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SYMPOSIUM: THE REGULATION OF PRIVATE FUNDS: ARTICLE: PRIVATE INVESTMENT FUNDS: HEDGE FUNDS' REGULATION BY SIZE, *39 Rutgers L. J. 657(2008)*

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BIO:

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SUMMARY:
... Third, dishonest fund managers, who manage the assets of a larger number of investors, can inflict harm on individual investors. ... Hedge funds have escaped strict investment companies' and securities' regulation by following the exceptions in the law (e.g., the limits on the number and quality of advisees and investors and offerees of securities). ... Since hedge funds are not confined by the leverage and borrowing restrictions that apply to registered investment companies under the Act, hedge funds are free to use large amounts of leverage to engage in risky investments. ... It should be noted that even though Amaranth's losses in dollar terms were higher than Long-Term Capital's, the fund's collapse was met with a "shrug," because the market at the time could easily absorb the losses. ... Regulated lenders, such as banks and broker dealers, should be required to keep hedge fund borrowing on their balance sheet, and prohibit them from selling the loans they made or covering their risks by any form of derivatives, third party obligations, insurance, and any other mechanisms currently available or in designed in the future.

TEXT:

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I. INTRODUCTION

This Article focuses on hedge funds - a species of private investment funds. These funds appeared in the 1950s and remained active but small. Then, in a fairly short period, they grew enormously to over $ 1.5 trillion, although the estimates vary. n1 Hedge fund managers engage in more than twenty-five different categories of investment strategies. n2 Since 2002, the number of hedge funds has more than doubled to an estimated 9,000 funds, n3 and their assets have grown by 400% to an estimated $ 1.4 trillion since 1999. n4 Other estimates are higher, suggesting current hedge fund assets at $ 2 trillion and their number worldwide at 13,000, although the United States [*658] market accounts for 70% of the funds' assets. n5 The different estimates may be due to the fact that these funds are not required to report as much as other regulated pools of assets are, that the funds are absorbing assets globally, and that their investor and lender base has grown. The number of funds does not represent their asset concentration, however. "The average size of a hedge fund, however, just exceeds $ 100 million. Thus, ten percent of the hedge funds hold about ninety percent of the total hedge fund assets." n6 Hedge fund managers engage in many different investment strategies. n7 But their size has increased by borrowing and by a variety of indirect leveraging techniques, such as short positions, futures, repurchase agreements, options, and other derivative contracts. n8 In addition, there is also a growing concern over the retailization of hedge funds. n9 Hedge funds have reached small investors' money indirectly by attracting mutual funds and pension funds. n10

Some hedge funds have produced enormous profits for their investors and their managers. Other funds have suffered significant losses due to fraud, n11 and some have generated devastating losses by speculation and risky structures. n12

This symposium poses the questions of whether private funds should be regulated, and whether the Securities and Exchange Commission ("SEC") should increase the level of its regulation over these funds. The attempts of the SEC to regulate the managers of hedge funds have been only partially successful. n13

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More importantly, the freedom of hedge funds from regulation is important to our financial system. n14 The fund managers are the mavericks, the innovators and risk-takers. They offer experimental and innovative approaches. Some of these approaches contribute to the efficiency of the markets. For example, a number of hedge funds trade in "miss-priced assets" and offer alternative investments to pension funds. These funds perform very well in market downturns. n15 Some funds may provide early danger signals, which are helpful to the markets and the regulators; that is, so long as these funds do not threaten to undermine the entire financial system. These funds did not threaten the financial system. That is when the funds remained small and investors did not clamor to invest in them. So long as they remained unique and out of the ordinary actors they did not endanger the system.

While there is a need to limit the impact of hedge funds on the financial system, I suggest that this goal should be achieved by regulating the size of these funds. Rather than controlling the funds' actions or their actors, it is the source of these funds' assets that requires control. Hedge funds should remain free of additional regulation if they remain small in terms of the amounts that their lenders invest in them. Thus, the necessary regulation of today's hedge funds should focus on how hedge funds grow in terms of assets under management, and who enables them to grow in this way.

This Article suggests that the lenders - the banks and large institutional investors, as well as funds of funds - should be regulated. The regulation of these institutions should induce them to limit the amounts they offer to finance hedge funds by requiring the financing to be kept on their books, prohibiting the sale of this financing and perhaps by increasing the loan loss reserves; our existing philosophy and method of regulation, falling within the duties of these financing institutions to their savings investors.

This Article is organized as follows: Part I outlines the regulation of investment companies and the exceptions that shelter hedge funds from some regulation. Part II examines the source of hedge funds' growth in the past few years. Part III describes the fraudulent behavior of some managers of large hedge funds and the impact of their behavior on the financial system. Part IV suggests principles on which regulation should be based. It emphasizes that regulation aims not only, and perhaps not mainly, at protecting investors as much as it aims at protecting the financial system. [*660] Regulators should keep hedge funds small and relatively free to take risks. The main lenders and institutional investors should be regulated by reducing their incentives to finance hedge funds.

II.THE REGULATION OF INVESTMENT COMPANIES AND THE EXCEPTIONS SHELTERING HEDGE FUNDS

After the U.S. market crash of the late 1920s and the devastating investors' losses, Congress passed laws to regulate intermediaries over the entire financial system: the securities market actors, n16 the banks, n17 and the investment companies. n18

In all these statutes Congress provided exceptions, distinguishing between Wall Street actors that cater to few members of the public and those that cater to large segments of the public. Congress imposed the highest level of regulation on the larger actors, and excluded the small ones fully or partially from regulation. For example, large advisers are required to register with the SEC. Small advisers, who have less than fifteen clients, n19 need not register. Investment companies with less than 100 holders of voting securities n20 and investment companies whose investors are wealthy and sophisticated are excluded from the definition of an investment company. n21 Thus, with respect to such exemptions there are no limits both on the assets under management and the number of investors.

Similarly, Congress imposed strict regulation on market actions that are widespread, such as public distribution of securities, n22 and imposed a lower level of regulation on more limited distribution of securities such as [*661] private placements. n23 These distinctions, however, do not apply to the amounts involved but to the number of clients or wealth and sophistication of the investors involved. An unlimited number of banks, for example, may invest unlimited amounts of money in managed pools of money, such as hedge funds. However, because banks are subject to strict substantive regulation on how and where they lend and invest the depositors' and other investors' money, and must diversify their loan portfolios, there are limits on the amounts they can invest in hedge funds.

A number of reasons can explain the distinctions between large and small institutions, whether by number of investors or amounts invested. First, "small" does not mean "less profitable" for investors. n24 Some studies have shown that smaller hedge funds are likely to perform better. n25 Second, when the number of investors or advisees is small, there is a better likelihood that they will be wealthier. Otherwise, the advisers might not find it sufficiently lucrative to operate their business. It is presumed that such wealthy individuals are more sophisticated and that they can fend better for themselves. n26 It is very likely that the clients will directly interact with the managers of their money. Such direct contact is likely to allow investors more control over their money managers. Third, dishonest fund managers, who manage the assets of a larger number of investors, can inflict harm on individual investors. The larger the number of individual investors, the greater the harm they can inflict. Fourth, the larger the number of investors is, the more harm can be inflicted on the entire financial system. As Andy Serwer wrote in Fortune about the impact of the financial system on citizens: "Don't for a minute think that this doesn't apply to you. The hedge fund boom has sweeping implications not just for Wall Street traders and a few [*662] thousand well-heeled investors, but increasingly for every American businessperson, investor, and retiree." n27

Disloyal managers of large populated funds can inflict harm not only because the amounts under management are large and not only because they can injure a larger number of investors. Such managers and the reactions of their victims can contaminate other, healthy, institutions and thereby threaten the integrity and sustainability of the financial system as a whole. For example, the contraction of the banking system is the main reason for the government's establishment of the FDIC to guarantee bank deposits. n28 Deposits are expected to be low risk; people would say - "as safe as money in the bank." If one bank fails, depositors are likely to "run over" other banks as well. n29 Bubbles and crashes in the markets exhibit the same phenomenon. Not all investors make their decisions independently of the actions of others, even if the investors are offered relevant information. That is especially so if the investments are expected to be safe. Many investors follow others, rather than evaluate and decide on their own. In some respects, these investors are rational and efficient. Rather than invest time and attention in evaluating market prices, they rely on others, whom they believe have done their homework, and, like free riders, follow the trend. n30

A similar sensitivity to size is demonstrated by the requirement that certain large investors of publicly held companies disclose their identity. n31 Professor Mark Roe has suggested that diversification, required by the tax code to allow mutual funds to avoid double taxation, was based on the concern that Wall Street might grow sufficiently large and control Main Street. n32

Where do hedge funds fit in the regulatory scheme? The term "hedge funds" is not defined in law, n33 except by the extent to which they are [*663] regulated. They are "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act." n34 Hedge funds have escaped strict investment companies' and securities' regulation by following the exceptions in the law (e.g., the limits on the number and quality of advisees and investors and offerees of securities). However, the SEC has continuously been attentive to them. n35 "As early as 1969, the Commission investigated hedge funds . . . ." n36

Thus, functionally, hedge funds fall within the definition of an investment company because they issue securities and invest in securities. n37 However, these funds are exempted from registration as investment companies under either section 3(c)(1) or section 3(c)(7) of the Investment Company Act. n38 To qualify for exemption under section 3(c)(1), a hedge fund may not be beneficially owned by more than 100 persons. n39 To qualify for exemption under section 3(c)(7), a hedge fund may sell its securities only to qualified purchasers. n40 Further, to qualify for exemption under either section 3(c)(1) or section 3(c)(7), the hedge fund must not make or propose to make a public offering of its securities. n41

Therefore, it is up to creditors, counterparties, and hedge funds themselves to place limits on the amount of leverage that hedge funds use. n42 In recent years, small investors' money could reach hedge funds through registered funds that distribute their securities to the public but invest their [*664] assets in hedge funds. n43 Thus, public investors' money does seep through to hedge funds through the pools in which the public invests its money.

Hedge funds are free of a number of constraints which apply to publicly held investment companies. One important constraint is the prohibition on borrowing. The law prohibits investment companies from borrowing, with very few limited exceptions. n44 The concern about excessive borrowing by investment companies led to the passage of section 18 of the Investment Company Act. n45 Before the Act, some investment companies were highly leveraged, n46 resulting often in highly speculative investments. n47 Section 18 of the Investment Company Act n48 imposes asset coverage requirements upon the issuance of senior securities. n49

Open-end investment companies are prohibited from issuing or selling any class of senior security, n50 and may only borrow from banks, subject to a 300% asset coverage requirement. n51 While the Investment Company Act does not prohibit mutual funds from investing in any specific type of instrument, including derivatives, mutual funds must disclose information about these transactions and their risks in the prospectus. n52

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Hedge funds are not required to maintain maximum leverage ratios under the Investment Company Act because they are structured so as to qualify for exclusion from registration as investment companies under the Act. n53 Since hedge funds are not confined by the leverage and borrowing restrictions that apply to registered investment companies under the Act, hedge funds are free to use large amounts of leverage to engage in risky investments. n54 In fact, hedge funds often use leverage aggressively. At the extreme, hedge funds leverage their capital thirty times, n55 or even fifty or more as in the case of Long-Term Capital Management. n56

In addition, there are a number of trading techniques that regulated investment companies may not practice. Most importantly, hedge funds need not disclose their investment policies and how they trade, while regulated investment companies must disclose these policies. n57

Historically, hedge funds traded in the securities markets. They adopted various trading strategies designed to capture the inefficiencies in the markets. And they borrowed, thus increasing their returns as well as their risks. When one trades successfully on borrowed money, one can increase the returns by capturing the profits minus the cost of the borrowing. However, if the trading is unsuccessful, the losses not only affect one's investment; the fund must pay the lenders the borrowed amounts and the interest due. In addition, speculative trading can turn into gambling ("I am sure to win this time!") and such gambling can turn into an addiction ("Just one more time and I will regain my losses!"). Examples, such as the Amaranth hedge fund and Bear Stearns funds, have demonstrated such a behavior and such an addiction. n58

In recent years hedge funds have turned to acquiring corporations that are rich in cash but slow in rising profits and share prices. Some funds turned such corporations into more profitable businesses long-term; others have [*666] turned their acquired corporations into more profitable operations short-term, but depleted the corporations long-term. n59 The main point is that, throughout their history, hedge funds have adopted various trading techniques, invested in various corporations, and were successful as well as unsuccessful. Some behaved with integrity and some turned out to be the rogue actors on Wall Street.

III. THE SOURCE OF HEDGE FUNDS GROWTH IN THE PAST FEW YEARS

A. How did Hedge Funds Grow to Such an Extent?

The first hedge fund, distinguished from other pooled funds by its investment strategy, was established in 1948, by Alfred Winslow Jones. n60 Others followed this strategy, and by 1968, the number of similar hedge funds grew to be nearly two hundred. n61 In the 1990s, their number and assets under management exploded. If hedge funds were subject to limits on the number and quality of investors, and if for so many years their size was minimal as compared to other publicly held managed investment pools, how did their assets under management grow to such an extent during the past ten years? Before the year 2000, most hedge fund investors were wealthy individuals. Since then, institutional investors, such as pension funds, endowment funds, and sovereign wealth funds, have invested in hedge funds. Infusion of money increased their size and raised the complexity of hedge fund groups. n62

One reason for their rapid growth may be the funds' spectacular performance. This performance was remarkable as compared to the declining [*667] market prices in the early 2000s. This performance was achieved in large part by leveraging, that is, "the use of credit to enhance one's speculative capacity" n63 or more broadly: the risk taken as compared with the ability to bear it, n64 or the ratio of assets to net worth. n65 Hedge funds leverage by using strategies that create greater exposure to risk and benefit than the invested amount, n66 such as buying securities with borrowed money. n67 In this Article, I focus only on borrowing, that is, not on the rise in risk but on the rise in hedge funds' assets under management.

Thus, the main source of hedge funds' enormous returns was increased borrowing. Some borrowing was direct, but new types of speculation by investing in various derivatives, for example, increased the assets far more. "Hedge Funds that have been around for a long time [have grown to about] $ 1.4 trillion in mid 2007. But the leverage hedge funds use alongside of this is much bigger. [The writer estimated that leverage] could be well over $ 5 trillion, if derivatives are taken properly into account." n68

B. Where is the Source of Hedge Funds' Borrowing?

Hedge funds rarely borrow from individuals. The exemptions under which they function prohibit them from publicly offering securities, including bonds. Besides, the hedge funds' individual investors and institutions invest in equity securities, rather than bonds. Thus, hedge funds' sources of borrowed capital are the banks, investment bankers, large broker dealers and underwriters. In the last analysis, the public's deposit and savings money has in fact found its way into, and caused the enormous growth of, hedge funds (and other private funds). n69

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Thus, while in the past the main source of funding for hedge funds was wealthy investors, and to a lesser extent lenders, during the past ten years the source of lending has expanded dramatically. Banks have considered hedge funds to be valuable customers and have lent to hedge funds enormous amounts. n70 Since 2001, banks have been competing to lend to hedge funds, offering these funds loans at an increasingly high leverage ratio. The funds' equity amounts were falling, and the "cushion" for the banks' loans was falling as well. The source of hedge fund loans expanded to foreign countries. Japan, for example, was often mentioned as a source of low interest loans. n71 Another example is the Long-Term Capital Fund. At the end of its life, the leverage ratio of this fund's assets turned out to be $ 1 investment for every $ 25 of borrowed money. n72 When the Russian government defaulted on its bonds, n73 the Fund failed, causing very serious losses to a number of banks. The lenders and investors bore the heavy burden. Because the lenders were banks and other regulated lending institutions, the government intervened to support coverage of the losses. n74 Otherwise, the financial system may have been adversely affected. n75 In 2001, the Federal Reserve Board lowered the interest rates for banks to 1%. This move caused refinancing capacity to rise and allowed hedge funds to grow. Hedge funds allowed managers to reap a significant amount by participating in the profits of their fund's investments. The gains provided a strong incentive to continue increasing profits by borrowing to increase investment assets. n76

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The regulators in the U.S. and the U.K. expressed worries about the quality of these loans and about the fact that the banks were not receiving sufficient security to back these loans. However, only with the severe losses in subprime loans did regulators begin investigations. The SEC, the Federal Reserve Bank of New York and the Financial Services Authority in London are conducting a joint investigation into whether banks and securities firms set strict enough limits on loans made to hedge funds. n77 The concern is that competition on borrowers has led to lower lending standards.

Because hedge funds are not required to disclose their leverage ratio, the current leverage of hedge funds can only be derived from past information relating to failed funds. For example, it is known that the impact of the failure of Long-Term Capital Management Company caused reduced credit for hedge funds which led to lower leverage ratio and size. n78

IV. ROGUE BEHAVIOR OF HEDGE FUNDS

Hedge funds experiment and innovate. Some funds have refined trading techniques. Others have moved to acquire or affect corporations that have potential for short-term profits. n79 Only a few hedge funds have taken the long-term route. n80 The creativity of hedge funds is undeniable, but that does [*670] not mean that the level of fraud posed by such funds has risen. There may have been more failures resulting from speculation and risk-taking. n81 Perhaps more frauds were caused by the greater temptations which accompanied the enormous growth of these funds.

Amaranth, a Greenwich, Connecticut based hedge fund, n82 reported losses of $ 3 billion to $ 5 billion and was being investigated by Connecticut Attorney General Richard Blumenthal. Arguably, "Amaranth's losses of about $ 5 billion in one week don't appear to be a systemic problem. 'An over confident trader, under lax supervision, lost billions of dollars.'" n83

According to the Wall Street Journal, Barclays Bank lost all $ 400 million that it lent to two big hedge funds managed by Bear Stearns Cos. that collapsed. n84 The bank brought suit against Bear Stearns Cos. and two of its fund managers. n85 Barclays argues that it was misled as to the "performance of the highly leveraged funds." n86 The hedge funds' investors lost $ 1.6 billion. n87 Bear Stearns Cos.' position is that the investors and lenders were sophisticated and knew that the high returns might also result in high losses. n88 The main issue is the time in which the managers of the funds knew about the funds' problems and to what extent they misled or had to warn the investors and lenders of the precarious position of the funds.

It is interesting to note that when the SEC proposed to increase the financial qualification of investors in hedge funds, small investors rose to protest. n89 For them, hedge funds meant that the rich could get richer, while they would be barred from the opportunity to become rich. Possible losses were not counted for much. Perhaps people who do not have much to lose [*671] are more willing to take risks in the hope of gaining very large amounts. After all, their losses can result in bankruptcy, and for many that is not a sufficient deterrent as weighed against the chance of high profits.

V. THE GUIDING PRINCIPLES FOR REGULATING ACTORS IN THE FINANCIAL MARKETS

A. Protecting the Individual Investor and the System

The guiding principles of market regulation in the United States have aimed at protecting investors who cannot rationally protect themselves. n90 For example, if the information that is necessary for investors to make a rational decision is generally too costly to acquire and understand, the law might interfere to require that the information be offered in plain English. n91 In addition, and perhaps more importantly, the purpose of regulation is to protect the financial system. The protection of investors and the protection of the system go hand in hand. But the system must be protected even at the cost of some investors and some managers.

B. How Do We Regulate?

In the 1940s, Congress was not as reluctant as it currently is to dictate how small investors should invest their money. With time, and with the rising belief that the market (whatever it is) is the best judge of the quality and value of investments, Congress has increasingly become more averse to regulating the manner in which money managers invest. Today, rightly or wrongly, we believe that the managers must disclose their investment policies to investors and let the investors and the markets determine the value and risk level and justified return from investments that follow these policies. If hedge funds are offered to sophisticated and wealthy investors that can protect themselves from losses and fraud, n92 and if hedge funds do not violate [*672] their fiduciary duties to their investors, n93 then, at the most, regulation would require hedge funds to offer information to investors. Otherwise, the funds should remain free to adopt investment policies as their managers choose. Hence, our culture points to freedom of hedge funds to act, subject to a prohibition on fraud and the requirement of disclosure.

However, we have in the past, and should in the present, regulate the banks and other lenders or holders of other people's money that is pooled for efficient investment. Banks and similar institutions are the main source of our system's liquidity and should not invest in speculative enterprises above a limited amount. Therefore, banks are required to account for the amounts they lend and provide backing in the form of loan loss reserves for these amounts. n94 This accounting system reduces bank dividends and bank stock prices (on which bank management depends for a significant part of their compensation). n95 Self-interest presses bank management to reduce loan loss reserves and to remove liabilities off its balance sheet. n96 There are many ways to do that, and we need not discuss them here. The creative talent of the accounting profession is boundless, and the regulators are attempting to limit the techniques which banks use to reduce the loans on their balance sheets.

To be sure, bank management strives to provide profits to its shareholders. While in the past the number of bank shareholders was relatively small, many banks are currently publicly held. n97 The pressure to [*673] increase profits and thereby bank share prices is rising. In addition, bank management is compensated by "performance" like any other enterprise. Hence, the pressures to finance and profit by various means have increased. Financing hedge funds and private equity funds provided one such means.

C. The Systemic Risk of Market Collapse

Highly leveraged financial institutions such as hedge funds have the potential of disrupting the financial markets. n98 The collapse of one large fund or several small funds using leverage could cause the default of obligations and direct losses for creditors and trading counterparties. n99 The inability of many debtors to pay their obligations at the same period can cause the collapse of the entire financial system. n100

Even market participants that are not direct creditors or counterparties of a defaulting hedge fund may be affected by its default if highly leveraged investors are overwhelmed by market shock or liquidity shock. When the investors who are ready to bear high risks disappear, other market participants can be affected by price changes. n101 Falling prices can deepen uncertainty about credit risk. This uncertainty could cause credit, liquidity, and economic activity to contract. n102

D. A Number of Hedge Funds that Collapsed Offer Examples of Such Possibilities

Long-Term Capital Management was a prestigious hedge fund which earned "spectacular returns" for its investors on a portfolio of $ 125 billion. n103 In 1995 and 1996 this hedge fund produced returns, net of fees, of approximately 40%, and slightly less than 20% in 1997. n104 However, in order [*674] to profit the fund had to borrow from banks and "leverage its bets" with over $ 120 billion. n105 It seems that Long-Term Capital "had less than $ 1 billion in capital to offset positions in securities worth $ 120 billion and derivatives with a notional value of $ 1.3 trillion," n106 at an estimated on-balance sheet leverage ratio of fifty. n107 The precise level of the leverage is not known because the financial derivatives were not reflected on the balance sheet. n108

The size of the fund's assets and the extent of its leverage made Long-Term Capital extremely "vulnerable to certain market conditions that emerged" when Russia defaulted on its debt. n109 The fund lost nearly $ 5 billion "practically overnight." n110 The losses and its failure to raise new capital n111 endangered Long-Term Capital's ability to meet its cash flow obligations. n112 At the time, it was estimated that its top seventeen counterparties would have lost about $ 3 to $ 5 billion. n113 The collapse of this hedge fund could have had extreme adverse consequences for world markets at the time, n114 and the Federal Reserve was concerned that if the hedge fund sold all its assets at once, "prices could collapse." n115 "That would set off a chain reaction" of other firms' bankruptcies. n116 Therefore, Bill McDonough, the head of the New York Federal Reserve, decided to intervene. n117 He convened the "top officials of sixteen of the world's most powerful banks and investment houses" and induced them to bail out the hedge fund. n118 Fourteen firms finally participated in infusing $ 3.6 billion in cash into Long-Term Capital to enable it to "dissolve in an orderly way." n119

A second example is Amaranth Advisors, LLC, which lost an estimated $ 6.6 billion in September 2006 - the largest hedge fund loss in history. n120
[*675] Amaranth actively traded in natural gas contracts, equities, equity-linked derivatives, credit derivatives, and bank loans. n121 The banks and securities firms which acted as dealers and counterparties to Amaranth had significant credit exposures to Amaranth. n122 So did pension funds. California's San Diego County employee pension fund lost an estimated $ 85 million in an Amaranth investment. n123

It should be noted that even though Amaranth's losses in dollar terms were higher than Long-Term Capital's, the fund's collapse was met with a "shrug," because the market at the time could easily absorb the losses. n124 In contrast to Long-Term Capital, Amaranth borrowed far less and had far smaller positions. n125 "Leverage in [Amaranth's] energy portfolio was 5.21 and 6.56 in its commodity portfolio," as compared to Long-Term Capital's estimated leverage level of fifty. n126

A third example of high leverage and the effect of its collapse is the case of three Bear Stearns hedge funds in the summer of 2007 n127 and in January 2008. n128 Together, the three funds lost $ 2 billion from investments mostly in the subprime mortgage market. n129 The collapse of these funds was similar to that of Long-Term Capital. The investment strategy of these funds required increased borrowing; banks lent the funds about $ 14 billion, and additional millions were borrowed by issuing short-term debt. n130 At some point the [*676] funds bought "$ 60 worth of securities for every $ 1 of investors' money." n131 When the lenders began to demand repayment, "the funds held only about 1% of their assets in cash." n132 These examples demonstrate the effect of borrowing on the stability of the financial system, including institutional lenders, such as the banks.

E. Proposed Solutions

There are numerous proposals to solve the leverage problem. One proposal calls for imposing leverage limitations on hedge funds by subjecting them to regulation under the Investment Company Act of 1940. n133 The Act requires investment companies to maintain a very low maximum leverage ratio. n134 Congress could implement this proposal by amending the Investment Company Act to require that all funds exempted from registration under 3(c)(1) or 3(c)(7) of the Investment Company Act must comply with the leverage restrictions of section 18 of the Act. n135 This leverage ratio would reduce systemic risk that hedge funds have created because the funds would have sufficient assets to pay off obligations. n136

Another proposal is to impose leverage restrictions based on non-balance sheet methods of measuring leverage. n137 Such leverage restrictions would be based on a "ratio of potential gains and losses relative to net worth" (e.g., "value-at-risk relative to net worth"). n138 This method might capture risks which are not reflected on the balance sheet. n139

Third, small (retail) investors need either additional protections from the misused leverage by hedge funds, or for the indirect sale of hedge fund investment to small investors to be discontinued. n140

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The debate on regulating hedge funds has resurfaced with "vigor" recently. n141 Dr. John Kambhu notes the arguments against direct regulation of hedge funds, especially the regulation of leverage by imposing "leverage ratios." After all, different investors have different risk tolerance. n142 Some investors seek restricted exposure to leverage but others could tolerate a higher risk level. Alan Greenspan has stated that "imposing a blanket of costly regulation will succeed only in stifling the enthusiasm for seeking niche profits." n143 In his opinion, regulation would cause the disappearance of hedge funds. n144 Similarly, if the same leverage ratio imposed on investment companies under section 18 of the Investment Company Act n145 applied to hedge funds, n146 they might become indistinguishable from investment companies. Besides, there are leveraging techniques that are not reflected on the balance sheet. n147 For example, derivative securities raising liabilities several times the value of the initial margin that the trader taking that position must put up, that never show up on the balance sheet. n148 For this reason, regulations, such as leverage ratios, which employ balance sheet-based measures of leverage may fail to capture the actual use of leverage by a hedge fund. n149 Long-Term Capital Fund demonstrates the failure of the balance sheet leverage ratio to measure leverage. n150 It is now estimated that Long-Term Capital's economic leverage was substantially higher than the estimated on-balance sheet leverage ratio of fifty. n151

In addition, hedge funds constantly change their holdings, n152 and that would require the regulators to examine the funds' portfolios "practically minute by minute." n153 It is hard to value non-balance sheet based leverage ratios. n154 In addition, high capital requirements might create a perverse [*678] incentive for funds to take additional risks in order to meet return targets on the required capital. n155 This would result in higher costs, n156 and drive some hedge funds offshore. n157

Arguably, non-regulatory solutions provide a balance between the benefits and risks of leverage. n158 These non-regulatory solutions include, for example, counterparty discipline. n159 Counterparties, creditors, and investors assess each other's ability to bear credit exposure. n160 They limit the use of leverage by requiring collateral, imposing trading limits, counterparty limits, margin requirements, and "ongoing monitoring of credit quality." n161 Yet, even proponents of this solution admit that counterparty discipline often fails to protect against failures, as the descriptions of the large hedge fund disasters have demonstrated. n162 The near-collapse of Long-Term Capital Management and the failures of the Bear Stearns funds are examples of major failures in counterparty discipline. In the case of Long-Term Capital, none of its investors, creditors, or counterparties provided an effective check on the fund's activities or borrowing. n163 Further, a large part of Long-Term Capital's lines of credit was unsecured. n164

In other cases, counterparty discipline may not be effective if "the incentives or the means [for discipline] are lacking." n165 Creditors might have no incentive to discipline if a fund's "obligations are guaranteed by a financially strong third party." n166 During favorable economic conditions, the incentives for discipline may become distorted. n167 Besides, retail investors may lack the "means to accurately evaluate" the fund's risk level. n168 And even when the incentives and means are not lacking, counterparty discipline may fail because of the difficulty in measuring risk n169 and the rise in errors in [*679] evaluation and judgment as happened in Long-Term Capital, Amaranth, and the Bear Stearns funds. n170

There are also proposals for enhanced disclosure as a means for effectively controlling the use of leverage. The President's Working Group recommended that hedge funds be required to submit additional and more updated information to the public. n171 Unless disclosure is made mandatory, however, disclosure of certain hedge funds may be limited either because of their stature or the reputation of its principals, as was the case of Long-Term Capital. n172 To increase the current level of disclosure by hedge funds, Congress must act. n173 Yet, even mandatory disclosure may not always provide the meaningful information that will be necessary for creditors, counterparties, and investors to assess risk. Balance sheets and income statements may not accurately reveal the extent of the fund's risk and exposure. n174 Hedge funds' positions and strategies change constantly. n175 Meaningful information would require continuously updated information that accurately reflects off-balance sheet use of leverage.

VI. CONCLUSION

The solution suggested in this Article is not to regulate leverage, nor to impose restrictions on hedge funds. The solution proposed here is to regulate the main sources of hedge funds' leverage. The regulation need not cover all sources so long as it covers the main sources. The regulation need not set up limits on lending either. It should, however, introduce disincentives for the lenders.

Regulated lenders, such as banks and broker dealers, should be required to keep hedge fund borrowing on their balance sheet, and prohibit them from selling the loans they made or covering their risks by any form of derivatives, third party obligations, insurance, and any other mechanisms currently available or in designed in the future. n176 The regulators should be granted authority to determine the level percentage of loans that should be [*680] covered by these limits, from 100% to not more than 50%, for example. That permission would introduce some flexibility to the system but would be linked to the amount of assets under hedge fund management. As to other lenders, such as pension funds, a requirement for publicity could be imposed. Let the public and the regulators know the extent to which the pension funds have lent to hedge funds. In sum, the risk of such loans should remain with the lenders and be either regulated or publicized! These measures might limit the size of hedge funds and allow them to engage in risky investments without threatening the financial system.

The guiding principle relating to hedge funds leverage should be: Keep hedge funds small and relatively regulation-free to take investment risks. Let hedge funds be financed by investors and lenders that can take care of their own interests, and allocate their capital sources wisely.

However, the source of hedge funds' asset growth is the lenders - mainly regulated lenders. Therefore, these lenders should be regulated with respect to the funding of hedge funds. The following rule must apply to any bank, any bank holding company and its subsidiaries, any entity that has a relationship with a bank, except a borrowing relationship, and any broker-dealers. All these entities (and there may be others that should be added to the list) may make loans to hedge funds directly or indirectly only if they keep the loans on their balance sheets. Thus, the risks involved in these loans may not be transferred to others or covered by derivatives of any kind. Loans to hedge funds must stay on the lenders' books and, if so required by law - carry loss reserves. No other rule is required. No changes should be made in the regulation of the financial system as a whole, and no government interference should be made in the trading or lending or investing. The restriction is not very intrusive, since these actors in the financial system are already subject to regulation including the requirement that they engage in prudent lending. Hopefully, this restriction would dampen the growth of hedge funds, leave them free to roam the field of the financial system, innovate, succeed and fail, but never endanger the financial system.

Legal Topics:

For related research and practice materials, see the following legal topics:
Banking LawBonds, Guarantees & Letters of CreditGeneral OverviewBanking LawRegulatory AgenciesGeneral OverviewSecurities LawInvestment CompaniesGeneral Overview

FOOTNOTES:

n1 In July 2007 the number of hedge funds was estimated to be about 9,000. Their assets have grown by 400% to about $ 1.4 trillion since 1999. Hedge Funds and Systemic Risk: Perspectives from the President's Working Group on Financial Markets: Hearing Before the H. Comm. on Financial Servs., 110th Cong. 61-66 (2007) (statement of Robert K. Steel, Treasury Under Secretary For Domestic Finance) [hereinafter Steel Testimony]; see also SEC. & EXCH. COMM., DIV. OF INV. MGMT. & OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS vii (2003), available at http://www.sec.gov/news/studies/hedgefunds0903.pdf [hereinafter SEC STAFF REPORT].

n2 SEC STAFF REPORT, supra note 1, at 34 n.120.

n3 Steel Testimony, supra note 1.

n4 Id.

n5 Thomas C. Pearson & Julia Lin Pearson, Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds, *33 N.C.J. INT'L L. & COM. REG. 1, 12-16 (2007).*

n6 *Id. at 16* (footnotes omitted).

n7 *Id. at 17.*

n8 SEC STAFF REPORT, supra note 1, at 37.

n9 Id. at 80.

n10 Id. at 81-83.

n11 See, e.g., Anuj Gangahar, Former Hedge Fund Chief Jailed for 20 Years, FIN. TIMES (USA Edition 2), Jan. 30, 2008, at 17 ("The former finance chief of bankrupt hedge fund company Bayou Management was yesterday sentenced to 20 years in prison, among the harshest sentences meted out in the US for a white-collar crime, for his part in defrauding investors of more than [$ 400m]."); Lori Montgomery, 2 Former Treasury Chiefs Add Clout to Hedge Funds, WASH. POST, Oct. 21, 2006, at D01 (Amaranth lost an estimated $ 6.6 billion).

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n15 Adrian Blundell-Wignall, Financial Market Innovation, http://www.oecd.org/dataoecd/47/56/38674683.pdf (OECD FORUM 2007, Innovation, Growth and Equity, May 14-15, 2007, Paris).

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n18 Investment Company Act of 1940, *15 U.S.C. § § 80a-1* to -64 (2000 & Supp. II 2002); Investment Advisers Act of 1940, *15 U.S.C. § § 80b-1* to -21 (2000 & Supp. II 2002).

n19 Investment Advisers Act of 1940, *15 U.S.C. § 80b-3*(b)(3) (2000).

n20 Securities Act of 1933, Regulation D, *17 C.F.R. § § 230.501*-.508 (2007); see generally State of Wisconsin Dep't of Fin. Insts., A Brief History of Securities Regulation, http://www.wdfi.org/fi/securities/regexemp/history.htm (last visited Mar. 5, 2008).

n21 Investment Company Act of 1940, *15 U.S.C. § 80a-3*(c)(1), (7) (2007). Courts are not sympathetic to such investors who decide to invest in risky securities and then sue to recover their losses. See *Moross Ltd. P'ship v. Eckenstein Capital, Inc., 466 F.3d 508 (6th Cir. 2006).*

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n24 Greg N. Gregoriou & Fabrice Rouah, Large Versus Small Hedge Funds: Does Size Affect Performance?, J. ALTERNATIVE INVESTMENTS, Winter 2002, at 75; see also James R. Hedges, IV, Size vs. Performance in the Hedge Fund Industry, 10 J. FIN. TRANSFORMATION 14, 16-17 (2004), available at http://www.edge-fund.com/Hedg.pdf; Christine Williamson, Midsize Funds of Funds Outperform Big, Small, PENSIONS & INVESTMENTS, Nov. 12, 2007, at 45. But see Noel Amenc et al., The Alpha and Omega of Hedge Fund Performance Measurement 26 (Feb. 27, 2003), http://www.edge-fund.com/AmCM03.pdf.

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n55 Id. at 5.

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n174 Id. at 15.

n175 GREENSPAN, supra note 103, at 372.

n176 Hedge funds can be defined as entities that are outside the applicability of the Investment Company Act of 1940 by virtue of sections 3(c)(1) and 3(c)(7). Proposed Rule, supra note 35, at 45,173-74.

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