

RECOMMENDATIONS FOR REALITY-BASED REGULATORY REFORM OF HEDGE FUNDS AND OTHER PRIVATE POOLS OF CAPITAL

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Current legislative efforts to regulate hedge funds are necessary, but likely to prove insufficient. As they stand today, these proposals would only require hedge fund managers to register as Investment Advisers with the Securities and Exchange Commission, but would fail to actually regulate hedge funds or other private pools themselves. Despite the recent support of the industry for some level of regulatory reform (relative to its steady resistance since the Long Term Capital Management (“LTCM”) meltdown of 1998), at the moment neither Congress nor the Administration seem prepared to take more than the small step of requiring manager registration.

While registration under the Advisers Act implies that hedge fund managers would have to comply with requirements standard to other investment advisers (e.g. attendant disclosure, recordkeeping, compliance, proxy voting, inspection, etc.), these 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. 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.

The problems associated with hedge funds and other unregulated pools relate to investment practices and operational controls, which predate the global financial crisis. The first step in solving these underlying issues involves revisiting the justification for allowing some investment pools (like mutual funds) to be highly regulated and others (like hedge funds) to be unregulated. As argued in [Taub \(2009\)](#), this bifurcation is based upon assumptions about the skills and behavior of “sophisticated investors”, which in most cases are nothing more than myths. Thus, some of the substantive protections of the 1940 Act that govern mutual funds should apply to hedge funds.

Regulation of hedge funds should be based on the following principles:

- Federal securities laws generally use disclosure and enforcement as tools to regulate conduct. As the experiences of 1929 and 2008 have shown, disclosure is not enough.
- Substantive restrictions are more effective tools to protect pools of other people’s money.
- Regulation efforts should start from the 1940 Act framework, and review it to ask for a justification as to why private pools should not be subject to each provision.
- In cases where there is a socially beneficial reason that such a provision would be undesirable, we should not simply create an exemption, but consider whether a “lighter” provision might be suitable.
- New requirements might include leverage restrictions, asset valuation controls, limitations on self-dealing and related party transaction and fiduciary duties to fund investors.

Reference

Taub, Jennifer (2009). “[Recommendations for Reality-Based Regulatory Reform of Hedge Funds and other Private Pools of Capital](#)” SAFER Brief #9, Political Economy Research Institute, October.