

HEDGE FUNDS

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How It All Began

The first hedge fund was started in 1949 by Alfred Winslow Jones, son of the GE-famous Arthur Winslow Jones, while a journalist for *Fortune Magazine*.

Jones had a fascinating early life. He was born in Melbourne, Australia, and moved to the U.S. when he was four years old. After graduating from Harvard, he toured the world as a purser on a tramp steamer and later joined the U. S. Foreign Service, where he was vice consul for the U.S. Embassy in Berlin during the 1930s, as Hitler rose to power.

During the 1940s, Jones was a writer for *Fortune Magazine*, covering a myriad of subjects. In 1941, he finished his PhD in sociology at Columbia. Then, in 1949, his research for a Fortune article titled, “Fashions in Forecasting,” led him to analyze a new class of stock market timers as he was looking for approaches that offered a return better than a “fair game.”

The research gave him the idea to try his own hand at investing. Two months before the *Fortune* article went to press, Jones established an investment partnership that would exploit this new style of investing. He raised \$100,000, \$40,000 of which was his own. In its first year the partnership’s gain on its capital came to a very respectable 17.3 percent. (1)

Jones hired legal counsel to operate ‘under the radar’ and without the cost and time of registration. (i.e., Securities Act of ’33). His lawyers obtained the following: exemption from the Act of ’33 by virtue of Regulation D, Safe Harbor provision and, later, D-506 ‘private placement,’ the exclusion from the Investment Company Act of ’40, and the exemption from the *Investment Advisers Act of 1940*.

However, these exemptions and exclusions initially restricted the fund to 99 investors and the fund had to be a limited partnership. (Years later, the rules were revised expanding the number of investors). Further, the partnership could not advertise or solicit investors. (That's why you still don't see public ads such as those frequently put out by mutual funds.)

But, unlike most mutual funds, Jones' new partnership could use leverage (margin) to increase performance as well as short selling for performance and sometimes to reduce the risk. Jones' compensation consisted of management fees charged to the fund and, because of his exemption, he implemented an incentive fee of 20% of the profits. (This fee is also known as a performance fee, or participation rate or carried interest.)

Hedge Fund Fees

Some funds charge significantly higher fees. For example, Steve Cohen, who runs SAC Capital Management, LLC, takes 40-50% of the profits. Typically, the performance fee is 20% of the profits and often called 2-20, meaning 2% management fee and a performance fee of 20% of the annual profits. (2)

This 20% incentive fee can be substantial and is the reason one often reads about a manager's income being in the millions and even in the hundreds of millions. Doing the math, if a billion-dollar hedge fund makes 10%, or \$100 million, the incentive fee to the manager is \$20 million. This would normally be taxed at a capital gains rate and is in addition to the \$20 million of management fees. Total \$40 million. Not a bad year.

Jones continued, quietly, until 1966, when another *Fortune* writer became curious as to his life and career after leaving the magazine. Being interviewed by *Fortune*, he was asked the name and nature of his fund. He replied that he 'hedged' his bets in the fund. The *Fortune* writer then called it a "hedged fund."

Others Are Established

On a 10 year basis, Mr. Jones' hedge fund had beaten the top performer Dreyfus Fund by 87%. This led to a flurry of interest in hedge funds and within the next three years at least 130 hedge funds were started, including George Soros' Quantum Fund and Michael Steinhardt's Steinhardt Partners. (3)

Regulation of Hedge Funds

Hedge fund growth hasn't gone unnoticed by regulators and Congress. There have been changes in the laws and rules along the way. First, the rules now require that investors in hedge funds be either 'accredited' or 'qualified,' meaning the investors must have a high net worth and annual income.

In 1996, the cap on the number of investors was eliminated, provided that all investors beyond 100 were 'qualified.' As long as a hedge fund keeps the total number of investors to 499, it avoids becoming a reporting entity. If a fund has \$10 million or more in assets and 500 or more investors, it must file a 10-Q.

Again, because of the exemptions, hedge funds aren't required to provide disclosure as required if they were registered and regulated. Also, the 2006 *Pension Protection Act* restricts ERISA pensions to a maximum of 25% invested in a hedge fund. By the end of 2006, there was over \$1.3 trillion invested in hedge funds. And, between 50% to 70% of the daily volume on the New York Stock Exchange is accounted for by hedge funds. (4)

Their Structure

Structurally, hedge funds use a Prime Broker who is either separate from a bank or is a bank. The Prime Broker facilitates the trading as well as the leverage or margin loans provided by the bank. It can be thought of as providing a hedge fund with a turn-key infrastructure in a box. Most large banks have set up Prime Brokerage units. Goldman Sachs calls theirs “Global Securities Services.”

Technically, prime brokers are broker/dealers that clear and finance customer trades executed by one or more broker/dealers, known as executing brokers. A prime broker may also act as custodian for the customer’s securities and funds.(5)

The degree or amount of leverage is one of the reasons for the abnormal profits and losses in a hedge fund. While the ordinary margin investor is limited to Regulation-T requirement (i.e., 50%), the hedge fund exemption enables the margin to be whatever the bank is willing to lend it.

The Precedent of Long Term Capital

Hedge funds aren’t required to publish their performance, their activity or even their positions. Occasionally, one learns a lot of details about a hedge fund after it implodes. Long Term Capital (LTC) had a huge, 7-year successful run before being liquidated in 2000. The model was based on hedged-arbitrage. But, as there is no perfect model, this model did not stand up to the 1998 Russian default on its debt. The fund was not allowed to fail as it had bank loans that were simply too large. Had it been allowed to fail, a financial crisis would have taken place. Thus, an effort organized by the New York Federal Reserve Bank resulted in most major Wall Street firms and banks contributing capital to save the fund, avoid the crisis, and then conduct a subsequent orderly liquidation. Notably, only Bear Stearns declined to participate in the bail-out.

This is a classic illustration of incredible leverage. Managed by world-famous financial people, including two Nobel Prize-winning economists (Wall Street leviety using the phrase: Nobel Dumbells), the fund was allowed to leverage over 30 times the capital

base. In addition, LTC had over \$1.2 trillion of assets off the balance sheet in the nature of swaps and futures. It doesn't take much market movement to wipe out a hedge fund's capital when banks make loans of this magnitude to hedge funds.

Long Term Capital's incentive fee was 25%, not the traditional 20% and investors had to agree to a 3-year commitment. Thus, for years the managers enjoyed millions in income. As the fund became more and more confident, it began to take larger and larger unhedged positions. (6)

Thus, the term hedge fund is often a misnomer. In fact, most of the tragedies in hedge funds are the result of the fund not being hedged - simply taking huge bets that fail.

Getting In

An investor's entry into a hedge fund is normally done through an Offering Memorandum that consists of three parts: Operating Agreement, Private Placement Memoranda and a Subscription Agreement. (In the hedge fund I recently started, there are 71 pages.)

One of the challenges claimants' attorneys have if they represent an investor who they believe has suffered losses by virtue of wrongful hedge fund conduct are the reams of documents the investor has to sign. These documents are loaded with disclaimers that disclose the risk and leverage. Most documents warn of *total loss*.

However, when a Registered Representative of a member firm recommends or solicits a hedge fund, then industry rules and regulations do apply. These are addressed below.

Getting Out – Definition of Terms

Exiting from a hedge fund can be tricky and lengthy. Because of the extensive use of derivatives and leverage, fund managers try to restrict liquidity so as not to disrupt

complicated positions. There can be a ‘lock-up’ period, which can range from six months to three years. Advance notice of withdrawal is usually required in periods of 30 days to 180 days. There are also ‘side pockets’, ‘gates’, and ‘holdback provisions.’ These are as follows:

Side pockets: An investment pool within the hedge fund that is typically made up of hard-to-value and illiquid assets. It is operated separately and the management determines which investors may invest in the ‘side pocket’ investments. An example would be the investment in a privately-owned business.

Gates: A provision sometimes present in governing documents only allows a limited partner to redeem a certain percentage of his capital each fiscal period. Gates are most often associated with hedge funds that carry illiquid positions such as those that invest in private equity.

Lock ups: A period of time following the initial subscription during which an investor cannot redeem his capital from the fund. This period is traditionally six months to three years.

Hold-back provisions: The percentage of a redemption ‘held-back’ by the fund pending an end-of-year audit. It is typically 5% and is disbursed post-audit after adjustments. Monies held back do not, ordinarily, earn interest or any other return.

Notice Period: The minimum number of days required to notify the fund of an investor’s intent to redeem capital prior to the actual redemption which takes place at the end of one of the fund’s fiscal periods. A period of 180 days is not unusual.

There are other terms that are often used in hedge fund agreements:

Hurdle Rate: A minimum that the hedge fund manager must earn each fiscal period in order to be entitled to the incentive fee. Generally, if a hurdle rate applies, the incentive fee only applies to the profit earned in excess of the hurdle rate.

Catch-up provision: A provision that sometimes is in governing documents that kicks in after the hurdle rate has been exceeded. Essentially, the incentive fee applies to 100% of the hedge fund's income over the hurdle rate until the hedge fund manager has been "caught up."

Hedge Fund Investing Techniques

Hedge fund investing techniques are typically very sophisticated and complex. For example, there are "swaps" - bilateral agreement in which two parties, called counterparties, agree to exchange a series of payments over time. Swaps can involve index performance, bond performance and credit default swaps. The last is the exchange of a fixed rate based on a benchmark such as LIBOR (premium) from the hedge fund (buyer) to a CDS Dealer (seller) in return for credit protection to the hedge fund (buyer). Derivatives such as options and futures are commonplace in the pursuit of both performance and, sometimes, to actually hedge.

Other strategies include, but are not limited to, Quantitative Approaches - selecting securities based on complex mathematical relationships, arbitrage including equity sectors, currencies, M&A parties, short selling and "Pairs Trades" (buy Best Buy, short Circuit City). And the list goes on....

There is one universal problem in evaluating hedge funds and their performance: *No one index has emerged as the industry standard.* Because of this fact and others, it is essential for the member and the member associate to ‘know their customer’, know the product and perform full disclosure.

Hedge Fund Suitability and Transparency

Let us migrate into hedge fund suitability and some industry ramifications. As a first step, it is important to know about hedge fund transparency. Here is what the FINRA training manual on hedge funds says about transparency:

[It] refers to the ability to know what positions a portfolio manager holds and the true values of those holdings. Because hedge funds frequently do not disclose their positions (secrecy is a hallmark of hedge funds), it can be difficult for an investor in a hedge fund, such as a pension fund, to know what it is really invested in and what the true value of its investment is. Thus, hedge fund investments often ‘lack transparency.’

“Hedge funds’ are notoriously difficult to define. The term appears nowhere in the federal securities laws.

Categories of Investors Allowed

There are different categories of investors allowed under the various laws including ’33 Act exemption (Regulation D, Rule 506, no dollar limit), exemption from Investment Advisors Act of 1940 (Sections 203 (b)(3) and the Investment Company Act of 1940 (Section 3 (c)(1). While most hedge funds choose an exemption or exclusion, they certainly can register under the ’33 Act and several have done so. These funds are typically larger and distributed through broker/dealers, which subjects them to full compliance with industry regulations (just as any of their other products)

. The Holy Grail of suitability - NASD 2310 - still applies to hedge fund sales when recommended by brokers of member firms.

Sales practices

FINRA has expressed concern about the areas of “retailization,” Funds of Funds, including Registered Funds, and Capital Introduction services of Prime Brokers and other Third Party Marketers (TPM).

Retail-ization is the advertising and broad-based solicitation of investors for a hedge fund. This practice is against the rules and regulations of FINRA. Typical prohibited activities include luncheons and public seminars featuring hedge funds. The reason is that hedge fund investors must fall into an accepted category and be judged suitable for such an investment. Broad-based advertising or public seminars promoting hedge funds do not allow individual due diligence of a potential investor.

A Fund of Funds (FOF) is a hedge fund that has no trading strategies of its own, except to invest in hedge funds. Even if an FOF registers its securities under the '33 Act, it is still required to be sold only to qualified investors.

While it is legal for a Prime Broker to conduct Capital Introduction Services that bring qualified purchasers to unregistered hedge funds, the scale of this activity has increased markedly in recent years and has invited more evaluation from FINRA. In 2003, the NASD (now FINRA) published a *Notice to Members* (NTM 03-07) that reinforced the standards of conduct for members, including Prime Brokers, in selling hedge funds, especially to retail investors. Specifically: disclosure in promotional efforts, suitability, supervision of associated persons and the training of associated persons regarding features, risks and suitability of hedge funds.

Both claimants' counsel and the industry's general counsels should be aware of the unique points in this Notice 03-07. For example, “Members also must provide investors

with any prospectus or other disclosure document of the hedge fund (or Fund of Funds). Members should bear in mind, however, that providing a prospectus does not satisfy the duty to provide balanced sales materials and oral presentations.” Further, “NASD also is concerned that customers may not fully understand the risks associated with hedge funds.”

FINRA enforcement actions have already taken place involving hedge funds. In 2004, UBS was found to be in violation of advertising rules. Specifically, “Fund seeks 20 to 25%.” Also in 2004, Citigroup was found to have violated advertising rules with the following: “Seeks an annualized return of 15% or more.” CIBC, in 2005, was found to have violated marketing and advertising rules by not properly disclosing risks specific to the funds’ objectives and the advertisement of a registered fund in a periodical contained insufficient risk disclosure.

Other Reading

The following, from FINRA’s training manual, is a list of Suggested Reading Web sites on hedge funds:

Regulation of Hedge Funds	www.cme.com/files/hedge.pdf
Marketing	www.cm-p.com/pdf/hedge_fund_marketing.pdf
Sales Practices	www.cm-p.com/pdf/hedge_fund_practices.pdf

ENDNOTES:

- (1) Wikipedia
- (2) FINRA Institute at Wharton, Hedge Funds Training Manual
- (3) Wikipedia
- (4) FINRA Institute at Wharton, Hedge Funds Training Manual
- (5) FINRA Institute at Wharton, Hedge Funds Training Manual
- (6) San Jose State University, Department of Economics

John J. Duval, Sr. is an arbitrator for the NASD and NYSE (now Finra) since 1998. He retired from Merrill Lynch where he was a broker, branch office manager, and district-level manager in the New York City District of the firm. He has also completed NASD Mediator training. In addition, he serves as a consultant and expert witness in securities cases having offered testimony in over 45 cases as well as being retained in over 150 cases since 2002. He is currently Managing Member of Duval Asset Management, an investment advisory firm and is co-founder of a hedge fund. He is also a candidate for the NASD-Institute at Wharton CRCP (Certified Regulatory and Compliance Person) designation. He can be reached at joduval@aol.com.