

## **Hedge Funds: Reignited debate on regulation<sup>1</sup>**

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To an extent not seen since the turn of the millennium, hedge funds are once again at the centre of international debate over policies towards financial markets. The statement issued at the recent G8 Summit included a section on hedge funds and complex financial techniques and products. After a ritual nod to their contribution to the efficiency of the financial system, the statement called for vigilance concerning the systemic and operational risks associated with these activities. The statement also drew attention to a new report of the Financial Stability Forum (FSF), a body bringing together regulators from major countries and international organisations. The report updates the FSF's 2000 review of policy towards Highly Leveraged Institutions.

The debate on hedge funds reflects conflicting pressures: on the one hand, resistance of the United States to abandoning the existing approach to the control of hedge funds of relying primarily on the oversight of investors, lenders and broker-dealers and, on the other, widespread conviction, especially in some major EU countries such as France and Germany, regarding the need for a stronger legal framework. Even within the United States government, there is acknowledgement that the current regime for hedge funds provides scope for opaqueness, which is inappropriate for institutions with a public policy dimension. The latter has increased with the scale of their participation in financial activities.

Assets under the management of hedge funds have grown rapidly since the beginning of the millennium and now amount to more than USD 1.5 trillion. The number of funds exceeds 9,000. The latter figure is the outcome of a high rate of births and deaths: in 2006 more than 1,500 funds were launched and more than 700 liquidated. Hedge funds play a disproportionately important role in particular markets: while they accounted for 15 per cent of trading volumes overall in United States markets for debt instruments, the proportion rose to 45 per cent for trading in emerging-market bonds, 47 per cent for distressed debt, and 58 per cent for credit derivatives. Such a disproportionate role has also been observed in emerging financial markets such as those of Asia in the late 1990s and has been the trigger for criticism of the industry.

Many countries, including emerging markets, are now home to at least a few hedge funds. For example, according to a recent survey, 337 hedge funds

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registered in Brazil managed assets worth USD 17.5 billion, and 18 registered in Hong Kong managed assets worth more than USD 1 billion. [International Organisation of Securities Commissions, “The Regulatory Environment for Hedge Funds: A Survey and Comparison”, Final Report, November 2006]

Nevertheless, hedge fund activity (though not necessarily legal domicile) is concentrated in industrial countries. The share of hedge fund assets managed in Europe, where the United Kingdom is the dominant centre, is now 24 per cent, and the share managed in the United States 65 per cent. [Financial Stability Forum, Update of the FSF Report on Highly Leveraged Institutions, May 2007]

Hedge funds do not have a clear, uniform definition. This complicates the task of estimating the sector's size and reflects differences in national approaches to regulation. The term, “hedge fund”, refers to an entity which manages pools of securities, other financial assets and investments in commodities in accordance with a number of different strategies, whose common feature is the objective of positive returns regardless of the direction of market prices. Hedge funds are characterised by high management fees: typically 15 to 20 per cent of trading profits and 1 to 2 per cent of assets under management.

Hedge funds are also frequently structured to avoid or minimise regulation. Indeed, in the United States they are often loosely identified as entities organised in such a way as to avoid being covered by key provisions of the country's legal framework for investment funds (such as traditional mutual funds) and their advisers or managers. This framework provides exemptions from requirements for registration and for disclosure to investors and supervisors, on certain conditions. Similarly, exemption is also provided to funds from restrictions on the use of certain transactions, leverage, and investments in illiquid securities.

Some of the investment strategies pursued by hedge funds are particularly associated with the limelight and critical comment on their activities. The strategies of macro hedge funds are directed at a country's macroeconomy and financial markets. These involve positions taken on the basis of assessments of the impact of international economic conditions and imbalances at national level, which are a potential source of substantial movements of the country's exchange rates, stock prices, bond yields and interest rates. Among event-driven strategies, “distressed securities” consists of positions taken to profit from price anomalies of the securities of firms going through bankruptcy or reorganisation. “Risk/merger arbitrage” – the strategy dramatised by the operations of Gordon Gecko in the film *Wall Street* – involves positions designed to profit from pending mergers. Here a long position in the stock of the firm to be acquired in a merger, buyout or takeover, i.e. a position based on expectations of a higher

price, is accompanied by a short position in the stock of the acquiring firm, i.e. a position which profits from a lower price.

Many of the strategies and transactions deployed by hedge funds are also used by the proprietary trading desks of large banks. Regulated as part of banks, proprietary trading desks, like most major hedge funds, are exempt from the transactional restrictions applying to traditional investment companies, though typically their traders are subject to internal controls (limits on the size and nature of positions, etc.), which differ in certain respects from those of hedge funds owing to differences in the business objectives of banks and hedge funds. In view of the substantial scale of proprietary trading desks' involvement in many of the same activities as hedge funds, in particular the more controversial activities which have attracted regulators' attention, official reports covering the industry mostly refer to Highly Leveraged Institutions (HLIs), a generic term intended to denote activities and strategies rather than institutional form.

In response to the growth of hedge funds, banks have recently been expanding their participation in the industry not only through development of in-house capacity but also through the purchase of stakes in outside institutions. As a result, well-known banks now figure amongst the largest hedge funds: JPMorgan/Highbridge with funds under management of USD 34 billion, Goldman Sachs Asset Management with USD 32.5 billion, and DEShaw (in which Lehmann Brothers has a stake of 20 per cent) with USD 26.3 billion. Funds associated with the sector's best known (heroic or piratical according to taste) names are still there but further down the list by assets under management: Tudor (managed by Paul Tudor Jones) with USD 15 billion, Moore Capital (Louis Bacon) with USD 12.5 billion, and Soros Fund Management (George Soros) with USD 11.3 billion.

The regulation or market-based control of hedge funds involves a number of different players or entities. The funds themselves are limited partnerships or corporations, in major cases domiciled offshore in jurisdictions such as Cayman Islands, British Virgin Islands, Bahamas, Panama, Netherlands Antilles or Bermuda. Management is in the hands of an investment adviser, generally located for offshore funds in another jurisdiction, of which the most important are the United States and the United Kingdom. In offshore centres, the adviser is often assisted by an independent fund administrator for tasks such as securities valuation, the calculation of the fund's net value, accounting and the maintenance of records.

Broker-dealer services are provided to the funds and their investment advisers by prime brokers, which are most frequently located in large banks. In addition to trading, broker-dealer services cover a broad range of activities including

securities and margin lending, introduction of new investors, start-up services, customized reporting to facilitate hedge funds' internal controls, research, securities valuation, and technology. In the case of hedge funds which are part of banks, the provision of broker-dealer services is likely to be accompanied by greater control of the funds' strategies and marketing, since these will be chosen as part of the bank's overall asset-management business.

Hedge fund investors are primarily wealthy individuals meeting regulatory conditions (see below) and institutions such as pension funds, endowments and foundations. Regulation still restricts the sale of hedge-fund products to retail investors in many countries, but is widely becoming more flexible.

For several years, banks in some European countries have sold certificates sometimes worth no more than EUR 5,000 to 10,000 per unit, on which the return and the sum repayable at maturity are linked to the value of a portfolio of hedge funds. Moreover, units in funds of hedge funds are now widely sold also to retail as well as institutional investors. Funds of hedge funds are vehicles with investments in a number of different funds, for the purpose of combining exposures to more than one investment strategy or fund and thus of spreading risks.

Hedge funds are rarely specified as such in countries' regulatory frameworks. The most common approach for the purpose of regulation is to characterise collective investment schemes (funds) by the operations in which they engage or the strategy which they adopt. Schemes with more complex investments and deploying more complex financial techniques are frequently limited to investors who are prepared to subscribe more than the specified minimum amounts or with threshold levels of net worth. Protection of retail investors is also the objective of restrictions on marketing and the more stringent disclosure requirements for hedge funds offered to retail customers. Moreover, such protection is the objective of regulations concerning minimum criteria as to diversification and as to the eligibility of funds for inclusion in a fund of hedge funds.

Investment advisers of hedge funds are subject to authorization and regulation in most countries. France, Germany, Hong Kong, Switzerland, the United Kingdom and the United States also have regulations specifically applying to prime brokerage. The collection of data from prime brokers is a key part of the supervision of hedge funds by the Financial Services Authority (FSA) of the United Kingdom. This is part of a two-pronged exercise by the FSA, which also includes firm-specific supervision of the 30 largest hedge-fund advisers, who are responsible for about 50 per cent of hedge fund assets managed from the United Kingdom.

Regulation of hedge funds in the United States, by far the most important domicile of hedge fund management, also takes place in a legal framework intended to achieve the same objective as elsewhere of ensuring that access to non-traditional investment funds is limited to sophisticated investors. In view of the country's importance as domicile to the managers of hedge funds, major features of this framework, which are exploited by hedge funds, merit special attention.

A primary objective of the Securities Act of 1933 is full disclosure of securities transactions to be achieved through registration of offerings with the Securities and Exchange Commission (SEC) and the provision to purchasers of specified information about the issuer and the securities. Exemption from these provisions is available for private offerings, which include those made exclusively to "accredited investors", defined to include individuals with net worth or income above certain thresholds, specified institutional investors, and employee benefit plans or trusts with assets above a threshold. The Securities Exchange Act of 1934 regulates brokers and dealers in securities. Exemption from its provisions for registration and reporting is available for entities whose trading activities meet certain conditions and whose investors' number is less than 500.

The Investment Company Act of 1940 prescribes features of the investment company's organisational structure and restricts its use of leverage (widely used by hedge funds), short selling (of borrowed stocks in anticipation of a fall in their prices, which will make possible a profit when they are repaid), and investments in illiquid securities (essential to the strategy of distressed securities). Exemption here is available to companies not making public offerings and with less than 100 investors or with securities owned only by "qualified investors", i.e. persons or family companies with overall investments of at least USD 5 million, certain trusts, and institutional investors with assets of at least USD 25 million.

The Investment Advisers Act of 1940 restricts registered advisers' receipt of performance-based remuneration (a key feature of hedge funds) and imposes disclosure requirements. Registered advisers must submit to periodic examinations by the SEC. Exemption from this Act is available to advisers with fewer than 15 clients. This requirement is not unambiguous and has been the subject of contention between the industry and its regulators (see below). If one "looks through" the hedge fund managed by the adviser to the funds' own investors as the true clients, the adviser could have thousands of clients. For example, if each of 14 funds managed by the adviser has up to 499 investors (thus meeting the requirement for exemption from provisions of the Securities

Exchange Act), the number of clients on this alternative measure could be as high as 6,986.

Hedge funds may also be subject to registration and reporting requirements vis-à-vis the Commodity Futures Trading Commission, concerning their involvement in trading commodity derivatives. But exemptions from most of these requirements are available to entities whose investors and managers meet qualifying conditions similar to those applying to investment funds and investment advisers.

Prominent among the issues fuelling the renewed debate on hedge-fund regulation are practices perceived as threatening the integrity of financial markets as well as investments and other on- and off-balance-sheet positions capable of increasing systemic risk. Market practices of hedge funds, which were arguably of this character, as well as the funds' potential for causing systemic destabilisation were also the targets of policy recommendations adopted in the aftermath of the collapse of Long-Term Capital Management (LTCM) and events in Asian financial markets during 1997-1998.

LTCM consisted of a limited partnership authorised in Delaware and managing a Cayman Islands partnership, Long Term Capital Portfolio, through which different funds were provided to investors. LTCM made huge macro bets based on the theory that assets all over the world are usually under- or over-valued but ultimately seek their true values. Established in 1994 and possessed of a star-studded cast of traders and academics, LTCM initially achieved stellar profits. However, the sophisticated computer models it used for prediction and risk control proved inadequate in disorderly markets as liquidity dried up after Russia's default in the summer of 1998: instead of the USD 50 million predicted as the ceiling for the firm's daily losses, the figure rose much higher and reached USD 500 million in one trading day.

LTCM's vulnerability to losses was magnified by its use of leverage, a concept indicating the potential for profits or losses in relation to equity. According to the accounting measure of assets (USD 125 billion) in relation to equity capital (USD 4.8 billion), LTCM's leverage was approximately 25 to one in comparison with an industry average of about two to one. But, after allowing for its off-balance-sheet derivative positions, the leverage was much higher.

To justify its organisation of a bailout by major banks, the Federal Reserve cited what it believed to be the likely systemic consequences of LTCM's failure. These would have involved not only huge losses for LTCM's counterparties, amongst which were prime brokers that had taken advantage of their knowledge of LTCM's operations to build what they believed would be similarly profitable

positions. In response to the failure of LTCM, these counterparties would have rushed to close their positions. As contagion spread through the markets, a vicious circle of falls in asset prices due to liquidation by investors and lenders, including those having no direct involvement with LTCM, would have followed.

In the event, a flight to high-quality and liquid assets by financial institutions and other investors took place anyway, ushering in a difficult period in financial markets (which might none the less have been worse in the absence of the official intervention). Moreover, the shock to the policy-making elite was a searing one.

During the onset of the Asian financial crisis in 1997 and the period which followed, hedge funds were accused by spokesmen in the region (including the Malaysian Prime Minister and senior financial officials) of destabilising exchange rates and other financial indicators. Features of hedge funds' behaviour singled out were aggressive trading, operating in packs (possibly with collusion), and market manipulation through collective buying and selling of assets and through releasing false information and spreading rumours. The role of hedge funds in the Asian crisis was initially belittled in an IMF study of May 1998, *Hedge Funds and Financial Market Dynamics*, primarily on the grounds that the funds were small in relation to other players, banks, pension funds and mutual funds, and that they were mostly latecomers to Asian financial markets.

Events during 1998, however, helped to cast doubt on the IMF's conclusions. Of these events, perhaps the most spectacular took place in Hong Kong, where hedge funds were involved in the "double play" in which short positions in the equity market were followed by aggressive selling in the foreign exchange and money markets to push interest rates up and thus equity prices down, a combination capable of leading to large profits on the short equity positions. In August, the Hong Kong Monetary Authority intervened in the equity market with about USD 15 billion of purchases. This action, from a body with a reputation for being well disposed to free markets, was a response to concerns that the integrity of territory's financial markets was threatened and that prices had seriously overshot levels justified by fundamentals.

A second major international report issued in 2000, that of the FSF Working Group on Highly Leveraged Institutions, cautiously endorsed the view that hedge funds were capable of having played a destabilising role in Asia through their large concentrated positions and aggressive trading. These conclusions were based on examination of experience in particular markets, rather than the more general considerations cited in the IMF study.

The official reports setting out recommended policy responses to the events such as those of 1997-1998 were directed primarily at containing the dangers of destabilisation associated with systemic financial risks highlighted by the LTCM crisis. Asian concerns were given mostly short shrift.

The package of recommendations in the 2000 report of the FSF (which represented the consensus of regulators from major financial markets) played down direct regulation of hedge funds themselves. Instead, it focussed principally on improved risk management on the part of HLIs and their financial counterparties (broker/dealers and other creditor banks); better regulatory oversight of HLIs' creditors; strengthening relevant parts of market infrastructure through harmonisation of documentation, collateral and valuation practices; improved disclosure by HLIs; and, subject to some continuing limitations on transparency which FSF regulators could not agree to abandon, more rigorous regulatory surveillance of activity in financial markets to identify leverage and other features of positions capable of posing risks to the functioning of financial markets.

Agreement was not reached on some of the actions proposed at the time. One of these, pushed mainly by some European countries, was for the introduction of an international credit register for HLIs. Firms with material exposures to HLIs would submit information on their on- and off-balance-sheet exposures to HLIs, which in the aggregated form would be made available on a confidential basis to counterparties, supervisors and other authorities. This proposal was rejected by the FSF in favour of mandatory or voluntary approaches directly targeting disclosure by HLIs themselves.

Another proposal was for improved disclosure concerning HLIs' positions (in particular foreign exchange positions) in key markets. Supporters argued that in aggregated form, the data could provide important information to both regulators and market participants concerning the size and concentration of HLIs' positions. Such an information system would have gone some way towards meeting the concerns of Asian authorities and facilitating their measures to prevent threats to the integrity of their financial markets. However, agreement on a concrete proposal along these lines proved impossible.

A close observer of the events in Asia, who was also a member of the Market Dynamics Study Group that contributed to the 2000 FSF report, concluded that the obdurateness of the United States in response to Asian criticisms of the conduct of HLIs in 1997-1998 had helped to undermine confidence in the country as a reliable ally in financial policy. The United States authorities were perceived as "inconsistent in their treatment of the issue of hedge funds: the Fed was prepared early on to get involved in the bail-out of LTCM because it feared



that, left to themselves, the US financial markets would become seriously destabilised...but when it came to official representations from many east Asian governments that HLIs were destabilising regional financial markets in 1997 and 1998, the Fed and the US Treasury demanded formal evidence of the level required in a court of law.” [G. de Brouwer, *Hedge Funds in Emerging Markets*, Cambridge University Press, 2001, p. 197]

Legislative attempts to enforce greater disclosure by hedge funds in accordance with recommendations of the 1999 report, “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management”, of the United States President’s Working Group on Financial Markets (which comprised representatives of the Treasury, the Federal Reserve, the SEC and the CFTC) proved abortive. However, in early 2006, faced with evidence concerning the involvement of the managers of hedge funds in fraud (the source of 51 investigations during 1999-2004), the SEC introduced new rules for the registration of the managers of hedge funds designed to enable it to deal more speedily and effectively with malpractices. These rules were based on the interpretation of the Investment Advisers Act, which “looks through” hedge funds to their investors as the advisers’ true clients, and were expected to more than double the number of managers registered from the previous figure of approximately 1,000.

However, in mid-2006, the new rules were struck down in a court case brought by Philip Goldstein, a New York hedge fund manager. At present, agreement is lacking in different branches of the United States government as to the best way forward. A recent statement of the President’s Working Group on Financial Markets broadly endorsed the existing regime for hedge funds. But in the Senate, a senior Republican, Senator Chuck Grassley, has introduced legislation which would tighten exemptions from registration under the Investment Advisers Act to achieve objectives similar to those of the struck down rules of the SEC.

Hedge funds’ involvement in questionable market practices has also been the subject of regulatory attention outside the United States. In mid-2005, the United Kingdom’s FSA expressed concern over institutionalization of insider trading affecting almost a third of mergers and acquisitions, where hedge funds are involved not only as part of their strategies of risk/merger arbitrage but also simply as traders.

Controversy has also accompanied hedge funds’ increased involvement in cases of distressed debt and the exercise of their rights as important shareholders. Restructuring companies’ debts and changes in their management and control in response to pressures from activist shareholders are inevitably often

controversial so that unsurprisingly hedge funds' activist role in high-profile cases attracts flak from parties directly affected and from politicians.

Abuses under the heading of practices endangering financial markets' integrity and good corporate governance might seem subjects appropriate for action at national rather than international level. But, as at the end of the 1990s, the concerns of regulators and other policy makers have none the less spilled over into calls for international action owing to the freedom accorded by the internationalization of financial markets to hedge fund activity outside the domiciles of their managers.

Furthermore, in spite of improvements in risk management by hedge funds and their counterparties and in surveillance by regulators since the end of the 1990s, there are still fears that the funds remain a potential source of systemic financial risk. The European Central Bank has drawn special attention to dangers posed by high correlations between the returns of the different investment strategies pursued by hedge funds and by the funds' increased recourse to illiquid investments in their search for higher yield. There is a risk that high correlations of the profits of different investment strategies during downturns in hedge funds' profitability lead to accelerated withdrawals by investors. Moreover, there is a danger that imbalances between the liquidity of hedge funds' assets and liabilities will result in sectoral concentration of the sales of assets to meet withdrawals, thus increasing their potential for further destabilising prices.

The European Central Bank is unconvinced that current arrangements are sufficient for the level of disclosure to regulators and counterparties that is required by a strategy relying on transparency for avoiding the systemic risks posed by the funds. For this purpose, it has again raised the proposal for an international credit register rejected in the FSF report of 2000. However, the proposal still lacks political traction.

An alternative proposal, which has been pushed by Germany and by Jean-Claude Trichet, President of the European Central Bank, is for the introduction of a voluntary code of conduct for hedge funds. This is being resisted by the industry, which points out that comprehensive guides to sound practices are already available from the two major industry associations, the Alternative Investment Management Association (for Europe) and the Managed Funds Association (for the United States). While codes of conduct can provide useful checklists of benchmark practices for discussions among industry participants and between the industry and its regulators, their effectiveness is subject to considerable limitations unless they are embodied in guidelines for supervisors (which would be difficult in view of the still unregulated character of large parts of the industry and would probably be considered incompatible with the status

of voluntary code) or in the conditions for accreditation by a body covering the industry (which does not currently exist).

Concerns in the debate on hedge funds registered by countries with emerging financial markets are still marginalised. Threats to the integrity of financial markets posed by hedge funds began to be taken seriously by countries exerting the main influence on the international regime for regulation and control, only when the threats involved their own markets (rather than the emerging ones). This marginalisation seems likely to remain true in the formulation of any new international initiatives regarding hedge funds. Countries with emerging financial markets will thus have to continue to rely on national policy solutions.

Some of the measures available to deal with problems posed by HLIs involve capital controls. For example, the shorting of a country's currency by a non-resident entity such as a hedge fund with the aim of profiting from devaluation is frequently undertaken through borrowing followed by repayment in devalued currency. Such transactions can be countered by restrictions on the borrowing of the currency by non-residents. If these restrictions are rendered less effective by the existence of an offshore market for the currency, then the regulations regarding switching foreign credits into local currency can be modified. This was the approach adopted by the Malaysian government in 1998 when it restricted the convertibility of the ringgit in response to sustained downward pressure on the currency, in which offshore operations by HLIs in Singapore and to a lesser extent in Hong Kong, London and New York played an important part.

Destabilising movements in local financial (stock and money) markets can be made more difficult by the imposition of disclosure requirements on local financial institutions, which enable the identification of positions and players that are a potential source of such movements. This disclosure would serve as an alternative to the abortive international proposal for the reporting of positions in key markets described above. The disclosure would also make possible exclusion of certain categories of institution from local financial markets in extreme cases, if the authorities judged this necessary.

Both types of measure presuppose the maintenance of necessary policy space. This in turn requires avoidance of, and resistance to, international obligations restricting this space (for example, through the IMF, through commitments on financial services assumed in multilateral negotiations in the WTO, and through commitments on financial services included in bilateral Free Trade Agreements).