MARKETS

SEC Finds Deficiencies at Hedge Funds

Shortcomings Include Valuation 'Flip Flopping'

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PHILADELPHIA—Recent examinations of hedge funds have uncovered a range of problems, a top Securities and Exchange Commission official said, including firms boosting their performance, and the fees they collect, by changing the way they value investments.

Andrew Bowden, the director of the SEC's Office of Compliance Inspections and Examinations, said the agency has found a series of deficiencies at the roughly 185 hedge-fund firms in which it completed exams.

The findings come as the SEC begins more closely scrutinizing hedge funds, which have historically operated with less oversight than other investment managers. The agency, in the wake of the 2010 Dodd-Frank financial-overhaul law, has begun requiring a wider swath of hedge funds and private-equity funds to register with the agency and provide detailed data on trading. Agency officials have vowed to examine about 400 of the roughly 1,500 newly registered advisers, and Mr. Bowden said the agency is on track to meet that goal by year-end.

Mr. Bowden, who spoke at an investment advisory conference sponsored by industry newsletter IA Watch, said regulators have discovered some funds engaging in what he called "flip-flopping," boosting valuations by changing the way they measure holdings several times a year. In some instances, the funds chose the measurement with the highest value or intentionally classified certain assets in a way that gave the fund manager more flexibility to inflate the price of the fund's holdings.

The moves may have helped hedge funds collect higher fees because they are based in part on a fund's performance. Hedge funds traditionally collect an annual performance fee of 20% or more of the trading profits they make for clients, in addition to a flat annual management fee of about 2%.

The changes have raised red flags at the SEC because investors may not be aware of the differing methods for valuing assets, Mr. Bowden said. SEC staff discovered hedge funds aren't always precise or specific when they tell clients how they evaluate securities and other assets.

Mr. Bowden declined to characterize the frequency of the alleged deficiencies and said some may stem from the complexity of the SEC's rules. He said some of the more egregious hedge-fund conduct was isolated, but didn't say if staff had referred individual firms to the agency's enforcement division. Funds could be forced to pay civil penalties if they are found to have broken SEC rules. Mr. Bowden said the agency is still finishing reviews and would more formally report on the specifics of the findings in coming months.

The SEC has sued funds for overly inflated valuations in the past. In 2012, the SEC charged the former $1 billion hedge-fund firm Yorkville Advisors LLC with planning to exaggerate its reported returns to hide loses and increase its fees earned. The litigation is pending.

Many hedge funds hold assets like real estate or defaulted debt, which trade hands so infrequently that it is up to the manager and its auditors to decide on current value.

"If you're trading an illiquid book, you may need to make certain assumptions," said Greg Farrington, partner at Constellation Advisers LLC, a compliance consultant to hedge-fund and private-equity firms. "It's not surprising that the SEC has focused on valuation and found deficiencies."

In addition to the valuation problems, Mr. Bowden said staff also uncovered marketing and advertising issues, with some firms potentially misleading clients on past performance by cherry-picking historical results.

Mr. Bowden told reporters the practices appear to violate SEC restrictions that require fund advisers to disclose all past investment decisions.

"You've got to tell them everything so you can't cherry-pick," he said.

Mr. Bowden also said some firms failed to comply with highly technical SEC rules governing the custody of assets they hold. He said the shortcomings didn't involve theft of fund assets and didn't involve hedge funds that manage money for pension funds and other large institutional investors, who have demanded robust policies on fund evaluations.

The deficiencies also appear less widespread than the inflated fees the agency found as part of a related set of examinations of private-equity firms. In a May speech on the results of the private-equity examinations, Mr. Bowden said the agency had identified "violations of law or material weaknesses in controls" in more than 50% of the exams where it looked at fees and expenses.

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