Corporate Governance and Hedge Fund Management

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Hedge Funds: Creators of Risk?
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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

⇒ 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 ($V_L$)
  - 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)

⇒ 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
  • Determinination 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 ⇒ 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
Additionally, hedge funds themselves benefit from activism: the risk-adjusted annual performance of hedge funds seeking changes in corporate governance is about 7-11% higher than for non-activist hedge funds and hedge funds pursuing less aggressive activism. These results imply that hedge funds can facilitate long-lasting changes in corporate governance, cash flows, and operating performance that benefit target firm shareholders and hedge fund investors alike. Keywords: hedge funds, activism, shareholder, corporate governance. JEL Classification: G23, G32, G34. Suggested Citation: Suggested Ci