Corporate Governance and Hedge Fund Management

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Hedge Funds Not Like Restricted Access Closed End Mutual Funds

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

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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
  \[ \Rightarrow \quad \text{Lenders treated broker/dealers like efficiently milked cash cows} \]
  - 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
Hedge funds have become critical players in both corporate governance and corporate control. In this article, we document and examine the nature of hedge fund activity. Keywords: Corporations, Organizations, Hedge-Fund Activism, Corporate Governance, Hedge Funds, Securities Regulation, Short-Term Payoff. Suggested Citation: Kahan, Marcel and Rock, Edward B., Hedge Funds in Corporate Governance and Corporate Control. University of Pennsylvania Law Review, Vol. 155, p. 1021, 2007; U of Penn, Inst for Law & Econ Research Paper No. 06-16; NYU, Law and Economics Research Paper No. 06-37; ECGI - Law Working Paper No. 76/2006. Available at SSRN: https://ssrn.com/abstract=919881. Hedge fund management firms are often owned by the managers in charge of the portfolio, meaning that they are entitled to a large amount of the profits that the hedge fund makes. When entering into a hedge fund, investors fund the management fees that cover the operating expenses, as well as performance fees that are usually distributed to the owners as profit. What sets hedge fund managers apart from other types of fund management is the fact that the personal worth and funds of hedge fund managers are usually tied directly to the fund itself. This means that the managers are looking for large opportunities to capitalize in a corporate environment. Examples of this include mergers and acquisitions, bankruptcies and shareholder buyback initiatives. Conventional thinking about governance issues for hedge funds is to view them as mutual funds or money managers. This article proposes an alternative view -- that hedge fund governance is best understood by looking at limited partnerships or public firms that are similar in terms of either their assets or liabilities. This reasoning suggests that most hedge funds can be classified into only two groups for the purpose of understanding governance issues: funds that engage in proprietary trading and those that are more like private equity partnerships. This dissertation focuses on two of these aspects, including the implications of hedge funds for asset management and for corporate governance. Read more. Article.