

**The Regulation of Hedge Funds:
Financial Stability and Investor Protection**

by

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Introduction

While hedge funds have been around at least since the 1940's, it has only been in the last decade or so that they have attracted the widespread attention of investors, academics and regulators.

Investors, mainly wealthy individuals but also increasingly institutional investors, are attracted to hedge funds because they promise high “absolute” returns -- high returns even when returns on mainstream asset classes like stocks and bonds are low or negative. This prospect, not surprisingly, has increased interest in hedge funds in recent years as returns on stocks have plummeted around the world, and as investors have sought alternative investment strategies to insulate them in the future from the kind of bear markets we are now experiencing.

Government regulators, too, have become increasingly attentive to hedge funds, especially since the notorious collapse of the hedge fund Long-Term Capital Management (LTCM) in September 1998. Over the course of only a few months during the summer of 1998 LTCM lost billions of dollars because of failed investment strategies that were not well understood even by its own investors, let alone by its bankers and derivatives counterparties. LTCM had built up huge leverage both on and off the balance sheet, so that when its investments soured it was unable to meet the demands of creditors and derivatives counterparties. Had LTCM's counterparties terminated and liquidated their positions with LTCM, the result could have been a severe liquidity shortage and sharp changes in asset prices, which many feared could have impaired the solvency of other financial institutions and destabilized financial markets generally.

The Federal Reserve did not wait to see if this would happen. It intervened to organize an immediate (September 1998) creditor-bailout by LTCM's largest creditors and derivatives counterparties, preventing the wholesale liquidation of LTCM's positions. Over the course of the year that followed the bailout, the creditor committee charged with managing LTCM's positions

effected an orderly work-out and liquidation of LTCM's positions. We will never know what would have happened had the Federal Reserve not intervened.

In defending the Federal Reserve's unusual actions in coming to the assistance of an unregulated financial institutions like a hedge fund, William McDonough, the president of the Federal Reserve Bank of New York, stated that it was the Federal Reserve's judgement that the "...abrupt and disorderly close-out of LTCM's positions would pose unacceptable risks to the American economy. ... there was a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer. This would have caused a vicious cycle: a loss of investor confidence, leading to further liquidations of positions, and so on."¹

The near-collapse of LTCM galvanized regulators throughout the world to examine the operations of hedge funds to determine if they posed a risk to investors and to financial stability more generally. Studies were undertaken by nearly every major central bank, regulatory agency, and international "regulatory" committee (such as the Basle Committee and IOSCO), and reports were issued, by among others, The President's Working Group on Financial Markets, the United States General Accounting Office (GAO), the Counterparty Risk Management Policy Group, the Basle Committee on Banking Supervision, and the International Organization of Securities Commissions (IOSCO).

Many of these studies concluded that there was a need for greater disclosure by hedge funds in order to increase transparency and enhance market discipline, by creditors, derivatives counterparties and investors. In the Fall of 1999 two bills were introduced before the U.S. Congress

¹Hearings of the U.S. House Banking and Financial Services Committee on Hedge Funds, 105th Cong. (Oct. 1, 1998), Statement of William McDonough, President, Federal Reserve Bank of New York ("McDonough Statement").

directed at increasing hedge fund disclosure (the “Hedge Fund Disclosure Act” [the “Baker Bill”] and the “Markey/Dorgan Bill”). But when the legislative firestorm sparked by the LTCM’s episode finally quieted, there was no new regulation of hedge funds.

This paper provides an overview of the regulation of hedge funds and examines the key regulatory issues that now confront regulators throughout the world. In particular, two major issues are examined. First, whether hedge funds pose a systemic threat to the stability of financial markets, and, if so, whether additional government regulation would be useful. And second, whether existing regulation provides sufficient protection for hedge fund investors, and, if not, what additional regulation is needed.

Hedge Funds as Legal Entities: Current Regulation

There is no precise definition of the term “hedge fund,” either in practice or in the U.S. federal securities laws. In practice, hedge funds are viewed as unregulated private investment vehicles for wealthy individuals and institutional investors. In the United States they are typically organized as limited partnerships and structured in a way that exempts them from most of the laws and regulations that apply to other investment vehicles, such as mutual funds and pension funds. It is this exempt legal status that gives hedge funds their uniqueness and makes them attractive to investors.

Hedge funds are free to pursue whatever investment strategies they believe are profitable: they can buy and sell whatever assets or financial instruments they want to, trade any kind of derivatives instrument, engage in unrestricted short-selling, employ unlimited amounts of leverage, hold concentrated positions in any security without restriction, set redemption policies without restriction, and can employ any fee structure and management compensation structure that is acceptable to their investors. In addition, hedge funds have very limited disclosure and reporting

obligations, to regulators, the public, and their own investors.

It is important to recognize, however, that unless structured in a way to gain exemption, U.S. hedge funds may be regulated both by the Securities and Exchanges Commission (SEC) and by the Commodity Futures Trading Commission (CFTC). They also are subject to statutory and common law partnership principles and remedies that protect the interests of the limited partners.²

To avoid regulation hedge funds must meet criteria laid out in four general exclusions or exceptions: (1) the exclusion from registration under the Investment Company Act of 1940 (“Company Act”); (2) the exemption from registration of the fund’s securities under the Securities Act of 1933; (3) the exception from registration of the hedge fund manager under the Investment Advisors Act of 1940 (“Advisers Act”); and (4) the exception from reporting requirements under the Securities Exchange Act of 1934.

To be exempt from the Company Act, which regulates mutual funds, most hedge funds rely on one of two exclusions to avoid registration. Section 3(c)(1) exempts a hedge fund if it has no more than 100 investors. Section 3(c)(7) exempts a hedge fund with more than 100 investors if its investors are “qualified purchasers.”³ “Qualified purchasers” are individuals or companies who own at least \$5 million in investments.⁴

Since both of these exclusions require hedge funds to sell their securities in non-public offerings, most hedge funds gain exemption from the 1933 Act by taking advantage of the “private offering” (or “private placement”) exception under section 4(2) or the related “safe harbor” section

² The Restatement (Second) of Trusts states that “[e]ach member of a partnership is in a fiduciary relationship to the other partners.” See Restatement (Second) of Trusts, section 2(b): Meinhard v. Salmon, 249 N.Y. 458 (N.Y. 1928).

³ While there is not a numeric limitation on the number of investors in a section 3 © (7) fund, the federal securities laws generally require any issuer with 500 or more investors and \$10 million of assets to register its securities and to file public reports with the SEC, which most hedge funds do not want to do. In practice, therefore, most hedge funds stay below the 500 investor level.

under Regulation D of the Securities Act of 1933. These require hedge funds to restrict their sales of securities (or limited partnerships) to individuals and institution that qualify as “accredited investors”⁵ Accredited investors are individuals that have income in excess of U.S. \$200,000 in each of the two most recent years, or joint income with that person’s spouse in excess of \$300,000 in each of those years, and have a reasonable expectation of reaching the same income level in the current year; or, they must have a net worth, or joint net worth with that person’s spouse, that exceeds \$1 million at the time of purchase. Accredited institutions must generally have assets in excess of \$5 million, or be a bank, savings and loan association, a broker/dealer, an insurance company, an investment company, or a small business investment company licensed by the U.S. Small Business Administration. The purpose of these restrictions, obviously, is to limit hedge fund investors to wealthy and financially sophisticated investors, who do not need the protections afforded by the federal securities laws.

Hedge fund managers (or general partners [GP’s]) also typically meet the “private manager” exemption from federal registration as an investment advisor under the Advisers Act, which requires that they have had fewer than 15 “clients” in the past 12 months, do not hold themselves out to the public as an investment adviser, and do not act as an investment advisor to a registered investment company or business development company. Each separate company (or hedge fund, investment partnership, managed account, etc.) that the GP manages is considered to be a single client if the manager bases its investment advice to the company on the company’s investment objectives as opposed to the investment objectives of individual owners.

Finally, hedge funds, like other investment funds, are subject to various regulatory reporting

⁴Investment Company Act of 1940, sec. 2(a)(51), and SEC Rule 2a 51-1.

⁵ While Rule 506 does allow them to have as many as 35 “non-accredited” investors, it is not worth it for most hedge funds to involve themselves with such investors.

requirements. The SEC requires the reporting of all stock positions that exceed five percent of any class of securities issued by a publicly traded company. The U.S. Treasury requires all traders to report large positions in certain foreign currencies and in treasury securities; and, if hedge funds hold positions in exchange-traded derivatives they are subject to “large trader” reporting requirements.

Many U.S. hedge funds also may be regulated by the CFTC if they trade futures or options contracts. They must register with the CFTC as a “commodity pool operator” (CPO) if they intend to invest in or trade one or more futures or options contracts on a regulated commodity exchange. The Commodity Exchange Act (CEA) subjects CPO’s and their advisers (CTA’s) to regulation, but not the commodity pools themselves. Once registered, CPO’s and CTA’s must comply with the rules of the National Futures Association (NFA), avoid conflicts of interest and protect customer funds, provide written disclosure to prospective investors of the risks of investing in commodity interests, adhere to restrictions on advertising, satisfy record-keeping and reporting requirements, and subject themselves to periodic inspections of their activities by the NFA.

Hedge fund managers in the United States also are subject to common law remedies for fraud, as well as claims for fraudulent manipulation under section 10(b) and Rule 10b-5 of the Securities Act of 1934. Typically, prior to investing in a hedge fund, limited partners (LP’s) are given for review and agreement an offering memorandum and partnership agreement. These documents provide investors with information on the potential risks associated with the fund and serve as a notice of *caveat emptor*, and form the basis for possible contractual law remedies at a future date. It is also important to keep in mind that the market discipline exerted by investors, creditors, and counterparties constrains hedge fund managers as well.

Probably half of the hedge funds in the world are “offshore funds,” or funds organized outside of the United States, generally in favorable tax jurisdictions such as the Cayman Islands.

U.S. tax-exempt investors, such as pension funds and endowment funds, will normally only invest in off-shore funds that are structured as corporate entities and hence not “tax transparent,” so that unrelated business taxable income is not treated as arising directly to the fund’s investors. Another reason for operating offshore is to insulate shareholders who are neither U.S. citizens nor residents of the U.S. from U.S. regulation and taxation.

Thus, hedge funds exist because they fill a gap created by the many laws and regulations that restrict the activities of other investment vehicles. Unencumbered by these restrictions hedge funds are able to offer investors “alternative” investment strategies with return distributions unlike those provided by traditional investment institutions like mutual funds, which can provide investors with additional diversification benefits. However, it is important to keep in mind that, to achieve their exempt regulatory status, hedge funds in the United States must confine their client base to relatively wealthy individuals and institutions – investors which the law views as financially sophisticated and not needing the protection of government.

Why Regulate Hedge Funds?

The exempt regulatory status of hedge funds in the United States is premised on the philosophy that wealthy (or “qualified”) investors should be free to make their own decisions unhindered by government regulation and its associated costs, and in return should have to bear the full consequences of their investment decisions – good or bad. In effect, this means that wealthy individuals and institutional investors are able to access non-traditional “alternative” investment strategies that may provide superior returns with possibly greater risk, while less well-off (or “unqualified”) investors are protected by being excluded from participating in these investments.

Despite limiting hedge funds to only “qualified” investors, there is still some debate about whether hedge funds should be subjected to greater regulation. This debate is generated by two

concerns. First, there is a concern that hedge funds may at times destabilize financial markets and even cause a systemic meltdown. This concern was triggered primarily by the near-collapse of Long-Term Capital Management in September 1998 and by the Federal Reserve's intervention to facilitate a creditor-rescue of LTCM.⁶

The second concern is that recent hedge fund innovations have eroded investor protections by enabling less wealthy (retail) investors to participate in hedge fund investments. Indeed, some observers go even further and argue that greater government protection of hedge funds investors is needed even if hedge fund investors continue to be restricted to "qualified" investors. Even these investors, they argue, are unlikely to have the requisite financial sophistication to be able to understand and assess the risks associated with hedge funds. The remainder of this paper examines these regulatory issues.

Financial Instability: Lessons from LTCM

LTCM employed trading strategies involving very high leverage and massive amounts of complex derivatives positions. On August 31, 1998, on an equity base of about \$2.3 billion, LTCM held over \$100 billion of assets on its balance sheet and had off-balance sheet derivatives positions with a notional value totaling more than U.S. \$1.4 trillion.⁷ LTCM financed these positions with an on-balance sheet debt-to-equity ratio of approximately 28-to-one.⁸ Its derivatives positions included

⁶While there is some concern that speculative or manipulative trading by hedge funds has caused large, destabilizing price moves, there is very little evidence to support this contention. See, for example, F. Edwards and M. Caglayan, "Do Hedge Funds Disrupt Emerging Markets?" in Brookings-Wharton Papers on Financial Services 2000, ed. by R. Litan and A. Sanatomero, Brookings Institution Press, Wash., D.C., 2000, pp. 409-418; and "Hedge Funds and Financial Market Dynamics," International Monetary Fund, Occasional Paper 166, ch. V, pp. 55-61, May, 1998.

⁷For a discussion of the collapse of LTCM and the Federal-Reserve-led creditor rescue of LTCM, see Franklin R. Edwards, "Hedge Funds and the Collapse of Long-Term Capital Management," Journal of Economic Perspectives, Spring, 1999, pp. 189-210.

⁸The President's Working Group on Financial Markets (the "Working Group"), Report at pp. 11-12;

OTC swap contracts with a gross notional value in excess of \$750 billion, futures contracts with a gross notional value in excess of \$500 billion, and options and other derivatives with a notional value in excess of \$150 billion. At times LTCM had as many as 60,000 trades on its books and more than 75 derivatives counterparties.⁹ Almost all of LTCM's positions were collateralized and subject to calls for additional collateral in the event that prices of the underlying securities moved against it.

And that is exactly what happened. After sizeable losses in the Spring and Summer of 1998, by September 1998 LTCM had lost 50 percent of its equity and was in danger of not being able to meet collateral obligations on its derivatives positions. More importantly, had it failed to meet a collateral obligation, or missed a required debt payment, its derivatives counterparties had the legal right to terminate and liquidate their positions with LTCM, which they would have done in order to protect themselves against incurring greater losses. Not even LTCM's filing for bankruptcy protection could have prevented this. Only the timely intervention of the Federal Reserve in organizing a \$3.6 billion creditor-bailout of LTCM in September 1998 was able to prevent a "counterparty run" on LTCM's derivatives positions. According to William McDonough, the rush of more than 75 counterparties to close out simultaneously hundreds of billions of dollars of derivatives contracts would have adversely affected many market participants with no connection to LTCM and would have resulted in tremendous uncertainty about how far prices might move.¹⁰

The creditor-consortium that recapitalized LTCM and took over the responsibility and

U.S. General Accounting Office ("GAO"), Report at p. 7.

⁹Ibid.; and "McDonough Statement."

¹⁰See "McDonough Statement." LTCM's own estimate was that its largest 17 counterparties, in closing out their positions with LTCM, would have incurred losses in the aggregate of between \$3 billion and \$5 billion, with some individual firms losing as much as \$500 million. See Paul N. Roth and Brian H. Fortune, "Hedge Fund Regulation in the Aftermath of Long-Term Capital Management," in Iain Cullen and Helen Parry, Hedge Funds: Law and Regulation, Sweet and Maxwell (London), 2001, ch. 5.

obligations of managing LTCM's portfolio and resolving its financial difficulties consisted of fourteen large banks and securities firms – most of LTCM's large creditors. In effect, the Federal Reserve organized an out-of-court creditor “work-out” of LTCM's positions.

The Federal Reserve-led creditor-bailout of LTCM raises two issues. First, how did a single hedge fund like LTCM get to be so large and so highly leveraged that its bankruptcy could threaten global financial stability? Why did LTCM's creditors and counterparties fail to reign in its activities? Second, even if LTCM had failed to meet its obligations, why was it necessary for the Federal Reserve to intervene in order to organize a creditor work-out for LTCM? Why could not LTCM have filed for bankruptcy protection and prevented the immediate liquidation of its assets, as most other firms do?

The failure of market discipline. It is generally agreed that a failure of market discipline enabled LTCM to use excessive amounts of leverage to assume huge positions in certain financial markets. Reports on the LTCM debacle agree that LTCM's banks and derivatives counterparties failed to appreciate the magnitude of the risks they were taking in their dealings with LTCM, and that they consistently failed to enforce even their own risk management standards.¹¹

An obvious implication of the LTCM debacle, therefore, has been to strengthen the regulation and supervision of banks and securities firms, which were LTCM's primary creditors and counterparties. To a large extent this has already been done. In addition, banks and securities firms have tightened their credit standards with respect to hedge funds, and have demanded greater disclosure from hedge funds. Thus, in the future we hopefully will not see a repeat of the breakdown in market discipline that we saw in the LTCM case.

¹¹Why LTCM escaped this discipline is a complex story of reputation, ignorance, psychology, greed, naivete, and hubris. See F. Edwards, “Hedge Funds and the Collapse of Long-Term Capital Management,” op. cit.

There is, nevertheless, still disagreement over whether increased transparency of hedge funds is necessary for market discipline to be effective. The IOSCO Report, for example, concludes that increased transparency of hedge funds is necessary to achieve effective market discipline and contain systemic risk, and recommends increased public disclosure by hedge funds in order to increase transparency. It is not clear, however, why banks and counterparties, when dealing with hedge funds, would not themselves demand whatever information they believe necessary to assess their risk exposures and monitor hedge funds, and to protect themselves generally.

Mandated public disclosure by hedge fund is unlikely to meet the needs of banks and securities firms. The information provided in accordance with typical public disclosure requirements is unlikely to be either informative enough or timely enough to serve the needs of creditors and counterparties. Further, creditors and counterparties already have a strong incentive to demand sufficient information in order to protect themselves, and they have the power to force hedge funds to disclose this information: they can refuse to deal with funds that do not provide the necessary information. Indeed, hedge funds themselves have a strong incentive to disclose voluntarily the information that creditors and counterparties need in order to gain access to credit and other services. Thus, mandated public disclosure seems unnecessary and unlikely to provide the kind of information that creditors and counterparties need to be effective monitors of hedge funds.

My position on mandated public disclosure is best summarized by a recent statement issued by a group of financial economists, of which I am a charter member:

“It is hard to think of a market environment more conducive to allowing private markets to determine market disclosure practices than the hedge fund industry – an intensively competitive industry with sophisticated investors and creditors. In these conditions it seems reasonable to leave the determination of hedge fund disclosure practices and requirements to private parties and to the workings of the private market, rather than

setting them by government mandate.”¹²

Why was Federal Reserve intervention necessary? The intervention of the Federal Reserve to head-off the insolvency of LTCM raises a serious systemic concern that still exists and is not widely understood. Further, this systemic concern is not specific to hedge funds but arises out of the pervasive use of derivatives by financial market participants. The fundamental reason that the Federal Reserve intervened in the LTCM case is that bankruptcy law in the United States (and in most other countries) does not treat derivatives counterparties as it does all other creditors.

Specifically, current U.S. bankruptcy law exempts derivatives counterparties from the normal operation of the Bankruptcy Code, and in particular from the automatic stay provisions of the Code.¹³ As a consequence, had LTCM been unable to meet its obligations and filed for protection under Chapter 11, its derivatives counterparties could still have, and certainly would have, immediately terminated their contracts with LTCM, resulting in the “... abrupt and disorderly close-out of LTCM’s positions which would [have] pose[d] unacceptable risks to the American economy.”¹⁴

Only the intervention of the Federal Reserve in arranging a creditor-bailout enabled LTCM to avoid a bankruptcy filing which would have triggered the immediate liquidation of its positions. In principle, the same result could have been achieved without the intervention of the Federal Reserve had the Bankruptcy Code not exempted LTCM’s derivatives counterparties from the automatic stay provision of the Code. In that case a bankruptcy filing by LTCM would have

¹² The Financial Economists Roundtable, “Statement on Long-Term Capital Management and the Report of the President’s Working Group on Financial Markets,” Oct. 6, 1999.

¹³ See Franklin R. Edwards, “Insolvency Law and Financial Stability in OTC Derivatives Markets,” Working Paper, March, 2003.

“stayed” LTCM’s derivatives counterparties, as well as its other creditors, and would have resulted in a court-supervised creditor-workout of LTCM’s positions. As subsequent events have shown, it was clearly in the joint interests of LTCM’s creditors to avoid a “fire sale” of LTCM’s positions and to facilitate a creditor “work-out” by putting in more capital and reorganizing the ownership structure of LTCM. Had the bankruptcy code allowed this, there would have been no need for the Federal Reserve to intervene.

Ironically, the potential destabilizing role that bankruptcy law played in the LTCM crisis was the result of series of changes in the Bankruptcy Code made by the U.S. Congress in order to reduce the likelihood of systemic instability in off-exchange derivatives markets. The rationale for exempting “derivatives securities” contracts from the automatic stay provisions of the Bankruptcy Code is that this exemption is necessary to maintain the liquidity and stability of derivatives markets – to prevent the “insolvency of one commodity or security firm (or derivatives counterparty) spreading to other firms and possibly threatening the collapse of the affected market.”¹⁵ The U.S. Congress believed that: “The prompt liquidation of an insolvent’s position is generally desirable to minimize the potentially massive losses and chain reaction of insolvencies that could occur if the market were to move sharply in the wrong direction.”¹⁶ In interpreting (and ratifying) the scope of the exceptions to the Bankruptcy Code, the bankruptcy appellate panel for the Ninth Circuit cited the comments of Senator Dole during the Senate discussion on the amendment to section 362 of the Bankruptcy Code:

“It is essential that stockbrokers and securities clearing agencies be protected from the

¹⁴See “McDonough Statement.”

¹⁵House Rep. No. 97-420, 97th Cong., 2nd Sess., 3 (1982).

¹⁶House Rep. No. 97-420, 97th Cong., 2nd Sess., 3 (1982).

issuance of a court or administrative agency order which would stay the prompt liquidation of an insolvent's positions, because market fluctuations in the securities markets create an inordinate risk that the insolvency of one party could trigger a chain reaction of insolvencies of the others who carry accounts for that party and undermine the integrity of those markets."¹⁷

In retrospect, it seems clear that had LTCM's derivatives counterparties not been exempted from the automatic stay provisions of the Bankruptcy Code, there would not have been either an "...abrupt and disorderly close-out of LTCM's positions..." or an "...unwinding [of] LTCM's portfolio in a forced liquidation..." and there would have been no need for the Federal Reserve to intervene to prevent a "... seizing up of markets ... [that] could have potentially impaired the economies of many nations, including our own."¹⁸

Thus, the major systemic risk issue raised by the near-collapse of LTCM is whether recent revisions to the bankruptcy law in the United States and other countries have created another source of financial instability in financial markets by enabling a "counterparty run" on the positions of a financially-stressed counterparty. As LTCM illustrated, a "counterparty run" has the potential to result in a systemic liquidity shortage, with uncertain and potentially damaging economic effects. It is notable that some recent academic papers have argued that a "fire sale" of financial assets can cause or exacerbate liquidity shortages, resulting in systemic illiquidity with the potential to cause

¹⁷128 Cong. Rec. s. 15981, (daily ed. July 13, 1982).

¹⁸See "McDonough Statement"; and "Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System," Committee on Banking and Financial Services, U.S. House of Representatives, Oct. 1, 1998.

widespread contagion.¹⁹

In sum, while the LTCM episode does raise a serious systemic issue, this concern is fundamentally a problem associated with the rapid growth of off-exchange derivatives markets and with the inability of existing bankruptcy law to deal in an orderly way with distressed derivatives counterparties. While hedge funds are participants in these markets, they are only bit players. The major players are the large banks and securities firms. Additional regulation of hedge funds will not solve this problem. If anything, the LTCM debacle raises the issues of whether bankruptcy law needs to be revised to prevent a repeat of an LTCM-type counterparty run and of what central banks' lender-of-last-resort policies should be with respect to unregulated derivatives counterparties (such as LTCM was).

The Argument For Increased Investor Protection

Although U.S. law restricts hedge fund investors largely to wealthy individuals and institutional investors, some observers argue that additional regulation is still necessary to provide adequate protection for investors. They argue, first, that an investor's "wealth" or "disposable income" is not indicative of his or her financial sophistication, so that even "qualified" investors need to be protected; and, second, that recent hedge fund innovations enable less wealthy (retail) investors to access hedge funds, which was never intended by the law.

Should qualified investors be protected? Many who argue that more regulation is needed to protect even financially sophisticated individual investors point to the non-transparency of hedge funds as a reason for government-mandated public disclosure requirements. Exactly what these disclosure requirements would be is not clear. One possibility is that hedge funds should have to

¹⁹See, for example, Douglas Diamond and Raghuram Rajan, "Liquidity Shortages and Banking Crises," Draft, 2000; and, Antonio E. Bernardo and Ivo Welch, "Financial Market Runs," Yale ICF Working Paper No. 02-11, September 16, 2002.

disclose periodically their positions (such as mutual funds do) as well as their trading activity. Such disclosure, however, may be both impractical and not very informative. LTCM, for example, had over 60,000 trading positions on its books, and many of these were complex derivatives positions. It is unlikely that even financially sophisticated investors would be able to decipher these positions. Further, hedge fund managers are reluctant to provide position information that could reveal their investment strategies to rival managers. Hedge fund investors also may not want this information revealed, since to do so could erode their returns.

Others argue that what is needed is greater “exposure” transparency, not “position” transparency. Hedge funds could disclose information about the overall portfolio risk associated with their strategies without revealing proprietary information. For example, a fund could provide quantitative measures of value-at-risk for its portfolio and the results of stress-tests for given assumptions, together with a description of its methodologies for computing these statistics. It also could provide information about common risk exposures such as industry/sector, duration and convexity, credit, short/long volatility, leverage, geographic, and market capitalization.²⁰

But there is also a strong argument to be made that government-mandated disclosure is not needed and may be counterproductive. Hedge fund investors have a strong incentive to demand the information they need from hedge funds, and hedge funds have a strong incentive to disclose this information. Further, information related to “exposure” transparency should be integral to sound portfolio management, so that the additional costs associated with providing this information to investors would seem minimal. Disclosure of this kind of information also would not reveal proprietary information about a fund’s trading strategies. Finally, the increasing interest of institutional investors in hedge funds should in the future provide a greater incentive for hedge funds

²⁰See Mark Anson, “Is Hedge Fund Transparency Obtainable?” [NMS Exchange](#), NMS Management,

disclose more information. The fiduciary responsibilities of institutional fund managers will require them to demand greater hedge fund transparency. Government-mandated disclosure requirements, which are typically slow to react to new strategies and innovations, also risk straitjacketing the disclosure process and can create legal disincentives to the disclosure of useful information that does not conform to the formal disclosure requirements. Thus, while greater hedge fund “exposure” transparency is desirable, I am reluctant to advocate government-mandated public disclosure.

Other advocates of increased investor protection regulation argue that the only way to assure adequate protection is to require hedge funds to make an assessment of the level of an investor’s sophistication and determine whether the investor’s “expertise” is suitable for the investment in question.²¹ Such a “suitability” standard would shift the responsibility of limiting access to hedge fund investments to hedge funds and other marketers of these products, and would relieve investors of the responsibility of determining whether hedge fund investments are suitable for them. The result will be increased costs for purveyors of hedge fund investments and reduced costs to hedge fund investors. Hedge funds will have higher costs because they will have to expend resources to determine an investor’s suitability, and, *ex post*, they will have to defend themselves against legal actions (some frivolous) taken by unsuccessful investors seeking restitution on the grounds that they were not “suitable” investors. A common characteristic of suitability standards is that they create greater legal ambiguity with respect to the legal responsibilities involved in customer relationships. As a consequence, this approach can be expected to impose a heavy cost on the courts and the legal system to oversee this process and to allocate guilt, which will result in a significant additional social cost (or a cost to taxpayers).

October, 2003, vol.3, no. 2, pp. 9-10.

²¹See, for example, Helen Parry, “Hedge Funds, Hot Market and the High Net Worth Investor: A Case For Greater Protection,” Working Paper, London Guildhall University, March 2001.

Hedge funds may respond to these costs and increased legal ambiguity in several ways, but most likely their response will be to limit access to a small segment of the investor population who clearly meet the “suitability” test. This result is not in the social interest because it may restrict access to hedge fund investments even more than it is already restricted under current U.S. law. Further, a “suitability” standard is not a cost-effective way for government to protect investors. If the objective is to limit investors’ hedge fund losses by restricting access, simply adopting a more stringent “wealth” (or “qualified”) investor standard can be used to achieve this outcome.

Recent hedge fund innovations. The second argument for greater investor protection regulation is that recent hedge fund innovations threaten to undercut the “qualified” investor restriction by enabling smaller and less sophisticated individuals to invest in hedge funds. In particular, there has been a proliferation of “principal-protected” and “structured” products on which the return is linked to the performance of some underlying hedge fund or funds, and in the United States there has been a recent surge of “registered” hedge funds.

An example of a structured product is UBS and Standard & Poor’s recently marketed investment certificates, which are linked to the S&P Hedge Fund Index. These can be purchased in denominations of \$10,000, and the return is linked to the performance of the S&P Hedge Fund Index: investors gain when the index goes up and lose when it goes down. The S&P index tracks the performance of forty hedge funds using several different strategies. Similarly, HypoVereinsbank recently launched its Companion-Family Certificates which are linked to the performance of sixty underlying hedge funds.

An example of a “principal-protected” product is the seven-year Euro Notes issued by Société Générale Acceptance NV and guaranteed by Société Générale, which guarantees the initial capital investment at maturity of the Notes. The return on the notes is linked to the performance of three funds of (hedge) funds which employ a wide range of investment strategies. The prospectus

disclaimer issued by Société Générale states: “All investors acknowledge that they are sophisticated investors and that they are purchasing the Euro Medium Term Notes on a private placement basis. Investors are deemed to be aware of any applicable law regarding the sale of the Euro Medium Term Notes in their country of residence.”

Registered “hedge funds” are closed-end (mutual) funds registered under the 1940 Investment Company Act that invest in hedge funds, typically funds of hedge funds. These funds are a recent development. In the United States, as of year-end 2002, there were forty-two registered hedge funds. There are now eighteen hedge funds eligible to sell their securities to the public. Registering under the 1933 Act permits a fund to publicly offer its securities. There are no restrictions (or “wealth” criteria) on the types of investors registered hedge funds can take. An example is Oppenheimer Tremont’s Market Neutral Fund, which is similar to a mutual fund but invests in funds of hedge funds that employ various types of market-neutral investment strategies. The Fund requires a minimum investment of only \$25,000, and its securities can be offered publicly. Oppenheimer Tremont, however, like most of the registered funds, requires its investors to have a net worth of at least \$1.5 million so that it can charge performance (or incentive) fees. The 1940 Investment Advisers Act requires that investors must have a net worth of at least \$1.5 million or have \$750,000 under management by a fund’s adviser to be eligible to be charged performance fees.²² If a fund does not choose to charge a performance fee, however, there is no federal requirement for a minimum investment. Thus, in principle, registered hedge funds can be “retail” hedge funds if they so choose.²³

²²Investment Advisers Act of 1940, sec. 203(b)(3), Rule 205-3.

²³Even a \$1.5 million net worth requirement is a considerable dilution of the current “qualified” investor standard (\$5 million of investments) because it includes all of the investors assets, including his or her home.

Thus, all of these innovations are in effect alternative legal vehicles that enable less wealthy investors to invest in the very hedge funds that would typically be prohibited by certain legal restrictions. A common characteristic of the products is that they provide investors with a return based on a diversified portfolio of hedge funds, rather than on the performance of just one or two hedge funds.

These products raise a number of regulatory issues. In particular, although registered hedge funds are subject to the same regulations as other closed-end mutual funds, it is not clear how effective these regulations will be when applied to registered hedge funds. First, while mutual funds are subject to substantial disclosure requirements directed at making their investments and risk exposures transparent to investors, such requirements are unlikely to provide the same level of transparency for registered hedge funds. Mutual funds, for example, must disclose their entire portfolio holdings at least twice a year (the frequency of such disclosure will soon be increased to quarterly). What position disclosure will registered hedge funds provide? They can only disclose the magnitude of their investments in the various hedge funds. They will not be able to disclose anything about the positions and trading activities of the underlying hedge funds because the hedge funds themselves do not typically disclose this information. Thus, applying mutual fund disclosure requirements to registered hedge funds will not provide the same level of transparency as for mutual funds. Given the typical complexity of hedge funds' investment strategies, investors in registered hedge funds are unlikely to be able to evaluate the risks associated with either the strategies of the underlying hedge funds or the registered fund itself.

Second, it is not clear how registered hedge funds will be able to value their portfolios. The only available values for their investments in the underlying hedge funds are those that the hedge fund managers typically provide themselves. It will be difficult to audit or authenticate those values. Further, such valuations are notoriously difficult because many hedge funds hold illiquid assets,

which affords hedge fund managers considerable discretion in valuing their assets. Hedge fund managers may at times also have an incentive to distort the values of their portfolios.

Third, mutual fund regulation limits the leverage and short-selling that mutual funds can engage in. Although these restrictions would also apply to registered hedge funds themselves, they would not apply to the underlying hedge funds in the portfolios of registered hedge funds. There are no leverage and short-selling constraints on these hedge funds. These funds will be able to go short without restriction and use as much leverage as they wish to, exposing investors in registered hedge funds to the risks commonly associated with hedge funds.

Thus, the advent of registered hedge funds threatens to undercut the “qualified investor” restriction and open hedge funds to a much larger segment of investors. As such, it raises a question about whether this development is desirable and about whether additional regulation is necessary to protect investors in registered hedge funds.

A benefit of permitting registered hedge funds is that it expands the universe of investors able to participate in hedge fund investments. Through access to hedge funds investors may be able to obtain additional diversification benefits and may be able to increase their risk-adjusted returns. The best example of this is probably the poor performance of most mutual funds during the past three years of “bear” stock markets, when most mutual fund investors lost between twenty and forty percent of their investments. During this period, in contrast, hedge fund investors fared significantly better, and some even had positive returns.²⁴ The ability of hedge funds to employ contrarian and non-traditional investment strategies (such as short-selling) provided a valuable alternative to the traditional stock and bond investments of mutual funds. Had registered hedge funds been a viable

²⁴ See Franklin R. Edwards and Stav Gaon, “Hedge Funds: What Do We Know?” Working Paper, March, 2002 (forthcoming in *Journal of Applied Corporate Finance*); and Franklin R. Edwards and Mustafa Onur Caglayan, “Hedge Fund and Commodity Fund Investments in Bull and Bear Markets,” *The Journal of Portfolio Management*, Vol. 27, no. 4 (Summer, 2001), pp. 97-108.

option during this period, many more investors could have benefited from these strategies, sparing at least some of them from the substantial losses that most mutual fund investors incurred.

Another potential benefit of providing greater investor access to hedge funds is that there will be an increased flow of capital into markets which exhibit pricing inefficiencies, which should reduce these inefficiencies and increase market liquidity. Indeed, an explanation for the success of hedge funds is that they have been able to exploit market inefficiencies in financial products and markets that are not “mainstream” markets.²⁵

The critical question is whether retail investors will be exposed to significantly greater risk if they are able to invest in registered hedge funds. The answer, I believe, is probably “no.” Funds of hedge funds typically hold diversified portfolios of hedge funds. It is common for these funds to diversify across both investment strategies (or “styles”) and individual hedge funds, typically holding twenty or more different hedge funds. The objective of most funds of funds is to use diversification to reduce the likelihood of investors experiencing large losses, either because of an unexpected shift in macroeconomic factors or from the collapse of one or two hedge funds.²⁶ A registered hedge fund is likely to be able to provide mutual fund investors with greater diversification benefits than does a typical mutual fund, since mutual funds are largely restricted to holding long positions in stocks and bonds.

Thus, as long as registered hedge funds hold a diversified portfolio of hedge funds I do not believe that the proliferation of these funds poses a significant investor protection problem. The policy issue, therefore, is whether regulation is needed to assure that registered hedge funds hold an adequately diversified portfolio. It is noteworthy that closed-end mutual funds are not subject to the

²⁵Edwards and Goan, *op. cit.*, pp. 23-27.

²⁶In other words, the typical diversification strategy of a fund of funds is to eliminate the negative skewness in the return distribution that is common to many hedge fund strategies.

same diversification requirements as are open-end mutual funds. The riskiness of registered hedge funds, therefore, may compare favorably to that of other closed-end mutual funds.

Constructing sensible diversification regulations for registered hedge funds will be difficult, in any case. Such requirements would have to be able to identify independent hedge fund “styles” and to determine the minimum number of styles that a fund would have to hold, and would have to determine the minimum number of hedge funds that would have to be held for each style. Further, it will almost certainly be true that it will be possible to achieve the same level of portfolio diversification by using many different combinations of styles and numbers of hedge funds. Thus, diversification regulations may straitjacket portfolio managers, increasing costs and risking some perverse results for investors.

To the extent that greater investor protection is desirable, the preferable approach is to require greater “exposure” transparency by registered hedge funds (as well as all other mutual funds). A registered hedge fund (or fund of funds) could, under the protection of a “safe harbor” provision, disclose information about the nature of its portfolio, its diversification, and the likely exposure that its investors would have to losses incurred by hedge funds in its portfolio and to changes in key economic factors. It also could provide quantitative measures of value-at-risk for its portfolio and the results of stress-tests for given assumptions, together with a description of the data and methodologies used to compute these statistics and the shortcomings of the data and the methodologies. This kind of “exposure” transparency should enable investors to make better risk assessments.

Conclusion

This paper has two objectives: to provide an overview of the structure and philosophy of the current regulation of hedge funds in the United States; and to examine the major regulatory

issues pertaining to hedge funds that regulators now confront. Two key issues are examined. First, whether the current operations of hedge funds pose a threat to the stability of financial markets; and, second, whether hedge fund investors need additional regulatory protection. More specifically, we examine the issue of whether recent hedge fund innovations, such as the advent of registered hedge funds, undermine the existing regulatory structure such that additional regulation of hedge funds is necessary to protect investors.

Concern about the impact of hedge funds on financial stability stems largely from the collapse of LTCM in September 1998 and the role on the Federal Reserve in engineering LTCM's rescue by its creditors. After re-examining the LTCM debacle, we conclude that this episode does reveal a systemic weakness in our financial system, but that this weakness is not specific to hedge funds but is generic to off-exchange derivatives markets. In particular, LTCM's collapse reveals a conflict in our Bankruptcy Code that exempts derivatives counterparties from the automatic stay provision of the Code, in contrast to other creditors. The import of this exception from the automatic stay provision is that it permits a "counterparty run" on a distressed derivatives counterparty, which may result in the kind of systemic consequences that the Federal Reserve feared could occur in the LTCM case.

The solution to this problem is not increased hedge fund regulation but possibly a revision to the Bankruptcy Code to prevent the fire sale of a distressed counterparty's assets. Barring such a revision, we need to determine the appropriate lender-of-last-resort policies that should guide central banks in intervening to assist non-regulated derivatives counterparties in financial distress.

Recent developments also raise a concern about whether additional regulation is necessary to protect hedge fund investors. The advent of registered hedge funds and other new hedge fund products threaten to open hedge funds to a much larger segment of the investor population, and, in particular, to investors who do not meet the "qualified investor" standard. Since many of these new

“retail” investors are unlikely to be as financially literate and sophisticated as “qualified” investors, there is a question about whether there is a need for additional investor protection.

After examining these new products, we conclude that, by expanding the availability of hedge fund investments to more investors, they are socially beneficial, and that the risks associated with these investments are likely to be no greater than those associated with most mutual fund investments. However, we also conclude that it may be useful to provide investors in registered hedge funds, as well as in all other mutual funds, with greater “exposure” transparency.

In particular, registered hedge funds should disclose information about the nature of the hedge funds in their portfolios, their portfolio diversification, and the likely exposure their investors have to key economic factors and to losses incurred by hedge funds in their portfolios. They also could provide quantitative measures of value-at-risk for their portfolios and the results of stress-tests for given assumptions, together with a description of the methodologies and data used to compute these statistics. Increased “exposure” transparency for both registered hedge funds and for mutual funds will provide greater transparency and will enable investors to make better risk choices.