



## The Perils of Hedge Fund Regulation

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To many investors, hedge funds seem like an oasis of positive returns in the current desert-like environment of poor returns. Whether this is true is debatable. But two trends have made the regulation of hedge funds – which so far have been very lightly regulated – a hot topic. One is the increasing availability of hedge fund products to a broader audience than previously had access to this asset class. The other is the barrage of news reports focused on hedge fund fraud and blowups, which directly or indirectly raise the idea that regulation might provide a useful fix.



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So should hedge funds be regulated? Absolutely not, argue Wharton faculty members. Not only should funds not be regulated, they say, but to do so would threaten the core of the industry itself.

“The important issue that hasn’t been much discussed publicly is the potential implications for the industry if hedge funds do reach a broader market,” says [Richard J. Herring](#), finance professor at Wharton and co-director of the Wharton Financial Institutions Center. “It’s easy to understand the pressures to make them available to a wider range of clients, but once the issue of protecting consumers enters into the discussion, the regulatory game shifts in a major way.”

And that would be an irrevocable mistake. “Regulation is in some sense incompatible with the fundamental role and character of hedge funds,” adds Herring, because “hedge funds are designed by law [to operate] with maximum flexibility.”

Hedge funds occupy an important niche in the markets. They provide liquidity to the capital markets and take speculative positions, an increasingly significant role as banks have shuttered or wound down their high-flying proprietary-trading desks. For investors, hedge funds can also serve a risk management purpose since their returns are often uncorrelated to those in the equity and fixed-income markets. These funds are able to achieve the returns they do precisely because they operate without many of the financial constraints that would otherwise hobble their complicated strategies.

Like mutual funds, hedge funds are pools of money invested in financial instruments. Unlike mutual funds, they do not trade on exchanges, they are not registered with the Securities and Exchange Commission, they are subject to few regulations, and their investors are not extended the same consumer-protection benefits that are given to investors in mutual funds and other entities that fall under the 1940 Investment Company Act. In addition, hedge funds frequently employ leverage and use sophisticated trading strategies that ordinary investors do not understand.

In short, investing in hedge funds can be like playing Russian roulette. This blatant risk has historically been addressed by limiting hedge funds to accredited investors – wealthy individuals with at least \$1 million in assets and institutions with \$5 million – and by stipulating minimum-investment thresholds of, say, half a million dollars.

“Congress originally was wise to limit the investor pool to those wealthy enough to be able to make judgments on their own, without the help of SEC regulations,” says Wharton finance professor [Richard Marston](#), director of the George Weiss Center for International Financial Research. The reasoning is that these individuals and institutions can perform the necessary due diligence themselves and can take on

large risks. “The only issue is whether or not that continues to be the case,” he notes.

This lack of regulation makes sense when investors are wealthy but doesn't when people with lesser means enter the market. “I don't think people really get terribly upset when somebody with \$10 million loses a couple million dollars,” says [Marshall E. Blume](#), finance professor and director of the Rodney L. White Center for Financial Research at Wharton. “But once average investors get hurt, as they will, all bets are off.” The threat is that broadening the investor pool will inevitably lead to the regulation of hedge funds.

## McHedge Funds

In the current bear market, it's easy to see why investors of all stripes are eyeing hedge funds as an asset class. Hedge funds are believed to perform well in good weather and bad. In 2002, the Standard & Poor's 500 Index lost more than 22% of its value, while the MSCI World Equity Index dropped 21%. The CSFB/Tremont Hedge Fund Index, on the other hand, was up 3% for the year.

At the same time, there is an institutional push to make hedge fund products available to investors who are not wealthy.

Funds of funds – essentially, funds that invest in a basket of different hedge funds – have lower minimums, even as low as \$25,000 for some investors. Hedge funds typically get a 1-2% management fee and a 15-20% performance fee based on the fund's returns, although fund-of-funds managers make their own arrangements with hedge funds and collect a premium from investors. “When you have such high profits, you can spend a lot of money on the sales effort,” says Blume. “To a great extent, financial products to the middle class are sold by securities firms. If they have more money to pay salesmen, they're going to sell more. There's a big incentive to do that.”

Meanwhile, ideas for hedge fund products are proliferating. PlusFunds, a New York-based financial company, is developing what it hopes will be an investable product based on a hedge fund index, somewhat akin to Spiders, the Standard & Poor's Depository Receipts, or Qubes, the Nasdaq-100 Index Tracking Stock. Interest is also brewing in the mutual fund industry to try to create mutual funds or other mainstream-oriented investment vehicles that invest in hedge funds. This is currently prohibited, but if a viable kind of legal framework is found, the plan might get off the ground.

Practically, the fund-of-funds effort and other forays into the once-secretive world of hedge funds appear to be a way around the accredited-investor requirement. The risk to average investors is that hedge funds are an enormously risky asset class and investors are currently afforded little protection. The irony is that such a plan to extend the reach of hedge funds and circumvent a strict regulatory requirement might wind up leading directly to the onerous and debilitating regulation of hedge funds.

## Hedge Fund Implosions

Recently, hedge funds have come under fire for misbehavior and runaway strategies. Some hedge funds abandon the risk profile investors have been led to expect. Others commit fraud or make fatally bad bets. In early January, for example, Eifuku Master Fund, a \$300 million hedge fund in Japan whose investors included the financier George Soros, laid on a series of unfortunate trades and promptly collapsed. There have been a number of other high-profile hedge fund implosions, including the notorious granddaddy of them all: Long-Term Capital Management, which in 1998 required a Federal Reserve-brokered \$3.6 billion bailout from a group of international financial institutions because of fear that the financial system could collapse if the fund were allowed to fail.

Hedge funds have faced down regulation in the past. After the Asian financial crisis of 1997, hedge funds were lambasted for whipsawing and destabilizing emerging markets, and for fueling financial contagion between countries.

Herring notes that there are three rationales for regulating hedge funds: 1. to protect consumers, 2. to protect the integrity of markets, and 3. to prevent systemic risk. As long as access to hedge funds is restricted to wealthy individuals, consumer protection is not an issue. But concerns about the integrity of markets and financial stability have risen.

The prime minister of Malaysia, for instance, instituted capital controls to limit the speculative excesses of hedge funds, and the collapse of LTCM intensified concerns about systemic risk. The Financial Stability Forum at the Bank for International Settlements studied the subject and ultimately issued a series of what it referred to as sound risk management practices for banks and lenders to hedge funds. It did not press for regulation, although it warned that other options might be considered in the future.

Nonetheless, direct regulation has always been avoided. And since the late 1990s, hedge funds as a group have reduced their leverage and changed some of their trading strategies.

Currently, there is an increasing push to restrict short-selling, a practice common in hedge funds and some investment management firms. Critics argue that aggressive hedge funds target the stock price of faltering companies and sell large amounts of the stock short, smacking down the price. But like other regulatory gambits, this one may be myopic. Placing negative bets on a company may be unsavory to some, but it serves a legitimate function in the markets. Inevitably, Marston points out, a restriction on short-selling would also hamper the essential strategy of many hedge funds, which involves, in the case of market-neutral funds, systematically shorting some stocks or assets while going long on other assets. “By doing this, hedge funds are able to reduce the net risk of the portfolio,” he says. “The SEC restricting short sales would be a very bad idea. It would also be a fundamental attack on the nature of the model hedge funds are using.”

While cries for regulation are getting louder, the viability of regulation also remains an issue. Hedge funds are footloose and often domiciled offshore, and if the regulatory regime in one country changes, they can pick up and switch jurisdictions, observes Herring. “At the same time,” he adds, “hedge funds must operate in large, deep financial markets, and there are always ways for the SEC and U.S. Treasury to get at them if they have the will and political mandate to do so.”

## **Bad Numbers**

As hedge funds become less mysterious and command larger amounts of investor money, some chinks are beginning to show in the public armor. An important issue for individual as well as institutional investors concerns the quality of information about hedge fund performance. Since reporting is voluntary and not systematic, it is difficult to get complete information about how hedge funds fare. “One thing that’s very clear is that people are probably overestimating returns in hedge funds,” says Herring.

The problem is that hedge fund data have significant survivor bias. “Incentive fees typically kick in only when a fund goes above its previous high,” explains Herring. “So if a strategy crashes, rather than keep the fund going, which would generate very low fees for the managers, or possibly no fees, they’ll close the fund and start another with a new track record.” In contrast, the regulated mutual fund industry doesn’t have this problem since it’s expensive to terminate a mutual fund and since there’s little incentive to do so as long as fees are still being collected.

A related reporting problem is that the pricing of illiquid assets in a hedge fund may not be sufficiently accurate. Highly liquid financial products have values that can be ascertained daily in the market. But not all products in a hedge fund’s portfolio are traded on an exchange or are liquid enough to have daily prices.

If a hedge fund owns a junk bond that’s not traded too often, it’s evaluated, but the mark-to-market value,

or fair value, isn't necessarily the value a seller would get for it in the marketplace, notes Blume. The value is somewhat subjective and could be used to help reduce the volatility of returns, he adds. So people may think they're getting better returns with lower volatility than what they're actually getting.

## Better Disclosure

Individual investors aren't the only ones clambering aboard the hedge fund express. Increasingly over the last few years, the well-heeled pension fund community has been turning to hedge funds as an alternative asset class to buoy returns. They face some of the same problems with transparency that individuals face, although they have the sophistication and wherewithal to understand the workings of hedge funds and the risks they are taking on. But hedge funds must also meet the requirements of pension funds' investment boards, which typically insist on daily prices for products and more information about risk sensitivities and strategies than hedge funds tend to provide.

The kind of disclosure pension funds require, however, does not need to come from regulation. "If a large investor or series of large investors invest in hedge funds, they're going to demand more disclosure," says Blume. "That will happen with or without regulation."

Marston agrees. "I suspect what will happen is that some trade groups and large institutional investors will start to develop the means to look at hedge funds more systematically," he says. "The Common Fund in the endowment market, for instance, is big enough to insist on more transparency. The whole philosophy behind the regulation of hedge funds is that you don't micromanage them." Yale University, he points out, has invested 25% of its \$10 billion portfolio in hedge funds – and that makes it big enough to demand transparency.

Unfortunately, this kind of disclosure isn't sufficient for average – that is, non-accredited - investors. Hedge fund managers are not accountable to investors in the same way that mutual fund managers are, and retail investors can be easily misled. "It's buyer beware," says Marston. "On the other hand, as long as you keep hedge funds with wealthy investors, these guys are sophisticated and should be able to take care of themselves."

Of course, hedge funds are crossing – or being pushed – across the Rubicon into the realm of regular investors who don't know what, say, inverse floaters are and who stand to lose large sums of money. That lowers the threshold for regulation. And therein lies the critical dilemma that the hedge fund community must now confront.

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