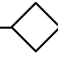
Hedge Fund Information for the Masses



This **Interactive Qualifying Project** report
Submitted to

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Project Code: KAW-0235

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Executive Summary

Hedge funds have been around since the late 1940s, and yet they are not a very widely known investment vehicle. This is largely due to the lack of information on hedge funds available to the general public. Financial magazines very rarely cover hedge funds. If one were to search the internet for information regarding these elusive securities, they would encounter one password protected site after another since the SEC has deemed that allowing the public access to hedge fund information is not to be allowed.

Our project set out with the intention of gathering as much material as we could find and compiling it into a report. We also created a website that would share the knowledge and information we have come across to the general public. It is not our intention to publish specific hedge fund performance values. Instead, we aimed to provide the information for those who seek to learn what a hedge fund is and how they differ from more commonly known securities.

Abstract

The focus of this project was to conduct research into the hedge fund industry and present it within a publicly accessible website. The information is presented in a manner that may be useful to those who have little knowledge about the industry. Also presented are some of the current issues in the industry. The stated conclusions are based on the research and directed at regulatory agencies.

Acknowledgements

We would like to thank our advisor, Kathryn Wilkens, for her support, dedication, and guidance throughout the course of our project.

Authorship Statement

We hereby declare that each project member had an equal part in the completion of this project.

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Introduction

Hedge funds represent a growing industry of alternative investments. Only the very wealthy are qualified to invest in hedge funds. For years, the SEC has been content to let hedge funds operate out of the spotlight. Yet their increasing size has raised concerns about the conduct and nature of hedge funds. Concerns about fraud have recently been raised, and the SEC is attempting to take a more proactive stance in the matter.

In addition to the standard goal of completing an Interactive Qualifying Project as a requirement for a WPI degree, it is our goal to inform the readers in this report about the hedge fund industry and some of the problems that we see. Perhaps we may go as far as to convince our readers that the SEC should move to allow more public access to hedge fund data that is accessible to accredited investors. Secondly, much of the information contained within this report will also be presented on a website for the benefit of those who seek to gain more knowledge about the hedge fund industry.

The SEC is preparing to impose a new regulation that requires all hedge fund managers to register as investment advisers. This is being done so that the SEC can take a more proactive stance in preventing hedge fund fraud. Investors may also help prevent instances of fraud by educating themselves about the hedge fund industry. Unfortunately, because of the manner in which the SEC defines solicitation of hedge funds, certain characteristics of hedge funds cannot be freely disclosed or discussed. As a result, some investors lack reasonable expectations for hedge fund performance. It is hoped that this project will convince the reader that increasing hedge fund transparency will reduce the need for fraud protection.

The implications of increased hedge fund transparency are far-reaching. Hedge funds are unique investment vehicles that deserve as much media attention as stocks, bonds and mutual funds. In the end, all investors can benefit from increased exposure to the nature of hedge funds. In the spirit of increasing investor exposure to hedge funds, the research and contents of this report will be packaged on a website for potential future use.

Ideally, the SEC would consider the arguments made in this report. Realistically, this report will likely never make it that far up the ladder. However, it may give Professor Kathryn Wilkens and her associates in the hedge fund industry something to consider

The project results will be presented in written format as part of this report. This report will also be included on a compact disk accompanying the printed report. The compact disk will also contain a website with research that led to the formulation of this report and links to more information.

The project began with research into the basics of the hedge fund industry. Learning about this shrouded, even secretive industry is a more difficult task than learning about stocks, bonds, and mutual funds. Hedge funds are not mainstream investments, and information about particular funds is generally only available at a premium. Without access to up-to-date library materials about hedge funds, most research was conducted online. James Cramer's *Confessions of a Street Addict* provided a feel for daily life at Cramer-Berkowitz, a hedge fund formerly led by James Cramer.

Literature Review

Until recently, many individuals were unfamiliar with the term *hedge fund*. Hedge funds have only recently become a popular investment vehicle. Still, hedge funds are not widely reported by the media; one will be hard pressed to find a story about a hedge fund on CNBC, let alone on any of the network news programs. It is for this reason that many people are unfamiliar with the function that hedge funds serve.

Picture a mutual fund that is not regulated by the SEC. In other words, the fund manager is free to manage his clients' money in any manner he sees fit, inside the boundaries of the law. He can enjoy many freedoms that mutual fund managers cannot; short selling and leverage are common tools of the hedge fund trade. Though it seems like the perfect setup, certain limitations are placed on hedge funds that will be discussed later. Due to the fact that they are setup as limited partnerships with less than 100 participators, hedge funds are excluded from the Investment Company Act of 1940, making them a largely unregulated investment vehicle[1]. Offshore hedge funds are non-U.S. corporations and thus are not regulated by the Security and Exchanges Commission.

The hedge fund is the financial vehicle used most often by wealthy individuals. They are generally able to implement aggressive strategies that are not available to mutual funds, such as selling short, arbitrage, leverage, swaps, program trading, and derivatives. Law restricts a hedge fund to have no more than 100 investors. As a result, most hedge funds require a minimum net worth of $250,000 to $1 million in order to join. Just like mutual funds, investors pay a manager's fee to the hedge fund, which additionally takes a percentage of earnings as profit.

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[1] Carl Ackerman. "The Performance of Hedge Funds: Risk, Return, and Incentives." *The Journal of Finance.* June, 1999.

The net worth of a potential hedge fund investor is of great importance, because it is this requirement that restricts the population at large from taking part in hedge fund investment. Only accredited investors are allowed to invest in hedge funds. An accredited investor can be simply defined as an investor having a net worth of $1 million or more. However, anyone with an income of at least $200,000 by themselves or $300,000 jointly with a spouse, for each of the two recent years, and the expectation that such income levels will continue is also considered an accredited investor. These steep requirements keep hedge fund investing exclusive to only the wealthy.

Some financial firms, however, have departed from the traditional investment requirements of hedge funds. Called 'fund of funds', these require an initial investment of only $100,000 and sometimes even less, depending on the firm. Those who invest in fund of funds are actually investing in several different hedge funds, all of which have been screened by the manager of the fund of funds. These investors enjoy the ability to entrust their investment out with the expertise of several different hedge fund managers, each with his unique investing style.

Hedge funds typically offer the possibility of higher returns, but at an increased risk to the investor. Over the past decade, hedge funds have outperformed the stock market by several percentage points, with about half the risk. They are known as absolute return vehicles because their managers aim for positive returns in all types of market conditions, regardless of how other stocks or bonds perform.

Most hedge funds only collect a fee that is beyond a one or two percent management fee if they surpass what it called the high water mark. The high water mark can be defined as the highest value that the hedge fund was able to attain based on

investment return. In order for a funds manager to be compensated, the fund must surpass the last year's performance. If this condition is met, only then would a manager be compensated for his work. For example, if in 2001 a hedge fund returned $200,000 on a $2,000,000 portfolio, then in 2002 the fund would have produce a positive return bringing the portfolio value to greater then $2,200,000 in order for the manager to be compensated for his work. Usually a fund manager will take as much as twenty percent of profits on top of his management fee, which generally runs one percent of assets.

The hedge fund has become a much more popular investment vehicle. Its proliferation over the past decade alone is staggering. At the end of 1999 there were only 3,000 hedge funds whereas now, more than 45,000 exist worldwide. The expected total assets under management are expected to reach $1.7 trillion by 2008. Currently more than 20% of hedge fund investors with $25 million dollars in assets invest almost $2.7 million into hedge funds alone.[2] These are clearly one of the fastest growing investment vehicles. $6.9 billion was put into hedge funds the first quarter of 2001, which was almost double that of first quarter 2000. An additional $8.4 billion was invested in second quarter 2001, which was more than what was invested in all of 2000. Last year alone, hedge funds capitalization increased from $144 billion to over $563 billion.

The amazing growth of hedge funds does have a downside. With the explosion in number of hedge funds, the amount of talent managing these investment vehicles has become diluted. While the average hedge fund was up 2.1% through July 2001, more

[2] Nancy Opiela. "Alternative Investments: Is now the Time?" *Journal of Financial Planning* 15, no. 10, October 2002, available at http://gateway.proquest.com/openurl?url_ver=Z39.88-2004&res_dat=xri:pqd&rft_val_fmt=info:ofi/fmt:kev:mtx:journal&genre=article&rft_dat=xri:pqd:did=000000218088911&svc_dat=xri:pqil:fmt=html&req_dat=xri:pqil:pq_clntid=2618; accessed December 3, 2002.

then 70 percent fall well below the mean of overall fund performance. A hedge fund by the name of Red Coat Capital, a New York based long/short hedge fund, lost $250 million of its $375 million in assets by year end 2000.[3] Red Coat was established in August 1997 and claimed to have a compound annual return of 29 percent through 1999. This shows that even fund managers with several years experience in hedge fund management can quickly lose control of their funds.

Sometimes the risks that hedge funds take on can cripple even the most talented managers. The well known Cramer Berkowitz hedge fund was nearly forced to capitulate when it lost $400 million of its clients' money in 2000. Fortunately for the fund's partners, the management team was somehow able to regain over $535 million, beating the performance of the market by nearly 50% for the year.[4]

Many different types of hedge funds exist. Each one is categorized according to the strategies it follows. The differences in hedge fund types can range from the types of markets they invest in to the kinds of positions they take within those markets. There is also the added distinction between a US hedge fund and an offshore fund.

In a *Distressed Security*, the manager focuses on companies that are in the process of reorganization or in danger of going bankrupt and his interest could be in anything from the senior debt of the company right down to its common stock. A manager in an *Arbitrage* fund simply buys stock in a company that is being acquired and sells the stock of the company that is acquiring that company. *Global International* managers are interested in economic change in the entire world, excluding the United States. They tend to favor picking stocks, however, in one particular market of the world. The

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[3] Eric Moskowitz. "Hedge Fund Chic is Undeserved – And Dangerous", September 10, 2001, available at http://www.redherring.com/Article.aspx?a=8906; accessed February 10, 2003.

[4] James Cramer, *Confessions of a Street Addict* (New York: Simon and Schuster), 312

Emerging Markets fund is one in which the manager invests in less mature markets of the world and hopes that the market will eventually mature. Examples of these markets would be Brazil, China, India, and Russia. Short selling is generally not allowed in these markets and thus the manager must go to cash or other markets where valuation makes going long less attractive. *Global Established Regional* is almost identical to *Global Emerging* except that the manager focuses on only one specific region in the world. *Global Macro* managers profit from the changes in the global economy that are typically based on major interest rate shifts and use leveraging and derivatives as their main investment tactics. Traditionally, *Long-Only Leverage* funds are equity funds that are structured more like mutual funds that use leverage and allow the fund manager to collect an incentive fee. A *Market Neutral* fund attempts to neutralize market risk, which is possible through using both long and short techniques. It is difficult to make a profit off a highly diversified portfolio and thus stock selection is crucial. A *Sector* fund focuses on one specific sector of the economy or industry and can employ a wide range of methodologies and primary focuses. Lastly, managers in a *Short-Seller* funds take the position that a stock is going to lose value. The fund borrows stock and sells it, hoping to buy it back later at a lower price.

Hedge funds, in addition to these various types, can also be classified as US or offshore. Offshore funds are simply funds that are based anywhere else in the world outside the United States. There are, however, some basic differences between US and offshore funds. Offshore funds tend to be more liquid. Offshore funds are generally structured as corporations whereas US funds are usually limited partnerships. This means that offshore funds can potentially have unlimited investors. US investors are not

allowed to invest in offshore hedge funds; however, many tax free entities, such as endowments, IRAs, foundations, and ERISAs, are allowed to invest in these offshore funds.

Ackermann concludes that hedge funds outperform mutual funds, but do not outperform indices funds such as S&P500 funds[5]. This indicates that while hedge funds may provide improved portfolio performance, a measure of risk is involved. In general, superior hedge fund returns do not appear to result from management skill because returns are not persistent over time. Rather, it seems to result from survival of the fittest; hedge funds that suffer heavy losses year after year cannot survive as long as mutual funds that also suffer heavy losses.

Incentive fees explain higher performance but not increased risk, unless we assume that fund managers are willing to take greater risks to secure greater returns. However, this possibility of increased risk may be offset because managers tend to also be investors. Also, they are general managers, and bankruptcy will lead to substantial personal liabilities on the part of the managers. It has been found that incentive plans that are symmetric, meaning the manager loses money for underperformance, do not generate the greatest magnitude of returns.[6] Managers appear to be reluctant to take on additional risks when positive returns have been secured for the year.

Some of these funds are very large, such as George Soros' that have a combined capitalization of $4.6 billion. Dr Mahathir Bin Mohamad, Prime Minister of Malaysia, said in the Wall Street Journal, "whole regions can be bankrupted by just a few people whose only objective is to enrich themselves and their rich clients…we welcome foreign

[5] Carl Ackerman. "The Performance of Hedge Funds: Risk, Return, and Incentives." *The Journal of Finance,* June 1999.
[6] Ibid.

investments. We welcome speculators. But we don't have to welcome share – and financial-market manipulators. We need these manipulators as much as travelers in the good old days needed highwaymen."

The term "Hedge Fund" was coined by Carol Loomis in a 1966 Fortune magazine article to describe the investment philosophy of one Alfred Winslow Jones, whose fund had two general characteristics: it was market neutral and it had a substantial incentive fee set at 20% of realized profit without any fixed management fee. Hedge funds are typically set up as limited partnerships or limited liability companies providing specialized investment vehicles for high net worth individuals and institutions.
The actual investment style of the fund is responsible for 20% of the variability in hedge fund performance[7]

The clout of hedge funds on world markets is magnified many times by the use of leverage through margin accounts. In some cases, fund managers have become notorious for destabilizing markets around the world. The term "hedge fund" is a misnomer. In fact, most hedge funds employ extremely risky investment tactics. The National Securities Markets Improvement Act of 1996 dictates that up to 500 individual investors with at least $5 million to invest, or institutions with at least $25 million to invest. Hedge funds may not publicly advertise or solicit investors.

Hedge fund managers typically have mandates to make an absolute return target, regardless of the market environment. Of the many differences between traditionally managed funds and hedge funds, two issues stand out: performance evaluation and survivorship bias.

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[7] William Goetzman and Stephen Brown. "Hedge funds with style". (Yale University and New York University, 2001).

Survivorship bias is the tendency for failed companies to be excluded from performance studies due to the fact that they no longer exist. Survivorship bias causes the results of some studies to skew higher because only companies which were successful enough to survive until the end of the period are included. Similarly, mutual fund performance may be misleading due to survivorship bias if the fund family tends to merge or discontinue underperforming funds. Fung and Hsieh (1998) have calculated an annual survivorship bias of 1.5% for hedge funds.

Hedge fund regulation dates back as far as the Securities Act of 1933, where it was stated that securities must be registered or exempt. Exemption D of the Securities Act stated that a security could be exempt from registration if it met one of two conditions: a) All 35 investors are "accredited investors". An accredited investor is one with a net worth greater then $1 million or with an income of $200,000 ($300,000 joint with a spouse) in each of the previous two years and expects to make at least the same amount in the coming year. b) The securities are privately placed.

The Securities Act was followed by the Exclusion of Investment Company Act of 1940 which had two sections, 3(c)1 and 3(c)7, that applied to hedge funds. Section 3(c)1 states that a security does not have to register if it has under 100 beneficial owners that are all qualified investors. Section 3(c)7 further exempts those securities that have over 500 "super-qualified" (higher net and income amounts) purchasers from having to register. This Act was amended in 1996 by adding that a fund must register if it has more than $30 million in assets under management and has more than 14 clients. Federal registration is not required for a fund that has less then $25 million in assets under management.

In 1995, the SEC made the decision that presenting information about a hedge fund on a website is considered open solicitation and advertising. This information can only be disseminated to those who had a previous relationship with the fund, even if the website is password protected. No links from outside the website may point to internal pages and passwords may only be given out to those who held a prior relationship with the fund and once their financial standing has been determined.

The SEC released a report, *Use of Internet Websites to Offer Securities, Solicit Securities Transaction or Advertise Investment Opportunities Offshore*, in 1998. The surmise of this report was that offshore funds must "implement measure that are reasonably designed" to guard against selling to US investors.[8] Several key points were outlined, including the fact that, in addition to the normal spam restrictions that affect US and offshore funds, offshore funds are further responsible for knowing the identity of those who they plan on emailing. Additionally, all websites for offshore funds must display prominent warnings that US investors may not buy into them.

The hedge fund industry continues to grow at a prodigious rate. Currently, there are 6,000 – 7,000 hedge funds nationally that have upwards of $650 billion under management. If growth trends continue as they are, within 10 years hedge funds will have over $1 trillion in assets under management.[9] If the newer funds of hedge funds, which offer investors that chance to invest in hedge funds without the enormous financial barrier, could market their funds openly to Americans it would likely be a surge of new investing that would accelerate the growth of hedge funds.

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[8] Hedgeworld. *Hedge Funds & the Internet*. Available at http://www.hedgeworld.com/education/index.cgi?page=HF_internet; accessed March 21, 2003.

[9] Securities and Exchange Commission. *Implications of the Growth of Hedge Funds.* http://www.sec.gov/news/extra/hedgestudyfacts.htm; accessed March 3, 2004.

The only real restrictions on the growth of the hedge fund industry are those placed on it by advertising. Since hedge funds are not allowed to advertise openly to the general public, thus eliminating public awareness, the hedge fund industry will never reach its full potential and therefore its capacity. This capacity is dictated by the ability of the managers in charge of running the hedge funds. While the capacity of the hedge fund industry has been expanding ever since the first fund was created, this trend in the growth of capacity can not continue indefinitely. This growth is limited in capacity by the capacity of the markets in which the hedge fund managers invest.

The measurement of the capacity of the hedge fund industry is also difficult because of the many different types of hedge funds. Each of the different types uses a different investment vehicle. The capacity of investment in these vehicles often differs and is always changing. This makes it difficult to measure the capacity of the fund based on a particular strategy. Additionally, a hedge fund manager may decide not to adhere strictly to the fund's strategy and pursue others that are not stated in the fund's prospectus.

The capacity of the hedge fund industry is also influenced by the regulations set in place by the SEC and NASD. Restrictions that these organizations place on the industry may artificially retard or effectively stop capacity growth by discouraging new individuals from becoming hedge fund managers. As the industry grows, the potential for increased regulatory action is a certainty. How this affects hedge fund market capacity must be assessed case by case.

On April 23, 2002, the NASD formally recognized hedge fund of funds as a risk to unsophisticated investors with a written statement emphasizing the increased costs and

risks to investors for the potential of increased returns. In an Investor Alert entitled "Funds of Hedge Funds – Higher Costs and Risks for Higher Potential Returns", the NASD proposed to investors that funds of hedge funds are too risky for the average investor. The statement expounds upon funds of funds in a largely negative light.

On February 13th, 2003, the SEC issued a statement regarding funds of hedge funds for less experienced investors. The statement, entitled "Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds" briefly explains the concepts of hedge funds and funds of funds for the reader. The bulk of the statement advises investors about how to properly protect themselves from unobvious risk factors and hedge fund fraud. For instance, the SEC advises investors to take such simple precautions as to "Ask questions about fees". The SEC also advises investors to dig deeper under the surface and "Understand how a fund's assets are valued". Above all else, the statement encourages investors to know exactly what they are getting into before blindly diving into an investment.

Currently, websites furnishing information about hedge funds often restrict users due to restrictions placed on hedge fund marketing by SEC Rule S7-31-95, *Use of Electronic Media for Delivery Purposes*.[10] Webmasters must password-protect their sites in order to prevent recourse by the SEC regarding hedge fund solicitations posed by information. In nearly all cases, in order to legally obtain a username and password to view these sites, the user must be an accredited investor or a fund manager. For instance, Hedgefund.net offers accredited investors and hedge fund professionals free access to hedge fund industry news, manager profiles, fund information, and hedge fund index

[10] Securities and Exchange Commission. "Use of Electronic Media for Delivery Purposes". Washington, DC, May 9, 1996, available at http://www.sec.gov/rules/final/33-7289.txt; accessed April 13, 2004.

data. This information is not available to unaccredited investors. Likewise, HedgeWorld allows accredited investors to search through its TASS database containing information about 2,400 hedge funds while blocking unaccredited investors from searching through the same database.

Methodology

The research conducted for this project was based on content analysis. In other words, research was accomplished by going through newspaper, magazine, and electronic documents written by experts in the alternative investment field. By drawing information from each document, a broader picture was painted about the hedge fund industry. Unfortunately, this kind of research is prone to the biases of the document writers.

Biases of individual writers may come into play for a variety of reasons. Documents written by individuals with a stake in the hedge fund industry are likely to be biased in favor of the industry, and against regulatory action. It is in their interest to allow managers to run their funds for the maximum profit. These individuals include hedge fund managers, advisors and investors. On the other hand, rules and documents issued by the SEC and NASD are biased toward regulatory concerns. In the middle are financial journalists who report on key issues but may or may not have a personal stake in the industry. To the best of the authors' knowledge, biased material has been recognized and taken with a grain of salt.

The research into the hedge fund industry was conducted in a systematic fashion. First, the authors sought to gain a basic understanding of the hedge fund industry. In general, regulation of hedge funds is much looser than that of mutual funds and other investment vehicles. Next, the authors dug deeper into the laws regulating the hedge fund industry. Greater obstacles exist to investing in hedge funds than mutual funds. Some of the misconceptions surrounding the hedge fund industry were analyzed. The numerous investment strategies of hedge funds were discussed. Transparency issues

were given special attention because of the difficulty involved in obtaining fund information.

Due to the lack of general information available about hedge funds in local university libraries, much of the research was conducted on the Internet. A disadvantage to online research is that few websites offering significant quantities of useful information are publicly accessible. Instead, these sites are password protected. Users must be accredited investors, hedge fund managers, or financial advisors to obtain a username and password for these websites. This is discussed in greater depth later in this report.

Because most of the information about hedge funds found online proved to be either biased or not comprehensive enough, the authors took it upon themselves to produce a website that covers a broad scope of hedge fund information. The information was furnished into a series of individual webpages connected as one website. The project website is structured to provide the results of the research in a manner that is not for or against investing in hedge funds. Rather, the website is designed to facilitate interpretations of the laws and regulations surrounding the hedge fund industry. The website is not in any way, shape, or form intended to be interpreted as a solicitation of any kind.

The website was built using Macromedia Dreamweaver MX version 6. The website was constructed in a simple frame format. The leftmost frame contains the navigation bar which remains in place for internal navigation throughout the site. The main part of the browser window will display the information corresponding to the link that a user has selected. The top and the bottom sections of the webpage are also static

parts, the top displaying the title of the website (and subsequently this project) and the bottom continuously displays the contact info of the project members.

Results and Analysis

According to the staff report, "the staff has no reliable data on the number of hedge funds in existence of the amount of hedge fund assets under management." It is estimated that as of May, 2003, there were 6,000 active hedge funds managing $600 billion in assets growing rapidly. This is up from an estimate of 400 hedge funds in 1992 with the value of assets estimated at only $50 billion in 1993. The total value of U.S. corporate equities was $11.2 trillion at the end of 2002. [11]Thus, the hedge fund industry can be estimated to have grown to over 5% of the size of the entire U.S. equities market. Meanwhile, the total value of mutual funds was $6.4 trillion at the end of 2002.[12] Hedge fund holdings are estimated to have grown to over 9% of the value of all mutual fund holdings. Hedge funds are becoming bigger players in the highly regulated equities markets, and their presence is being felt.

Hedge funds represent a serious contender within the equities markets, and need to be more fully understood by investors and the SEC. The staff report recognizes a need for the SEC to develop an improved understanding of the rapidly growing hedge fund industry, and recommends that hedge fund advisers register with the SEC as investment advisers under the Advisers Act to achieve this end[13]. Yet, the staff report discounts the need for investors, accredited and unaccredited alike, to also develop a better understanding about the hedge fund industry. Instead, a vague risk is associated with dissemination of hedge fund information to the general public.

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[11] Staff of the Commission's Division of Investment Management, Office of Compliance Inspections and Examinations, "Implications of the Growth of Hedge Funds". (Washington, DC, 2003), 1.
[12] Ibid., 2.
[13] Ibid., 89.

The staff report recommends that the SEC consider revising section 3(c)(7) of the Investment Company Act of 1940 such that it would permit hedge funds following this rule to publicly market hedge funds[14]. Section 3(c)(7) states that partners of this type of hedge fund must have a minimum net worth of $5 million. The staff report also recommends that hedge funds following the rules set forth in section 3(c)(1) not be allowed the same consideration[15]. The staff report's reasoning is that less wealthy and potentially less sophisticated investors would be lured into a high risk hedge fund that could potentially wipe out a sizeable portion of an individual or family's net worth. The staff report makes a broad generalization by stating that individuals with a higher net worth are more financially sophisticated than individuals with less money. By keeping information out of investors' easy grasp, the SEC hopes to protect investors from themselves.

While it seems probable that investors who are qualified purchasers will invest a smaller portion of their total net worth into one particular hedge fund, the staff report produces no evidence that this is the case. Also, the staff report provides no evidence to show that the proportion of financially sophisticated qualified investors is greater than the proportion of financially sophisticated accredited investors.

While calling for a reduction of restrictions on funds following section 3(c)(7), the staff report simultaneously states, "The staff would be reluctant to ease or eliminate the prohibition on general solicitation for hedge funds or other funds that use the accredited investor standard as their minimum investor criteria. We believe that such an arrangement could increase the level of risk of investment interest by less wealthy

[14] Ibid., 100.
[15] Ibid., 101.

investors[16].” This reiterates the idea that the SEC’s preferred method of protecting financially unsophisticated investors is by the “out of sight, out of mind” method. The theory seems to be that if unsophisticated accredited investors are not exposed to advertisements for hedge funds open to them, they will not necessarily have the inclination to invest in a hedge fund. Meanwhile, are these same individuals expected to ignore advertisements for hedge funds open only to qualified purchasers? The effect could be the opposite, potentially increasing the risk of accredited, yet financially unsophisticated, investors placing large sums of wealth into hedge funds. There is the potential that general solicitations for hedge funds beyond the reach of accredited investors could spark increased interest in accessible hedge funds as stepping stones to greater wealth and security.

When the SEC launched a fraudulent website to learn how susceptible the public was to hedge fund fraud, the results were disturbing. Within four months, the site, which promised high returns with minimal risk, had 80,000 hits from web users scouring search engines for hedge funds offering high returns. Many of these users contacted the SEC by email requesting more information about this phenomenal “fund”.[17] The Guaranteed Returns Diversified (GRDI) example presents clear evidence that many investors do not know enough about hedge funds to make reasonable assessments about their nature. Yet, dissemination of information about individual funds is restricted on the Internet by SEC

[16] Staff of the Commission’s Division of Investment Management, Office of Compliance Inspections and Examinations, “Implications of the Growth of Hedge Funds”. (Washington, DC, 2003), 101.
[17] US Securities and Exchange Commission, “Testimony Concerning the Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk”. May 22, 2003. Available from http://www.sec.gov/news/testimony/052203tswhd.htm; accessed April 10, 2004.

Rule S7-31-95, *Use of Electronic Media for Delivery Purposes*.[18] The staff report's recommendation to require hedge fund managers to register as investment advisers is a step in the right direction. By registering with the SEC, hedge fund advisers will have to notify the SEC about which funds they manage. With this information in the hands of a federal regulatory agency, it will become possible to publish a list of legitimate hedge funds in which American citizens are invested. The next step is to make hedge fund performance data accessible to all to encourage open dialogue about individual funds and create a clearer picture of the industry for investors.

[18] Securities and Exchange Commission. "Use of Electronic Media for Delivery Purposes". Washington, DC, May 9, 1996, available at http://www.sec.gov/rules/final/33-7289.txt; accessed April 13, 2004.

Conclusions

The SEC can take an alternative approach to protecting investors from hedge fund fraud. The argument that unaccredited investors need to be protected from hedge fund solicitation exposure in the same way they need to be protected from cigarette and pornography advertisements is ludicrous[19]. Rather than continuing to restrict the free flow of hedge fund information in the name of fraud prevention, perhaps the answer lies in investor notification. Referring to the previously mentioned SEC publication *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds*, the staff report notes that the SEC website hosts "a partial list of questions that investors should ask, and most importantly, understand the answers to before making any investments in hedge funds..."[20] The SEC could make this list available in other mediums as well for individuals without the technological sophistication to access the Internet. The value of this improved document could be enhanced by issuing it (or directions to obtain it) with the staff report's proposed standardized brochure to be issued with each hedge fund prospectus.[21] The proposed brochure would contain disclosure information about various aspects of hedge funds that all investors should know before investing in a hedge fund.

In the spirit of empowering investors through education, a website is included with this report offers users the opportunity to learn more about the hedge fund industry. Included are basic facts about the hedge fund industry and the market it serves. Links to other websites offering in-depth information about the industry are also included. The

[19] Smartmoney.com, "In Hedge Funds We Trust", May 19, 2003, available from http://www.smartmoney.com/tradecraft/index.cfm?story=20030519; accessed April 3, 2004.
[20] Staff of the Commission's Division of Investment Management, Office of Compliance Inspections and Examinations, "Implications of the Growth of Hedge Funds". (Washington, DC, 2003), 103.
[21] Ibid., 98.

website may act as a foundation for future research by other individuals who do not come from a financial – or wealthy – background.

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