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## Regulating the unknown

By Richard W. Rahn

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What is a "hedge fund"? If you have trouble answering the question, you are not alone, because the term is commonly used to describe many types of pooled investments that may have little in common with each other. Despite the lack of agreement about what is meant by the term hedge fund, some politicians, commentators and financial regulators now advocate more regulation of hedge funds.

Financial regulation is most often justified by arguing it is needed to protect all participants from those who would engage in fraud or theft, and to protect unsophisticated investors from losing money in investments they do not understand. The U.S. Securities and Exchange Commission (SEC) has just proposed that the amount of liquid net worth an individual must have before investing in hedge funds and other so-called risky investments be raised to as much as \$2.5 million. People meeting a net liquid worth requirement are considered "accredited investors."

The new SEC proposal and other proposals for increased regulation raise a number of important questions, such as: Are hedge funds riskier than stocks and bonds that everyone is allowed to invest in? Is a liquid net worth requirement an appropriate measure of one's ability to evaluate an investment opportunity? Is it fair to the nonwealthy to only allow people who already have a large amount of money to invest in certain things that may provide higher rates of return? Why is liquid net wealth as opposed to total wealth an appropriate measure, particularly now that almost all real estate, and many other non-liquid assets, can easily be securitized?

I serve on the board of directors of a non-U.S. financial regulatory agency. All of us involved, one way or another, in regulating the global financial industry are struggling with the above and many other related questions.

Even though most people would agree it is important to try to protect "widows and orphans" from unscrupulous and/or incompetent financial promoters, there is a fine line between protecting those who need protection and denying freedom to those who don't. Does it make sense to prohibit a person who has recently obtained a graduate degree in finance from a leading business school from buying and selling hedge funds, because he or she has not yet accumulated some arbitrary amount of wealth -- while legally allowing any adult man or woman to take all of his or her wealth and go to Las Vegas and blow it at the gambling tables?

In fact, if people are determined to lose money, there are infinite ways to do so, and the evidence to date is that a pool of "hedge funds" may be no riskier than mutual funds or other investments that are legally sold to everyone regardless of wealth or expertise. Generally speaking, a hedge fund is a private investment pool that is open to a limited number of high net worth individuals and institutions, which seeks to achieve above average returns by taking greater risks, and then seeks to offset some of the risk by "hedging the bet."

Hedge funds often use "leverage" or borrowing to obtain higher returns (or losses). For example, an energy fund might buy petroleum futures but offset some of the risk (and potential profit) by buying and selling options to protect against unexpected price movements. It is estimated there is now more than \$2 trillion invested in tens of thousands of hedge funds.

Fund promoters have come up with a huge array of investment strategies, many of which are of great complexity. Some funds even bet on the weather, by taking positions in agricultural commodities, insurance companies and other industries that can be affected positively or negatively by the weather.

There are infinite numbers of investment strategies, and people create hedge funds, nonhedged investment pools (which are often called hedge funds), and retail mutual funds to exploit whatever strategy they believe in. Hedge funds often make money by betting against the conventional wisdom, and thus can lead to greater international financial stability because, in the aggregate, their gains and losses are not heavily correlated with the movements of stock and bond markets.

The evidence is not now unambiguously clear as to whether politicians and regulators best serve the public interest by further regulating hedge funds and further limiting who can invest in them or making it easier for people with only a modest net worth to invest in them (or at least in pools of hedge funds).

But what we do know from history is that rushing to do more, before carefully trying to answer all of the relevant questions, is likely to take what is at most a minor problem at the moment and make it worse.

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