Regulation of hedge funds: Why is it a social security issue?

Originally, hedge funds were supposed to be very specialized investment vehicles whose access was highly restricted to sophisticated investors. But the last few years have seen a considerable broadening of the investor class with access to hedge funds. Governments are also increasingly investing their pension programme money in hedge funds. Since the funds are accessible to common citizens, the need for public intervention to ensure that investments are carried out according to good practices and standards, that managers meet integrity and competence criteria, and that transparency and disclosure requirements are implemented, makes eminent sense.

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Hedge funds can be defined as "private pools of funds that invest in traded instruments (both cash securities and derivatives); can employ leverage through various means, including the use of short positions; and are generally not regulated" (Cole *et al*, 2007, p. 8). Hedge funds specialize in pursuing highly sophisticated, high-risk investment strategies with the purpose of achieving returns above average. In a simpler definition, hedge funds are funds established for the purpose of investing the money of their participating partners (Edwards, 1999, p. 190).

Originally, hedge funds were supposed to be very specialized investment vehicles whose access was highly restricted to sophisticated investors. Direct investment in hedge funds used to be accessible only to wealthy investors, due to high entry tickets (Noyer, 2007, p. 107). Hedge fund investors could be presumed to have the sophistication and the resources to protect their own interests (Crockett, 2007, p. 23; Hildebrand, 2007, p. 71).

But the last few years have seen a considerable broadening of the investor class with access to hedge funds. One way this has happened has been through the relaxation of accreditation requirements, to the point that few if any limits exist on who can invest in hedge funds (Danielson and Zigrand, 2007, p. 31). In many countries, from Hong Kong and Australia to Germany and the UK, a new category of investors with relatively more modest financial means are now able to invest in them. This is also partially the case in France, where hedge funds can now be accessed by individuals with a minimum amount of EUR 10,000 (Prada, 2007, p. 130). Moreover, according to recent news reports, German investors can buy hedge funds from Deutsche Bank in units of less than EUR 125 and UK regulators are considering reducing restrictions on marketing hedge funds to individuals (Financial Times, 2007a).

As part of this movement, regulated institutions accessible to average investors, such as mutual funds and pension funds, are increasing their investments in hedge funds (Danielson and Zigrand, 2007). It is reported that a significant portion of the growth in hedge funds is due to institutional investors' demand for investment alternatives to standard long-only equity and fixed-income investments (Cole *et al*, 2007, p. 11). Hedge funds now tap into a larger share of household savings that is channelled through institutional investors, such as funds of funds[1] and pension funds. In fact, pension funds are estimated to amount to around 30% of the investor base (Noyer, 2007, p. 107; Crockett, 2007, p. 23).[2]

Governments are also increasingly investing their pension programme money in hedge funds. In the United States, for example, the Securities and Exchange Commission (SEC) reports that about 20% of corporate and public pension plans were using hedge funds in 2002, up from 15% in 2001, and the trend is rising.[3] Public pension funds are among a number of entities that have sharply increased the amount of money they put into hedge funds in the last few years, in an effort to boost their returns and diversify their holdings.[4]

Motivation: the crisis of publicly financed social security

A larger pool of retirement savings is being invested in hedge funds through two main channels. The first channel is a direct one: investment by individuals in hedge funds as their choice of instrument to insure themselves. Public institutions in charge of providing retirement support are being either privatized, downsized or precarized. In some cases, public social security systems are providing insufficient assistance, so individuals are advised to rely on their own private insurance systems instead of (or in addition to) those provided by the state. This is especially the case with the generalized switch from defined-benefit to defined-contribution plans. In other cases, the search for private solutions comes from the precarious state of social security programmes and the trend towards a higher ratio of ageing citizens to working citizens, which raises fears about the sustainability of the public system and its ability to respond to the increased demand over the long term.

The second channel is indirect: investment in hedge funds by institutions, whether private or public, that manages individuals' retirement savings. In the case of private institutions, individuals resort to them as a way to complement or replace what are foreseen as meagre pension benefits due to the collapse of public social security systems, and the shift to defined-contribution plans. In the case of the public ones, it is the pressure triggered by the looming difficulties to finance their obligations that is prompting many governments to seek higher-than-average returns through strategies such as those offered by hedge funds.

As can be seen, the collapse of public social security systems is a common thread running through these two channels.

The controversy over the regulation of hedge funds

The reason hedge funds can engage in potentially more rewarding strategies is that they are not regulated. The lack of regulation on hedge funds tended to go relatively undisputed until the end of last decade. The perceived benefits of hedge funds were, in effect, directly linked to their lack of regulation. Hedge funds' higher returns were made possible by the flexibility and capacity to implement innovative strategies that can only happen in the absence of the regulations to which other financial actors, such as mutual funds, are subject. However, as hedge funds have grown in significance and the evidence of their potential shortcomings has begun to come to light, controversy about the need to regulate them has ensued.

Two events at the end of the 1990s became critical hallmarks triggering a reconsideration of the issue of whether hedge funds should be regulated. The first was the East Asian financial crisis. Authorities of the countries affected expressed concern that the activities of hedge funds in their markets during the period of the crisis had a destabilizing impact and could have potentially damaged their economies (Financial Stability Forum, 2000, p. 5). Brouwer (2001, cited by Cornford, 2005) has found grounds for this concern, arguing that operations of macro hedge funds and to a lesser extent financial institutions' proprietary trading desks were an important source of instability in the region's financial markets in 1997-1998 and contributed to the overshooting of exchange rates and other asset prices (Cornford, 2005).

It is worth noting that some researchers, including researchers from the International Monetary Fund (IMF), have called this contention into question (Fox,

1 A fund of funds is an investment fund that holds a portfolio of other investment funds rather than investing directly in shares, bonds or other securities.

2 One of the asserted bases for the retailization of funds is fairness: it is argued that not only wealthy investors should have access to the superior hedge fund returns, which accounts for the fact that sometimes supervisors themselves have called for retailization (rather than the funds themselves).

3 Financial Times (2004a), which also stated that millions of people worldwide, both working and retired, have money invested in hedge funds and might not even know it.

4 *Ibid.*

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1998; IMF 2004, p. 146-8). But Brouwer found that IMF research tends to overemphasize the global size of hedge funds when what matters, he argues, is the size of their positions in relation to those of other actors in particular markets in the region. Leader-follower patterns of behaviour in these markets tend to be neglected in such studies, he says. According to these patterns, groups of hedge funds would act as if in packs and, vis-à-vis other firms, assume the role of leaders based on their willingness to take large positions in particular assets and currencies based on what is widely regarded as superior knowledge (Cornford, 2005).

The second critical landmark was the failure and subsequent bailout of the Long Term Capital Management hedge fund. LTCM had been established in 1994 with equity of USD 1.3 billion and its equity had grown, by 1998, to USD 5 billion (Edwards, 1999, p. 197). For an investor who was in at the beginning and stayed until 1997, the annual return would have been 15% a year (Kahn and Truell, 1998). LTCM's leverage, based on money it had borrowed, was around 20 to 1, high by any standard. A detailed description of the strategy LTCM had pursued and why it failed is beyond the scope of this paper. It is important to note that in September 1998, the Federal Reserve Bank of New York convened a series of firms that had lent money to the company and warned them about the "systemic risk posed by LTCM going into default." Federal Reserve chairman Alan Greenspan asserted that rescuing LTCM was necessary to prevent markets from "seizing up" and "impairing the economies of many nations." As a result, a consortium of financial institutions organized a rescue (Edwards, 1999).

By 1999 the (then) Group of 7 (G7) had decided to task the Financial Stability Forum with calling a Working Group on Highly Leveraged Institutions. The Working Group was set up with a mandate to "assess the challenges posed by highly leveraged institutions to financial stability and to achieve consensus on the supervisory and regulatory actions which would minimize their destabilizing potential" (Financial Stability Forum, 2000, p. 1).

The Working Group took the approach that the challenges were best addressed through indirect regulation measures, such as better risk management practices in counterparty institutions and the bolstering of market discipline through enhanced disclosure requirements.[5]

In 2006, the regulation of hedge funds drew renewed attention. Some events that contributed to this were the USD 6 billion loss by hedge fund Amaranth and the 75% loss of its USD 13 billion fixed income trading by hedge fund Vega. The government of Germany, which had already taken some strong positions on the subject, and whose public exhibits a pronounced hostility towards hedge funds, announced in late 2006 that it intended to use its presidency of the G8 (in 2007) to place hedge funds on the Group's agenda (Financial Times, 2007c; 2007d; 2007e). In February 2007, at their first meeting of the year, the G7 Finance Ministers agreed on commissioning the Financial Stability Forum to update its 2000 report on hedge fund practices, and calling for direct talks with the hedge fund industry about future regulatory options.[6]

However, the G8 Summit at Heiligendamm (June 2007) failed to take any meaningful action. The German finance minister's attempts to push for an agreement on tightening regulation of hedge funds were quickly opposed, mainly by the US and UK governments, and were soon watered down to mere calls for disclosure in the interest of greater transparency. As the G8 Summit drew closer, it seemed that even modest transparency requirements of a mandatory nature were too much to enforce on hedge funds. The German government had toned down its demand to have a Code of Conduct, with the US arguing that if such a Code of Conduct was necessary the hedge fund industry itself would be advocating the idea and designing it, so not much action was required on the part of governments. In the end, the G8 communiqué settled for taking note of an updated report on the matter prepared by the Financial Stability Forum, and promised further work.

Circumventing safeguards meant to protect citizens' futures

The main rationale behind regulation of mutual funds and pension funds has been the need to protect the interest of the citizens who invest in them. Since the funds are accessible to common citizens who presumably have little or no investment expertise, the need for public intervention to ensure that investments are carried out according to good practices and standards, that managers meet integrity and competence criteria, and that transparency and disclosure requirements are implemented, makes eminent sense.

Since hedge funds were originally limited to 'high net worth' or wealthy investors, that rationale was arguably not applicable to them. In fact, hedge funds were largely created to limit the constraints that regulation set on other financial institutions for this very limited group of superwealthy investors, who were very much 'insiders' to the world of investment strategies and could be trusted to know what they were doing.

As mentioned above, restricted investors' access is no longer a characteristic of hedge funds. Thus, the more that hedge funds are similar to other investment vehicles accessible to common citizens, the weaker the rationale for keeping them outside of regulatory scrutiny. Moreover, we argue that when the funds that could be at risk are the retirement savings of ordinary people, the issue becomes one of social security regulation. In fact, the state jeopardizes its social security obligations when it invests in hedge funds and when it fails to properly regulate them. If citizens have to rely on private pension systems, and the state is unwilling to regulate the investments made by these agents in hedge funds, or the behaviour of hedge funds that actually receive pension savings, then the state is relinquishing its obligations to regulate in the interest of the social security of its citizens.

The risk to retirement savings

The better returns achieved by hedge funds come at the cost of higher risk. In hedge funds, this higher risk results from the use of leverage, oftentimes several layers of it. In this regard, for example, investors could borrow to invest in funds of funds which, in turn, borrow to invest in hedge funds which, in turn, use derivatives to leverage themselves (Ferguson and Laster, 2007, p. 53). Hedge funds can leverage themselves with very high multiples either directly (borrowing from prime brokers)[7] and indirectly (through selling credit derivatives), making themselves especially vulnerable to a sudden decrease in market liquidity (Noyer, 2007, p. 108).

Moreover, there is a generalized view that hedge funds' leverage, in the aggregate, only keeps increasing. A figure from 2004 indicated hedge fund leverage in the form of bank debt to be at an average of 141% (Financial Times, 2004b). Leaving estimates aside, though, the main problem is posed by the lack of reporting requirements on hedge funds, which makes it very difficult to know, at any point in time, how leveraged hedge funds really are, especially through their derivatives exposure. An expert witness who testified to the US Congress when it inquired into the crisis at LTCM is quoted as saying: "When Greenspan went round the banks and asked them what the impact would be on their balance sheets of allowing the fund to go down, they said they didn't really know, and didn't want to find out" (Financial Times, 2004b).

According to one author, effective leverage "has become notoriously difficult to measure, due to the difficulty in capturing the effect of different layers of leverage, and in particular the leverage embedded in the most complex forms of credit derivatives." (Noyer, 2007, p. 109). According to the vice president of the European Central Bank, "the total leveraged assets of an individual hedge fund can sometimes be quite significant and comparable with the size of some systemically important banks" (Papademos, 2007, p. 115).

Not only do hedge funds present higher risks but, as repeatedly warned by analysts, the benign liquidity conditions prevailing in the market in which they have proliferated makes current hedge fund-related risks hard to even estimate with any degree of accuracy.

Ethical issues regarding the types of investment made by hedge funds

In addition to the issues raised for the average citizens whose savings end up feeding hedge funds, it is important to assess the ethical issues raised by the behaviour in which hedge funds engage when utilizing those savings. In their search for financial performance, hedge funds have been known to incur in strategies with negative impacts on the 'real economy' and workers.

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5 It is worth noting that, according to a recent assessment by the European Central Bank, the implementation of even the limited measures called for in this report remains far from satisfactory (European Central Bank, 2005).

6 *Ibid.* The political currency of regulating hedge funds is not unique to the German context. For instance, US Senator Charles Grassley (Chair of the Senate Finance Committee in 2007) sent a letter in October 2006 to all US financial regulators seeking information about reporting requirements, if any, of hedge funds. During his campaign, Nicolas Sarkozy – who would later be elected in the French presidential elections – promised to take a tough stance on hedge fund regulation.

7 A broker which acts as settlement agent, provides custody for assets, provides financing for leverage, and prepares daily account statements for its clients, who are money managers, hedge funds, market makers, arbitrageurs, specialists and other professional investors.

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There is certainly no question that the real economy suffers most when financial crises of a systemic nature are triggered by the speculative activities of hedge funds, as many argue was the case in the East Asian crisis. But even without such large-scale events, routine activities pursued by hedge funds pose threats that cannot be ignored.

As US House of Representatives Financial Services Committee chairman Barney Frank stated in a letter addressed to President Bush in May 2007:

> An important question to explore is whether the high rates of return required to finance private equity debt-driven buy-outs can jeopardize the long-term interests of target companies and the provision of decent employment conditions and employee security. We are troubled by those cases in which rather than corporate restructuring for the purpose of shared productivity gains and increased competitiveness, numerous private equity funds now appear to be looking at extracting maximum value over a short period before re-selling the company. This poses the risk that employees will be disadvantaged in a fashion that would not have happened without the acquisition.

One example of these hedge fund practices consists of influencing the direction of companies by taking activist positions in their shareholder assemblies. While it is common to assume that this activism brings more efficiency to corporations by creating value and promoting efficiency, it can also disrupt companies' economic activity based on immediate return considerations, and regardless of other implications for the long-term performance of the company. Critics of funds have argued that they are interested only in short-term returns, which may be generated at the expense of the long-term interest of the companies in whose securities they invest (Crockett, 2007, p. 24).

Notably, this criticism was recently voiced by German Finance Minister Peer Steinbrück, who said that "the German model – medium to long-term industrial planning – worked even if it was not compatible with the short-term aims of hedge funds." He went on to add: "The focus of industry should be 'how do I keep a company market-competitive in the medium term' – not the short-term profit maximization" (Financial Times, 2007g).

Similar concerns were expressed by SEC commissioner Paul Atkins, who warned that "giving investors greater say on the composition of boards could have the unintended consequence of increasing the power of hedge funds… What if a shareholder who participates by voting at a meeting holds no economic interest or possibly a negative interest in the corporation?" (Financial Times, 2007b). Meanwhile, two University of Texas professors warned in a 2006 study that hedge fund tactics could be eroding the traditional link between economic ownership of shares and corporate voting power (Financial Times, 2007b).

However, 'short-termism' is also especially damaging to employees in the restructured companies who, as stated by Paul Myners, the former chairman of Marks and Spencer, "generally suffer an erosion of job security and a loss of benefits" (Financial Times, 2007f). It is worth noting that leveraged buy-outs of the type practiced by hedge funds with profit-making purposes are financed with debt, with the purchased firm becoming responsible for servicing those debts. The higher the leverage, the higher the risk of subsequent failure of the company, with workers being the first casualty.

Moreover, workers may be double losers in this trend because, at the same time, the high profits are made possible by the fact that interest can be offset against tax in many jurisdictions, which basically means taxpayers' money is what subsidizes the profits. Lower tax pressure on the owners of big capital means, everything else being equal, more tax pressure on workers.

'Short-termism' might be especially damaging to long-term economic considerations in the context of the increased hedge fund shareholder activism aimed at forcing specific management decisions (or management changes) through their stakes in a company. This risk exists when funds take short-term stakes, using non-transparent techniques, with the sole objective of putting pressure on management, at a specific point in time, for the defence of their specific interests (Prada, 2007, p. 133).

Recently, analysts have noted another channel through which hedge funds may influence the real economy, that is, in the context of increased difficulties for companies to achieve workouts. Bankruptcy regimes are a policy instrument that countries craft with the goal of setting incentives for companies' productive activities not to be unduly disrupted. They balance the interests of creditors and debtors on the basis of protecting the longer-term interest of society in not disrupting production processes vital to the economy. Hedge fund intervention may dramatically distort these incentives, as noted by an analyst: "In the past, banks that held loans on their balance sheets had a substantial financial incentive to come to an amicable workout with borrowers. When banks securitize loans, however, that incentive may be diminished because they don't bear as much of the risk of default… [H]edge funds and even banks may profit from a default if they have bought protection through a credit default swap in excess of the amount of the loans they hold… [Hedge funds'] participation can also affect the ability of borrowers near default to work out their problems" (Cole *et al*, 2007, p. 10).

The implications of this problem have come to light recently in the US in the context of the crisis of subprime mortgage lending and the intervention by banks and regulators to aid subprime borrowers facing steep interest rates on their housing loans. What would have otherwise been a reasonable and welcome help to disadvantaged communities of borrowers, became the target of accusations by hedge funds holding derivatives tied to defaults on such loans, who had bet that defaults would take place.

Conclusion

The crisis in state-provided pension benefits has meant that an increasing share of citizens' retirement savings is being placed in hedge funds. The original rationale for not regulating hedge funds (their availability only to a limited number of investors) is no longer in place. Stronger regulation of hedge funds in the interest of fulfilling social security obligations is long overdue. Otherwise, hedge funds will have simply become vehicles by which social security obligations can be easily circumvented. ■

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