

# Recommendations for Reality-Based Regulatory Reform of Hedge Funds and Other Private Pools of Capital

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*Abstract: Taub contends that current legislative proposals that would require hedge fund managers to register as Investment Advisers with the SEC are necessary but insufficient. In order to protect investors and reduce systemic risk, hedge fund operations and investment strategies should be subject to many of the substantive requirements of the Investment Company Act of 1940, the law governing mutual funds. These requirements might include leverage restrictions, asset valuation controls, limitations on self-dealing and related party transaction and fiduciary duties to fund investors. The justification for continued exemption from comprehensive regulation is based upon false premises, including the myth that only “sophisticated investors” have capital at risk through hedge funds. Taub dispels these “myths” and recommends reality-based regulatory reform.*

In the coming months, it is quite likely that legislation will be enacted, requiring hedge fund managers to register as Investment Advisers with the Securities and Exchange Commission. The proposed legislation<sup>1</sup> would *not* actually regulate hedge funds or other private pools themselves. Instead, new laws would merely close a loophole that has allowed managers (or “Advisers”) to avoid registration and the attendant disclosure, recordkeeping, compliance, proxy voting, inspection and other requirements common to all other investment advisers.

These requirements are very mild and hardly new. Indeed, more than half of the members of the Managed Funds Association already register as Investment Advisers with the Securities and Exchange Commission.<sup>2</sup> In addition, hedge fund managers would still be given special treatment regarding fees. The lucrative 2 and 20<sup>3</sup> type fee structure can only exist with this continued favoritism. In contrast, other advisers (including mutual fund managers) are prohibited from charging performance fees based upon their clients’ profits.<sup>4</sup> They can only charge a percentage of assets under man-

<sup>1</sup> A number of bills have been introduced in 2009 proposing to require hedge fund managers to register with the Securities and Exchange Commission under the Investment Advisers Act of 1940 (the “Advisers Act”). These include, The Hedge Fund Advisers Registration Act, H.R. 711, introduced in January 2009 by Rep. Mike Castle (D-DE) and Rep. Mike Capuano (D-MA), The Private Fund Transparency Act of 2009, S. 1276, introduced by Sen. Jack Reed (D-RI) in June, 2009 and The Private Fund Investment Advisers Registration Act of 2009, introduced by the Obama Administration in July 2009. In contrast, the Hedge Fund Transparency Act, introduced in January by Sen. Chuck Grassley (R-IA) and Sen. Carl Levin (D-MI) would require the fund itself to register under a different law, the Investment Company Act of 1940, unless the fund provided disclosure and cooperation to the SEC.

<sup>2</sup> Id. Testimony of Richard H. Baker, President and Chief Executive Officer, The Managed Funds Association, available at [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/baker\\_testimony.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/baker_testimony.pdf)

<sup>3</sup> Two percent of assets under management and twenty percent of capital gains up to a high water mark.

<sup>4</sup> Section 205(1)(a) of the Investment Advisers Act sets forth a general ban on the adviser receiving a share of one’s clients profits. Investment Advisers Act of 1940. Specifically it prohibits an agreement that: “provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.” Congress included this provision in the Advisers Act because of the belief that these types of “per-

agement and sometimes a fulcrum fee.<sup>5</sup> Also, even with registration under the Advisers Act, hedge fund managers would remain free to engage in a variety of self-serving transactions at the expense of fund investors and to take on excessive leverage that can damage investors and the markets. This is because the funds themselves would remain exempt from the Investment Company Act of 1940 (the “1940 Act”).

While so much more is needed to protect investors and prevent systemic risk, at the moment neither Congress nor the Administration seem prepared to take more than this small step requiring manager registration. Signs that the process might now be focused more on industry consensus than investor protection were visible in recent Congressional hearings. On October 6, 2009, the United States House of Representatives Committee on Financial Services held a hearing entitled, “Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office.” Panel Two promised a discussion of “Enhancing Oversight of Private Pools of Capital.” However, all four witnesses were members of the hedge fund, venture capital or private equity management industries.<sup>6</sup> Not a single witness was an institutional investor, a retail investor or any trade association with an investor-protection focus. Even in Panel One, “Strengthening Investor Protection,” the only witness who spoke about hedge funds or private pools was a representative from a trade association for investment advisers.

Nonetheless, the outcome was in some ways positive. It is clear that the industry supports some level of regulatory reform. This is in stark contrast to the steady resistance since the Long Term Capital Management (“LTCM”) meltdown of 1998.<sup>7</sup> For example, in 2004, the hedge fund industry and legal counsel had objected to the SEC proposed rule that managers be required to register under the Advisers Act.<sup>8</sup> With industry support, now, however, Congress likely will provide the SEC with the authority necessary to put this in place. However, some industry leaders hope Congress will impede the SEC from ruling that hedge fund managers owe fiduciary duties to hedge fund investors.<sup>9</sup> It is striking that an industry trade association has objected to this trusted doctrine of investor protection.

Even with expected legislative success, this should be just the beginning of the conversation. Hedge fund adviser registration and the attendant disclosure, recordkeeping and other requirements are nec-

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formance fees created incentives for advisers to take inappropriate risks in managing a client’s account in order to increase advisory fees.” Div. of Inv. Mgmt., U.S. Sec & Exch. Commission, *Protecting Investors: A Half Century Of Investment Company Regulation* 5 (1992).

<sup>5</sup> A fulcrum fee increases and decreases based upon performance relative to a benchmark.

<sup>6</sup> *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office*: Hearing Before the House Comm. on Financial Services, 111th Cong. (2009). For witness list and testimony see, [www.house.gov/apps/list/hearing/financialsvcs\\_dem/hr\\_092909.shtml](http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr_092909.shtml)

<sup>7</sup> A giant hedge fund with \$125 billion in assets and just a 4-year track record that collapsed in 1998.

<sup>8</sup> See, e.g. U.S. Sec. & Exch. Comm’n, Comments by the Managed Funds Association on Proposed Rule: Registration Under the Advisers Act of Certain Hedge Fund Advisers, [www.sec.gov/rules/proposed/s73004/mfa102204.pdf](http://www.sec.gov/rules/proposed/s73004/mfa102204.pdf) (Oct. 22, 2004) and available at [www.sec.gov/rules/proposed/s73004/mfa101804.pdf](http://www.sec.gov/rules/proposed/s73004/mfa101804.pdf) (Oct. 18, 2004). Ultimately, as a result of litigation brought by a hedge fund manager, the D.C. Circuit overturned the rule on the basis that the SEC lacked the Congressional authority to treat a single hedge fund as more than one “client.”

<sup>9</sup> See Baker Testimony, supra note 2.

essary but insufficient steps. The problems associated with hedge funds and other unregulated pools relate to investment practices and operational controls. These problems predate the global financial crisis.<sup>10</sup> These problems were common to the hedge fund and mutual fund precursor – the investment trust. The justification for allowing some investment pools (like mutual funds) to be highly regulated and others (like hedge funds) to be unregulated must now be revisited. The bifurcation is based upon assumptions about the skills and behavior of “sophisticated investors.”<sup>11</sup> We have learned from LTCM through the most recent global financial crisis that “sophisticated investors” do not have the ability to select and monitor “private” unregulated investment options. Moreover, we can now appreciate that the decisions made by sophisticated investors affect not just them (the direct owners) but the true underlying investors and market integrity.

So long as hedge funds and other investment pools have control over the savings and retirement security of ordinary Americans they should be made safe. And, as long as these pools have the ability individually or collectively to create systemic risk they should also be subject to substantive investment regulations. Accordingly, we should eliminate the loopholes that allow unregistered investment pools broad discretion to operate in the shadows, without transparency or supervision, to engage in self-dealing or related-party transactions, without a fiduciary duty to fund investors, to inaccurately value and inadequately protect assets and to take on excessive leverage and illiquid portfolio holdings. Instead, a 1940-Act “lite” regime should apply to investment pools regardless of whether they are ostensibly offered privately to “sophisticated investors.” In other words, some of the substantive protections of the 1940 Act that govern mutual funds should apply to hedge funds. While the federal securities laws generally use disclosure and enforcement as tools to regulate conduct, the country learned in 1929 and again in 2008 that regarding investment pools, disclosure is not enough. Substantive restrictions are more effective tools to protect pools of other people’s money.

A full study comparing the investment trust abuses of the early 20<sup>th</sup> Century to the problems with some hedge funds today is necessary. In addition, we should not build from the current state of nearly no regulation or oversight. Instead, we should start with the 1940 Act framework. We should then review the 1940 Act and ask for a justification as to why private pools should not be subject to each provision. And, if there is a socially beneficial reason that such a provision would be undesir-

<sup>10</sup> Robert Metz, *Market Place: Big Guys Lost in Hedge Fund*, N.Y. TIMES, Mar. 16, 1972.

<sup>11</sup> See, e.g. Speech by SEC Commissioner Luis A. Aguilar, Hedge Fund Regulation on the Horizon: Don’t Shoot the Messenger, Spring 2009 Hedgeworld Fund Services Conference, New York, NY, June 18, 2009 (“One of the underlying principles behind the idea that hedge funds could operate with little to no regulatory requirements was that interests in the funds were only sold in private offerings to wealthy investors. These investors were thought to be sufficiently “sophisticated” to protect their interests, and to be able to engage in effective arms-length negotiation in order to achieve fair and equitable terms.”) See also, FINRA Funds of Hedge Funds – Higher Costs and Risk for Higher Potential Returns, available at [www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P006028](http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P006028) (“Historically hedge funds have been offered as unregistered securities that, because of the risks they posed, were only available to a limited number of wealthy, financially sophisticated investors.”)

able, we should not simply create an exemption, but consider whether a “lighter” provision might be suitable.<sup>12</sup>

The freedom from regulation uniquely afforded to hedge funds and other private pools of capital is premised upon oft-repeated, but questionable premises. Those who resist meaningful substantive regulation of hedge fund operations and investment practices continue to rely upon these “myths.” In the interest of clarity, in its conclusion this issue brief offers reality to replace these myths.

## Dispelling the Top Ten Myths about Hedge Funds

*Myth 1:* Hedge funds investors are all high net worth individuals.

*Reality 1:* Americans of modest means are invested in hedge funds through financial intermediaries. These include pension fund beneficiaries, mutual fund investors and others whose savings and future retirement income are exposed to unregulated hedge funds and other so-called “private” pools.<sup>13</sup> While the “direct” owner of a limited partnership interest in a hedge fund might be an institution, the institution often is merely a middleman, investing other people’s money. In addition with the “retailization” of hedge funds through the fund-of-fund structure, a broader range of ordinary individuals are exposed both to riskier investments and higher management fees.<sup>14</sup>

*Myth 2:* Hedge funds direct investors are financially “sophisticated.”

*Reality 2:* “Direct investors” or owners are those who have the authority directly to purchase interests in hedge funds on their own account or, typically, as a financial intermediary on behalf of many others. These direct investors are designated to be sophisticated based upon assets or wealth alone. There are no special skills or knowledge required of an individual before he directly purchases interest in a hedge fund. For real people who directly invest in hedge funds, the “sophistication” test is asset or income based. For example, someone with an annual salary of \$200,000 can qualify to be a direct investor.

*Myth 3:* Sophisticated investors have the ability to select and monitor private offerings without the need of government protections

*Reality 3:* Even the most financial savvy of investors including Nobel prize-winning economists and other highly educated and trained individuals have lost huge sums by selecting untrustworthy hedge fund managers or unreasonably relying upon risky strategies and excessive leverage. When subject to lawsuits, many whom the law deems to be “sophisticated investors” claim they did not have the ability to select and monitor hedge funds. Sophisticated investors can neither take care of themselves nor

<sup>12</sup> For example, the 7-day redemption requirement for mutual funds may not be desirable for hedge funds. The obligation to stand ready to redeem shares places pressure on mutual funds in terms of investment choices and liquidity. There are many hedge fund strategies that require stickier capital. Examples may be used to illustrate how these types of investments can improve corporate governance and performance of underlying portfolio investments.

<sup>13</sup> Speech by SEC Commissioner Luis A. Aguilar, *supra* note 11. It is clear that “In recent years, [hedge fund] growth has been fueled in part by institutional investors, such as endowments, foundations, insurance companies, and pension plans.”

<sup>14</sup> These fund-of-hedge fund structures are more costly to investors than traditional mutual funds. Direct fees and expenses (the expense ratio) is usually around 2.15% compared to an average of 1.36%. In addition, FINRA noted that managers of a fund of funds receives an addition 10% of annual gain above an 8% benchmark. Other experts observe that the performance fee is 5% or 10%.

the investors who entrust them with their money. They have proven to be no match to the complexity and fraud that arises in an opaque market. Moreover the failures of sophisticated investors impact the market as a whole. Since and including the collapse of LTCM, the news pages are filled with stories of institutions and individuals who meet the legal definitions of “sophistication” being duped or swindled.

*Myth 4:* Hedge funds are offered privately.

*Reality 4:* To be a private offering, what is critical under the Supreme Court’s view is not just the number of people to whom the offer is made, but whether the investors can “fend for themselves”<sup>15</sup> without the need of detailed disclosures or protections. History has shown that those who select hedge funds are not capable of fending for themselves. Moreover the public at large is exposed with their savings channeled into unregulated funds through use of intermediary legal structures which “hide” the public faces and undercount the number of people who have assets at risk.

*Myth 5:* Hedge funds were not a contributor to the global financial crisis

*Reality 5:* Hedge funds did contribute to the global financial crisis in meaningful ways. However, this is a red herring. The need to regulate hedge funds pre-dated the global financial crisis and problems associated with hedge funds still exist. The most common objection to proposed regulation of hedge funds is the claim that hedge funds did not cause this crisis. Yet, hedge funds did play an important role. The convergence of undercapitalized mortgage pools, credit default swaps and leveraged hedge funds created the perfect storm.<sup>16</sup> Hedge funds were willing buyers of risky tranches of subprime mortgage-backed CDOs.<sup>17</sup> In addition, they were big players in the credit default swap market. The collapse of the two Bear Stearns hedge funds signaled a transformation of the subprime crisis into a much larger credit problem. Unregulated hedge funds are a problem due to the harm they can cause to investors and the markets because they cannot withstand market turmoil. The need to deleverage during the financial crisis created broader problems. Most importantly the *techniques* used by hedge funds were the cause of this crisis and earlier meltdowns and crashes. Restricting a dangerous behavior makes sense regardless of who the market player is. Excessive leverage was a chief contributor to the collapse and we know that hedge funds have no leverage restrictions. The greatest leverage were broker-dealers and hedge funds at 27 to 1. At the other end of the spectrum were commercial banks (9.8 to 1) and savings banks (8.7 to 1).<sup>18</sup> We do not know the full extent of economic leverage because there is not uniform of clear disclosure. Limiting leverage ratios, should not offend those hedge funds that act responsibly.

<sup>15</sup> SEC v. Ralston Purina, 346 U.S. 119, 125 (1953).

<sup>16</sup> Richard Bookstaber, *Blowing up the Lab on Wall Street*, TIME, Aug. 6, 2007.

<sup>17</sup> Paul Tustain, Bear Stearns and MBS Hedge Funds: What are the Real Risks Today? SAFE HAVEN, Jun. 22, 2007, available at <http://www.safehaven.com/article-7812.htm>

<sup>18</sup> CONG. OVERSIGHT PANEL, SPECIAL REP’T ON REG. REFORM 24 (January 2009) (This report was submitted under Section 125(b)(2) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343).

*Myth 6:* Since many hedge funds offer market benefits, we must not place any limits on risky techniques used by other hedge funds.

*Reality 6:* Not all hedge funds use leverage, and many hedge funds have positive effects on the market. Some activist hedge funds can improve long-term shareholder value. Some pressure entrenched management to create long term shareholder value. They also have the potential to mitigate risk and perform better than the market index during bear markets. However, one does not need to overlook the benefits of some hedge funds to recognize the dangers others have, do and can cause due to their unlimited investment options. At the heart of the sudden, massive failure of LTCM was leverage. It had capital of around \$4.8 billion, but assets of more than \$125 billion and was said to have derivatives positions with a notional value of \$1.25 trillion. In a report after the event, the President's Working Group noted: "that excessive leverage can greatly magnify the negative effects of any event or series of events on the financial system as a whole. The near collapse of Long-Term Capital Management . . . highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system."<sup>19</sup> This was not an isolated event. There were several more hedge fund scandals, including in 2006, when Amaranth Advisors lost \$6.4 billion of its \$9 billion in assets as a result of aggressive speculation in the natural gas markets.<sup>20</sup> At the time, of this various scandals, many recognized the failure of private constraints on excessive risk taking by unregulated pools of capital. The President's Working Group wrote that "Our market-based economy relies primarily on market discipline to constrain leverage. But market discipline can break down."<sup>21</sup> Nevertheless, many of the recommendations in the report were never implemented. There was no recommendation for outright regulation of hedge funds or restrictions on hedge fund leverage.

*Myth 7:* Hedge funds are not significant market players

*Reality 7:* At the recent peak, hedge fund had assets totaling around \$1.9 trillion. Presently hedge fund assets are \$1.5 trillion. While this may seem small relative to the mutual fund industry worldwide, it is worth noting that US mutual fund assets were at that same level in the early 1990s. While there are more than 18,000 hedge funds across the globe, the assets are highly concentrated with 75% of the assets are managed by approximately 200 firms, each with more than \$1 billion under management. Recently hedge funds were said to make 30% of all US fixed income trades, including 85% of distressed debt and 80% of certain credit derivative trades.<sup>22</sup>

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<sup>19</sup> Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management*, (Apr. 2009), available at <http://www.treas.gov/press/releases/reports/hedgfund.pdf>

<sup>20</sup> William Klunk, Actuary Domestic Policy Division, Pension Funds Investing in Hedge Funds, CRS Report to Congress, June 15, 2007.

<sup>21</sup> President's Working Group on Hedge Funds, *supra* note 19 at viii.

<sup>22</sup> John P. Hunt, *Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports – Raising the Bar but Missing Risks*, Berkeley Law working paper, June 2008.

*Myth 8:* The exemption given to hedge funds in the 1930s and 1940s anticipated the types of funds in existence today

*Reality 8:* The first hedge fund was launched in 1949 by Alfred Jones. It was a true hedge – designed to provide market-neutral returns.<sup>23</sup> In other words it was designed to reduce market risk. He went long on undervalued stocks and short on overvalued. In the first twenty years of their history, these funds experienced little growth. There were only about 215 in 1968.<sup>24</sup> By the 1990s, there were possibly 3,000. Over 16 years, hedge funds experienced a 3,000% growth rate.<sup>25</sup> Hedge funds have higher leverage, are more interconnected and have shown to create systemic risk. Had hedge funds been subject to any leverage restrictions, even not as draconian as mutual funds, the damage would not have been as severe. Due to the leverage restrictions under the 1940 Act, there have not been problems with the use of leverage by mutual fund or close-end funds. Moreover, the level of leverage at LTCM was far greater than the magnitude that the 1940 Act was designed to prevent.<sup>26</sup>

*Myth 9:* Hedge funds can all truly hedge risk in times of turmoil

*Reality 9:* Unregulated hedge funds are a problem due to the harm they can cause to investors and the markets because they cannot withstand market turmoil. Even if they were not the sole or primary contributor to the GFC, they help to magnify the damage done and harm their own investors. In terms of defining the systemic risk, many acknowledge that hedge funds are like banks, that generate tremendous negative externalities when they fail. Yet, hedge funds are even more prone to such effects because:

“[U]nlike banks, hedge funds can decide to withdraw liquidity at a moment’s notice, and while this may be benign if it occurs rarely and randomly, a coordinated withdrawal of liquidity among an entire sector of hedge funds could have disastrous consequences for the viability of the financial system if it occurs in the wrong time and in the wrong sector.”<sup>27</sup>

In addition, recent research suggests that in times of extreme crisis (LTCM and the global financial crisis), certain latent risk factors that hedge fund share interfere with the “diversification benefits that can usually be obtained by investing across different hedge fund strategies in tranquil times.”<sup>28</sup>

*Myth 10:* Regulation will kill the industry

*Reality 10:* There is also a popular claim that government regulation kills private enterprise. History disproves this contention. In the mutual fund case the opposite was true. Only with government oversight and substantive controls was investor confidence restored in investment trusts. Then the industry flourished. The 1940 Act (and associated rules) is complex, detailed and comprehensive.

<sup>23</sup> Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-term Capital Management* 25 (2000).

<sup>24</sup> *Id.* at 26.

<sup>25</sup> Klunk, *supra* note 20.

<sup>26</sup> MATTHEW P. FINK, *THE RISE OF MUTUAL FUNDS: AN INSIDER’S VIEW* 44 (2008) (In the words of the former president of the Investment Company Institute, Matthew Fink, LTCM’s leverage ratio “would have been the envy of the most speculative closed-end funds of the 1920s.”)

<sup>27</sup> Andrew W. Lo, *Hedge Funds: An analytic Perspective* 302 (2008).

<sup>28</sup> Monica Billio, Mila Getmansky & Lorianna Pelizzon, *Crises and Hedge Fund Risk*, Draft, Sept. 7, 2009

Many initially predicted the law would destroy the industry. However, the opposite has occurred. One of the most regulated industries has become a success story. At the time of the 1940 Act, there were only \$2 billion in assets under management at U.S. funds. By the time of the study, around \$1.3 trillion.<sup>29</sup> And, as of June 2009, over \$10 trillion.<sup>30</sup> Many asset managers acknowledge the race-to-the-top effects of sound regulation.<sup>31</sup>

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<sup>29</sup> HALF CENTURY, *supra* note 4 at xviii.

<sup>30</sup> Investment Company Institute website.

<sup>31</sup> Aguilar speech, *supra* note 11 citing Letter from Third Avenue Funds Chairman of the Board Martin J. Whitman to Shareholders, at 6 (Oct. 31, 2005) available at [www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-05Q4.pdf](http://www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-05Q4.pdf). Martin Whitman wrote in a letter to shareholders that “Because of the existence of strict regulation, the outside investor knows that money managers can be trusted. Without that trust, the industry likely would not have grown the way it had grown.”