Frank Act of 2010.

⁴ The Dodd-Frank Act and the Investment Company Act, issued by the US legislature, define hedge funds as funds that utilize the exemptions provided for in paragraphs 1 and 7 of Title III of the Investment Company Act. Therefore, they are either those with 100 investors or accredited investors. According to the Securities and Exchange Commission (SEC), an accredited investor is either a natural person or a legal entity, as follows:

- For a natural person, it is one whose net worth exceeds \$1 million (individually or jointly), excluding the value of their personal residence.
- A natural person whose income during the preceding two years exceeds \$200,000 (individually) or \$300,000 (jointly).
- An investment professional licensed by the Securities and Exchange Commission.
- For a legal person (entity or institution), it is one that owns assets or investments in excess of \$5 million.

⁵ Article 16/Third/1 of the Iraqi Companies Law No. 21 of 1997, as amended, states that "the founders of a joint-stock company, whose number does not exceed one hundred founders, shall elect a committee from among themselves..."

the remaining 1% of the capital can be acquired by the company's founders by recruiting other people to subscribe to this remaining percentage and then repurchase it later (Ibrahim 2022, p. 294). Therefore, a hedge fund can be established in Iraq in the form of a joint-stock company, but the number of people in this fund must not exceed 100 investors. However, instead of the above, we find that hedge funds in the United States of America enjoy regulatory flexibility. This flexibility is a result of the fact that the type of investors in hedge funds are often accredited investors, who have sufficient experience that makes them dispense with legal protection. As a result, we find that the legislator in the United States of America did not restrict hedge funds with legal texts, with regard to all stages of the fund, especially with regard to It is related to the investment approach, which is in conflict with what the Iraqi legislator has gone to in the joint-stock company in general and the financial investment company in particular, as the Iraqi legislator intervened in organizing the provisions of the joint-stock company with rules of a mandatory nature in all its stages, starting from the establishment and ending with liquidation (Jabr 2015, p. 137), in order to protect the interests of the company's shareholders and creditors (Ibrahim 2022, p. 250). We also find that the Iraqi legislator restricted the financial investment company. For example, he obligated financial investment companies to certain percentages related to investment in other companies, as the Iraqi legislator stipulated in Article 32/Third of the Iraqi Companies Law No. 21 of 1997, as amended, (An investment company may not invest more than (5%) five percent of its capital in the shares of one company, and it may not own in one company more than (10%) ten percent of the capital of that company, taking into account the previous percentage...). Likewise, Article 6/Third of the Iraqi Financial Investment Companies System No. 6 of 2011 stipulated, (Investing part of its funds in other companies in accordance with the provisions of Companies Law No. (21) of 1997 And at a rate not exceeding (10%) ten percent of its capital in accordance with the provisions of the Order of the Provisional Coalition Authority (dissolved) No. (94) of 2004 (Banking Law). Thus, the above is considered a legal restriction that directly enters into the investment approach, which is contrary to what the American hedge funds aspire to, which enjoy high organizational flexibility that gives them complete freedom in drawing up their investment approach.

CONCLUSION

Hedge funds can be established in Iraq, but they must take the form of a joint-stock company. Therefore, the offering must be public, not closed. However, founders may avoid a public offering, as they can subscribe to 99% of the fund's capital and offer the remaining 1% for public subscription. As we noted in this research, Iraqi law stipulates that founders must contribute no less than 20% of the capital, with the remainder offered for public subscription. Therefore, we believe that Iraqi law does not specify a maximum contribution limit for founders. Even the remaining 1% can be acquired by founders by recruiting other individuals to subscribe to this percentage, which can then be repurchased later by the founders.

Hedge funds established in the Republic of Iraq are restricted by regulatory provisions, unlike hedge funds established in the United States, which enjoy legal flexibility.

One of the legal restrictions on hedge funds in the Republic of Iraq is what the Iraqi legislator referred to in Article 22/Third of the Iraqi Companies Law No. 21 of 1997, which states that an investment company may not invest more than 5% of its capital in the shares of a single company, and may not own more than 10% of that company's capital in a single company, taking into account the above percentage...). Therefore, the above is considered a legal restriction that directly impacts the investment approach, which contradicts the approach followed by American hedge funds, which enjoy regulatory flexibility that gives them complete freedom to define their investment approach.

The Iraqi legislator must regulate hedge funds, which constitutes an incentive to attract more local and foreign investors and capital.

The necessity of taking into account legal and investment flexibility when regulating these funds.

xfThe necessity of taking into account the type of investors (accredited investors) when regulating these funds, given that this category possesses investment experience that makes them not in need of legal protection.

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