HEDGE FUNDS: A POLITICAL AND ECONOMIC ANALYSIS

ABSTRACT

Hedge funds are indispensable to the modern day economy, but remain one of the most poorly understood instruments of financial globalization. The financial crisis of 2007-2009 propagated fallacious interpretations of the role of hedge funds in precipitating the crisis. In turn, this has led to unsubstantiated policymaking. This paper seeks to clarify many of the misconceptions surrounding hedge funds and elucidate their rise to prominence. It will be argued that the excessive regulation of hedge funds is unnecessary and ultimately detrimental to the global financial system. Governments can prudently utilize hedge funds because they have the potential to reduce systemic risk and induce innovation.

Keywords: Alternative Investment Vehicles, Assets under Management (AUM), Capital Markets, Long-Term Capital Management, 2007-2009 Financial Crisis

JEL Classification: G15, G21, F30, F38

RIASSUNTO

Gli hedge funds: un’analisi politica ed economica

Gli hedge funds sono indispensabili nella economia moderna, ma rimangono uno degli strumenti di finanza globale meno compresi. La crisi finanziaria del 2007-2009 ha indotto interpretazioni fallaci sul ruolo degli hedge funds nel far precipitare la crisi. Di conseguenza ciò ha portato a decisioni politiche infondate. Questo studio cerca di chiarire molte incomprensioni che riguardano gli hedge funds e di spiegare perché sono diventate così diffuse. Si argomenta che l’eccessiva normazione degli hedge funds non è necessaria, anzi è addirittura dannosa per il sistema finanziario globale. I governi possono utilizzare gli hedge funds prudentemente perché sono potenzialmente in grado di ridurre il rischio sistemico.
1. **INTRODUCTION**

Hedge funds have become ubiquitous in today’s vernacular, but they remain one of the most poorly understood instruments of financial globalization. The general public and the media have become enamored with hedge funds because of their unprecedented ability to raise billions of dollars in capital and profits within a short time frame. The media has systematically developed a portrayal of hedge funds as an insidious creation of capitalism, which is responsible for creating financial crises and rising inequalities in the advanced economies. Unfortunately, such generalizations also propagate misconceptions about the nature and role of hedge funds, including misguided policymaking. This paper provides a corrective by providing a more nuanced view of hedge funds, its composition and functionality, its origins, and economic effects, especially in the United States. Also addressed will be issues pertaining to “herding” and the psychological attributes of managers, the role of hedge funds in the 1997 Asian financial crisis, their disruptive effects in Europe, the role of hedge funds in the 2007-2009 financial crisis, Germany and France’s attempts to heavily regulate the industry throughout the European Union, the European Union’s Alternative Investment Fund Managers Directive (AIFMD), and the effectiveness of other regulatory measures and their broader implications for the global economy. The paper will conclude by making a case against imprudent regulations. It will be argued that the excessive regulation of hedge funds is unnecessary and ultimately detrimental to the global financial system.

2. **COMPOSITION AND FUNCTIONALITY OF HEDGE FUNDS**

Hedge funds are highly complex private investment vehicles managed by professional managers where investors pool their money to maximize positive returns (SEC, 2012). The objective of hedge funds is to make money in both the bull and bear markets. The fund’s organizational structure can generally be broken into two distinct components: the fund manager that manages the money and the limited partners (also known as the investors) that provide the majority of the fund’s capital. It is important to note that hedge funds are exempt from the Investment Company Act of 1940 (Investment Company Institute, 2007). Hedge Funds primarily cater to high net worth individuals and institutions where investors’ pool their money in order to invest in multitudinous assets. The SEC has created a system of accreditation to determine who can qualify to invest with a hedge fund. According to Eric Bank of Zacks,
“the SEC’s definition of accredited individuals include those with $1 million in net worth or those with incomes exceeding $200,000 in each of the previous two years...” (Bank, 2011).

This system of accreditation was instituted to limit the number of people that qualify for investing in hedge funds since they are highly risky investment vehicles.

Hedge funds have the ability to take both long and short positions and the assets that they generally invest in include commodities, equities, derivatives, futures, bonds, securities, and currencies (US Treasury, 2002 p. 19). Hedge funds are unique in the fact that they can thrive in both liquid and illiquid markets. This flexibility has enabled them to engineer returns in bear markets and minimize their risk. The average hedge fund manages about $40 million (referred to as AUM or assets under management) and the largest hedge funds manage around $1 billion (Wilson, 2010 p. 7). In addition, hedge funds are somewhat similar to mutual funds, both structurally and functionally. However, hedge funds are distinct by the fact that they are not widely accessible to the general public and are usually exempt from registering with the SEC or other regulatory bodies (Managed Fund Association, 2014). The legendary fund manager, George Soros, notes that,

“hedge funds engage in a variety of investment activities. They cater to sophisticated investors and are not subject to regulations that apply to mutual funds geared toward the public. Fund managers are compensated on the basis of performance rather than as a fixed percentage of assets” (Soros, 2000 p. 32). This is another important difference between hedge funds and mutual funds.

Hedge fund managers generally charge a 2 percent management fee and a 20 percent performance fee (commonly referred to as the “Two and Twenty”). However, these fees can range from 10 to 20 percent for performance fees and 1 to 2 percent for management fees (Wilson, 2010 p. 5). The fee structure is an integral part of hedge funds and arguably contributes to the viability of the fund. Most managers pool their own money into the fund, which they use for investment and speculation. This creates a powerful incentive to actively engage in risk-aversion to avoid losses. Hedge funds have also developed sophisticated mechanisms to provide additional reassurance to investors since they often engage in risky trading strategies. Some of these mechanisms include the so-called “hurdle rate,” which is
“... a performance figure that must be achieved before any performance fees will be calculated or paid to the hedge fund manager” (Wilson, 2010 p. 7).

This ensures that investors will not be charged for a dismal performance and incentivizes the manager to maximize absolute returns. Hedge funds have historically promised these absolute returns. In other words, the fund guarantees the investor that they will return a profit regardless of the market conditions (The Economist, 2012). Absolute returns are another differentiating factor between hedge funds and other investment vehicles. Another mechanism that is employed by hedge funds is known as a high-water mark. A high-water mark is essentially an assurance on the manager’s part to the investors that they will not be charged performance fees during losses. If the hedge fund incurs losses, then the investors will not be charged until the manager has made up those losses.

Hedge funds also employ a highly controversial practice known as a gating clause (controversial due to the rise in the practice of manager’s “closing the gate” or preventing investors from withdrawing their money entirely). A gating clause enables managers to “restrict or completely cut off redemptions from the portfolio due to market illiquidity or specific sets of circumstances set forth in the contract” (Wilson, 2010 p. 8).

In other words, the manager retains the ability to prevent investors from withdrawing their money from the fund. The purpose of a gating clause is to prevent a massive capital flight that could cripple the hedge fund or cause it to implode. Gating clauses can be viewed as a necessary instrument to ensure that redemptions or withdrawals have a limited impact on the liquidity and value of the hedge fund’s portfolio (Lestz, 2011). Another essential component of hedge funds is their ability to maximize leverage. Their use of leverage is central to understanding the functionality of hedge funds. Leverage enables hedge funds to maximize their profits by giving them the ability to trade in greater volume (Mallaby, 2011a p. 10). In other words, hedge funds can use borrowed money or sophisticated investment instruments to increase their returns by enabling them to buy and trade in greater volume. Hedge funds are not as leveraged as investment banks or other investment vehicles. Sebastian Mallaby notes that “the average hedge fund borrows only one or two times its investors’ capital, and even those that are considered highly leveraged generally borrow less than ten times” (Mallaby, 2011a p. 12).
This is partly because managers often have their own capital in the fund and there is no safety net to bail them out if they get into trouble.

Among the most important innovations of hedge funds that have enabled them to accumulate enormous profits is the method of combining leverage and short selling. As previously stated, a fund manager can use leverage to borrow, which in turn enables the manager to trade in greater volume in long positions (allowing for greater diversification), and he or she can still use some of the funds to purchase bad short positions, which helps offset his or her total market exposure (Mallaby, 2011a p. 24). In More Money Than God, Sebastian Mallaby writes,

“the [hedge] fund does better in a bull market despite the lesser risk it has assumed; and the [hedge] fund does better in a bear market because of the lesser risk it has assumed” (Mallaby, 2011b p. 25).

This flexibility enables hedge funds to see profits in both market types while minimizing the risk their investors are exposed to. Lastly, it is important to mention two fundamental terms that are commonly used in hedge fund jargon. These are alpha and beta. Beta is the systematic risk or volatility of a market or portfolio and alpha is a measurement of performance based on a benchmark or risk-adjusted basis (Koba, 2012). These serve as important evaluative means to measure the aggregate performance of hedge funds.

3. ORIGINS OF HEDGE FUNDS

Hedge funds can be traced back to 1949 (Johnson, 2007). Their narrative attests to the entrepreneurial and innovative nature of the industry. Hedge funds have evolved from an obscure abstract creation of one man to an ever-expanding sector of finance. Today, there are an estimated 11,000 hedge funds that manage roughly $2.6 trillion in assets (Delevingne, 2014). The narrative begins in 1949 with an eccentric individual by the name of Alfred Winslow Jones. Alfred Jones was an author, sociologist, financial journalist for Fortune, and a former vice counsel in the United States Foreign Service office in Berlin (Russell, 1989). While working for Fortune, Jones began to explore financial markets and the correlation between returns and investor psychology (Mallaby, 2011a p. 20). He believed that psychology shaped stock market trends and the key was to become cognizant of the different factors that contribute to the emotions that influence investment decisions (Mallaby, 2011a p. 20). By understanding human
psychology, one can analyze market trends to determine whether the market will continue to rise based on optimism or will contract due to a fear that the market is becoming unstable (Mallaby, 2011a p. 20). Jones used this belief as a basis for establishing the world's first hedge fund and began soliciting investments from his inner circle. His hedge fund was established on the belief that the key to maximizing profits was to invest in long positions that he believed would outperform the market and short positions that he believed would underperform. This limited his market exposure and enhanced his flexibility in volatile markets. Jones's success was inconceivable for many in the world of finance. He was achieving what academics and economic theory posited was impossible: the ability to systematically beat the market. In fact, Sebastian Mallaby writes,

“by 1968 he had racked up a cumulative return of just under 5,000 percent...” (Mallaby, 2011a, p. 24).

It would take several years for others to catch on to the stunning returns that Jones was generating and venture into the realm of hedge funds.

The subsequent decades saw an exponential increase in the number of hedge funds and the formation of more sophisticated investment methods. The stock market crash of 1973-1974 was a foreboding sign. Theoretically, hedge funds should have been insulated from the turbulent market and continued to make money. However, many hedge funds had overextended themselves through excessive borrowing, which resulted in many of them being decimated on their short and long positions (Loomis, 1970). The economic downturn at the beginning of the decade and the eventual crash in 1973-1974 wiped out the majority of the world's hedge funds (Mallaby, 2011a p. 41). An important legal implication for hedge funds came directly out of this crash. Namely, the SEC had been considering regulating the sector, but the annihilation of so many hedge funds convinced the SEC that there was not a need to regulate them (Mallaby, 2011a p. 41). One hedge fund was able to solidify its place among hedge fund lore during this epoch. Steinhardt, Fine, Berkowitz & Company (led by the legendary Michael Steinhardt) was able to survive the crash by balancing their long stocks through shorting their short stocks (Mallaby, 2011a p. 42). Thus, they were able to rely on their intuition and knowledge of the market to ride out the crash, and remarkably returned 361 percent over the period of the 1960s and 1970s (Mallaby, 2011a p. 42). Michael Steinhardt became a trading superstar during this time by going against conventional wisdom. According to Michael Noer of *Forbes*,

...
“from 1967 to 1995 his pioneering hedge fund returned an average of 24.5% annually to investors, even after Steinhardt took 20% of the profits” (Noer, 2014).

This case example of Steinhardt, Fine, Berkowitz & Company illustrates the notion that success in the hedge fund sector can largely be attributable to betting against conventional wisdom and intrepidly exploring new mediums of finance.

The remainder of the 20th century saw the continued evolution of hedge funds. The introduction of computers dramatically redesigned hedge funds and the financial sector as a whole. The addition of computers for high frequency trading ushered in the “quants.” A hedge fund by the name of Commodities Corporation was one of the first hedge funds to be founded by these so-called “quants” (Mallaby, 2011a p. 63). Quants are known for using highly sophisticated computers and mathematical formulas for trading. In More Money Than God, Sebastian Mallaby explains that the basic tenets of the Commodities Corporation were to use sophisticated math and computer models to beat the market (Mallaby, 2011b p. 65). This greatly changed the game by adding a different dimension into trading. However, many of the hedge funds run by “quants” soon discovered that their sophisticated mathematical formulas and computer systems could not account for every variable. In particular, they discounted basic human intuition. Intuition has the capacity to predict trends and forecasts that computers simply cannot. The rise of Michael Marcus and Bruce Kovner came to epitomize the development of trend surfing. Trend surfers systematically monitor the market and various charts to uncover recurring patterns that can then be capitalized on to make a profit. Lastly, any summation of the origins of hedge funds would be incomplete without a reference to the iconic George Soros. George Soros used his philosophical understanding of the world and human nature to become one of the greatest investors of all time. He developed a general theory of reflexivity to understand the workings of financial markets and human decision-making. Reflexivity essentially posits that

“investors’ and traders’ biases can change the fundamentals that assist in determining market trends” (Investopedia, 2012),

but Soros elaborated on this by concluding that a feedback loop exists, which drives both markets and investors forward until a crash eventually occurs (Soros, 2009). In other words, Soros concluded that a boom-bust cycle exists between markets and investors, which can be utilized to maximize one’s profits. His success would have drastic implications on the global
economy and set a precedent for the trajectory of future hedge funds. This will be explored in depth at a later point in this paper.

4. **THE ROLE OF HEDGE FUNDS**

Hedge funds play a distinct role in the market – specifically capital markets – and influence the direction of the global economy. The extent of their influence is currently a controversial issue. Proponents of hedge funds posit that they stabilize the market by providing liquidity and muscling prices into line whereas opponents posit that hedge funds are inherently destabilizing and contribute or exacerbate economic downturns (Mallaby, 2011a p. 10). Opponents fallaciously attribute recessions and other financial difficulties to hedge funds due to their incognizance. In actuality, hedge funds have historically played a minimal role in economic crises and have not exacerbated crises to the extent that the media delineates. This is particularly true in capital markets. Hedge funds facilitate the flow of capital and provide additional sources of opportunity for investors. This encourages economic development and innovation. Innovation is a central component of economic stability and growth since it fosters additional avenues for investment. The capacity of hedge funds extends further than just economic growth. Hedge funds can also curtail stress in the markets, thus reducing its negative effects. In a meeting before the Senate subcommittee on Securities, and Investment, Patrick M. Parkinson elucidates this notion by writing,

“... when the options and other fixed income markets were under stress in the summer of 2003, the willingness of hedge funds to sell options following a spike in options prices helped restore market liquidity and limit losses to derivatives dealers and investors in fixed-rate mortgages and mortgage-backed securities” (Parkinson, 2006).

The flexibility of hedge funds enables them to engage in practices that other investment vehicles are either unable or unwilling to engage in. This in turn, stabilizes the market and encourages further investment. The mere fact that hedge funds can theoretically trade and invest in a multitudinous array of opportunities with minimal regulations enables them to utilize a global approach to financial markets. In a speech in 2004 at the National Conference on the Securities Industry, Timothy Geithner substantiates these facets by stating:
“Hedge funds play a valuable arbitrage role in reducing or eliminating mispricing in financial markets. They are an important source of liquidity, both in periods of calm and stress. They add depth and breadth to our capital markets. By taking risks that would otherwise have remained on the balance sheets of other financial institutions, they provide an important source of risk transfer and diversification” (Geithner, 2004).

Although hedge funds control a sizable share of capital, their assets are highly diversified and most engage in risk management, which reduces the potential for triggering a crisis. The portfolio diversification provided by hedge funds ensures that the investor's assets are not as directly correlated with certain market conditions, thus reducing the risk of sustaining serious losses. Hedge funds play an essential role in financial markets – in particular capital markets – by providing liquidity, risk management, innovative solutions and investment opportunities, and stabilizing market prices, which ultimately facilitates economic growth.

5. THE ECONOMIC EFFECTS OF HEDGE FUNDS IN THE UNITED STATES

The economic effects of hedge funds in the United States are ubiquitous. Hedge funds are an integral component of market competitiveness in the United States and are gradually expanding their role. The current estimate for the total assets under management is more than $2.4 trillion (Zakaras, 2012) and American hedge fund managers are frequently referred to as the Masters of the Universe (Wolfe, 2008). They have reshaped the functionality of finance and the way that firms derive their profits. For instance, The Economist notes that a sizeable portion of investment banks' income now comes from lending and trading for hedge funds (The Economist, 2006). Investment banks and hedge funds are intrinsically linked since they are reliant upon one another to maximize their profits. In addition, the portfolio diversification offered by hedge funds is an attractive feature for institutional investors since it reduces the risk that their portfolios are exposed to. As previously stated, hedge funds also provide an important source of liquidity to capital markets, which is especially true in the United States. Hedge funds increase the flexibility in the US market by providing additional liquidity, which has limited the extent of financial shocks (Hall, 2007). They also frequently force inefficient prices into line, which reduces the likelihood of market distortions. In a testimony before the House Financial Services Committee, George E. Hall, the Chief Investment Officer of Clinton Group, stated,
“in targeting temporary price inefficiencies and market dislocations, hedge funds effectively help to minimize market distortions and eliminate these dislocations” (Hall, 2007).

Chester S. Spatt of the American Enterprise Institute elucidates this by asserting that it is the diversification in different market sectors that enables hedge funds to ensure the fairness of pricing (Spatt, 2006). This supplementation of additional liquidity and efficient prices decreases market volatility.

The expansion of hedge funds in the United States has also generated extensive debate among central bankers and regulators regarding the systemic risk they pose. It has been concluded that as a sector, hedge funds do not pose a serious systemic risk to the market. Moreover, only about 400 or 500 hedge funds actually have the ability to create systemic risk in the market (Cantrell, 2005). This is because the majority of hedge funds are too small to generate any market turbulence, but the collaboration of several of the largest hedge funds could potentially cause market turbulence and an economic crash. The failure of a major hedge fund could also pose serious macroeconomic problems. The case of Long-Term Capital Management (LTCM) is an example. The failure of LTCM in 1998 shocked Wall Street and threatened to upend the entire financial system. At the time, LTCM was one of the world’s largest hedge funds and was run by John Meriwether of Salmon Brothers and Myron S. Scholes and Robert C. Merton, winners of the 1997 Nobel Prize in Economics. The firm was a relative-value fund and engaged in convergence trading. The firm would take long positions in bond markets that they deemed as inefficient with the intention that those inefficiencies would ultimately be eliminated by the market. LTCM also employed an arbitrage strategy “that could take advantage of temporary changes in market behavior and, theoretically, reduce the risk level to zero” (McWhinney, 2010).

This in turn, would result in impressive profits for their investors. This strategy was based on the firm’s combination of Nobel Prize winning academics that could provide innovative quantitative models to the all-star traders that could then execute these models (Bancware, 2006). Unfortunately, LTCM became highly leveraged when it used derivatives to take exorbitant positions in volatile Russian bonds (Dungey, 2002). Russia ultimately defaulted and the firm began losing $300 to $500 million a day (Lowenstein, 2009). LTCM lost $4.5 billion before the Federal Reserve organized a rescue (Lowenstein, 2009). It ultimately took a $3.6
billion recapitalization to stymie the fund's bleeding and avert a financial crisis. The case of LTCM is a cautious anecdote of the implications of being heavily reliant on esoteric quantitative models and being heavily leveraged without a system of risk management in place. Regulators and central bankers in the United States frequently refer to the tragic ending of LTCM when they are evaluating systemic risk and future directives involving hedge funds.

6. “Herding” and Psychological Attributes

Psychological attributes and the notion of herding are two unique phenomena that contribute to the success of hedge fund managers and influence market trends. There are certain characteristics that many of the top hedge fund managers seem to possess and many believe that it takes a certain type of person to truly be successful in the industry. The legendary Michael Steinhardt, believes that contrarians are especially well suited for the industry. When it came to recruiting employees for Steinhardt, Fine, Berkowitz & Company, Steinhardt specifically looked for people with strong contrarian views who were decisive and capable of defending their positions (Mallaby, 2011a p. 47). It appears that contrarianism is omnipresent among hedge funds because it inherently posits that one goes against the prevailing opinion. With regard to investing, this means that an investor should go against the prevailing opinion of the market and go against the current trend. This is an essential component for successful trading since the investor is capable of capitalizing on profitable opportunities while most people are incognizant. Accompanied with contrarianism is the ability to remain flexible. Many investors become attached to certain stocks because they have spent countless hours researching it before taking their position, but a hedge fund manager must be willing to cut his losses or remain in a position when others are bailing out. In other words, confidence in one’s personal convictions, discipline, and intellectual agnosticism are additional characteristics that are highly rated in the industry. An incredibly high-risk tolerance and a relentless work ethic are often seen as necessary dispositions to succeed in the industry (Agnew, 2012). A high-risk tolerance is necessary because the industry is inherently risky and a manager must possess the ability trade on a whim and take calculated risks that could potentially result in the loss of millions of dollars. Likewise, a relentless work ethic is necessary because financial markets are globally connected and many of the preeminent managers continue to trade in the middle of the night or while on their holidays. It often requires personal sacrifices that many people are unwilling or unable to make.
These facets help explain why very few people make it into the hedge fund industry and why even fewer succeed as managers.

The phenomenon of herding plays a distinct role in the realm of hedge funds. Herding is a mentality that is characterized by a group of investors basing their investment decisions on the belief or action of others. For example, if a prominent investor is shorting his position in a given stock, then it is likely that many others will follow suit because they do not want to be left out or caught off guard. It has often been assumed that hedge funds are the driving force behind herding in financial markets and mere speculation that a hedge fund is going to take a certain action could result in investors frantically following suit. This would subsequently destabilize markets and cause massive price swings in prices. However, recent research has discredited this claim and actually shown that hedge funds herd less frequently and have less portfolio overlap with one another than other financial institutions (Reca et al., 2012). The authors of the study found that,

“on average, hedge funds’ trades appear to push prices toward equilibrium whereas non-hedge fund institutions’ trades push prices away from equilibrium” (Reca et al., 2012).

In other words, hedge fund herding does occur, but to a lesser extent than many had previously believed. When it does occur, it generally does not destabilize markets or prices (Reca et al., 2012).

7. THE ROLE OF HEDGE FUNDS IN THE 1997 ASIAN FINANCIAL CRISIS

The 1997 Asian Financial Crisis shook the very foundation of the financial system. The crisis began in Thailand in July 1997 with the devaluation of the Thai baht. The collapse of the baht and the burden of foreign debt effectively bankrupted the state. The crisis soon disseminated to other East Asian countries – namely, South Korea, Malaysia, Indonesia, Singapore, and the Philippines. Foreign debt ratios of these countries increased exponentially, a devaluation of their respective currencies occurred, and the International Monetary Fund had to intervene to limit the calamity. Several studies and actors (namely, the former Prime Minister of Malaysia, Dr. Mahathir Bin) have identified hedge funds as the perpetrators of the currency crisis, but these accusations need to be seen in the broader perspective. Namely, it is undeniable that hedge funds were involved in creating the crisis, but their role has often been exaggerated.
The role of hedge funds in the beginning of the crisis can be traced back to George Soros’ Quantum Fund. Stanley Druckenmiller and George Soros realized that a devaluation of the Thai baht was imminent after their team had met with senior Thai officials (Mallaby, 2011a p. 200). They immediately shorted $2 billion worth of baht, which could have served as a trigger for extensive shorting of the currency among other financial institutions (Mallaby, 2011a p. 200). Rather than devalue its currency, the Thai government immediately started buying baht from investors (Mallaby, 2011a p. 200). The economic crisis intensified as the government continued to make injudicious policy decisions. Soros was largely accused for precipitating the crisis by shorting the baht, but ultimately other actors such as mutual funds, investment banks, and domestic investors were more actively involved in the baht’s devaluation. A seminal study by Barry Eichengreen and Donald Mathieson of the IMF concluded that hedge funds were not the principal actors in the crisis. They estimate that hedge funds were involved in short selling around $7 billion out of $28 billion worth of baht (Eichengreen, 1999). Their study notes that “the baht is the only Asian currency for which hedge funds collectively took significant short positions...” (Eichengreen, 1999).

It has also been identified that the currency volatility caught most hedge funds by surprise and they were largely removed from the market calamity (Eichengreen, 1999). Thus, many hedge funds were unable to take short or long positions against the various currencies, equities, and other assets. Many of those that were in position, were caught off guard by the extent of the crisis and incurred significant losses from being ill-prepared for the resultant currency devaluations.

Hedge funds played a minimal role in the overall extent of the crisis because they were miniscule in comparison to the institutional investors that were actively involved. In “Who Triggered the Asian Financial Crisis,” Michael R. King writes,

“Hedge fund assets, estimated at up to $150 billion, are dwarfed by other institutional investors such as pension funds with over $13,000 billion or mutual funds with over $7,000 billion” (King, 2001).

In other words, hedge funds were dwarfed by the larger institutional investors and were incapable of exacerbating the crisis to the extent that they are often ascribed to. Rather, commercial and investment banks compounded the contagion and were responsible for the
deleterious macroeconomic effects on the East Asian countries. Hedge funds were involved in the crisis by taking both long and short positions against various East Asian currencies, but they cannot be held entirely responsible for the negative implications of their actions. They were unfortunately blamed for the crisis because the data on their activities existed whereas it was non-existent for some of the larger institutional actors. The experience of the 1997 Asian Financial Crisis is a cautionary tale of crises and the propensity to fallaciously ascribe blame to hedge funds due to them being viewed as exploitative capitalistic vehicles that are utilized by egomaniacal investors.

8. **THE DISRUPTIVE EFFECTS OF HEDGE FUNDS IN EUROPE**

Hedge funds have primarily been associated with the United States, but they are also an important part of the financial sector in Europe. Europe is home to some of the world’s largest hedge funds such as Man Investments, Brevan Howard, and BlueCrest Capital Management. Globalization has enabled hedge funds to invest in assets from around the world, but this has also enabled the largest hedge funds to impact countries that they are not domiciled in. This has most notably occurred in Europe with hedge funds intervening in the currency markets in 1992, George Soros’ Quantum Fund (Soros Fund Management) destroying the British sterling (also in 1992), and the disruptive implications of Deutsche Börse’s failed takeover of NYSE Euronext. The actions of hedge funds in the 1990s would drastically alter the relationship between governments and markets due to globalization, interconnected financial system, and the dissemination of information regarding the intentions of central banks.

The actions of hedge funds in 1992 and the subsequent decades is a result of the interconnection between politics and economics. The policies of governments heavily influence the trajectory of the market and vice versa. The European political landscape of the late 1980s and early 1990s was dominated by the European Currency Unit (ECU) and the proposition of creating the Euro. The antipathy to the various regional differences – most notably, the central banks’ ideological differences among one another – enabled hedge funds such as the Quantum Fund and the Commodities Corporation to capitalize on the disarray. The reunification of Germany resulted in the Bundesbank becoming the anchor for both the deutsche mark and Europe’s exchange-rate mechanism (ERM) (Mallaby, 2011a p. 152). The high interest rates in Germany in the 1990s resulted in a sudden influx of investments into the deutsche mark, which drastically altered the
functionality of the ERM (Mallaby, 2011a p. 152). The influx of investments into the deutsche mark meant that the currencies of countries with lower interest rates such as Italy, France, and Great Britain were trading toward the bottom of the ERM while Germany was trading at the top (Mallaby, 2011a p. 152). This robbed these countries of much needed capital and set the stage for the devaluation and ejection of several of their currencies from the ERM. More importantly, Britain’s fall to the bottom of the ERM meant that the Bank of England would be obligated to intervene and purchase an unlimited amount of pounds as traders continued to sell them off (Drobny, 2006 p. 14).

The President of the Bundesbank, Helmut Schlesinger, refused to modify Germany’s monetary policy or adjust interest rates, which essentially threw several European countries to the wolves. The British government was opposed to higher interest rates, thus sealing the state’s fate for the devaluation of the sterling or a recession (Mallaby, 2011a p. 159). Various hedge funds began mobilizing by purchasing weaker currencies before ultimately going on the attack. In More Money Than God, Sebastian Mallaby states,

“on Tuesday, September 8, the day that Schlesinger declared he could make no promises on German interest rates, a wave of speculative selling overpowered the Finnish central bank, forcing the government to abandon its peg to the ECU...” (Mallaby, 2011b p. 159).

This was just the beginning of the onslaught. Three days later, a wave of speculative selling struck the Italian lira resulting in its ejection from the ERM and its devaluation (Sevilla, 1995). The devaluation of the lira should have served as a forewarning to the British government that the sterling was at risk for a similar fate. The only defensive measure that the Bank of England took was to borrow £7.5 billion so that it could continue to purchase sterling to fend off additional attacks by hedge funds (Mallaby, 2011a p. 159). Unfortunately, this was to little avail. It became clear that the Bundesbank was disinterested in continuing to bail out its monetarily weaker neighbors and saw no need to cut interest rates. George Soros’ Quantum Fund began shorting its position in sterling, which triggered massive selling throughout the world. On September 16, 1992, the British government decided to withdraw from the ERM and the pound subsequently fell 15 percent against the deutsche mark (Drobny, 2006 p. 15). The Quantum Fund netted several billion dollars from shorting the pound and George Soros was given the moniker,
“the man who broke the Bank of England” (Drobny, 2006 p. 15).

The repercussions of this were immense. Governments immediately called for the regulation of hedge funds and central bankers stood in disbelief. How could a hedge fund cause such catastrophic consequences? The interconnectivity of the financial markets and George Soros’ clout enabled him to capitalize on his vast position in pounds, which resulted in a trickle down effect. This encouraged other traders to short their positions and the British government’s ill-advised decision to continue to buy pounds resulted in taxpayers footing the bill for the several billion dollars that the Bank of England squandered.

The ability for hedge funds to amass prodigious returns and effect sociopolitical and geopolitical outcomes is well documented. However, hedge funds also have the ability to derail mergers and other sophisticated deals. This is commonly referred to in the vernacular as shareholder activism. Europe witnessed several surprising instances of shareholder activism by a little known hedge fund called The Children’s Investment Fund Management (TCI) led by Sir Chris Hohn. In 2012, Deutsche Börse, the operator of the Frankfurt Stock Exchange and a leading exchange organization that provides investors with access to global markets through trading, was in negotiations to merge with NYSE Euronext, a global equities exchange. The merger would have created one of the largest organizations for global derivatives trading. Philip Stafford of the Financial Times elaborates on this by writing,

“the merger would have created a powerhouse, representing more than 95 per cent of Europe’s trading and clearing in benchmark exchange-traded derivatives” (Stafford, 2012).

Thus, the merger would have created a substantial platform for the high-volume trading of derivatives and enhanced the efficacy of the business. The consolidation would have arguably increased competition and stimulated markets. The European Commission along with hedge funds called upon shareholders to reject the proposal, which effectively killed the deal. Deutsche Börse sought to purchase the London Stock Exchange (LSE) in 2005 and TCI management helped derail that deal as well by acting in the shareholders interests by publically renouncing the acquisition and calling upon the shareholders to replace the entire supervisory board at Deutsche Börse. The ability for hedge funds to act in the interest of shareholders is diametrically opposed to the traditional belief that hedge funds are only out to maximize their profits. TCI and the other hedge funds might have disrupted global stock markets by killing the
deals, but they were operating under the notion that the shareholders should have been given a better deal. The experiences involving hedge funds in Europe have dramatically changed the political opinion in several countries regarding their regulation.

9. The role of hedge funds in the 2007-2009 financial crisis

Academics, central bankers, and regulators have debated the role of hedge funds in the 2007-2009 financial crisis extensively. The media and other commentators fallaciously identified hedge funds as playing a central role in precipitating the crisis. However, subsequent studies have concluded that hedge funds did not precipitate the crisis and the extent of their role has largely been over-exaggerated. It is undeniable that hedge funds were involved in the crisis and arguably exacerbated certain facets of it, but they were not responsible for triggering the crisis.

One of the common arguments expounded by hedge funds is that they cannot be held liable for any of the losses incurred during the crisis because they did not provide the collateralized debt obligations, credit default swaps, and synthetic collateralized debt obligations, which contributed to the subprime bubble. Another commonly used argument is that they did not create the toxic securities that were passed off as safe investments by credit rating agencies (Lysandrou, 2012). Both of these arguments are valid to a certain extent. Investment banks, mortgage lenders, credit rating agencies, issuers of credit default swaps, and other global financial services firms were responsible for packaging and selling these various derivatives and other sophisticated financial instruments to ingenuous investors and institutions. These entities were the real culprits, not hedge funds. However, hedge funds did actively engage in the purchasing and selling of these various credit derivatives and other instruments. Lloyd Dixon, a senior economist at RAND, writes:

“In contrast to banks, which invested heavily in subprime mortgages, hedge funds invested on both sides of the market. By betting that assets based on subprime mortgages and the banks that invested in them would decline in value, hedge funds called attention to the growing bubble” (Dixon, 2012).

In other words, hedge funds were clearly not the precipitating actors in the crisis. Many hedge funds were ill-equipped for the crisis and were either bankrupt or lost billions of dollars. For example, two Bear Stearns hedge funds went bankrupt at the beginning of the crisis because they were highly leveraged and had taken ill-advised positions in the housing market.
Nevertheless, hedge funds did contribute to the crisis by taking certain actions. It exacerbated the financial crisis by short-selling various assets and withdrawing liquidity from the market. Lloyd Dixon elucidates this by writing,

“hedge funds destabilized financial markets by withdrawing billions of dollars from prime brokers and their parent investment banks out of fear that those assets could be frozen if the banks declared bankruptcy...” (Dixon, 2012).

These measures were primarily defensive in nature to protect the funds and their investors from incurring enormous losses. Unfortunately, it also exacerbated the crisis by withdrawing billions of dollars of crucial liquidity from the market. Central bankers eventually intervened in many states by prohibiting short-selling, which mitigated its pervasiveness to a certain extent (Strömqvist, 2009). The High-Level Group on Financial Supervision in the EU also substantiates the notion that hedge funds played a minimal role in the precipitation of the crisis and were primarily engaged in the crisis through transmission functions of withdrawing liquidity and short-selling of stocks and transactions (The European Commission, 2009). Hedge funds do not play a central role in financial markets, and thus the majority of them are too small to seriously threaten the financial system (Mallaby, 2011a p. 12). The extent of the systemic risk that hedge funds pose to the market remains a highly contested issue, but the experience of the 2007-2009 financial crisis is an exemplary lesson of the deleterious risks associated with being highly leveraged.

10. GERMANY AND FRANCE LEAD THE CHARGE TO HEAVILY REGULATE HEDGE FUNDS IN THE EU

The European experience of the 2007-2009 global financial crisis accompanied with the experience of the exchange-rate mechanism crisis in the 1990s has resulted in the desire to heavily regulate the industry. Germany and France in particular have led the charge to regulate hedge funds throughout the European Union. The United Kingdom is antipathetic to the regulations since it is home to four out of five hedge funds in Europe (Quaglia, 2009). Heavily regulating the industry would have detrimental consequences for the British economy such as inducing capital flight. It is also conceivable that the regulation of hedge funds would have broader implications for the continent as a whole. Hedge funds could circumvent the regulations by merely becoming domiciled in offshore jurisdictions such as the Cayman Islands or British Virgin Islands, which some have already done. The basis for imposing stricter regulations on the
industry is based on the experiences of hedge funds in the European market as well as a misunderstanding of the extent of their actions. Lucia Quaglia writes,

“episodes such as the failed merger between the Deutsche Börse and the London Stock Exchange brought to the fore the potential disruptive effects that hedge funds can have on corporate governance in continental European countries...” (Quaglia, 2009).

The directive aimed at imposing stricter regulations on hedge funds came into effect in 2013, but it is important to understand the basis for why countries such as France and Germany were eager to institute fresh regulations.

There are multitudinous explanations given for why regulations are necessary. However, many of them lack substantive statistical or economic data to corroborate the need for them. Moreover, the desire to regulate hedge funds has become politically polarized in Germany and France. The Social Democratic Party and Christian Democratic Union have frequently criticized the transparency of hedge funds and popular opinion has taken a xenophobic undertone against British and American hedge funds. Mark Landler of The New York Times writes,

“party leaders have tarred foreigners as ‘locusts’ who plunder German companies and throw out their workers” (Landler, 2005).

This viewpoint is largely a byproduct of Deutsche Börse’s stymied acquisition of the London Stock Exchange by hedge funds, which had a ripple effect across the German economy. Germany has been able to garner the support of France with its push for enhanced regulatory measures largely because public opinion is in support of it. Central bankers and regulators have been propagating the notion that hedge funds induce systemic risk in markets, and thus regulation is necessary to reduce market volatility. It is understandable that Europe has witnessed a backlash against hedge funds after its perceived negative experiences with them, but it is misguided to reduce the efficacy of capital markets and market liquidity by imposing stricter regulatory measures that will reduce their flexibility, cause capital flight, and stymie innovation.

11. THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

The Alternative Investment Fund Managers Directive (AIFMD) is a European Union directive with the objective of creating a comprehensive regulatory framework to enhance the
transparency and reduce the systemic risk of hedge funds (among other types of investment vehicles) (The European Commission, 2014). It went into effect in 2013 and requires all EU states to comply with its measures. The directive applies to a variety of investment vehicles such as private equity funds, but this discussion will solely focus on its applicability to hedge funds. The proposal was initially adamantly opposed by the United Kingdom until the government realized that it would have been injudicious to spend a considerable amount of money fighting the directive when it was guaranteed to pass. The basis for the AIFMD is to stabilize the financial market, create a universal platform to regulate hedge funds through supervisory measures, and protect investors from market volatility and exploitative investment schemes. The directive will require hedge funds to become more transparent and compliant through four distinct measures. However, hedge funds with assets under management of €100 million or less will not be required to comply with the directive (Govier, 2013). Hedge funds will be required to appoint a depository, create a comprehensive system of risk management to minimize losses and protect investors, disclosure of remunerations, and enhanced transparency and accountability through annual reports to investors and quarterly reports to regulatory bodies. PricewaterhouseCoopers elucidates some of the impacts that the AIFMD will have on hedge fund managers in a comprehensive brochure. They state that some hedge funds will be unable to institute the mandated system of risk management because they do not have the necessary financial resources and the additional red tape will impose unnecessary costs on hedge funds while reducing their flexibility to engage financial markets (Pricewaterhousecoopers, 2012). The directive applies to all hedge funds that are trading, operating, or conducting business throughout the European Union. According to Preqin, the industry leader in intelligence and data, 48 percent of European (excluding the UK) fund managers are in compliance with the directive and only 43 percent of UK managers are in compliance (Preqin, 2014). The cost of implementation has also been significantly higher than many had expected, costing most hedge funds about $300,000 to fully comply with the directive’s measures (Preqin, 2014). The substantial cost of compliance has deterred many from fully implementing the directive’s measures and registering with regulators. The directive will have a detrimental impact on European economies since 40 percent of US based hedge funds and 27 percent of non-European hedge funds have stated that they will not actively market themselves in the European Union (Preqin, 2014). The loss of capital from foreign investors and hedge funds will reduce the competitiveness in European capital markets and an exodus of European based hedge funds could
hinder the economies of countries such as the United Kingdom where most European hedge funds are based. It is an erroneous assumption by central bankers and regulators to believe that the AIFMD will produce any substantial benefits and it appears that they have taken a shortsighted view of the economic extent of hedge funds for political purposes rather than sound economic data.

12. EFFECTIVENESS OF OTHER REGULATIONS AND THE BROADER IMPLICATIONS FOR THE GLOBAL ECONOMY

It is too early to make a definite conclusion about the efficacy of the various regulatory measures since they have not had ample time to be in effect for. However, it is important to understand some of the measures that have come into effect since the global financial crisis of 2007-2009. The United States and several Asian countries have instituted supervisory and regulatory measures to increase the transparency and oversight of hedge funds. However, the extent of regulations is significantly less stringent than the measures that have been implemented in the European Union. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into law in 2010. The act is intended to stabilize the financial market by addressing deficiencies that were responsible for the financial crisis and also includes measures that are specifically geared toward hedge funds. Under the new provisions, all hedge fund managers with $100 million or more in total assets under management are now required to register with the Securities Exchange Commission (SEC) and all must file information regarding their systemic risk with the SEC and CFTC (Managed Funds Association, 2014a). This is aimed at providing better oversight over the larger hedge funds and to enhance their transparency for investors. The Frank-Dodd Reform also constructed a new regulatory regime called the Commodity Futures Trading Commission (CFTC), which specifically deals with the derivatives market. One of its functions is to oversee security-based swaps and banks and insurance companies that trade over-the-counter derivatives to hedge funds are now required to register with the SEC and be subject to regulation (Managed Funds Association, 2014b). This is supposed to further minimize the risk and volatility associated with hedge funds.

The majority of the Asian countries that have implemented regulatory and supervisory measures for hedge funds have sought to enhance the transparency of the industry by requiring them to register with a governmental agency or regulatory body. However, several states have also expanded upon this to incorporate some of their practices as well. In Hong Kong, the
Securities and Futures Commission (SFC) now requires all hedge funds (funds and individuals as well) to disclose their short positions on a net basis (SFC, 2011). Taiwan and India have both proposed to tax hedge funds at a higher percentage than they had previously done. As previously stated, central bankers and regulators view all of these measures as a way to reduce systemic risk.

The effectiveness of these measures remains to be seen along with their broader implications for the global economy. However, the basis for these measures following the 2007-2009 financial crisis is to stabilize financial markets and reduce systemic risk. Regulatory and supervisory measures to increase transparency and accountability are important to provide protection to investors and minimize the tremors from the largest hedge funds. It is important to note that most of these measures only apply to the largest hedge funds and do not create an abundance of regulatory tape. Hedge funds have continued to accumulate impressive returns, and thus it can be inferred that the regulatory measures taken in the United States and Asia have not had the detrimental impact that many anticipated.

13. CONCLUSION

Hedge funds have gradually evolved since their inception by Alfred Winslow Jones in 1949. Their innovative trading techniques have become pioneering mediums for finance and investing. The industry remains shrouded in secrecy and the very notion of hedge funds and their managers evokes a veneration that has not been witnessed before. The media’s infatuation with hedge funds has propagated various fallacies and misconceptions about their structural and functional basis. Hedge funds play an important role in markets – in particular, capital markets – by stabilizing inefficient prices, providing liquidity, and absorbing risk. These characteristics are especially true in the United States where the majority of hedge funds are based. The experience of Long-Term Capital Management in the United States and the 1997 Asian Financial Crisis have served as invaluable lessons for the repercussions of being highly leveraged and have furthered our understanding of hedge funds and their systemic risk. Additionally, the disruptive effects of hedge funds such as the Quantum Fund in Europe have demonstrated the resultant interconnectivity between governments and markets that have occurred from globalization. It has been concluded that hedge funds did not precipitate the 2007-2009 financial crisis, but did play a role during the crisis. However, this role was primarily confined to withdrawing liquidity
from the market and excessive short-selling of assets. Unfortunately, the aftermath of the crisis witnessed an unprecedented rise in the desire to heavily regulate the industry. Germany and France led the charge in Europe to heavily regulate the industry through the proposition and passage of the Alternative Investment Fund Managers Directive. The efficacy of the AIFMD and regulatory measures taken by other countries remains to be seen. However, these measures have raised a multitude of concerns regarding the detrimental impact on the industry as a whole from the additional red tape and other legal restrictions that threaten to stymie the various tenets that are responsible for their success.

It is imprudent to heavily regulate hedge funds following the 2007-2009 financial crisis. The financial contagion was precipitated by credit rating agencies, investment banks, mortgage lenders, and other financial institutions that specialized in engineering and promulgating collateralized debt obligations, credit default swaps, synthetic collateralized debt obligations, and other toxic investment instruments. Regulations were supposedly in place to stabilize the market and prevent such risky behavior. If the regulations that were supposed to create a safety net and prevent an implosion of the financial sector failed once, what is to stop them from failing again? In other words, regulations have proved to be fallible and restricting the ability of hedge funds to function effectively is injudicious. The proliferation of hedge funds and similar investment vehicles will enhance the viability of markets, strengthen economic development, create jobs, and spur innovation. Governments should encourage this and not attempt to constrain them with gratuitous regulatory measures. The failure of hedge funds has never required taxpayer dollars to bail them out (Mallaby, 2011a p. 376). As Sebastian Mallaby notes, it is inevitable that there will be some hedge funds that will prove too big to fail (Mallaby, 2011a p. 12). The focus of regulatory measures should be devised with a limited extent to prevent the failure of a major hedge fund from triggering a crisis. This will prove both conducive to diminishing systemic risk and cost effective for the private sector and governments. Thus, the excessive regulation of hedge funds is unnecessary and could ultimately prove detrimental to the global financial system by sabotaging the viability of an entire industry.
REFERENCES


Cantrell, A. (2005), “Could Hedge Funds Hurt the U.S.?”, CNN, November 29,


Landler, M. (2005), “U.S. Balks at German Chancellor’s Call for Global Regulations to Curb Hedge Funds”, *The New York Times,* June 17,


McWhinney, J. (2010), “Massive Hedge Fund Failures”, Investopedia, 


Parkinson, P. (2006), “The Role of Hedge Funds in the Capital Market,” Before the Subcommittee on Securities and Investment, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Federal Reserve, May 16, 

Preqin (2014), “Global Hedge Fund Managers Responded to the AIFMD”, Preqin, July, 


Quaglia, L. (2009), “The ‘Old’ and ‘New’ Political Economy of Hedge Funds Regulation in the EU”, Prepared for the UACES Conference in Angers, September 3-5, 


SEC (2012), “Hedge Funds”, U.S. Securities and Exchange Commission, 


