

FEDERAL RESERVE BANK OF ATLANTA

# Corporate Governance and Hedge Fund Management

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It would appear to be obvious that the right way of thinking about the governance issues associated with hedge funds is to think of them as mutual funds or money managers. Hedge funds differ from other managed portfolios in a number of dimensions, including the restriction of sales to qualified—that is, high net worth or institutional—investors, lower transparency due to reduced reporting requirements, difficulties in marking assets to market when they are highly illiquid (as is frequently the case), and the widespread use of leverage, to name a few. The Securities and Exchange Commission (SEC) clearly thinks of hedge funds as a type of closed-end mutual fund, albeit one not covered by all provisions of the Investment Company Act (ICA) of 1940, since the SEC now requires hedge funds to become registered investment advisers under Rule 203(b)(3)-2.

On this view, an analysis of the governance of hedge funds should proceed by comparing and contrasting them with more highly regulated investment vehicles. Yet only two of the ten TASS categories of hedge funds—emerging market and some, but not all, global macro funds—are cut from this mold.<sup>1</sup> Fund-of-funds or multistrategy-fund hedge fund managers might be viewed as less regulated ICA investment advisers as well, but this fact would not facilitate our understanding of the governance issues associated with the underlying hedge funds unless they functioned as less restricted mutual funds or money managers.<sup>2</sup>

My contention is that the corporate governance issues associated with most other hedge funds and, to some extent, even with global macro and emerging market funds should be viewed from a different perspective. Most hedge funds are organized as limited partnerships, and I argue that other private partnerships or groups within public companies that function in a manner similar to such partnerships comprise the appropriate peer group. This view is hardly surprising for hedge funds that are private-equity-like in their investment strategies, but it does not appear to be the way in which students of hedge funds think about convertible arbitrage, short and long/short

equity strategies, fixed-income arbitrage, short-term event-driven trading, and the like. If this notion is correct, the implications of the governance of most hedge funds can best be understood by asking why they are not structured as some other type of private partnership, not why they are not mutual funds.<sup>3</sup>

This reasoning suggests the hedge fund universe can be decomposed into only two groups for the purpose of understanding governance issues: those hedge funds that engage in proprietary trading and those that are more like private equity partnerships. This view might seem to be overly simplistic given the heterogeneity of the hedge fund universe, but one can view most hedge funds as one type or the other, at least through my rose-colored glasses. Accordingly, the next section discusses governance issues associated with the particular needs of proprietary trading while the penultimate section does the same for private equity. A brief conclusion rounds out the paper.

### Organizational Form and Proprietary Trading

In my classification scheme, most of the hedge funds in the TASS categorization are similar to proprietary trading desks. Convertible arbitrage, dedicated short bias strategies, equity market neutral portfolios, fixed-income arbitrage, and managed futures trading fit into this group. So do global macro funds to the extent that they engage in frequent trading based on relative valuations of countries, sectors, or individual firms. Most event-driven strategies other than distressed securities—such as merger arbitrage, Regulation D funds, and high-yield (junk bond) portfolios—fit into this group as well. The first two subsections that follow describe governance issues associated with proprietary trading under the private partnership structure that used to dominate the Wall Street investment houses and those under the public-company form that followed. The last subsection contrasts these observations with the governance issues associated with hedge funds.

**A brief account of proprietary trading in private partnerships.** The corporate governance issues associated with proprietary trading used to be so simple. A single structure—the conventional private partnership—dominated the industry because investment banks and broker/dealers were structured that way.<sup>4</sup> Proprietary trading was a natural outgrowth of the other business lines, particularly the synergy between the dealer and investment banking functions. The “production function” of proprietary trading involved two main capital inputs: human capital, which provided the necessary skills, and access to financial capital. The former was bound to the firm by the structure of partnership agreements that, in conjunction with the inventory of securities held by the firm, provided the basis for brokers’ loans that funded its dealing and trading.

Salomon Brothers in the mid-1970s provides a representative example.<sup>5</sup> The company’s average daily inventory was on the order of \$6 billion in 1976, and the paid-in capital of the firm was about \$200 million. Book-value leverage was thirty to one although leverage at market was much less since book value understated market value. The inventory was used as collateral to obtain overnight brokers’ loans, which were valued by Salomon and not by the lender. The firm also had general unsecured debt obligations for which the general partners had unlimited liability.

The asset side of the balance sheet looked a bit different. On any given day, the overall assets of the proprietary trading desks ( $V_A$ ) had three components: the value of the long positions ( $V_L$ ), cash on hand devoted to margin requirements ( $C_M$ ), and uncommitted cash ( $C_U$ ) or

$$V_A = V_L + C_M + C_U.$$

The cash committed to margin requirements could have been on short or long positions or, after the introduction of financial derivatives, futures and options contracts. The assets in which the firm invested were typically illiquid, making the true value of long positions unobservable, suggesting that a potential moral hazard problem associated with overnight brokers' loans existed since Salomon set the price at which securities were marked to market. Note also that one would need to drill down beneath these numbers to get a handle on the risks incurred by the proprietary trading desks since losses on any short positions or on any leveraged long positions required the use of uncommitted cash, increased borrowing, sales of existing long positions, or covering existing short positions.

Personnel management in sales and trading—and, for that matter, investment banking and research—looked remarkably like that of a university. General partners in the firm made up the senior faculty, limited partners were analogous to tenured associate professors, and the remaining nonpartner professionals played the role of junior faculty. The firm made “up or out” decisions regarding these junior faculty members four to seven years after they joined the firm. Those who did not receive tenure by making limited partner moved to another firm. 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.

Compensation consisted of a relatively small base salary and a potentially large—by the standards of the time—annual performance-based bonus.<sup>6</sup> The determination

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1. See Tremont Advisers and TASS Investment Research (2002). The TASS database (acquired by Lipper research firm in 2005) is the leading industrial-quality hedge fund database, covering 6,600 hedge funds.
  2. Indeed, the empirical evidence confirms that a portfolio of hedge funds can have a lower standard deviation than a single fund. The lower standard deviation, however, comes at a cost: A portfolio of hedge funds has returns that are more skewed toward losses and more correlated with the stock market than returns of single funds.
  3. This view would be strained if the SEC weakened the qualified investor standard to permit the creation of retail hedge funds with smaller investors of the sort found in Europe because the organizational forms of such funds would likely differ substantially from those under the current provisions. In addition, the argument for regulation predicated on investor protection considerations would be stronger for such funds; see Edwards (2006) for a contrary view. At the Atlanta Fed conference, SEC Commissioner Gay Huey Evans pointed out that the European experience with retail hedge funds can provide much guidance in this regard.
  4. The major New York commercial banks also had proprietary trading desks, devoted almost exclusively to fixed-income securities. The banks were particularly active in government and municipal bond trading. Thinking through the associated corporate governance issues is difficult because of the regulated nature of commercial banks and, in particular, the role of deposit insurance.
  5. What follows is based on my recollection of putting brokers' loans together to fund the inventory in the summer of 1975 and of keeping (approximate) daily profit and loss records for a number of trading desks in the summer of 1976. Salomon was lurching in the direction of more automated, near real-time profit and loss calculations, which provided me with exposure to the major trading desks because Profit Control, the group that performed this task, had to keep and reconcile two sets of books, the old manual books and the new automated ones. One such desk was the arbitrage desk, which could, in principle, make any relative value trade in any security. Common trades were convertible bond arbitrage, convertible preferred arbitrage, and relative value trades across and within sectors. Another desk was the industrials desk, which handled sales and trading in such bonds and, as a consequence, supported both the dealer and proprietary trading functions. It was here I learned that “summer kid” could be a great job description since partners were delighted to answer my questions no matter how dumb they were (the questions, not the partners). The word “lurching” in the foregoing refers to the fact that automation did not go well initially and turned into a multiyear project.
  6. The most extreme spread I recall was a trader who received \$12,000 in salary and a bonus of almost \$500,000.

of these bonuses was a contentious process that gave rise to much lobbying and to occasional manipulation of the trading books. For general and limited partners, these bonuses did not represent pure income: General partners had a mandatory plowback ratio of 80 percent while that of limited partners was lower. Partners at Salomon Brothers had a strong incentive to remain productive after tenure: In some sense, they were asset rich and cash poor although they were hardly poverty stricken.

Now consider the structure of such firms from the perspective of agency theory. In economic terms, their liabilities were collateralized and unsecured debt obligations and an implicit claim on human capital in the form of the general and limited partners.

*I argue that the governance issues associated with hedge funds are best understood by looking at other limited partnerships or public firms that are similar in terms of assets or liabilities.*

As was the norm, partners had unlimited liability. Consequently, lenders were treating these investment banking/broker/dealer firms like they were cash cows being milked by the equityholders in the firm. Lenders could reasonably count on the equityholders to perform this task for at least three reasons. First, the human capital was bound to the firm by the plowback provisions of the partnership agreement. Second, partnership shares were valued at cost until sometime around the onset of retirement, further binding the partners to the firm. Finally, more productive partners received higher fractional ownership through the bonus system, ensuring that the best traders and investment bankers served on the important committees and, thus, closely oversaw the business activities of the firm.<sup>7</sup>

**A brief account of proprietary trading in public corporations.** This structure remained in place at most Wall Street firms until the late 1970s. Around that time, such firms started to change their corporate form to become public corporations.<sup>8</sup> The binding of human capital to the firm via plowback provisions and book-value accounting was not sustainable for most of the industry as competitors lured productive general and, to a greater extent, limited partners with substantial signing bonuses. Even Goldman Sachs, which had a long-standing policy of not making lateral hires from other firms, began to do so in 1990 to stem the outflow of human capital even while it remained a private partnership. Most firms remained extremely profitable as public companies during this transition even if they did have some spectacularly bad years.

Proprietary trading in public corporations differs from that in a private partnership in two main ways. First, the opportunity cost of capital tends to fall since the idiosyncratic risk is spread over a diversified shareholder base. Second, this benefit has a cost: the agency problems engendered by the separation of ownership and control. These problems are qualitatively different from those in the typical public corporation because of the nature of proprietary trading. The asset side of the balance sheet is identical to that for proprietary trading within private partnerships since  $V_A = V_L + C_M + C_U$ , and large gains or losses on the long or short positions can dramatically change the capital allocated to the trading desks and, with it, the corresponding risk exposures and leverage.

Agency theory suggests that the lack of transparency regarding profitability, risk exposure, liquidity, and leverage in proprietary trading under the corporate form naturally creates substantial problems for external monitors. To be sure, compensation in the form of performance-based bonuses and executive stock options can mitigate these problems to some extent. However, there is little doubt that performance-based compensation without explicit external monitoring is an imperfect substitute for direct monitoring under those conditions in which good governance is especially

important: when actual or pending losses plunge the firm into financial distress. Proprietary trading typically accounts for a disproportionate amount of firm risk and, with it, the risk of financial distress. All of the usual costs of financial distress are potentially at work here: the myopic focus on short-term gain at the expense of good long-term decisions and the incentive to allocate scarce capital to excessively risky strategies for a modest probability of great gains and away from good, but modestly profitable, ones.

Moreover, the corporate analogues of the full and limited partners are relatively cash rich and (firm-specific) asset poor. After all, human capital in the form of skill at proprietary trading is an almost tangible asset that can be freely transferred across firms although distinguishing good luck from good policy is sometimes hard. In other words, the human capital of proprietary traders is not bound to the public firm as it was under private partnerships. Shareholders implicitly look to the franchise value—that is, the value of the brand or the reputation of investment banking/broker/dealers organized as public corporations—to provide appropriate incentives to managers.

**The hedge fund form and proprietary trading.** The types of hedge funds mentioned at the beginning of the section seem to me to be analogues of proprietary trading desks because their strategies ultimately profit from the same drivers. One such strategy is the provision of liquidity in illiquid markets faced with unexpected demands for immediacy that are not value related. Another is market timing that involves taking positions before other momentum, contrarian, or event-driven traders decide to make similar bets. An example of the former involves taking positions in mortgage-backed securities when regulations affecting savings and loans require them to change the size of their mortgage portfolios, a motive for trade that is hardly value related. If other traders do not take the opposite side of their trades, the hedge fund will take a substantial haircut for doing so, an outcome that can be viewed as selling immediacy when it is dear. An example of the latter is short-term currency trading at global macro hedge funds, which typically involves guessing better than the crowd where the crowd is headed. Such trades can be viewed as transferring liquidity over time (that is, buying immediacy when it is cheap and selling it later when it is predicted to be expensive), or they can be viewed as directional bets or as contributions to price discovery.

The capital and risk structures of proprietary trading operations are essentially the same across organizational forms. Here, too, traders take long positions in some securities and short positions in others. Hence, the capital committed to proprietary trading is made up of uninvested cash, the cash dedicated to the margin requirements for the relevant asset and derivatives positions, and the market value of the long positions. That is,  $V_A = V_L + C_M + C_U$  for these sorts of hedge funds as well. 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.

The question at hand, however, is how hedge fund governance structures and their concomitant moral hazard problems compare with those of otherwise similar entities in private partnerships and public companies. One natural solution—the one that is codified in the Investment Company and Investment Advisers Acts of 1940—is periodic reporting of the asset side of hedge fund balance sheets, fiduciary obligations, and restrictions on position sizes, short sales, and leverage. However, limited

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7. This last aspect was not universal. For example, Goldman Sachs allocated ownership shares primarily on the basis of seniority until 1990.

8. Until about 1970 the law prohibited the incorporation of investment banks.

partnerships that function as proprietary trading hedge funds follow strategies that are trade secrets, making disclosure requirements more burdensome. Moreover, they routinely use short sales and leverage, and their assets are typically less liquid, making marking to market more problematic. Even if these barriers can be overcome, hedge fund trading strategies are so dynamic that “snapshots” such as quarterly reports are an extremely unreliable guide to the recent history of their risk, return, and leverage characteristics. Long positions become short positions, and leverage changes by an

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order of magnitude so readily that periodic reporting simply cannot play a role similar to that in the mutual fund universe.<sup>9</sup>

Put differently, the underlying economics of proprietary trading probably means that such hedge funds cannot function as less highly regulated mutual funds without nontrivial changes in regulatory

structure. Regulators can choose to make hedge funds conform to the disclosure obligations and other requirements of mutual funds, but in so doing they will likely push proprietary traders into other organizational forms that are probably less economically efficient or into other regulatory jurisdictions offshore. The transparency of SEC-regulated funds would not appear to be an option for such hedge funds.

One dimension in which hedge funds differ from their investment banking/broker/dealer predecessors arises from a change in legal technology. General partners, as well as limited partners with control responsibilities, had unlimited personal liability under the old structure. Partnerships can now create a limited liability corporation to serve as the general partner, and the individual partners can be made into limited partners, thus limiting their liability. Older firms that became public corporations probably would have adopted this structure had they persisted as private partnerships; Goldman Sachs, the last of the major Wall Street partnerships to go public, was organized in this fashion well before its initial public offering in 1998. Hence, the stronger incentives associated with the unlimited liability of general partners in the *ancien régime* would have disappeared in all likelihood and, with them, the comparative merits of hedge fund governance structures in this dimension.

That said, the limited partners in hedge funds are glorified creditors, not active participants in the day-to-day operations of the business. Under the old structure, senior and junior partners, along with relevant nonpartner employees implicitly and sometimes formally and explicitly, monitored each other, mitigating to some extent the moral hazard problems afflicting external creditors and internal equityholders. As is the case with the corporate form, performance-based compensation alone is an imperfect substitute for explicit monitoring in the presence of moral hazard.

However, the governance structure of hedge funds improves on that of public companies with regard to moral hazard in three ways. First, hedge fund managers receive a more refined performance-based fee, the high-water-mark contract. Second, managerial wealth is managed inside the fund. Third, managers are bound to the fund to some extent via exit restrictions.

The high-water-mark contract more closely aligns managerial incentives with those of the limited partners in the hedge fund. A recipient of conventional performance-based compensation receives a specified fraction of any increase in net asset value over the evaluation period when returns are positive and nothing when they are not. The high-water-mark contract differs in the baseline for the calculation: the highest net asset value attained by the fund at any time on or before the beginning of the

evaluation period. Thus, the general partners of a hedge fund receive the performance bonus only when the net asset value of the fund at the end of the evaluation period exceeds the high-water mark, not when annual returns are positive during the evaluation period. That is, managers are not compensated for returns obtained by simply reversing prior losses.

A second device directly exposes hedge fund managers to downside risk as well. In the typical hedge fund, all partners and sufficiently senior employees invest the bulk of their wealth in the fund (or fund family) and manage their major liabilities such as home mortgages within the partnership as well. Both income and wealth are performance based in these circumstances, which makes for a more powerful incentive than performance-based income alone. Note that the marginal incentive to take on too much risk stemming from the optionlike payoff of the high-water-mark contract is counterbalanced to some extent by the increased exposure to downside risk engendered by this aspect of the partnership structure. Of course, the precise balance between these opposing incentives cannot be determined without knowledge of the precise structure of these contracts, the nature of the assets and liabilities of the fund, the size of the management team's position in the fund (particularly in relation to the upside potential of the high-water-mark contract), and the risk aversion of the management team.

Finally, hedge fund managers are bound to the firm more tightly than their analogues in publicly owned firms. To some extent, their partnership agreements typically make it difficult for them to leave the fund, binding them to it much as plow-back provisions, book-value accounting, and annual bonuses did in the earlier private partnerships. Moreover, the formal strictures may well be weaker than the informal ones because of the rewards to reputation in this industry. Here, too, the increase in downside risk exposure created by this aspect of the limited partnership structure serves to counterbalance risk-seeking incentives to some extent.

Clearly, the incentives associated with the typical hedge fund governance structure are far stronger than their analogues for proprietary trading groups, broadly defined, at public corporations.<sup>10</sup> By the same token, these incentives are probably weaker than those associated with proprietary trading within the old investment banking/broker/dealer private partnerships. The strengthening of incentives comes at a cost: The principals in these organizations bear more fund-specific risk when their wealth is more closely related to the fortunes of the fund.<sup>11</sup>

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9. It is also hard to see a need for regulation in this regard since routine disclosure could be—and often is—part of the partnership agreement. Qualified investors should have the necessary acumen and resources to demand and obtain such provisions if they increase value. One putative benefit of government-mandated, as opposed to contractual, disclosure is that only the former can be backed with criminal sanctions.
10. One modest benefit of the public form might be that the managers of proprietary trading groups, the analogues of the general partners in hedge funds, can be dismissed for poor performance in the corporation, while firing the managing partners of hedge funds is more problematic. More information regarding hedge partnership agreements would be necessary to assess the difficulty in doing so. As Ken Scott pointed out in his discussion of this paper at the Atlanta Fed conference, any collective-action problem is more easily solved in the hedge fund form because the number of investors—and qualified investors at that—is smaller and because the investors are not subject to the regulatory constraints on collective action contained in the 1934 Securities Exchange Act or to the 1968 Williams Act that amended it. That is, the management of a public firm can fire the managers of its proprietary trading desks, but shareholders find it much harder to oust the management of the firm should it fail to adequately monitor and control proprietary traders.
11. In his discussion (see footnote 10), Scott noted that comparing and contrasting the details of actual hedge fund partnership agreements would be useful.

Hence, the opportunity cost of capital or required rate of return will typically depend on total risk, not just systematic or market risk, in these circumstances. The high-water-mark contract, the commitment of managerial wealth to the fund, and any exit restrictions increase the idiosyncratic risk exposure of the hedge fund management team compared with that of proprietary trading groups within a public corporation. By the same token, proprietary trading within the old private partnerships bound the principals even more tightly to the fortunes of the firm. Consequently, the opportunity cost of capital implicit in the hedge fund organizational form will typically be higher than that for comparable entities within public corporations and lower than that associated with the private partnerships that used to dominate Wall Street.<sup>12</sup>

### Hedge Funds That Trade on Corporate Governance

Most types of hedge funds are the functional equivalent of proprietary trading desks, but an important class of hedge funds that bet on corporate governance remains: those that invest in assets that are expected to appreciate over the medium term because of the general partner's skill and acumen in finding, funding, and managing investment opportunities. The governance issues associated with proprietary trading involve the incentive effects on the liability side of the balance sheet. The governance issues associated with this type of hedge fund involve the asset side of the balance sheet and, in particular, the governance issues associated with the assets themselves.

Before proceeding, it is worthwhile to contrast this type of hedge fund with private equity more broadly defined. Both hedge funds and private equity funds such as buy-out funds are organized as limited partnerships. However, private equity partnerships have a contractual life of ten to twelve years—called the lockup period—in which the general partner chooses a portfolio of companies from a prespecified asset class over five to seven years, and the limited partners provide the capital to fund these investments. Since there is a long lockup period and since the limited partners cannot hope to measure the value of the portfolio of companies until the assets are liquidated, the limited partners implicitly rely on the compensation structure to provide appropriate incentives to the general partner. To oversimplify matters, the standard contract involves a fixed fee that pays the salaries of the management team and other costs of doing business, incentive compensation that is a fraction of the profits, and a hurdle rate that governs the payments that must be paid to the limited partners before the incentive fee is paid.<sup>13</sup>

**Private-equity-like hedge funds.** Private-equity-like hedge funds have shorter lockup periods. Limited partners may be required to keep their funds invested for one to three years, after which time they may be permitted to withdraw funds each quarter. The asset menu of such hedge funds can make the de facto lockup period longer than the de jure one: Marking to market is done by the general partner, giving the manager considerable latitude when the assets in question are highly illiquid. That said, the asset classes for which the hedge fund structure is viable are made up of investment opportunities expected to be profitable over the intermediate term. The hedge fund form with a comparatively short lockup period will work only for such asset classes.<sup>14</sup>

In addition, the compensation structure of such hedge funds has nothing special about it relative to conventional private equity limited partnerships. If the assets are sufficiently liquid, the natural form of incentive compensation is the high-water-mark contract; if they are not, the high-water-mark contract is not viable, and so the incentive contract is of the type found in private equity firms described briefly above.<sup>15</sup>



Distressed securities represent one such investment opportunity. The skill sets of the general partners of such funds include the ability to identify firms that have a real chance of climbing out of their distressed circumstances, to acquire a controlling interest in the firm at prices that represent substantial discounts, and to manage the bankruptcy or reorganization process. Such skills make it possible to identify and purchase undervalued distressed securities, usually distressed debt.

The hedge fund cannot expect to profit by selling distressed debt before the firm exits financial distress; high adverse selection costs exist because potential buyers know that resellers are potentially much better informed than they are, and this high adverse selection risk implies a correspondingly large haircut. Hence, the limited partners understand the risk that the de facto lockup period will exceed the de jure one. Put differently, limited partners will only want to liquidate their positions and, thus, force the general partner to sell the distressed debt in the marketplace when it becomes sufficiently implausible that the general partner will be able to successfully bring the portfolio companies out of financial distress.<sup>16</sup>

Hedge funds that specialize in buyouts also differ from their private equity counterparts in the horizon over which candidate buyouts are expected to be profitable. This sort of buyout fund typically acquires divisions of large firms that want to concentrate

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12. I would hardly expect this ordering to hold uniformly. The asset, liability, compensation, and legal structures of hedge funds contain many moving parts, and the balance across these factors can reverse this ordering in particular cases. For example, one can view the decision of the group led by John Meriwether at Salomon Brothers to form Long-Term Capital Management as one based on the impact of organizational form on the opportunity cost of capital. However, the implicit opportunity cost of capital for the Meriwether group appeared to fall when they left Salomon Brothers, in contradiction to the argument in the text.

All of the great Wall Street partnerships of the last century are now organized as public corporations, a change that was accompanied by the consolidation of these former partnerships as well. This observation suggests that the reduction in the opportunity cost of capital of large public companies or hedge funds outweighs the potential improvement in governance associated with private partnerships. To be sure, there are still private partnerships engaged in proprietary trading, but they tend to be smaller boutique or niche firms. Perhaps the signal sent by tying the fortunes of the partners more tightly to the profit and loss of the proprietary trading operation is sufficiently valuable for partnerships with less reputational capital.

13. The prevailing incentive contract is more like the dividend on a preferred stock—in fact, the industry refers to it as a preferred return or hurdle rate—than it is like the high-water-mark contract. Viewed as an option, the contract moves the strike price each period by the hurdle rate. The limited partners receive this dividend—which is a fraction of the capital committed by the limited partner—but, if the dividend is not paid, it accrues so that the limited partners receive the cumulative dividend with interest. Once the preferred return is paid in full to the limited partners, subsequent income pays the cumulative incentive fee to the general partner, and, once this fee is paid in full, subsequent income is divided between the general and limited partners in accordance with the contract. This description offers a bare outline of the standard contract; many variations on this theme exist in the industry.

14. One way to get around lockup provisions without forcing the fund to sell securities is for the hedge fund to make in-kind payments to investors. Many hedge funds transfer illiquid securities to investors through a vehicle called a special investment account, termed a side pocket in the industry. Side pockets can resolve the problem of lockups, but, by themselves, they do not solve the valuation and agency problems that make the securities in question illiquid in the first place.

15. Here, too, side pockets can be used to some extent to make incentive compensation more like that in the high-water-mark contract.

16. Perhaps this gap between de facto and de jure lockups can be mitigated to some extent with conditional lockup provisions that permit more rapid withdrawals when adverse circumstances arise that are observable to the general partners in real time and to the limited partners ex post.

on their core business or small firms that are in the later stages of incubation by venture capitalists. The general partners of these funds expect to profit by using their managerial expertise to nurture the growth of the target firms or by finding synergies among several target firms and then bundling them together. Gone, for the most part, is the “buy and bust up” form of buyout fund that was so popular in the 1980s.

That said, the moral hazard problems inherent in the corporate form that leveraged buyout firms were designed, in part, to address remain nontrivial ones. The menu of problems includes large cash positions that incumbent management may use

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inefficiently, unexploited tax shields associated with too little leverage, poison pills that insulate management from the market for corporate control, and staggered voting that ensures that only a fraction of the board of directors can be replaced at any time, thus facilitating corporate cronyism. However, leveraged buyouts and even

distressed debt acquisition to some extent are blunt tools for dealing with such problems unless the target firm requires sweeping changes.

**Activist hedge funds.** Activist hedge funds target public companies, the performance of which they hope to improve with better corporate governance. Such funds take a minority position in the firm—sometimes several hedge funds target the same firm—but do not seek to acquire the firm or even control it. Their aim is to use their minority position to lobby incumbent management to make specific changes in governance such as disgorging excess cash, increasing leverage, and revoking poison-pill and staggered-voting provisions in the corporate charter. They acquire their toeholds in secret and hope to profit from increased share prices if they are successful.

Since they lobby publicly from a minority position, activist hedge funds typically seek (and probably require) more traditional stockholders to agree with proposed governance changes, making this strategy similar to virtuous greenmail when it works in this fashion. Of course, sometimes the entrenched management will simply pay the activist fund to go away, payments that are implicitly paid for by the dispersed shareholder base. That is, not all greenmail is virtuous.

The very public nature of their activities in the market for corporate control after the toehold is acquired mitigates considerably the moral hazard problems confronting the limited partners. Here too a substantial difference can exist between the de facto and de jure lockup periods, but the difference is, to some extent, a choice made by the limited partners, not one forced by the general partner. Limited partners in activist hedge funds can make their own assessments of the likelihood that the attempt at greenmail will be successful, and therefore they are far better situated to implicitly mark the hedge funds’ assets to market than are limited partners of buyout and distressed securities funds. These partners are also better able to assess the impact of any failure to effect changes in governance on share values.

As with hedge funds that function as proprietary trading desks, the moral hazard problem prior to the acquisition of the toehold cannot be solved via the disclosure provisions of the Investment Company and Investment Advisers Acts of 1940 without seriously affecting the opportunity set of distressed debt, buyout, and activist hedge funds. Any revelation of the firms that are “in play” will increase the share, debt, or overall firm prices. Put differently, these hedge funds also follow investment strategies that are trade secrets, the value of which will be diminished by periodic disclosure.

## Conclusion

The central tenet of this paper is that the governance issues associated with hedge funds are best understood by looking at other limited partnerships or public firms that are similar in terms of either their assets or liabilities. If this view is correct, the costs and benefits associated with the hedge fund form should be compared with those of otherwise similar entities that are organized differently. Hedge funds should fall more under the purview of the SEC's regulations governing broker/dealers, public corporations, or limited partnerships than under its regulations regarding mutual funds and money managers. The agency problems are more like those at Enron, Goldman Sachs, or law partnerships than they are like those at Vanguard or Fidelity.

The theory, such as it is, in this paper is largely descriptive, providing a framework for thinking about governance issues in hedge funds. The discussion implicitly explains why proprietary-trading-like hedge funds replaced the unlimited liability partnerships of the Wall Street investment houses that preceded them: Unlimited liability partnerships require higher opportunity costs of capital than hedge funds with strong incentive contracts. Similarly, the separation of ownership and control associated with proprietary trading in a public firm suggests that this organizational form is viable only for those entities that have substantial franchise values based on reputation. From this perspective, private-equity-like hedge funds are seen to be like niche firms carved out from the larger private equity universe with time horizons that are shorter and underlying assets that are more liquid or that can be more readily valued by limited partners.

As such, the analysis does not provide ready answers to the question of how best to improve hedge fund governance. To do so would require an explicit analysis of the trade-offs associated with different organizational forms that facilitates the calculation of the net burden of regulation. For example, more stringent disclosure requirements for private-equity-like hedge funds regarding later-stage changes in portfolio company valuations might well be a good idea. However, any case for imposing such requirements would necessarily rest on identifying the market failure that prevents general partners from committing to the provision of such information in the current regulatory regime. The analysis in this paper provides the scaffolding for assessing the net burden of regulation, but the real heavy lifting requires a more detailed explication of the nature of and limits to contractibility in these markets.

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