Facts About Hedge Funds

FACT: Hedge funds are required to comply with rules, regulations, and laws that affect virtually all investors in the public and private financial markets.

Hedge funds are subject to the same statutory and regulatory restrictions on their investment and portfolio trading activities as are other institutional market participants engaged in the same trading and investing activities.

Laws and regulations covering hedge funds, or private investment companies, include:

- Anti-fraud and anti-manipulation requirements [15 U.S.C. §78i, §78j], as well as insider-trading prohibitions [CFR §§240.10b-5, 17 CFR §240.10b-5]
- Margin rules, which cover the use of loans to purchase and carry publicly traded securities and options [12 CFR §§220.1, §221.1, §224]
- Securities and Exchange Commission Regulation SHO governing short selling activities and reporting [17 C.F.R. §§242.200-203]
- Williams Act amendments regulating and requiring public reporting on the acquisition of blocks of securities in connection with takeovers and proxy contests [Exchange Act §§13(d), 13(e), 14(d), 14(e), and 14(f); 15 U.S.C. §§78 n(d), 78 n(e), and 78 n(f)]
- Laws covering hedge funds include SEC, CFTC and Treasury reporting requirements for large positions [Securities Exchange Act of 1934 Sections 13(d), (f), (g), and (h) (15 USC 78m(d), (f), (g), and (h)); Commodity Exchange Act Section 4i (7 USC 6i); Securities Exchange Act of 1934 Section 15C(f) (15 U.S.C. 78o–5(f))]
- Financial Industry Regulatory Authority "new issues" rule 2790 (governs initial public offering allocations) [FINRA (formerly NASD) Notice to Members 05-65]
- Rules and regulations of markets in which they seek to buy or sell financial products. [e.g., New York Stock Exchange and NASDAQ OMX]

FACT: Hedge funds constitute a small portion of total assets.

Hedge funds ($1.43 trillion) constitute a tiny share—one percent—of the $196 trillion invested globally in equities ($65 trillion), tradable government and private debt ($79 trillion), and bank deposits ($53 trillion), according to McKinsey Global Institute.[1]

FACT: Indiscriminate lending policies, a bubble in real estate prices, poor risk-management strategies by financial institutions, and weak regulatory oversight caused the sub-prime crisis, not hedge funds.

1. McKinsey Global Institute, *Mapping Global Capital Markets: Fifth Annual Report*. October 2008. Available at: http://www.mckinsey.com/mgi/reports/pdfs/fifth_annual_report/fifth_annual_report.pdf .

What is a Hedge Fund?

The term "hedge fund" generally refers to privately offered, professionally managed pooled investment vehicles. Hedge funds aim to deliver positive returns under all market conditions while reducing risk and preserving capital—their source of attraction for pension funds, endowments, insurance companies, private banks, and high net worth investors.

"Hedge funds will continue to play an important role and be an important source of capital and liquidity in world markets, by providing financing to new companies, industries and markets, as well as by committing capital in times of both market stress and market stability."

Asset Managers' Committee
January 15, 2009

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> "The increased risk-sharing capacity and liquidity provided by hedge funds over the last decade has contributed significantly to the growth and prosperity that the global economy has enjoyed."
>
> ***Government Accountability Office***
> ***January 2008***

"The problem is that banks, not hedge funds, have been affected by excessive investment in asset-backed securities and in structured credit products that have turned out to be illiquid and that those banks have thus appeared insolvent to their counterparties in the money market. So it is the most heavily regulated . . . institutions whose new capital rules (Basel 2) were presented three years ago as the result of reflection on the lessons learned from the financial crises of the previous two decades, especially with respect to credit risk—that have required the intervention of central banks on a massive scale."[2]

According to a New York University Stern School of Business white paper, "Hedge funds didn't cause the growth in the subprime mortgage market, or make housing prices collapse so that subprime loans would default, or force financial institutions (government-sponsored enterprises (GSEs), commercial banks, and broker-dealers) to hold $785 billion worth of CDOs on their books. In fact, there is very little evidence to suggest that hedge funds caused the financial crisis or that they contributed to its severity in any significant way."[3]

FACT: Hedge funds' leverage is typically at conservative levels.

Many hedge funds don't have any leverage. Most of the rest have very controlled conservative levels. Recent studies indicate that, while around 72 per cent of hedge funds embody leverage, only 20 per cent have balance sheet leverage ratios of more than 2:1. Overall, the majority of them utilize quite conservative leverage by most measures.[4]

FACT: Through their financial innovations, hedge funds help investors reduce investment risks, including diversification of their portfolios.

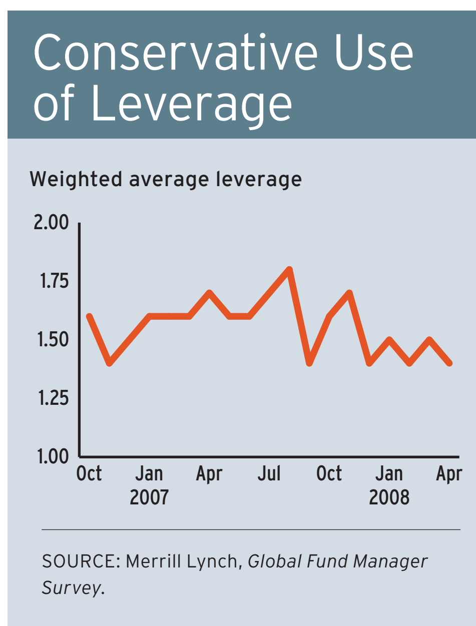
Hedge funds innovate by creating new and often complex investment strategies that may build upon innovations in trading instruments and strategies. The net impact of such innovation is generally to reduce exposures to sector and systematic risks by providing options for diversifying an investment portfolio.

"The historical performance of hedge funds suggests that the ultimate result of hedge fund innovation is to help investors reduce economic losses during market downturns," according to Houman B. Shadab, a George Mason University professor. "In 2008, as losses from the U.S. mortgage market transformed to an international financial crisis, global equities dropped 42 percent while hedge funds worldwide lost a comparatively smaller 19 percent for their investors."[5]

FACT: Hedge funds disclose information to their clients and regulators.

Hedge funds work with existing and potential investors as part of a process called "due diligence." Properly done, due diligence provides a thorough analysis and understanding of the potential operational and financial risks involved.

Conservative Use of Leverage



SOURCE: Merrill Lynch, *Global Fund Manager Survey*.

2. Professor Noël Amenc, EDHEC Business School, France. http://www.edhec.com
3. Stephen Brown, Marcin Kacperczyk, Alexander Ljungqvist, Anthony Lynch, Lasse Pedersen, Matthew Richardson, "Hedge Funds in the Aftermath of the Financial Crisis." New York University Stern School of Business White Paper, 2008. Available at: http://whitepapers.stern.nyu.edu/docs/white_papers_ch06.pdf.
4. European Central Bank, *Financial Stability Review*. December 2008.
5. Houman B. Shabab,"The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection " (September 5, 2008). *Berkeley Business Law Journal*, Vol. 6, Fall 2009. Available at: http://ssrn.com/abstract=1066808.