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Hedge Funds: History, Strategies and Regulation

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HEDGE FUNDS:
HISTORY, STRATEGIES AND RGULATION

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Definition

A hedge fund can be defined as an actively managed, pooled investment vehicle that is open to only a limited group of investors and whose performance is measured in absolute return units. Hedge funds can have a positive impact in terms of generating wealth, providing liquidity for the markets, and greasing the wheels of capitalism, but they can also have a negative impact when the culture of greed that drives the whole process goes into overdrive and neglects wider societal responsibilities in favour of profits.

History

The story of hedge funds, from their conceptual birth in the boom years of the 1920s through their emergence in the post-war years into their current status as the pre-eminent high-end investment vehicle. The investment craze of the 1920s saw millions of dollars poured into the markets, creating what we now refer to as a bubble, and when the overheated capital markets went into a tailspin in 1929, the results were catastrophic.

The big turning point in Alfred Jones' life occurred in 1948 when he was asked by his employers at Fortune magazine to write an article about current investment trends.

In 1952, he changed the structure of his investment vehicle from a general partnership to a limited partnership, and gave the managing partner a 20% cut of the profits from the fund as an added incentive. Alfred Jones launched a fund based on the concept of the long/short equities model, which he dubbed the 'hedged fund", used leverage – the idea of borrowing money at a lower interest rate than the anticipated rate of return from his investment strategy – to enhance the returns from the fund.
This made Jones the first money manager to combine the use of leverage, short selling, shared risk through a partnership with other investors, as well as a means of compensation based on investment performance. To a large extent, this investment model remains the template for hedge funds, and this is why Jones is so often credited as being the true hedge fund pioneer. This made Jones the first money manager to

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As is so often the case, it took time for the world to catch up with a truly innovative concept, and it was more than a decade before Alfred Jones' hedge(d) fund idea took off as a major investment vehicle. Again, Fortune magazine holds a place in the story.

During the boom years of the 1960s, the hedge fund industry underwent a period of frantic expansion, but the recession of 1969–70 and the 1973–1974 stock market crash put the kibosh on this growing trend, in the same way that previous and subsequent recessions had done to the investment industry in general.

Many fund suffered heavy losses during the bear markets of 1969-70 and 1973-74.

Having had their fingers burned badly by the market downturns of the late '60s/early '70s, hedge funds found themselves very much out of fashion among investors. However, in an echo of the original hedge fund boom, the tide turned in 1986 when an article in Institutional Investor shone the spotlight on the phenomenal double-digit success of Julian Robertson's Tiger Fund.

In 1980, Julian Robertson started the Tiger fund with $8 million in start-up capital. By the late '90s – the peak of this fund's performance – the fund was worth over $22 bilion, and in 1993 Robertson was estimated to have made $300 million personally from the fund. Robertson expressed the basic philosophy behind the fund as follows: *"our mandate is to find the 200 best companies in the world and invest in them, and find the 200 worst companies in the world and go short on them. If the 200 best don't do better than the 200 worst, you should probably be in another business*[1] *"*.

In 1990, there were approximately 300 hedge funds managing $39 billion in assets worldwide[2]. As of 2004, there were approximately 8000 to 9000 hedge funds managing $1 trillion[3] in assets worldwide, with current estimates reaching as high as $1.4 trillion[4].

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1 in MILNES P., *op. cit.*

2 DANIEL, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles,* COLUM. Bus. L., 2007.

3 TAYLOR, MACDONALD, *Hedge Funds Get Europe's Clippers,* WALL ST. J., May 23, 2006.

4 SHIVANI VORA, *Hedge-Fund Milestones,* WALL ST. J., Jan. 30, 2007.

As an industry, hedge funds have experienced an average growth rate of 20% since 1990[5]. In addition to providing investors with diverse financial instruments and investment strategies, one of the main reasons hedge funds have experienced such growth is the rate of returns they offer.

During the 2007–09 financial crisis, commercial banks, hedge funds, and investment banks suffered huge losses from investments that were exposed to housing markets. In fact, in 2008 the International Monetary Fund estimated that these types of institutions, along with insurance companies, had lost a combined $1.1 trillion[6].

Today

In their new incarnation, hedge funds employed a much bigger variety of strategies including derivatives and currency trading.

The bull market days of the early 1990s saw a huge outflow of top market talent from the mutual fund industry into the hedge fund industry, where they enjoyed far greater flexibility and remuneration.

Today, despite recent troubles, the hedge fund industry continues to flourish once more. Crucial to its success was the development of the 'fund of funds', essentially a hedge fund with a diversified portfolio of numerous underlying single-manager hedge funds.

The introduction of the fund of funds allowed for greater diversification, thereby taking some of the risk out of hedge funding, but also allowed minimum investment requirements of as low as $25,000. This greatly opened up the hedge fund investment option to a far greater number of average investors than ever before. Today's hedge funds look significantly different to their forerunners of the 1940s, and even the 1980s. A far greater variety of strategies is used by today's hedge funds, including many that do not involve traditional hedging techniques at all. While Albert Jones started the first hedge fund with just $100,000, in 2013 the global hedge fund industry recorded a record high of US$2.4 trillion in assets under management.

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[5] *Ibidem*

[6] INTERNATIONAL MONETARY FUND, *Global Financial Stability Report*, April 2008, avaible at http://www.imf.org.

LTCM

During the late 90s, the largest tremor through the hedge fund industry was the collapse of the hedge fund Long-Term Capital Management (LTCM).

LTCM was the premier quantitative-strategy hedge fund, and its managing partners came from the very top tier of Wall Street and academia. From 1995-1997, LTCM had an annual average return of 33.7% after fees. At the start of 1998, LTCM had $4.8 billion in capital and positions totalling $120 billion on its balance sheet.

LTCM largely (although not exclusively) used relative value strategies, involving global fixed income arbitrage and equity index futures arbitrage.

Size today of the Hedge Fund Industry

The explosive growth in hedge funds led to a market for professionally managed portfolios of hedge funds, commonly called "funds of funds." Funds of funds provide benefits that are similar to hedge funds, but with lower minimum investment levels, greater diversification, and an additional layer of professional management. In the context of funds of funds, diversification usually means investing across hedge funds using several different strategies, but may also mean investing across several funds using the same basic strategy. Since hedge funds are structured to avoid regulation, even disclosure of the existence of a hedge fund is not mandatory. There is no regulatory agency that maintains official hedge fund data. There are private firms that gather data that are voluntarily reported by the hedge funds themselves.

Over the decade, the number of mutual funds grew at 23% annualised and the capitalisation of the New York Stock Exchange grew at 17.5% annualised[7].

Features

Hedge funds are often mistaken to be very similar in risk to other types of investments, and although they are often measured through the same types of quantitative metrics,

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[7] FINANCIAL STABILITY FORUM, *op. cit.*

hedge funds have qualitative risks that make them unique to evaluate and analyze[8]. The most common risk measure used in both hedge fund and mutual fund evaluations is standard deviation. **Standard deviation** in this case is the level of volatility of returns measured in percentage terms, and usually provided on an annual basis. Standard deviation gives a good indication of the variability of annual returns and makes it easy to compare to other funds when combined with annual return data. Another measure that provides an additional dimension of risk is called value-at-risk (VaR). **VaR** measures the dollar-loss expectation that can occur with a 5% probability. maximum drawdown. **Maximum drawdown** measures the percentage drop in cumulative return from a previously reached high. This metric is good for identifying funds that preserve wealth by minimizing drawdowns throughout up/down cycles, and gives an analyst a good indication of the possible losses that this fund can experience at any given point in time.
Finally, **leverage** is a measure that often gets overlooked, yet is one of the main reasons why hedge funds incur huge losses. As leverage increases, any negative effect in returns gets magnified and worse, and causes the fund to sell assets at steep discounts to cover margin calls.

While most observers tend to agree that hedge funds have some systemic importance, there is little agreement on how large a role they play as transmitters of adverse financial shocks.

Structure

A hedge fund is an investment vehicle that is most often structured as an offshore corporation, limited partnership or limited liability company[9] managed by an investment manager in the form of an organization or company that is legally and financially distinct from the hedge fund and its portfolio of assets[10]. Hedge fund administrators are

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[8] See LO, *Risk Management for Hedge Funds: Introduction and Overview,* Financial Analysts Journal (CFA Institute), 2001, retrieved 29 March 2011; CASSAR, GERAKOS, *How Do Hedge Funds Manage Portfolio Risk?*, EFM Symposium. European Financial Management Association, retrieved 17 March 2011.

[9] LINS, LEMKE, HOENIG & RUBE, *Hedge Funds and Other Private Funds: Regulation and Compliance*, §1:1, 2014.

[10] STRACHMAN, *The Fundamentals of Hedge Fund Management*. Hoboken, New Jersey, Wiley, p. 47, 2012

responsible for operations, accounting, and valuation services. This back office support allows fund managers to concentrate on trades[11].

Fees

Hedge fund managers are compensated by two types of fees: a management fee, usually a percentage of the size of the fund (measured by AUM), and a performance-based incentive fee, similar to the 20% of profit that Alfred Winslow Jones collected on the very first hedge fund. The incentive fee is a crucial feature for the success of hedge funds. A pay-forprofits compensation causes the manager's aim to be absolute returns, not merely beating a benchmark. To achieve absolute returns regularly, the hedge fund manager must pursue investment strategies that generate returns regardless of market conditions; that is, strategies with low correlation to the market.

According to the Center for International Securities & Derivatives Markets (CISDM), there are twelve main hedge fund investment strategies described as follows:

1. **Equity Market Neutral** strategies take long equity positions and an approximately equal dollar- amount of offsetting short positions in order to achieve a net exposure as close to zero as possible;

2. **Convertible Arbitrage** strategies take long positions in convertible securities (usually convertible bonds) and try to hedge those positions by selling short the underlying common stock. Convertible bond arbitrage funds typically capitalize on the embedded option in these bonds by purchasing them and shorting the equities;

3. **Fixed Income** strategies attempt to take advantage of mispricing opportunities between different types of fixed income securities while neutralizing exposure to interest rate risk;

4. **Event-driven** strategies attempt to predict the outcome of corporate events and take the necessary position to make a profit. These trading managers invest in events like liquidations, spin-offs, industry consolidations, reorganizations, bankruptcies and so forth;

[11] LHABITANT, *ibidem*, p. 4-2.

5. **Merger/Risk Arbitrage** strategies concentrate on companies that are the subject of a merger, tender offer or exchange offer. Merger/Risk Arbitrage strategies take a long position in the acquired company and a short position in the acquiring company;
6. **Distressed** strategies take positions in the securities of companies where the security's price has been, or is expected to be affected by a distressed situation like announcement of reorganization due to financial or business difficulties;
7. **Equity Hedge** strategies take long and short equity positions varying from net long to net short, depending if the market is bullish or bearish. The short exposure can also be a put option on a stock index, which is used as a hedging technique for bear market conditions;
8. **Global/Macro** funds refer to funds that rely on macroeconomic analysis to take bets on major risk factors, such as currencies, interest rates, stock indices and commodities; Hedge funds utilizing a global macro investing strategy take sizable positions in share, bond or currency markets in anticipation of global macroeconomic events in order to generate a risk-adjusted return[12]. Global macro fund managers use macroeconomic ("big picture") analysis based on global market events and trends to identify opportunities for investment that would profit from anticipated price movements.

While global macro strategies have a large amount of flexibility due to their ability to use leverage to take large positions in diverse investments in multiple markets, the timing of the implementation of the strategies is important in order to generate attractive, risk-adjusted returns[13]. Global macro is often categorized as a directional investment strategy. Global macro strategies can be divided into discretionary and systematic approaches. Discretionary trading is carried out by investment managers who identify and select investments; systematic trading is based on mathematical models and executed by software with limited human involvement beyond the programming and updating of the software.

[12] COGGAN, *Guide to Hedge Funds* (2nd ed.) The Economist Newspaper Ltd, 2011
[13] BARTOLO, *Hedge Fund Strategies Guide*, Goizueta Business School, Emory University, 2011.

9. **Short Selling** strategies take short positions in U.S. equities with expectation of price declines;

10. **Sector Funds** concentrate on selective sectors of the economy. For example, they may focus on technology stocks if these are overpriced and rotate across to other sectors;

11. **Long-only Funds** are funds that take long equity positions typically with leverage. Emerging market funds that do not have short-selling opportunities also fall under this category;

12. **Fund of Funds** refer to funds that invests in a pool of hedge funds. This strategy gives everyday investors a chance to join the excitement of investing in hedge funds. They specialize in identifying fund managers with good performance and rely on their good industry relationships to gain entry into hedge funds with good track records.

The strategies listed above, though not complete, are the main ones. They have different names from manager to manager but all have similar investment strategies.

Due to their recent astronomical growth, hedge funds have attracted the attention of the media, investors, investment professionals, and government regulators, not only in the United States, but in Europe as well. In 1990, there were approximately 300 hedge funds managing $39 billion in assets worldwide[14]. As of 2004, there were approximately 8000 to 9000 hedge funds managing $1 trillion[15] in assets worldwide, with current estimates reaching as high as $1.4 trillion[16]. As an industry, hedge funds have experienced an average growth rate of 20% since 1990[17]. In addition to providing investors with diverse financial instruments and investment strategies, one of the main reasons hedge funds have experienced such growth is the rate of returns they offer

[14] DANIEL, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles,* COLUM. Bus. L., 2007.

[15] TAYLOR, MACDONALD, *Hedge Funds Get Europe's Clippers,* WALL ST. J., May 23, 2006.

[16] SHIVANI VORA, *Hedge-Fund Milestones,* WALL ST. J., Jan. 30, 2007.

[17] *Ibidem*

The United States' regulatory framework of hedge funds

The recent global financial crisis harbingered substantial changes in the regulatory environment of financial markets and institutions throughout the world. One of the first and foremost sweeping changes was the enactment of the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (hereinafter the Dodd-Frank Act) passed on July 21, 2010. Unless otherwise provided in the Act, it became effective one year after the date of its enactment. The enactment of this Act triggered massive regulatory reforms and resulted in a major overhaul of the regulatory environment of the U.S. financial markets.

Hedge Fund Regulation prior to the Dodd-Frank Act

At least four different approaches to the structure of financial regulation exist worldwide. These include the institutional, functional, integrated, and twin peaks approaches to financial regulation[18].

1. Public issuance and the trade of securities are regulated by the Securities and Exchange Commission (SEC).
2. Futures and commodities are regulated by the Commodity Futures Trading Commission (CFTC).
3. Banks are regulated by the Federal Reserve (Fed), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)[19].
4. Insurance industry is mostly regulated by state regulators.

Within the above regulatory framework, hedge funds' primary regulator is the SEC.

With the introduction of the Dodd-Frank Act, if hedge funds are designated as a Systemically Important Nonbank Financial Company (SINBFC), they may be regulated

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[18] The Group of Thirty, Working Group on Financial Supervision, *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace,* Washington, DC, 2008.

[19] The OTS is abolished/dismantled by the Dodd-Frank Act. Other institutions such as the FDIC can occasionally engage in the regulation of the banking industry in the U.S.

by the Fed[20]. Before the enactment of the Dodd-Frank Act, hedge funds were considered 'unregulated' financial entities. In other words, prior to the 2010 U.S. financial regulatory overhaul, hedge funds were -by design- exempt from most of the regulations which are normally applicable to investment companies. In the U.S. legal framework, hedge funds are negatively defined.
Hedge funds are studied in four main acts. These legislations include: the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934.

Dodd-Frank Act

The Dodd-Frank Act introduces registration and disclosure requirements by making changes to the Investment Advisers Act of 1940. In general, the effectiveness of the Dodd-Frank Act in achieving its objectives remains highly controversial. The effects of the newly introduced regulations in the U.S. on hedge fund industry also remain unclear.

In November 2010, the EU approved a law that will require all EU hedge fund managers to register with national regulatory authorities. The EU's Directive on Alternative Investment Fund Managers (AIFMD) was the first EU directive focused on hedge fund managers According to the EU, the aim of the directive is to provide greater monitoring and control of alternative investment funds[21].
The directive introduced a "passport" for hedge funds authorized in one EU country to operate throughout the EU.
The scope of AIFMD is broad and encompasses managers located within the EU as well as non-EU managers that market their funds to European investors[22]. An aspect of AIFMD which challenges established practices in the hedge funds sector is the potential

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[20] *See* HORTON, *When does a Non-Bank Financial Company Pose a "Systemic Risk"? A Proposal for Clarifying Dodd-Frank*, Journal of Corporation Law, 37, no. 4, 2012, P. 815-848.

[21] "Directive on Alternative Investment Managers ('AIFMD'): Frequently Asked Questions". European Union, 11 November 2010, retrieved 8 March 2008.

[22] CHAY, *ibidem*

restriction of remuneration through bonus deferrals and clawback provisions[23]. Under the EU's 2010 Alternative Investment Fund Managers directive, offshore hedge funds using prime brokers as depositories are required to use EU-registered credit institutions before they can be sold in the EU[24]. The AIFMD's regulatory requirements will essentially mandate equivalent regulations for non-EU investment funds, if they wish to operate in EU markets[25].

United Kingdom's experience

The approach taken by the Financial Services Authority (FSA), the regulatory body of financial markets in the United Kingdom, for regulating hedge funds is a principles-based approach. This approach contrasts with the SEC's rules-based approach. In its oversight of hedge funds, the FSA has focused on risks associated with market stability, investor protection barriers, and valuation standards[26]. The FSA emphasized that it will further study hedge funds' use of side-letters and will establish regulatory measures if needed.

Germany's experience

Germany's regulatory approach, which is characterized by substantial regulatory measures, is interesting because it is diametrically opposite to the United States' approach. While it appears that Germany's regulatory scheme has had some success, it is crucial to point out that Germany's share of the hedge fund market is relatively small, and thus the cost of regulation is lower than in other countries, such as the United States and the United Kingdom, which have relatively large shares of the hedge fund market.

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[23] BARKER, JONES, *EU hedge funds face pay threat - FT.com*, avaible at ft.com, 2012.

[24] "Offshores Could Struggle Under Directive, Says Collins' Meader", Investment Adviser. Financial Times Group, 8 March 2008.

[25] DRAWBAUGH, *op. cit.*.

[26] SCHMIDT, NOTE, *Investor Protection in Europe and the United States: Impacting the Future of Hedge Funds*, 25 WIS. INT'L L.J, 2007, p . 161-181.

Governance principles and framework

One of the underlying aims of the AIFMD is to require AIFMs to enhance their governance frameworks so that they are more accountable to regulators and investors.

The AIFMD seeks to improve overall transparency in the way AIFs are managed.

Investors and regulators will seek regular and clear evidence from AIFMs of good governance in action.

With the introduction of Level 2, the requirements focus on the need to create robust governance frameworks, as opposed to the imposition of a set of "one size fits all" prescriptive rules, which had initially been feared. A sound framework will allow different types of AIFMs and AIFs to manage risks and operations generally with regard to their own particular strategies, without unnecessary intervention from regulators. As far as possible, it appears that the AIFMD operational requirements have been aligned with existing provisions in the UCITS IV Directive (UCITS Directive) and the Markets in Financial Instruments Directive (MiFID).

The governing body of an AIFM refers to the component of the governance structure with ultimate jurisdiction and power of direction. In corporate structures this is usually the board of directors but in other structures it may be an equivalent body. The governing body is distinct from senior management, whom it directs, but some or all members of senior management may comprise the governing body. The governing body may also contain non-executive members. As such the board of directors and senior management of an AIFM will have a key role to play in meeting the governance requirements under AIFMD.

The AIFMD at both Directive level and Level 2 have one major governance "gap" which has been remarked on by industry commentators and which needs to be considered.

That gap is the lack of recognition of the roles of existing governance bodies at the fund level. The AIFMD fails to recognise that many funds and other entities which will be classified as AIFs under the AIFMD have governing bodies, whether boards, trustees, or partners, which have specific sets of responsibilities and fiduciary obligations. How these bodies will discharge their obligations given the pre-emptive assignment of responsibilities to AIFMs and some oversight responsibilities to depositaries remains to be seen.

Operating and organisational conditions

The AIFMD contains a broad set of general principles that the AIFM must comply with. Certain general principles apply to an AIFM both in relation to the way that its business is organised and controlled, and in relation to the way it conducts its business. Many of the principles will be familiar to firms already authorised. The conduct of business principles applicable to an AIFM are as follows:

- It must act honestly, fairly and with due skill, care and diligence in conducting its activities;
- It must act in the best interests of the AIF, or the investors in the AIF and the integrity of the market;
- It must employ effectively the resources and procedures that are necessary for the proper performance of its business activities;
- It must take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable disclose, those conflicts of interest;
- It must comply with all regulatory requirements applicable to the conduct of its business activities and;
- It must treat all AIF investors fairly.

These requirements will be familiar to those operating under the UCITS or MiFID regimes.

An AIFM is required to take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, prevent, manage and monitor and, where applicable, disclose those conflicts. This requirement is to prevent them from adversely affecting the interests of the AIF and the AIF's investors and to ensure that the AIFs it manages are fairly treated. In particular, the AIFM must take all reasonable steps to identify conflicts of interest between:

(i) The AIFM (including its staff, controllers and subsidiaries) and the AIF or AIF investors;

(ii) One AIF (or its investors) and a second AIF (or its investors);

(iii) One AIF (or its investors) and another client of the AIFM;

(iii) The AIF (or its investors) and any UCITS fund also managed by the AIFM (or the investors in the UCITS fund) and;

(iv) Any two clients of the AIFM.

The European Long-Term Investment Fund regulation

On 20 April 2015 the Council adopted a regulation aimed at increasing the pool of capital available for long-term investment in the EU economy by creating a new form of fund vehicle.

European long-term investment funds (ELTIFs), by virtue of the asset classes that they will be allowed to invest in, are expected to provide investors with long-term, stable returns. Regulation (EU) 2015/760 on European long-term investment funds (ELTIFs) (the Regulation) aims to increase the capital available for long-term investment in the EU economy through this new form of fund vehicle. It is targeted at investment fund managers who want to offer long-term investment opportunities to institutional and private investors across Europe using the AIFMD passport.

The Regulation was published in the Official Journal of the EU on 19 May 2015 and it will apply from 9 December 2015.

Conclusion

In some instances the general provisions introduced by AIFMD should have little material impact on the way that alternative managers carry out their business. In some cases it will be a case of formalising existing arrangements: in many areas the requirements being introduced are common sense, and should be followed by AIFMs anyway.

However, there are some areas that will cause damage to the existing alternative fund industry, with the new delegation rules being top of the list here. If AIFMs must maintain "a substantial part" of investment management functions in-house then many firms will be carefully considering their options of how to carry on doing business. Restructuring existing arrangements may be the answer here, though this may cause other problems, such as increased costs and taxes levied on a fund, reducing the returns that investors will receive.

Comparative analysis

Despite the fact that mandatory registration and regulation of hedge funds was struck down in Goldstein, such an approach would inevitably lead to hedge funds moving offshore or moving to other jurisdictions that are not as heavily regulated as the United States. For this reason, the German approach is not recommended, as it would threaten the United States' robust capital markets. The United Kingdom's approach does not require registration unless a hedge fund plans to solicit to the general public. The United States' approach is the same with respect to public solicitations. However, this is where the similarities between the two approaches end.

The United Kingdom's approach, which is principles-based, is characterized by a risk-based monitoring scheme. This approach is effective and is narrowly tailored since it identifies hedge funds that pose the highest levels of systemic risk, and in turn monitors them. This is a practical approach since it would be impractical and inefficient to monitor funds that do not pose a risk. Moreover, this approach is more costeffective than mandatory registration and regulation because resources are allocated based on the level of risk a fund poses. This approach is superior to mandatory registration because if hedge funds move offshore, then there will be a greater, more detrimental risk of limited or no oversight. The United Kingdom also requires that funds have independent third parties evaluate their valuation processes. This part of the United Kingdom's approach is discussed more in detail in part VI-A.

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