Hedge Fund Due Diligence

Resources to Help Investors Better Understand Their Investment Options in this Asset Class

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Overview

Recent changes relating to the way investments in hedge funds may be offered and sold may mean that you will be hearing more about these types of investments.

While these changes will generally mean more transparency and communication about these types of investments, it may also mean that investors will hear more about them than they previously did.

With this in mind, MFA produced the following presentation to help provide investors with information, tips and resources to help make sure they make informed investment decisions.

This presentation does not – in any way – evaluate any specific investment opportunity, nor does it provide a way to evaluate any individual fund manager's capabilities. It is simply intended as a guide with helpful information and external resources for individuals and organizations to reference as they contemplate investment opportunities.

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Why am I hearing more about hedge funds recently?

A recent change to federal law, called the Jumpstart Our Business Startups (JOBS) Act, permits hedge fund managers to advertise and provide information about their funds to the general public.

It is important to remember, however, that only sophisticated investors who meet high net worth or income thresholds may actually invest in hedge funds.*

**Prior to the JOBS Act legislation, hedge funds were prohibited by law from engaging in any activity that could be interpreted as general solicitation or advertising of fund interests. The JOBS Act removes this prohibition. The U.S. Securities and Exchange Commission (SEC) has finalized rules to implement the JOBS Act which will become effective in September 2013.*

2 What is a hedge fund?

A hedge fund is a pooled investment vehicle through which individuals and institutions invest their money. Hedge funds engage in a wide range of strategies and investments to achieve their investment objectives and hedge funds vary in strategies and trading activities from each other.

Hedge funds differ from other investment products, such as mutual funds, in that they are designed only for sophisticated individual and institutional investors, such as pensions, endowments, and foundations.

While hedge funds resemble other pooled investment products like mutual funds, they differ in very significant ways. Hedge funds are regulated differently than mutual funds, and are not restricted in their investment strategies like mutual funds. Hedge funds generally restrict an investor’s ability to withdraw funds, and they also can invest in a wider range of asset classes.

For these reasons, hedge funds may only be sold to sophisticated individual and institutional investors.

3 How are hedge funds different than mutual funds?

Hedge fund investment is limited to investors who typically qualify based on a high-threshold income or net worth test for individuals, or total asset test for institutions such as large pension funds and university endowments, which represent the majority of hedge fund assets.

Hedge funds limit the ability of investors to withdraw or redeem their investments and do not offer the same liquidity as mutual funds or other investments. Accordingly, investors should be able to invest for a longer time period and must understand the frequency of the redemption rights. In addition, other restrictions may also apply to redemptions, such as notice requirements and fees.

Minimum investments in a hedge fund may be significant in some cases.

Fees are typically much higher for hedge funds than other types of investments.

Many hedge fund managers invest significant amounts alongside their investors.

Because of these differences, and the recent changes under the JOBS Act, MFA developed this resource to remind potential investors of the need for scrutiny of investment opportunities and their promoters before making a decision whether to invest.

4

I saw an advertisement for a hedge fund. May I invest?

To invest in an advertised hedge fund, you must be an **accredited investor**.

To be an **accredited investor** you must have:

- A net worth, or a joint net worth with your spouse of over $1,000,000 (excluding your primary place of residence), or
- An income in excess of $200,000 in each of the two most recent years or joint income with your spouse in excess of $300,000 in each of those years and a reasonable expectation of reaching the same income level in the current year.

Investors may need to meet other requirements to invest in a hedge fund.

For more information on how exactly the U.S. Securities and Exchange Commission (SEC) defines accredited investor, click here.

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Someone claiming to be an investment adviser invited you to invest in his hedge fund and said he can “work with you” to meet the accredited investor standard. Is this okay?

You must be an accredited investor to invest in a hedge fund that is being advertised. No one may “skirt” the accredited investment standards or combine investments (bundle) to avoid the minimum net worth requirements.

In other cases, such as if someone you know asks you to invest in a hedge fund, it is strongly recommended that you <u>only invest in a hedge fund if you are an accredited investor</u>.

6

I am an "accredited investor." What are some of the precautions I should take before I invest in a hedge fund?

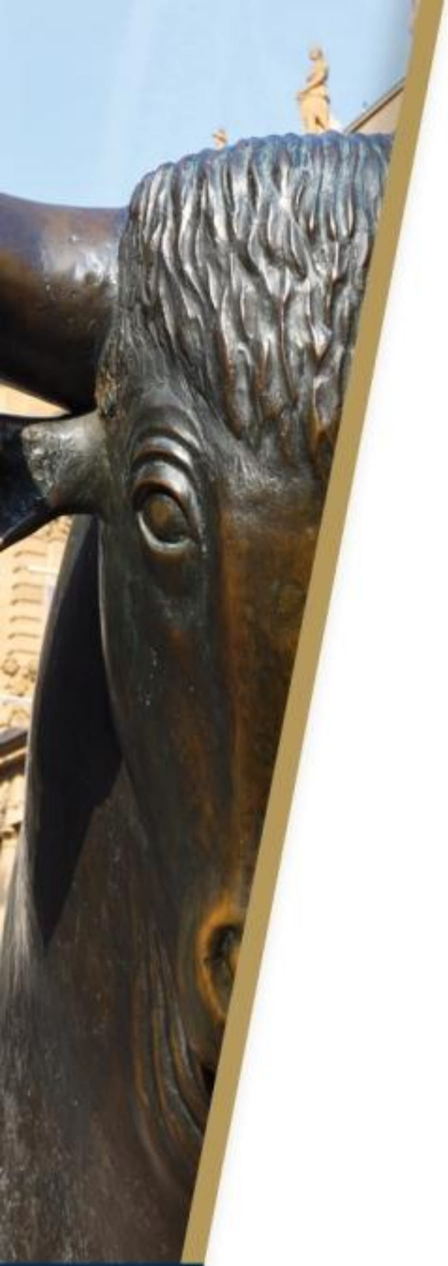
Income and other related requirements governing hedge fund investments are designed to ensure that hedge funds are only accessible to sophisticated investors with investment experience, considerable investible capital, and access to experts to advise them on the prudence of investments.

Unfortunately, unscrupulous people occasionally try to disguise their deceptive schemes as hedge funds, in an attempt to lure investors for their money.

Accordingly, before you invest in a hedge fund, you should assure yourself that you understand and are comfortable with the investment strategy and risk profile and are familiar with the advisers and investment professionals managing the fund, including their reputation and background.

Pay particular attention to whether a fund adviser has a checkered history with law enforcement or regulators.

You should also be wary that an individual with criminal intent may deceptively appear to be related to a particular registered adviser, when in fact it is a sham and not affiliated in any way with the registered entity.



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How can I begin to research a specific hedge fund manager?

Generally speaking, a hedge fund manager must be registered with the Securities and Exchange Commission (SEC) or a state securities commission as an investment adviser.

Larger advisers register with the SEC; smaller advisers generally register with the state securities commission in the state in which they are located.

- You can search for the manager (investment adviser) on the SEC's Investment Adviser Public Disclosure website.
- If the adviser is listed, you can read about the adviser's background, including any disciplinary record.
- Advisers registered with the SEC must complete a Form ADV, providing information about the business, ownership, clients, etc. You may read that form for each manager listed. Check the "gatekeepers" or service providers who perform critical roles for the firm, including the firm's auditor, prime broker, custodian and outside law firm.
- Generally, smaller advisers (those managing less than $100 million in assets) that are not registered with the SEC should be registered with the state securities commission in the state. You can search for state securities regulators through the North American Securities Administration Association website.
- In addition, the due diligence process should involve things such as understanding of the investment strategy of the fund, learning more about the principals managing the fund, visiting the fund's offices if possible, having your lawyer and / or accountant read any of the legal documents before you invest, and developing an understanding of the historical tax treatment of the fund's returns.

8

What should I do if I can’t find any information about an investment adviser or hedge fund manager?

<u>Be careful!</u>

If there is no SEC or state information about an adviser, it means it is not registered with the SEC or a state securities commission.

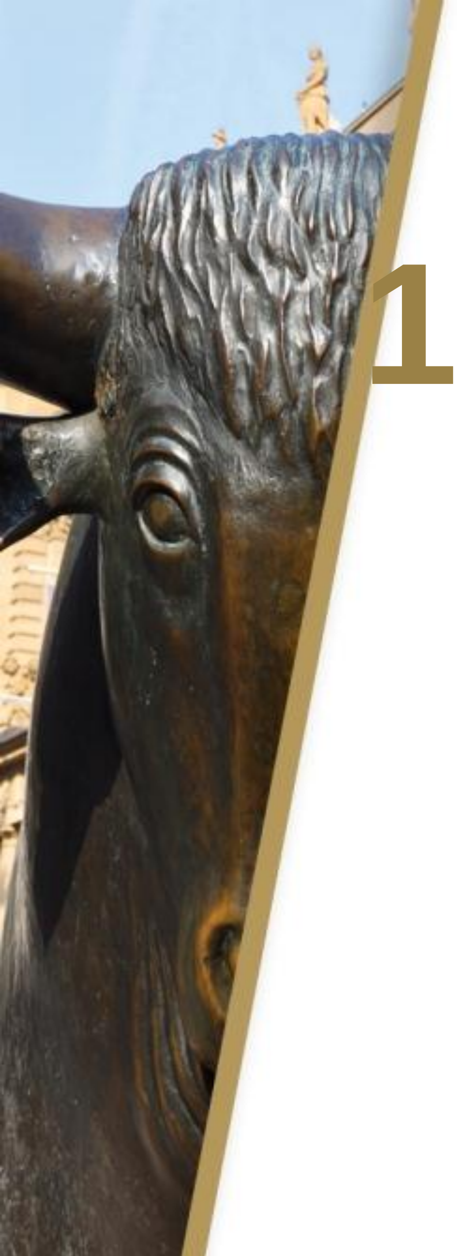
While there may be legitimate reasons for an adviser not to be registered, <u>it is a strong indication that you should conduct additional research about the adviser.</u>

At a minimum, you should ask the adviser why it is not registered. It would also be a good idea to explain that you would be more comfortable if it were registered.

9 Why wouldn’t an adviser be registered?

One reason an adviser may not be registered with the SEC or a state securities commission is if it is based in another country.

Such an adviser may be registered in the country where it is based, but you may not have the protections of U.S. law if you invest with that adviser.



10 What else should I consider before investing?

Registration with the SEC or a state securities commission is not a guarantee of anything. Just because a manager is registered does not mean that the manager is appropriate for your needs. Registration is not an assurance that the manager will be successful – no one can promise that.

Do not invest without careful consideration!

- Hedge fund managers typically offer shares in the fund on the basis of a private placement memorandum (PPM).
- Most PPMs are lengthy legal documents that lay out the rights and obligations of the manager, the investor and the fund's characteristics.
- You should consider reviewing the PPM with your financial adviser, accountant and / or attorney.
- When reviewing a PPM, investors should pay close attention to the section of the memorandum that describes all of the potential risks of investing in the hedge fund.
- This section is often lengthy, but is important for potential investors to fully understand the risks of investing.

Red flags

Although most hedge fund managers are legitimate, as with any other types of investments, investors must be careful with their decisions as to whom they give their money to invest. Here are some “red flags” that, if present, should lead to greater research and caution before investing:

- **The manager is applying pressure to make an investment immediately.**
    - Generally, hedge fund managers understand that it takes time for an investor to review an investment. Applying pressure or claiming that the opportunity is limited may be a sign that something is amiss.
- **The manager guarantees a high return.**
    - No one can or should guarantee a return of any kind, particularly one that seems too good to be true.
    - If a manager shows you performance history that is too good to be true, it probably is; a fund claiming to be able to generate returns no matter what is likely a fraud.
- **The manager encourages you to lie about your assets / income to meet the “Accredited Investor” test.**
    - A manager that encourages fudging or lying is a sign of untrustworthiness.
    - If you have to lie to be able to invest, it is a sign that the investment is not appropriate for you.
- **You cannot find information about the manager on the SEC website or through any state securities commission.**
    - Ask the manager why it isn’t registered and ask for additional information about the fund.

MFA has prepared an investor due diligence questionnaire for investing in hedge funds.

The questionnaire is designed to identify the kinds of questions that a potential investor may wish to consider before investing in a hedge fund.

For example:

Q: Is the firm currently aware of any pending criminal or administrative proceedings against the firm, a principal or key employee of the firm, or any affiliate of the firm?

Q: Does the firm have any affiliates or subsidiaries that are broker-dealers or execution agents? If yes, do these broker-dealers or execution agents: (a) execute on behalf of investment vehicles managed by the firm; and (b) charge commissions or mark-ups on these executions or otherwise bill expenses to investment vehicles managed by the firm in instances in which the investment vehicle is not the sole owner of the execution agent or broker-dealer?

Q: What is the firm's risk management philosophy and the approach used by the firm in the management of the fund's exposure to: equity, interest-rate, currency, and credit market risk (as applicable); financing and counterparty risk; and operational risk?

If you are not familiar with these or any other questions in the questionnaire, you may want to consider learning more before investing.

Invest Carefully

This guide is not meant as specific investment advice.

Rather, it should help educate you about hedge fund basics and provide resources for additional research before investing.

Hedge fund investments may be an important part of an investor's overall investment portfolio. Many sophisticated individuals and institutional investors have successfully invested in hedge funds as a way to meet their financial goals and investment objectives, and manage risk.

However, hedge fund investing is not for everyone. It may be risky and care must be taken to carefully research and select appropriate funds in which to invest.

Consult with your financial adviser, accountant, or attorney before making any investment.

Here are some additional resources you may wish to consult before investing:

- MFA’s due-diligence questionnaire for investors.
- The SEC’s definition of accredited investor.
- The SEC’s Investing Basics website.
- The SEC’s Investment Adviser Public Disclosure page – registration of fund advisers can be found here.
- Contact information for state securities regulators – as provided by the North American Securities Administrators Association (NASAA).