DISPELLING THE TOP TEN MYTHS ABOUT HEDGE FUNDS

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The freedom from regulation uniquely afforded to hedge funds and other private pools of capital is based 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."

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.

Myth 2: Hedge funds direct investors are financially "sophisticated."
Reality 2: "Sophistication" in the context of hedge funds is based upon assets or wealth alone, which implies that no special skills or knowledge is required to directly purchase interest in a hedge fund.

Myth 3: Sophisticated investors have the ability to select and monitor private offerings without the need of government protections.
Reality 3: In practice, sophisticated investors have proven to be no match to the complexity and fraud that arises in an opaque market. Moreover the failures of these investors impact the market as a whole.

Myth 4: Hedge funds are offered privately.
Reality 4: Historically those who select hedge funds have not been capable of "fending for themselves" without the need of detailed disclosures or protections—a key component of private offering under the view of the Supreme Court.

Myth 5: Hedge funds were not a contributor to the global financial crisis.
Reality 5: The convergence of undercapitalized mortgage pools, credit default swaps and leveraged hedge funds created the perfect storm. Hedge funds were willing buyers of risky tranches of subprime mortgage-backed CDOs, as well as big players in the credit default swap market.

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. 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.

Myth 7: Hedge funds are not significant market players.
Reality 7: At the recent peak, hedge fund had assets totaling around $1.9 trillion (and $1.5 trillion presently). 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.

Myth 8: The exemption given to hedge funds in the 1930s and 1940s anticipated the types of funds in existence today.
Reality 8: Compared to the early hedge funds, today's funds have higher leverage, are more intercon-

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nected, 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.

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. In terms of defining the systemic risk, many acknowledge that hedge funds are like banks in that they can generate tremendous negative externalities when they fail. Hedge funds are even more prone to such effects because they can quickly withdraw liquidity.

Myth 10: Regulation will kill the industry.
Reality 10: As shown by the mutual fund case, it was thanks to the 1940 Act (and associated rules) that investor confidence was restored, and the industry flourished.

Reference

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