The tie between hedge funds and financial stability: is the current financial crisis a call for regulation?

Domenico Ferrari, New York University
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Domenico Ferrari¹

¹ LL.M., New York University School of Law (2009); LL.M., National University of Singapore Faculty of Law (2009); attorney at law, Chiomenti Studio Legale.
1. **Introduction**

Once relatively obscure, hedge funds today manage more than two trillion dollars in assets for their investors, and acquired an increasing importance in the international financial markets. However, most regulatory authorities have yet to promulgate a legal definition of "hedge fund".

Hedge funds are private investment vehicles less regulated than traditional investment companies. The name refers to the funds’ traditional role as "hedges" against downturns in more conventional investments, by taking positions that are relatively uncorrelated with, or in opposition to, broader financial markets.

For the purposes of this paper, we can refer to George Soros’ description of hedge funds: "hedge funds engage in a variety of investment activities. They cater to sophisticated investors and are not subject to the regulations that apply to mutual funds geared toward the general public. Fund managers are compensated on the basis of performance rather than as a fixed percentage of assets".

The attitude of regulatory authorities towards hedge funds has been severely affected by the current international financial crisis.

At the beginning of last year, the markets began to understand, with mounting panic, that the debt-driven consumer boom experienced by the United States in the last decade was becoming unsustainable. Financial troubles started from the mortgages crisis, with repayment problems arising for loans backed by mortgages issued by borrowers with a low credit rating (so-called subprime mortgages). The fall of the subprime market caused the crisis of the U.S. government-sponsored agencies Fannie Mae and Freddie Mac.

Confidence in the interbank market was broken, due to the lack of transparency and to the uncertainty related to many banks’ risk exposure in the subprime market. Such a crisis of confidence caused extensive liquidity restrictions, the securities markets plummeted through

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3 See, for example, T. Garbaravicius and F. Dierick, “Hedge funds and their implications for financial stability”, in *European Central Bank Occasional Paper Series*, Paper no. 34/2005, noting that there is “no legal or even generally accepted definition of a hedge fund"...


the floor, and the current credit crunch resulted, as clearly explained by Christian Kellermann.\(^5\)

Obviously, most of the countries affected by the credit crunch, starting from the United States, are focusing on proposals of reform for financial regulatory frameworks which have proved to be totally ineffective. Such proposals are increasingly raising the issue of hedge funds’ role in the international crisis and in the markets’ instability, in light of their highly leveraged nature and their lack of regulation.

The problem of regulation, or lack of regulation, of hedge funds has always been addressed by academics and regulatory authorities concerned about the risks that such funds pose to investors and about their potential to destabilize the economy.

On the other end, regulation has always been opposed by those highlighting that hedge funds benefit the economy by mitigating price downturns, bearing risks that others will not, making securities more liquid and ferreting out inefficiencies.

The international financial crisis, and the need to develop a brand new regulatory framework to address the current failures, urges a solution for the problem of what degree of regulation should be required for hedge funds. At the same time, the mistake of over-regulation, by using hedge funds as an easy scapegoat for a crisis caused by many different shortcomings and several regulatory loopholes, should be avoided.

We will try to address such problems, and to envisage a possible solution, through an analysis of the features and developments of hedge funds, the most recent trends of hedge funds regulation, and the role of hedge funds during the current financial crisis.

2. **Hedge funds: origin, features and developments**

The first hedge funds were created in the United States in the 1940s. Such new funds were devised to escape Securities and Exchange Commission (SEC) regulation and achieve versatility in their investments\(^6\). It is helpful to try to identify the specific features of hedge funds and to distinguish them from other kinds of institutional investors.

A defining characteristic of most hedge funds is the so-called “short-selling”: they take both long and short positions in stock, to mitigate market risk and so to allow absolute returns whatever the state of the market\(^7\).

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Another important feature is leverage: most hedge funds buy securities using borrowed money, or most often, they purchase derivatives in which positions are maintained by posting a margin, rather than supporting the full economic position. This approach consents to achieve amplified returns, if successful, but it also increases exposure and risk. In addition, hedge funds are generally much more active than other investment funds.

The fee structure that hedge funds charge to their investors is also typical: it will be much higher than other institutional investors, usually composed of a management fee of 1-2% per year and a performance fee of 20%. Such a structure means that managers are highly incentivized to generate high returns.

Most hedge funds are organized as limited liability partnerships created for the purpose of investing the money of their partners.

In short, hedge funds are to a large extent the creation of the legal restrictions imposed on mutual funds and other institutional funds, which they are specifically designed to avoid. Their advantage is that they can pursue investment and speculative strategies that are not open to other investment funds, avoiding the costs associated with regulatory oversight and using whatever fee structure they believe to be optimal.

It is important, for our analysis, to understand and measure the growth of the hedge fund industry, and so the real impact of hedge funds on the economy as a whole. Even if it is difficult to obtain precise data about the activities, profits or even the size of hedge funds, the available information, even if limited, is quite interesting for our purposes. Most research and advisory firms estimate that hedge funds today manage more than one trillion of client capital: an amount that shows a huge and rapid increase in the hedge fund industry in terms of size, numbers and portfolios. Such a huge and rapid increase in the number and value of hedge funds is directly connected to the increasing, substantial impact of hedge funds on prices and markets through their ability to leverage their investments with large-scale borrowings and derivatives.

Such an amazing growth of hedge funds is attributable to two factors: the demographics of potential hedge funds investors and the attractive performance of hedge funds. About 80% of hedge fund investors are high net worth individuals, whose number has grown sharply in the last decade.

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8 J.W. Verret, *ibidem*.
9 Hedge Fund Working Group, *ibidem*.
What investors apparently expect from hedge funds are not only double-digit annual returns, but very little correlation between those returns and the returns on stocks and bonds. In the last two decades, hedge funds have delivered on those expectations. The attractive returns delivered by hedge funds raise the obvious question of what they do to generate those returns. An answer to this question is not easy to find, considering the lack of transparency in the hedge fund market. Such opacity caused worries about the true extent of systemic risk that the growing hedge fund industry can cause to the whole economy, and about the role of hedge funds’ lack of regulation in the current financial crisis.

The collapse of Long-Term Capital Management (LTCM) in 1998, and its consequences on the international capital markets, were an early warning on the growing risks caused by hedge funds.

LTCM was primarily engaged in the so-called “market-neutral arbitrage”. Its main holdings were long positions in bonds that it considered undervalued and short positions in bonds that it considered overvalued.

In early September 1998, LTCM advised the Federal Reserve Bank of New York of its impeding difficulties. During the next few weeks, Federal Reserve representatives met with LTCM’s creditors and partners to discuss the situation. As a result of those meetings, a 16-member creditor consortium agreed to put in additional capital of $3.625 billion in exchange for 90% of the remaining equity in LTCM.

The near-bankruptcy of LTCM and its rescue by a creditor consortium organized by the Federal Reserve raise some broad sets of policy issues that are extremely important also for our analysis of the role of hedge funds in the current credit crunch, and the possible case for their regulation. In particular, a difficult issue raised by the LTCM rescue was the serious moral hazard problem in extending the federal safety net to a speculative financial firm traditionally outside the Federal Reserve’s jurisdiction. In addition, the massive leverage used by LTCM in its activities raises the issue of how could banks and securities firms have loaned so much money to LTCM and taken such a large counterparty risk vis-à-vis LTCM without knowing more about what LTCM was doing. If the Federal Reserve was correct that the rescue of LTCM was necessary to face a huge systemic risk, this circumstance raises a number of regulatory issues about the effectiveness of the banking regulatory system. At a minimum, the ability and the incentives of bank depositors, creditors and shareholders to discipline banks and securities firms for taking imprudent risks should have been enhanced. Such loopholes in the banking regulatory system should have suggested, more than ten years ago, that a comprehensive reform was necessary to indirectly address the risks caused by the
hedge fund industry. However, the debacle of LTCM would not have justified the introduction of a stricter, direct regulation of hedge funds themselves, as we will see through an analysis of the current regulatory framework, and of the benefits and costs of hedge funds as currently structured.

3. **Regulatory framework: the U.S. experience**

The U.S. experience shows us that hedge funds are structured specifically to avoid the more stringent regulation under each piece of legislation that could theoretically apply to them.

Following the financial crisis of 1929, the Securities Act of 1933 was enacted to ensure that investors receive material information concerning securities that are available for public sale. However, hedge funds are structured to fall within Section 4(2) of the Act, which exempts the highly detailed disclosure requirements for “transactions by an issuer not involving any public offering”\(^{11}\). In particular, hedge funds must not sell to more than 35 investors who are not accredited\(^{12}\). Hedge funds also must not advertise or solicit the purchase of quotas in the fund.

In addition, the Securities Exchange Act of 1934 requires stringent registration and disclosure for dealers in securities, and so the hedge funds managers seek to avoid being registered as “broker-dealers” under Section 15 of the Act. They aim is to fall within the “trader exception”, so that they are considered as trading securities for their own accounts, not as part of a business\(^{13}\). Furthermore, to avoid regulation under Section 12 of the 1934 Act, hedge funds must ensure they have less than 500 interest holders or less than $10 million of assets\(^ {14}\).

The Investment Company Act of 1940 also requires companies regulated by it to comply with the regulatory and disclosure requirements therein\(^ {15}\). However, there are two exceptions that can be exploited by hedge funds to avoid regulation: under Section 3(c) of the 1940 Act, an entity is excluded if it either has less than 100 private investors or the investments are owned only by “qualified purchasers”\(^ {16}\).

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\(^{12}\) 17 C.F.R. § 230.506.
In addition, under the Investment Advisers Act of 1940, investment advisers are subject to unannounced searches by the SEC of books and records, as well as other filings and disclosures. However, hedge fund managers can exploit the “private advisor exemption” contained in the Act itself. Crucially for the purposes of this test, the clients of the investment manager are deemed to be the individual hedge funds.

In short, in modelling themselves to fit all the above-mentioned exceptions, hedge funds are able to operate with little U.S. regulatory oversight.

In 1999, the President’s Working Group on Financial Markets published a major report on hedge funds, focusing on the concerns of excessive leverage raised in the aftermath of LTCM’s collapse. The Working Group did not recommended anything more than “indirect regulation”. Such an approach was confirmed by the next publication of the Working Group in February 2007.

The SEC’s 2004 rulemaking and the following Goldstein case have given a great example of the practical difficulties faced in developing an effective direct regulation for hedge funds.

In 2004, in order to bring the hedge fund managers within the scope of the Investment Advisers Act of 1940, the SEC rulemaking closed the “loophole” that allowed each single hedge fund to be counted as a “client” for the purposes of the Act.

The SEC rulemaking, only changing one small definition, would have had a very large effect on the regulatory structure applied to hedge funds. In fact, such funds would have been subject to the full provisions of the Investment Advisers Act.

There was a general disagreement and resistance to the revised rule. Many hedge fund managers attempted to find a different loophole to avoid registration, while others simply disregarded the new rule and carried on as before.

The new loophole was through a new provision which was included to prevent private equity funds from being covered by the Act. In particular, in the new version, the definition of “private funds” regulated by the Act only included funds that permit their owners to redeem any portion of their ownership interest within two years from the purchase. In short, the only distinction the SEC could find between private equity and most hedge funds was the

20 L. Tiffith, “Hedge Fund Regulation: what the FSA is doing right and why the SEC should follow the FSA’s lead”, in 27 Northwestern Journal of International Law and Business, 518 (2007).
difference in lock-up provisions\textsuperscript{21}. As a consequence, many hedge fund managers simply increased lock-up period to two years or more, once again proving the chameleon nature of hedge funds and fitting themselves in the cracks of the system\textsuperscript{22}.

Philip Goldstein, manager of the Bulldog Investors group of hedge funds, brought suit in Federal Court, alleging that the SEC had abused its agency rulemaking powers in changing the definition of "client".

The Circuit Court unanimously agreed with Goldstein’s position, finding the SEC’s rulemaking to be “arbitrary”\textsuperscript{23}. The Goldstein decision severely impaired the effectiveness of the SEC rulemaking. Over the course of 2007, it became apparent that the Commission was not going to pursue as tenaciously the course of direct regulation of hedge funds that the Commission had previously followed\textsuperscript{24}.

In the recent past, a number of prominent figures close to the Commission have expressed support for a self-regulatory scheme, and the Commissioners had indicated their willingness to follow the lead of the above-described President’s Working Group on Financial Markets.

However, such a trend was suddenly reverted by the rise of the current international financial crisis in 2008. The credit crunch showed, dramatically, the limits of the current regulatory framework, and will lead to a broad revision of the regulatory policies everywhere. The hedge fund industry has not been exempted from this general trend leading to more stringent and comprehensive regulation of the financial markets. In particular, the crisis amplified the worries about the possible systemic risk caused by the huge growth in size and number of hedge funds.

How much the above-mentioned worries are justified remains to be seen. In the meantime, it is worthwhile to analyze the Singapore experience in regulating hedge funds, which shows a similar path to the one experienced in the United States, as well as costs and benefits of hedge funds’ direct regulation, as opposed to the past trend of indirect and self regulation, to understand what regulatory solution would be optimal in the long run to give answers to the issues raised by the development of such a massive hedge fund industry.

\textsuperscript{21} H. Ordower, ”Demystifying Hedge Funds: a design primer”, in 7 University of California Davis Business Law Journal, 324.
\textsuperscript{23} Goldstein v. SEC, 451 F.3d 873, 883-84 (D.C. Cir. 2006).
\textsuperscript{24} J.W. Verret, ibidem.
4. **Regulatory framework: the Singapore experience**

In Singapore, as it happened in many other financial centres in the world, hedge funds form part of an expanding menu of financial products.

The huge growth of the hedge fund industry recently experienced in Asia as a whole and particularly in Singapore, together with the above-described near collapse of LTCM in 1998, raised questions about the risks that large and highly leveraged hedge funds pose to systemic stability.

In order to address these concerns, the Financial Stability Forum, of which Singapore is a member, set up a working group on highly leveraged institutions. As a result, in March 2000 the group issued a sobering reminder: institutions that provide leverage must improve their counterparty risk management and hedge funds need to enhance their disclosures.

As a result, Singapore’s approach to regulating hedge funds is risk-focused and differentiated, trying to balance the potential benefits with the risks that hedge funds could pose to the financial system.

Hedge fund managers are regulated like any other fund manager managing third-party funds in Singapore. Small fund managers, that manage funds for accredited investors\(^{25}\), are subject to less stringent licensing requirements because investor protection concerns are less acute. Smaller funds, with fewer than 30 qualified investors\(^{26}\), are exempted from licensing.

Hedge fund managers, as it happens in the United States, should find such operating structures conducive, as they are typically managing funds for a limited number of institutions and high net worth individuals.

The Monetary Authority of Singapore (MAS) applies the same risk-focused and differentiated approach to the marketing of hedge funds. In particular, MAS does not regulate offers of collective investment schemes and hedge funds to professional and institutional investors in the financial sector, as these investors are considered adequately skilled to fend for themselves.

MAS’ regulatory oversight of the marketing of hedge funds is focused on retail investors, that may not be familiar with the differences between a hedge fund and a typical collective investment scheme. In particular, key aspects such as legal structure, investment objectives, trading strategies and fees may not be fully appreciated by a retail investor.

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\(^{25}\) "Accredited investor" refers to an individual with net personal assets exceeding $\text{S}\$ 2 million or a corporation with total net assets of more than $\text{S}\$ 10 million.

\(^{26}\) "Qualified investor" means an individual with net personal assets exceeding $\text{S}\$ 5 million, a corporation with total net assets of more than $\text{S}\$ 10 million, a collective investment scheme that is marketed only to accredited investors, or a collective investment scheme that is not marketed in Singapore.
Furthermore, MAS correctly pointed out that retail investors may be lulled into thinking that hedge funds are low risk investments based on studies showing hedge fund returns to be less volatile than mutual fund returns\textsuperscript{27}. Such statistics should be carefully evaluated especially because hedge fund returns are anything but normally distributed. Indeed, they are negatively skewed and exhibit high kurtosis. A fat-tail event, such as the Russian default of 1998, was enough to scuttle any profits LTCM might have projected with its elaborate models.

However, the above-mentioned concerns did not induce MAS to completely prohibit the marketing of hedge funds to retail investors. Retail hedge funds are in fact permitted under a broad regulatory framework, aimed at balancing investor needs and investor protection on three pillars: enhanced disclosure, enabling regulation and enlightened investors.

In relation to the first pillar, in order to enhance disclosure in prospectuses for offers of investments, including hedge funds, the Singapore regulatory framework provides for prospectus checklists, prospectus registration procedures and advertising regulations. In particular, a prospectus must contain all material information that a reasonable investor would require to make an informed investment decision. In addition, MAS issued comprehensive retail hedge fund guidelines providing for, among other things, a requirement for some specific information to be disclosed in both prospectuses as well as marketing materials.

Turning to the second pillar, enabling and flexible regulation, the guidelines aim to align Singapore hedge fund regulations with international best practice. A key development was the distinction made between single hedge funds, funds of hedge funds and capital protected hedge funds. Considering that features such as diversification and capital protection reduce the risk of investing in hedge funds, MAS has differentiated the minimum initial subscription requirements for the three types of funds, with single hedge funds, the most risky type, having to provide for a minimum initial subscription of S$ 100,000 in order to be offered to retail investors.

In relation to the third pillar, “enlightened investors”, this is an essential element of the Singapore disclosure-based regulatory regime. In this respect, the Financial Advisers Act of 2002 created a class of financial advisers who can advise and inform investors on a whole range of investment products. The creation of such financial advisers is aimed at promoting public awareness of more sophisticated products such as hedge funds.

In general, the current Singapore regulatory framework seems to take into account the important growth of the hedge fund industry, without attempting to strictly control the hedge fund industry.

\textsuperscript{27} Yeo Lian Sim, “Hedge Funds: a mainstream alternative”, (2002).
fund market through a difficult and cumbersome direct regulation. The focus seems correctly directed at the pivotal relationship between hedge funds and retail investors that should be protected considering the highly complex nature of the financial products offered by the hedge funds.

The Singapore regulators seem to have been practical in acknowledging the difficulty of a direct control over hedge funds, due to their intrinsic nature of vehicles designed to be flexible enough to escape any kind of regulation exploiting the unavoidable loopholes of any legal system. At the same time, the Singapore authorities correctly decided not to give up as far as the fundamental relationship between hedge funds and retail investors is concerned, reaching a good balance of indirect regulation, protection of retail investors, promotion of self-regulation and an essential enhanced disclosure requirement for the offering of such complex financial products.

Unfortunately, it is likely that such a positive trend will be impaired by the current financial crisis, and by the new international crusade in favour of the enactment of stricter, direct regulation of hedge funds.

5. The recent trend towards self-regulation: a useful development?

Before considering the recent trend towards self-regulation, it is worth noting the reasons behind the rising calls for regulation of hedge funds.

Two main arguments have been raised in favour of increased regulation with regard to investor protection. First, the increasing “retailization” of hedge funds has blurred, in recent years, the “sophisticated investor” distinction, so the sophisticated nature of hedge fund investors cannot longer be held as a justification. In fact, the proportion of investments by institutional investors in hedge funds has increased greatly, and the beneficiaries of most institutional investors are “unsophisticated” people who will ultimately take the risk of the investments, so being indirectly exposed to hedge funds.

Second, the general lack of disclosure from hedge funds enables the latter to engage in fraud and can cause even sophisticated investors to suffer from information asymmetries.

Another reason for hedge fund regulation is the concern that the failure of a highly leveraged hedge fund could cause a chain of correlated defaults, endangering the whole financial markets: the so-called “systemic risk”\(^{28}\). Very unlikely but very severe events will

\(^{28}\) N.T. Chan et al., “Systemic risk and Hedge Funds” (2005).
be discounted almost entirely by fund managers, but present the greatest threat to the global financial system if they happen.

Finally, hedge funds have been much criticized by someone for their governance actions as shareholder activists in recent years. Activist hedge funds often appear to exert great power as shareholders, through the ability to quickly and quietly amass significant shares, with the credible threat of further action. Hedge funds are also successful in encouraging other investors to follow their strategies.

It is helpful to consider briefly the problems that hedge fund activism may raise and that regulators may consequently wish to tackle. First, the typical hedge funds are, by definition, hedged, and thus will short certain stocks. If they vote stocks they do not own, the funds are engaging in “empty voting”, effectively betting against the price of some stocks they “hold”. In addition to that, there is the possible problem of “short-termism”. Hedge funds may be incentivized to bring about short-term gains in their investee companies, even if such gains harm the companies in the long run.

Overall, however, the costs and benefits of hedge fund activism are not well understood, and commentators disagree as to how the balance of regulation should be struck.

Having seen the approaches of government regulators in the United States and Singapore and the recent moves towards self-regulation prior to the start of the international financial crisis, it is worthwhile to examine the theoretical advantages and disadvantages of self-regulation itself.

As far as the benefits of self-regulation are concerned, an important argument in favour of self-regulation is its capacity to react to industry changes quickly. Such speed and flexibility of self-regulation is pivotal in a modern, globalized, rapidly changing marketplace.

In addition to the above, a number of commentators have suggested that a government regulator would be likely to over-regulate, as it would be less likely to factor the opportunity

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31 M. Kahan and E.B. Rock, ibidem.

costs of lost trades into his calculus. The problem is exacerbated by the fact that it takes a long time for government regulators to “unwind” any inefficient regulation.

Finally, the most important benefit of a self-regulatory system is its capacity to be cross-border. Clearly, a globally effective self-regulatory scheme would prevent a regulatory “race to the bottom” among developed markets to attract hedge funds in their jurisdictions.

As far as the costs of self-regulation are concerned, one problem is that the incentives of hedge fund managers are aligned with the market only in certain ways. In many aspects, however, the incentives of hedge fund managers may conflict with the market’s goals.

The problems of misalignment can be countered somewhat by supplementing the composition of the self-regulatory organizations. The best solution is likely for the self-regulatory organizations to have some detailed government regulatory oversight.

In addition to the misalignment problem, any self-regulatory scheme that is voluntary and does not have an enforcement mechanism will always suffer from the appearance that it might be ineffectual. Such a problem is exacerbated by the voluntary nature of such schemes.

As we have seen, in both the United States and Singapore, as well as many other countries around the world, there has been a move towards self-regulation in the past few years. Given this, it is important to consider whether this form of self-regulation can be really different from government regulation, and if so, whether it is an effective response to regulatory loopholes, especially in light of the recent financial crisis.

As noted above, one of the key benefits of self-regulation is efficiency. It is possible, however, that self-regulatory organizations act only in response to the threat of government regulation: to fill the vacuum that they believe would otherwise be filled by direct government regulation.

It is notable that self-regulatory organizations appear to pay particular attention to areas of hedge fund regulation that government regulators have recently focused on. In particular, the majority of self-regulatory proposals and standards relates to investor protection and systemic risk: the areas where government regulators have consistently expressed concerns. At the same time, self-regulatory efforts pay little attention to corporate governance and activist hedge funds, areas that have not recently been discussed by government regulators.

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34 T.A. Paredes, ibidem.
35 J. Mackintosh, “Adviser says hedge fund code needs to be tougher”, in Financial Times (London), January 3, 2008.
It is apparent that self-regulatory proposals shadow government proposals, most probably as a way to prevent direct regulation. Consequently, some of the proposed benefits of self-regulation may be lost. If self-regulatory organizations rely on government regulators finding and pointing areas that need regulation out, the regulation may be not quicker or more efficient than government regulation itself. Conversely, government regulators may come to over-rely on self-regulatory groups, so exacerbating the enforcement problems.

The above considerations show that, even if self-regulation is undoubtedly beneficial for the regulatory system, it cannot be considered an effective response to regulatory loopholes by itself. In fact, it should be supplemented by a government-based regulatory system to address the above described shortcomings, without impairing the beneficial effects of the hedge fund industry for the economic system as a whole.

6. **Hedge funds and the financial crisis: a case for regulation?**

As we have seen, the development of hedge funds has undoubtedly been a source of innovation in the global asset management industry, and has contributed at improving the efficiency of price discovery in financial markets.

In addition, hedge funds play an important role in trading and distributing risk. In fact, they enhance market liquidity, even in periods of stress when nobody else is willing to take risks.

Finally, hedge funds have proved to be quite robust to stock market drops. In stress situations in the last decade, the hedge fund industry incurred less losses than the stock indices. The only exception was the Russian crisis in 1998 with the collapse of LTCM.36

Notwithstanding the above-mentioned benefits that hedge funds provide to the market, it is extremely important to understand whether such highly leveraged institutions represent a direct risk to financial stability and, at the same time, whether there are transmission channels through which hedge funds could indirectly weaken the financial sector as a whole.

In relation to the direct influence exerted by hedge funds on the markets, it is worth noting that the size of the hedge fund industry, notwithstanding its huge growth in absolute terms, is comparatively small from both an individual and aggregate point of view. Furthermore, the hedge fund industry is highly segmented in a broad range of different investment strategies. Finally, and even more importantly, such highly leveraged institutions play no role in traditional financial intermediation. Hence, the failure of one or more

important hedge funds would not directly encumber the real economy. Hedge funds do not represent a direct threat to financial stability.

The true concern in relation to financial stability is that the failures of one or more hedge funds could have a severe impact on systematically important financial institutions and, as such, constitute an indirect threat to the financial system. There are two transmission channels through which such a shock could be transmitted to the banking sector.

The first transmission channel is caused by financial institutions acting as counterparties and creditors of hedge funds, by providing leverage, and so being directly exposed vis-à-vis hedge funds. As a consequence, when hedge funds incur losses, this has a direct impact on banks, and it could threaten the banks’ solvency in an extreme case.

The second transmission channel is caused by the fact that hedge funds act as buyers and sellers on the financial markets. As a consequence, their actions have an impact on prices, liquidity and volatility.

In short, hedge funds cannot be seen as a direct risk to financial stability. However, there are two potential transmission channels through which shocks on the hedge fund market could spread to large international banks. If these shocks are large and banks are not robust enough, then the stability of the financial system could be at risk.

Notwithstanding the above, available data and experience with failure of large hedge funds in the past suggest that the disruptive capacity of hedge funds is limited. Such a conclusion is confirmed if we analyse the role of hedge funds in the current financial crisis. In particular, 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, in part because many 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 the ongoing financial crisis. Probably, 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. In

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addition, academics and organizations like the International Monetary Fund have found that hedge funds involvement in credit markets made those markets more stable and efficient\(^\text{40}\).

During the current financial crisis, hedge funds have increasingly purchased other companies’ poorly performing securities, and made loans that help borrowers in otherwise tight credit conditions\(^\text{41}\).

In light of the above, a direct regulatory framework for hedge funds, by limiting the main feature of such funds - that is: the flexibility to freely operate on the financial markets without regulatory constraints - would probably be implemented only at extensive costs, especially in terms of loss of market liquidity, economic instability, difficult monitoring and enforcement, hedge fund forum shopping. Such costs would be exacerbated by the current financial crisis, characterized by serious lack of liquidity in the markets. In such a situation, hedge funds role, as an important source of liquidity for the financial markets, seems to be particularly important.

In addition, a direct regulation would fail to address the true Achilles’ heel of the system: the link between hedge funds and financial institutions of systemic importance. The systemic risk originating from hedge funds are better addressed through indirect measures aimed at the hedge funds’ counterparties and creditors. Such an approach has the advantage that regulation would be focused directly on the transmission channels through which the risk would be propagated and on the institutions which are cornerstones from a financial stability perspective.

In particular, in regulating financial institutions that deal with hedge funds, it should be taken into account that risk assessment and risk management are crucial. In addition, the protection of less sophisticated retail investors who are indirectly exposed – through pension funds and commercial banks – to hedge funds, is definitely a legitimate concern. However, in light of the above analysis, regulations could probably be implemented more efficiently on the pension fund and commercial bank side, as opposed to a probably inefficient direct regulation of hedge funds themselves.

7. **Conclusions**

The analysis of the main features of hedge funds, and a realistic assessment of their systemic importance and disruptive capacity, lead us to the conclusion that direct prudential regulation for hedge funds would be difficult to justify. The apparent benefits to be delivered


by regulation seem not to justify the related costs, such as reduced market efficiency and slower financial innovation.

The analysis, however, is not meant to deny the important issues arising from the steady growth of the hedge fund industry. In particular, we have seen that there are two channels through which a shock occurring in hedge funds could be transmitted to systemically relevant financial institutions. Potential regulatory measures should therefore focus on the link between hedge funds and such institutions.

As a consequence, a form of indirect regulation, targeting those financial institutions that are systemically important, seems to be the best possible solution.

In particular, financial intermediaries should be forced to enhance their risk assessment and risk management. In addition, financial institutions particularly linked to the public at large, such as commercial banks and pension funds, should be strictly limited in their ability to invest in the hedge fund industry, either directly or indirectly through the incorporation of special purpose vehicles.

At the same time, considering the difficulties of implementing an effective regulatory framework for hedge funds, the recent trend towards self-regulation should be supported and strengthened.

Self-regulation, even if unable to be an autonomous response to the threat posed by hedge funds, could give a pivotal support to a regulatory framework otherwise too rigid to effectively regulate a market characterized by flexibility and velocity in adapting to any new change.

Considering the likelihood that self-regulatory organizations will issue rules that shadow the government proposals, such organizations should be subject to some kind of detailed government regulatory oversight, focused on the use of the political leverage to lead the self-regulatory organizations to the most efficient path, and to address the shortcomings of self-regulation itself.

In short, the above analysis was meant to show how recent proposals for a tight, direct regulation of hedge funds, arisen as a response to the international credit crunch, could represent a dangerous step on the path of over-regulation of a highly leveraged industry that provides liquidity and stability to the financial markets, and that needs flexibility to be able to survive. By jeopardizing the survival of the hedge fund industry, an excessive regulation could plant the seeds of the next financial crisis and of future market instability.

In order to properly address the problems arising from the steady growth of hedge funds, the public authorities should probably make reference to the positive trends
experienced before the occurrence of the international credit crunch, which means: an acceptable balance between indirect regulation and self-regulation.

Such a mixed regulatory system, if properly developed, could be able to address the above described shortcomings of the hedge fund industry, without impairing its beneficial effects for the economic system as a whole.
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