—— FINANCIAL POLICY FORUM ——
DERIVATIVES STUDY CENTER
www.financialpolicy.org 1333 H Street, NW, 3rd Floor
rdodd@financialpolicy.org Washington, D.C. 20005

SPECIAL POLICY BRIEF 29

ON THE HEDGE FUND QUESTION:
A PROGRAM OF RECKLESS COMPLACENCY

Randall Dodd
Director, Financial Policy Forum
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Even a short trip to Berlin allows a visitor to take a subway through Rosa Luxemburg Platz, take a bus down Karl Liebknecht Strasse, from there have a view down Karl Marx Allee and end up at the monument to the revolution of March 18, 1848 which stands before the Brandenburg Gate. Berlin is apparently is a city that can honor its intellectual and political past. This all brings to mind the famous phrase, written shortly before the March revolution, that a spectre is haunting Europe. Today there is a spectre haunting financial markets, but instead of a mass organization it is a pack of elite high yield investment companies known as hedge funds.

The brief journey through Berlin was but a preface that lead to a conference on financial stability organized by the German Ministry for Economic Cooperation and Development. The event brought together a variety of people, and its location on the top floor of the Ministry looked immediately down on the Max Gropius Building and the former headquarters of Goering's Luftwaffe which now serve as the Ministry of Finance (the modern marvel of Renzo Piano and Kohlbecker's Potsdamer Platz is in the near distance.)

One presentation at this event on the issue or hedge fund regulation lead to this Special Policy Brief. It was remarkable not for its content, but rather the context which consisted of weeks and weeks in which a new hedge fund failure, or new scandal or some recent legal development linked to a past failure or scandal populated the major newspapers and other media. There is indeed more than one way to interpret these events and what they mean for financial stability, but the one that astonished many participants at the conference was a presentation by a senior official from the Bank of International Settlements that sounded the call for complacency. The presenter claimed that everything was in fact in good shape, that the recent troubles were in fact proof that the system was sound and capable of "digesting" these failures, and that the real challenge ahead was to avoid establishing any new regulatory measures. Moreover, any future difficulty would best be dealt with through dialogue and voluntary changes in conduct.

These remarks were even more striking since they occurred during the same week that the German government announced that hedge fund regulation would be put on the agenda at the next G8 meeting in June 2007, and US Senator Charles Grassley (Chair of the Senate Finance Committee) sent a letter to all US financial regulators seeking information about reporting requirements, if any, of hedge funds.

Moreover, the BIS official did not specifically address the number of recent events, including the $6.6 billion loss by a single hedge fund[1] and revelations that another hedge fund had hired a trader after being fired by Citigroup for fraud.[2] Instead, he chose to make the following points.

- Warned against any attempt to introduce new regulatory measures, and that it would be better instead to create dialogues with private financial institutions in order to create voluntary remedies.
- Recent failures did not threaten systemic failures in the world economy and that instead they served to prove that the system worked.
- Hedge funds should be appreciated because they add to market liquidity.
- Hedge funds are also helpful because they take contrarian bets on the market.
- Regulated financial institutions such as banks and broker-dealers which acted as the primer brokers to hedge funds were doing a good job of overseeing leverage and risk taking at hedge funds.
- And the standard exit strategy of a statement saying that perhaps things could change in the future and that these unforeseeable developments might require revisiting the issue, and that after all no one knows how to regulate these things anyway.

None of this is new, and even the closing qualification of his prior statement is right out of the Greenspan playbook. While there is some truth to each of these points, there is a larger truth and more significant economic concern that these points attempt to evade. Taken at their face value, these six points might best be called the six steps to reckless complacency.

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[1] In September alone, Amaranth, one time worth $10 billion, is reported to have lost $6.6 billion on energy derivatives positions (and MotherRock, a $400 million hedge fund, collapsed after similar losses on energy derivatives). Vega hedge fund recently lost 75% of its $13 billion in fixed income trading and other areas.

[2] International Herald Tribune (from Bloomberg), by Jenny Strasburg, "Trader's Past Raises Concerns Over Hedge Funds," October 16, 2006.

While it is tempting to ignore these arguments because they do not really change anyone's mind and mostly serve to get other complacent free market fundamentalists to wag their heads, it is more responsible to drive the ol' wooden stake through these restless, reappearing notions so that they might finally rest in peace.

VOLUNTARY MEASURES

Private dialogues with major market players and voluntary compliance are poor governance procedures. Regulators should be public institutions with open door policies, with media scrutiny and with parliamentary or executive branch oversight. A council of financial lords to work out their differences is a throwback to the feudal methods of the ancient regime which for Germany ended – though not completely – in 1848. Moreover, voluntarism just does not make good sense given the recidivism with which financial market participants commit fraud and manipulation – again, recent news includes reports from French regulators that Deutsche Bank and GLG hedge fund conspired to use non-public, i.e. "insider," information to profit from a public security offering.[3]

Moreover, these hedge funds are too diffused and too dispersed to get them into a room for such as dialogue. The dialogue would likely focus on the major money center banks and maybe a few of the largest hedge funds. Even if they work out a voluntary agreement there would not likely be "buy-in" and compliance by the 10,000 other hedge funds.

Most importantly, these are important problems that need regulatory measures that are legally enforceable. Financial market are important, and increasingly more so, for both developed and developing economies. Stamping out fraud, and detecting and deterring manipulation are paramount. In order to do so, policy makers should heed the lessons of the New Deal era legislation and write statutes that strictly prohibit such conduct by making it a criminal offense and enabling injured parties to sue for damages.

While there are certainly some issues or problems that can be addressed through voluntary measures, the fundament prudential regulatory issues of registration requirements, reporting requirements, capital or collateral requirements (which govern leverage and risk) are too important not to be codified.

Poor governance producing bad policy is not an acceptable policy recommendation from a global financial regulator such as the BIS, it is just reckless complacency.

FAILURES PROVE THE SYSTEM WORKS

This is the same talking point used by ISDA, the NFA and other Wall Street lobbyists as they swarmed Capitol Hill after Enron's collapse in their successful attempt to stem any effort to regulate energy derivatives markets.[4] Was the nuclear accident at Three Mile

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[3] Financial Times, October 18, 2006, reported results of an investigation regarding manipulation in issuance of convertible bonds by Alcatel back in December 2002.

[4] ISDA is the International Swaps and Derivatives Association which represents the dealers in major OTC derivatives markets, and the NFA is the Managed Futures Association which represents hedge funds (which

Island not a serious failure because the lights did not go out? Did Katrina prove that the nation can withstand a hurricane and 'digest' a natural disaster? This rhetoric begs the question, what level of failure or calamity would ever constitute proof that there was a systemic problem?

The hedge fund failures and trading scandals are in fact generating the following economic costs. These might not constitute systemic crises, but they indicate vulnerabilities in the financial system even if they have yet to rise to the level of a systemic collapse.

- A freeze or cessation – although temporary – of trading in fixed income securities following the failure of Long Term Capital Management.
- Collapse of trading in OTC energy derivatives markets following the failure of Enron and other energy merchant firms.
- Near systemic meltdown in the credit derivatives market following downgrading of GM and Ford in May 2005.[5]
- Systemic vulnerabilities caused by the severe backlog in the confirmation of credit derivatives trades which has yet to be solved (though it has been reduced) through dialogue and voluntary compliance under the guidance of the New York Fed.
- Defrauding of investors by hedge fund managers who made grossly incompetent investments or flat out embezzled investor funds.
- Defrauding of mutual fund investors by hedge funds acting in concert with mutual fund investment managers.[6]
- Market distortions from insider trading by hedge funds.[7]
- Market price distortions caused by hedge funds shorting securities and then paying research firms to produce and distribute negative reports on firm.
- Market price distortions from buying proxy votes to confirm or reject mergers in which hedge fund hold positions.

These points are cited in order to support the following analysis of the statement of complacency. To restate this claim, failures which do not result in systemic failures or crises prove that the current regulatory arrangement is working successfully. The flaws with this statement are: 1) that there are no other costs or public interest concerns other than systemic crisis; 2) there is an implicit assumption that what constitutes a systemic crisis is indeed a very major event (i.e. Enron's failure is not systemic even though trading of OTC energy derivatives was disrupted for years);[8] and that the numerous non-systemic failures do not indicate that there are serious structural weaknesses in the current market and regulatory structure which can someday result in a systemic crisis of major proportion.

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are sometimes regulated by the US Commodity Futures Trading Commission as commodity pool operators).

5 See Special Policy Brief 26 on "Rumors and News." (www.financialpolicy.org/dscbriefs.htm)

6 See Brooke Masters' recent book about Eliot Spitzer, *Spoiling For A Fight*, for an excellent account of this type of fraud.

7 See recent New York Times (October 17, 2006) reports by Jenny Anderson and editorial on hedge fund using information from their lending activities to generate inside information for their securities trading.

8 Based on media reports of market trading volume, trading did not return to previous levels until Wall Street firms were able to replace former energy merchant companies as market makers.

ADDED LIQUIDITY

Speculation is most often justified on the basis that the speculative trading adds to liquidity. Trading volume, by some definitions, is liquidity, and hedge funds are said to provide somewhere between 25% to 50% of 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 statement needs more careful evaluation.

One needed qualification involves the economic benefit of the additional trading volume. Markets such as the NYSE are, and for a long time have been, very liquid. One might say that the markets are so liquid that they saturated – they cannot get more liquid and so there is not much, if any, economic benefit from additional trading volume. In such cases, the additional trading volume of hedge funds needs to be weighed in light of whether there is any actual economic benefit arising from actually narrower bid-ask spreads and greater market depth. Trading volume is an indicator, but it is not proof.

Another needed qualification is that speculative trading volume may all be in one direction. This adds less benefit to the bid-ask spread and may not result in better price discovery. Recent evidence suggests that speculation was behind the massive accumulation of long positions in energy commodities that resulted in excessively high prices before their even sharper collapse (crude fell 25% from its peak and natural gas fell 74%). Ask consumers and manufacturers of energy intensive goods and services about the benefits of this speculative trading.

Perhaps the strongest case for the benefits of added liquidity can be made for trading in some less liquid OTC markets for securities and derivatives. The OTC market in credit derivatives is often cited as a case in point where hedge funds play a critical role in market liquidity. Indeed it is likely the case that market depth and bid-ask spreads are improved by the participation of hedge funds. While benefiting liquidity, there are other concerns.

One concern is best expressed by the question of why are the major derivatives dealers not capable of otherwise making a more efficient market? Why are the likes of J.P. Morgan so dependent upon hedge funds to create market liquidity? If a $17 trillion market proves to be insufficiently liquid, the solution needs to involve the dealers and not focus on adding marginally creditworthy speculators.

Another concern involves the practice of major money center financial institutions buying credit protection from highly leveraged hedge funds. Isn't this like buying car insurance from a guy selling out of the truck of his car in a parking lot, or buying homeowners insurance from a guy standing on the corner? The sellers of insurance should have a higher prudential standing than the risks and circumstances they are underwriting. Why buy insurance on AA debt from a counterparty with a BBB rating?

Aside from these pricing questions, another concern arises form these major financial institutions, which are governed by prudential regulatory measures such as risk-adjusted capital requirements, moving their credit risk into hedge funds which are governed neither by capital requirements nor other prudential regulatory measures. This process appears to be eroding the ratio of risk-taking to capital in the financial system.

Qualifications such as these must be considered before agreeing with the oft repeated justification for otherwise economically unproductive speculative activity. In the absence of answers to these critical qualifications, the public and policy makers should be skeptical of these claims. If in politics patriotism is the last refuge of scoundrels, in financial policy liquidity is often the first refuge of scoundrels.

HEDGE FUNDS AS CONTRARIANS

Hedge funds, and speculators in general, do in fact often pursue contrarian investment strategies. After all, it is profitable to buy when prices are low and sell when prices are high – although not necessarily in that order – and thus put upwards pressure on prices when they are down and assets are undervalued, and downwards pressure on prices when prices are high and assets are overvalued.

But hedge funds and speculators do not always do this. Amaranth was evidently very long when prices were already very high. No contrarian thinking there. Long Term Capital Management was contrarian by shorting spreads on forward interest rates when they were too large. In this case they were contrarian, but it was not stabilizing.

Other hedge fund investment strategies such as arbitrage or pursuing profits from the carry trade lack this contrarian quality. Arbitrage may serve a useful economic role, but it is not contrarian. Other investment strategies such as organizing bear raids on troubled companies seems more like self-fulfilling, rather than contrarian, investment strategies.

BANKS WILL OVERSEE HEDGE FUNDS TO PROTECT THE PUBLIC INTEREST

This is one of the hardest points to say with a straight face, but the BIS official managed it without any sign of effort. Banks are of course concerned with their credit exposures to hedge funds from loans and derivatives transactions. The issue is not whether they care about losses on credit exposures, they certainly do. The issue is not whether they try to manage this risk exposure, they do. The problem is that they cannot reasonably be expected to be able to track all that the hedge funds are doing. Some hedge funds are not complex, their investment strategies are straightforward and involve only liquid securities or traditional financial activities such as distress lending, and these hedge funds can be economically monitored. Other hedge funds are complex and multifaceted and it is simply not economical for prime brokers to stay on top of all the activities that such hedge funds are doing.

Moreover, there are serious conflicts of interest. Banks earn a lot of commissions and fees and trading profits from transactions with their hedge fund clients. Constraining these hedge fund activities runs against the expansion of this lucrative income source.

In addition to the above conflict of interest, an additional concern is worth identifying. The apparent incidence of banks actively colluding with hedge funds to engage in illegal and hence potentially destabilizing transactions. Two examples, one more egregious than the next, involve Bank of America and Deutsche Bank. Bank of America conspired with Canary Capital hedge fund through a series of equity derivatives to rip-off investors in a set of mutual funds, called Nations Funds, managed by Bank of America. Deutsche Bank worked with one or more hedge funds, as mentioned above, to capture unwarranted profits surround a public securities offering. If banks are in fact colluding with hedge funds to commit fraud on the market, then it is a dangerous regulatory policy to indirectly depend upon banks to supervise hedge funds. Yet that is precisely what the BIS representative was recommending.

EXIT STRATEGY

Greenspan made such an art of this ruse that other public regulatory officials are copying it. The trick is to follow reckless policy advice built upon unsound reasoning with a little qualifier that will serve as an exit if the regulator finds themselves hung out on a fat tail of unfortunate events. It functions as an infuriating conclusion to an aggravating presentation.

The captains of complacency might well think themselves bold for telling a group of people concerned with financial stability that things are in fact just fine, thus implying that these concerns come from a bunch of nervous nellies. If someone is going to stand in the face of overwhelming common sense and say, in effect, "all is well so do nothing," then they should have the courage of their convictions and not keep a mouse hole open.

CONCLUSION

The justification for appropriate prudential regulation should not be dependent upon the frequent occurrence of deep and destructive systemic crises. Such events would more appropriately serve as the justification for revolution. The case for prudential regulation is premised on preventing crises, as well as a host of other disruptions, manipulations and fraud because they end up harming a great number of people who were not party to the investment decisions and were not going to share in the profits had they occurred. The case for complacency is weak, and the advocacy of complacency can be just as reckless as fear mongering is shameless. These captains of complacency should heed to lessons of the March 18th revolution which ended with King Friedrich Wilhelm IV conceding to the revolutionaries' demands for a constitution and with the King having to bow his head to honor the bodies of the fallen revolutionaries.