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The Challenge of Reigning-in Hedge Funds through Regulation and the Need to Improve Disclosure Requirements

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The Challenge of reigning-in Hedge Funds through Regulation and the Need to improve Disclosure Requirements

by

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ABSTRACT

This study aims to look at the definition of the group of alternative investments commonly known as 'hedge funds', in order to better understand why regulatory bodies the world over are vehemently working on introducing new legislation and guidelines as a means of maintaining market security and integrity in order to ensure adequate investor protection. This study posits that the two most viable options available to regulatory bodies to ensure effective implementation of these changes are (i) to either further restrict access to hedge funds and thereby curb their 'retailization' and/or (ii) to introduce rigorous levels of disclosure on the part of hedge funds and their intermediaries.

It is the objective of this study to establish that for either of these options to be attained, tangible improvement in both the quantity and quality of information disclosure from hedge funds and their intermediaries about their positions, strategies and exposures in a manner that would enable them to continue to provide the market efficiency-enhancing services that they currently offer. After introducing all the key issues that have motivated this resolve, the study looks at the current regulatory environment and the challenges facing regulators such as the varying degrees of banking freedom offered by different states and jurisdictions. Proposed changes to current legislation are also considered across several jurisdictions. The results from the local market field study set the platform for recommendations to be investigated in future studies in order to provide guidelines for the supervision of the hedge fund industry.

ABSTRACT – AFRIKAANS
OPSOMMING

Hierdie studie het ten doel om die definisie van die groep alternatiewe beleggings wat algemeen as ‘skansfondse’ bekend staan, te ondersoek ten einde beter te begryp waarom regulerende liggame wêreldwyd hulle vurig beywer vir die instelling van nuwe wetgewing en riglyne om marksekuriteit en -integriteit te handhaaf ten einde beleggers voldoende te beskerm.

Na die bespreking van die sleutelkwessie, stel die studie ondersoek in na die huidige regulerende omgewing en die uitdagings wat reguleerders in die gesig staar, soos die wisselende grade van bankvryheid wat verskillende state en jurisdiksies bied. Voorgenome veranderinge aan huidige wetgewing vir verskeie jurisdiksies word ook oorweeg.

Die studie toon deur opname in die mark dat die twee mees lewensvatbare opsies tot beskikking van regulerende liggame om te verseker dat hierdie veranderinge doeltreffend geïmplementeer word, is (i) om toegang tot skansfondse verder te beperk en sodoende die ‘verkleinhandeling’ (*‘retailization’*) daarvan te kniehalter en/of (ii) om streng vlakke van openbaarmaking vir skansfondse en hulle tussengangers, in te stel. Die studie toon dat <u>enigeen</u> van hierdie opsies tasbare verbetering meebring in sowel die kwantiteit as die kwaliteit van die openbaarmaking van inligting deur skansfondse en hulle tussengangers aangaande hulle posisies, strategieë en blootstelling, en op ’n wyse dat hulle in staat gestel word dat hulle huidige dienste vir verbeterde markdoeltreffendheid, voortgesit word.

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Chapter 1 Introduction

***"It is a riddle wrapped in a mystery inside an enigma*"** **-** Sir Winston Churchill

This provocative quote by Mr Churchill, when deliberating on the seemingly unpredictable nature of the then Russian government, may appear prophetic to those who have taken a mild look at the group of alternative investment vehicles known as 'hedge funds'.

Caldwell (1995) proposes that hedge funds are generally recognised as having been introduced to the world by journalist-turned-investment guru, Alfred Winslow Jones. A.W. Jones' investment creation combined the concepts of short-selling and leverage into a single-purpose financial instrument. Short-selling involves borrowing a security and selling it to another party in anticipation that the market price of the security will fall before the debt is due enabling the initial buyer to repurchase it - at a lower price- in the market. Thus, the initial buyer (i.e. investor) can 'return' the security to the initial lender and earn a profit from the resultant price differential. Leverage is the process of investing with borrowed money as a means of amplifying potential gains.

Jones identified two sources of risk and sought to mitigate these by going *long* on the stocks he considered "undervalued" and *short* on the stocks he considered "overvalued". By establishing a portfolio consisting of stocks that would be rewarded in part when the market went up with those that would also be rewarded when the market went down; the fund was thus considered to be hedged as losses from one position would be used to offset against profits of the other position. And so was born the term 'hedge fund'. It may thus come somewhat as a shock to learn that most hedge funds today do not necessarily hedge at all – deliberately, so! Hedge funds are one of the largest growing investment vehicles amongst private investors, and endowment funds. Even the World Bank is heavily invested in them. Data from Managed Account Reports Inc. (Mar/Hedge) estimated that in 1998 US$110 billion was invested in hedge funds. Figures quoted from Hedge Fund Review (HFR) puts the current asset under management for the year ending December 2003 at US$817 billion. E-financialnews.com estimates that total assets invested in hedge funds will exceed US$1 trillion by the end of December 2004. This forecast, however, still pales in comparison to the US$25-plus trillion that is currently estimated to be invested in mutual funds, pension funds and insurance companies.

According to the Investment Company Institute, the funds are *"highly regulated financial entities that comply with federal laws and regulations. In particular, the Securities and Exchange Commission (SEC) regulates [them] under the Investment Company Act of 1940, ...which imposes restrictions not only on [the] funds but also on their investment advisers, principal underwriters, directors, officers and employees"*.

However, the aforementioned attributes only apply to the mutual funds, pension funds and insurance companies, to the exclusion of hedge funds. Consequently, hedge funds are not bound by most of the aforementioned regulatory authorities because they fall beyond the reach of most regulatory platforms.

Hedge funds are an alternative investment group of assets that, in terms of classification, fall into a grey area. As with lifestyles and artistic genres, alternative investments define the exclusion of all that is in the mainstream. The term hedge fund is commonly, but erroneously, used to define the entire class of alternative investment vehicles, when in fact they are a subset, albeit a pre-eminent one as a result of the ability to attract seemingly ever increasing investor funds (see Kunene, 2002:8). Hedge funds find private equity and venture capitalists as neighbours under this banner. Gregoriou and Rouah (2003), in referring to earlier work by Bing (2000) and Brown et al. (1997), aptly noted that the current problem with hedge funds is that there is a dearth of academic literature available defining their operations as "most of the literature and analysis of hedge funds has focused on assessing their performance".

Despite the billions of dollars entrusted to them, great uncertainty regarding hedge funds still persists. Even amongst academics and leading hedge fund managers, there is still no clear definition for the term 'hedge funds', and that is just the tip of the iceberg. The recurring issue is that research on hedge funds has been inhibited as a result of the lack of disclosure by industry participants. Subsequently, the present size of the hedge fund universe can at best only be estimated as significant numbers of hedge funds elect not to participate in statistical surveys conducted by index providers such as TASS and Mar/Hedge