Corporations, Securities & Antitrust

Sovereign Wealth, Private Equity, and Hedge Funds . . . Oh My

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Americans have long exhibited a suspicion of concentrated pools of capital controlled by small groups of people. During convulsive economic times, with little understanding as to the causes and great fear as to the effects of the turmoil, we have tended to the diversion of scapegoating paranoia. Alan Brinkley's 1982 book on Depression-era populists Huey Long and Father Coughlin captures this mood well in describing how the two demagogues railed against "large, faceless institutions; wealthy, insulated men; vast networks of national and international influence: all exercising power and controlling wealth that more properly belongs in the hands of ordinary citizens."

The last time we experienced disruptions in our financial system on a scale like we have seen of late—in the wake of The Great Depression—the regulatory response was massive, and the legal edifice that was erected, in the form of our still regnant banking and securities laws, was designed in particular to divorce investors' pecuniary interests from their ability to control American industry in which they are invested.

The enacted restrictions and prohibitions were not undertaken lightly—nor were their hazards to economic efficiency misunderstood. Washington intended to prevent financial institution control of industrial companies. Beyond mere mistrust of Wall Street, this was an attempt by regulators to enact a broad-ranging regime that would guide (or restrict, depending on your point of view) the growth of the financial services industry and our capital markets for the foreseeable future.

In its 1934 report on stock exchange practices, the Senate Committee on Banking and Currency argued that investment companies had become "the instrumentality of financiers and industrialists to facilitate acquisition of concentrated control of the wealth and industries of the country." The report urged Congress to "prevent the diversion of these trusts from their normal channels of diversified investment to the abnormal avenues of control of industry."

At the time, the nascent mutual fund industry was a great scapegoat and the perception of risk likely was overstated. Lawmakers wanted to protect against the eventuality that the mutual funds would abuse the resources of their portfolio companies. But in hindsight, the resulting regulatory regime seems like a solution that was in search of a problem, and the distancing of shareholders from company operations has led to some of the worst excesses of corporate abuse.

Today, distrust of concentrated pools of capital continues, aimed at a new crop of suspects: sovereign wealth, private equity, and hedge funds. Now, as then, populist rhetoric is rising and with it the clamor for government action. Adding urgency is the view of many politicians in Washington that private equity and hedge fund managers are ripe, low-hanging fruit with enough juice to fund numerous social programs.

Sovereign Wealth Funds

The U.S. is the biggest recipient of foreign direct investment. The International Trade Commission reports that in 2006 the U.S. received over $175 billion from foreign investors—amounting to roughly 13.5% of U.S.'s gross domestic product. U.S. capital markets offer a stable and predictable legal system, relatively low taxes, and access to the most coveted consumer market on the globe. There is a global trend developing of sovereign governments forming massive pools of capital specifically to invest in the U.S.

Conceivably, foreign powers could have sinister reasons for wanting to invest in the U.S.: their funds could be used to destabilize financial markets, protect their own domestic industries or even to expropriate security-sensitive technologies. Yet such risks have not materialized in any appreciable way. Political and industrial espionage are as old as nation-states, but there is scant evidence, if any, that sovereign wealth funds have served as Trojan horses for nefarious activities.

And suspicion has real costs. If we turn away sovereign wealth fund capital, innovation will be stifled, productivity reduced, economic growth undermined and employment depressed. Between 2003 and 2007, over 3,300 new projects were announced or opened on account of foreign investment, yielding $465 billion in investment and about 447,000 new jobs in the U.S. We need these numbers to grow, not recede.

Moreover, numerous mechanisms, including banking and export controls, mitigate the risk of foreign ownership of sensitive assets. In addition, the Department of Commerce's Invest in America initiative and the Treasury Department's working group on sovereign wealth funds are working with foreign governments to establish voluntary protocols regarding transparency, stability and security.

Recently, the Treasury Department proposed regulations that would appear to expand the scope of review of foreign investments, including sovereign wealth funds. These regulations confirm that investments below 10% of a U.S. business may be subject to review and approval by the Committee on Foreign Investment in the United States (CFIUS). CFIUS is an inter-agency committee chaired by the Secretary of Treasury which reviews foreign investment transactions with the aim of safeguarding national security. Under these proposed regulations the threshold for CFIUS review includes situations where an investment provides the foreigner with "the power... to determine, direct, or decide important matters affecting the entity." Previously, a safe harbor for less than 10% investments was thought to apply.

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Thus, the move toward limiting foreign capital already has begun, and there is a risk that the trend will expand to endanger much-needed sources of funding in the wake of a devastating credit bubble. So long as sovereign wealth funds exhibit a rational investment strategy designed to maximize profit, we should be wary of any further regulatory restriction, lest we sabotage ourselves.

Private Equity Funds

Private equity firms are a unique and pervasive creature of the capital markets. Structured as long-term, illiquid investment vehicles, these firms typically take controlling positions in private operating companies that have been, among other things, emancipated from a larger public company, transitioned from private ownership, or built by rolling up smaller enterprises into a single firm.

Funding for private equity firms often comes from larger pools of capital, such as pension funds and charitable endowments seeking alternative investments to help generate outsized returns to fund their long-dated liabilities. Historically, the key to private equity firms' success was not only the long-dated nature of their capital but cheap and easy financing in the form of leverage extended by investment banks and then syndicated to other financial institutions. Until recently, with as little as 10-20% down, private equity firms were able to purchase and control enormous enterprises.

With such power comes scrutiny. Lambasted as "locusts," "vultures," and other less flattering epithets—particularly by domestic and foreign free market critics—these firms are under increasing pressure. The high debt loads which fund their purchases are seen by some as a potentially destabilizing force in the capital markets and beyond as economic contraction looms large. It is likely, however, that negative impulses in reaction to private equity are both overstated and misguided, barring the menacingly self-fulfilling prophecy of populist regulatory intervention.

Given their relatively longer investment horizons, private equity funds could prove uniquely positioned to withstand the current credit storm—provided it is not overly prolonged. Private equity firms typically aim to "harvest" (i.e., sell) their investments 3-5 years after acquisition. In the hands of patient capital, private equity portfolio companies can weather the credit crisis with owners who recognize the difference between illiquidity (the short-term inability to freely finance, buy, or sell at full value) and insolvency (a fundamental inability to fund operations on an on-going basis).

As rational actors, private equity firms can be expected to shield fundamentally sound but illiquid businesses and assets until market conditions improve. Similarly, they should be expected to restructure and/or shed businesses and assets that prove to be uneconomical. Moreover, there is no doubt that they will find value in the remains of failed businesses.

And even a wave of private equity led defaults is unlikely to stir up serious systemic risk. A study by the McKinsey Global Institute concludes that private equity borrowing continues to form only a small part of the overall corporate debt market, 11% of overall corporate borrowing in the U.S. and Europe in 2006. According to Diana Farrel, Director of McKinsey Global Institute, if we assume a spike of private equity defaults of 15% from the historic highs of 10%, estimated implied losses would equal only 7% of the 2006 syndicated lending issuance in the U.S. and 3% in Europe. As McKinsey's study points out, private equity-owned companies are worth just 5% of the value of companies listed on U.S. stock markets and 3% of those in Europe.

Unfortunately for private equity funds and their hedge fund cousins (discussed below), the political climate is ominous. The Treasury Department's recently released blueprint for future market regulation envisions much greater scrutiny. Under Treasury's long-term "optimal" plan, the Federal Reserve would act as a safety and soundness regulator with the power to extract "detailed financial information" from any firm viewed as engaging in investments with potentially system-wide effects. The proposal even envisions a central bank that can more or less impose any "corrective actions to address financial stability problems."

More than anything else, private equity firms are allocators of capital. They can be trusted to serve their own profit motives, and as such maximize the value of their holdings. There is reason to doubt that regulators operating under pressure-driven political mandates (even with the advantage of economy-wide information) would do so much better as to justify their intrusion into lawful investment activities.

Hedge Funds

What is a hedge fund? Given their diverse investment strategies, varied investment horizons, assorted sizes and areas of expertise, this is a surprisingly difficult question to answer. The few commonalities of hedge funds are their structure and their payment schemes. In domestic form these funds are typically structured as private partnerships; offshore, as private Cayman corporations. Investors range from wealthy individuals and charitable endowments to pension funds and sovereign states. Hedge fund managers are typically paid a fixed fee (1%-2% of assets under management) and a cut of the profits (typically 20%) every year. One certainty about hedge funds: it is good work if you can get it.

Hedge funds also are the pariahs of the capital markets. Criticized for making too much money and the occasional fantastic flame-out, there is little sympathy for hedge fund managers. Often depicted by the media as "murky" or "secretive" unregulated pools of capital, suspicion of these investment vehicles abounds.

But hedge funds serve important market functions. By introducing specialization in trading strategies and financial analysis, hedge funds help ensure that markets are comprised of many investors with heterogeneous views of value. When market participants disagree on value, they deploy capital in the direction they favor and, importantly, provide liquidity to markets through trading. They bet long (if they expect prices to rise) or short (if they predict a decline), and in so doing facilitate more efficient and accurate market pricing.

Sensible and dependable pricing has extraordinary value well beyond the capital markets, and hedge funds are given far too little credit for this ancillary benefit that emanates from their trading practices. Without effective price feedback loops,

all parts of the modern economy, micro and macro, are at risk of misallocating their resources. One would think that busted bubbles (whether of the Internet or credit variety) would teach us the importance of efficient market pricing and caution against limiting players that facilitate price discovery.

In addition, the sheer abundance and diversity of hedge funds provide a counterbalance to the concentrated power of massive global banking institutions. Securities and Exchange Commission (SEC) Chairman William O. Douglas, a key figure in 1930s financial legislation, articulated an overarching goal of fragmenting economic power under the view that "tremendous power" lays in the hands of firms and people who have the ability to dominate financial markets. Hedge funds are a market-based fragmenting of capital (both cash and human) with the salutary effect of dispersing power of banks.

Despite their notoriety, hedge funds are the runts of the capital markets. Neither a dominant force on a relative or absolute basis, these small, nimble players can nonetheless achieve extraordinary results. As hedge funds grow larger and more bank-like, however, there is no doubt that calls for their regulation will increase; but hedge funds already are subject to significant regulation and forced transparency.

As soon as hedge funds amass 5% stakes in listed companies, they are typically forced to disclose publicly their positions (as well as the prices they paid and the timing of each purchase) by way of filings with the SEC. Once they reach 10% ownership positions, every transaction must be publicly reported. Firms that manage in excess of $100 million are required to report publicly the bulk of their listed company holdings on a delayed quarterly basis. Holdings in derivative instruments such as customized options or exotic equity swaps are not publicly disclosed as a matter of requirement, but these financial instruments are traded on the so-called over-the-counter market (i.e., face to face with bank counterparties). As a result, a hedge fund's bank counterparties know what it holds, how much it holds, what it is worth, when it buys and when it sells and there is complete transparency for all such transactions from the bank's end.

Thus, hedge funds hardly are the popularly depicted ravenous vampires of the capital markets, casting neither shadow nor reflection. If regulators truly do view a collective failure of these firms as an emerging source of systemic risk or action, they should acknowledge the benefits they provide and enhance transparency by providing more carrots than sticks as they contemplate regulation.

Finally, transparency to regulators does not necessarily mean greater transparency to other market participants. Private investment partnerships may object less to providing insight to regulators, so long as they do not have to share their ideas (and potential profits) with their competition in the capital markets.

CONCLUSION

We stand again on the brink of significant government intervention in the capital markets. Sovereign wealth, private equity, and hedge funds, although popular political targets, are investment vehicles that provide real economic benefits including much-needed risk capital to fuel growth for the U.S. economy. While they carry with them some risk factors that extend beyond their immediate investors, the primary burden of any losses they may incur are likely to fall on the shoulders of their backers and not on the U.S. citizenry writ large. In contemplating more aggressive intrusion, lest we saddle these vital investment pools with detrimental rules and restrictions, we should consider the following: (1) Limitations on sovereign wealth, private equity, and hedge funds come at an immediate cost we can ill afford; (2) Absent evidence of widespread or significant political scheming, scrutiny of sovereign funds should be, at this stage, limited to a threshold "rational investor" test; and (3) Policymakers should proceed cautiously, skeptical of populist and ideologically anti-capitalist political motivations and pressure.