Hedge Funds: Should They Be Regulated?

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Summary

In an echo of the Robber Baron Era, the late 20th century saw the rise of a new elite class, who made their fortunes not in steel, oil, or railroads, but in financial speculation. 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 use 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. To prevent default, the Federal Reserve 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. Despite the risks, investors poured money into hedge funds in recent years, until market losses in 2008 prompted a wave of redemption requests.

In view of 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 required 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. In December 2006, the SEC proposed raising the "accredited investor" standard—to be permitted to invest in hedge funds, an investor would need $2.5 million in assets, instead of $1 million, but has yet to adopt a final rule.

Bills before the 111th Congress would require hedge funds to register with the SEC if their capital exceeded $50 million (S. 344) or $25 million (H.R. 711). S. 1276 would require registration of hedge funds, private equity firms, and venture capital funds, and would authorize the SEC to collect systemic risk data from them. H.R. 712 mandates more disclosure for pension funds that invest in hedge funds, and H.R. 713 directs the President's Working Group on Financial Markets to study the hedge fund industry. S. 506 and H.R. 1265 would change the tax treatment of offshore funds.

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Introduction

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 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.

Hedge funds are structured to avoid SEC regulation. To avoid becoming public issuers of securities, subject to extensive disclosure requirements, they accept funds only from "accredited investors," defined by SEC regulations as persons with assets of $1 million or more.

Hedge funds also avail themselves of statutory exemptions in the Investment Company Act of 1940, which governs public mutual funds. Mutual funds must comply with a comprehensive 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 is a "qualified purchaser" with at least $5 million in total invested assets.)

Most hedge funds are structured as limited partnerships, with a few 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.

Data on hedge funds are available from several private sources, but estimates as to the size of the hedge fund universe vary considerably. Before the financial crisis that began in 2007, estimates were in the range of 8,000-9,000 funds, with about $2 trillion in assets under management. Large numbers of funds have closed as a result of severe losses in the bear markets of 2008; George Soros, one of the best-known hedge fund managers, has estimated that the value of capital under management may shrink by 75%.[1]

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

[1] Imogen Rose-Smith, "The Credit Pandemic and the New World Order," *Alpha*, December 2008/January 2009, p. 26. See also Lawrence C Strauss, "Hedge Funds Meet Their Match," *Barron's*., January 5, 2009, p. 18.

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]

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 survivorship 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 extremely 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 provided 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.

[2] Many hedge funds bill themselves as low-risk, or "market-neutral," but these appear no less likely to fail. Stephen 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, January 1998, pp. 2 and 12.

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 sell billions of dollars of securities at a time when the liquidity to absorb them is not present, causing markets to "seize up";
- lenders to hedge funds, including federally insured banks, may suffer serious losses when funds default—LTCM raised questions about their ability to evaluate the risks lending to hedge funds;
- default on derivatives contracts may disrupt markets and may threaten hedge fund 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 or short positions is significant in relation to the target 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 argue that blaming hedge funds for crises is like shooting the messenger who brings bad news, and that speculators' profit opportunities are often created by bad economic policies. 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.

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.[3] 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, and 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 desirable. 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.[4] The staff set out several benefits to mandatory registration:

- funds registered as investment advisers would become subject to regular examinations, permitting early detection and deterrence of fraud;
- the SEC would gain basic information about hedge fund investments and strategies in markets where they may have a significant impact; and
- the SEC could require registered hedge funds to adopt uniform standards and improve disclosures they make to their investors.

On October 26, 2004, the SEC adopted (by a 3-2 vote) a rule to require hedge funds to register under the Investment Advisers Act.[5] The rule was controversial: opponents argued that hedge fund investors are sophisticated and know the risks, that the SEC already has authority to pursue hedge fund fraud, that systemic risk concerns are overstated, and that instead of trying to circumscribe hedge funds, the SEC ought to be encouraging registered mutual funds to adopt hedge fund investment techniques.

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 had "no interest in impeding the manner in which a hedge fund invests or placing restrictions on a hedge fund's

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

[4] U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds: Staff Report to the U.S. SEC*, September 2003, at http://www.sec.gov/news/studies/hedgefunds0903.pdf.

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

ability to trade securities, use leverage, sell securities short or enter into derivatives transactions."[6]

The rule 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.

Another issue involves the "retailization" of hedge funds.[7] As noted above, all fund investors must meet an "accredited investor" standard: they must have incomes of at least $200,000 and assets of $1 million. This threshold was established in the 1980s, and a much larger fraction of the population now meets the test, particularly since the $1 million includes the value of the investor's residence. The SEC has been concerned that relatively unsophisticated households may be putting their money in hedge funds, encouraged by market developments such as the introduction of funds-of-hedge funds, which accept smaller investments than traditional funds.

A related investor protection issue arises from the fact that pension funds and other institutional investors are placing more of their money with hedge funds, meaning that unsophisticated beneficiaries may be unwittingly at risk of significant hedge fund-related losses, if the plan fiduciaries are not prudent and cautious.

On December 13, 2006, the SEC proposed a regulation that would raise the accredited investor threshold from $1 million to $2.5 million in assets (excluding the value of the investor's home). If adopted, the rule would significantly reduce the pool of potential hedge fund investors, but would not be expected to have a strong impact on the largest funds, which do not depend on "mere" millionaires. The SEC received many unfavorable comments from investors who meet the current standard but would be excluded under the new limits: these investors do not wish to be protected from risks that the SEC might view as excessive. The SEC has yet to adopt a final rule raising the accredited investor standard.

In February 2007, the President's Working Group issued an "Agreement Among PWG and U.S. Agency Principals on Principles and Guidelines Regarding Private Pools of Capital."[8] The document expresses the view that policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk. The Agreement does not call for legislation to give regulators new powers or authorities to regulate hedge funds.

In December 2008, the revelation that a firm registered as both a broker/dealer and an investment adviser with the SEC, Bernard L. Madoff Investment Securities, had operated a multi-billion dollar Ponzi scheme raised new questions about the efficacy of market self-regulation. A number of hedge funds and funds-of-funds had placed billions of their clients' money with Madoff, but

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[6] Ibid.

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

[8] See http://www.treasury.gov/press/releases/reports/hp272_principles.pdf.

failed to detect the fraud.[9] The Madoff case prompted calls for more stringent regulation of investment advisers, including hedge funds.

The Obama Administration's 2009 white paper, *Financial Regulatory Reform: A New Foundation*, recommends that advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act. The advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability.[10]

Legislative Proposals

In the 109th Congress, the House passed H.R. 6079 (Representative Castle), which directed the President's Working Group to study the growth of hedge funds, the risks they pose, their use of leverage, and the benefits they confer. The Senate did not act on the bill.

In the 111th Congress, H.R. 711 (Representatives Capuano and Castle) would remove the exemption in the Investment Advisers Act for firms with fewer than 15 clients, which was the figure at the center of the 2006 *Goldstein* decision. This would require hedge funds with more than $25 million in client funds to register as investment advisers with the SEC.

H.R. 712 (Representative Castle) would require defined benefit pension plans to disclose their investments in hedge funds.

H.R. 713 (Representative Castle) directs the President's Working Group on Financial Markets to conduct a study of the hedge fund industry, and report to Congress with any recommendations regarding hedge fund regulation.

S. 344 (Senator Grassley) would limit the exemptions available under the Investment Company Act, requiring hedge funds with more than $50 million under management to register with the SEC.

S. 506 and H.R. 1265 would change the tax treatment of offshore funds.

S. 1276 would require managers of hedge funds to register as investment advisers, private equity firms, and venture capital funds, and would authorize the SEC to collect systemic risk data from them.

[9] Assuming they were not accomplices.

[10] Available online at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

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