Order Code 94-511 E
Updated October 13, 2006

CRS Report for Congress

Received through the CRS Web

Hedge Funds: Should They Be Regulated?

Mark Jickling
Specialist in Public Finance
Government and Finance Division

Summary

"Perhaps never before in history have so few made so much money so fast."[1] These gilded few are the managers of a group of private, unregulated investment partnerships, called hedge funds. Deploying their own capital and that of well-to-do investors, successful hedge fund managers frequently (but not consistently) outperform public mutual funds. Hedge funds have many different investment strategies, but the largest and best-known funds engage in high-risk speculation in markets around the world. Wherever there is financial volatility, the hedge funds will probably be there.

Hedge funds can also lose money very quickly. In 1998, one fund — Long-Term Capital Management — saw its capital shrink from about $4 billion to a few hundred million in a matter of weeks. With the fund at the point of collapse, the Federal Reserve Bank of New York engineered a rescue by 13 large commercial and investment banks. Intervention was thought necessary because the fund's failure might have caused widespread disruption in financial markets and damage to the real economy. Despite the risks, investors have poured money into hedge funds in recent years. After considering the growing impact of hedge funds on a variety of financial markets, the Securities and Exchange Commission (SEC) in October 2004 adopted a regulation that requires hedge funds to register as investment advisers, disclose basic information about their operations, and open their books for inspection. The regulation took effect in February 2006, but on June 23, 2006, a court challenge was upheld and the rule was vacated. H.R. 5712 in the 109th Congress would reinstate the SEC's authority. H.R. 6079, which passed the House on September 27, 2006, calls for the President's Working Group on Financial Markets to conduct a study of the growth, risks, and benefits of hedge funds.

Hedge funds are essentially unregulated mutual funds. They are pools of invested money that buy and sell stocks and bonds and many other assets, including foreign currencies, precious metals, commodities, and derivatives. Some funds follow narrowly-defined investment strategies (e.g., investing only in mortgage bonds, or East Asian stock

[1] Dyan Machan and Riva Atlas, "George Soros, Meet A.W. Jones," *Forbes*, Jan. 17, 1994, p. 43.

markets), while others, the so-called macro funds, invest their capital in any market in the world where the fund managers see opportunities for profit.

Mutual funds subject to the Investment Company Act of 1940 must comply with a comprehensive and rigorous set of regulations designed to protect small, unsophisticated investors. These regulations include limits on the use of borrowed money, strict record keeping and reporting rules, capital structure requirements, mandated adherence to specified investment goals and strategies, bonding requirements, and a requirement that shareholder approval be obtained (through proxy solicitation) for certain fund business. An investment company becomes subject to this regulation only if it has 100 or more shareholders; hedge funds therefore generally limit themselves to 99 investors. The National Securities Market Improvement Act of 1996 (P.L. 104-290) broadened this exemption by permitting hedge funds to have an unlimited number of partners, provided that each was a "qualified purchaser" with at least $5 million in total invested assets.

Most hedge funds are structured as limited partnerships, with one or two general partners who also serve as investment managers. Hedge fund managers are often ex-employees of large securities firms, who strike out on their own in search perhaps of greater entrepreneurial freedom and certainly in search of greater financial rewards. Those rewards, even by Wall Street standards, can be extremely high. In addition to the return on his or her own capital, the typical hedge fund manager takes 15%-25% of all profits earned by the fund *plus* an annual management fee of 1%-2% of total fund assets. This performance-based compensation system imposes another requirement on hedge funds: they may accept only "qualified investors," defined by the Investment Advisers Act of 1940 as persons with a net worth of $1 million or more. Many hedge funds require a minimum investment of several hundred thousand dollars.

Data on hedge funds are available from several private sources, but estimates as to the size of the hedge fund universe vary considerably. Current estimates are in the range of 8,000 — 9,000 funds with over $1 trillion in assets under management.

Starting a hedge fund is relatively simple, and, with a few quarters of good results, new hedge fund managers can attract capital and thrive on performance and management fees. Because many of them make risky investments in search of high returns, hedge funds also have a high mortality rate. Studies find that the rate of attrition for funds is about 20% per year, and that the average life span is about three years.[2] In 2000, two of the best known macro funds — George Soros' Quantum Fund and Julian Robertson's Tiger Fund — shut down after failing to anticipate the end of the tech-stock boom.

---

[2] Many hedge funds bill themselves as low-risk, or "market-neutral," but these appear no less likely to fail. Steohen J. Brown, William N. Goetzmann, and Roger G. Ibbotson, *Offshore Hedge Funds: Survival and Performance, 1989-1995*, NYU Stern School of Business, Working Paper FIN 98-011, Jan. 1998, pp. 2 and 12.

Performance: Can Hedge Funds Beat The Market?

Estimates of the average annual return earned by hedge funds differ. Some studies find that they generally outperform common benchmarks such as the Standard & Poor's 500, but others conclude that they have lagged. The short life span of many funds creates obvious difficulties for measurement, including a strong surviviorship bias: the many funds that shut down each year are not included in return calculations. Annual return figures of course conceal a wide variation from year to year and from fund to fund. In any period, the law of averages dictates that at least a few funds will do spectacularly well. These success stories may explain the continued popularity of hedge funds with investors, despite the high fees that they charge, and the high risk of loss.

The Long-Term Capital Management Case

Hedge funds are understood to be high risk/high return operations, where investors must be prepared for losses. Investors who accept the risks are seeking high returns or a means to diversify their portfolio risk. As long as these investors are sophisticated and wealthy, as current law requires, hedge fund losses or even failures should not be a public policy concern. However, a 1998 case appears to be an exception to this rule.

Long-Term Capital Management (LTCM), a fund headquartered in Connecticut and chartered in the Cayman Islands, opened in 1994 and produced annual returns of over 40% through 1996. It was billed as a "market-neutral" fund, that is, its positions were based not on predictions of the direction of interest rates or other variables, but on the persistence of historical price relationships, or spreads, among different types of bonds. In 1998, however, turmoil in world markets, stemming from financial crises in Asia and Russia, proved to be too much for its computer models: during the month of August 1998 alone, the fund lost almost $2 billion, or about half its capital. By late September, LTCM was on the verge of collapse, whereupon the New York Fed stepped in and "facilitated" a rescue package of $3.6 billion cash contributed by 13 private financial institutions, who became 90% owners of the fund's portfolio.

Why was government intervention needed? The Fed cited concerns about systemic risk to the world's financial markets — while LTCM's capital was a relatively modest $3-4 billion (during the first half of 1998), it had borrowed extensively from a broad range of financial institutions, domestic and foreign, so that the total value of its securities holdings was estimated to be about $80-$100 billion. In addition, the fund supplemented its holdings of stocks and bonds with complex and extensive derivatives positions, magnifying the total exposure of the fund's creditors and counterparties, and making the effect of a general collapse and default difficult to gauge. If the fund (or its creditors) had tried to liquidate its assets and unwind its derivative positions in the troubled market conditions that prevailed, the result might have been extreme price drops and high volatility, with a negative impact on firms not directly involved with LTCM.

Critics of the Fed's action expressed concerns about moral hazard — if market participants believe they will be rescued from their mistakes (because they are "too big to fail"), they may take imprudent risks. To the Fed, however, the immediate dangers of system-wide damage to financial markets, and possibly to the real economy as well, clearly outweighed the risks of creating perceptions of an expanded federal safety net.

Policy Concerns

In the wake of the Long-Term Capital Management episode, systemic risk emerged as the major policy issue raised by hedge funds. The funds had demonstrated an ability to raise large sums of money from wealthy individuals and institutions, and to leverage those sums, by borrowing and through the use of derivatives, until they become so large that even U.S. financial markets may be at risk if they fail. Not all hedge funds borrow heavily and not all follow high-risk strategies. But many do, and there is no reason to think that other hedge funds will not amass positions as large and complex as LTCM's. In time, some of them can be expected to suffer equally spectacular losses. The systemic risk concerns may be summarized as follows:

- failing funds may dump billions of dollars of securities on the market at a time when the liquidity to absorb them is not present, causing markets to "seize up;"
- lenders to hedge funds, including insured depository institutions, may suffer serious losses when funds default — LTCM raised questions about their ability to evaluate the risks of hedge fund lending;
- default on derivatives contracts may cause disruptions in markets and may threaten individual counterparties in ways that are hard to predict, given the lack of comprehensive regulatory supervision over derivative instruments; and
- since little information about hedge fund portfolios and trading strategies is publicly available, uncertainty regarding the solvency of hedge funds or their lenders and trading partners may exacerbate panic in the markets.

LTCM illustrates the dangers of hedge fund failure. However, the funds' successes can also worry policymakers and regulators. Particularly in foreign exchange markets, manipulation by hedge funds has been blamed as a cause of instability (e.g., the European currency crises in the early 1990s and the Asian devaluations of 1997-1998). Hedge funds and other speculators can borrow a currency and sell it, hoping to profit if the currency is devalued (allowing them to repay with cheaper money). If the size of these sales and/or short positions is significant in relation to the country's foreign currency reserves, pressure to devalue can become intense. (To defend the currency's value may call for painful steps such as sharp increases in domestic interest rates, which have negative effects on the stock market and economic growth.)

In the United States, which has not been the target of such speculative raids, many economists and policymakers maintain that blaming hedge funds for currency crises is like shooting the messenger who brings bad news. They would argue that speculators simply exploit profit opportunities created by bad policies or fundamental economic problems. The effect of speculation on price volatility is an unresolved question in finance. While there has never been a conclusive demonstration that speculation *causes* volatility, the two are frequently observed together. Hedge funds, as the most visible agents of speculation in today's global markets, are looked upon by some regulators and market participants with a fair amount of suspicion: "Hedge funds have been caught

loitering near the scene of all the best-known accidents in the financial world in recent years."[3] Proximity, of course, does not prove responsibility.

Policy Responses and Proposals

In April 1999, the President's Working Group on Financial Markets, which includes the Fed, the SEC, the CFTC, and Treasury, issued a report on hedge funds.[4] The report cites the LTCM case as demonstrating that a single excessively-leveraged institution can pose a threat to other institutions and to the financial system. The report found that the proprietary trading operations of commercial and investment banks follow the same strategies in the same markets as the hedge funds, and they are much larger and often more highly-leveraged. The general issue, then, is how to constrain excessive leverage.

The Working Group concluded that more disclosure of financial information by hedge funds was needed. The report recommended that large funds be required to publish annual disclosure statements containing a "snapshot" of their portfolios and a comprehensive estimate of the riskiness of the fund's position, and that public companies and financial institutions should include in their quarterly and annual reports a statement of their financial exposure to hedge funds and other highly-leveraged entities.

In 2003, in response to continued rapid growth in hedge fund investment, an SEC staff report recommended that hedge funds be required to register as investment advisers.[5] The staff set out four chief benefits to mandatory registration:

- hedge funds registered as investment advisers would become subject to regular inspections and examinations, permitting early detection and deterrence of fraud;
- the SEC would gain basic information, which it now lacks, about hedge fund investments and strategies in markets where they may have a significant impact;
- the SEC could require registered hedge funds to adopt uniform standards and improve disclosures they make to their investors; and
- the Investment Advisers Act would prohibit registered hedge funds from charging performance-based fees, unless each investor had at least $750,000 in the fund or a net worth of $1.5 million. This is more restrictive than the current "qualified investor" standard, and would give the SEC a tool to limit the "retailization" of hedge funds and minimize the associated investor protection and suitability concerns.[6]

---

[3] Tom Pratt, "Hedge Funds: Jekyll or Hyde?" *Investment Dealers' Digest*, Dec. 14, 1992, p. 18.

[4] *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management,* Washington, Apr. 28, 1999.

[5] U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds: Staff Report to the U.S. SEC*, Sept. 2000, at [http://www.sec.gov/news/studies/hedgefunds0903.pdf].

[6] Instead of the traditional minimum investment of several hundred thousand, some now allow investors to put in as little as $10- or $20,000. Hedge funds-of-funds and registered investment pools are increasingly marketed not just to the "super-rich" but to the merely "mass affluent."

On October 26, 2004, the SEC adopted (by a 3-2 vote) a rule that requires hedge funds to register under the Investment Advisers Act.[7] The rule was controversial: opponents of registration argue that hedge fund investors are sophisticated and know the risks, that the SEC and other regulators already have authority to pursue hedge fund fraud, that systemic risk concerns are overstated, and that instead of trying to circumscribe hedge fund investment, the SEC ought to be encouraging registered mutual funds to adopt hedge fund investment techniques.

Nevertheless, the SEC expected registration to yield four chief benefits:

- the SEC will obtain basic, census-like data on the number of funds and the size of their portfolios;
- screening of individuals in the industry will permit the exclusion of those with a record of securities fraud;
- funds will be required to adopt compliance policies to prevent violation of the Investment Advisers Act; and
- examination of hedge fund advisers may allow the identification of compliance problems at an early stage, and will allow the SEC to anticipate problems and crises before they develop.[8]

The regulation fell short of what some critics of hedge fund behavior would have liked to see. The SEC would still not be able to monitor hedge fund trading in real time, and the possibility of another LTCM remains. However, the SEC explicitly decided against this course — the 2003 staff report found "no justification for direct regulation" and the adopted rule has "no interest in impeding the manner in which a hedge fund invests or placing restrictions on a hedge fund's ability to trade securities, use leverage, sell securities short or enter into derivatives transactions."[9]

The rules took effect on February 1, 2006, and some basic information on registering hedge funds appeared on the SEC website. However, on June 23, 2006, an appeals court found that the rule was arbitrary and not compatible with the plain language of the Investment Advisers Act, vacated it, and returned it to the SEC for reconsideration. SEC Chairman Cox instructed the SEC's professional staff to provide the Commission with a set of alternatives for consideration. H.R. 5712 in the 109th Congress would amend the Investment Advisers Act to restore the SEC's authority to require registration of hedge funds.

On September 27, 2006, the House passed H.R. 6079, which directs the President's Working Group to study the recent growth of hedge funds, the risk they pose, their use of leverage, and the benefits they confer, and to report to Congress within 180 days.

---

[7] See [http://www.sec.gov/news/press/2004-95.htm].

[8] Speech by Paul Roye, director, Division of Investment Management, Nov. 30, 2004. Online at [http://www.sec.gov/news/speech/spch113004pfr.htm].

[9] Ibid.