

REGULATION OF Alternative Investment Vehicles

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ABSTRACT

Alternative Investment Vehicles have become increasingly common and highly controversial elements of today's financial markets. They have faced calls for stricter regulation in recent years since they remain less regulated than traditional financial institutions and are rarely required to publish financial information. This article reviews the main characteristics and effects of Alternative Investment Vehicles as a basis to drive suitable regulatory measures. From a regulatory perspective it is especially important to consider their function as financial intermediaries. In this role, they may impact the efficiency and stability of financial markets or the companies they invest in. While this leads to several positive effects, these come with certain risks which have to be addressed with effective regulation tailored to their specific characteristics.

Keywords: *Alternative Investment Vehicles, Leverage, Systemic Risk, Financial Markets Efficiency, Regulation*

1 INTRODUCTION

Alternative Investment Vehicles are controversial in many aspects. They have very high minimum investment amounts and only accept institutions and “high-net-worth individuals” as investors. They are exposed to a high risk of failure but also often achieve high returns. To date, they lack regulation and disclosure requirements, making them a subject of scrutiny from politicians and economic analysts. It is often alleged that they destabilise financial markets through their speculation and extensive use of leverage or take advantage of their portfolio companies to boost their returns.

This article reviews the main characteristics of Alternative Investment Vehicles, in particular Hedge Funds and Private Equity Funds. From a regulatory point of view their function as financial intermediaries is crucial. Like traditional financial institutions they allocate capital from savers to investors through different channels. The objective of this analysis is to identify the key economic risks and benefits related to their transactions and to derive efficient regulatory measures. The analysis finds that Alternative Investment Vehicles have several positive effects that come however with certain risks. These risks have to be addressed with effective regulation tailored to their specific features. Most suitable in case of Hedge Funds is an indirect approach through the large financial institutions that act as their main counterparties. For Private Equity Funds measures have to differentiate between the two segments Venture Capital and (leveraged) Buyouts.

The forthcoming analysis is structured as follows: In section 2 Alternative Investment Vehicles will be characterised. Section 3 describes their economic function as financial intermediaries and the related risks and benefits. Section 4 derives effective regulatory measures and section 5 concludes.

2 CHARACTERISTICS OF ALTERNATIVE INVESTMENT VEHICLES

There is no commonly accepted definition of the term Alternative Investment Vehicle. It generally refers to a broad category of rather heterogeneous investment vehicles, which are usually private pools of capital and share distinctive features (OECD, 2007):

- Investors are exclusively institutional investors or “high-net-worth individuals”;
- Leverage is used to increase the returns;

- They are often registered off shore in tax havens as limited partnerships, while being managed from one of the world's financial centres;
- Due to their domiciles, they are usually not or only weakly regulated.

The most common and most important Alternative Investment Vehicles are Hedge Funds and Private Equity Funds. Although they are often referred to as similar entities, they differ in regard of their investment strategy and business models. A clear definition is therefore fundamental to derive suitable regulatory measures.

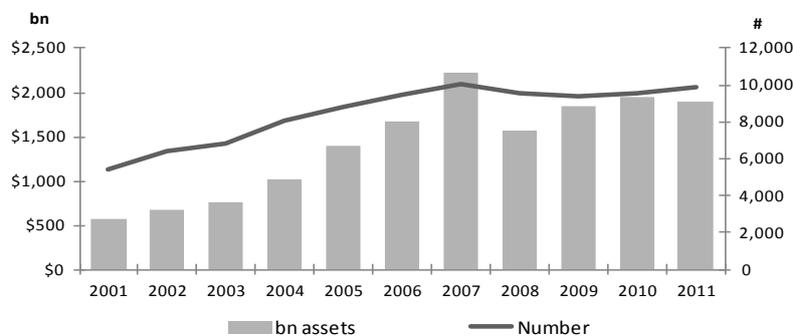
Hedge Funds

Hedge Funds execute transactions on numerous public financial markets, using complex investment instruments. Their investments are usually made for a short-term and follow different strategies, for example market-neutral, event-driven and directional strategies. In doing so, Hedge Funds aim to achieve positive returns independent from market development ("absolute return") and not relative returns compared to a market index (European Central Bank, 2006).

For the forthcoming analysis Hedge Funds are therefore defined as barely regulated investment vehicles managing the funds of institutional investors and high net worth individuals by following leveraged short-term investment strategies on different financial markets.

Hedge Funds are by their nature secretive, and opaque. Since Hedge Funds are not required to register with financial authorities or disclose information, only limited data from industry service providers is available (Garbaravicius and Dierick, 2005). Currently, it is assumed that around 10.000 Hedge Funds are operating worldwide (see The CityUK, Hedge Funds 2012). As illustrated in the chart below, assets under management by Hedge Funds have grown to approximately 1.8 trillion dollars in 2011. Although the volume has dropped slightly since the pre-crisis peak in 2007, Hedge funds have become important players in today's financial markets. This sum may only represent between 1-2% of the assets managed worldwide (King and Maier, 2009), but they are the dominant players in many financial markets through their extensive use of leverage and high-frequency trading strategies.

Figure 1 - Hedge Funds Market Development



Source: TheCityUK, Hedge Funds 2012.

Private Equity Funds

In contrast to Hedge Funds, Private Equity Funds invest in non-public companies being in an early or crucial stage of their development and/or in need of funding. Private Equity Funds provide these companies with equity capital and strategic guidance (Ferran, 2011). Investments in these portfolio companies are made for a medium-term, usually for five to eight years. During the course of the investment, Private Equity Funds try to increase the value of the company in order to realise a profit when selling their stake ("Exit"). A Private Equity Fund is usually set up with an investment focus on a specific region or industry for a limited time period and managed by a Private Equity Company being responsible for several funds.

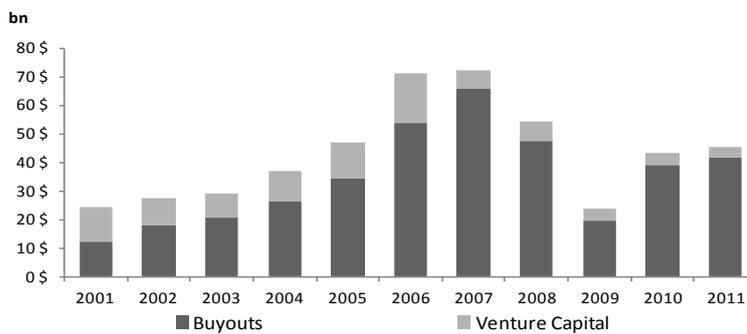
Private Equity Funds are further classified according to the development stage of the portfolio companies they invest in. Venture Capital encompasses start ups and small companies in an early state of their development, which have promising technologies or innovative business concepts. Buyouts denote investments in later stages and crucial situations like turnarounds, where companies are in need of additional funding. While Venture Capi-

tal rarely uses leverage, Buyouts may use extensive leverage to enhance the returns of their investments (Frommann and Dahmann, 2005).

For the forthcoming analysis Private Equity Funds are therefore defined as investment vehicles encompassing Venture Capital as well as (leveraged) Buyouts directly providing capital and management expertise for a limited time period to companies being in a very early or crucial stage of their development with the intention to realise a return on the exit of the investment.

Private Equity has become an increasingly important part of today’s economy. Around the world the portfolio companies owned by Private Equity Funds account for a substantial percentage of GDP and private sector employment (Popov and Roosenboom, (2009). Current numbers of the Private Equity Growth Capital Council (PEGCC) indicate that in 2011 approximately USD 274 billion were invested in more than 3,700 companies worldwide, half of it in the United States. Usually Buyouts account for the majority of volume (up to 90%) as well as the number of transactions (up to 70%). In Europe, the invested amounts are growing again, after a sharp decline in 2009:

Figure 2 – Private Equity Investments in Europe



Source: European Private Equity and Venture Capital Association (EVCA) Yearbook 2012.

3 THE ECONOMIC FUNCTION OF ALTERNATIVE INVESTMENT VEHICLES

To analyse the policy implications of Alternative Investment Vehicles, it is important to understand their macro-economic role as a financial intermediary. Financial markets play a crucial role for an economy. They allocate capital from savers to investors across time and provide for an efficient allocation of risk. In perfect financial markets capital would directly find its most efficient use from savers to investors. However, the textbook assumptions are typically not appropriate in most of financial markets, where agency problems, externalities, information asymmetry and moral hazard are common and may lead to market failure. Financial institutions like banks and investment funds help to reduce this market failure by providing information, pooling risks and transforming maturities and volumes of capital on its way from savers to borrowers. And so do Alternative Investment Vehicles. Given their differing investment strategies they impact the economy through different channels. While Hedge Funds influence the efficiency and stability of global financial markets, Private Equity Funds directly impact the portfolio companies they invest in.

Table 1 – Main characteristics of Alternative Investment Vehicles

Criteria	Hedge Funds	Private Equity Funds	
		Buyout	Venture Capital
Investors	Institutional investors and high-net-worth individuals		
Investment Strategy	Liquid investments in global currency, bond, stock or derivative markets exploiting market inefficiencies	Direct investments in companies being in a crucial stage of their development	Direct investments in young and start-up companies
Leverage	Use of (extensive) leverage to increase returns		Usually no use of leverage
Investment Horizon	Short-term	Mid-term (5-8 years)	
Impact on investment	-	Active support of management	
Returns	Absolute return strategy	Dependant on successful exit of portfolio companies	
Impact channel	Global financial markets	Non-public companies	

Market Efficiency

In case of Hedge Funds, the function as a financial intermediary does not per se differentiate them from other traditional financial institutions. They have however distinctive features (Kambhu et al., 2007):

- They are not restricted by mandated risk limits and can follow flexible trading strategies;
- They may act as underwriters, originators, distributors of credit and traders in the secondary markets;
- They are able to take trading positions which are not feasible for traditional financial institutions.

Applying their flexible strategies, they have the possibility to act counter cyclically during a crisis and often represent the only counterparty for market participants looking to hedge their economic risks. In combination with their high trading volume this increases the liquidity of the financial markets they are active in (c et al., 2012).

In financial markets prices of financial assets represent the coordination mechanism to direct capital to its most efficient use. To ensure the efficient allocation of capital it is therefore important that prices comprise all publicly available information to reflect the fundamental, fair value. In reality however, prices deviate constantly from their fundamental value. Mispricing between assets may for example arise because market participants do not have costless or immediate access to information. Many Hedge Funds, especially with a market neutral strategy, focus on finding and exploiting these efficiencies through arbitrage and speculation (Lhabitant, 2002). By acting upon their research, Hedge Funds detect these price inefficiencies and reveal some of their private information to the market, helping assets to move back to fundamental values.

Systemic Risk

An essential prerequisite for the efficient allocation of capital is the stability of the financial system. With regard to Hedge Funds, the main question from this perspective is to what extent Hedge Funds may increase the systemic risk of financial markets. Systemic risk has been described by the Financial Stability Board (2009) as the instability of one financial institution or a market segment that may pose a risk to the system as a whole through mutual dependencies with other institutions. This may lead to a systemic crisis, which is characterized by De Brandt and Hartmann (2002), as impacting “a considerable number of financial institutions or markets in a strong sense, thereby severely impairing the general well-functioning of [...] the effectiveness and efficiency with which savings are channelled into the real investments.” The devastating effects of such financial crises on the real economy have been analysed in depth (See for example Allen and Gale (2007) or Reinhart and Rogoff (2008)).

Hedge Funds are specifically prone to systemic risk. They are unregulated financial vehicles exposed to a high risk of failure. Every year between 5-10% of all Hedge Funds fail (Payne, 2011). Their use of leverage may further amplify the impact of a given shock when the value of collateral falls and margins are increased (Ang et al., 2011). Hedge Funds are also deeply interconnected with core financial institutions which act as their prime brokers. Besides the clearing and settlement of trades, risk management and custodial services they also provide leverage. At the same time these financial institutions represent the most important investors in Hedge Funds. This manifold interconnectivity exposes them to a high degree of Hedge Fund risk (King and Maier, 2009). The size and interconnection of Hedge Funds may make some of them systemically significant. A failure could provoke chain reactions that may ultimately lead to a collapse of financial markets (Adrian, 2007).

Funding of innovative companies

Similar to Hedge Funds, Private Equity Funds also have a comparative advantage over traditional financial institutions in overcoming the considerable uncertainty and asymmetric information problems of financial markets. Due to asymmetric distributed information in credit markets, companies in a crucial or early stage of their development often have difficulties to find capital through banks or other traditional investors. Private Equity Funds are specialised on the valuation and analysis of these companies and are able to conduct the risk analysis with lower transaction costs than traditional financial institutions (Hall and Lerner, 2009). Through diligent analysis and selection of the projects in combination with ongoing monitoring and strategic guidance they decrease information asymmetries and fund projects that would otherwise not have been realized.

This effect is enforced by the strategic support of the Management. Especially Venture Capital Funds may facilitate innovate ideas and technologies of young companies and guide them on the way to marketability. The effective introduction of new products and processes on the market and the development of know-how and skills spur innovation on an aggregated level. This effect is reinforced through spill-over effects from the portfolio

companies to other companies which copy newly introduced technologies and management techniques (Hellmann and Puri, 2000).

Impact on portfolio companies

One of the most controversial issues regarding Private Equity is the impact of Buyout Funds on the development of their portfolio companies.

On the one hand the active support and monitoring of the management may lead to a positive impact on the operational efficiency and productivity in portfolio companies of Venture Capital and Buyout transactions (Kaplan and Strömberg, 2008). One explanation is the reduction of agency problems (Jensen, 1989). Monitoring the manager is a public good and shareholders have incentives to free-ride on each other. By closely monitoring the management, Private Equity Funds realign the incentives between managers and dispersed owners. Davis et al. (2009) also suggest that Private Equity Funds achieve this enhancement of productivity by a reorganizing of operations. They tend to close low productivity establishments and open new more productive ones leading to a reallocation of resources to more productive uses.

On the other hand, Buyout-Funds are regularly accused of leaving their portfolio companies behind in financial distress. The biggest threat for portfolio companies is considered to be the extensive use of leverage. Often the debt falls on the company that was acquired – not on the Buyout Fund. The greater use of leverage not only magnifies the returns of successful investments of the Fund but also the losses from unsuccessful efforts. Private Equity Funds may still bear main risk of insolvency, but one has to consider that Leveraged Buyout Funds usually have a portfolio of companies. Thus the bankruptcy of a portfolio company may only have minor effect on the Buyout Fund's return and even less on the Private Equity firm that manages the Fund, but may turn out to be devastating for failed companies (Balboa et al., 2006).

4 POLICY IMPLICATIONS

Financial institutions like traditional investment funds, banks or Alternative Investment Vehicles carry out a significant economic function: They provide for the efficient allocation of capital and risks. Accordingly, the financial sector is in general one of the most regulated sectors in developed economies. Considering this, it is even more startling that Alternative Investment vehicles as a part of this sector remain mostly unregulated to date. When it comes to regulatory measures, the heterogeneous investment strategies and economic effects of Alternative Investment Vehicles have to be taken into account.

The main argument in favour of regulating Hedge Funds comes from the perspective of financial stability. One should however consider that while they may increase systemic risk, Hedge Funds also facilitate the efficiency of capital markets. Restricting the activity of Hedge Funds would likely diminish the beneficial effects of Hedge Funds on market liquidity along with the risks. To address both aspects, Hedge Funds require effective regulation that is flexible and tailored to their specific characteristics.

A direct approach may include requirements on registration, minimum capital ratios and liquidity of Hedge Funds or the disclosure of information. One should, however, bear in mind that an efficient, yet stable, financial system should not prevent Hedge Fund failures but limit the transmission of a Hedge Fund failure to the broader financial system. In addition, these approaches would only be feasible, if all global jurisdictions adhered to such a regulation. This seems to be highly unlikely. The vast majority of Hedge Funds is already registered in off shore tax havens to avoid existing regulations.

Therefore it appears to be more promising to follow an indirect approach through the Hedge Funds counterparties. Hedge Funds are highly dependent on services of their prime brokers, who provide leverage and execute transactions. The most promising regulative measures would therefore start at the "Counterparty Risk Management" of financial institutions. In specific, margining and collateral practices, which are designed to reduce counterparty credit risk in leveraged trading, could be regulated and monitored (Kambhu et al., 2007). Financial institutions could also be obligated to require a certain level of information from Hedge Funds to improve their own risk management and enable authorities to assess the systemic risk. As a final step, exposure to Hedge Funds, which do not adhere to certain risk management and disclosure standards, could require higher capital ratios. Given that the market of prime brokers is highly concentrated and mainly carried out through a hand full of institutions, these measures would be relatively easy to implement (Danielsson et al., 2005).

With Private Equity Funds investing directly in non public companies, they channel funding into innovate projects and have a direct impact on the development of these companies. Based on the previous analysis regulatory measures should differ between Venture Capital and Buyouts. Venture Capital mainly closes a funding gap for young companies and facilitates innovation. Buyouts on the other hand have a two-fold impact on their portfolio companies. While they also provide funding to companies in need of capital and may have a beneficial impact on their productivity and operational efficiency, they may as well increase the risk of bankruptcy through the excessive use of leverage. These specific transactions have a questionable value from a macroeconomic point of view, basically presenting a rent transfer from taxpayers to Private Equity investors.

To enhance the positive macroeconomic impact of Venture Capital, regulators should focus on increasing the volume of Venture Capital investments. This can be achieved through tax incentives coupled with well-functioning exit markets and labour regulation aimed at promoting the mobility of skilled labour (Popov and Rosenboom, 2009).

With regard to Buyouts, the current regulatory frameworks in most developed countries do not restrict the kind of transactions that raise the probability of bankruptcy and permit the extraction of value. Even worse, some regulators (e.g. in the United States) facilitate it by allowing debt interest of Buyout transactions to be deducted from income. In addition, the lack of disclosure requirements makes an effective oversight difficult. Accordingly, two substantive measures are particularly warranted: eliminating the preferential tax treatment for debt relative to equity for Buyout transactions and improving transparency through stricter disclosure requirements (Appelbaum and Batt 2012).

5 CONCLUSION

This analysis focused on the regulation of Alternative Investment Vehicles. From a regulatory perspective, they act as financial intermediaries in capital markets, allocating capital from savers to borrowers. However, depending on their strategic focus, they impact the real economy through different channels.

Hedge Funds make short-term investments in global currency, bond, stock or derivative markets and try to achieve returns by exploiting market inefficiencies. As a result, they improve the efficiency of financial markets while at the same time posing a systemic risk to the financial system.

Private Equity Funds invest directly in non public companies channelling capital into innovate projects. While Venture Capital closes a funding gap and facilitates innovation, Buyouts have a beneficial impact on productivity and operational efficiency of their portfolio companies. They may however also increase the risk of bankruptcy through the excessive use of leverage.

To conclude, Alternative Investment Vehicles have several positive effects on financial markets and economies. But these benefits come with certain risks. The establishment of a stable regulatory framework, which limits these risks without restricting the benefits, represents the main challenge regulatory authorities are facing.

In case of Hedge Funds, the indirect regulation through the "Counterparty Risk Management" of financial institutions has been identified as the most promising approach.

Measures for Private Equity Funds should differentiate between Venture Capital and Buyout transactions. While Venture Capital investments should be facilitated, specific Buyout transactions that raise the probability of bankruptcy and permit the extraction of value should be restricted.

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