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A Balancing Act: Privacy, Regulation, and Innovation in Hedge Funds

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*Selected definitions and terminology available in Appendix at the end of the chapter.

Introduction

In a world where individuals and institutions try to diversify away systematic risk, collective investment schemes provide a way to hedge risks and to share the costs of doing so with others. Hedge funds are unregulated, private and exclusive collective investment schemes. Hedge funds are only available to 'accredited investors,' meaning individuals with a net worth in excess of one million dollars or a previous and expected future salary in excess of $200,000 per year. Thus, investing in hedge funds has traditionally been limited to the wealthy. Currently, the assets that hedge funds hold under management are estimated to be well over one trillion dollars (Labaton). A few major components separate hedge funds from other types of collective investment pools such as mutual funds, pension funds and insurance companies. First, limitations on participants and minimum investments work to ensure hedge funds are not available to the general public. Second, most other collective investment vehicles are highly regulated by limiting which types of securities they can hold (i.e. only technology stocks or bonds). Regulated investment firms also face strict borrowing and leveraging restrictions. Additionally, registered investment companies, like mutual funds, are prohibited from charging performance or incentive fees, a component of hedge funds that magnifies the lucrative returns these funds are associated with.

Because hedge funds are not registered with the Securities and Exchange Commission (SEC) or the National Association of Securities Dealers (NASD), hedge funds cannot be regulated by these agencies. Only the terms of the contract and the bankers who loan the money can regulate positions taken by the fund manager. Without regulation, and with performance incentives rewarding high risk, hedge fund managers have strong incentives to employ severe leverage as well as incredibly complex uses of derivative markets – and they are free to do so without

disclosing the positions they have taken (Labaton). This lack of hedge fund regulation has many implications. It creates the potential for hedge funds to make, and potentially lose, extravagant amounts of money. Without proper controls, this could have consequences that disrupt the larger, public, financial markets. Recently, major hedge fund collapses have lead to increased media attention and more scrutiny from governing bodies. Even so, hedge funds are still an accredited investment vehicle that, when managed correctly, have a proven history of offsetting risk and earning solid returns. With both harsh critics and vehement supporters, the future of hedge fund regulation is centered on a balance between efficiency and privacy, control and protection.

Research Methods

Few people have much experience or knowledge of hedge funds. In order to overcome this naïveté, several financial experts were interviewed. To gain a perspective of how those in the private investment sector view hedge funds, an interview was conducted with both a managing director and a senior associate in a prominent private equity fund. To achieve the academic aspect of the hedge fund industry, Finance professors David M. Gross, Ph.D., and Tom C. Nelson, Ph.D. at the University of Colorado - Boulder were interviewed. The objective of these interviews was to gather insights from people with different perspectives in order to maintain a balanced view on how hedge funds operate and what their impacts are. In an attempt to get an idea of how the ordinary consumer thinks about hedge funds, a survey was given to a group of 32 students at the University of Colorado. Due to the fact that students generally do not have a vast knowledge of the industry, we geared the questions towards finding out how much they knew, trusted, or cared about how a company manages their retirement fund. By combining research, interviews with experts and a survey pertaining to the ordinary consumer's perceptions of the issue, the paper will explore the future of regulation and innovation in the hedge fund world, as well as 'what it means to the ordinary consumer.'

Why Does Hedge Fund Regulation Matter?

> *"After observing lavish salaries hedge fund managers pay themselves, these funds are no more than a compensation package dressed as an industry."*
>
> *- Warren Buffet*

A common belief towards hedge funds is that 'people who are not actively involved in hedge funds are not affected by them.' Hedge funds are private, highly sophisticated investment tools that only wealthy, 'market savvy' investors are supposed to be involved in. This begs the natural question: Why does it matter if hedge funds are regulated or if the extremely wealthy lose a ton of money? Considering the number of financial problems that people deal with on a day-to-day basis, is there a reason to waste time being concerned with these obscure funds? In the past, one could easily argue that hedge funds have no effect on the average American. Hedge funds were hidden away from the public eye and very few people had stakes in them. However, with the innovation of the 'fund of funds,' access to hedge funds is not as restrictive as it used to be. Similar to mutual funds for single investors, a fund of funds is commonly setup by a group of investors who combine their money to invest in something that they otherwise would not have been able to. This means that investors without significant wealth can pool their money and be exposed to hedge funds. With the recent development of this 'fund of funds' concept, it is much easier for people without high net worth to invest in a hedge fund. For example, to reach the million dollar mark needed to invest in a hedge fund, only 20 people would need to pool $50,000 a piece in order to invest. $50,000 is a far more manageable amount of money than the original one million dollar requirement, and thus, potential investors encompass a far greater percentage of the population. The use of 'fund of funds' has progressed hedge funds from an entirely exclusive private investment mechanism along the spectrum towards the public.

As hedge funds become available to more people, a number of new concerns have cropped up. More people have become very concerned with their financial plan for retirement. With Social Security faltering and companies changing the structure in which their employees' retirements are funded, there is great concern over whether retirees will have enough saved to last for as long a period as necessary. Although the current trend is toward defined contribution retirement plans (where the employee manages their pension), there are still many employers that hire money managers to control and invest the funds of money the company has set aside for its retiring employees. These retirement plans, classified as defined benefit plans, require that the company manage its money to have a certain amount to pay out when employees retire. Money managers employed by companies with defined benefit plans may control exceptionally large pools of money. After many companies' pension funds took major hits in 2001, even those with diversified portfolios, the need for higher future returns to make up for these setbacks became pressing for many pension managers. Even competently managed pension funds invested in companies like Enron and WorldCom, whose collapse greatly hurt the pension funds invested in them. If a pension fund does not meet requirements to pay off the required pensions, the company must look

for taxpayers to bail them out or to cut retiree benefits (Steffy). Obviously, each of these moves is undesirable for the company and detrimental to the pension fund manager's career. One way to escape these suffering pension funds is to invest in hedge funds, where the possibility of high returns grant enough leeway to easily cover prior losses. Thus, falling markets and dropping pension funds, combined with ever-increasing numbers of retirees, meant that pension managers had strong incentives to take any action necessary to ensure sufficient funds once employees in these companies began retiring.

One example of this risky pension fund management can be found in the company 3M, a San Diego based company responsible for making such products as Scotch tape and Post-It notes. Facing a situation very similar to the one described in the prior paragraph, the pension fund manager at 3M decided to use hedge funds as a way to increase the performance of their pension fund. The professional fund manager invested a sizable amount of money into a hedge fund called Amaranth. When Amaranth lost most of the money invested in a matter of weeks, an already struggling pension fund suffered the loss of all that was invested in Amaranth. The employees at 3M took a huge hit in their retirement packages. The fund manager at 3M lost most of the $175 million dollars it had invested in Amaranth (Strasburg). Additionally, companies that Amaranth invested in, such as Toronto-based Counsel Corp., took huge hits in their own stock prices when positions were liquidated. As a component of many pension or benefits packages of companies, the stock price loss of 14% at Counsel Corp. would have been hugely detrimental to the employees (Strasburg). Just as the thousands of employees at Enron or WorldCom were affected by the poor decisions of their executives, so too can the average consumer be affected by the mismanagement of hedge funds.

Survey Results

One of the most direct impacts hedge funds can have on ordinary consumers is through pension funds. A survey was administered addressing these concerns most pertinent to this chapter. Asked if they currently trusted or would trust their pension plan to their employer, 52% of the respondents mentioned that they had not even considered it. 37.5% said that they would trust their employer. Interestingly, 91% of those questioned mentioned that the safety of their retirement plan was 'very important' to their career. Similarly, we asked if the students worried that some or most of their pension could be lost. Not surprisingly, most of the respondents mentioned that they either "didn't know it could happen," or "had not thought about it." Lastly, we asked if the students thought that a company should have to disclose risky pension investments to its employees. While 16% of the respondents mentioned that they do not care, 78% noted that they should, leaving just 6% of those questioned who think that taking risky positions without disclosure should be allowed. These trends give insight into how the younger generation feels about investing and its affect on their money.

Brief History

Hedge funds date back to 1949 when a Harvard graduate named Alfred Winslow Jones, a sociologist, tested a new investment strategy of buying stocks long while simultaneously selling similar stocks short (McWhinney). By having equally invested amounts in long and short positions, volatility in the market would be counteracted and have limited effect on portfolio value. By eliminating this market risk, Jones was able to narrow his risk to whether or not he had chosen the correct side of the straddle (i.e. long positions went up in value while short positions went down). Alfred Winslow Jones, known as the father of the hedge fund, "altered the structure of this investment vehicle, converting it from a general partnership to a limited partnership and adding a 20% incentive fee as compensation for the managing partner" (McWhinney). The two biggest innovations that came from Jones were his fee structure, as well as this new approach to managing and manipulating exposure to risk. With these new financial tactics that Jones developed, he was much better able to choose which risks he wanted to take, as well as those which he wished to neutralize.

In 1966, the media trumpeted hedge funds for substantially outperforming every mutual fund and their popularity skyrocketed. Within two years, there were about 140 hedge funds in operation. New strategies started to develop, spurred by these new players. Instead of always trying to hedge risk, strategies were developed in an effort to take on more risk. Because the return levels in some of these funds shot out the lights, this style started to become more prevalent. In the market downturn of the 1970's, this led to many fund closures. The industry was relatively quiet until a 1986 article told of an investment that was making consistently higher returns than any other. Alluring strategies kept advancing, and the hedge fund industry grew rapidly until the late 1990's/ early 2000's when the stock market was corrected and many high-profile funds failed (McWhinney). These events lead us to the current debate of hedge fund regulation and disclosure.

Secrecy and Privacy in the Hedge Fund World

Scarcity of regulation has great significance in the financial world. Hedge fund managers defend this privacy and secrecy they need by explaining that many of their strategies are highly proprietary and that performance and efficiency are compromised by public disclosure. Most observers understand this position, but still believe investors need a better way to judge their risk profile. With the recent massive growth of hedge funds, it is no wonder that many in the investment world are wondering if hedge funds may be overhyped and that a substantial sell-off is on the horizon. During an interview, Dr. Tom C. Nelson discussed the present state of the hedge fund industry. Dr. Nelson argues that when hedge funds are run correctly (to hedge risk), they are designed to foster lower but more stable returns. In opposition to their inherent nature of decreasing risk, hedge fund managers (like those at Amaranth) use a lack of regulation to take severely leveraged positions that are not 'hedged' at all (Nelson). The hope of these managers is to see huge returns and capitalize on performance fees. However, as evidenced by Amaranth's $6 billion loss, a lack of disclosure and regulation allows for irresponsible investing and the potential for major losses. Dr. Nelson concluded his interview by warning of a potential burst in the hedge fund bubble, a prediction that could have grave

ramifications. With the current size and growth of hedge funds, a collapse could, in fact, negatively pressure the entire capital market.

How Hedge Funds are Affected by Technology

In the past two decades, some significant technological advances have helped fuel financial innovation. The main catalyst behind many of these innovations is the computing revolution which broke its way into societal mainstream. This has caused the spread of information to be much cheaper and easier. It is now feasible to disseminate information to a much broader range of people instantaneously. Using the power of the Internet, anyone with a computer can access financial information, whereas 10 years ago only professionals (large brokerage houses) could acquire this information. Technology has also affected the speed of the financial world. Trades are now done the exact instant a mouse is clicked. Before the Internet connected the entire financial world, trades had to be done on trading floors where only brokers had access.

Hedge funds are on the forefront of financial technological innovation. Because of the complex trading strategies they pursue, as well as their creativity in managing risk, they are mandated to stay ahead of other investment firms. As the number of entities chasing the same returns increases, software and computing power that is capable of locating, processing and finding mispriced assets is a necessity for hedge fund success. As Dr. Nelson summarized, there were lots of opportunities to capitalize on mispricing when the hedge fund market was relatively small. However, with the massive explosion of the market in the last decade, the ability to capture value is becoming far more difficult and requires extremely sophisticated methodology. Additionally, he explained that, as little as five years ago, hedge funds were adept at capturing inefficient niches in the market and exploiting them. This added to market efficiency by correcting the previously incorrect market prices (Nelson).

What Kind of Regulation would be Affective?

> *"Although markets tend toward rational positions in the long run, markets can stay irrational longer than you can stay solvent."*
>
> *- John Maynard Keynes*

Hedge funds are organized to cater to a much different, higher wealth clientele who care deeply about their privacy and also have the means to lobby to keep their privacy intact. To get around this, attempts have been made to regulate the banks that supply the credit necessary for hedge funds to leverage their positions heavily. Regulators are trying to require the disclosure of risks by the bank and its clients. This involves giving up a level of privacy they have enjoyed until now. Also, by requiring the use of risk controls that force hedge funds to sell assets when their bets experience falling prices, regulators are trying to enact downside protection. These regulations are at the forefront of controversy as they are being introduced in international legislation, through the Basel Capital Accord, or Basel II. During an interview, the Managing Director at a private equity firm explained that one of the main modern, as well as future, movements in finance is the

consolidation of regulations internationally by moving to introduce international accounting standards (Private Equity). Avinash D. Persaud, the London-based Managing Director of Global Research for Boston's State Street Bank, is a critic of Basel II. Persaud believes attempting to supervise hedge funds through their lenders could backfire. He agrees some disclosure is essential, but that too much can be dangerous. This could be harmful when a hedge fund needs to sell assets quickly. When this occurs, and this information becomes known to other owners of the same asset, they will try to sell first, driving prices down further (Coy). Such illiquidity is one of the many factors that kept LTCM from remaining afloat when its bets turned sour. Persaud believes disclosure would be less damaging if positions were disclosed only once a month or so, and stated, "Disclosure… must not be a religion" (Coy). Dr. Nelson believes that disclosure is not much of a problem. He believes that these funds already know what positions their competitors are in, so compelling them to disclose publicly would have very little affect on trading styles. These opposing views by sophisticated members of the financial community expose the fundamental disagreements on how hedge funds should operate and how much privacy they should have. Some of the most intelligent individuals in the financial world admit they don't really understand the intricacies of how hedge funds operate. Due to this fundamental ignorance regarding hedge funds, even the regulatory bodies such as the SEC and New York Federal Reserve Bank stated that they don't have the knowledge or experience necessary to effectively regulate hedge funds (Private Equity).

Persaud thinks 'value-at-risk' systems are more damaging. They automatically force funds to sell assets when too much of a funds asset base is at a risk of loss. This strategy could work if one fund engaged in it, but when everyone uses this autopilot form of risk management, the consequences can be undesirable. When a large sell-off occurs, prices go way below their true economic value (Coy). The Asian financial crisis of 1997 is an example of a market downturn that was intensified by these value-at-risk philosophies. One essential reason value-at-risk doesn't always work is that hedge funds actively try to take contrary positions. Many hedge funds take positions inverse to other players in the market, such as buying when everyone else is selling. Hedge funds cannot carry out this opposing strategy if banks shrink loan levels right when they are most needed. The result of this value-at-risk system is that it leads to banks over-lending when the market is rising and overly drastic measures when values become depressed. Although infinite in complexity, these issues all boil down to a main point. Hedge funds may have a riskier probability of causing economic damage, but as is the first rule of medicine, the important thing is making sure the cure is not worse than the disease.

Regulating Hedge Funds in a New Economy

Regulatory bodies are having an exceedingly difficult time trying to regulate hedge funds since they are designed to operate with strong levels of privacy and highly innovative financial strategies. This dilemma is one that the newly appointed President and CEO of the Federal Reserve Bank of New York, Timothy Geithner, has been dealing

extensively with since coming to the Federal Reserve in 2003. During a speech in Hong Kong, Mr. Geithner remarked:

> The fundamental challenge for policy is how to achieve the appropriate balance between efficiency and financial resilience… Some vulnerability to crisis is a necessary and unavoidable feature of a dynamic and efficient financial system where asset prices need to be able to adjust to changes in fundamentals. The consequences of trying to induce regulated financial institutions to self-assure against all conceivable potential risks would do substantial damage to the level and efficiency of economic activity and cause the same risks to migrate to other institutions (Geithner 2).

When technology and privacy become entangled, there is always debate about what better serves society's interests. In many cases, increased regulation on technology means additional privacy for those involved. This is the opposite case with hedge funds. Additional regulation means hedge funds would have less privacy in carrying out their investment strategies without the world learning of their unique investment methods.

Geithner went on to discuss how innovation in trading technology and hedge funds has affected how financial markets should be regulated. He stated: "Among the most notable of these changes has been the rapid growth and innovation in derivatives and the greater relative importance of private leverages financial institutions such as hedge funds" (Geithner 2). Because hedge funds have such low levels of regulation and have come under recent media scrutiny, regulatory agencies and central banks are trying to come up with ways in which they can effectively reduce risks these funds pose. Although hedge funds still only control a small percentage of assets under management, their relative share has recently increased significantly and their potential impact on financial market conditions is magnified by their ability to take on substantial leverage and risk.

One of the problems with these new regulations is the unintentional consequences. Regulators certainly have honorable intentions in trying to stabilize the markets, but some believe the effect could be the opposite. Many critics argue that these risk management systems are not as infallible as they appear on the surface. It is suggested that when the market is put under pressure, these regulatory systems will not provide much protection to investors. Along with the untested nature of new regulation comes the idea of regulation inefficiency. In an interview conducted with the Managing Director of a well-respected private equity firm, he warned against the inefficiencies that overregulation can create. He pointed out that Hong Kong has extremely low financial regulation, yet one of the highest growth rates in the world. While this is attributable to many factors, the point that overregulation creates inefficiencies does not fall on deaf ears. The United States is one of the least financially regulated sophisticated markets; and for a long time, the U.S. has experienced higher growth rates economically than most countries in similar situations (Private Equity).

Arguments countering the libertarian idea of unregulated free markets are made by many experts in finance. Dr. Gross points out that while arguments for less regulation always reference the inefficiencies

regulations can create. Perhaps, it is really the short versus the long-term effects that matter more. Dr. Gross agrees that regulation inevitably creates inefficiency. In a social sense, paying police officers to protect our streets against crime can be considered inefficient. Police cost resources that could otherwise be allocated to a more productive means for the economy. Large corporations paying one of the Big Four accounting firms to audit all of their financial statements uses money that could otherwise be distributed to the shareholders. Does this mean police stations should be shut down? Can we trust corporations to report accurately without oversight? Some forms of inefficiency can actually be efficient in the long run by serving the function of offering a necessary form of protection (Gross).

Financial markets can be looked at in the same light. Confidence is one of the main reasons capitalism has been such a successful system of equity distribution. In the United States, people trust that effective property rights ensure their property will not be seized by the government without probable cause. Conversely, a lack of protected property rights is at the root of many underdeveloped nations' inability to grow and expand their economies. Finance in the U.S. is no different. Protection and regulation allow for U.S. citizens to feel safe when investing their money. If this sentiment was not widespread, people would be hesitant to invest their money in such markets, thus making the free market economy inefficient and growth limited. Regulation acts to both prevent and punish fraud ensures investor confidence. Average investors are free to invest their money wherever their risk tolerance allows (Gross).

Concluding Remarks

With more time to do primary research, it would be crucial to examine how people closer to retirement viewed their pension. Doing so would give a better idea of sentiments by those currently working towards their retirement, and how safe they believe their money is. We would also like to observe and interview hedge fund managers directly to obtain a better grasp of how those directly involved in the industry feel.

In conclusion, technology has changed the financial world drastically over the past few decades. When interviewees were asked about technology, the first thing out of their mouth was that the Internet has changed absolutely everything in finance. Amidst this technological backdrop, hedge funds have been forced to create innovation as well as learn the ramifications of its use. While major collapses have earned a large portion of the media attention, proper hedge fund management remains a successful and reliable trading strategy. Additionally, although huge performance fees have created some misaligned incentives for managers, it still remains that hedge funds are one of the most efficient forms of investing and can actually work to correct market inefficiencies. Moreover, while regulation serves to protect, the privacy and lack of disclosure hedge funds enjoy is part of what has made them so successful in the past. Considering the risks inherent in hedge funds, it is advisable to do careful research before investing in such a fund. Similarly, those who cannot or do not invest in hedge funds should be equally cautious and observant of the safety of their pension. The key to the future is balancing how privacy, technology,

regulation and efficiency interact in the hedge fund industry. A successful combination of regulation and privacy towards hedge funds will result in controlled risk as well as a more efficient and stable economy.

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Appendix/Definitions

The below definitions are simple explanations of some of the financial vocabulary used in our chapter. Including these definitions allow people who are not well-versed in financial vocabulary to understand the ideas and concepts behind this paper.

Hedge: Using an investment to reduce or cancel out the risk in another investment.
Leverage: Money borrowed in order to increase the potential return of an investment.
Market risk: Also known as systematic risk, it is risk inherent to the entire market.
Long position: Owning an asset (expectation for price appreciation).

Short Position: Borrowing an asset along with a contract to sell it in the future.
Risk-adjusted return: A measure of how much risk a fund takes on to earn its returns.
Liquidity: The ability to transfer an asset to cash.