

Do We Really Need to Clip the Hedge? ©
By Roger Levy, LLM, AIFA®

Much is being debated about hedge funds and their role in the financial crisis that enmeshes the world's financial markets. Congress holds hearings about the Madoff scandal and the failure of US regulators to detect or pursue claims of fraud. The President's Working Group on Financial Markets commissions a report on Principles and Best Practices for Hedge Fund Investors. The US Government Accountability Office investigates the impact of conflicts of interest on investment returns. The leading public pension plans in the US announce market regulation reform principles and the G20 nations clamor for greater hedge fund regulation. No doubt, regulators themselves are asking what new regulatory weapons are needed. This author argues that before we introduce new regulation we should examine and more rigorously enforce the fiduciary standard which already applies to hedge fund management.

Regulation may be seen by many as an answer; maybe not. One thing's for sure. New regulation will draw some to invent new investment vehicles and strategies designed to avoid regulation and what's the sense in that? Perhaps, we should first examine the behavior of hedge funds as well as investor behavior - after all hedge funds would not exist without the sophisticated individuals and institutional investors who provide investment capital - and determine whether behavior modification would achieve a better result than increased regulation.

First of all, what's the problem? According to Hedge Fund Research Inc., 15% of hedge funds, or 1,471 out of 9,284, disappeared in 2008 with assets falling 37% from a June peak of \$1.2 trillion. While no exact data as to the causes of these losses is published, many point to excessive use of leverage which, as prices fell, required positions to be liquidated to cover loan obligations as well as redemptions by investors who sought to trim their hedge fund holdings. At the same time, there was the sensational disclosure of massive fraud by Bernard Madoff who, though not himself a hedge fund manager, was able to make assets entrusted to him by hedge funds evaporate in a monumental Houdini like disappearing act. While all of this suggests that a lot of people were paid a lot of money to make other people's assets disappear, the panoply of losses coupled with fraud and the mystique of hedge funds in general has provided a platform for those who advocate increased government regulation as the antidote.

As noted earlier, hedge funds would not exist but for institutional and other sophisticated investors seeking a home for their cash and the belief that the strategies pursued by hedge funds as an alternative to traditional investments in equities and fixed income will improve portfolio returns and lower volatility. For the most part, this belief has been valid. The Hennessee Hedge Fund Index which monitors 1,000 hedge funds showed positive returns of 7.9% in 2005, 11.4% in 2006 and 11.6% in 2007 before recording a negative 19.8% in 2008 when the S&P Index was off 38.5%.

Before anyone invests in a hedge fund, a good deal of due diligence should be performed by the investor. This can be something like a mating dance. On the one hand, the investor needs a lot of information about the fund, its management and management process, its investment strategy and holdings, its use of leverage and, of course, its past performance and the fees and costs associated with investing in the fund, to name some of the important areas to be examined. On the other hand, hedge fund managers want to provide as little information as they can in order to protect the secrecy of their investment methodology. Many do this by taking advantage of

regulatory exemptions from SEC registration in order to establish their fund with the greatest flexibility, management control and freedom from mandatory disclosure. This most often results in the fund being some form of limited liability company or limited partnership in which the manager is the general partner and the investors are limited partners i.e. investors with limited rights.

Some managers are more forthcoming than others, but often investors don't get full disclosure of what they need to know and ultimately rely on past performance and reputation of the manager to justify the investment decision. Posing a true example of "Trust Me Money," this approach has worked well while hedge funds had access to cheap credit to increase returns, but looks lacking when hedge fund liabilities exceed falling asset value.

So, today, when people speak of increased regulation, they are calling for greater transparency and regulatory oversight and, in some case, restrictions on investment practices. Is this what's needed? Or would it be better to rely on existing mechanisms and the private sector to regulate the market? Back in 1942, the SEC adopted Rule 10b-5 under the Securities Act of 1933 to give the private sector a civil cause of action for insider trading. This effectively turned over to the investing public the opportunity to police securities fraud, an otherwise costly and manpower intensive regulatory role if performed by the SEC.

It can be argued that such a rule is not needed in the case of hedge funds and that there is no need for further regulation in general. This is because hedge fund managers already have legal obligations respecting transparency and disclosures for which remedies exist if the obligations are not met. These obligations arise because, like it or not, hedge fund managers act as fiduciaries when they manage other people's money and as such they have an obligation to act in the best interests of their investors and an obligation, among others, to provide them with as much information as an investor would need to make an informed investment decision. Thus, if managers breach these obligations, they are liable to those who suffer loss.

At the same time, most institutional investors (for the most part, public and private pensions, endowments and foundations) are managed by investment committees, trustees or others who themselves owe a fiduciary responsibility towards the institution they represent. These fiduciaries have a responsibility to undertake due diligence prior to investing and to understand a hedge fund's underlying investments and investment strategy. They also have an obligation to periodically monitor and evaluate the investment once the investment is made.

Accordingly, each participant in the investment decision making chain owes a fiduciary obligation to those on whose behalf the money is invested. But, if these obligations already exist, why is it, one may ask, that fiduciary obligations on the part of hedge fund managers have not been well observed by managers or well enforced by the institutional investors who are the majority of their clients? One possible answer is that few hedge fund managers acknowledge their fiduciary status and that many specifically disclaim their role as fiduciaries, particularly as it relates to ERISA which governs private pension plans.

Without getting too technical, ERISA imposes strict fiduciary responsibilities on those who manage private pension assets. However, hedge funds are able to structure themselves so that the managers are not considered to be fiduciaries for ERISA purposes. What seems to escape attention is that fiduciary responsibility arises on the basis of function rather than the form of investment structure and that one can have fiduciary responsibility for private pension plan assets

even if one is not a fiduciary within the ERISA definition. Other investors, such as public pension plans, enjoy similar protection. However, that this is not visible is not necessarily an argument in favor of new regulation but an argument for education and reinforcement.

So, who is a fiduciary? In the context of investments, we may say that a fiduciary is someone who is managing the assets of another person and stands in a special relationship of trust, confidence and/or legal responsibility. Thus, once a hedge fund accepts money to invest on behalf of any person, whether a pension plan, foundation, endowment or an individual, it can be said that the manager owes that investor broad fiduciary obligations.

Assuming the broad fiduciary burden that hedge fund managers bear, all that it will take to increase investment transparency is for institutional investors to enforce their rights and demand full disclosure, or withhold investment if managers refuse. Support for this approach is found among the recommendations in the Report of the Investors' Committee to The President's Working Group on Financial Markets dated January 19, 2009. In fact, if institutional investors fail to act in this way, they may be in breach of their own fiduciary obligations owed towards their institutions.

Arguing in favor of market regulation reform, the leading public pension funds of the US, which collectively invest over \$900 billion, have announced a set of five financial regulation principles aimed at restoring trust and confidence in the global capital markets. According to a March 10, 2009 press release by California Public Employees' Retirement System, the key elements of the principles are:

1. Greater disclosure and transparency
2. True regulatory independence
3. An increased and effective shareowner voice in the capital markets
4. Earlier identification by regulators of issues that give rise to overall market risk that threaten global markets: and
5. The preservation of institutional investors' freedom to invest in the full range of investment opportunities.

While these principles address capital market issues that go beyond just hedge funds, the first and last principles have direct bearing on hedge fund practices. This article, while not intended as a legal treatise on the law affecting fiduciaries (a rich and well defined body of law), suggests that the rush to reform should be tempered by an examination of the existing rights and remedies available to investors, because in large measure the tools to compel disclosure and transparency while preserving the freedom for institutional investors to invest in the full range of investment opportunities, including hedge funds, already exist in the form of well defined laws affecting fiduciary responsibility.

While the existence of a well articulated fiduciary standard is widely recognized, some prominent experts on fiduciary practices have nonetheless argued in favor of legislation to put a federal fiduciary standard in place. Speaking at the recent IA Compliance Summit 2009, Vanguard Mutual Fund Group founder, John "Jack" Bogle, and Fiduciary360 CEO, Blaine Aikin, argued that such a standard is critical to restoring trust in the capital markets. They saw this as consistent with the President's call for "a new era of responsibility." This author believes that such a standard exists and that, in an era which promises more reform than society can absorb, we should resist the temptation to codify what already exists. By holding all those

involved in the investment management process accountable to the global standard of fiduciary excellence already in place, a culture of fiduciary responsibility will prevail with more speed, relevance and effect than any new regulation could conjure.

And if investors need an ally in reinforcing a fiduciary standard, they need not look to the federal government but to existing private sector organizations whose function it is to assess and certify an investment firm's conformity with fiduciary prudence. One such organization, CEFEX, is already providing this service and is helping to restore trust in the investment process that recent market activity has eroded. Why not start there?

Roger Levy has over 20 years of experience in the financial services industry and during that time has provided counseling on investment fiduciary issues to the retirement plan community. Mr. Levy focuses on advising ERISA and other clients on investment practices. He also is an Accredited Investment Fiduciary Analyst™ awarded by the Center for Fiduciary Studies which operates in association with the University of Pittsburg, Center for Executive Education, Joseph M. Katz Graduate School of Business. The Center for Fiduciary Studies was founded in 1999 and is the first full-time research and training organization dedicated to the study of investment fiduciary responsibility.

Mr. Levy has practiced law in London as an English solicitor and as a member of the Pennsylvania Bar in Philadelphia and subsequently New York. He became a founding member of Cambridge Financial Services Group in Greenwich, CT, an investment advisory firm to the institutional market and is a Managing Director of Cambridge Fiduciary Services, LLC with offices in Greenwich, CT, and Scottsdale.

©Roger L. Levy LLM, AIFA® April 7, 2009