

**Hedge Funds and Financial Stability: Explaining the Debate at the  
Financial Stability Forum**

## **Introduction**

The regulatory story of hedge funds is a remarkable one, especially for an investment class born to remain outside any regulatory oversight. Between 1998 and 2005, they became in turn: object of legislative and administrative actions and discussions in the US (1998--1999), part of a regulatory effort at the international level to promote financial stability (Financial Stability Forum: 1999--2002), subject of regulatory debate in the UK (2002 and 2005) and Australia (1999), target of a regulatory reform in the US (2003--2004), recipient of warning calls by both national (Federal Reserve Bank and Bank of England, 2004) and international organizations (World Bank and International Monetary Fund, 2004), and last but not least, object of an endless dispute in academic circles over the desirability of their regulation (Financial Economists Roundtable 2005; Danielsson et al. 2006 forthcoming).

What is remarkable is not only the number of initiatives in such a short period of time, but also the contested nature of their purposes, procedures and outcomes, which caused most of them to die halfway through the process or not to reach any substantial conclusion at all.

When initiatives actually materialized, they divided the very regulatory bodies that implemented them – as in the case of the recently--introduced registration of hedge fund advisers in the U.S., which split the Board of the Securities and Exchange Commission (SEC 2004a). What does make the issue of hedge funds so contested?

The article searches for an answer in the first phase of the hedge--fund debate, the one triggered by the Asian financial crisis of 1997 and the near--collapse of Long--Term Capital Management (LTCM) in 1998. The former event brought up issues of market dynamic and integrity,<sup>1</sup> while the latter brought up issues of systemic stability<sup>2</sup> triggered by the activities

of hedge funds. In 1999, G--7 countries decided to tackle both issues by launching an international debate at the Financial Stability Forum (FSF) in Basel. The FSF debate – which took place mostly between 1999 and 2002 – is the focus of this article.

According to participants, the FSF debate was intense and challenging. Yet by 2002, when FSF regulators considered it closed, no major reform had been formulated. It is true that some recommendations were made, especially in terms of indirect monitoring of hedge funds through their counterparties. However, if one compares the situation before and after the debate took place one finds only minor differences. Why?

Four explanations are presented. The first is the claim of a good part of the financial, academic, and regulatory community, which says that regulation is unnecessary. Hedge funds are not posing any serious threat to the financial system and the problem is one of regulatory misconception and excessive alarmism. In particular, hedge funds are said to be more likely to stabilize than destabilize market equilibrium. By acting as market contrarians,<sup>3</sup> the argument goes, they bring efficiency and liquidity to the market.

Another set of explanations says that, besides the argument of the benign role of hedge funds, it is to be considered that regulatory decisions were taken by a particular group of decision--makers, in particular venues and within a particular regulatory discourse. Three explanations stem from this approach: one looks at the conflict of interest between FSF decision--makers; another one looks at the power of the FSF institutional setting; and the last one looks at the power of the discourse within which these issues were debated.

The article analyses these three political--economy explanations and points to the policy options that stem from each of them. Methodologically, it draws on elite interviews with regulators (especially with the members of the FSF Working Group on hedge funds), academics, market commentators, and practitioners.

### **1. Phases and sites of the hedge fund regulatory debate**

Hedge funds are a massively growing investment category. According to the US Securities and Exchange Commission, between 1999 and 2004 their assets grew by 260 percent and by 30 percent in 2004 alone (SEC 2004b). Today they are estimated to be a \$1 trillion industry with about 8000 funds (Financial Economist Roundtable 2005). They are also said to be very active traders and to be responsible for up to 20 percent of equity trading volume only in the US (SEC 2004b).

Technically, hedge funds are defined as private investment partnerships that operate largely outside any regulatory net and as a consequence have maximum flexibility in their investment strategies. An investor protection rationale imposes regulation upon those companies collecting money from the broader public, but leaves unregulated those partnerships that only accept private placements.<sup>4</sup> Hedge funds belong to this category. Their clients are high--net--worth individuals or investment companies, which are deemed to be in no need of investor protection.

Hedge funds are especially known for the use of two kinds of strategies: the first one consists of taking directional bets on the likelihood of changes in macroeconomic indicators

such as currency or interest rates; and the second one in trying to profit from perceived mispricing among similar assets and from inefficiencies in price formation. Hedge funds using the first type of strategy are known as macro funds or currency speculators and were active in Asia during 1997. Hedge funds using the second type of strategy are known as arbitrage or market neutral funds: an excellent example is LTCM, the US--based hedge fund that nearly collapsed in the wake of the emerging market turmoil of 1998.

Since the Asian financial crisis and to a larger extent, the near--collapse of LTCM, hedge funds have been among the most cited (and blamed) market actors in discussions of financial speculation and have somehow contributed to define the meaning of the term at the turn of the century (see for instance Krugman 1999: 119; Chancellor 1999: 335; Marsh 2002: 165). The question of whether their regulation could help avoid the recurrence of financial crises thus became a cornerstone in discussions on the Global Financial Architecture (GFA). In 1999, hedge funds were chosen as one of three main issues to be addressed by the Financial Stability Forum (FSF).<sup>5</sup> The FSF Working Group on Highly Leveraged Institutions (HLIs) was created along with a specific task force to address the role of hedge funds in the emerging market crises of 1997/1998, the Study Group on Market Dynamics. 'HLI' was the name chosen to identify hedge funds.

Though the FSF debate formally closed by the early 2000s, discussions on hedge funds and financial stability have continued to the present. For instance, in November 2005, the FSF convened two informal workshops – one in London and one in New York – gathering members of the hedge fund community, their counterparts and financial authorities to discuss issues pertaining to financial stability (FSF 2005). These meetings confirm that the

FSF mandate to monitor hedge fund activities is ongoing. The result of all this conferring, however, is not straightforward. The impression is that, after more than 5 years since the hedge--fund debate started, regulators are still at the stage of getting to know the hedge fund industry and deciding whether something ought to be done. The question that runs throughout the article, therefore, is whether this debate is just a 'much ado about nothing'.

Regulatory actions and statements outside the FSF venue reinforce this impression. In November 2004, for instance, the World Bank warned that pension funds and other institutions were investing in hedge funds without understanding the risks (Davis 2004). Yet in the same year the World Bank invested \$1.5 billion of its \$12 billion pension fund in hedge funds. In December 2004, both the Bank of England and the European Central Bank warned that the large and increasing amounts of money flowing into the hedge fund industry could have serious financial stability consequences (Bank of England Financial Stability Review 2004; ECB 1<sup>st</sup> Financial Stability Review, Dec 2004). Yet a few months later the EC's internal market commissioner, Charlie McCreevy, warned of the dangers of tightening regulation in a sector that proved beneficial to the EU economy (Forbes 2005). In June 2005, Alan Greenspan once again warned of the systemic-stability risks posed by giant hedge funds (Greenspan 2005), but at the same time he kept opposing any regulation on the ground that hedge funds contribute to financial stability by increasing market liquidity and spreading financial risk (Ibid).

On the one hand, regulators warn about the dangers of hedge funds on financial stability ground. On the other hand, they praise the service hedge funds provide to financial markets and are adamant against any recommendation that goes beyond a call for due diligence by

counterparties. The nature of the hedge fund debate lies in the tension between these two attitudes and in the attempt to reconcile them. How can this tension be explained?

The following four sections offer four different answers. The first answer explains the nature of the debate in terms of technical necessity: there is no empirical evidence pointing to the need and desirability of regulation. The second answer says that the hedge fund problem changes with the position a country occupies in the financial system – e.g. advanced industrial countries versus emerging markets. The third answer gives an explanation based on the institutional setting of the debate; while the fourth answer looks at the regulatory discourse within which the debate was constrained.

## **2. The empirical evidence**

‘The analysis [...] does not suggest a strong case for supervisory and regulatory measures such as these targeted specifically at hedge funds’ (IMF 1998: 4)

‘...[As] a number of independent studies [...] [have] suggested, the activities of highly leveraged institutions do not appear to have played a significant role in precipitating the financial market crises of the past few years’ (The President’s Working Group on Financial Markets 1999: xiv)

‘The case for monitoring hedge fund activity has not been made’ (Greenspan 2004).

The above quotes capture a widespread position among practitioners and regulators: the rationale for regulating hedge funds is low. After the Asian financial crisis and the bailout of LTCM two main claims were made to dismiss the need for changing the regulatory regime of hedge funds. First, it was said that hedge funds’ number and capital under management are insignificant if compared to those of other market players engaged in similar activities.

Second, it was said that hedge funds are a positive element of the market as they contribute to market efficiency. The first point was said to make regulation of hedge funds unnecessary, while the second point was said to make it undesirable.

The claim that hedge funds' number and capital under management are too small to represent a threat to the financial system was especially formulated in the IMF Occasional Paper Hedge Funds and Financial Market Dynamics (IMF 1998) and in a working paper of the National Bureau of Economic Research, Hedge Funds and the Asian Currency Crisis of 1997, (Brown et al. 1998). These studies are referenced in the second quote above (from the President's Working Group).<sup>6</sup>

The IMF paper argued that, 'while hedge funds are large in absolute terms they are dwarfed by other institutional investors (banks, pension funds, mutual funds), some of which engage in many of the same activities as hedge funds' (IMF 1998: 1). Foreign commercial and investment banks, as well as domestic banks and corporations, were said to have played a much larger role in the Asian crisis than the one played by hedge funds.

The paper Hedge Funds and the Asian Currency Crisis of 1997 made a similar argument about hedge funds' involvement in the crisis. The authors assessed 'the dollar exposure of the top ten global hedge funds to Asian currencies before and during the crisis' (Brown et al. 1998: 1) and found that hedge funds were not responsible for the currency attack. One of the reasons to dismiss their role was once again the size of their capital compared to other players. The total capitalisation of their sample of global--macro funds in September 1997 was reported to be \$29 billion, which was said to pale in significance when compared to the

daily volume of foreign exchange (estimated to be in the trillions of dollars) (Ibid: 7). Similar arguments were brought forward in the aftermath of the near--failure of LTCM. The President Working Group's report on LTCM pointed out that, although growing in absolute terms, hedge funds were still small compared to other industries (PWG 1999: 2). Why should regulation of hedge funds be enforced, if regulated entities were much more relevant than hedge funds in all of the crisis events under inquiry?

These papers were not well received among emerging markets and in general among those economies that suffered the consequences of the currency attacks. The IMF paper in particular was said to confuse the issue by comparing the capabilities of hedge funds with those of banks, without considering that in Thailand and Malaysia the size of hedge funds was considerable in relation to the size of those domestic markets. Some countries also questioned the very methodology of the paper, which only relied upon interviews with hedge fund managers and which was prepared by professionals with strong links to the hedge fund industry. Later on these criticisms found support in some of the conclusions of the FSF Task Force on hedge funds and market dynamics (FSF 2000). For example, the FSF Task Force reported that in 1998 in the Hang Seng futures (Hong Kong futures market) there was one instance when 'three hedge funds accounted for around half of the net open interest'<sup>7</sup> of the entire market while one fund accounted for a third' (FSF 2000: 119).

By 2006, hedge funds account for a large market share in advanced industrial countries too, and can no longer be seen as quantitatively irrelevant. This new awareness was clearly manifested in a 2004 SEC note discussing the registration of certain categories of hedge fund advisers.

One concern is the tremendous growth in the industry. While no one knows for sure, it is estimated that in the last five years, hedge funds have grown by 260 percent [and in] the last year alone, hedge fund assets have grown over 30 percent. Hedge funds are one fifth the size of equity mutual funds, but are growing at a much faster rate. Moreover, hedge funds tend to be very active traders. One study estimates hedge funds are responsible for up to 20 percent of equity trading volume in the United States. [...] This growth and potential impact on our markets simply cannot be ignored (Paul Roy, SEC 2004b).

The quantitative irrelevance of hedge funds, therefore, no longer holds up. The second claim was that of the efficiency--enhancing role of hedge funds. This claim was brought forward especially after the near--collapse of LTCM. LTCM was an arbitrage fund, one of those hedge funds seeking to profit from inefficiently priced assets. They buy under--priced securities and sell short over--priced ones, betting that the spread between the two assets narrows. By doing so, they are supposed to help markets achieve equilibrium and thus enhance efficiency. The high consideration hedge funds are held in, however, does not stop at the category of arbitrage funds. All hedge funds are attributed some sort of efficiency--enhancing behavior and the reason is to be found at the very heart of financial theory.

Contemporary financial theory and practice revolves around the Efficient Market Hypothesis (EMH), which postulates a link between the efficiency of the market and the rational behaviour of the investors herein. A complement to the EMH is the Theory of Arbitrage, which says that, even if investors are irrational, markets can still be efficient thanks to the operation of rational arbitrageurs, which by acting as 'market contrarians' help prices go back to their equilibrium level (Friedman 1953; Fama 1965). In Fama's formulation, the Theory of Arbitrage says that:

[I]f there are many sophisticated traders [...] they will be able to recognise situations where the price of a common stock is beginning to run up above its intrinsic value. Since they expect the price to move eventually back toward its

intrinsic value, they have an incentive to sell this security or sell it short (Fama 1965: 38)

Sophisticated traders/arbitrageurs are not only perfectly rational and able to recognise the fundamental value of an asset, but are also able to correct other investors' irrationality. By doing so, they will earn a net profit for themselves and bring prices in line with their fundamental values. Arbitrageurs thus become for the EMH what the invisible hand is for the theory of perfect competition.

All those speaking against regulation of hedge funds both during and after the FSF debate drew upon this argument. Alan Greenspan, for instance, argued that:

“Hedge funds have become major contributors to the flexibility of our financial system. [...] Taking positions in volume, as hedge funds do, tends to eliminate the abnormal profits and the inefficiencies by aligning prices across markets and provides liquidity to markets” (Greenspan as quoted in MFA 2005).

The EMH has been increasingly contested both inside and outside academic circles. The strongest critique comes from behavioral finance, which has questioned the efficiency--enhancing role of arbitrage on the basis of two considerations. The first is that in real world financial markets perfect substitutes among securities are extremely rare. If securities have only imperfect substitutes, they will be subject to different fundamental news/shocks: when arbitrageurs buy the undervalued asset and sell short the overvalued one, they bear the risk of further mispricing (Shleifer 2000). The mispricing is mainly attributed to investors' overreaction and under--reaction to news (Shiller 1998; Sheifer 2000; De Bondt and Thaler 1993). This, however, was already pointed out in Fama's model. More interesting is the second consideration that behavioural financial economists make, that is, that arbitrageurs might find it more profitable to follow instead of to contrast investors' irrationality. For

instance, they can accentuate and reinforce an upward trend in the price of an asset only to sell the asset short later on at a profit. (Short selling means selling assets that the seller does not own on the expectation that their price will go down by the time of repayment.) In this way, both the overvaluing and undervaluing of securities is not only the mere effect of investors' irrational trades, but results from the purposeful activities of sophisticated traders. This effect is called the 'bandwagon effect' and has been documented in several episodes of hedge fund investing (e.g. conglomerate boom of the 1960s; the REIT boom of the 1970s; Internet bubble of 2000). Recent studies on the Internet bubble show that hedge funds were 'riding the bubble' instead of bringing prices back to their fundamental value. In other words, it was more profitable for them to keep pushing prices up before shorting the stocks, which disproves Fama's model of rational arbitrageurs (Brunnermeier and Nagel 2003; Temin and Voth 2003). Along the same line, sociologists have pointed at various forms of 'social connectivities' – e.g. imitation, reciprocal monitoring of each other's trading – to challenge the efficiency-enhancing role of arbitrageurs (MacKenzie 2003; 2004).

These considerations partly undermine the argument that the regulation of hedge funds is unnecessary if not undesirable. Consequently, the reason why the FSF initiative has achieved little regulatory substance must be searched for somewhere else. The following sections make this search in three directions: Section 3 looks at power relations among decision-makers, Section 4 at the power of the institutional structure, and Section 5 at the power of the regulatory discourse.

### 3. Conflicts of interest at the FSF table

This section argues that the FSF debate did not reach any substantial conclusion due to the conflicts of interest at the regulatory table. To understand these conflicts, it is first necessary to describe the composition of the FSF Working Group on HLIs (from now onward ‘FSF Group’). The FSF Group gathered representatives of the G-7, the Netherlands, Australia and Hong Kong. It also included a representative from the IMF. Altogether, it counted 12 members (Table 1). Australia and Hong Kong were invited to represent those countries where hedge funds were active in 1998.

Table 1 – Financial Stability Forum Working Group on HLIs: composition

| <b>National authorities G--7 countries</b>      |  |
|---|--|
| <b>Canada</b>                                   | <b>David Brown</b> (IOSCO; Ontario Securities Commission)  |
| <b>France</b>                                   | <b>Jean--Pierre Patat</b> (Banque de France; Committee on the Global Financial System)   |
| <b>Germany</b>                                  | <b>Dietrich Jahn</b> (Ministry of Finance)   |
| <b>Italy</b>                                    | <b>Giovanni Sabatini</b> (CONSOB)  |
| <b>Japan</b>                                    | <b>Takashi Oyama</b> (Bank of Japan)   |
| <b>Netherlands</b>                              | <b>Jan W. Brockmeijer</b> (Basel Committee on Banking Supervision and De Nederlandsche Bank)   |
| <b>United Kingdom</b>                           | <b>Howard Davies</b> (Chairman) Financial Services Authority   |
| <b>United States</b>                            | <b>Peter R. Fisher</b> (Federal Reserve Bank of New York and Multidisciplinary Working Group on Enhanced Public Disclosure)<br><b>Edwin M. Truman</b> (Department of the Treasury) |
| <b>National authorities non G--7</b>            |  |
| <b>Australia</b>                                | <b>Ric Battelino</b> (Reserve Bank of Australia)   |
| <b>Hong Kong</b>                                | <b>Norman T. L. Chan</b> (Hong Kong Monetary Authority, HK SAR)  |
| <b>International Financial Institutions (1)</b> |  |
| <b>IMF</b>                                      | <b>Charles Adams</b> (IMF)   |
| <b>Secretariat</b>                              |  |
|   | <b>Svein Andresen</b> (FSF Secretariat, Basel)   |
|   | <b>Verena Ross</b> (FSA, UK)   |
|   | <b>Adam Shapiro</b> (FSA, UK)  |
|   | <b>Andrew Sykes</b> (FSA, UK)  |

Source: FSF 2000 (my elaboration)

The major conflict was between G-7 countries on the one hand, and emerging markets on the other. The former were concerned with the systemic stability impact of a large hedge fund collapsing and bringing down with it a good part of the financial system. This was identified as Pillar I in the Group's agenda: issues of systemic stability – i.e. LTCM type of problems. The latter were concerned with the effect that hedge funds' concentrated positions could have on their markets. This was identified as Pillar II: issues of market dynamics and integrity – i.e. Asian-crisis type of problems.

Pillar II was particularly controversial and, as participants acknowledge, only a minor consensus could be reached on it.<sup>8</sup> This can be evidenced by looking at the final list of recommendations that the Group issued in March 2000 (Table 2). Only two recommendations concern Pillar II (Numbers 9 and 10) and they do so not by tackling hedge funds but rather domestic financial systems in emerging markets. Despite acknowledging that hedge funds might have exacerbated the macro-economic situation during the Asian crisis and in the immediate aftermath (FSF 2000: 118-126), the Group concluded that there was no sufficient evidence of their culpability and that, 'provided the economic fundamentals are strong, HLI positions and strategies are unlikely to present a threat to stability' (FSF 2000: 19). As for the issue of aggressive trading, though some practices were seen to constitute market manipulation, 'the working group as a whole was not [...] able to reach a firm conclusion on the scale of these practices and the implications for market integrity' (ibid).

Another conflict was determined by the fact that emerging markets, especially in Asia, were on average in favor of mandatory regulation, while advanced industrial countries were more

inclined to market-led solutions.<sup>9</sup> On this issue, however, the two groups were not monolithic. Among G-7 countries, France and Germany were overall more concerned with the problems raised by hedge funds and they too advocated a more mandatory approach to their regulation. Some participants even talk of an unbridgeable ‘philosophical division’. This division was apparent in the discussions on two proposals that France and Germany advanced: the proposal to enhance aggregate disclosure on positions in key markets such as foreign exchange markets and the proposal to introduce an international credit register. The former, which was brought forward by the French representative and previously considered by the Committee on the Global Financial System, was discussed in the context of Pillar II. The proposal was opposed by the US representatives and by the industry<sup>10</sup> and did not proceed further. The FSF report mentions several limitations, ‘including the difficulty in obtaining compliance, the feasibility of producing the data in a timely manner, and the substantial costs involved’ (FSF 2000: 40). Yet, other FSF members argued that the proposal was ‘politically and technically doable and that, despite some difficulties, it could have been implemented given the current state of technological advance. The proposal to set up an international credit register (ICR) was advanced by the German delegate in order to track counterparties’ exposures to hedge funds and was discussed in the context of Pillar I. It was opposed for three main reasons: (1) hedge funds rarely receive credit; (2) their operations are mostly off-balance sheet; and, (3) information on emerging markets is lacking, so that data cannot be comprehensive. In the end, the proposal was not taken seriously, though its proponents argued that meaningful data could be collected through an ICR.

Efforts in the end focused on Pillar I and, within it, on two sets of recommendations: those calling for indirect regulation of hedge funds through their counterparties

(Recommendations 1, 3 and 4 in Table 2) and those calling for enhanced disclosure and risk management through voluntary industry initiatives (recommendations 2 and 7 in Table 2). Clearly, consensus was tipped towards the preferences of G-7 countries, mostly interested in Pillar I, and, within this group, towards the advocates of a non-mandatory approach geared on indirect- and self-regulation. These conclusions are summarized in Table 2. Eight out of ten recommendations concern Pillar I and only two Pillar II. In addition, as said before, the two recommendations that concern Pillar II do not tackle hedge funds but rather domestic financial systems in emerging markets. Among Pillar I recommendations, only two directly address hedge funds (2 and 7), and they do so by relying upon hedge funds' voluntary disclosure and risk management efforts. Most recommendations call for counterparties (banks, securities firms, prime brokers) to indirectly monitor hedge funds.

Table 2 – FSF Report: main recommendations

| <b>Recommendations</b>   | <b>Pillar 1 or 2</b> | <b>Addressing hedge funds</b> | <b>Addressing hedge funds' counterparties</b> |
|--|----------------------|-------------------------------|---|
| (1) Stronger counterparty risk management                        | 1                    |                               | X   |
| (2) Stronger risk management by hedge funds                      | 1                    | X                             |   |
| (3) Enhanced regulatory oversight of HLI credit providers        | 1                    |                               | X   |
| (4) Greater risk sensitivity in bank capital adequacy regulation | 1                    |                               | X   |
| (5) Sustaining industry progress                                 | 1                    |                               | X   |
| (6) Building a firmer market infrastructure                      | 1                    |                               | X   |
| (7) Enhanced public disclosure by HLIs                           | 1                    | X                             |   |

|   |   |  |  |
|---|---|--|--|
| (8) Enhanced public disclosure practices generally              | 1 |  |  |
| (9) Enhanced national surveillance of financial market activity | 2 |  |  |
| (10) Good practice guidelines for foreign exchange trading      | 2 |  |  |

*Source:* data from FSF 2000: 2--4 (my elaboration).

The consensus reached on Pillar I, however, did not wipe out the conflicts present at the regulatory table but transferred them at a different level, outside the decision-making process in Basel. Due to the nature of the solution achieved, the conflict became one of private versus public interests or, more precisely, a conflict between private actors' incentives and regulators' goals.

The recommendations on enhanced disclosure and risk management by hedge funds (Numbers 2 and 7 in Table 2) rested on the voluntary codes of conduct that the hedge fund and banking industries issued between 1999 and 2000. This solution had already been adopted in the US during its domestic debate on hedge funds, sparked by the near-collapse of LTCM.<sup>11</sup> The Counterparty Risk Management Policy Group (CRMPG), made up of 12 Western banks and securities firms, issued the report Improving Counterparty Risk Management Practices (CRMPG 1999), while a group of five large hedge funds issued the report Sound Practices for Hedge Fund Managers (2000). By delegating disclosure responsibilities to private actors, the Group opened the possibility to the fact that banks' and hedge funds' incentives could conflict with those of regulators.

To begin with, it is not clear whether the five hedge funds that drafted the report managed to adopt all of their own recommendations (Temple 2001: 187), despite the fact that they should be an example for the rest of the industry (FSF 2000: 25). Even in case of full implementation, however, their recommendations would be flawed because of the strenuously defended non-disclosure of proprietary information – which was re-stated in an update of the hedge funds’ report in 2005 (Sound Practices 2000: 24; MFA’s 2005 Sound Practices). Without this disclosure, the working of market discipline is greatly limited (Temple 2001: 187). For instance, although LTCM was reporting VaR information before its collapse, it did not include proprietary data. Without these data, it would have been difficult to know which risks its VaR models referred to (FSF official, interview 2003). In addition, the very use of VaR to measure risk is of little use in the case of hedge funds, since they can employ complicated trading strategies to lower or hide losses (Danielsson 2004). In 2001 the Multidisciplinary Working Group on Enhanced Disclosure, another Basel grouping made up of both private and public sector officials,<sup>12</sup> was rather pessimistic on the achievements in terms of disclosure ‘both on the part of regulated and unregulated firms (MWGED 2001). Five years since, participants are still unable to say whether substantial changes occurred in the industry.

The other leg of Pillar I consensus was the idea of indirectly regulating hedge funds through their counterparties. This was by far the most important set of recommendations that the Group issued (Recommendations 1, 3 and 4). Since hedge funds depended on their counterparties for credit and other services (e.g. prime brokerage) and since those institutions were already regulated, it was argued, the best option was to regulate/supervise hedge funds through them. Some commentators (e.g. Eichengreen 2003) argue that

counterparties have placed hedge funds on a stricter credit diet and that this should pose less of a risk than before. Is it really so?

The idea of indirect regulation is based on two assumptions: the first assumption is that counterparties are adequately regulated and supervised in relation to their business with HLIs; the second assumption is that counterparties and regulators share the same agenda, that is, that counterparties have sufficient incentives to comply.<sup>13</sup> These assumptions will be tested in the case of commercial and investment banks, which are the largest prime brokers for the hedge fund industry.

The nature of the contracts that banks enter into with hedge funds makes effective supervision extremely difficult. Banks do not simply lend money to hedge funds – a rather straightforward operation. They mainly provide them with credit through securities lending and derivative transactions. Securities lending gets particularly complex with the use of reverse repurchase agreements and contracts for difference,<sup>14</sup> which are both means to quickly and inexpensively leverage hedge funds' capital. It is difficult for counterparties' supervisors to track the many ways by which assets are used as collateral for different transactions and what this implies in terms of risk.

Supervisors cannot exercise control by relying upon the information banks release to the public (annual reports, etc.). This is because data on banks' transactions with hedge funds are either buried in larger categories such as net interest, securities fees, etc. or are not reported at all. Supervisors might be equally unable to exercise this control by relying upon the information that banks confidentially disclose to them. This is because information on each

transaction and customer is not available, unless the bank has a large exposure to one single client, in which case it has to report it. Outside large-exposure cases, information about banks' clients is precluded, as it is part of a bank's confidentiality clause. In any case, what regulators are able to know is the total net exposure by a counterparty, which means the total exposure a bank has to a hedge fund after all its transactions with it have been combined and netted. However, as a Fed official pointed out, there is no certainty that the netting is capturing all the risks. Another important piece of information that regulators miss is the aggregate exposures to any single hedge fund by all its counterparties – and the previous pages showed that the FSF dismissed the need to collect aggregate statistics on banks' exposures to hedge funds, including the need of an international credit register (FSF 2000: 8).

Has anything changed since the near-collapse of LTCM and the FSF debate? The opinions of regulators are split over this issue. Some of them think that banks and supervisors now pay more attention to the quality of risk management. As a Basel official said, 'in the US post--LTCM world, the ability of banks to disregard supervisors has diminished, so that supervisors have more power in redirecting banks towards desired risk management policies'. Other Basel officials are less optimistic and argue that the capacity of supervisors to get a grasp of banks' activities with hedge funds should not be overestimated. As Crockett writes, 'consider [...] how little counterparties knew about the exposures of LTCM. And how little information is still available about the risk profiles of financial institutions generally' (Crockett 2001, my italics). According to another BIS official, supervising banks' transactions with hedge funds can be part (a small part) of the supervisory process, but it is not a high level inquiry: 'It is more an issue of credit risk management by banks than the job

of supervisors: it is impossible to supervise these aspects'. In addition, exposures to hedge funds are really quick. Sometimes banks do not even know who the counterparty is (e.g. for certain swap agreements).

Further obstacles are encountered in the case of investment banks. It has to be remembered that banking supervisors in the US<sup>15</sup> have jurisdiction over commercial banks but not over investment banks. Investment banks such as Morgan Stanley and Goldman Sachs are under the oversight of the Securities and Exchange Commission (SEC), but only for what concerns their broker/dealer activities. Anything that is put outside the broker/dealer activity is not supervised. For instance, Goldman Sachs's derivatives transactions are in principle under the SEC jurisdiction, but since Goldman Sachs does not keep them inside the broker/dealer division, its derivatives transactions are not filed with the SEC. They might even be under a foreign jurisdiction (e.g. the Financial Services Authority in London) if Goldman Sachs executes them as a stand--alone operation in another country. The same applies to contracts for difference and repurchase agreements, which are covered by the SEC but only if the broker/dealer chooses to conduct its activity in the US. Furthermore, the activities executed in different countries are not aggregated, that is, they are not added to the overall activity of Goldman Sachs. The SEC, in fact, has responsibility for brokerage but not consolidated oversight of it. Things have started changing with the new Basel Accord and especially with the new European Financial Conglomerates Directive (2002), which prompted the SEC to issue a rule that would bring investment banks in line with their commercial counterparts. Yet these changes were not present when the FSF issued its recommendations and even now, in 2006, it is difficult to evaluate how they will affect the way banking supervision is executed.

In principle the difficulty of monitoring the activities of banks explains why regulators are more inclined to delegate to banks and counterparties in general most of the work of monitoring and controlling HLIs. But are banks willing to do so? Is the assumption that banks and regulators share the same agenda tenable? Two developments in particular question the assumption that it is in banks' self-interest to perform due diligence in their dealing with hedge funds in the post-LTCM scenario. First, banks have started acquiring or creating their own 'satellite' hedge funds. Second, banks have found a very profitable business in the provision of prime brokerage and other services to the hedge fund industry. This second point is particularly important. Banks have realised that they make more money with the margins they gain from this kind of operation than by playing the market themselves. By acting as prime brokers, banks are going to cash in the fees no matter what will happen to the currency or the equity market, so that their operations are even more profitable than that of hedge funds – and this without taking open positions.

Hedge funds need to borrow securities in order to sell short. Banks – especially investment banks – can provide this service. By doing so, they earn an interest on the proceeds of the short selling, trading and clearing commissions, and income from derivative transactions. Since hedge funds are heavy short sellers, the more they short the more banks find business with them profitable (Forbes 1998). It is difficult to exactly quantify the gains that banks make from the provision of prime brokerage services, since no bank or financial house breaks out revenues derived from dealing with hedge funds. Yet an estimate can be obtained by looking at items such as net interest income or securities services and fees. In 2001, for instance, Goldman Sachs saw its net interest revenues increased by 46 percent over 1999 and

Morgan Stanley by 20 percent over 1997 (Goldman Sachs 2001 Annual Report; Morgan Stanley 2001 Annual Report). Also, banks started competing over the slice of the hedge fund industry they serve as prime brokers. With increased competition, margins from prime brokerage are getting slimmer (FSF 2002: 4). This is another reason why banks have an interest in hedge funds trading more aggressively rather than more prudentially, as the FSF requires.

This conclusion is important, since the whole debate on hedge funds, from the publication of the FSF report in 2000 onwards, has revolved around the idea of indirect regulation. When in 2005 the FSF convened a series of workshops gathering regulators, hedge funds and their counterparties (FSF 2005), the purpose was once again to call for supervision by hedge funds' prime brokers. When Alan Greenspan in the same year argued that 'the case for monitoring hedge fund activity has not been made', he continued saying that 'if there were a public policy reason to monitor hedge fund activity, the best way of doing so [...] would be indirectly through oversight of those broker--dealers that clear, settle and finance trades for hedge funds' (Greenspan 2004).

Yet the reliance upon banks and other credit providers to control hedge funds' leverage and risk might be misplaced if banks are the first to profit from high levels of leverage and aggressive trading. In order to work, indirect regulation through banks needs a powerful system of supervision and a strong system of incentives for banks to exercise due diligence. If, as the analysis in this section shows, both these systems are weak, efforts to make indirect regulation work are bound to be difficult. The reliance on indirect regulation provides

another example of how conflicts at the FSF decision-making level translated into conflicts between private and public interests in the implementation phase.

#### **4. The Institutional Setting**

The previous section showed the nature of the conflicting interests in the FSF debate in Basel and how the preferences of G-7 countries – and of the US more specifically – prevailed. It also showed how these preferences moved the conflict at the level of private versus public interests, where the lack of incentives for hedge funds and counterparties to comply undermined the effectiveness of the Group’s core recommendations.

The analysis so far focused on overt conflicts as expressed in the decisions taken by the FSF Group. It did not account for the fact that non-decisions might be equally crucial to understand the dynamics of a decision-making process and that conflicts might be hidden by a particular institutional setting. According to Lukes’ distinction between the one- and two-dimensional views of power, covert conflicts are those that cannot reach the decision-making level because the institutional setting confines the agenda to those issues that are ‘safer’ for the most powerful actors (two-dimensional view, Lukes 1974: 238). More generally, the institutional setting of a debate can make it particularly hard for certain claims to come forward and be given proper attention.

Institutions are herein understood not just as formal organizations (e.g. the Bank for International Settlements) but more generally as the rules and norms governing these bodies.<sup>16</sup> The classical question that a regime-theory analyst would pose is: Was the

institutional setting at the FSF likely to foster cooperation or to promote the will of the strong? An answer will be provided by looking at three sets of FSF rules: (1) those governing the setting of the agenda, (2) those governing the way decisions were taken; and (3) those governing the evaluation of results.

To understand the agenda-setting rules – including the definition and naming of the problem – it is necessary to look at the composition and statutory principles of the FSF. To begin with, the decision to address hedge funds in an international forum grew inside the G-7 (Crockett, interview 2003). Australia and Hong Kong were invited to participate in the works of the FSF as a way ‘to reach out to non-G7 countries and by so doing gain credibility’ (Ibid). They remained, however, ‘guests’ in a house they did not contribute to build.

The membership rule at the FSF is three representatives for each G-7 country and only one for any non-G-7 country. An exception was made in the case of the US, which was allowed to keep two representatives. In a 12-member committee, this was bound to make a difference at the regulatory table, especially since the US representatives had the greatest experience and expertise on hedge funds. This does not mean that the other FSF members did not have competence on the issues debated. The US, however, was the only country together with the UK to have direct familiarity with hedge funds – which at the time did not exist in France, Italy, Germany or Japan.

Finally, to follow an old convention in international affairs, the FSF Working Group on hedge funds was ‘assigned’ to the UK. The balance between countries had to be maintained in the appointment of the chairmen of the three FSF working groups (HLIs, capital flows

and offshore centers): one had to be European, one North American and one from the UK. Howard Davies, Chairman of the Financial Services Authority (FSA), was appointed for the Working Group on HLIs. As a result, the Group was somehow hosted by the FSA: three out of four of the Secretariat members were from the FSA. This was not going to be without consequences, given the fact that London and Washington shared the same view on the hedge--fund problem.

Not only the composition, but the very principles of the FSF house are biased towards G--7 countries. In its statutory objectives, the FSF sets itself as a forum for ‘national authorities responsible for financial stability in significant international financial centers’ (FSF 1999). This entails that the FSF is bound to deal with issues affecting leading financial markets. This can be seen in the very naming of the problem in terms of ‘highly leveraged institutions’, which since the beginning tipped the debate towards Pillar I. There was certainly the need to stress that hedge funds are more numerous than a couple of macro global funds and thus a change of name was in principle desirable. Yet the choice of the name ‘HLIs’ was not neutral. It implied that hedge funds and equivalent vehicles raise concerns because of the high levels of leverage they can accumulate, which only accounts for half of the problem. Hedge funds can raise concerns even when they do not accumulate high levels of leverage. As the FSF report acknowledges, reduced leverage may not be enough to address the concerns of small open economies, as ‘[e]ven with reduced overall leverage, HLIs could still build large foreign exchange positions relative to these markets’ (FSF 2000: 39). In other words, high leverage is a concern for LTCM--type crises (Pillar I concerns), but not necessarily for what happened in Asia in 1997 (Pillar II concerns).

As for the rules governing the way decisions are taken, the FSF only works by consensus. This in principle foreshadows a participatory and legitimate system of global governance (Germain 2002), but it can also be a way to confine decision-making to ‘safe issues’ (Lukes 1974). In the case of the debate on hedge funds, countries began negotiating from very different starting points and did not considerably change their positions in the course of the process. A consensus in this situation could have been struck only at the cost of lowering the common denominator countries could agree to. In the case of Pillar II this denominator was so low that the consensus was achieved only on irrelevant recommendations – e.g. guidelines for foreign exchange trading. As a member of the Group said, ‘you reach a consensus by writing a report that says very little and whose final proposals are “hot air”: everyone agrees on it, but its substance is almost nil’. In addition, there are further grounds to be pessimistic about the modality of consensual decision-making. A consensus creates a set of guidelines that are supposed to be followed by both participating and non-participating countries. It creates, in other words, a ‘regime’, intended as the normalization of a previously contested issue rather than an order-supporting mechanism as in neo-realist approaches. Cox’s definition of regime as institutionalised hegemony, where institutionalisation is the means to stabilise and perpetuate a particular order (Cox 1996: 219), can partly explain the FSF process. The comment of a Basel official enlightens this point. He said that, ‘the aim of the FSF Working Group was to have a political consensus on what to do and put this issue to bed’. To paraphrase Jenny Edkins, consensus might produce a situation where issues ‘are even more firmly constrained within the already accepted criteria of a specific social form’ (Edkins 1999: 11). To conclude, it might be true that participating countries formally agreed on a set of recommendations. Consensus, however, was achieved by confining the decision-making process to issues that were relatively safe for the dominant actors.

Moving to the last phase of the rule-making procedure, i.e. how recommendations are implemented, another institutional fragility is evident: an enforcing mechanism that can ensure compliance in each domestic setting is lacking. As Eichengreen points out, the FSF Group delegated many initiatives, especially the ones on disclosure, to national regulators (2003). Delegation to the national level, however, requires that a mechanism is in place to monitor and evaluate results, which was not the case with the FSF Group. For instance, the FSF took for granted that US regulators implemented domestic initiatives to improve disclosure of hedge fund activities, but no instrument was in place to assess whether those initiatives had been implemented according to schedule. Reference is to the introduction to the US Congress of two bills, the Baker and the Markey bill, respectively, in 1999. These bills, which required some form of disclosure of hedge fund activities, had never been enacted and eventually died in 2000 with the end of the 106<sup>th</sup> Congress. Given the emphasis that the FSF Group placed on the US initiatives, the very fact that they were not implemented undermined the process in Basel.

In summary, the institutional setting where the debate took place was tipped towards the preferences of a particular constituency. Other issues and problems could have been included in the agenda – or the very way of addressing hedge funds could have been altered – under different rule-making procedures. The composition and statutory principles of the FSF, the rule of consensus in decision making, and the lack of proper ex-post evaluation procedures helped promote the preferences of the US and, more generally, of G-7 countries. With this conclusion, this institutionalist perspective re-enforces the argument made in the previous section.

## 5. The regulatory discourse

The assumption behind the explanations in Sections 3 and 4 is that there are well-identified conflicts of interest among the participants in the debate – in the first case they are overt, while in the second case they are suffocated within a particular institutional setting. Both explanations do not account for the fact that most concerns simply fail to be perceived as such and do not generate neither overt nor covert conflicts. For this reason the article proposes to look at the structure of meaning or discourse within which the debate was carried out and to the limits it poses to any critical understanding of regulatory options.

Discourse is herein defined as an apparatus ‘which makes possible the separation [...] of what may from what may not be characterised as scientific’ (Foucault 1980: 197). It is not, however, only an episteme or body of ideas. When Foucault defines discourse as a dispositif or apparatus, he refers to ‘a thoroughly heterogeneous ensemble consisting of discourses, institutions, architectural forms, regulatory decisions, laws, administrative reforms, scientific statements, philosophical, moral and philanthropic propositions – in short, the said as much as the unsaid. [...] The apparatus is also always linked to certain co-ordinates of knowledge which issue from it but, to an equal degree, condition it’ (Foucault 1980: 196--197).

This model of analysis can be applied to the regulatory discourse within which issues of hedge funds were dealt with. The co-ordinates of knowledge of this discourse will be identified in the primacy given to a particular definition of financial systemic stability and in the efficiency-enhancing role attributed to hedge funds. Another important point that is

captured by this model is that the ‘said’ in a discourse is as important as the ‘unsaid’ or, more precisely, that both are part of the apparatus. This provides a link to and, at the same time, a differentiation from Lukes’s two-dimensional view of power. As much as the two-dimensional view (analysed in the previous section) is concerned with non-decisions and what is intentionally kept outside the political agenda, Foucault is concerned with what discourse does not say or prevents from being said. The concept of apparatus, however, goes beyond the two-dimensional view of power. The latter explores what is kept outside the political agenda because of a clearly-defined conflict between dominant and marginal interests. For the former, instead, issues are kept outside the policy agenda without a deliberate struggle. Battles are not only ‘at the level of wanting or resisting a particular policy initiative, but at the level of constituting the shape of the issue to be considered’ (Bacchi 1999: 50). Instead of looking solely at what is intentionally kept outside the regulatory table, a discourse approach reflects upon the fact that only certain grievances can be formulated and only certain problems can be thought of (Ibid: 49). As Shapiro says with reference to urban policy in Los Angeles, decision-makers are not faced with problems that exist out there, but create those problems in the very process of targeting them. Talking about public policy in LA, Shapiro writes:

“[T]raffic congestion”, which receives more space than any other urban problem, is a middle-class problem, in that it accepts the already-produced segregation, housing, and shaping of the labour force that has arisen from the structures of real estate speculation, work force creation, city planning, and so on. Traffic congestion is a “complaint” from those who are in a position to vocalise: it does not access the production and distribution of such position (Shapiro 1992: 99--100).

This article makes a similar argument about the problem of financial systemic stability, the first coordinate of the hedge-fund regulatory discourse. Here the word ‘systemic’ conceals the fact that stability (1) is mainly defined as a G-7 problem and (2) measures to restore it

serve the interest of only one section of the market, notably the self-regulating one. The FSF debate on hedge funds provides a good case in point.

As shown above, the two pillars of the hedge fund debate concerned: (1) the sudden liquidation of a highly leveraged fund and the domino effect that this can have on the financial system; and (2) the impact of aggressive trading strategies and the accumulation of large and concentrated positions in small open economies. The former were said to be issues of systemic stability, while the latter were said to be issues of market dynamics and integrity. The stability of the system, in other words, was made dependent upon the prevention of LTCM--type of failures, which, as explained above, mainly concern advanced financial markets. While financial stability should in principle be defined as including any type of financial crisis, this was not the case in the FSF debate, where the role of hedge funds in currency crises in emerging markets was taken out of the stability heading. This had two major consequences. First, given the importance that is currently attributed to financial stability considerations, this decision implicitly relegated concerns for market dynamics and integrity in emerging markets as secondary problems. Second, neglect for the second pillar could have been justified by saying that it was outside the FSF priority areas, which is what happened in the course of the Basel debate. As a Basel official said, ‘the FSF was there primarily for issues of systemic stability; its terms of reference are on systemic stability; [...] and many countries were not concerned about market integrity, as it does not affect their markets’. This shows how the enormous emphasis that is currently devoted to financial stability serves to keep other issues and concerns outside the policy agenda (the ‘unsaid’).

To analyse the measures adopted to restore stability, the concept of financial systemic stability needs to be analysed in its historical perspective. Stability is one of today's most central concerns in finance and has catalysed a variety of initiatives (including the very creation of the Financial Stability Forum).<sup>17</sup> It is no exaggeration to say it has become 'the' concern in discussions of the global financial architecture. The prevention and management of any sort of market failure and crisis have been included under its heading. Yet the concept is less inclusive than it might appear at first sight.

Concerns for financial instability rose with the resurgence of a market--led, as opposed to a government--led, financial system. It is only when this resurgence was complete (at the end of the 20<sup>th</sup> century) that episodes of financial instability became more prominent. LTCM is an episode when market discipline broke down (Crockett 2001). Mechanisms to ensure financial stability thus became the counterbalancing effect of having an increasingly market--driven regulation. In other words, the stress on financial stability is a direct consequence of a financial system that increasingly relies upon private actors' due diligence in order to remain sound.

When measures to achieve financial stability are discussed, however, they are made dependent upon responsible behaviour (due diligence) by each player in the market. In circular reasoning, the cause of instability and the restoring of stability are made identical: reliance on private actors' self--assessment of risk. It is here that due diligence becomes tightly linked to financial stability and regulators tightly dependent upon the behaviour of the institutions they should supervise. In conclusion, systemic stability becomes the stability of a self-assessed market.

Since at least the 1970s, a whole structure of meaning has given sense to projects and recommendations directed at enhancing market discipline. It was not simply a question of theories and ideas, but of a very ‘apparatus’, according to the definition given above, made up of financial concepts, models, instruments, strategies and institutions. Huge resources have gone into perfecting private actors’ self--assessment of risk, e.g. the models of risk internally used by banks, which are then the basis upon which their supervision is carried out. Banks’ supervisors can only assess whether banks’ models make sense and whether banks stick to these models, but no innovations or suggestions come from the official sector. It is inevitable, therefore, that ideas like indirect regulation and due diligence are preferred to other options, even if these ideas are likely to increase the conflict between public and private interests, as shown in Section 3.

The second co--ordinate of knowledge of the regulatory discourse is the efficiency--enhancing role attributed to hedge funds. The argument that hedge funds are efficiency--enhancers was not only a justification against the regulation of hedge funds but shaped the mindset of decision--makers in any venue where the issue was debated. Section 2 explained that this argument draws on one of the main tenets of modern finance – the EMH. The debate on hedge funds could not be understood without this element, which produced the very dilemma the article talks about: any regulatory action against hedge funds is balanced against the perspective that it could undermine the positive role hedge funds play in the market. Section 2 showed that this efficiency explanation has been increasingly contested and that data to quantify hedge funds’ contribution in this sense is missing. This, however, has not made the efficiency argument any less attractive. Despite being criticized by different

approaches, the EMH has shown a spectacular resilience. This can be explained by the fact that the EMH has become embodied in an ‘apparatus’ made up of theories but also of administrative and legislative decisions that keep drawing on and referring to it. Many regulatory debates in the recent history make reference to the role of the EMH. For instance, the Commodity Futures Modernization Act (CFMA) which the US Congress passed in 2000, made easier and cheaper the use of short selling, one of the most distinctive features of hedge fund investing. The justification was once again the desirability of introducing efficiency-enhancing instruments into the market (Jenkins 2000). Indeed the whole debate on short selling, both in the US and in other advanced financial markets (e.g. the UK), is centered on the principles of Fama’s theory.

The regulatory discourse on hedge funds, which revolves around efficiency and financial stability, narrowed the policy space in Basel. First, it was difficult to discuss any regulation of hedge funds without triggering a chorus of protest over the negative impact on efficiency and liquidity that such a move would entail. Second, it was difficult to discuss anything outside the dominant concern with financial stability as defined in this section. Not only market integrity, but also the distributive impact of hedge-fund investing (like in the case of arbitrageurs riding the bubble, see Section 1) and other ethical concerns were not formulated as problems at the FSF.

The three political economy explanations outlined in Sections 3 to 5 lead to different policy options. While the first and the second explanation lead to policy options in favor of greater inclusion of non-G-7 countries in the governance of global finance (Griffith Jones 2002; 2003), the third explanation calls for greater conceptual inclusiveness. This means calling for

a reevaluation of the major tenets of financial market regulation and in particular of the two major goals of financial stability and efficiency.

## **Conclusions**

The article has defined and dealt with the regulatory debate on hedge funds carried out at the Financial Stability Forum in Basel. Since 1998, hedge funds have been among the most debated instruments of financial markets. Discussions have focused on their ability to manipulate markets, affect financial stability and, more recently, defraud investors. Yet any call for their regulation has been accompanied by fierce contestation, with the end result often being a ‘much ado about nothing’.

The article argued that the dispute over whether hedge funds should or should not be regulated cannot be resolved at the technical level, that is, by analysing available empirical evidence. The empirical evidence brought forward to prove whether hedge funds are affecting stability and market integrity – the two main concerns this article focused on – is far from being straightforward. In addition, finance explanations are often biased in favour of hedge funds because of the role they are assigned within the Efficient Market Hypothesis.

The article then considered a political economy explanation and looked at the power--issues that (1) emerged at the FSF decision--making level, (2) were embodied within the broader institutional setting in Basel, and (3) rested in the regulatory discourse over hedge funds.

Section 3 to 5 developed this three--facet political economy answer.

Section 3 pointed to the difficulty of reaching a solution at the international level when too diverse interests are brought to the regulatory table. It specifically illustrated the conflict of interest between emerging markets on the one hand and G--7 countries on the other and highlighted the role of US authorities in defending a 'light--hand' solution to the hedge fund problem (Eichengreen 2003). It also illustrated how this solution moved the conflict away from the decision-making process in Basel and made it into a conflict of private versus public interests.

Section 4 reinforced this view by looking at the role of the institutional setting where the debate took place. The FSF debate was hosted by a G--7 driven institution that invited within its structure a few non--G7 countries. The procedural rules of the FSF debate were biased towards the preferences of its main constituencies since the outset.

The article observed, however, that both the first and second political-economy explanations presuppose a clearly--defined conflict between two groups of countries/regulators. This overlooks the fact that many issues in finance, especially when the level of technical sophistication is high, do not necessarily trigger an overt battle of interests. It might be the way issues are problematized that shapes the fate of a policy initiative. The third leg of this political economy explanation thus went on to look at the regulatory discourse within which issues of hedge funds were debated and analysed how this discourse narrowed the political space in Basel. The two coordinates of this discourse were identified in the efficiency--role attributed to hedge funds and in the concept of financial systemic stability. The former made it difficult to discuss any regulation of hedge funds without triggering a chorus of protest over the negative impact on efficiency and liquidity that such a move would entail. The latter

made it difficult to discuss anything outside the dominant concern with financial stability as defined in Section 5. In this context, increasing the geographical inclusiveness of the FSF without rethinking the tenets of financial market regulation might not serve the purpose. Inclusiveness, in other words, needs to be conceptual before geographical and sectoral.

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<sup>1</sup> The power of hedge funds to precipitate currency and equity market crises by taking large and concentrated positions (issues of market dynamics) and by using aggressive trading strategies (issues of market integrity).

<sup>2</sup> The domino effect that the sudden liquidation of a highly-leveraged hedge fund could have on the financial system.

<sup>3</sup> Doing ‘contrarian investing’ means doing the opposite of what other investors do.

<sup>4</sup> This rule is written in the US Investment Company Act of 1940 and in similar legislations in other advanced industrial countries.

<sup>5</sup> The other two issues were offshore centers and capital flows.

<sup>6</sup> The President’s Working Group on Financial Markets (PWG) gathers representatives of the four major US regulators: the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the US Treasury, and the Board of Governors of the Federal Reserve System.

<sup>7</sup> Net open interest is the sum of all positions of all sign in a market.

<sup>8</sup> Pillar II was addressed by a special task force, the Task Force on Market Dynamics, which visited 6 countries where hedge funds were active in 1998: South Africa, Australia, New Zealand, Singapore, Malaysia and Hong Kong.

<sup>9</sup> Eichengreen also talks of the divergent interests within the emerging market group, with Latin American countries being on average less willing to regulate hedge funds than their Asian counterparts.

<sup>10</sup> The industry was adamantly against it for two main reasons: (1) as the largest players in these markets are few, it is easy for the market to spot those who have open positions and trade against them; and (2) data would have been incorrect and approximate. These reasons have never been verified.

<sup>11</sup> It was the US President Working Group (PWG) that first praised the CRMPG initiative and called the hedge fund industry to follow their footsteps.

<sup>12</sup> The MWGED is an ad hoc working group set up in June of 1999 at the Bank for International Settlements with the purpose of formulating recommendations for improving the public disclosure practices of financial intermediaries.

<sup>13</sup> In this debate, the words ‘regulation’ and ‘supervision’ are often used interchangeably. In concrete, the word supervision would be the most appropriate. Banks in fact are under the supervision of central banks or national agencies. Regulatory measures, however, which supposedly are more stringent, co-exist with supervisory ones. Many reports (e.g. Fed Trading Manual) talk of both supervision and regulation. This seems to be the wisest solution, since the line between regulation and supervision is blurred.

<sup>14</sup> Repurchase agreements (repo) are agreements in which one party (seller or dealer) sells a *security* to another party and agrees to repurchase it on a specified date at a specified price. The security serves as collateral against the obligation of the borrower and does not become the property of the lender. Contracts for difference (CFDs) are agreements to exchange at the closing of the contract the difference between the initial and the final price of an equity multiplied by the number of equities in the contract.

<sup>15</sup> The Office of the Comptroller of the Currency (OCC) regulates and supervises national banks and supervises the federal branches and agencies of foreign banks. The Fed supervises state member banks and international banks that have an office in the US.

<sup>16</sup> For a literature on new institutionalism in IPE see for instance Young 1996; Keohane 1988 and 1989; Goldstein and Keohane 1993. For a literature on historical institutionalism see Germain 1997 and 1999; Steinmo and Thelen 1992; for an attempt to synthesize the two literatures see Hall and Taylor 1996 and 1998; and Hay and Wincott 1998.

<sup>17</sup> The UNDP, for instance, has promoted financial stability as a global public good together with market efficiency (Griffith-Jones 2003).

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