



Hedge Funds: What Scares Regulators and What Can We Do About it?

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Regulatory Exposure

- Systemic risk
- Fraud
- Misvaluation of assets
- Misallocation of capital
- HF Activism/Voting power in excess of CF rights

APEC Financial Regulators'
Training Initiative - Beijing, March
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Systemic Risk

“Systemic risk describes the likelihood of the collapse of a financial system, such as a general stock market crash or a joint breakdown of the banking system. As such, it is a type of "aggregate risk" as opposed to "idiosyncratic risk", which is specific to individual stocks or banks.”

- *Wikipedia*

“Systemic risk is commonly used to describe the possibility of a series of correlated defaults among financial institutions---typically banks---that occur over a short period of time, often caused by a single major event.”

- *Chan, Getmansky, Haas and Lo*

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Systemic Risk (2)

- What kinds of investments increase intermediary or bank default risk?
 - Large bets
 - Leveraged bets
 - Correlated bets
 - Non-transparent bets

Systemic Risk (3)

- What kinds of actions increase intermediary or bank default risk?
 - Mass selling of similar illiquid assets
 - Mass purchase of similar assets
- Key Concepts
 - Flight to quality or "Phase locking"
 - Is there HF "contagion"?
- Why was Amaranth different than LTCM (wrt systemic risk)?

Systemic Risk (4)

- Measuring strategy risk
 - HF follow dynamic strategies
 - HF follow “tail strategies”
- Measuring counterparty risk
 - What info can counterparties demand and verify?
 - What can regulators verify about counterparty risk management?

Key Regulatory Issues

- What is the regulator's responsibility in limiting systemic risk?
- How can systemic risk be measured?
- Is it sufficient to place responsibility on registered counter party?

Fraud

- Lying about performance
- Improperly attracting additional assets
 - Single period game - Outright theft?
 - Multi-period game - Ponzi scheme?
- Improperly increasing managerial compensation
- Improperly hiding increases to leverage (and by extension, counter-party risk)

Key Regulatory Issues

- Creating reliable disclosures to (potential) investors
 - Are protections based on fraud protection or direct regulatory authority?
 - Reliable fair valuation methods
 - Reliable disclosures of performance (for investors or the market generally)?
- What are the requirements for establishing and maintaining internal controls?
- What's the legal standard for proving fraud?

Misvaluation/Misallocation

- How does it arise?
 - When investments are non-transparent and leverage is non-transparent...
 - ...Investors may not fully understand the risk of the investment
 - What's the outcome?
 - True risk of the investment is not reflected in price (mis-valuation)
 - Investor's portfolios may be inappropriate with respect to desired risk (misallocation)
 - What's the implication for counter-parties?

Key Regulatory Issues

- Sufficient disclosure
 - To regulators
 - To potential and actual investors
 - To counter-parties
 - To the market generally

HF Activism

- Concern:
 - HF's can exert pressure on operating companies to make decisions that are not beneficial to other shareholders
 - HF's interests are "short term" only and can lead the company to pass up value enhancing projects

HF Activism (2)

- Think of activism as a potential hedge fund strategy
 - Identify companies who's values are depressed by bad decision-making with respect to:
 - Capital structure
 - Business strategy
 - Sale of the company
 - Governance
 - Invest, apply pressure, divest

HF Activism (3) – Potential harms

- If the HF amasses significant control
 - Self dealing
 - Greenmail
 - Asset sales
 - Disposition of cash
 - Special dividends
- But these problems are not unique to HF's
 - Relate to the protection of minority shareholder rights

Voting Power in Excess of CF Rights

- Allows the HF to exert voting control disproportional to ownership
- Can be potentially created via stock borrowing (see Black and HU)
- May lead to similar harms as previous case

Voting Power (2)

- Similar in economics to effects of pyramidal ownership, cross-holdings often seen in East Asian countries
- With a potentially important difference
 - Extent of additional voting rights are not publicly known
 - May have broad pricing implications

Key Regulatory Issues

- Do HF's have to publicly disclose intent when ownership threshold is crossed?
- Are minority shareholder rights protected? How?
- What is the regulatory infrastructure for one share-one vote?
- Should voting with borrowed shares have to be disclosed?

Summary

- Identifying four types of regulatory risk
- Common components:
 - Potential harm is motivated by non-transparency and conflicts of interest
 - Problems may be partially mitigated by disclosure
- Key regulatory issues:
 - Disclosure to whom?
 - What are the right disclosures?
 - What is the proper form of internal controls?
 - What is the proper threshold for proving harm (civil or criminal)?