De Facto Regulation of Hedge Funds through the Financial Services Industry and Protection against Systemic Risk Posed by Hedge Funds—Part III

By Isaac Lustgarten

With no leverage over hedge funds, financial services regulators are expecting and requiring banks and broker-dealers to strengthen their own risk management infrastructure to deal with hedge funds. So, the costs of developing an infrastructure is borne by financial services firms directly, not by the hedge fund industry. The regulators expect that each kind of activity that a financial firm conducts with a hedge fund requires the implementation of specific measures, including:

- Establishment of effective internal communication as to (1) classes of activities that are subject to the review process, (2) involvement of independent control personnel, (3) reasonable expectations concerning the performance of operational and related infrastructure to support new products and (4) the ability to curtail activities (if necessary);
- Requirements that hedge fund transaction review processes have the following minimum features: (1) effective internal communication of classes of activity that are subject to review, (2) involvement of independent control personnel, (3) adequate training of sales and related personnel, and (4) appropriate review of documentation;
- Dedication of a fully independent group of professionals who are fully responsible for all aspects of model verification, including final approval of all changes in model design and specification;
- Provision to their primary supervisors of timely quantitative and qualitative risk-related information on a regular basis and being prepared to provide such information on an ad hoc basis when necessary;
- Incorporation into their public disclosures of descriptions of the roles the firm plays (market maker, transaction structurer, distributor, investor), discussions of how complex products are addressed in the firm's risk management framework, etc.;
- Greater attention to the full range of exposures the firm faces in the variety of relationships that it has with hedge funds, especially by paying attention to the conflicts of interest, legal and reputational risks that can arise—hedge fund activities should be integrated into the firm's broader compliance program;
- Improvement in the overall discipline of the firm's stress-testing regime, which may not necessarily provide an effective measure of vulnerability to loss under more severe market conditions:
  - Stress-test results must be used by banks to inform their judgments on the scale of exposure that they are willing to take to individual hedge funds or groups of funds;
  - Banks need to consider assessments of their stress-level exposures to hedge funds in tandem with stress tests of their own market risks to inform an overall judgment on the extent of capital market trading-related risks that the bank is taking on, especially in relation to unlikely but high-impact events;
- Understanding funds' valuation policies and procedures, including pricing sources, methodology for evaluating multiple "official" settlement prices, determination of liquidity and the frequency of valuation;
- Conducting due diligence on the market, credit, sovereign, operational and liquidity risks presented both by a hedge fund's entire portfolio and by the portfolio's subcomponents (by strategy, asset class, type of institution, geographic region or industry sector); and
- Reviewing hedge fund managers' tests of market risk models.

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Financial Firms' Documentation of the Right to Access Counterparty Information to Improve Transparency, Measurement, Management and Reporting

A crucial method for financial firms to understand hedge funds' operations, strategies and positions is to document their arrangements with funds to ensure access to important fund information. For example, a typical International Swaps & Derivatives Association (ISDA) form would require hedge funds to provide monthly net asset performance reports to the credit department of the financial institution. A financial firm's documentation should assure that the firm:

- Obtain entity-level portfolio and other data from hedge fund counterparties on a private and confidential basis to assess credit quality;
- Periodically review the risk metrics, stress-test methodologies, behavioral characteristics of models and other analytics used by the risk managers of their hedge fund counterparties in assessing the funds' overall risk profile;
- Assess both the quality of the funds' processes and systems and details of the associated market scenarios;
- Obtain disclosure from hedge fund counterparties of contingencies that may have a material impact on the funds' credit quality (*e.g.*, increases in collateral requirements due to rating triggers); and
- Develop and refine internal policies and procedures to manage sensitive data and endeavor to address confidentiality issues.

The documentation should also:

- Establish time frames for completing the negotiation of master agreements and prioritize the negotiation of unsigned master agreements;
- Develop a process to identify agreements in need of updating;
- Inform senior management and the financial firms' primary regulator about progress being made in reducing confirmation backlogs;
- Decide and coordinate across the relevant master agreements methods for closing out transactions;
- Encourage the broad use of netting as a mechanism to reduce settlement risk, including cross-affiliate netting if there is a well-founded basis for believing that it is legally enforceable; and
- Provide for appropriate collateral where advisable

Among other things, the goal of this documentation process is to:

- Harmonize and centralize counterparty risk assessment;
- Encourage hedge funds to adopt strong corporate governance;
- Focus attention on the credit, legal, operational and concentration/liquidity risks to which credit derivative transactions may intentionally or unintentionally give rise; and
- Control risks relating to assignments.

CPRMG II recommended that the following specific problem areas, and suggested solutions, deserve close attention by senior management of prime brokers:

- Failure to maintain a barrier between confidential customer information and the firm's proprietary trading desks (can be avoided by physically and electronically separating operations and using personnel exclusively dedicated to prime brokerage);[1]
- Offering overly generous credit enhancement or credit limits in consideration of receiving brokerage commissions or dealer spreads (can be avoided by giving senior credit officer ultimate authority);
- Placing excessive reliance on a particular hedge fund or family of hedge funds that, if there is a downturn, may expose the firm to credit and settlement risk (can be avoided by directing marketing to a broad client base);
- Failure to obtain sufficient ongoing information about the hedge fund's projected investment strategies and performance in order to anticipate the need for additional collateralization (can be avoided by scheduling periodic due diligence visits and calls); and
- Having a false sense of security that models governing the timing of margin calls, including VaR, stress-testing and back-testing, will provide sufficient notice to take protective action in all scenarios (it is prudent to be conscious of the possibility).[2]

In addition to these oversight issues, as a practical matter prime brokers should pay close attention to

specific areas that, if they are overlooked, can cause day-to-day operations to rapidly melt down:

- Failure to monitor and track collateral whose hypothecation or rehypothecation is not permitted under the terms of the customer's agreement (can be avoided by requiring sign-off of collateral management group before agreement can be executed);
- Failure to continuously reconfirm with a customer the volumes and types of transactions in which the customer plans to engage, as well as the jurisdictions and currencies in which trading will occur (again, can be avoided by periodic due diligence visits and calls);
- Failure to maintain surveillance of electronic trading systems to ensure they are not being used improperly and not having a contingency plan in place to deal with technical failures or market disruptions (can be avoided by subjecting each system to regular testing and using techniques such as site key verification); and
- Failure to know the customer and confirm authority of key personnel, including the investment manager, to execute transactions (can be avoided by requiring customer to submit evidence of authority, such as offering document, resolutions or partnership agreement and updates of same).

Risk Measurement Techniques for Financial Firms as Counterparties to Hedge Funds: Aggregation of Information

The challenge for financial firms that are hedge fund counterparties is to obtain accurate and complete information about their hedge fund customer as well as the risk positions of the industry as a whole. Federal Reserve Chairman Bernanke has emphasized the need for aggregate-masked information about hedge fund positions for use by counterparties:

> Effective market discipline requires that counterparties and creditors obtain sufficient information to reliably assess clients' risk profiles and that they have systems to monitor and limit exposures to levels commensurate with each client's riskiness and creditworthiness. Placing the onus on market participants to provide discipline makes good economic sense; private agents generally have strong incentives to monitor counterparties as well as the best access to the information needed to do so effectively
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> Despite this progress, some concerns about counterparty risk management remain and may have become even more pronounced given the increasing complexity of financial products. I will note four of these concerns. First, hedge funds are profitable customers for dealers, and our supervisors are concerned that competition for hedge fund business has eroded initial margin levels. Second, given the increasing volume of complex transactions with hedge funds, we are also concerned whether counterparty exposures in such complex transactions are being measured accurately. Supervisors are monitoring banks with these issues in mind. Third, our supervisors are concerned that more extensive stress-testing should be done. Although stress-testing of exposures at the level of the individual hedge fund counterparty is becoming more common, still-wider application of this technique would be useful. Similarly, aggregate stress tests—by which a dealer evaluates its exposure to the hedge-fund sector in the event of a large market move—merit wider use. Aggregate stress tests are a desirable complement to stress tests of individual hedge fund counterparties because funds sometimes imitate each others' strategies or choose strategies that are affected by common market factors. Supervisors are encouraging the expanded use of stress-testing when it is appropriate. Fourth, supervisors are concerned that the assessment of counterparty risks should be better tied to the amount of transparency offered by hedge funds. In particular, good risk management should link the availability and the terms of credit granted to a hedge fund to the fund's willingness to provide information on its strategies and risk profile. Our supervisors are pushing banks to clearly link transparency with credit terms and conditions.[3]

Market discipline has allowed the development of risk measurement and management techniques that enable financial services firms, who have delegated responsibility to monitor hedge fund counterparties, to measure their risk exposure to individual hedge funds or a group of funds. Our objectives are to understand what information hedge funds should disclose to their

counterparties in a disclosed and undisclosed format: (1) obtaining aggregate risk position information about one fund or across the hedge fund industry is difficult as a result of the existing legal requirements and contractual agreements and (2) the difficulty of creating a complete and accurate data source. The 2007 Financial Stability Forum Report notes: "Supervisors report that dealer firms' direct current and potential credit exposures to hedge funds are modest in relation to their capital. However, their indirect exposures, such as via wider market liquidity erosion, are difficult to gauge. Moreover, the diversity of methodologies and measures of risk used by counterparties and the challenges firms face in aggregating exposures to a single counterparty across all the business lines of the firm present further problems for supervisors in monitoring consolidated exposures within a firm and comparing them across firms." The 2007 FSF Report recommends recognizing "the inherent limitations of summary data in capturing the complex counterparty exposures of major dealer firms to hedge funds. Nevertheless, it would be useful to review what information is provided currently and consider whether the collection by supervisors of systemic and consistent information on major dealer firms' global consolidated exposures to hedge funds would complement supervisory efforts aimed at strengthening counterparty risk management practices (including in the areas of exposure measurement and aggregation). It could be useful for supervisors to discuss with the private sector what information ought to be considered."

Federal Reserve Chairman Bernanke has addressed proposals for creating a database of hedge fund positions. He generally views such proposals positively, but is concerned that a prescriptive regulatory regime supporting or requiring an aggregation method would lead to systemic risk:

> Concerns about hedge fund opacity and possible liquidity risk have motivated a range of proposals for regulatory authorities to create and maintain a database of hedge fund positions. Such a database, it is argued, would allow authorities to monitor this possible source of systemic risk and to address the buildup of risk as it occurs. Various alternatives that have been discussed include a database maintained by regulators on a confidential basis, a system in which hedge funds submit position information to an authority that aggregates that information and reveals it to the market, and a public database with non-confidential information on hedge funds
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> I understand the concerns that motivate these proposals but, at this point, remain skeptical about their utility in practice. To measure liquidity risks accurately, the authorities would need data from all major financial market participants, not just hedge funds. As a practical matter, could the authorities collect such an enormous quantity of highly sensitive information in sufficient detail and with sufficient frequency (daily, at least) to be effectively informed about liquidity risk in particular market segments? How would the authorities use the information? Would they have the authority to direct hedge funds or other large financial institutions to reduce positions? If several funds had similar positions, how would authorities avoid giving a competitive advantage to one fund over another in using the information from the database? Perhaps most important, would counterparties relax their vigilance if they thought the authorities were monitoring and constraining hedge funds' risk taking? A risk of any prescriptive regulatory regime is that, by creating moral hazard in the marketplace, it leaves the system less rather than more stable.[4]

There are two market solutions to Bernanke's suggestion for greater transparency of hedge fund positions.

RiskMetrics Group has formulated a service called HedgePlatform, whereby each fund participating provides RiskMetrics Group, on a monthly basis, its underlying positions. Bear Stearns reportedly has a similar product. Many of those funds use the services of RiskMetrics themselves for their own internal use; this is independent of whether they use Hedge Platform for investor reporting (even positions among funds are aggregated and masked). A fund participates because investors in or counterparties to the fund (including investors in hedge funds, fund of funds, endowments, pension funds, etc.) have made it a condition to investment. RiskMetrics Group aggregates the positions, analyzes them for internal information purposes, and compiles the information in a statistical format (which masks the underlying positions on a monthly basis) available to investors in a fund. The investor or

counterparty is given the information, broken down fund by fund and in the aggregate by each of its funds. RiskMetrics Group acquires information about these positions by working with hedge funds themselves, administrators and/or prime brokers, with the hedge fund's permission depending on the hedge fund's determination of which entity has the best information. The function of compiling these statistics resembles the sharing of information financial services firms may do with each other and the government regarding leveraged capital adequacy or credit exposure.

Functioning like a clearinghouse of information, the HedgePlatform service provides to hedge fund counterparties and investors a number of different risk measures that allow hedge fund investors and counterparties to monitor their risk across different funds in different investment strategies. Thus, the risks within the fund are transparent to the investor/counterparty, but not the individual position.

RiskMetrics Group performs the analyses and produces the reports utilizing position data on a monthly basis from all of the hedge funds on the platform.

Reporting of Investments Made by Hedge Funds

Annex I is a partial list of various filings required by the US securities and banking laws that might apply to hedge funds and the companies that control them on a consolidated basis.[5] These regulations were not meant to focus solely on hedge funds, but they are required if the thresholds are met. Although hedge fund managers tend to say that their strategies are private, these filings are required and occur after the fact. Most of the filings therefore yield no information that is useful for systemic risk purposes. Indeed, most of these filings are for the protection of investors (especially the public filings), and are unhelpful in gauging systemic risk because the information becomes quickly out of date and irrelevant.

Regulation of Other Financial Services Companies

As a point of comparison, other financial services companies, mutual funds, advisors, broker-dealer banks and insurance companies are regulated. Some financial services companies, like banks, have a partial government guarantee to their creditors. Some financial services companies are licensed, like leasing or lending companies, and can be huge, but if not part of a larger financial services company, go largely unsupervised, especially for a federal regulator. Most companies are "regulated" (including commercial or industrial companies) for investor protection purposes through (1) antifraud statues of various kinds (including the securities laws), (2) lawsuits, and (3) in the case of financial services companies (like broker-dealers, asset managers, mutual funds and banks) through explicit rules on capital, conduct of business, reports, filings, etc. Generally, only banks are regulated for systemic risk and protection of the banking system. Although, increasingly, the SEC is looking at the large securities firms is the same way. Except for litigation, none of these forms of regulation applies to hedge funds. Annex II contains a brief description of how other financial service companies are regulated. The most obvious protection against systemic risk is that many (not all) types of financial services companies have capital adequacy requirements of some sort.[6] Although hedge fund activities (especially the trading activities) may resemble those of banks, broker-dealers, mutual funds, finance companies, etc., it is unrealistic to require capital (whether related to risk positions, customer relationships, etc.), because a hedge fund would move offshore and, given the global economy, raise funds from non-US investors, or US investors transacting outside the United States. Indeed, now with the proliferation of hedge fund-linked notes, an investor can assume hedge fund risk without transacting directly with a fund. Thus, the only way to capture hedge fund activities for a snapshot is through their bank and investment bank counterparties, and even such a snapshot would be incomplete because a fund may engage in transactions with other non-regulated counterparties.

Assessing the Costs of Regulating and Supervising Hedge Funds

The current mantra among regulators is that regulated entities need to engage in risk-based assessments to determine which areas of their business operations pose the greatest risks and to take remedial actions. There are, of course, complaints that, despite the regulators' emphasis on prioritization of remedial action based on risk, government examiners take the approach that all risks are equal and require remediation. Such complaints are loudest and most frequent when the government has delegated the regulatory/supervision function to the private sector. Financial institutions argue that by

delegating the supervision over activities (as described previously) to financial firms, the regulators have spared themselves the cost of regulation and are essentially taxing the financial community and ultimately taxing investors or customers of those financial firms. More importantly, however, regulators arguably do not focus on the cost-benefit analysis when the regulatory function is delegated to financial firms because the regulators do not bear the costs. Finally, there is a conflict of interest in forcing financial firms regulating hedge funds who are financial firms' biggest customers and increasingly their biggest competitors. Unless objective aggregated data of position risk is compiled, to which the regulators should ultimately have access, risks can arise. For example, in the implosion of the Amaranth fund, the investment strategy and limits and internal controls were exceeded over a short time period. Yet the investor fund of funds and counterparty, which supposedly performed their own due diligence, did not note the problem.

Litigation and Regulatory Investigation as a Form of Regulation

In our capitalist system, regulation has partly been delegated to litigation. The following is a brief list of recent controversies, litigation and regulatory investigations regarding hedge fund activities. Again, none of these will protect against systemic risk because the problems generally occur after the fact and are generally specific to a fund or a particular narrow practice among funds.

1. Recently, a federal bankruptcy judge ordered Bear Stearns to pay $160 million to investors in a hedge fund (called Manhattan Investment Fund, which collapsed in 2000 from selling short Internet stocks in the belief that their prices would fall lower than they actually did) for failing to monitor the activities of the fund which transferred $141 million to the fund's Bear Stearns account to meet increased margin requirements so that it could continue to sell stocks short. The fund allegedly falsified statements and paid early investors with the money of later investors. The court concluded that Bear Stearns knew (from its own risk management reports and its increased margin calls) about the losses and the intent of the fund to disclose fraudulently a 20 percent profit. Most significantly for this paper, the court found that Bear Stearns (which questioned the hedge fund manager about the losses) should have verified on its own the manager's explanation that Bear Stearns did not have a complete picture of the fund's investment activities since it was one of eight or nine brokerage firms. On one hand, the case increases the burden of the prime brokerage firm to police the activities of hedge fund clients, without having a clear fiduciary duty or contractual duty to the fund's investors.
2. Another prime brokerage service that has drawn attention, in this case the attention of the SEC, is capital introduction.[7] Prime brokers sponsor investor conferences or arrange individual meetings and prepare information documents to bring together hedge fund managers with potential investors. Although the major prime broker firms are careful to disclose their relationship with the funds and pre-qualify the potential investors, the SEC is looking into these services and the way they are disclosed to investors.
3. The US Senate Judiciary Committee, in June 2006, initiated an investigation into links between funds and independent analysts.
4. Regulators are scrutinizing banks leasing space to hedge funds. According to the *New York Times* of June 2, 2007, the Massachusetts Secretary of State has subpoenaed UBS and perhaps others on the fees charged by the banks to lease office space to hedge funds to see whether hedge funds are paying higher than normal trading fees to banks to compensate them for office space and failing to disclose this expense to investors—soft-dollar-like payments benefiting the manager and not the investor.
5. There are also charges that banks are providing hedge funds with material non-public information so that the fund will reward the bank with prime brokerage business.
6. In France, the Autorité des Marchés Financières (AMF) penalized a hedge fund and Deutsche Bank for the funds acting on information offered by Deutsche Bank before the bonds' issuance was publicly announced.[8]
7. Moreover, funds affiliated with larger financial institutions have conflicts. According to press reports,[9] a Goldman fund sought to acquire a company only months after Goldman's investment bank pitched unsuccessfully to defend the company against a takeover.
8. The SEC[10] has filed enforcement actions against hedge funds and brokerage firms which shared material, non-public information, allowing the fund

to partner in order to get more fees. According to press reports, mutual funds have been complaining about the practice.

9. The G-7 ministers[11] asked the Financial Stability Forum to update a 2000 report on hedge fund activity impact.
10. In March, 2007, authorities announced the breakup of Wall Street's largest insider trading ring schemes since the 1980s, in which a research executive at UBS AG and a Morgan Stanley attorney revealed nonpublic information about stock analysis and impending takeovers to a group of hedge fund managers and other Wall Street insiders, who allegedly profited over $15 million between 2001 and the fall of 2006 by trading on the insider information. At UBS, an executive in the research department's investment review committee would receive market moving analyses regarding stock performance and earnings forecasts and would feed that information to an accomplice, who would trade on both his own account and on that of his hedge fund employers, permitting coworkers access to the information to similarly trade for themselves, and ultimately netting profits for three hedge funds through this trading activity totaling several million dollars. Similarly, the information provided by the former Morgan Stanley attorney regarding impending acquisitions ended up in the hands of brokers, their friends and relatives, who traded on insider information regarding the takeovers of Argosy Gaming Co. and Pacificare Health Systems Inc., among others. To date, the SEC and federal prosecutors have filed charges against more than 13 people.

Notes

1. Speech by Annette L. Nazareth, Director of Market Regulation, US Securities and Exchange Commission, Remarks before the SIA Compliance and Legal Division Member Luncheon (July 19, 2005).
2. *See* Hedge Fund Roundtable, SEC File No. 05-007-03 (May 14, 2003).
3. Remarks by Chairman Ben S. Bernanke, Federal Reserve Board of Atlanta; 2006 Financial Markets Conference, Sea Island, Georgia, May 16, 2006.
4. Remarks by Chairman Ben Bernanke, Federal Reserve Board of Atlanta; 2006 Financial Markets Conference, Sea Island, Georgia, May 16, 2006.
5. The Annexes were not included in this three-part article. Please contact the author directly for access to the Annexes. This article does not examine the international perspective. But we refer the reader to the UK Companies Act, the UK Takeover Code, the Financial Services and Markets Act (FSMA), the UK Enterprise Act, and the EU Transparency Directive requiring an acquiror at various levels to disclose to the issuer and the FSA in a short time period.
6. The Basel Committee's *The New Basel Capital Accord*, issued in May, 2001, defined operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events," and outlined three means for banks to determine their operating risk capital, encouraging banks with greater operational risk to use more sophisticated means to measure their exposure and thereby afford themselves greater flexibility in determining capital charges. (Under the current Basel rules, banks hold a certain amount of capital in proportion to its risk-weight assets.) Under the "Basic Indicator Approach, of Basel II" recommended as available to all banks, an institution would simply hold capital in an amount equivalent to a fixed percentage of the sum of its net interest and net non-interest income. The more advanced "Standardised Approach" was intended for banks satisfying the *Committee's Operational Risk Sound Practices* guidelines, maintaining operational risk management and control processes and conducting regular internal audits, and having systems in place for accurately tracking operational risk by business line. Under this approach, the Committee recommended separating a bank's practices into business lines, multiplying an indicator approximating the operational risk in each business line by a capital factor appropriate for that line, and then summing the capital charges for each business line to reach an institutional total.

   Finally, the "Internal Measurement Approach," which was intended for the most sophisticated institutions, advocated dividing a bank's business into the lines used in the Standardised Approach; defining multiple categories of operational risk within each; assigning for each line/risk combination an indicator that approximated the relative size of each line's risk exposure in that area; calculating for each area both a probability of loss and the probable size of the loss in the event of one; and, finally, translating each expected loss into a capital charge and summing those capital charges across all business lines and risks. Banks intending to employ this final approach had to meet all standards expected of those using the Standardised Approach, and, among other requirements, had to have established use tests for verifying the accuracy of probability and size of loss data and integrate the data collection functions into daily operations, maintain internal loss policies and databases, maintain risk measurements methodologies permitting accurate calculation of the projected probability and size of loss data, and maintain and study these data collection and analysis tools over time.
7. Testimony Concerning Investor Protection Implications of Hedge Funds by William H. Donaldson, Chairman, US Securities and Exchange Commission, before the Senate Committee on Banking, Housing and Urban Affairs (April 10, 2003).
8. *WSJ.com*, Dec. 28, 2006.
9. *Wall St. J.*, Feb. 9, 2007, p. C1.
10. *Id.*, Feb. 7, 2007.
11. *NY Times*, February 11, 2006, p.21.