CAPITOL REPORT

White House ponders: Are some hedge funds too big to fail?

Expect regulatory battle over who would pay to unwind hedge funds, buyouts

By Ronald D. Orol, MarketWatch
Last update: 4:27 p.m. EDT April 7, 2009

WASHINGTON (MarketWatch) -- When the $9.2 billion Connecticut hedge fund Amaranth Advisors collapsed in 2006, securities attorneys jumped all over each other to express gleefully how the markets absorbed such a mega-fund failure.

In fact, the markets did soak up the implosion fairly well.

However, two and a half years later, policymakers aren't so sure the volatile and fragile markets of 2009 could handle another mega-hedge fund collapse.

'Why should taxpayers pay for hedge-fund failures?'

— Professor Vikas Agarwal, Georgia State University Business School

In an effort to limit the fallout from any future major hedge fund collapse -- or private equity implosion -- Treasury Secretary Timothy Geithner proposed on March 26 a framework for regulatory reform that not only included registration of hedge funds managers, but also called for new rules for buyout shops, venture capital and insurance companies.

Nevertheless, Geithner's proposal leaves more questions than answers.

"Why should taxpayers pay for hedge-fund failures?" asked Georgia State University Business School Professor Vikas Agarwal who argues that already disgruntled taxpayers and legislators are sure to take issue with a government bailout of a major hedge fund.

New regulation of hedge funds would require legislation from Capitol Hill, or new rules from the Securities and Exchange Commission.

Geithner made it clear he believes that a group of large non-bank investment firms are systematically significant and need to be regulated more thoroughly than they are now because their collapse could have a catastrophic impact on the markets overall. Such regulation would likely involve limits on leverage, lending, access to credit, as well as restrictions on investment activities, such as how much investing these firms can do in the unregulated over-the-counter market.

However, Geithner's plan may seek to use U.S. taxpayer dollars, leading to political concerns. Government bailouts of mega-hedge funds or buyout shops may be needed to stem systemic economic failures, but such an approach would likely raise the ire of the retail public, already apprehensive about the world of hedge funds and private equity.

How to unwind?

Possibly the most controversial aspect of Geithner's plan for hedge funds focuses on how regulators could unwind systemically significant non-bank institutions by bypassing traditional bankruptcy proceedings that might pose a threat to the workings of the financial system as a whole.

His measure called for the creation of a resolution authority that could help unwind systemically significant banks, but the entity would likely also oversee the winding-down of mega-hedge funds and other super-sized alternative investment vehicles whose pending collapse would ripple catastrophically through the markets.

The resolution authority could be housed at the Federal Reserve or a brand-new entity designed for the purpose; it could also be set up by a new interagency panel that delegates authority to different agencies.

But the most obvious agency to put such authority would be at the Federal Deposit Insurance Corp., which already routinely winds down failed banks through its deposit insurance fund.

Here's how the FDIC program works: The agency charges banks fees to build up its deposit insurance fund, which are used to pay depositors of failed institutions.

Keeping with this system, the FDIC could be required to set up a similar insurance fund or funds for large hedge funds, buyout shops and insurance companies.

However, placing the authority with the FDIC raises questions. Bankers complain that they already are being charged heavily to wind-down failed banks. They don't want their fees to help unwind systemically significant hedge funds.

"It would be unfair to pull resources from the banking industry to resolve non-banks," said Edward Yingling, president of the American Bankers Association.

FDIC Chairwoman Sheila Bair recently told a gathering of bankers not to worry: Should the FDIC be imbued with broader resolution authority, alternative investment companies would be regulated separately from banks.

The funding issue - industry or tax-payer funded?

Presumably, that would mean these systemically significant non-bank institutions would pay fees to set up their own insurance funds, said Columbia Law School Professor John Coffee.

The fees would be used to pay off counterparties of a mega-collapsing hedge fund in the same way U.S. government cash infusions into troubled American International Group Inc. (AIG) were used to make sure that the insurance company stayed afloat while its credit default swap trading partners, in the U.S. and Europe, were paid to exit their positions. However, to stem political discontent, a hedge fund's counterparty banks are likely to receive only a percentage of their total investment.

Fees from large hedge funds could be put into a hedge fund pool, while separate insurance funds could be set up for systemically significant buyout shops and venture capital companies.

Hedge funds that trade heavily in credit default swaps are increasingly being required to use established clearinghouses to complete their trades. Large funds, which already pay administrative fees to operate clearinghouses, could also be required to pay additional fees to support a resolution fund.

Perhaps only large risky funds that trade heavily in CDSs and use a large amount of leverage would be required to pay the fee, said one Washington securities attorney.

However, it may turn out that the fees aren't enough.

Columbia's Coffee contended that, if the hedge fund insurance fund were used up, the FDIC should be required to draw down capital from its bank insurance fund as a contingency to avoid a catastrophic collapse of a mega-hedge fund.

"You could have two hedge fund failures and it could take out the entire fund," Coffee said.

Already, the FDIC is having a difficult time making sure it has enough deposit insurance funds. The agency had $18.9 billion as of Dec. 31, while it estimates that $65 billion will be needed to pay out to depositors of failed banks through 2013. Legislation moving on the Hill would temporarily increase the FDIC's borrowing authority from Treasury from $30 billion to $500 billion until the end of 2010.

Such authority could be used in case of hedge-fund collapses, but it would raise political concerns. "A large hedge-fund collapse could require international counterparty settlements that would be controversial if paid for by U.S. taxpayers," said Georgia State's Agarwal.

Beefed up disclosure

Geithner's plan calls for legislation that would require many hedge funds, buyout shops and venture capital firms to register with the agency and open up their books to periodic SEC examinations.

An overturned 2004 SEC rule allowed hedge funds exemptions if managers required their investors to keep their money with the fund for at least two-years. The SEC set up the exemption to make sure only hedge funds needed to register, exempting private equity shops with their long-term investors. However, with Geithner's broader plan, which seeks to capture hedge funds, private equity companies and venture capital firms, don't expect any exemptions this time around. "There is nowhere to hide," Agarwal said.

It is unclear how stringent hedge-fund rules would be. In addition to opening up their books to the SEC, hedge-fund managers could be subject to costly anti-money laundering rules requiring managers to respond to a request by the Fed for information within 120 days of the request.

After the financial crisis expanded in late 2008, the SEC installed a temporary regulation requiring hedge funds to report their short positions every week on a confidential basis until Aug. 1, 2009. However, Geithner is expected to push for expanded hedge-fund reporting requirements, including a provision requiring disclosure of the leverage they have.

Regarding capital requirements, some European regulators are pressing to require all hedge funds to be regulated like banks by maintaining significant capital on hand. Geithner is not looking for this limitation. Nevertheless, hedge-fund attorneys are pressing to make sure such a condition is not required.

"That would have a huge cost," said Kevin Scanlan, partner at Dechert LLP. "The cost would be in lost opportunities for hedge funds." ■

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