PWG Tells Hedge Funds Where to Go and How

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On April 15, 2008, the President's Working Group released the recommendations of two of its sub-committees for improvements to the hedge fund industry: The Asset Managers' Committee and The Investors' Committee. Hedge funds are widely blamed for their role in exacerbating the current crisis in the credit markets, making these reports particularly relevant at this time. Hedge funds are also a substantial source of business for traders. Things that affect hedge funds eventually come home to roost on the desk.

The President's Working Group, or PWG if you consider yourself among the *cognoscenti*, was established in 1988 by President Reagan through an executive order in response to the 1987 market crash. The PWG has four members: The Secretary of the Treasury and the chairs of the Board of Governors of the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

As is often the case with high-level committees established by executive order, a fair number of conspiracy theories have circulated about the PWG. I'm not a conspiracy theorist – readers that are fond of this sort of thing can Google the President's Working Group. One thing that seems fairly clear about the PWG is that their recommendations can be expected to make the case that additional regulation is not necessary to solve whatever problem is currently in their gun sights. The PWG is as predictable as the Chamber of Commerce on that score.

The current reports are a somewhat classic example of the breed. In the midst of arguably the greatest financial crisis in several decades, where hedge funds played a leading role, the Asset Managers' Committee concludes that the current problems, if any, can be solved by hedge fund managers voluntarily adopting "best practices." The report then provides a fairly detailed list of these best practices, many of which are wildly impractical for all but the largest hedge fund groups. The Investors' Committee, for its part, thinks investors in hedge funds need to perform more "due diligence" before investing. Large institutional investors, such as CALPERS, have the resources to engage in extensive due diligence. For that matter, they are also in a position to dictate best practices, since even a whiff of their money makes most hedge fund managers swoon. But, this advice is mostly lost on high net worth investors and the smaller family offices. More cynical observers than me think this amounts to blaming the victim.

Compare the attitude of the PWG with the Congress of the 1930's, which left in its wake most of the federal securities regulation encountered by the financial services industry today. The enemy, in their mind, consisted of "puts and pools," and their initial impulse was to ban them from the face of the earth. We now know of "puts" as derivatives. Today's options traders can thank the Puts and Calls Association of New York for the stalwart lobbying effort that convinced Congress to regulate derivatives, rather than prohibit them altogether. Pools are, of course, hedge funds. In the days prior to the Investment Company Act of 1940, the mutual fund, as we know it, did not exist.

Best practices are generally inspired by the fear that, if an industry doesn't clean up it own act, government regulators will be forced to do it for them. Regulation generally is more costly than self-regulation, if for no other reason than regulators represent a group of additional employees that someone has to pay for through taxes or otherwise. In the United States, we are fond of making industries pay for the own regulation through the vehicle of "self-regulatory organizations." The desire to avoid this form of taxation has inspired many best practices.

Nonetheless, the fact is that compliance with best practices imposes a cost on the organization determined to follow them that places it at a competitive disadvantage with its less scrupulous competitors. In some cases, it may be possible to shame the unscrupulous into some sort of grudging compliance. Best practices usually evolve into governmental regulation when the ostracism strategy turns out to be ineffective.

Worse yet, best practices tend to be self-serving, as demonstrated by the PWG's Asset Managers' Committee report. Hedge funds have been plagued recently by margin calls from their prime brokers resulting from the collapse of the markets for many of the exotic securities that were popular hedge fund investments. When the securities became difficult to value, or failed to find a "ready market," prime brokers called for more capital. At the same time, nervous investors have been seeking redemptions, in some cases to meet their own margin calls. The report's best practice to resolve this difficult problem of valuation informs us that the hedge fund's valuation of the unmarketable security should be accepted by all and sundry, rather than relying on a third party valuation. Recognizing the obvious conflict of interest this involves, the report sublimely suggests that employees other than the portfolio manager should do the valuing. It is hard to see how this solution solves the problem, since a low valuation threatens the solvency of the fund and places the jobs of all of its employees in jeopardy.

More pressing yet, the financial services industry tends to affect the larger economy, which explains why the Congress of the 1930's wasn't content with best practices. If it were just a matter of a few rich people losing some money, they might have been content to allow ostracism and business pressures to suffice for regulation. But the havoc created by puts and pools tossed the economy into a depression and put a quarter of the working population on the dole.

The U.S. economy is now going through a period of intense deleveraging as thousands of hedge funds unwind dubious investments. The Fed's efforts to stave off economic collapse have been heroic, if a bit uncertain from a legal point of view. Unemployment and poverty are the usual outcomes of this type of event. It remains to be seen whether or not these horrors can be avoided this time around. If not, people who have no idea what a hedge fund is are likely to bear the brunt of this catastrophe.

That said, federal regulation of the financial services industry is not a panacea, and regulations conceived in the 1930's are long overdue for an overhaul. A good bit of the problem results from the way "pools" ended up being regulated. Ideally, regulation would permit sophisticated heavily endowed institutions and rich people to eat the unripe grapes without setting everyone else's teeth on edge. More on that in future articles.