Suggestions for Regulation of Hedge Funds
Following the Financial Crisis of 2008

Testimony of Professor David S. Ruder[1]
Before the House of Representatives Committee on
Oversight and Government Reform

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Chairman Waxman, Congressman Davis, and Committee Members.

It is with great pleasure that I offer my views regarding the impact of hedge funds on the ongoing financial crisis. I will describe hedge funds, discuss the background of the current credit crisis, and address hedge fund impact on the crisis. The remainder of my testimony will be devoted to describing the efforts of the Securities and Exchange Commission to regulate hedge funds and to my recommendations for future regulation of hedge funds following the financial crisis of 2008.

Summary of Recommendations

The Securities and Exchange Commission should be given power to register hedge fund advisers, power to require hedge advisers to disclose hedge fund risks and other activities, and power to monitor and assess the effectiveness of hedge fund risk management systems. The SEC should be required to share risk information about hedge funds on a confidential basis with the Federal Reserve Board. The SEC's funding should be increased and it should remain an independent agency.

The swaps exclusion included in the Commodity Futures Modernization Act of 2000 should be repealed so that non exchange traded derivative instruments can be regulated in a manner that will protect investors and help to prevent de-stabilization of the financial markets.

Hedge Fund Distinguishing Characteristics

The definition of hedge fund is unclear. The SEC has acknowledged that the term has no "precise legal or universally accepted definition."[2] The President's Working Group on the Financial Markets has called a hedge fund "any pooled investment vehicle that is privately organized, administered by professional managers, and not widely available to the public."[3]

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[1] Professor of Law Emeritus, Northwestern University School of Law, Former Chairman of the U.S. Securities and Exchange Commission (1987 – 1989).

[2] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, September 2003 at p. 3. Hereinafter SEC Staff Report.

[3] Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Report of the President's Working Group on Financial Markets (April 1999).

Although there is no universally accepted definition of hedge funds, some generally understood characteristics can help to identify hedge funds. Hedge funds seek to achieve absolute returns rather than measuring their performance against a securities index or other benchmark. They trade stocks, bonds, currencies, physical commodities, and other securities. They seek greater than market returns by identifying pricing anomalies, by engaging in hedging strategies, by making bets on the future, by using leverage, and by investing in derivative instruments. Hedge fund managers do not want their investment strategies to become known.

Hedge fund advisers receive compensation based upon a percentage of the fund's total assets under management, typically 2 %, and performance fees, typically 20% of realized and unrealized gains. If a fund loses money in a particular year, it usually must bring assets under management to the starting point of that year (the "high-water mark") before measuring gains for the next year. Some hedge fund contracts permit hedge fund managers to manage some assets off book in so called "side pockets," with the result that the returns from these investments are not counted in measuring performance. Hedge fund compensation features have the effect of encouraging hedge fund advisers to take substantial risks.

Most hedge fund investors are sophisticated high net worth individuals or institutions. Hedge fund investors are usually permitted to redeem their interests periodically, sometimes quarterly, semi-annually, or yearly,[4] or perhaps only after two years or longer, but there are often contractual restrictions requiring extensive advance notice of intended withdrawals. Hedge funds pose risks to their investors. Because of their high risk strategies hedge funds may suffer substantial losses, may not be able to repay investors in times of stress, or may simply dissolve without returning any monies to investors.

Hedge funds vary in the amount of information they provide to investors. Dishonest hedge fund advisers may injure investors through misrepresentations when selling their funds, may falsify operating results, or may steal from hedge fund investors. Hedge funds may be involved in insider trading or market manipulation. Hedge funds valuation practices are not uniform, especially with regard to non-marketable, illiquid securities.

Hedge fund investment and hedging activities make positive contributions to capital formation, market liquidity, price discovery, and market efficiency. Negative financial market effects of hedge fund activities occur when their losses cause them to liquidate market positions, resulting in downward pressures on the asset classes they are selling. Their defaults may cause losses to their counter parties.

[4] Consultation Report, the Regulatory Environment for Hedge Funds, A Survey and Comparison, Technical Committee of the International Organisaton of Securities Commissions, March 2006, p.7.

The Credit Crisis[5]

The credit crisis arose from losses in mortgage loans in the home housing market. Many of these loans were "subprime" loans made to home buyers who had inadequate income or who made low or no down payments. Some of the loans had low initial fixed interest rates that subsequently converted to higher unaffordable adjustable rates. Many home buyers were eventually unable to meet their loan obligations.

Mortgage originators sold the home loan mortgages to others, including off balance sheet entities created by investment banks. These entities issued structured notes called collateralized debit obligation (CDOs), secured by groups of home mortgage loans. These CDOs were divided into levels (or tranches) that had varying degrees of risk. They were often then sold by the investment banks on behalf of the investment entities to sophisticated investors, including hedge funds.

In some cases, the CDOs received credit ratings from credit rating agencies, with the highest (AAA) ratings assigned to the safest debt levels. As part of the selling process many investment banks carried CDOs in all risk categories on their balance sheets. Additionally, many investment banks held some of the most highly rated CDOs on their balance sheets for investment.

When home buyers began to default on loans, the market value of the CDOs, including AAA rated CDOs, fell dramatically because market participants became aware of the risks of default and stopped purchasing the notes. As the market for CDOs dried up, credit became unavailable in the broader markets. Market participants became uneasy about the financial stability of other participants, including banks, investment banks, and hedge funds, both in the U.S. and in other countries, and eventually became unwilling to deal with each other because of the fear of counter party inability to meet obligations. The values of CDOs owned by investment companies and banks worldwide fell to extremely low levels, affecting the abilities of these institutions to meet their financial obligations and to engage in lending activities.

Another important aspect of the credit crisis collapse was the impact of "credit default swaps" (CDSs). Credit default swaps are derivative instruments in which a credit default risk seller insures the buyer against the risk of default on a debt instrument issued by a third party. These instruments originally were intended to provide protection for the owners of corporate bonds or mortgage backed securities against defaults by the issuers of these debt instruments. During recent years they have been used to provide protection to the CDOs issued by investment banks and others. Recently the buyers of these swaps have been market speculators as well as debt instrument owners. The credit default swap industry has had explosive growth during the last two years, doubling in size to a notional

[5] This description is taken in part from Testimony of David S. Ruder, Before the Senate Banking, Housing, and Urban Affairs Committee's Subcommittee on Securities, Insurance, and Investment, United States Senate, May 7, 2008, pp. 1-2.

value of $55 trillion.[6] The credit default market is unregulated and little information exists regarding the amount of payments that will be required by the sellers of this insurance. The possible inability of insurers to meet their obligations has further added to market uncertainty.

One key aspect of the credit crisis was the failure of both market participants and regulators to predict the collapse of the home loan mortgage market. None of the primary market participants predicted the collapse. The risk management systems of most banks, investment banks, rating agencies, and credit default swap insurers did not predict the collapse. Regulators, including the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Department of the Treasury, the SEC, and the Commodity Futures Trading Commission did not predict the collapse.

Hedge Fund Involvement in the Credit Crisis

Although hedge funds have been active participants in the financial markets during the past years, they do not seem to have played a major role in the events precipitating the crisis. As noted above, the market participants central to the credit crisis were loan originators, investment banks, rating agencies, and sellers of credit default swaps.

Nevertheless, hedge funds were participants in several phases of the crisis. Although some hedge funds hedged CDO risk and made substantial profits, many hedge funds suffered major losses when the CDOs lost value. Hedge funds have contributed to declines in stock and asset prices by liquidating stocks and other assets in order to meet other obligations and in order to pay investors seeking to withdraw funds. They have been charged by some with contributing to the market decline by engaging in short selling activity, but there seems to be no showing at this time that they were engaged in illegal activity.

Regulation of Hedge Funds by the SEC

Hedge funds are subject to a broad range of SEC regulations applicable to all securities market participants. They may not engage in illegal fraudulent activities, including insider trading. They must comply with federal proxy rules and takeover laws. They may not violate SEC rules regulating naked or manipulative short selling. They must comply with recent SEC rules requiring disclosure of large short positions.

Hedge funds are usually organized as limited partnerships or similar entities. Sales of hedge fund securities must be registered with the SEC under the Securities Act of 1933, unless an exemption can be found.[7] Most hedge funds avoid registration under that Act by selling their securities only to institutional investors or high wealth individuals

[6] Testimony of Eric Sirri, Director of the SEC Division of Trading and Markets before the House Committee on Agriculture (October 15, 2008).
[7] Securities Act of 1933, Section 5.

who are presumed to be sophisticated in financial matters.[8] Hedge funds avoid registration and disclosure under the Securities Exchange Act of 1934 by selling interests in each fund to fewer than 500 investors.[9]

Most hedge funds are not required to register as investment companies under the Investment Company Act of 1940 because of statutory exemptions from that Act. They may avoid registration under that Act by limiting the number of owners of each fund to fewer than 100 persons[10] or limiting the owners of their securities to qualified purchasers[11] who own at least $5 million in investments.[12]

Investment advisers to hedge funds meet the definition of investment adviser under the Investment Advisers Act of 1940 because they are persons who for compensation engage in the business of advising others regarding the advisability of investing in securities.[13] Many investment advisers obtain an exemption from registration under that Act by advising fewer than fifteen clients.[14] However, approximately 2,500 hedge fund advisers are registered with the SEC under the Investment Advisers Act of 1940.[15] As of January 2008, registered investment advisers included 49 of the largest hedge fund advisers, accounting for about one-third of U.S. hedge fund assets under management.[16]

In 2003, the Staff of the SEC issued a report on hedge funds[17] expressing concern about lack of information about hedge funds. The report noted: the inability to detect hedge fund fraud and misconduct at early stages; lack of accurate information about hedge fund assets, trading, and investment activities; and lack of information about valuation of portfolio securities, conflicts of interests, and other matters. The report expressed concern about lack of disclosure to hedge fund investors. The Staff recommended that the SEC seek to force hedge fund investment advisers to register with the SEC so that those deficiencies could be remedied.

In 2004, in reliance upon the Staff's recommendation and its own concerns about fraudulent activities by hedge funds, the SEC adopted a new rule that would have

[8] The SEC's Regulation D provides a safe harbor under Section 4(2) of the Securities Act based on numerical financial standards. The SEC has proposed amendments to Regulation D strengthening the safe harbor numerical standards for hedge fund investors, but has not yet adopted the amendments. Rel. 33-8766 (Dec 27, 2006) and Rel. 33-8828 (Aug 3, 2007).
[9] Securities and Exchange Act of 1934, Section 12(g).
[10] Investment Company Act of 1940, Section 3(c)(1). Under the exemption, the hedge fund may not make a public offering of securities.
[11] *Id*. Section 3 (c)(7). Under the exemption, the hedge fund may not make a public offering of securities.
[12] *Id*. Section 2 (a)(51)(A).
[13] Investment Advisers Act of 1940, Section 202(a)(11).
[14] And do not hold themselves out to the public as an investment adviser or act as an investment adviser to a registered investment company. *Id*. Section 203-3(b)(3).
[15] Christopher Cox, Testimony Concerning Hedge Fund Regulation before the U.S. Committee on Banking, Housing and Urban Affairs, July 25, 2006, p.2.
[16] United States Government Accountability Office, Report on Hedge Funds (January 2008), p.5.
[17] Implications of the Growth of Hedge Funds, Staff Report the United States Securities and Exchange Commission (September 2003).

required most hedge fund advisers to register with it.[18] Under that rule, hedge fund advisers would have been subject to SEC disclosure, inspection, and conduct regulation regarding their hedge fund advisory activities.

The hedge fund industry strenuously objected to the new SEC regulation of hedge fund investment advisers. In Goldstein v. SEC,[19] the D.C. Circuit of Appeals invalidated the new SEC rule, holding that the SEC had exceeded its power when it promulgated the rule.

In requiring registration of hedge advisers, the SEC's new rule had mandated that for purposes of meeting the exemption from the Advisers Act based upon advising fewer than 15 clients, an investment adviser must count hedge fund investors as clients.[20] Since most hedge funds have 15 or more investors, almost all hedge fund investment advisers would have been required to register.

In its Goldstein decision, the Court held that the client of a hedge fund investment adviser was the hedge fund, not the investor in the hedge fund. The opinion raised questions whether the SEC's enforcement powers under Sections 206(1) and (2) of the Advisers Act would be limited.[21] In order to meet this problem, the SEC adopted a new rule under 206(4) of the Act. The new rule prohibited investment advisers from making false statements to investors or prospective investors in hedge funds or otherwise defrauding those investors.[22]

The new SEC rule expanded SEC's powers over hedge funds because it applies to all hedge fund investment advisers, whether or not registered with the SEC, and reaches negligent conduct in addition to knowing and deliberate conduct. The rule powerfully enables the Commission to discipline hedge fund advisers who make misrepresentations to hedge fund investors regarding the valuation of securities, earnings, conflicts of interest, or other matters.[23]

Adoption of the new rule gives the SEC important powers to regulate hedge fund relationships with their investors, but it does not permit the SEC to inspect hedge funds or to monitor and assess the effectiveness of hedging activities that might create systemic risk.

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[18] Rel. IA-2333, Registration Under the Advisers Act of Certain Hedge Fund Advisers (Dec 2, 2004).
[19] Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).
[20] Rule 203(b)(3)-2.
[21] The SEC became concerned about its ability to utilize Sections 206(1) and (2) of the Advisers Act to bring actions against hedge fund advisers that had defrauded investors.
[22] Rule 206(4)-8, Rel. IA-2628, Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles (August 3, 2007). The rule defines a pooled investment vehicle as any investment company that utilizes Section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid registration.
[23] The rule is not enforceable by investors in private actions.

Recommendations for Regulation of Hedge Funds

New regulations are needed in order to protect hedge fund investors and in order to monitor hedge fund contributions to systemic risk. These regulatory needs can be accomplished by giving the Securities and Exchange Commission power to register and inspect hedge fund advisers, including the power to require disclosure of activities that might injure investors, power to require hedge fund advisers to disclose hedge fund risk activities, and power to monitor and assess the effectiveness of hedge fund risk management systems.

Protection of Investors

Protection of investors should be a major goal in hedge fund regulation. The SEC already has power to discipline hedge fund investment advisers who defraud hedge fund investors. SEC powers over hedge fund investment advisers through registration and inspection will allow the SEC to learn about potential fraudulent activities at an earlier stage than is possible through after the fact enforcement activities.

Systemic Risk Regulation

Systemic risk regulation of hedge funds is necessary because hedge funds' size, strategies, and opacity pose risks to the financial markets. Highly leveraged hedge funds that borrow large sums and engage in complex transactions using exotic derivative instruments may severely disrupt the financial markets if they are unable to meet counter party obligations or must sell assets in order to repay investors.

Hedge funds are major users of non-exchange traded derivative instruments. Although general characteristics of derivative instruments are well known, a tremendous void exists regarding the specific characteristics of many of these instruments, the amounts at risk, and the identity of their counter parties. The terms of these instruments are often unique and complicated, and the instruments are frequently not easily settled or offset.

A primary problem identified in the credit crisis has been the loss of confidence among market participants regarding the ability of counter parties to honor contractual obligations and to repay their debts. The main reason for the lack of confidence is lack of information. Regulation should exist allowing information about hedge fund risk positions to be known by regulators.

Ten years ago, following the Long Term Capital Management crisis, I testified before the House Committee on Banking and Financial Services urging that steps be taken to determine the risk positions of those engaged in hedging and derivatives trading activities.[24] At that time I urged establishment of a system to learn what risks are being

[24] Testimony of Professor David S. Ruder Before the House Committee on Banking and Financial Services Concerning Public Policy Issues Raised by the Collapse and Interim Rescue of Long Term Capital Management LP, October 1, 1998.

taken by hedge funds and their counter parties. I noted the danger that failure of one large participant in a market may cause the failure of other parties. I warned that if in times of stress the amount or nature of risk is unknown, participants in the market may assume the worst and unnecessarily exit the market.

By way of recommendation I urged that "through legislation or the use of available powers efforts should be made to determine the risk positions being taken by the various participants in hedging and derivative trading activities."

Steps to prevent or correct systemic calamities in the financial market should be based on comprehensive risk information. I continue to believe that a system should be created requiring hedge funds to divulge to regulators information regarding the size and nature of their risk positions and the identities of their counter parties.

I believe the Securities and Exchange Commission is the proper entity to obtain hedge fund risk information. The SEC understands the markets and the need to allow innovative risk taking. By monitoring and assessing hedge fund risk management systems, the Commission will be able to determine whether those systems are effective in meeting their protective goals.

Congress should give the SEC power to register, inspect, and obtain systemic risk information from hedge fund advisers. It should also give the SEC power to monitor and assess the effectiveness of hedge fund risk management systems. The information collected by the SEC should be shared with other regulators in a cooperative effort designed to identify excessive risk positions that may endanger the financial markets. This information should be held in confidence by the regulatory authorities.

In any reorganization of the federal financial market system I believe the Federal Reserve Board should have primary responsibility for systemic risk regulation, focusing on its traditional role of implementing monetary policy and providing liquidity to the financial system. In that capacity I believe the Board should be the central repository of information regarding the risk positions in the financial markets. It is the logical regulator to receive risk information so that steps can be taken to reduce systemic risks.[25]

The SEC and the Federal Reserve Board have already agreed to share risk information necessary in order to facilitate corrective steps.[26] The SEC has agreed to provide the Board with information that it receives regarding the financial condition of securities brokers and dealers, clearing agencies, transfer agents, investment companies, and investment advisers. The SEC should also have power to regulate hedge funds

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[25] See United States Treasury: Blueprint for a Modernized Financial Regulatory Structure (March 2008), p.144 (available at http://www.treas.gov/press/releases/reports/Blueprint.pdf).

[26] Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008) (available at http://www.sec.gov/news/press/2008/2008-134_mou.pdf).

advisers, and therefore be able to share hedge fund risk information with the Federal Reserve Board.

Although new regulatory powers are important for the protection of investors and the stability of the financial system, imposing regulation of hedge fund risk activities, including use of leverage and derivative instruments, is not desirable. Hedge funds should not be regulated in a manner that stifles their innovative financial market activities. Government regulation of financial market systemic risk is a necessity, but government control over market activity should be avoided.

I recommend that the SEC be the risk management system assessor for the hedge fund industry. If my proposals are accepted, the SEC will have increased responsibility for monitoring and assessing hedge fund risk management systems as well as continuing to be charged with risk management assessment activities in other parts of the securities industry. In order to accomplish its increased inspection and risk assessment tasks, the Commission should receive additional funding. Additionally, it is extremely important that the SEC remain independent. Its independence has been essential to its regulatory success, allowing it to resist business and Congressional pressures.

Derivative Instrument Regulation

Congress made a serious mistake when it included in the Commodity Futures Modernization Act of 2000 a "swaps exclusion" that prevents regulation of a broad range of non-exchange traded derivative instruments by either the CFTC or the SEC. These over the counter derivative instruments, including credit default swaps, should be subject to federal regulation. The swaps exclusion should be repealed so that non-exchange trading of derivative instruments can be regulated in a manner that will help to protect investors and prevent de-stabilization of the financial system.

One approach to regulating the systemic risk involved in derivative instruments would be to standardize the terms of over the counter derivative instruments, such as credit default swaps, and to cause those instruments to be traded on futures or options exchanges. Standardization would have the great benefit of reducing the opaque nature of the derivative instruments. The nature of the obligations owed by each party and the amounts of those obligations would be better known.

Exchange trading of these standard contracts would place a well financed exchange clearing corporation as a responsible party on each of the contracts traded on the exchange, thereby eliminating the counter party risks that have been the crucial element in the current credit crisis. Additionally, the exchange and its clearing corporation would be able to monitor the risks being undertaken by each of the parties trading on the exchange, and to establish limits on their positions. These limits would be designed to limit the risk of the clearing corporation as to any single trading party, and would also have substantial systemic benefits. Exchange trading of derivatives now traded in the over the counter market would also create an effective clearing and payment system for participating trading parties.

Along similar lines, I understand efforts are already underway to create a voluntary platform for clearance and settlement of credit default swaps. The Federal Reserve Board, the SEC, other regulators, and industry participants are working to develop a central counterparty for credit default swaps, with four potential CDS central counterparties expressing interest in the project.[27] This is a positive step that should be pursued.

[27] Testimony of Eric Sirri, note 6 supra.