Exploratory Analysis of Regulation of Hedge Fund in India

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Abstract:

This research paper provides critical insights of hedge funds, examining their positive and negative impacts on investment vehicles. Hedge funds cover a broad range of investment Philosophies and Risk tolerance strategies to grow the invested funds of their investors. Hedge funds are known for their diverse investment strategies, offering potential diversification benefits and the ability to generate alpha in various market conditions. Their strong risk management systems and potential for liquidity make them an attractive option for certain investors. However, this research also underscores both positives and negatives with hedge funds, including high fees, complexity, and inaccessibility to most retail investors. Regulatory risks and lack of transparency pose additional challenges, while performance variability and the risk of significant losses require careful consideration. The paper explores the intricate nature of hedge funds, addressing the need for due diligence and professional guidance when evaluating investment opportunities. By providing a comprehensive assessment of hedge funds, this research paper aims to inform investors, financial professionals, and policymakers about the advantages and drawbacks of these investment vehicles, facilitating more informed decision-making within the dynamic landscape of alternative investments. This paper will also have a comparative analysis of other countries where hedge funds are regulated and how they are regulating hedge funds and how they are utilizing hedge funds to grow their GDP.

Keywords: Alternative investments, Due diligence, GDP growth, Investment opportunities, Positive impacts, Regulatory risks

Introduction:

Alfred Winslow Jones, an Australian-born businessman, founded the first hedge fund in 1949 as a US general partnership. The term 'hedge fund' was developed in a Forbes magazine article to characterize Jones' unique investment strategy at the time. Alfred Jones managed an investing portfolio that included long stock positions in firms he thought were undervalued and short stock positions in companies he thought were overpriced. The mix of long and short stock positions shifted the portfolio's risk from market timing to security selection. Today, the term 'hedge funds' is a catch-all phrase for a diverse range of non-traditional fund managers. While academics, industry experts, regulators, and the media frequently use the phrase "hedge fund," the reality is that hedge funds are notoriously difficult to explain clearly and concisely. Hedge funds typically have assets and exposures in a diverse variety of asset markets and investing methods, making them difficult to define in a short set of definite terms. The definitions that follow give an idea of what a Hedge fund is.

How Sebi Classified HEDGE FUND:

According to SEBI, Alternative Investment Funds shall seek registration through any three categories. As per the BSE, Category III AIFs involve hedge funds or funds that function with a view to get short-term returns. Hedge fund is an actively managed investment pool whose manager uses a wide range of strategies, often including buying with borrowed money and trading esoteric assets, in an effort to beat average investment returns for their clients.The term hedge fund refers to an investment vehicle in which the manager of these funds frequently creates a hedged bet by investing a portion of assets in the opposite of the fund's emphasis to counter any losses in its core holding. Hedge fund is concentrated on a cyclical industry where the funds are invested by dividing in proportions where one half is invested on cyclical industry such as travel, may invest a portion of its assets in a non-cyclical area, such as energy, with the goal of using non-cyclical stock returns to balance cyclical stock losses. Hedge funds employ riskier tactics, leverage assets, and invest in derivatives such as options and futures contracts. Many hedge funds' attractiveness stems from the reputation of their managers in the restricted world of hedge fund investment.[1] Because hedge funds are private investment vehicles, they can do pretty much whatever they want as long as they are transparent with investors about their strategy. (The investment plan is typically detailed in a prospectus, which investors must read before investing.) While this degree of freedom can be extremely hazardous, it also provides hedge funds with a great deal of flexibility.

Hedge fund strategies can concentrate on:

- Macro - invests in stocks, bonds, and currencies with the hopes of profiting from changes in macroeconomic variables (for example, global interest rates, economic policies, and so on).
- Equity - invests in stocks worldwide or locally while hedging against equity market downturns by shorting overpriced stocks or stock indices.
- Relative-value - exploits price or spread inefficiencies
- Activism entails a manager manipulating fund volatility by changing the board of directors, appointing new management, or attempting to sell a company.

Furthermore, a hedge fund can take a 'fund of funds' strategic approach by joining other hedge funds or pooled investment vehicles. The goal here is to deliberately combine the underlying strategies and funds in order to better control the volatility, risk, and returns of the umbrella fund.

How do these Hedge funds make money :

- Hedge funds charge an asset management fee based on the net assets of the fund, as well as a performance-based fee. Here are some of the numerous ways hedge funds can profit:
- Hedge funds seek capital appreciation by investing in securities and other financial instruments that they believe will appreciate in value over time. For example, if a hedge fund buys in a stock that appreciates significantly in value, the fund can sell the stock at a higher price and profit.
- Hedge funds often charge a performance fee that is based on a proportion of the profits made. The most popular performance fee structure is the "two and twenty," in which the fund management earns 20% of the fund's profits if an unavoidable threshold return is attained.
- Short selling funds make money when prices fall.

[1] Ivestopediohttps://www.investor.gov/introduction-investing/investing-basics/investment-products/private-investment-funds/hedge-funds

- Short selling is the practice of borrowing securities from a third party, selling them at market price, and then repurchasing them at a lower price to repay the lender. The hedge fund earns from the difference in sale and repurchase prices.
- Hedge funds also charge management fees, which are typically a proportion of the assets under management. This fee compensates the fund manager for continuing fund management and administration.

POSITIVES:

Financial integration:

Hedge funds seek investment possibilities (equity, debt, and hybrids) by analyzing the value and linkages of global markets. As a result, hedge funds contribute to the global financial integration of markets. Hedge funds that participate in capital structure arbitrage, for example, analyze the relative pricings of corporate debt, equity, hybrid, and derivative instruments. Hedge fund activity clearly helps to the general integration of financial markets across the investing universe.[2]

Financial Regulation:

The hedge fund sector is regarded as one of the main pillars of financial innovation in global financial markets. Short selling, market (or beta) neutral techniques, commodities and exotic-based investments are only a few of the financial products and services produced by the hedge fund business. While these financial advances broaden the range of alternative investments available, they also increase support for stricter hedge fund regulation. The justification for greater control is also related to the recent invention and trading of collateralized debt obligations (CDOs) and credit default swaps (CDSs)

Diversification:

Hedge funds offer valuable diversification benefits to investors by spanning a wide spectrum of asset classes, including stocks, bonds, currencies, commodities, and derivatives. This multifaceted approach to investing allows hedge funds to contribute significantly to portfolio diversification. One of the primary reasons for their appeal is their low correlation with traditional asset classes like stocks and bonds. This low correlation means that hedge fund returns tend to move independently from the broader market, which can help reduce overall portfolio risk. In practice, this translates to hedge funds potentially delivering positive returns when traditional assets are underperforming.[3] For instance, during the 2008 global financial crisis, certain hedge funds employing strategies such as market-neutral and managed futures displayed resilience and even generated profits, demonstrating their value in diversified investment portfolios. These case studies underscore the effectiveness of hedge funds in diversification, but it's crucial to remember that not all hedge funds are alike. The success of diversification depends on the specific strategies implemented by the fund manager, emphasizing the importance of careful selection and due diligence when incorporating hedge funds into an investment strategy

Liquidity:

Hedge funds have gained popularity in the investment landscape due to their unique characteristics, and

[2] Robert J Bianchi & Michael E Drew, '*Hedge Fund Regulation and Systemic Risk*',(2014),19:1, OJ Griffith Law Review, https://doi.org/10.1080/00036846.2021.2003748, 14

[3] *Idbi. at pg 14*

among these characteristics, liquidity and accessibility stand out as key advantages. In this brief exploration, we delve into how hedge funds offer liquidity, discuss the benefits of liquidity for various types of investors, and compare the accessibility of hedge funds to other investment vehicles. One of the notable features of hedge funds is their ability to offer liquidity by allowing investors to redeem their investments periodically. Unlike many traditional investment vehicles, such as mutual funds or private equity, hedge funds permit investors to access their capital on a more frequent basis, typically through monthly or quarterly redemptions. This feature provides investors with the flexibility to make adjustments to their investments or access their capital when needed, a crucial advantage in the world of finance.The advantages of liquidity in hedge funds extend to different categories of investors. Institutional investors, such as pension funds and endowments, rely on liquidity to meet their financial obligations promptly. For these large institutions, having the ability to access their investments on a regular basis is essential in managing their financial responsibilities and ensuring the well-being of their beneficiaries. Liquidity allows them to maintain a well-balanced portfolio while simultaneously addressing their immediate needs. High-net-worth individuals also benefit significantly from the liquidity offered by hedge funds. This demographic often has diverse financial interests, ranging from personal needs to investment goals. The ability to redeem their investments relatively quickly enables them to respond to financial opportunities, emergencies, or changes in their personal circumstances. It allows for the dynamic management of their investments, offering peace of mind and adaptability in their financial planning. Moreover, liquidity in hedge funds aligns with the evolving nature of investment strategies in today's fast-paced financial world. It allows investors to make timely adjustments to their portfolios in response to changing market conditions. This is especially valuable in volatile markets, where quick decision-making can make a significant difference in investment performance. Hedge funds' liquidity feature empowers investors to stay agile and seize opportunities as they arise. In terms of accessibility, hedge funds have advantages that make them more accessible to a broader range of investors compared to certain alternative investments. Hedge funds typically have lower minimum investment requirements than private equity or real estate funds, making them accessible to a more extensive pool of investors. This lower threshold allows investors with varying levels of wealth to participate in hedge fund strategies. Furthermore, hedge funds do not necessarily require investors to have extensive industry knowledge or expertise, which can be a barrier in other investment vehicles.[4] They are designed to be managed by professionals, which means that investors can rely on the expertise of the fund managers rather than navigating complex investment decisions themselves. This aspect of hedge funds makes them more inclusive, allowing a wider range of individuals to access and benefit from sophisticated investment strategies. Hedge funds provide liquidity and accessibility that cater to the diverse needs of investors. The ability to redeem investments periodically offers flexibility, benefitting both institutional investors and high-net-worth individuals in different ways. Additionally, the accessibility of hedge funds, with lower minimum investment requirements and professional management, broadens their appeal to a wider range of investors. These features make hedge funds a valuable and dynamic component of modern investment portfolios, enabling investors to navigate the complex and ever-changing world of finance.

Operational Risk Faced:

Operational risk refers to the shortcomings of the policies, procedures and activities of a hedge fund and

[4] *Idbi. at pg 13*

its employees. For example, quite often hedge funds deal in the over-the-counter market, where positions can be tailor-made to suit the needs of the involved parties. The biggest issue with OTC securities is in valuing them on an ongoing basis, since they are not publicly traded and very illiquid. This issue came to light in the early stages of the 2008 credit crisis, when, seemingly, no two institutions were able to accurately value the mortgages and asset-backed securities that had flooded the marketplace in the early 2000s. The very nature of the hedge-fund industry creates operational inefficiencies, and thus operational risks.[5]

Fraud Risk:

The risk of fraud is more prevalent in the hedge fund industry compared to mutual funds, due to the lack of regulation for the former. Hedge funds do not face the same stringent reporting standards as other funds, and therefore the risk of unethical behavior on the part of the fund and its employees is heightened. There have been numerous media reports of hedge fund managers who have bilked investors out of huge sums of money in order to lead lavish lifestyles or cover up constant losses for the fund. Knowing your hedge-fund manager and staying abreast of the literature provided to you by the fund are keys to protecting yourself from investment fraud.

Style Drift:

Style drift occurs when a manager strays from the fund's stated goal or strategy to enter a hot sector or avoid a market downturn. Although this may sound like good money management, the reason an investment was made in the first place in the fund was due to the manager's stated expertise in a particular sector/strategy/etc., so abandoning his or her strength is probably not in the investors' best interests.

Overall Market Risk:

Both equity and fixed-income funds, and overall directional move by the equity markets, can play a big role on the returns of a fund. For equity funds, although many may claim to be market neutral or have a zero beta, it is very difficult in practice to achieve such a balance, as the equity markets can move very quickly in either direction—especially down. In times of crises, correlations go to one, so even the most diversified portfolio will not be safe from a market crash. Widening credit spreads are the biggest threat to the performance of fixed-income funds. Since most fixed-income funds take long positions in corporate bonds and short positions in comparable treasuries, adverse economic movements can cause the simultaneous increase in corporate yields while the Treasury yields fall, thus widening the spreads between positions and hurting the funds' performance.[6]

Leverage:

The use of leverage within the hedge fund industry is commonplace, since a smart leveraged position can magnify gains. But as we all know, leverage is a double-edged sword and even a small move in the wrong direction can put a major dent in a fund's returns, especially those funds which speculate heavily in commodities and currencies.

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[5] Wei Kuang,'*Is hedge fund a hedge for equity markets*?',(2022) 54:27,OJ Applied Economics, https://doi.org/10.1080/00036846.2021.2003748,
3168

[6] *Idbi. at pg*

Regulatory and Transparency:

Hedge funds are private entities with relatively less public disclosure requirements. This, in turn, is perceived as a 'lack of transparency' in the immense interest of the community. Another common perception is that in comparison to various other financial investment managers, the hedge fund managers are not subjected to regulatory oversight and rigid Registration requirements. Such features expose the funds to fraudulent activities, faulty operations, mismatch of handling the Fund in case of multiple managers, etc. Additionally, the influence of institutional investors is pressurizing the hedge funds to provide more information on Valuation Methodology, Positions, and Leverage exposures.

Investment Risks:

Hedge funds share several risks as other investment classes are broadly classified as Liquidity Risk and Manager Risk. Liquidity refers to how quickly security can be converted into cash. Funds generally employ a lock-up period during which an investor cannot withdraw money or exit the Fund. This can block possible liquidity opportunities during the lock-up period, which can range from 1-3 years. Many such investments employ leverage techniques, which are the practice of purchasing assets based on borrowed money or using derivatives for obtaining market exposure over investors' capital. Another massive risk for all hedge fund investors is the risk of losing their entire investment. The Offering Memorandum (Prospectus) of the hedge fund generally states that the investor should have the appetite of losing on the whole amount of investment in case of unforeseen circumstances without holding the hedge fund responsible.

Concentration Risk:

This type of risk involves an excessive focus on a particular kind of strategy or investing in a restricted sector to enhance returns. Such risks can be conflicting for particular investors who expect vast diversification of funds to enhance returns in various sectors. E.g., the hedge fund investors may be having a defensive technique of investing the funds in the FMCG sector since this is an industry that will be operating continuously with a broad scope of expansion as per the changing customer requirements. However, if the macroeconomic conditions are dynamic like inflation challenges, high input costs, less consumer spending, in turn, will spur a downward spiral for the entire FMCG sector and hamper overall growth. If the hedge fund manager has put all the eggs in one basket, then the performance of the FMCG sector will be directly proportional to the performance of the Fund.

On the contrary, if the funds have been diversified in multiple sectors like FMCG, Steel, Pharmaceuticals, Banking, etc., then a dip in the performance of one sector can be neutralized by the understanding of another industry. This will largely depend on the macroeconomic conditions of the region where the investments are being made and its future potential.

Performance Issues:

Various factors related to interest rate formation, credit spreads, stock market volatility, leverage, and government intervention create various hurdles that reduce opportunities for even the most skillful fund managers. One area from where the hedge funds earn is by taking advantage of volatility and selling them. As per the below chart, the volatility index has been steadily declining downward since 2009, and it is hard to sell volatility since there is none to take advantage of. This deterioration in performance can be

pinned to the overabundance of investors. The hedge fund investors have now become very cautious in their approach and opt to preserve their capital even in the worst of conditions.

As the number of hedge funds has swelled, making it a $3 trillion industry, more investors are participating. Still, the overall performance has shrunk since more hedge fund managers have entered the market, reducing the effect of multiple strategies that were traditionally considered speculative.[7] In such cases, the skills of a fund manager can carve a niche for themselves by beating various estimates and exceeding expectations of general market sentiment.

Mismatch or Incomplete Information:

The fund managers must reveal the performance of the Fund regularly. However, the results can be fabricated to match the directions of the fund manager since the offering documents are not reviewed or approved by the state or federal authorities. A hedge fund may have little or no operating history or performance and hence may use hypothetical measures of execution, which may not necessarily reflect the actual trading done by the manager or advisor.

Hedge fund investors should do a careful vetting of the same and question possible discrepancies. E.g., a hedge fund could have a very complicated tax structure that may expose possible loopholes but not be understood by the typical investor. A fund manager may invest in P-Notes of the Indian stock market but routed through a tax haven. However, the manager may make such an investment by making all tax payments misleading the investors. A hedge fund may not provide any transparency regarding its underlying investments (including sub-funds in a Fund of Funds structure) to the investors, which in turn will be difficult for the investors to monitor. Within this, there exists a possibility of getting the trades done through trading expertise and experience of third-party managers/advisors, the identity of which may not be disclosed to the investors.

Taxation:

Hedge funds are generally taxed as Partnerships to avoid instances of "Double Taxation" and the Profits and Losses being passed on to the investors. These gains, losses, and deductions are allocated to the investors for the respective fiscal year as determined by the General Partner.This is detrimental to the investors since they will be the ones to bear the tax liabilities and not the hedge fund. The Fund's tax returns are usually prepared by the accounting firm, which provides audit facilities to the hedge fund. Expenses are also passed on to the investors, depending on whether the hedge fund is a "Trader" or an "Investor" insecurities during the year.

Problem of Plenty:

Presently, the biggest problem faced by the hedge fund industry is the existence of far too many hedge funds. If an investor wants to multiply his investment and generate a continuous trend of positive alpha (returns above the risk-adjusted return), the hedge fund needs to be exceptional regularly. The issue for the hedge fund investors here is in which Fund they shall proceed with their investments. Most of the small hedge funds are currently struggling with the burden of additional costs being imposed along with Prime brokerage fees. As a result, for a fund to survive, it needs to have a good rise in its Assets under Management (AUM) to at least $500m for countering the increasing costs and risk appetite it needs to

[7] Robert J Bianchi & Michael E Drew, '*Hedge Fund Regulation and Systemic Risk*',(2014),19:1, OJ Griffith Law Review, https://doi.org/10.1080/00036846.2021.2003748, 20

spur for earning large returns. A fund in such instances will need around three years to break even after it can earn profits and breach its “high-water mark” limit for charging Performance Fees.

Restrain in India:

The inability to accord “pass-through” tax status to CAT III AIFs has led to a downturn in investors taking for the pooling vehicle CAT III AIFs are taxed at the fund level, which considerably increases the fund's back-end operations, thereby increasing administrative expenses. Further, these administrative expenses are passed on to the unit holder as an increased cost as they cannot be set-off. The taxation uncertainty has been growing around the CAT III models as they derive four sources of income namely, Business income, LTCG, STCG, and Dividend income which all accord with independent rates of taxation. The fund is under the obligation to maintain separate books of accounts for investments versus trading, which further increases the complexity of classifying the income. The ability of CAT III AIFs to employ complex derivatives and strategies has allowed them to adapt to market conditions and consistently derive higher returns compared to a PMS. However, it must be highlighted that there has been a considerable reduction in the investor taking for CAT III AIFs due to the inability to accord “pass-through” status. With the notification of reduced ticket size for Accredited Investors to 50 lakhs, the number of potential entrants into the AIF sector is on the path to growing further. To accommodate the growing interest in the sphere, it is essential to address the tax ambiguity and give “pass-through” status to CAT III AIFs to allow for a unified taxation framework across the AIF industry.

Conclusion:

AIFs are the most efficient medium for mobilizing investments in India; the securities market can see multi-fold growth through the AIF structure being implemented more efficiently. All this will be possible if the tax and setting-up policies are eased out and streamlined. Another critical barrier for the development of AIF is investor education; Investor education is essential to make them aware of new investment models and make a conscious choice. With the increase of investors in the Indian market with the help of electronic brokers like Zerodha, Angel Broking, and Fyers, it becomes more important for investor education initiatives. In the context of the global securities market, there are relatively new asset classes that are being offered by banks and other financial institutions such as CDF options in cryptocurrencies, Cryptocurrencies vanilla options, and futures. The availability of new products shows how the securities market is evolving with the inclusion of new specialized asset classes from relatively new forms of assets like cryptocurrencies. With a long-term view, we can see more liquidity and volume in these markets, with more retailers and institutions accepting and transacting these securities. This will give the AIF managers a variety of assets to invest in, which are not restricted only to hedge funds. New asset classes will mean AIFs in CAT-I and II will have more opportunities to invest in blockchain enabled Defi companies. This economic encouragement will inspire a new generation of minds to start homegrown Defi and blockchain-enabled companies propelling the further growth of AIFs across categories. In the backdrop of such growth potential, it is essential to streamline the current AIF regulations in relation to taxation and eligibility criteria to capitalize on the sectoral growth.