Although they are fairly new investment vehicles for institutional investors and wealthy individuals, hedge funds can achieve remarkable returns. Still, high fees on profit have encouraged some hedge fund managers to engage in illicit behavior. Following a few recent cases of such fraud, the Securities and Exchange Commission (SEC) has expanded its regulatory efforts to restrict hedge funds. Most recently, the Obama Administration has advanced several regulatory proposals to promote robust supervision and regulation of financial firms, arguing that at various points in the financial crisis “de-leveraging by hedge funds contributed to the strain on financial markets.”

As part of a broad legislative effort to regulate hedge funds, Congress has introduced a bill that would require hedge funds to register with the SEC and comply with new record-keeping and disclosure requirements. A much more effective method of regulating hedge funds would be to institute a strategy which effectively encourages markets to self-police by instituting financial regulatory policies that support self-regulation of hedge funds.

BACKGROUND

Though hedge funds’ investment strategies are more diverse today than they were at the market’s start in 1949, they have retained many of their original characteristics. They provide liquidity to U.S. markets by taking short positions in equities in which other large institutions, like mutual funds, cannot engage. Hedge funds also trade more actively and invest more resources in determining their trading strategies than mutual funds and other players in the market, which causes asset prices to trade at levels that reflect their real values. Additionally, they engage in corporate governance by taking large positions in firms and then advocating for organizational changes to enhance efficiency and returns for inves-
tors. As such, hedge funds have an extraordinary degree of leverage in comparison to other vehicles.9

High leverage, management expertise, and absolute return strategies are hallmarks of the industry.7 Still, the high fees charged by hedge funds are the source of much strife for regulators. Hedge fund managers get 20 percent of the amount by which they can make an investment grow along with 2 percent of assets under management. With typical hedge funds running a minimum of $100–500 million, and many running $1–5 billion, those fees can be enormous.8 Such earning potential has led a handful of hedge fund managers to engage in illicit behaviors that violate their duty to their investors and tempt institutional investors to violate their fiduciary duty to their principals.9

REGULATING HEDGE FUNDS

Though previously exempt from mandatory registration with the SEC under the “private adviser exemption” of the Investment Advisers Act of 1940, hedge funds face increasing regulation. In 2003, the SEC required any hedge fund with fifteen or more “shareholders, limited partners, members or beneficiaries”20 to register as an investment adviser,11 subjecting hedge funds to an intense compliance inspection program.

The SEC justified requiring registration on the grounds that information gained through registration and compliance will increase the probability that it will be able to detect fraud in the future in this rapidly growing industry.12 The SEC also argued that registration would be a constructive solution to the SEC’s concerns about hedge funds’ lack of disclosure to their investors. As individuals charged with managing money may have vested financial interests contrary to those of the individuals whose money they are managing, registration would give regulators more information about and oversight over these active, but secretive, market participants.14

Critics of hedge fund registration, such as former Federal Reserve Chairman Alan Greenspan, argue that over-regulating hedge funds would stifle the liquidity that these funds bring to the securities markets.15 They also question why the SEC needs to protect the sophisticated investors in these funds, since the regulatory exemption of hedge funds only applies to multi-millionaires. Still others argue that certain hedge funds, especially those already running mirror offshore entities, might simply move offshore to avoid the regulation. They note that offshore funds would still pose the same risks to U.S. markets, but would escape all government oversight.16

Finally, critics assert that registration might send the wrong signal to investors that hedge funds are completely safe when registration only means that the SEC conducts minimal compliance audits of some firms.17

When the registration requirement passed, fund managers immediately challenged the SEC’s authority to promulgate this rule, and in a 2006 ruling, Goldstein v. SEC, the District of Columbia Court of Appeals invalidated the 2004 registration provision.18

GOVERNMENT REGULATION OR SELF-REGULATION?

Even though research indicates that the hedge fund industry significantly outperformed the heavily regulated mutual fund sector and was never in jeopardy of collapsing during the financial crisis,19 various sectors of government are calling for increased regulation of the hedge fund industry. Recently, the Department of Treasury announced its intention to support a further regulatory effort.20

The Treasury claims that requiring the investment advisers of hedge funds and other private pools of capital to register with the SEC would allow the SEC to collect data that would enable it to determine how such funds are changing and “whether any such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes.”21 Besides requiring hedge fund advisers to keep particular records, the SEC would conduct periodic examinations to monitor compliance.

The Treasury also argues that there is a compelling investor protection rationale for regulating hedge fund advisors and their funds.22 After all, in the last five years, the SEC has initiated roughly 40 enforcement actions involving hedge fund fraud. Although this is not a disproportionately large number compared to the number of fraud cases involving other investment vehicles, the SEC enforcement staff alleges that, due to the lack of information about the industry, the losses involved in each case were far higher than usual because the SEC was unable to act until long after the fraud occurred. Though subjecting hedge funds to regulation does not ensure fraud detection (recall the Enron scandal), the SEC believes regulatory oversight at least increases the chances of earlier detection.23

Nevertheless, these legitimate concerns about investor protection and fraud are best addressed not through government action, but through a combination of market discipline and regulatory policies that limit direct investment in such pools to sophisticated investors (see Figure 1).24 Regulators can achieve investor protection by allowing the private market to regulate itself through encouragement and support from a government oversight body.25 In theory, this self-regulatory strategy would utilize many of the advantages of a consolidated market structure while sidestepping many of its disadvantages.

For starters, unlike government regulators, self-regulators are not severely constrained in their ability to regulate the rapidly innovating hedge fund market because of regulatory limitations stemming from institutional focus and the slower pace of bureaucratic change.26 Further, businesses have a more specialized knowledge of current and abusive strategies and the
task of regulation is ultimately beyond the SEC’s resources to oversee.27

Government-sponsored, self-regulatory strategies have a longstanding tradition in the area of finance. For instance, from its very origins, national securities regulation utilized, in part, a self-regulatory strategy for regulation of some parties, such as broker-dealers, supplemented by SEC oversight.28 Additionally, the Financial Accounting Standards Board (FASB), National Futures Association (NFA), National Association of Securities Dealers (NASD), Financial Industry Regulatory Association (FINRA), and to some extent the Federal Reserve are all examples of self-regulatory organizations (SROs) sponsored by federal regulators.29

The benefits of self-regulation are frequently paired with supplemental government oversight. The SEC would therefore be instrumental in establishing and maintaining an SRO since creating a regulatory regime that effectively signals fiduciary duty violations to investors requires government authority.20 In the hedge fund market, the SEC’s oversight role would play out in four ways. First, since the hedge fund industry suffers from a collective-action problem in coming together to form an SRO,31 the SEC would have to encourage hedge funds to establish the SRO. Second, the SEC would have to design the SRO’s charter to define the rulemaking process and approve any amendments to it. Third, the SEC would need to approve members of the rulemaking body to ensure that they encompassed a representative sample of the hedge fund industry so that, for instance, the regulations do not work to the advantage of larger funds over smaller ones. Fourth, the SEC would need to establish that individuals with a working knowledge of the hedge fund world, but independent of industry ties, would compose the decision-making body of the hedge fund SRO.32

CONCLUSION

In the post-Sarbanes era,33 criticism of the self-regulatory model is in vogue. Failures at the New York Stock Exchange (NYSE) to oversee a reasonable compensation package for Dick Grasso, former chairman and chief executive of the NYSE, signaled the end of self-regulation to some. However, agency conflicts over remuneration between the SRO executive and the board are a different animal from SRO oversight of member firms. Additionally, some version of self-regulation will remain in the financial community for some time. No one is considering abandoning the NASD.34

As the Madoff scandal shows, government entities do a poor job of preventing fraud. Moreover, they present the false impression that investments are safe merely because the government regulates them. To avoid these problems in the areas of hedge funds, the SEC should support significant elements of self-regulation as an alternative to onerous registration and compliance requirements. A self-regulatory model that uses the inherent advantage of firms in regulating each other could overcome the severe disadvantage that bureaucratic regulators face in the field.

ENDNOTES


FIGURE 1: POLICY RECOMMENDATIONS FOR SELF-REGULATION OF HEDGE FUNDS

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Explanation</th>
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<tbody>
<tr>
<td>1. The SEC should encourage creation of a private market intermediary.</td>
<td>A private information intermediary would minimize agency conflict by providing more information to hedge fund investors.</td>
</tr>
<tr>
<td>2. The SEC should grant authority to an SRO organization it creates to license members.</td>
<td>Its functions would be registration, standards of practice, inspection, investigations, discipline, and budgetary and operational decision making.</td>
</tr>
<tr>
<td>3. The SEC should enhance coordination with other regulators.</td>
<td>This would continue the benefits of self-regulation, eliminate the high cost and redundancy in dual regulation, and foster a competitive regulatory environment.</td>
</tr>
<tr>
<td>4. The SEC should recognize hedge fund best practices to encourage registration with an SRO.</td>
<td>The SEC could provide statutory defense of regulatory enforcement action to any hedge fund that follows guidelines promulgated by such a body.</td>
</tr>
</tbody>
</table>

8. Ibid., 7.
22. Ibid.
28. Ibid.
30. For more on this and how government oversight is particularly effective in the SRO sphere, see Peter M. DeMarzo, Michael J. Fishman, and Kathleen M. Hagerty, “Contracting and Enforcement with a Self-Regulatory Organization,” (working paper, August 2001), http://ssrn.com/abstract=297302.
32. Ibid., 836–7.
34. Indeed, just this year the NASD’s regulatory arm merged with its regulatory cousin at the NYSE to consolidate and enhance the effectiveness of its self-regulatory capability. For an earlier criticism of self-regulation, see Thomas Gehrig and Peter J. Lost, “Quacks, Lemons, and Self-Regulation: A Welfare Analysis,” Journal of Regulatory Economics 7, no. 3 (May 1995): 309, http://www.springerlink.com/content/w63x537h22046433/.

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