Regulators Face Calls on Scrutiny of Hedge Funds

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Government regulators, scrambling to measure the fallout from the near-collapse of Long-Term Capital Management LP, are preparing for questions from Congress about the need to expand oversight of the hedge-fund industry.

Securities and banking regulators have long resisted calls for closer scrutiny of the hedge-fund industry and its complex financial instruments, known broadly as derivatives. But in the wake of Long-Term Capital's near-failure, regulators are under pressure to provide more supervision.

In Washington, some lawmakers are criticizing regulators for failing to blow the whistle earlier on Long-Term Capital. Studies and Congressional hearings about the matter are in the works.

More urgently, however, regulators are rushing to determine whether other hedge funds are poised to blow up. The Securities and Exchange Commission, for one, has launched a broad examination of hedge-fund activities, including probes of whether Wall Street firms have exposure to other troubled funds, according to people close to the matter.

The SEC regulates the securities industry but has little oversight over hedge funds; indeed, hedge funds aren't required to register with the agency. However, the SEC's market-regulation division began monitoring Long-Term Capital a few weeks ago, and agency officials have spoken with members of the Greenwich, Conn., fund to discuss its deteriorating finances, according to a regulator close to the matter.

Now, SEC officials are calling "broker-dealers to find out their exposure to other hedge funds," according to the regulator, but so far, they haven't identified any trouble spots. That could be because Long-Term Capital is unique in the hedge-fund industry, he said. "This was a little aberrant; it was a very high-leveraged situation. Most hedge funds don't have that much [leverage]."

The regulator said the SEC could ultimately seek increased oversight of hedge funds. However, there appears to be deep-seated reluctance, he said. "It's not clear if there's a need for regulation just because some firm stumbled."

As for the banking regulators, people at the Comptroller of the Currency said the agency bears little responsibility for the crisis because relatively few of the national banks under its purview made loans to Long-Term Capital. Most of the bank loans came from state-chartered banks regulated by the Federal Reserve.

A spokesman for the Federal Reserve of New York, which arranged the bailout of Long-Term Capital by banks and securities firms, defended the Fed's role.

"The role of the Fed is not to make certain that there are not losses," said spokesman Peter Bakstansky. "The crisis doesn't signify a breakdown of the financial-regulatory system. Banks are supposed to take risk. What we want is to make sure that banks have a full understanding of their entire risk profile and capitalize themselves appropriately."

But the Long-Term Capital situation underscores the extent to which regulators have let the hedge-fund business prosper—and grow more complex using arcane financial instruments—without imposing the usual constraints placed on other investment entities.

Because hedge funds cater to a small, supposedly sophisticated class of investors, they face very little government scrutiny. As long as the funds meet a few simple requirements—they must have fewer than 100 investors, with substantial financial experience and large capital—they do not have to register with the SEC. Hedge funds tend to be secretive about investments and strategies, and registration would mean filing financial reports.

The SEC has the authority to examine hedge funds only if the regulators suspect fraud. The agency does regulate the big Wall Street firms that poured money into Long-Term Capital, but it scrutinizes only the capital levels of brokerage firms, not the risk levels of their investments. Banking regulators, in contrast, do evaluate the risks of loans to hedge funds.

House Banking Chairman James Leach (R.-Iowa), who plans a hearing on hedge-fund regulation, said his concern is "about systemic risk and ramifications for the banking system . . . I'm not immensely concerned by the loss of investments by risk takers."

Mr. Leach said European nations ought to take a hard look at hedge-fund-related risk as well. Some European financial institutions have announced losses related to Long-Term Capital, and regulators in the U.K. and Switzerland are asking banks and other institutions about their hedge-fund-related exposure.

In the U.S., Treasury Secretary Robert Rubin, chairman of the President's Working Group on Financial Markets, said he has commissioned "a study of the potential implications of operations of firms such as Long-Term Capital and their relations with their creditors." The group includes representatives of the SEC, the Fed, and the Commodity Futures Trading Commission.

SEC Chairman Arthur Levitt, scheduled to address a congressional panel tomorrow to discuss mutual-fund fees and bond-market transparency, expects questions about hedge-fund regulation.

Rep. Edward Markey (D.-Mass.), who has asked the General Accounting Office to investigate the Long-Term Capital situation, said the fact that the New York Fed coordinated the rescue plan suggests regulators "had not been doing enough previously."