



Hedge Funds Escape Regulation: Should Investors Be Worried?

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When the Lilliputians came upon the sleeping Gulliver, they didn't know if he was friendly or hostile, but he was so big it seemed prudent to tie him down. Should the 9,000 hedge funds -- the secretive investment pools controlling \$1.4 trillion in assets -- be treated the same way?

The President's Working Group on Financial Markets doesn't think so. In a late-February report, the group, chaired by Treasury Secretary Henry M. Paulson, urged vigilance but concluded that new regulations are not needed. The freewheeling world of hedge funds and their cousins, private equity and venture capital, have for now escaped the tightened oversight imposed on publicly traded companies after Enron and WorldCom.

Was this the right decision? For the most part, it was, say several Wharton professors who have studied hedge funds and other so-called private pools of capital.

Private pools have a key role in providing market liquidity -- making sure anyone who wants to buy or sell a given instrument has someone to trade with -- these faculty say, adding that restricting private pools' activities or forcing them to disclose too much about their strategies would hurt liquidity and weaken the financial markets.

"These private pools may help keep markets from overshooting [when prices rise], and they may provide floors [when prices fall]," says Wharton finance professor [Richard J. Herring](#). "It's very secretive," adds Wharton finance professor [Richard Marston](#). "Even a fairly wealthy client won't necessarily find out about the hedge fund strategy." If regulators forced hedge funds to disclose their holdings, "that would be the end of some of these strategies," he predicts.

Inexperienced Managers: Exotic Investments

Still, the Wharton professors note that, because of their size and secrecy, private pools can create risks for the broad market that no one can perfectly gauge. "The fear is that [hedge funds] have grown so rapidly that you have a lot of managers who don't have a lot of experience, and you have a lot of inexperienced investors who aren't disciplining them very well," says Herring.

To compete with the mushrooming number of competitors, hedge funds may be driven to take riskier and riskier positions in illiquid investments, such as emerging-market bonds or mortgage-backed securities created out of subprime loans, Herring says, adding, "The thing that worries people most, I guess, is the kinds of exotic instruments that they take on, which are very opaque and very hard for anyone to figure out."

And it's not just the private-pool investors who shoulder the risks, notes Wharton finance professor [Marshall Marshall E. Blume](#). "If you have a large number of hedge funds all following the same investment strategy and it goes wrong and the investments are highly leveraged, there's a potential banking problem," he says, adding that a problem in federally insured banks would affect everyone.

Freedom to do as they like has made private pools enormously attractive to well-heeled investors and institutions. According to the Treasury Department, the number of hedge funds, for example, has more than doubled over the past five years, to more than 9,000, and their assets under management have quadrupled since 1999. Some experts believe that hedge funds account for a third to half of the trading in the U.S. stock markets.



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Hedge funds and other private pools are investment funds that are privately organized, run by professional managers and, unlike stocks or mutual funds, generally not available to the public. Because these types of investments are not regulated or required to make detailed financial disclosures, federal regulations generally prohibit investments by individuals with less than \$1 million in net worth.

In recent years, however, investors with lower net worth have been able to get into hedge funds through certain mutual funds. Also, many Americans are exposed to private-pool risks through their pension funds or holdings in public companies such as banks, insurers and brokerages that are involved with private pools in one way or another.

Private pools appeal to individual and institutional investors because they can do things that mutual funds may not, such as selling stocks short, borrowing large sums to invest or mixing stock and bond bets with others using derivatives, commodities or real estate.

While distinctions are blurring, hedge funds typically do not take management roles when they invest in companies, while private equity and venture capital firms do. Venture capital firms typically invest in young companies, while private equity firms are more likely to buy troubled older companies in hopes of turning them around.

Hedge funds and other private pools have been "unjustly maligned," says [Thomas Donaldson](#), professor of legal studies and business ethics at Wharton. Many offer investors tax advantages and freedom from regulation that they cannot get with other investments. Still, he adds, it is fair to wonder whether private-pool investors are getting sufficient returns to offset risks taken on by their managers. "You just have no idea what they are doing."

The working group assumed that private pool investors take these risks by choice. But Donaldson says that even institutional investors do not always understand what risks they are taking on. Donaldson sits on the board of a small non-profit organization that uses hedge funds for half of its investments.

"The question of what the risks are, and whether they are fully disclosed, is very real for me," he says. "I think people are being driven by a kind of euphoria and pressure not unlike that affecting decisions to enter the dotcoms years ago.... You look at the dazzling records of, say, the Yale investment funds, and it's a bit like, 'Gee, everybody else is making all this money on this stuff, and I'm a fool not to.'"

Systems to Evaluate Risk

Concerned that hedge funds wield too much invisible power, the Securities and Exchange Commission last year tried to require them to register with the agency and make limited disclosures about their activities. But a federal appeals court ruled last June that the commission did not have that authority.

Subsequently, the President's Working Group on Financial Markets took up the issue, updating work it did in 1999. The committee was formed by President Reagan to make recommendations after the October 1987 market crash. It is chaired by the Treasury Secretary and includes the chairmen of the Federal Reserve Board, the SEC and the Commodities Futures Trading Commission.

The group's report, issued February 22, concluded that "the current regulatory structure ... is working well." Private pools contribute to the health of the financial markets by improving liquidity of various types of assets, the group concluded.

While it rejected calls for tougher regulation, it urged all parties involved to redouble efforts to understand risks. It said the risk posed to pension funds and other institutions that invest in private pools "can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles."

The working group also said private pool managers should have systems for evaluating risks and should "provide accurate information to creditors, counterparties and investors with appropriate frequency, breadth and detail." But it did not define "appropriate."

The systemic risks -- those affecting the broad markets and people who have not chosen to take on private-pool risks -- are best protected by creditors and counterparties looking after their own interests, rather than by regulators, the group concluded. Creditors are institutions such as banks or securities firms

that lend money to private pools. Counterparties are people and institutions on the other side of the deals -- the firms that write futures contracts or the "prime brokerages" that lend money, execute trades and provide other services. Although the private pools are not closely regulated, banks and brokerages are.

The emphasis on creditors and counterparties "hit the nail on the head," says [Christopher C. Geczy](#), finance professor at Wharton. While some critics have called the working group report toothless, Geczy says this emphasis was "a cautionary note between the lines. I think the focus on the counterparty is correct, and the focus on the prime brokerage is correct." He also thinks that the Federal Reserve "needs to closely monitor the prime brokerage business" for a better understanding of how much leverage is used by private pools.

Risks to individual investors would be reduced by a recent SEC proposal, supported by the working group, to require a net worth of \$2.5 million rather than \$1 million, and to exclude the investor's primary residence from the tally," Geczy says, adding that this is "not a bad idea."

In addition, there may be other ways to guard the public interest without handcuffing private pools. Blume believes the government should routinely examine hedge fund failures, the way the Federal Aviation Administration investigates plane crashes. "I like the idea of examining failure and making very public what went wrong," he says.

Donaldson says private pools can help ease worries on their own. "In light of public confusion and mistrust, and the possibility that even a few catastrophic failures could trigger irrational regulation, I would encourage leaders to get together to see if there aren't some principles of transparency that the industry might agree on," he says. "I don't see why at least some information about investments, returns and fees cannot be made public."

None of the Wharton professors interviewed thought private pools would spark a financial-market catastrophe. But all agreed that no one has a clear understanding of the systemic risk these pools may have created.

So much money has poured into hedge funds that they have taken to betting on ever more exotic and illiquid investments, Marston notes. The effect can be seen in the shrinking risk premium, or extra return, demanded by people who invest in risky securities like junk bonds and emerging-market debt. "Right now I believe that in both the high-yield market and the emerging-debt market we have the most optimistic pricing I have ever seen in my career," he says. "They are assuming there are never going to be any more devaluations, there are never going to be any more emerging-market crises....There is very little realization of the risk out there, in my view."

If something does go wrong -- such as an emerging-market country defaulting on its bonds -- hedge funds and other holders could rush to sell but not find enough buyers, causing a vicious downward cycle, Marston says, adding that there hasn't been a serious shock of this type since the Russian default crises of 1998 -- before the hedge-fund boom. "A lot of traders in the market haven't seen anything go wrong, and a lot of risk managers haven't tested their approaches. This is a little unsettling."

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