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A gathering storm?
by Ron Orol
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So far, embattled Amaranth Advisors LLC's mammoth trading mistakes leading to massive losses have not had much of an impact on global markets. The Greenwich, Conn.-based hedge fund, with $9.2 billion in assets under management, collapsed after making a huge bet that an upward trend in natural gas prices would continue. Amaranth estimates that its year-to-date loss may be in excess of two-thirds of its assets, or $6 billion. Meanwhile, the Securities and Exchange Commission has begun its own investigation of the hedge fund, sources close to the agency say.

Amaranth's problems did not transmit to the greater markets because its failures were isolated to energy trading and the energy market. But other problems may be on the horizon. Experts worry about a sequence of crises or collapses, creating systemic and far-reaching problems. "If a lot of hedge funds cave in at the same time, there could be serious ramifications," says Vikas Agarwal, assistant professor of finance at Georgia State University's J. Mack Robinson College of Business.

The prospect of lurking crises seems to have moved regulators and legislators in Washington to start focusing on hedge funds, but whether they do anything meaningful is another matter. The most concrete step so far? A study. On Sept. 27, the House approved a bill by Rep. Michael Castle, R-Del., requiring the President's Working Group on Financial Markets to conduct a six-month study into the hedge fund industry and to make recommendations about their regulation. Sen. Chuck Hagel, R-Neb., is expected to introduce a similar bill in the Senate.

"The problems at Amaranth have definitely prodded this legislation forward," says Elizabeth Wenk, Castle's deputy chief of staff. "Amaranth shows how little information we have about hedge funds and how massive they are and their need to be examined."

The study would look at a wide variety of issues, including the growth of hedge funds within the financial markets, increased investment in hedge funds by public and corporate pension funds and what kind of oversight is needed for the industry. House Financial Services Committee Chairman Michael Oxley, R-Ohio, added his own questions to the Castle legislation, asking the working group to look at other countries' approaches for regulating funds as well as how hedge funds benefit the economy and markets as a whole. Some lawmakers are pushing legislation that would give the Commodities Futures Trading Commission greater authority to regularly survey energy trading at electronic energy exchanges such as IntercontinentalExchange Inc. in Atlanta. Amaranth lost much of its investors' funds trading gas futures on this exchange, sources say, but others point out that the CFTC is poorly staffed to handle such an additional responsibility. House lawmakers in December passed a measure expanding the authority of the CFTC to insist that energy traders provide information on natural gas trades. A similar measure that includes giving the agency the authority to complete regular surveys of ICE Atlanta trades is being considered in the Senate.

SEC Chairman Christopher Cox, meanwhile, has instructed the SEC staff to consider a key provision that would increase the minimum net-worth level for individuals permitted to invest in hedge funds. Cox is worried that investors of modest income and less sophistication might not understand the complex risks hedge funds pose and won't be able to absorb losses if a fund blows up.

The SEC may also consider adopting a basic "notice and filing" system that requires managers to provide the agency with information about their financial background, their auditor, the number of investors being served and the value of assets under management. An SEC spokesman says the corporate finance division is working diligently on putting together draft rules on the net-worth provision. He declined to comment on when proposals could be introduced.

In the minds of many observers, the agency took a huge step backward when it decided against trying to restore a rule requiring hedge fund managers to register with the agency and open their books to periodic inspections. Concerned about the explosive growth of hedge funds, the SEC two years ago ordered this registration requirement and these periodic inspections of books. But that registration rule was struck down by a court in June.

"The SEC has acknowledged that without an act of Congress you won't see the full extent of the struck-down hedge fund manager rule," says Michael R. McCoy, an associate at Bryan Cave LLP in Phoenix.

With no hedge fund registration rule, there is the possibility that key states such as Connecticut, where roughly $300 billion of hedge fund assets are managed, could take a larger role. Connecticut Attorney General Richard Blumenthal, who has formed a task force to consider whether stiffer state regulations are necessary for the hedge fund industry, says he is hopeful that the SEC will be proactive in regulating the industry. Blumenthal acknowledges that Amaranth's partial collapse worries him.

"Federal inaction or inertia will provide an impetus and invitation to state action to fill the void," Blumenthal says. "I would prefer that the federal government provide disclosure standards, transparency and accountability because federal authorities have the expertise and resources and they can impose a uniform set of rules instead of a patchwork of different state standards."

Blumenthal says he would support any SEC plan to adopt a basic "notice and filing" system and raising net-worth requirements for hedge fund investors. But if the SEC doesn't take meaningful steps, Blumenthal may begin to advocate state rules requiring all hedge fund managers registered in the state to open up their books to periodic inspections. Doing that may take time, he added, and perhaps even local legislation for it to work.

Without meaningful regulation from Washington or the states, institutional investors and others are turning to more informal safeguards. The key is due diligence and how much of it investors are doing or at least requiring of other hedge fund intermediaries. Georgia State's Agarwal points out that investors may start turning in greater numbers to funds of hedge funds because of the additional due diligence these investment pools perform on their underlying hedge funds.

"One risk investors have in investing in a hedge fund like Amaranth is that they don't have the additional due diligence that a fund-of-funds provides," Agarwal says, though he concedes that it's impossible to make a broad statement that funds-of-funds are less risky than hedge funds. Many factors need to be considered, Agarwal says, such as flexibility of strategies, liquidity of investments and the cost of fees.

Investors may start taking a closer look at hedge fund intermediaries, such as fund administrators, brokers, auditors and custodians that allow the hedge fund manager to make trades. Institutional investors may start turning to rating agencies such as Moody's Investors Service, which has recently launched a service that will rate the operations of select hedge funds, Agarwal adds. They were not monitoring Amaranth.

Gary Witt, managing director at Moody's, says the firm's risk reporting and control division could perform the kind of due diligence that would help investors avoid another Amaranth. The rating agency checks hedge funds to measure the risks they are taking and their internal reporting. Witt says Moody's would identify whether the hedge fund manager has written policies in place describing what risk is tolerable and what procedures are in place if that policy is breached. "Is there a committee that makes a judgment on what to do if there is a problem?" Witt asks.

He says it's unclear at this stage whether Amaranth had these kind of protocols in place. Hedge funds pay fees to Moody's to perform its operational due diligence. Institutions and high-net-worth investors can access the ratings for free.

In any case, Georgia State's Agarwal says Amaranth has reinvigorated both regulators and others to begin taking long, hard looks at the hedge fund industry. "It's institutionalized the process of due diligence," he says.

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