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Group of Thirty Provides Hedge Fund Recommendations

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On January 16, the Group of Thirty, an international body of central bankers and finance ministers, issued a report detailing their proposals for reforming the financial industry. Although focused mainly on a dire economic forecast, the report also provided recommendations that would radically change hedge funds.

Led by Paul Volcker, former chairman of the Federal Reserve Board and current chairman of the Economic Recovery Advisory Board under President Barack Obama, the Group of Thirty's proposal called for a regulatory crackdown that would curb risk-taking by large financial institutions by capping their share of deposits. As a result, hedge funds could cease to operate as they have for years–and create a booming industry for law firms, like WilmerHale, with practices specializing in investment management.

"The recommendations as to the regulation of the leverage of hedge funds and private equity funds mark a new front in the debate as to whether those funds should be regulated by the federal government," says WilmerHale securities partner Matthew Chambers, a member of the firm's Investment Management Practice Group.

Volker and his fellow money men have advised lawmakers that regulators should impose capital limits on trading and prevent large banks from running hedge funds and private-equity firms that mix their own money along with their clients'. In the report, the group also urged governments in Europe and Asia to tighten supervision of insurance companies, brokerage houses and investment banks. If the Obama administration acts on these recommendations, miles of federally certified red tape would become the rule and no longer the exception for Wall Street. And clients would have to turn to their out-of-house counsel for guidance through the regulatory maze.

Among the 18 recommendations made by the group is a call to merge regulators so there's a single oversight body that looks at the largest, most complex banking organizations. And the Group of Thirty says self-regulation of hedge funds is no longer acceptable because "volatility has been greater than anticipated," which has contributed to greater uncertainty in the financial markets. The group also calls for national regulation of private pools of capital if they employ substantial amounts of borrowed money; in short, leveraging looks like it might get more difficult.

While holding the Federal Reserve chairman post from 1979 to 1987, Volcker stomped out inflation in the early 80s and helped usher in two decades of global economic prosperity. His group's recommendations come as US lawmakers and the newly minted Obama administration consider ways to redraft the regulation system after leading financial institutions reported almost $1 trillion in losses and write-downs stemming from the frozen credit markets and subsequent deleveraging binge.

Volcker says the report is “a reasonable indication of the direction in which we might go.” He adds that the current financial system has “failed the test of the marketplace.”