Hedge Fund Regulation

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The debate over hedge fund regulation suffers from several shortcomings. One is that the opponents to regulating such private investment companies have stuck steadfastly to a short list of polished communications 'talking points'. While such sound-bites may be good for improving public relations, they often do not provide legitimate content for an informed public debate. This policy brief evaluates these talking points.

"Hedge funds are beneficial because they disperse risk in financial markets"

It is indeed important to avoid concentrations of risk and to diversify risks, but it is neither the case that hedge funds are needed for this type of risk management nor that they in fact significantly contribute to such ends.

Even the premise of the argument needs further investigation. Most risks in the financial system are not that 'lumpy' or concentrated, and are instead already dispersed across a wide array of investors. Stocks and bonds are sufficiently granular that their ownership is spread across millions of individuals and institutions. In the case of loans, risk shifting often involves aggregating – not disaggregating – risks through various types of securitization. Securitized loans, mortgages and other assets are sold to a wide variety of investors. The risks on very large loans are often dispersed through syndication. Securities exchanges as well as derivatives exchanges have provided liquid markets for risk shifting for a long time. Hedge funds have not been necessary for these activities.

According to the data, there are only two areas of risk dispersion where hedge funds play a major role. One is credit derivatives and the other is distressed debt.

Hedge funds should not be necessary for the credit derivatives market. There is enough interest in credit risk shifting amongst banks, other regulated financial institutions and institutional investors to support the market. The above institutions originate or hold the vast majority of credit risk and have the greatest incentive for risk shifting. They also have the greatest knowledge of credit risks and have the greatest potential to gain from diversifying across such risks. If the credit derivatives market cannot thrive upon the business amongst these firms, and if it cannot exist without participation by speculating hedge funds, then it implies these markets are not really generating the economic benefits they are claiming.

Aside from whether they are necessary, there are indications that hedge funds are harmful for and disruptive to credit derivatives markets. One example is that hedge funds are at the center of an SEC investigation into the use of credit default swaps to trade on insider information about corporate mergers. Another is the inefficiency with which they confirm and clear their trades.

An additional question about hedge funds' role in this market is whether it is an improvement to financial stability that these unregulated, highly leveraged investment companies without formal credit ratings are being used to off-load credit risk from our core regulated financial institutions – namely the major banks and securities firms. How can it be sound to buy credit protection on AA or A rated debt from a counterparty that is B rated or less? But that is precisely what the major banks are doing by buying credit protection from hedge funds. Even if it does amount to dispersion of risk, it is not being conducted in a manner that makes markets more safe and sound.

In regards to distressed debt, the problem here is that some hedge funds are using their position as creditors to obtain non-public information about firms, and then turning around and trading on that inside information. In other cases, 'vulture' hedge funds buy distressed debt and sue for immediate repayment so as to prevent rescheduling or allow rescheduling only after other creditors and the debt have paid off the hedge fund in full.

"Hedge funds are beneficial because they add to market liquidity."

Trading volume, by some definition, is liquidity, and hedge funds are said to provide somewhere between 25% and 50% of the trading volume on the New York and London stock exchanges. So, in this regard, the statement is true in and of itself. However, the economic meaning of the claim needs more careful evaluation.

However, markets such as the NYSE are, and for a long time have been, very liquid. These markets are so liquid that they are saturated – they cannot get more liquid. There is not much, if any, economic benefit from additional trading volume. Whether there are actual benefits depends upon whether there is actually any narrowing of bid-ask spreads or increases in market depth.

Another needed qualification is that speculative trading volume may all be in one direction. Consider the speculation behind the massive run up in energy prices in 2006. Ask consumers and industrial users of energy about the benefits of this speculative trading. Also, such liquidity often dries up when it is needed most – during periods of market disruptions and crises.

"Banks and other regulated financial institutions will discipline hedge funds through their role as prime-brokers."

Banks and securities firms are, of course, concerned with their credit exposures to hedge funds from loans and derivatives transactions. The problem is that they cannot reasonably track all that the hedge funds are doing. This is especially true of hedge funds operating complex and multifaceted investment strategies. In such cases, it is simply not economical for prime-brokers to stay on top of all their customers' positions and trading.

In addition, there are serious conflicts of interest. Banks and securities firms earn a lot of commissions, fees and trading profits from their business with hedge funds. Restricting their customers' activities will undermine the incentives to expand this lucrative source of income.

In addition to conflicts of interest, there are incidents of banks actively colluding with hedge funds to engage in illegal and potentially destabilizing transactions. Bank of America conspired with Canary Capital hedge fund to trade equity derivatives as part of a scheme to rip-off mutual funds managed by Bank of America. Deutsche Bank worked with hedge funds to manipulate a public securities offering in France. If banks are in fact colluding with hedge funds, then it is dangerous to depend upon them to indirectly supervise hedge funds.

"The failure of Amaranth proves the system works because it did not lead to a systemic crisis."

This is the same talking point used after Enron's collapse. It assumes a high threshold for what constitutes a systemic event, and it serves to dismiss the seriousness of other financial disruptions. Some examples are:

- A freeze or cessation – although temporary – of trading in interest rate swaps and fixed income securities following the failure of Long Term Capital Management (LTCM).
- The collapse of trading in OTC energy derivatives markets following the failure of Enron.
- A near systemic meltdown in the credit derivatives market following the downgrading of GM and Ford in May 2005.
- The defrauding of mutual fund investors through late trading and market timing.
- Market price distortions from insider trading or market manipulation.

The claim implicitly assumes that there are no other costs or public interest concerns other than systemic crisis, and that market-wide events, such as those listed above, are not systemic crises. It wrongly implies that the numerous disruptions and distortions are not indications of serious structural weaknesses in the current market and regulatory structure that could someday give rise to an undisputedly large systemic crisis.

"Caveat emptor*: Investors should protect themselves through their own diligence."*

This claim diverts the focus of concern over hedge funds, i.e. about protecting the many people whose livelihoods depend upon the safe, sound and efficient functioning of financial markets, rather than about protecting those who invest in hedge funds. When the trading activities of hedge funds disrupt or distort financial markets, it imposes costs on everyone through its impact on the overall economy. Investors in hedge funds cannot be expected to reliably police such actions – especially if they might privately benefit from it. It is the integrity of the market place -- and not specific individual investors -- that needs protecting.

Conclusion

In summary, these claims do not advance policy discussion or regulatory policy formation. Instead, they are a disservice. We need a well informed debate to ascertain the most appropriate financial policy – one that will accommodate what benefits hedge funds actually provide, while curtailing the harm brought by the rapid rise of this new investment vehicle. Like architecture, the design of public policy should heed the dictum that form should follow function. If hedge funds are important to markets and the economy, then their place in the regulatory framework should be important. If they are not proving capable of effective self-governance, then a legally enforceable regulatory framework is needed. If they play critical roles in credit markets, then they need appropriate regulatory standards for capital and the use of collateral. If they are taking large positions in securities and derivatives markets, then they should be subject to large trader reporting requirements to enable proper market surveillance.

The Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24) was established in 1971. Its main objective is to concert the position of developing countries on monetary and development finance issues. This first issue of the G-24 Policy Brief was written by Randall Dodd, the founder and director for Financial Policy Forum in Washington D.C., a non-profit organization that deals with regulation of financial markets.