Regulating Hedge Funds

A Re-Define Input for the European Commission

On behalf of the European Parliament

Sony Kapoor, Executive Director, Re-Define

Sony.Kapoor@re-define.org

Background

In finance, because of 1) higher information asymmetries due to the inability to "road test" products 2) longer term consequences of buying products such as insurance and pension funds etc and 3) the relative lack of financial sophistication of most retail consumers, there is a critical need to have solid consumer protection regulation.

In the case of retail consumers the asymmetry between the average hedge fund and the average retail customer is so high that it makes sense to have

1) Restrictions or prohibition of direct exposure through hedge funds being unable to offer products to retail consumers and 2) Restrictions on indirect exposure through a) limits on pension fund and bank exposure to hedge funds b) a special vetting process or a positive list for hedge funds where such retail vehicles such as pension funds and banks are allowed to invest c) a total prohibition even of such second order exposure for the retail consumer.

"In short, few would think it appropriate that granny Tina' life savings are invested in hedge funds."

So hedge funds need to be regulated for the purpose of consumer protection.

While we do not want granny Tina to lose risk losing money we do not mind if Soros loses his shirt investing in hedge funds. The presumption here is twofold 1) that Soros knows what he is doing so the caveat emptor principle is appropriate and 2) that Soros has the right kind and amount of information so as to make his considered judgement as to whether to invest in a hedge fund or not.

The first means that hedge fund investment should only be open to sophisticated investors – defined as finance professionals and institutional investors or to those such as High Net Worth Individuals who can afford to hire good professional advice before investing in hedge funds.

The second means that the hedge fund does not lie or mis-sell its products and provides a minimum amount of information to current and prospective investors to allow them to make up their mind. This highlights the need for proper disclosure.

So hedge funds need to be regulated for the purpose of investor protection

Because "all you get in exchange for you money is a piece of paper" finance depends on trust and confidence more than any other commercial activity. That is why it is essential to have in place legislation that guards against fraud, insider trading, market timing, front trading and a whole host of other rogue activities that sap market confidence.

Hedge funds have often been found to be involved in such activities.

So hedge funds need to be regulated to maintain market integrity and trust

As this crisis has highlighted the financial system is now highly inter-connected and highly geared. Distress in one institution leads to forced asset selling and because many financial institution assets are now "marked to market", the resulting fall in asset prices can cause financial stress in other institutions through marked to market losses.

These institutions are then, in a bid to reduce risk and maintain capital ratios, forced to sell some of their liquid assets which can then trigger an asset price fall – loss – forced de-leveraging and forced selling downward spiral which can result in a systemic breakdown.

Even if such systemic breakdown is prevented, any form of market stress imposes significant costs on a whole host of other financial institutions and often also the real economy. Importantly, this total cost to the system or to society is much higher than private cost to the institution where the financial stress originates.

So, financial disturbances in a hedge fund (or any other significant financial institution) have significant negative externalities.

Such potential negative externalities are perhaps the most important reason to regulate hedge funds.

(1) Are the above considerations sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?

Because of their nature, hedge funds encompass the whole universe of investment strategies so while it is possible to give taxonomy of the major kinds of strategies used; it is true that this is not a very useful way of defining or distinguishing hedge funds.

Hedge funds also vary widely in their use of leverage so this is not a very useful definitional criterion either.

However we do not believe that it is necessary to have strict definitional criteria for hedge funds. Hedge funds belong to the family of collective investment vehicles (CIVs) which also encompasses pension funds, mutual funds and private equity etc.

A useful functional definition of hedge funds would then be a negative one where investment vehicles that are NOT pension funds or mutual funds or one of the other special categories end up being treated as hedge funds by default.

Each of these other categories of CIVs for example pension funds and mutual funds, operate under restrictive regulatory regimes such as restrictions on what assets they can invest in etc and in turn get specific privileges such as access to pension savings and tax deductibility etc.

The way to look at hedge funds would then be CIVs that forego such special benefits (including we believe access to retail customers) in return for having more or less total flexibility on investment strategies. This is a fair trade off and takes care of many of the definitional problems.

These hedge funds should then be exempt from overt restrictions on investment strategies but should, we firmly believe, be subject to regulation under the purview of

1) consumer protection
2) investor protection
3) market integrity
4) potential negative externalities especially their potential impact on financial stability

Additionally, they should also be subject to the ad hoc emergency regulations that need to be introduced from time to time such as the recent ban on naked short selling.

(2) Given the international dimension of hedge fund activity, will a purely European response be effective?

The answer to this question is "it depends". It depends on what we are trying to achieve. We try and answer this question from the four perspectives we considered in the preamble to this document.

Consumer protection

European legislation on this needs to be both bottom up and top down. Top down this means that European hedge funds should be forbidden from marketing and selling their products to everyone outside of restricted list of sophisticated investors.

In order to make sure that non-European hedge funds do not arbitrage a more lax home regime we also need to have legislation 1) prohibiting any hedge funds from marketing to retail customers and 2) making sure that only qualified and registered 'advisers' are allowed access to retail customers and these should then be prohibited from marketing hedge funds at the risk of losing their license and even personal liability

We believe that this combination of measures will provide sufficient consumer protection.

Investor protection

Minimum investor disclosure rules need to be in place for European hedge funds. We believe that while it would be impossible to protect all European sophisticated investors from "insufficient disclosure" by non European funds, investors in this post sub-prime post Madoff financial landscape will become more demanding and discerning.

In fact, we firmly believe that mandatory minimum disclosure requirements and a more robust regulatory regime will give European hedge funds a sharp competitive edge as investors seek more reassurances and security and become more cautious.

Of course, we should still strive for globally binding minimum disclosure and investor protection rules etc.

Market integrity

Most of the practices that threaten market integrity are already illegal under existing regulations. In many cases the solution is to apply these regulations more rigorously.

What if foreign based hedge funds try and manipulate European markets? There are two possible ways to address this. One is to hold the European entity (brokerage or dealer etc) through which foreign hedge funds indulge in unscrupulous activities accountable. This would incentivized such institutions to do better due diligence on the activities of their foreign hedge fund clients.

The other is to introduce a pre-registration provision for foreign hedge funds before they are allowed to take positions in European markets and to ensure that funds that are allowed to trade in Europe have a comparable home regulation regime.

This will not put Europe at a competitive disadvantage as it is too big and too important for most diversification strategies for most hedge funds to choose not to invest in.

Financial stability

This is dealt with in the next answer in more detail. The only point we will make here is that ideally we need global solutions to dealing with the potential systemic impact of hedge funds. However, purely European legislation would still be a step in the right direction and the benefits in terms of lower systemic risk through better prudential norms would far exceed any potential costs in terms of a loss of competitive edge.

(3) Does recent experience require a reassessment of the systemic relevance of Hedge funds?

Proponents of hedge funds point to two facts about the ongoing crisis 1) hedge funds did not cause this crisis 2) they have not needed tax payer bailouts

They are correct on both counts.

However, no serious commentator could disagree with our perspective which is that 1) hedge funds could easily have caused or triggered a crisis and 2) forced asset sales by hedge funds have helped exacerbate the ongoing crisis so has had indirect systemic consequence both in terms of the scale of the crisis and the magnitude of tax payer bail outs needed.

In fact many hedge funds are characterized by the very same factors that make banks systemic – they use leverage (in a number of cases this leverage is very high) and they have serious asset-liability mismatches. Another reason to be concerned about the potential systemic impact of hedge funds is that they have grown ever bigger and ever more interconnected with the rest of the financial system.

However, all hedge funds are not the same and what regulators need to do is to distinguish between those that are systemic – (due to their size and/or leverage and/or asset-liability mismatch and/or inter-connectedness) and those that are not. And this assessment has to be updated regularly over time.

Once this is done, there is a need to have more stringent supervisory and regulatory requirements for systemic funds including but not limited to 1) minimum capital adequacy ratios 2) minimum liquidity requirements and 3) other appropriate prudential norms such as restrictions on leverage

(4) Is the 'indirect regulation' of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of Hedge fund failure? Do we need alternative approaches?

The answer to this question has to be a big NO. We firmly believe that those hedge funds deemed 'systemic' – see previous answer – should be subject to direct prudential supervision. The prime broker route may be used for 'non-systemic' funds.

Prime brokers face significant conflicts of interest in terms of earning large fees from hedge funds. They cannot be wholly relied on to monitor and impose prudential norms. As has often been the case (remember LTCM?) prime brokers often sacrifice good practice for higher profits. A higher capital charge on lax prime brokers may help align incentives better but is clearly a second best solution.

Another problem is that most large hedge funds use multiple prime brokers so no one broker is in a good position to monitor their activities.

(5) Do prudential authorities have the tools to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements? If not, what types of information about hedge funds do prudential authorities need and how can it be provided?

The introduction of strict reporting requirements on 1) capital 2) leverage 3) investment strategy 4) investment portfolio 5) links with systemic financial institutions 6) source of funds and 7) risk management metrics is essential and overdue.

It is of course essential to ensure the confidentiality of some of this information which is proprietary in nature and this can be done by ensuring that such disclosures are only made to the macro-prudential authorities which in most cases would be the central bank.

Some of this information is of course relevant to and can be shared with other stakeholders and where concurrent disclosure may not be appropriate suitably lagged disclosure might work.

It is imperative that financial authorities have an accurate picture of the state of the financial system including aggregate amounts of capital, leverage and risk as well as inter-linkages amongst various actors.

Disclosure of such information to the regulatory authorities will also ensure that the scope for market abuse and market manipulation is significantly reduced which also has second order positive benefits for systemic stability as a large scale prevalence of such activities can erode confidence in the whole financial system.

(6) Has the recent reduction in hedge fund trading (due to reduced assets and leverage, and short-selling restrictions), affected the efficiency of financial markets? Has it led to better/worse price formation and trading conditions?

Hedge funds have often been given credit for enhancing market liquidity amidst figures which show how significant (and growing) a proportion of particular financial markets (such as the NYSE) trading their activity constitutes. This is then often used to say that they have increased the efficiency of financial markets.

Three points need to be made here

1) many of these markets the hedge funds have supposedly helped make more liquid were already highly liquid. No one would say that the NYSE was illiquid before the hedge funds started playing a significant role. In fact there is a saturation point beyond which an increase in the number of transactions does not contribute to greater liquidity in the markets

2) true liquidity in the financial markets comes from a diversity of opinion amongst market players. To the extent that Hedge funds were contrarian investors they contributed to greater liquidity but evidence shows that a majority of hedge funds simply run with the herd and are more leveraged versions of more conventional investment vehicles. These simply make the financial system more pro-cyclical and so perhaps contribute to less efficient markets.

3) some of the new markets such as Credit Default Swaps where hedge funds were significant market players have not worked so well

Being allowed to short sell means that hedge funds can contribute to increasing the efficiency of the price formation process by, for example allowing them to take bets against bubble valuations in assets which can help reduce the likelihood of damaging asset price bubbles forming in the first place.

In that sense, short selling restrictions can harm the efficiency of financial markets. However, it is necessary to protect against abusive practices that allowing naked short selling can engender – such as selling off more shares than are outstanding and available for purchase.

(7) Are there situations where short-selling can lead to distorted price signals and where restrictions on short-selling might be warranted?

When short selling becomes a significant share of the outstanding 'free stock' of a company available for trading, price signals can get distorted. Also, restrictions might be warranted in the event of a run on particular sector of the kind that the finance sector experienced recently.

(8) Are there circumstances in which short-selling can threaten the integrity or stability of financial markets? In combating these practices, does it make sense to tighten controls on hedge funds, in particular, as opposed to general tightening of market abuse disciplines?

[See previous answer]. Short selling can easily be abused as has happened often in the recent past when short selling has been accompanied by marker rumours started by the same hedge fund which allows it to make a large but unscrupulous profit when the markets react to those rumours.

While tackling this falls within the purview of general market discipline, it is mostly hedge funds who are the biggest short sellers so the regulation needs to be designed keeping them in mind.

(9) How should the internal processes of hedge funds be improved, particularly with respect to risk management? How should an appropriate regulatory initiative be designed to complement and reinforce industry codes to address risk management and administration?

Systemically significant hedge funds (see previous answers) need to be subject to macro-prudential as well as micro-prudential norms. The micro-prudential norms here would include tighter supervision as well as specifications along the lines of 1) better operational risk management (half the hedge funds fail because of bad operational risk management practices 2) better market risk management and 3) better liquidity risk management

Mandated Independent third party assessments of 1) capital adequacy 2) adequate liquidity 3) operational risk and back office practices 4) valuation would also help improve risk management and are essential for systemically significant hedge funds.

A lighter touch regime should govern the non-systemically significant hedge funds

Together with these, appropriate compensation structuring regulations as well as disclosure norms and counter cyclical norms that are agreed need to be applied to systemically significant hedge funds in order to ensure better risk management and administration practices.

(10) Do investors receive sufficient information from hedge funds on a pre-contractual and ongoing basis to make sound investment decisions? If not, where do the deficiencies lie? What regulatory response if any is needed to complement industry codes to make a significant contribution to the transparency of hedge fund activities to their investors?

We have nothing to add to the existing European Parliament response.

(11) In light of recent developments, do you consider it a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures?

NO. (See previous answers)