



# Avoiding the HEDGE-FUND STORM

Hedge funds have been beneficial to the U.S. economy, but they have also been at the center of many recent controversies. Is that a coincidence, or do financial storms form at the weakest regulatory link?

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**H**edge funds were at the epicenter of two recent major financial storms.

Refco's CEO allegedly hid off-balance sheet debt with a hedge fund and hedge funds (including Millennium Partners) profited with illegal after-hour mutual-fund trades.

Why are hedge funds susceptible to controversy? Broker/dealers pay "soft dollars" (commission rebates) to independent hedge funds marketed to the brokers' private banking or wealth-management clients. These relationships are often cozier than they should be, raising questions about independence and conflicts of interest.

Banks and brokerage firms are rushing to create and market hedge "fund of funds" with low minimum investments (around \$25,000) as an alternative to stagnant mutual funds. This is a departure from a few years ago, when hedge funds were primarily marketed to wealthy investors with minimum account sizes of more than \$100,000.

## The new gold rush

Forming a hedge fund is the new gold rush for entrepreneurs and established players on Wall Street. The fee structures in hedge funds are significantly higher than in mutual funds. Pension funds, endowments, and other institutional investors have added hedge funds to their asset allocation models, and they are in hot pursuit of the next great hedge-fund managers.

Everyone wants to beat lackluster market indices with stellar hedge fund returns. However, when everyone chases the same asset class or type of business, it's normal to expect there will be over-investment and corners cut on due diligence. It happened with the tech bubble of the 90s and in online trading over the past decade. The same thing may be happening with lightly regulated hedge funds.

It's never been easier to start your own hedge fund. The barriers to entry are very low. You can work from home, not hire any employees, purchase standard computers and software, and get great service from brokerage firms and other profes-



sional providers at very low cost.

Generate an excellent performance record and/or have a great pedigree and the investor money will follow. Be a small hedge fund this year and a larger hedge fund in five years. Success stories abound.

The environment is fostering a rush to form hedge funds and invest in them. It is very reminiscent of the history of online trading. Similar circumstances fostered tremendous growth, and it took years of significant losses to finally dissuade many from continuing. The same thing can happen to hedge funds.

Great losses at financial institutions are often caused by unauthorized trading or irregularities. Nick Leeson at Barings

Bank in Asia covered up huge trading losses by relying on hidden accounts. Once this fraud was uncovered, his remaining losing positions were forced into liquidation. This caused the bankruptcy of Barings, one of London's oldest and most distinguished banks, and helped start the Asian contagion of the late 90s.

### **The weak regulation link**

The SEC recognizes trouble brewing in the proliferation of hedge funds, so they have adopted expanded investment advisor registration rules effective in February 2006. (See "Size doesn't always matter," *Active Trader*, October 2005.)

The problem is hedge funds are only lightly regulated as private securities; they are exempt from the heavy regulation and oversight of public securities.

The SEC's expanded advisor rules for registration help ensure that thousands of currently unregistered investment advisors to U.S.-based hedge funds must register for this light regulation. In light of these recent debacles, current industry and media consensus indicates larger hedge funds should be subject to heavier regulation and smaller funds should remain lightly regulated, as is the case now.

It's very unlikely a smaller fund could start a financial storm that could cause damage beyond its investment base. However, it's quite possible larger hedge funds could cause shocks to the markets.

Because of their limited regulation, hedge funds are free to act quickly in the markets and they are compensated for it more than mutual funds.

For example, unless a mutual fund is specifically set up as a short fund, it cannot short stocks. A hedge fund, on the other hand, is free to do whatever it wants (although it must disclose its trading programs in its offering documents). Mutual-fund fees are very restricted and fairly low, whereas hedge fund fees can be whatever the market will pay. These factors create an environment that can foster unnecessary risk and inappropriate market behavior.

Consider the Refco debacle. According to the federal criminal complaint, Refco's CEO allegedly hid trading losses and debts in a separate company he controlled and then went on to further hide the debt in a New Jersey hedge fund.

The SEC regulates U.S.-based securities hedge funds with more than \$25 million under management (current news indicates the SEC may raise it to \$50 million); otherwise, states regulate hedge funds and investment advisors underneath that amount. The CFTC regulates U.S.-based commodities and futures hedge funds, regardless of size.

The SEC and CFTC don't regulate international funds, although other jurisdictions do, such as the UK and most tax-haven countries. The SEC and CFTC also don't regulate spot forex and custom derivatives, as these instruments aren't traded on U.S. exchanges.

Hedge funds often trade forex and derivatives, and most use international funds as well. Therefore, hedge funds can operate largely outside of the regulatory reach of the SEC and CFTC.

The regulators cannot fully protect your hedge-fund invest-

ment. And while audits are necessary and helpful, they don't guarantee anything. Plus, unlike savings accounts that belong to the Federal Deposit Insurance Corporation (FDIC), there is no insurance for hedge-fund investments.

### **One state turns up the heat**

There is a new trend for states to act in their own best interests (including tax and regulatory matters), even when they may step on established federal turf. It's a big factor in recent tax reform legislation (see "What's in your tax future?" *Active Trader*, December 2005). And it's happening now on the hedge-fund regulation front.

A recent *Wall Street Journal* article ("In Connecticut, A New Cop Walks Hedge-Fund Beat") states Connecticut Attorney General Richard Blumenthal "is putting hedge funds on notice that pending changes from the SEC don't go far enough, and he is preparing to do something about it."

In the article, Blumenthal says, "The SEC rules are just not that demanding. We're looking to achieve a greater measure of scrutiny and oversight, particularly in regards to conflicts of interest." Blumenthal says his goal is to protect smaller investors exposed to hedge funds.

### **Are auditors enough?**

Audit firms are overworked and undermanned, thanks to Sarbanes Oxley, a bill passed in 2002 that regulates corporate governance. Plus, there is a brain drain and revolving door with regard to audit-firm CPAs, who often jump ship and join hedge funds. Few CPA firms specialize in hedge-fund audits.

Another problem is that, not withstanding a CPA firm's ability to digest and handle any complexity of transaction, financial trading transactions are among the most complex and hard to decipher. The public can't always count on audited financial statements — there have been too many blown audits. Investors must protect themselves.

U.S. banks pay very low corporate taxes, yet they report record profits every year. How can that be the case? These banks have been known to shift trading profits from high taxing jurisdictions to offshore tax-free havens.

Many larger financial institutions have global operations and affiliate companies operating around the world, and their business is mostly operated virtually. Money and virtual transactions move at great speeds; it's easy to shift profits and transactions from one party to another.

Financial institutions have also been known to delay the reporting of losses and hide them from auditors. For example, consider the Japanese banking crisis of the 90s. Japan's recession was prolonged because banks would not report their bad loans and related losses. Many economists argue China has the same problem now.

### **What happens when the musical chairs stop?**

If there is a financial crisis and large losses appear from behind the woodwork, where do you think those losses may have been hidden? One good guess is in larger hedge funds.

*continued on p. 84*

Whenever there is a market-changing event, it's to be expected that some fund portfolios will face a liquidity crisis. The word "hedge" should be removed from hedge funds, as most today are not hedged and it's a misnomer inviting false security.

The other big point is that hedge funds are the weakest link in terms of regulation and the most likely to consider aggressive transactions with great risk — for the highest reward possible.

It's no secret that some hedge funds wheel and deal with brokers and banks in the great financial musical chairs trading game, and all these counter parties may exacerbate the risk in hedge funds. There are ways for hedge funds to spread the wealth from this type of gamesmanship. A hedge fund can give the lion's share of its commission and borrowing business to a certain broker to reward them for special deals and access. They can find ways around the best execution rules to stay in compliance. Don't be naïve, this stuff happens.

### You can't react fast enough

The Refco debacle ushered in a new era of shoot-to-kill first, ask questions later. Prior to Refco, it took weeks or months for a financial crime to unfold and for corrective action to happen. There was time for a Federal Reserve chairman and/or others to arrange a "rescue" package.

This all changed with Refco's demise. Within a span of just a few days, the problem was publicized, and even before people could figure out the nature and extent of the problem, Refco's customers' assets were frozen and the firm was plunged into bankruptcy.

### How to protect yourself

When push comes to shove in a market crisis, your hedge - fund investment can disappear in a hurry. The following tips will help safeguard your investments:

1. Due diligence is paramount. Due diligence does not include being impressed with fancy offices, cars, planes, and other trappings of wealth (i.e., the Bayou hedge-fund fraud). Due diligence also doesn't include relying on the smarts of other investors. If a third party supports the investment, question if they are being compensated to do so. Due diligence is accomplished by asking tough questions about all the facts, circumstances, and conditions. Plus, everything the hedge fund does needs to be transparent — i.e., it needs to be out in the open for everyone to see.
2. Say no to dangerous or overly complex trading programs. A good performance record is an absolute must, but it's not enough. You should understand the trading program disclosed and make sure the manager adheres to it. Many new funds harp on a unique discovery they have made to beat the markets. Skip the stories and invest in proven techniques that generate gains consistently. If the trading program involves highly complex derivatives and other arcane instruments, be skeptical. If it involves a great deal of private market investments, skip that too. There are too many ways to fool the investors.

Due diligence applies to a manager too; their (suitability) rules require that investors rise to the level of suitable dollars and knowledge. If a manager does not check

their investors in this manner, it's a sign of carelessness.

3. Take profits early. It's wise to take your profits as distributions each year if you can. If a manager cannot honor withdrawal requests, it's a sign of trouble. Managers tend to run in streaks — they have good and bad years as market conditions change.
4. Diversify and respect your asset allocation model. Don't invest all your aggressive, high- risk assets into one fund or series of funds from one manager. Choose the right trading program at the right time. If forex is hot, consider a forex-trading program. If there is a bear market, choose a manager that does well in bear markets.
5. Get tax benefits as a passive investor. Most hedge funds are investment partnerships (LLCs or LPs) for tax purposes. Join as a passive member or partner so you are not liable for firm-wide losses or debts. Offering documents are geared to passive investors only. In case of a blowup, being passive protects you legally and all you can lose is your investment (not more).

Many hedge funds pass realized capital losses and investment expenses through to their investors. The problem is that many investors get few tax benefits on these losses and expenses. For example, the investor may not have sufficient capital gains from other sources to offset their hedge fund capital losses, and they are subjected to the onerous capital loss limitation of \$3,000 per year.

Investment interest expenses can only be deducted against investment income, and investment expenses are only deducted in excess of 2 percent of adjusted gross income. Plus there are itemized deduction limitations and investment expenses are not deductible for the alternative minimum tax. They can be significant as they include management fees.

6. If a fund trades on an intraday basis, it may qualify for business tax treatment (trader tax status). With business tax treatment, expenses are ordinary business expenses rather than investment expenses. Ordinary expenses are eligible for full deduction, whereas investment expenses have deduction restrictions.
7. Elect mark-to-market (MTM) accounting for business trading funds. This converts capital gains and losses into ordinary gains and losses. This is preferable only if the fund trades stocks.

What happens when a fund blows up and you lose your remaining capital? Note that your book capital may be higher or lower than your tax basis, because of unrealized gains or losses. By default, you have a capital loss on your unreturned tax basis. There may be limited ways to explore ordinary loss treatment, but you need to consult a tax advisor.

Hedge funds have added excellent liquidity to the markets and are an exciting alternative investment for savvy investors willing to do their homework. It's important to increase your due diligence in the face of increased hype. Try to avoid risky investments and keep an eye out for tax benefits. 📌