



Hedge funds grab the spotlight on Wall St.

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This was the week the hedge funds ate Wall Street.

Even as the storied financial names vanish — Lehman Brothers, Merrill Lynch and Bear Stearns — they're being quietly replaced by less familiar ones: Cerberus Capital Management, Citadel Investment Group, SAC Capital Partners and the other biggest hedge funds and private equity shops in the world.

The consensus in Washington is that the Wall Street meltdown means an inevitable resurgence of regulatory authority over the financial sector. But what it may actually portend is just the opposite: the emergence of an almost entirely unregulated financial sector that replaces investment banks that were more rigorously regulated.

It has now become very clear to market insiders that the \$2.1 trillion hedge fund industry is larger in terms of capital than the remnants of the investment banking sector.

And in their understandable focus on the regulatory implications of the \$700 billion bailout pending in Congress, policymakers may be missing a far more important fact: The very hedge funds that helped destroy the investment banking sector are the biggest winners in the financial world.

One man who knows much about the new emerging financial order is **James G. Rickards**. He works at the McLean, Va.-based market intelligence firm Omnis Inc., but he's best-known as the former general counsel of Long Term Capital Management, the hedge fund whose late-1990s implosion sparked fears of a marketwide meltdown similar to the one happening now. That disaster was averted by the intervention of the large Wall Street players at the behest of the government. But Rickards learned a lot about meltdowns in the aftermath.

"I'm one of the people that other people call when the world is collapsing, because I've been there before," he joked.

What Rickards sees now is a financial order that has been turned on its head. The irony, he says, is that the investment banks generally nurtured and encouraged the hedge fund sector's emergence and came to largely depend on the fees that the hedge funds paid for their heavy trading activity.

"This is like people who think baby tigers are cute," he explained. "And then one day they grow up and eat you."

The world as Rickards sees it now is this: "The classic investment bank has gone away, and hedge funds are increasingly taking on the functions of the investment banks. Except

they are unregulated.”

At the end, it was the hedge funds whose aggressive short selling killed off the investment banks. They profited in the demise of their predecessors.

To be sure, plenty of hedge funds invested in the subprime mortgage sector, and some may collapse as a result. Sept. 30 represents an important milestone within the hedge fund industry — it’s one of the dates on which investors can demand their money back from underperforming hedge funds.

The ones that have already seen a large number of so-called redemption letters asking for money back will be scrambling to raise cash. But those investors who withdraw money from suffering hedge funds will have to reinvest it someplace else. So it’s a good bet that the biggest hedge funds will be the biggest recipients of the new cash, making them ever more powerful in a world where capital is scarce.

On Capitol Hill, that means that hedge funds will go from niche player to dominant industry. Even before the meltdown, they were already flexing their political muscle: Senate Banking Committee Chairman Chris Dodd’s Senate and presidential campaigns this year have collected more from the three big hedge funds, Cerberus, Citadel and SAC, than they collected from the investment banks Lehman, Merrill and Bear Stearns. Employees of the three hedge funds gave Dodd \$295,500; employees and political action committees of the three investment banks gave him \$221,650.

The other big winners this week are the private equity sector, which generally buys companies or large stakes in companies and holds them for a long-term investment, and the global sovereign wealth funds, foreign-owned pools of trillions of dollars in capital.

The private equity industry is having little trouble raising new funds, according to market research. The industry raised a total of \$323 billion in the first half of this year, matching fundraising from the same period in 2007, reported industry researchers at Preqin Ltd. Over the past year, the number of funds in the market increased by 40 percent.

Although sovereign wealth funds have shied away from pouring more money into the failing banks, analysts predict they will diversify their holdings with commercial real estate investments.

Private equity and sovereign wealth funds — once perceived as villains on Capitol Hill — could transform their political fortunes.

On Monday, the Federal Reserve increased the size of the stake private equity firms can hold in banks without being subject to heightened disclosure rules.

The Service Employees International Union, a longtime opponent of the industry, slammed the Fed’s decision.

“Federal regulators remain out of step with the rest of the country,” said SEIU President Andy Stern. “Allowing secretive, unregulated private equity firms to own a bigger stake

and a greater say in the nation's banks now will only ensure less stability for our financial institutions — and permit conflicts of interest in the future.”

Last year, Congress slammed private equity funds for their lack of transparency. Several legislative proposals attempted to curtail the industry by more than doubling the taxes paid by fund managers and publicly traded funds.

And sovereign wealth funds came under intense political scrutiny as lawmakers questioned high-profile investments the government-backed funds made in Western financial institutions.

Now, industry lobbyists anticipate a different environment on Capitol Hill.

“If you're sitting on a big pile of money and people want it, they are probably going to think more of you,” said a private equity industry lobbyist.

Credit Unions Say They've Distinguished Themselves

Credit unions could also come out on top once the dust settles.

Representatives from both top credit union trade associations say there's wide recognition on Capitol Hill that their members did not engage in the bad lending practices and now-toxic mortgage products at the heart of the nation's financial crisis and have weathered the storms in a strong and secure position.

“I think we've distinguished ourselves in this climate as good actors,” said John Magill, senior vice president of legislative affairs for the Credit Union National Association. “We're still lending. We are absolutely in business, and our assets are protected.”

In the wake of the announcement of the massive financial bailout, lobbyists have been busy making sure that credit unions would have access to the rescue “even if we don't need access to it necessarily,” said Ryan Donovan, the association's vice president of legislative affairs.

Most credit unions won't need federal help, said the association's chief economist, Bill Hempel. But members in the hard-hit states of California, Nevada, Florida and Arizona — where home prices have fallen as much as 30 percent — have suffered “collateral damage” from the larger market and may need a lift.

But in the longer run, the industry's strength in the face of financial meltdown could give a boost to some credit union priorities.

Along with pushing for credit union access to the bailout, industry lobbyists continue to talk to lawmakers about how credit unions can be part of the solution, said Brad Thaler, director of legislative affairs for the National Association of Federal Credit Unions. And that could include passage of the industry's long-sought increase in the amount of business lending that credit unions can undertake, Thaler suggested.

But that increase and several other regulatory changes have been fiercely fought by the industry's arch nemesis, the banking industry.

Once the bailout is passed, the economy will remain weak, Donovan said, and "Congress is going to need to look for ways to help Main Street recover." Allowing credit unions to lend to small businesses — when other institutions are cutting back — would be one good option, he said.

"Credit unions were created in the aftermath of the Depression to help the economy recover, so it makes perfect sense that, coming out of this situation, Congress and American consumers should look to credit unions to help them."

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