Competitive Enterprise Institute

Recognize the Value of Hedge Funds and Private Equity for Entrepreneurs and Shareholders

Hedge funds and private equity are vehicles for wealthy investors to take risks and potentially reap high returns. But the benefits of these types of funds—and of funds that combine features of both—extend beyond their investors to all entrepreneurs and shareholders. Private equity funds build wealth in distressed and startup companies. Hedge funds have forced incentivized companies to create more wealth for shareholders through streamlining—cutting costs and, when necessary, selling off divisions.

In addition, both types of funds provide liquidity and have reduced risks of disruptions to capital markets. Private equity firms have helped to ease the credit crunch by helping to recapitalize commercial banks and stepping in to fill the void of investment banks in financing new business growth. Hedge funds were ahead of the curve in short-selling subprime securities—thereby sending out valuable market information about the risks of those instruments. Cumbersome restrictions would impede their ability to perform in these vital roles. Rather than curtail these vehicles, Congress should consider how to make their benefits available to more investors, by doing the following:

- **Reject attempts to subject hedge funds and private equity to the Security and Exchange Commission's (SEC) one-size-fits-all registration process for ordinary investment vehicles.** These entities are already subject to securities fraud statutes, as well as numerous regulations from agencies, such as the Commodity Futures Trading Commission. Congress should modernize this regulatory structure to get rid of overlapping jurisdictions for more effective oversight. Since the Dodd-Frank financial reform law gave the Securities and Exchange Commission open-ended authority to require registration of some hedge funds, Congress should make sure such rules don't burden capital formation and distract the SEC from more pressing systemic threats.
- **Stop the SEC from raising the minimum income requirements for hedge fund and private equity investors.** On several occasions, the SEC has proposed raising the minimum net worth needed to invest in hedge funds from $1 million to $2.5 million. Obviously, the SEC does not need to protect "poor" millionaires. This increase will further drain the pool of capital for innovative new businesses. An attempt to codify this foolish increase was stripped from Dodd-Frank after concerns expressed by the "angel" investor community attracted bipartisan opposition. But the SEC still has the authority impose this draconian increase, and Congress

should reject any proposed rule taking such an action

- **Revise the Investment Company Act of 1940.** This would allow mutual and exchange-traded funds more freedom to pursue some of the strategies of hedge funds and private equity, such as short-selling, and give some of the hedge fund benefits to ordinary investors with minimal risk. This allows useful information to get out to the market earlier. For instance, had mutual funds had more freedom to engage in short selling during the subprime boom, the mortgage bubble likely would never have grown as large as it did.

John Berlau