

Notice to Members

FEBRUARY 2003

SUGGESTED ROUTING

Legal/Compliance
Retail
Senior Management

INFORMATIONAL

NASD Reminds Members of Obligations When Selling Hedge Funds

KEY TOPICS

Hedge Funds
Funds of Hedge Funds
Suitability
Due Diligence
Internal Controls
Supervision
Training

Executive Summary

As a result of a recent review of members that sell hedge funds and registered products (closed-end funds) that invest in hedge funds ("funds of hedge funds"), NASD staff is concerned that members may not be fulfilling their sales practice obligations when selling these instruments, especially to retail customers. In issuing this *Notice to Members*, NASD reminds members of their obligations when selling hedge funds and funds of hedge funds, including: (1) providing balanced disclosure in promotional efforts; (2) performing a reasonable-basis suitability determination; (3) performing a customer-specific suitability determination; (4) supervising associated persons selling hedge funds and funds of hedge funds; and (5) training associated persons regarding the features, risks, and suitability of hedge funds.

Questions/Further Information

Questions regarding this *Notice* may be directed to Daniel Sibears, Senior Vice President and Deputy, Member Regulation, NASD Regulatory Policy and Oversight, at (202) 728-6911, or Gary L. Goldsholle, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8104.

03-07

Discussion

Background

With the recent surge in the popularity of hedge funds, NASD is concerned about the sales practices of certain members selling direct interests in hedge funds and indirect interests through funds of hedge funds.¹ This *Notice to Members* highlights members' obligations when recommending hedge funds and funds of hedge funds to retail investors.²

Most investment funds constitute "investment companies" under the Investment Company Act of 1940 ("IC Act") and are registered with the Securities and Exchange Commission (SEC). The registration of investment companies provides investors in the fund with a panoply of disclosures and protections, including regulations that, among other things: (1) require a certain degree of liquidity; (2) limit how much can be invested in any one investment; (3) require that fund shares be redeemable; (4) protect against conflicts of interests; (5) assure fairness in the pricing of the fund shares; (6) require disclosure of information about a fund's management, holdings, fees and expenses, and performance; and (7) limit the use of leverage.

In addition, registered investment companies generally conduct public offerings of securities that are registered with the SEC under the Securities Act of 1933 (the "'33 Act"). This registration of the securities under the '33 Act provides further investor protection by virtue of the disclosure requirements that pertain to the characteristics and risks of the securities being offered.

By contrast, most hedge funds are investment companies that are not

registered pursuant to certain exemptions under the IC Act.

Furthermore, the securities offered by hedge funds, in most cases, are exempt from registration under the '33 Act. Typically, hedge fund offerings are conducted as private placements under Regulation D under the '33 Act. Because neither the hedge fund nor the securities offered are registered, the range of protections attendant to such registrations are not provided; consequently, such securities may only be offered privately to certain qualified investors who meet the financial standards promulgated in the exemptions of the investment company and the securities from registration.

By comparison, certain funds of hedge funds are registered with the SEC under the IC Act and offerings of their securities registered under the '33 Act. Nevertheless, since the underlying investments are in unregistered hedge funds, these funds of hedge funds pose many of the same risks to investors.³ This presents a particular concern because registered funds of hedge funds may be offered to investors meeting far lower financial thresholds than those investors eligible to invest directly in the underlying unregistered hedge fund. In addition, the minimum investment levels for registered funds are significantly lower than that for unregistered hedge funds, sometimes as low as \$25,000. (Unregistered hedge funds generally have had investment minimums of \$1,000,000.)

There are wide differences between the fees associated with investments in registered hedge funds and those in unregistered hedge funds. Managers of unregistered hedge funds may receive both a management fee, which is a fee based on the percentage of assets under management, and a carried interest,

which is a direct percentage interest in the profits earned. The total of these fees is significantly more than those normally associated with the securities offered by registered investment companies.

Beyond the distinctions between registered and unregistered hedge funds, NASD is concerned about the offering of hedge funds as an asset class to retail investors. Specifically, NASD believes that members should take into account the fact that hedge fund investing historically has been available only to high net worth individual investors and institutions and consider whether the fact that certain hedge funds are now available to a broader segment of investors may itself be a red flag that casts doubt on the desirability and suitability of such funds for retail investors.

NASD's review revealed that some members may not be fulfilling their sales practice obligations when selling hedge funds (or funds of hedge funds). Furthermore, NASD also is concerned that customers may not fully understand the risks associated with hedge funds. In particular, NASD would like to remind members of their obligations concerning the sale of hedge funds in the five following areas: (1) Promotion of Hedge Funds; (2) Reasonable-Basis Suitability; (3) Customer-Specific Suitability; (4) Internal Controls; and (5) Training.

Promotion of Hedge Funds

Sales material and oral presentations that promote hedge funds (or funds of hedge funds) raise particular investor protection concerns. NASD reminds its members that the promotion of hedge funds must be balanced by a fair presentation of the risks and potential disadvantages of hedge fund investing.

For example, members may not claim that hedge funds offer superior professional management with more investment flexibility, protection against declining markets, and better returns due to the imposition of performance fees (e.g., fees charged by the hedge fund adviser based on the fund's investment performance), unless these statements are fair, accurate, and without exaggeration. In addition, members must balance sales material or oral presentations that promote the advantages of hedge fund investing with full disclosure of the risks that hedge funds present, including, as applicable, the fact that hedge funds (or funds of hedge funds):

- ♦ Often engage in leveraging and other speculative investment practices that may increase the risk of investment loss;
- ♦ Can be highly illiquid;
- ♦ Are not required to provide periodic pricing or valuation information to investors;
- ♦ May involve complex tax structures and delays in distributing important tax information;
- ♦ Are not subject to the same regulatory requirements as mutual funds; and
- ♦ Often charge high fees.

Members also must provide investors with any prospectus or other disclosure document of the hedge fund (or fund of hedge funds). Members should bear in mind, however, that providing a prospectus does not satisfy the duty to provide balanced sales materials and oral presentations.

Reasonable-Basis Suitability

Under reasonable-basis suitability, a member that recommends hedge funds, directly or indirectly, must have a belief that the product is suitable for any investor. Members discharge this requirement by conducting due diligence with respect to the hedge fund, or in the case of a fund of hedge funds, with respect to the underlying hedge funds. Due diligence is especially important for hedge funds because, as noted above, many hedge funds are not registered as investment companies and are offered through unregistered private placements. Members therefore have a heightened responsibility to investigate the hedge funds and funds of hedge funds that they recommend to customers. Members must perform substantial due diligence into a hedge fund before making any recommendation to a customer, including, but not limited to: an investigation of the background of the hedge fund manager, reviewing the offering memorandum, reviewing the subscription agreements, examining references, and examining the relative performance of the fund. Finally, NASD is concerned about the offering of hedge funds as an asset class to retail investors. Specifically, NASD believes that members should take into account the fact that hedge fund investing historically has been available only to high net worth individual investors and institutions and consider whether the fact that certain hedge funds are now available to a broader segment of investors may itself be a red flag that casts doubt on the desirability and suitability of such funds for retail investors.

Customer-Specific Suitability

To satisfy the requirement of customer-specific suitability, a member must determine that its recommendation³ to invest in a hedge fund or a fund of hedge funds is suitable for that particular investor.⁴ Under NASD Rule 2310, members must ensure that a recommendation is suitable for a specific customer by examining (1) the customer's financial status, (2) the customer's tax status, (3) the customer's investment objectives, and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. NASD's review of members revealed that some firms rely heavily on an investor's status as an accredited investor under Regulation D of the '33 Act as the single criterion for satisfying their suitability obligations in connection with the sale of hedge funds. A customer's specific level of assets does not, by itself, satisfy a member's obligations under the suitability rule.⁵ Members and their associated persons must examine the factors listed in NASD Rule 2310 prior to making any recommendation.

Internal Controls

A member's internal controls, including supervision and compliance, must ensure that sales of hedge funds and funds of hedge funds comply with all relevant NASD and SEC rules. Members must include written procedures for supervisory personnel to review compliance with NASD and SEC rules, the accuracy of information gathered, and the appropriateness of the suitability determinations made by their associated persons. Beyond establishing written

supervisory procedures, members also must be able to demonstrate adherence to such procedures.

Training

Members must train associated persons about the characteristics of and risks associated with hedge funds before they allow associated persons to recommend hedge funds or funds of hedge funds. Educational pamphlets, videos, intranet systems, in-person lectures, and explanatory memos are all appropriate vehicles for training. The training may vary based on the type of firm and the firm's size, customer base, and resources. NASD urges any member that sells hedge funds to include hedge funds as part of the Firm Element of their Continuing Education Program.

Conclusion

Hedge funds are complex investment vehicles, which are often risky and lacking in transparency. Consequently, many investors, especially retail investors, may not understand the risks associated with investing in hedge funds and funds of hedge funds. Given these considerations and the fact that certain hedge funds are for the first time being offered to a broader investor segment, NASD considers it essential that members reach an initial determination about the suitability of such funds to any retail investors before performing an individual suitability assessment. Members also must ensure that any promotional efforts of hedge funds or funds of hedge funds are fair and balanced. Finally, members must properly supervise and train all associated persons selling these products to ensure that associated persons comply with applicable securities laws.

Endnotes

- 1 For purposes of this *Notice to Members*, a hedge fund can be described as a private and unregistered investment pool that accepts investors' money and employs sophisticated hedging and arbitrage techniques using long and short positions, leverage and derivatives, and investments in many markets. Hedge funds vary in size and trading strategies, including categories such as: relative value hedge funds, event driven hedge funds, equity hedge funds, global asset allocator hedge funds, short selling hedge funds, sectoral hedge funds, and market neutral hedge funds.
- 2 See also NASD Investor Alert, *Funds Of Hedge Funds - Higher Costs And Risks For Higher Potential Returns* (Aug 23, 2002) at http://www.nasdr.com/alert_hedgefunds.htm
- 3 While funds of hedge funds offer a greater degree of diversification, they still present the same concerns as investments in hedge funds directly.
- 4 Acting as a placement agent may still bring a member within the term "recommendation." NASD has previously stated, "In particular, a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of a customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic materials." *Notice to Members 96-60* (Sept. 1996). Bringing a specific hedge fund to the attention of a customer therefore may constitute a recommendation.
- 5 NASD's suitability rule states that in recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer. As the rule states, a member's suitability obligation applies to securities that the member "recommends" to a customer. See *Notice to Members 01-23* (Apr. 2001).

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- 6 See *Patrick G. Keel*, 51 S.E.C. 282, 286 n.14 (1993) (“[E]vidence of wealth, as we have stated previously, is not an indicator of suitability.”); *Arthur J. Lewis*, 50 S.E.C. 747, 749 (1991) (“The fact that a customer . . . may be wealthy does not provide a basis for recommending risky investments”)

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