SEC

OFFICE of INVESTOR
EDUCATION and ADVOCACY

INVESTOR BULLETIN

Hedge Funds

The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to educate individual investors about hedge funds.

What are hedge funds?

Hedge funds pool investors' money and invest the money in an effort to make a positive return. Hedge funds typically have more flexible investment strategies than, for example, mutual funds. Many hedge funds seek to profit in all kinds of markets by using leverage (in other words, borrowing to increase investment exposure as well as risk), short-selling and other speculative investment practices that are not often used by mutual funds.

You generally must be an accredited investor, which means having a minimum level of income or assets, to invest in hedge funds. Typical investors include institutional investors, such as pension funds and insurance companies, and wealthy individuals. Hedge funds are not subject to some of the regulations that are designed to protect investors. Depending on the amount of assets in the hedge funds advised by a manager, some hedge fund managers may not be required to register or to file public reports with the SEC. Hedge funds, however, are subject to the same prohibitions against fraud as are other market participants, and their managers owe a fiduciary duty to the funds that they manage.

What information should I seek if I am considering investing in a hedge fund?

- Read a fund's offering memorandum and related materials. The hedge fund's offering documents and agreements contain important information about investing in the fund, including the investment strategies of the fund, whether the fund is based in the United States or abroad, the risks of the investment, fees earned by the hedge fund manager, expenses charged to the hedge fund and the hedge fund manager's potential conflicts of interest. It is important that you read all the documents before making your decision to invest in a hedge fund. You should consider consulting an independent financial advisor before investing in a hedge fund.

- Understand the fund's investment strategy. There are a wide variety of hedge funds with many different investment strategies. Some hedge funds will be diversified among many strategies, managers and investments, while others may take highly concentrated positions or may only use a single strategy. Make sure you understand the level of risk involved in the fund's investment strategies and ensure that they are suitable to your personal investing goals, time horizons and risk tolerance. As with any investment, generally the higher the potential returns, the higher the risks you must assume.

- Determine if the fund is using leverage or other speculative investment techniques. Leverage is the use of borrowed money to make an investment. A hedge fund using leverage will typically invest both the investors' capital and the borrowed money to make investments in an effort to increase the potential returns of the fund. The use of leverage will magnify both the potential gain and the potential loss from an investment. The use of leverage can turn an otherwise conservative investment into an extremely risky investment. A hedge fund may also invest in derivatives (such as options and futures) and use short-selling (selling a security it does not own) to increase its potential returns, which could likewise increase the potential gain or loss from an investment.

- Evaluate potential conflicts of interest disclosed by hedge fund managers. For example, if your investment adviser recommends that you invest in a fund that the adviser manages, there may be a conflict of interest because your adviser may earn higher fees from your investments in the hedge fund than the adviser might earn from other potential investments.

- Understand how a fund's assets are valued. Hedge funds may invest in highly illiquid securities that may be difficult to value. Moreover, many hedge funds give themselves significant discretion in valuing illiquid securities. You should understand a fund's valuation process and know the extent to which a fund's securities are valued by independent sources. Valuations of fund assets will affect the fees that the manager charges.

- Understand how a fund's performance is determined. Hedge funds do not need to follow any standard methodology when calculating performance, and they may invest in securities that are relatively illiquid and difficult to value. By contrast, federal securities laws dictate how mutual funds can advertise their performance by requiring specific ways to calculate current yield, tax equivalent yield, average annual total return and after-tax return, as well as having detailed requirements for the types of disclosure that must accompany any performance data. If you are provided with performance data for the hedge fund, ask whether it reflects cash or assets actually received by the fund as opposed to the manager's estimate of the change in value of fund assets and whether the data includes deductions for fees.

- Understand any limitations on your right to redeem your shares. Unlike mutual funds where you can elect to sell your shares on any given day, hedge funds typically limit opportunities to redeem, or cash in, your shares (*e.g.*, monthly, quarterly or annually), and often impose a "lock-up" period of one year or more, during which you cannot cash in your shares. In the time it takes for you to redeem your shares, their value could diminish and you will not have use of the money invested in those shares. Furthermore, hedge funds may charge you a redemption fee before you are allowed to cash in your shares. Hedge funds may also have authority to suspend redemptions under certain circumstances, including in times of market distress or when their investments are not able to be quickly or easily liquidated.

- Research the backgrounds of hedge fund managers. Before entrusting your money to anyone, research their background and qualifications. Make sure hedge fund managers are qualified to manage your money, and find out whether they have a disciplinary history within the securities industry. If the manager is registered with the SEC, you can get this information (and more) by reviewing the manager's Form ADV. Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities regulators. You can search for and view a firm's Form ADV using the SEC's Investment Adviser Public Disclosure (IAPD) website. You also can get copies of Form ADV for individual advisers and firms from the investment adviser, the SEC's Public Reference Room or the state securities regulator where the adviser's principal place of business is located. If you don't find the investment adviser firm in the SEC's IAPD database, be sure to call your state securities regulator or search FINRA's BrokerCheck database for any information they may have.

> Disciplinary history. In a recent action, *SEC v. GEI Financial Services, Inc.*, the SEC alleged that a hedge fund manager failed to disclose to his advisory clients that the State of Illinois had barred him from acting as an investment adviser.

What questions should I ask the hedge fund manager before investing?

- Ask about fees and expenses. Fees and expenses affect your return on investment. Hedge funds typically charge an annual asset management fee of 1 percent to 2 percent of assets as well as a "performance fee" of 20 percent of a hedge fund's profit. These fees are typically higher than the fees charged by a mutual fund. A performance fee could motivate a hedge fund manager to take greater risks in the hope of generating a larger return.

> Excessive fees. In *GEI Financial Services*, the SEC also alleged that the hedge fund manager withdrew excessive fees from the hedge fund he managed. The amounts withdrawn allegedly were based on fee calculations that substantially differed from what the manager initially told investors about how the fees were to be calculated.
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> Tip. A fund of hedge funds is an investment company that invests in hedge funds—rather than investing in individual securities. Funds of hedge funds typically charge a fee for managing your assets, and some may also include a performance fee based on profits. These fees are charged in addition to any fees paid to the underlying hedge funds and, therefore, you will be paying two layers of fees. You may wish to read FINRA's investor alert, which describes some of the costs and risks of investing in funds of hedge funds.

- Ask about how a fund's assets are safe guarded. A hedge fund's manager generally has authority to access and transfer the fund's assets. This authority can potentially be misused. To guard against this, many hedge funds undergo an annual financial audit by an independent auditor that includes verification of the existence of the fund assets. You should inquire about where a fund's assets are held (*e.g.*, whether they are held in custodial accounts at a reputable bank or broker) and whether an independent third party confirms or otherwise verifies the existence of the fund's assets.

Manager malfeasance. In a recent action, *In the Matter of Gerasimowicz*, the SEC's Enforcement Division alleged that, unbeknownst to investors, a hedge fund manager over the course of several years invested the majority of a fund's assets into a private business owned by the manager's affiliated company. The fund was marketed as being invested primarily in public equity securities with the aim of constructing a "diversified portfolio" and employing "controlled risk diversification." The manager allegedly failed to inform investors of this substantial investment in a private business or the conflict of interest resulting from the manager's substantial personal investments in the business. The business ultimately filed for bankruptcy, and a distribution to the fund to recover its investment in the business is uncertain and could be very small. Audited financial statements that were months late in being prepared and delivered to investors, if delivered at all, allegedly failed to timely alert investors to the investment.

In another recent action, *SEC v. Lion Capital Management, LLC*, the SEC alleged that a manager used his hedge fund as a ruse to misappropriate over $550,000 from a retired schoolteacher. The schoolteacher considered the manager a close family friend and believed him to be a successful money manager. Instead of investing as he represented, the manager allegedly used the funds for personal and office expenses, including his residential mortgage, office rent and staff salaries. The manager allegedly provided false account statements to the schoolteacher reflecting nonexistent gains on her investment.

- Ask about others that perform services for the fund. A hedge fund typically has third parties who provide various services to the fund, including a prime broker, an administrator, an outside accountant that audits the fund's financial statements, and possibly a valuation agent. You should consider contacting these third party service providers to check the accuracy of information provided to you by the hedge fund and its manager.

- Don't be afraid to ask questions. You are entrusting your money to someone else. You should know where your money is going, who is managing it, how it is being invested, how you can get it back, what protections apply to your investment and what your rights are as an investor.

What protections do I have if I purchase a hedge fund? Hedge fund investors do not receive all of the federal and state law protections that commonly apply to most mutual funds. For example, hedge funds are not required to provide the same level of disclosure as you would receive from mutual funds. Without the disclosure that the securities laws require for most mutual funds, it can be more difficult to fully evaluate the terms of an investment in a hedge fund. It may also be difficult to verify representations you receive from a hedge fund.

The SEC can take action against a hedge fund or a manager that defrauds investors, and the SEC has brought a number of fraud cases involving hedge funds. For example, a number of these cases involved hedge fund managers misrepresenting their experience and the fund's track record. Other cases involved "Ponzi schemes," where returns to existing investors were paid with funds contributed by new investors. In some of the cases the SEC has brought, the hedge funds sent phony account statements to investors to cover up the fact that their money had been stolen. That's why it is extremely important to thoroughly check out every aspect of any hedge fund you might consider as an investment.

Ponzi schemes. In a recent action, *SEC v. Jawed*, the SEC alleged that a hedge fund manager operated a long-running, $37 million Ponzi scheme. Instead of investing in securities as he represented to investors, the manager allegedly used most of his investors' money to pay back old investors, to pay himself, to travel and to create an illusion of achievement by hiring professionals and educated personnel. The manager allegedly hid the Ponzi scheme by creating fake, illiquid investments. With increasing redemption requests, the manager and others he hired manufactured a sham buyout of the funds to make investors think their hedge fund interests would soon be redeemed.

In another recent action, *SEC v. Alleca*, the SEC alleged that a hedge fund manager caused investor losses of $17 million as he engaged in a Ponzi scheme to cover-up losses from his undisclosed trading. The manager created a fund of hedge funds—a hedge fund that would be invested in other hedge funds. Instead of investing in other hedge funds, the manager allegedly engaged in active securities trading and incurred substantial losses. To satisfy redemption requests and conceal losses, the manager created two additional funds and allegedly siphoned investors' money from these funds to satisfy redemptions on the first fund.

Where can I go for help?

If you have a question or concern about an investment, or you think you have encountered fraud, please contact the SEC, FINRA or your state securities regulator to report the fraud and to get assistance.

U.S. Securities and Exchange Commission
Office of Investor Education and Advocacy
100 F Street, NE
Washington, D.C. 20549-0213
Telephone: (800) 732-0330
Fax: (202) 772-9295

Financial Industry Regulatory Authority (FINRA)
FINRA Complaints and Tips
9509 Key West Avenue
Rockville, Maryland 20850
Telephone: (301) 590-6500
Fax: (866) 397-3290

North American Securities Administrators Association (NASAA)
750 First Street, NE
Suite 1140
Washington, D.C. 20002
Telephone: (202) 737-0900
Fax: (202) 783-3571

Additional Information

For information about accredited investors, visit www.sec.gov/answers/accred.htm.

For our Investment Adviser Public Disclosure (IAPD) website, visit www.adviserinfo.sec.gov.

For FINRA's BrokerCheck resource, visit www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

To determine the contact information for your state securities regulator, visit www.nasaa.org/about-us/contact-us/contact-your-regulator/.

For FINRA's investor alert regarding hedge funds, visit www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P006028.

For the SEC's press releases regarding the recent actions brought against hedge fund managers, visit www.sec.gov/news/press/2012/2012-192.htm, www.sec.gov/news/press/2012/2012-206.htm and www.sec.gov/litigation/litreleases/2012/lr22487.htm.

For more information about Ponzi schemes, visit www.sec.gov/answers/ponzi.htm.

For our Avoiding Fraud resource, visit www.investor.gov/investing-basics/avoiding-fraud.

For additional investor educational information, see the SEC's website for individual investors, www.investor.gov.

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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