Corporate Governance and Hedge Fund Management

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Hedge Funds Not Like Restricted Access Closed End Mutual Funds

- Are governance issues best understood by contrasting them with more highly regulated investment vehicles?
- No in most cases
  - Emerging market and some global macro funds only major TASS categories cut from this mold
  - Fund of funds or multi-strategy hedge funds like less regulated 40 Act investment advisors
- Other hedge funds do not function like less restricted mutual funds or money managers

Relevant Peers Are Other Potential Organizational Forms

- Most hedge funds are organized as:
  - Limited partnerships
  - Groups within public companies that function in a manner similar to such partnerships
- $\Rightarrow$ other limited partnerships relevant peers
  - Obvious for private equity-like funds
  - Less obvious for convertible arbitrage, short and long/short equity strategies, fixed income arbitrage, short term event-driven trading, etc.
    - Obvious when viewed as proprietary traders

Road Map

- Sort hedge funds into two categories
  - Proprietary trading firms
  - Private equity
- Explore governance issues arising from these assets in other governance structures
  - Proprietary trading in other private partnerships and within the public company form
  - Alternative buyout and distressed debt investors
- Examine implications for the governance of hedge funds

Proprietary Trading in the Ancien Regime

- Proprietary trading in the good old days
  - Traditional private partnerships form for investment banks and broker/dealers
  - Natural outgrowth of the other business lines
    - i.e., broker/dealer and investment banking synergies
- Two main inputs:
  - Human capital with necessary skills
  - Access to financial capital (i.e., leverage)
- Managing human and financial capital main governance challenge in proprietary trading

Salomon Brothers in the Mid-1970s

- Daily inventory roughly $6.5 billion in 1976
  - Inventory used as collateral to obtain overnight broker's loans
    - Valued by Salomon and not by the lender
- Paid-in capital about $200 million
- Book value leverage was thirty to one
  - Leverage at market much less since book value understated market value
  - Other unsecured debt increased leverage
- General partners had unlimited liability

The Asset Side of the Balance Sheet: $V_A = V_L + C_M + C_U$

- Assets of proprietary trading desk (V_A)
  - Value of the long positions (VL)
  - Cash devoted to margin requirements (C_M)
  - Uncommitted cash (C_U)
- Assets typically quite illiquid
  - Losses required use of uncommitted cash, increased borrowing, sales of existing long positions, or covering existing short positions
  - Unobservable collateral value creates mark to market moral hazard in overnight broker’s loans
    - Collateralized loans might be optimal dealer contract

Human Capital Under the Partnership Form

- Personnel management like a university
  - General partners comprised the senior faculty
  - Limited partners like tenured associate profs
  - Remaining non-partner professionals played the role of junior faculty
    - “Up or out” decisions in four to seven years
    - Most of those denied tenure at the best Wall Street firms found good jobs at other investment houses, as is typically the case in academia as well
- Partnership structure naturally binds human capital to the firm

Compensation Structure under the Partnership Form

- Small base salary and potentially large annual performance-based bonus
  - Contentious process with much lobbying and occasional manipulation of trading books
- Not pure income for general and limited partners
  - 80% mandatory plowback for senior partners
    - Lower for limited partners
- Strong incentive for post tenure productivity
  - Partners asset rich and cash poor

The Economics of Proprietary Trading in Partnerships

- Human capital bound to firm by partnership structure and plowback provisions
- Shares valued at cost until retirement
- More productive partners received higher fractional ownership through bonus system
- $\Rightarrow$ Lenders treated broker/dealers like efficiently milked cash cows
  - Collateral higher valued by broker/dealer
- Main problem: high required return due to partners' idiosyncratic risk exposure

Proprietary Trading in Public Corporations

- Asset side of the balance sheet identical to private partnership case
  - $V_A = V_L + C_M + C_U$
  - Qualitatively different from typical public firms
- Proprietary trading in public firms different in private partnerships in two main ways
  - OCC falls since idiosyncratic risk is spread over a diversified shareholder base
  - Increased agency costs engendered by separation of ownership and control

Proprietary Trading in Public Firms and the Risk of Financial Distress

- Lack of transparency regarding profitability, risk exposure, liquidity, and leverage creates a monitoring problem
- Absence of explicit external monitoring is most problematic in bad states can generate
  - Much firm risk and risk of financial distress
  - Myopic focus on short term gain
  - Incentive to reallocate scarce capital from good but modestly profitable strategies to excessively risky strategies with high option value

The Economics of Proprietary Trading in Public Companies

- Proprietary trading skill is an almost tangible asset easily transferred across firms
  - Corporate analogues of full and limited partners relatively cash rich and firm-specific asset poor
  - Human capital of proprietary traders not tightly bound to public firms
- Shareholders implicitly look to franchise values and performance-based bonuses to provide appropriate incentives to managers
  - Works in some markets and not in others

Proprietary Trading under the Hedge Fund Form

- Common thread among hedge funds that function like proprietary trading desks
  - Liquidity provision in illiquid markets faced with unexpected non-value-related demands for immediacy that are not value-related
  - Market timing by taking positions before other momentum, contrarian, or event driven traders decide to make similar bets
- Same profit drivers: buying immediacy when it is cheap and selling it when it is dear

Asset Side of the Balance Sheet Remains $V_A = V_L + C_M + C_U$

- Capital and risk structures of all proprietary trading operations are essentially the same across organizational forms
- One simply cannot look at the books of a convertible arbitrage, short or long/short portfolio, fixed income arbitrage, managed futures portfolio, or short term event-driven strategy and tell its underlying governance structure

Can Proprietary Trading Function Well as 1940 Act Mutual Funds?

- Hard to see how
  - Strategies viewed as trade secrets
  - Extensive use of short sales, leverage, and illiquid assets
  - Dynamic trading strategies make snapshots less informative
- 1940 act regulations would probably push proprietary traders into:
  - Other organizational forms
  - Other regulatory jurisdictions

Changes in Legal Technology

- Personal liability in limited partnerships
  - General partners and limited partners with control responsibilities had unlimited personal liability under old structure
  - Partnerships now:
    - Create an LLC to serve as general partner
    - Make managing partners limited partners in LLC
- Weakens incentive and diversification effects relative to older organizational form

Limited Partners and External Oversight

- Limited partners in hedge funds are glorified creditors
- Senior and junior partners monitored each other and ran the firm under the old system
  - Mitigated moral hazard problems afflicting external creditors and internal equity holders
- Performance-based compensation alone is an imperfect substitute for explicit monitoring in the presence of moral hazard
  - Similar to problem in public companies

Hedge Fund Governance and the High Water Mark Contract

- Old performance-based compensation:
  - fraction of increased NAV over the evaluation period when returns are positive
- High water mark contract has different baseline
  - Highest NAV of fund on or before the beginning of the evaluation period
- Much stronger long run incentive
  - Downside risk counterbalances upside potential incentives in high water mark contracts

Hedge Fund Governance and Managerial Wealth Management

- Partners must invest bulk of wealth in the fund (or fund family)
- $\Rightarrow$ i.e., both income *and* wealth are performance-based
  - More powerful incentive than performance-based income alone
  - Further mitigation of risk-taking incentives from option-like payoff
  - Determininination of the optimal balance requires more detailed analysis, insight, and information

The Economics of Proprietary Trading in Hedge Funds

- Incentives are:
  - Far stronger than at public firms
  - Weaker than at older private partnerships
- Cost is bearing fund specific risk when wealth is closely related to fund payoffs
  - Limited partnerships have higher OCCs
  - Public companies have lower OCCs
- Counterbalancing effects of high water marks and internal wealth management
- Considerable rewards to reputation

Hedge Funds that Trade on Corporate Governance

- Some hedge funds work on asset side of the balance sheet often on governance issues
- Like private equity but with:
  - Shorter lockups
    - Asset illiquidity $\Rightarrow$ *De facto* longer than *de jure* lockups since general partner values assets
  - More liquid investments in intermediate term
    - Distressed debt
  - More efficient intervention in the market for corporate control via activist hedge funds
    - Targeted changes in governance, not LBOs

Summary and Conclusion

- Hedge fund governance issues should be contrasted with those of otherwise similar but differently organized entities
  - SEC registered funds not relevant comparables
- Hedge fund contract (probably) more efficient solution to moral hazard and monitoring problems in proprietary trading
- Private-equity-like hedge funds carve out shorter horizon or more liquid or easily valued niches from private equity universe

The Elements of the Computation of the Net Burden of Regulation

- What limits contractibility in proprietary trading and private-equity-like hedge funds?
  - Where is the market failure?
- What limits private supply of transparency?
  - *Ex ante* or *ex post*
- What disclosure requirements meet the negative net burden test?
- My analysis is merely the scaffolding for a more serious investigation of these issues
  - Asking these questions is the easy part