The Future of Hedge Funds Post the Credit Crisis

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By

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April 2010

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Abstract

The global financial crisis of 2007 not only devastated the hedge fund industry but triggered the increased regulation of hedge funds. This paper explains why hedge funds were placed at the forefront of the financial crisis, the benefit of hedge funds to our capital market, and the past failure of the federal regulator of hedge funds, the Securities and Exchange Commission (SEC) in regulating hedge funds. It will also explore why increased regulation by the SEC alone does not protect the public from future hedge fund failures. Through observation, publications, and independent surveys, this research will illustrate that: (i) the new world of hedge fund investor, institutions, are in the best position to prevent future hedge fund failures; (ii) self governance by hedge funds in conjunction with investor pressure to close the gaps created by the SEC in regulating hedge funds; (iii) how the financial crisis of 2007 has materially changed the way hedge funds operate; and (iv) increasing marketing pressure from institutional investors (post the credit crisis) materially improved the organizational culture of hedge funds.

This paper illustrates that institutional investors, (the new life blood of hedge funds) are placing the necessary pressure to mitigate future hedge fund market failure by being in the best position to enforce effective infrastructure improvements for the hedge fund community.

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Chapter One

Introduction

During the past decade hedge funds represented one of the fastest growing segments in the alternative investing industry (Bank of New York Mellon April 2008); however in 2008, the hedge fund community faced a crisis. A crisis created in large part by: (i) an economic devastation forcing investors to redeem their investments in hedge funds; (ii) one of the largest Ponzi schemes in history; and (iii) poor decisions by hedge funds investing in toxic assets (Lenziner, R., December 12, 2008). To prevent future hedge fund failures and fraud on investors, the public demanded either increased regulation or the near abolishment of federal exemptions from registration available to most private hedge funds. [1] It is thought by some that broader regulation was necessary to either prevent or at least greatly reduce a repeat of the hedge fund failures during the credit crisis (Rayasam R., March 10, 2009).

This paper will explore if increased regulation is indeed the answer to protecting the public from the past failures of hedge funds. Relying on personal experience, third-party publications and timely independent surveys of the hedge fund community, this paper proposes that to avoid future losses and fraud within the financial market, the Securities and Exchange Commission (SEC) must rely on the support from the most powerful hedge fund investor, institutions (Institutions). [2] We will illustrate that Institutions are both the primary source of new hedge fund capital and the key to successful reform within the hedge fund community.

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1. Regulation is only required if you have assets under management in excess of 30 million and offer to provide investment advisory services to more than 15 clients. An entity is considered a client; therefore, an Investment Adviser may manage up to 15 hedge funds without registering with the SEC. Section 203 Investment Advisers Act of 1940.

2. Institutions are generally defined as qualified institutional buyers ("QIBs") under Rule 144A of the Securities Act of 1933. Generally, a QIB, a person with a net worth in excess of $100 million. (Code of Federal Regulations Title 17, Part 230 (17 CFR 230).

We will support our position that Institutions since the 2007 financial crisis leveraged their influence as the primary source of investor capital to demand from managers, a robust infrastructure, transparency, knowledgeable and trustworthy portfolio management. We will also explore how and why Institutions are institutionalizing the hedge fund community to change the culture of hedge funds forever. We find that Institutions (as the primary target market investor) for hedge funds continue to enforce major business risk improvements within the hedge fund community. Institutions protect both the financial markets and their own financial interest regardless of the Securities and Exchange Commission (SEC) motivation to increase its supervision of hedge funds. We also examine the SEC and illustrate some of the reasons why the SEC failed to adequately regulate hedge funds and prevent some of the largest hedge fund failures in history. We will support our positions with independent surveys as to why the future success of hedge funds rests primarily with Institutional investors.

We begin with a brief description of the characteristics of hedge funds and their overall benefit to the financial market. We then examine some of the key factors that triggered the material losses by hedge funds affecting the financial markets. What are the SEC deficiencies when it comes to regulating hedge funds? We illustrate through independent surveys, the dramatic change in the hedge fund culture over the past several years resulting from the influence of Institutions post the financial crisis of 2007. We review literature and third-party surveys to support our position that for the SEC to succeed in preventing or mitigating future hedge fund failures it should rely on the emerging power of Institutional investor to augment the policing of hedge funds.

The support and sophistication of Institutions in conjunction with their demand for institutional quality self regulation of hedge funds is critical for the SEC to succeed. Institutions have both the leverage and skill set to impose self governance, full transparency, and an institutional quality infrastructure. Institutions will demand the necessary changes to hedge funds without crippling the hedge fund business model with increased regulation.

This paper takes the position that: (i) the dominant hedge fund investors, Institutions, are in the best position to prevent future hedge fund failures; and (ii) hedge fund self governance now necessary to raise assets will close the SEC regulation gap. This paper concludes with a brief discussion of the future role of hedge funds, the SEC, and Institutions in controlling and regulating the hedge fund industry.

Chapter Two

What is a Hedge Fund?

Hedge funds are defined as private pooled investment vehicles, which offer a limited type of investor access to the financial market. Hedge Funds are open solely to a limited range of professional or wealthy investors that meet certain criteria set by federal statute. [3] Investors' typically invest in hedge funds with the goal to generate large profits that exceed an index benchmark such as the S&P 500 (Index). [4] Beating the benchmark is defined as achieving absolute returns. [5] Investors' also invest in hedge funds to, among other things: (i) take advantage of a specific portfolio manager's track record, reputation and background; (ii) to capture the return and diversification a particular investor may be seeking; or (iii) rely on portfolio edge created by a hedge fund's management and investment team over its the competitors or a regulated mutual fund.

While hedge funds received a great deal of criticism during and after the 2007 fiscal crisis less has been pointed out about their benefits. A diverse group of financial institutions, which together play an increasingly important role in our financial system. As we will illustrate, hedge funds provide many benefits creating opportunities for investors that ultimately improve our financial markets. Hedge Funds provide a necessary source of diversification for an investor's portfolio; especially the pension funds upon which millions of pensioners rely upon.

3. The general definition requires an investor to have a minimum net worth of $1,000,0000 or annual income of $200,000 or $300,000 if investing with a spouse. Definition adopted and unchanged since 1980 by a Congress. Rule 501(a), 17 C.F.R. § 230.501(a) (2007). A high net worth investor is generally an individual investor with a minimum net worth in excess of $5 million in investable assets or if an entity $25 million.
4. An index is a broad measure of the market performance of a specific group of securities in a particular market or sector. You cannot invest directly in an index.
5. Alpha is a risk-adjusted measure of the so-called "excess return" on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index such as the S&P 500. The difference between the fair and actually expected rates of return on a stock is called the stock's alpha.

Pension funds prefer hedge funds because they typically create larger returns with less risk by imposing fewer constraints on a portfolio manager. Fewer constraints, which provide skilled investment hedge fund teams' far wider latitude in how they invest relative to traditional benchmark-driven strategies such as mutual funds (Bank of New York Mellon, April 2008 p.10). Moreover, hedge funds by nature seek investment opportunities that mitigate risk relying on sophisticated technology to develop instruments typically unavailable or not thought of by other financial sectors such as mutual funds. Hedge funds play a vital role in reducing or eliminating mispricing in financial markets, distribution of capital, and provide liquidity to our financial markets. An important source of liquidity both in periods of calm and stress, hedge funds add the depth and breadth to our capital markets. To many investors, hedge funds are a critical part of what makes the U.S. financial market tick.

Indeed, for more than twenty years hedge funds have played a vital role in the financial growth and stability of our financial markets (SEI Interview, December 2007). The rapid growth in their numbers and their assets under management supports the significant economic value to investors and the financial markets as a whole. 6 The rise and power of hedge funds also represents one of the biggest changes to the global economy over the past half century; developing, a reputation of being able to move financial market markets by anticipating future expectations (Field, M. September 28, 2009).

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6. Estimates of industry size vary widely due to the lack of central statistics, the lack of a single definition of hedge funds and the rapid growth of the industry. As a general indicator of scale, the industry may have managed around $2.5 trillion at its peak in the summer of 2008. The credit crunch has caused assets under management (AUM) to fall sharply through a combination of trading losses and the withdrawal of assets from funds by investors. Recent estimates find that hedge funds have more than $2 trillion in AUM. Ineichen A., Silberstein K. AIMAS Road Map to Hedge Funds, November 2008.

On point, in 1990 there were approximately 640 hedge funds worldwide with total assets of $39 billion. By mid-2007 there were an estimated 9,700 hedge funds with more than 1.7 trillion in assets under management (SEI Knowledge Partnership, December 2007 p. 4). Despite their growth in popularity, hedge funds soon faced a crisis in 2008. Attention started to focus on the increased volatility of hedge fund strategies, notable hedge fund closures, the credit crunch, and the fraud committed by a few unscrupulous hedge fund managers.

Demand for Hedge Fund Reform - 2007 Credit Crisis

Despite investor expectations of enhanced diversification, absolute returns with a low correlation or risk to the broader markets, with few exception hedge funds could not avoid the damage created by the financial crisis in 2007-2008 (SEI Knowledge Partnership, January 2009). In 2007, subprime loans froze the credit markets, sent stock markets gyrating, triggering the collapse of Bear Stearns, Lehman Brothers and may other large financial institutions leaving the U.S economy on the brink of the worst recession in a generation (Leonhardt, D. March 19, 2008). The events of 2007 became even more of a crisis when a number of hedge funds at major brokerage firms collapsed as investors ran to redeem hedge fund capital.

Starting in the third quarter of 2008, the hedge fund industry suffered from major net redemptions for the first time since the collapse of one of the largest hedge funds of all time, Long Term Capital Management. [7] Hedge funds forced to sell holdings at below market value to satisfy investors' demands created a domino effect in which remaining investors in hedge funds watched as their investments declined rapidly in value. This in turn created more stress on

7. Long-Term Capital Management (LTCM) was a very large hedge fund ($126 billion in assets) that nearly collapsed in late 1998. When Russia declared it was devaluing its currency and basically defaulting on its bonds, it moved beyond the regular range that LTCM had counted on. In response, the U.S. and European market dropped significantly. In 1998, the near collapse of LTCM spawned a global liquidity crisis and calls for regulatory scrutiny in the financial services industry's last largely unregulated domain. The History of Hedge Funds - The Millionaire's Club By Mario J. Gabelli http://www.gabelli.com/news/mario-hedge, October 25, 2000.

hedge funds forcing them to sell in an environment in which potential buyers refused to buy (Boelcke, G., October 11, 2007). Hedge funds faced their worst yearly returns ever in 2008 and a devastating reputational blow when more than $10 billion of investors' monies in the Bernie Madoff hedge fund was lost in the largest Ponzi scheme in history (the Madoff Fund). Large and otherwise sophisticated bankers of hedge funds were also hit hard by the credit crisis (Gregoriou, G. January 2009). A tsunami of both financial and reputational events exposed the people, operational and systemic failures of hedge funds changing the face of the hedge fund industry forever.

Today the hedge fund industry continues a transformational crisis precipitated by the external market events of 2007. It is estimated as a result of the financial crisis, poor returns, and the systematic risk created by both fraud such as Madoff and bankruptcy, total hedge fund industry redemptions amounted to one trillion by mid-2009 (Bank of New York Mellon, April 2008 p.7). The stress of redemptions exacerbated by the hedge fund industry's inability to meet the rapid and continuous demand for cash as funds became automated teller machines for anxious investors to trigger the sale of holdings at below fair market prices, historic losses for investors, and increasing pressure on our financial market. The strain of redemptions on the financial market and the negative portrayal of the hedge fund industry as a responsible party caused an outcry for the Securities and Exchange Commission (SEC) to heighten its enforcement power (Bank of New York Mellon, April, 2008).

The Securities and Exchange Commission ("SEC"), the regulator of Hedge Funds

The primary regulator of hedge funds is the US Securities and Exchange Commission (SEC), a U.S. government agency, which oversees securities transactions, activities of financial professionals and, among other things, hedge fund trading to prevent fraud and intentional deception. To fall under the supervision of the SEC, hedge funds must either voluntarily register with the SEC (but only after meeting certain criteria) or are unable to avoid a valid exemption under the Investment Advisers Act of 1940. [8] Once registered with the SEC, a hedge fund is required to file regulatory public filings related to its business and management team. A registered hedge fund is also subject to routine inspections by the SEC to confirm it has adopted and documented its compliance with certain policies and procedures designed to protect investors. Most hedge funds however prior to recently adopted regulations were not subject to the public disclosure or regulatory reporting requirements that apply to a range of other financial institutions. This lack of transparency is thought by some to make necessary broader regulation to prevent (or at least greatly reduce) a repeat of the recent financial failures. Others argue that increased regulation alone is not the answer.

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8. Kirsch, E. Clifford, Investment Adviser Regulation A Step by Step Guide to compliance and the Law, 2nd Edition, Practicing Law Institute, Section 2:4:3. June 2008.

The past failure of the SEC to regulate hedge funds.

The hedge fund industry has repeatedly taken an antagonistic approach towards regulators, particularly in the US. Hedge funds reaction for the most part to the SEC has been reluctant cooperation or litigious confrontation (Glynn, C., March 8, 2010, citing the SEC's failure to effectively supervise hedge funds). Moreover, on September 4, 2009, the SEC published the report of the Office of the Inspector General (OIG) chronicling the failure of its enforcement and examination staff to uncover the Madoff Fraud despite numerous red flags dating as far back as 1992. Ironically, Madoff unlike a large majority of hedge funds at the time was registered with the SEC and subject to its supervision and regulation.

On September 10, 2009, SEC Inspector General H. David Kotz testified before the Senate Banking Committee regarding the audit of the SEC's failed oversight of Madoff Fund fraud. The OIG investigation discovered that the SEC received ample information over the years of the SEC registered Madoff Fund to warrant a comprehensive examination or investigation of the Madoff Fund. It noted that the SEC received at least six substantive complaints that raised significant red flags concerning the operations of the Madoff Fund. "The SEC failed to do rudimentary common sense investigative work" (Hedge Fund Law Report, 2009, April 23). A SEC registered hedge fund that became one of the largest Ponzi schemes in history leading some to question whether increased regulation of hedge fund is the answer to avoid future fraud on investors.

In Ernst & Young's Sixth Annual Hedge Fund Symposium 2009, speakers noted that some politicians' efforts at reform are often led by common sense approaches, which appeal to voters, but can be based on faulty reasoning. Most of those approached do little to improve transparency, or risk management practices, and often cost investors by imposing unnecessary regulatory requirements. Managers surveyed by Ernst & Young believed that changes in response to investor demands are more productive and less costly than regulations imposed by the SEC (Ernst & Young 2010, January). Investors also point out that the failure to detect what could be the world's biggest fraud perpetuated by the Madoff Fund raised questions about the capabilities of the SEC.

A material transformation of the hedge fund investor to close the SEC regulatory gap.

Over the years "high net worth" or "accredited" investors (so called sophisticated investors) were the majority of investors attracted to hedge funds for not only their superior returns (compared to the typical investment benchmarks such as the S&P 500) but also for their lack of regulation and secrecy. Hedge funds avoided registration with the SEC by selling to sophisticated investors that met the definition of an "accredited" investor relying primarily on the wealth of an investor rather than its comprehension of investing in a hedge fund, pointing out a criticism of the definition of accredited investor that is "both under-and over-inclusive" in scope.[9] It is under-inclusive because otherwise-financially knowledgeable investors may be deemed unaccredited because they do not meet the minimum wealth requirements. On the other hand, it is over-inclusive because a financial novice may be deemed accredited, as long as he or she meets the standard's requirements based solely upon wealth. Indeed, the SEC recognized that the current accredited investor definition may be over-inclusive. The SEC noted that due to inflation and sustained growth in wealth, many more individuals meet the wealth and income thresholds than when the standards were initially set. A lack of sophistication led to the Old

9. See footnote 3.

World investor prior to the 2007 financial crisis to fall victim to hedge fund fraud and its collapse due primarily to a lack of understanding or the resources to discover hedge fund fraud, mismanagement or poor risk controls. Relying on this desire by its core investors to retain their confidentiality, most hedge funds took the position that disclosure of certain information to investors dulls their edge and negatively impacts their competitive advantage. Moreover, the need for secrecy by both investors and hedge funds motivated hedge funds to avoid registration with the SEC to promote a culture refusing investors full transparency into a hedge funds operational and trading infrastructure. Secrecy perpetuated by both the hedge funds and an unsophisticated investor with little to no leverage to demand transparency was the norm of the hedge fund industry pre credit crisis. The culture promoted by the hedge fund leadership pre-credit crisis avoided allocating the resources necessary to provide greater risk management and transparency. Spending resources on seeking operational efficiencies or improving risk management viewed as neither necessary nor an efficient use of resources. The time and resources spent on risk management was a draw on the bottom line without much benefit to achieving higher returns geared toward a high net worth investor driven more by chasing returns than risk adjusted returns. For those hedge funds that sought to avoid regulation, the greatest motivation to focus on risk management was from its investors. Reliance on the pre-credit crisis investor to pressure hedge funds was difficult due to their lack of financial sophistication creating a perfect storm in 2007. Post the 2007 financial crisis however, hedge funds faced with increased pressure from both the federal government and the new world investor, Institutions - were forced to respond to the demand for heightened transparency, operational and regulatory risk management to win and maintain assets. For many Institutional investors, 2008 brought the realization they could no longer afford to be in the dark about the safety of their assets. At the same time, hedge fund managers could less easily justify their veil of secrecy. SEI Knowledge Partnership and Greenwich Associates survey (2010, January p. 10) noted nearly 80% of Institutions cited “portfolio transparency” as an important or very important factor in hedge fund selection.

The changing culture of hedge funds

Before the financial crisis, portfolio managers without pressure from the investor community (under the veil of secrecy and confidentiality) denied meaningful transparency. Investors craving the investment into a hedge fund that provided an edge willingly invested for fear of rejection and potential lost opportunities. Empowered by investors’ desire to chase returns rather than understand the risk management to generate those same returns, hedge funds increased risk at the sacrifice of risk adjusted returns. In 2010 however, the practice of hedge funds’ ignoring investors’ demands is a thing of the past. The power shift to Institutional investors and their representatives increasingly asserting themselves [as competition for assets increased] has changed the rules of hedge fund investing as they push managers toward greater transparency . . . and intensify their focus on operational effectiveness (SEI Knowledge Partnership and Greenwich Associates 2010, January).

Going forward, both Institutional investors and the SEC demanded a change in the way hedge funds do business. A transformation of hedge fund culture created in large part due to the changing investor base from “high net worth” to Institutional. A new majority investor with extensive due diligence resources and skills that placed safety of assets on an equal par with generating attractive returns. Institutional investors no longer looking solely at pedigree and track record of a hedge fund manager but also infrastructure and a deep understanding of running a hedge fund business necessary to mitigate trading- business volatility and reputational risk.

Respondents asked in an SEI survey of more than 100 institutional investors to define "institutional quality" as it pertains to hedge funds, the top three factors cited all related to people "having critical support and staffing," "pedigree" and "division" of labor in key positions named by 67%, 63% and 50%, respectively, What do Institutions mean by "infrastructure?" Institutional investors conducting due diligence typically consider two levels of infrastructure. The first is the gamut of operating systems surrounding investment process . . . . The second level addresses staffing, resources, and the systems of the hedge fund management itself (SEI Knowledge Partnership and Greenwich Associates 2010, January). Conclusion, hedge funds must act quickly to meet Institutional demands to both attract capital, and retain existing investor capital necessary to survive in this New World of investing. The growing influence of Institutional investors is fundamentally changing the nature of the hedge fund business. To be entrusted with a larger share of Institutional investor assets, hedge fund managers must meet the evolving demands of these investors. Institutional investors' expectations are reshaping the competitive dynamics within the industry (SEI Knowledge Partnership and Greenwich Associates 2010, January p.8).

As we explain more fully in Chapter four, the institutionalization and self-regulation of hedge funds has been driven largely by the Institutional investors. For example, high net worth share of hedge fund assets remained higher in 2008 than Institutional investors, but dropped considerably from 67% in 2005 to 57% as of the year end of 2008 driving by rapid investments and resulting dilution of high net worth investors from pension fund investments (Bank of New York Mellon, (April 2008). Pension plans, a large and well-established market, are becoming the obvious source of the industry's current and future growth (SEI Knowledge Partnership and Greenwich Associates 2010, January p.4).

A dramatic change in primary investor is an important trend since Institutions have the financial sophistication, skill set and leverage lacking with most high net worth investors. In a recent Ernst & Young Survey, 22% of survey respondents said that greater transparency is the biggest change taking place in the industry. This trend driven by [Institutional] investors, who have become more sophisticated and involved in the wake of the financial crisis (Ernst & Young, 2010 p. 2).

10 It is estimated as a result of the financial crisis, poor returns, and systematic risk created by fraud and bankruptcy of counter-parties, total hedge fund industry redemptions amounted to one trillion by mid-2009 – primarily from high net worth investors. Although high net worth share of assets remains higher than institutional investors it has dropped considerably from 67% in 2005 to 57% as of year end 2008. (The Hedge Fund of Tomorrow: Building and Enduring Firm –Bank of New York Mellon "Thought Leadership Series, April 2008 p. 7).

Chapter Three

Results and Findings

Changing investor base forcing material hedge fund self regulation

The primary investor of hedge funds, high net worth individuals failed to fully recognize the priority of operational due diligence and independence resulting in best practices frequently taking a back seat during its investment decision process. Consequently, managers could take short cuts in operations without accountability. Interviews however conducted by (Bank of New York Mellon, 2009) "indicate that willingness to ignore best practices and acquiesce in manager preference is now at a low point." The reason as we will illustrate below is the material change in the primary investor of hedge funds.

Against the backdrop of the worst financial crisis in decades as well as the collapse of a number of hedge funds, SEI Knowledge Partnership conducted its 2009 global survey of Institutional hedge fund investors. The findings of the survey reflected that Institutions have started to replace high-net worth individuals as the core business for hedge funds. Institutional investor commitment comes with increased expectations from hedge funds going forward. Indeed, leverage has shifted and Institutional investors are changing the rules and the culture of hedge funds as they push towards greater transparency and intensify their focus on operational effectiveness (SEI Knowledge Partnership, 2010).

Institutional investors will expect greater information regarding their hedge fund investments. In fact, those surveyed named transparency as both the biggest worry and single-greatest challenge related to hedge fund investing. What's more, a majority of investors have already acted on their transparency concerns. Over 70% reported requesting more detailed information from managers than they did a year earlier" (SEI Knowledge Partnership and Greenwich Associates, 2010 p. 2).

In 2007 the SEI Knowledge Partnership conducted a survey of more than 100 institutional investors. In this study institutions ranked infrastructure as the number one priority in hedge fund selection not high returns, with 46% ranking it as most important (SEI Knowledge Partnership, 2007). This and other surveys make it clear that the Institutional investor is a different breed from the high net worth investors that was the majority of hedge fund investments of the past. Unlike high net worth investors, Institutional investors tend to invest with a different rational. Rather than solely chasing returns, Institutional investors seek stable returns and have an increasing concern with both risk and the way its assets are managed to avoid losses. Of those that responded in this SEI survey, 54% said the reason for this risk management focus is that "better managed firms produce better returns" (SEI Knowledge Partnership, 2007, p. 2.). Investors' worries and perceptions of risk show how much their views on hedge fund investing have been altered by the 2007 financial crisis. In SEI's 2008 survey, "poor performance" was investors' top concern named by 84% of those questioned. In the 2009 SEI survey, short term performance only ranked fifth on the list of investor concerns taken over by concerns over risk management and transparency (SEI Knowledge Partnership and Greenwich Associates, 2010).

Ernst & Young, global hedge fund survey recorded the views and opinions of hedge funds globally to understand how the market forces and changing regulatory landscape are affecting them and what actions they are taking to prepare for the future. Greenwich Associates conducted 100 telephone interviews with hedge funds in the United States, Europe and Asia, representing roughly half the industry in assets under management

(Ernst & Young & Greenwich Associates, 2009, p. 5). The study noted that performance cannot be the panacea for the entire industry – even those hedge funds that performed well during the financial crisis have been subject to far greater scrutiny on the risks they have been running (Ernst & Young & Greenwich Associates 2009, p. 10).

From December 2008 through March 2009, (the Bank of New York- Mellon, 2008) conducted 144 hour long interviews with 158 individuals around the world. Interviewees represented a broad cross section of senior industry professionals, including institutional investors, investment consultants, family offices, wealth advisors, private banks, accountants, lawyers, prime brokerage professionals, fund of hedge fund managers and hedge fund manager" (Bank of New York Mellon, 2008). Investors experienced three surprises post the credit crisis and the Madoff Fund scandal: inferior returns, illiquidity, and the Madoff Fund fraud itself, all of which prompted demands for greater portfolio and risk transparency, including, separation of controls by independent outside firms. While committed to the investment premise of hedge funds, investors feel strongly that the industry must change. Investors highlighted three key areas they seek reform: alignment liquidity and transparency (Bank of New York Mellon, 2008 p.10). From the portfolio manager's perspective, the combination of multiple factors, including poor investment returns, unexpected liquidity, rapid market de-leveraging, major counter-party failures and unprecedented fraud triggered investors and regulators to redefine standards for transparency and business risk to remain competitive (Bank of New York Mellon, 2008). Survey results also show that investors are exerting their influence to demand greater portfolio and process transparency (SEI Knowledge Partnership and Greenwich Associates, 2010 p. 7).

Proposed increased regulation.

The structure of a hedge fund is designed specifically to enable it to avoid registration requirements, along with restrictions on investment strategies that apply to other financial sectors. The principal justification for the lack of regulation of hedge funds was the restriction on participation in a hedge fund to those who had the financial resources to bear the high risk of its activities.

The United States Congress explored the possibility of regulating all hedge funds. February 2007, the (President's Working Group on Financial Markets 2007, p. 3) echoed Gibson in preferring market discipline over command-and-control regulation. In mid-October, 2009, the SEC issued for comment its strategic plan for 2010-2015. The plan laid out broad goals and performance measures for, among other things, oversight, regulation, and enforcement. The plan discusses a variety of initiatives having an impact on hedge funds (Ernst & Young, 2009). Despite all the changes, hedge funds are currently making on their own as it become clear that many regulatory changes will continue. Speakers at the 2009 Ernst & Young Survey agreed that legislators have set their sights on the hedge fund industry, and little can be done to escape increased scrutiny. A growing number of managers now register with the Securities and Exchange Commission (SEC), Ernst & Young 2010, January).

The need for self governance over regulation

In 2007, the PWG examined the need for regulation of hedge funds, and concluded, "Market discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk from private pools of capital (President's Working Group On Financial Markets, 2007 p.3). In a global study of hedge funds conducted by (Ernst & Young, Greenwich Associates, 2009 p. 11) increased regulatory oversight was felt to be imprecise, slower, of less benefit to investors and expensive Investors are resigned to accepting some increased regulation; however, there remains a fear of the regulatory authorities such as the SEC overreaching and some of the actions being fundamentally misguided resulting in costs far outweighing any benefits to investors. Overall, respondents also believe that investor rather than regulatory driven change is the most productive. According to the Ernst & Young survey, regulation will increase. The entry barriers for smaller hedge funds will also increase. For smaller hedge funds, it will be difficult to survive. The regulatory landscape will be unfavorable to fund managers and investors as well as some providers. The oversight regulation is going to impede the entrepreneurial nature of the hedge fund industry and its ability to generate returns. There will be more consolidation and more institutional clients (Ernst & Young Greenwich Associates 2009, p. 40.

Chapter Four

Analysis

The dramatic change in the hedge fund culture

The market is changing. There is a marriage going on between the world of the mutual fund (a highly regulated investment vehicle) and hedge funds. This marriage created as a result of the changing investor base over the last ten years from that of high net worth individuals to Institutions. Many hedge funds no longer look primarily to high net worth individuals as a source of asset growth. “Those that believe their investment models are scalable understandably prefer to target institutional assets, which are both “stickier” and abundant (SEI Knowledge Partnership, 2007).

Institutional investment has been a major factor in the phenomenal growth of hedge funds. By year end in 2007, (prior to the 2008 crisis) institutional assets in hedge funds were about $750 billion or 40% of total industry assets. Since then the global financial crisis has accelerated the institutionalization of the hedge fund industry (Bank of New York Mellon, 2008). Once geared to the needs of high net worth individuals and large sophisticated endowments and foundations, hedge funds are increasingly serving a full range of Institutional investors, including public and private pension plans.

This new source of investment has creating an investor base now dominated by Institutions; Institutions that demand a robust infrastructure, knowledgeable and trustworthy management. SEI analyzed industry trends and sponsored a survey of more than 100 institutional investors. The survey was conducted by Infovest21 in the first half of 2007 (SEI Knowledge Partnership, 2007). 85% of institutions surveyed said they would not invest in a strategy they did not understand. Institutions also ranked infrastructure as the number- one criterion in manager selection, with 46% ranking it as most important. Institutions forcing the asset management industry to focus on operational and regulatory risk management in an effort to institutionalize the hedge fund industry. In the past year, funds have responded with greater transparency, greater clarity about fund governance (Ernst &Young, 2010). "SEI's 2008 and 2009 survey results underscore and document this power shift as well as the continued commitment of institutional investors" (SEI Knowledge Partnership and Greenwich Associates, 2010 p. 7).

The days now gone when the right pedigree of a manager and the funds track record was the sole guaranteed recipe for success. More so than ever both hedge funds must distinguish themselves from similar strategies by marketing not only their track record and pedigree but also their operational, portfolio and regulatory infrastructure. Legislators are preparing tighter regulation, while investors are closely vetting every position hedge funds take. In order to thrive in this new world of hedge funds, hedge fund managers will have to change how they interact with investors as well as manage risk and operations. The industry has already initiated major changes that are likely to continue.

Hedge funds that typically fail do not address the growing concern over fraud, mismanagement, operational, regulatory or business risk. The perception of the new world investor is that infrastructure and performance are directly connected. To be well positioned in the future the hedge fund community must address an investor's growing concern over business risk. Responding to the Institutional investor's increasing desire for full transparency will be paramount. Full transparency such as having access to the decisions of the Board of Managers or the hedge fund's Investment Committee decision process as well as access to the hedge fund's key processes and controls.

Chapter Five

Summary

Regulation will only work with support from the new world of hedge fund investors

As noted in a recent Ernst & Young Sixth Annual Hedge Fund Symposium 2009, politicians' efforts at reform are often led by common sense approaches, which appeal to voters but can be based on faulty reasoning. Most of those approached do little to improve transparency or risk management practices, and often cost investors by imposing unnecessary regulatory requirements. In fact, most managers surveyed by Ernst & Young believed that changes in response to investor demands are more productive and less costly than regulations imposed by the SEC. In order to ensure that regulations are sensible and beneficial, hedge fund advocates such as the Managed Funds Association **(fn)** are now working on educating both legislators and the public (Ernst & Young, 2010).

Hedge Funds experienced a difficult stretch during the financial crisis, and many challenges remain ahead, Regulators have set their sights on the industry. Despite challenges the industry remains strong. In order to compete in the future; however, hedge funds must continue on the long path of transformation demanded by Institutions. The new world investor has redefined transparency, and will no longer accept incomplete visibility into managers' portfolio risk and operations. Coupled with the new regulatory scrutiny, the hedge fund industry will have no choice but to open up. The hedge fund industry must now help itself by embracing transparency and working with Institutional investors to close the gap created by the failure of the SEC to adequately regulate.

The hedge fund industry we believe will benefit from the credit crisis of 2007. The credit crisis revealed the shortcomings of the hedge fund business model as it relates to the best interest of investors. This in turn requires managers lacking competence to leave the industry no longer able to simply mask poor operations or a lack of understanding of how to run a hedge fund business. Now the best of breed survives with a deep understanding of how to run a hedge fund business as Institutions require a hedge fund to have the look and feel of a pragmatic institutional infrastructure where applicable. This in turn will create even bigger opportunities in our opinion for the hedge fund industry to greatly surpass the assets it has managed in the past. "All indications are that the institutional tilt will continue and most likely accelerate" (SEI Knowledge Partnership, 2007) p. 6). The great unknown is what will regulation end up being and how will it impact the hedge fund industry.

We take the position that for the SEC to succeed in creating an environment that materially lowers the risk of a repeat of past hedge fund failures both the culture of hedge funds as well as the thinking of hedge fund leadership must change through self-governance. The SEC's past and present failure to understand and regulate hedge funds adequately creates a greater need for self governance over forced regulation. Robust self-governance created by the need to satisfy the new world investors' demands to attract capital.

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