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Regulating hedge funds – an obstacle to financial innovation?

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Abstract

Hedge funds play an important role in providing liquidity to markets and risk-transfer services. Until recently hedge funds have been unregulated investment vehicles excluded from the full range of restrictions that are imposed on other investment intermediaries such as commercial banks or mutual funds. As a result hedge funds attained relatively high returns while reducing exposures to market risk. Due to their unregulated nature, hedge funds have been flexible in pursuing novel and complex investment strategies. It should be assumed that hedge funds provide positive contribution to the overall economy by facilitating market efficiency, diversification and price discovery. This view is justified in the light of their operation over the last decade. The need for some regulation have been undisputable in the wake of the last financial crisis in order to resolve the informational uncertainty. However, the problems cannot be addressed by traditional methodology as being detrimental to financial innovation and net performance of hedge funds. This paper aims at analyzing influence of new regulatory framework on performance and structure of hedge funds, financial innovation and investor protection. The comparison is also made to the US answer to the same problems.