Chapter 12*

Hedge Funds and Mutual Funds

Overview

Hedge funds and mutual funds are major participants in the so-called shadow banking system, which runs parallel to the more standard banking system. Hedge and mutual funds add value to the financial system by being primary providers of liquidity and a source for sophisticated capital.

Hedge funds can be highly levered asset management organizations. A significant drop in the value of their underlying assets could, therefore, cause the hedge fund to fail. If the hedge fund held a large quantity of illiquid assets that generated fire sales, or if the fund were interconnected to many other financial firms, systemic counterparty risk could result. There are many ifs, but the collapse of Long-Term Capital Management (LTCM) in 1998 shows that there are circumstances under which hedge funds and mutual funds may impose externalities on the financial system.

Mutual funds are much less levered, so, on the surface, these funds would appear to be at little risk. Many mutual funds, however, are subject to daily redemptions. If a large enough economic shock took place, or some type of operational risk were realized, then these funds could be susceptible to runs. Since mutual funds hold large quantities of assets, systemic risk could emerge through fire sales or a run on the system. Money markets aside, however, no example of this type of event has occurred.

The Crisis

While the first major realization of the financial crisis came about when two of Bear Stearns's large levered hedge funds collapsed in June 2007, there is no evidence to suggest that this, or later failures, caused the recent financial crisis or that they contributed to its severity in any significant way. In fact, a case could be made that hedge and mutual funds that invested in structured finance products actually reduced systemic risk in the crisis by taking these toxic products off the books of the banking sector.

Current Proposals Concerning Hedge Funds

While hedge funds are largely unregulated, they compete with regulated banks that have advantages like the explicit guarantee of deposit insurance and the implicit "too-big-to-fail" guarantee. Almost all mutual fund regulation is designed to protect investors. The case for hedge and mutual fund regulation can be built on two separate justifications: the potential for systemic risk; and investor protection in general. Regulation that limits the ability of hedge and mutual funds to impose externalities by generating systemic risk often diminishes their ability to add value to the financial system and their investors. Balancing these considerations is important.

---

* Working group: Stephen Brown, Marcin Kacperczyk, Anthony Lynch, Antti Petajisto, Matthew Richardson, Philipp Schnabl and Robert Whitelaw

The Senate bill requires hedge funds to register with the Securities and Exchange Commission (SEC) as investment advisers and raises the assets threshold for federal regulation of investment advisers from $25 million to $100 million, a move expected to increase the number of advisers under state supervision by 28%. According to the Senate bill, the SEC may require any investment adviser registered with the SEC to maintain such records and file such reports as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Agency for Financial Stability.[*] This data will be shared with the Agency for Financial Stability. The records and reports required to be filed with the SEC shall include a description of the following: (1) the amount of assets under management and the use of leverage; (2) counterparty credit risk exposure; (3) trading and investment positions; (4) valuation methodologies of the fund; (5) types of assets held; (6) side arrangements whereby certain investors in a fund obtain more favorable rights or entitlements than other investors; (7) trading practices; and (8) such other information as the SEC, in consultation with the Agency for Financial Stability, deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. Further, the SEC shall conduct periodic inspections and other inspections prescribed as necessary by the SEC of all records maintained by an investment adviser registered with the SEC. The Senate bill also requires investment advisers to use independent custodians for client assets to prevent Madoff-type frauds.

The House bill calls for the establishment of a Systemic Dissolution Fund to facilitate and provide for the orderly and complete dissolution of any failed financial company or companies that pose a systemic threat to the financial markets or economy. According to the House bill, the regulator can assess levies on hedge funds with $10 billion or more (adjusted for inflation) of assets under management, using the same guidelines as those to be used for large financial corporations. The House bill also proposes that the regulator, in consultation with the Financial Services Oversight Council (FSOC), shall create a risk matrix to be used in establishing assessments that takes into account a number of factors, including the risks presented by the financial company to the financial system, and the extent to which the financial company has benefited, or likely would benefit, from the dissolution of a financial company under the bill. The House bill explicitly includes the following factors: (1) the nature (including the amount when applicable) of the activities, assets, liabilities, sources of funding, as well as the market share and leverage level of the financial company; (2) the potential exposure to sudden calls on liquidity precipitated by economic distress; (3) the nature of the financial company's financial obligations to, and relationship with, other financial companies; and (4) the financial company's importance as a source of liquidity for the financial system.

In terms of international reforms of hedge funds, the Group of Twenty (G20), Financial Stability Board (FSB) and European Commission (EU) all call for the oversight of hedge funds, with a special emphasis on improving transparency, especially with respect to their leverage.

Evaluation of Current Proposals

[*] H.R. 4173, Sec. 5003 and 5004.

The House bill does not mention mutual funds, while the Senate bill only asks for studies into the financial literacy of mutual fund investors and into mutual fund advertising, both with a view to generating recommendations to improve investor protections. Yet the issues associated with regulating mutual funds overlap substantially with those of regulating hedge funds. The major differences are that hedge funds can use leverage, while mutual funds cannot, and hedge funds can slow or even halt redemptions, while mutual funds cannot. It is important to realize that long-only hedge funds have the same systemic risk characteristics as mutual funds.

The Senate bill gives very extensive powers to the SEC to regulate hedge funds as it sees fit: In addition to the listed items, the SEC is also given the authority to require anything else it deems necessary to achieve its objectives. Given that the SEC likely has its own conflicts of interest and has been prone to ineffectiveness in the past, it would be better if the SEC's mandate were instead limited to a few prespecified items that are clearly described in the bill.

Proposals Regarding Systemic Risk

Transparency to regulators can help them measure and manage possible systemic risk and is relatively costless. Consequently, we support the Senate bill's proposal that hedge funds provide information to the SEC about their trades and portfolios necessary to assess systemic risk. The information needs to be provided in a regular and timely fashion about both their asset positions and leverage levels.

If a hedge fund or group of hedge funds generates systemic risk for the financial system, then that hedge fund or group of hedge funds needs to be treated as a systemic institution and regulated (and taxed) as such. By requiring the regulator to assess levies on hedge funds with $10 billion or more of net asset value (NAV) for the Systemic Dissolution Fund using the same guidelines that are to be used for large financial corporations, the House bill is potentially a step in this direction. However, NAV alone is not sufficient to determine if a hedge fund (or mutual fund) is generating systemic risk. As we discuss above, the House bill recognizes this by explicitly listing a number of factors to be taken into account by the regulator when determining assessments -- factors that likely affect the ability of a hedge fund to generate systemic risk. It is critical that the regulator take these factors into account when determining assessments on hedge funds, and it may even be that after considering these factors, no hedge fund ends up being charged assessments. The House bill also leaves the door open for groups of hedge funds, which together are imposing systemic risk on the system, to be charged assessments by the regulator for the Systemic Dissolution Fund, since it leaves open the possibility (no matter how remote) that hedge funds with less than $10 billion in NAV could be charged such assessments.

Proposals Regarding Investor Protection

It is not at all clear that additional regulation is needed to improve protections for hedge fund investors. There are several important considerations: (1) such regulation is costly to funds; (2) the effectiveness of regulators like the SEC is questionable; (3) private information providers play an important role in the dissemination of information to investors; and (4) fiduciaries who are investing money in hedge funds on behalf of pension funds and other investors have the primary responsibility to do due diligence. However, we support the requirement in the Senate bill that investment advisers use independent custodians for client assets, since it is a simple way to prevent misappropriation of the hedge fund assets.

Under the Senate bill, the new threshold for required registration as an investment adviser with the SEC is $100 million up from $25 million. If the argument for registration is to provide investors with necessary information about the operational characteristics of funds, it is not clear why this requirement should be limited to funds over $100 million. It is perhaps better to have them register with the SEC and file the mandated Form ADV disclosure, as all mutual funds are required to do without artificial limitations on asset size or lockup period exception. Form ADV does not reveal competitive concerns such as positions taken and strategies used, but it does reveal conflicts of interest, both internal and external to the fund, and the existence of past legal or regulatory issues. In addition, registration opens the fund up to possible audit by the SEC. The mandated disclosures would have the additional benefit of shifting the burden of proof to fiduciaries who would otherwise claim "nobody told us, we did not know."

If any legislation is enacted with the purpose of protecting investors, we support greater disclosure of all expenses charged to fund investors, as well as greater transparency about any fund-level tax discrimination between investors. This is because both fees and taxes have a first-order impact on the investors' net return, and neither is well-disclosed in today's hedge fund business.