There's A New Sheriff in Town

With the SEC's hands tied on hedge fund regulation, arbitration is stepping up as the new protector of law and order -- and of investors' money.

Remember the good old days, when Eliot Spitzer was steamrolling over Wall Street and hedge funds didn't tend to implode?

A lot has changed. Just a few short years ago, Spitzer, then New York's Attorney General, was embarrassing the SEC by pushing Wall Street regulation, and the SEC, well, wasn't accomplishing a whole lot. It was kind of like having a guest bring a bottle of Mr. Clean and a roll of paper towels over to your house, then scrubbing your bathroom before they were willing to use it.

The SEC reacted by searching for a villain, and it pinned its target on the hedge fund industry. While they never really identified the problem, the SEC moved "to protect investors" by issuing new rules that required hedge funds to register with the SEC as investment advisors. These measures made hedge funds subject to audits, but the SEC never really explained how this would protect investors. Not long after the SEC started brandishing this newly minted power, a federal appeals court determined that the SEC lacked the legal authority to regulate hedge funds. The SEC got its comeuppance. Now, just a few months into his tenure as Governor, Spitzer appears to have gotten his comeuppance in the political arena.

So what does this all mean for hedge funds? Even a cursory review of the news since June shows that m any funds are experiencing differing degrees of legal and financial difficulty. A Few examples:

1. Bear Stearns High- Grade Structured Credit Fund
2. Bear Stearns High-Grade Structured Credit Enhanced Leveraged Fund
3. Caliber Global Investment Ltd. -- $908 million
4. Carlyle Group
5. Dillon Read Capital Management LLC
6. Lake Shore Asset Management Ltd. -- $466 million
7. Queen's Walk Investment Ltd.
8. Ritchie Risk-Linked Strategies Trading (Ireland) Ltd.
9. Ritchie Risk-Linked Strategies Trading (Ireland) Ltd. II

My question is this: Had the SEC been permitted to continue regulating hedge funds, Could all this have been averted?

Now, if you're to that question – like mine – is a definitive "no," then let me ask you two follow-up questions: 1. If SEC regulation of hedge funds could not have prevented these funds from imploding, what, exactly, would be the benefit of SEC regulation?

2. If the SEC can’t effectively regulate hedge funds, then who can?

While Question 1 was rhetorical, Question 2 remains an interesting quandary. Its answer may be found in the arbitration recently filed against Bear Stearns for losses suffered by one of its funds’ investors.

Ross B. Intelisano, Esq., an attorney representing the investor(s) suing Bear Stearns, told me, “I think arbitration is the proper forum to resolve these hedge fund matters as opposed to civil or bankruptcy court. I think raising the qualified investor requirements will help protect investors. It is hedge funds' lack of transparency which causes concern for investors and that's where SEC regulation may help. Just because someone is wealthy doesn't mean he's sophisticated or that he doesn't need some protection by the SROs.”

Even though Mr. Intelisano and I usually don’t see eye to eye, I can’t entirely disagree with him on this topic. His argument that arbitration being the proper method for resolution is valid, and it’s hard to argue that raising qualified investor requirements wouldn’t help protect investors.

With that said, I still don’t see how SEC regulation would help, while Mr. Intelisano thinks it “may.” Looking at the big picture, my answer to Question 2 is that regulation can best be achieved by investor lawsuits like the one filed by Mr. Inteslisano.

The overwhelming majority of Wall Street favors less government regulation. They have a strong belief in the ability of the capital markets to work things out on their own. Ironically, the arbitration filed against Bear Stearns is a prime example of that theory. The SEC is not involved, nor is the regulatory body of the newly formed FINRA; it is merely a private investor using already existing laws to seek compensation for losses caused by alleged wrongdoing. That’s how the legal system lets markets work things out on their own.

Ultimately, an arbitration panel will determine Bear Stearns’ liability in this case. But if these investor lawsuits end up, as expected, costing Bear Stearns several hundred million dollars, it’s safe to say that the lawsuits themselves will deter any future malfeasance far better than an SEC audit ever could.