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HEDGE FUNDS AND THE FINANCIAL CRISIS

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THE PERFORMANCE OF hedge funds during the financial crisis suggests that wide-ranging financial regulation is not always necessary to advance investor protection and financial stability. While 2008 was a year of record hedge fund losses and investor withdrawals that came about in part because many hedge fund managers failed to adequately respond to the financial crisis, the hedge fund industry significantly outperformed the heavily regulated mutual fund sector and, unlike the banking industry, was never in jeopardy of collapsing. Hedge funds did not cause or meaningfully exacerbate the financial crisis and in fact have reduced its impact and are helping the economy to recover.

BACKGROUND

AN INVESTMENT FUND is a collection of money gathered from investors for the purpose of having the money managed by an investment adviser. Hedge funds are a type of private investment fund. Typically, hedge funds function by making very frequent trades in stocks, bonds, and financial derivatives.¹ Some, however, do make relatively long-term investments, even in assets other than financial instruments (such as real estate and commodities). In an attempt to ensure that only financially sophisticated parties invest in hedge funds, federal law does not permit hedge funds to raise capital through widespread advertising or solicitation and prohibits them from accepting funds from individuals having less than \$200,000 in annual income or companies having less than \$5,000,000 in assets.² After suffering a trillion dollars in losses and investor withdrawals in 2008, at the start of 2009, hedge funds worldwide managed a total of \$1.84 trillion in assets.³

Although both mutual fund and hedge fund managers are compensated by charging a management fee based upon the size of the fund (typically 1 to 2 percent for hedge funds),

hedge fund managers also charge an annual performance-based fee, typically 20 percent of profits and, unlike mutual fund managers, often invest their own money in the funds they manage.⁴ This compensation structure generally leads hedge funds to be more prudent in risk-taking than other financial companies.

HEDGE FUND REGULATION

HEDGE FUNDS ARE NOT subject to the full range of disclosure requirements and limitations on investment activities that federal law imposes on publicly registered mutual funds. However, hedge funds are fully subject to federal prohibitions on fraud, insider trading, and price manipulation. Hedge funds typically make substantial and timely disclosures to their investors,⁵ have the risks they take on monitored by creditors and counterparties,⁶ and are required by law to publicly disclose their large investments in public companies and certain short sale positions to federal regulators.⁷ Hedge funds also typically use third parties, such as prime brokers, custodians, and administrators that have direct access to the fund's assets and are able to verify the fund's actual investment returns.⁸ The hedge fund legal regime and associated business practices provide substantial assurances against fraud and other forms of wrongdoing. The multibillion dollar Ponzi scheme fraud carried out by Bernard Madoff was made possible in part because Madoff did not manage a hedge fund and did not utilize independent services providers.

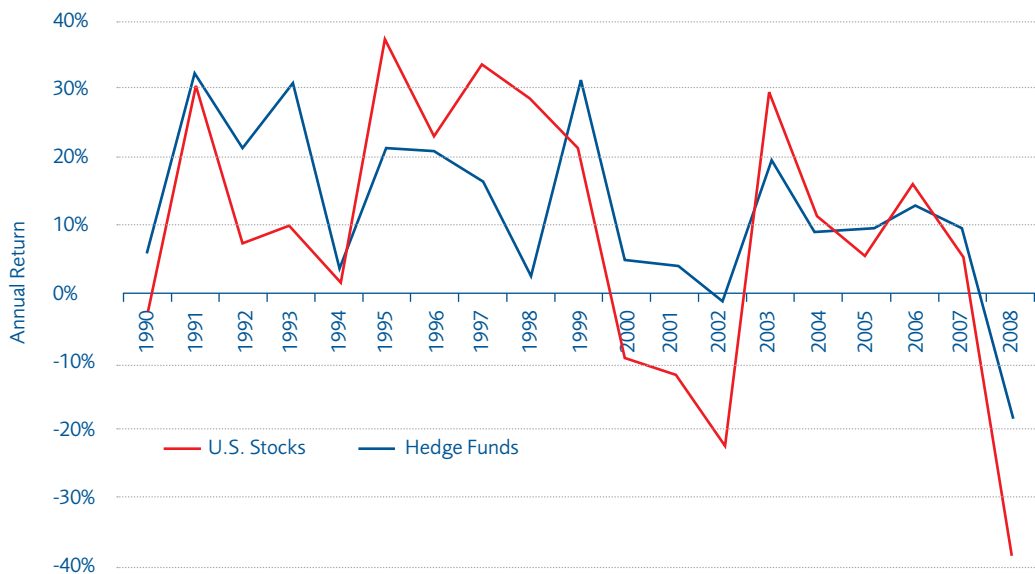
INVESTMENT ACTIVITIES AND RISK REDUCTION

IN ADDITION TO buying stocks, bonds, and other financial instruments to be later sold at a higher price, hedge funds often engage in non-traditional investment strategies involving short selling and derivatives trading.⁹ Hedge funds can use a far wider array of investment strategies than mutual funds because hedge funds are not subject to the investment activity restrictions of the Investment Company Act.¹⁰

Hedge funds use short sales and derivatives to manage risk and reduce losses when the overall market is performing poorly. This practice is difficult for mutual funds because of the legal restrictions on their investment activities. In addition, hedge funds often borrow funds or use other forms of leverage to magnify gains. Using leverage, however, also has the potential to magnify losses.

Although some hedge funds are highly leveraged, such funds are the exception rather than the rule. A 2007 study of hedge fund leverage by the Organization for Economic Co-operation and Development (OECD) estimated that average hedge fund leverage was 3.9 to 1, which means that for every 3.9 dollars in hedge fund assets, one dollar was equity and the rest was borrowed (or the economic equivalent of borrowing was achieved by using derivatives).¹¹ By contrast, banking sector leverage generally ranges from about 12 to 1 to 17 to 1 while major U.S. investment bank leverage in particular ranged from 20 to 1 to as high as 33 to 1 in recent years.¹²

FIGURE 1: HEDGE FUNDS VERSUS U.S. STOCK MARKET FROM 1990 TO 2008



Sources: Econ Stats. S&P 500 Yearly Data; Hedge Fund Research (HFRI Fund Weighted Composite Index).

By pursuing non-traditional investment strategies with the incentives created by their unique compensation structure, hedge funds have historically helped reduce their investors' exposures to overall risks. Because hedge funds provide a cushion to their investors from overall market downturns, hedge funds help investors to diversify their portfolios and not keep all their eggs in one basket. Despite losing 18.3 percent of their value in 2008,¹³ Figure 1 illustrates that even after fees hedge funds consistently outperformed the stock market when the market produced losses for investors.

THE ROLE OF HEDGE FUNDS IN THE FINANCIAL CRISIS

HEDGE FUNDS DID NOT cause the ongoing financial crisis. They are reducing the crisis' overall impact and helping the economy to recover.

The financial crisis stems from unsound business practices and poorly crafted regulation in the mortgage, banking, and credit markets. Hedge funds were not the primary investors in securities backed by mortgages and therefore did not create an excessive demand for banks to make risky mortgage loans.¹⁴ Hedge funds did become significant players in the markets for buying and selling credit instruments,¹⁵ and academics and organizations like the International Monetary Fund have found that hedge funds' involvement in credit markets made the markets more stable and efficient.¹⁶

During the financial crisis, hedge funds have increasingly purchased other companies' poorly performing securities, including mortgage-backed securities, and made loans that help borrowers in otherwise tight credit conditions.¹⁷ By purchasing poorly performing mortgage-backed securities, hedge funds are helping to keep asset prices from declining further, which may help to reduce taxpayers' responsibilities for funding bailouts and economic stimulus measures.

HEDGE FUNDS AND SYSTEMIC RISK

GROWTH IN THE number and size of hedge funds and the increasing interconnectedness of global financial markets has raised concerns about "systemic risk": the extent to which hedge funds pose a risk to the entire, or at least large portions of, the financial system. The theory is that if one large or several smaller hedge funds experience losses, these losses may spread to other financial institutions and in turn severely undermine the stability of the financial system.

In practice, however, hedge funds likely would not pose a threat to the stability of financial markets. Hedge funds seem to become less prone to collapsing as their size grows, and when a hedge fund does shut down it is more likely to happen after a steady decline in returns than a sudden, surprising crash.¹⁸ Moreover, the risk-management practices of hedge funds, the parties that hedge funds trade with, and hedge fund

lenders are generally sufficient to prevent hedge fund losses from disrupting the broader financial system. For example, most hedge funds limit their borrowings from the prime brokerage divisions of banks far below what banks are willing to lend, which helps to ensure that banks are well protected against hedge fund losses.¹⁹

In September 2006, the \$6.6 billion hedge fund Amaranth Advisors set an industry record for the largest hedge fund collapse, yet its creditors and the broader financial system experienced no significant disruptions. Financial economists have even found that hedge fund losses have not spread to the general economy.²⁰ The recent economic turmoil is a case in point. Widespread and sustained losses in the hedge fund industry did not begin until June of 2008, several months after the stock market began to experience persistent monthly losses and a recession was already underway.

CONCLUSION

THE LEGAL REGIME applicable to hedge funds helps protect investors against market downturns by providing managers with the flexibility to adopt a wide range of investment strategies and incentives to strike a relatively healthy balance between risk taking and risk management. The outcomes hedge funds produce for their investors on the whole and their lack of a direct role in the financial crisis indicate that there is no hedge fund market failure that demands additional government regulation. Indeed, additional regulation might hurt investors and the economy. For instance, restricting hedge funds' ability to use leverage could increase economic instability because certain investment strategies that reduce market fluctuations require substantial leverage to be effective.²¹

Moreover, additional government oversight may increase complacency, undermine ongoing private efforts to improve best practices, and overwhelm regulators with duties beyond their resources and abilities. In recent years, the Securities and Exchange Commission (SEC) devoted unprecedented resources to enforcement with an aggressiveness among the highest of all securities regulators.²² Yet the Bernard Madoff scandal and the collapse of investment banks have shown that the SEC nonetheless failed to exercise appropriate oversight or adequately enforce existing laws. Creating an even more expansive system of securities regulation is therefore unlikely to increase the SEC's overall effectiveness. Hedge funds, however, have already begun to respond to the financial crisis by improving risk-management practices.²³ Regulatory reform for hedge funds should therefore focus on improving existing enforcement priorities and practices, not adding to the tasks that regulators are expected to perform.

ENDNOTES

1. Derivatives are financial instruments whose price is derived from the value of some other underlying asset. Employee stock options, for example, are derivatives because the price of the option is dependent upon the price of a company's stock.
2. 17 C.F.R. § 230.501(a).
3. Peter Laurelli, "Press Release: December Asset Flow and Performance Estimates," *HedgeFund.Net*, Jan. 14, 2009.
4. Government Accountability Office (GAO), *Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention is Needed*, (Washington, DC: GPO, January 2008), 27-30.
5. U.S. Securities and Exchange Commission, *Implications of the Growth of Hedge Funds* (Washington, DC: GPO, 2003), 46-51; PriceWaterhouseCoopers, *Transparency Versus Returns: The Institutional Investor View of Alternative Assets* (March 2008), 50 (finding that 89 percent of surveyed hedge funds reported at least monthly to investors).
6. *Regulators and Market Participants*, 30-33.
7. Houman B. Shadab, "The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection," 6 *Berkeley Bus. L. J.* (forthcoming 2009), <http://ssrn.com/abstract=1066808>; U.S. Securities and Exchange Commission, "Disclosure of Short Sales and Short Positions by Institutional Investment Managers," *Federal Register* 73 (October 17, 2008): 61678.
8. François-Serge Lhabitant, *Handbook on Hedge Funds* (Hoboken, NJ: John Wiley and Sons, 2006), 93-103.
9. Selling a security short means to borrow a security from another investor, sell it, and then repurchase the security with the expectation of a drop in price. Short selling helps ensure that stock prices reflect the actual worth of companies and thus diverts capital from companies that are fundamentally unstable. See Ekkehart Boehmer, Charles M. Jones & Xiaoyan Zhang, "Which Shorts Are Informed?" *Journal of Finance* 63 (2008): 491; Jonathan M. Karpoff & Xiaoxia Lou, "Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions" (paper, AFA, San Francisco, 2008).
10. See generally Audrey Talley & James L. Love, "Restrictions on Investments," in *Mutual Fund Regulation*, ed. Clifford E. Kirsch, 2d ed. (New York: Practising Law Institute, 2007).
11. Adrian Blundell-Wignall, *An Overview of Hedge Funds and Structured Products: Issues in Leverage and Risk, Financial Markets and Trends* 48 (Washington, DC: OECD, 2007). See also IMF, *Global Financial Stability Report Financial Stress and Deleveraging Macro-Financial Implications and Policy* (Washington, DC: IMF, October 2008), 41.
12. Jan Hatzius, *Beyond Leveraged Losses: The Balance Sheet Effects of the Home Price Downturn* (Washington, DC: Brookings Papers on Economic Activity, Fall 2008), 29; U.S. Securities and Exchange Commission, Office of the Inspector General, *SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Entity Program* (Washington, DC: GPO, 2008), 120, Appendix IX.
13. Hedge Fund Research, *Monthly Indices, HFRI Fund Weighted Composite Index for 2008* (Chicago, IL: Hedge Fund Research, Inc., 2008).
14. Bank for International Settlements (BIS), Basel Committee on Banking Supervision, The Joint Forum, *Credit Risk Transfer, Developments from 2005 to 2007* (Basel: BIS, 2008), 9, 16-17; John Lipsky, "The Global Economy and Financial Markets: Where Next?" (speech, Lowy Institute, Sydney, Australia, July 31, 2007), <http://www.imf.org/external/np/speeches/2007/073107a.htm>.
15. "Hedge Funds Become the U.S. Fixed-Income Market," *Euromoney*, Sept. 2007; Roger Merritt & Eilileen Fahey, *Hedge Funds: The Credit Market's New Paradigm* (New York: FitchRatings, 2007), 2.
16. See, e.g., *An Overview of Hedge Funds and Structured Products*, 43-44; Roger W. Merritt et al., *Hedge Funds: An Emerging Force in the Global Credit Markets* (New York: FitchRatings, 2005), 3; *Credit Risk Transfer, Developments from 2005 to 2007*.
17. Helia Ebrahimi, "Distressed Debt Funds Line Up New Year Raids," *Sunday Telegraph*, Dec. 21, 2008; Bruce W. Fraser, "New Role for Hedge Funds: Lending Money," *MarketsMedia Online*, Jan. 5, 2009.
18. See, e.g., Roger G. Ibbotson, "The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs" (Yale ICF Working Paper, No. 06-10 14, Sept. 2006); Greg N. Gregoriou & Neal E. Duffy, "Hedge Funds: A Survey of the Literature," *Pensions* 12 (2006): 24, 27; Jung-Min Kim, "Failure Risk and the Cross-Section of Hedge Fund Returns" (January 7, 2009), <http://ssrn.com/abstract=1324341>.
19. *Hedge Funds: The Credit Market's New Paradigm*, 4; *An Overview of Hedge Funds and Structured Products*, 49-51.
20. See Monica Billio et al., "Crisis and Hedge Fund Risk" (working paper, Department of Economics, Ca' Foscari, University of Venice, 2008); Nicole Boyson et al., *Hedge Fund Contagion and Liquidity*, NBER Working Paper No. 14068 (Cambridge, MA: National Bureau of Economic Research, June 2008).
21. *An Overview of Hedge Funds and Structured Products*, 39-41, 43-44, 46.
22. See "To Catch a Thief," *The Wall Street Journal*, December 17, 2008; John C. Coffee, Jr., "Law and the Market: The Impact of Enforcement," *Univ. of Penn. Law Review PENNumbra* 156 (2007): 229, 268-84.
23. Sameer Shalaby, "The End of the Single Prime Broker Model," *Advanced Trading*, Sept. 30, 2008; Ivy Schmerken, "Hedge Funds Outsource to Independent Fund Administrators," *Wall Street & Technology*, Jan. 6, 2009.

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